Consumer Federation of America

TESTIMONY OF

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REGARDING

THE ROLE OF THE GOVERNMENT SPONSORED ENTERPRISES
IN THE MORTGAGE MARKET

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Mr. Chairman, Senator Sarbanes, and Members of the Committee, my name is Allen J. Fishbein and I am the Director of Housing and Credit Policy for the Consumer Federation of America. We appreciate the opportunity to offer our comments on the topic of "*The Role of the Government Sponsored Enterprises in the Mortgage Market.*"

CFA is a national non-profit association of some 300 pro-consumer organizations, with a combined membership of over 50 million people, founded to advance the consumer interest through public education, research, and advocacy. (www.consumerfed.org) My own background in the areas of GSE regulation includes my tenure at the U.S. Department of Housing and Urban Development (HUD) where I served as senior advisor for GSE oversight. In this capacity I assisted with the supervision of the Department's public mission regulation of Fannie Mae and Freddie Mac and in rulemaking to set the two GSEs' affordable housing goals.

My testimony today addresses four main points:

- The GSEs' public mission matters to consumers;
- The GSEs' have played an important role in helping to overcome at least some barriers to affordable housing;
- The GSE's mission mandates have bolstered increases in affordable housing activity but further progress is needed, and,
- Improvements are needed to the present affordable housing mandates.

Why mission still matters.

First, let me speak to why the GSEs' public mission matters to consumers.

The three government sponsored housing enterprises -- Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (FHLBs) – were established at different times by Congress to ensure the smooth flow of mortgage credit throughout the nation. Each engages in activities that are valuable to promoting a sound housing market and targeting resources for affordable housing. Fannie Mae and Freddie Mac accomplish this through their secondary market activities, while the Federal Home Loan Banks are cooperative entities that function somewhat independently of each other and serve as a "wholesale lender" to their member financial institutions.

The GSEs are owned by private shareholders and operated for-profit or, in the case of the FHLBs, for the mutual benefit of their owner-members. Yet they differ from fully private companies in that they are intended to serve as an instrument of national housing policy and therefore they are required to perform a broad public mission and also fulfill certain public policy objectives that are set by Congress. For this reason, the GSEs are granted certain legal privileges and exemptions not generally available to others. They are also limited to a narrow range of business activities deemed important to public policy. Because of the importance of their mission as reflected by their charters and the collection of privileges conferred to achieve that mission, the capital markets infer an implicit government guarantee behind the GSEs. Consequently, the GSEs are able to fund their operations at lower cost than other firms with similar financial characteristics.

Fannie Mae and Freddie Mac (and in different ways the FHLBanks) make important contributions to expanding the mortgage market and increasing homeownership levels. Fannie Mae and Freddie Mac purchase residential mortgages from originating lenders that then use these proceeds to make additional mortgages. Although they hold some mortgages to hold in their portfolios, most mortgages are placed in mortgage pools to support Mortgage Backed Securities (MBS) that are issued and are either sold to investors or held in their retained portfolios. They also guarantee the timely payment of interest and principal on MBS that they issue. Through these functions Fannie Mae and Freddie Mac have been highly successful at bringing capital into the housing loan market from domestic and international sources which, in turn, works to make mortgage credit available more broadly to U.S. consumers.

The FHLB System (the "other GSE" as it is sometime known) comprises 12 publicly chartered and privately owned regional banks and over 8,000 member institutions. Originally members were exclusive Savings & Loan associations, but today most of these are commercial banks, thrifts, and credit unions. Traditionally the primary function of the regional banks was to make loans, known as credit advances, to their members. More recently, the FHLBs have initiated programs to purchase mortgages directly from their members and hold them in their retained portfolios. This process is similar to Fannie Mae and Freddie Mac's traditional business activities, although the FHLBs currently do not have authority to securitize mortgages.

Congressional mandates bolster the GSEs' affordable housing activities.

In addition to serving the broad mission to promote homeownership, Congress decided more than a decade ago to require the GSEs to apportion more of their investment capital to serving special demands for low and moderate income housing finance.

Fannie Mae and Freddie Mac by statute are required to meet three annual percentage -of-business goals – a low and moderate income goal, an underserved geographic areas goal, and a special affordable goals directed at very low income and low income households. These mandates were established in 1992 and annual goal levels for these goals are set by HUD, Fannie Mae's and Freddie Mac's mission regulator. The goal levels adopted by HUD last year represent a substantial increase over the previous housing goal levels set in 2000. For example, for this year the two GSEs are required to devote 52% of their mortgage purchases benefitting low and moderate income households, rising to an eventual 58% in 2008.

Congress also expanded the role of the FHLBs in providing capital for affordable housing as part of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989. This act, among other things, mandated the establishment of an Affordable Housing Program (AHP) set aside that required each FHLB to devote at least 10 percent of net income to the program. These funds are used to provide grants and loans to support the financing of lower income homeownership and rental housing.

Mission and public purpose requirements distinguish the GSEs from other fully private companies.

The Fannie Mae and Freddie Mac business model calls for them to function as for-profit entities and both have been quite good at this. The FHLBs through their lending activities also generate earnings and pay dividends to their member institutions. Yet it is their public mission and other public purpose requirements that make GSEs do that makes them unique and should ultimately justify their government chartered status. Thus the challenge for a GSE is to continually strike the right balance between both functions.

Critics maintain that the GSEs, particularly in recent years, have been too profit driven in their mix of activities. Richard Syron, the new chief of Freddie Mac, in effect acknowledged that his company had indeed strayed too far from its mission. In a public remarks delivered last year Mr. Syron stated: "Unfortunately, over the last several years, we have not been aggressive enough. Rather than focusing on improving housing affordability in these markets (i.e., low and moderate income markets) as a core part of our mission, we sometimes have viewed this as a regulatory requirement that we were forced to meet. That must change." He pledged to make Freddie Mac a "mission-centric organization – so that mission is always front and center of everything we do." (See Prepared remarks before the LBJ School of Public Affairs, University of Texas, May 13, 2004.)

Fannie Mae also has chosen to set new corporate policy to help ensure that it too is more mission-centric. For example, last year Fannie Mae announced a new major initiative -- the "Expanded American Dream" commitment -- which featured as its center piece a company goal to launch activities to help raise the minority homeownership rate of over 55 percent (up from the current 48 percent). Public purpose oriented goals such as these would not be expected of a bank, thrift, or any other type of private lending institution.

Statements and corporate policies such as mentioned here are positive signals that fulfilling mission and public purpose must at all times be central to the core activities of publicly chartered companies. Ensuring that mission remains central should be a key principle incorporated into any new GSE regulatory oversight scheme. Accordingly, we urge lawmakers to take great care to ensure that the mission and public purpose functions are afforded comparable status with safety and soundness considerations. Proper direction should also be provided so that the financial standards that will be applied to the GSEs are appropriate given their special status, public purpose obligations, and to permit them to carry out the activities needed to advance these objectives. We also urge that the standards applied fully reflect both their uniqueness and differences from other private companies with similar characteristics.

Barriers to expanding affordable housing opportunities and the GSEs' role in overcoming these barriers.

Next, let me speak to the barriers to affordable housing GSE roles in helping to overcome these problems. I would also like to comment on the activities that we find particularly helpful to serving low and moderate income households.

As a society, the U.S. for decades has subsidized homeownership through income tax deductions, guaranteed mortgages, grants, and other financial incentives. Aided by a favorable economic climate and regulatory incentives like the Community Reinvestment Act (CRA) for depository lending institutions and GSE commitments, the application of more sophisticated mortgage loan underwriting, and declining down payment requirements which the underwriting supported, homeownership gains have been boosted.

As a consequence, the nation particularly over the past decade has made great progress in increasing homeownership. Among all households, between 1994 and 2003 homeownership rates increased from 63.9 percent to almost 69 percent and the number of households owning their own home increased by 13.3 million. Minority households experienced similar substantial gains over the past decade in homeownership, with African American rates rising from 42.2 percent to 48.4 percent, and Hispanic rates expanding from 41.6 percent to 46.6 percent. These are important accomplishments although serious housing and housing finance needs remain.

Fannie Mae's and Freddie Mac's contribution to overcoming these barriers.

Fannie Mae and Freddie Mac today own or guarantee more than $3 trillion in mortgages – almost half of all outstanding mortgage debt issued – and fund nearly 80 percent of the estimated total of all non-governmental insured mortgages. Their substantial presence in the mortgage market has promoted standardization in the mortgage market, which in turn, has increased the availability of mortgage credit. They are able to use this market presence to help expand housing opportunities for consumers. Their GSE status and the fact that their cost of funds is less than others is also though to have had an impact on reducing mortgage interest rates for consumers (exactly how much has become a subject of some dispute).

In addition to these functions Fannie Mae and Freddie Mac have both played a useful role to overcoming barriers and thereby increasing the flow of affordable housing funds. They are highly complex and innovative financial institutions and as such are able to employ a variety of approaches that along with other mortgage lenders and the private mortgage insurance companies expanded the mortgage market to less affluent borrowers, particularly in the past decade. The progress in raising homeownership levels mentioned above resulted from what HUD and others have termed a "revolution in affordable housing finance." A key contribution has been their adoption of more flexible underwriting guidelines and the expanding approvals that their automated underwriting systems permit. These steps have increased the pool of potential households that can qualify for homeownership. Other positive contributions include the development of customized mortgage products, partnering with sponsors of affordable housing, and other forms of expanded outreach that to reach untapped segments of the affordable housing market. These efforts must be continue to be expanded, however, before existing homeownership gaps can be further reduced and the pressing need for rental housing for lower income families can be fully addressed..

The GSEs' role as "defacto" regulators.

Predatory lending has been a disturbing part of the growth of the subprime market. The explosion of abusive practices has been stripping equity, threatening families with foreclosure, and destabilizing communities. The victims of the worse abuses are often the elderly and lower income homeowners.

Both Fannie Mae and Freddie Mac have instituted corporate policies designed to protect consumers from predatory lending practices. These policies were later codified into HUD regulation for the GSEs. Last year both Fannie Mae and Freddie Mac expanded these policies to provide further protections to consumers.

We understand that the FHLBs have adopted anti-predatory policies as well.

Measures such as these help send a strong message industry-wide message that certain practices will not be acceptable and also helps to foster "best practices" standards. Also, GSE policy in this area can help to restrict the supply of secondary market funding for unscrupulous lenders and thereby deter at least some of the predatory lending occurring.

A greater GSE role in the subprime lending market is also likely to have a positive impact on consumers. Fannie Mae and Freddie Mac indicate that this market is inefficient and that many subprime borrowers are being overcharged for mortgage credit in excess of their actual risks. The GSEs believe that their expanded presence in this market would help to standardize business practices and result in better prices for subprime borrowers. It is also thought that expanded GSE underwriting could help qualify significant number of subprime borrowers for cheaper prime mortgages.

Substantial homeownership gaps and the lack of affordable rental housing remain a considerable problem.

The revolution in affordable housing finance has been helpful in addressing some, but certainly not all affordable housing needs. Higher income families remain much more likely to own homes than lower income families (only 48 percent of very low-income households compared to 88 percent of high income households). Homeownership rates are also lower in central cities across all income groups. Minority homeownership rates still are 25 percent below those of whites.

The lagging minority homeownership rates should be of particular concern. New immigrants and other minorities, who accounted for about 40 percent of the homeownership growth in recent years, are expected to represent two-thirds of the growth in new households over the next decade. Differences in average incomes explain some, but not all, of these gaps. Even if minorities owned at the same rate as whites of comparable incomes do, the minority homeownership rate overall would still be more than 12 percentage points below that of white households.

There are a series of reasons why consumers who are renters may face obstacles to buying a home. These include skyrocketing housing prices in many markets, a lack of income to afford monthly payments, lack of net savings to pay for downpayment and closing costs associated with buying a home due, impaired or the lack of traditional credit histories, discrimination, lack of access to mainstream lenders, and information barriers that undercut opportunities to shop and apply for a home loan, and the lack of affordable units. Improving the ability of such households to make a transition to homeownership will be critical to creating economic opportunities for these families.

Further, many lower income families cannot even afford rental housing in the open market. The bi-partisan Millennial Housing Commission found that one in four – almost 28 million – American households reported spending more on housing than the federal government considers appropriate (over 30 percent of income). Even working families find no escape from severe housing affordability problems. One in eight lower income working families earning at least the full time equivalent of minimum wage reported spending more than half of their incomes on housing. Inadequate financing for housing development limits supply and contributes to these problems as does the lack of subsidies to assist tenants with rent payments.

The GSEs' will need to make an even greater contribution to address at least some of these barriers. Setting appropriate public mission mandates is an important means for helping to ensure that they continue to address these challenges.

The FHLBs' AHP program is a popular program that supports affordable housing.

The FHLB system provides a stable source of funding to its member institutions, which for the first forty years of its existence, were exclusively the thrift institutions that specialized in making mortgage loans. The system's core activity continues to be cash advances (collaterized loans). These advances, which are made at lower rates than available in the commercial market and at small spread than comparable Treasury instruments, provide a reliable low-cost source of non-deposit funds for the banks, thrifts, and credit unions that comprise the systems members. Advances still represent over 60 percent of the system's outstanding debt.

Data is limited on benefits from the advances. In fact, some research suggests that over 52 percent of advances are used to fund jumbo loans made to wealthy borrowers. (See Congressional Budget Office, "*Federal Subsidies and the Housing GSEs*," 2001.) Should this be true, at the very least it suggests that additional targeting of FHLB System resources to affordable housing purposes is warranted.

In 1997, the Federal Housing Finance Board, the system's regulator, granted authority to the FHLBank of Chicago to initiate a pilot program called the "Mortgage Partnership" (MPF), which allowed the Bank to directly acquire mortgages originated by its members. MPF is designed to serve as a strategic alternative for its members holding loans in portfolio or selling them to the secondary market. Under the program, the Bank buys mortgages and holds them in portfolio, fully assuming the interest rate risk, liquidity and prepayment risk associated with the loans. The member retains the servicing and part of the credit risk.

The program has expanded to all but three of the FHLBs. The remaining three initiated their own, similar program, the Mortgage Purchase Program (MPP) in 2000. Again, the program is not targeted to low and moderate income households and neither the Finance Board or the FHLBanks have published data disclosing the extent to which these programs expand opportunities for the underserved. Both programs have grown rapidly.

By almost all accounts, the Affordable Housing Program (AHP) remains the principal system activity engaged in by the system to support affordable housing activities. AHP has been referred to by regulators as the "crown jewel" of the system. It provides subsidized long-term financing for very low, low, and moderate income households who income is less than 80 percent of area median income and is awarded on a competitive basis. These funds may be used to leverage other public and private funding and are used in support of a variety of rental housing projects and to support homeownership.

In addition to the AHP, the FHLBs offer to members targeted advance programs, such as the Community Investment Program (CIP), which is mandated by law, and the Community Investment Cash Advance (CICA) programs, which is not. These programs can finance not just affordable housing, but also eligible community and economic development projects. These targeted advances provide only a small pricing advantage to borrowers, however.

The GSEs' performance and the continuing need for strong mission oversight.

Now, let me speak to my observations about the GSEs performance in meeting affordable housing challenges and the ongoing need for strong mission oversight.

Fannie Mae's and Freddie Mac's performance.

Both Fannie Mae and Freddie Mac over the years have continued to increase their funding of mortgages benefiting low and moderate income consumers and underserved areas. These improvements have been significantly bolstered by their Affordable Housing Goals requirements.

According to HUD, both GSEs almost always meet their goal levels. In general, Fannie Mae's performance in meeting the goals and in other areas of affordable housing has been better than Freddie Mac's. But like Freddie Mac, Fannie Mae's average performance over the years has been below market levels and they have tended to be less successful in purchasing goals-qualifying mortgages than they have for the overall mortgage market. More recent HUD data indicates that Fannie Mae's share of this market has increased.

Notwithstanding their general success in meeting their goals there remain important segments of the affordable housing market where data shows that both GSEs have not been as successful at serving the available market. In particular, they have tended to have a lower share of the first-time homebuyer and minority first-time homebuyer market than the primary market. The GSEs also account for a relatively small share of the market for important segments, such as underserved lower income and minority communities, the rental housing market, including loan purchases for rehabilitation of these properties, and for seasoned loans made by lenders for CRA purposes ("CRA Loans"). Data for 2003 (the last reported year), however, indicates that Fannie Mae approximated or even led the primary market for some of these segments and that Freddie Mac has made significant progress toward this as well.

We believe the setting challenging goal levels can bolster GSE performance in at least some of the areas in which they lag. Last year CFA joined with other leading national low income housing, consumer, and community organizations to submit public comment in support of the establishment of higher housing goal levels as part of the HUD rulemaking on this subject. In our comment we emphasized the usefulness of higher and appropriate goal levels. Goals that lead the GSEs to match or exceed the primary market remains an appropriate benchmark for measuring GSE performance. Yet the fact that the GSEs' can meet their goals but not be as active as they need to be in certain affordable housing markets signals that need to refocus these requirements.

FHLBs' performance

Much less attention has been focused on the affordable housing performance of the 12 FHLBs (certainly compared to the activities of Fannie Mae and Freddie Mac).

Most of the data available about FHLB affordable housing activities centers around the AHP set aside. AHP is sometimes referred to by the FHLBs as the largest private source of subsidy funding in the nation.

According the Federal Housing Finance Board (FHFB) since the program's inception in 1990 over $1.7 billion in subsidy funds have been awarded ($182 million in 2003) that helped to finance over 355,000 units of affordable housing (two-thirds rental/ one-third homeowenrship). The average subsidy per unit by AHP is relatively small ($4,922) consistent with the fact that these funds are frequently used by affordable housing sponsors as gap financing and in conjunction with other subsidy sources.

Some information is available on an aggregated system-wide basis about the CIP and CICA targeted advance program. For example, total advances for these two programs in 2002 are reported to be about $2.7 billion about $1 billion for small business and another $1.7 billion made for housing purposes). Advances made through these programs have totaled more than $32 billion since1990). There are indications that the use of these advances has increased rapidly in recent years, but that it still only comprises a small percentage of overall system-wide advance activity and that the volume varies substantially between the individual regional banks.

Much less is known about the characteristics of the households and communities that have benefited from the FHLBs Acquired Member Asset Programs (MPF and MPP) To my knowledge, data of this sort has not been published by either the individual FHLBs or the Finance Board. There are indications, however, serve a smaller percentage of low and moderate income families than is required under the Fannie Mae and Freddie Mac Affordable Housing Goals.

Stronger regulatory oversight of affordable housing would help to increase FHLB funding for these activities.

Existing GSE statutory mandates should be improved upon.

Finally, let me offer recommendations to revise and refocus the present affordable housing requirements for the GSEs. A number of these were adopted by the Committee as part of the GSE regulatory bill approved last year. We urge that these recommendations be considered as part of any new legislation that is acted upon this year.

For Fannie Mae and Freddie Mac:

- Require Fannie Mae and Freddie Mac to set aside a percentage of their annual profits to provide new capital to support sponsors of affordable housing and important affordable housing needs.

- Improve targeting and enforcement of Fannie Mae's and Freddie Mac's affordable housing goals. Bringing the income targets for these goals more in alignment with the CRA income requirements for banks and thrifts institutions would help direct more mortgage credit to truly lower income households and severely underserved communities.

- Codify Fannie Mae's and Freddie Mac's responsibility to provide financing for underserved markets that lack adequate credit for low and moderate income families through conventional lending sources.

- Improve the utility of the GSE Public Use Data Base currently provided by HUD.

For the FHLBanks:

- Establish affordable housing goals for appropriate FHLBanks programs, such as the Acquired Member Asset Programs.
- Establish a Public Use Database in a manner and form comparable to the database provided by HUD for Fannie Mae and Freddie Mac.
- Retain public interest director slots for the 12 FHLBs.

This concludes my testimony this morning. I will be happy to answer any questions.