Statement of

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on behalf of FM Watch

Federal Subsidies and the Housing GSEs

before the

Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises

Committee on Financial Services
U.S. House of Representatives

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Mr. Chairman, Members of the subcommittee, thank you for the opportunity to testify today. I especially would like to thank you, Mr. Chairman, for holding this and previous hearings on the performance of and potential taxpayer risks associated with the Government Sponsored Enterprises, Fannie Mae and Freddie Mac .

My name is Ed Rothschild. I am a principal at the consulting firm of PodestaMattoon and a consultant to FM Watch, a coalition of financial sector and housing related trade associations.

Since its inception FM Watch has supported efforts to expand affordable homeownership in America. When HUD proposed its new Affordable Housing Goals rule last year, FM Watch submitted comments that urged HUD to set higher goals for the GSEs. We commented that, “While the new goals are a step in the right direction, they are still modest and will not move the GSEs to lead the market in underserved communities.”

FM Watch then decided to initiate a study on how the GSEs allocated their taxpayer subsidy. This decision followed research and reports by the General Accounting Office, the Urban Institute, HUD, the National Community Reinvestment Coalition, and many others concluding that the GSEs lagged rather than led the market in supporting affordable housing (as Congress intended), particularly for low- and moderate-income, African-American and Hispanic families. Initially, we had planned to base our analysis on the results of the Congressional Budget Office’s 1996 report, but when you, Mr. Chairman, asked CBO to update that report, we decided to use the most current subsidy analysis.

Following the issuance of the new CBO report, “Federal Subsidies and the Housing GSEs,” FM Watch published “Shuttered Dreams: How Fannie Mae and Freddie Mac Misspend the GSE Housing Subsidy.” This study examines the distribution of the $10.6 billion subsidy, particularly as it relates to promoting affordable housing for low- and moderate-income borrowers.

In establishing the GSEs, Congress conferred specific benefits on them for a specific purpose – expanding and promoting home ownership, especially for low- and moderate income homebuyers and those in underserved communities. These benefits were not given to create government-subsidized entities that could dominate private markets. Rather, Congress expected the GSEs to perform a clear but constrained mission: to provide liquidity to the secondary mortgage market and to promote affordable housing. The essence of Congress' deal was clear: publicly granted powers were given for public purposes.

FM Watch’s study demonstrates that the GSEs misspend their taxpayer-funded subsidy by continuing to allocate more to their stockholders than to helping put people into homes. This is going on even though the Department of Housing and Urban Development (HUD) forecasts continuing substantial unmet housing needs into the foreseeable future among minority and low-income families. Moreover, as the CBO, HUD, Treasury, and others have pointed out, the subsidy that does reach homebuyers is predominately spent to help wealthier borrowers – whose mortgages yield more lucrative returns – but disproportionately fails to serve low-income households and minorities, particularly African-Americans and Hispanics.

So long as there are unmet homebuying needs, the federally subsidized GSEs ought not to retain $3.9 billion or 37 percent of the housing subsidy. Public subsidies are a public trust. The GSEs should be required to focus on the mission that Congress mandated – to promote affordable housing for the benefit of low- and moderate-income families and the American taxpayer.

I would like to summarize the major findings of "Shuttered Dreams" to demonstrate how the GSEs are misspending the subsidy.

<u>Over one-third of the GSE subsidy never reaches the housing sector. It is retained by the GSEs for stockholder profits. Even more startling, less than one-third of the subsidy actually goes to helping people buy homes.</u>

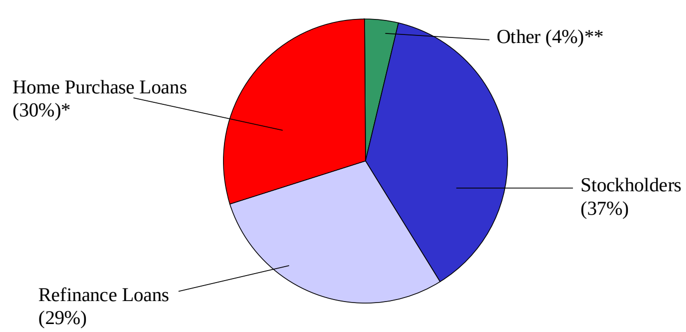
- The CBO study concluded that the GSEs retained fully 37 percent ($3.9 billion) of the taxpayer-provided housing subsidy to benefit their stockholders. As Figure 1 shows, this is the largest single use of the taxpayer subsidy. It does nothing to promote homeownership, and only serves to enrich private GSE stockholders.

- An additional 29 percent ($3.1 billion) went to the GSEs' purchase of mortgages to refinance existing debt. This refinancing activity does not help Americans buy homes. *Thus, 66 percent of the subsidy goes either to GSE stockholders or refinancing activity – none of which actually helps American families buy homes.*

- Only 30 percent of the subsidy ($3.2 billion) was applied to purchasing the mortgages of single-family homebuyers. This should be the GSEs' core mission, yet less than one-third of the subsidy is spent for this purpose. Moreover, as discussed below, this part of the subsidy is disproportionately spent on purchasing more lucrative mortgages, rather than the mortgages of low- and moderate-income households (Figure 1).

Figure 1

GSEs Keep 37 Percent of the Housing Subsidy for their Stockholders



* Single-family, owner-occupied. **Multi-family, non-owner occupied single-family, and other loans.

CBO estimate of the GSEs' subsidy allocated according to 1999 HMDA Data. Conventional loans within the $240,000 conforming limit.

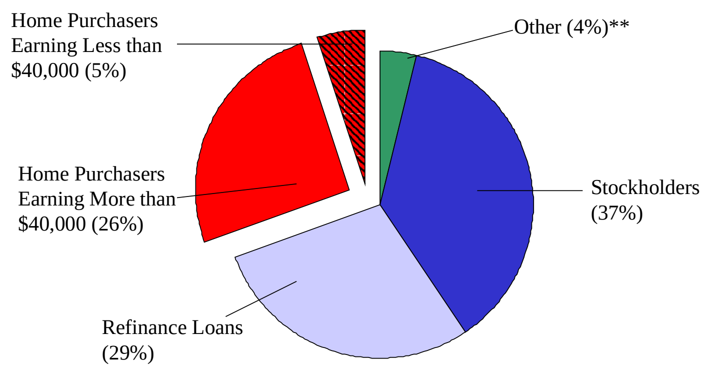
Only five percent of the subsidy is spent to create new homeownership opportunities for the bottom half of Americans by income.

- The bottom half of Americans by income receive a disproportionately small share of the GSE housing subsidy. In 1999, the median household income in the U.S. was $40,800. Single-family homebuyers who earned up to $40,000 received only 5 percent ($0.5 billion) of the subsidy (Figure 2). Clearly, GSE affordable housing efforts should be directed at this segment of the population, but the data shows only a paltry percentage goes to this important group of under-served Americans.

Figure 2

GSE Stockholders Receive Over Seven Times the Subsidy Going to Lower Income Home Purchasers*

1999 Median Household Income = $40,800.



*Single-family homebuyers earning less than $40,000. ** Multi-family, non-owner occupied single-family, and other loans. CBO estimate of the GSEs' subsidy allocated according to 1999 HMDA Data. Conventional loans within the $240,000 conforming limit. Percentages may not total 100 percent due to rounding.

- This contrasts sharply with GSE stockholders, who receive 37 percent of the subsidy. *Thus, GSE stockholders received over seven times more of the subsidy than the bottom half of Americans by income.*

- This also contrasts sharply with support for wealthier borrowers earning above the median household income, who receive 26 percent of the subsidy. Thus the top half of American homebuyers by income received five times the subsidy as the bottom half.

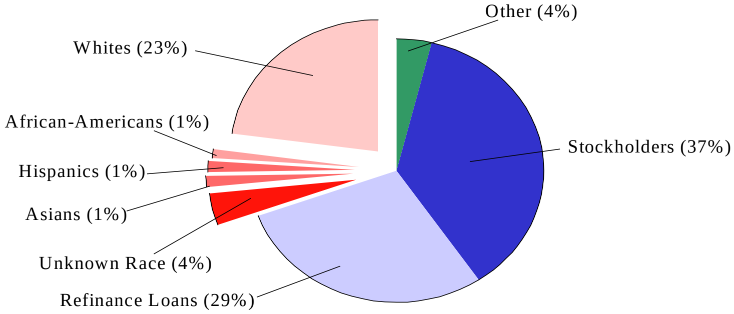
- Congress clearly intended that the GSEs lead the market when it comes to affordable housing, but the GSEs in fact *lag the marke*t, as both the Department of Housing and Urban Development (HUD) and the General Accounting Office have concluded. The data bears this out. Of all conventional, conforming loans made to borrowers with incomes below $20,000, the GSEs purchased only 26 percent by dollar volume, whereas the private market held or purchased 74 percent. But of these types of loans to borrowers with incomes above $100,000, the GSEs purchased 51 percent, while the private sector held or purchased 49 percent. In other words, GSE activity is more concentrated at higher income levels than the private market.

By a surprisingly significant margin, African-Americans and Hispanics receive a disproportionately small share of the subsidy, a complete reversal of Congressional intent.

- It is especially important that the GSEs use their government subsidy to serve both African-Americans and Hispanics. While the overall U.S. homeownership rate is at a record high of 67.7 percent, the homeownership rate for African-Americans is 47.3 percent and for Hispanics, 46.7 percent.[1] When Congress directed the GSEs to promote affordable housing, it certainly intended that these important groups would be served.

- Just the opposite is the case. Only two percent of the entire taxpayer-financed GSE housing subsidy went to African-Americans and Hispanics to purchase and live in their own homes (Figure 3).

Figure 3
Only Two Percent of the Housing Subsidy Helps African-Americans and Hispanics Buy Homes



1999 HMDA Data. Conventional, single-family, owner-occupied home purchase loans within $240,000 conforming limit.

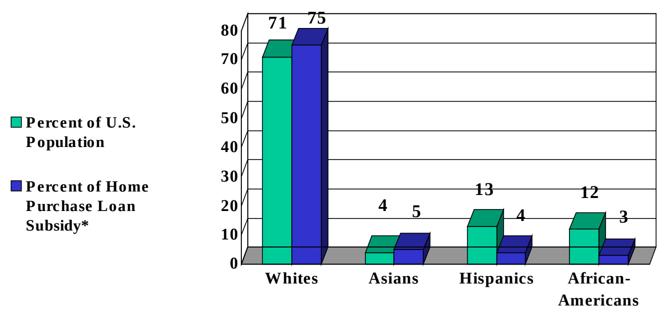
- The share of the subsidy used for single-family home purchases by African-Americans and Hispanics significantly lagged their share of the population. Figure 4 compares the allocation of the 30 percent portion of the total subsidy that actually went to promote homebuying. African-Americans constitute 12 percent

[1] Press Release, U.S. Department of Housing and Urban Development. October 27, 2000.

of the U.S. population, but received only three percent of the GSE housing subsidy supporting home purchases. Hispanics make up 13 percent of the population, but received only four percent of the subsidy (Figure 4).[2]

Figure 4

African-Americans' and Hispanics' Home Purchase Loan Subsidy Lags Their Share of the U.S. Population



* Compares the allocation of the 30 percent portion of the total subsidy that actually goes to promoting homebuying. CBO estimate of the GSEs' subsidy allocated according to 1999 HMDA Data. Conventional, single-family, owner-occupied home purchase loans within the $240,000 conforming limit. Includes only the subsidy supporting single-family, owner-occupied home purchase loans.

The GSEs Can and Should Do More

Clearly the GSEs have ample opportunity to do more to assist African-Americans and Hispanics. The GSEs only purchased 31 percent of the dollar volume of conventional, conforming mortgage loans made to African-Americans and 39 percent of those made to Hispanics, while purchasing 47 percent of those loans made to whites.[3]

FM Watch undertook this study because other organizations, among them, HUD, GAO, the Urban Institute, and the National Community Reinvestment Coalition, have issued reports which demonstrate that the GSEs to lag the market when it comes to supporting low- and moderate-income and African-American and Hispanic homebuyers. Our analysis demonstrates the same pattern of activity and Congress should step in.

For example, in December 2000 HUD reported that (the numbers cited below exclude subprime B and C loans),

[2] The GSE Public Use Data Base supports the conclusions regarding the distribution of the subsidy among racial groups drawn from the HMDA data. African-Americans received $0.183 billion (3 percent) and Hispanics received $0.279 billion (4 percent) of the portion of the subsidy the GSEs pass through to borrowers, while whites received $4.8 billion or 72 percent. (See Appendix A.)

[3] The GSE Public Use Data shows a similar pattern. In dollar terms, the GSEs purchase 36 percent of loans made to African-Americans, 53 percent made to Hispanics, and 63 percent made to whites.

- In 1999, the share of the conventional conforming market that was composed of Special Affordable home purchase loans was 36 percent more than the corresponding share of Fannie Mae's purchases and 34 percent more than the corresponding share of Freddie Mac's purchases.

The GSEs similarly lag the market in the purchase of loans for African-American and Hispanic borrowers.

- In 1999, the share of the conventional conforming market that was composed of loans to African-Americans was 47 percent more than the corresponding share of Fannie Mae's purchases and 43 percent more than the corresponding share of Freddie Mac's purchases.

- In 1999, the share of the conventional conforming market that was composed of loans to Hispanics was 15 percent more than the corresponding share of Fannie Mae's purchases and 25 percent more than the corresponding share of Freddie Mac's purchases.

According to HUD, this performance, and the fact that the GSE purchases of loans for low-income and African-American borrowers typically have high down payments, has raised questions about the contribution of the GSEs to increasing homeownership for these borrowers.

Given the direction from Congress at the time the GSEs were established, followed by the 1992 passage of the Federal Housing Enterprises Financial Safety and Soundness Act, and the 1992 affordable housing goals, we question why the GSEs are not using their taxpayer subsidy to purchase more affordable housing loans from these groups of homebuyers. The answer is that the GSEs have placed a greater priority on increasing profits at the expense of promoting low- and moderate-income housing. Affordable housing loans tend to be smaller, riskier and less profitable, so the GSEs have tended to purchase the larger, less risky loans which are made to wealthier borrowers.

This strategy has produced impressive returns for the GSEs. In 2000, the GSEs' return on equity was 25 percent versus 13 percent for Federally-insured depository institutions. But the GSE emphasis on profits has come at the expense of creating affordable housing opportunities for homebuyers.

The GSEs can do more to increase affordable housing, without reducing the subsidy to other borrowers. The GSEs argue they must choose between giving a few borrowers a large subsidy or giving many borrowers a small subsidy. This is a false choice. Allocation of the subsidy is only a zero sum game when Fannie Mae and Freddie Mac retain over a third of the taxpayer-financed subsidy to boost returns for their stockholders.

The $3.9 billion retained by the GSEs can and should be used to expand homeownership. Down payment grants or interest rate subsidies could be used to help more low-to-moderate income Americans buy their own homes. Or, changing HUD's Affordable Housing Goal definitions to bring them in line with CRA could channel more GSE activity to underserved areas. Currently, for example, there is a discrepancy between HUD's housing goal definitions and those for CRA that enables the GSEs to meet goals for underserved areas with loan purchases that would not qualify as underserved under CRA. Moreover, simply changing HUD's Affordable Housing Goal definition of low- and moderate-income to conform with the definitions of low- and moderate income under the Community Reinvestment Act could also shift more of the subsidy from GSE shareholders to truly low- and moderate income homebuyers.[4]

In closing, Mr. Chairman, we want to take note of a statement made last year by the Chairman of Fannie Mae to a conference of low-income housing advocates.

"We have made a decision that we do not believe that it is the best use of the kind of resources that we have in the secondary market for us to take the subsidy that the [private] bank says they are providing [to a low-income borrower] and to move that subsidy to Fannie Mae, because that's what essentially buying it at par means. Now if the bank wants to continue the subsidy, we'd be delighted to buy the loan. But for us to take over the subsidy that they've entered into is something we've decided we wouldn't do. But if the bank wants to continue the subsidy, they want to buy down the rate, continue that, we'd be delighted to buy the loan."

We strongly disagree with that statement. If the GSEs were to use more of their subsidy to do precisely what Fannie Mae's Chairman has stated his company *will not do,* many more families would be able to buy homes. The GSEs can – and should – do much more to promote affordable housing. The private sector would welcome their increased involvement and renewed commitment to redressing this pressing need. Finally, we believe Congress should be as vigilant in overseeing the expenditure of the taxpayer subsidy as they are in overseeing the expenditure of appropriations.

[4] For more detailed information on this issue, see Canfield & Associates, Inc.'s "Fannie Mae's and Freddie Mac's Affordable Housing Goals," an analysis of the important differences between CRA requirements for depository institutions and the GSEs' Affordable Housing Goals.