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Insurance, and Government-Sponsored Enterprises

House Committee on Financial Services

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Thank you Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee. My name is Tim Howard, and I am Executive Vice President and Chief Financial Officer at Fannie Mae and a member of our Office of the Chairman. I am pleased to be here again to continue our dialogue on Fannie Mae's business and our role in the marketplace. Today I will update the Subcommittee on a variety of initiatives and developments since I last testified before the Subcommittee in March of this year, and provide Fannie Mae's perspective on the Congressional Budget Office's recent report on Fannie Mae and Freddie Mac.

Congress plays a central role in guiding U.S. housing policy, and continued Congressional oversight of the housing finance system and of Fannie Mae's role, in particular, is crucial to our ability to fulfill our mission. I commend the Members of the Subcommittee for their ongoing commitment and energy, and I look forward to our discussion today.

Housing as a Driver of Economic Growth

To set the proper context for today's hearing, it is important to remember the role that housing plays in our larger economy and to understand some of the forces shaping the housing sector. Housing is a bulwark of the economy, helping to drive economic growth even in the current economic slowdown, and it is a source of wealth and financial security for many households.

The housing and mortgage markets are the strongest sector in the economy today, and they are major reasons why economists do not expect the overall economy to sink into recession. A generation ago, the housing industry was more volatile, and when the economy slowed, the housing sector slowed as well. Today, the housing sector -- which accounts for between 8 and 22 percent of annual gross domestic product -- is more stable than other sectors of the economy. [1] Indeed, while manufacturing has been in a

[1] If defined to include only residential housing expenditures for single-family housing, renovations and improvements, and other residential housing, housing accounts for about 8 percent of GDP. If defined more broadly -- i.e., to include residential housing expenditures plus housing-related expenditures

downturn, overall job growth has slowed sharply and orders for high-tech equipment have dropped significantly, housing activity has remained robust. In fact, total home sales in the first five months of 2001 reached a record level.

The strength of the housing industry translates into greater financial stability for American families. For most Americans, purchasing a home is the largest investment they will make. Strong home price appreciation in recent years has increased the average net worth of homeowners, and these gains in housing wealth have helped offset declines in equity wealth.[2] With the declining trend in mortgage rates -- from 8.16 percent in June 2000 for 30-year fixed-rate mortgages, to the current rate of 7.19 percent (and the recent low of 6.89 percent in March) -- many homeowners have refinanced, allowing them to reduce their monthly mortgage payments. The savings that result from refinancing can then be deployed for other purposes, helping cushion the slowing economy. We estimate conservatively that consumer spending may increase by $40 billion this year as a result of refinancing activity, and, as columnist Ken Harney wrote this past weekend, this added spending "play(s) a key role in keeping the U.S. economy chugging along."[3]

The role that Fannie Mae plays in the secondary mortgage market -- through all types of economic environments -- is one reason that the housing sector is so stable. Despite home price declines in the oil patch states in the mid 1980s, in California in the first half of the 1990s, and in New England in the early 1990s, Fannie Mae delivered a steady supply of financing to lenders across the country and consistent earnings to our investors. During the credit crunch of late 1998, Fannie Mae and Freddie Mac stepped up their mortgage purchases and ensured that U.S. homebuyers had access to the lowest rates in a generation, even as other credit markets suffered. Our strong financial performance over time is a key factor in drawing investors from around the world to invest their capital in U.S. housing finance -- and thereby keeping mortgage rates low for American homebuyers. The role we play in providing liquidity and stability to the market for conforming mortgages means that, this week, borrowers with a conforming mortgage will save as much as $20,800 over the life of their loan, compared with a jumbo loan.

The "Over Housed" Myth

Housing continues to be a huge force in the economy in large part because the need and demand for housing continues to be very strong. While some assert that the country is "over housed", recent Census data indicate that, if anything, we are looking at the prospect of a housing **shortage** as demand for housing outstrips supply.

(predominantly furniture and appliances) and other housing activity -- housing accounts for 22.4 percent of GDP. See Andrew J. Filardo, "The Outlook for Housing: The Role of Demographic and Cyclical Factors," Federal Reserve Bank of Kansas City, *Economic Review*, Third Quarter 1996, pp. 39-61.

[2] According to the House Price Index from the Office of Federal Housing Enterprise Oversight, the year-over-year average increases in home prices in 1998, 1999, and 2000 were 5.5 percent, 5.7 percent, and 8.1 percent, respectively.

[3] Kenneth R. Harney, "Research Shows How Home Sales Power the Economy," *The Washington Post*, June 7, 2001, p. H1.

Specifically, Census data show that the national vacancy rate for owner-occupied homes decreased from 2.1 percent in 1990 to 1.7 percent in 2000. Moreover, the supply of unsold homes (especially looking at the inventory-to-sales ratio) is at historical lows. Not only have favorable economic conditions helped drive housing demand, but important demographic trends have fueled this growth. The number of new households increased by 1.35 million a year during the past decade -- approximately 200,000 more per year than previously estimated.

Key drivers of this growth in household formation include rising immigration rates and an increase in the rate of minority household formation. A recent study released by Harvard's Joint Center for Housing Studies found that, since 1995, immigrants have accounted for one-third of household growth.[4] Minority households have made up fully two-fifths of the record net gain in homeownership over the past six years.[5] As immigration continues to increase, as efforts continue to close the gap between minority and white homeownership rates, and as more and more "echo-boomers" reach adulthood, the demand for housing will likely continue to grow. The Joint Center projects household growth over the next decade at or above the 11.5 million new households of the 1990s and estimates that, factoring in immigration, minorities will make up roughly two-thirds of net household growth.[6]

The greater number of financing options available for those seeking to attain homeownership for the first time has further fueled this demand. As a recent *Wall Street Journal* article noted, new prospective homeowners,

> *(H)ave taken advantage of new, low-down-payment loans and other new mortgage products designed to boost homeownership among minorities, immigrants, and low-income families.*[7]

Continued strong demand for housing and housing finance poses both challenges and opportunities for those of us in the housing industry and for policymakers with responsibility for guiding housing policy. We look forward to working with our industry partners and with policymakers to meet this challenge.

Now I would like to provide the Subcommittee with an update in three important areas since I testified in March:

- **American Dream Commitment.** We have had an excellent start our American Dream Commitment (ADC), the goal we announced in March of 2000 to devote $2 trillion over ten years to increase homeownership rates and serve 18 million targeted families. Through May of this year -- less than 18 months into this initiative -- working with lenders and many other partners, we already have made

[4] Joint Center for Housing Studies, "The State of the Nation's Housing," 2001, at 11.
[5] Id. at 13.
[6] Id. at 9.
[7] Patrick Barta, "Looming Need for Housing A Big Surprise," *The Wall Street Journal*, May 15, 2001, p. B1.

available over $341 billion in targeted housing finance, serving over 3.4 million underserved families, including 535,000 minority borrowers. The ADC includes a national initiative to increase minority homeownership, with a commitment to invest more than $420 billion over the next decade. As part of this, we have entered into several alliances with national lenders focused on serving minority and immigrant borrowers. We also have launched efforts such as the "Welcome Initiative: A New Home in a New Country," a comprehensive bilingual marketing campaign to help lenders respond to the needs of immigrant borrowers. The ADC also includes a promise to finance at least $175 billion in multifamily housing. Through May of this year, we have already provided $20 billion in multifamily housing finance toward this goal.

- **Safety and Soundness.** While other financial regulators issue annual reports to Congress, only OFHEO reports publicly on the exam results of the two companies it regulates. In its annual report to Congress issued on June 15 of this year, OFHEO found the companies to be financially sound and well managed. Furthermore, OFHEO gave each company its highest possible rating -- "exceeds safety and soundness standards" -- in each of the six examination areas.

- **Voluntary Initiatives.** Last fall, Fannie Mae and Freddie Mac, along with the leadership of this Subcommittee, announced a set of six voluntary initiatives aimed at enhancing our safety and soundness and at further increasing the level and transparency of information available to policymakers and investors about our risk management. I reported to you in March that we implemented all of these initiatives fully -- and in some cases went beyond the commitment from last fall -- during the first quarter of 2001. In the second quarter, we continued to make the regular disclosures that we announced last fall. Also, in addition to the $1.5 billion in 10-year subordinated debt that we issued in January, we issued $1.5 billion in 5-year subordinated debt in early May. Both issues of our subordinated debt have continued to trade at yields ranging between 17 and 29 basis points above Fannie Mae senior debt of similar maturities. This difference in yields indicates that the market views our sub debt differently than our senior debt.

The 2001 CBO Report

The principal reason for my testimony before the Subcommittee today is to provide Fannie Mae's perspective on the Congressional Budget Office's 2001 update to its 1996 estimate of the costs and benefits of Fannie Mae and Freddie Mac. Fannie Mae released a detailed response shortly after CBO issued its update. This response is posted on our website at www.fanniemae.com/cboresponses.html, and I respectfully request that it be included in the hearing record.

CBO solicited our comments on the draft of the 2001 report prior to its release. While CBO ultimately chose not to incorporate our suggestions, we appreciated the dialogue and hope it will continue.

The 2001 CBO report is flawed in its premise and in its treatment of specific aspects of our business. The premise underlying CBO's work is that it can estimate the value of a "subsidy" that does not explicitly exist. Clearly, we receive benefits as a result of our charter -- benefits that we help transform into greater market efficiencies and home buyer savings -- but these benefits should not be equated with an outlay of taxpayer dollars. Fannie Mae and Freddie Mac do not benefit from any appropriation of federal funds, and we are required by law to tell investors that our securities are not guaranteed by the federal government.[8] By virtue of our unique position in the U.S. housing finance system, our borrowing costs are lower than those of other "AA" borrowers; but if the government were to revoke the Fannie Mae charter, it would not recover a single "subsidy" dollar -- and homebuyers would face higher mortgage rates.

CBO tackles the understandably difficult task of trying to estimate a nonexistent funding stream by creating an analytical framework unique to Fannie Mae, Freddie Mac, and the Federal Home Loans Banks, and applying it to them alone. This framework is based on the assumption that the difference between our borrowing costs and the borrowing costs of banks, less the difference between jumbo and conforming mortgages, should equal the amount of "subsidy" that Fannie Mae, Freddie Mac, and the Home Loan Banks retain.

Herein lies our first serious concern with the CBO calculation. Following CBO's logic, any reduction in the companies' cost of funds achieved through their own efficiency or expertise increases the government "subsidy." We are constantly trying to improve our funding with initiatives such the liquidity-enhancing regularity of Benchmark securities, sale of debt through Dutch auctions, the use of derivatives, Internet debt placement, and enhanced debt marketing efforts. However, such market-driven innovations -- innovations which helped earn Fannie Mae *Euromoney* magazine's 2000 award for "Best Borrower of the Year" -- would, under CBO's approach, represent a further increase in the government "subsidy."[9]

Under the CBO methodology, if we run our business efficiently, the "subsidy" that CBO posits grows -- without any change in either our Congressional charter or our regulatory regime. Even less understandably, if we run our business poorly, the "subsidy" actually shrinks. This single assumption, by leading inevitably to an irrational result, greatly reduces the value of CBO's analysis for policymaking purposes. Should the government instruct Fannie Mae and Freddie Mac to operate less efficiently to minimize the so-called "subsidy"? Should the government forbid Fannie Mae and Freddie Mac from issuing innovative debt instruments that reduce the companies' debt costs and in turn reduce mortgage rates for consumers -- again, because these innovations increase the value of CBO's theoretical "subsidy"?

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[8] Each Fannie Mae security is required by law to state on its cover that its "obligations, together with the interest thereon, are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any agency or instrumentality other than the corporation."

[9] For instance, many analysts estimate that Fannie Mae's Benchmark Note program has saved the company 5 to 7 basis points compared with funding operations prior to the introduction of the program.

Fortunately for U.S. homebuyers, Fannie Mae does not have the choice to operate less efficiently. Our obligation to our shareholders and the competitive environment in which we operate requires that we strive for efficiencies in every part of our business every day. Our success in managing credit and interest rate risk has led the market to view us as an exceedingly safe company. Fannie Mae, through effective credit enhancement and aggressive loss mitigation strategies, has steadily reduced its credit losses, which now total less than one basis point (0.01 percent) over our entire book of business. Our successful hedging of interest rate risk has led to consistent earnings growth in a wide range of interest rate environments.

Our second serious concern with CBO's analysis relates to its comparison of our borrowing costs to those of banks. One might suppose from the CBO calculation that banks and Fannie Mae finance their operations with long and short-term borrowings in much the same way. However, banks and Fannie Mae use debt very differently. Indeed, senior debt is the highest cost and smallest component of a bank's funding base. Banks have access to non-interest and other low-cost insured deposits and to low-cost advances from Federal Home Loan Banks, while Fannie Mae and Freddie Mac can only raise funds by issuing debt. As a result, banks' average cost of funds is actually lower than that of Fannie Mae and Freddie Mac, and CBO's comparison of yields on our debt to yields on bank debt overstates any relative funding benefit we receive by ignoring the funding advantages available to banks by virtue of their government-provided benefits.

Our third major concern relates to CBO's failure to account for the restrictions and obligations in our Congressional charter and to capture fully the benefits we provide to the mortgage market. If, as CBO states, others would be willing to pay for a government-sponsored enterprise charter, then presumably the price they would be willing to pay would include the costs of the business restrictions and obligations in that charter. Fannie Mae and Freddie Mac are restricted to the business of residential housing in the U.S., may only purchase or securitize loans below the conforming limit (in 2001, $275,000 for single family mortgages), must have credit enhancements such as mortgage insurance on loans with less than 20 percent borrower equity, face rigorous capital requirements, and must meet three specific percent-of-business housing goals. CBO's calculation includes none of these restrictions or obligations.

Similarly, in terms of the benefits we deliver to homebuyers, CBO captures the lower interest rates only on the loans that we purchase or securitize, despite the fact that all conforming loans enjoy lower interest rates because of our presence in the secondary market. Fannie Mae and Freddie Mac also provide liquidity and stability to the housing finance market, support innovation that removes barriers to homeownership, and invest in targeted housing finance for underserved borrowers, yet CBO captures none of these benefits.

One example I would like to highlight -- and there are others in our detailed response -- is our investment in multifamily housing. Fannie Mae has become the nation's largest investor in multifamily housing, with a book of business of $65 billion at the end of 2000. In 2000 alone, Fannie Mae made $13.5 billion in multifamily investments, creating or preserving affordable housing for more than 266,000 households. In addition, Fannie Mae's $1.3 billion in equity investments, through the purchase of low-income housing tax credits, makes us the largest investor in the nation's most significant program for the production of affordable rental housing. None of these investments, benefits to the market, or business restrictions are included in the CBO calculation.

In addition to the main points I have just set out, we have concerns with many other elements of the CBO calculation. These concerns are discussed in detail in our May 23rd response. Briefly,

- CBO compares the yields on Fannie Mae debt to that of both 'A' rated and 'AA' rated financial companies, even though S&P rated Fannie Mae's "risk to the government" as 'AA-' -- which means that the most accurate comparison would be to 'AA' rated firms. CBO also misstates the amount of short-term debt the two companies issue. Correcting these errors reduces the funding "subsidy" from $6 billion to between $3.0 billion and $3.6 billion for 2000.

- CBO mismeasures any "subsidy" attached to MBS issued by Fannie Mae and Freddie Mac. CBO concludes that there is a $3.6 billion "benefit" from MBS guarantee activities. This $3.6 billion MBS benefit is based on a 30 basis point "subsidy" that is 10 basis points more than the gross revenue the companies receive from their guaranty fee. Correcting the errors in the MBS benefit calculation would decrease it from the reported $3.6 billion to a range between zero and $0.6 billion.

- As described above, CBO applies the benefit to homebuyers of lower mortgage rates only to the mortgages Fannie Mae and Freddie Mac own or securitize. Because of market competition, every borrower eligible for a conforming mortgage enjoys lower rates, regardless of whether their mortgage is part of a transaction that involves Fannie Mae or Freddie Mac. Correcting this mistake increases the homeowner benefit from $6.7 billion to a range of between $10.4 billion and $13.3 billion.

Correcting these errors changes CBO's "retained subsidy" of $3.9 billion to a net benefit to homebuyers ranging from $5.6 billion to $9.7 billion. As a result, those who claim that Fannie Mae and Freddie Mac are not fulfilling their public mission by "retaining" this $3.9 billion clearly are incorrect -- as Fannie Mae and Freddie Mac pass along to American households far more than they receive in benefits.

I also would like to address briefly a June 21 letter from CBO Director Dan Crippen to Fannie Mae Chairman and CEO Frank Raines, which CBO posted on its website last week. In that letter, Director Crippen took issue with Fannie Mae's response to the CBO report.

We engaged in a dialogue with CBO throughout their work on this report, and we stand by our critique of the final product. Our analysis is relevant because it points out the limits of the framework CBO has chosen and the flaws in the estimate it provided. We commend our critique to policymakers so they can weigh for themselves the relevance and reliability of CBO's estimate.

Indeed, prior to the release of the report, we suggested to CBO that publishing a range of estimates would provide policymakers with more information about the range of reasonable assumptions and the types of benefits we provide that are difficult to measure. Instead, CBO conveyed a false sense of precision by reporting point estimates, and it chose not to quantify in any way important benefits we provide.

The Regulatory Regime

There has been some discussion recently of changing the regulatory regime for Fannie Mae and Freddie Mac. The starting place for any such discussion is the regulatory structure that Congress established in 1992 -- a unique regulatory regime with a high level of rigor and unparalleled transparency. Fannie Mae and Freddie Mac are subject to and exceed the highest standards of safety and soundness. OFHEO has conducted a comprehensive, continuous, on-site examination program since 1994, the scope and rigor of which equals or exceeds that to which any other regulated financial institution is subject. We consistently receive OFHEO's highest examination marks. We must meet minimum statutory capital standards, and, furthermore, we voluntarily adhere to an interim risk-based capital test pending OFHEO's publication of its final risk-based capital regulation. We are the only financial companies in the world to issue subordinated debt in large volume and on a regular basis. And we voluntarily release financial information on our interest rate risk, credit risk, and liquidity at a level consistent with the most recent recommendations of Basel and others, including the Shipley Commission. The combination of all our sub debt issuances and our numerous disclosures make Fannie Mae and Freddie Mac among the two most transparent firms in the world.

Of course, we are always ready to engage with policymakers on these issues. From our perspective, two considerations are of paramount importance: one, that any regulator of Fannie Mae and Freddie Mac have the confidence of policymakers in the Congress and the Executive Branch; and two, that such a regulator recognize the importance of balancing safety and soundness with our mission to expand homeownership and affordable rental housing.

Conclusion

We find ourselves in a period of tremendous opportunities and challenges. The homeownership rate in America today stands at a record 67.5 percent, up by 3.6 percentage points from ten years ago. As the most recent Census showed, 49 States have higher homeownership rates than they did ten years ago, and demand for housing continues to grow. But the gap between whites and minorities is huge. Seventy-four percent of white Americans own their homes, but that figure is less than 50 percent for African Americans and Hispanics. We have the best housing finance system in the world, and this system's success translates into financial strength for the economy as a whole and at the level of the individual household. Now we must make it work for more American families.

Fannie Mae is well positioned to help bring the housing finance system to the next level in terms of our ability to deliver the American Dream of homeownership to more and more families. We operate successfully under the most rigorous of safety and soundness regimes; we are subject to a high level of market discipline and provide the marketplace with world-class disclosures; we fulfill our obligations to our shareholders; and most importantly, we do the job that Congress gave us -- we provide liquidity and greater access to affordable homeownership for all Americans.

Clearly, there is a great deal of value that flows from the efficient operation of the U.S. housing finance system and from the role that Fannie Mae plays in this system. Yet, there is much more that our housing finance system could accomplish. In this context, I would like to reiterate the straightforward test Frank Raines proposed a year ago for examining policy proposals that affect the housing finance system:

- Do they reduce costs for consumers?
- Do they improve the safety and soundness of the housing finance system?
- Do they expand opportunities for homeownership?
- Do they allow innovation in the market without cumbersome regulatory requirements?

We believe these questions remain relevant, particularly in view of the challenges we continue to face in expanding homeownership opportunities for all Americans.

Thank you for inviting me to testify before you today. I look forward to working with the Subcommittee on these important issues.

Setting the Record Straight: An Analysis of CBO's 2001 Report on Fannie Mae and Freddie Mac

May 23, 2001

Setting the Record Straight:
An Analysis of CBO's 2001 Report on Fannie Mae and Freddie Mac

Executive Summary

Last year, Congressman Richard Baker asked CBO to update its 1996 report estimating the costs and benefits of Fannie Mae and Freddie Mac. In response to many critiques of the 1996 report, CBO employed a new approach in its 2001 report, *Federal Subsidies and the Housing GSEs*. Unfortunately, while the new report corrects earlier methodological mistakes, it retains many of the conceptual flaws in the old report and relies on a new set of flawed assumptions. The result is an analysis that neither accurately reflects the imputed public costs of Fannie Mae and Freddie Mac nor adequately captures their significant impact on homeownership and the mortgage market. After correcting for the errors in CBO's analysis, our conclusion is that Fannie Mae and Freddie Mac deliver a net benefit to homeowners of between $5.6 billion and $9.7 billion.

Any review of this report must begin by recognizing that CBO is trying to estimate the value of a "subsidy" that does not explicitly exist. If the government were to revoke the Fannie Mae charter, it would not recover a single "subsidy" dollar, but homebuyers would face higher mortgage rates. The fundamental flaw of the 1996 report – repeated in this 2001 update – is that in reducing the operations of Fannie Mae and Freddie Mac to a static accounting exercise, CBO fails to recognize how the companies add value to the housing markets. Under CBO's accounting methodology, any reduction in the companies' cost of funds through their own efficiency or expertise, or through improvements in risk management, increase CBO's estimate of the government "subsidy."

CBO then applies this flawed theory in a way that distorts the result. CBO overstates any funding advantage the companies receive, misestimates any benefit the companies derive from MBS issuance, and fails to capture the benefit the companies provide to American homeowners.

The first error relates to the debt benefit calculation. CBO compares the yields on Fannie Mae debt to that of **both** 'A' rated and 'AA' rated financial companies, even though S&P rated Fannie Mae's "risk to the government" as 'AA-' -- which means that the most accurate comparison would be to 'AA' rated firms. CBO also misstates the amount of short-term debt the two companies issue. **Correcting these errors reduces the debt benefit from $6 billion to between $3.0 billion and $3.6 billion for 2000.**

A second error relates to CBO's mismeasurement of any "subsidy" attached to MBS issued by Fannie Mae and Freddie Mac. CBO concludes that there is a $3.6 billion "benefit" from MBS guarantee activities. This $3.6 billion MBS benefit is based on a 30 basis point "subsidy" that is 10 basis points more than the gross revenue the companies receive from their guaranty fee. **Correcting the errors in the MBS benefit calculation would decrease it from the reported $3.6 billion to between zero and $0.6 billion.**

The third mistake relates to the homeowner or "pass-through" benefit that CBO applies only to the mortgages owned or securitized by Fannie Mae and Freddie Mac. Every borrower eligible for a conforming mortgage enjoys lower rates, regardless of whether their mortgage is part of a transaction that involves Fannie Mae or Freddie Mac. **Correcting this mistake increases the homeowner benefit from $6.7 billion to between $10.4 billion and $13.3 billion.**

In addition, CBO acknowledges that it did not calculate the benefit from Fannie Mae's pursuit of our mission to low- and moderate-income households. **CBO's analysis fails to capture some of Fannie Mae's most important contributions to the housing and mortgage markets.**

The chart below shows how the numbers change when one corrects these significant mistakes. We calculate that correcting these errors reverses the results from a "retained subsidy" of $3.9 billion to a net benefit to homeowners ranging from $5.6 billion to $9.7 billion.

Benefit analysis correcting for flaws[1]
(Billions of dollars)

	CBO 1995	1995 Corrected	CBO 2000	2000 Corrected
Debt Benefit	$2.7	$1.4	$6.0	$3.0 to $3.6
MBS Benefit	$3.8	$0.5	$3.6	0 to $0.6
Tax Benefit	NA	NA	$0.9	$0.6
Gross "Subsidy"	$6.5	$1.9	$10.6	$3.6 to $4.8
(Homeowner Benefit)	($4.4)	($6.2)	($6.7)	($10.4) to ($13.3)
Retained "Subsidy"	$2.1	($4.3)	$3.9	($5.6) to ($9.7)

Fannie Mae provides more benefits to homebuyers than it realizes from any theoretical "subsidy." Fannie Mae clearly adds value to the mortgage market far beyond the confines of the theoretical model that CBO has posited, even if that model were accurately applied. For these reasons, we do not believe the report offers policymakers reliable or relevant analysis in seeking to support homeownership successfully.

[1] This table reflects calculations for Fannie Mae and Freddie Mac only. The tax benefit is included in order to present numbers comparable to those in the CBO report.

Introduction

In 1968, Congress chartered Fannie Mae to use private capital to achieve the public goals of more affordable homeownership and rental housing and an efficient, stable secondary mortgage market. Nearly thirty years later, Fannie Mae is a spectacular policy success. We lower mortgage rates every day for borrowers across the country, invest trillions of dollars in housing finance for underserved borrowers, create new kinds of mortgages to expand homeownership, attract capital from across the globe, and finance affordable rental housing -- and we do all of this using private capital and not a penny of government funds.

It is important and necessary for Congress to review the workings of the system it created to see whether Fannie Mae is providing to homebuyers and investors the value that Congress expects. Does Fannie Mae reduce mortgage rates consistently and in all parts of the country? Is Fannie Mae making long-term fixed-rate mortgages available to U.S. borrowers? Is Fannie Mae introducing more efficient ways of raising private capital? Is Fannie Mae identifying communities and borrowers who now do not have access to fairly-priced, conventional financing and looking for ways to provide such financing? And is Fannie Mae doing all of this while meeting the highest standards of safety and soundness?

We think the answer to all of these questions is demonstrably "yes" -- and that it is important to capture all of the elements of Fannie Mae's role in the U.S. housing market. Unfortunately, CBO's report does not meet this standard.

I. Background

When Congress created a new regulatory regime for Fannie Mae and Freddie Mac in 1992, it also required four government agencies -- including the Congressional Budget Office (CBO) -- to examine the effects that repealing Fannie Mae's and Freddie Mac's charters would have on the housing finance system, low- and moderate-income families, the companies, and the financial markets overall. In its 1996 report, CBO attempted to estimate the public costs and benefits of Fannie Mae and Freddie Mac. CBO created a unique theory for measuring the benefits of a government charter, applied this model to Fannie Mae and Freddie Mac alone, and identified and quantified an implicit government "subsidy" in Fannie Mae's business.

The 1996 CBO report was broadly criticized both for its design and for its methodology. Robert Zoellick, then an executive vice president at Fannie Mae, said the report was "at best an advocacy document and at worst a polemic."[2] Reagan OMB Director Jim Miller

[2] Testimony of Robert B. Zoellick, Executive Vice President, Fannie Mae, before the Subcommittee on Capital Markets, Securities, and GSEs of the Committee on Banking and Financial Services, U.S. House of Representatives, July 31, 1996.

argued in an analysis released earlier this year that the report "used faulty data and inappropriate methodology."[3]

Last year, Congressman Richard Baker asked CBO to update the 1996 report. In response to many critiques of the 1996 report, CBO constructed a new approach in its 2001 report, *Federal Subsidies and the Housing GSEs*. Unfortunately, while the new report corrects earlier methodological mistakes, it retains many of the conceptual flaws present in the old report and relies on a new set of erroneous assumptions. The result is an analysis that neither accurately reflects the imputed public costs of Fannie Mae and Freddie Mac nor adequately captures their significant impact on homeownership and the mortgage market. After correcting for errors in CBO's analysis, we find that Fannie Mae and Freddie Mac deliver a net benefit to homeowners of between $5.6 billion and $9.7 billion and do not retain any "subsidy."

II. CBO Corrects Some Errors From 1996 Report But Introduces New Ones

In its new estimate, CBO has corrected some of the most obvious flaws of its 1996 report. It now makes a distinction between short-term and long-term funding (though it has not properly weighted each in its new estimate). It no longer relies on the misconception that Fannie Mae and Freddie Mac enjoy an advantage on the option embedded in callable debt. It no longer seeks to estimate a benefit to mortgage-backed securities (MBS) by estimating the spread between MBS guaranteed by the two companies and so-called private-label MBS. CBO also acknowledges that it is not possible to have an MBS benefit that is larger than the guarantee fee we charge (although its summary of costs and benefits fails to clarify that point). Had these and other corrected assumptions been used in the 1996 report, the "retained subsidy" CBO estimated at that time would have been zero.

The corrections CBO made, however, have been replaced by a whole new set of assumptions that result in equally mistaken and misleading conclusions. The assumptions behind CBO's new model are flawed in many respects:

- the report does not compare Fannie Mae and Freddie Mac funding to the most likely alternative source of funding for mortgages and relies on assumptions that dramatically overstate the companies' funding advantage;

- the report assumes an "MBS benefit" that lacks analytical rigor and mistakenly characterizes the two companies as receiving and then distributing this "benefit"; and

- the report fails to quantify the full impact of the companies on all U.S. homebuyers.

Even if one were to agree with the premise that this theory could appropriately estimate the benefits Fannie Mae and Freddie Mac receive and pass on to homeowners, the flaws in the current report render any ultimate conclusion unreliable. In fact, CBO conveys a

[3] James E. Pearce and James C. Miller III, *"Freddie Mac and Fannie Mae: Their Funding Advantage and Benefits to Consumers,"* January 9, 2001, p. 1.

false sense of precision by reporting point estimates rather than a range for their theoretical “subsidy.” There will never be market or budget data that can show, even retroactively, the precise benefits that Fannie Mae has received as a result of its GSE status. Even using the very limited alternative parameter values in Table 9 of the report, CBO’s own sensitivity analysis displays a large range of possible “subsidy” values.

As shown in the table below, correcting the errors in CBO’s analysis changes a “retained subsidy” for the companies into a net benefit for homeowners:

	CBO 1995	1995 Corrected	CBO 2000	2000 Corrected
Gross "Subsidy"	$6.5	$1.9	$10.6	$3.6 to $4.8
Retained "Subsidy"	$2.1	($4.3)	$3.9	($5.6) to ($9.7)

Note also that CBO does not report after-tax values, which would be the relevant analysis for any business decisionmaker. Any positive “retained subsidy” would be subject to federal income tax at the 35 percent corporate rate. This would reduce CBO’s estimate from $3.9 billion to $2.5 billion.

III. CBO’s Report is a Theoretical Exercise about Nonexistent Funds

Any review of this report must begin by recognizing that CBO is trying to estimate the value of a “subsidy” that does not explicitly exist. Fannie Mae and Freddie Mac do not benefit from any appropriation of federal funds, and we are required by law to tell investors that our securities are not guaranteed by the federal government.[4] By virtue of our unique position in the U.S. housing finance system, our borrowing costs are lower than those of other ‘AA’ borrowers; but if the government were to revoke the Fannie Mae charter, it would not recover a single “subsidy” dollar and homebuyers would face higher mortgage rates. Indeed, Fannie Mae actually incurred $1.6 billion in taxes in 2000. There are no explicit guarantees to price, and there is no way ultimately to compare any “subsidy” estimate to actual results to determine its accuracy.

CBO tackles the understandably difficult task of trying to estimate a nonexistent funding stream by creating a unique theory to analyze Fannie Mae and Freddie Mac and applying it to them alone. As there is no established methodology for analyzing a theoretical “subsidy,” CBO’s analysis necessarily depends upon a broad set of assumptions. If these assumptions are flawed, they can dramatically skew the result. For example, correcting the erroneous assumption regarding Fannie Mae’s credit rating reduces the presumed debt benefit by between $2.4 billion and $3 billion.

In fact, there has been an established methodology in place for over a decade that calculates the value of an ***explicit*** guarantee from the government. The government provides a clear, calculable value to some securities by granting a full faith and credit

[4] Each Fannie Mae security is required by law to state on its cover that its “obligations, together with the interest thereon, are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any agency or instrumentality other than the corporation.”

guarantee, e.g., on MBS guaranteed by the Government National Mortgage Association. This explicit guarantee is clearly far more valuable than any benefit the debt and MBS of Fannie Mae and Freddie Mac may receive from GSE status. It is instructive, therefore, to compare CBO's quantification of an implicit benefit to GSE status to the established methodology that the Federal Credit Reform Act of 1990 (FCRA) requires for pricing the value of a full government guarantee.

At Fannie Mae's request, PriceWaterhouseCoopers (PWC) applied the methodology required under the FCRA to derive an estimate of what the government "subsidy" would be if Fannie Mae's 2000 guaranty business were guaranteed by the federal government. PWC estimates that the cost under FCRA would be zero, unless Fannie Mae losses exceeded its reserves and capital. If the company exhausted its capital and reserves, PWC's upper-bound measure of the government cost to guarantee Fannie Mae MBS would be $148.5 million, only 8 percent of the CBO estimate of the "subsidy" the company receives through its MBS issuances.[5]

Obviously, this is a far more lucrative "subsidy" than anything that Fannie Mae actually receives as a result of our charter. It assumes that the government would cover any losses on the MBS we guarantee, but even an explicit government guarantee on Fannie Mae MBS would only lead to actual costs to the government if Fannie Mae completely exhausted its private equity capital.

IV. When We Manage Well, CBO Increases the Subsidy

The fundamental flaw of the 1996 report – repeated in this 2001 update – is that in reducing the operations of Fannie Mae and Freddie Mac to a static accounting exercise, CBO fails to recognize how the companies add value to the housing markets.

Under CBO's accounting methodology, any reduction in the companies' cost of funds through their own efficiency or expertise increases CBO's estimate of the government "subsidy." Recent innovations that have lowered the yield of Fannie Mae's and Freddie Mac's debt -- such as the liquidity-enhancing regularity of Benchmark or Reference securities, sale of debt through Dutch auctions, the use of derivatives, Internet debt placement, and enhanced debt marketing efforts -- would, under this approach, merely represent a further increase in the government "subsidy."[6] These innovations were recognized by Euromoney magazine in June 2000, when it named Fannie Mae "Best Borrower of the Year" for innovations such as our Benchmark Bond program.

The same is true of our success in managing credit and interest rate risk, which has led the market to view us as an exceedingly safe company. Fannie Mae, through effective credit enhancement and aggressive loss mitigation strategies, has steadily reduced its credit losses, which now total less than one basis point over our entire book of business.

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[5] *"Alternative Measures of the Charter Benefit to Fannie Mae Mortgage Backed Securities,"* PriceWaterhouseCoopers, draft prepared for Fannie Mae, May 2001.

[6] For instance, many analysts estimate that Fannie Mae's Benchmark Note program has saved the company 5 to 7 basis points compared to funding operations prior to the introduction of the program.

Our successful hedging of interest rate risk has led to consistent earnings growth in a wide range of interest rate environments.

In addition, Fannie Mae and Freddie Mac recently committed to new voluntary disclosures of interest rate risk and credit risk. These disclosures, combined with the regulatory regime Congress enacted in 1992, place Fannie Mae at the vanguard of risk management and disclosure practices worldwide. Moody's described these disclosures:

> *"These financial disclosure commitments by Fannie Mae and Freddie Mac set new standards not only for them, but also for the global financial market."*[7]

Unfortunately, any impact of these efforts in the form of lower yields on our debt is merely evidence to CBO of a larger government "subsidy." Perversely, were we to mismanage risk, which would certainly be punished in the market by higher yields on our debt, the value of our government "subsidy" would decline in CBO's view. **According to CBO, efficiency and effective risk management are signs of a highly subsidized company; inefficiency and the dangerous mismanagement of risk are signs of an unsubsidized company.** This kind of flawed framework does not provide useful analysis for Congress.

V. CBO Commits Several Errors of Measurement

After adopting a theory with substantial conceptual flaws, CBO then applies the theory in a way that distorts the result. CBO overstates any funding advantage the companies receive, misestimates any benefit the companies derive from MBS issuance, and fails to capture the benefit the companies provide to American homeowners.

CBO Overstates the Funding Advantage

The new CBO report asks the wrong question when it attempts to measure a debt benefit by comparing yields on the companies' senior debt to that of banks. This comparison is inappropriate for at least two reasons. First, bank senior debt is the highest cost and smallest component of a bank's funding base. Second, bank senior debt is actually subordinated to claims of depositors, the FDIC, and the FHLBs. Banks have access to non-interest and other low-cost insured deposits, while Fannie Mae and Freddie Mac can only raise funds by issuing debt.[8]

Given the question CBO has asked, several of CBO's assumptions overstate any difference in yields between the companies' senior debt and that of other firms. First, CBO does not compare the two companies to a group of truly comparable firms. In both the old and new studies, CBO measures Fannie Mae's funding advantage by comparing the yields on our debt to that of **both** 'A' rated and 'AA' rated financial companies. In 1997 and again in 2001, S&P, a preeminent statistical rating agency, rated Fannie Mae's

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[7] Moody's Investor Services Special Comment, "*New Freddie Mac and Fannie Mae "Open Book" Policy: A Positive Credit Development*," Oct. 2000, p. 3.
[8] See Appendix 1.

and Freddie Mac's "risk to the government" as 'AA-'. Thus, Fannie Mae and Freddie Mac should be compared to 'AA' rated firms.

For use in its 2001 report, CBO commissioned Brent Ambrose and Arthur Warga to compare the yields of the two companies to other firms.[9] In the sample of 70 firms used by Ambrose and Warga, more than 80 percent have an 'A' rating, a rating inferior to that of Fannie Mae and Freddie Mac. Nevertheless, CBO relies upon the entire sample, resulting in a funding advantage that is significantly overstated. Indeed, the Ambrose and Warga report shows that 'AA' rated banks had debt with an average spread of 27 basis points relative to Fannie Mae and Freddie Mac debt over the 1995-1999 period. 'A' rated banks had debt that was 51 basis points over GSE debt for the same time period (see Table 2 in the Ambrose and Warga study).

A better comparison would be to the swap market. The swap market represents a generic 'AA' rated borrower. Banks and other financial institutions have access to long-term debt through interest rate swaps and to short-term funds through the interbank market. These funds can be swapped for term or callable funding through the swap and swaption markets. Fannie Mae's cost of funds typically ranges from 25 basis points below to 5 basis points above LIBOR. Any cost of funds advantage in this market could likely be explained by the quality of Fannie Mae's portfolio and the stability of our earnings. If there is a funding cost advantage associated with Fannie Mae's charter, it is unlikely to be worth more than a few basis points.

CBO also misstates the amount of short-term debt the two companies issue. CBO estimates a 47 basis point advantage in issuing long-term debt, and a 15 basis point advantage in short-term debt. The report assumes that the GSEs hold 20 percent in effective short-term debt and 80 percent in effective long-term debt. However, CBO itself acknowledges (p. 19) that in 1999 Fannie Mae short-term debt made up 41 percent of its total debt. Reflecting the fact that long-term debt made up 60 percent of Fannie Mae's liabilities, and short-term debt made up the remaining 40 percent would reduce our weighted average funding advantage by about 17 percent.

Correcting these errors in estimating our cost of long-term debt and proportion of short-term debt cuts the debt benefit estimate from $6 billion to between $3.0 billion and $3.6 billion for 2000. Using a more appropriate cost of funds comparison that reflects swap-based funding could eliminate any debt benefit.

CBO Overstates the MBS Benefit

A second methodological error relates to CBO's mismeasurement of any "subsidy" attached to MBS issued by Fannie Mae and Freddie Mac. The 1996 report used a point estimate of 40 basis points for this benefit based on the historical spread between agency and so-called "private-label" MBS. In response to critiques of the 1996 methodology, CBO has abandoned its earlier approach in the new report. CBO now believes that

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[9] Brent Ambrose and Arthur Warga, *An Update on Measuring GSE Funding Advantages,* CBO commissioned report, 2000.

Fannie Mae and Freddie Mac cannot retain a benefit larger than the guaranty fee they charge. CBO states:

> *"Currently, the GSEs charge approximately 20 bp for that guarantee, which puts an upper bound on the benefit that they can retain from this line of business."* (p. 22)

The methodology in the new report is quite different from that in 1996. The report states that "CBO's approach to estimating the subsidy rate on MBSs is largely deductive," i.e., it does not estimate an MBS benefit from real data. CBO's calculation of a total MBS benefit consists of two components: a benefit to borrowers and a "retained subsidy" to the GSEs. CBO defines the borrower benefit as the average spread between jumbo and conforming mortgage rates, assumed to be 25 basis points in their study. The retained benefit, 5 basis points, is assumed to derive from the GSEs "perceived government backing." The total MBS benefit is thus assumed to be 30 basis points, the sum of the borrower benefit and the retained benefit.

It is important to deconstruct CBO's deductive methodology. First, it assumes that the entire benefit on conforming mortgages must come from a "subsidy" that the government provides. Second, the retained benefit is determined by citing a report by Alden Toevs that does not purport to determine what, if anything, the companies retain.[10] Both assumptions are flawed.

First, CBO assumes the benefit to borrowers results solely from a government "subsidy" and does not reflect efficiencies in the private market. Fannie Mae and Freddie Mac have securitized almost $2 trillion in MBS. The MBS market is nearly as liquid as the market for Treasury securities. The liquidity and standardization that GSE securitizations bring to the market substantially contribute to borrower benefits. In short, CBO fails to account for the fact that a significant portion of the estimated 25 basis points in benefits that homebuyers receive derives from the liquidity and efficiencies that the companies create. In their recent analysis, Pearce and Miller concur:

> *"What CBO is saying, in effect, is that the federal government gives the GSEs [a] 'subsidy,' which they are supposed to pass on to consumers (mortgage borrowers). It's a closed, zero-sum model. The GSEs never create value, they are merely conduits for the 'subsidy'."*[11]

Second, the report implies that Fannie Mae first receives the total MBS benefit of 30 basis points before passing on 25 basis points to borrowers. This is clearly incorrect. When Fannie Mae creates a MBS by guaranteeing the mortgages originated by a lender, the company receives only a guaranty fee. The benefit from the lower yield on the MBS is received not by Fannie Mae, but by the lender who sells the MBS into the market.

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[10] Alden Toevs, First Manhattan Consulting Group, *A Critique of the CBO's Sponsorship Benefit Analysis,* 2000.

[11] James Pearce and James Miller III, *Response to CBO's Draft Report: Federal Subsidies and Housing GSEs,"* 2001, p. 6.

Summary Table 1 utilizes a 30-basis-point MBS benefit to calculate the "subsidies by GSE." This is despite the fact that in the text CBO explicitly acknowledges that at most 5 basis points is retained by the companies, and the other 25 basis points accrue to mortgage borrowers as "gross subsidies to securities." Summary Table 1 unfairly misrepresents CBO's own understanding of the analysis and the data as described in the text, and significantly overstates the "subsidies" the companies receive.

In addition, the assumption of a 5 basis point "retained subsidy" lacks any analytical rigor. There exists a curious dichotomy in CBO's report: all other institutions operate in fully competitive markets that perfectly transmit government subsidies while Fannie Mae and Freddie Mac retain large portions of these same subsidies. CBO assumes that the MBS market is frictionless, with the exception of the GSEs, by assuming that lenders or other intermediaries do not retain any portion of the benefit that comes from having a guarantee from the companies (as opposed to a private label guarantee) on an MBS.

CBO further assumes that the 5 basis point MBS benefit the companies retain exists regardless of the ability of lenders to negotiate guaranty fees. In fact, Fannie Mae's effective guaranty fee has decreased from 22 basis points in 1995 to 19.5 basis points in 2000, as the competition for guaranty fee business has intensified. The clear question is, how can a "retained subsidy" be unaffected at the same time as guaranty fees decline through competition? CBO presents no empirical evidence or theory as to why the 5 basis point figure is correct, or why it remains constant over time. Instead, they simply cite a report by Alden Toevs in 2000:

> *"Nevertheless, in order to maintain a benefit structure similar to the one used by the CBO and to see whether the impact of any reasonable assumption about a benefit is significant, we have assumed a 5 basis points benefit. This is a conservative approach that may overstate the benefit."*[12]

It is not convincing for CBO to cite Toevs as an authority without providing the full context of his report. In his report, he found that Fannie Mae and Freddie Mac provide more benefits to mortgage borrowers than they retain from any "subsidy." He also made it clear that the 5 basis point figure was an assumption <u>not</u> based on any empirical evidence. Toevs used the 5 basis points only to parallel CBO's calculations in the 1996 report. He concluded that, "Any such benefit is likely to be small."[13]

At the very least, given the lack of analysis CBO provides, any benefit would need to be cited as a range, perhaps zero to 5 basis points. This would allow CBO to recognize that competition has had a demonstrable effect on guarantee fees in the past five years, reducing or erasing any "retained subsidy."

[12] Toevs, *Op. Cit.* at 9.
[13] Toevs, *Op. Cit.* at 9.

CBO concludes that there is a $3.6 billion "benefit" from MBS guarantee activities. This $3.6 billion MBS benefit is based on a 30 basis point "subsidy" that is 10 basis points more than the gross revenue the companies receive from their guaranty fee. In addition, the assumed 5-basis point retained benefit to the companies does not hold up to analytical scrutiny. Under CBO's own analysis, the most that can be claimed as an MBS "subsidy" is 5 basis points, not 30. **Assuming a benefit of 0 to 5 basis points, the MBS benefit would decline from $3.6 billion to between zero and $0.6 billion.**

CBO Understates the Homeowner Benefit

The third methodological mistake relates to the homeowner or "pass-through" benefit that CBO applies only to the mortgages owned or securitized by Fannie Mae and Freddie Mac. As of December 31, 2000, Fannie Mae estimates that there were $5.6 trillion of residential mortgage debt outstanding. Fannie Mae bears interest rate risk through its mortgage portfolio on 11 percent of this market and effectively hedges most of that interest rate risk. Freddie Mac bears another 7 percent. Including net MBS outstanding, Fannie Mae bears credit risk on 21 percent of this market and hedges that risk as well. Freddie Mac bears another 16 percent.

CBO's analysis should reflect the impact on the total mortgage market. The companies' substantial investments in the mortgage market assure that every borrower eligible for a conforming mortgage enjoys lower rates, regardless of whether their mortgage is part of a transaction that involves Fannie Mae or Freddie Mac. The marginal borrower receives the market rate, and the market rate is substantially lower than it would be in the absence of the two companies' activities. The weekly mortgage rate sheets that appear in the newspaper do not distinguish between conforming loans bought or securitized by Fannie Mae or Freddie Mac and conforming loans untouched by either company. Federal Reserve Chairman Alan Greenspan agreed with this in his letter to Congressman Baker on August 25, 2000. He wrote:

> *"It should be noted that rates on all mortgages that are conforming for purchase by Fannie Mae or Freddie Mac, as well as those financed through FHLB advances, are influenced by the GSE "subsidy", aiding those that would have, without the "subsidy", purchased homes at higher rates as well as those induced to purchase by lower rates."*

In addition, as Toevs notes in his new report, CBO largely ignores the spillover impact of Fannie Mae and Freddie Mac on nonconforming mortgages.[14] He argues that CBO's estimate of a 3 basis point impact by the GSEs on jumbo rates is far too low and cites recent research that estimates the effect to be 10 basis points. He also notes that similar spillovers into subprime mortgage markets likely occur. CBO's analysis of the impact of FHLB "subsidies" on non-conforming mortgage rates is also an underestimate. Fannie

[14] *A Critique of the CBO's 2001 Study on 'Federal Subsidies and the Housing GSEs,* Alden L. Toevs, First Manhattan Consulting Group, May 2001, p. 11.

Mae estimates that, if this calculation were done correctly, it would increase the jumbo-conforming spread from CBO's estimate of 25 basis points to 58 basis points.[15]

CBO erred in not applying the mortgage interest savings to the entire conforming market. **Correcting this mistake to account for the entire conforming market increases the homeowner benefit from $6.7 billion to between $10.4 billion and $13.3 billion.**

In addition to missing the full impact of Fannie Mae and Freddie Mac's participation on the mortgage market, CBO acknowledges that it does not calculate the benefit from Fannie Mae's pursuit of our commitment to serve low- and moderate-income households. CBO states in the new report that:

> *"The housing GSEs are charged with increasing the availability of mortgages for low and moderate income borrowers…Any additional benefits to low income borrowers (beyond the estimated rate reduction on their conforming mortgages) are not estimated here."* (p. 11)

Lower interest rates in the conforming mortgage market are only the most visible sign of Fannie Mae's support for this market. In addition to lower rates, we provide liquidity and stability to the housing finance market, support innovation that removes barriers to homeownership, and invest in targeted housing finance for underserved borrowers.

- For example, Fannie Mae has launched two ambitious investment plans in the last decade. The *Trillion Dollar Commitment*, launched in 1994, was Fannie Mae's commitment to invest $1 trillion in targeted housing finance to serve 10 million families. Achieving this goal helped to transform the company. Between 1993 and 1999, the percentage of our business serving targeted households -- including low- and moderate-income families, minorities, new Americans, and residents of rural areas and central cities -- rose from 55 percent to 69 percent. And we dramatically increased the volume of mortgages we buy with low downpayments, from less than $100 million in 1990 to nearly $6.0 billion in 2000. As a result of our leadership, low-downpayment lending has become more readily available.

- In March 2000, Fannie Mae launched the successor to the *Trillion Dollar Commitment*. Our new *American Dream Commitment* is a 10-year, $2 trillion plan to raise homeownership rates for minorities and strengthen America's communities.

- We also create value through product innovation and market expansion. Borrowers who in the past only had access to subprime mortgage finance can now qualify for our Timely Payments Rewards mortgage. With this new mortgage, borrowers with slightly impaired credit can get a conventional loan with an interest rate two percentage points lower on average than the typical subprime mortgage, and their mortgage rate is further reduced after 24 months of on-time payments.

[15] Details of this calculation are available in Appendix 2.

- Fannie Mae has become the nation's largest investor in multifamily housing, with a book of business of $65 billion at the end of 2000. In 2000 alone, Fannie Mae made $13.5 billion in multifamily investments, creating or preserving affordable housing for more than 266,000 households. In addition, Fannie Mae's $1.3 billion in equity investments, through the purchase of low-income housing tax credits, makes us the largest investor in the nation's most significant program for the production of affordable rental housing.

- Fannie Mae's commitment to communities brings value to the neighborhoods where we work with local partners. In 2000, our American Communities Fund invested $124 million in such communities. Overall, Fannie Mae made more than $870 million in community development investments that leveraged over $1 billion in total community development investments.

All of these activities are at the core of Fannie Mae's mission and the Congressional requirements under which we operate. Our commitment to market leadership and our investments in more flexible underwriting, in expanding the availability of multifamily credit, and in community revitalization projects that stimulate other public and private investment confer substantial benefits to homeowners and renters. **CBO did not attempt to measure any of these benefits, and its analysis therefore fails to capture some of Fannie Mae's most important contributions to the housing and mortgage markets.**

VI. The Bottom Line is a Flawed Theory, Incorrectly Applied

The chart below shows the impact of correcting the major flaws related to the debt benefit, the MBS benefit, and the pass-through benefit to homebuyers. We calculate that correcting just these errors reverses the results from a "retained subsidy" of $3.9 billion to a net benefit to homeowners of between $5.6 billion and $9.7 billion.[16] Fannie Mae provides more benefits to homebuyers than it realizes from any theoretical "subsidy."

Fannie Mae clearly adds value to the mortgage market far beyond the confines of the theoretical model that CBO has posited, even if that model were accurately applied. The model suffers from the fallacy of reducing a business to an accounting exercise. This zero-sum logic does not accommodate the full value of what the companies bring to the market. Having posited a flawed theory, the report then uses erroneous assumptions to produce an inaccurate estimate. The result is a fundamental miscalculation of the benefits we receive and the value we bring to homeowners. For these reasons, we do not believe the report offers policymakers reliable or relevant analysis in seeking to support homeownership successfully.

[16] The tax benefit is included in order to present numbers comparable to those in the CBO report. The study does not account for the deductibility of state and local taxes from the companies' federal tax bills. State and local income taxes, SEC fees, and rating fees would all be deductible from Fannie Mae's federal income tax liability. This would reduce the size of the tax and regulatory benefit by about $300 million.

Benefit analysis correcting for flaws[17]
(Billions of dollars)

	CBO 1995	1995 Corrected	CBO 2000	2000 Corrected
Debt Benefit	$2.7	$1.4	$6.0	$3.0 to $3.6
MBS Benefit	$3.8	$0.5	$3.6	0 to $0.6
Tax Benefit	NA	NA	$0.9	$0.6
Gross "Subsidy"	$6.5	$1.9	$10.6	$3.6 to $4.8
(Homeowner Benefit)	($4.4)	($6.2)	($6.7)	($10.4) to ($13.3)
Retained "Subsidy"	$2.1	($4.3)	$3.9	($5.6) to ($9.7)

[17] Assumes a 27 rather than 47 basis point advantage on long-term debt, a 60/40 split in long-term vs. short-term debt, and a 5 basis point MBS benefit. CBO assumes in Table A-1 that the conventional conforming mortgages market, excluding government and jumbo, but including FRMs and ARMs is $3.5 trillion. Fannie Mae has an active securitization program for ARMs. We assume that the non-government portion of the market grows at a 9.8 percent annual rate, and that the "rollover" percentage is the same as that used by CBO. The discount rate for the present value calculation is the same as that used by CBO, as is the 25 basis point pass-through "subsidy." This table reflects calculations for Fannie Mae and Freddie Mac only. Numbers may not add to totals because of rounding.

Appendix 1: The Wrong Competitive Comparison

The new CBO report asks the wrong question when it attempts to measure a debt benefit by comparing yields on the companies' senior debt to that of banks. There are two problems with this approach.

- Bank senior debt is the highest cost and smallest component of a bank's funding base. Banks have access to non-interest and other low-cost insured deposits, while Fannie Mae and Freddie Mac can only raise funds by issuing debt. Because of this, banks' average cost of funds is lower than that of the GSEs.

- Bank senior debt is actually subordinated to claims of depositors, the FDIC, and the FHLBs. In addition, the heterogeneous and illiquid nature of bank assets means that the recovery rate in a bank default tends to be much lower than for an entity – such as Fannie Mae – that holds only residential mortgage loans.

Senior debt is the highest cost and smallest component of a bank's funding base. Because the banking industry does not issue much long-term senior debt, comparing the yield on senior long-term debt of banks to that of Fannie Mae overstates any benefit. At the end of 2000, only 1.7 percent of the banking industry's assets were financed with debt with a remaining maturity of more than three years. A more appropriate competitive comparison would measure the average cost of funds for Fannie Mae versus that for other financial institutions.

Banks and thrifts have access to low-cost, federally-insured deposits and low-cost advances from the Federal Home Loan Bank (FHLB) System, while Fannie Mae and Freddie Mac do not. Commercial banks and thrifts funded 65.9 percent of their balance sheets with deposits totaling $4.9 trillion, of which $4.2 trillion was in domestic bank and thrift offices (see table below). According to FDIC estimates, $3.1 trillion of those deposits were backed by the full faith and credit of the U.S. government.

The Funding Sources of Commercial Banks and Thrifts
(December 2000)

Source of Funds	Dollars ($B.)	Percent
Deposits	**$4,915**	**65.9%**
Federal Home Loan Bank Advances	**$436**	**5.8%**
Other Borrowed Funds	**$1,031**	**13.8%**
Subordinated Debt	**$90**	**1.2%**
All other Liabilities	**$356**	**4.8%**
Total Liabilities	**$6,828**	**91.5%**
Capital	**$633**	**8.5%**
Total Liabilities and Capital	**$7,461**	**100.0%**

In addition, consumers and businesses maintain hundreds of billions of dollars in non-interest-bearing checking accounts in banks. At the end of 2000, commercial banks held

$766 billion in such accounts -- an amount larger than Fannie Mae's entire balance sheet. Thus, the banking industry held more in funds with a zero-interest cost than Fannie Mae had in total debt outstanding.

Banks and thrifts fund short-term adjustable rate mortgages, home equity loans and second mortgage assets through deposits, not exclusively through debt. We estimate that as of December 31, 2000, banks and thrifts used federally-insured deposits to command an 84 percent share of the home equity loan and second mortgage market, and a 68 percent share of the ARM market. Fannie Mae and Freddie Mac, who do not have access to insured deposits but fund their operations with debt, had combined shares in these two market segments of just 2 percent and 5 percent, respectively.

Moreover, banks and thrifts have access to FHLB advances. The FHLB System sells debt to investors at yields comparable to those on Fannie Mae debt. CBO notes correctly that the FHLB charges a markup on its advances rates, but then it remits dividends to its members. FHLB member institutions therefore have access to virtually the same marginal cost of funds as Fannie Mae and Freddie Mac. The Federal Home Loan Bank System supplied the bank and thrift industries with $438 billion in advances in 2000.

As a result of the difference in structure and the government support that banks and thrifts receive, banks' average cost of funds is lower than that of GSEs, which is why banks use deposit funds to buy GSE debt securities. It is simple economics -- unless banks could raise funds more cheaply than Fannie Mae, how could they profitably invest in Fannie Mae debt?

Bank senior debt is actually subordinated to other claims and has low recovery rates. There are other reasons why bank senior debt is not truly comparable to GSE senior debt. Bank senior debt is actually subordinated to claims of depositors, the FDIC, and the FHLBs. Since a large majority of bank financing is provided through deposits, senior bank debt typically has a very junior claim on bank assets in default. In contrast, Fannie Mae and Freddie Mac senior debt holders do not stand behind depositors.

In addition, the heterogeneous and illiquid nature of bank assets means that the recovery rate in a bank default tends to be much lower than for an entity – such as Fannie Mae – that holds only residential mortgage loans. When S&P rates senior debt, it assesses the probability of default and not of loss. However, differential loss rates are key in assessing the spreads at which Fannie Mae debt might trade relative to other corporate bond issuers. Actual losses in default on corporate bonds have averaged almost 60 percent. In contrast, failed institutions that invested in single-family mortgages had losses of only 4 percent in their single-family mortgage portfolios. Bank senior debt trades 15-20 basis points higher in yield than similarly-rated debt from industrial issuers. Accordingly, the right comparison is almost certainly not to bank debt. In fact, even industrial yields are probably much too high because of the historically high losses associated with industrial corporate defaults.

Appendix 2: Other Errors in the 2001 CBO report

In addition to the key conceptual flaws, and the complete omission of benefits from Fannie Mae's mission activities, there are other errors that if corrected would further increase the net benefit to homebuyers:

- An error that would significantly change the results is the assumption regarding the capitalization horizon. The report assumes an average life of seven years for the mortgages in Fannie Mae's portfolio. CBO does not provide any evidence to substantiate this assumption. In fact, the duration of mortgage assets in our portfolio at year-end has averaged 42 months from 1996-2000, equivalent to an average life of about 5 years. CBO's limited sensitivity analysis shows that assuming a longer average life increases the size of the "subsidy." Using a correct estimate of the average life of our mortgage assets would greatly reduce the estimated debt benefit.

- The report does not calculate benefits to multifamily borrowers, but charges a "subsidy" on debt used to fund multifamily mortgages. Table 3 in the report shows total debt outstanding for Fannie Mae of $643 billion in 2000. However, this debt funds not only single-family mortgages, but also multifamily mortgages and non-mortgage investments held for liquidity. At year-end 2000, Fannie Mae's mortgage portfolio totaled $607 billion, of which $17 billion was in multifamily mortgages. Since CBO does not give any credit for the multifamily business, they should not charge a "subsidy" against debt used to fund this business. Excluding debt used for multifamily or liquidity purposes would result in a decrease in debt used in the calculation and the resulting "subsidies" of about 8 percent.

- The report incorrectly calculates the FHLBs benefit to jumbo mortgages, resulting in an underestimate of the jumbo-conforming spread. The report calculates that the FHLBs receive a "subsidy" on debt issuance that in 1999 was assessed at $2.1 billion. Having estimated that conforming mortgage rates were 22 basis points lower than nonconforming rates as a result of the GSE guarantee on their securities, the CBO presumed that the FHLB members would subsidize their purchases of conforming mortgages. More than $1 billion of flow "subsidy" is thus allocated to buy conforming mortgages at yields that are 22 basis points too low. The remaining "subsidy" is spread out evenly across the remaining $3.2 trillion of assets held by FHLBs.

    – The CBO makes a very unusual assumption: they assume the FHLBs do not maximize profit in their purchase of assets. If conforming mortgages do indeed have yields 22 basis points below non-conforming mortgages, any profit maximizing FHLB member would cease investing in conforming product and buy non-conforming mortgages or other assets. In fact, FHLB advances are only intended to support mortgage investments. A more reasonable assumption would be that the CBO's assessed $2.1 billion "subsidy" is allocated entirely to the highest-yielding mortgages (nonconforming mortgages). That assumption would cause nonconforming mortgage yields to fall by 36 basis points.

- The report presumes that some part of the FHLBs' "subsidy" is lost to homeowners through its use in funding other assets. While money is fungible, funding cannot pass freely across institutions. The ten largest FHLB advance holders (that held 32% of FHLB advances) are mainly mortgage specialists. On average more than 67 percent of their assets are residential mortgages. Even allowing for some use of FHLB funding to other uses than residential mortgages, that slippage must be heavily constrained by the asset portfolios of FHLB advance holders.

- Note that while the CBO assesses that more than $1 billion of funding "subsidy" is allocated, inappropriately, to conforming mortgages on a flow basis, on a present value basis only $250 million of "subsidy" goes to conforming mortgages. The two approaches produce results that are counter-intuitive.

- Interestingly, the report lists the federal government as a "stakeholder" in the FHLBs because they must pay 20 percent of their net income to meet an assessment for interest on the REFCORP bonds. Although Fannie Mae and Freddie Mac are subject to federal income tax at the corporate rate of 35 percent, no similar acknowledgement of an interest by the federal government is made in listing the "stakeholders" for those two companies.

- Correcting this analysis for the errors noted above would show that the three GSEs lower conforming mortgage rates by as much as 58 basis points, not 25 basis points as measured by CBO.