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CONGRESSIONAL TESTIMONY

**“Transparency, Transition and
Taxpayer Protection: More Steps to
End the GSE Bailout**

**Testimony before
Subcommittee on Capital Markets and
Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives**

May 25, 2011

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Good afternoon, I am David C. John, a Senior Fellow in Retirement Security and Financial Institutions at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

Starting about 157 B.C., The Roman statesman Cato the Elder began to end all of his public speeches, regardless of what the topic of the talk was, with the phrase “Carthago delenda est”, which translates “Carthage must be destroyed.” Cato did this to keep the focus on what he considered to be the ultimate goal, the elimination of a rival city to Rome’s supremacy. And in 146 B.C., Carthage was destroyed.

I mention this story because while this subcommittee is following a very logical and wise strategy of passing many small, but important individual bills designed to hasten the end of Fannie Mae and Freddie Mac, it is important to keep the focus on the end result – a housing market free of the massive distortion that is Fannie Mae and Freddie Mac. A bit later in my testimony, I will review additional steps that I believe are necessary to reach that goal.

Last month, this subcommittee marked up a package of eight bills that started the process of phasing out Fannie Mae and Freddie Mac and encouraging private competitors to provide the services that the two GSEs currently offer. The eight bills would increase the guarantee fees and require both to reduce the size of their portfolios to no more than \$250 billion over five years. In addition, the eight would eliminate affordable housing goals and prohibit both from entering new lending markets. Finally, the subcommittee’s package of bills would tighten existing restrictions on both entities by strengthening federal oversight and reducing pay at both entities to the same level as federal employees. Both Fannie Mae and Freddie Mac have been well known for their generous pay levels.

Before I discuss the seven bills before you today and my view of a way to reach the ultimate goal, let me also acknowledge Rep. Jeb Hensarling’s GSE Bailout Elimination and Taxpayer Protection Act, HR 1182, co-sponsored by Financial Services Committee Chairman Spencer Bacchus (R-AL), which would place a two-year limit on the current conservatorship and end the various affordable housing mandates that Congress imposed upon Fannie Mae and Freddie Mac. It would also place a \$700 billion cap on the size of their portfolios and shrink them to \$250 billion each over the next five years. Private-sector competitors would be encouraged to re-enter the market by reducing the maximum mortgage size that Fannie Mae and Freddie Mac could purchase and repackage into mortgage-backed securities and by gradually increasing the guarantee fee charged by them. Increasing the guarantee fee, which protects buyers of bonds created by packaged mortgages if the homebuyer defaults on the loan, will force Fannie and Freddie to compete on a more level playing field with private-sector financing.

Today’s seven bills

The policies contained in the seven additional bills that the subcommittee is examining today represent the next step in free the housing market from the influence of Fannie Mae and Freddie Mac. I have a couple of brief comments about the policy implications of each bill in the order in which they are listed in the hearing announcement.

1. **Prevent Dividend Payment Decrease:** This bill by Rep. Manzullo would prevent Treasury from reducing the dividend payment that Fannie Mae and Freddie Mac pay in return for the taxpayer dollars that they receive. It is only fair that the taxpayers receive some return for the literally hundreds of billions of dollars that they provide to the bankrupt GSEs, and that this amount remains constant. It would be best if the language is coordinated with that of the proposed legislation by Rep. Fitzpatrick to ensure that the two do not clash.
2. **Abolish the Affordable Housing Trust:** This bill by Rep. Royce is also a very valuable policy advance. While I am certainly not opposed to assisting moderate and low income workers to own their own home, these programs should be explicitly funded through the regular appropriations process, and not by assessing a fee on a supposedly privately owned company. The process has always been a way to sneak around the proper funding process, and should never have been started in the first place.
3. **Ensure an Exact GSE Replica is not Created:** This is also a very important policy goal. This bill by Rep. Stivers corrects a serious flaw in the Housing and Economic Recovery Act. The current GSEs should be eliminated, and not cloned to reappear in the future like a monster in a Grade B horror movie. Such an event would not only guarantee another taxpayer funded bailout in the future, it would stifle a badly needed debate on a reformed housing finance system that better meets the needs of today's consumers.
4. **Require Disposition of Non-Mission Critical Assets:** Rep. Hurt's legislation would assist in the process of replacing Fannie Mae and Freddie Mac with private sector entities. The money received from their sale could also help to lower the eventual cost of the bailout to taxpayers.
5. **Set a Bailout Cap for the GSEs:** I strongly sympathize with the policy recommendations behind Rep. Fitzpatrick's bill. An open-ended commitment to this bailout is wrong, and limits should be placed on it as long as they are crafted to be both practical and don't limit the ability of FHFA to best resolve Fannie Mae and Freddie Mac. For instance, the language needs to be crafted in a way that does not conflict with Rep. Manzullo's bill if either Fannie Mae or Freddie Mac earn enough in a quarter to repay only part of the dividend owed for their bailout and the overall effort is approaching the bailout cap. Under the current situation, they would borrow enough from Treasury to pay the dividend in full with the expectation that the total would be repaid at a later date. Further, this bill must not inadvertently affect the recovery of the overall housing market.
6. **Subject Fannie Mae and Freddie Mac to FOIA:** Rep. Chaffetz's bill would enable citizens to better understand how these two entities failed at such a

massive cost. It would also make it easier for private sector replacements to avoid the same errors, and to find and prosecute those officials who may have committed criminal acts that helped to weaken them.

7. **Prohibit Taxpayer Funding of GSE Legal Fees:** Taxpayers should not be on the hook for literally hundreds of millions of dollars in costs to defend those who caused the failure of Fannie Mae and Freddie Mac. FHFA made a serious error in continuing to pay those fees after the GSEs were taken into conservatorship. This practice should stop as soon as possible.

Focus on the Future by Eliminating the Portfolios of Fannie Mae and Freddie Mac

Eliminating Fannie Mae and Freddie Mac includes two tasks, but only one of them concerns future housing growth. The two housing giants both package new mortgages into securities that can be sold to investors and manage their existing portfolios of similar securities. Rather than placing equal weight on both, Congress should place a strong emphasis on fostering the growth of private-sector companies that will securitize new mortgages. The task of liquidating Fannie Mae and Freddie Mac's portfolios is of secondary importance and should be handled separately.

Both have huge portfolios. As of 2010, Fannie Mae had about \$789 billion worth of mortgage investments, while Freddie Mac had about \$697 billion. Some of each entity's investments are of such poor quality that they are essentially worthless; the rest should be sold off to recoup as much as possible of the taxpayer money that has been spent on covering the GSEs' losses. However, to avoid flooding a still shaky market for these securities, the sales should be handled over a number of years, and there is no reason to delay liquidating the two until it is completed. Both Fannie and Freddie would almost certainly have to be placed in a formal receivership instead of their current conservatorship status in order to transfer the portfolios.

The sale of the portfolios should be handled by a temporary subsidiary of the FHFA staffed with liquidation and investment professionals. This subsidiary would separate the good quality investments from the rest and sell them off as the market for them gradually firms up. At the same time, the poor quality assets could be sold for whatever the FHFA can get for them—again over time to avoid flooding the market.

Building for Tomorrow's Opportunities, Not Today's Fears

Once the portfolios of both GSEs have been separated from their parents, Congress can focus on creating a new housing finance system. This is not something to fear, but at the same time, care should be taken to avoid undermining the fragile recovery of the housing sector.

If all goes well, by the time that Fannie Mae and Freddie Mac completely disappear, the housing market should be fully recovered from the 2008 crash. Most of the housing and mortgage finance industry fear that eliminating the two GSEs could crimp that market's slow recovery. However, they are reacting to the past few years and not

looking towards the future. A careful and considered phase out should create conditions that will encourage private companies to package mortgages into securities and credit should be available to all creditworthy potential home buyers.

To avoid these problems, the end of Fannie Mae and Freddie Mac should come gradually—but with a clear, unambiguous understanding that they will be completely and permanently phased out. While some level of presence may be necessary while the housing sector recovers, there is a growing consensus that neither organization is necessary in the future. The private sector is more than capable of producing mortgage-backed securities and appropriately pricing a guarantee that should satisfy investors. There are plenty of investors who would be willing to buy mortgage-backed securities with a private guarantee instead of one by the government.

As the crash of 2008 showed, the old structure of housing finance was a spectacular and expensive failure. Allowing it to remain in place, or even worse, recreating it is the very last thing that either homeowners or taxpayers need to bequeath to future generations. Instead, both legislators and the Obama Administration should work to structure a mortgage-finance system based in the private sector that has the flexibility to meet market needs while still ensuring that mortgages meet strict underwriting standards and protecting consumers from predatory lending practices.

Separating Two Unrelated Functions

In addition to managing their portfolios, Fannie Mae and Freddie Mac have two additional responsibilities that should be handled separately. First, they purchase and package mortgages from banks and other originators, package them into mortgage-backed securities with a guaranty against credit risk. Second, they are required to meet a variety of housing policy goals aimed at ensuring that Americans of all income levels are able to own a home. These are two separate and distinct functions, and each require specific tasks to remove from Fannie Mae and Freddie Mac.

1. Encourage Private-Sector Replacement of the GSEs' Financial Activities. Since 2008, privately issued mortgage-backed securities which once had over half of the market, have virtually disappeared. These securities are important components of housing finance because they allow new money from investors who buy the securities to finance additional mortgages. Restoring private issuers will take time, and policymakers should encourage this with specific steps mentioned below.

In addition to the conventional forms of securitized mortgages, Congress should also encourage further exploration of covered bonds—a mortgage-financing mechanism used successfully in other countries to finance additional mortgages instead of mortgage-backed securities—and similar innovative financing methods. While ideally, the transition to private financing mechanisms should be as rapid as possible, policymakers should avoid the temptation to put firm deadlines on the complete phase-out of Fannie Mae and Freddie Mac given the still fragile state of the housing market. Instead, specific steps to encourage that transition should be clearly described and scheduled, with the

Federal Housing Finance Agency being given the job of monitoring the situation under close oversight and charged with ending the two GSEs as market conditions allow.

Private providers of mortgage-backed securities will reappear if the subsidized fees that the two GSEs charge for guaranteeing the credit quality of mortgages included in mortgage-backed securities gradually rise using a set and unambiguous schedule. In addition, the emergency legislation that allowed Fannie Mae and Freddie Mac to purchase mortgages of up to \$729,750 to include in their securities should be allowed to expire. This would drop the maximum to \$625,500, which should then be further reduced over time.

2. Move Subsidies and Policy Goals to HUD. Housing policy goals and subsidies should be separated from the market-oriented activity so that they do not distort incentives and decision making. The actual cost of the subsidies should be made transparent and placed on budget and then transferred to the Department of Housing and Urban Development (HUD). At the same time, the Financial Housing Enterprise Safety and Soundness Act of 1992, which imposes affordable housing goals on the GSEs, should be repealed, while other housing policy goals that were the responsibility of Fannie Mae and Freddie Mac should be moved to HUD. Once the subsidies and policy responsibilities are in HUD, Congress can eliminate those that are not necessary, cost effective, or affordable. The subcommittee has already started this process, and Mr. Royce's bill to abolish the Affordable Housing Trust Fund will continue that progress.

Congressional Oversight

In order to monitor that these changes are taking place, Congress should place explicit sunsets on the charters of both Fannie Mae and Freddie Mac rather than continuing the perpetual charters that the two GSEs have today. Sunsets would force a regular congressional reexamination of the phase-out process to ensure that it is continuing and not being circumvented by GSE staff. It would also allow for Congress to see if market conditions allow for the process to be conducted faster.

Fannie Mae and Freddie Mac have great expertise in issuing mortgage-backed securities that would be extremely valuable to the private sector. As the move toward private-sector mortgage-backed securities grows, Congress should also sell off pieces of the two GSEs' underwriting activities to private companies. However, Congress should not sell pieces that are geographically based, since these pieces could be reattached to recreate the two GSEs. Instead, portions that are sold should contain a geographically dispersed share of mortgages and should be sold to purchasers of different sizes and in differing locations, including at least some smaller banks or other financial entities.

Making Housing GSE-Free

Creating Fannie Mae and Freddie Mac were serious policy mistakes, as were subsidizing them through privileged access to federal funds and implicit guarantees. These mistakes should never be repeated. Nothing less than the complete elimination of

both Fannie Mae and Freddie Mac is acceptable. This is not a development to fear but rather the first step in rebuilding a modern housing finance industry that would provide Americans with greater opportunities to own their own home without the risk of another multi-hundred-billion-dollar bailout.

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United States House of Representatives
Committee on Financial Services

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