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FANNIE MAE AND FREDDIE MAC

Analysis of Options for Revising the Housing Enterprises' Long-term Structures

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Chairman Dodd, Ranking Member Shelby, and Members of the Committee:

I am pleased to be here today to discuss the results of our recently issued report on options for restructuring two government-sponsored enterprises (GSE): Fannie Mae and Freddie Mac (enterprises).[1] On September 6, 2008, the Federal Housing Finance Agency (FHFA) placed Fannie Mae and Freddie Mac in conservatorship out of concern that their deteriorating financial condition and potential default on $5.4 trillion in financial obligations threatened the stability of financial markets. Since then, the Department of the Treasury (Treasury) has provided nearly $100 billion to the enterprises, and the Congressional Budget Office (CBO) estimated that the total cost of Treasury financial assistance will be nearly $400 billion.[2] Moreover, the Board of Governors of the Federal Reserve System (Federal Reserve) has committed to purchasing up to $1.45 trillion in the debt and securities of the enterprises (and other entities) to support housing finance, housing markets, and financial markets. While the conservatorships can remain in place as efforts are undertaken to stabilize the enterprises and restore confidence in financial markets, FHFA said that the conservatorships were not intended to be permanent. Over the longer term, Congress and the executive branch will face difficult decisions on how to restructure the enterprises and promote housing opportunities while limiting risks to taxpayers and the stability of financial markets.

Congress originally established Fannie Mae and Freddie Mac as government entities in 1968 and 1989, respectively, chartering them as for-profit, shareholder-owned corporations.[3] They share a primary mission that has been to stabilize and assist the U.S. secondary mortgage market and facilitate the flow of mortgage credit, including in periods of economic

[1]GAO, *Fannie Mae and Freddie Mac: Analysis of Options for Revising the Housing Enterprises' Long-Term Structures*, GAO-09-782 (Washington, D.C.: Sept. 10, 2009).

[2]On September 7, 2008, Treasury agreed to provide up to $100 billion in financial support to each enterprise through the purchase of its preferred stock so that the enterprises could maintain a positive net worth. In February 2009, Treasury increased this commitment to $200 billion per enterprise. Treasury also agreed to purchase the enterprises' mortgage-backed securities and establish a lending facility to meet their borrowing requirements if needed.

[3]Congress initially chartered Fannie Mae in 1938 but did not establish it as a shareholder-owed corporation until 1968. Congress initially established Freddie Mac in 1970 as an entity within the Federal Home Loan Bank System and reestablished it as a shareholder-owned corporation in 1989.

stress. To accomplish this goal, the enterprises issued debt and stock and used the proceeds to purchase conventional mortgages (conforming mortgages) that met their underwriting standards from lenders such as banks or thrifts.[4] In turn, banks and thrifts used the proceeds to originate additional mortgages. The enterprises held some of the mortgages they purchased in portfolio, but packaged most into mortgage-backed securities (MBS) sold to investors in the secondary mortgage market.[5] For a fee, the enterprises guaranteed the timely payment of interest and principal on MBS that they issued. Charter requirements for providing assistance to the secondary mortgage markets also specify that those markets are to include mortgages on residences for low- and moderate-income families (targeted groups). In 1992, Congress instituted authority for requiring the enterprises to meet numeric goals set by the Department of Housing and Urban Development (HUD) annually for the purchase of single- and multifamily mortgages that serve targeted groups.

While the enterprises operated profitably for many years, their structures long have been in question. For example, critics questioned the extent to which private for-profit corporations could be expected to serve a federally mandated housing mission. Furthermore, critics stated that federal sponsorship conveyed certain financial and other advantages that encouraged them to engage in riskier activities than otherwise would be the case. In particular, despite the lack of an explicit government guarantee on enterprise debt and MBS, the assumption in financial markets of an "implied" federal guarantee enabled the enterprises to borrow at lower rates than other for-profit corporations. Critics argued that this implicit guarantee and access to less costly credit created a moral hazard, or encouraged the enterprises to assume greater risks and hold less capital than would have been the case in the absence of a guarantee.

[4]For example, the enterprises typically purchased mortgages with loan-to-value ratios of 80 percent or less (mortgages with down payments of at least 20 percent) and required private mortgage insurance on mortgages with higher loan-to-value ratios. The enterprises also had a limit on the size of mortgages they purchased (the conforming loan limit), with mortgages above this limit called jumbo mortgages. The conforming conventional market differs from other markets (such as the subprime market) that generally have differing underwriting standards, or markets in which the federal government insures or guarantees mortgages (for example, through Federal Housing Administration or Department of Veterans Affairs programs).

[5]Each enterprise's portfolio also includes MBS that it issued.

We initiated our recently issued report—on which my statement is based—as part of a broader effort to assist Congress in its efforts to address the current financial crisis and weaknesses in the U.S. financial regulatory system. The report provides Congress with information on the roles, benefits, and risks associated with the enterprises' activities and is intended to help inform the forthcoming deliberation on their future structures. In my testimony, I will

- summarize the enterprises' performance in achieving key housing mission objectives;
- identify various options for revising the enterprises' long-term structures;
- analyze these options in terms of their potential capacity to achieve key housing mission and safety and soundness objectives; and
- discuss how the federal government's management of the conservatorships and response to the housing crisis could affect any transition.

To meet our objectives, we reviewed reports, studies, and data on the enterprises and their regulation, including our reports, as well as proposals to revise their structures. We met with researchers who wrote relevant reports on or were knowledgeable about enterprise-related issues and with representatives from FHFA, Treasury, the Federal Reserve, HUD, the Government National Mortgage Association (Ginnie Mae), CBO, the enterprises, banking and mortgage organizations, the National Association of Home Builders, and community groups. In addition, FHFA provided written comments on a draft of the report. FHFA stated that the report is timely and does a good job summarizing the dominant proposals for restructuring the enterprises and some of their strengths and weaknesses. FHFA also offered key questions and principles for guiding initial decisions that will have to be made about the future of the mortgage market.

Enterprises Had a Mixed Record in Achieving Housing Mission Objectives, and Risk Management Deficiencies Compromised Their Safety and Soundness

It is generally accepted that the enterprises were successful in achieving key housing mission objectives to support the secondary mortgage market and facilitate the flow of mortgage credit: (1) We reported that the enterprises established a viable mortgage market for secondary loans that enabled capital to flow to areas with the greatest demand for mortgage credit. (2) The enterprises' activities have been credited with lowering interest rates on qualifying mortgages below what they otherwise would have been, although estimates regarding the extent of this benefit vary.[6] (3) Furthermore, the enterprises established underwriting practices and forms for conventional mortgages that became standard in the industry, increased the efficiency of underwriting, and helped develop the MBS market.

However, it is not clear to what extent the enterprises have been able to support a stable and liquid secondary mortgage market during periods of economic stress, which is another key objective. As noted in our 1996 report, we did not find clear evidence that Fannie Mae's mortgage purchase activities during the 1980s supported mortgage markets in certain states that had experienced substantial economic setbacks.[7] During the current financial crisis, the enterprises have provided critical support to mortgage finance as private-sector MBS issuance largely collapsed. Yet the enterprises have been able to provide this support to mortgage finance only with the substantial financial assistance from Treasury and the Federal Reserve discussed earlier.

While the enterprises also were to facilitate mortgage credit opportunities for targeted groups, it is not clear that the numeric mortgage purchase program materially benefited such groups. HUD administered the program

[6]In 1996, we participated in research with CBO, HUD, and Treasury that included analysis of the degree to which the advantageous borrowing rates the enterprises derived from government sponsorship were passed to borrowers. We estimated the benefit on interest rates on 30-year, fixed-rate, single-family mortgages below the conforming loan limits ranged from 15 to 35 basis points (a basis point is equal to one 1/100 of a percent). This amounted to a savings of about $10–$25 on the monthly payments on a $100,000 mortgage. See GAO, *Housing Enterprises: Potential Impacts of Severing Government Sponsorship*, GAO/GGD-96-120 (Washington, D.C.: May 13, 1996). More recent research by Federal Reserve staff suggests that borrower savings ranged from 0 to 7 basis points. See Wayne Passmore, Shane M. Sherlund, and Gilliam Burgess, "The Effect of Housing Government-Sponsored Enterprises on Mortgage Rates," *Real Estate Economics*, 33, Fall 2005: 427-463, and Wayne Passmore, Diana Hancock, Andreas Lehnert, and Shane Sherlund, "Federal Reserve Research on Government-Sponsored Enterprises," Proceedings from the 42th Annual Conference on Bank Structure and Competition, May 2006.

[7]GAO/GGD-96-120.

from 1992 until the authority was transferred to FHFA in 2008. Recent research indicates that, although the enterprises have enhanced their product offerings to meet the housing goals, the effects of the housing goals on affordability and opportunities for targeted groups have been limited. For example, one study found that as the enterprises' activities increased in certain areas pursuant to the mortgage purchase program, they may have been offset by a decline in FHA's existing activities in those areas.[8] Earlier research sponsored by HUD in 2001 found that the enterprises generally did not play a leading role in affordable multifamily mortgage finance because their underwriting standards were considered conservative and fairly inflexible, compared with those of other multifamily mortgage providers.[9] In contrast, I should note that representatives from mortgage finance, housing construction, and consumer groups we contacted said that the benefits from enterprise purchases of multifamily mortgages were significant. The representatives said that the enterprises' involvement in or guarantees of the financing of affordable multifamily projects were crucial to their successful completion. In addition, they said that during the current financial crisis the enterprises were the only source of funding for multifamily projects because many other traditional providers, such as banks and insurance companies, largely have withdrawn from the market.

While housing finance may have benefited from the enterprises' activities over the years, GAO, federal regulators, researchers, and others long have argued that the enterprises' structures (for-profit corporations with government sponsorship) undermined market discipline and provided incentives to engage in potentially profitable but risky business practices that did not necessarily support their public missions. As examples,

- We and others raised consistent concerns about rapid growth in the enterprises' retained mortgage portfolios, which reached a combined $1.6 trillion by 2005. Although increasing the size of the portfolios may have been more profitable than issuing MBS, it exposed the enterprises to significant interest rate risk. We reported that the rapid increase and the

[8]Xudong An and Raphael Bostic, "GSE Activity, FHA Feedback, and Implications for the Efficacy of the Affordable Housing Goals," *Journal of Real Estate Finance and Economics* 36 (2008) 37: 207-231.

[9]Abt Associates, "Study of the Multifamily Underwriting and the GSEs' Role in the Multifamily Market: Final Report," prepared for HUD (August 2001).

associated interest rate risk did not result in a corresponding benefit to the achievement of their housing missions.

- In 2003 and 2004, the enterprises were found to have manipulated accounting rules so that their public financial statements showed steadily increasing profits over many years and thereby increased their attractiveness to potential investors. The misapplication of accounting rules generally involved standards for reporting on derivatives, which the enterprises used to help manage interest rate risks associated with their large retained portfolios. The enterprises had to restate their financial statements and adjust their earnings reports by billions of dollars.
- Finally, beginning in 2004 and 2005, the enterprises purchased a large volume of questionable mortgage assets, such as private-label MBS and Alt-A mortgages, which typically did not have documentation of borrowers' incomes and had high loan-to-value or debt-to-income ratios. According to FHFA, these questionable mortgage assets accounted for less than 20 percent of the enterprises' total assets but represented a disproportionate share of credit-related losses in 2007 and 2008. FHFA stated that the losses on these assets helped precipitate the enterprises' financial deterioration and resulted in the decision to place them in conservatorship in September 2008.

Options for Restructuring the Enterprises Aim to Achieve Housing Mission Objectives while Mitigating Safety and Soundness Risks

The enterprises' mixed records in achieving their housing mission objectives and the losses and weaknesses that resulted in the conservatorships reinforce the need for Congress and the executive branch to fundamentally reevaluate the enterprises' roles, structures, and business activities in mortgage finance. Researchers and others believe a range of options could better achieve housing mission objectives (in some cases through other federal entities such as FHA), help ensure safe and sound operations, and minimize risks to financial stability. These options generally fall along a continuum, with some overlap among key features, and advocate (1) establishing a government corporation or agency, (2) reconstituting the enterprises as for-profit GSEs in some form, or (3) privatizing or terminating them (see table 1).

Table 1: Summary of Options to Revise the Enterprises' Structures

Potential structure	Proposed function
Government corporation or agency	Focus on purchasing qualifying mortgages and issuing MBS but eliminate mortgage portfolios, which are complex to manage and can result in losses due to fluctuations in interest rates. Responsibilities for promoting homeownership for targeted groups could be transferred to FHA, which insures mortgages for low-income and first-time borrowers.
Reestablish for-profit enterprises with government sponsorship	Restore the enterprises to their previous status but add controls to minimize risk. These controls might include eliminating or reducing mortgage portfolios or imposing public utility-type regulation, which involves business activity restrictions and profitability limits, and establishing executive compensation limits. Or, convert the enterprises from publicly traded, shareholder-owned corporations to cooperative associations owned by mortgage lenders.
Privatization or termination	Abolish the enterprises and disperse mortgage lending and risk management throughout the private sector. Some proposals involve the establishment of a federal mortgage insurer to help protect mortgage lenders against catastrophic mortgage losses.

Source: GAO.

The following paragraphs summarize key principles and aspects of each option:

Government corporation or agency.[10] Supporters of these proposals maintain that the implied federal guarantee and the enterprises' need to respond to shareholder demands to maximize profitability encouraged excessive risk taking and ultimately resulted in their failures. They believe that a government entity, which would not be concerned about maximizing shareholder value, would best ensure the availability of mortgage credit for primary lenders while minimizing risks associated with a for-profit structure with government sponsorship. Establishing a government corporation or agency also would help ensure transparency through appropriate disclosures of risks and costs in the federal budget. Elements of the proposals include eliminating retained mortgage portfolios over time; establishing sound underwriting standards and risk-sharing arrangements with the private sector; establishing financial and accountability requirements for lenders; instituting consumer protection standards for borrowers; and eliminating responsibility for the numeric mortgage purchase program (instead, FHA's mortgage insurance programs would be expanded to address this objective).

[10]See Dwight M. Jaffee, "Reforming Fannie and Freddie," *Regulation*, Winter 2008-2009: 52-57, and Thomas H. Stanton, "Lessons from Public Administration: Recommendations for the Future of Fannie Mae and Freddie Mae," presented at the 45th Annual Conference on Bank Structure and Competition, Federal Reserve Bank of Chicago, May 7, 2009.

Reconstituted GSEs. Market participants and commenters, trade groups representing the banking and home construction industries, and community and housing advocates we contacted believe that reconstituting the enterprises would help ensure that they would remain responsive to market developments, continue to produce innovations in mortgage finance, and be less bureaucratic than a government agency or corporation. But they also advocate a variety of additional regulations and ownership structures to help offset the financial risks inherent in the for-profit GSE structure, such as substantially downsizing or eliminating the enterprises' mortgage portfolios; breaking up the enterprises into multiple GSEs to mitigate safety and soundness and financial stability risks; establishing public utility-type regulation for the enterprises (for example, limiting their rates of return); and converting the enterprises into lender-owned associations (creating incentives for mortgage lenders to engage in more prudent underwriting practices).

Privatization or termination. Some analysts and financial commenters contend that privatizing or terminating the enterprises (including dispersing key functions among private-sector entities) represents the best public policy option.[11] Advocates believe that privatized entities would align mortgage decisions more closely with market factors and that the resultant dispersal of credit and interest rate risk would reduce safety and soundness risks. Federal Reserve Chairman Ben S. Bernanke has suggested that privatized entities may be more innovative and efficient than government entities, and operate with less interference from political interests.[12] Elements of the proposals include introducing a transition period to mitigate any potential market disruptions and facilitate the development of a new mortgage finance system; and establishing a federal entity to provide catastrophic mortgage insurance for lenders and help

[11]We treat "termination" and "privatization" as equivalent terms.

[12]Federal Reserve Chairman Ben S. Bernanke, "The Mortgage Meltdown, the Economy, and Public Policy," presented at the University of California at Berkeley/University of California at Los Angeles Symposium (Berkeley, California, Oct. 31, 2008).

ensure that mortgage markets would continue functioning during stressful economic periods.[13]

A Framework for Analyzing Trade-offs Associated with the Options and Potential Oversight and Regulatory Structures to Help Ensure Their Effective Implementation

We sought to assess each restructuring option in terms of its capacity to meet key housing objectives (providing liquidity and support to mortgage markets and facilitating housing opportunities for targeted groups) while also mitigating safety and soundness and financial stability risks. Our analysis indicates that each option involves important trade-offs, which are summarized in table 2. The table also identifies regulatory and oversight structures that might help ensure that any option implemented would achieve housing mission and safety and soundness objectives.

[13]See Arnold Kling, "Freddie Mac and Fannie Mae: An Exit Strategy for the Taxpayer," Cato Institute Briefing Papers, no. 106 (Washington, D.C.: Sept. 8, 2008). For additional information on privatization and transition issues, see Peter Wallison, Thomas H. Stanton, and Bert Ely, *Privatizing Fannie Mae, Freddie Mac, and the Federal Home Loan Banks: Why and How*, The AEI Press (Washington, D.C.: 2004); and HUD, Policy Development and Research, *Studies on Privatizing Fannie Mae and Freddie Mac* (Washington, D.C.: 1996). See also Diana Hancock and Wayne Passmore, "Three Mortgage Innovations for Enhancing the American Mortgage Market and Promoting Financial Stability" The University of California at Berkeley/University of California at Los Angeles Symposium. (Berkeley, California, Oct. 31, 2008).

Table 2: Trade-offs Associated with Enterprise Reform Options as They Relate to Long-Established Enterprise Objectives and Potential Oversight Structures

Proposed reform option	Provide liquidity and support to mortgage markets, including in bad economic times	Support housing opportunities for targeted groups	Ensure safe and sound operations	Possible elements of regulatory and oversight structure
Government corporation or agency	A government entity, with access to Treasury-issued debt to fund its operations, may be in a better position to provide liquidity to the mortgage market during normal economic periods and when capital markets are impaired. However, because in some cases investor demand for its MBS may be limited in times of financial stress, a government entity that does not have a retained portfolio may face challenges supporting mortgage markets during such periods. Treasury or the Federal Reserve may have to purchase mortgage assets under such circumstances (as has been the case during the current disruption in mortgage credit markets).	A government entity most likely would be expected to pursue housing opportunity programs for targeted groups because of its public status. However, if the government entity does not have a retained mortgage portfolio, it may face certain challenges in managing a housing goal program, since some types of affordable loans, like multifamily loans may be difficult to securitize, and therefore, often have been held in portfolio. As alternatives, fees could be assessed on the government entity's activities to support housing opportunities for targeted groups or FHA's mortgage insurance programs could be expanded.	This structure may represent less risk than has been the case with the GSE structure because MBS issuance is less complicated and risky than managing a retained mortgage portfolio. However, this activity still would be more complicated than Ginnie Mae's (a government corporation that does not buy or sell loans or issue MBS) and could result in substantial taxpayer losses if mismanaged. A government corporation could face greater challenges than private-sector entities in obtaining the human and technological resources needed to manage complex processes or it might lack the operational flexibility to do so.	Key elements for consideration include (1) certain operational flexibilities to obtain appropriate staff and information technology to carry out responsibilities, (2) risk-sharing agreements with private lenders or mortgage insurers, (3) appropriate disclosures in the federal budget of risks and liabilities to ensure financial transparency, and (4) robust congressional oversight of operations.

Proposed reform option	Provide liquidity and support to mortgage markets, including in bad economic times	Support housing opportunities for targeted groups	Ensure safe and sound operations	Possible elements of regulatory and oversight structure
Reconstituted GSEs	As reconstituted GSEs, the enterprises may provide liquidity and other benefits to mortgage finance during normal economic times, as they did for many years. However, their ability to provide such support during stressful economic periods is questionable given current experience. Furthermore, with significantly reduced or eliminated retained mortgage portfolios, the capacity of reconstituted GSEs to provide support to mortgage markets during periods of economic distress also may be limited.	Reconstituted GSEs, with their responsibility to maximize profits for their shareholders, might find it difficult to support some public policy housing initiatives. Moreover, without a retained mortgage portfolio, the reconstituted GSEs may face challenges in implementing a numeric housing goal purchase program. This challenge could be addressed by permitting a reconstituted GSE to maintain a relatively small portfolio or by supporting housing opportunities for targeted groups through assessments on its activities.	The current financial crisis highlights problems with the traditional GSE structure, including incentives to increase leverage and maximize portfolios. Reconstituting the GSEs would reestablish and might strengthen the incentive problems, which could lead to even greater moral hazard and safety and soundness concerns and increase systemic risks. Proposals to regulate GSEs like public utilities in principle could constrain excessive risk-taking, but the applicability of this model to the enterprises has not been established. Moreover, FHFA has not been tested as an independent safety and soundness and housing mission regulator, as the agency has largely acted as a conservator since its establishment in July 2008.	Key elements for consideration include (1) reducing or perhaps eliminating retained mortgage portfolios as deemed appropriate depending on prioritization of numeric housing and safety and soundness objectives, (2) establishing capital standards commensurate with relevant risks, (3) developing additional regulations such as executive compensation limits or perhaps including public utility-type regulation, (4) requiring appropriate financial disclosures in the federal budget to enhance transparency, and (5) ensuring strong congressional oversight of the enterprises’ and FHFA’s performance.

Proposed reform option	Provide liquidity and support to mortgage markets, including in bad economic times	Support housing opportunities for targeted groups	Ensure safe and sound operations	Possible elements of regulatory and oversight structure
Privatization or termination	Privatizing or terminating the enterprises would eliminate many problems with the current GSE model, including the conflict between public policy and private shareholders. If key enterprise activities such as mortgage purchases and MBS issuances are provided by other financial institutions, liquid mortgage markets could be reestablished in normal economic times. There is significant reason to question the capacity of private banks to support mortgage markets in times of financial distress without government support, given the failure or near failure of key financial institutions and the absence of private-label securitization during the current financial crisis. A federal mortgage insurer could help such lenders provide liquidity and other benefits in times of financial stress.	Privatization or termination would remove the traditional legislative basis, government sponsorship, for the enterprises to implement programs to serve the mortgage credit needs of targeted groups. However, the basis for such programs may remain if a government insurer for mortgage debt is established and the federal government guarantees its financial obligations. Furthermore, Congress might justify the programs on the grounds that large lenders that assume responsibility for key enterprise activities or purchase their assets are viewed as "too big to fail" and benefit from implied federal guarantees of their financial obligations.	Termination and reliance on private-sector firms would leave market discipline and regulators of financial institutions with responsibility for promoting safety and soundness. However, moral hazard concerns would remain if some mortgage lenders were deemed "too big to fail." These concerns may be heightened because the current financial regulatory system already faces challenges in overseeing such organizations. Additionally, safety and soundness concerns may remain if a federal entity were established to insure mortgage debt and did not charge appropriate premiums to offset the risks it incurred. FHA and the FHLBank System may become more prominent if the enterprises were privatized or terminated.	The need for a new financial regulatory system, due to concerns about the current fragmented system, may be heightened to the extent that terminating or privatizing the enterprises results in larger and more complex financial institutions. In considering a new system, Congress should consider the need to mitigate taxpayer risks and consider establishing clear regulatory goals and a systemwide risk focus. If a new federal mortgage insurer is established, there should be an appropriate oversight structure for such an entity. This structure might include appropriate regulations and capital standards, the disclosure of risks and liabilities in the federal budget, and congressional oversight.

Source: GAO.

While the table provides a comprehensive overview of our analysis, let me highlight some implications and trade-offs as they relate to the critical issues of safety and soundness and systemic risk. In some regards, a government entity may mitigate the safety and soundness and systemic risk concerns of the traditional GSE structure. That is, it would eliminate the concern that publicly held profit-maximizing corporations would be able to operate with relatively low levels of capital and take excessive risks because of an implied federal guarantee that undermined market discipline. And, if a government entity were to focus on MBS issuances and not retain a mortgage portfolio, then it would be less complex and potentially less risky than the GSEs were. Nevertheless, a government entity may find successfully managing a large conventional mortgage purchase and MBS issuance business to be challenging. As described in our previous work on FHA, government entities may lack the financial

resources to attract highly skilled employees and obtain information technology to manage complex business activities.[14] The failure to adequately manage the associated risks also could result in significant losses for taxpayers. For example, the enterprises' losses in recent years have been credit-related (because of mortgage defaults), including substantial losses in their MBS guarantee business. This risk may be heightened if a government entity was expected to continue purchasing mortgages and issuing MBS during stressful economic periods.

Reconstituting the GSEs could present significant safety and soundness concerns as well as systemic risks to the financial system. In particular, the potential that the enterprises would enjoy explicit federal guarantees of their financial obligations, rather than the implied guarantees of the past, might serve as incentives for them to engage in risky business practices to meet profitability objectives. One option to mitigate these safety and soundness concerns would be to make the enterprises into lender-owned associations. By selling mortgages to the enterprises, lenders would have financial incentives to adopt sound underwriting practices (as any losses the reconstituted GSEs incurred on such mortgages would affect the lenders' investments in them). While the public utility model of regulation also has been proposed to help mitigate the risks associated with reconstituting the GSEs, it is not clear that this model is appropriate. Unlike natural monopolies such as electric utilities, the enterprises faced significant competition from other providers of mortgage credit over the years.

It is difficult to determine the extent to which privatizing or terminating the enterprises mitigates current safety and soundness and financial stability risks. Under one scenario, such risks would be mitigated because large and complex enterprises that might engage in risky business practices due to an implied federal guarantee would not exist. Instead, private lenders would be subject to market discipline and be more likely to make credit decisions on the basis of credit risk and other market factors. However, if a federal entity were established to insure mortgage debt and did not set appropriate premiums to reflect its risks, then lenders might have incentives to engage in riskier business practices than otherwise

[14]See GAO, *Federal Housing Administration: Modernization Proposals Would Have Program and Budget Implications and Require Continued Improvement in Risk Management*, GAO-07-708 (Washington, D.C.: June 29, 2007) and *Information Technology: HUD Needs to Strengthen Its Capacity to Manage and Modernize Its IT Environment*, GAO-09-675 (Washington, D.C.: July 31, 2009).

would be the case. Moreover, if large private-sector financial institutions assumed responsibility for key enterprise activities or purchased a significant portion of their assets, the perception could arise that the failure of such an institution would involve unacceptable systemic financial risks. Therefore, perceptions that the federal government would provide financial assistance to such financial institutions could undermine market discipline. As we previously reported, the fragmented and outdated U.S. financial regulatory structure already lacks the capacity to effectively oversee large financial conglomerates and reform is urgently needed.[15]

Oversight and regulatory structures could help ensure that each option mitigated safety and soundness and systemic risk concerns while helping to achieving housing mission objectives. These oversight and regulatory structures could include the following:

- for the government entity, granting operational flexibility to obtain staff and informational technology to carry out responsibilities, requiring appropriate disclosures in the federal budget of risks and liabilities to ensure transparency, and instituting robust congressional oversight;
- for the reconstituted GSE option, reducing or perhaps eliminating mortgage portfolios, establishing capital standards commensurate with risk, and establishing executive compensation limits; and
- for the privatization or termination option, reforming the current regulatory structure, setting capital standards commensurate with risks (if a federal insurer is established), disclosing risks and liabilities in the federal budget in the interests of transparency, and instituting robust congressional oversight.

[15] GAO, *Financial Regulation: A Framework for Crafting and Assessing Proposals to Modernize the Outdated U.S. Financial Regulatory System*, GAO-09-216 (Washington, D.C.: Jan. 8, 2009).

Federal Efforts to Support Housing Markets during the Conservatorships Could Affect Transition to New Structures

Since the beginning of the FHFA conservatorships, the enterprises have been tasked to initiate a range of programs, such as assisting homeowners to refinance or modify their mortgages. These initiatives could benefit housing markets and, in doing so, potentially improve the enterprises' financial condition. However, the initiatives also may involve additional risks and costs for the enterprises, which could increase the costs and challenges associated with transitioning to new structures. For example, borrowers who received mortgage loan modifications could redefault, incurring additional losses.

Similarly, certain provisions in the Treasury agreements with the enterprises may affect their long-term financial viability and complicate any transition. For example, the enterprises must pay quarterly dividends that accrue at 10 percent annually to the Treasury, and in a liquidation proceeding the department has a claim against the assets of any enterprise that cannot pay such dividends. Since Treasury has already purchased $50 billion in preferred shares of Freddie Mac to date, the enterprise is responsible for paying a dividend to Treasury of $5 billion annually. Prior to the conservatorship, Freddie Mac's reported annual net income twice came close to or exceeded $5 billion, and the dividends it distributed to shareholders in those years likely were substantially lower.

Although it is not possible to predict what effects federal initiatives to respond to the housing crisis and the Treasury agreements with the enterprises could have on any transition, they could be substantial. For example, under the proposal to reconstitute the enterprises, potential investors might not be willing to invest in reconstituted GSEs that had a substantial volume of nonperforming mortgage assets or financial obligations to Treasury. To minimize this risk, the federal government could retain nonperforming assets in a "bad bank," spin off the performing assets to a "good bank," and devolve key functions, such as issuing MBS, to investors in a reconstituted GSE.[16] Or, the federal government could use this process to terminate or privatize the enterprises. However, to the extent that the enterprises previously engaged in activities or incurred financial obligations inconsistent with maintaining long-term financial viability, the level of nonperforming assets and long-term costs to taxpayers may be higher than otherwise would be the case.

[16]Such proposals generally involve the federal government maintaining existing guarantees on the assets in the "bad bank" as well as assets in the "good bank" as may be required.

Regardless of what changes are implemented, policymakers should pay careful attention to how a potential transition is managed to mitigate potential risks to the housing finance system. The enterprises evolved to become dominant participants in housing finance, and, in some respects, their roles have expanded during the conservatorships. Therefore, transitioning to a new structure could have significant consequences for housing finance and should be managed carefully and perhaps implemented in phases, with periodic evaluations to determine if corrective actions were necessary.

Finally, regardless of any enterprise structural reforms that are adopted, we urge Congress to continue to actively monitor the progress of such implementation and to be prepared to make legislative adjustments to ensure that any changes are as effective as possible. In addition, we believe that it is important that Congress provide for appropriate GAO oversight of any structural and related reforms to help ensure accountability and transparency in any new system. GAO stands ready to assist the Congress in its oversight capacity and evaluate the progress that is being made in implementing any changes.

Chairman Dodd, Ranking Member Shelby, and Members of the Committee, this concludes my prepared testimony. I would be pleased to address any questions that you or the members of the committee may have.

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