Center for American Progress Action Fund

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before

The Committee on the Budget
United States House of Representatives

hearing on

"Fannie Mae, Freddie Mac & FHA:
Taxpayer Exposure in the Housing Market"

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Chairman Ryan, Ranking Member Van Hollen, and members of the Committee, thank you for the opportunity to testify today about the budgetary treatment of Fannie Mae, Freddie Mac, and the Federal Housing Administration.

As I understand it, the primary purpose of this hearing is to examine how the federal budget reflects the taxpayer's cost of federal support for the housing market through the government-sponsored enterprises, or GSEs, in conservatorship, Fannie Mae and Freddie Mac, as well as the Federal Housing Administration, or FHA.

Let me begin by making three central points about the budget impact of the GSEs:

- First, the cost to the taxpayers of government support for Fannie and Freddie is already reflected in the federal budget. In addition, there is transparency about the financial position of the enterprises and the risks to the taxpayer provided by a number of other reports from the Treasury Department; the Office of Management and Budget, or OMB; and the Federal Housing Finance Agency, or FHFA. There is a technical debate between budget analysts about what is the best methodology to use to report these costs, but please do not let anyone tell you the costs are hidden or not reflected in the budget. I detail below how they are reported.

- The treatment of the GSEs is uniquely complex because we are talking about budget treatment of obligations incurred when the securities were not expressly backed by the full faith and credit of the federal government at a time when we now have an effective government guarantee and ongoing obligations as well. As the housing markets stabilize and a long-term housing finance reform policy is determined, new policy will be made that will involve unwinding the GSEs as we know them. Far more important than the debate about the current treatment of the historical obligations is to ensure any future system of government support includes express terms, fees charged for support provided, and reserves held to protect taxpayers against loss, and all these terms accounted for in the budget using standard budget treatment for credit liabilities under the Federal Credit Reform Act.

- Finally, the taxpayers' exposure to risk from the books of business originated before the collapse of the housing market cannot now be altered. It is fixed. But of course the ultimate cost of those obligations to the taxpayers is still undetermined. The cost depends heavily on the recovery of the housing market, which in turn depends upon the policy steps taken by Congress, the administration, and regulators. The GSEs in conservatorship and FHA are playing a central role in stabilizing the housing markets. This month's economic reports show that the housing market remains very weak. Had the GSEs and FHA not played their central role, the housing collapse would have been far more severe, the economic recovery slower to take hold and even more tepid, and the losses to the taxpayer far greater. What is more, precipitous actions now to limit their role prematurely and imprudently would weaken the housing recovery and have the effect of significantly increasing the GSEs' and FHA's losses on outstanding obligations. Thus, the cost to the taxpayers of these existing obligations depends upon the wise exercise of policy discretion in the months and years ahead.

A note about the GSEs in conservatorship

Before addressing the budget treatment of the GSEs in conservatorship, it's important to point out that the GSEs in conservatorship will be much different from those of the past. Since Fannie Mae and Freddie Mac were placed into conservatorship, the FHFA has monitored their business operations closely and mandated heightened underwriting standards. Both enterprises have also increased their guarantee fees and adjusted their pricing to attempt to price for risk.[1]

As a result, under most scenarios, the loans currently being guaranteed by the GSEs will not contribute to the losses Fannie Mae and Freddie Mac face going forward. Instead, the profits made from these new books of business will help to reduce losses from the outstanding obligations. In 2009 default rates for GSE-administered loans in their first 18 months were 1.2 percent and 1.1 percent, respectively. That's compared to 28.7 percent and 22.3 percent for GSE loans originated in 2007.[2] The losses GSEs are still reporting today are disproportionately the result of delinquencies and defaults on loans that were originated and guaranteed in 2006, 2007, and 2008.[3]

Even as the financial situations of the GSEs improve, the Obama administration has repeatedly stated it has no interest in returning to the way things were before the crisis. The Treasury's white paper on housing reform released in February calls for reducing overall government support for the housing market (which currently relies on governmental support for more than 90 percent of loans) and winding down Fannie Mae and Freddie Mac. The phase-out plan includes continuing to increase guarantee fees, reducing conforming loan limits, and winding down their investment portfolios.[4] So the GSEs in conservatorship represent a temporary situation whose ongoing operations are mitigating the costs of prior mistakes. The most important question is what a reformed housing finance system looks like.

How taxpayer support of the GSEs is reported

In September 2008, upon the action of FHFA to place Fannie Mae and Freddie Mac in conservatorship, the Treasury Department launched temporary programs to provide capital to the GSEs to ensure each maintains a positive net worth. Specifically, Treasury agreed to make investments in senior preferred stock as required, but in exchange, Fannie Mae and Freddie Mac were required to pay quarterly dividends to Treasury at a rate of 10 percent.

The president's first budget after the stock purchase programs began was released in February 2009 for FY 2010. It included a report of all projected payments to and receipts from the GSEs under those programs in the summary tables; in addition, those payments and expenses were reflected in the budget's projections of spending and revenues and resulting deficits. The table appeared again in the FY 2011 and FY 2012 budgets. The most recent version can be found at Table S-12 on page 201 of the President's Budget for Fiscal Year 2012.

Outlays to the GSEs to bolster their liquidity are reported as costs to the government. Dividends on preferred stock paid to the Treasury by the GSEs are reported as payments to the Treasury. The balance of those two numbers is the program's net effect on the federal deficit.[5]

The Office of Management and Budget projects these numbers for the next 10 years. The FY 2012 budget estimates that the government will pay $236 billion to the GSEs between 2009 and 2021 in "Senior Preferred Liquidity Payments" and collect $163 billion in dividend payments. This means a net cost to government of $73 billion spread out over 13 years.[6]

More detailed financial information on Fannie's and Freddie's financial position that underlies these budget cost estimates is provided in the budget's "Appendix on Government Sponsored Enterprises." It includes a balance sheet for each enterprise, including the value of all assets, liabilities, and equity and status of outstanding mortgage-backed securities.[7]

Similar financial information can be found in the Treasury Department's Performance and Accountability Report, which includes the audited financial statements of the Treasury. The "Management's Discussion and Analysis" section of the FY 2010 report (released November 15, 2010) contains the value of all current payments to and revenues from the GSEs, as well as long-term projections of future costs to the government. The Treasury estimated as of that date that it would eventually pay $508.1 billion in GSE outlays between 2009 and 2031 and receive $472.2 in preferred stock dividends that were the obligations to be outstanding for that period. That would mean a net cost to the government of $35.9 billion over 22 years.[8] (The difference with the OMB numbers above is timing and the duration of the projected period.)

Fannie Mae and Freddie Mac also report themselves on what they receive from the Treasury and pay back in preferred stock dividends each year in their 10-k securities filings.

Finally, the Federal Housing Finance Agency reports quarterly its Conservator's Report on the Enterprises Financial Performance. In October 2010 the oversight agency also published its own projection of Fannie and Freddie's financial performance through 2013. The Projections of the Enterprises' Financial Performance report estimated $221 billion in Treasury outlays and $80 billion in dividend revenues between 2009 through 2013, which is similar to the OMB and Treasury projections over that period.[9] This report also included a stress test of the budgetary effect under difference scenarios for the economy. In its most recent quarterly report, FHFA noted that its October 2010 estimates of Treasury draws for the second half of 2010 had ranged from $24 billion to $48 billion, but the actual combined Treasury draw for the second half of 2010 was only $6 billion, as the performance of loans was better than had been expected.

In short, the federal budget reflects the current and projected costs of the federal government's support of the GSEs through the Preferred Stock Purchase Agreements. Additional information about the financial condition of the GSEs in conservatorship and the risk to the taxpayers from their obligations is also reported by an array of federal agencies and by the GSEs themselves.

CBO's alternative budget treatment

CBO treats the GSEs differently than does OMB for budget purposes. As other witnesses will testify, CBO has concluded that Fannie Mae and Freddie Mac should be treated in the federal budget as government entities. As a result, CBO says, it "considers transactions between them and the Treasury to be effectively intra-governmental payments, which do not affect net federal outlays."[10]

OMB's treatment, on the other hand, is based on the conclusion that the GSEs remain separate private companies, under conservatorship. According to the 1967 Commission on Budget Concepts, inclusion of an entity's assets and liabilities in the federal budget depends on three basic factors: ownership, control, and permanence.[11] Under the terms of the Housing and Economic Recovery Act of 2008, FHFA as conservator may take any action that is necessary to return Fannie Mae and Freddie Mac to sound and solvent condition and to preserve and conserve the assets of these firms. Treasury has made clear its intention to work with Congress to reduce the GSEs' role in the market and ultimately wind down both institutions at a pace that does not undermine economic recovery. Given these factors, it seems difficult to conclude that the current arrangement between Treasury and the GSEs is permanent.

One consequence of treating the GSEs as on budget now will be that their treatment will inevitably change again as they are unwound. This may complicate further efforts to produce a consistent budget display and make effective comparisons over time. There is risk that, like Hall of Fame baseball players in the era of performance-enhancing drugs, budget records for this period will be marred by asterisks.

CBO's preferred methodology estimates "subsidy costs" for each of the GSEs' existing businesses. It treats the GSEs' MBS business as if it were a government direct loan program. For estimating the subsidy of these credit obligations, CBO uses a method similar to the treatment of Federal Credit Reform Act of 1990, except that they diverge from the requirements of the FCRA by using an alternative discount rate. This alternative is an estimate of a private-sector discount rate, rather than the Treasury discount rate used under the Federal Credit Reform Act, where Treasury's discount rate is used to calculate a current value for the stream of revenues and expenses that will arise from a guarantee obligation.

CBO argues that the Treasury discount rate underestimates the "tail risk" to the taxpayers of costs proving to be far greater than thought most likely. They seek instead to determine the value that the private market would charge for the guarantee, arguing that is a more accurate measure of the cost to the taxpayers. Of course, no private actor, however, is in the position of the government with the ability to borrow at Treasury rates and the ability to spread risk across such a broad portfolio. So CBO must develop a measure of value through a series of assumptions. And the resulting estimate is really a measure of how the private market might value the guarantee rather than what it costs the Treasury to provide it.

Finally, CBO's treatment of the GSEs as governmental requires them to explain why the GSE debt is nonetheless not included in estimates of the federal debt held by the public. CBO reports that budget documents prescribe a more narrow definition.[12] In fact, no one is arguing that the $1.5 trillion in GSE debt outstanding should be added to the federal debt. Such a move would accomplish nothing other than upset investor expectations, prompt confusion, and potentially roil capital markets at great cost to the U.S. economy and housing markets in the form of reduced liquidity, higher interest rates, and downward pressure on home values.

The dispute between CBO and OMB on the proper way to account in the budget for the GSEs is complex and technical. Both parties are acting in good faith to improve accuracy and provide clarity. But the choice of budget reporting parameters is not what is most important. CBO's treatment does nothing to reduce the taxpayers' exposure to loss or improve transparency about the taxpayer's actual exposure to loss or move us forward toward reform of the housing finance system.

The fact of the matter is that budget analysts are trying to jerry rig a set of budget rules for these hybrid entities after the fact. We must acknowledge that the bulk of their costly obligations were originated under the policy that these entities did not carry a government guarantee, when events have subsequently revealed that they did. What is more, the guarantee was not priced or paid for. This experience teaches us important lessons about how we must treat any future government guarantee obligations in the future.

Reform of the housing finance system

My colleagues and I at the Center for American Progress have testified and written elsewhere about our views on long-term reform of the housing finance system. Our views are based on a proposal developed by the Mortgage Finance Working Group, convened by CAP, made up of secondary market and affordable housing experts. Our proposal can be found at: http://www.americanprogress.org/issues/2011/01/responsible_market.html.

We believe that, in the future, we must establish a way to assess and budget for public risk while continuing to provide, where needed, a limited liquidity backstop. The added liquidity of a government guarantee will give millions of creditworthy borrowers access to the American Dream of homeownership and a chance to retain a foothold in the middle class. It will help families afford a long-term mortgage with a reliable fixed rate. It will help developers find capital to finance new apartments and other homes so households don't see their rents spike as growing demand and inadequate supply put decent rental options out of reach. And it will provide a mechanism to ensure that there does not develop a two-tier system of housing finance in which qualified borrowers who can sustain homeownership are nonetheless only given access to higher-priced credit because they live in underserved communities and communities of color.

But never again, after housing finance reform, should we have implicit guarantees. Where a liquidity backstop is important, as I believe it will be for some targeted portion of the market, the guarantee should be explicit, available only for qualified obligations of a well-capitalized and regulated entity, a guarantee fee should be charged, and those fees should be collected in a catastrophic loss insurance fund to stand behind the guarantee, protecting the taxpayers against future loss.

Any future government guarantees must be administered with strict discipline to protect taxpayers and promote ongoing market stability. This means that every obligation insured by the federal government must be for a specific public benefit and the value of its subsidy cost appropriated under the Federal Credit Reform Act.

How FHA costs and revenues are reported

Before concluding, let me mention the budget treatment of FHA insurance programs. I was a deputy assistant secretary at FHA and I even got to know my husband, then the OMB FHA Budget examiner, by working together to develop a credit reform estimate for FHA reform legislation in the mid-1990s. So I fully understand the difficult task of accurately estimating the cost of federal credit programs.

In contrast to the GSEs, FHA is a federal government entity. What is more, in exchange for federal insurance, a mortgage insurance premium is charged and a reserve fund is maintained with those fees to pay claims and to protect the taxpayers against loss. As a result, after experiencing significant losses on books of business incurred during the height of the housing bubble and in the immediate aftermath of the collapse, there remains more than $30 billion in the FHA Mutual Mortgage Insurance, or MMI, Fund. And the fund's capital reserve, while depleted, is still solvent. Premiums charged on current higher-quality books of business are replenishing the MMI fund. As a result, the most likely scenario is that FHA will continue unbroken its 77-year history of operations without requiring any infusion of taxpayer funds to remain solvent.[13]

Since the passage of the Federal Credit Reform Act of 1990, or FCRA, as part of the Omnibus Budget Reconciliation Act of 1990, the cost of FHA's loan guarantees are accounted for in the federal budget under Credit Reform. According to a "primer" on credit reform by budget expert and fellow at the Johns Hopkins University Center for the Study of American Government Tom Stanton:

> Prior to credit reform, Federal credit program costs were budgeted and accounted for on a cash basis (the amount of cash flowing into or out of the Treasury), like other Federal programs. Cash accounting failed to portray accurately credit activities' long-term costs: direct loan costs were overstated, as annual loan disbursements appeared with a cost equivalent to grant outlays, and there was norecognition that borrower loan repayments would offset some or all of those outlays; guaranteed loan costs were understated, as they appeared as having no cost in the year the guarantee was made, with no recognition that future default outlays could result.
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> Most loan programs were funded through revolving funds, in which repayments from prior loans offset outlays from new loans, and a program's net cash flows could appear to be reducing the deficit at the same time that billions of dollars in subsidized loans were being made. Policy makers, therefore, did not have the information with which to make informed budget allocation decisions, and credit program managers often were not fully aware of how their loan origination and servicing actions affected program costs.
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> Credit reform recognizes that a loan's true cost is not captured by its cash flows in any one year; the true cost is the net value of its cash flows over the life of the loan.[14]

Since enactment of credit reform, FHA has struggled to accurately predict revenues and costs in its single-family mortgage insurance program. In some years they assumed budgetary savings larger than ultimately proved to be the case. Beginning in 2002 they began estimating savings when the books insured proved to have a budgetary cost.[15] These difficulties reflect weaknesses in the previous model that FHA and OMB used to predict future streams of premiums and expenses. The misestimates were most extreme during the housing bubble, when loans incurred under a down-payment assistance program proved to perform terribly but the model did not distinguish between these loans and more standard FHA lending.

FHA responded in 2010 by revamping its independent actuarial review, including a more sophisticated forecasting model for home prices developed by Moody's (accurate price forecasting is a critical aspect of predicting defaults). For its first book of business using the new model, FHA slightly overestimated its subsidy costs for the first time in 18 years. This is a promising first step. And OMB and HUD continue to work to improve the estimates of house-price performance that are so central to predicting the performance of FHA insurance in force.

Yet some members of Congress contend that the better remedy is to shift from Credit Reform accounting to the use of "Fair Value" reporting. But in reality this change would in no way help FHA's ability to come up with accurate predictions of performance of insured loans. As described above, the key difference between these two methods is the choice of discount rates employed: Treasury discount rates are used for Credit Reform and an approximation of a "private sector" equivalent discount rate is used for the Fair Value reporting (see discussion on page 5 above regarding the choice of discount rate). Regardless of whether they're discounted by Treasury rates or a private market premium, the cost estimates will still be grounded on the same market forecasts. Biasing the estimates high will not change the economic reality in which FHA operates. It will, however, overstate the cost of operating the FHA program, so as to encourage misguided opposition and drive legislation to constrain its growth.

But whatever the process, it is imperative that Congress apply the same budget rules to FHA loan guarantees as it does to all other federal credit programs. To responsibly manage government resources, we must measure the cost of all programs by the same standards. It would be irresponsible for Congress to cherry-pick individual credit programs to be subjected to special budget rules. This would make some programs appear more expensive than others, when really they are just calculated using entirely different measures of cost. It's like comparing two products priced in different currencies without considering the exchange rate.

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In closing, I would like to commend the chairman and the other members of this committee for holding this hearing. This is technical stuff, but it implicates larger issues before Congress. First, Congress's responsibility to carefully manage the housing market to protect against greater harm to American families and taxpayers; and second, Congress's role with the administration in designing a smart system of housing finance for the future. I would be happy to take any questions.

ENDNOTES

[1] Assistant Secretary for Financial Institutions Michael S. Barr, Testimony before the House Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, “The Future of Housing Finance: A Progress Update on the GSEs,” September 15, 2010, available at http://financialservices.house.gov/Media/file/hearings/111/Printed%20Hearings/111-153.pdf.
[2] Ibid.
[3] Ibid.
[4] Treasury Department, Reforming America’s Housing Finance Market: A Report to Congress, February 2011, p12
[5] Office of Management and Budget, “Analytical Perspectives of the Budget of the United States Government for Fiscal Year 2012” (February 2011), p. 374.
[6] Office of Management and Budget, “Budget of the United States Government for Fiscal Year 2012” (February 2011), p. 201.
[7] Office of Management and Budget, “Budget of the United States Government for Fiscal Year 2012” (February 2011), Appendix on Government Sponsored Enterprises, p. 1319.
[8] U.S. Department of Treasury, “2010 Performance and Accountability Report” (December 2010), p. 21.
[9] Federal Housing Finance Agency, “Projections of the Enterprises’ Financial Performance Report” (October 2010), p. 10 (baseline scenario).
[10] Congressional Budget Office, “CBO’s Budgetary Treatment of Fannie Mae and Freddie Mac” (January 2010).
[11] President’s Commission on Budget Concepts, “Final Report” (1967). The final report has a section specifically on exclusion of GSEs from the federal budget, stating as a general rule that GSEs should be “omitted from the budget when such enterprises are completely privately owned.” The report also recommends that the “total volume of loans outstanding and borrowing of these enterprises at the end of each year be included at a prominent place in the budget document as a memorandum item” (p30). This information is currently included as an appendix to the budget document.
[12] Congressional Budget Office, “CBO’s Budgetary Treatment of Fannie Mae and Freddie Mac” (January 2010), p. 3.
[13] U.S. Department of Housing and Urban Development, “Annual Report to Congress Regarding the Financial Status of the FHA Mutual Mortgage Insurance Fund Fiscal Year 2010” (November 2010), p. 21.
[14] Thomas Stanton, “Primer on Credit Reform” (1998), p. 1, available at http://www.coffi.org/pubs/Primer%20on%20Credit%20Reform%20by%20Stanton.pdf.
[15] Congressional Budget Office, “Accounting for FHA’s Single-Family Mortgage Insurance Program on a Fair-Value Basis” (May 2011), p. 7.

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Ms. Wartell helped found CAP and CAP Action in 2003. For five years she served as its Chief Operating Officer and then Executive Vice President for Management. Today, she oversees the Center's policy program, while continuing her own work in economic policy and housing.

Ms. Wartell served as deputy assistant to the president for economic policy and deputy director of the National Economic Council in the Clinton administration, where she advised the president; led interagency policy development; and negotiated with Congress on banking, housing and community development, consumer protection, pensions, bankruptcy, e-commerce, legal reform, and a host of other issues. She also oversaw the development of President Clinton's New Markets and Consumer Protection and Financial Privacy initiatives.

From 1993 to 1998, she held various titles including deputy assistant secretary at the Federal Housing Administration in the Department of Housing and Urban Development, where she focused on FHA reform, single-family finance, risk-sharing, credit reform, consumer protection under RESPA and manufactured housing standards, and other housing finance policy issues.

She also served as a consultant to the Millennial Housing Commission and the William J. Clinton Presidential Foundation. Earlier, she practiced law with the Washington, D.C., firm of Arnold & Porter.

She is a member of the Board of Directors of the Corporation for Enterprise Development, an innovative nonprofit working at federal, state, and local levels to expand economic opportunity for low- and moderate-income Americans through asset-building strategies. She also is a member of the Board of Directors of CLASP, a policy and advocacy organization that focuses on policy solutions that work for low-income people.

She is a graduate of the Yale Law School and Princeton University.