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Statement of Franklin D. Raines
Chairman and CEO, Fannie Mae
Before the Senate Committee on Banking, Housing, and Urban Affairs
February 25, 2004

Chairman Shelby, Senator Sarbanes, members of the committee, thank you for inviting me today to testify on GSE regulatory reform. The last time I came before you to discuss this subject was last October. Since that time, this committee has worked diligently to give shape to a new GSE regulatory regime that ensures strong oversight of Fannie Mae and Freddie Mac.

On behalf of Fannie Mae, let me express how much I appreciate the hard work and serious thought the Committee has invested in this issue over many years and in particular over the past several months.

I believe at the end of the day we share the same goals. We all want to protect, advance and strengthen the best housing finance system in the world. We all want to ensure that the government-sponsored housing enterprises, which fuel this remarkable system, continue to achieve their mission to expand homeownership in America. And we want to strengthen GSE oversight because effective oversight is in the best interest of the company, our mission, and the U.S. housing finance system. Let me repeat something I said last October: Fannie Mae supports a strong, credible safety and soundness regulator.

In fact, strong, effective oversight is the backbone of our unique GSE status.

Congress created Fannie Mae in 1938 as an instrument of national policy -- a policy to expand homeownership because it is good for families, communities, the economy, and the country. In 1968, Congress privatized Fannie Mae, but imposed a restrictive charter to ensure we continued to be an instrument of national policy promoting homeownership. And in 1992, Congress further focused us as an instrument of national policy, creating explicit affordable housing goals for the company and establishing a safety and soundness regulator to ensure the company's ongoing financial viability so that it could continue to serve homeowners. Strong oversight is the means by which the federal government displays its commitment to a national policy favoring homeownership.

That national policy is working. Fannie Mae and Freddie Mac have helped to create a market-based, consumer-focused housing finance system that draws capital from all over the world, making long-term, fixed-rate, refinanceable mortgages more widely available at lower costs. All of this is accomplished at no cost to the government. The highly efficient mortgage market touches millions of homeowners, as well as an entire housing industry. Last year, over $3.7 trillion of single-family mortgages were originated, as an estimated 22 million households either financed a new home purchase or refinanced an existing mortgage. In each of the last two years homeowners were able to take advantage of strong home price appreciation and low interest rates by taking out over $125 billion of home equity through "cash-out" refinancing, using the proceeds both to retire other, more expensive debt and to finance home improvement or other consumer expenditures. Other homeowners who refinanced were able to lower dramatically their mortgage payments, increasing their purchasing power. For example, a homeowner with a $150,000 mortgage was able to lower his monthly payment from $948 to $852 as mortgage rates dropped from 6.5 to 5.5 percent. And low interest rates and strong demographic demand led to record home sales and a record high homeownership rate of 68.6 percent last year.

We have consistently said that there should be a straightforward test for examining policy proposals that will affect our housing finance system:

- Does it improve the safety and soundness of the housing finance system?
- Does it reduce costs for consumers?
- Does it expand opportunities for homeownership?
- Does it support innovation necessary to better serve consumers and address the nation's toughest housing problems?

There are three issues that I would like to examine in the context of these four questions today: the GSE capital regime, conservatorship versus receivership and the necessary balance between private management and public oversight.

CAPITAL

There has been much discussion of capital in the debate over reform of our regulatory structure. It is critical that our capital regime be considered as one integrated whole, and that when it is compared to bank capital regimes, the comparison be made on the basis of relative risk.

The structure of our capital regime is different from the bank capital regime because it applies to only two companies and we essentially invest in only one asset, residential mortgages. As a result, our risks are more easily specified by a regulator and are lower than those of other financial institutions that invest in higher-risk assets such as commercial loans, credit card debt and foreign debt.

Development of Our Capital Regulation

In the early 1980s, faced with declining capital levels among banks, deregulation of the industry and problems caused by stagflation and crises with less-developed-country debt, U.S. bank regulators instituted numerical capital standards for the first time in the form of a leverage requirement. It was recognized that such a requirement was blunt in that it did not tie capital to risk and, in 1988, U.S. regulators joined their colleagues from other industrialized countries in instituting a risk-based capital standard in what was known as the Basel Accord.

The new bank risk-based standard only covered credit risk. It divided a bank's assets into four "buckets," depending on the obligor. Government securities required no capital support. The capital requirement for agency securities was 1.6 percent, for prime residential mortgages 4 percent and for assets such as commercial and consumer loans 8 percent. Regardless of whether a commercial loan was to a blue-chip or startup company, the capital requirement was the same 8%. The rules also required that banks hold capital against off-balance-sheet exposures.

Because the Basel Accord did not cover interest rate risk but, instead, was narrowly tailored to credit risk, U.S. regulators, unlike their foreign counterparts, uniquely continued to impose a leverage requirement as well as the new risk-based requirement on banks. However, they intended that this dual set of capital requirements would only be temporary until an interest-rate risk component could be developed for the risk-based standard. As Federal Reserve Chairman, Alan Greenspan, testified before this committee in 1992:

> "[W]e are looking very closely at the leverage ratio which was imposed as a necessary concomitant to the risk-based capital requirements which are being imposed worldwide to substitute for interest-rate risk.
>
> "But now that we are in the process of getting interest-rate risk embodied into the overall risk-based capital policy, I believe that we will fairly quickly be able to dispense with the leverage ratio."[1]

The following day he elaborated before a House committee:

> "And, as I've indicated elsewhere, one of the things that we are endeavoring to get changed, which we think might have some effect, is to try to eliminate the so-called leverage ratio in bank supervision by essentially getting the detailed means of evaluation of the interest rate risk, which is what the leverage ratio is supposed to measure, embodied in another way in our risk-based capital system, and eliminate what in my judgment at least is a much too Draconian tool to achieve what is endeavoring to be achieved by that."[2]

At the time Chairman Greenspan made these statements, the financial regulatory community anticipated that an interest-rate risk component of the risk-based capital requirements would be in place by early 1993.[3] It is still not in place.

The U.S. federal banking regulators put a lot of effort into developing an interest-rate risk capital requirement. The Federal Reserve, OCC and FDIC issued joint proposals for an interest-rate risk component in 1992, 1993 and 1995.[4]

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[1] Testimony of Alan Greenspan, Senate Banking Committee, July 21, 1992

[2] Testimony of Alan Greenspan, House Subcommittee on Domestic Policy, July 22, 1992.

[3] "The agencies are expected to adopt final rules on interest rate risk by early next year," *Boston Chief Slams Regulators*, Claudia Cummins, *American Banker*, July 6, 1992 at 2.

Their efforts foundered. In June 1996, they finally abandoned attempts to promulgate an explicit interest-rate risk standard,[5] in part because of the great difficulty in fashioning an interest-rate risk requirement for an industry comprised, at the time, of 9,500 heterogeneous banks.

Where bank regulators failed, OFHEO succeeded. Based on legislation adopted by Congress in 1992, OFHEO, over a 10-year period, developed a comprehensive set of capital requirements that covered all of the risks faced by the two companies it regulates: credit risk, interest-rate risk and operations and management risk. For OFHEO the task was made easier by the fact that the new standard was designed to cover just two relatively homogeneous companies that invest in assets with broad and deeply liquid markets and finance these assets with wholesale funds.[6]

That is the crux of the difference between developing capital standards for GSEs and banks. Because there are just two low-risk, transparent enterprises supervised by a focused regulator, it is possible to develop capital standards tailored to the risks they face. In contrast, bank regulators must rely on the leverage requirement to compensate for the fact that the risk-based capital standards at their disposal are not sophisticated enough to capture all the risks a bank faces and not flexible enough to adequately cover the varied circumstances that the thousands of banks encounter. Faced with these conditions, bank regulators must have the flexibility to adjust the leverage ratio when they see a bank taking on increased risk.

<u>OFHEO's Risk-Based Capital Rule</u>

Fannie Mae's exposure to a severe economic scenario is more than adequately captured by the risk-based capital test that is now in force. The risk-based capital rule is rigorous and closely aligns required capital with the risks that the company takes. Under our risk-based capital standard, we must hold enough capital to survive a ten-year period of severe economic and financial stress characterized by simultaneous movements in interest rates of up to 600 basis points and nationwide mortgage defaults equal to those experienced in the oil patch region during the early 1980s. Risk-based capital is defined as the amount necessary to maintain positive capital over this 10-year period plus an additional 30 percent surcharge to cover unspecified management and operations risk.

A recent study by Joseph Stiglitz, winner of the 2001 Nobel Prize in economics, confirms the rigorous nature of this test, and the comfort policymakers should take regarding the inherent financial strength of any institution that can pass such a test. The paper

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[4] *See* 57 FR 35507 (August 10, 1992), 58 FR 48206 (September 14, 1993) and 60 FR 39495 (August 2, 1995).

[5] *See* 61 FR 33166 (June 26, 1996).

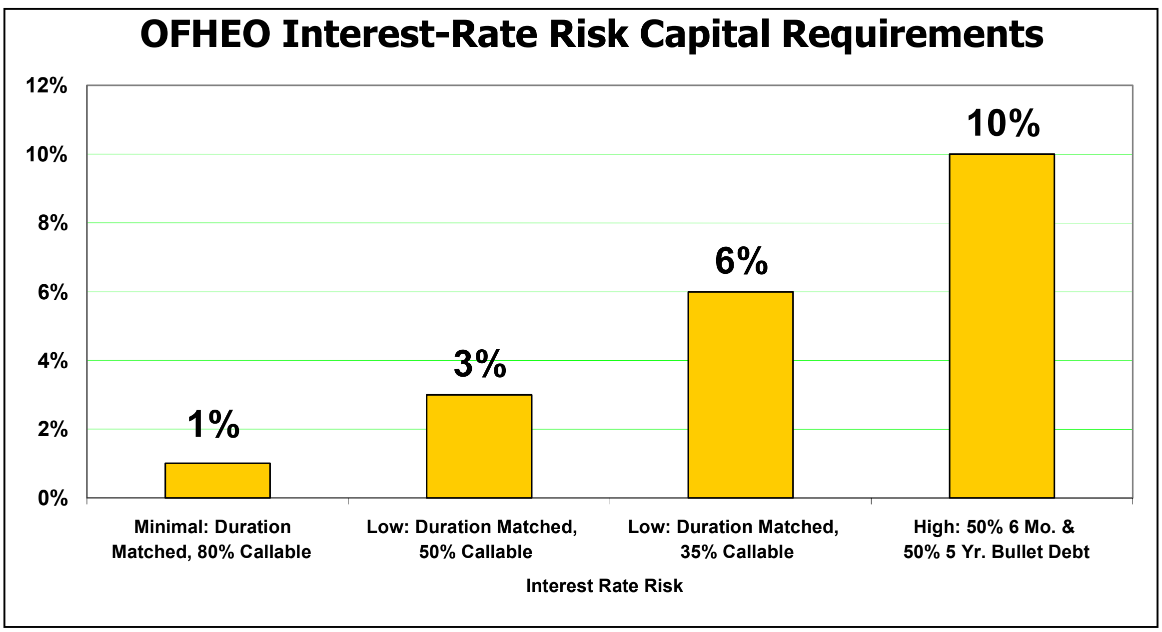
[6] One of the difficulties faced by bank regulators in developing an interest-rate risk capital requirement was determining the duration of bank core deposits such as checking and savings accounts. Although these are nominally short-term, or even overnight, funds, they are often left on deposit for extended periods of time even in the face of rising interest rates. In contrast, the duration of wholesale funds is more explicit.

concluded that the risk of default by Fannie Mae, if it holds sufficient capital to meet the risk-based capital rule's stress test, is "effectively zero."[7]

Several authorities have concluded that this test is far more rigorous than the risk-based capital test applied by bank regulators. A 1999 study by IPS-Sendero found that the thrift industry would run out of capital between the fifth and the seventh year of the ten-year stress test and that it would need to increase its capital by at least 60 percent if it was to meet a regulatory risk-based standard similar to that applied to Fannie Mae and Freddie Mac.[8] In addition, after reviewing the test, former FDIC chairman William Seidman concluded that: "The risk based capital standard set forth in the 1992 GSE Act creates a very stringent capital standard, one that could be devastatingly stringent if applied to most other financial institutions."[9]

Interest-rate risk is recognized as the biggest risk in mortgage investment, particularly, as in the case of Fannie Mae, where credit risk is geographically dispersed and is shared with counterparties. As shown in Exhibit 1, our capital requirement is closely tied to interest-rate risk. If we increased the amount of interest rate risk we take, our capital requirement would rise sharply and appropriately.

Exhibit 1



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[7] *Implications of the New Fannie Mae and Freddie Mac Risk-Based Capital Standard,* Joseph E. Stiglitz, Jonathan M. Orszag, and Peter R. Orszag, Fannie Mae Papers, Volume I, Issue 2, May 7 2002 at 5.

[8] *Risk-Based Capital and the Thrift Industry: Implications of Risk-Based Capital Stress-Test Requirement,* Dave Dufresne, IPS Sendero (February 1999)

[9] Memorandum of L. William Seidman, Jacqueline Pace and David S. Chung to Freddie Mac (March 29, 2000)

This risk-based capital requirement is the premier tool of our regulator. And unlike a bank standard, it is structured to encourage us to reduce our risk. The more we hedge against interest rate risk, the lower our risk-based capital requirement.

But clearly, even if we hedge extensively and reduce our risk-based requirement, we must still hold some capital against unquantifiable risk. That is the role of our minimum capital requirement. Our minimum capital requirement is 2.5 percent of on-balance sheet assets and 45 basis points of off-balance sheet assets. It is a true backstop to our risk-based capital standard.

Because the bank risk-based standard does not align capital with risk to the extent that ours does, bank regulators rely to a greater extent on the leverage ratio to ensure banks hold adequate capital. Our risk-based capital standard is the primary tool for our regulator for providing this assurance. The incentives that stem from these two choices are very different. Under our risk-based capital standard, the more we hedge our risks, the less capital we have to hold. That is an incentive to reduce risk.

On the other hand, the higher the leverage ratio imposed on a bank, the greater risks those institutions must take in order to cover their cost of capital and provide a market rate of return for their investors. As Exhibit 2 shows, a higher leverage requirement does not necessarily reduce risk. In Europe, where there is no leverage requirement for banks but only a risk-based capital requirement, large banks hold lower risk assets than their U.S. counterparts.[10]

[10] One of the reasons why regulators in other countries may feel a comfort in the absence of a leverage requirement, not shared by U.S. authorities, is that foreign banks tend to be larger, on average, than U.S. banks and therefore relatively few in number. Citigroup, the largest banking company in the world, is a U.S. bank. Otherwise, however, large European banks tend to be much larger than U.S. ones, reflecting the fact that the banking industry in the U.S. is much more atomistic than in other countries. Of the 50 largest banks in the world at the end of 2002, 32 were European, and only 8 were headquartered in the U.S. As a result, the median size of the 25 largest European banks at the end of 2002 was $526 billion, the median size of the 25 largest U.S. banks was only one sixth the size, at $81 billion. Since U.S. authorities have to oversee a vastly greater number of banks than their counterparts abroad, they may feel the need for blunter tools such as a minimum leverage requirement.

Exhibit 2

The Median Capital Ratio of the 25 Largest Banking Companies In the U.S. and Europe		
	U.S.	Europ
Median Size of Bank (Total	$81B.	$526B.
Tier 1 Risk-Based Capital	8.2%	8.0%
Risk-Weighted Assets to Total	80.8%	41.6%
Leverage	6.7%	3.1%
Memo		
Fannie Mae Leverage Ratio (Core Capital to Total Assets,		3.2%
* European banks are not required to meet a leverage capital standard. The for all banks is defined here as Tier 1 or core capital (as defined by the divided by total		

Sources: U.S. bank holding company call reports, annual reports. Data as of 12-31-02

If Fannie Mae were to stop guaranteeing and investing in mortgages, the credit and interest rate risks inherent in mortgages would not go away. Instead these risks would have to be borne by other institutions, primarily commercial banks and thrifts. These institutions take insured deposits that have an explicit guarantee from the government. Our debt securities have an explicit disavowal of any government support.

Fannie Mae raises funding in the world's capital markets where we are able to sell debt with characteristics that closely match the cash flow from our mortgages. The S&L experience in the 1980s shows the short maturity of the typical deposit makes it an unsuitable funding source for the long-term fixed-rate mortgage that is the norm in this country. If risk migrated from Fannie Mae to the banking system, taxpayers would be exposed to higher risk.

In order to fulfill our mission of attracting low-cost funding to the mortgage market, we must maintain our position as a low-risk, very high credit quality company. That is, our mission requires us to be one of the top-rated financial institutions in America and the world.

We have committed to maintain a stand-alone "risk-to-the-government" rating from Standard & Poor's of at least AA-, and a stand-alone "bank financial strength" rating from Moody's of at least A-, where A is the highest rating. We have also committed publicly to capitalize and hedge our mortgage portfolio and credit guaranty business so that each is able to withstand internal or external "stress tests" set to at least a AA standard, and meeting that commitment is an important corporate goal in 2004. Finally, we have as a goal to keep our mortgage prepayment and credit risk low enough that over time our core business earnings are less variable than the median of all AA and AAA companies in the S&P 500.

To put just one of these goals into further context, an A- rating on Moody's bank financial strength scale is the second highest after an A rating. A financial strength rating is a judgment as to the underlying health of a bank or other financial institution without any reliance on government support.[11] Only four banks *worldwide* have earned the A rating and eight, including Fannie Mae, the A- grade.[12]

Proposed Changes to Our Capital Regulation

From the perspective of how best to reduce risk to the financial system, it is clear that our regulatory structure, with a strict risk-based capital regime, is preferable. And while our risk-based capital test is the most rigorous faced by any financial institution, we recognize that a strong regulator should have the flexibility to regularly update the standard to ensure it remains consistent with best practices in financial regulation. We believe that giving the regulator complete flexibility to adjust the risk-based capital standard is the best way to ensure we hold capital commensurate with the risks we face.

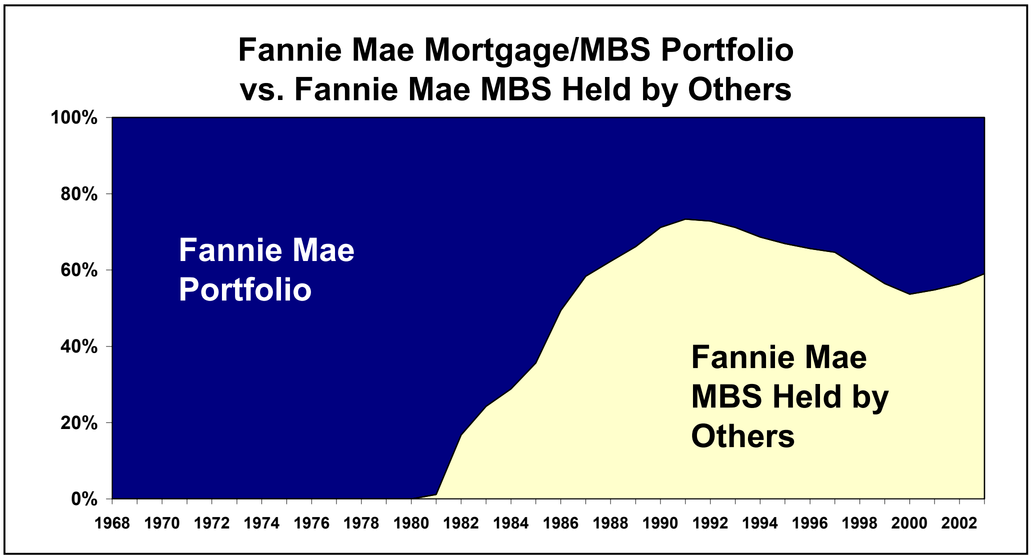
Some have suggested that our new regulator should have the same authority a bank regulator has to raise our minimum capital requirement. Given the far greater sophistication of our risk-based capital standard, it is unclear why that would be necessary. In the event we take on additional interest-rate, credit or operational risk, our risk-based capital standard would capture that risk and require us to hold more capital.

A decision to require us to hold more minimum capital with no change in the risk we face is not a safety and soundness decision, but rather a policy decision to reduce the amount of capital we provide to the mortgage market. We would buy fewer mortgages, reducing the demand for mortgages in the marketplace, which leads to lower prices and therefore higher mortgage rates. Our mortgage purchase activity has been our primary means of carrying out our mission since we were created in 1938. Until 1981, the company held all of the mortgages we bought in our own portfolio (Exhibit 3). It was only in that year that the company started guaranteeing MBS that were held by other investors.

[11] "Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support. In addition to commercial banks, Moody's BFSRs may also be assigned to other types of financial institutions such as multilateral development banks, government-sponsored financial institutions and national development financial institutions. Bank Financial Strength Ratings do not address the probability of timely payment. Instead, Bank Financial Strength Ratings are a measure of the likelihood that a bank will require assistance from third parties such as its owners, its industry group, or official institutions." *Rating Action: Federal National Mortgage Association, Moody's Assigns Bank Financial Strength Rating of A- to Fannie Mae; Affirms Debt and Preferred Stock Ratings (Long-Term Senior Debt at Aaa).* Moody's Investor Service, New York, February 27, 2002.

[12] "At this time, four financial institutions (including one in the United States) have BFSRs of A, Moody's highest rating. Eight institutions (including three in the United States, among them Fannie Mae) have BFSRs of A-." Moody's, *id.*

Exhibit 3



Fannie Mae's purchase of mortgages or MBS are more effective in reducing mortgage rates than is the guaranty alone. An econometric study in 2002 found that "Fannie Mae purchases are over 30 percent more influential than GSE securitizations on mortgage yields."[13]

Hence, a decision to reduce the flow of mortgage capital to homeowners by raising our minimum capital requirement irrespective of risk amounts to a policy decision to reduce our impact on the market – a decision that is properly made by the legislative branch, not by a financial regulator. That is why we strongly urge that our minimum capital standard remain written into the law.

At the same time, we understand the interest in giving the regulator some flexibility to respond to unanticipated events. So we believe that if any unanticipated safety and soundness risk should arise – a risk not covered by our risk-based capital requirement – then our regulator should have the ability to temporarily increase our minimum capital to protect against that specific risk. Then, when the risk goes away, the capital surcharge would go away as well.

<u>Subordinated Debt</u>

Finally, there is another difference between bank capital regimes and ours. When we meet our minimum and risk-based capital standards, we are classified as "adequately capitalized" by our regulator. Banks, however, have an additional option – to hold added capital and achieve the category of "well-capitalized." This category provides a bank

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[13] *The Effects of Purchases of Mortgages and Securitization by Government Sponsored Enterprises on Mortgage Yield Spreads and Volatility,* Andy Naranjo and Alden Toevs, *The Journal of Real Estate Finance and Economics*, 2002, Volume 25, Issue 2 at 173-195.

with the incentive to issue subordinated debt and achieve a higher rating from its regulator.

Both regulators and academics recognize that subordinated debt can play a valuable role in financial institution capital requirements in addition to equity:

- Federal Reserve Chairman Alan Greenspan has said, "The great advantage of having vehicles on the balance sheet such as subordinated debentures is that it is something in the nature...of a canary in a mine, that if...some of the credit capacity of these institutions seems to be eroding at the edges, it is very much more likely to show up in the prices of liabilities which are not insured and have no collateral behind them."[14]

- Former Fed Governor Lawrence Meyer has said "If the train crashes, then the subordinated debt holders sit not in the caboose but in the cab of the engine. They are thus quite sensitive to the speed of the train and the quality of the tracks."[15]

- According to a Federal Reserve Bank of Cleveland report, "Because sub-debt holders put their money on the line, they have an incentive to monitor the bank. If the bank's behavior should become riskier, investors will demand a higher premium for bearing that risk, and the interest rate will increase. Not only would potential investors be alerted by such information, but regulators too would find it useful as a signal that a bank needs more attention."[16]

- And the Shadow Financial Regulatory Committee has written "[I]t is desirable to go beyond a permissive approach toward subordinated debt as a component of bank capital by requiring that a minimum proportion of capital take the form of subordinated debt."[17]

Fannie Mae has made a voluntary commitment to issue subordinated debt, and has met that commitment, but it is not recognized in our capital regime. The use of incentives in bank regulation could easily be replicated in our regulation by creating a designation called "well-capitalized" when we hold capital, including loan loss reserves and subordinated debt, equal to 4 percent of our on balance sheet assets.

CONSERVATORSHIP

Just as GSE and bank capital regimes are appropriately different, GSE and bank regulation are appropriately different in the tools available to the regulator if an institution gets into serious financial trouble.

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[14] Alan Greenspan, Senate Banking Committee, January 26, 2000
[15] Former Federal Reserve Governor Lawrence Meyer, quoted by Bloomberg, October 31, 2000
[16] *Subordinated Debt: Tough Love for Banks*, Joseph Haubrich, Staff economist, Federal Reserve Bank of Cleveland, December 1998 at http://www.clevelandfed.org/research/com98/1201.pdf
[17] Shadow Financial Regulatory Committee, Statement No. 160, March 2, 2000 at http://www.aei.org/publications/pubID.16542/pub_detail.asp

This issue has received attention lately, in part because a recent critique in the Administration's Budget proposal said that, "even a small mistake by a GSE could have consequences throughout the economy."

The budget document made this point in reference to the growth of the housing GSEs throughout the 1990s, observing that they grew in the aggregate by over 500 percent in the period. As it happens, such growth over that extended period of time is not exceptional in the United States.

Exhibit 4

Growth Rate of Large Financial Institutions in the United

Three Largest Bank Holding Companies					
Company in 1991	1991	2002	Total Growth	Compound Annual Growth	Company in 2002*
Citicorp	$217	$1,097	405.85%	15.88%	Citigroup Inc.
Bank of America	$116	$851	636.84%	19.91%	Bank of America Corporation/Fleetboston
J.P Morgan	$104	$1,036	901.14%	23.30%	J.P. Morgan Chase and Co./Bank One
Total	$436	$2,984	584.66%	19.11%	
* Reflects announced, but not yet consummated, mergers					
Three Largest GSEs					
Company in 1991	1991	2002	Total Growth	Compound Annual Growth	
Fannie Mae	$147	$888	503.33%	17.75%	
FHLBank System	$158	$764	383.04%	15.39%	
Freddie Mac	$47	$752	1505.21%	28.70%	
Total	$352	$2,403	582.67%	19.08%	

As shown in Exhibit 4, large banking companies have grown at a similar rate in a combination of mergers and internal organic growth.[18] Taking into account recent merger announcements, the three largest bank holding companies in the country will have grown by 585% since the early 1990s, almost exactly the same as the three housing GSEs.

The suggestion that a small mistake by a GSE could cause a major economic problem is simply not true. We have effective controls in place to protect against mistakes, and we have effective protections in place in the rare chance that something dramatic does happen.

[18] There may be those who object to this comparison on the ground that growth through merger is different from organic internal growth. This is not a tenable objection for at least two reasons: (1) Suppose two $100 billion banks merge to form a $200 billion bank. If the new bank should fail, the authorities have a $200 billion problem on their hands, which would not be the case without the merger except in the unlikely case where an extraordinary systemic shock forced the correlation of failure of the two $100 billion banks and (2) Numerous examples exist of mergers, *per se*, being the cause of problems in the banking industry, particularly as far as operations risk is concerned. Such problems arise from the forced conjunction of different systems, different credit philosophies, different cultures, etc.

Our financial regulator and a Nobel laureate in economics have both looked closely at our risk and found that our capital model is designed to prevent not just a small problem—but huge, devastating problems—from harming Fannie Mae or the economy. OFHEO examined the issue of systemic risk in early 2003[19], and found that we are a "very strong" financial institution, that the possibility of our "failing or contributing to a financial crisis is remote" and that the risk of our "causing a systemic disruption is highly unlikely." And Nobel laureate economist Joseph Stiglitz examined the stress test supporting our risk-based capital standard and found that the probability of this scenario occurring is exceedingly small -- less than 1 in 500,000. Given that result, he concluded that as long as Fannie Mae meets the risk-based capital standard, the likelihood of a default is "effectively zero." Those are the same odds that the asteroid 1999 AN10, discovered in January 1999, could crash into the earth.

In fact, it is virtually impossible for a small mistake to fell Fannie Mae. We have $35 billion in total capital, which includes nearly $6 billion in core earnings from last year. In addition, we have $14 billion of subordinated debt outstanding. It would take a very large mistake to cause us to run through the $49 billion in capital, subordinated debt and earnings we have today.

Even given how unlikely such an event could be, we have safeguards in place to protect us if such an unforeseeable event occurs.

First, we meet the very highest standards of liquidity management. We maintain a liquid investment portfolio of high-credit quality investments that we can draw on for liquidity purposes. We committed in 2000 to maintain enough liquidity to survive a three-month period without access to new-issue debt markets and to maintain at least 5 percent of our on-balance sheet assets in high-quality liquid investments. Over the last 6 years, the ratio of Fannie Mae's liquid non-mortgage assets to total assets has ranged from 6 percent to 17 percent. Second, we have mortgages and MBS to draw on. In the event of a liquidity crunch, we could borrow against this unencumbered portfolio.

In addition, in 2003, Glenn Hubbard, former Chairman of President Bush's Council of Economic Advisers, reviewed our liquidity management and concluded that "a 'liquidity crisis' for Fannie Mae is an extremely remote possibility."[20]

Altogether, for every $2 we have in debt and liabilities on our balance sheet, we have access to about $3 in capital, credit enhancements, and collateral. That collateral includes $1.5 trillion in property value—the homes and land behind our mortgages—some of the safest collateral in the world.

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[19] *Systemic Risk: Fannie Mae Freddie Mac and the Role of OFHEO,* Office of Federal Housing Enterprise Oversight, February 4, 2003 available at http://www.ofheo.gov/Media/Archive/docs/reports/sysrisk.pdf.
[20] *Evaluating Liquidity Risk Management at Fannie Mae,* R. Glenn Hubbard, *Fannie Mae Papers* (Volume II, Issue 2), November 6, 2003 at 2, available at http://www.fanniemae.com/commentary/pdf/fmpv2i5.pdf.

Given our stringent capital requirements and our resilient asset base, Fannie Mae is one of the last financial institutions in the world that could cause a problem in the economy. To the contrary, during stressful times—including the global credit crunch of 1998 and post-September 11, 2001—we served to stabilize the financial system by keeping housing capital flowing smoothly.

Still, in the highly unlikely event of financial trouble, the regulator needs the authority to step in. Bank regulators and our regulator have these authorities. Bank regulators have the option to appoint a receiver or a conservator. When a bank gets into serious financial trouble, the regulator can install a receiver to close and sell the bank. The receiver has all the powers of the directors, officers and shareholders of the institution, and can repudiate certain contracts in the wind down process. This authority is critical in the banking system, as a means of protecting the taxpayer from the exposure created by federal deposit insurance. After the secured creditors, insured depositors have the first call on the failed bank's assets. The FDIC pays the depositors, and then is reimbursed from the assets of the bank. The receiver is necessary in order to put the FDIC – and thereby the taxpayers – first in line among the creditors of a failed bank. The other creditors collect only after the deposit insurance fund is repaid.

In the case of the GSEs, if one of the companies faces serious capital shortfalls, the regulator can install a conservator. In fact, the regulator can install a conservator at a GSE far earlier in the onset of a capital problem than a bank regulator can put a bank in receivership. The conservator has all the powers of the officers, directors and shareholders of the company and can take the steps necessary to rebuild the capital of the institution. What the conservator does not have is the ability to close down the company and the ability to repudiate contracts.

Conservatorship, rather than receivership, is the right model for the GSEs. Even in the banking world, the law provides the regulators with several ways of avoiding receivership for the largest banks if winding them down would create serious adverse effects on economic conditions or financial stability. In the case of Superior Bank, the last large bank failure, a conservatorship was established. And the law also provides special protections to "qualified financial contracts" to insulate them from the consequences of the exercise of the receiver's power to repudiate such contracts. This area of the law and the regulation has been long subject to interpretation, and the FDIC has issued numerous clarifying regulations to protect certain contracts.

It is unclear how a wholesale implementation of FDIC receivership powers, designed to protect insured depositors, would apply to Fannie Mae's obligations – our debt, our MBS, and our guaranty. For example, enacting a receivership provision unfairly imposes new risks on holders of existing obligations that they could not have anticipated at the time they purchased these obligations. The imposition of these risks, therefore, could undermine the pricing of existing obligations and cast uncertainty on how new obligations should be priced. The uncertainty would have a greater price impact on longer-term securities, and poses risks to the 30-year fixed-rate mortgage. The resulting higher debt prices would translate into higher mortgage rates for consumers. These issues must be carefully studied to avoid serious unintended market consequences. The risks inherent in moving to a receivership structure seem to far outweigh any benefit such a structure brings in the remote case in which one of the enterprises faces serious financial distress.

While government has a financial stake in a financial institution with guaranteed deposits, the government's stake in the GSE's success is not financial. The government's interest in these two institutions is their ability to serve as instruments of national policy, making homeownership more affordable and more available. That is why a conservator is the appropriate tool to deal with a capital inadequacy problem at a GSE. The conservator's role is to rebuild the capital of the GSE and ensure it remains an ongoing concern. Only Congress should decide if there is no longer a need for this instrument of national policy to support homeownership.

PRIVATE MANAGEMENT

Fannie Mae and Freddie Mac have been an incredible public policy success, driving private capital to accomplish the public mission of expanding homeownership. The model works because our incentives are properly aligned – we earn a return for our shareholders by fulfilling our mission.

Given our mission and charter, we agree that we should be subject to rigorous oversight of our safety and soundness and of our mission. In fact, rigorous oversight is an integral component of our charter. Our charter gives us benefits and restrictions designed to marshal private capital toward the public policy goal of expanding homeownership. In granting us this charter to expand homeownership, policymakers are expected to conduct effective oversight to ensure we are achieving our mission and operating safely and soundly so that we will continue as an ongoing business delivering on our mission.

It is critical to be clear on the balance between supervision and oversight and private management. This distinction between supervision and management is the foundation of commercial regulation throughout the marketplace. In the financial services sector, public policy has found the right balance between private management and public supervision. Companies thrive when management is allowed to take risks, innovate, and experiment, and even to see a new innovation fail, as long as that failure does not put the entire enterprise at risk. Companies that take no risks and do not innovate cannot evolve to meet the demands of consumers and improve living standards for all Americans. For us, we must have the freedom to innovate and experiment in order to accomplish our mission and reward our shareholders. As long as the company is well-capitalized, operating safely, complying with the charter and meeting its mission requirements, regulators can be confident in the day-to-day business operations and routine management decisions.

Continuing our success in expanding homeownership opportunities in the coming decade will require continued entrepreneurship. It requires a regulatory regime that effectively oversees the companies, without dictating the private management of the companies. This is true with regard both to risk management and to our pursuit of our mission.

Banking regulation recognizes the importance of private management in running a successful financial institution. While banking law gives bank regulators authority to set operational and managerial standards as the agency determines to be appropriate, bank regulators have interpreted this authority to mean that banks must have in place appropriate standards for operations and management. In risk management, bank regulators recognize that their role is not to dictate how an institution manages risk but to ensure that every bank has the necessary standards and meets them. The interagency rule implementing banking law states that the "standards established the objectives that proper operations and management oversight should achieve, while leaving the methods for achieving those objectives to each institution." It is private management of risk, with rigorous public oversight, that best serves the financial system, ensuring continued innovation to meet the needs of the ever-evolving marketplace.

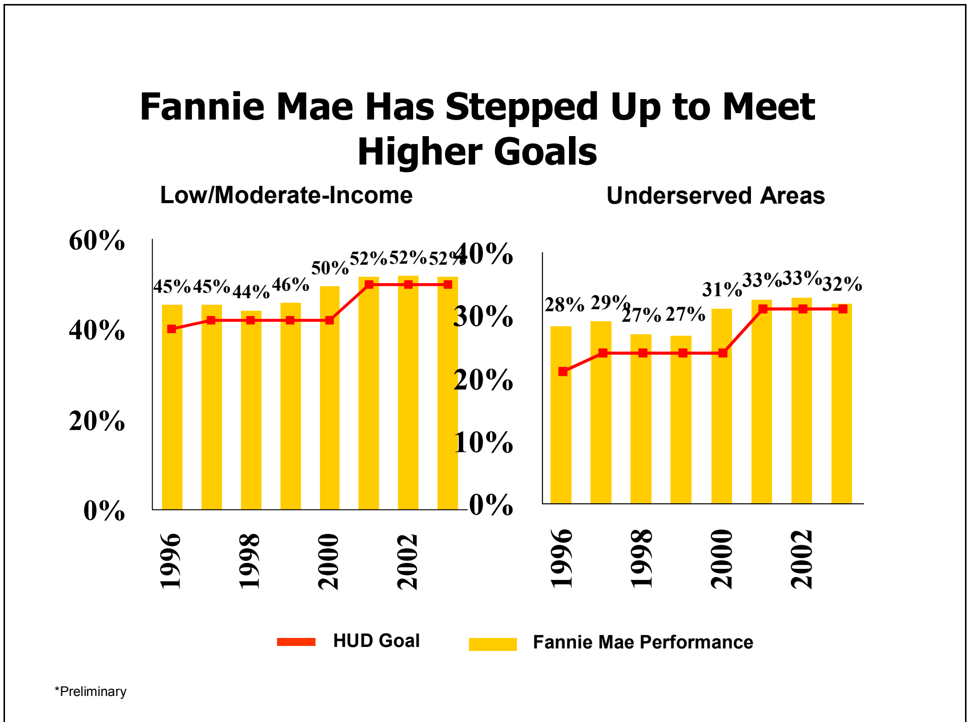
This bank model makes sense for Fannie Mae and Freddie Mac as well. Our regulator must ensure that we have standards in place to achieve best practices in risk management, without dictating the internal process at the company. Rigorous on-site examination ensures that our regulator validates the appropriateness of our risk management strategies and ensures that we live up to them. It is up to the company to devise those strategies and to disclose publicly the measures used by management to assess risk. We are a transparent company, disclosing risk measures on a monthly and quarterly basis. As an SEC-registrant, we make all the disclosures required of every publicly traded company. Our corporate governance and transparency were reviewed by Standard & Poor's in a report published in January 2003. The S&P report assigned Fannie Mae a corporate governance score of 9.0 on a 10-point scale -- a score it said reflected "governance practices that are consistently strong or very strong across each of [the] areas of analysis." With regard to transparency, S&P found that Fannie Mae's regulatory oversight and voluntary initiatives provide "disclosure about Fannie Mae's financial health that is unavailable from other, similar financial institutions" and that Fannie Mae provides "strong disclosure of its special purpose vehicles and risk management techniques."

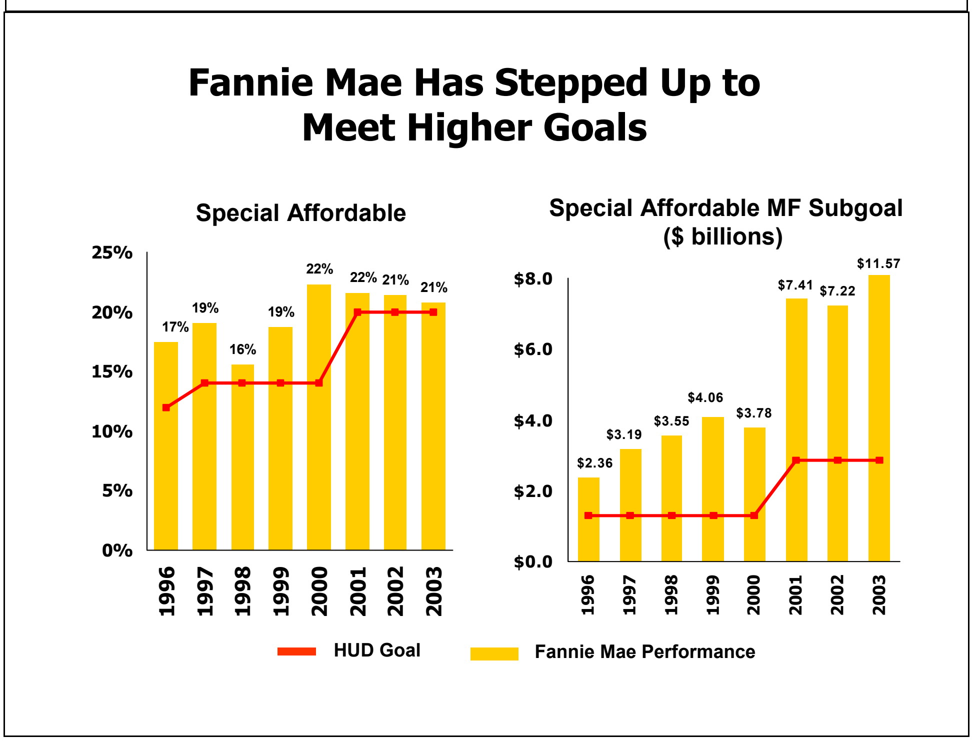
With our charter, Fannie Mae has a special responsibility to focus on some of the nation's toughest housing problems. We do that every day in furtherance of our mission to expand homeownership. In 1994, Fannie Mae launched a *Trillion Dollar Commitment* dedicated to expanding markets and increasing access to mortgage credit. Upon completion of the *Trillion Dollar Commitment* in 2000, we announced our $2 trillion *American Dream Commitment*, a decade-long effort to close homeownership gaps and strengthen communities. Since 1994, Fannie Mae has served more than 16.5 million low- and moderate-income families and more than 5.5 million minority families. And last month we announced a third iteration of our American Dream Commitment, with a goal of financing mortgages for 6 million first-time homebuyers, including 1.8 million first-time minority homebuyers, in 10 years. We set a goal of increasing the minority homeownership rate to 55 percent in the next 10 years, a goal we cannot meet alone, to push ourselves to work with the industry to find mortgage solutions that work for minority families and minority communities.

HUD Housing Goals

The 1992 Act created housing goals for Fannie Mae and Freddie Mac, to ensure that we remain focused on our affordable housing mission and to ensure that our business continues to promote homeownership as a national public policy priority. Under this authority, HUD sets specific share of business goals for purchasing loans to low- and moderate-income families, purchasing loans made to families living in underserved communities, and purchasing loans made to very low-income families and low-income families living in low-income areas.

Exhibit 5



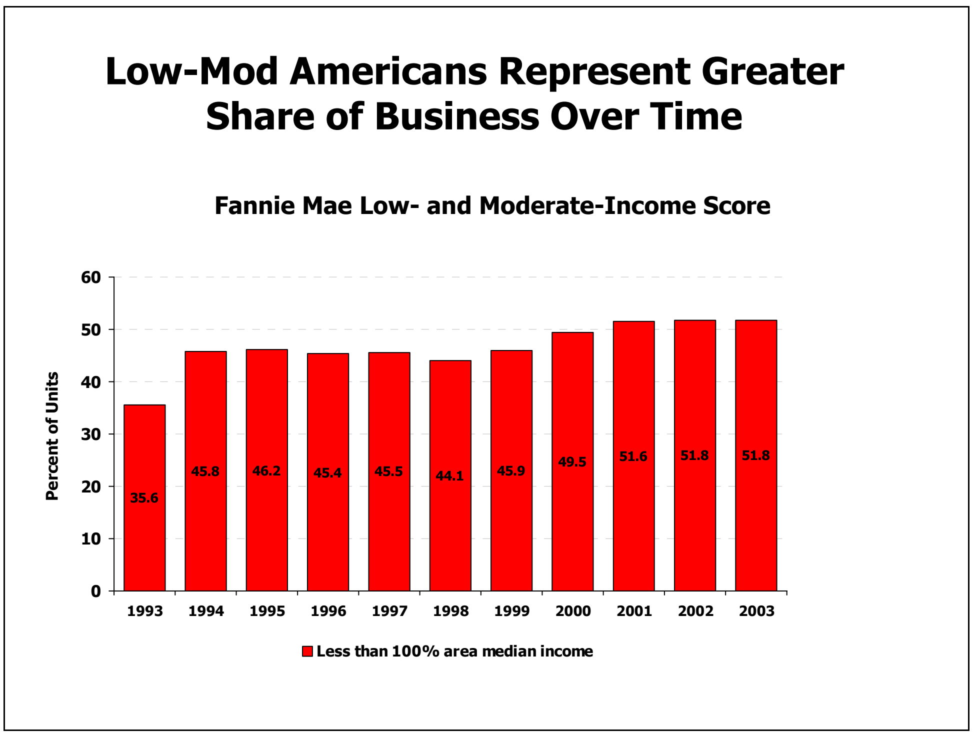


Those goals have increased substantially over the past 10 years, and we have consistently met those goals, even as they have become more demanding. In 2003, 59 percent of the mortgages we financed satisfied a HUD goal.

While we consistently meet the HUD affordable housing goals, we carry out a mission that is broader than specific governmental mandates. We are dramatically increasing our impact in underserved communities and we are responding to President Bush's challenge to expand minority homeownership. Since January 2000, we have financed $188 billion in purchase money loans to minorities, serving 1.4 million families. We work every day to innovate and develop creative ways to bring homeownership opportunities to all corners of the nation.

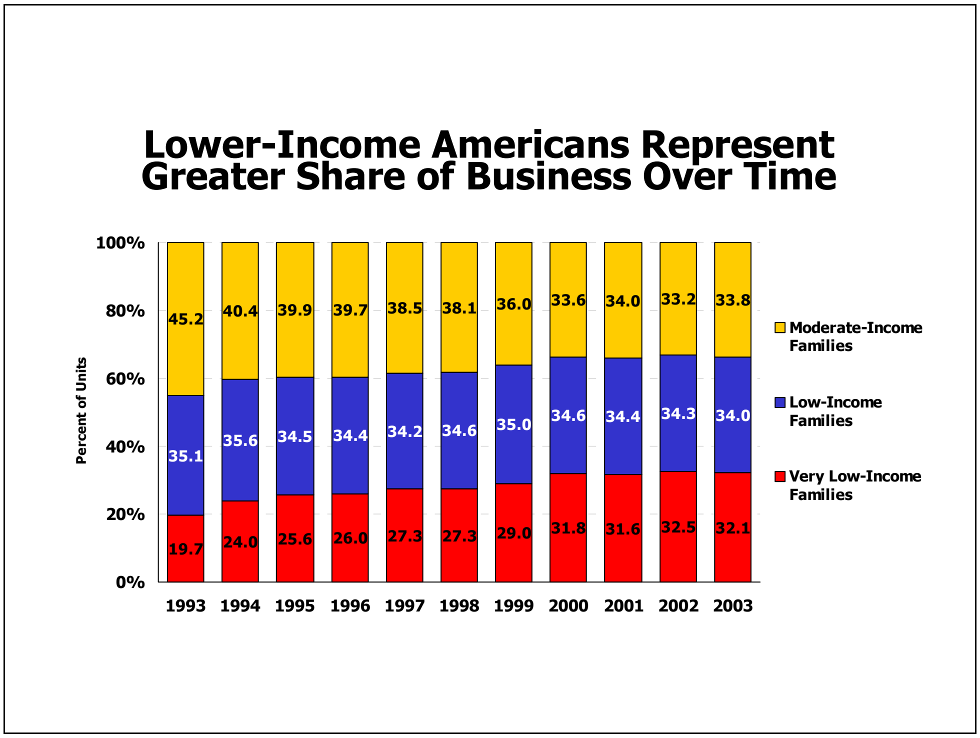
In fact, since Congress enacted the 1992 Act, we have steadily increased the share of our mortgage purchases that are loans to low- and moderate-income families. Over the past decade, the percentage of low-and moderate-income Americans we serve has grown substantially, from 35 percent to over 50 percent.

Exhibit 6



And within that population of borrowers, we have steadily increased the share of mortgage purchases that are loans to families earning between 60 percent and 80 percent of area median income, and the share of families earning less than 60 percent of area median income.

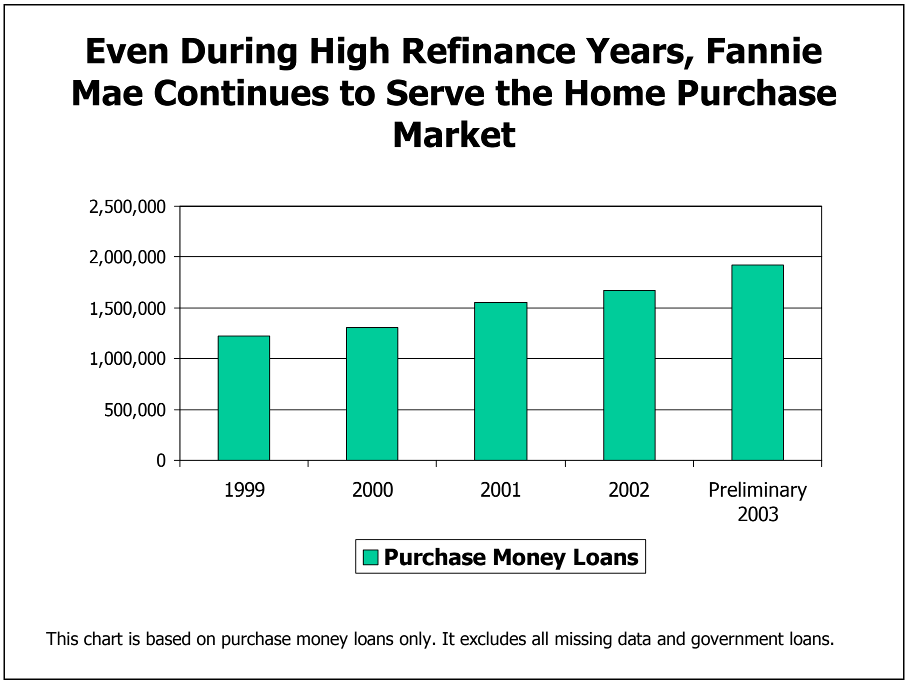
Exhibit 7



We share the President's goal of creating an ownership society, and we understand the interest policymakers have in seeing us do more to make homeownership a reality for more Americans.

Last fall, the Administration proposed legislation that would create a purchase money mortgage goal for Fannie Mae and Freddie Mac. We are not opposed to the idea that we focus more specifically on home purchase mortgages as a means to increase the homeownership rate. As a company, we have increased the number of home purchase mortgages we buy every year and made a public commitment just last month to fund mortgages for 6 million first-time homebuyers in the coming decade. As this figure shows, even in years of record refinance volumes, such as 2002 and 2003, the number of home purchase mortgages we finance continues to grow.

Exhibit 8



Our strong commitment to homeownership is coupled with our responsibility to provide low-cost financing to the entire market. In fact, purchasing refinance mortgages is a critical part of our charter responsibility to ensure liquidity in the mortgage market. At the same time, the unpredictable nature of refinance volumes make forecasting extremely difficult as HUD establishes housing goals for future years. For example, in 2000, when HUD established the housing goals for 2003, economists at the Department, like economists elsewhere, predicted that the range of possible refinance volumes would not exceed 60 percent of total conventional conforming originations. In fact, last year refinance mortgages composed almost 80 percent of the total conventional conforming originations market.

Refinance volumes above predicted levels can put the housing goals out of reach. In 2002 and 2003, with refinance volumes far above anything anyone had predicted, Fannie Mae had to take extraordinary measures to meet the goals. In future years, if such a scenario occurs again, it is possible that we will have to limit our mortgage purchases to only those loans that meet one or more goals. Such a step is clearly not what is intended by our charter, which plainly states that the purposes of the company are to "promote stability in the secondary market for residential mortgages" and to "promote access to mortgage credit throughout the nation by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing."

A goals structure that creates incentives for us to focus on financing home purchase mortgages for low- and moderate-income Americans and underserved communities is appropriate. The Administration has various options to achieve this goal in a way that would ensure that in a high refinance year we are not forced to turn away from the refinance market in order to meet the housing goals.

Innovation

We embrace our mission, but the flexibility to pursue it is essential. In order for Fannie Mae to achieve our mission of making homeownership available to underserved families, we must be able to work directly with our partners to develop new products and new business processes. Intrusive regulation that seeks to replace business judgment with the government's judgment would prevent us from bringing these initiatives to market in a timely way.

Under current law, we work with our lender and community partners to create new products and new approaches to bring homeownership opportunities to underserved areas of the nation. We are required to seek approval from HUD when we want to engage in a new program – something significantly different from the business we were engaged in before the 1992 Act. The standard Congress created in 1992 has fostered an environment of unprecedented innovation in the mortgage industry over the last 10 years. Despite the constantly changing interest rate environment, and unprecedented volumes of business, Fannie Mae and the mortgage finance industry have created a revolution in underwriting, product innovation, and streamlined technology processes, to produce significant gains in lending to low- and moderate-income and other traditionally underserved borrowers. For example, Fannie Mae annual financing for low down payment loans (5 percent or less) has grown from $109 million in 1993 to $31 billion in 2003.

Under the current program approval standard, we can act in a timely manner to respond to the needs and ideas presented by our partners, such as low down payment loans through Flexible 97 and 100, My Community Mortgage products to meet Community Reinvestment Act needs, and Expanded Approval to reach out to underserved borrowers with blemished credit. These mortgage features have been crucial tools in reaching into communities that were previously underserved. The mortgage market today has a wider variety of products available than ever before, and therefore is better poised to meet the individual financing needs of a broader range of homebuyers. This has been possible because the program approval requirements in the 1992 law respect the need for innovation and strike an appropriate balance between charter enforcement and management discretion.

The current standard has allowed us the flexibility to work with lenders to meet the needs of the marketplace, while ensuring proper oversight of our mission. Just last year, we sought program approval for a new initiative to provide Acquisition, Development and Construction lending to help our lender partners finance the development of affordable housing.

We urge that any legislation reiterate the congressional view that Fannie Mae should support innovation in the market as it carries out its mission. Congress needs to make clear again that the companies are encouraged to innovate and be responsive to market needs. In addition, we believe that any change in this area must take into account the very strong concerns that have been raised from many within the housing industry, to ensure that innovation can remain strong.

Some have proposed an intrusive process that would require us to seek approval from HUD or from our new regulator every time we undertake a new "activity" or create a new "product." Such micromanagement would put a halt to the innovation that has made the mortgage industry efficient enough to handle the volumes of mortgage originations last year and creative enough to bring homeownership opportunities to underserved communities around the nation.

Such micromanagement would also be far more constraining than anything imposed by bank regulators. Under the OCC and OTS regimes, banks are not required to seek pre-approval of new activities. Gramm-Leach-Bliley allows banks to go into broad new lines of business, like securities or insurance, without any pre-approval. They can engage in activities listed in their charters and incident thereto; they seek regulatory "cold-comfort" when they are pushing the envelope with respect to legal authority or suspect the regulator might have concerns. Regulators and courts have interpreted banks' freedom very broadly.

Today, when a lender identifies a new mortgage product designed to meet the needs of a particular underserved community, we can examine the product and its risk profile and give the lender a timely response as to whether or not we will buy the loan. When we can respond quickly, lenders can bring the new mortgage product to market in a timely fashion. Under a "new product" standard, every time a lender approached us about a new mortgage feature, we would have to go to our regulator to get permission to purchase these loans. Small lenders could not put these targeted products into the market without knowing that we will buy them once originated. Innovation to meet the needs of underserved communities could come to a halt.

These innovations are critical to our ability to continue to serve our mission. And they could come to a halt under a "new activity" or "new product" standard.

THE ROLE OF OUR PORTFOLIO

The portfolio business has been and continues to be an important tool for achieving Fannie Mae's housing mission. By purchasing mortgages and MBS for our portfolio, Fannie Mae expands the universe of mortgage market investors, bringing more capital into the mortgage market and bringing down mortgage rates. Investors who do not want the prepayment risk inherent in MBS can instead invest in Fannie Mae debt securities, which have more predictable cash flows over time. In this manner, Fannie Mae acts as an intermediary for the prepayment risk in mortgages, transforming risk, and providing value to homeowners and investors alike.

Fannie Mae follows a conservative and comprehensive strategy with respect to managing the interest rate risk of its portfolio business. Fannie Mae's approach to managing this risk involves investing in assets and issuing liabilities that perform similarly in different interest rate environments in the context of a reliable, diversified, and disciplined approach to interest rate risk management.

Fannie Mae's mortgage portfolio business aims to achieve stable net interest income, regardless of changes in interest rates. In order to meet this objective, the risk management approach encompasses a set of well-defined strategies.

First, Fannie Mae funds new mortgage investments using a blend of debt securities, to achieve an approximate match between asset and liability cash flows. Second, in addition to matched funding, Fannie Mae uses options to reduce risk. Over the life of a mortgage, interest rates will change in ways that cannot be anticipated. Recognizing this, Fannie Mae purchases insurance against moves in rates by issuing extensive amounts of callable debt, which better matches the characteristics of the mortgage assets. Third, Fannie Mae uses derivatives, economic substitutes for noncallable and callable debt, to reduce risk and lower hedging costs. Finally, rebalancing, or active asset-liability management, is an additional, and important, element of portfolio interest rate risk management. We rebalance regularly, modifying the portfolio's composition and characteristics in order to adjust its exposure to changes in interest rates.

The effectiveness of Fannie Mae's interest rate risk management strategies can be seen in the fact that the company has continually produced remarkable stability in earnings growth and net interest margin. In spite of significant swings in interest rates over the past 15 years, the company has increased earnings every year. In fact, there have been significant interest rate movements within the last year. Mortgage rates increased by a full percentage point in just one month in July 2003. Fannie Mae has been a steady presence through these volatile times.

Our portfolio purchases reduce mortgage rates for homeowners. A recent study by Andy Naranjo and Alden Toevs of the First Manhattan Consulting Group showed that increases in securitizations or portfolio purchases each led to declines in mortgage rates for consumers. Further, they found that increased portfolio purchases led to larger declines in mortgage rates than did increased securitizations, and these purchases also reduced the volatility in mortgage rates.

By purchasing mortgages for its portfolio, Fannie Mae has been able to move independently to stabilize the mortgage market during a crisis. In so doing, it has provided an important source of stability to the market. This was clearly evident during the global financial market turmoil in the fall of 1998. Markets for many other securities dried up, while the market for conforming mortgages was relatively stable due to the extensive purchase activity by Fannie Mae and Freddie Mac. In their study, Naranjo and Toevs found that conforming rates would have been 66 basis points higher during this crisis without the stepped up purchasing activity of Fannie Mae and Freddie Mac.

Fannie Mae repeated this role of market stabilizer following the events of September 11. Unlike many other financial markets that week, the market for conforming mortgages remained open, and Fannie Mae was buying mortgages.

Our portfolio enables us to support our mission of providing liquidity to the secondary mortgage market, thereby making possible the availability of long-term, fixed-rate mortgages for homeowners, a product that is not generally available outside of the United States. An additional benefit of the portfolio is that if fosters innovation at Fannie Mae and in the broader mortgage market. New or unusual products are often difficult to securitize, at least initially. The ability to buy loans directly improves the company's flexibility when working with lenders to design new products. Although these new products cumulatively make up a small portion of the portfolio, the ability to design new products is greatly enhanced when lenders know that Fannie Mae can directly purchase the product in the secondary market.

Through the securitization of mortgages and through the transformation of risk in the portfolio, Fannie Mae attracts investors from around the world into the U.S. mortgage market, and lowers mortgage costs for homeowners. As a result, the average difference in 2002 between the conforming mortgages we can purchase and the jumbo mortgages we cannot purchase was 29 basis points, which translates into $19,300 in savings to consumers over the life of a 30-year fixed-rate loan.

Lowering the cost of a mortgage is critical to the bipartisan public policy goal of making homeownership available to Americans for whom the American Dream has long been out of reach. For every 25 basis points (one-quarter of a percentage point) decrease in mortgage rates, nearly 400,000 additional families can qualify to become first-time homebuyers.

<u>Fannie Mae's portfolio competes with other investors for mortgage product</u>

Fannie Mae competes with literally thousands of other institutions in the secondary market for the purchase of mortgage assets. In fact, commercial banks taken as a group, and particularly large banks (those with greater than $10 billion in assets) are the largest investors in mortgage assets, bigger than Fannie Mae and Freddie Mac combined. Some might be surprised to learn that market competition has seriously impeded growth in Fannie Mae's portfolio in recent months. As we regularly remind investors, we do not increase the size of our portfolio for its own sake. We employ our shareholders capital only when there is an acceptable rate of return available. In seven of the last 12 months, Fannie Mae's portfolio has declined because these returns were not available, largely due to the fact that banks were aggressively bidding for mortgage assets.

Exhibit 9

Banks Have Grown Their Market Share More Quickly Than Fannie Mae			
	Share of MDO		
	12/31/1999	9/30/2003	Growth in Share
Largest Commercial Banks	16%	20%	4%
Fannie Mae	10%	12%	2%
Mortgage Debt Outstanding	$5.2 trillion	$7.6 trillion	

As shown in the table above, the largest banks have increased their investment in mortgage assets at a rate more than twice as fast as the growth in the underlying mortgage market, and have rapidly increased their share of total mortgage debt outstanding. Their share has increased by four percentage points from 2000 through the third quarter of 2003. Fannie Mae has grown in line with the market, increasing our share by only two percentage points over this time frame.

<u>Impact of Portfolio Limits</u>

There are some who would argue that the government through regulation or legislation should place an artificial limit on the growth of Fannie Mae's portfolio. We do not believe that such an approach is in the interest of homeowners. The question for policymakers is to ascertain where mortgage interest rate risk is best managed. The alternatives are institutions that are not focused exclusively on the mortgage market, banks which can go in and out of the mortgage market based upon prevailing returns, and homeowners themselves.

If Fannie Mae were limited in our ability to invest in mortgages, the interest rate risks inherent in mortgages would not go away, they would be borne by other institutions, primarily commercial banks and thrifts, or by homeowners. If risk migrated from Fannie Mae to the banking system, there is no doubt that taxpayers would be at higher risk. Commercial banks and thrifts take insured deposits that have an explicit guarantee from the government. Our debt securities have an explicit disavowal of any government support.

Because banks can use deposits as their primary funding for mortgages, their mortgage asset cash flows may not match up well against their deposit liabilities when interest rates change. In general, to maintain an overall asset-liability match, banks fund mortgages with short-term deposits and adjust the relative weighting of mortgages within their portfolios. In particular, banks do not use callable debt to fund or hedge mortgage investments.

Because they hedge to a lesser extent, banks investing in mortgages retain a good portion of the prepayment risk. But when interest rates move up significantly, they may have to sell mortgages into the market.

The market will ultimately adapt in one of two ways. Either banks will face higher risks, because they continue to hold fixed-rate mortgage assets without a liquid secondary market or any other market outlet, or banks will reduce the availability of 30-year, fixed-rate loans. Consumers would be left with only adjustable-rate products that expose them to uncertainty and interest rate volatility. If interest rate risk is not managed in the financial system, it has to be managed by individual mortgage borrowers, forced to take adjustable-rate mortgages. In fact, this is what the IMF explicitly advocated in its Global Financial Stability report, saying, "A more fundamental way for mortgage lenders to reduce their hedging needs would be to price adjustable-rate mortgage more aggressively to limit the creation of new fixed-rate mortgages with prepayment rights, although persuading borrowers to accept adjustable-rate mortgages when fixed rates are still at historically low levels would undoubtedly be difficult."

As Dr. Todd Buchholz has noted, "One of the most beneficial financial revolutions in recent memory has been in the housing sector, namely, the creation of secondary mortgage markets…the secondary mortgage market has been a vital technological and financial innovation that has helped spread risk, dampen economic crises, and attract more investors into the housing market…Without the secondary market, banks would have less liquidity available and would make fewer loans and charge higher interest rates."

A limit on our portfolio growth would eliminate our function as an outlet for banks in this situation. With Fannie Mae in place as backstop, ready and able to purchases mortgage assets should banks wish to unload them from their portfolios, the system works. When mortgages present a profitable opportunity for banks, banks invest, and Fannie Mae's portfolio is stable or declines. When mortgages are no longer profitable for banks relative to the many other assets they are able to invest in, banks can offload their mortgages to Fannie Mae and Freddie Mac. That is a benefit to the system, to banks, and to consumers.

Any arbitrary constraint on our portfolio would remove an important bid for mortgages from the market, which would lead to higher and more volatile mortgage rates for homeowners. It would also increase risk to the taxpayer, as mortgage interest rate risk migrates from Fannie Mae and Freddie Mac to commercial banks, which fund themselves with government-insured deposits. Finally, it would increase risk to the financial system, removing Fannie Mae and Freddie Mac's ability to act as stabilizer during financial crises.

CONCLUSION

I applaud every member of this committee for the time and effort you have put into examining the options for strengthening our regulatory regime and carefully considering the implications of the different choices you may make. Our mortgage finance system today is the envy of the world – the only system in the world that has made long-term, refinanceable fixed-rate mortgages the standard consumer product. And the efficiency of our system has created an enormously liquid mortgage market that reduces mortgage rates for millions of homebuyers.

A recent paper by a Federal Reserve Board economist has questioned the benefits our current system brings to consumers, estimating that the GSEs only reduce mortgage rates by seven basis points.[21] To measure the extent to which Fannie Mae and Freddie Mac reduce conforming mortgage rates, the author constructs a complex equation (Exhibit 6) that does not reflect the way the mortgage market works. He also uses data that he himself characterizes as "not up to the task." Not surprisingly, his resulting estimate that Fannie Mae and Freddie Mac reduce conforming mortgage rates by only 7 basis points has little statistical significance and is at odds with everyday experience in the mortgage markets.

Exhibit 10

Calculated GSE Effect on Jumbo-Conforming Mortgage Rate Spread

$$a_1 = \beta_0 + \beta_1\mathrm{GA} + \beta_2\mathrm{RT} + \beta_3\mathrm{CR} + \beta_4\mathrm{PR} + \beta_5\mathrm{MR} + \beta_6\mathrm{DEM} + \beta_7\mathrm{LTRT} + \beta_8\mathrm{CAP} + \beta_9\mathrm{DEV} + \sum_{s=1}\beta_{10}^{s}\mathrm{STATE}_s + \sum_{j=1}\beta_{11}^{j}\mathrm{QTR}_j + \mu$$

Source: *The GSE Implicit Subsidy and Value of Government Ambiguity*
Wayne Passmore, Board of Governors of the Federal Reserve System

The Fed study, like a study in 2001 by the Congressional Budget Office, is based on the presumption that Fannie Mae and Freddie Mac receive a "subsidy" from the government, which is the sole determinant of the enterprises' ability to attract low cost funding. We asked David Gross of Lexecon to examine this premise. He noted that "By ignoring the fact that debt issued by banking organizations differs from debt issued by Fannie Mae and Freddie Mac for reasons other than the presence of a guarantee, the CBO overestimates the expected cost of government guarantees. In particular, to the extent that part of the reason that GSE debt has low interest rates is because of high levels of liquidity, the CBO methodology will overestimate the expected cost of government guarantees."[22]

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[21] *The GSE Implicit Subsidy and Value of Government Ambiguity,* Wayne Passmore, Board of Governors of the Federal Reserve System, December 2003, available at http://www.federalreserve.gov/pubs/feds/2003/200364/200364pap.pdf.
[22] *The Government Role in Promoting Financial Sector Stability*, David Gross, *Fannie Mae Papers* (Volume II, Issue 3) July 2003, available at http://www.fanniemae.com/commentary/pdf/fmpv2i3.pdf

Fannie Mae's economists and econometricians reviewed the methodology of the Fed study, and found reason to be concerned that the analysis did not support the stated findings. The findings are attached. Specifically, they noted that both the data and techniques used caused a serious downward bias in trying to measure our effect on mortgage rates.

We also asked several eminent economists outside of Fannie Mae to take a look at the Fed study. Dr. William Greene, a prominent econometrician, examined the methodology employed in the Fed study and concluded, "Based on my review of the model specification, I conclude that the results in the Passmore study may well be seriously flawed…I believe the study should be subjected to extensive scrutiny before being used as a guide to the magnitude of Fannie Mae and Freddie Mac's impact on conforming mortgage rates." I've attached his comments for the record.

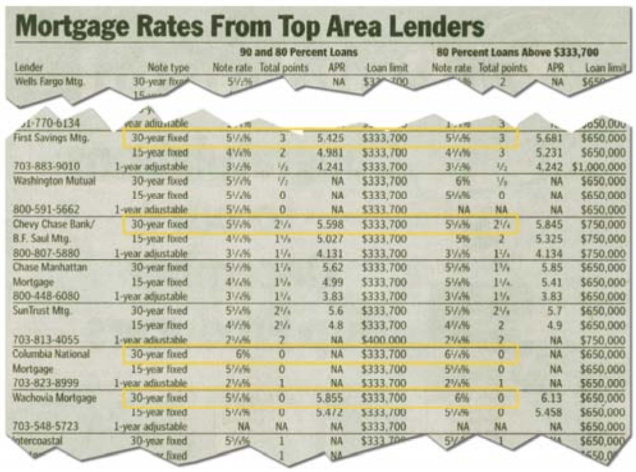
Last year, we commissioned a study from Professor R. Glenn Hubbard, former Chairman of the Council of Economic Advisers and a Professor at Columbia University, on Fannie Mae's management of liquidity risk. We recently asked for his views on the Fed study. In a letter, which I would like to enter into the record, he noted, "In the study I conducted last year, I found that Fannie Mae's return on assets and net interest margin have been less volatile historically than those of large commercial banks. This finding is consistent with the possibility that Fannie Mae's overall business risk is lower as well. This possibility and its implications for differences in funding costs between Fannie Mae and other financial institutions have not been fully explored in recent studies, including a recent Federal Reserve working paper."

We have also asked Professor Alan Blinder of Princeton, a former Vice Chairman of the Board of Governors of the Federal Reserve System for his reaction to the study. In a letter which is attached for the record, he states that there are a number of questions that could be asked with respect to such an analysis. "Passmore's conclusions depend sensitively on both his assumptions and the details of his estimation methods, many of which can be legitimately questioned," Blinder wrote.

Real world observations also differ from the econometric estimates in the Fed study. Many local newspapers publish mortgage rate charts every weekend, like the example from the Washington Post (Exhibit 7), listing the rates offered by many lenders.

Exhibit 11

Observed GSE Effect on Jumbo-Conforming Mortgage Rate Spread



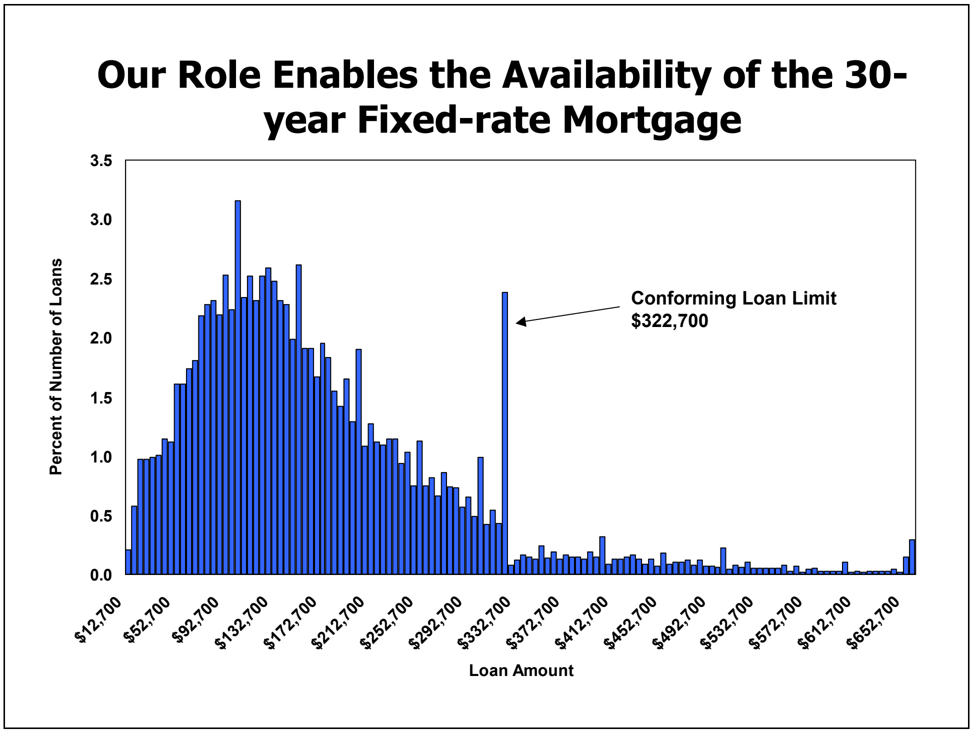
Mortgage Rates From Top Area Lenders

		90 and 80 Percent Loans				80 Percent Loans Above $333,700			
Lender	Note type	Note rate	Total points	APR	Loan limit	Note rate	Total points	APR	Loan limit
Wells Fargo Mtg.	30-year fixed	5½%		NA	$33[illegible]	[illegible]	2	NA	$650[illegible]
	15-[illegible]								
[illegible]1-770-6134	[illegible]year adjustable	[illegible]				[illegible]	3	[illegible]	$650,000
First Savings Mtg.	30-year fixed	5⅛%	3	5.425	$333,700	5⅜%	3	5.681	$650,000
	15-year fixed	4⅝%	2	4.981	$333,700	4⅞%	3	5.231	$650,000
703-883-9010	1-year adjustable	3½%	½	4.241	$333,700	3½%	½	4.242	$1,000,000
Washington Mutual	30-year fixed	5⅞%	½	NA	$333,700	6%	⅛	NA	$650,000
	15-year fixed	5¼%	0	NA	$333,700	5⅜%	0	NA	$650,000
800-591-5662	1-year adjustable	5¼%	0	NA	$333,700	NA	NA	NA	$650,000
Chevy Chase Bank/	30-year fixed	5⅜%	2¼	5.598	$333,700	5⅝%	2¼	5.845	$750,000
B.F. Saul Mtg.	15-year fixed	4⅞%	1⅛	5.027	$333,700	5%	2	5.325	$750,000
800-807-5880	1-year adjustable	3¼%	1¼	4.131	$333,700	3⅜%	1¼	4.134	$750,000
Chase Manhattan	30-year fixed	5½%	1⅛	5.62	$333,700	5⅝%	1⅛	5.85	$650,000
Mortgage	15-year fixed	4¾%	1⅛	4.99	$333,700	5⅛%	1¼	5.41	$650,000
800-448-6080	1-year adjustable	3¼%	1⅛	3.83	$333,700	3¼%	1⅛	3.83	$650,000
SunTrust Mtg.	30-year fixed	5⅜%	2⅛	5.6	$333,700	5½%	2⅛	5.7	$650,000
	15-year fixed	4½%	2⅛	4.8	$333,700	4⅝%	2	4.9	$650,000
703-813-4055	1-year adjustable	2⅞%	2	NA	$400,000	2⅞%	2	NA	$750,000
Columbia National	30-year fixed	6%	0	NA	$333,700	6⅛%	0	NA	$650,000
Mortgage	15-year fixed	5⅜%	0	NA	$333,700	5⅝%	0	NA	$650,000
703-823-8999	1-year adjustable	2⅞%	1	NA	$333,700	2⅞%	1	NA	$650,000
Wachovia Mortgage	30-year fixed	5⅝%	0	5.855	$333,700	6%	0	6.13	$650,000
	15-year fixed	5⅛%	0	5.472	$333,700	5⅜%	0	5.458	$650,000
703-548-5723	1-year adjustable	NA	NA	NA	$333,700	NA	NA	NA	$650,000
Intercoastal	30-year fixed	5⅜%	1	NA	$333,70[illegible]	5[illegible]	1	[illegible]	$650,000
[illegible]	[illegible] fixed		1	NA					$650,0[illegible]

There is a substantial interest rate difference between the mortgages we finance, on the left, and those we don't finance on the right. The loans we finance typically cost between 20 and 50 basis points less than jumbo loans.

Not only do we lower rates, but we also make fixed-rate mortgages more available.

Exhibit 12



As you can see in Exhibit 8, there is a dramatic increase in share of adjustable-rate mortgages that begins just above our conforming loan limit. This difference is even more pronounced when you compare our market to the bank-based systems common throughout the world. Only in the United States are long-term, fixed-rate mortgages readily available, and here they account for nearly four of every five single-family first mortgages taken out by consumers.

In many bank-based systems in other countries, consumers only have access to the adjustable-rate mortgage loans that are a match for the banks' deposit base. But long-term, refinanceable fixed-rate mortgages are better for both consumers and the economy. With a fixed-rate mortgage consumers don't have to worry that rising interest rates will jeopardize their ability to make the payments on their home loan. And because the cost of existing mortgages is not affected when interest rates go up, and consumers can refinance their mortgages when rates go down, the fixed-rate mortgage contributes greatly to economic stability.

By making the long-term, fixed-rate mortgage more affordable and more available to American families, Fannie Mae fulfills its role as an instrument of national policy to expand homeownership. We believe in that mission, and work every day to achieve it. It is in the best interest of our mission – and of national policy to support homeownership – to ensure oversight by a world-class financial regulator. Millions of American families are counting on our mortgage finance system to continue to provide opportunities to reach the American Dream of homeownership. A great deal is at stake here. The 1992 Act has led to a transformation in mortgage finance unleashing innovation to make homeownership more affordable and more available in communities around the nation. I believe that Congress can build on that success, strengthening our regulatory regime to enhance our ability to achieve our mission and benefit millions of families in the future.