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FANNIE MAE, FREDDIE MAC & FHA: TAXPAYER EXPOSURE IN THE HOUSING MARKETS

HEARING

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

HEARING HELD IN WASHINGTON, DC, JUNE 2, 2011

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FANNIE MAE, FREDDIE MAC & FHA: TAXPAYER EXPOSURE IN THE HOUSING MARKETS

THURSDAY, JUNE 2, 2011

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The Committee met, pursuant to call, at 10:30 a.m., in room 210, Cannon House Office Building, Hon. Paul Ryan [Chairman of the Committee] presiding.

Present: Representatives Ryan, Garrett, Campbell, Black, Mulvaney, Young, Rokita, Van Hollen, Kaptur, Doggett, McCollum, Pascrell, Honda, Wasserman Schultz, and Castor.

Chairman RYAN. Good morning. Welcome all to this very important hearing. The purpose of today's hearing is to highlight the true cost and risk posed by the government's ongoing bailout of Fannie Mae and Freddie Mac. It also seeks to shed some light on the hidden cost of the mortgage insurance program run by Federal Housing Administration. This is obviously a very complex subject, but a critically important issue. The federal take-over of Fannie and Freddie is the most costly taxpayer bailout in the wake of the 2008 financial crisis.

For years, we were told Fannie and Freddie posed no liability to the Federal Government. Through their unique status cultivated through political influence, they pursued, what I would call "crony capitalism." And the taxpayer is now being stuck with the bill. To date, the Treasury Department has provided about a $160 billion to Fannie and Freddie, and the CBO estimates that they are all end-cost for the decade will be about $370 billion. While the Treasury Department has put forward a framework for reform, the Obama administration still does not account for these estimated future costs in its budget, even though it has lifted the cap on Fannie and Freddie's line of credit. When it comes to this ongoing bail out of Fannie and Freddie, taxpayers have a right to know how much they are on the hook for. FHA is different than these two GSEs because it is included in federal budget totals. However, the current budgetary treatment of FHA under states the risks and costs of FHA guarantees, which now amount to nearly a fifth of all new single-family home loans. While CBO adjusts the cost of Fannie and Freddie loans for market risk under Federal Credit Reform Act, budget projections do not incorporate market risk into the cost of FHA guarantees. The housing market is still in a very fragile shape; all the recent news confirms this. There are no two ways about it.

For the homeowners, for taxpayers and for working families across this country, we need to put an end to an ongoing bailout of Fannie and Freddie and advanced serious permanent solutions. That starts with a full accounting of their activities. We must advance plans to reform Fannie and Freddie to fully account for FHA loans and to stop the hemorrhage of taxpayer dollars and to limit the government's dominance and distortion of housing finance.

I look forward to hearing from our witnesses today regarding these serious problems, and I look forward to a constructive debate on how we can save taxpayers from the consequences of misguided housing policy and crony capitalism, now and in the future.

We have our own experts from our side of the aisle, Mr. Garrett and Mr. Campbell, who are senior members of the Banking and Financial Services Committee. But before I turn it over to the witnesses, I would like to recognize, Mr. Van Hollen for his opening statement.

[The prepared statement of Chairman Paul Ryan follows:]

PREPARED STATEMENT OF HON. PAUL RYAN, CHAIRMAN, COMMITTEE ON THE BUDGET

Welcome all, to this important hearing. The purpose of today's hearing is to highlight the true costs and risks posed to taxpayers by the government's ongoing bailout of Fannie Mae and Freddie Mac.

It also seeks to shed light on the hidden costs of the mortgage insurance program run by the Federal Housing Administration. This is a complex subject, but it is a critically important issue.

The federal takeover of Fannie and Freddie is the most costly taxpayer bailout to result from the 2008 financial crisis.

For years we were told Fannie and Freddie posed no liability to the Federal Government. Through their unique status, which they cultivated through political influence, they pursued what I call crony capitalism. And now, the taxpayer is stuck with the bill.

To date, the Treasury Department has provided about $160 billion to Fannie and Freddie, and the Congressional Budget Office estimates their all-in cost for the decade will be about $370 billion.

While the Treasury Department has put forward a menu of options for reform, the Obama administration still does not account for these estimated future costs in its budget, even though it has lifted the cap on Fannie and Freddie's line of credit.

When it comes to this ongoing bailout of Fannie and Freddie, taxpayers have a right to know how much they are on the hook for.

FHA is different from the two GSEs because it is included in federal budget totals. However, the current budgetary treatment of FHA understates the risk and cost of FHA guarantees, which now amount to nearly a fifth of all new single family home loans.

The CBO adjusts the cost of Fannie and Freddie loans for market risk. But under the Federal Credit Reform Act, budget projections do not incorporate market risk into the cost of FHA guarantees.

The housing market is still in very fragile shape—no two ways about it. For the homeowners, for taxpayers, and for working families across this country, we need to put an end to the ongoing bailout of Fannie and Freddie and advance serious solutions.

That starts with a full accounting of their activities. We must advance plans to reform Fannie and Freddie; to fully account for FHA loans; to stop the hemorrhaging of taxpayer dollars; and to limit government's dominance and distortion of housing finance.

I look forward to hearing from our witnesses today regarding these serious problems, and I look forward to a constructive debate on how we can save taxpayers from the consequences of misguided housing policy and crony capitalism, now and in the future.

I'd like to welcome our panel of distinguished witnesses.

Dr. Deborah Lucas, Assistant Director for Financial Analysis at the Congressional Budget Office—we are grateful to have her testimony before she returns to MIT's Sloan School of Management as a professor of finance.

We also have Alex Pollock from the American Enterprise Institute—who has years of housing and finance expertise, including serving as President of the Federal Home Loan Bank of Chicago.

I'd like to finally welcome to the Committee Sarah Rosen Wartell, with us today from the Center for American Progress and Center for American Progress Action Fund.

Thank you for testifying this morning, and with that, I yield to the Ranking Member, Mr. Van Hollen.

Mr. VAN HOLLEN. Well, thank you, Mr. Chairman. And let me also join you in welcoming our witnesses today. As the chairman said, this hearing focuses on a number of issues, including the technical issue of how to best account for the cost of federal support for the housing markets, both now and possibly into the future. That is a very important question. Whatever method we use should accurately and transparently provide the best estimate of what those costs are to the taxpayer.

But the larger question, and the one that will have a much bigger impact on taxpayers and the economy are what housing policies decisions we make going forward, and how they will first influence the ultimate cost to taxpayers and homeowners of the book of business originated before the housing crisis and the financial meltdown; and two, whether our housing policies decision going forward will ensure that creditworthy borrowers will still have access to credit and be able to achieve the American Dream of homeownership.

I do not know anyone who has proposed that we return to a system of what amounted to first an implicit and then an explicit government guarantee. The Treasury Department's February white paper on housing reform calls for reducing overall government support for the housing market and winding down Fannie Mae and Freddie Mac. The key question is what would a reformed housing market look like and what role, if any, should the Federal Government have in that. As the chairman mentioned, and we all know, the housing market is in a very fragile state right now.

One proposal that has been advanced by Congressman Hensarling and six members of this committee, would very quickly end any federal role in the housing market. I am very concerned that those proposals, which would create fire sales of GSE portfolios, would only further depress home values and reduce the return to taxpayers of the current portfolio at Fannie Mae, regardless of what cost accounting method we use. Those concerns are shared by many others. And Mr. Chairman, I ask unanimous consents just to put in the records, statements from the home builders and the realtors, people who are, of course, intimately involved in the housing market.

Chairman RYAN. Without objection.

[The information follows:]

NATIONAL ASSOCIATION OF REALTORS,
Washington, DC, March 31, 2011.

Hon. CHRIS VAN HOLLEN, *Ranking Democrat,*
House Committee on the Budget, Washington, DC 20515.

REALTORS® URGE CONGRESS TO APPROACH GSE REFORM SLOWLY

The National Association of REALTORS® today urged Congress to move cautiously when reforming government-sponsored enterprises Fannie Mae and Freddie Mac.

Reforming America's housing finance market can only be achieved through a forward looking, comprehensive approach that supports the housing and economic recoveries, said NAR President Ron Phipps in testimony before the House Subcommittee on Capital Markets today.

"As the leading advocate for home ownership, NAR strongly agrees that the existing system failed and that reforms are needed; however, redesigning a viable secondary mortgage model that will protect taxpayer dollars and serve the country's home owners today, and in the future, can only be achieved through a methodical, measured effort," said Phipps, broker-president of Phipps Realty in Warwick, R.I.

NAR is concerned that without a comprehensive plan for reforming the secondary mortgage market, proposed legislation to quickly constrain Fannie Mae and Freddie Mac before an adequate replacement secondary mortgage market mechanism is established will further disrupt the still fragile housing market recovery.

"REALTORS® agree that increasing private capital in the mortgage finance market is necessary for a healthy market and for reducing the government's involvement; however, proposed legislation that relies only on private capital to operate the secondary mortgage market will slow, if not stop, the housing and economic recovery," he said.

Phipps testified that the pendulum on mortgage credit has already swung too far in the wrong direction and is hurting consumers and the economy. He added that quick decisions aimed at punishing certain market players will only punish the taxpayers by constraining their ability to access affordable mortgage financing, and that making it harder for those who can afford a safe mortgage does not further the goals of the recovery.

"Home ownership is a pillar of our economy. NAR research shows for every two homes sold, a job is created, providing needed revenue to both our state and local economies. This must be considered when debating the future of federal housing policies," said Phipps.

He added that overreaching rules, like the qualified residential mortgage (QRM) exemption, could further curtail access to affordable credit and will only slow economic growth and hamper job creation.

"The QRM is likely to shape housing finance for the foreseeable future, and we believe that Congress intended to create a broad QRM exemption from the 5 percent risk retention requirement to include a wide variety of traditionally safe, well-underwritten products," said Phipps. "Congress chose not to include a high down payment among the criteria it specified in the Dodd-Frank Act. A poor QRM policy that does not heed their intentions will only increase the cost and reduce the availability of mortgage credit."

The National Association of REALTORS®, "The Voice for Real Estate," is America's largest trade association, representing 1.1 million members involved in all aspects of the residential and commercial real estate industries.

Washington, DC, May 10, 2011.

HOUSING FINANCE MARKET REFORM
MUST ENSURE MORTGAGE AFFORDABILITY, AVAILABILITY

Reforms to America's housing finance market must ensure a reliable source of affordable mortgage lending for creditworthy consumers. That's according to Realtors® and other industry insiders who examined the Federal Government's future role in the secondary mortgage market at the "Fannie Mae & Freddie Mac: Obama Options and Beyond" session during the National Association of Realtors®, here through May 14.

Panelist Steve Brown, 2011 NAR first vice-president nominee, opened the session by outlining NAR's position for reforming the government-sponsored enterprises (GSEs), saying that reform is required, taxpayers must be protected from losses, and the Federal Government must continue to play a role in the secondary mortgage market to ensure a steady flow of mortgage liquidity in all markets under all economic conditions.

"As the leading advocate for home owners, NAR is concerned that eliminating the GSEs without a viable replacement is not a reasonable option and will severely restrict mortgage capital and result in higher fees and costs for qualified borrowers," said Brown. "Reform of the secondary mortgage market needs to be comprehensive and undertaken methodically."

James Parrot, senior advisor for housing at the National Economic Council in Washington, D.C., overviewed the Obama administration's recommendations for reforming the GSEs in the wake of the financial crisis, which included varying levels of government backing. He noted the primary objective of the proposals was twofold—first, to lay out an immediate near-term path for reform, with steps that could be taken the next few years to reduce taxpayer risk and move the housing market to more stable footing, and second, to frame the discussion regarding the government's long-term role in housing finance.

"The government's large presence in the housing finance is unhealthy and needs to be scaled back; however, the steps we take over next few years to reduce the government's role and increase private capital will have a tremendous impact on the housing market and economy as well as the availability and affordability of mortgages," said Parrot. "The objective isn't to turn away from housing, but to make the housing finance market stronger so that families and their most important asset are better protected," said Parrot.

Panelist Susan Wachter, a professor at The Wharton School, University of Pennsylvania, agreed that private capital needs to return to the housing finance market, but that most likely won't happen until the market has stabilized.

"There needs to be more accountability and transparency in the secondary mortgage market so that private investors can best assess their risk and safely get back into the market," she said.

Mark Calabria, director of Financial Regulation Studies at the Cato Institute, argued for a very limited government role in the secondary mortgage market; saying that the private capital market has the funds and capacity to absorb Fannie Mae and Freddie Mac's market share. He said that increased government support in the past few decades have only slightly increased America's home ownership rate and that rates in other countries are higher despite their government's limited involvement. Despite his opposing viewpoint to the level of involvement, Calabria did acknowledge that some government backstop was essential in the future, since the housing and finance markets are sensitive to booms and busts.

David Katkov, executive vice president and chief business officer at The PMI Group, countered that it would be naive to move to a purely private market because it's been successful in other countries, adding that the U.S.'s housing finance system dwarfs that of other countries and is far more complex.

Ann Grochala, vice president at the Independent Community Bankers of America also shared concerns for small lenders and community bankers in a purely private market, where competition from large lenders would be great.

The National Association of Realtors®, "The Voice for Real Estate," is America's largest trade association, representing 1.1 million members involved in all aspects of the residential and commercial real estate industries.

Washington, DC, March 29, 2011.

STATEMENT FROM NAHB ON PROPOSALS TO ELIMINATE THE ROLE OF THE GSE'S IN THE U.S. MORTGAGE MARKET

Bob Nielsen, chairman of the National Association of Home Builders (NAHB) and a home builder from Reno, Nev., today issued the following statement on legislative proposals by Congressional leaders to effectively eliminate the role of the GSEs in the U.S. mortgage market:

"The National Association of Home Builders strongly supports efforts to modernize the nation's housing finance system, including reforms to the government sponsored enterprises Fannie Mae and Freddie Mac.

We can't go back to the system that existed before the Great Recession, but it is critical that any reforms be well-conceived, orderly and phased in over time.

"Proposals announced today by key Republicans in Congress represent a piecemeal approach to reform that would disrupt the housing market and could push the nation back into a deep recession. These proposals, along with similar plans announced by the Obama administration in February, show that many policy makers have clearly forgotten housing's importance to the economy.

"America's home builders urge the administration and Republicans in Congress to consider the potential consequences of their proposals. Congress needs to develop a workable housing finance system before it moves forward with policies that would further destabilize a housing market that is already struggling.

Housing can be the engine of job growth this country needs, but it can't fill that vital role if Congress and the administration make damaging, ill-advised changes to the housing finance system at such a critical time."

Mr. VAN HOLLEN. And there is also a bipartisan concern on that score. As you mentioned, there has been other legislation introduced that does not immediately wipe out any federal participation, but, in fact, allows federal participation to go forward in a much more responsible way. That has been introduced by Congressman Campbell, Gary Peters, and others that preserves a limited government role and one that is designed to protect the taxpayers but also allow for creditworthy borrowers to have access to the market.

Others, like the Center for American Progress that put forward their own proposals and I commend them for putting something on the table. So Mr. Chairman, I thank you for holding this hearing. I think the question of how we account for these costs is, of course, an important one and I look forward to the testimony. But the real cost and the larger cost in the long run to taxpayers, homeowners and the economy will be determined by the housing policy decisions that we make here in the Congress. So with that, I thank you, and again, thank you for the witnesses.

Chairman RYAN. Thank you. Today we are joined by Dr. Deborah Lucas.

Mr. CAMPBELL. Mr. Chairman?

Chairman RYAN. Yeah.

Mr. CAMPBELL. Before we get to the witnesses, I would ask unanimous consent to submit for the record a letter from the National Association of Realtors.

Chairman RYAN. Sure, and without objection.

Mr. CAMPBELL. Thank you.

[The information follows:]

Washington, DC, June 1, 2011.

DEAR CHAIRMAN RYAN AND RANKING MEMBER VAN HOLLEN: Our nation's housing markets remain fragile and due to their dramatic impact on our nation's economy, our economic recovery has been slow at best. The 1.1 million members of the National Association of REALTORS® urge you to recognize the importance of both the Federal Housing Administration (FHA) and the secondary mortgage market to our nation's economic health. As the Budget Committee reviews "Taxpayer Exposure in the Housing Markets," please consider the overall impacts of housing on our economy.

Since its inception in 1934, FHA has successfully operated as a self-sufficient entity without expense to the American taxpayer. More recently, FHA has played a critical role in our nation's housing finance system and has outperformed all expectations in its ability to ensure the availability of safe, affordable mortgage financing to all markets during all economic conditions. Changing the way this program is evaluated doesn't change that.

Today FHA is evaluated using standards set by the Federal Credit Reporting Act which is the same method that is used to evaluate ALL federal programs. In its recent report responding to the Chairman's request, the Congressional Budget Office (CBO) reaffirmed that using this traditional methodology FHA will generate a $4.4 billion surplus in FY12. Singling out and subjecting FHA to a different accounting standard such as fair value accounting does not permit a fair comparison of FHA's performance to all other federal programs. In addition, a fair value accounting method is an inappropriate way to analyze a public program like FHA unless the intent is to sell its assets at the time of analysis. Market conditions change and, therefore, a fair value accounting analysis is only as good as the day it is performed and only if the assets were to be sold at fire-sale prices. The FHA program should not be singled out for a less comparable and highly volatile measurement such as fair value accounting. Instead, an appropriate review of FHA's financial health—including cash reserves, loan performance and credit quality—indicate that FHA's performance is strong and its financial standing is solid.

Freddie Mac and Fannie Mae, the government-sponsored enterprises (GSEs), have also played a very valuable role in housing markets. REALTORS® agree that reforms are needed and an influx of private capital is necessary for the housing finance system to right itself. However, REALTORS® are practical and understand that in extreme economic conditions like the one from which we are currently recovering, private capital will retreat from the market requiring the participation of entities that will remain in the marketplace regardless of economic conditions. The GSEs were created to support this specific mission within the secondary mortgage market and any replacements must meet this criterion as well. If government support of the GSEs was unavailable at the onset of the financial crisis, our nation's housing and overall economic recovery would be further stunted.

The National Association of REALTORS® urges the Committee to consider the overall impact on housing programs on our national economy. Housing accounts for more than 15 percent of the national gross domestic product. For every additional 1,000 home sales, about 500 jobs are added to the economy. Those are real jobs that give our families, friends and neighbors a chance to work. Our nation's recovery depends upon housing. What we need now is for the market to heal, to self-correct, and stabilize.

Sincerely,

RON PHIPPS, ABR, CRS, GRI, GREEN, e-PRO, SFR,
2011 President, National Association of REALTORS®.

Chairman RYAN. Anybody else want to submit anything? Sure, we will have the clerk make photocopies and distribute it out.

Mr. GARRETT. As long as you do it, I was going to do it at the end, but since you are doing it. One for the National Multi Housing Council letter.

Chairman RYAN. Okay, without objection.

[The information follows:]

June 2, 2011.

Hon. PAUL RYAN, *Chairman,*
Committee on the Budget, U.S. House of Representatives, Washington, DC 20515.

DEAR CHAIRMAN RYAN: The National Multi Housing Council (NMHC) and National Apartment Association (NAA) applaud your leadership for holding a hearing: "Fannie Mae, Freddie Mac & FHA: Taxpayer Exposure in the Housing Markets." As an industry, we share your concern that the bursting of the housing bubble has exposed serious flaws in our nation's housing finance system. As policymakers craft solutions to fix the single-family housing problems, it is critical they do not do so at the expense of the less understood, but vital multifamily sector.

NMHC and NAA represent the nation's leading apartment firms. Our combined memberships are engaged in all aspects of the industry, including ownership, development, management and finance. NMHC represents the principal officers of the industry's largest and most prominent firms. NAA is the largest national federation of state and local apartment associations with 170 state and local affiliates comprised of more than 50,000 members. Together we represent approximately six million apartment homes.

One-third of American households rent, and over 14 percent of households—16.7 million households—live in a rental apartment (buildings with five or more units). Our industry's ability to meet the nation's rental housing needs depends on reliable and sufficient sources of capital. To understand the role of Fannie Mae, Freddie Mac and FHA from a multifamily perspective, it is necessary first to have a broad understanding of the apartment industry's current capital sources—both before and during the crisis.

For more than two years after the onset of the financial meltdown, virtually all private mortgage lenders abandoned the market, leaving the apartment industry to rely heavily on credit either insured or guaranteed by the Federal Government. An estimated 70 percent of apartment loans issued in 2010 had some form of government credit behind them, namely FHA, Fannie Mae or Freddie Mac. Even as the private debt markets improve, the FHA and Government Sponsored Enterprises (GSEs) are expected to account for half to two-thirds of the $60 billion-$75 billion in credit provided to the apartment sector this year alone.

Historically, however, the apartment industry has enjoyed access to mortgage credit from a variety of capital sources. In addition to the FHA and GSEs, banks and thrifts, life insurance companies, pension funds and the commercial mortgage-backed securities market have all provided significant amounts of mortgage capital to the apartment industry. Prior to the financial crisis, these capital sources provided our sector with $100-$150 billion annually, reaching as high as $225 billion, to develop, refinance, purchase, renovate and preserve apartment properties.

As policymakers consider the causes of, and solutions to, the single-family meltdown, it is important to distinguish between the finance systems supporting the single-family sector and the multifamily sector. The apartment industry did not overbuild in the housing boom. The discipline shown by the apartment industry has translated into stronger portfolio performance as well. Overall loan performance in the $853 billion multifamily sector remains healthy, with delinquencies and default rates only a fraction of those seen in single-family.

Fannie Mae and Freddie Mac: The multifamily portfolio has earned net revenues of $2 billion for the taxpayers since conservatorship.

The presence of a government-supported secondary multifamily mortgage market lowers the cost of capital, which enables the apartment industry to provide millions of units of unsubsidized workforce housing. Although Fannie Mae and Freddie Mac have rightfully been criticized for their role in the single family housing meltdown, they have performed admirably in the multifamily marketplace. Fully 90% of the apartment units financed by Fannie Mae and Freddie Mac over the past 15 years—more than 10 million units—were affordable to families at or below the median income for their community.

Furthermore, the GSEs' multifamily programs were not part of the meltdown and are not broken. They have default rates of less than one percent—a tenth of those in the single-family sector—and even during conservatorship, they have earned net revenues of $2 billion.

FHA: AN ALTERNATIVE DEBT CAPITAL SOURCE AND PRIVATE SECTOR BACKSTOP

Since its inception in 1934, FHA has insured over 47,000 multifamily mortgages. It currently holds 13,000 multifamily mortgages in its portfolio (compared to 4.8 million single-family mortgages). While it accounts for just six percent of the total outstanding multifamily mortgage debt, it is a material and important source of capital for underserved segments of the rental market.

In normal capital markets, FHA/Ginnie Mae play a limited, but important, role in the rental housing sector. During the economic crisis, however, FHA became virtually the only source of apartment construction capital. Demand for FHA financing surged, increasing more than five-fold. Applications have increased from $2 billion annually to $10 billion, and HUD anticipates that demand for FHA multifamily mortgage insurance will remain high for the next several years.

Unfortunately, HUD's failure to keep pace with the volume of multifamily mortgage applications is exacerbating the nation's shortage of workforce housing, jeopardizing the thousands of jobs created by new apartment construction and reducing the new revenues the program could be generating for the Federal Government.

The consequences of this backlog are magnified by the fact that private capital markets still have not recovered, leaving apartment firms with few alternatives. The result is a dramatic reduction in new apartment construction at a time when the nation's demand for affordable rental housing is growing faster than in recent decades.

We greatly appreciate your efforts to review the housing needs of our nation. We respectfully request that this letter and the accompanying testimony presented to the House Financial Services Committee, Subcommittee on Housing regarding "The Future Role of FHA and Ginnie Mae in the Single-Family and Multi-Family Mortgage" be inserted in the record.

Sincerely yours,

DOUGLAS M. BIBBY, *President,*
National Multi Housing Council.

DOUGLAS S. CULKIN, CAE, *President,*
National Apartment Association.

ATTACHMENT: NMHC/NAA testimony "The Future Role of FHA and Ginnie Mae in the Single-Family and Multi-Family Mortgage"

TESTIMONY BY PETER EVANS, PARTNER, MORAN & CO., ON BEHALF OF THE NATIONAL MULTI HOUSING COUNCIL AND THE NATIONAL APARTMENT ASSOCIATION

Before the Insurance, Housing and Community Opportunity Subcommittee of the House Committee on Financial Services for the hearing on "The Future Role of FHA and Ginnie Mae in the Singlefamily and Multifamily Mortgage Markets," held on May 25, 2011.

Chairwoman Biggert and Ranking Member Gutierrez, on behalf of this nation's 17 million households who call an apartment their home, the National Multi Housing Council (NMHC) and the National Apartment Association (NAA) would like to thank you for the opportunity to testify today on the future role of the Federal Housing Administration (FHA) and the Government National Mortgage Administration (GNMA) in multifamily mortgage markets.

NMHC and NAA represent the nation's leading firms participating in the multifamily rental housing industry. Our combined memberships are engaged in all aspects of the apartment industry, including ownership, development, management and finance. The National Multi Housing Council represents the principal officers of the apartment industry's largest and most prominent firms. The National Apartment Association is the largest national federation of state and local apartment associations. NAA is a federation of 170 state and local affiliates comprised of more than 50,000 multifamily housing companies representing more than 5.9 million apartment homes.

We applaud your efforts to examine the role of FHA in America's housing market and ways to improve its ability to provide liquidity to key sectors of the rental housing market.

GROWING DEMAND FOR RENTAL HOUSING AGAINST A BACKDROP OF A SUPPLY SHORTFALL

Prior to addressing the role of FHA and GNMA multifamily finance programs now and in the future, it is worthwhile to take a moment and note the fundamental role multifamily housing plays in our nation's economy.

The U.S. is on the cusp of a fundamental change in our housing dynamics. Changing demographics and new economic realities are driving more people away from the typical suburban house and causing a surge in rental demand. Tomorrow's households want something different. They want more choice. They are more interested in urban living and less interested in owning. They want smaller spaces and more amenities. And increasingly, they want to rent, not own. Unfortunately, our housing policy has yet to adjust to these new realities.

Our society is changing in meaningful ways that are translating into new housing preferences. Married couples with children are now less than 22% of households and that number is falling. By 2030, nearly three-quarters of our households will be childless. Seventy-eight million Echo Boomers are beginning to enter the housing market, primarily as renters. Seventy-eight million Baby Boomers are beginning to downsize, and many will choose the convenience of renting.

Beyond just changing demographics, there is also a much-needed change in consumer psychology underway that favors more long-term renters in the future. The housing crisis taught Americans that housing is shelter, not an investment. That awareness is freeing people up to choose the housing that best suits their lifestyle. For millions, that is an apartment.

Renting has many advantages. Convenience, walkable neighborhoods and mobility to pursue job opportunities are some of the reasons why renting is no longer something you do until you can buy a house.

Today, nearly 89 million Americans, almost one-third of all Americans, rent their home. There are 17.3 million apartments (properties with 5 or more units) in the U.S. that, taken together, provide a place to live for more than 14 percent of all households. In this decade, renters could make up half of all new households—more than seven million new renter households. Because of these changes, University of Utah Professor Arthur C. Nelson predicts that half of all new homes built between 2005 and 2030 should be rental units.

Unfortunately, supply is beginning to fall short of demand. An estimated 300,000 units a year must be built to meet expected demand. Yet most forecasts suggest ground will be broken on fewer than half that many in 2011. In fact, new multifamily construction set an all-time post-1963 low in 2010 at 97,000 new starts. That level of construction is not even enough to replace the units lost every year to demolition, obsolescence and other losses.

While there may be an oversupply of single-family housing, the nation could actually see a shortage of multifamily housing as early as 2012. The shortage is particularly acute in the area of workforce and affordable housing. The Harvard Joint Center for Housing Studies estimates a nationwide affordable housing shortfall of three million units.

This context is particularly important in understanding why it is vital that as Congress looks to reform housing finance, it do nothing that would jeopardize the construction, financing and availability of multifamily housing.

The bursting of the housing bubble exposed serious flaws in our nation's housing finance system. As policymakers craft solutions to fix the single-family housing problems, they should be mindful not to do so at the expense of the much smaller and less understood, but vital, multifamily sector.

The government sponsored enterprises' (GSEs) multifamily programs were not part of the meltdown and are not broken. They have default rates of less than one percent—a tenth of those in the single-family sector—and they actually produce net revenue (profits) for the U.S. government. They pose no risk to the taxpayer.

Through careful underwriting, the GSEs' multifamily models have met the test. They have attracted enormous amounts of private capital; helped finance millions of units of market-rate workforce housing without federal appropriations; sustained liquidity in all economic climates; and ensured safety and soundness in their multifamily business. As a result of the liquidity provided by the GSEs, the United States has the best and most stable rental housing sector in the world.

Apartments are not just shelter. They are also an economic powerhouse. The aggregate value of this apartment stock is $2.2 trillion. Rental revenues from apartments total almost $120 billion annually, and management and operation of apartments are responsible for approximately 550,000 jobs.

FEDERAL SUPPORT OF THE MULTIFAMILY CREDIT MARKET

Multifamily Capital Markets Overview

Historically, the apartment industry has enjoyed access to mortgage credit from a variety of capital sources, each with its own focus, strengths and limitations. Private market sources include commercial banks, which offer short-term, floating rate financing for smaller, local borrowers. Life insurance companies target higher-quality properties in select markets. Their capital allocations change with market conditions, and their loan terms do not typically extend beyond 10 years. The commercial mortgage-backed securities (CMBS) market became a material source of capital for the industry in the mid1990s but has been shut down since 2008, and it is unlikely to return to its pre-bubble levels of lending. Even in healthy economic times, these capital sources have been insufficient to meet the full needs of the apartment sector, most notably the affordable and workforce housing sectors and rental housing in smaller markets.

To fill that gap, the Federal Government supports the multifamily housing finance market through three primary entities: the GSEs Fannie Mae and Freddie Mac; the Federal Housing Administration (FHA); and Ginnie Mae (GNMA). Each of these plays an important but different role in ensuring the availability of mortgage finance to the rental industry.

The GSEs have served as the cornerstone of the multifamily housing finance system for decades, offering a broad range of mortgage products, including long-term debt for the entire range of apartment properties (market-rate workforce housing, subsidized, large properties, small properties, etc.) in all markets (primary, secondary and tertiary) at all times regardless of economic conditions.

FHA was created in 1934 to insure multifamily loans originated by FHA-approved lenders to increase the capital availability to the industry. It offers high-leverage, long-term mortgages to many markets underserved by private capital. It primarily targets construction lending, although it is also available for substantial rehabilitation and acquisition and refinancing.

GNMA was established in 1968 to help create a secondary market for both single-family and multifamily FHA-insured loans. GNMA guarantees investors the timely payment of principal and interest on mortgage-backed securities (MBS) comprised of federally insured or guaranteed loans, including FHA loans. The GNMA guaranty allows mortgage lenders to obtain a more favorable price for their mortgage loans in the secondary market. Lenders can then use the proceeds to make new mortgage loans available. Notably, GNMA securities are the only MBS backed by the full faith and credit guaranty of the United States government, which means that even in troubled economic times, such as those that continue to confront the nation, investments in GNMA MBS are safe for investors.

FHA/GNMA: An Alternative Debt Capital Source and Private Sector Backstop

Since its inception in 1934, FHA has insured over 47,000 multifamily mortgages. It currently holds 13,000 multifamily mortgages in its portfolio (compared to 4.8 million single-family mortgages). While it accounts for just six percent of the total outstanding multifamily mortgage debt, it is a material and important source of capital for underserved segments of the rental market.

It is best known for offering construction loans to developers who lack access to bank and other private construction capital sources. It also serves borrowers with long-term investment goals as the only capital provider to offer 35-40-year loan terms. FHA lending is essential to borrowers in secondary markets, borrowers with smaller balance sheets, new development entities and non-profit firms, all of which are often overlooked by private capital providers.

FHA-insured debt has also been widely used by sponsors of targeted affordable housing and properties that receive federal, state and local subsidies, project-based Section 8 and proceeds from Low-Income Housing Tax Credits (LIHTCs).

FHA serves the multifamily market through three key programs.

- Section 221(d)(3) and Section 221(d)(4) Mortgage Insurance Programs: These programs are of the most importance to the conventional apartment industry. They insure mortgages for new construction or substantial rehabilitation of multifamily rental or cooperative housing for moderate-income families, the elderly and the handicapped. Section 221(d)(3) is used by nonprofit sponsors while Section 221(d)(4) is used by profit-motivated sponsors. Notably, the program enables GNMA to use mortgage-backed securities to provide liquidity support for long-term mortgages (up to 40 years), which leads to lower interest rates for borrowers.
- Section 207/223(f) Program: These mortgage insurance programs insure mortgage loans to facilitate the purchase or refinancing of existing multifamily rental housing that was originally financed with conventional or FHA-insured mortgages. Properties requiring substantial rehabilitation are ineligible for mortgage insurance under this program, though HUD permits the completion of non-critical repairs after endorsement for mortgage insurance. The Section 223(f) program enables GNMA to use mortgage-backed securities to provide liquidity support for long-term mortgages (up to 35 years), which leads to lower interest rates for borrowers.

CAPACITY AND PROCEDURAL OBSTACLES CREATE HISTORIC BACKLOG AT FHA

In normal capital markets, FHA/GNMA play a limited, but important, role in the rental housing sector. During the economic crisis, however, FHA became virtually the only source of apartment construction capital. Demand for FHA financing surged, increasing more than five-fold. Applications have increased from $2 billion annually to $10 billion, and HUD anticipates that demand for FHA multifamily mortgage insurance will remain high for the next several years.

FHA's lack of resources and recently implemented new processing procedures have created an enormous backlog of pending applications for new construction financing (through the 221(d)(3) and 221(d)(4) programs and refinancing for maturing mortgages through the 207/223(f) programs. As a result, FHA is struggling to meet this increased demand. Further exacerbating its capacity issues are efforts implemented over the past year to create stricter credit requirements through more stringent loan terms and expanded underwriting review. Additionally, FHA has recently revised its mortgage closing documents for the first time in 30 years. These changes mean that borrowers are subject to processing times that can exceed 18 months, and there are increasing questions over whether applications will move forward at all.

NMHC/NAA strongly support FHA's efforts to introduce sound credit and underwriting policies; however, these changes are disruptive to the critical housing needs of our nation's communities. Improvements cannot be undertaken at the cost of unnecessarily increasing government bureaucracy that results in a bottleneck of applications and the rejection of qualified development transactions. Multifamily rental developments financed through FHA create thousands of jobs and generate revenue for the Federal Government and communities; hence, delays at FHA miss an opportunity to contribute to the economic recovery. Moreover, the FHA multifamily program generates net revenues for the taxpayer—revenues that are forsaken when FHA is unable to process the applications in its pipeline.

Before examining the specific problems facing FHA in greater depth, we must note that HUD Secretary Donovan and his team are working diligently to resolve some of the issues we are raising today. In fact, NMHC/NAA, along with the National Association of Home Builders and the Mortgage Bankers Association, meet with top HUD officials on a quarterly basis to drive continued progress. All that said, while some progress has been made, it remains incomplete. Congressional action and vigilance will be required to ensure all problems are swiftly and satisfactorily addressed.

Loan Processing Issues

Increased demand for FHA financing has resulted in significantly longer loan processing times throughout the country. This is creating a significant hardship for apartment providers seeking to meet the nation's growing demand for rental housing.

In recent months, HUD has attempted to reallocate resources to high-demand offices and increase the amount of information offered to borrowers so they will better know their place in the pipeline. HUD has also clarified its application fee refund policies to enable would-be borrowers to withdraw their applications without material financial penalty when alternate financing is available.

Despite these efforts, applicants in many HUD field offices still have no idea how many projects are in the queue ahead of them or when HUD/FHA is likely to respond. We offer the following recommendations, which include some items HUD/FHA has already identified:

1. Follow the Multifamily Accelerated Processing (MAP) Guide to ensure loans are processed efficiently.

HUD insists that transactions can be expedited through its MAP program; however, field offices often deviate from the guide, creating confusion among borrowers and lenders over what is required to secure FHA-insured debt. A more consistent application of the MAP Guide will eliminate this confusion and help reduce FHA's review time.

2. Seek a more efficient means to address credit concerns.

As noted above, FHA has undertaken steps to strengthen the credit risk of its portfolio. However, some of these steps could be reworked in ways that would help expedite loan processing and still protect the agency. For instance, FHA has mandated that all loans over $15 million be processed by a National Loan Committee instead of being evaluated by the field office. This is an unnecessary complication. For years, FHA has relied on its lender partners to conduct due diligence, and the results have produced an FHA multifamily portfolio with acceptable credit performance. Instead of essentially abandoning this process, FHA should only require centralized review of loan requests that exceed the program's loan terms and requirements.

3. Establish a special underwriting team for large, atypical loans.

While we agree that loans that exceed the general parameters of loans typically insured by FHA should be carefully examined, creating a special team to process them would relieve the clogs in the pipeline and expedite the processing of more standard transactions.

4. Provide greater oversight over market assessment information.

HUD should use both appraisal data and the information provided by the Economic Market Analysis Division (EMAD) when reviewing applications instead of relying solely on EMAD data, which often is not an accurate assessment of local market conditions.

Resources

While some of the processing backlogs are a result of procedural obstacles, the greatest source of the problem lies in the insufficient staffing and financial resources available to FHA to meet current and future demand.

Although NMHC/NAA recognize that budget constraints confronting Congress and the nation make it unlikely that additional funding can be secured for administering the FHA multifamily mortgage insurance programs, we believe that existing resources can be reallocated to help alleviate bottlenecks.

Most notably, HUD can establish field office monitoring teams to evaluate and improve the ability of each FHA office to process applications, relative to their market share and based on the timelines set forth in the MAP Guide. Appropriators in Congress should give HUD the discretion to reallocate capital and staffing resources to offices that are the most efficient. Until then, however, HUD should not stand on the lack of such flexibility as a reason for the backlog instead of finding alternative solutions within its authority. For example, high-performing offices could be exempted from having the National Loan Committee review certain types of transactions that are unlikely to result in taxpayer losses. Finally, personnel in offices that are experiencing high volumes of applications could be supplemented by temporary duty assignments to help reduce backlogs.

FHA–RURAL REGULATORY IMPROVEMENT ACT OF 2011

The Committee has asked us to comment on its discussion draft, the FHA-Rural Regulatory Reform Act of 2011. While the bill predominantly addresses issues specific to the single-family and rural housing programs, there are several issues we want to raise regarding the FHA multifamily programs.

- Loan Limits: The current FHA multifamily loan limits are not high enough for properties that require elevator construction. Increases to the base loan limits and cost factors enacted over the past eight years have helped in many parts of the country, but they have not helped in urban areas where high-rise elevator construction is common As a result, there is a significant financing shortage in these areas, where demand for affordable and workforce housing is high.

To meet the growing demand for affordable rental housing in urban areas, we propose a 50 percent increase in the FHA multifamily loan limits for elevator buildings. Elevator buildings are significantly more expensive to build, yet the loan limits for elevator buildings in FHA's most popular program, the 221(d)(4), are just 10 percent higher than garden apartment loan limits—$68,7000 for a two-bedroom in a high-rise versus $62,026 for a garden apartment. In a high cost market, the maximum elevator limit is $214,421 compared to a non-elevator limit of $195,382.

Our proposal would increase the base loan limit for a two-bedroom unit in an elevator property from $68,070 to $93,039 (approximately a 37% increase). Adding the high-cost area factors to this base limit would allow FHA to insure loans in elevator structures of up to $293,073 per unit. Such a change would make a material difference in the amount of rental housing constructed in urban markets.

Last year, the House passed bipartisan legislation to increase the FHA multifamily loan limits in high-rise elevator properties. We urge this Congress to address the demand for construction financing in our nation's cities by including those provisions in your forthcoming bill.

- Capital Reserves. We appreciate the Committee's efforts to improve the long-term viability of the FHA multifamily programs by implementing a risk-based capital reserve. We strongly support adequately capitalizing the General Insurance and Special Risk Insurance Fund (GI/SRI funds). However, the mortgage insurance premium for lower-risk loan programs should not be increased to subsidize higher-risk FHA insurance activities. Such transfer of risk-based capital could have a chilling impact on the multifamily programs if premiums are raised to subsidize losses in other loan categories.

FHA IS NOT THE SOLUTION TO THE CRISIS CONFRONTING THE GSE'S

As this Committee and Congress examine ways to address the crisis confronting Fannie Mae and Freddie Mac, some have suggested that Fannie Mae and Freddie Mac's secondary mortgage programs be replaced by or merged with FHA. NMHC/NAA strongly oppose such efforts. Such a move would exacerbate liquidity issues facing the multifamily industry, which could reduce the availability of workforce housing and jeopardize the economic recovery.

There are many reasons for our opposition. Lawmakers should recognize that FHA serves a very different market than Fannie Mae and Freddie Mac. It provides capital to help develop and preserve rental housing where bank financing and other forms of capital are unavailable or in short supply. It should continue to perform this important mission, and an important element of housing finance reform should be to identify areas where it is appropriate for private capital and FHA to partner. But even such risk-sharing programs would not come close to meeting the apartment industry's broad capital needs.

Even if FHA served similar market segments to Fannie Mae and Freddie Mac, as our testimony suggests, FHA is woefully unprepared to assume greater responsibility. It is already failing to meet current multifamily program demand, and there is no expectation that the resources exist within the current budgetary framework to bring it to the level that it could replace the liquidity provided by Fannie Mae and Freddie Mac.

Beyond its general capacity issues, FHA also has insufficient capacity to effectively respond to the multiplicity of unique and often complex issues presented by income property underwriting. This means that many viable deals that could lead to the construction of workforce housing might not be able to go forward simply because FHA would be incapable of structuring a deal.

FHA's limited and inflexible mortgage products do not fit the variety of needs of the market and market conditions. Again, this means that profitable deals Fannie Mae and Freddie Mac might be able to underwrite today would not go forward under a regime where FHA was the only government-backed market participant.

FHA also imposes arbitrary loan limits on its products that preclude credit in markets with significant land and development costs (i.e., high-cost markets). If FHA took over the activities of the GSEs, credit support could well be inadequate in urban markets nationwide, which would lead to reduced construction and very possibly a smaller number of units available to lower-and middle-income families.

It is also critical to note that FHA's mortgage documents are outdated and not considered to meet many market conventions and standards. Imposing these on the entire sector would expose the entire industry to significantly slow processing times currently being experienced by the small segment of FHA borrowers. It would also force multifamily firms to devote resources to the bureaucratic exercise of filling out forms instead of doing what they do best, namely constructing multifamily housing.

Finally, FHA has inadequate systems to oversee existing portfolios to manage credit risk and support prudent loan servicing. Whereas the GSE multifamily serious delinquency rates remain below one percent, moving operations to FHA could jeopardize this sterling record of success and unnecessarily leave American taxpayers open to billions of dollars in losses.

Instead of joining Fannie Mae and Freddie Mac with FHA, housing finance reform should seek to encourage partnership between private and FHA multifamily mortgage credit sources where appropriate. Although such areas may be limited, they should focus on the development and preservation of multifamily housing where bank and other forms of capital are unavailable or in short supply.

We believe there is a better solution than folding the GSEs' multifamily programs into FHA and that with more time and data from the Federal Housing Finance Agency (FHFA) we can develop a proposal to serve both the taxpayer and the millions of Americans who rely on rental housing for their shelter.

REFORM MUST PROTECT MULTIFAMILY PROGRAMS, DO NO HARM AND TAKE FACT–BASED APPROACH

While NMHC/NAA oppose merging GSE activities with FHA, we do strongly support housing finance reform and recognize the necessity of addressing the problems confronting Fannie Mae and Freddie Mac. That said, because of the multifamily sector's importance to the economy and prospects for recovery, proposals to address single-family housing problems must not be enacted at the expense of the very different, but vital, multifamily sector. Accordingly, we urge Congress to observe two principles before moving forward with any legislation:

First, proposals should do no harm to a multifamily sector that was not responsible for the financial crisis and, at the same time, is critical to ensuring a robust supply of workforce housing that will help drive our nation's economic recovery. Over 20 percent of all American households now live in apartment homes. In addition, demand for apartments is forecast to grow rapidly: In this decade, renters could make up half of all new house-holds—more than seven million new renter households in total. Thus, public policy should take special care not to harm the planned production of workforce housing.

Moreover, while many have called for the elimination of Fannie Mae and Freddie Mac, this could have devastating consequences to multifamily housing if not done in a thoughtful and deliberative manner. Nearly all of the multifamily funding provided by the existing GSEs helped create workforce housing. In fact, fully 90 percent of the apartment units financed by Fannie Mae and Freddie Mac over the past 15 years—more than 10 million units—were affordable to families at or below the median income for their community.

Looking forward, it is hard to imagine a scenario in which necessary levels of workforce housing could be constructed without some level of government credit support, particularly during times of economic difficulty. Without government credit support of multifamily mortgages or mortgage-backed securities to ensure a steady and sufficient source of capital going forward, the apartment industry will be unable to meet the nation's housing needs in all markets, and Americans will pay more for workforce housing. Finally, it is also critical for Congress to note that in stark contrast to the GSEs' single-family programs, the agencies' multifamily programs did not contribute to the housing meltdown. The risk models and underwriting standards Fannie Mae and Freddie Mac have used to produce millions of units of affordable housing work. In fact, Fannie Mae and Freddie Mac have actually earned net revenues exceeding $2 billion during conservatorship.

As a second principle, proposals to address Fannie Mae should only be enacted after the best available data has been made publicly available and analyzed. This will help Congress to avoid unintended consequences that could threaten the availability of workforce housing and ensure that future legislation reflects lessons that can be gleaned from Fannie Mae and Freddie Mac's activities prior to and following conservatorship.

We encourage House Financial Services Committee Chairman Bachus to request that the Government Accountability Office (GAO) conduct a study on the performance history of Fannie Mae and Freddie Mac's multifamily mortgage purchase activities since the enactment of the Housing and Community Development Act of 1992 (P.L. 102-550).

NMHC/NAA believe that Congress should not move forward with comprehensive legislation addressing GSE multifamily mortgage activities until GAO obtains and analyzes data from the GSEs and FHFA that provides:

- An overview of the lending activities and multifamily housing mortgage products offered by the enterprises.
- Data regarding loan origination activities broken down by mortgage product, state and metropolitan area where the loans financed properties, the type of properties financed and the period of the loans (5-, 7-, 10-, 15-, 20-, 25-and 30-year mortgage terms) used for financing.

- An assessment of annual loan performance by product type based on debt coverage ratio and loan-to-value. This should also include an analysis of annual delinquency, default and foreclosure characteristics (in percentage and absolute numbers), and annual multifamily mortgage securitization activities.
- An examination of the credit standards and policy requirements the enterprises require for multifamily loans along with a comparison to other mortgage capital sources for both multifamily and single-family loans as available.
- Information about GSE multifamily loan loss reserves and their usage.
- An assessment of the enterprises' achievement of affordable housing goals, including multifamily contributions to corporate affordable housing goals and multifamily special affordable housing goals.
- An analysis of the enterprises' multifamily risk-sharing activities with the Department of Housing and Urban Development, the Federal Housing Administration, the Rural Housing Administration, and state and local housing finance agencies.

In closing, NMHC/NAA look forward to working with this Committee and the Congress to reform the nation's housing finance markets while ensuring that a robust supply of capital is available to provide for a sufficient supply of workforce housing that is so necessary to driving a sustained economic recovery.

Thank you again for the opportunity to testify this afternoon, and I stand ready to answer any questions you may have.

Chairman RYAN. Anybody else want to submit something for the record? We will send copies of this one around as well.

We are joined today by Deborah Lucas, the assistant director of the financial analysis division from the CBO. Also Alex Pollock, who is no stranger to this committee, a resident fellow at the American Enterprise Institute, former chair of the Chicago Federal Home Loan Bank, if I am not mistaken, and Sarah Rosen Wartell, executive vice president from the Center for American Progress Action Fund. Why do not we just start with Deborah and then move over?

STATEMENTS OF DEBORAH J. LUCAS, ASSISTANT DIRECTOR, CONGRESSIONAL BUDGET OFFICE; ALEX J. POLLOCK, SENIOR FELLOW, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH; AND SARAH ROSEN WARTELL, EXECUTIVE VICE PRESIDENT, CENTER FOR AMERICAN PROGRESS & CENTER FOR AMERICAN ACTION FUND

STATEMENT OF DEBORAH J. LUCAS

Dr. LUCAS. Okay. Thank you. I appreciate the opportunity to testify about CBO's estimates of the budgetary cost of Fannie Mae and Freddie Mac, and the options for the future role of the Federal Government in the secondary mortgage market.

In CBO's judgment, the federal conservatorship of Fannie Mae and Freddie Mac and their resulting ownership and control by the Treasury, make them effectively part of the government and imply that their operations should be reflected in the federal budget. Hence, in its baseline budget projections, CBO accounts for the cost of the GSE's operations as though they are being conducted by a federal agency.

Now after consulting with the House and Senate Budget Committees, CBO concluded that using a so-called fair value approach to estimate those costs would give the Congress the most accurate and comprehensive information about the budgetary cost of supporting the GSEs. A fair value approach provides estimates of the value of the GSE's assets and liabilities that either corresponds to or approximates prices in a well-functioning financial market.

Using that method, back in August of 2009, CBO estimated that the net cost to the government of all of the GSE's outstanding mortgage commitments made through the end of 2009 would total $291 billion. Now, since that time, CBO has not updated its estimate of the cost of the government of those past commitments. However, the GSE's financial report suggests that losses on those obligations may have increased somewhat since that time because of the continued weakening of the housing markets.

So, looking forward, in its recent March 2011 baseline projections, CBO estimates that the new guarantees the GSEs will make over the next decade will cost the government $42 billion.

The subsidy rate for the GSE's new business has fallen since the peak of the financial crisis and it is projected to decline further as conditions in the housing market and the economy improve. However, under a fair value approach, the subsidy rate will remain positive as long as Fannie Mae and Freddie Mac provide guarantees at prices below what private financial institutions would offer.

Now, unlike CBO, the administration's Office of Management and Budget treats Fannie Mae and Freddie Mac as non-governmental entities for budgetary purposes. That implies that in the budget, OMB records only cash transfers between Treasury and the GSEs, such as for stock purchases and dividend payments. That approach can postpone the recognition of the costs of the GSE's new guarantee obligations for many years.

The fair value approach that CBO is using for projections is also different than the procedures specified by the Federal Credit Reform Act of 1990, otherwise known as "Credit Reform," which applies to most federal credit programs. Unlike Credit Reform estimates, which use Treasury rates for discounting, fair value estimates use discount rates that incorporate a risk premium. The inclusion of a risk premium recognizes that the financial risk to the government that it assumes when it issues mortgage guarantees, represents a cost to taxpayers.

Now, those two approaches paint very different pictures of the cost of continuing to operate Fannie Mae and Freddie Mac under a current law over the next decade, whereas, on a fair value basis, their new obligations generate a budgetary cost under Credit Reform, the continuing operations would result in budgetary savings.

Currently fair value accounting is used for the Troubled Asset Relief Program and by CBO for the GSEs, but the Credit Reform approach is used for most federal mortgage guarantee programs, including the Federal Housing Administration's Single Family Mortgage Insurance Program.

CBO recently estimated the difference between the two methodologies as applied to that FHA program. Under Credit Reform, the FHA program would produce budgetary savings of $4.4 billion in fiscal year 2012, but on a fair value basis, the program would cost $3.5 billion in the same year. That different budgetary treatment of the GSEs and the FHA means that a mortgage that generates a budgetary cost when it is guaranteed by Fannie Mae or Freddie Mac could show budgetary savings if FHA provide the coverage instead.

Policymakers are contemplating a wide range of proposals for federal role in the secondary mortgage market, in general, for the future of Fannie Mae and Freddie Mac, in particular, and for the transition path to a new model. In a recent study, CBO analyzed those alternatives and the trade-offs among them. And my written statement summarizes that work. Any new approach would need to confront major design issues; if the approach includes federal guarantees, how to structure and price them, whether to support affordable housing, and if so, by what means, and how to structure and regulate the secondary market.

Options will need to be evaluated using several criteria, including whether a given alternative would ensure a stable supply of financing for mortgages, how affordable housing goals would be met, how well taxpayers will be protected from risk, whether the federal guarantees would be priced fairly, and to what extent the approach would provide incentives to control risk-taking.

Whichever direction is ultimately chosen, the policy choices will have budgetary implications that could differ considerably depending on the budgetary treatment used. In CBO's judgment, continuing to use a fair value approach to estimate subsidy costs for Fannie Mae and Freddie Mac would provide the most accurate measure of the cost to taxpayers of any eventual transition to a new federal role in the secondary mortgage market. However, doing so would maintain the practice of accounting for similar federal credit programs and financial transactions in different ways. Thank you.

[The prepared statement of Deborah Lucas may be accessed at the following Internet address:]

http://www.cbo.gov/doc.cfm?index=12213

Chairman RYAN. Mr. Pollock?

STATEMENT OF ALEX J. POLLOCK

Mr. POLLOCK. Thank you, Mr. Chairman, Ranking Member Van Hollen, and members of the committee. Over the past four decades in this country, we have engaged in a truly remarkable financial experiment, or adventure of exploding agency debt, which is described in the graphs and the discussion in my written testimony. Now, this explosion in my view, calls into question old ways of thinking about accounting for, and managing, such debt. A vast debt of the non-budget agencies and government-sponsored enterprises, most of which is devoted to subsidizing housing finance, fully relies on the credit of the United States. This means by definition, it exposes taxpayers to losses, but, as we know, it is not officially accounted for as government debt. This debt puts federal budget at risk, or more precisely, subjects it to major uncertainties and potentially huge credit losses, as we have experienced. Indeed, it represents a kind of off-balance sheet financing and risk-taking by the government. Fannie Mae and Freddie Mac in particular, can quite reasonably be thought of as government SIVs or S-I-Vs, and the analogy to say the SIVs used by Citibank to try to finance mortgages off off-balance sheet, is quite a tight analogy.

In 1970, some 40 years or so ago, Treasury debt held by the public was $290 billion. Seems like a small number these days. And agency debt was $44 billion; so $290 versus $44.

By 2006, at the height of the housing bubble Treasury debt was almost $5 trillion, but agency debt had inflated to $6.5 trillion dollars. So over this time while Treasury debt increased 17 times, agency debt had multiplied 148 times. This created a, altogether, new and unprecedented situation in government finance.

In 1970, agency debt represented only 15 percent of outstanding Treasury debt. By 2006, this had inflated to 133 percent of Treasury debt. So, if you were managing the Treasury debt, you were managing less than half of the government's credit exposure. If we add these two types of debt together, we get what I call "effective government debt", that is debt dependent on the government's credit, which is held by the public, and this number is now nearly $17 trillion as shown in my written testimony.

How was this agency debt explosion possible, we should ask. The financial reality is that bond salesmen peddling trillions of dollars of Fannie, Freddie, and other agency securities to investors all over the world, said to them something very much like this: You cannot go wrong buying these because they are really U.S. government credit. But they pay you a higher yield so you get more profit with no credit risk. And although this description was disputed by various official voices, in fact, what the bonds salesmen said was absolutely right, as experience has demonstrated, it was a good deal for the bond-buyers but it was hardly a good deal for the taxpayers.

How can we better think about the risk to the taxpayers represented by the explosion of agency debt? For entities subject to Federal Credit Reform Act, the expected, or that is really the best guess estimates of losses, must be reflected as costs in the federal budget. This requirement is useful, but it does not address the fact that we do not and cannot know what the losses will turn out to be. As the Congressional Budget Office points out, the FHA, for example, has often had to significantly increase its credit loss estimates which it worked so hard to make in the first place. The CBO correctly states, "The expected cost of defaults does not account for the uncertainly about how costly such defaults ultimately will be." I concur with the recommendation that the budget cost analysis should reflect the reality of this uncertainty, which is imposed on the taxpayers.

The explosion of agency debt means that managing the issuance of Treasury securities, as I said, has come to deal with only about half, and often less than half of the effective government debt. Now this brings me to two statutory recommendations.

Congressman Van Hollen asked about the government role. In my view, a key government role is to manage its own credit, all of its own credit exposure. And this means that the Treasury Department should be firmly in control of the government's credit and its use by the off-balance sheet agencies. So I propose that we return to the logic, we remember the logic of the Government Corporation Control Act of 1945, an act still in force. This act spells out the responsibility of the Treasury Department to control the debt expansion of government corporations with notable rigor, and I cite the language of the act in my written testimony. There is no doubt whatsoever that Fannie and Freddie are now mixed ownership government corporations. So I recommend that Congress should amend the Government Corporation Control Act, explicitly to add

Fannie Mae and Freddie Mac to the list of mixed ownership government corporations in that act, thus formally subjecting them to the appropriate financial discipline of the Treasury.

A second useful reform was to find in the Revenue Act of 1992, passed by the Congress but not enacted due to a veto for other reasons, this provision would have forced the Treasury Department to focus on how agency debt affects the cost of treasuries required in annual report to the Congress on that question. And in my view, there is no question that the explosion of agency debt increases the cost of treasuries. It raises the interest rate on treasuries by creating a giant competing supply of government-backed debt to compete with treasuries. How big this increased cost is subject to some debate. A recent fed study suggests that by taking $1.7 trillion in government securities of which more than $1 trillion were agencies securities out of the market, the rate on the 10-year Treasury was reduced by 30 to 100 basis points. This is a Federal Reserve brand new study. We put this logic and just apply it in reverse, adding $7 trillion of agency debt to the market, certainly, or at least, plausibly would have increased the cost of financing the Treasury by a like amount. So, by increasing the cost of the Treasury, the agency debt actually increases the explicit government deficit by increasing the cost of financing the government.

So in this Revenue Act of 1992, the provision, which is quoted in my written testimony, would require an annual report of the Treasury analyzing the extent to which the behavior of agency debt has increased the cost of financing the Treasury itself. Now, I recommend that this provision should be reintroduced and enacted. In these ways, and I am sure there are others as well, we can help control for the future, the exposure of taxpayers created by the use of the government's credit card by agency debt. The consequent uncertainty of the true budget cost and the possibility of huge losses and the over-leveraging of the housing sector which uncontrolled agency debt promotes. Thank you very much for the opportunity to be here.

[The prepared statement of Alex Pollock follows:]

Prepared Statement of Alex J. Pollock, Resident Fellow, American Enterprise Institute

TAXPAYER EXPOSURE THROUGH THE DRAMATIC EXPANSION OF AGENCY DEBT

Mr. Chairman, Ranking Member Van Hollen, and members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI in 2004, I was the President and CEO of the Federal Home Loan Bank of Chicago from 1991 to 2004. I have both professionally experienced and extensively studied the historical development of mortgage finance, including the remarkable role of agency debt.

The huge debt of the non-budget agencies and government-sponsored enterprises ("agency debt") fully relies on the credit of the United States, which means by definition exposure of the taxpayers to losses, but it is not accounted for as government debt. As the Federal Reserve carefully notes in its "Flow of Funds" report, non-budget agency and GSE debt is not "considered officially to be part of the total debt of the Federal Government."

Not "considered officially," but what is it really? It puts the federal budget at risk, or more precisely, subjects it to major uncertainties of credit losses. It represents a kind of off-balance sheet financing for the government. The vast majority of agency debt goes to finance housing though Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and the FHA/Ginnie Mae combination. Fannie and Freddie in particular have not unreasonably been characterized as "government SIVs," which failed.

AGENCY VS. TREASURY DEBT

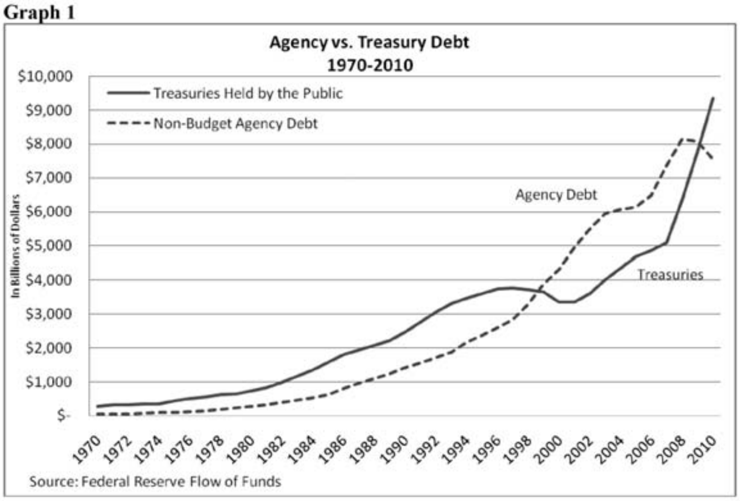
Over the last several decades, we have engaged in a financial experiment, or adventure, of exploding agency debt relative to Treasury securities.

In 1970, Treasury debt held by the public ("Treasury debt") was $290 billion. Agency debt totaled only $44 billion. At the height of the housing bubble in 2006, Treasury debt was up to $4.9 trillion, but agency debt has inflated to $6.5 trillion. While Treasury debt had increased 17 times during these years, agency debt had multiplied 148 times.

At the end of 2010, Treasury debt was $9.4 trillion, and agency debt was $7.5 trillion.

Graph 1 shows the remarkable history of agency vs. Treasury debt.

Graph 1

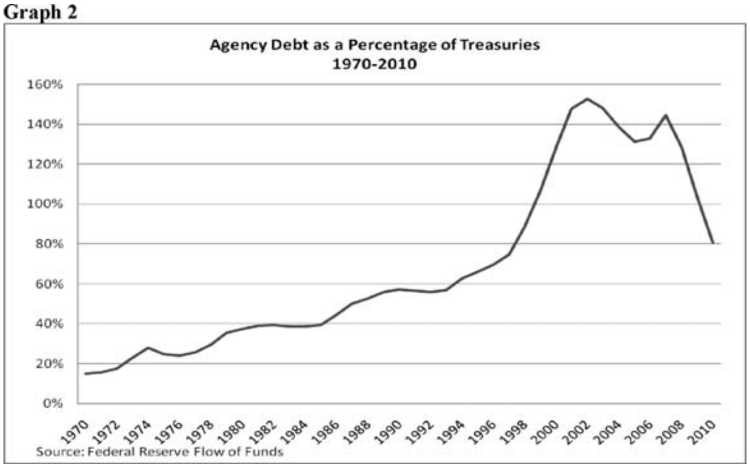


Source: Federal Reserve Flow of Funds

In 1970, agency debt represented only 15% of Treasuries. By the peak of the housing bubble in 2006, this had inflated to 133%. At the end of 2010, agencies were 81% of Treasuries, or about the level of 1997-98, just before the housing bubble, still a notably high level.

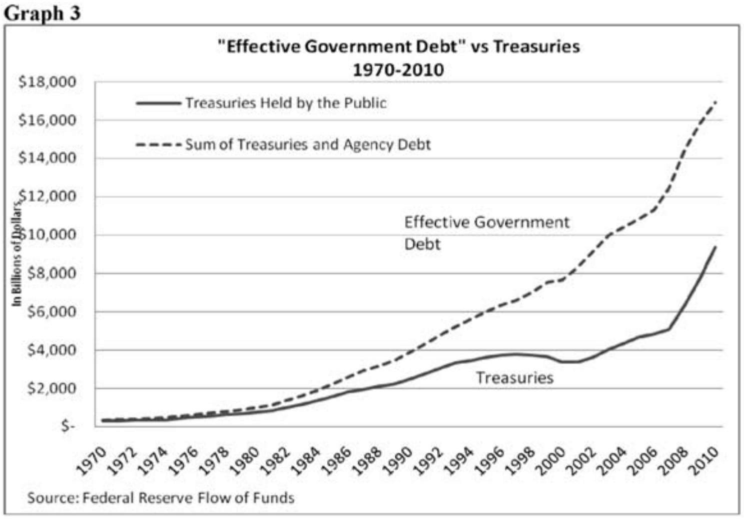
Graph 2 displays the trend of agency debt as a rapidly increasing percentage of Treasury debt. The percentage is falling at the end because of the big increases in Treasury debt we all know about.

Graph 2



If we add these two types of debt together, we can get a total of "effective government debt" (debt dependent on government credit) held by the public. Graph 3 compares this "effective government debt" with Treasuries—an instructive comparison.

Graph 3



INCREASING THE COST OF TREASURY DEBT

The expansion of agency debt not only imposes risk and realized losses on taxpayers (we do not need to mention the $160 billion which the U.S. Treasury has been forced to put into Fannie and Freddie to prevent their financial collapse), it also increases the cost of Treasury's direct financing, by creating a huge pool of alternate government-backed securities to compete with Treasury securities, and thus increases the interest cost to taxpayers.

So although agencies are not "officially government debt," they undoubtedly increase the required interest rates on Treasury securities, in my judgment, and thus increase the federal deficit. The greater the amount of agency securities available as potential substitutes for Treasuries, the greater this effect must be. As a manager of a major institutional investor told me recently, "We view Fannie and Freddie MBS as Treasuries with a higher yield—so now we own very few Treasuries."

It is difficult to put an exact number on the counterfactual question of how much this increased cost has been. However, a quantitative suggestion is implied by a recent Federal Reserve analysis (Joseph Gagnon et al., "Large-Scale Asset Purchases by the Federal Reserve: Did They Work?"—FRBNY Economic Policy Review, May 2011). The authors conclude that by taking $1.7 trillion in securities out of the market by Federal Reserve purchases, of which more than $1 trillion were purchases of agency securities, the interest rates on ten-year Treasuries were reduced by "somewhere between 30 and 100 basis points."

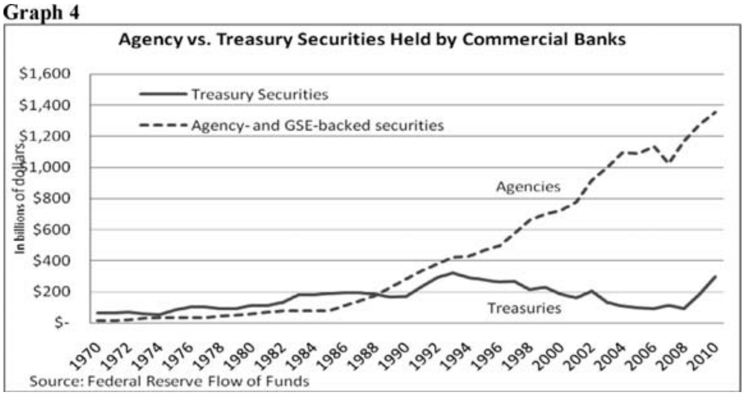
Suppose we run this logic in reverse: if the supply of effective government debt is increased by trillions of dollars of agency debt, perhaps that would increase the cost of long-term Treasuries by at least a like amount.

This result depends on the idea that investors will substitute agency debt for Treasuries and thus reduce the demand for Treasuries from what it would have been. We can observe a striking example of this substitution in the aggregate balance sheet of the commercial banks.

In 1970, commercial banks owned $63 billion in Treasuries and $14 billion in agency securities. Their Treasury holdings were more than four times their agency holdings. By 2006, at the peak of the bubble, all commercial banks owned only $95 billion in Treasuries, which was dwarfed by their $1.14 trillion in agencies. They then had 12 times the investment in agencies as in Treasuries.

At the end of 2010, the corresponding totals are $299 of Treasuries and $1.35 trillion in agencies. This long-term trend of agencies vs. Treasuries in banking investments is shown in Graph 4.

Graph 4

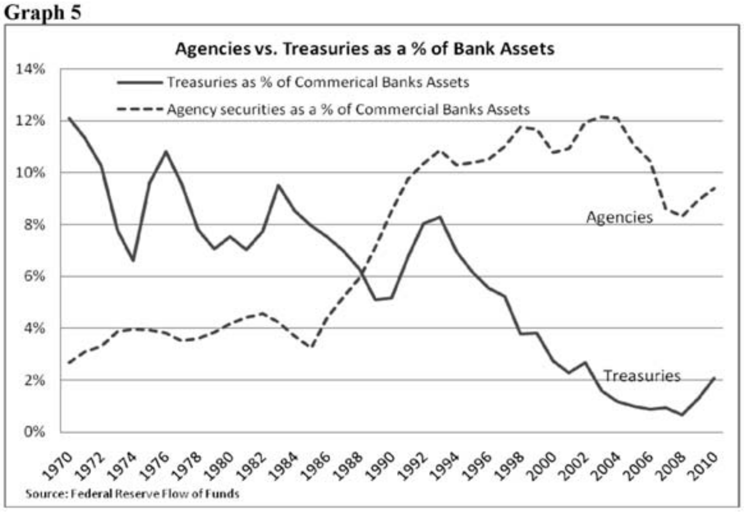


Agency vs. Treasury Securities Held by Commercial Banks

Source: Federal Reserve Flow of Funds

Expressed as a percentage of banking assets, investment in Treasuries falls from 12% to less than 1%, then recovers to only 2% under current circumstances. Meanwhile investments in agencies inflates from less than 3% of banking assets to over 10%, then ended last year at 9.4%. This substitution is shown in Graph 5.

Graph 5



Agencies vs. Treasuries as a % of Bank Assets

Source: Federal Reserve Flow of Funds

WHY WAS THE AGENCY DEBT INFLATION POSSIBLE?

How was it possible for agency debt, and the corresponding taxpayer exposure, to grow so much for so long?

Well, bond salesmen, peddling trillions of dollars of Fannie, Freddie and other agency securities to investors all over the world, told them something like this: "You can't go wrong buying these, because they are really a U.S. government credit, but they pay you a higher yield! So you get more profit with no credit risk."

In contrast, a senior member of the Financial Services Committee memorably opined that Fannie and Freddie had "no explicit guarantee * * * no implicit guarantee * * * no wink and nod guarantee." Official voices liked to point out that the offering memoranda for GSE debt said right there in bold face type that these securities were not guaranteed by the United States.

Nonetheless, what the bond salesmen said was right, as events have conclusively demonstrated. A good sense of the resulting situation is described by then-Secretary of the Treasury Henry Paulson in his memoir of the financial crisis:

"Foreign investors held more than $1 trillion of the debt issued or guaranteed by the GSEs. * * * To them, if we let Fannie or Freddie fail and their investments got wiped out, that would be no different from expropriation. They had bought these securities in the belief that the GSEs were backed by the U.S. government. They wanted to know if the U.S. would stand behind this implicit guaranee—and what this would imply for other U.S. obligations, such as Treasury bonds."

Note how in this description, the belief that agency debt is simply government debt links to discussion of Treasury securities themselves.

RISK VS. UNCERTAINTY

Of course, using the credit of the United States to make, guarantee, insure or finance mortgage loans though any of the agencies which do so entails credit losses. This in itself is not a problem: if we knew what the losses would be, or knew what they would be within a narrow range, the losses could be easily priced and budgeted for.

For entities subject to the Federal Credit Reform Act, the expected (best guess estimates) of losses must be reflected as costs in the federal budget. This requirement was without doubt a major improvement over previous practice, but it does not address the fact that we do not know what the losses will be. As the Congressional Budget Office points out, the FHA, for example, has often had to increase its estimates of credit losses. In fact, the expansion of leverage created by the very programs in question, may make the losses bigger.

Huge increases in loss estimates characterized the failure of Fannie and Freddie. The limits of the most expert knowledge of the future extent of losses is highlighted by this statement of the then-Director of the Office of Federal Housing Enterprise Oversight: "Let me be clear—both [Fannie and Freddie] have prudent cushions above the OFHEO-directed capital requirements." This March, 2008 statement was indeed clear, but wrong; only six months later both agencies collapsed.

Two months before the collapse, in July, 2008, the Chairman of the Senate Banking Committee pronounced: "What's important are facts—and the facts are that Fannie and Freddie are in sound situation."

As the Congressional Budget Office correctly says: "The expected cost of defaults * * * do not account for the *uncertainty* about how costly such defaults ultimately will be." [italics added] We need to consider both, but indeed, the uncertainty, as opposed to the estimated cost, is the hard issue.

To help take the uncertainty into account, the CBO advocates using fair value cost estimates for Fannie, Freddie and the FHA, which draw from the market price for bearing credit loss uncertainty. I believe this is a reasonable thing to do, but even using such estimates, we would have greatly underestimated the losses imposed on the taxpayers by the use of the government's credit to back agency debt.

MAKE TREASURY RESPONSIBLE FOR MANAGING THE GOVERNMENT'S CREDIT

Managing the issuance of Treasury securities under the circumstances of the last decade, deals with only about half, and sometimes less than half, of the effective government debt.

In contrast, in the 1970s, the Treasury Department was more actively involved with agency debt. That is probably one reason agency debt was proportially smaller. In those days, for example, it demanded its approval of every individual debt issuance by the Federal Home Loan Banks, as required by the Government Corporation Control Act of 1945.

This Act, which grew out of the sensible worry that government corporations were too free in using the credit of the United States, considered that the Treasury Department should be in control of the government's own credit and its use by agencies.

It defined among its terms "a mixed ownership government corporation," reflecting government ownership of some of the capital of the entity, as one form of "government corporation" this category included and still does include the Federal Home Loan Banks.

The responsibility of the Treasury Department for such corporations is spelled out by the Act with notable rigor—much more so than in the Fannie and Freddie charter acts. Thus:

"Before a Government corporation issues obligations and offers obligations to the public, the Secretary of the Treasury shall prescribe——

(1) the form, denomination, maturity, interest rate, and conditions to which the obligations will be subject;

(2) the way and time the obligations are issued; and

(3) the price for which the obligations will be sold."

Pretty thorough.

Since 2008, there is no doubt whatsoever that Fannie and Freddie have been and are substantively government corporations. The bulk of their equity capital is owned by the government, although there are small residual private interests in common and junior preferred stock. So Fannie and Freddie are clearly "mixed-ownership government corporations," in the sense of the Government Corporation Control Act.

I recommend that Congress should amend this Act explicitly to add Fannie Mae and Freddie Mac to its list of mixed-ownership government corporations, thus formally defining them as such.

This would:

—Reflect reality.

—Clarify and emphasize the Treasury's responsibilty to manage the single biggest use by agencies of the credit of the United States.

MAKE TREASURY RESPONSIBLE FOR OVERSEEING THE EFFECTS OF AGENCY DEBT ON THE COST OF TREASURY FINANCING

In 1992, when agency debt was up to 56% of Treasuries, there was debate about the resulting effects on increasing the cost of Treasury debt (I am reliably told). The Treasury Department of the time declined to estimate this effect, however, plausibly reflecting the political muscle and hardball political tactics of Fannie in those days.

In the text of the Revenue Act of 1992, passed by the Congress, but not enacted due to a veto, was this useful provision, intended to force the Treasury to focus on the issue:

"The Secretary of the Treasury shall annually prepare and submit to the Committee on Banking, Housing and Urban Affairs of the Senate and the Committee on Ways and Means of the House of Representatives a report setting forth the impact of the issuance or guarantee of securities by Government-related corporations on——

(1) the rate of interest and amount of discount offered on obligations issued by the Secretary

(2) the marketability of such obligations." [internal citations omitted]

To help address the obvious problems created by the inflation of agency debt, I recommend that this provision should be reintroduced and enacted.

In these ways, we could help control, for the future, the exposure of taxpayers created by the use of the government's credit card by agency debt, the consequent uncertainty of losses, and the overleveraging of the housing sector which resulted in this last cycle.

Thank you again for the opportunity to share these views.

Chairman RYAN. Thank you, Mr. Pollock. Ms. Wartell?

STATEMENT OF SARAH ROSEN WARTELL

Ms. WARTELL. Good morning. And thank you, Chairman Ryan, Ranking Member Van Hollen and members of the committee. I am pleased to have the opportunity to testify today.

Today's purpose is to examine how the budget reflects the taxpayers' cost to federal support for the housing market through Fannie Mae, Freddie Mac and FHA, but before I speak to that issue I want to put in a broader context. Right now the GSE's in conservatorship and FHA are essential to stabilizing the housing market. Their new business is both prudently underwritten and most likely profitable, allowing them to make dividend payments to the Treasury, offsetting losses incurred on earlier obligations during the housing bubble, and so reducing the net cost to the taxpayer.

First quarter case Schiller Index shows that the housing market remains very weak. Had the GSEs and FHA not been able to pick up when the private market withdrew, the housing collapse would have been far more severe and the recovery even slower; something we should remember as we think about the future. No one wants to sustain the current situation. Government bears the credit risk on over 95 percent of mortgages today. Going forward, private capital at risk must be made to bear as much of the load as is possible. But we must ensure that the private market is ready to pick up the slack before we withdraw federal support or we risk deepening the vicious cycle of falling home values and a shrinking economy.

The taxpayers' exposure to risk from the books of business originated before the housing collapse by the GSEs. It is fixed; there is nothing we can do about it; their exposure is fixed, but the ultimate cost of those obligations to the taxpayers is undetermined. The size of the losses that the taxpayers will pay will be determined in large part by the housing recovery, which in turn depends on the consistent availability of sustainable mortgage lending to the housing market. Limiting the GSE's role prematurely without a better design mechanism to ensure liquidity while protecting the taxpayers would weaken the housing recovery and have the effect of significantly increasing the GSEs and FHA's losses on past obligations, and thus the cost to the American taxpayer. With that in mind, let me address the budgetary treatment of the GSEs.

First, the cost to the taxpayers of government support for Fannie and Freddie is already reflected in the federal budget. There is an important technical debate between budget analysts about what is the best methodology to use to report these costs and that debate in part hinges on whether the GSEs are now governmental entities or more like a bank that has been taken over by the FDIC, which is not treated as a governmental entity, and also it hinges on what discount rates to use. Those are important discussions. But please, we should not suggest that they are not reflected in the federal budget; the cost to the taxpayers of those obligations are.

The payments in revenues and the effect on the deficit can be found in fact on Table S12 on Page 201 of the president's Fiscal Year 2012 Budget. Where OMB projects for 10 years the payments made under the preferred stock purchase agreements to bolsters the GSE's capital position and the dividend payments to the Treasury that are required under those agreements to be made and returned. It also shows the balance of those two numbers, which is the programs net effect on the deficit. What is more, additional information regarding the financial position of the enterprises is reported in many places, including by the Treasury Department's audited financial statements, the enterprises 10-K filings with the SEC, and quarterly reports from FHFA, their conservator.

In my written testimony, I detail the consequences of the OMB and CBO approaches and my concerns with some of the inconsistencies created by the CBO approach, which is as Ms. Lucas noted in her testimony. I ask that that full statement be submitted for the record.

A second concern is that we must recognize why the budgetary treatment of the GSEs is so complex. We are talking about how to reflect in the budget today when we have an effective guarantee of the GSEs. Obligations that were occurred at an earlier time when the securities were not explicitly backed by the full faith and credit. This situation is unique and it is temporary. There will be a transition to a new system and the GSEs as we know them, will be unwound. There is no debate among the administration, Congress or any party that that will be the case.

So what is far more important than a debate about the budget treatment of past obligations is to ensure that any future system of government support includes explicit terms, fees charged for any federal support provided, and reserves held on the books of the taxpayers to protect themselves against future losses. Any explicit guarantee in the future should be accounted for in the budget using standard treatment for credit liabilities under Federal Credit Reform Act, and which establishes consistent ground rules for ensuring that the true cost of credit obligations are recognized when incurred.

Personally, I support the availability of a government guarantee for liquidity targeted to support middle-class home buyers and renters. I am pleased to see that there is some emerging bipartisan support for this idea with Representative Campbell and Peters offering their own proposal which contains this core feature. But under any future plan, it is important that new guarantee obligations be treated under the same budget rules used for other federal credit programs, not that the entities are, but the guarantee costs are, so that the costs and benefits can be compared across programs under consistent assumptions.

Finally, let me close by commending the Chairman and the committee for this hearing. This is technical stuff, but it implicates issues that matter to every American family, as Congressman Van Hollen mentioned. What is at stake in the housing finance reform debate is what kind of future is available to all Americans middle-class families. Can creditworthy borrowers get non-discriminatory access to a 30-year fixed-rate mortgage? What that means for their family is that they can provide their families with the security of a home of their own on terms that they can afford. Will they see wild swings again in credit availability and the resulting depression of their home values and their savings? Will new quality rental housing be built to meet the burgeoning projected demand, or will we instead see skyrocketing rents and limited choices for renters?

Congress and the administration have the responsibility to design a smart system of housing finance for the future that both protects the taxpayers and achieves these goals. I thank you, and would welcome a chance to answer any questions.

[The prepared statement of Sarah Wartell follows:]

PREPARED STATEMENT OF SARAH ROSEN WARTELL, EXECUTIVE VICE PRESIDENT, CENTER FOR AMERICAN PROGRESS ACTION FUND

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.

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.

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.

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.

Mr. GARRETT [presiding]. I thank you for your testimony. I appreciate the panel's testimony. And at this time, I will yield myself such time, I guess, as I consume in this committee. Unlike Financial Services where I am limited to five minutes, I am told by Paul before he left, I can just go on ad nauseam here, but I will try not to do that.

Ms. Wartell, your comment at the end, you said, "This is technical stuff." But that is not any reason why we should not have transparency with what we are talking about. And I will start with Ms. Lucas on this point.

So we just had a hearing recently in Financial Services, and we brought up the letter up to Paul that CBO wrote with regard to this issue that the panels also addressed, and on the upside was the fact that there was agreement on everyone on the panel that, in fact, that there should be a reevaluation, if you will, of how the numbers are reported and to provide for more and greater transparency in regard to the budget and all. So that was the upside. The push-back, though, at least from one of the panelists was that well maybe the CBO just did not get it right. And looking back on the witness statement, it says, The CBO maybe been a little off, and it used Fannie and Freddie fees and private mortgage fees as to determinate to how the market risks to FHA should be calculated.

Would you like just to spend a moment to expand upon your analysis and why that push-back is not correct but the CBO's analysis what for fair value is the correct analysis for determining on budget?

Dr. LUCAS. Yes, Congressman. Thank you. I guess where I would like to start is to say that, of course, any estimate of these costs is extremely difficult to get right. I am not sure any of us would even know what right was when we saw it because it involves so many uncertainties. Remember that we are projecting the cash flows over the life of 30-year mortgages in a world where we do not know what is going to happen to housing prices, default rates, and so forth. So there is a great deal of uncertainty in these estimates whether they are done under Credit Reform or on a fair-value basis.

I think what is fundamentally important is that CBO is striving to give an unbiased estimate to the best of our ability. So when we are trying to go give these fair-value estimates, the idea is that you are trying to reflect what the price would be in a well-functioning financial market. Now, that was particularly challenging task for Fannie and Freddie, given how disrupted markets have been recently. But what we do is very much like the practice in private financial institutions that also have to struggle to do fair-value accounting because they are required to do so. And it does mean looking at market prices and trying to understand what is driving those market prices and how much risk is embodied in those prices.

So when we look at the private guarantee fees, we look for mortgages that are comparable in their risk to the ones the GSEs are doing. We make adjustments for differences in the borrowers and the houses and the leverage and so forth, and so we try to come around to the best estimate that we can make of the cost of those guarantees, taking into account the cost of market risk as it is reflected in market prices. Now, I would be happy to provide you with a more technical answer to the question later on if you wanted more details.

Mr. GARRETT. That was pretty technical right there. But the bottom line is that there should be an evaluation or an appreciation of the fact that we are talking about mortgages here where there is market risk, and basically what CBO is trying to do is to put that into the calculation, that the valuation of those things are going to change overtime, and that the obligation of us, the taxpayer, the Federal Government is going to vary because of that over time, and you are trying to price that today, so we understand what that cost is going forward. Is that not, in a nutshell, what we you are trying to do?

Dr. LUCAS. That is it.

Mr. GARRETT. Okay.

Dr. LUCAS. Exactly.

Mr. GARRETT. And absent doing that, you are really not giving a truly transparent answer to what the cost is to the taxpayers, and to the government today.

Dr. LUCAS. Well, you are certainly not giving as comprehensive a measure of the cost. I mean the view that this is important comes from viewing the taxpayer as the ultimate bearer of the risk that is coming from this. So, if everything goes well, the taxpayers will be fine. But if we have another dip in the housing market, another recession, that is when defaults are likely to really hit, that is when those defaults are most costly, and that is the source of this market risk that taxpayers would require compensation to bear if they were investors. And that is the philosophy behind including that cost in these cost estimates.

Mr. GARRETT. And Ms. Wartell, although you say that there is all this information out that is published in other reports, and what have you, elsewhere, there is also reports on everything else that Federal Government does elsewhere as well, but we still require the CBO and the OMB to actually put these things outside of here on budget so it is actually properly reflected as far as the obligations of the government. So why is it with just this one unique area that is satisfactorily that just because it is reported someplace else it is not prudent to actually list it as on-budget and what the cost is today? Why do you make this exception?

Ms. WARTELL. Well, I do not think it is exception. What I was arguing, in fact, is that the cost to the Treasury of those obligations, what they will pay in future support under the contract that they have with the GSEs, which is the preferred stock purchase agreement, those costs are projected and they are on the budget, as well as the revenues that they anticipate receiving from the dividend payer.

Mr. GARRETT. But the market risk is not on the budget?

Ms. WARTELL. Well, the market risk is embedded in the estimate of what those costs will be because those costs will vary.

Mr. GARRETT. When you say that it is in CBO's estimate, it is not in OMB's estimate that is embedded.

Ms. WARTELL. OMB's estimate has a measure of risk. The difference between CBO and OMB's estimate is whether or not they use a discount rate that is the rate that is charged to the Treasury, what Treasury obligations essentially can be purchased at, versus what a private actor would be charged because there is no private actor with this capacity; it is an estimate of what that would be. We do know what the Treasury rates are.

But the other problem is that the Federal Government is not a private actor; we know it is fixed costs, which are borrowing at Treasury costs; no one else has the capacity to borrow, and no one else has the capacity to spread risk. So what the use of that discount rate does is it is an attempt to estimate what the value of that risk is, but not necessarily the cost. That is the technical debate between analysts is to whether this is a more precise estimate of the cost to tax payers.

Mr. GARRETT. I put my time in. Mr. Pollock, I will let you verbally have the closing word on this comment.

Mr. POLLOCK. Thank you, Mr. Chairman. The economist, Frank Knight, almost 100 years ago, famously and correctly distinguished between risk, which are odds that you know and uncertainty which means you do not know what is going to happen. As I interpret this discussion, it is about the uncertainty, which inevitably comes into the picture when you are extending credit and when you are financing things. So if you knew what the losses would be by a best-guess estimate, or estimated loss, and you knew that is what the losses were, then it would be very easy. You have the Credit Reform Act procedure. The problem is, not only do you not know it, you cannot know it. And I think, as I interpret, the CBO's recommendation is trying to correctly to take into account the inherent uncertainty that these losses may be much greater than anybody's previous best guess, we have experienced that many, many times. And there is one final point, which is the very fact that you think you know what the losses are going to be, as we just saw in the housing bubble, induces you to extend more credit, to run up the risk further and to make the losses bigger. And all of that, while hard to do in a precise way, is directionally what the CBO is trying to do, and I think that is correct.

Mr. GARRETT. Mr. Van Hollen?

Mr. VAN HOLLEN. Thank you, Mr. Chairman. Again, I want to thank all the witnesses for their testimony. I want to stay on the technical point for a minute and then get to the larger question of where do we go from here. And, Mr. Chairman, I do want to submit from the record the portions of the OMB budget, page 201; it talks about the market valuation, a balance sheet of Fannie Mae and Freddie Mac.

[The information referred to follows:]

Table S–12. Market Valuation and Balance Sheet of Fannie Mae and Freddie Mac

(In billions of dollars)

	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Totals		
														2012–2016	2012–2021	2009–2021
Transactions between Treasury and Fannie Mae/ Freddie Mac:																
Senior Preferred Liquidity Payments to Fannie Mae/Freddie Mac	96	53	48	29	11	....	....	....	....	....	....	....	....	40	40	236
Senior Preferred Dividend Payments from Fannie Mae/Freddie Mac	–4	–12	–17	–21	–23	–17	–14	–11	–10	–9	–8	–8	–8	–86	–129	–163
Net Payments	100	40	30	8	–12	–17	–14	–11	–10	–9	–8	–8	–8	–46	–89	73
Market Valuation of Fannie Mae and Freddie Mac: [1]																
Market Value of Net Liability	–18															
Value of Private Equity Shares	–3															
Net Position of Fannie Mae and Freddie Mac:																
Assets:																
U.S. Treasury Securities	12	68														
GSE Portfolio Securities and Loans	1,525	1,007														
Consolidated Trust Securities [2]	....	4,241														
Cash	73	105														
Other	146	96														
Liabilities:																
GSE Debt Outstanding	1,607	1,539														
Consolidated Trust Debt [2]	....	3,934														
Other Financial Liabilities	155	48														
Equity:																
Treasury Senior Preferred Stock [3]	98	150														
Private Equity	–103	–153														
Net Position	–5	–3														

[1] Market valuation not available for 2010 because of NYSE delisting.

[2] New FASB accounting standards required consolidation of Variable Interest Entity securitization trusts on January 1, 2010.

[3] Face value of Treasury senior preferred stock equal to original liquidation preference of $2 billion plus Treasury investments through September 30.

Mr. VAN HOLLEN. And I understand Ms. Wartell's testimony to be those risks are embedded in their analysis and their projections. [inaudible] Ms. Wartell in your testimony, you talk about the fact that you are going to apply this other approach to measuring the risk and cost and that we need to do it uniformly across all credit programs. And just a quote from your written testimony: it says, "It would be irresponsible for Congress to cherry-pick individual credit programs to be subject to special budget rules. This would make some programs appear more expensive than others, when really they are calculated using entirely different measures of costs. It is like comparing two products priced in different currencies without considering the exchange rate.” Could you elaborate a little bit on that?

Ms. WARTELL. Yes, that reference was to the discussion about FHA and whether or not FHA, which is a Federal Government program, there is no controversy there, should be evaluated using the fair value method versus the methodology that is used under Federal Credit Reform Act. And I think they are two points there.

The first is it that consistency is enormously important because the ability to weigh the difference priorities of Congress requires you be able to treat like-items alike.

The second point is that it is perfectly appropriate for us to have supplemental information about FHA or other credit programs that get to this question of variability of risk because housing markets are different than energy markets that we also guarantee. But we should be looking at the cost to the taxpayers of those programs using similar methodologies.

Mr. VAN HOLLEN. Thank you. Ms. Lucas would you agree with that?

Dr. LUCAS. I certainly would agree with that. In fact, one of the stated purposes of the Credit Reform Act was to put credit on a level playing field with other commitments that the government makes. And I think one of those problematic things going on right now is the different treatments are being used in different places. Just to mention that Ms. Wartell said that what OMB is doing right now is it under Credit Reform, but for the GSEs it is actually using a cash basis of accounting in the budget. So right now, we have an inconsistency between cash and even Credit Reform for the GSEs. So the GSEs, as they are being accounted for now, are not comparable with the FHA either in the way the administration is accounting for them. But certainly being consistent is extremely important.

The GSE accounting is consistent with the way TARP was accounted for, and those obligations sort of arose in connection with the same problems that led to the TARP. So there was a consistency there, but there are inconsistencies in other places.

Mr. VAN HOLLEN. Ms. Wartell, if you want to briefly respond to that.

Ms. WARTELL. You are right about the reference to Fannie and Freddie. The question of consistency then determines whether or not you believe that Fannie and Freddie are like FHA in their current situation. Are we treating them consistently? They were private entities with private shareholders. They are now mixed ownership because the government owns a portion of them. But they are entities that are being wound down in their status. And we do not treat other entities being wound down like the banks that are on resolve by the FDIC that way. And so we have, in our striving for consistency, there are multiple facets in which we are striving to be consistent. And on that regard, the treatment of the GSEs, like FHA, makes them inconsistent with other things that are also not temporary in nature.

Mr. VAN HOLLEN. Mr. Chairman, I think members of this committee are getting a good sense of just how technical this issue is. That does not mean it is not important, it is. I think we would all agree we want the most transparent and accurate assessment of the cost to the taxpayers. And we obviously will continue to pursue that. But the larger costs in the long run has been said by some of our witnesses, and I mention in my opening statement is how we respond to the current situation because there are certain actions we could take that I believe would dramatically cost the taxpayer more both in terms of the obligations that we have already signed up to, but also would hurt the availability of credit for creditworthy borrowers going forward.

And so, Ms. Wartell, if you could just briefly explain what you think the consequences would be of three proposals. One, proposal is that introduced by Mr. Hensarling and a number of members of this committee. And the second, and I know Mr. Campbell has an interest in this, the one that he introduced that has bipartisanship co-sponsorship, and then the proposal that you have advanced at the Center For American Progress.

Ms. WARTELL. Well I think the nut of the Hensarling proposal is an effort to unwind the GSEs but not to replace them with any form of targeted government liquidity backstop in the future and to do it quickly. And the speed is of particular concern because of the current fragile state of the housing market. If you were to disrupt the expectations of investors, people would worry now that a house that they buy today, no one will be able to buy or be able to get a mortgage on similar terms if there is no GSEs in the future. So they will be worried that they will not be able to sell it for what they purchased it for. That will deter purchases in the housing market and that will deflate values. So, my fear is that if Congress were to give serious consideration to that legislation, the market today would begin to price in some of those risks. And the effect of that would be to make our current economic fragility even more extreme.

The Campbell Peters Bill and others represent this notion that there should be a limited targeted liquidity back stop standing behind private capital that is fully at risk, meaning that the private investors have to lose all of their money before any government insurance and it also embodies the notion that there would be a charge paid for the government standing behind it. It would be built into the cost of the mortgage and the government would collect that money and hold it as a reserve fund, but would leave liquidity available, not for jumbo mortgages and high-end mortgages, but for the mainstream middle part of the market. So there is consistent availability that will allow house prices to resume their normal appreciation based on underlying economics. That approach, it seems to me goes a long way towards moving forward in the housing market.

The cap proposal that was developed by our Mortgage Finance Working Group, takes the nut of the Peters Campbell proposal, but also includes with it some obligations to ensure that all of our communities have access to credit. One of the consequences of this unfortunate foreclosure crisis is that particular communities that were targeted by some primary lenders are seen equity stripped and where there are high concentrations of foreclosures; it is going to take a long time for housing values there to recover. And so we create an obligation to ensure that the private market would serve all of our communities with access to credit, and to the extent they cannot do it profitably, there would be a shared risk with the taxpayers on budget priced under federal Credit Reform that we hope think will ensure that we recover most quickly but, at the same time, limit the taxpayer's exposure from the future.

Mr. GARRETT. And then I guess it is appropriate to follow that line of questioning with the gentleman from California.

Mr. CAMPBELL. Thank you, Mr. Chairman, and thank you all for being here.

It has been said many times there is no debate or discussion that Fannie and Freddie as they exist should be wound down. And that we want to account for them accurately and transparently, and that we want to reduce that cost to the taxpayer. Nobody disagrees with that. So I would like to focus on, obviously, the future and what we are going to replace Fannie and Freddie with and what consequences that may have. So Dr. Lucas, starting with you. If we have, as Ms. Wartell described, something that is an explicit permitted federal guarantee behind a lot of private capital, and for that guarantee there is a market charge, not dissimilar from FDIC insurance, the way that works, CBO, in that sort of instance, something like that could score at zero or little or low cost; is that correct? I am not asking to score the proposal at this time, but just in concept that kind of thing.

Dr. LUCAS. It is certainly true that the more private protection there is in front of the government and the less likely it is that the government will see losses, the lower the estimated score would be.

Mr. CAMPBELL. And you mentioned in your testimony about one of the problems that Fannie and Freddie is that there was no charge for what was implicit and became explicit. In this case, there would be a market charge.

Dr. LUCAS. That is right. Unfortunately, the term "market charge" brings us squarely back to the ugly technical discussion we were having earlier because one person's view of what covers the cost to the government is different than the others. If, in my mind, a market charge would include a cost for the risk-bearing, and as you said, it would not be particularly large if the government was protected by a lot of private capital and by the value of the houses and so forth, and good under writing.

Mr. CAMPBELL. Okay. Let me go on to one other. If we were to withdraw any government support and wind down Fannie and Freddie and withdraw any government support, and that resulted in a drop in housing prices, that would put further taxpayer money at risk in the Fannie and Freddie portfolios that exist, correct?

Dr. LUCAS. Yes, it would.

Mr. CAMPBELL. And that could potentially cost the taxpayer's money?

Dr. LUCAS. Yes, it could.

Mr. CAMPBELL. Ms. Wartell, I think you testified kind of to this degree that if we were to wind down Fannie and Freddie and replace them with nothing, no government support and the 30 year fixed rate mortgage as we know it vanished, which means that people would pay more money per month for the same house, and the only way that can happen is if there is a significant and matching decline in housing prices. And so, if that then occurs, it could cost the taxpayer a lot of money. So by replacing it with a system, as Mr. Peters and I have introduced, we could actually be saving a lot of taxpayer money, both with the Fannie and Freddie portfolio, and in terms of what that kind of drop in housing, which is one-seventh of the economy, would do to the overall, very fragile recovery. Your comments?

Ms. WARTELL. I would agree with that. I think that there is a real concern that our housing prices today assume the lesson we learned after the 1930s, which is that there will be consistent availability of mortgage credit that was built into the prior system with all its flaws. It did, in fact, until we had the explosion of the private label securities market outside of that system, we did, in fact, avoid bubble bust cycles. If we go back to a world out that consistent availability and the potential for bubble-bust, it will make people much more reluctant to invest. I would also add another point. I think that one consequence of that system, without any government liquidity backstop to an otherwise private market, is that a great deal more of the market would land in FHA. FHA is 100 percent government guarantee. That means that we charge premiums for it, but we stand behind the whole mortgage loss. There is no credit risk on the part of the lender. So it seems to me that that privatization scheme actually will shift a significant portion of the market to government with no private credit ahead of us. And that seems to me exposing us loss more loss, not less.

Mr. CAMPBELL. Thank you, Mr. Pollock, and I have very little time, but you seem to stand out in believing that if we withdrew federal guarantee and had no replacement, that somehow that is not going to cause problems for the economy, for taxpayers and for housing, and that somehow the elimination of the 30-year mortgage, as we know it, or a 40 percent down payment, as you have suggested in some of your work, is somehow not going to have a very negative impact on housing, very negative impact on the economy, very negative impact on revenue, and therefore on taxpayers with their Fannie and Fred portfolio, come on.

Mr. POLLOCK. Let me back up a minute, if I may, Congressman and look at the result of the GSEs and the explosion of the agency debt, which was to create hyper-leverage in housing markets and housing finance markets, hyper-leverage in particular.

Mr. CAMPBELL. Mr. Pollock?

Mr. POLLOCK. Wait a minute.

Mr. CAMPBELL. And my time is over so, I do not know how the Chairman wants to handle it, but we are not proposing to replace the GSEs with the GSEs. No one in this room proposing that, so do not go to a failed model to describe what a future, different, entirely different model might look like.

Mr. GARRETT. Let him answer your question.

Mr. POLLOCK. Congressman, with respect, I agree. We do not want to go to the failed model and we certainly do not want to repeat the failed model, neither the 30s model which created tremendous housing busts in the 1960s and '70s nor the GSE model. Remember that this theory of having private capital in front of government risk was exactly a theory of Fannie Mae and Freddie Mac and in the 1990s when their risk-based capital was set up, the theory was that this risk based capital would allow them to survive a new depression, obviously, it was all wrong. The government never prices risk right. It does not price in right in the FDIC. That has why the FDIC's net worth was vastly negative. It does not private it right in pension guarantees. It does not price it right in housing. It does not price it right in flood insurance. It never prices it right. What we need to move to, and where I think we would agree is we need to move in a coordinated transition, which we have suggested would be a five-year transition to solve the problems that you point to, problems largely created by the past mistakes of this design. We need to go through a five-year transition; the end point of which is, we move to a largely private mortgage market where the prices are market prices. I have no doubt there will be a robust 30 year mortgage in that market.

Mr. CAMPBELL. That, no doubt, is not shared by anybody in the marketplace who might actually fund those 30 year fixed rate mortgages, by the way.

Mr. POLLOCK. With respect, we could discuss that more later. And the final point would be we would bring the government, or we need to bring the government, as I said in my testimony, into control of its own credit, not hand it over to uncontrolled agencies which run around with the government's credit card.

Mr. GARRETT. Thank you. I recognize the gentle lady.

Ms. MCCOLLUM. Thank you, Mr. Chair. In my district and throughout the United States, communities are still struggling. The repercussions of the housing crisis are still being felt by too many homeowners. And this is great reading, the financial crisis inquiry report. And so I am just going to kind of refresh the housing bubble here from page 422.

The housing bubble had two components: the actual homes and the mortgages that financed them. And they looked briefly at the components and it is possible causes. It goes on to say conventional wisdom is that a bubble is hard to spot when you are in one, and it is obviously painful later after it is burst. Even after the U.S. housing bubble burst, there is no consensus of what caused it, but they go on to list a couple of things that they went into detail: population growth, land use restrictions, over optimism, easy financing, and they go on to explain that.

Now, just recently, Standard & Poors found the single family homes dropped to their lowest level since 2009. Even more troubling to me is in the 20 metropolitan areas that they looked at, housing prices in the Twin Cities had the biggest drop, which is very unusual for the Twin Cities. Compared to March of last year, prices fell 10 percent in my community, making it the only area to see a double-digit drop. Well, it is important that we understand the causes of the 2008 housing finance market collapse. It is equally important that we enact smart reforms to ensure it does not happen again. There seems to be a consensus on part of the solution of restructuring Fannie and Freddie that in a way that protects housing opportunities for middle class families, but also limits taxpayer risk, as Mr. Campbell was describing.

The second equally important part is ensuring that Wall Street reforms passed last year are fully enacted. So the second part is where I want to focus on my question because I think we have heard a lot of talk about repealing the financial regulatory overhaul pass last year as well as weakening the consumer protection. In fact, Republicans who want to protect taxpayers from bail-outs, yet their budget intends to take the cops off the Wall Street watch here by cutting the SEC, the CTFC and completely eliminating the Consumer Finance Protection Bureau. So the very agencies charged with making sure that big banks that play by the rules when it comes to issuing mortgages and other credit products, there is no one watching the fox in the hen house. So I have a question, and my question is directed to you, Ms. Wartell. I am interesting in hearing what steps are needed in addition to reforming the GSEs to ensure that similar crises are avoided in the future, particularly what would happen to the housing market if Fannie and Freddie are completely privatized in the Dodd-Frank Act is not implemented. And after you are done answering that question, if there is any time remaining, I would yield it to the gentleman from California, if he has any further rebuttal to make.

Ms. WARTELL. Yes, thank you. Representative McCollum. I would make two points. I think first of all as we were talking about earlier, if we simply unwound the GSEs with no replacement, I think we face a real risk of returning to the period of time of real wild swings in housing prices. Not simply regionally, as we have had in the pass, but nationwide. And that was the experience in the 1930s. The United States housing market enjoyed between the 1930s and the 1990s, certainly had ups and downs. But there was never time in which mortgage capital was not available. FHA was there as a backstop during the oil patch crisis. And that availability of crises helped to ensure that these swings were not as extreme. That allows people to invest in homeownership, have the community benefits that we get from homeownership and also the opportunity to participate in the well savings that homeownership has provided for American families, the fourth savings, if you will, that homeownership provides.

To your question about implementation of Dodd-Frank, I would just note that specifically as to the housing market, the Dodd-Frank legislation has a number of important regulatory actions that are currently pending. Members of this committee who feel strongly that we need to get the private market to be back bearing more of the risk in the housing market, have a strong interest in having those regulations completed. The qualified residential mortgage definition and the QM definition, the Qualified Mortgage definition, both of those are, right now, the private market does not know what the ground rules are going to be. When those regulations are in place, we will have clarity about the ground rules. And I think you will then see the beginning of private label securities market serving the top end of the market and have the capacity as we withdraw the GSEs from the upper end of the market, to take over more of that. If we do not complete those rule makings, the ability to shift some of this risk from the public sector to the private sector will be limited. So I would argue implementation of

Dodd-Frank is extremely important to getting the private sector to serve more of our housing market today.

Mr. GARRETT. Thank you. The gentleman from South Carolina.

Mr. MULVANEY. Thank you, Mr. Chairman.

Very briefly a couple of comments. I want to get beyond the technical aspects of it and come back to what is actually happening here. Mr. Pollock, let me walk through these scenarios and tell me if I have got this correct.

If a private lender issues a non-conforming loan, say a jumbo loan, that has no government backing at all, and the homeowner defaults, just does not pay their mortgage, it is the lender who bears the brunt of that, correct?

Mr. POLLOCK. Correct.

Mr. MULVANEY. But the lender ends up losing their money in that particular transaction. However, if we are in a FHA back situation, the lender lends the money to the homeowner, the homeowner is unable to pay, tell me then, Mr. Pollock, who bears the brunt of that?

Mr. POLLOCK. The FHA.

Mr. MULVANEY. Which is ultimately the taxpayer of the United States of America, correct? And I think that is what is in a lot of this discussion, is that that is essentially what we are doing is that we are asking the taxpayers to help subsidize people who do not pay their mortgages. And I think that gets lost in a lot of the detail about this discussion.

What you have brought to my attention today, Mr. Pollock, was something I had not considered before, which was the indirect impact of the agency debt on the overall interest rate environment. Was it your testimony, I think that your estimate was some place between 30 and 100 basis points that we are paying higher on our public debt because of this huge agency debt. Did I get that right?

Mr. POLLOCK. That is correct, Congressman.

Mr. MULVANEY. And I think this committee has heard testimony several times from the CBO and other folks that an additional 100 basis points on what we pay for our debt when the debt is $14 trillion is roughly $1.4 trillion over the decade. So the taxpayer is paying there. And I think what we lose track of here is that we all talk about propping up the housing industry, and listen, I am a home builder, so I understand the importance of this particular industry to the nation. There is no question about it. But what we are doing is essentially shifting a tremendous burden on to the taxpayer.

I want to address Mr. Campbell point very quickly and then I want to ask one question about the 30-year mortgage. Mr. Chairman, I would suggest that what my colleague from California is suggesting, along with folks on the other side of the aisle, is that this time we will get it right. We know we screwed it up before. We know we have done a really, really lousy job in doing this in the past and it is cost literally trillions of dollars. But this time, we are going to be much smarter in doing this than everybody else who has been here before. And that is all that I hear again. Is well, we know we screwed this up, but boy, if we do it right this time, it is really, really going to work, and Mr. Pollock, I think you hit the nail on the head when you said that government cannot do that because it does not know how to price risk. And that is because we do not price risk on a market-based assessment. We price risk on a political-based assessment. We make political decisions about what things cost as opposed to free market decisions about what things cost.

That is a lot of talking for me. I do have a legitimate question for everybody on the Board, which is I have heard a great deal of discussion about the possible existence or non-existence of the 30 year mortgage that so many of us are familiar with. I have heard arguments that it will go away if we get rid of the GSEs and do not replace it, and then I have heard arguments that it will not go away. I was always under the impression when I was in the industry that the reason for the 30-year mortgage was, in large part, because of the 30-year Treasury bill or Treasury note. And my understanding is that is not going away any time soon. You all have a minute and a half each or a minute left each I would love Ms. Wartell to tell me why you think the 30 year is going away, and then, Mr. Pollock to tell me why you think it is not.

Ms. WARTELL. The 30 year fixed rate mortgage requires a lender if there is not access to a secondary market investor or the ultimate investor to hold out their money for 30 years. And on terms, if it is fixed rate, that are set at the beginning of that 30 year period. That is a great deal of uncertainty about how interest rates will shift. And the most market investors are unwilling to leave their obligations out for that long without knowing where interest rates will go. They will at a price. And I think that Alex is right when he says that the 30 year fixed rate mortgage will be available, but it will not be available, in my view, at a price that most middle class American families will be able to afford. Those mortgages that Alex will cite that are available at that price tend to be for very, very high quality borrowers with very high down payments. Most Americans do not have those terms and conditions.

Mr. POLLOCK. Congressman, there are private fixed rate mortgages that have 30 year terms. There has not been in this country a middle class private 30 year mortgage securitization market for prime mortgages. Now, this is a puzzle, which we will solve readily, but the puzzle is, it is the most logical market that should have developed as a secondary market prime 30 year middle class mortgages. Why do we not have it? Because the government, in the form of Fannie Mae and Freddie Mac, crowded out the private market. And there are big pools of money in this country and all over the world who are long-term investors who are looking for what we call long duration securities, duration and they buy long term corporates, they buy long term governments, they buy long term infrastructure bonds, they buy long term municipal bonds, and they will buy the long term mortgages as well.

Mr. GARRETT. Thank you. The gentleman from New Jersey.

Mr. PASCRELL. I want to thank the gentleman from New Jersey, chair?

Mr. Campbell, unfortunately, we, many of us on this side, not all of us, agree with your analysis, so I hope it does not doom whatever you are going to work at. We get the idea. We understand.

Ms. Rosen Wartell, you said on Page 8 of your testimony the 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, and you discuss that on page 5 in your remarks. Regardless of whether they are discounted by Treasury rates or a private market premium, the cost estimates will still be grounded on the same market forecast. Biasing the estimates high will not change the economic reality in which FHA has to operate. 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, you say, it is imperative that Congress apply the same budget rules that FHA loan guarantees as it does to all other federal credit programs. Am I stating your position correctly? So I do believe in what Mr. Campbell has stated as an analysis of the program. I think your analysis is right-on.

I would like to know, Ms. Rosen Wartell, what would this piecemeal approach, which I am reluctant to embrace, and apparently, you are too. We have heard what it would do to the 30-year mortgage; you have been pretty specific about that. What would it do to the following three things: consumer protection, first-time home buyers, and multi-family units. Give me one or two sentences on each.

Ms. WARTELL. And to be clear, this is not about scoring, this is about unwinding the GSEs in a piecemeal fashion.

First of all, I think one of the things the GSEs have done is they have provide standard terms and decisions for most of the market until we had the private markets take their place. Those standardizations help make it far easier for consumers to shop and compare. They could not do that during the private label subprime boom because everything was so confusing. That has hurts consumers, to first-time homeownership.

Down payment is the single greatest barrier to first-time home buyers. It is very hard for people to save, particularly with stagnant wages over the last decade, and the availability of low down payment lending to well-qualified borrowers will be made more difficult in the world that has been described.

Mr. PASCRELL. Excuse me, what exactly would be made more difficult?

Ms. WARTELL. If we have only private investor loans at a price affordable to home buyers, low down payment lending, lending that requires five percent down payment for borrowers who are otherwise well qualified, who have good credit, will be far more difficult to get, its prices would be higher. I think the availability would be diminished.

For multifamily, it is very important to remember that the GSEs during the crisis also provided an enormous amount of liquidity for the rental market. For demographic reasons, we are going to see a huge increase in demand for rental housing over the next 20 years, and we have had a complete shut down in the supply for a significant period of time. One of the reasons families with three kids bought homes was because there was not decent rental housing that they would afford and so they stretched themselves to become homeowners. Without a mechanism for liquidity for long-term finance for rental housing, we will also see increasing pressure on rents and difficulty in homeownership.

Mr. PASCRELL. Okay, thank you, so much. Mr. Pollock, how would you expand consumer protection in your protocol?

Mr. POLLOCK. Thanks Congressman. First of all, let me say, I believe the greatest obstacle to first-time home buyers is inflated house prices. And inflated house prices reflected among other things, all the government subsidies flowing into housing so we are doing a disfavor to first-time home buyers by subsidizing house prices; so one way to protect them would be to not do that.

Secondly, I have discussed for years a theme, which the nascent Consumer Financial Protection Bureau has picked up, which is simplified, clear, straight-forward mortgage disclosure, which I do think would be a major improvement. You certainly do not need a new government agency, which is free of the discipline of appropriations to get that, but to get that simplified disclosure; I think is something that we could all agree on. It turns out to be hard to do to make things clear and simple, but it can be done.

Mr. PASCRELL. Thank you for your contribution. Thank you, Mr. Chairman.

Mr. GARRETT. And I thank the gentleman from New Jersey. Gentleman from Indiana.

Mr. YOUNG. Dr. Lucas, I believe it was Ms. Wartell who spoke earlier of the incongruity of using one sort of accounting analysis for one particular government program and then a different sort of accounting analysis for a different government programs. Why in your mind is it appropriate to use a fair value analysis for the housing market and using a unique accounting method just for this sector in terms of how government keeps its books?

Dr. LUCAS. Okay. I did not mean to imply that it is appropriate to use a unique accounting treatment for any sector, and I believe that we want to move towards an accounting treatment for all credit obligations that give Congress the best picture of what their true cost is. The way that we got to fair value where the GSEs really started, I think with the treatment of TARP, where our fair value was required, because it was possible that TARP would have appeared to make money for the government, which did not seem like, perhaps the best way to account for it.

So for the GSEs, there was a number of considerations, many of which are legal, many of which I do not want to go into detail on because I do not think I am the best qualified to describe it. But basically, the GSEs were difficult. They did not fit into any natural bucket. The budget has two choices, basically, cash and credit reform. Cash did not seem appropriate for the reasons I discussed in my testimony. It does not give a sense of the obligations going forward and so forth. The Credit Reform Act was also problematic. There were some contradictions between the GSE's charter acts and the Credit Reform Act that did not quite reconcile. But beyond all that, I think that fair value treatment does give the most comprehensive picture of what the costs are, and that ultimately was why we settled on that for the GSEs.

Mr. POLLOCK. Chairman, could I just add a footnote there? It is my view that there is a big difference between the housing finance activities of the government and these other things, in that the housing finance activities are so much bigger. So in a day when the total agency debt was 15 percent of the Treasury market, you probably did not care that much. But when it is as big as or bigger than the whole outstanding stock of direct government debt, you care a lot. And I think it gives us good reason to focus on them independently as opposed to a lot of many smaller things.

Mr. YOUNG. It would seem logical and consistent that, frankly, in other sectors, in other areas of government-backed finance, we would also try and incorporate market risk, right? I mean, that is a counter to the argument that I frequently hear, which is that we have an inconsistency here. Perhaps we do. Maybe all the more reason for its embracing a fairer value sort of method of accounting for other areas. But I know that broadens the conversation here.

Mr. Pollock, under the current cash accounting method, the FHA uses, government makes a profit. That is correct, sir, right, according to our books?

Mr. POLLOCK. Well, actually, what FHA does under Credit Reform is to estimate its future losses, which is a kind of an accrual, and have to book those. Whether you call it a profit or not is a little tricky because we do not charge the FHA in the accounting for their operating expenses. Those are separately appropriated and separately budgeted. So all these numbers we have been talking about, unlike with a normal company, or a normal insurance company, we do not count the cost of actually operating the programs, as the CBO correctly points out. So one of the things I would like to see as a supplementary FHA account would be a set of GAP books that actually measures the profit and loss of the insurance business of the FHA the same way we would measure any other insurance company.

Mr. YOUNG. It seems curious to me, could not the government actually improve its balance sheet if we mandated that the United States government had to insure every loan in the mortgage marketplace, right?

Mr. POLLOCK. Well, that is the reductio ad absurdum, if I could use the reduction to absurdity of the argument that, of course, we make profits and the more we guarantee, the more profits we make. And of course, the more we do that, the less market discipline, the less efficient is our resource allocation, and the bigger the ultimate collapses tend to be.

Mr. YOUNG. Thank you. And for the record, I was not suggesting that we do that.

Mr. GARRETT. The gentleman from California.

Mr. HONDA. Thank you, Mr. Chairman. I want to thank the chair and ranking member for convening this panel and for the panelist being here. It is my hope that our community can use hearings like this to engage in a serious discussion about the housing market. We have seen too many debates on serious issues hijacked by the special interest agendas.

For example, in this committee, a budget was reported to claim to tackle the deficit and did, but really represents an agenda to privatize Medicare and block Medicaid in order to pay for more spending tax on charity for the top two percent of our earners. This is unacceptable.

We are facing serious economic issues in this country that Congress must address. The eyes of the nation, and indeed of the world, are upon us. Today we have two critical questions to address: First, Republicans have a single mantra regardless of the issues, deregulate, deregulate, deregulate, the market will police itself. Will completely deregulating the housing market prevent future crisis? I think everyone, Democrats, Republicans, understands that certainty is a key ingredient for a high-growth economy. So my colleagues across the table would like to wind down Fannie Mae and Freddie Mac. However, given the increasing income inequality in our country, and I will say that again, given the increasing income inequality in our country, when the median income for 90 percent of families is around $30,000, given these factors, under the Republican proposal, how will the bottom 90 percent buy homes in the absence of Fannie Mae and Freddie Mac, and will they be able to obtain a 30-year mortgage at reasonable rates? I may like to start with Ms. Lucas and then Mr. Pollock and then end with Wartell.

Dr. LUCAS. Okay.

Mr. HONDA. You have a minute each.

Dr. LUCAS. Okay. Well CBO really has not done an analysis of what the affect would be of reducing the subsidies to Fannie Mae and Freddie Mac. It is clear that if they were less subsidized, the cost of borrowing would go up to some extent. There has been some estimates that range from just a few basis points to over a percent. Whether that is a good or a bad thing, I think depends on the perspectives, and I am going to let my colleagues on the panel give those perspectives.

Mr. POLLOCK. Congressman, in my judgment, these median income families will be able to buy houses and with mortgages in a market system with market prices. You mentioned regulation. I would like to point out that one of the reasons why house prices are falling right now and why the housing market is so soggy is the natural regulatory overreaction in the wake of the bust, which has had the effect of making mortgage credit much more difficult to get because the lenders are terrified with their increased legal and regulatory risks of even making a loan. So I am sure we have all heard endless anecdotes about people with good credit who are put through the most outrageous process even to get a loan. And when the credit is tied up in this way, it makes it harder for anybody to buy a house. We see this cycle after cycle, that in the wake of the bust comes a regulatory overreaction of clamping down excessively which makes recovery from the bust more difficult.

A second reason that I would like to point out why we have continuing serious problems is exactly the 30-year fixed rate mortgage. The 30-year fixed rate mortgage is an instrument, which if housing prices are inflating, works very well. If housing prices are deflating, it is a terrible instrument. It locks people into high mortgage payments which they cannot get out of. And when they do not have the equity to refinance, they are trapped in the mortgage, so we have endless programs of trying to modify and change the rates on the mortgages to reflect the current market, which do not work very well. So we do need to understand these underlying causes of our current problems. Thank you, Congressman.

Mr. HONDA. Okay, Mr. Chair I would like to have Ms. Wartell.

Ms. WARTELL. For the medium income family that you describe, the availability of long-term finance allows them to set their housing prices. If they were subject to only affordable adjustable rate mortgages, they would recognize that as interest rates fluctuate, their housing costs could suddenly grow dramatically. The transaction cost for a family to move their home because their housing just got more expensive is far more difficult than it is for investors to adjust their portfolios in different interest rate environments. So it is the availability of the long-term finance that I think is so important to the median income family.

Under Mr. Campbell's bill and my own proposal, the cost of the subsidy the GSEs got would be priced in the future, which means housing costs will go up a little bit. And everybody thinks that is appropriate. We should not have a hidden cost to the taxpayers. But what is important is the consistent availability of credit to allow people to make investments in homes.

Mr. HONDA. Thank you.

Mr. GARRETT. Gentleman, yield back. Gentleman from Indiana.

Mr. ROKIA. Yes. Thank you, Mr. Chairman. I appreciate the witnesses coming today. I have enjoyed listening and have one, maybe two questions, if I can get them in.

First, to Mr. Pollock. Earlier this year, Dr. Carmen Reinhart, you may be familiar with her work, testified in front of this committee. She has done extensive work on debt burden, specifically in countries or models that have 90 percent debt to GDP ratios, and what the negative impact on economic growth is. One thing she talked about was that not only does public borrowing rise precipitously ahead of a sovereign debt crisis, but that the governments involved when this happens, are often found to have, quote-unquote hidden debts. Mr. Pollock, from your testimony, you would say that the U.S. has hidden debts, right?

Mr. POLLOCK. That is correct Congressman.

Mr. ROKIA. Okay. What is the impact of GSE and other agency debt, so not just GSE, on our fiscal solvency? All right, I am getting a little way from Fannie and Freddie here, as our debt held by the public approaches the high levels that Reinhart discusses in her analysis?

Mr. POLLOCK. I should say that Carmen and her husband are good friends of mine and we share many approaches to understanding financial cycles. When any borrower is running up his debt, it is very tempting to try to put the debt in an off-balance sheet way, that we observed again and again in private markets, and it is also observed in government markets exactly as you suggest. So the curious thing about the explosion of agency debt over the last four decades is precisely this creation of a debt that really was not hidden, I mean, we knew it was there, but it was hidden in terms of the official way we talk about the debt. Among the results, being much more risk to the taxpayers, a higher cost to financing the Treasury. And I reiterate my recommendation that we ought to require the Treasury to provide an annual report to the Congress on the extent to which agency debt has made Treasury debt more expensive or has affected Treasury debt, and on the overall credit worthiness of the government. And I reiterate my recommendation that we ought, in statute, explicitly to make the Treasury responsible for managing the overall credit worthiness of the United States, and that means they have to manage the debt of these mixed ownership government corporations, like, Fannie Mae and Freddie Mac. Or, we just have to recognize the reality.

Mr. ROKIA. Thank you, Mr. Pollock. And I said this was a question to Mr. Pollock, but I was wondering now if CBO wants to comment on the same set of questions?

Dr. LUCAS. CBO has published various reports that talk about different measures of the debt, and certainly the public debt is the public debt. But these other obligations affect the fiscal situation of the United States.

I think it is important to think about the sum of the two, as Dr. Pollock has. I think it is also important, though, to recognize that not all debt is the same. So the debt of the GSEs is backed by the mortgages that are making payments on that debt. So it is not quite the same thing as debt which is just backed by tax revenues from the citizens. So it certainly matters, but it has to be a little bit careful.

Mr. POLLOCK. Just like the SIVs of Citibank.

Mr. ROKIA. Say that again, please?

Mr. POLLOCK. Just like this term SIV, SIV stands for Structured Investment Vehicle.

Mr. ROKIA. Oh, thank you.

Mr. POLLOCK. Just like the SIVs of Citibank, I said.

Mr. ROKIA. Right, thank you.

Mr. POLLOCK. I was having some fun with my good friend and colleague.

Mr. ROKIA. I was going to ask you if you had a reply to that. A serious one.

Mr. POLLOCK. Well, no, I agree we have to look at the whole picture just as any entity looking at its finances has liabilities of different kinds. But you have to tote up the total liabilities and figure out and control their effect on your credit worthiness.

Mr. ROKIA. Okay. Thank you, very much, Mr. Pollock. And then, Ms. Wartell, not to leave you out. And if you want to quickly comment on that you can. But I have interest in this rent versus buying.

Mr. GARRETT. Would the gentleman yield?

Mr. ROKIA. Sure.

Mr. GARRETT. Ms. Lucas, you said it is all the debt is backed by mortgages?

Dr. LUCAS. Well, I was just noting that the debts that the GSEs have issued was issued in order to purchase mortgages.

Mr. GARRETT. But not their entire book of all their debt is backed by mortgages, correct?

Dr. LUCAS. At the time when they issued the debt, they are issuing it to purchase a mortgage. Some of the mortgages have since fallen in value. And so there is a gap between the value of those mortgage assets and the liabilities of their debt. And that gap is what is reflected in those costs of the business that they already have. I did not mean to say those were not real costs, only that when you have an asset as well as a liability, the existence of the asset can change your view of the liability and what it does to the stability of the financial situation of the country.

Mr. GARRETT. Yield back.

Mr. ROKIA. Thank you, Mr. Chairman. Just real quick with Ms. Wartell. I am intrigued by the concept that we are starting to realize now that maybe not everyone should be, or has to be, a homeowner in order to realize an American dream. Maybe the American dream evolves and changes. Do you think the history of pushing people to buy homes has distorted markets and that perhaps not everyone should own a home?

Ms. WARTELL. I think there is widespread consensus that federal housing policy has been imbalanced, that we need to get the balance right, that we need to make sure that there are appropriate housing choices for everyone at their stage of life and with their family conditions. That means we need to ensure there is credit availability to finance rental housing and that that are good rental housing choices.

Mr. ROKIA. Thank you.

Ms. WARTELL. Absolutely.

Mr. ROKIA. Okay. Thank you, ma'am.

Mr. GARRETT. And I thank you. And the lady is recognized as soon as the light comes on.

Ms. KAPTUR. Thank you, Mr. Chairman. I want to thank our witnesses very much, and our committee for at least providing us the opportunity to talk with one another across party lines.

My two main questions are, and I am going to make a statement after the question so you can think about the questions, six banks in our nation now control two-thirds of our banking system. How do we restore real competition for mortgage credit? And number two, how do we restore prudent mortgage lending and origination that recapitalizes local and regional community financial institutions, not distant speculative lenders? Some, as you have heard this morning want to blame Fannie Mae and Freddie Mac for the financial meltdown. And I would like to put their role in perspective as I see it. They were doing fine until deregulation of private financial markets occurred during the 1990s and what we have experienced now in this past decade is the government has become the dumpster for the mistakes of the private sector and the cost are enormous.

High-risk behavior in America's housing market began during the early 1990s when financial deregulation pushed by some here in Congress, allowed the private financial sector to turn formally prudent mortgage loans into bonds and then securitize them into the international market in a manner that bore no relationship to true value nor the local real estate market. I would like to place in the record an article from this week's New York Times, the "Good Banker," by Joe Lucera. There are many good bankers left out there. They need to come before our committee and help us figure out a better future for this country.

I remember in the early 1990s when the largest commercial banks, and later Wall Street's speculative investment houses came up here and applauded the demise of the staid thrift industry and its conservative mortgage lending practices as the big Wall Street banks hungrily sought after a globalized market, and after the housing market, that they had not been into as a new national profit center. I recall when the sign outside the door of the former Banking and Housing and Urban Affairs Committee was taken down and that committee renamed the financial services committee. That signaled a new era of abandonment of strict practices in mortgage loan origination and standards of prudent lending that had regulated private sector mortgage behavior for most of the 20th Century, following The Great Depression.

In fact, during the 1990s, the securities jurisdiction of the energy and commerce committee was merged under that Financial Services Committee as Congress passed, without my support, the Leach-Bliley Act. And when the Glass-Steagall Act that it separated banking and speculations since 1933 was wiped off the books in 1990 under that Leach-Bliley Act, the speculators were unleashed full bore. I have a bill, H.R. 1489 that would restore important Glass-Steagall provisions.

Fannie Mae and Freddie Mac were not the quarterbacks in this game of market manipulation, Wall Street was. But Fannie and Freddie were very important wide receivers in this high-stakes big bank hyperventilation of the mortgage market. The private sector big banks and speculative houses soon discovered that home mortgages were pretty sleepily instruments with a 30 year pay-back time horizon that did not yield the quick seven-year pay back of commercial loans or speculative prospects. So the big banks and their minions and the origination servicing and rating industries figured out how to inflate their returns. I would like to place on the record a few pages from the book published in 1996 by former chairman and CEO of Fannie Mae, James Johnson, entitled "Showing America a New Way Home." In it, he clearly described what the private sector was up too: transforming the way America financed home buying, the mortgage system, from an industry that is almost exclusively dependent on depositors to one that is investor-based. He lauds the fact that capital to finance homeownership will be virtually unlimited, I am quoting, unlike the former savings and loans, and that international capital markets will now assume the risk, and our superbly well-equipped to evaluate performance as they invest in securities backed by mortgages. Fannie Mae and Freddie Mac were wide receivers in this transformation, but the quarterbacks sat on Wall Street and on the Board of the Federal Reserve.

Looking back, it is hard to understand how he could have such unguarded faith in an untested system of the deregulated global private financial marketplace for housing finance. But that is what happened. And Fannie Mae and Freddie Mac then adopted high-risk practices too, becoming key agents to move this mortgage paper into international tranches.

For our nation to dig itself out of the worst housing depression since the Great Depression, we must go back and unwind what happened and restore prudent lending standards again. I have a bill, the Fannie Mae and Freddie Mac Investigative Commission Act. It is a straight-forward piece of legislation that creates an independent commission to investigate and analyze what policies practices and board decisions on risk management that were made at Fannie Mae and Freddie Mac that led to the enterprises financial instability and the subsequent conservatorship of the two entities. This commission would build on the work of the Financial Crisis Inquiry Commission as a basis for, again, disciplining the financial practices that led our nation to such a precipice.

I have many, many documents to enter into the record and Mr. Chairman, I will wait for the second round for them to address the two questions I have asked about restoring competition in our banking system. Again, and recapitalizing local markets that are capital-starved at this moment.

Mr. GARRETT. And the gentle lady yields back and as the gentle lady indicates as long as our panel's available, we are going to do, at the request of some of the members, a second round. And we should probably put the caveat to members that are here too, since these members have been sitting here through all this.

I will yield at first to the gentleman from California.

Mr. CAMPBELL. Thank you, Mr. Chairman. Mr. Pollock, well, we have to have a little discussion about some of the things that obviously, that you and I disagree about.

In your comments and responses to the gentleman from Indiana, I believe I heard you advocate for lower housing prices, correct?

Mr. POLLOCK. Congressman, first of all, let me say I really look forward to a discussion when we get a chance in person to go over some of these things. I know you are very knowledgeable on these topics and I would look forward to that a lot.

Lower housing prices are obviously good for some people, mainly the people who are buying houses, especially the first time home buyers. They are bad for people who bought the house previously at a higher price. They are like the price of anything. When it goes up it is good for the people who are long, and when it goes down, it is good for the people who are short.

Mr. CAMPBELL. Yes, but I believe I heard you say that you thought they were too high and that they were artificially propped up and that this was hurting new home buyers and that we out to let them fall.

Mr. POLLOCK. What I was trying to point out was that in the housing bubble, we, without question, artificially inflated house prices to a great extent.

Mr. CAMPBELL. Okay, how about now?

Mr. POLLOCK. And I think they are probably now in my own forecast, they are coming across a long and rocky bottom, where house prices will be falling in real terms but moving in an irregular flat line in nominal terms.

Mr. CAMPBELL. Okay, that is what you forecast. But you think it would be good if they dropped some more?

Mr. POLLOCK. The specific point I make is that the gentleman asked about what is an obstacle to homeownership for first-time home buyers, and I said high house prices, inflated house prices are such an obstacle. There are other obstacles, of course.

Mr. CAMPBELL. You know, we out to switch places because your very good at not answering the question that supposed to be our job. But I heard what you said before to the gentleman from Indiana. Now I think maybe I get it. Because if you believe that a fallen home prices is okay, then having no government support for the system, which will trigger that, and that is okay. But the recession, or near depression, that we had in 2008 was triggered by 28 percent drop in home prices. I do not want to do that again. I do not want to see that again. The home market is one-seventh of the U.S. economy and it is already holding back this recovery and we are not going to get any kind of recovery if we do not have a robust housing market, and removing that support and triggering another significant drop is just going to move us into recession, which in terms of the Budget Committee that we are talking means less revenue and it means that all these Fannie and Freddie debts, which none of us are happy about but we got them, I mean the taxpayer has them, and further declines in home prices, I think there is no dispute about that is going to cost taxpayers a lot more lost money on Fannie and Freddie portfolios that we already have. You like to comment on that?

Mr. POLLOCK. Yes, sir, I would love to Congressman. Thank you very much.

First of all the trigger, of course, for the fallen house prices was the 90 percent inflation in house prices, which made the subsequent fall absolutely inevitable. The fall was about 30 percent of the peak, which is about 60 percent of the base.

Mr. CAMPBELL. Okay, Mr. Pollock, you always want to go back and talk about that. I want to talk about where we are now and where we might go now.

Mr. CAMPBELL. And if I am wrong on this, say I am wrong, but your concept of what you want to do going forward will result in a drop in housing prices, and you are okay with that. Is that correct?

Mr. POLLOCK. I think that is not correct. My view is I think it would be correct if our proposal were to happen in five minutes. But since it is a five year transition, I think it is not correct.

Mr. CAMPBELL. What if the five year transition is not correct?

Mr. POLLOCK. The very point of a five year transition is to leave the financing, which is now in place, with the support of the government and the taxpayers to get us through the transition out of the bust, which is unfortunately necessary because of the bubble.

Mr. CAMPBELL. Okay, well, Mr. Pollock, I just in my final 22 seconds, you know, my conversations with the people who would lend the money, I know you seem to think that there be 30 year fixed rate mortgages without government support. But, you know, we do not have to speculate. That exists. There is the non-conforming market, the jumbo market out there right now, and as Ms. Wartell indicated, you can get a jumbo loan at a 30-rate fix with, like, 50 percent down. And if that is the place we are going and that is what it looks like and that is where your proposals would lead us, that is going to make the last housing drop look small. And that is why we cannot afford to have that happen. I yield back. Thank you, Mr. Chairman.

Mr. GARRETT. Ms. Kaptur.

Ms. KAPTUR. Thank you, Mr. Chairman. I am very interested in your comments on my statement. That has how I view the world. Two questions: six banks in our country now control two-thirds of the system. What do we do to restore real competition for mortgage credit, just taking that piece of the credit system? And secondly, how do we restore prudent mortgage lending and origination that recapitalizes local and regional community financial institutions, not just in speculative lenders? Yes, Ms. Wartell?

Ms. WARTELL. If I may, thank you, Ms. Kaptur. I think that having a system of housing finance in the future that ensures access to the secondary market for community-based financial institutions is one of the goals of the kind of proposal that cap has and could well be achieved under Representative Campbell and Peters legislation with some minor adjustments.

It is a great concern to me that we have such concentration and a very small number of lenders. For origination of so much of our mortgage market these days.

Ms. KAPTUR. Will the gentle lady yield just for one statement? And also a group of individuals and institutions that have no respect for the local real estate market. When they end up owning these homes and holding these homes, they do not take care of them. Plumbing is ripped out. What is going on across this country is a disaster.

Ms. WARTELL. In a fully privatized world, where access to the secondary market where the lender's ability to sell, the larger financial institutions will have a far greater ability to access the secondary market as many of them develop their own private label security origination schemes during the last bubble.

My concern is that there is a mechanism to ensure that small banks and community-based institutions like CDFIs and others have access to the secondary market. Our proposal includes a requirement that those who insure mortgages and package them for securitization should not be originators of those mortgages except to the extent that it is in the form of a co-op of originators, so that we can ensure that a wide array of financial institutions have that access. That will, I think, in part address some of your concerns that community-based lenders cannot effectively compete against these large institutions.

Ms. KAPTUR. May I ask, you assume securitization is fundamental to the housing system of the future?

Ms. WARTELL. Yes, I do. I think if you were to take the size of the housing market today and imagine putting that on balance sheet of our current financial institutions, it would dwarf their capacity to lend and it would collapse access to capital for other parts of our community.

Ms. KAPTUR. But how do we strength local institutions as opposed to these very irresponsible distant institutions in that scheme? I am not sure I support securitization as the only option for the future.

Ms. WARTELL. I do not support it as the only option. I think we need to go back to a world in which we have securitization and balance sheet lending as we did in the past. Some of that securitization needs to be like FHA lending for targeted borrowers and some can be private with private capital risk, but access to the secondary market through liquidity backstop and some of it needs to be fully private. But what we need to do is have appropriate regulation to ensure that lenders throughout our economy, large and small, can access those markets.

Ms. KAPTUR. Thank you. Mr. Pollock, you have been waiting to say something.

Mr. POLLOCK. Congresswoman, I have to say, I enjoyed your comments so much because it makes me think of one of the great proofs that economics is not a science, and that is that whatever happens, we can have mutual inconsistent interpretations of the events and neither side can prove its story. And by the way, Congressman Campbell, I really look forward to some further discussions. I know we will find something we agree on.

Mr. CAMPBELL. And I do too. I failed to mention that, but I look forward to further discussions as well.

Mr. POLLOCK. I have in the course of my career worked for big banks.

Ms. KAPTUR. I noticed that.

Mr. POLLOCK. And I ran a thrift. So I have some experience with that.

Ms. KAPTUR. Yes, you were on Federal Home Loan Bank Board.

Mr. POLLOCK. And a federal home loan bank. The thrifts, of course, were extremely heavily regulated and, nonetheless, collapsed. When I was with the Federal Home Loan Bank of Chicago, we made the observation that you could find a regularity in the mortgage market, and that was that the mortgages originated by small banks and thrifts had consistently higher credit quality than those originated by all other originators. And we set out to give them a better way to finance these mortgages because we used so say to them, and what do you think the credit quality of your mortgages is? And they would say, Excellent. And we would say what do you think your charge-off on your customers, your local mortgages? And they would say, one basis point a year, or something. So we said, well, in that case, why did you want to pay 25 basis points to Fannie Mae and Freddie Mac to divest the credit of your own customer? That does not make sense. And they would say, Yeah, I never thought about it, but you are right. They were basically being overcharged for the transfer of the credit risk consistently for decades by Fannie and Freddie.

So what I would like to see is a way for small banks to be more robust competitors in the credit sector of the market where they are demonstrably extremely competent actors, where they could retain the credit risk, be paid for retaining the credit risk, but have a way to finance the interest rate risk. We actually have designed a program like that, which I think much more could be made of if we set about it rightly because we have a set of actors in our 6,000 or 7,000 smaller banks that make mortgage loans and whose local credit talent, we need to take much more advantage of.

Ms. KAPTUR. I am so glad you came today. We probably do not agree on many things but I want to thank the Chairman because I think this is very valuable. You know, members of Congress do not talk about this very much. The whole housing sector and it is terrible role in bringing our economy down after the rising gas prices triggered the whole mess and the rising oil per barrel back in 2008. But it is really sad that this institution has not met its obligation to the American people when you look at what has happened over the last three or four years and the hemorrhage that is going on across this country. So I would just encourage the Chairman to bring them back with a brown bag lunch and let's talk about their experience. Because somehow these discussions are not occurring in the Senate, they are not happening in the Financial Services Committee, maybe this Budget Committee could do the country a favor. We need to take the best talent we have, take the bills that are being proposed and actually try to do something on a bipartisan basis to move forward. Now, I am very concerned about the future and about our credit system, certainly for mortgages and about the hemorrhage in this housing market that is devaluing these assets and destroying these assets as we sit here today. So I would just ask the Chairman to think forward and, you know, I would be willing to work with you and our chairman, Mr. Van Hollen in that effort.

Mr. GARRETT. And I thank you. And I know you have been very interested in a leader on this issue and just one differ is that, yes, we have actually been taking up these issues in the Financial Services, at least in the Capital Markets Committee, as some of these members have been here on that. But I look forward to the idea of coming again and exploring them. Gentleman from Indiana.

Mr. ROKIA. Thank you, Mr. Chairman. Just picking up a little bit on the question I asked Ms. Wartell about the American dream, and this came out in of the exchange you had with Representative Campbell, Mr. Pollock, the idea that our economy somehow revolves or orbits around the idea of housing starts and homeownership, and we can discuss the definition of the American dream and if it should stay the same or if it should evolve or if politicians of both parties have forced the American dream by distorting the free market system instead of allowing Americans to earn the American dream. But can each of you point to any economic and empirical data, not cultural or political rhetoric, again, economic or empirical evidence of why the economy should be based on homeownership or home starts or home building, or anything like that, I receive a good deal of support from the Home Builder Associations, so I am sure I am going to be in trouble for this, but we have to be honest as Ms. Kaptur says, and if we are going to ask these questions, figure out why it is that it has to be this way to the economy to center itself around home building and homeownership. Ms. Lucas?

Dr. LUCAS. Okay. Well, from an economist perspective, it does not have to be centered around it, it is an important part of the economy.

Mr. ROKIA. Why?

Dr. LUCAS. Because people want and need good places to live. So I am a little perplexed by the question. There needs to be homes.

Mr. ROKIA. I am talking about homeownership.

Dr. LUCAS. There is a role for rental housing and there is a role for homeownership, and there are other countries where rental housing plays a significantly larger role and people seem to get good housing services through the rental markets there. So it is true that your economy has sort of moved in the direction of heavily favoring homeownership and we could be organized in different way, but where we are right now, is that it is a large faction.

Mr. ROKIA. Okay, thank you. Same question.

Mr. POLLOCK. Congressman, if you look around the world and homeownership rates vary a lot among countries, among developed countries. The U.S. is sort of in the middle of the pack in terms of the percent of households who are homeowners who are neither the highest nor the lowest. An interesting country is Switzerland, a very rich, pleasant country, which has very low homeownership, perhaps in consistent with your hypothesis here. It also has a central bank whose shares are publicly traded or the citizens can buy shares in the central bank, an interesting concept by the way. My view would be that obviously shelter is a very big and very important sector and that people ought to exercise their preferences to own or rent as they like and as they are able, and many people will like to own and will be able to own. Others will like to rent and that that should be a market outcome left to the voluntary exchange of the citizens.

Mr. ROKIA. I note your term voluntary.

Ms. WARTELL. I largely agree with Alex and since that does not happen that often it is worth noting. But I would note that in our society, we have created a system that uses housing as a principal form of savings for American families. And people essentially pay down their mortgages over time and they receive significant tax advantages for doing so. So we are, in a sense, encouraging that savings and that wealth accumulation and that wealth accumulation allows families to both invest in small businesses and educations of their children, as well as provide for their own secure retirement when they are no longer earning. We could make a policy decision not to encourage savings in that form and to do that differently, but those are very fundamental changes in the way our tax code operates and our housing system has been built.

Unfortunately, we have created that set of incentives but we have only allowed some to participate in this. And so we have enormous disparities in wealth in our society, especially on our racial grounds but on a wide array of grounds, including geography, and so that some people are getting the benefits of those subsidies and that encouragement of homeownership and others are not. Unless and until we are prepared to say that we do not want to encourage homeownership, then it seems to be important that we ensure access to homeownership as a means of accumulating wealth and to give access to the opportunities to grow businesses, to educate children, and to have a secure retirement.

Mr. ROKIA. Thank you, Mr. Chairman. Very educational. Yield back. Thank you witnesses.

Mr. GARRETT. Gentleman yields back. Gentle lady from Florida.

Ms. WASSERMAN SCHULTZ. Thank you, Mr. Chairman. My question is for Ms. Wartell. Would you agree that one way the Federal Government can assist in stabilizing the housing market is by helping to prevent avoidable foreclosures?

Ms. WARTELL. Absolutely.

Ms. WASSERMAN SCHULTZ. I am from the state of Florida and, you know, right now we have many homeowners who are locked into high interest rate loans and they do not have the ability to refinance, they lost too much equity, many of them are upside down. Four and a half million borrowers with outstanding mortgage loans in Florida are in that situation; 2.1 million owe more than the value of their home; that is 47 percent of the population in Florida. Nearly 20 percent of underwater mortgages in the United States involve Florida properties. So allowing homeowners to refinance and lock in historically low rates would help a lot of people be able to stay in their homes. Our colleague, Dennis Cardoza from California, has introduced legislation, and I do not know if Mr. Chairman, that has been spoken about already. But, he has introduced legislation called "The Home Act," the Housing Opportunity and Mortgage Equity Act: And that would require Fannie Mae and Freddie to allow homeowners to refinance those mortgages. So rather than pull the rug out from under the housing market, is there not a better solution, like this one, for stabilizing home prices?

Ms. WARTELL. I think finding ways to avoid avoidable foreclosures has got to be an enormous priority in efforts to stabilize the market. I am not familiar with that legislation, so I would rather not comment on it now without looking. But I would say that there are a couple of different strategies that are useful in that. One thing we have written about in the past is mediation, which requires lenders before they foreclose to sit down with the borrowers and consider seriously, with an advocate on their side before they foreclose. Nothing forces them to do a modification but gives them another bite at the apple. There have been models in a number of states that have been very successful in showing that lenders actually get higher recoveries through those programs. I think taking a look at what has happened to credit scores because of the foreclosure crisis, to help people become eligible for refinances, of the kind you have mentioned, is another piece. And I think I have been encouraging the administration and others to bring together the credit rating agencies and the lenders to work on that. I think in the servicing standards, we have to establish national servicing standards and lenders have to be encouraged to give a loan loss mitigation a more serious try before they move to foreclosure, and, essentially, they become worried about time.

And I think that there are tricky issues with Fannie and Freddie in mandating them to refinance because it is not always the case that a refinance in that case will result in higher recoveries. And the government in the current period has an obligation to mitigate their losses. But I think it is possible if you do that in the right circumstances, to encourage Fannie and Freddie to do refinancings or principal write-downs. It might actually increase recoveries.

Ms. WASSERMAN SCHULTZ. And you would agree that it is certainly better than what the Republicans have proposed which is to just get rid of all the foreclosure mitigation programs and do nothing else and leave people twisting in the wind?

Ms. WARTELL. I understand the frustration because many of these programs have not worked as nearly as well as we would have liked. And I think we do not understand something about the behavioral models of the financial institutions as to why what seems to be economically rational have not been steps that they have chosen to take, but I think that approach, which is to throw the baby out with the bath water, if you will, is only to, sort of, finding the bottom faster in very painful ways.

Ms. WASSERMAN SCHULTZ. But what disturbs me is that the only thing that our Republican colleagues under their leadership has proposed is, what are colleague, Mr. Henserling has said, that is that best foreclosure mitigation program is a job. And that is certainly a let them eat-cake approach and one that is not going to help solve the problem over the long term, would you agree?

Ms. WARTELL. I would. I think that avoiding avoidable foreclosures is not only in the best interest of maintaining the larger economy, it is also in the lender's best interest and we have to find a way to see where those interests align.

Ms. WASSERMAN SCHULTZ. Thank you, very much. I yield back.

Mr. GARRETT. The gentle lady yields back. Yield to the gentle lady for introduction.

Ms. KAPTUR. I thank the gentlemen. I just want to encourage the Chairman and the Ranking Member to keep focus on deep probes about the future of the U.S. housing finance system is essential to our system of capital formation. And I just wanted to put on the record the book, the "Mystery of Capital," by Hernando Desoto, where he talks about the importance of our property valuation system. And housing is so tied to that now, as essential to our form of capital accumulation and savings in this country; we need to be talking at that level in this Congress about where we are headed with this market. And so I thank the Chairman for this hearing today and look forward to working with him and Mr. Van Hollen in the future to do a better job for the American people.

Mr. GARRETT. And I thank the lady for that. And I will yield myself the remaining five minutes of this hearing to just run down a couple of questions. So we heard from at the very outset from Ms. Lucas with regard to the necessity or the encouragement for it to go into consistency and a more transparent and a fair value rating as far as accounting. We heard from Ms. Wartell to say that as far as for all the debts has already incurred we should not go back and change it for what is on the books already and use that system, correct? And basically going forward, though, I also thought I heard you say that you would not suggest that we go and adopt what the CBO is recommending with regard to changing the evaluation or the accounting methodology for the entities; is that correct?

Ms. WARTELL. As to the GOCs I think, in their current form in conservatorship, that is correct.

Mr. GARRETT. And with the FHA?

Ms. WARTELL. With the FHA, I believe that they should be accounted for under Credit Reform, they need to improve their models, which I think they are working on, but I think the fair value accounting should certainly not be done only for FHA, and I think probably needs to be refined significantly before we are adopted government wide.

Mr. GARRETT. My understanding, though, is you would not, then, take into the risk factor that which CBO would be placing in their accounting, is that correct?

Ms. WARTELL. This method of pricing that risk factor is not one that I think is appropriate at this time.

Mr. GARRETT. Right. And that is where we disagree because I think most people would understand that you have various risk factors, both in the pricing of housing going forward over the next 30 years, you are nodding your head that that is a risk. And also, there certainly is interest rate risk, and the first, of course, is credit risk. Somehow or other that has to be taken and accounted for because system rehab right now, correct me, if not, shows actually that there is a profit over FHA, correct?

Ms. WARTELL. For FHA.

Mr. GARRETT. And I think the gentleman from Indiana made somewhat of a flippant sort of comment saying, well, if that is making a profit, then I guess we should insure the entire marketplace. Is there any reason why his flippant comment is not correct that we should not insure the entire market if we are making a profit there or expand it significantly?

Ms. WARTELL. Yes. And I think the reason is because of the wisdom of the policy makers in this committee and in this Congress who will not simply because it is a revenue source to make decisions that are bad for the housing market.

Mr. GARRETT. Okay. At the very beginning of our hearing today, Mr. Van Hollen started off by saying, "Well, no one wants to go back to a system that guarantees either explicitly or implicitly," and then he continued on. But after the last hour, I realized yes, there are. The gentleman to the right wants to do that, and the gentleman over to the left also want to do that. They do want to go back to a system that has, at least at some level, in their proposals, at least some level where the government will explicitly guarantee it. Well, Mr. Pollock, you said something that sparked an idea in my head. You said we have already tried that to the extent to say that with the GSEs to say that, well, there was private equity in there and it got wiped out. Is that not really just on a different variation of what these various proposals are here today: it will wipe these things all out, but you still, at the end of the day, the Federal Government, that means you and everybody in this room, backs it up?

Mr. POLLOCK. Yes, I agree with that, Mr. Chairman.

Mr. GARRETT. Okay. So there is any version that comes out either side of the aisle, as well-intentioned as they mean, where at the end of the day, that Federal Government has to step in to provide the liquidity into the marketplace, means that there is a guarantee by Federal Government. Ms. Lucas, is that too simple of an understanding of that if there is a guarantee at the end of the day?

Dr. LUCAS. No. I think it is absolutely right. And I think the challenge in the design of moving to a new system is to make the need for that as unlikely as possible.

Mr. GARRETT. And was that not also partly the design for the GSEs that we have right now, the design was to make it unlikely and not possible because that was the system we already just went through, correct?

Dr. LUCAS. That is right.

Mr. GARRETT. All right.

Dr. LUCAS. It was a system where they tried to put private capital there, but the requirements for the capital were quite thin.

Mr. GARRETT. Right. And another point, the gentleman from South Carolina made an interesting point with regard to what this is costing us, and he came up with a number of $140 billion a year in a sense that there is a cost to the fact that we have so much GSE debt out there, agency debt out there, this is impacting upon the price of treasuries. Mr. Pollock, you said that, correct?

Mr. POLLOCK. That is right, Mr. Chairman.

Mr. GARRETT. Does anyone disagree with that assessment that the fact that we have so much agency debt out there that that effects in some way shape or form price of treasuries? No one disagrees?

Ms. WARTELL. I have not had a chance to look at the study Alex refers to so I would be happy to comment for the record.

Mr. GARRETT. If that is true, though, and the gentleman says that that is costing even $100 billion, should not that be reflected somewhere in our accounting for Federal Government besides the price risking Ms. Lucas is talking about, should that not be reflected some place in our budget?

Ms. WARTELL. If that is the case, it is, because that is the price the Treasury is paying for the debt. So I think it is reflected in our budget.

Mr. GARRETT. So it is priced in the fact that it was costing us more money to borrow all the money that we are stuck having to borrower all the time, is what you are saying?

Mr. POLLOCK. But we do not understand it was an effect of what we are doing with agency debt.

Mr. GARRETT. But you said it is built into the higher cost of borrowing.

Ms. WARTELL. I am not prepared at this point to comment on the study because I have not seen it. But Treasury pays the price the Treasury pays for a debt. It fluctuates based on a variety of factors consistently, and to what extent the size of the agency debt is a part of that, I cannot comment today.

Mr. GARRETT. And last point on this, and not to open up a whole thing, but as the gentle lady from California made the accusations that we do not care on the Republican side of the aisle, and that sort of thing about people twisting in the wind and I do not think anyone on our side wants that to occur.

Ms. WARTELL. Of course.

Mr. GARRETT. But is it not possible that we can try to get to the same end game? To try to make sure that there is sufficient housing in the country, to try to deal with the situation that the gentle lady is trying to deal with here, people in difficult situations that, instead of financing debt, which is what our system does right now, correct, we could finance equity and we could finance equity through a whole host of other programs and would still get to the same end game of trying to deal with the housing situation. Is that not an alternative to this situation?

Ms. WARTELL. I am not sure what you mean by financing equity. If you mean provide direct grants in the form of down payment assistance, you can, although the leverage there means that the additional amount of assistance is significantly more expensive for the taxpayers.

Mr. GARRETT. And it is all on the books as well.

Ms. WARTELL. I would argue that the goal of Credit Reform and all of our policies here is to put it on the books. And if I might, sir, the one difference between the past in any of the proposals in the future, is that the guarantee for the GSEs in the past was implicit, not explicit and they never paid for it. And what we are all proposing for any system in the future is that it be paid for so that that would be on the books.

Mr. GARRETT. And I think we will close to understand that someone is going to pay for it no matter what. You are right. But I do thank you very much, to the panel, and the gentle lady's comment with regard to further hearings on this or other discussions, formal or otherwise, I think would be a great thing because they are to technical and it is so very important. So, thank you for that. We will look forward to doing that. Thanks to the panel.

The record, it will be open for the next 30 days and if there are additional questions, they can submit it to the panel. And to that end, I will take the profit of the chair and to submit one question to Ms. Wartell right now to elicit your comments on that last question with regard to the studies. That would be fantastic. Thank you again to the panel and to all the members who stayed with us. Thanks. The meeting is adjourned.

[Questions submitted for the record and their responses follow:]

Questions Submitted for the Record From Chairman Ryan

FOR MR. POLLOCK

1. Collective risk of government guarantee in housing markets.

a. This question pertains to the risks associated with providing a government guarantee for housing. Spreading the government guarantee among smaller financial institutions may have the benefits of risk diversification, but it also creates different types of risk, do you agree? The Savings and Loan crisis, for example, caused a systemic shock to markets, despite it originating among many smaller institutions. Would you say that systemic risk to the taxpayer exists regardless of the size of a financial institution, or group of institutions, carrying the implicit or explicit government guarantee?

2. Government support of housing values.

a. Is there risk associated with government trying to maintain housing values at artificial levels? Didn't such policies contribute to the bubble in housing markets—and isn't the U.S. economy now continuing to suffer the consequences? If government keeps in place its policy of artificially holding up housing values, couldn't that lead to another bubble and bailout?

FOR DR. LUCAS

1. Discrepancies in Fannie & Freddie vs. FHA accounting.

a. If fair value treatment were applied to FHA—the same accounting method that is currently used to estimate the cost of Fannie and Freddie—how would FHA appear in the budget? Would the cost go up or down? Can you explain why?

b. Does the current accounting treatment, credit reform, understate the risk exposure of FHA loans? In other words, are premiums collected for FHA loans currently sufficient to cover the risks of insuring the loans?

c. If a policy were to, for example, lower the conforming loan limit for FHA-insured loans, how would the scoring differ under straight, credit reform versus fair value?

Questions Submitted for the Record From Mr. Calvert

COMMENTS

The GSEs today have more than $5 trillion in mortgage assets. The GSEs provide the vast majority of liquidity for the residential housing market, guaranteeing 70 percent of single-family mortgage-backed securities issued.

We should know the facts and base our actions on the causes of the crisis. We need to understand what needs to be fixed without making drastic changes that are not based on the complexity of the system.

Reform of the housing finance system should be comprehensive and should not be done in haste.

There is no question that we need to bring private capital back into the housing market. When this happens, the role of the GSEs will be reduced. But, we need to be realistic. Private capital is not here in the near term. What would happen in the mortgage market right now if there were no Fannie and Freddie today? In order to support recovery, we need to be sure there is liquidity in the system.

QUESTIONS

- For all witnesses—FHA's performance is stronger than ever—with credit scores topping 700 and a foreclosure rate that is lower even than prime conventional loans. FHA's total capital resources are more than $33 billion, and FHA is outpacing expectations for rebuilding the required excess reserves. Do you believe this program is at risk?
- For Director Deborah Lucas of CBO—Does CBO disagree with the findings of the independent actuarial report of FHA, which shows that the program is strong and will rebuild their excess reserves within the next several years?
- For Alex Pollock of AEI—In 2008, Peter Wallison of AEI published a critique on fair value accounting. In this paper, he states that "fair value accounting has been the principal cause of an unprecedented decline in asset values and an unprecedented rise in instability among financial institutions." If this is true, don't you agree that fair value accounting is then a dangerous way to try and evaluate FHA?
- For Alex Pollock of AEI—If FHA and the GSEs had not worked as their designers had planned—to remain in the marketplace during times like we are experiencing today—our housing and economic recovery would probably be a lot slower. Do you believe that private capital is ready to return to the market, and do you believe that it won't flee again during tough economic times?

RESPONSES TO BUDGET COMMITTEE QUESTIONS FROM MS. LUCAS

REPRESENTATIVE KEN CALVERT

Question 1: For all witnesses—FHA's performance is stronger than ever—with credit scores topping 700 and a foreclosure rate that is lower even than prime conventional loans. FHA's total capital resources are more than $33 billion, and FHA is outpacing expectations for rebuilding the required excess reserves. Do you believe this program is at risk?

CBO Answer: CBO does not believe that the FHA MMI program is at risk of exceeding its budgetary resources. Even if performance turns out to be poorer than projected, Congress will not have to provide funding for any future credit reestimates because the MMI program is subject to the Federal Credit Reform Act (FCRA), which provides Treasury with permanent indefinite authority to cover any shortfalls associated with this program.

The FHA estimates that the 2011 subsidy rate for the MMI forward is negative (over −3%), meaning that the value of fee collections are estimated to exceed the cost of net payments for defaults as estimated under FCRA. (To date, FHA has never requested an appropriation for the program.) In contrast, CBO estimates that under FCRA, insuring more than $250 billion of new mortgages in 2011 would result in fewer savings to the government because CBO's estimated subsidy rate for 2011 is close to −1 percent.

The MMI Fund that tracks FHA's capital resources is an accounting mechanism that can provide some useful information regarding the financial position of the MMI program in terms of its long-term cash inflows and outflows. However, the actuarial report does not measure budgetary resources, and the results from that report do not affect the government's ability or commitment to pay eligible claims.

From a broader economic perspective, the FHA program continues to pose a risk to taxpayers despite higher credit scores on new mortgages guaranteed in recent years and relatively low default rates. The program has grown significantly, increasing taxpayer exposure to potential future losses. The mortgages guaranteed by FHA have very high loan-to-value ratios which could lead to large future losses in the event of a national drop in home prices or a future recession.

Question 2: For Director Deborah Lucas of CBO—Does CBO disagree with the findings of the independent actuarial report of FHA, which shows that the program is strong and will rebuild their excess reserves within the next several years?

CBO Answer: CBO agrees that if the most likely path for future default losses and revenues materialize, the FHA's reserves would increase over the next several years. However, there is significant downside risk associated with those estimates. A borrower's equity position in the mortgaged home is one of the most important drivers of default behavior. Over 65 percent of new loans guaranteed by the FHA in the past few years had loan-to-value ratios in excess of 95 percent, leaving those borrowers particularly vulnerable to negative equity with even moderate drops in the value of their homes. A further nationwide fall in housing values or a slower than expected reduction in unemployment rates could result in significantly higher default losses and lower reserve levels.

CHAIRMAN PAUL RYAN

Question 1: If fair value treatment were applied to FHA—the same accounting method that is currently used to estimate the cost of Fannie and Freddie—how would FHA appear in the budget? Would the cost go up or down? Can you explain why?

CBO Answer: Using a fair value treatment rather than the Federal Credit Reform Act (FCRA) methodology to estimate the budgetary cost of FHA would result in a cost increase. For example, under the FCRA methodology, CBO estimates that the program would produce budgetary savings of $4.4 billion in fiscal year 2012. That result stems from an estimated subsidy rate of -1.9 percent applied to an estimated loan volume of $233 billion. On a fair-value basis, in contrast, the program would have a cost of $3.5 billion in 2012, CBO estimates—reflecting an estimated positive subsidy rate of 1.5 percent applied to the same projected loan volume.

The cost of FHA is higher on a fair value basis primarily because, by incorporating a market-based risk premium, fair-value estimates recognize that the financial risk that the government assumes when issuing credit guarantees is more costly to taxpayers than FCRA-based estimates suggest. By using Treasury rates for discounting, FCRA accounting implicitly treats market risk—a type of risk that is reflected in market prices because investors require compensation to bear it—as having no cost to the government. However, when the government guarantees risky mortgages, it is effectively passing market risk through to members of the public. If the mortgages pay off as expected, the premiums paid cover the average loss rate from defaults; but if default losses turn out to be higher than expected, the losses must be paid for through higher future taxes or lower future government spending.

(See CBO's Letter to Honorable Paul Ryan, "Accounting for FHA's Single-Family Mortgage Insurance Program on a Fair-Value Basis," May 18, 2011, for additional information.)

Question 2: Does the current accounting treatment, credit reform, understate the risk exposure of FHA loans? In other words, are premiums collected for FHA loans currently sufficient to cover the risks of insuring the loans?

CBO Answer: The current accounting treatment does not reflect the full cost to taxpayers of the risk exposure from FHA mortgage guarantees, as discussed in my previous answer. When the cost is measured on a more comprehensive fair value basis, projected premium income is not sufficient to offset that cost—there is a positive fair value subsidy.

Question 3: If a policy were to, for example, lower the conforming loan limit for FHA-insured loans, how would the scoring differ under straight, credit reform versus fair value?

CBO Answer: Such a policy would alter the expected future volume of FHA-insured loans and possibly affect the composition and risk characteristics of borrowers. The effects on the predicted path of future cash flows would be the same under either accounting treatment. The difference between FCRA and fair value estimates is in the effective discount rates; the same projected cash flows generally result in higher costs on a fair value basis, all else equal, because losses tend to occur during periods of economic stress when they are most costly to society.

Under FCRA, FHA's subsidy rate generally has been negative. A policy that reduced the size of a program with a negative subsidy rate would tend to show a budgetary cost because profitable activity would be curtailed. By contrast, the subsidy rate for FHA on a fair value would generally be positive. Hence shrinking the program would be expected to reduce its budgetary cost, assuming no other offsetting changes.

RESPONSES TO BUDGET COMMITTEE QUESTIONS FROM MR. POLLOCK

Thanks for these interesting follow-up questions. My responses are as follows:

CHAIRMAN RYAN'S QUESTIONS

1. Yes: many small institutions can create systemic risk and experience systemic failure when they all do the same thing, thereby making themselves subject to the same macro risk factors. As the question suggests, the savings and loan collapse of the 1980s is a good example of this. The common risks were in the first place interest rate risk (a risk they were required to take by regulation), and then later commercial real estate risk (a risk they were encouraged by the government to take, in an attempt to correct the first problem). The 1970s, 1980s, 1990s and 2000s each experienced a widespread real estate credit collapse. The government, i.e. taxpayer, guarantees of various kinds—FSLIC, FDIC, GSEs, FHA—promote the expansion of credit into the inflating sectors, thereby putting the federal budget also at risk.

2. Yes: House prices in the 2000s inflated to (in retrospect) irrational levels. The government's promotion of mortgage credit and guarantees, including the so-called "implicit" but very real GSE guarantees, were an important element in this bubble behavior. Having reached irrational levels, house prices needed to fall. We should not expect house prices to be different in this respect from any other price. National average house prices, having fallen more than 30%, have approximately reached their longer-term trend, which suggests to me that we are probably in the process of a lengthy, rocky bottoming process in nominal house prices. Real house prices will, I believe, continue to fall as part of the adjustment out of the bubble.

CONGRESSMAN CALVERT'S QUESTIONS

1. On the FHA: I believe all lending programs are always at risk, because lending is a risky business, subject to recurring bouts of losses much greater than expected. Having losses much greater than expected has certainly characterized the FHA's experience. If we were to take the FHA's capital resources as the $33 million stated in the question, that would mean a capital ratio of about 3%, a low capital ratio. However, their capital ratio as officially calculated is only about 1/2%, obviously extremely low. I must confess to finding the financial statements of the FHA rather opaque: I would like to see it produce a set of GAAP statements as additional information so it could be compared to the rest of the credit risk-taking world. Such statements, like those of all private insurance companies, would cause the FHA to pay for its own operating expenses out of its operating income and/or capital. As we know, FHA's operating expenses are now excluded from its reported results.

2. On fair value accounting: this is an interesting and subtle question. When it comes to banks' financial statements, I believe all financial institutions should publish both a GAAP balance sheet and a fully marked-to-market (fair value) balance sheet. They are each informative one aspect of the financial reality. I would similarly be happy to publish both calculations about the FHA. No single perspective can capture the whole truth. As I interpret the CBO's recommendation, it is properly trying to estimate the economic cost of uncertainty, which is unavoidably imposed on the taxpayers when they guarantee credit risk. The best guess or "expected" net future credit losses do not capture this uncertainty, which is an additional cost, well recognized in the accepted theory of risk.

3. On GSEs: if the GSEs had not been escalating leverage in the housing finance sector, in accordance with the way their designers had planned, the housing bubble would have been less extreme, and the resulting bust would have been less severe. The GSEs have been systematically displacing private capital for a generation, which resulted in hyper-leverage of mortgage credit risk and consequent great risk (now come home to roost) to the federal budget; I recommend a five-year transition in which this dynamic is reversed.

[Additional submissions of Ms. Kaptur follow:]

[December 23, 2009; House Advantage: Product Design]

Banks Bundled Bad Debt, Bet Against It and Won

By GRETCHEN MORGENSON and LOUISE STORY

In late October 2007, as the financial markets were starting to come unglued, a Goldman Sachs trader, Jonathan M. Egol, received very good news. At 37, he was named a managing director at the firm.

Mr. Egol, a Princeton graduate, had risen to prominence inside the bank by creating mortgage-related securities, named Abacus, that were at first intended to protect Goldman from investment losses if the housing market collapsed. As the market soured, Goldman created even more of these securities, enabling it to pocket huge profits.

Goldman's own clients who bought them, however, were less fortunate.

Pension funds and insurance companies lost billions of dollars on securities that they believed were solid investments, according to former Goldman employees with direct knowledge of the deals who asked not to be identified because they have confidentiality agreements with the firm.

Goldman was not the only firm that peddled these complex securities—known as synthetic collateralized debt obligations, or C.D.O.'s—and then made financial bets against them, called selling short in Wall Street parlance. Others that created similar securities and then bet they would fail, according to Wall Street traders, include Deutsche Bank and Morgan Stanley, as well as smaller firms like Tricadia Inc., an investment company whose parent firm was overseen by Lewis A. Sachs, who this year became a special counselor to Treasury Secretary Timothy F. Geithner.

How these disastrously performing securities were devised is now the subject of scrutiny by investigators in Congress, at the Securities and Exchange Commission and at the Financial Industry Regulatory Authority, Wall Street's self-regulatory organization, according to people briefed on the investigations. Those involved with the inquiries declined to comment.

While the investigations are in the early phases, authorities appear to be looking at whether securities laws or rules of fair dealing were violated by firms that created and sold these mortgage-linked debt instruments and then bet against the clients who purchased them, people briefed on the matter say.

One focus of the inquiry is whether the firms creating the securities purposely helped to select especially risky mortgage-linked assets that would be most likely to crater, setting their clients up to lose billions of dollars if the housing market imploded.

Some securities packaged by Goldman and Tricadia ended up being so vulnerable that they soured within months of being created.

Goldman and other Wall Street firms maintain there is nothing improper about synthetic C.D.O.'s, saying that they typically employ many trading techniques to hedge investments and protect against losses. They add that many prudent investors often do the same. Goldman used these securities initially to offset any potential losses stemming from its positive bets on mortgage securities.

But Goldman and other firms eventually used the C.D.O.'s to place unusually large negative bets that were not mainly for hedging purposes, and investors and industry experts say that put the firms at odds with their own clients' interests.

"The simultaneous selling of securities to customers and shorting them because they believed they were going to default is the most cynical use of credit information that I have ever seen," said Sylvain R. Raynes, an expert in structured finance at R & R Consulting in New York. "When you buy protection against an event that you have a hand in causing, you are buying fire insurance on someone else's house and then committing arson."

Investment banks were not alone in reaping rich rewards by placing trades against synthetic C.D.O.'s. Some hedge funds also benefited, including Paulson & Company, according to former Goldman workers and people at other banks familiar with that firm's trading.

Michael DuVally, a Goldman Sachs spokesman, declined to make Mr. Egol available for comment. But Mr. DuVally said many of the C.D.O.'s created by Wall Street were made to satisfy client demand for such products, which the clients thought would produce profits because they had an optimistic view of the housing market. In addition, he said that clients knew Goldman might be betting against mortgages linked to the securities, and that the buyers of synthetic mortgage C.D.O.'s were large, sophisticated investors, he said.

The creation and sale of synthetic C.D.O.'s helped make the financial crisis worse than it might otherwise have been, effectively multiplying losses by providing more securities to bet against. Some $8 billion in these securities remain on the books at American International Group, the giant insurer rescued by the government in September 2008.

From 2005 through 2007, at least $108 billion in these securities was issued, according to Dealogic, a financial data firm. And the actual volume was much higher because synthetic C.D.O.'s and other customized trades are unregulated and often not reported to any financial exchange or market.

GOLDMAN SAW IT COMING

Before the financial crisis, many investors—large American and European banks, pension funds, insurance companies and even some hedge funds—failed to recognize that overextended borrowers would default on their mortgages, and they kept increasing their investments in mortgage-related securities. As the mortgage market collapsed, they suffered steep losses.

A handful of investors and Wall Street traders, however, anticipated the crisis. In 2006, Wall Street had introduced a new index, called the ABX, that became a way to invest in the direction of mortgage securities. The index allowed traders to bet on or against pools of mortgages with different risk characteristics, just as stock indexes enable traders to bet on whether the overall stock market, or technology stocks or bank stocks, will go up or down.

Goldman, among others on Wall Street, has said since the collapse that it made big money by using the ABX to bet against the housing market. Worried about a housing bubble, top Goldman executives decided in December 2006 to change the firm's overall stance on the mortgage market, from positive to negative, though it did not disclose that publicly.

Even before then, however, pockets of the investment bank had also started using C.D.O.'s to place bets against mortgage securities, in some cases to hedge the firm's mortgage investments, as protection against a fall in housing prices and an increase in defaults.

Mr. Egol was a prime mover behind these securities. Beginning in 2004, with housing prices soaring and the mortgage mania in full swing, Mr. Egol began creating the deals known as Abacus. From 2004 to 2008, Goldman issued 25 Abacus deals, according to Bloomberg, with a total value of $10.9 billion.

Abacus allowed investors to bet for or against the mortgage securities that were linked to the deal. The C.D.O.'s didn't contain actual mortgages. Instead, they consisted of credit-default swaps, a type of insurance that pays out when a borrower defaults. These swaps made it much easier to place large bets on mortgage failures.

Rather than persuading his customers to make negative bets on Abacus, Mr. Egol kept most of these wagers for his firm, said five former Goldman employees who spoke on the condition of anonymity. On occasion, he allowed some hedge funds to take some of the short trades.

Mr. Egol and Fabrice Tourre, a French trader at Goldman, were aggressive from the start in trying to make the assets in Abacus deals look better than they were, according to notes taken by a Wall Street investor during a phone call with Mr. Tourre and another Goldman employee in May 2005.

On the call, the two traders noted that they were trying to persuade analysts at Moody's Investors Service, a credit rating agency, to assign a higher rating to one part of an Abacus C.D.O. but were having trouble, according to the investor's notes, which were provided by a colleague who asked for anonymity because he was not authorized to release them. Goldman declined to discuss the selection of the assets in the C.D.O.'s, but a spokesman said investors could have rejected the C.D.O. if they did not like the assets.

Goldman's bets against the performances of the Abacus C.D.O.'s were not worth much in 2005 and 2006, but they soared in value in 2007 and 2008 when the mortgage market collapsed. The trades gave Mr. Egol a higher profile at the bank, and he was among a group promoted to managing director on Oct. 24, 2007.

"Egol and Fabrice were way ahead of their time," said one of the former Goldman workers. "They saw the writing on the wall in this market as early as 2005." By creating the Abacus C.D.O.'s, they helped protect Goldman against losses that others would suffer.

As early as the summer of 2006, Goldman's sales desk began marketing short bets using the ABX index to hedge funds like Paulson & Company, Magnetar and Soros Fund Management, which invests for the billionaire George Soros. John Paulson, the founder of Paulson & Company, also would later take some of the shorts from the Abacus deals, helping him profit when mortgage bonds collapsed. He declined to comment.

A DEAL GONE BAD, FOR SOME

The woeful performance of some C.D.O.'s issued by Goldman made them ideal for betting against. As of September 2007, for example, just five months after Goldman had sold a new Abacus C.D.O., the ratings on 84 percent of the mortgages underlying it had been downgraded, indicating growing concerns about borrowers' ability to repay the loans, according to research from UBS, the big Swiss bank. Of more than 500 C.D.O.'s analyzed by UBS, only two were worse than the Abacus deal.

Goldman created other mortgage-linked C.D.O.'s that performed poorly, too. One, in October 2006, was a $800 million C.D.O. known as Hudson Mezzanine. It included credit insurance on mortgage and subprime mortgage bonds that were in the ABX index; Hudson buyers would make money if the housing market stayed healthy—but lose money if it collapsed. Goldman kept a significant amount of the financial bets against securities in Hudson, so it would profit if they failed, according to three of the former Goldman employees.

A Goldman salesman involved in Hudson said the deal was one of the earliest in which outside investors raised questions about Goldman's incentives. "Here we are selling this, but we think the market is going the other way," he said.

A hedge fund investor in Hudson, who spoke on the condition of anonymity, said that because Goldman was betting against the deal, he wondered whether the bank built Hudson with "bonds they really think are going to get into trouble."

Indeed, Hudson investors suffered large losses. In March 2008, just 18 months after Goldman created that C.D.O., so many borrowers had defaulted that holders of the security paid out about $310 million to Goldman and others who had bet against it, according to correspondence sent to Hudson investors.

The Goldman salesman said that C.D.O. buyers were not misled because they were advised that Goldman was placing large bets against the securities. "We were very open with all the risks that we thought we sold. When you're facing a tidal wave of people who want to invest, it's hard to stop them," he said. The salesman added that investors could have placed bets against Abacus and similar C.D.O.'s if they had wanted to.

A Goldman spokesman said the firm's negative bets didn't keep it from suffering losses on its mortgage assets, taking $1.7 billion in write-downs on them in 2008; but he would not say how much the bank had since earned on its short positions, which former Goldman workers say will be far more lucrative over time. For instance, Goldman profited to the tune of $1.5 billion from one series of mortgage-related trades by Mr. Egol with Wall Street rival Morgan Stanley, which had to book a steep loss, according to people at both firms.

Tetsuya Ishikawa, a salesman on several Abacus and Hudson deals, left Goldman and later published a novel, "How I Caused the Credit Crunch." In it, he wrote that bankers deserted their clients who had bought mortgage bonds when that market collapsed: "We had moved on to hurting others in our quest for self-preservation." Mr. Ishikawa, who now works for another financial firm in London, declined to comment on his work at Goldman.

PROFITS FROM A COLLAPSE

Just as synthetic C.D.O.'s began growing rapidly, some Wall Street banks pushed for technical modifications governing how they worked in ways that made it possible for C.D.O.'s to expand even faster, and also tilted the playing field in favor of banks and hedge funds that bet against C.D.O.'s, according to investors.

In early 2005, a group of prominent traders met at Deutsche Bank's office in New York and drew up a new system, called Pay as You Go. This meant the insurance for those betting against mortgages would pay out more quickly. The traders then went to the International Swaps and Derivatives Association, the group that governs trading in derivatives like C.D.O.'s. The new system was presented as a fait accompli, and adopted.

Other changes also increased the likelihood that investors would suffer losses if the mortgage market tanked. Previously, investors took losses only in certain dire "credit events," as when the mortgages associated with the C.D.O. defaulted or their issuers went bankrupt.

But the new rules meant that C.D.O. holders would have to make payments to short sellers under less onerous outcomes, or "triggers," like a ratings downgrade on a bond. This meant that anyone who bet against a C.D.O. could collect on the bet more easily.

"In the early deals you see none of these triggers," said one investor who asked for anonymity to preserve relationships. "These things were built in to provide the dealers with a big payoff when something bad happened."

Banks also set up ever more complex deals that favored those betting against C.D.O.'s. Morgan Stanley established a series of C.D.O.'s named after United States presidents (Buchanan and Jackson) with an unusual feature: short-sellers could lock in very cheap bets against mortgages, even beyond the life of the mortgage bonds. It was akin to allowing someone paying a low insurance premium for coverage on one automobile to pay the same on another one even if premiums over all had increased because of high accident rates.

At Goldman, Mr. Egol structured some Abacus deals in a way that enabled those betting on a mortgage-market collapse to multiply the value of their bets, to as much as six or seven times the face value of those C.D.O.'s. When the mortgage market tumbled, this meant bigger profits for Goldman and other short sellers—and bigger losses for other investors.

SELLING BAD DEBT

Other Wall Street firms also created risky mortgage-related securities that they bet against.

At Deutsche Bank, the point man on betting against the mortgage market was Greg Lippmann, a trader. Mr. Lippmann made his pitch to select hedge fund clients, arguing they should short the mortgage market. He sometimes distributed a T-shirt that read "I'm Short Your House!!!" in black and red letters.

Deutsche, which declined to comment, at the same time was selling synthetic C.D.O.'s to its clients, and those deals created more short-selling opportunities for traders like Mr. Lippmann.

Among the most aggressive C.D.O. creators was Tricadia, a management company that was a unit of Mariner Investment Group. Until he became a senior adviser to the Treasury secretary early this year, Lewis Sachs was Mariner's vice chairman. Mr. Sachs oversaw about 20 portfolios there, including Tricadia, and its documents also show that Mr. Sachs sat atop the firm's C.D.O. management committee.

From 2003 to 2007, Tricadia issued 14 mortgage-linked C.D.O.'s, which it called TABS. Even when the market was starting to implode, Tricadia continued to create TABS deals in early 2007 to sell to investors. The deal documents referring to conflicts of interest stated that affiliates and clients of Tricadia might place bets against the types of securities in the TABS deal.

Even so, the sales material also boasted that the mortgages linked to C.D.O.'s had historically low default rates, citing a "recently completed" study by Standard & Poor's ratings agency—though fine print indicated that the date of the study was September 2002, almost five years earlier.

At a financial symposium in New York in September 2006, Michael Barnes, the co-head of Tricadia, described how a hedge fund could put on a negative mortgage bet by shorting assets to C.D.O. investors, according to his presentation, which was reviewed by The New York Times.

Mr. Barnes declined to comment. James E. McKee, general counsel at Tricadia, said, "Tricadia has never shorted assets into the TABS deals, and Tricadia has always acted in the best interests of its clients and investors."

Mr. Sachs, through a spokesman at the Treasury Department, declined to comment.

Like investors in some of Goldman's Abacus deals, buyers of some TABS experienced heavy losses. By the end of 2007, UBS research showed that two TABS deals were the eighth- and ninth-worst performing C.D.O.'s. Both had been downgraded on at least 75 percent of their associated assets within a year of being issued.

Tricadia's hedge fund did far better, earning roughly a 50 percent return in 2007 and similar profits in 2008, in part from the short bets.

[June 17, 2010]

The Giant Revolving Door of Regulatory Hostage-Taking

By Ilan Moscovitz and Morgan Housel

The late economist George Stigler wouldn't be surprised at today's world.

Stigler, you see, won a Nobel Prize for the concept of "regulator capture," or the idea that "regulation may be actively sought * * * by the industry and is designed and operated primarily for its benefit."

Sound familiar? If you've noticed a pattern of government favoring Wall Street, you've cracked an important code. One of the great confusions of the past two years is how the financial industry managed to fully wreck shop while remaining mostly untouched from the hands of regulators. After 9/11, airline security was immediately revamped from head to toe. Three years after the financial collapse began, here we are; almost nothing has changed.

FRIENDS DON'T LET FRIENDS TURN DOWN PLUTOCRACY

If you're trying to make sense of this, look no further than what's often called Wall Street's revolving door to Washington. In short, those whose duty it is to regulate Wall Street have a curious tendency to be elite members of * * * Wall Street.

We've compiled a brief list of examples:

Person	Was (or still is)	Then became (or now serves as)
Donald Regan	CEO, Merrill Lynch	Treasury Secretary (under Reagan)
Nicholas Brady	Chairman, Dillon Read	Treasury Secretary (Reagan)
Robert Rubin	Co-Chairman, Goldman Sachs (NYSE: GS)	Treasury Secretary (Clinton)
Roger Altman	Partner, Lehman Brothers	Deputy Secretary of Treasury (Clinton)
Frank Newman	Chief Financial Officer, Bank of America (NYSE: BAC)	Undersecretary of Domestic Finance (Clinton)
Robert Steel	Vice Chairman, Goldman Sachs	Undersecretary of Domestic Finance (G.W. Bush)
Hank Paulson	CEO, Goldman Sachs	Treasury Secretary (G.W. Bush)
Josh Bolten	Executive Director, Goldman Sachs	White House Chief of Staff (G.W. Bush)
Neel Kashkari	Vice President, Goldman Sachs	U.S. Treasury, Head of TARP (G.W. Bush)

Person	Was (or still is)	Then became (or now serves as)
Bill Donaldson	Chairman, Donaldson Lufkin Jenrette	Chairman, SEC (G.W. Bush)
Edward Forst	Every imaginable senior position, Goldman Sachs	TARP Advisor (G.W. Bush)
John Snow	Chairman, Business Roundtable	Treasury Secretary (G.W. Bush)
Kendrick Wilson III	Managing Director, Goldman Sachs	Advisor, Department of Treasury (G.W. Bush)
Barbara Shycoff	Vice President, American Express (NYSE: AXP)	Managing Director, Office of Thrift Supervision (G.W. Bush)
John Dugan	Banking industry lobbyist	Comptroller of the Currency (G.W. Bush)
Michael Froman	Managing Director, Citigroup (NYSE: C)	White House Liaison to G7, G8, G20 (Obama)
Herb Allison	Chief Operating Officer, Merrill Lynch	Assistant Secretary for Financial Stability, Department of Treasury (Obama)
Lewis Sachs	Director, Bear Stearns	Treasury top aide (Obama)
Richard Fisher	Investment banker, Brown Brothers Harriman	President, Federal Reserve Bank of Dallas
Dennis Lockhart	Senior Corporate Officer, Citigroup	CEO, Federal Reserve Bank of Atlanta
William Dudley	Managing director, Goldman Sachs	President, Federal Reserve Bank of New York
Jon Corzine	Senior partner, Goldman Sachs	Governor, New Jersey
Stephen Friedman	Chief Operating Officer, Chairman of Goldman Sachs	Chairman, New York Fed
Edward Murphy	Chief Financial Officer, JPMorgan Chase	Executive Vice President, New York Fed
Peter Peterson	Co-Founder, Blackstone	Board of Directors, New York Fed
Walter Shipley	Chairman, Chase Manhattan	Board of Directors, New York Fed
Sanford Weill	Chairman, Citigroup	Board of Directors, New York Fed
Richard Fuld	Chairman, CEO, Lehman Brothers	Board of Directors, New York Fed
Jeffrey Immelt	Chairman, CEO, General Electric (NYSE: GE)	Board of Directors, New York Fed
Jamie Dimon	Chairman, CEO, JPMorgan	Board of Directors, New York Fed
Kevin Warsh	Executive Director, Morgan Stanley	Governor, Federal Reserve Board
Elizabeth Duke	Chairman, American Bankers Association	Governor, Federal Reserve Board
Robert Kimmitt	Managing Director, Lehman Brothers	Deputy Secretary of Treasury (G.W. Bush)
Gary Gensler	Partner, Goldman Sachs	Undersecretary of Treasury (Clinton), Head of Commodity Futures Trading Commission (Obama)

We found hundreds of examples, but we'll stop there. You get the point.

FIRST-CLASS FINANCIAL INCEST

Now, just because someone has worked in the financial industry doesn't necessarily mean they can't take on Wall Street when it's their job to do so. In spite of his former career as an investment banker, Dallas Fed president Richard Fisher argued earlier this month that "banks that are 'too big to fail' are simply 'too big.'

We must cap their size or break them up." He's an independent voice who doesn't robotically hew to the interests of the financial lobby.

But he's also a rare gem. Consider John Dugan, a former bank lobbyist who now serves as comptroller of the currency. His office (the OCC) regulates and supervises the big national banks.

You probably know where this is going. Instead of policing banks, Dugan's OCC has played the role of mama bear protector.

- The New York Times reports that of the hundreds of thousands of consumer complaints fielded over the past decade, fewer than 200 enforcement orders were issued.
- When West Virginia tried to sue Capital One (NYSE: COF) for credit card abuses, the company applied for a charter under the OCC, ostensibly seeking its infamously gentle embrace. Now a national bank under Dugan's sole purview, Capital One escaped West Virginia's jurisdiction, and the state was politely told to pipe down and move along. The head of the Financial Crisis Inquiry Commission told Dugan, "You tied the hands of the states and then sat on your hands." And it worked magnificently.
- Under the OCC's light watch, commercial banks took on insane derivatives exposure. Untold commercial banks were backstopped by taxpayers when things turned explosive. Dugan seems content with this result: "In the end, the fact that they got the [bailout] money but took steps to fix themselves * * * to pay the government back quickly, will be viewed as a successful way to deal with a very difficult situation." Forget moral hazard. His friends lived.

THE CUSTOMER IS ALWAYS RIGHT (AHEM)

This kind of behavior isn't restricted to Wall Street. After the BP (NYSE: BP) oil spill, the world has * * * been appalled after learning how the Minerals Management Service (MMS) was literally in bed and snuggling with the oil companies it oversaw.

Appalling, yes. But MMS' relationship with Big Oil was juvenile compared with banks and their regulators.

OCC derives its operating budget not from Congress, not from states, but from the banks it regulates. Big deal, you say? The problem is that banks can shop around for friendlier regulators if OCC's restrictions rain on their master plan. Banks are literally regulators' paying customers, which must be kept happy for a regulator to justify its existence. Consider this profile of former Countrywide CEO Angelo Mozilo (courtesy of The New Yorker):

Mozilo called some of the regulators' concerns "much ado about nothing." He decided that Countrywide should try to switch regulators, leaving the Fed and the O.C.C. for the weaker Office of Thrift Supervision (O.T.S.) * * * the O.T.S. had lobbied Countrywide to make the switch.

That's impressively stupid.

GET US OUT OF HERE

What's the solution? Consolidating regulators and giving them their own operating budgets so they don't have to compete against one another for business seems like a no-brainer. But we're admittedly stumped on the issue of regulatory capture and won't pretend to have all the answers. When regulators are hiring, they can't just reject every Wall Street veteran. We want regulators who know what they're doing. We just don't want the police to coincidentally be the criminal's frat brother.

That said, here are two things we can do that would help us turn this ship around.

(1) Find ways to have less money in politics.

The financial industry spends more than $1 million a day on lobbying. All too often that means industry sellouts are appointed as regulators.

Fixing this problem is easier said than done. Voting for politicians with backbones is probably a good start, as is demanding some kind of campaign finance reform or improved transparency of who's paying for those annoying ads.

(2)When a simple law will work, don't tinker with regulatory discretion.

Firm laws can be far superior to discretion. We shouldn't always give regulators discretion to exempt and make random subjective calls as they please.

Consider this: Currently, the Federal Reserve subsidizes Dugan's too-big-to-fail banks by allowing them to use our FDIC-insured deposits for gambling with risky derivatives—the same ones that contributed to the 2008 financial meltdown. That's a recipe for disaster. Because there's no good reason for taxpayers to subsidize derivatives casinos, why not just end the practice and be done with it?

This is actually something that's being voted on over the next week.

[Posted Dec. 2, 2010 at 5:57 a.m.]

Evanston's Magnetar Benefited From TALF

By DOW JONES NEWSWIRES-WALL STREET JOURNAL

Hedge funds and investors whose bearish trades on housing helped them profit amid the credit crisis were among those that benefited from a U.S. government emergency rescue program to kick-start lending, according to Federal Reserve data released Wednesday.

That program, known as the Term Asset-Backed Securities Lending Facility, or TALF, and established during the financial crisis, provided low-cost loans from the Federal Reserve to investors buying bonds backed by student, auto and commercial-property loans and other assets. The program, which lasted from March 2009 until June 2010, was aimed at helping banks move loans off their books by repackaging them into bonds and selling them.

Funds managed or backed by Evanston-based Magnetar Capital, Tricadia Capital and FrontPoint Partners, which made large profits betting on a downturn in the U.S. housing market before the crisis, were among those who obtained low-cost loans from the Fed to buy securities, according to the Fed data.

The Fed on Wednesday released the names of 177 borrowers that obtained a total of $71 billion in low-cost loans from the TALF program to buy newly issued asset-backed securities with a market value of about $79 billion. In effect, buyers were able put up a small amount of their own money and borrow about 82 percent to 95 percent of the securities' value.

The program generated big returns for investors—as high as 48 percent in some cases at the height of the crisis, though more commonly in the range of 20 percent to 40 percent, analysts say. Toward the end of the TALF program, as yields on many securities fell, returns for borrowers were closer to 10 percent.

The fact that some investors who profited amid the financial downturn benefited from TALF could elicit questions about why a U.S. bailout using taxpayer money helped finance new investments for them.

A spokesman for the Federal Reserve Bank of New York, which administered the TALF program, said it was meant to increase the flow of credit to consumers and businesses and achieved that purpose. "The program was designed to encourage very broad participation, as long as borrowers met specific eligibility criteria," he added.

TALF borrowers also included New York distressed debt investors such as Angelo, Gordon & Co. and Siguler Guff & Co. Pension funds such as the California Public Employees' Retirement System and the municipal pension plan of Milford, Conn., took part, as did scores of large mutual funds and little-known funds set up specifically to invest in securities using money from TALF.

John Paulson, whose hedge fund Paulson & Co. made large profits betting against subprime mortgages, also was an indirect beneficiary of the government's rescue progra OneWest Bank, a Pasadena, Calif., bank previously known as IndyMac, which now counts Paulson and his fund among its private-equity backers, borrowed $34.4 million from TALF in July 2009 to buy securities backed by mortgage-servicing advances, the Fed data show. It repaid the money a few months later.

Representatives for the hedge funds and other borrowers either declined to comment or weren't available for comment.

When TALF was set up, funds hoping to establish new investment vehicles had to move quickly before prices on asset-backed securities rebounded from super-distressed levels, said Sreeniwas Prabhu, managing partner of Atlanta money manager Angel Oak Capital Advisors LLC, which invests in mortgage securities but didn't participate in TALF.

"A lot of the guys in our business had already figured out that the valuations had gotten way out of whack," Prabhu said.

Ernie Patrikis, a partner at New York law firm White & Case who previously served as general counsel for the Federal Reserve Bank of New York, said the Fed likely will learn lessons about who benefited from the rescue progra But Patrikis said that the investor money in the TALF program did help stabilize markets.

"They got that money, and what did they do with it?" Patrikis said. "They recycled it, presumably, and that's a good thing."

Like other Fed lending programs, the TALF program wasn't designed to exclude any particular firms; as long as they met the program's eligibility criteria, they could obtain loans to buy securities. The program did impose restrictions on borrowers' ability to hedge or make bearish bets on the securities they purchased using Fed money.

Most of the Fed loans carried interest rates of between 1 percent and 2 percent and were used to purchase securities with higher yields. The borrowed money juiced some of those returns to double-digit levels at relatively little risk to the buyers

[WALL STREET JOURNAL article, page A13]
By KENNETH E. SCOTT and JOHN B. TAYLOR

Despite trillions of dollars of new government programs, one of the original causes of the financial crisis—the toxic assets on bank balance sheets—still persists and remains a serious impediment to economic recovery. Why are these toxic assets so difficult to deal with? We believe their sheer complexity is the core problem and that only increased transparency will unleash the market mechanisms needed to clean them up.

The bulk of toxic assets are based on residential mortgage-backed securities (RMBS), in which thousands of mortgages were gathered into mortgage pools. The returns on these pools were then sliced into a hierarchy of "tranches" that were sold to investors as separate classes of securities. The most senior tranches, rated AAA, received the lowest returns, and then they went down the line to lower ratings and finally to the unrated "equity" tranches at the bottom.

But the process didn't stop there. Some of the tranches from one mortgage pool were combined with tranches from other mortgage pools, resulting in Collateralized Mortgage Obligations (CMO). Other tranches were combined with tranches from completely different types of pools, based on commercial mortgages, auto loans, student loans, credit card receivables, small business loans, and even corporate loans that had been combined into Collateralized Loan Obligations (CLO). The result was a highly heterogeneous mixture of debt securities called Collateralized Debt Obligations (CDO). The tranches of the CDOs could then be combined with other CDOs, resulting in CDO2.

Each time these tranches were mixed together with other tranches in a new pool, the securities became more complex. Assume a hypothetical CDO2 held 100 CLOs, each holding 250 corporate loans—then we would need information on 25,000 underlying loans to determine the value of the security. But assume the CDO2 held 100 CDOs each holding 100 RMBS comprising a mere 2,000 mortgages—the number now rises to 20 million!

Complexity is not the only problem. Many of the underlying mortgages were highly risky, involving little or no down payments and initial rates so low they could never amortize the loan. About 80% of the $2.5 trillion subprime mortgages made since 2000 went into securitization pools. When the housing bubble burst and house prices started declining, borrowers began to default, the lower tranches were hit with losses, and higher tranches became more risky and declined in value.

To better understand the magnitude of the problem and to find solutions, we examined the details of several CDOs using data obtained from SecondMarket, a firm specializing in illiquid assets. One example is a $1 billion CDO2 created by a large bank in 2005. It had 173 investments in tranches issued by other pools: 130 CDOs, and also 43 CLOs each composed of hundreds of corporate loans. It issued $975 million of four AAA tranches, and three subordinate tranches of $55 million. The AAA tranches were bought by banks and the subordinate tranches mostly by hedge funds.

Two of the 173 investments held by this CDO2 were in tranches from another billion-dollar CDO—created by another bank earlier in 2005—which was composed mainly of 155 MBS tranches and 40 CDOs. Two of these 155 MBS tranches were from a $1 billion RMBS pool created in 2004 by a large investment bank, composed of almost 7,000 mortgage loans (90% subprime). That RMBS issued $865 million of AAA notes, about half of which were purchased by Fannie Mae and Freddie Mac and the rest by a variety of banks, insurance companies, pension funds and money managers. About 1,800 of the 7,000 mortgages still remain in the pool, with a current delinquency rate of about 20%.

With so much complexity, and uncertainty about future performance, it is not surprising that the securities are difficult to price and that trading dried up. Without market prices, valuation on the books of banks is suspect and counterparties are reluctant to deal with each other.

The policy response to this problem has been circuitous. The Federal Reserve originally saw the problem as a lack of liquidity in the banking system, and beginning in late 2007 flooded the market with liquidity through new lending facilities. It had very limited success, as banks were still disinclined to buy or trade such securities or take them as collateral. Credit spreads remained higher than normal. In September 2008 credit spreads skyrocketed and credit markets froze. By then it was clear that the problem was not liquidity, but rather the insolvency risks of counterparties with large holdings of toxic assets on their books.

The Federal Government then decided to buy the toxic assets. The Troubled Asset Relief Program (TARP) was enacted in October 2008 with $700 billion in funding. But that was not how the TARP funds were used. The Treasury concluded that the valuation problem seemed insurmountable, so it attacked the risk issue by bolstering bank capital, buying preferred stock.

But those toxic assets are still there. The latest disposal scheme is the Public-Private Investment Program (PPIP). The concept is that private asset managers would create investment funds of half private and half Treasury (TARP) capital, which would bid on packages of toxic assets that banks offered for sale. The responsibility for valuation is thus shifted to the private sector. But the pricing difficulty remains and this program too may amount to little.

The fundamental problem has remained untouched: insufficient information to permit estimated prices that both buyers and sellers find credible. Why is the information so hard to obtain? While the original MBS pools were often Securities and Exchange Commission (SEC) registered public offerings with considerable detail, CDOs were sold in private placements with confidentiality agreements. Moreover, the nature of the securitization process has made it extremely difficult to determine and follow losses and increasing risk from one tranche and pool to another, and to reach the information about the original borrowers that is needed to estimate future cash flows and price.

This account makes it clear why transparency is so important. To deal with the problem, issuers of asset-backed securities should provide extensive detail in a uniform format about the composition of the original pools and their subsequent structure and performance, whether they were sold as SEC-registered offerings or private placements. By creating a centralized database with this information, the pricing process for the toxic assets becomes possible. Making such a database a reality will restart private securitization markets and will do more for the recovery of the economy than yet another redesign of administrative agency structures. If issuers are not forthcoming, then they should be required to file the information publicly with the SEC.

Mr. Scott is a professor of securities and corporate law at Stanford University and a research fellow at the Hoover Institution. Mr. Taylor, an economics professor at Stanford and senior fellow at the Hoover Institution, is the author of "Getting Off Track: How Government Actions and Interventions Caused, Prolonged and Worsened the Financial Crisis" (Hoover Press, 2009).

[New York Times, October 16, 2009]

Bill Shields Most Banks From Review

By STEPHEN LABATON

WASHINGTON—Bowing to political pressure from community bankers, the House Financial Services Committee approved an exemption on Thursday for more than 98 percent of the nation's banks from oversight by a new agency created to protect consumers from abusive or deceptive credit cards, mortgages and other loans.

The carve-out in legislation overhauling the regulatory system would prevent the new consumer financial protection agency from conducting annual examinations of the lending practices at more than 8,000 of the nation's 8,200 banks, leaving only the largest banks and other lenders subject to the agency's examiners.

Earlier in the day, the committee completed its work on a different contentious provision of the legislation when, on a nearly straight party-line vote of 43 to 26, it approved tougher regulations over the derivatives market. That provision, too, contained exemptions for many businesses.

The exemption for the banks was endorsed by the chairman, Representative Barney Frank of Massachusetts, who saw it as necessary to win support for the overall bill from the committee's moderate and conservative Democrats. Their support is particularly important because the Republicans are unified against the legislation.

The committee approved the exemption for all but the largest banks in an amendment offered by two of those Democrats, Representative Brad Miller of North Carolina and Representative Dennis Moore of Kansas.

"Community banks and credit unions were perhaps not without sin in the last couple of years but they were certainly not engaged in the worst abuses," Mr. Miller said. "They make the argument that for bigger banks, examiners are camping out. But for them, examiners come and it is very disruptive and adds compliance costs. The consumer financial protection agency will be able to do the job but it will not create a further burden on small banks and credit unions."

The measure creating the new agency has already been significantly pared back from the Obama administration's proposal. While the exemption approved on Thursday would cover a vast sector of the banking industry, those institutions control only about 20 percent of the roughly $14 trillion in assets held by commercial banks. The 150 largest banks, which would face more regulatory scrutiny, hold the remaining four-fifths of the assets.

Under the Miller-Moore amendment, the new agency would have the authority to write rules for all banks and other lenders, including lenders that have never faced significant regulation. But the banks with assets of less than $10 billion and credit unions smaller than $1.5 billion would not face regular exams by the agency.

Instead, the consumer regulations would continue to be enforced in most cases by the agencies that monitor the financial condition of the banks. Mr. Frank said that under the amendment, the new agency would still have the authority to investigate complaints raised at any bank.

Mr. Frank and senior administration officials have accused the bank agencies of failing to aggressively enforce rules protecting consumers from predatory loans. Mr. Frank said the change would not in any way diminish the oversight of the smaller banks, which would continue to face regular examinations by bank regulators for consumer problems. He also noted that the largest banks, which would face examinations by the new agency, had engaged in the worst abuses.

The amendment was warmly greeted by lobbyists for the smaller banks,

"The Miller-Moore amendment addresses some of our key concerns," said Camden R. Fine, president of the Independent Community Bankers of America, which represents about 5,000 financial institutions.

But the American Bankers Association said it was not enough.

"We continue to have our fundamental concern that the bill will create a new agency with incredibly broad powers that will be in constant conflict" with other regulators, said Edward L. Yingling, president of the association.

In a briefing by telephone with reporters, the assistant Treasury secretary, Michael S. Barr, deflected questions about whether the administration had a view about the Miller-Moore amendment.

The legislation's chapter on derivatives would impose new regulations and capital requirements on dealers, and would force more trades onto exchanges or electronic platforms. But in a major concession to businesses, many trades intended to hedge risks by companies like airlines, manufacturers and energy interests would be exempt from trading through exchanges or clearinghouses.

While the administration quickly embraced the derivatives legislation, a top regulator appointed by President Obama indicated that compromises made to win the support of moderate Democrats led to problematic loopholes. The regulator, Gary G. Gensler, chairman of the Commodity Futures Trading Commission, vowed to try to strengthen the measure when it is considered by a second House committee next week.

"The committee's bill is a significant step toward lowering risk and promoting transparency," Mr. Gensler said. "Substantive challenges remain." He added that he hoped a final bill "covers the entire marketplace without exception."

Mr. Gensler did not spell out the specific problems with the legislation on Thursday, but last week he listed a host of exemptions and loopholes, a few of which have since been addressed.

The derivatives legislation was criticized by consumer groups as being too weak and by Wall Street interests as being too onerous.

Kenneth E. Bentsen Jr., an executive vice president at the Securities Industry and Financial Markets Association, said provisions requiring some types of now-private transactions to trade through clearinghouses or exchanges "could raise transaction costs while not necessarily reducing risk in a commensurate amount."

Robert G. Pickel, the chief executive of the International Swaps and Derivatives Association, a trade group, said the legislation would "force people to trade a certain way, which ultimately means parties would have less flexibility to effectively manage their risks."

But Ed Mierzwinski, consumer program director at the United States Public Interest Research Group, said the legislation had "broad exceptions that swallow any rule it creates."

[New York Times, April 20, 2009, op-ed columnist]

Erin Go Broke

By Paul Krugman

“What,” asked my interlocutor, “is the worst-case outlook for the world economy?” It wasn’t until the next day that I came up with the right answer: America could turn Irish.

What’s so bad about that? Well, the Irish government now predicts that this year G.D.P. will fall more than 10 percent from its peak, crossing the line that is sometimes used to distinguish between a recession and a depression.

But there’s more to it than that: to satisfy nervous lenders, Ireland is being forced to raise taxes and slash government spending in the face of an economic slump—policies that will further deepen the slump.

And it’s that closing off of policy options that I’m afraid might happen to the rest of us. The slogan “Erin go bragh,” usually translated as “Ireland forever,” is traditionally used as a declaration of Irish identity. But it could also, I fear, be read as a prediction for the world economy.

How did Ireland get into its current bind? By being just like us, only more so. Like its near-namesake Iceland, Ireland jumped with both feet into the brave new world of unsupervised global markets. Last year the Heritage Foundation declared Ireland the third freest economy in the world, behind only Hong Kong and Singapore.

One part of the Irish economy that became especially free was the banking sector, which used its freedom to finance a monstrous housing bubble. Ireland became in effect a cool, snake-free version of coastal Florida.

Then the bubble burst. The collapse of construction sent the economy into a tailspin, while plunging home prices left many people owing more than their houses were worth. The result, as in the United States, has been a rising tide of defaults and heavy losses for the banks.

And the troubles of the banks are largely responsible for putting the Irish government in a policy straitjacket.

On the eve of the crisis Ireland seemed to be in good shape, fiscally speaking, with a balanced budget and a low level of public debt. But the government’s revenue—which had become strongly dependent on the housing boom—collapsed along with the bubble.

Even more important, the Irish government found itself having to take responsibility for the mistakes of private bankers. Last September Ireland moved to shore up confidence in its banks by offering a government guarantee on their liabilities—thereby putting taxpayers on the hook for potential losses of more than twice the country’s G.D.P., equivalent to $30 trillion for the United States.

The combination of deficits and exposure to bank losses raised doubts about Ireland’s long-run solvency, reflected in a rising risk premium on Irish debt and warnings about possible downgrades from ratings agencies.

Hence the harsh new policies. Earlier this month the Irish government simultaneously announced a plan to purchase many of the banks’ bad assets—putting taxpayers even further on the hook—while raising taxes and cutting spending, to reassure lenders.Is Ireland’s government doing the right thing? As I read the debate among Irish experts, there’s widespread criticism of the bank plan, with many of the country’s leading economists calling for temporary nationalization instead. (Ireland has already nationalized one major bank.) The arguments of these Irish economists are very similar to those of a number of American economists, myself included, about how to deal with our own banking mess.

But there isn’t much disagreement about the need for fiscal austerity. As far as responding to the recession goes, Ireland appears to be really, truly without options, other than to hope for an export-led recovery if and when the rest of the world bounces back.

So what does all this say about those of us who aren’t Irish?

For now, the United States isn’t confined by an Irish-type fiscal straitjacket: the financial markets still consider U.S. government debt safer than anything else. But we can’t assume that this will always be true. Unfortunately, we didn’t save for a rainy day: thanks to tax cuts and the war in Iraq, America came out of the “Bush boom” with a higher ratio of government debt to G.D.P. than it had going in. And if we push that ratio another 30 or 40 points higher—not out of the question if economic policy is mishandled over the next few years—we might start facing our own problems with the bond market.

Not to put too fine a point on it, that’s one reason I’m so concerned about the Obama administration’s bank plan. If, as some of us fear, taxpayer funds end up providing windfalls to financial operators instead of fixing what needs to be fixed, we might not have the money to go back and do it right.

And the lesson of Ireland is that you really, really don't want to put yourself in a position where you have to punish your economy in order to save your banks.

[The report, "Report on Foreign Portfolio Holdings of U.S. Securities as of June 30, 2008," may be accessed at the following Internet address:]

www.treasury.gov/resource-center/data-chart-center/tic/Documents/shla2008r.pdf

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[Saturday, October 27, 2007]

Fannie, Freddie Portfolios Shrink

Firms Have Argued for Higher Investment Caps

By DAVID S. HILZENRATH, Washington Post Staff Writer

Though Fannie Mae and Freddie Mac have been arguing that they should be granted authority to buy more mortgages to help ease a credit crunch, data released by the companies this week show that they haven't been using the authority they already possess.

Both companies reduced their mortgage-related investments in September, widening the gap between their holdings and the limits on those holdings.

Freddie Mac sold more mortgage-related assets last month than during any other month in the almost four years for which it has posted data on the Web.

In addition, Freddie Mac reduced its commitments for future purchases, indicating that it was slackening activities that might give the mortgage markets a lift.

The federally chartered companies buy mortgages from lenders and package them into securities for sale to investors, making money available for banks and other lenders to issue new loans.

In response to accounting scandals at the two companies, the government capped the amount of mortgages and mortgage-backed securities they can hold in their portfolios.

The companies and their allies in Congress have argued that they could provide relief to borrowers facing foreclosure if their regulator, the Office of Federal Housing Enterprise Oversight, loosens their shackles.

Historically, the investment portfolios have been major profit centers for the two companies. Limiting the growth of the portfolios has the potential to constrain the companies' future profits, but OFHEO has argued that the caps are necessary to prevent the companies from putting themselves and the financial system at risk.

Fannie Mae, of the District, said its portfolio of mortgage-related investments shrank by $5.1 billion last month. The company declined yesterday to explain.

Freddie Mac, of McLean, whose portfolio shrank by $19.1 billion, said the reduction in its holdings was partly an effort to ensure that it has the required capital to absorb potential losses.

"A lot of it is reflective of the value of the assets in the portfolio," said Michael Cosgrove, a Freddie Mac spokesman.

Noting that other investment firms have been reporting big losses on mortgage-backed securities, Karen Shaw Petrou, an analyst with Federal Financial Analytics, said it appeared that Freddie Mac was selling assets to prepare for write-downs in the value of mortgage investments.

Petrou, whose clients include adversaries of Fannie Mae and Freddie Mac, said Freddie Mac was more vulnerable to problems with subprime loans than Fannie Mae.

In addition to imposing caps on the companies' portfolios, OFHEO increased the level of capital the companies must maintain as a cushion against losses. Freddie's disclosure this week was a reminder that if the portfolio caps are loosened, the capital requirement could remain a constraint on the companies.

For the quarter ended Sept. 30, Fannie Mae and Freddie Mac were each allowed to hold $735 billion of mortgages and securities backed by mortgages. As of that date, Fannie Mae's holdings totaled $723.8 billion and Freddie Mac's totaled $713.2 billion.

Freddie Mac's commitments for future purchases declined to $11.5 billion in September from $20.4 billion in August. Fannie Mae's net commitments rose $13.6 billion in September over August.

The monthly snapshot does not reflect actions the companies might have taken since OFHEO adjusted the caps on Sept. 19, allowing the companies to expand their portfolios slightly.

[From *MarketWatch,* Sept. 12, 2006, 4:28 p.m. EDT]

Freddie Mac Says U.S. Investigation Dropped

By ROBERT SCHROEDER, MarketWatch

WASHINGTON (MarketWatch)—A U.S. criminal probe into accounting missteps at Freddie Mac appears to be over, the mortgage finance company said Tuesday.

"The U.S. Attorney's office has not initiated contact with us in well over two years and it is our understanding that the matter is inactive," said Doug Duvall, Freddie's senior director of public relations.

"We expect no further action in this matter," Duvall said.

Duvall added Freddie understands the U.S. Attorney's office for the Eastern District of Virginia doesn't issue notices about concluding investigations.

A spokesman for the U.S. Attorney's office said he couldn't comment on the matter.

Freddie Mac has been under scrutiny since admitting in 2003 that it understated earnings for 2000, 2001 and 2002 by $5 billion. The scandal led to the ouster of former CEO Leland Brendsel, former company president David Glenn and chief financial officer Vaughn Clarke. The company has paid fines including a $125 million penalty to federal regulators to settle the accounting matter.

The apparent discontinuation of the case follows similar action by the Justice Department in its case against Fannie Mae , another government-sponsored housing enterprise. See full story.

Congress has been attempting to create a new, more powerful regulator to oversee both housing finance companies, which were created by lawmakers but whose stock and debt are publicly traded. However, with elections looming and few legislative days left on the calendar, analysts are skeptical Congress will be able to fashion new rules for the companies soon.

Freddie is still trying to get back to regular financial reporting. Last Friday, CEO Richard Syron said the company is aiming to get its books current by 2007, after it announces its full-year 2006 results. See full story.

Shares of the McLean, Va.-based company gained 38 cents to finish trading at $63.90 on Tuesday.

[From the *New York Times,* April 27, 2009]

Geithner, Member and Overseer of Finance Club

By JO BECKER and GRETCHEN MORGENSON

Last June, with a financial hurricane gathering force, Treasury Secretary Henry M. Paulson Jr. convened the nation's economic stewards for a brainstorming session. What emergency powers might the government want at its disposal to confront the crisis? he asked.

Timothy F. Geithner, who as president of the New York Federal Reserve Bank oversaw many of the nation's most powerful financial institutions, stunned the group with the audacity of his answer. He proposed asking Congress to give the president broad power to guarantee all the debt in the banking system, according to two participants, including Michele Davis, then an assistant Treasury secretary.

The proposal quickly died amid protests that it was politically untenable because it could put taxpayers on the hook for trillions of dollars.

"People thought, 'Wow, that's kind of out there,'" said John C. Dugan, the comptroller of the currency, who heard about the idea afterward. Mr. Geithner says, "I don't remember a serious discussion on that proposal then."

But in the 10 months since then, the government has in many ways embraced his blue-sky prescription. Step by step, through an array of new programs, the Federal Reserve and Treasury have assumed an unprecedented role in the banking system, using unprecedented amounts of taxpayer money, to try to save the nation's financiers from their own mistakes.

And more often than not, Mr. Geithner has been a leading architect of those bailouts, the activist at the head of the pack. He was the federal regulator most willing to "push the envelope," said H. Rodgin Cohen, a prominent Wall Street lawyer who spoke frequently with Mr. Geithner.

Today, Mr. Geithner is Treasury secretary, and as he seeks to rebuild the nation's fractured financial system with more taxpayer assistance and a regulatory overhaul, he finds himself a locus of discontent.

Even as banks complain that the government has attached too many intrusive strings to its financial assistance, a range of critics—lawmakers, economists and even former Federal Reserve colleagues—say that the bailout Mr. Geithner has played such a central role in fashioning is overly generous to the financial industry at taxpayer expense.

An examination of Mr. Geithner's five years as president of the New York Fed, an era of unbridled and ultimately disastrous risk-taking by the financial industry, shows that he forged unusually close relationships with executives of Wall Street's giant financial institutions.

His actions, as a regulator and later a bailout king, often aligned with the industry's interests and desires, according to interviews with financiers, regulators and analysts and a review of Federal Reserve records.

In a pair of recent interviews and an exchange of e-mail messages, Mr. Geithner defended his record, saying that from very early on, he was "a consistently dark voice about the potential risks ahead, and a principal source of initiatives designed to make the system stronger" before the markets started to collapse.

Mr. Geithner said his actions in the bailout were motivated solely by a desire to help businesses and consumers. But in a financial crisis, he added, "the government has to take risk, and we are going to be doing things which ultimately—in order to get the credit flowing again—are going to benefit the institutions that are at the core of the problem."

The New York Fed is, by custom and design, clubby and opaque. It is charged with curbing banks' risky impulses, yet its president is selected by and reports to a board dominated by the chief executives of some of those same banks. Traditionally, the New York Fed president's intelligence-gathering role has involved routine consultation with financiers, though Mr. Geithner's recent predecessors generally did not meet with them unless senior aides were also present, according to the bank's former general counsel.

By those standards, Mr. Geithner's reliance on bankers, hedge fund managers and others to assess the market's health—and provide guidance once it faltered—stood out.

His calendars from 2007 and 2008 show that those interactions were a mix of the professional and the private.

He ate lunch with senior executives from Citigroup, Goldman Sachs and Morgan Stanley at the Four Seasons restaurant or in their corporate dining rooms. He attended casual dinners at the homes of executives like Jamie Dimon, a member of the New York Fed board and the chief of JPMorgan Chase.

Mr. Geithner was particularly close to executives of Citigroup, the largest bank under his supervision. Robert E. Rubin, a senior Citi executive and a former Treasury secretary, was Mr. Geithner's mentor from his years in the Clinton administration, and the two kept in close touch in New York.

Mr. Geithner met frequently with Sanford I. Weill, one of Citi's largest individual shareholders and its former chairman, serving on the board of a charity Mr. Weill led. As the bank was entering a financial tailspin, Mr. Weill approached Mr. Geithner about taking over as Citi's chief executive.

But for all his ties to Citi, Mr. Geithner repeatedly missed or overlooked signs that the bank—along with the rest of the financial system—was falling apart. When he did spot trouble, analysts say, his responses were too measured, or too late.

In 2005, for instance, Mr. Geithner raised questions about how well Wall Street was tracking its trading of complex financial products known as derivatives, yet he pressed reforms only at the margins. Problems with the risky and opaque derivatives market later amplified the economic crisis.

As late as 2007, Mr. Geithner advocated measures that government studies said would have allowed banks to lower their reserves. When the crisis hit, banks were vulnerable because their financial cushion was too thin to protect against large losses.

In fashioning the bailout, his drive to use taxpayer money to backstop faltering firms overrode concerns that such a strategy would encourage more risk-taking in the future. In one bailout instance, Mr. Geithner fought a proposal to levy fees on banks that would help protect taxpayers against losses.

The bailout has left the Fed holding a vast portfolio of troubled securities. To manage them, Mr. Geithner gave three no-bid contracts to BlackRock, an asset-management firm with deep ties to the New York Fed.

To Joseph E. Stiglitz, a Nobel-winning economist at Columbia and a critic of the bailout, Mr. Geithner's actions suggest that he came to share Wall Street's regulatory philosophy and world view.

"I don't think that Tim Geithner was motivated by anything other than concern to get the financial system working again," Mr. Stiglitz said. "But I think that mindsets can be shaped by people you associate with, and you come to think that what's good for Wall Street is good for America."

In this case, he added, that "led to a bailout that was designed to try to get a lot of money to Wall Street, to share the largesse with other market participants, but that had deeply obvious flaws in that it put at risk the American taxpayer unnecessarily."

But Ben S. Bernanke, the chairman of the Federal Reserve, said in an interview that Mr. Geithner's Wall Street relationships made him "invaluable" as they worked together to steer the country through crisis.

"He spoke frequently to many, many different players and kept his finger on the pulse of the situation," Mr. Bernanke said. "He was the point person for me in many cases and with many individual firms so that we were prepared for any kind of emergency."

AN ALTERNATE PATH

A revolving door has long connected Wall Street and the New York Fed. Mr. Geithner's predecessors, E. Gerald Corrigan and William J. McDonough, wound up as investment-bank executives. The current president, William C. Dudley, came from Goldman Sachs.

Mr. Geithner followed a different route. An expert in international finance, he served under both Clinton-era Treasury secretaries, Mr. Rubin and Lawrence H. Summers. He impressed them with his handling of foreign financial crises in the late 1990s before landing a top job at the International Monetary Fund.

When the New York Fed was looking for a new president, both former secretaries were advisers to the bank's search committee and supported Mr. Geithner's candidacy. Mr. Rubin's seal of approval carried particular weight because he was by then a senior official at Citigroup.

Mr. Weill, Citigroup's architect, was a member of the New York Fed board when Mr. Geithner arrived. "He had a baby face," Mr. Weill recalled. "He didn't have a lot of experience in dealing with the industry."

But, he added, "He quickly earned the respect of just about everyone I know. His knowledge, his willingness to listen to people."

At the age of 42, Mr. Geithner took charge of a bank with enormous influence over the American economy.

Sitting like a fortress in the heart of Manhattan's financial district, the New York Fed is, by dint of the city's position as a world financial center, the most powerful of the 12 regional banks that make up the Federal Reserve system.

The Federal Reserve was created after a banking crisis nearly a century ago to manage the money supply through interest-rate policy, oversee the safety and soundness of the banking system and act as lender of last resort in times of trouble. The Fed relies on its regional banks, like the New York Fed, to carry out its policies and monitor certain banks in their areas.

The regional reserve banks are unusual entities. They are private and their shares are owned by financial institutions the bank oversees. Their net income is paid to the Treasury.

At the New York Fed, top executives of global financial giants fill many seats on the board. In recent years, board members have included the chief executives of Citigroup and JPMorgan Chase, as well as top officials of Lehman Brothers and industrial companies like General Electric.

In theory, having financiers on the New York Fed's board should help the president be Washington's eyes and ears on Wall Street. But critics, including some current and former Federal Reserve officials, say the New York Fed is often more of a Wall Street mouthpiece than a cop.

Willem H. Buiter, a professor at the London School of Economics and Political Science who caused a stir at a Fed retreat last year with a paper concluding that the Federal Reserve had been co-opted by the financial industry, said the structure ensured that "Wall Street gets what it wants" in its New York president: "A safe pair of hands, someone who is bright, intelligent, hard-working, but not someone who intends to reform the system root and branch."

Mr. Geithner took office during one of the headiest bull markets ever. Yet his most important task, he said in an interview, was to prepare banks for "the storm that we thought was going to come."

In his first speech as president in March 2004, he advised bankers to "build a sufficient cushion against adversity." Early on, he also spoke frequently about the risk posed by the explosion of derivatives, unregulated insurancelike products that many companies use to hedge their bets.

But Mr. Geithner acknowledges that "even with all the things that we took the initiative to do, I didn't think we achieved enough."

Derivatives were not an altogether new issue for him, since the Clinton Treasury Department had battled efforts to regulate the multitrillion-dollar market. As Mr. Geithner shaped his own approach, records and interviews show, he consulted veterans of that fight at Treasury, including Lewis A. Sachs, a close friend and tennis partner who managed a hedge fund.

Mr. Geithner pushed the industry to keep better records of derivative deals, a measure that experts credit with mitigating the chaos once firms began to topple. But he stopped short of pressing for comprehensive regulation and disclosure of derivatives trading and even publicly endorsed their potential to damp risk.

Nouriel Roubini, a professor of economics at the Stern School of Business at New York University, who made early predictions of the crisis, said Mr. Geithner deserved credit for trying, especially given that the Fed chairman at the time, Alan Greenspan, was singing the praises of derivatives.

Even as Mr. Geithner was counseling banks to take precautions against adversity, some economists were arguing that easy credit was feeding a more obvious problem: a housing bubble.

Despite those warnings, a report released by the New York Fed in 2004 called predictions of gloom "flawed" and "unpersuasive." And as lending standards evaporated and the housing boom reached full throttle, banks plunged ever deeper into risky mortgage-backed securities and derivatives.

The nitty-gritty task of monitoring such risk-taking is done by 25 examiners at each large bank. Mr. Geithner reviewed his examiners' reports, but since they are not public, it is hard to fully assess the New York Fed's actions during that period.

Mr. Geithner said many of the New York Fed's supervisory actions could not be disclosed because of confidentiality issues. As a result, he added, "I realize I am vulnerable to a different narrative in that context."

The ultimate tool at Mr. Geithner's disposal for reining in unsafe practices was to recommend that the Board of Governors of the Fed publicly rebuke a bank with penalties or cease and desist orders. Under his watch, only three such actions were taken against big domestic banks; none came after 2006, when banks' lending practices were at their worst.

THE CITIGROUP CHALLENGE

Perhaps the central regulatory challenge for Mr. Geithner was Citigroup.

Cobbled together by Mr. Weill through a series of pell-mell acquisitions into the world's largest bank, Citigroup reached into every corner of the financial world: credit cards, auto loans, trading, investment banking, as well as mortgage securities and derivatives. But it was plagued by mismanagement and wayward banking practices.

In 2004, the New York Fed levied a $70 million penalty against Citigroup over the bank's lending practices. The next year, the New York Fed barred Citigroup from further acquisitions after the bank was involved in trading irregularities and questions about its operations. The New York Fed lifted that restriction in 2006, citing the company's "significant progress" in carrying out risk-control measures.

In fact, risk was rising to dangerous levels at Citigroup as the bank dove deeper into mortgage-backed securities.

Throughout the spring and summer of 2007, as subprime lenders began to fail and government officials reassured the public that the problems were contained, Mr. Geithner met repeatedly with members of Citigroup's management, records show.

From mid-May to mid-June alone, he met over breakfast with Charles O. Prince, the company's chief executive at the time, traveled to Citigroup headquarters in Midtown Manhattan to meet with Lewis B. Kaden, the company's vice chairman, and had coffee with Thomas G. Maheras, who ran some of the bank's biggest trading operations.

(Mr. Maheras's unit would later be roundly criticized for taking many of the risks that led Citigroup aground.)

His calendar shows that during that period he also had breakfast with Mr. Rubin. But in his conversations with Mr. Rubin, Mr. Geithner said, he did not discuss bank matters. "I did not do supervision with Bob Rubin," he said.

Any intelligence Mr. Geithner gathered in his meetings does not appear to have prepared him for the severity of the problems at Citigroup and beyond.

In a May 15, 2007, speech to the Federal Reserve Bank of Atlanta, Mr. Geithner praised the strength of the nation's top financial institutions, saying that innovations like derivatives had "improved the capacity to measure and manage risk" and declaring that "the larger global financial institutions are generally stronger in terms of capital relative to risk."

Two days later, interviews and records show, he lobbied behind the scenes for a plan that a government study said could lead banks to reduce the amount of capital they kept on hand.

While waiting for a breakfast meeting with Mr. Weill at the Four Seasons Hotel in Manhattan, Mr. Geithner phoned Mr. Dugan, the comptroller of the currency, according to both men's calendars. Both Citigroup and JPMorgan Chase were pushing for the new standards, which they said would make them more competitive. Records show that earlier that week, Mr. Geithner had discussed the issue with JPMorgan's chief, Mr. Dimon.

At the Federal Deposit Insurance Corporation, which insures bank deposits, the chairwoman, Sheila C. Bair, argued that the new standards were tantamount to letting the banks set their own capital levels. Taxpayers, she warned, could be left "holding the bag" in a downturn. But Mr. Geithner believed that the standards would make the banks more sensitive to risk, Mr. Dugan recalled. The standards were adopted but have yet to go into effect.

Callum McCarthy, a former top British financial regulator, said regulators worldwide should have focused instead on how undercapitalized banks already were. "The problem is that people in banks overestimated their ability to manage risk, and we believed them."

By the fall of 2007, that was becoming clear. Citigroup alone would eventually require $45 billion in direct taxpayer assistance to stay afloat.

On Nov. 5, 2007, Mr. Prince stepped down as Citigroup's chief in the wake of multibillion-dollar mortgage write-downs. Mr. Rubin was named chairman, and the search for a new chief executive began. Mr. Weill had a perfect candidate: Mr. Geithner.

The two men had remained close. That past January, Mr. Geithner had joined the board of the National Academy Foundation, a nonprofit organization founded by Mr. Weill to help inner-city high school students prepare for the work force.

"I was a little worried about the implications," Mr. Geithner said, but added that he had accepted the unpaid post only after Mr. Weill had stepped down as Citigroup's chairman, and because it was a good cause that the Fed already supported.

Although Mr. Geithner was a headliner with Mr. Prince at a 2004 fundraiser that generated $1.1 million for the foundation, he said he did not raise money for the group once on the board. He attended regular foundation meetings at Mr. Weill's Midtown Manhattan office.

In addition to charity business, Mr. Weill said, the two men often spoke about what was happening at Citigroup. "It would be logical," he said.

On Nov. 6 and 7, 2007, as Mr. Geithner's bank examiners scrambled to assess Citigroup's problems, the two men spoke twice, records show, once for a half-hour on the phone and once for an hourlong meeting in Mr. Weill's office, followed by a National Academy Foundation cocktail reception.

Mr. Geithner also went to Citigroup headquarters for a lunch with Mr. Rubin on Nov. 16 and met with Mr. Prince on Dec. 4, records show.

Mr. Geithner acknowledged in an interview that Mr. Weill had spoken with him about the Citigroup job. But he immediately rejected the idea, he said, because he did not think he was right for the job.

"I told him I was not the right choice," Mr. Geithner said, adding that he then spoke to "one other board member to confirm after the fact that it did not make sense."

According to New York Fed officials, Mr. Geithner informed the reserve bank's lawyers about the exchange with Mr. Weill, and they told him to recuse himself from Citigroup business until the matter was resolved.

Mr. Geithner said he "would never put myself in a position where my actions were influenced by a personal relationship."

Other chief financial regulators at the Federal Deposit Insurance Company and the Securities and Exchange Commission say they keep officials from institutions they supervise at arm's length, to avoid even the appearance of a conflict. While the New York Fed's rules do not prevent its president from holding such one-on-one meetings, that was not the general practice of Mr. Geithner's recent predecessors, said Ernest T. Patrikis, a former general counsel and chief operating officer at the New York Fed.

"Typically, there would be senior staff there to protect against disputes in the future as to the nature of the conversations," he said.

COPING WITH CRISIS

As Mr. Geithner sees it, most of the institutions hit hardest by the crisis were not under his jurisdiction—some foreign banks, mortgage companies and brokerage firms. But he acknowledges that "the thing I feel somewhat burdened by is that I didn't attempt to try to change the rules of the game on capital requirements early on," which could have left banks in better shape to weather the storm.

By last fall, it was too late. The government, with Mr. Geithner playing a lead role alongside Mr. Bernanke and Mr. Paulson, scurried to rescue the financial system from collapse. As the Fed became the biggest vehicle for the bailout, its balance sheet more than doubled, from $900 billion in October 2007 to more than $2 trillion today.

"I couldn't have cared less about Wall Street, but we faced a crisis that was going to cause enormous damage to the economy," Mr. Geithner said.

The first to fall was Bear Stearns, which had bet heavily on mortgages and by mid-March was tottering. Mr. Geithner and Mr. Paulson persuaded JPMorgan Chase to take over Bear. But to complete the deal, JPMorgan insisted that the government buy $29 billion in risky securities owned by Bear.

Some officials at the Federal Reserve feared encouraging risky behavior by bailing out an investment house that did not even fall under its umbrella. To Mr. Geithner's supporters, that he prevailed in the case of Bear and other bailout decisions is testament to his leadership.

"He was a leader in trying to come up with an aggressive set of policies so that it wouldn't get completely out of control," said Philipp Hildebrand, a top official at the Swiss National Bank who has worked with Mr. Geithner to coordinate an international response to the worldwide financial crisis.

But others are less enthusiastic. William Poole, president of the Federal Reserve Bank of St. Louis until March 2008, said that the Fed, by effectively creating money out of thin air, not only runs the risk of "massive inflation" but has also done an end-run around Congressional power to control spending.

Many of the programs "ought to be legislated and shouldn't be in the Federal Reserve at all," he contended.

In making the Bear deal, the New York Fed agreed to accept Bear's own calculation of the value of assets acquired with taxpayer money, even though those values were almost certain to decline as the economy deteriorated. Although Fed officials argue that they can hold onto those assets until they increase in value, to date taxpayers have lost $3.4 billion. Even these losses are probably understated, given how the Federal Reserve priced the holdings, said Janet Tavakoli, president of Tavakoli Structured Finance, a consulting firm in Chicago. "You can assume that it has used magical thinking in valuing these assets," she said.

Mr. Geithner played a pivotal role in the next bailout, which was even bigger—that of the American International Group, the insurance giant whose derivatives business had brought it to the brink of collapse in September. He also went to bat for Goldman Sachs, one of the insurer's biggest trading partners.

As A.I.G. bordered on bankruptcy, Mr. Geithner pressed first for a private sector solution. A.I.G. needed $60 billion to meet payments on insurance contracts it had written to protect customers against debt defaults.

A.I.G.'s chief executive at the time, Robert B. Willumstad, said he had hired bankers at JPMorgan to help it raise capital. Goldman Sachs had jockeyed for the job as well, but because the investment bank was one of A.I.G.'s biggest trading partners, Mr. Willumstad rejected the idea. The potential conflicts of interest, he believed, were too great.

Nevertheless, on Monday, Sept. 15, Mr. Geithner pushed A.I.G. to bring Goldman onto its team to raise capital, Mr. Willumstad said.

Mr. Geithner and Mr. Corrigan, a Goldman managing director, were close, speaking frequently and sometimes lunching together at Goldman headquarters. On that day, the company's chief executive, Lloyd C. Blankfein, was at the New York Fed.

A Goldman spokesman said, "We don't believe anyone at Goldman Sachs asked Mr. Geithner to include the firm in the assignment." Mr. Geithner said he had suggested Goldman get involved because the situation was chaotic and "time was running out."

But A.I.G.'s search for capital was fruitless. By late Tuesday afternoon, the government would step in with an $85 billion loan, the first installment of a bailout that now stands at $182 billion. As part of the bailout, A.I.G.'s trading partners, including Goldman, were compensated fully for money owed to them by A.I.G.

Analysts say the New York Fed should have pressed A.I.G.'s trading partners to take a deep discount on what they were owed. But Mr. Geithner said he had no bargaining power because he was unwilling to threaten A.I.G.'s trading partners with a bankruptcy by the insurer for fear of further destabilizing the system.

A recent report on the A.I.G. bailout by the Government Accountability Office found that taxpayers may never get their money back.

THE DEBT GUARANTEE

Over Columbus Day weekend last fall, with the market gripped by fear and banks refusing to lend to one another, a somber group gathered in an ornate conference room across from Mr. Paulson's office at the Treasury.

Mr. Paulson, Mr. Bernanke, Ms. Bair and others listened as Mr. Geithner made his pitch, according to four participants. Mr. Geithner, in the words of one participant, was "hell bent" on a plan to use the Federal Deposit Insurance Corporation to guarantee debt issued by bank holding companies.

It was a variation on Mr. Geithner's once-unthinkable plan to have the government guarantee all bank debt.

The idea of putting the government behind debt issued by banking and investment companies was a momentous shift, an assistant Treasury secretary, David G. Nason, argued. Mr. Geithner wanted to give the banks the guarantee free, saying in a recent interview that he felt that charging them would be "counterproductive." But Ms. Bair worried that her agency—and ultimately taxpayers—would be left vulnerable in the event of a default.

Mr. Geithner's program was enacted and to date has guaranteed $340 billion in loans to banks. But Ms. Bair prevailed on taking fees for the guarantees, and the government so far has collected $7 billion.

Mr. Geithner has also faced scrutiny over how well taxpayers were served by his handling of another aspect of the bailout: three no-bid contracts the New York Fed awarded to BlackRock, a money management firm, to oversee troubled assets acquired by the bank.

BlackRock was well known to the Fed. Mr. Geithner socialized with Ralph L. Schlosstein, who founded the company and remains a large shareholder, and has dined at his Manhattan home. Peter R. Fisher, who was a senior official at the New York Fed until 2001, is a managing director at BlackRock.

Mr. Schlosstein said that while he and Mr. Geithner spoke frequently, BlackRock's work for the Fed never came up.

"Conversations with Tim were appropriately a one-way street. He'd call you and pepper you with a bunch of questions and say thank you very much and hang up," he said. "My experience with Tim is that he makes those kinds of decisions 100 percent based on capability and zero about relationships."

For months, New York Fed officials declined to make public details of the contract, which has become a flash point with some lawmakers who say the Fed's handling of the bailout is too secretive. New York Fed officials initially said in interviews that they could not disclose the fees because they had agreed with BlackRock to keep them confidential in exchange for a discount.

The contract terms they subsequently disclosed to The New York Times show that the contract is worth at least $71.3 million over three years. While that rate is largely in keeping with comparable fees for such services, analysts say it is hardly discounted.

Mr. Geithner said he hired BlackRock because he needed its expertise during the Bear Stearns-JPMorgan negotiations. He said most of the other likely candidates had conflicts, and he had little time to shop around. Indeed, the deal was cut so quickly that they worked out the fees only after the firm was hired.

But since then, the New York Fed has given two more no-bid contracts to BlackRock related to the A.I.G. bailout, angering a number of BlackRock's competitors. The fees on those contracts remain confidential.

Vincent Reinhart, a former senior Federal Reserve official, said a more open process might have yielded a better deal for the taxpayers.

"They may have been able to convince themselves that this was the only way to go, but it sounds to me like nobody stepped back and said, 'What's this going to look like to the outside world,'" he said.

RESCUES REVISITED

As Mr. Geithner runs the Treasury and administration officials signal more bailout money may be needed, the specter of bailouts past haunts his efforts.

He recently weathered a firestorm over retention payments to A.I.G. executives made possible in part by language inserted in the administration's stimulus package at the Treasury Department's insistence. And his new efforts to restart the financial industry suggest the same philosophy that guided Mr. Geithner's Fed years.

According to a recent report by the inspector general monitoring the bailout, Neil M. Barofsky, Mr. Geithner's plan to underwrite investors willing to buy the risky mortgage-backed securities still weighing down banks' books is a boon for private equity and hedge funds but exposes taxpayers to "potential unfairness" by shifting the burden to them.

The top echelon of the Treasury Department is a common destination for financiers, and Mr. Geithner has also recruited aides from Wall Street, some from firms that were at the heart of the crisis. For instance, his chief of staff, Mark A. Patterson, is a former lobbyist for Goldman Sachs, and one of his top counselors is Lewis S. Alexander, a former chief economist at Citigroup.

A bill sent recently by the Treasury to Capitol Hill would give the Obama administration extensive new powers to inject money into or seize systemically important firms in danger of failure. It was drafted in large measure by Davis Polk & Wardwell, a law firm that represents many banks and the financial industry's lobbying group. Mr. Geithner also hired Davis Polk to represent the New York Fed during the A.I.G. bailout.

Treasury officials say they inadvertently used a copy of Davis Polk's draft sent to them by the Federal Reserve as a template for their own bill, with the result that the proposed legislation Treasury sent to Capitol Hill bore the law firm's computer footprints. And they point to several significant changes to that draft that "better protect the taxpayer," in the words of Andrew Williams, a Treasury spokesman.

But others say important provisions in the original industry bill remain. Most significant, the bill does not require that any government rescue of a troubled firm be done at the lowest possible cost, as is required by the F.D.I.C. when it takes over a failed bank. Treasury officials said that is because they would use the rescue powers only in rare and extreme cases that might require flexibility. Karen Shaw Petrou, managing director of the Washington research firm Federal Financial Analytics, said it essentially gives Treasury "a blank check."

One year and two administrations into the bailout, Mr. Geithner is perhaps the single person most identified with the enormous checks the government has written. At every turn, he is being second-guessed about the rescues' costs and results. But he remains firm in his belief that failure to act would have been much more costly.

"All financial crises are a fight over how much losses the government ultimately takes on," he said. And every decision "requires we balance how to achieve the most benefits in terms of improving confidence and the flow of credit at the least risk to taxpayers."

This article has been revised to reflect the following correction:

CORRECTION: APRIL 28, 2009

An article on Monday about Treasury Secretary Timothy F. Geithner misstated, in some editions, the surname of a former Treasury official who gave an account of a meeting last June about the approaching financial crisis. She is Michele Davis, not Smith.

[From the *Washington Post,* Wednesday, July 16, 2008]

The Help Fannie and Freddie Need

By FRANKLIN D. RAINES

Don't bail out Fannie Mae and Freddie Mac. They don't need it. The losses they face are not surprising, given what's happened to housing prices. They have more than enough capital to meet their cash obligations when those become due, which is the most basic definition of solvency. They also have hundreds of billions of dollars' worth of unencumbered assets that can be used as collateral for secured borrowing, were that to become necessary. The recent Treasury proposals do not change these facts.

What the companies need from Washington is policy clarity. I say this not just on the basis of my experience as an executive at Fannie Mae but also because of my experience as director of the Office of Management and Budget and my time as an investment banker in the 1980s, when I helped solve the problems of cities and states in financial crisis.

The Treasury proposals, curiously, substitute government capital for private capital. Fannie and Freddie have served their housing mission for decades by marshalling private equity from around the world. Federal capital funds are inherently limited, while private capital is essentially unlimited. The goal of any rescue plan should be to restore unfettered access to the private markets.

The administration and Congress need to recodify the basic understanding between the two companies and the capital markets that has worked so well for so long. While recent efforts have quelled short-term concerns about an imminent collapse, we should be focused on what's needed for the longer term.

Here are a few sentences for policymakers to start with:

Fannie Mae and Freddie Mac remain and will continue to be integral parts of the U.S. housing finance system. Their central role in housing policy, not a federal guarantee, is what has attracted trillions of dollars of debt capital.

This would not be an easy statement for the White House or the Fed to make. It would require them to abandon their multiyear effort to eliminate the companies by talking them down to the financial markets. Buyers of long-term debt are not interested in investing in entities that are opposed by their national government or are slated for extinction. Treasury Secretary Henry Paulson appears to be trying to make such a declaration, but the silence from the Fed and the White House on whether the companies have a future is deafening.

Fannie and Freddie will be permitted to operate as for-profit companies able to earn a competitive return on invested equity capital.

It has been confusing, at best, for equity investors to hear officials call for Freddie and Fannie to raise more capital while simultaneously restricting their ability to earn a profit on that capital. The government needs to remove impediments to the companies' investing in on-balance-sheet assets, creating new products within the secondary mortgage market and managing risks in the most cost-effective manner. Also, Congress needs to make clear that the companies are not going to be a cookie jar to be raided whenever housing funds are needed elsewhere. If Fannie and Freddie can earn a competitive return on capital invested, there will be no limit to the amount of equity capital they can raise.

Congress should make clear that the requirements imposed on Fannie and Freddie regarding the capital they must have on hand will be based solely on the amount needed to support the risks they take. Many in the market fear that a new regulator, as contemplated in pending legislation, would use capital requirements as a way to restrain the companies' growth or limit the scope of their activities in the secondary market. Injecting the Fed into the capital regulatory process does nothing to assuage this fear.

Fannie and Freddie can borrow from the Federal Reserve on a fully collateralized basis in the same manner as any bank in America.

The Fed has acknowledged the need for such access on a temporary basis. Congress needs to make that access permanent.

It is ironic that the administration is straining to convince the financial markets that the U.S. government stands behind the two companies. That was the market view seven years ago. However, ideologues in the Bush administration and commercial competitors of Fannie and Freddie have skillfully manipulated the markets to undermine Fannie and Freddie for more than six years. The result has been a weakening of the two linchpins of the housing finance system just when they are needed most.

Just yesterday, Fed Chairman Ben Bernanke outlined the problems facing our economy. It is time to make a choice: Continue the policy approach of trying to kill off the companies and reap the economic carnage that will inevitably produce, or make a forthright statement that these companies are necessary instruments of national policy. Paulson has tried to move the administration and the Fed back from the brink. But too much ambiguity remains.

President Bush should stand with Secretary Paulson, Chairman Bernanke, Fannie and Freddie's regulator, and with the chairmen of the relevant House and Senate committees, and together they should declare Fannie and Freddie's clear roles in our markets. They should codify this role in legislation that will bind future administrations. The sooner this happens, the better.

The writer was chairman and chief executive of Fannie Mae from 1999 to 2004 and served as director of the Office of Management and Budget in the Clinton administration. He receives a pension and deferred compensation from Fannie Mae and owns stock in the company.

[Government Securities Dealers Statistics Unit, Federal Reserve Bank of New York, June 5, 2008]

Federal Reserve Bank of New York: Primary Dealers List

Memorandum to all Primary Dealers and Recipients of the Weekly Press Release on Dealer Positions and Transactions

The latest list reflects the following changes:

- Effective September 18, 2006, Dresdner Kleinwort Wasserstein Securities LLC changed its name to Dresdner Kleinwort Securities LLC.*

List of the Primary Government Securities Dealers Reporting to the Government Securities Dealers Statistics Unit of the Federal Reserve Bank of New York

BNP Paribas Securities Corp.
Banc of America Securities LLC
Barclays Capital Inc.
Bear, Stearns & Co., Inc.
Cantor Fitzgerald & Co.
Citigroup Global Markets Inc.
Countrywide Securities Corporation
Credit Suisse Securities (USA) LLC
Daiwa Securities America Inc.
Deutsche Bank Securities Inc.
Dresdner Kleinwort Securities LLC
Goldman, Sachs & Co.
Greenwich Capital Markets, Inc.
HSBC Securities (USA) Inc.
J. P. Morgan Securities Inc.
Lehman Brothers Inc.
Merrill Lynch Government Securities Inc.
Mizuho Securities USA Inc.
Morgan Stanley & Co. Incorporated
UBS Securities LLC.

NOTE: This list has been compiled and made available for statistical purposes only and has no significance with respect to other relationships between dealers and the Federal Reserve Bank of New York. Qualification for the reporting list is based on the achievement and maintenance of the standards outlined in the Federal Reserve Bank of New York's memorandum of January 22, 1992.

[From the *Washington Post,* Wednesday, October 31, 2007]

Buffett Testifies That He Saw Early Signs of Freddie Mac's Woes

By DAVID S. HILZENRATH, Washington Post Staff Writer

Billionaire investor Warren E. Buffett sat in front of a video camera in Omaha, spelled his name for the record and minced no words as he testified for the government yesterday in its case against former Freddie Mac chief executive Leland C. Brendsel.

Brendsel is accused of presiding over accounting manipulations and running Freddie Mac in a reckless manner. Buffett, one of the most successful and revered investors, sold a huge stake in the mortgage funding company before the manipulations came to light, and the government wanted him to explain why.

Buffett said he was troubled in part by a Freddie Mac investment that had nothing to do with its business.

"I follow the old dictum: There's never just one cockroach in the kitchen," Buffett said.

The government is trying to show that Brendsel's promises of double-digit earnings growth set Freddie Mac on a dangerous path, and Buffett said they were another key reason he sold.

Sometimes, when executives offer earnings projections and cannot make the numbers, "they start making up the numbers," he said.

Trying to deliver smoothly increasing earnings "can lead to a lot of trouble in any company," and it is "unachievable" at a company like Freddie Mac, whose business is inherently unpredictable, Buffett testified.

Under cross-examination by an attorney for Brendsel, Buffett acknowledged that many companies offered earnings projections, including two big companies where he has been a director, Coca-Cola and Gillette.

He agreed that his antipathy for the practice was a minority view among professional investors. Asked to read aloud from Freddie Mac annual reports, he showed that the McLean company had been predicting "mid-teens" earnings growth years before he began liquidating his stake.

Three weeks into Brendsel's trial on administrative charges, Buffett's testimony by video link was the most vivid, yet. The Berkshire Hathaway chairman, who is

*Revised July 15, 2008 to reflect correct effective date Dresdner Kleinwort Wasserstein Securities LLC changed its name to Dresdner Kleinwort Securities LLC.

a member of the board of The Washington Post Co., sat at a table against a wrinkled gray backdrop, a Coke bottle in easy reach and looked into the lens. Brendsel and other participants in the proceeding watched Buffett on big-screen televisions in a richly paneled Washington courtroom.

Because the case involves regulatory rather than criminal charges, Brendsel is not at risk of going to prison. He is trying to avoid liabilities and penalties that could exceed $1 billion.

With a fortune estimated at $52 billion, Buffett, known by admirers as the Sage of Omaha, ranked second on Forbes magazine's latest list of the richest Americans. Buffett has pledged the vast majority of his wealth to the philanthropic foundation run by Microsoft Chairman Bill Gates, who topped the list with $59 billion, and Gates's wife Melinda, also a member of the Post Co. board.

Buffett said he bought stock in Freddie Mac in the 1980s because "it looked ridiculously cheap." He said his company became one of Freddie Mac's largest shareholders before it began liquidating its stake in the late 1990s at an eventual profit of about $2.75 billion.

Buffett said he met with Brendsel and former Freddie Mac president David W. Glenn five or six times over the years at Brendsel's request, initially at a summer house Buffett had in Laguna Beach, Calif. Brendsel requested and followed some of his recommendations on whom Freddie Mac should appoint to its board, Buffett said.

Buffet said he became troubled when Freddie Mac made an investment unrelated to its mission. He wasn't clear on the specifics but said he "didn't think that made any sense at all" and "was concerned about what they might be doing * * * that I didn't know about."

Achieving "mid-teens" earnings growth "seemed to become more and more a mantra of the organization," giving him greater cause for concern, Buffett said.

Buffett said he reviewed Freddie Mac's annual reports every year he held stock in the company. Presented with excerpts from reports for as early as 1992, he agreed with Brendsel's lead attorney, Kevin M. Downey, that he held onto his shares while Freddie Mac repeatedly affirmed its earnings goals.

Buffett said he thought he expressed his concern to Brendsel in several conversations but added that he didn't keep notes or a diary and couldn't recall details.

Downey said the specific wording about mid-teens earnings growth did not appear in a disclosure Freddie Mac filed in 2001, but Buffett rejected the implicit suggestion that Brendsel was responding appropriately to his concern.

"He may have seen the writing on the wall," Buffett said.

Downey suggested that Freddie Mac properly tempered its projections, pointing to warnings in an annual report that its earnings could be affected by various adverse developments. Buffett said the cautionary words were merely legal boilerplate.

"I would not be particularly impressed by them," he said.

Asked by the judge, William B. Moran, whether he felt his concerns were vindicated, Buffett said, "I think they were fully vindicated."

[Mother Jones, January/February 2010 Issue]

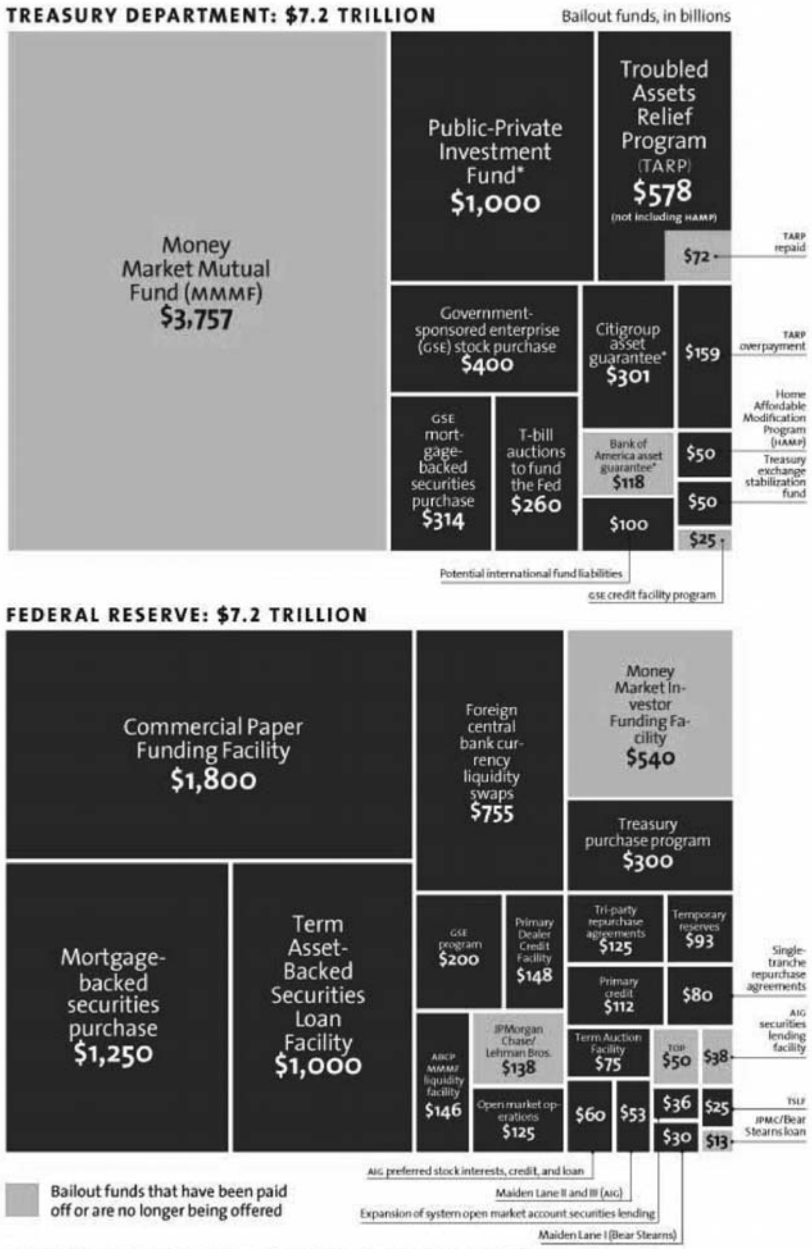
The Real Size of the Bailout

By Nomi Prins

The price tag for the Wall Street bailout is often put at $700 billion [3]—the size of the Troubled Assets Relief Program. But TARP is just the tip of the iceberg of money paid out or set aside by the Treasury Department and Federal Reserve. In her book, It Takes a Pillage: Behind the Bailouts, Bonuses, and Backroom Deals from Washington to Wall Street [4], Nomi Prins [5]uncovers the hush-hush programs and crunches the hidden numbers to calculate the shocking actual size of the bailout: $14.4 trillion and counting.

(Figures current as of October 31, 2009. Click here [6] for an explanation of the abbreviations and programs below.)

This chart is part of Mother Jones' coverage [7] of the financial crisis, one year later.



* = Joint Treasury-Fed program. Sources: Federal Reserve; SIGTARP; Treasury Dept. Research by Krisztina Ugrin. More details at *motherjones.com/the-real-bailout.*

[Mother Jones, January/February 2010 Issue]

Too Big to Jail?
Time to Fix Wall Street's Accountability Deficit

By Monika Bauerlein and Clara Jeffery

MAYBE WALL STREET should open a casino right there on the corner of Broad, because these guys simply cannot lose. After kneecapping the global economy, costing millions their homes and livelihoods, and saddling our grandchildren with massive debt—after all that, they're cashing in their bonuses from 2008. That's right, 2008—when amid the gnashing of teeth and rending of garments over the $700 billion TARP [1] legislation (a mere 5 percent of a $14 trillion [2] bailout; see "The Real Size of the Bailout [3]"), humiliated banks rolled back executive bonuses. Or so we thought: In fact, those bonuses were simply reconfigured to have a higher proportion of company stock. Those shares weren't worth so much at the time, as the execs made a point of telling Congress, but that meant they could only go up, and by the time they did, the public (suckers!) would have forgotten the whole exercise. It worked out beautifully: The value of JPMorgan Chase [4]'s 2008 bonuses has increased 20 percent to $10.5 billion, an average of nearly $6 million for the top 200 execs. Goldman [5]'s 2008 bonuses are worth $7.8 billion.

And why are bank stocks worth more now? Because of the bailout, of course. Bankers aren't being rewarded for pulling the economy out of the doldrums. Nope, they're simply skimming from the trillions we've shoveled at them. The house always wins. Indeed, 2009 bonuses are expected to be 30 to 40 percent higher than 2008's. And don't forget AIG [6], which paid the same division that helped cook up collateral debt obligations and credit default swaps "retention bonuses" worth $475 million, in some execs' cases 36 times their base salaries.

As anyone who watches Dog Whisperer [7]knows, rewarding bad behavior produces more of the same—so it's no surprise that Wall Street is back to business as usual. Derivatives are still unregulated (thanks, Congress!), exotic sliced-and-diced securities are being resliced and rediced, and the biggest offenders in peddling subprime mortgages? They are raking in millions in federal grants to—wait for it—fix subprime mortgages.

And the worst part? These fat-cat recidivists don't even have the decency to fake contrition. The New York Times' Andrew Ross Sorkin [8] says that whenever he asked Wall Street CEOs "Do you have any remorse? Are you sorry? The answer, almost unequivocally, was no." When asked by MoJo's Stephanie Mencimer if he regretted helping to bring down the economy, former AIG CEO Hank Greenberg [9] said flatly, "No. I think we had a very good record." Lloyd Blankfein [10], Goldman Sachs' CEO (his haul between 2006-2008: $157 million) went so far as to tell the Times of London, "We help companies to grow by helping them to raise capital. It's a virtuous cycle. We have a social purpose." Bankers like him are "doing God's work."

This is blasphemy worthy—along with usury—of the 7th circle of hell. And while Goldman's PR minions, visions of pitchforks dancing in their heads, coaxed Blankfein into coughing up a lame apology, the comment perfectly distilled the Kool-Aid Wall Street has forced down our throats. MoJo's Kevin Drum sums it up in his investigation [11] of Wall Street's outsize influence in Washington: Political payola—$475 million in campaign contributions just in the 2008 cycle—is only part of it. Something more insidious is at work. "Unlike most industries, which everyone recognizes are merely lobbying in their own self-interest, the finance industry successfully convinced everyone that deregulating finance was not only safe, but self-evidently good for the entire economy, Wall Street and Main Street alike," he writes. Some call this phenomenon "intellectual capture," he adds, but "considering what's happened over the past couple of years, we might better call it Stockholm syndrome."

Sure enough, as our Washington bureau chief David Corn reports [12], pollsters have been surprised to find that while Americans are angry about the economy, they often blame not the bankers, but politicians—and even themselves. We spent too much, the logic goes, and now we're reaping the rewards. There's some validity to that—we all played along as if the good times would never end. But who sold us this crock? Wall Street and its troubadours, from faux regulators like Alan Greenspan [13] to so-called financial journalists like Jim "Mad Dog" Cramer [14].

And actually, when it comes to restraint and humility, consumers seem to be the only ones learning their lesson. Personal savings are up for the first time in decades; spending is down. Why? Because we, the little people, actually felt the pain of the crash. New incentives, new behavior. Not so on Wall Street; not so in Washington [15].

It's not too late. If nothing else, last summer's tea parties showed that politicians will listen to popular outrage—when it seems to threaten their jobs. What if, as Nobel-winning economist Joe Stiglitz suggests [16], we foreclosed on bankers and politicians who are morally bankrupt? What if people started showing up at town halls demanding accountability from those who gambled away their jobs and homes? There is plenty of blame to go around. Let's start putting some of it back where it belongs.

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[4] *http://motherjones.com/kevin-drum/2009/06/un-bailout*

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[7] *http://channel.nationalgeographic.com/series/dog-whisperer*

[8] *http://www.nytimes.com/2009/10/19/business/media/19askthetimes.html?pagewanted=all*

[9] *http://motherjones.com/mojo/2009/11/greenberg-still-unrepentant*

[10] *http://www.timesonline.co.uk/tol/news/world/us—and—americas/article6907681.ece*

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[13] *http://motherjones.com/politics/2008/10/alan-shrugged*

[14] *http://www.cnbc.com/id/15838187*

[15] *http://motherjones.com/politics/2010/01/henhouse-meet-fox-wall-street-washington-obama*

[16] *http://motherjones.com/politics/2010/01/joseph-stiglitz-wall-street-morals*

[The *New York Times,* March 8, 2009]

All Boarded Up

By Alex Kotlowitz

TONY BRANCATELLI, A CLEVELAND CITY COUNCILMAN, yearns for signs that something like normal life still exists in his ward. Early one morning last fall, he called me from his cellphone. He sounded unusually excited. He had just visited two forlorn-looking vacant houses that had been foreclosed more than a year ago. They sat on the same lot, one in front of the other. Both had been frequented by squatters, and Brancatelli had passed by to see if they had been finally boarded up. They hadn't. But while there he noticed with alarm what looked like a prone body in the yard next door. As he moved closer, he realized he was looking at an elderly woman who had just one leg, lying on the ground. She was leaning on one arm and, with the other, was whacking at weeds with a hatchet and stuffing the clippings into a cardboard box for garbage pickup. "Talk about fortitude," he told me. In a place like Cleveland, hope comes in small morsels.

The next day, I went with Brancatelli to visit Ada Flores, the woman who was whacking at the weeds. She is 81, and mostly gets around in a wheelchair. Flores is a native Spanish speaker, and her English was difficult to understand, especially above the incessant barking of her caged dog, Tuffy. But the story she told Brancatelli was familiar to him. Teenagers had been in and out of the two vacant houses next door, she said, and her son, who visits her regularly, at one point boarded up the windows himself. "Are they going to tear them down?" she asked. Brancatelli crossed himself. "I hope so," he mumbled.

Prayer and sheer persistence are pretty much all Brancatelli has to go on these days. Cleveland is reeling from the foreclosure crisis. There have been roughly 10,000 foreclosures in two years. For all of 2007, before it was overtaken by sky-high foreclosure rates in parts of California, Nevada and Florida, Cleveland's rate was among the highest in the country. (It's now 24th among metropolitan areas.) Vacant houses are not a new phenomenon to the city. Ravaged by the closing of American steel mills, Cleveland has long been in decline. With fewer manufacturing jobs to attract workers, it has lost half its population since 1960. Its poverty rate is one of the highest in the nation. But in all those years, nothing has approached the current scale of ruin.

And in December, just when local officials thought things couldn't get worse, Cuyahoga County, which includes Cleveland, posted a record number of foreclosure filings. The number of empty houses is so staggeringly high that no one has an accurate count. The city estimates that 10,000 houses, or 1 in 13, are vacant. The county treasurer says it's more likely 15,000. Most of the vacant houses are owned by lenders who foreclosed on the properties and by the wholesalers who are now sweeping in to pick up houses in bulk, as if they were trading in baseball cards.

Brancatelli and others—judges, the police, city officials, residents—are grappling with the wreckage left behind, although to call this the aftermath would be premature. Even with President Barack Obama's plan to help prevent foreclosures, the city is bracing for more, especially as more people lose their jobs. The city's unemployment rate is now 8.8 percent. Moreover, on some streets so many houses are already vacant that those residents left behind are not necessarily inclined to stay. "It just happens so fast, the sad part is you really have little control," Brancatelli told me. "It snowballs on the street, and you try to prevent that avalanche." Walking away from a house even makes a kind of economic sense when the mortgage far exceeds the home's value; Obama's foreclosure-prevention plan does little to address that situation. Now outside investors have descended on Cleveland; they pick up properties for the price of a large flat-screen TV and then try to sell them for a profit.

So much here defies reasonableness. It's what Brancatelli keeps telling me. A few months ago, he met with Luis Jimenez, a train conductor from Long Beach, Calif. Jimenez had purchased a house in Brancatelli's ward on eBay and had come to Cleveland to resolve some issues with the property. The two-story house has a long rap sheet of bad deals. Since 2001, it has been foreclosed twice and sold four times, for prices ranging from $87,000 to $1,500. Jimenez bought it for $4,000. When Jimenez arrived in Cleveland, he learned that the house had been vacant for two years; scavengers had torn apart the walls to get the copper piping, ripped the sinks from the walls and removed the boiler from the basement. He also learned that the city had condemned the house and would now charge him to demolish it. Brancatelli asked Jimenez, What were you thinking, buying a house unseen, from 2,000 miles away? "It was cheap," Jimenez shrugged. He didn't want to walk away from the house, but he didn't have the money to renovate. The property remains an eyesore. "Generally, I'm an optimist, but none of this makes sense," Brancatelli told me. "Trying to give order to all this chaos is the big challenge."

Like others who have stayed in Cleveland, Brancatelli, who has lived in his two-story American Foursquare for 15 years, is trying to hold the wall against the flood. Of his ward, known as Slavic Village, he says: "It's one of the most resilient communities in the country. People are rolling up their sleeves and working. We can't wait for others to step in." This was a tone—the swagger of the underdog—that I heard from other Cleveland stalwarts during the weeks I spent in the city this winter. "Cleveland's a blue-collar community," Mayor Frank Jackson told me. "They're surviving-cultures. And we will fight back."

The task is achingly slow; each house its own battle. On one street I visited, in a ward near Brancatelli's, a third of the houses were abandoned. One resident, Anita Gardner, told me about the young family who moved in down the street a few years before. They spruced up the house with new windows, a fireplace, wood kitchen cabinets, track lighting and a Jacuzzi. When they lost the house to foreclosure, they left nothing for the scavengers. They stripped their own dwelling, piling toilets, metal screen doors, kitchen cabinets, the furnace and copper pipes into a moving van. "They said, 'Why should someone else get it?'" Gardner told me. "So they took it themselves." In December, Gardner's neighbor watched a man strain to push a cart filled with thin slabs of concrete down the street. It explained why so many of the abandoned homes in the city are without front steps, as if their legs had been knocked out from under them. Perhaps such pillage is part of the natural momentum of a city being torn apart. If you can't hold onto something of real value, at least get your hands on something.

Foreclosures are a problem all over the country now, but Cleveland got to this place a while ago. Cities, old and new, are looking at what's occurring in Cleveland with some trepidation—and also looking for guidance. Already places as diverse as Atlanta, Chicago, Denver, Las Vegas and Minneapolis have neighborhoods where at least one of every five homes stands vacant. In states like California, Florida and Nevada, where many of the foreclosures have been newer housing, there is fear that with mounting unemployment and more people walking away from their property, houses will remain empty longer, with a greater likelihood that they will deteriorate or be vandalized. "There are neighborhoods around the country as bad as anything in Cleveland," says Dan Immergluck, a visiting scholar at the Federal Reserve Bank of Atlanta and an associate professor in the city and regional planning program at Georgia Tech. Local officials from other industrial cities have visited Cleveland to learn how it's dealing with the devastation. "Cleveland is a bellwether," Immergluck says. "It's where other cities are heading because of the economic downturn."

TONY BRANCATELLI, WHO IS 51, is a man of a birdlike build and intensity, but he also possesses a Midwestern folksiness, closing most conversations with a cheerful "alrighty." Over the past couple of years, he has become a minor media star. Journalists from Sweden, Japan, China, Germany, Britain and France have visited him, drawn to his ward because of the high rate of foreclosures, at present two a day. Brancatelli's world is defined by the borders of Slavic Village. It's where he grew up and where he has lived for all but three years of his life. His license plate reads Slavic 1. (He tried to convince his wife to get plates that read Slavic 2, but she declined.) The neighborhood took root roughly a hundred years ago: diminutive, narrow homes—some no more than 900 square feet—built within walking distance of the steel mills now shuttered. The demographics have been changing over the past decade: African-Americans moving in, whites moving out. A common story. Unintentionally, it's one of the few racially mixed communities in Cleveland.

Brancatelli's mother worked as a waitress at a local diner, then as a clerk at a neighborhood Army-Navy store. His father was an auto mechanic. They divorced when Brancatelli was 12, yet Brancatelli describes his childhood in Slavic Village in nostalgic hues. "You always knew somebody," he says. "You didn't need formal day care. There was always somewhere to stay."

He began working for the Slavic Village Development Corporation, a local nonprofit group, in 1988 and a year later became its director. The organization built and renovated storefronts and homes, bringing new people to the area. In fact, he met his wife when she bought a rehabbed house in the neighborhood. He stayed at the development group for 17 years until moving on to the City Council.

Cleveland has long been known for its unusually large number of nonprofit housing groups, and in the 1990s their impact on the city was noticeable. Under Brancatelli's watch, Slavic Village Development constructed more than 500 new homes and rehabbed more than 1,000. Brancatelli measured success by the number of homes the group sold for more than $50,000. "We started to see this incredible transformation," he recalls. A local thrift, Third Federal Savings and Loan, built its new corporate headquarters in Slavic Village. Marc A. Stefanski, chairman and chief executive of Third Federal, told me, "There was a good feeling that, hey, this neighborhood's coming back." Throughout the city, there was a renaissance of sorts: new housing construction in the neighborhoods and, downtown, three sports stadiums and the Rock and Roll Hall of Fame. Cleveland adopted the moniker "The Comeback City."

But then Cleveland was hit hard—and early—by the foreclosure crisis. In 1999, Brancatelli noticed something peculiar: homes, many of which were in squalid condition, were selling for inflated prices. One entrepreneur in particular caught Brancatelli's attention: 27-year-old Raymond Delacruz. He would buy a distressed property and, at best, make nominal repairs before quickly selling it for three or four times what he paid for it. The flips needed the cooperation of appraisers and the gullibility of home buyers. But the proliferation of mortgage companies—mostly based out of state and willing to provide loans with little documentation—also facilitated flippers. And the flippers justified the high prices to both home buyers and mortgage companies by pointing to the high prices nonprofit housing groups, like Brancatelli's, were getting for their new construction.

There was something else going on in the city that was even more destructive. Unlike fast-growing communities in Florida and California, Cleveland didn't see housing prices rise through the stratosphere. But even moderately rising property values created the conditions for subprime lenders to exploit strapped homeowners. Cold-calling mortgage brokers offered refinancing deals that would let homeowners use the equity in their houses to pay off other debts. A neighbor of Brancatelli's had medical problems and fell behind in her bills. She refinanced, then did it two more times, draining the equity in her house. "She used her house as an A.T.M.," Brancatelli says. "In the end, they just walked away. The debt exceeded the value of the house." In other instances, mortgage brokers would cruise neighborhoods, looking for houses with old windows or a leaning porch, something that needed fixing. They would then offer to arrange financing to pay for repairs. Many of those deals were too good to be true, and interest rates ballooned after a short period of low payments. Suddenly burdened with debt, people began to lose homes they had owned free and clear.

As early as 2000, a handful of public officials led by the county treasurer, Jim Rokakis, went to the Federal Reserve Bank of Cleveland and pleaded with it to take some action. In 2002, the city passed an ordinance meant to discourage predatory lending by, among other things, requiring prospective borrowers to get premortgage counseling. In response, the banking industry threatened to stop making loans in the city and then lobbied state legislators to prohibit cities in Ohio from imposing local antipredatory lending laws.

In the ensuing years, the city's real estate was transformed into an Alice-in-Wonderland-like landscape. Local officials began keeping track of foreclosed homes by placing red dots on large wall maps. Some corners of the map, like Slavic Village, are now so packed with red dots they look like puddles of blood. The first question outsiders now ask is, Where has everyone gone? The homeless numbers have not increased much over the past couple of years, and it appears that most of the people who lost their homes have moved in with relatives, found a rental or moved out of the city altogether. The county has lost nearly 100,000 people over the past seven years, the largest exodus in recent memory outside of New Orleans.

Banks are now selling properties at such low prices—many below what they sold for in the 1920s—you have to wonder why they bother to foreclose at all. (The F.D.I.C. estimates that each foreclosure costs a bank on average $50,000, more than if they were to do a loan modification.) All of this leaves Brancatelli in a constant state of exasperation. When asked how he's doing, he often takes a breath and replies, "Another day in paradise."

O.V.V. IS A TERM OF ART that stands for Open, Vacant and Vandalized. Houses fitting this description have popped up like prairie dogs. They are boarded, unboarded, then boarded again, and the city can't keep up with the savvy squatters. They will prop the plywood over the front entrance to make it look as if it's nailed shut. One woman told me that she called the police last summer when she saw smoke coming out of a vacant home across the street; it turned out that some young men were cooking on a grill inside.

On a dreary wintry day, Brancatelli took me to Hosmer Street, on which a fourth of the homes were foreclosed. As we strolled down the block, Brancatelli noticed something odd. Through a side window of one slender house, we could make out a waist-high pile of tree limbs and branches. The front door was off the hinges and propped against the entrance. We entered through the rear, where the door was gone altogether. "Hello," Brancatelli hollered, "City!"—an effort to both warn squatters and frighten animals. Earlier that day we entered another O.V.V. and heard footsteps upstairs. "They don't have a gun," he had assured me. He explained that scavengers know enough not to carry weapons because it would mean more prison time should they be caught. Even in O.V.V.'s, there are rules.

Inside, we found firewood and brush piled in the kitchen and front room. "The crap we deal with," Brancatelli muttered to himself. He snapped a photo with his cellphone and sent an e-mail message to the city's Building and Housing Department, urging the department to send someone to secure the house. He often does this two or three times a day. But finding a collection of timber like this is of particular concern; over the past year there have been more than 60 fires in his ward, all in vacant houses. The fire department tried stakeouts but has not caught anyone. The general belief is that the fires are set either by squatters trying to stay warm or by mischievous kids. Brancatelli, though, wonders aloud if it might be vigilantes who don't like the blight on their block. "Maybe I'm overthinking it," he says. More likely, he's projecting. He would like to see many of these houses just disappear.

This is Brancatelli's conundrum: many of the abandoned homes should be razed. They're either so old or so impractically tiny that they have little resale value, or they have been stripped of their innards and are in utter disrepair. There are an estimated one million lender-owned properties nationwide, and on average each house sits empty for eight months, a length of time that is only growing. Demolition, though, is costly: roughly $8,000 a house. Two years ago, Litton Loan Servicing, a mortgage servicer, discussed giving the city a number of foreclosed homes. Free. The city told them that would be fine, but only if the company came up with money to pay for the necessary demolitions. The transaction never occurred.

Last summer, Congress appropriated $3.9 billion in emergency funds for cities to acquire and rehab foreclosed properties. (An additional $2 billion will be available under the recently enacted economic-stimulus package.) The legislation was labeled the Neighborhood Stabilization Program, but Cleveland and a handful of other cities had to lobby hard to convince Congress that "stabilization" in their cities meant tearing down houses—not renovating them. Last month, Cleveland said it planned to use more than half of its $25.5 million allotment to raze 1,700 houses. This presents an opportunity to reimagine the city, to erase the obsolete and provide a space for the new. (There's little money now to build, so imagine is the operative word.) Cuyahoga County is also establishing a land bank, a public entity that can acquire distressed properties and hold on to the land until improved economic times allow for redevelopment. The county hopes to persuade banks to unload their distressed properties, which the land bank would then raze, as well as give up some foreclosed properties in the suburbs, which the county could eventually renovate and sell.

Other cities—including Minneapolis, Youngstown, Detroit and Cincinnati—have put aside at least a third of their neighborhood-stabilization funds for demolition. "As properties stay vacant for longer periods of time," says Joe Schilling, a founder of the National Vacant Properties Campaign, "it's inevitable that even in some of the fast-growing communities, they'll have to look at demolition." Phoenix, for instance, has set aside a quarter of its grant money to tear down abandoned homes.

Cleveland may use some of those demolition dollars on houses now owned by the Federal Government. Between the Department of Housing and Urban Development and entities like Fannie Mae and Freddie Mac, the Federal Government has control of roughly a thousand abandoned properties in Cleveland. Across the street from the house with the timber inside sits a one-and-a-half story vacant property owned by HUD, which had guaranteed the last mortgage. On the front porch, a large picture window was wide open, but Brancatelli chose to enter through the front door. Going on a hunch, he punched the numbers in the address into the lockbox. The toilet was gone, as was the copper piping. HUD recently sold this house—for $1,500—but didn't inform the new owner that the house had been condemned. "They dumped the house," Brancatelli grumbled. "It's this kind of stuff that drives me nuts."

A few weeks ago Brancatelli persuaded HUD to let the owner out of his purchase. Then HUD offered to sell the city its distressed properties, including this one, for $100 each. You might think this was something to celebrate. Brancatelli, though, is irked. As he sees it, the city will now have to use some of its emergency HUD financing to demolish houses that HUD was responsible for.

THE LIFE OF A CLEVELAND CITY COUNCILMAN has become one of answering complaints derived in one way or another from the foreclosure crisis. In November, Zachary Reed, who represents the ward near Slavic Village, received a pleading phone call from Cecilia Cooper-Hardy, a constituent and school-bus driver who lives next to a vacant house. Cooper-Hardy told Reed that as she was leaving for work at 5 one morning, she peered out her living-room window and noticed a pair of eyes staring back at her from behind a slit cut in a window shade next door. Reed had the house secured, but within days the boards were pulled off. Cooper-Hardy then purchased a pistol that she now keeps under her pillow. The local police commander calls her regularly, just to make sure everything's O.K., a routine he has adopted with others as well. Last summer, while Cooper-Hardy was doing yardwork, someone slipped in her back door. She hollered to a neighbor across the street who was drinking in the yard with friends. They rushed to her aid as the burglar fled. That neighbor is gone now. Another foreclosure. So every morning she offers up a prayer, and then she peeks out her living room blinds to see if there's anyone peeking back at her from the house next door. Reed, the councilman, told me, "If we don't get some help we're going to turn into a third-world nation."

Brancatelli doesn't necessarily disagree with the sentiment, but he continues to search for reasons to be sanguine. He insisted on driving me past a small store called Johnny's Beverage because, he told me, it was a key to his community's future. Johnny's Beverage sits in the middle of a residential block. Its facade is worn. Dark plastic sheeting covers the front windows so you can't see in. A hodgepodge of posters and handwritten signs advertise cold beer and wine, cigarettes and lottery tickets. A tattered American flag flaps in the breeze. When Jerome Jackson purchased the store three years ago, Brancatelli told him in no uncertain terms that he wasn't too happy about it and that he was going to oppose the transfer of the liquor license. It did not, after all, have the aspect of a family-friendly enterprise you would want in a residential neighborhood.

Jackson, who is 52 and barrel-chested, has a retiring demeanor. His perch is a narrow space separated from the rest of the store by counter-to-ceiling plexiglass. He had managed a store in another neighborhood and saved up to buy his own business. He renovated the upstairs and moved in (and hung the American flag from a second-floor deck he built).

He then purchased a foreclosed house down the street, where his brother could live. The house next door to the store went into foreclosure, and Brancatelli heard that Jackson kept watch over it, chasing scavengers away and erecting a fence in the rear. He also heard that Jackson had alerted the city that there was a foot of water in the basement of the vacant, the result of pipes having been ripped out. (This is common; Brancatelli has seen back water bills for vacant houses as high as $6,000.)

Brancatelli began to reconsider his opinion of Jackson. He was keeping an eye on the neighborhood—and he was committed to staying. Brancatelli decided to support the liquor-license transfer and then told Jackson that he would help get him the property next door, if he agreed to tear it down.

U.S. Bank, which owned the house, appealed a city condemnation order. “It’s the running joke,” Brancatelli told me. “The banks appeal the condemnations because they say they want more time to make repairs to put it on the market to sell. And I go to the hearings on a regular basis to say you shouldn’t get more time. Here, they owned it for more than six months and hadn’t made any repairs. They just want time to try to unload the property.” Jackson offered U.S. Bank $2,000. He heard nothing. He upped his offer to $3,000. Again, no response. When Brancatelli intervened and made it clear that U.S. Bank would be stuck with the $8,000 demolition bill, the bank agreed to sell it for a dollar to the Slavic Development Corporation. The nonprofit group then turned it over to Jackson, who agreed to pay for the razing. “Imbeciles,” Brancatelli said more than once, referring to the banks. “They’re imbeciles.”

I spent an evening with Jackson in his store and watched as a young disheveled man came in and purchased a pack of cigarettes. He hovered around the plexiglass. “Do you want to buy some tools?” the man asked.

“No,” Jackson curtly replied.

Customers frequently offer Jackson sinks, cabinets and other scavenged items. He says that in the few years he has owned the store, the community has become more transient. “I don’t know nobody no more,” he said. “I don’t know who to trust.” Everyone calls him Johnny. They assume the store was named after him, even though it has been there for decades. The week before Christmas, two men rammed a van into the front of the store, intending to rob it. The van got stuck, and the robbers fled. But Jackson isn’t deterred. He says he hopes one day to knock down his store and build a row of small enterprises, including a restaurant and a barbershop. He is trying to buy another vacant house on the block. Brancatelli now fears he’ll lose Jackson. “I want to convince him we have a strategy for the neighborhood,” he told me. “The worst thing you can have happen is to have this store close up.”

BY MID–2007, IT BECAME CLEAR to Brancatelli that his was a city at the mercy of lenders and real estate wholesalers, who now owned thousands of abandoned properties in the city. Somehow, the city needed to hold these new land barons accountable for their vacant houses, so many of which were in utter disrepair.

Brancatelli and others looked to Raymond Pianka, the judge in the city’s lone housing court. In 1996, Pianka gave up his seat on the City Council to accept this judgeship. His judicial colleagues derisively refer to it as “rat court,” because its main function is to make sure that owners mow their lawns, trim their hedges, clean up their garbage, repair leaning porches or hanging gutters—in short, that they make their homes inhospitable for rats. No one foresaw that this lowliest of courts would become one of the most powerful instruments in the city’s fight for survival. “The court’s the only tool we have,” Brancatelli said. “When we get them into court, we can’t let them go.”

In 2001, when it became clear how Raymond Delacruz was wreaking havoc on city neighborhoods by flipping houses, it was Pianka who ran him out of town. The city’s building and housing department cited Delacruz for code violations on a house he hadn’t flipped fast enough. When he didn’t show up in court, Pianka had his chief bailiff stake out Delacruz at a doughnut shop. Pianka placed him on house arrest, ordering him to spend 30 days in the dilapidated structure he owned but had not maintained. Shortly after his sentence was up, Delacruz moved to Columbus, where he continued his flipping, and was eventually convicted for fraud that included swindling a bank vice president.

Housing codes, which were established in the mid-19th century, set minimum standards for housing quality. They traditionally help maintain both a city’s aesthetics and safety. In Cleveland today, they seem to be all that keeps the city from crumbling. In 2007, Pianka realized that the banks weren’t showing up in court after being cited for code violations. “They were thumbing their noses at the city,” he told me. “They were probably thinking, It’s Municipal Court. What can they do? And we thought, How loud can this mouse roar?” Pianka set up what he called his Clean Hands Docket. If a bank didn’t respond to a warrant, Pianka refused to order any evictions it requested.

Pianka’s staff also dug up a little-used 1953 statute that allowed for trials in absentia, and every other Monday afternoon for the last year and a half Pianka has held trials with a judge and a prosecutor but no defendant. The first case involved Destiny Ventures, a firm based in Oklahoma that buys foreclosed properties in bulk and then sells them. It was cited in 2007 for violations on one of its houses, but didn’t show up in court. The idea of a trial without a defendant was so unusual that when the prosecutor said he had no opening statement, Pianka prodded him. “You’re going to waive opening statement?” he asked. “Don’t you want to give the court a little road map about the strategy?” A housing inspector testified that Destiny Ventures had done nothing to correct the code violations on the vacant two-story clapboard house in question. The windows were punched out, the front door was wide open and roof shingles were missing. Pianka fined Destiny Ventures $40,000, and then had a collection agency sweep the company's bank accounts for the money. Brancatelli celebrated by taping a copy of the check to his office wall. In a recent phone interview, an owner of Destiny Ventures, Steve Nodine, said, "It's unconstitutional the way they fine people." His firm now refuses to do business in Cleveland.

One morning this fall, I visited Pianka before his Monday court session. His office, on the 13th floor of the Justice Center, overlooks Lake Erie and the new Cleveland Browns Stadium. It might be one of the nicer views in the city, but he would just as soon overlook the city's residential neighborhoods. When I entered his chambers, he was on his computer scanning Web sites to tap into the real estate chatter. He found a Cleveland house on eBay selling for $500. In the photos, Pianka could make out mold on the walls and noticed a large portable heater, which he said was illegal. He shook his head. He has no power to haul people into court. Building and housing inspectors issue citations for code violations, and then the city's law department decides whether to prosecute. Pianka hears only misdemeanor offenses, but he can both fine and jail defendants.

Pianka, who has a bushy mustache, often seems amused, so it's easy to underestimate his resoluteness. The chief magistrate told me she has heard Pianka curse only once. It was in late 2007. He had fined Wells Fargo $20,000 for code violations but told the bank he would rescind the fine if it spent that amount rehabilitating the structure. Wells Fargo fixed up the house, and it was, for Pianka, a success story. When he drove the chief magistrate to the address to show off the house, there was nothing there, just a vacant lot. The city, he discovered, had razed it, unaware of the repairs.

Pianka lives on a beautiful block in Cleveland's Detroit-Shoreway neighborhood, where there is a stunning variety of architecture. But even on his street, there have been three foreclosures. For months, Pianka helped keep watch on a majestic 19th-century Victorian down the street. One neighbor paid for the electricity so the vacant house would be protected against vandals by an alarm system. Pianka shoveled the snow in winter and often parked his car in the driveway so it would appear as if someone were living there.

Pianka is an amateur historian, and his office shelves are filled with books on Poland, his grandfather's native country. During my visit, he retrieved a book about wartime Warsaw and opened it to a photograph of a lone man with a wheelbarrow collecting bricks from the rubble of a building's ruins. "He's putting the city back together," Pianka told me. "We just have to make the best of things. We have to do it because nobody else will."

One of his assistants poked her head in the doorway. "It looks like we're going to have another packed house," she announced, and Pianka headed for the courtroom. A line of people snaked into the hallway. When the bailiff called their names, they approached the lectern, usually without an attorney. Pianka asked one man how he wanted to plead. "I plead whatever it takes," he replied. Most of the defendants are simply asking for guidance, or at least some understanding, and the word is that you can trust Pianka. "He's the most loved judge in Cleveland," Brancatelli told me. A good number of the defendants are facing foreclosure themselves and don't have the means to keep up their property. Until recently, many might have refinanced, but that is no longer an option.

One of the first cases I observed involved Sally Hardy, who is 52 and works as a housekeeper at a nursing home. She asked Pianka if she could confer briefly with the prosecutor, which she did, and then began to cry softly. "What'd you say to her?" Pianka asked the prosecutor in an attempt to lighten the mood. Hardy jogged out of the courtroom in tears. When she returned, Pianka apologized. "I'm sorry," he said. "These are emotional times, and sometimes it feels like the weight of the world is on your shoulders." Her house was in foreclosure, she told Pianka, but she had rescued it. Pianka brightened. "That's a great accomplishment," he told her. He ordered her into a program that assists struggling homeowners; a housing specialist will work with Hardy to find money to repair her roof and porch.

Mayra Caraballo, a 39-year-old mother of two, appeared in court in response to code violations on her home. She explained to Pianka that she no longer owned the house. She had lost her job at a processing plant, and an adjustable rate had kicked in on her mortgage, boosting her monthly payments to $1,100, from $800. She had left after receiving a foreclosure notice. The house was quickly stripped of everything but the furnace. Pianka asked a clerk to check into the house's ownership; he suspected that the lender had withdrawn the foreclosure at the last minute, as is becoming more common. The clerk tracked down the trustee on the mortgage, Deutsche Bank, and confirmed that the foreclosure had indeed been withdrawn.

Pianka calls these situations "toxic titles." "You're in limbo," Pianka told a shocked Caraballo. "There's no hope in your getting out of this property as a result of foreclosure. We're seeing this more and more."

Pianka sees these toxic titles as an effort by lenders to dodge responsibility for vacant houses. Later, I called Deutsche Bank to ask about Caraballo's house. "We don't own the property," a spokesman told me. "We're the owner of record, but the investors who bought the mortgage-backed securities own it." Pianka chuckled when I told him of the bank's response. "That's their mantra: we don't own it," he said. "It's handy for them to say, 'Oh, it's not us.' It's part of this big shell game they're playing." I checked in with Caraballo, too. She's now renting and working part time at a day care center. She told me that she would like to move back into the house, but she's not sure she has the money to replace all the hardware that has been stripped by scavengers or to make the necessary repairs.

Over the last year and a half, the housing court has collected $1.6 million in fines from defendants who didn't show up for their trials. Last April, Pianka fined Washington Mutual $100,000 for a vacant property on the city's west side. Washington Mutual, now owned by JPMorgan Chase, appealed, and in December, the Eighth District Court of Appeals in Ohio ruled that trials in absentia were not permitted in misdemeanor cases, essentially putting an end to Pianka's efforts. JPMorgan Chase disputes the code violations, but a spokeswoman said the bank was not planning to send a representative to court to respond to the city's charges.

"We just have to figure out some other ways," Pianka told me. He has suggested that the city could name corporate officers when prosecuting code violations. He told me that a Cleveland police officer was so angered by all the abandoned properties that he volunteered last month to serve warrants to bank officers should they ever be issued. In the meantime, early last year, Cleveland sued 21 lenders, arguing that their vacant houses created a public nuisance, virtually destroying some neighborhoods. Ten of those lenders have since gone under, been acquired or gone into bankruptcy. The case is slowly winding its way through federal court.

"This crisis changes weekly," Pianka told me. "It's a torrent of water coming at us. We can divert it one way or another. But we can't stop it."

ON FEB. 29 LAST YEAR, Derek Owens, a 36-year-old police officer on patrol, spotted a group of young men drinking beer in the open garage of an abandoned house. Neighbors previously complained of teenagers both selling and using drugs in the row of vacant houses on the street. When Owens and his partner got out of their squad car, the men fled. As Owens chased them, one of the men stopped in the driveway of yet another abandoned house, turned around and opened fire. One shot hit Owens in the abdomen, and he died several hours later.

When Brancatelli heard of Owens's murder, he wondered who owned the abandoned house and garage where the young men were drinking. He made some phone calls and discovered that he knew the owners, Eric and Sheila Tomasi, a couple from Templeton, Calif., who had been buying up foreclosed houses in Cleveland as an investment. Eric Tomasi soon called. He had heard about the shooting. Brancatelli liked the Tomasis, and suggested that it might be a good idea to begin repairs on the house. The neighbors, he told Tomasi, were up in arms over the vacant houses in their community. The Tomasis soon sought permits to do work and began to fix up the house.

Brancatelli had met the Tomasis a few weeks earlier at a suburban hotel where a private company was auctioning off foreclosed homes. Brancatelli was there to scare off speculators. He passed out a flyer, which read in part: "Dealing with the increasing problem of abandoned and vacant homes is at the forefront of our efforts to continue improving our community. * * * You should be aware that some of these homes were the source of incredible community concern and some resulted in criminal prosecution of mortgage brokers."

This is what Brancatelli calls "the next tsunami"—companies and individuals who are buying foreclosed houses in bulk and then quickly selling them for a profit, often without making any repairs. The companies have appellations like Whatever Inc., Under Par Properties and Tin Cup Investments. Brancatelli thought all the equity had been wrung out of these properties, but clearly he was mistaken.

At this auction, Brancatelli was introduced to the Tomasis. They are both in their 40s. Before investing in real estate, Sheila Tomasi owned a small chain of clothing stores and Eric Tomasi was a mortgage broker and before that managed a chain of sporting-goods stores. Brancatelli found them surprisingly open, unlike some of the other wholesalers—or "bottom feeders" as some derisively refer to them—who wouldn't return his phone calls or e-mail queries. He invited the couple to a gathering of local housing activists, and they laidout their business plan. Brancatelli was curious to find out how anyone was making money in a market where houses were selling for a few thousand dollars on eBay.

The Tomasis said that they owned about 200 houses in Cleveland. (They purchased 2,000 homes last year, in 22 states.) They explained that they, unlike most other wholesalers, provide each buyer with the mechanicals—pipes, a boiler, a furnace, all the basic materials that had been stripped—that the purchaser would then be responsible for installing. Brancatelli derived some comfort from this description. From his background with a nonprofit housing group, he knew the theory that people who put sweat equity into a house will be more committed to its upkeep and to making the mortgage payments. The financing the Tomasis laid out, though, made Brancatelli squirm. The purchaser would pay $500 down and then make monthly payments of no more than $450, which was below local rental prices. But the interest rate was 10 or 11 percent. What most concerned Brancatelli was that the Tomasis eventually hope to package the mortgages and sell them to investors.

"It's Groundhog Day all over again," Brancatelli remembers thinking to himself. "Intuitively, it doesn't make any sense that a person from California would be buying hundreds of distressed properties in a place that's in a downward spiral. It has nothing but the makings of someone coming to pillage our neighborhood." But did that mean he shouldn't work with the Tomasis? If he considered them the enemy, he wondered, where would that get him? Eric Tomasi assured Brancatelli and the others that they had a shared interest. "I want to put people in homes," he said. "And you want to get homes occupied."

Pianka says Brancatelli faces a difficult choice: work with the Tomasis to make sure their properties are maintained and then sold to people who make the payments, or contest the Tomasis' efforts and lose any oversight. In December, while I was driving through Slavic Village with Brancatelli, we passed a Tomasi-owned house that wasn't secured. He left a message for Tomasi: "Eric, calling about 6921 Gertrude. The door's open in the back. Give me a call. Hope things are well." Tomasi sent someone out to board it up. "Even if I didn't like this guy, I don't have the ammo to fight him," Brancatelli later told me. "Let's see if this is a model we can work with."

THERE ARE REASONS to be wary. During my time in Cleveland, I came across two properties owned by an investment company that goes by the name Thor Real Estate. The first I stumbled across while driving through the city's west side with Jay Westbrook, a city councilman. We passed a compact two-story house that had been vacant just a few weeks earlier. Westbrook peeked through the windows and, much to his surprise, saw some activity. A young, stocky man was inside installing new floors. He introduced himself as Oswan Jackson and told us he had just bought the house. He planned to move in with his wife, who was pregnant with their first child. He seemed disoriented, like many new homeowners, overwhelmed by the amount of work he needed to do. "I didn't know there were code violations," he told Westbrook. The foundation was failing and the roof needed replacing. He said the purchase price was $24,580 for the house: $500 down and $290 a month. "We'll make it work for you," Westbrook cheerfully told him. "Welcome to the neighborhood." A few days later, after a colleague researched the property, Westbrook learned that the house had been in such poor condition that it was condemned three weeks after Jackson signed the contract—and that Jackson owed the back taxes on the property, which amounted to $4,000. The last I spoke with Jackson, he planned to walk away from his new home.

The second house was on East 113th Street. The front steps were missing; piles of brush and rubbish clogged the driveway. One side was tagged by a local gang, an indication that it had been used as a gathering place. Posted to the front porch was a sign that read: 500 Down, 295 a month. In January on Craigslist, the owner advertised it this way: "I have a beautiful home at 3637 East 113th Street, Cleveland, OH 44105 Move in now! No credit check!" One neighbor I spoke to wondered why anyone would want to buy it. "It looks like there's nothing left for that house to give," the neighbor said.

The dispiriting part of the story behind these houses, certainly from Brancatelli's point of view, is that Thor Real Estate had been in partnership with the Tomasis. The Tomasis say they are now separate entities, but in court, the Tomasis have admitted that properties have been transferred between the two companies, and on occasion Eric Tomasi has offered to speak for Thor on code-violation cases. Once again, it's hard to know who owns what.

In January, Sheila Tomasi appeared in housing court. Sheila Tomasi is a personable, cheerful woman with high cheekbones and honey-streaked hair. The Tomasis purchased a house for their own use near Cleveland, and she was back for a couple of weeks to appear in court and to check on their properties. It wasn't the Tomasis' first time in Pianka's court, and on that day, five of the Tomasis' properties were cited for code violations. During her appearance, she told the court about a new owner, a single mother of seven, who had hired a contractor to install new pipes provided by the Tomasis. But it was a shoddy job. So, the Tomasis hired a plumber themselves and paid him $1,300 to redo the work. They added that charge to the woman's monthly mortgage payments. "I can't go to sleep at night if we can't give someone a good start," Tomasi told me on an earlier occasion. "You want to groom them and get all the hiccups out of owning a home: that they're getting all their improvements done, that they're paying their taxes. We want to make sure that everything's going O.K."

Tomasi also confirmed to the judge that they were considering the purchase of another 1,000 homes in the city. "That's the nature of what's happening here," Pianka sighed. "We feel in many ways helpless.

"You've moved to Cleveland at least temporarily," he said. "That's important, and taking care of your inventory properties, making sure you come into compliance with the law. There aren't enough inspectors to follow you around." Tomasi nodded. Pianka continued, "If we find out you have a property and it's flying below the radar, there are going to be severe consequences."

"Yes, your honor," Tomasi replied.

Then, as if thinking aloud, Pianka said, "It is really tough being a city municipality because we're subject to international banks, national banks, acts of Congress, buyouts of mortgages. * * * We have no control over those entities, so I guess we're going to have to try to work with you."

He fined the Tomasis $50,000 but gave them time to either raze the properties or repair them. "I'd like you to appreciate what we're dealing with in Cleveland," he told Tomasi. "Now if you don't have some good reason, I expect a good check made out to the clerk."

Pianka left the bench shaking his head and later told me he better understood why Brancatelli was willing to work with the Tomasis. "What are you to do?" he said.

When I told Brancatelli about the court proceedings and about the Tomasis' mention of purchasing another 1,000 homes, Brancatelli said, "It's just really strange times."

CORRECTION: MARCH 08, 2009

The cover article on Page 28 this weekend about efforts by Cleveland and other cities to deal with the growing number of foreclosures misstates the name of an area in Louisiana with a recent exodus of people comparable to that of Cleveland. It is Orleans Parish, or New Orleans—not New Orleans Parish.

[Whereupon, at 12:40 p.m., the Committee was adjourned.]