

Testimony of

Alex J. Pollock

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### The Federal Home Loan Banks in the Context of Housing GSE Reform

Good morning, Mr. Chairman, Senator Sarbanes, and Members of the Committee. Thank you for the opportunity to testify today. I am Alex Pollock, a Resident Fellow at the American Enterprise Institute, and these are my personal views concerning the Federal Home Loan Banks (FHLBs) in the context of housing GSE reform legislation.

I will address five main topics:

1. Creating the new housing GSE regulator
2. The implicit guaranty and competition under the new regulator
3. The challenge for the FHLBs: Competing in a securitized world
4. Effects of the Gramm-Leach-Bliley Act
5. Required studies by the new regulator

#### Creating the New Housing GSE Regulator

To begin with the main point, I fully support creating a common housing GSE regulator which would include the FHLBs, as you have consistently proposed, Mr. Chairman, and as contained in proposed legislation introduced this year by Senators Hagel, Sununu and Dole.

Combined oversight of Fannie Mae, Freddie Mac and the FHLBs constitutes a logical and effective regulatory domain. The new regulator would of course replace the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board, both of which have regulatory domains which are too narrow. They both also suffer from

various structural factors which reflect the historical circumstances of their origin in a political and housing finance world which has profoundly changed since then.

The new GSE regulator would oversee a sector with total assets plus mortgage-backed securities of approximately \$5 trillion. It would address fourteen entities, all of which have the same financial essence: linking residential mortgage loans to the global bond markets. Almost everything the FHLBs, Fannie and Freddie do reflects this essential function. It is how the FHLBs provide liquidity to their member institutions and how Fannie and Freddie provide liquidity to their customers. In the process, all the housing GSEs have become among the largest issuers of debt securities in the world.

A coherent understanding of and regulatory approach to the entire sector and its combined effects on mortgage and debt markets would be a big step forward.

### The Implicit Guaranty and Competition Under the New Regulator

One problematic result of this reformed and improved regulation needs to be addressed, however. This is that strengthened regulation will be perceived as representing even closer ties to the government and as making the implicit government guaranty of GSE obligations even stronger than before.

HUD Secretary Jackson said in his testimony last week that “comprehensive change to the regulatory structure will boost the confidence of all GSE stakeholders. Investors will be better protected...” (emphasis added). I believe that statement is correct. I also believe that this same conclusion will be drawn by investors and indeed all financial market participants.

Chairman Greenspan, in his testimony, defined the consequence: “we run the risk of solidifying investors’ perceptions that the GSEs are instruments of the government and that their debt is equivalent to government debt.” In my opinion, however, this is not just a risk, but a near certainty.

A general lesson of the history of banking legislation is that the pursuit of safety and soundness without equivalent emphasis on competition leads to cartels and monopolies—often presided over by the regulators. This was certainly the result of the banking legislation of the 1930s.

So with the GSEs: a strengthened implicit guaranty could increase the duopoly power of Fannie and Freddie, their ability to dominate the mortgage market, and their ability to extract large duopoly profits (economic rents) from the other market participants. Enhancing duopoly power would be an unfortunate unintended consequence of reform legislation.

Consider the following insightful arguments against a memorable GSE:

“The powers, privileges and favors bestowed upon it in the original charter operate as a gratuity to the stockholders.”

“Every monopoly and all exclusive privileges are granted at the expense of the public.”

“Some of our citizens petitioned that the door of competition might be opened. But this proposition has been set aside.”

“If we can not at once make our government what it ought to be, we can at least take a stand against grants of monopolies and exclusive privileges.”

Thus President Andrew Jackson in 1832, in the message accompanying his veto of the rechartering of the Second Bank of the United States, the GSE of its day. Jackson correctly diagnosed the problem with GSEs: exclusive privileges; and if we are unwilling to adopt the result of his veto, which was privatization, he suggested another solution: open the door to competition.

The FHLBs have demonstrated through their mortgage programs (which I had a hand in creating) that they can be effective alternatives to Fannie and Freddie. This is true notably because the FHLBs can utilize their close relationships with member institutions in developing mortgage finance structures. This mortgage finance partnership between the member institutions and the FHLBs simultaneously puts both the members and the FHLBs into competition with Fannie and Freddie.

The popularity of this idea among FHLB members has surprised its critics, and also its advocates. More than one thousand banks, thrifts and credit unions across the country are now participating in FHLB mortgage programs.

A major advantage of having the GSE regulator include the FHLBs, is that the same regulatory framework can be applied to the FHLB mortgage finance programs as to those of Fannie and Freddie. This has important potential for both pro-competitive development of the GSE sector and for enhanced regulation of the entire sector. In this context, Treasury Secretary Snow’s suggestion in his recent testimony of “converging the regulation of all of the GSEs” would enhance both competition and safety and soundness.

How this combination might be applied in more detail is discussed in “The Next Steps in Reforming the Housing GSEs: Creating the Common Regulator and Enhancing Competition,” which is attached for the record.

### The Challenge for the FHLBs: Competing in a Securitized World

Last week Chairman Greenspan referred to mortgage securitization as “the key to success of secondary mortgage markets in the United States.” There is no doubt that securitization has wrought huge changes in mortgage finance, as well as in many other

financial sectors. Today's largely securitized mortgage markets would be unrecognizable from the perspective of only a generation ago—say, from 1980. Imagine how foreign they would be to the authors of the 1932 Federal Home Loan Bank Act!

I believe the single greatest challenge faced by the FHLBs is to continue to adapt to this securitized world-- to translate the capabilities of securitized financial markets into benefits for their member institutions and American households. One step in this direction was the development of FHLB mortgage programs.

The next step seems obvious: to bring the FHLBs into the business of securitization performed for their member institutions, in even more direct competition with Fannie and Freddie. It can be argued that the FHLBs have the implied authority to engage in this business now, but I agree that it would be best to have the power made explicit. The Mortgage Bankers Association and the National Association of Homebuilders have proposed a well-designed amendment to GSE reform legislation to do so

This seems to me an excellent idea. It is a logical strategic extension for the FHLBs. It opens the door to competition which would benefit especially smaller FHLB members. It would fit perfectly within a regulatory convergence under a common GSE regulator. It would address the existence of a powerful duopoly in the mortgage securitization business which generates exceptional profits for Fannie and Freddie, estimated at annual after-tax returns on equity in this line of business of about 28%.

As Secretary Snow testified, "In general, the risks of the mortgage investment business are more complex to manage than the risks of the credit guarantee business"-- the "credit guarantee business" being securitization. In other words, we are discussing giving the FHLBs the possibility to add competition to the less complex business.

And as Andrew Jackson might have said today, "We can at least take a stand against grants of duopolies."

### Effects of the Gramm-Leach-Bliley Act

The last major FHLB legislation was contained in the Gramm-Leach-Bliley Act (GLB), a little more than five years ago. I wish to highlight two changes made by this act which are of fundamental importance to current legislative reform discussions: the nature of FHLB capital and the relationship between management and regulation.

GLB made most FHLB capital into real equity. Historically, FHLB capital was always problematic because it could be withdrawn by the member: was that really equity? Probably not. But GLB fixed this problem, in what I believe was its single most important FHLB provision, by unambiguously prohibiting any withdrawal of capital which would cause any FHLB to fail any capital requirement. This transformed all required capital into real, permanent equity.

Without this GLB change, discussion of the FHLBs as competitors to Fannie and Freddie would have much less meaning. With it, a competitive GSE sector became a genuine possibility.

However, there are very large differences in the capital requirements of Fannie and Freddie, on one hand, and of the FHLBs, on the other. This applies to both leverage capital requirements, which are much higher for the FHLBs, and to risk-based capital requirements, which operate on totally different approaches in the two cases.

A combined GSE regulator would be perfectly placed to compare, contrast and analyze the implications of these different capital requirements, while considering possible changes in concepts or magnitudes.

A deep historic problem with the FHLB structure was that the regulatory agency acted as manager of the business, as well as regulator—an obviously undesirable situation. This problem went back to the 1930s design of the Federal Home Loan Bank Board and was carried forward into its lineal descendent, the Federal Housing Finance Board. GLB made significant steps in separating these functions, but did not do so entirely. For example, FHLB debt is still issued by an office which is legally part of the regulator, of all things!

To create a common GSE regulator, this must obviously be fixed, as the Hagel-Sununu-Dole bill proposes. In general, GSE reform legislation creates the opportunity to distinguish properly between management and regulation for all GSEs, and for the FHLBs in particular.

#### Required Studies by the New Regulator

Understanding the entire housing GSE sector and its effects on mortgage markets, mortgage lenders, homebuyers, debt markets, fixed income investors, derivatives markets, risk distribution, costs of mortgage transactions, international capital flows, and other relevant matters should be an essential responsibility of the new GSE regulator.

I recommend that three studies in particular are of such importance that the GSE reform legislation should mandate that the new GSE regulator complete and submit them to Congress with all deliberate speed. These are:

1. Competition. To what extent is the secondary mortgage market duopolistic vs. competitive? What actions are recommended to increase competition, consistent with safety and soundness?
2. Capital. Compare and contrast the capital requirements of Fannie and Freddie vs. the FHLBs vs. Basel II. Can they be made logically consistent? What changes are recommended?

3. Affordable Housing. Compare and contrast the affordable housing requirements of Fannie and Freddie vs. the FHLBs. How should donating 10% of profits by the FHLBs be valued relative to meeting loan target percentages by Fannie and Freddie? What can the programs learn from each other?

### Conclusion

I believe GSE reform legislation which includes the FHLBs can significantly improve both regulation and competition in the housing GSE sector.

Thank you again for the opportunity to be here today.

Attachment: “The Next Steps in Reforming the Housing GSEs: Creating the Common Regulator and Enhancing Competition”

