Statement of

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Chairman Waxman, it is an honor and a pleasure to appear before you today to share my views on the role of the GSEs in the current financial crisis and the lessons for GSE reform going forward. I will briefly review the GSEs' role in promoting lax underwriting standards and the underpricing of risk in the mortgage market, explain what drove their behavior, and discuss its consequences. I will also address the counterfactual question of how the crisis would have evolved in the absence of the massive purchases by the GSEs of subprime and Alt-A instruments. Finally, I will address policy options for the future. (I ask that two articles, Calomiris 2008 and Calomiris and Wallison 2008, which provide more detailed analysis in support of my statement, also be entered into the record).[1]

The Role of the GSEs in the Current Subprime and Alt-A Mortgage Mess

In reviewing the current crisis, it is important to emphasize that incentives and pricing behavior by lenders were the key problem that produced the subprime and Alt-A lending boom and bust, and that government policies toward the GSEs were prime contributors to this problem.

Subprime and Alt-A loans, per se, are not a bad idea. These loans address a specific and legitimate purpose: If a borrower has poor credit history and little available wealth for a downpayment, and if the market is willing to realistically measure and bear the risks relating to that borrower's income and the potential for housing price depreciation, then the market may want to give that borrower a mortgage at a high cost to

[1] Charles W. Calomiris, "The Subprime Turmoil: What's Old, What's New, and What's Next," Paper presented at the Federal Reserve Bank of Kansas City's 2008 Jackson Hole Syposium (final draft of October 2, 2008), and Charles W. Calomiris and Peter J. Wallison, "The Last Trillion-Dollar Commitment: The Destruction of Fannie Mae and Freddie Mac," Financial Services Outlook, American Enterprise Institute, September 2008.

compensate for that risk. The problem with these sorts of loans arises, however, when the risk is not priced properly as the result of either a distorting government subsidy or a market failure. In the presence of such distortions, subprime portfolios may grow to be too large, may earn too little income and may be securitized with too high leverage, all of which results from the underestimation of their risk. If this happens in the extreme, as during the current financial crisis, the excessive lending and leveraging can lead to a systemic threat to the financial system.

There is a clear link between, on the one hand, government policies and government subsidies captured by the GSEs, and on the other hand, the GSEs conscious decision to encourage the underestimation of risk in subprime and Alt-A lending, which drove the financial crisis. Prior to the runup in subprime and Alt-A lending, the GSEs felt pressured to increase their role in financing mortgages for borrowers who otherwise would have had difficulty securing financing. One Freddie Mac risk manager called this "the push to do more affordable business."[2] Others at Freddie Mac noted similar perceived political consequences of an insufficient commitment to poor underwriting. Robert Tsien wrote on July 14, 2004, in his letter to Dick Syron, that: "Tipping the scale in favor of no cap at this time was the pragmatic consideration that, under the current circumstances, a cap would be interpreted by external critics as additional proof we are not really committed to affordable lending." This commitment to affordable housing was the quid pro quo for government support for the GSEs, which took the form of implicit, but universally recognized, guarantees by the government of their liabilities. Increasing pressures to meet HUD goals and to retain support in Congress, especially in light of

[2] April 1, 2004 Letter of David Andrukonis to Tracy Mooney.

accounting scandals and the movement to rein in the GSEs prior to 2005, drove the GSEs to boost their support for subprime and Alt-A lending. Freddie Mac did so even when its own risk managers were sounding the alarms about the high risks of these products, as well as the way that the poor underwriting standards in the market encouraged fraud and predatory lending.

This conclusion is consistent with publicly available information about the shifts of GSEs into subprime and Alt-A lending, as well as with internal email correspondence among risk managers and other executives at Freddie Mac during 2004, which was provided to me by your staff in preparation for this testimony. The emails, in particular, provide clear and unambiguous support for the proposition that Freddie Mac consciously undertook the acquisition of loans with poor underwriting processes in spite of factual evidence, both from the past and the current market experience, that led its own risk managers to recommend raising auditing standards and scaling back their involvement in these loans.

The evidence from past experience is alluded to in several emails, including one from David Andrukonis to Paul Peterson, April 5, 2004, which stated that "In 1990 we called this product 'dangerous' and eliminated it from the marketplace." Note that Mr. Andrukonis here recognizes the special role of the GSEs in the market, and specifically their ability, via their acceptance or rejection of originators' underwriting standards, to shape market practices more broadly. The initial adverse experience of Freddie Mac in 2004 with the poorly underwritten "NINA" mortgages is alluded to in Donna Cogswell's September 7, 2004 memo to Dick Syron, Mike May, and others, as well as elsewhere in various Freddie Mac executives' 2004 correspondence. These objections were made at the early stage of formulating a strategy for entering this market (the Spring of 2004), and then were reiterated in strong words to senior managers in September 2004.

Those warnings about lax underwriting standards were ignored because senior management feared that a tightening of standards would (1) hurt current profits, (2) lead to a broad market pullback from subprime and Alt-A lending because of the key role of Freddie Mac in setting market standards for these instruments, which would lead to widespread complaints by market participants, and (3) that such a pullback would harm Freddie Mac materially because of the political and regulatory ramifications of failing to be perceived as sufficiently committed to the promotion of affordable housing.

One impassioned plea from a risk manager, seeking to convince management that the political gains were not worth the risks, noted that even from a political perspective, the promotion of poor underwriting standards was a two-edged sword, given that subprime and Alt-A loan marketing often worked to the disadvantage of borrowers, since unsound underwriting practices are often closely linked with predatory practices: "…what better way to highlight our sense of mission than to walk away from profitable business because it hurts the borrowers we are trying to serve?" (September 7. 2004, Letter of Donna Cogswell to Dick Syron, Mike May and others).

Apparently, as reflected in the correspondence within Freddie Mac, the GSEs' senior managers reasoned that the economic and human costs and systemic risks of the subprime and Alt-A lending boom did not outweigh the short-term economic and political gains they enjoyed from propping up poor lending standards in the market, for example, by continuing to support no-docs mortgages. One senior risk manager expressed apparent disdain for management's deaf ear to his warnings, as he took the opportunity to create a clear email record of his displeasure with management's decisions regarding risk management:

> At last week's risk management meeting I mentioned that I had reached my own conclusion on this product from a reputation risk perspective. I said that I thought you and or Bob Tsien had the responsibility to bring the business recommendation to Dick [Syron], who was going to make the decision. Marty and Patti asked me what it meant that I opposed this product. I said that my job was to speak out to Dick and then to the Board if I thought we were in the wrong place on business or reputation risk. I think of this letter as comparable to the one Don B sent Paul. What I want Dick to know is that he can approve of us doing these loans, but it will be against my recommendation. I wouldn't be surprised if he disagrees with my conclusion. (September 8, 2004, Letter of David Andrukonis to Mike May).

Mr. May responded to that email by challenging Mr. Andrukonis: "Wow. This seems a bit premature. I'm not sure what you are trying to accomplish" (September 7, 2004, Letter of Mike May to David Andrukonis). Earlier that year, Mr. Andrukonis had indicated in a letter to a colleague at Freddie Mac that: "while you, Don and I will make the case for sound credit, it's not the theme coming from the top of the company and inevitably people down the line play follow the leader" (April 1, 2004, Letter from David Andrukonis to Tracy Mooney). Clearly, the risk managers had been uncomfortable with the changes in risk standards policies throughout 2004, but the changes were pushed through by top management, who were described as "very comfortable" with no-docs lending.[3]

Mr. Andrukonis, like many others familiar with the history of housing cycles, also recognized in his April 5, 2004 letter to Mr. Peterson that the reliance of underwriters on house price appreciation to "bail out" subprime lenders was based on a false extrapolation of the past into the future: "We are less likely to get the house price

[3] April 9, 2004 Letter of Ann Herington to Mike May and others.

appreciation we've had in the past l0 years to bail this program out if there's a hole in it.” Mr. Andrukonis’ objections about house price projections here were both extremely pertinent and well-grounded in experience. It is important to stress that the modeling of risk in subprime and Alt-A lending were heavily dependent on exaggerated and unjustifiable projections of continuing house price appreciation (Calomiris 2008). The combination of poor underwriting of loans and unrealistic projections of home price appreciation were at the heart of the subprime boom and bust.

Mr. Andrukonis recognized that the GSEs played a crucial and unique role in the mortgage market through their ability to set market standards. He argued that Freddie Mac could influence broader market practices for accepting underwriting policies and for pricing loans if they refused to permit poor underwriting practices on the assets they bought (as Freddie Mac had done in 1990). In his April 5, 2004 letter to Mr. Peterson, Mr. Andrukonis expressed the view that “I’m not convinced we aren’t leading the market into this product.” Ms. Cogswell shared this view. In her September 7, 2004 letter to Dick Syron, Mike May and others she specifically described the ramifications of Freddie Mac’s continuing participation in the market as effectively “mak[ing] a market” in NINA mortgages.

And Mr. Andrukonis and Ms. Cogswell were not alone at Freddie Mac in objecting to the new strategic direction undertaken in 2004. Donald Bisenius also noted in several letters that spreads in the market were thin (i.e., that compensation for potential loss was low), that the relevant group of borrowers being served in the new subprime and Alt-A markets were untested and unknown, and that there was significant risk of fraud due to poor underwriting standards. He noted in his April 1, 2004 letter to Mike May that:

"we did no-doc lending before, took inordinate losses and generated significant fraud cases. I'm not sure what makes us think we're so much smarter this time around."

These various statements from Freddie Mac's risk managers in 2004 – which were made before the massive increases in subprime and Alt-A lending that occurred in 2005, 2006, and early 2007, which produced our current financial crisis – now sound a bit like Cassandra's advice to Agamemnon that his palace wasn't really a very safe place to have a nap.

Ed Pinto, who is also appearing before this committee today, has calculated that the GSEs together ended up with about half of the total $3 trillion in total world exposure to subprime and Alt-A losses. That was a remarkable achievement over a very short period of time. In previous work (Calomiris and Wallison 2008, Calomiris 2008), Peter Wallison and I have shown that subprime and Alt-A holdings by Fannie and Freddie grew rapidly after 2005, so that it is clear that they played an increasing proportional role in the market particularly during its most obviously dangerous ending phase of 2006-2007, when housing prices were flattening, and ABX price declines and many other observable indicators were prompting many lenders to limit their exposures to subprime and Alt-A mortgages.[4]

How could the GSEs' exposures to risky mortgages have grown so large without someone on the outside complaining? Despite the crucial role of the GSEs in promoting the subprime boom and bust, most market observers, including myself, had no idea of the extent of their exposures until recently. As the numerous GSE accounting scandals of the

[4] Josef Ackerman of Deutsche Bank, in particular, has commented publicly on his bank's recognition of increasing risks in 2006 and early 2007, and his actions to limit exposure to those risks. For more details, see also Gary Gorton, "The Panic of 2007," Paper presented at the Federal Reserve Bank of Kansas City's 2008 Jackson Hole Syposium.

last five years illustrate, accounting transparency has never been a strength at the GSEs; not surprisingly, the GSEs did not disclose the extent of their subprime and Alt-A exposures to the market. To give you an idea how little was known until very recently, economist and Nobel Laureate Paul Krugman confidently opined as late as July 14, 2008, in his *New York Times* column, that Fannie and Freddie did not participate in subprime lending at all; Krugman believed that they were effectively forbidden from doing so.[5]

How much less severe would the current crisis have been if the GSEs had not chosen to become the dominant source of subprime and Alt-A buying in the market? That counterfactual question is hard to answer precisely. The GSEs were not alone as buyers of subprime and Alt-A exposures, and it is conceivable that in their absence, non-GSE buyers might have increased their exposures to subprime and Alt-A mortgage risks. In my view, however, it is likely that the GSEs crowded in other buyers of risky mortgages more than they crowded them out. Thus, in my view, it is likely that the magnitude of the crisis would have been much less (that is, less than half as severe) in the absence of the GSE's dominant involvement in subprime and Alt-A markets.

Why wouldn't private buyers simply have stepped in to replace the GSEs as subprime and Alt-A buyers? After all, as I show in other work (Calomiris 2008), some non-GSE market participants took on substantial subprime and Alt-A risks, too, and those risks seem best explained by so-called "agency" or incentive problems on the buy side (related to compensation structure) in some (but not all) financial institutions, which led buy-side managers to consciously overpay for risks at the expense of their clients or shareholders because of the private gains to buy-side managers of doing so (that is, via

[5] See Paul Krugman, "Fannie, Freddie and You," New York Times, July 14, 2008. For a description of the actual rules pertaining to Fannie and Freddie, see Calomiris and Wallison (2008).

higher fees and bonuses). Furthermore, loose monetary policy in 2002-2005 contributed to this agency problem by providing ample credit at low cost. And finally, many other non-GSE government policies, including lending by the Federal Home Loan Banks, lax prudential capital regulatory treatment of securitization, outsourcing of the measurement of asset risk to ratings agencies, and federal government action in 2006 to encourage lax ratings of subprime mortgage-backed securities, all played a role in promoting unwise risk taking by buyers other than the GSEs.

Nonetheless, important aspects of the GSEs involvement in the subprime and Alt-A market suggest that their role in crowding in other subprime and Alt-A buying was substantial; therefore, in their absence, it is likely that the counterfactual amount of subprime and Alt-A loans that would have been purchased by other buyers would have been less than, rather than more than, the amount those buyers actually purchased. I conclude that the counterfactual size of the crisis in the absence of GSE involvement would have been less than half of its actual magnitude (given that the GSEs currently hold roughly half of the total market exposure).

What aspects of GSE involvement in the market suggest that they crowded in, rather than crowded out, private investment in subprime and Alt-A mortgages? First, the timing of GSE involvement is important. Their entry into these products in 2004 coincided with the acceleration of subprime and Alt-A growth. Total subprime and Alt-A originations grew from $395 billion in 2003 to $715 billion in 2004 and increased to $1,005 billion in 2005.[6] Furthermore, the GSEs stayed in these markets long after the mid-2006 downturn, when many other lenders were exiting; during the last year of the subprime and Alt-A origination boom, when originations remained near peak levels

[6] See Calomiris (2008), Table 2.

despite clear evidence of an impending meltdown, the GSEs were even more important in “making the market” for subprime and Alt-A securities.

Second, the GSEs were uniquely large and protected players in the mortgage market (due to their GSE status), and thus could set standards and influence pricing in ways that other lenders could not. This is what Freddie Mac’s risk managers meant when referring to Freddie’s role in “mak[ing] a market” in no-docs mortgages. And they had evidence from the past that Freddie’s decision not to support poorly underwritten lending had led to the disappearance of this “dangerous” product in 1990.

After 2004, and continuing long after the subprime market turned down in 2006, originators of subprime and Alt-A mortgages knew that the GSEs stood ready to buy their poorly underwritten instruments, and this GSE legitimization of unsound underwriting practices gave assurance to all market participants that there was a ready source of demand for the new product. This had important consequences both for accelerating and maintaining the large quantity of subprime and Alt-A deal flow and for promoting the overpricing and overleveraging of these instruments. That “market mak[ing]” role of the GSEs had consequences for the expansion of the market and the pricing of subprime and Alt-A mortgages and mortgage-backed securities that exceeded the particular securities purchased by the GSEs.

The Way Forward

The GSEs are currently in conservatorship, and are being used as one of many of the mechanisms for buying mortgages in a highly illiquid market. The GSEs have gone from being implicitly guaranteed by the government to being explicitly guaranteed, and are now instruments of policymakers for adding government-sponsored funding to the mortgage market. That fact reflects the realities of the current emergency and the preexisting structure of the industry. But that does not mean that the GSEs should continue to play the same role once the crisis passes.

Once the crisis has passed, the GSEs assets should be fully privatized. This can be accomplished in a variety of ways (e.g., the sale of the assets, or the carving up of the two GSEs into a larger number of competing, and non-government guaranteed entities). The important change that is needed is to end the risk-inviting practice of using the GSEs as an off-balance sheet means of government subsidization of risk in the mortgage market. To the extent that the government wants to support low-income borrowers in the mortgage market during normal times, such support should be accomplished explicitly through government programs.[7] One such program would be FHA guarantees. Another approach would be to imitate the Australian policy of offering grants to first-time homeowners to assist them with their downpayments. I emphasize that a desirable aspect of the latter approach is that it achieves the goal of encouraging homeownership while avoiding the destabilizing consequences of government subsidization of excessive mortgage leveraging (which has been a direct consequence of the subsidization of leveraging inherent in government programs like GSE and FHA guarantees).

A second question is whether the GSEs – or some similar governmental authority to securitize, purchase or guarantee mortgage instruments, with government backing of one kind or another – are worth preserving because of its usefulness as a source of

[7] A more complete discussion of the lack of any legitimate economic motivation for the GSEs as a policy mechanism is provided in Charles W. Calomiris, “An Economist’s Case for GSE Reform,” in Peter J. Wallison, ed., *Serving Two Masters Yet Out of Control: Fannie Mae and Freddie Mac*, AEI Press, 2001, 85-109.

liquidity during emergencies. The most obvious problem with this argument is that the current emergency is itself largely a consequence of incentive problems inherent in the GSEs, and thus, it is hard to argue from experience that the GSEs are helpful as crisis mitigation mechanisms.

Of course, even in the absence of the GSEs, it is conceivable that a major systemic crisis like the current one could arise for other reasons, and that policymakers would want to insulate the mortgage market from collapse during such a crisis. Federal Reserve Board Chairman Ben Bernanke addressed this topic in a recent speech, where he showed that several alternative mechanisms would be able to provide the same emergency liquidity provision without the incentive problems or the politicization of mortgage risk inherent in the current structure and regulation of the GSEs.[8] It is beyond the scope of my remarks to explore all of those alternatives today, some of which are preferable to others, but I would note that one obvious vehicle for dealing with a systemic liquidity shock in the economy is to encourage the Fed and the Treasury to provide support to the market if and only if a liquidity crisis occurs. As we have seen recently, the Federal Reserve Act provides the Fed with ample flexibility to provide support to particular markets, especially if the Treasury is able to offer fiscal guarantees supporting Fed market making. The risk of liquidity crises, therefore, cannot reasonably be used as a justification for preserving the GSE status quo.

[8] Ben S. Bernanke, "The Future of Mortgage Finance in the United States," UC Berkeley/UCLA Symposium: The Mortgage Meltdown, the Economy, and Public Policy, Berkeley, California, October 31, 2008.