Statement No. 218

Statement of the Shadow Financial Regulatory Committee on

Limiting GSE Portfolios

May 16, 2005

Since the last statement by the Shadow Financial Regulatory Committee on Fannie Mae and Freddie Mac (Statement 216, “Proposed Legislation to Regulate the GSEs,” February 14, 2005), the central issue in the debate over the regulation of these two GSEs has become whether their portfolios of mortgages and mortgage-backed securities (MBS) should be capped or reduced. This is encouraging, since it reflects a recognition by many in Congress and the administration that tougher regulation alone will not reduce the risk that Fannie and Freddie create through their accumulation of massive portfolios of mortgages and MBS.

Fannie and Freddie now hold approximately $1.5 trillion in mortgages and MBS in their portfolios and have guaranteed the payment of interest and principal on approximately $2.2 trillion in MBS, for an aggregate exposure of $3.7 trillion. To put this in perspective, Treasury debt held by the public totals $4.4 trillion, and all corporate bonds outstanding total $2.9 trillion.

In Statement 216, commenting on the Hagel-Sununu-Dole bill (S. 190) and the Senate Banking Committee bill that was marked up in 2004, the Shadow Committee noted that “neither the original Senate committee bill nor the Hagel-Sununu-Dole bill provides directly and clearly for the elimination of the main source of that risk: Fannie and Freddie’s ability to
borrow in unlimited amounts for the purpose of acquiring and holding mortgages and mortgage-backed securities (MBS). Borrowing for this purpose is the source of their enormous interest rate and liquidity risk, which far exceeds the minimal credit risk that they take in guaranteeing MBS. While [the bill] permits the regulator to establish standards ‘for the management of asset and portfolio growth,’ the Committee believes that this provision should be strengthened so that the regulator will have the power to limit the size and compel the gradual divestment of Fannie and Freddie’s mortgage and MBS portfolios.”

The question for Congress is whether the accumulation of portfolios of more than $1 trillion is necessary for the GSEs to fulfill their functions. The Committee believes that both companies can perform their functions equally well if they were limited to securitizing mortgages rather than holding mortgages and MBS in their portfolios.

Although the GSEs have argued that the accumulation of large portfolios of mortgages and MBS is necessary to create liquidity in the mortgage market, and that their purchases of these instruments help reduce interest rates, there is little evidence to support these contentions. Fannie and Freddie do not make a market in MBS by actively trading these securities; they buy and hold MBS for investment. This does not create liquidity for these instruments. And because they borrow virtually all the funds they use for acquiring the mortgages and MBS in their portfolios, those borrowings are as likely to raise interest rates as much as their purchases of mortgages might lower them. As Fed Chairman Alan Greenspan noted in Congressional testimony on April 6, 2005, “A recent study by the Federal Reserve Board staff found no link between the size of the GSE portfolios and mortgage rates. The past year provides yet more evidence, with GSE portfolios not growing and mortgage spreads, as well as the spread between yields on GSE debentures and Treasury securities, declining further.”

Accordingly, requiring Fannie and Freddie to carry on their secondary market activities almost entirely through securitization will have a negligible effect, if any, on interest rates for conventional/conforming mortgages. Moreover, since investors and not the GSEs take the interest rate risk on MBS, requiring the GSEs to carry on their functions through securitization will eliminate most of the risk that they currently create for taxpayers and the economy generally.
For these reasons, the Committee strongly endorses the administration's proposal for limiting the portfolios of Fannie and Freddie, recently advanced by Secretary Snow in testimony before the House Financial Services Committee. That proposal would direct the GSEs' new regulator to reduce the size of their portfolios to the level necessary to support their securitization activities. This would be a much lower level than the portfolio's current size, yet would enable the companies to continue the functions for which Congress chartered them.

Unfortunately, the only legislation currently on the table in Congress does not go far enough to limit the risks that Fannie and Freddie create through their accumulation of large portfolios. H.R. 1461, drafted by Chairman Michael Oxley and Subcommittee Chairman Richard Baker, would place the responsibility for reducing GSE portfolios solely on the shoulders of the new regulator, but without any direction by Congress and without any workable standard except a finding by the regulator that such a reduction is "consistent with the safe and sound operation of the enterprises." The Shadow Committee believes that this standard is deficient in a number of respects. It does not direct the regulator to reduce the size of the GSEs' portfolios, but only to do so if the portfolios threaten their safety and soundness. Unfortunately, by the time this becomes clear, the losses that Congress fears will have occurred. If, as the Committee believes, the GSEs can carry on their functions entirely through securitization, there is little reason for the taxpayers or the economy to be exposed to the interest rate risk associated with the GSEs' accumulation of portfolios. Finally, without a clear direction from Congress, it is unlikely that a regulator will be able to challenge these two powerful companies when Congress itself seems fearful of doing so. If the risks associated with the portfolios of Fannie and Freddie are ever to be limited, Congress must summon the political will to give this direction to the regulator, and the best way to do that would be to substitute the administration's proposal for the language currently in the H.R. 1461.

The Committee also suggests strengthening the provisions of H.R. 1461 that authorize the regulator to appoint a receiver in order to bring them closer to the mechanisms already in place for resolving failing banks. In particular, the draft bill now authorizes the regulator to appoint a receiver if a GSE becomes critically undercapitalized, but does not require the regulator to do so or specify the capital ratio at which this action must be taken. However, we know from the S&L crisis that discretionary authority of this kind
provides the opportunity for forbearance, which is a natural tendency of regulators confronting politically painful actions. Accordingly, the bill should be amended to make the appointment of a receiver mandatory if a GSE becomes critically undercapitalized.

Finally, Congress should adopt a number of additional provisions that will reduce the impression among investors that Fannie and Freddie are backed by the government. Thus, Congress should repeal their exemption from state and local taxes, their so-called line of credit at the Treasury, the authority for national banks to make unlimited investments in their securities, and the fact that their securities may be used to collateralize Treasury's deposits in banks. In addition, as appropriate for organizations that receive a government subsidy, the GSEs should be prohibited from making political contributions and their lobbying activities should be limited.