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Statement of the Shadow Financial Regulatory Committee

Mortgage Backed Securities in the Federal Reserve's Portfolio

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The Federal Reserve has recently begun discussing strategies for reducing its approximately $1.2 trillion of Mortgage Backed Securities (MBS) acquired from Freddie Mac, Fannie Mae and Ginnie Mae during the financial crisis. The increase in these assets, together with the purchases of U.S. Treasury obligations, contributed to the huge increase in bank excess reserves currently being held by banks in their accounts with the Federal Reserve. The Fed's MBS acquisition program was terminated at the end of March. But the associated reserves will ultimately have to be extinguished before they result in a potentially huge increase in bank credit and money supply, which could lead to a serious inflation problem.

The Fed is faced with several options to address the reserve problems. First, it could engage in reverse repurchase agreements with primary dealers and other possible counterparties like money market mutual funds. The Fed has already begun experimenting with pilot programs to do just that. But such transactions would only temporarily, and not permanently, reduce the reserves. Second, the Fed could simply let the securities run off as they mature. The Fed staff estimates that this would reduce holdings by about $200 billion per year. Finally, the Fed could begin to sell MBS into the market place. But the market for these securities is relatively thin, so that sales would have to be gradual to avoid raising mortgage rates that might adversely affect the housing market or that result in losses to the Fed that might seriously deplete its book capital.

There is, however, another option that the Shadow Committee recommends be considered. Freddie and Fannie have been placed in conservatorship and the Treasury has confirmed that their debt is now guaranteed by the U.S. Government. This means that their debt is essentially identical to Treasury debt. The Treasury could simply issue Treasury debt to Freddie and Fannie with the offsetting accounting transaction being an IOU to the U.S. Treasury. Freddie and Fannie could then swap the acquired Treasury debt for MBS held by the Federal Reserve. This transaction would have several desirable features. It would place housing debt on the books of Freddie and Fannie where it belongs and remove the Fed from financing U.S. housing policy, which is appropriately a fiscal policy and not a monetary policy function. This would also help to re-establish Federal Reserve independence from the Treasury and fiscal policy. Finally, it would free the Fed to device strategies to reduce its balance sheet by engaging in more traditional asset sales in the much deeper Treasury market where the pricing impacts would be smaller and would accommodate a more rapid reduction in excess reserves.