From: Bert Ely [Bert@ely-co.com]
Sent: Monday, January 29, 2001 7:58 PM
To: sysrisk@ofheo.gov
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Subject: Comment on Systemic Risk posed by Fannie Mae and Freddie Mac

To whom it may concern:

The following are comments I am filing with the Office of Federal Housing Enterprises Oversight (OFHEO) in response to a solicitation for comments regarding the systemic risk posed by Fannie Mae and Freddie Mac that OFHEO published in the Federal Register on October 30, 2000. Please email me or call me at 703-836-4101 if you have any questions regarding this response.

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Comments by Bert Ely on the systemic risk posed by Fannie Mae and Freddie Mac

My comments on the systemic risk posed by Fannie Mae and Freddie Mac were largely reflected in my written testimony to the House Budget Committee on July 25, 2000. Set out below are excerpts from that testimony. However, I offer the following responses to specific questions OFHEO posed in its Federal Register notice.

Questions 1 to 10:

As a practical matter, Fannie and Freddie (F&F) pose no systemic risk to the U.S. or international financial systems because they both are GSEs as well as too-big-to-fail institutions (TBTF). At the slightest whiff of trouble or financial market disturbance, the federal government will be compelled to make explicit the implicit federal backing F&F enjoy, and which the financial markets believe exists. The previous congressional bailouts of the Farm Credit System in 1987 and the FICO bonds in 1996 understandably reinforce that belief.

Questions 11 to 13:

The financial markets quite properly, and with near certainty, believe that, in order to avoid stressing the financial markets, the federal government will rescue F&F should they experience any financial difficulty. Current federal regulation has no impact on the systemic risk F&F pose since (1) they are GSEs who would be bailed out if they stumbled into trouble and (2) they are TBTF.

Questions 14 to 20:

The only steps to take to eliminate the risks F&F pose as GSEs is to fully privatize them. Any action short of full and complete privatization will not eliminate or even reduce the taxpayer bailout risk they pose to American taxpayers. Depending on how it is done, F&F's privatization may, or may not, eliminate their TBTF risk.

Excerpts from July 25, 2000, testimony by Bert Ely to the House Budget Committee

Systemic risk

Systemic risk arises when the failure of a large financial institution, due to its actual or apparent insolvency, threatens the stability of the financial markets. While the failure of a small institution would not threaten financial stability, the failure of a large institution could. Hence, size matters. Because stable financial markets are essential to the smooth functioning of the economy overall, systemic risk must be treated extremely seriously.

Systemic risk also can arise when a large financial institution begins to suffer funding problems; that is, it experiences difficulty and high cost in rolling over its debt because of financial market fears that the institution might be sliding towards insolvency. That situation arose in the fall of 1998 when a large, highly leveraged hedge fund, Long Term Capital Management, or LTCM, experienced a funding problem. Although LTCM apparently never was actually insolvent, on a mark-to-market basis, there were grave doubts about its solvency in the aftermath of the Russian debt default in the summer of 1998.

Due only to the intervention of the Federal Reserve Bank of New York, LTCM was able to keep rolling over its debt in sufficient quantities to enable it to shrink itself in an orderly manner. Had LTCM been forced to sell its assets at fire-sale prices, in order to pay its maturing debt, chaos would have reigned in the financial markets. Those fire-sale prices would have caused tremendous mark-to-market losses for other financial firms, possibly rendering some of them insolvent. A cascade of losses could have wracked global economic havoc.

I mention LTCM because as big as it was, its outstanding debt at the time of its troubles was less than one-seventh of the amount of debt Fannie and Freddie combined had outstanding at the end of last year. Adding in their MBS, the total outstanding obligations of Fannie and Freddie at the end of 1999, $2.125 trillion, was 17 times LTCM's obligations when it crashed. Unquestionably, Fannie and Freddie pose serious systemic risks. Clearly, they are too-big-to-fail financial institutions.

The fact that Fannie and Freddie are GSEs makes it nearly certain that the federal government will rescue them should they experience financial problems. History bears out this statement. In January 1988, Congress threw a $4 billion life ring to the much smaller Farm Credit System, or FCS, even though it was solvent on a book-value basis, after yields on FCS debt over longer term Treasuries went above 100 basis points, signalling that new FCS debt might become virtually unmarketable. In September 1996, Congress averted a possible default on the so-called FICO bonds by extending the FICO bond interest assessment from savings-and-loans, or S&Ls, to all federally insured depository institutions. And of course, starting in 1989, Congress coughed up approximately $160 billion, drawn from various sources, to ensure that the federal deposit insurance commitment would be met for all failed S&Ls.

Much has been made in hearings held earlier this year by the Capital Markets Subcommittee of the House Banking Committee that a statutorily required stress test will prevent Fannie or Freddie from reaching insolvency. Although the Office of Federal Housing Enterprise Oversight, or OFHEO, has strived valiantly to implement this stress test, the test will not prevent either Fannie or Freddie from creating systemic risk. This is a most important point that Rep. Richard Baker, chairman of the Capital Markets Subcommittee, made in a hearing last Thursday. This is the case because any meaningful deterioration in the financial condition of either Fannie or Freddie, even if neither is insolvent, will create funding problems for both GSEs since they are, for all practical purposes, Siamese twins.

What to do about the systemic risks Fannie and Freddie pose

Until such time as Fannie and Freddie can be transformed into genuinely private-sector firms by eliminating their special privileges, Congress must ensure that a reliable mechanism is in place to rescue Fannie and Freddie should one of them stumble financially. Because there are innumerable reasons why they might stumble, some of which lie outside of the U.S. financial system, it would be pointless to try to prevent an external event. Instead, if needed, a rescue mission should be executed as quickly and smoothly as possible.

It would be foolhardy to rely upon "market discipline" to prevent a stumble because the exercise of market discipline could collapse the financial markets. We got a whiff of that potential effect in the aftermath of Treasury Under Secretary Gary Gensler's testimony in March before the Capital Markets Subcommittee when yields on Fannie and Freddie debt shot up at the mere suggestion that they are not government-backed institutions.

The two existing rescue mechanisms are grossly inadequate. First, Fannie's and Freddie's Treasury lines of credit, at $2.25 billion for each institution, pale in light of the total amount of their outstanding debt and MBS. Fannie's line of credit is less than .2% of its outstanding obligations; the comparable figure for Freddie is about .25%. Second, if Congress were out of session and the Treasury lines of credit had been fully drawn, then presumably the Fed could lend to Fannie and Freddie or buy their securities, but to do so, the Fed would have to sell

a like amount of Treasury securities. Massive sales of Treasury debt could be highly disruptive to the financial markets.

Key, therefore, to dealing with a Fannie or Freddie funding crisis would be congressional enactment of a line of credit, comparable to the life ring Congress tossed to the Farm Credit System in 1988, that the Treasury Department could draw upon to keep the financial markets funding Fannie and Freddie even if these GSEs were experiencing financial difficulties. That action would give Congress time to resolve their problems in a manner that would minimize the cost of any rescue. As distasteful as this recommendation may seem, going forward with the present limited rescue resources is playing Russian roulette with the U.S. economy