February 16, 2001

Mr. Robert S. Seiler, Jr.
Manager of Policy Analysis
Office of Federal Housing Enterprise Oversight
1700 G Street, NW
Fourth Floor
Washington, DC 20552

Re: Solicitation of Public Comments on Systemic Risk Published in the Federal Register on October 30, 2000.

Dear Mr. Seiler:

FM Watch, a coalition of eight trade associations, is pleased to submit comments in response to the Solicitation of Public Comments on Systemic Risk published in the Federal Register on October 30, 2000.

We applaud the Office of Federal Housing Oversight (OFHEO) for its solicitation of these comments. As the safety and soundness regulator of Fannie Mae and Freddie Mac, OFHEO provides the first and most important line of defense for the American taxpayer and the domestic financial system. This inquiry is also a matter of importance to OFHEO itself. In the event that one of these large, and excessively leveraged, financial institutions fails with damaging consequences, OFHEO will be held responsible.

We note that OFHEO is not alone in examining this issue. Concern about how the federal safety net might get entangled in a GSE bailout has prompted the Federal Reserve Bank of Chicago to organize a May 2001 conference that will examine the relationship between the federal government and its sponsored enterprises like Fannie Mae and Freddie Mac.

Establishing protective rules now is not an idle exercise. Given the wide distribution of GSE debt obligations among federally insured depository institutions, OFHEO must be vigilant, and err on the side of caution. Far-sighted actions now can prevent a cascade of failing financial institutions from one day staggering the economy if the seemingly improbable were to strike without warning.

The size of Fannie Mae and Freddie Mac creates systemic danger. *They own more first mortgages than all fifty of the top bank holding companies combined.* Secondly, not only are they large, but also the GSEs are growing rapidly. Together, their annual debt issuances almost equal that of the U.S. Treasury – and soon they will surpass the U.S. government. Certainly, there are few signs of a slowdown. Fannie Mae and Freddie Mac together grew at an annual rate of 30 percent from 1997 to 1999, and have doubled in size since 1997. To reduce systemic risk, OFHEO must achieve two objectives. First, it must regulate to reduce the likelihood of a GSE failure. Second, in the event that regulatory oversight fails, it must have in place a plan to minimize the collateral damage to taxpayers, depositors, and other innocent parties in the event of a GSE failure.

There are many reasons to question the financial invincibility of Fannie Mae and Freddie Mac, as many commentators have pointed out. For example, Federal Reserve Chairman Alan Greenspan has warned House Financial Services Subcommittee Chairman Richard Baker against allowing the GSEs to take advantage of their ties to the federal government. According to the Chairman, "If the subsidy enables Fannie and Freddie to hold less capital, then bondholders and taxpayers may be at a greater risk if these government-sponsored enterprises need financial assistance in the future."

The following are some commonly heard fears about GSEs that could threaten the financial system:

- They are supervised by a small regulator with inadequate statutory authority.
- They have on retainer a vast array of powerful lobbyists and ex-government officials that likely would be deployed to limit early intervention efforts by their regulator to manage a troubled GSE.
- They are committed to aggressive profitability growth rates that become ever harder to reach as they saturate their existing markets, and that can only be realized by moving into new, riskier markets.
- They have poor asset diversification, concentrated only in residential housing. This concentration means that a shock impairing a portion of the company's assets is likely to devalue many other assets simultaneously.
- They have only one-third the capital of large banks that hold a diversified asset mix.
- They are running highly leveraged derivatives portfolios, with a combined notional amount of derivatives outstanding of over $700 billion in 2000. Fannie Mae's leverage of this notional value was over 2000%, or about four times the average leverage of derivatives portfolios at other financial services companies.

- Their earnings are propped up by large federal subsidies that are generating growing controversy. If these earnings fall, so do the long-term financial reserves of the companies. According to the Congressional Budget Office, 40 percent of their 1995 profits came from their retained government subsidies.

GSE management does not recognize concerns that their missteps could ever plunge their companies into insolvency and thereby threaten the financial system. However, the most dangerous financial failures of the past twenty years all have involved institutions that were considered beyond reproach. For example:

- Long Term Capital Management (LTCM) was a multi-billion dollar hedge fund managed by Nobel laureates lauded as geniuses in derivative investment. In order to maintain above-market rates of return as it grew, LTCM took on riskier investment positions that plunged in value when the market unexpectedly turned. The GSEs are facing a similar challenge to maintain above-market rates of return while growing rapidly. LTCM was leveraged, so its debt quickly surpassed its asset values when the market plummeted. The New York Federal Reserve Bank brokered a bailout to prevent a market collapse. Of course, even GSE management would acknowledge that their skill set is unlikely to earn anyone on their teams a Nobel Prize in finance. If it can happen to the very best when leverage is employed, it can happen to anyone.
- Many savings and loan institutions failed dramatically in the early 1980s despite serving their communities for decades, costing taxpayers $150 billion.
- Orange County, California, was the largest municipal bankruptcy in U.S. history. This was the result of the county following a leverage-based investment strategy that could not withstand unanticipated derivatives losses.
- Continental Illinois National Bank failed and this led the FDIC to provide $4 billion to repay debt that carried no explicit federal guarantee. This bailout was justified by the fact that other banks that did business with Continental Illinois might fail if Continental defaulted on its debt obligations.

To justify their confidence, Fannie Mae and Freddie Mac rely on econometric models to protect their burgeoning investment portfolios against interest rate fluctuations. This is another way that the two GSEs resemble the LTCM hedge fund. If, as happened to LTCM, a GSE suddenly faces financial circumstances that differ from the predictions of its models, significant losses could occur. The high leverage and lack of diversity in assets of the GSEs could mean that, as with LTCM, the shock could cause failure of the institutions.

It is not the prospect of large losses at a GSE alone that creates systemic risk. After all, the stock market listed stocks dropped *$3 trillion* in value in 2000 without creating systemic danger. While there was substantial private pain due to the slump, much of it was absorbed by private institutions that were either unleveraged or adequately capitalized. Therefore, there was no contagion effect. If a GSE were to stumble, the same cannot be said. Contagion is possible.

In Congressional testimony on March 22, 2000, Gary Gensler, Undersecretary of the Treasury for Domestic Finance, stated:

> As the GSEs continue to grow and to play an increasingly central role in the capital markets, issues of potential systemic risk and market competition become more relevant. …
>
> Treasury's general approach to mitigating systemic risk in capital markets emphasizes the role of the private sector. …For institutions where the public has a special interest – for example, depository institutions carrying federal deposit insurance – further government involvement such as on-site examinations and capital standards is appropriate.[1]

The Undersecretary also noted the significant linkages between federally insured depositories and GSEs. He released statistics to document that GSE debt has become an excessive percentage of banking system assets, stating that banks held over $210 billion in GSE direct debt obligations at mid-year in 1999. *This constituted over one-third of total bank capital, more than twice that permitted for all other private borrowers.*

However, these statistics understate the exposure of the banking system to GSE health. In addition to direct debt, banks *also* held over $355 billion in mortgage-backed securities (MBS) guaranteed by the GSEs.[2] The GSEs also affect banks and other financial services companies through their rapidly growing derivatives portfolios, currently at over $700 billion in notional amount, and the fact that so many large financial firms are counterparties.

GSEs are probably the largest private users of the Federal Reserve payments system for purposes of transferring their debt and equity obligations. The Federal Reserve guarantees the settlement of

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[1] Treasury Under Secretary Gary Gensler, Testimony before the House Banking Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises, March 22, 2000.

[2] As used in this comment letter, the term "debt obligation" refers to the unsecured debt of an institution; by contrast, the term "MBS" refers to a securitized pool of mortgage loans for which a GSE provides its guarantee of timely payment to security holders. Thus, the term “debt holder” does not include holders of MBS.

payments to transfer GSE securities and also to make payments to holders of GSE debt obligations and MBS. If a GSE becomes unable to meet its obligations, the Fed could find itself at risk on those guarantees.

Potential GSE failures pose threats to other important debt holders as well, including insurance companies, pension funds, state and local governments, and even foreign governments. Purchases by these debt holders, like those of banks, may trouble regulators for the same reason: GSE failure could lead to financial difficulty or even insolvency.

Analyzing GSE Failures

There are two general scenarios of financial failure at a GSE.

The first would be if the value of the assets that the GSE holds or guarantees – single-family residential mortgages – were to lose value. This scenario is unlikely to occur suddenly. Moreover, if it did occur, this is likely to be in the context of a larger disaster, such as the Great Depression.

The second scenario is more probable than the first. This would be the occurrence of some significant loss at a GSE that resulted in pressure on management to "bet the bank," *i.e.*, increase financial risk by taking a large gamble to recoup the original losses. Betting the bank occurred at many thrift institutions that took losses because of a serious interest rate mismatch in the early 1980s, for example. Such risky gambles tend to compound the initial level of losses substantially.

Viewed in terms of the risk to stockholders, Fannie Mae and Freddie Mac are not "too big to fail." Because the GSEs are so highly leveraged, their total stockholder capital is quite small, compared to the capitalization of other companies. The government could, and should, compel stockholders to lose every penny in the event that either GSE failed.

The only justification for a bailout would be to protect innocent parties. GSE stockholders do not have sufficient money at stake to create a widespread financial panic, negating any sound policy claim for providing taxpayer funds to injured stockholders. No one has suggested that Yahoo! stockholders who lost more than $200 billion last year should receive refunds from the U.S. Treasury. The market understands that stockholders take both gains and losses by themselves, without support from the government. Furthermore, the government has offered no assurances to GSE stockholders that suggest there will be any protection against financial losses.

This dispenses with the claims of stockholders. However, the high leverage of the GSEs, means that there is much more GSE debt than equity outstanding. Together, Fannie Mae and Freddie Mac have about one trillion dollars of debt obligations outstanding, plus another $1.2 trillion of outstanding MBS. Yet debt holders have no claim to taxpayer funds either. By law, the face of the debt obligations and securities of a GSE must clearly state that, "such obligations and securities, together with the interest thereon, are not guaranteed by the United States and do not constitute a debt or obligation of the United States or any agency or instrumentality thereof other than the Corporation."[3]

Section 1304 of the 1992 Federal Housing Enterprises Financial Safety and Soundness Act also says:

> This title [establishing OFHEO] and the amendments made by this title may not be construed as obligating the Federal Government, either directly or indirectly, to provide any funds to the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, or the Federal Home Loan Banks, or to honor, reimburse, or otherwise guarantee any obligation or liability of the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association, or the Federal Home Loan Banks. This title and the amendments made by this title may not be construed as implying that any such enterprise or Bank, or any obligations or securities of such an enterprise or Bank, are backed by the full faith and credit of the United States.4

Clearly, holders of GSE debt obligations purchase such obligations knowing they are not backed by federal guarantees. Indeed, the holders of GSE debt obligations have reaped financial benefit from the absence of federal government guarantees; GSE debt obligations trade at spreads above Treasury obligations that do bear federal guarantees. Of course, the market does act as if there is a good chance that the government will bail out GSE debt holders; but this is a matter of popular perception rather than law.

With no legal obligation to do so, the only justification for a taxpayer bailout of GSE debt holders is to avoid contagion. OFHEO should insist that debt holders take the maximum amount of losses possible before taxpayer funds are committed. This has not always been done in past bailouts, costing taxpayers needlessly.

OFHEO Has Authority to Initiate Change Now

There are a number of options that OFHEO can and should review to reduce the transmission of a financial shock from a GSE to the rest of the financial system. OFHEO should examine whether

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3 Freddie Mac Charter Act, Section 306(h)(2)

4 (12 U.S.C. § 4503).

controls are necessary to prevent a GSE from "betting the bank" if it gets into financial difficulty. The OFHEO review should include such controls as requiring the establishment of early warning systems to detect significant changes in risk profile of a GSE. OFHEO should consider requiring each GSE to submit a quarterly report on its risks, signed and certified by senior GSE officials, similar to the kind of review which Federal bank regulators require of depository institutions.

In addition, OFHEO should consider requiring that the GSEs report immediately on any changes in risk profile from those in the most recent certified report. OFHEO should examine whether the GSEs' annual reports provide information comparable to that required of other private financial institutions, so that investors can rely upon them. This publication of risk to investors would extend legal liability to responsible GSE officials for failures to make accurate, material statements about risk in a timely fashion.
OFHEO should be prepared to intervene promptly in the event that it detects a significant change in risk profile at a GSE. OFHEO should consult with bank regulators to learn how best to intervene to prevent a GSE from "betting the bank." OFHEO also needs to arrange in advance with bank regulators so that it has access to adequate resources in the event of a crisis.

In evaluating stakeholders' rights, OFHEO could use the rulemaking process to clarify its procedures in dealing with a failing or failed GSE without committing taxpayer funds to assist stockholders or debt holders. Such procedures could also clarify the priority of MBS holders over debt holders, and of debt holders over stockholders. The articulation of these priorities could have the salutary effect of encouraging investors to shift their holdings from GSE debt obligations to GSE MBS. The housing markets will be reassured that, even if investors shift their investments out of debt obligations, MBS will continue to exist as a stable source of housing funding.

OFHEO Should Develop A Comprehensive List Of Remedial Proposals To Strengthen Its Ability to Oversee the GSEs

OFHEO operates under statutory constraints that prevent it from protecting the taxpayers. As numerous commentators have pointed out, OFHEO lacks the statutory powers that allow federal bank supervisors to intervene promptly and effectively to contain a shock at a financial institution before losses can exceed the amount of stockholder capital at the institution. OFHEO should develop a comprehensive list of remedial proposals to strengthen its ability to oversee the GSEs, including consideration of the following matters:

- Expand OFHEO's authority so as to make its ability to regulate the GSEs comparable to the powers available to that granted to regulators who oversee private sector depository institutions.
- Examine the impact of giving OFHEO the authority to place a failing or failed GSE into receivership and conform OFHEO's enforcement powers to those of the federal regulators of insured depository institutions.

- Examine the growth of the GSE portfolio within the context of systemic risk.
- Review the adequacy of their existing leveraged capital relative to risk.

Expanding The Ability Of OFHEO To Foster Market Discipline In Overseeing The GSEs

1) Increasing OFHEO's independent authority and capacity to take prompt corrective action to deal with a failing GSE

OFHEO needs to have the enforcement powers of the federal bank supervisors, and needs to have its own statutory authority clarified. Most of OFHEO's current enforcement powers are triggered by adverse changes in the capitalization of Fannie Mae or Freddie Mac. Unfortunately, capital is a lagging indicator of trouble at a financial institution, and OFHEO needs the authority to intervene before rather than after the GSE has taken a loss that results in diminished capital.

To truly act as an independent and impartial regulator, OFHEO should examine the impact of being tied to the appropriations process, and whether it could perform its regulatory duties more effectively by conforming to the manner in which the federal bank supervisors are funded. OFHEO should also consider the implications of its current position within HUD, and whether it would be better situated elsewhere in the Federal regulatory structure.

2) Enhancing market discipline so that both GSEs and holders of GSE securities become more able to withstand a shock

OFHEO should review the subordinated debt issues recently announced by the GSEs to ascertain whether they, in fact, promote market discipline and improve transparency. It is not clear that, in their current form, the subordinated debt issues will have their desired effect.

3) Reducing risk to the financial system from Fannie Mae and Freddie Mac
OFHEO should review its current authority regarding risk-based capital standards to determine if a more meaningful risk-based capital framework for the GSEs is appropriate. However, this should not delay implementation of the existing regulations. Changes in this area could reduce GSE risk to the financial system. Under current conditions of very thin capitalization, we fear that GSE managers will be under significant pressure to "bet the bank" in a crisis. They will have so little capital at stake that they could perceive great benefits from taking a gamble: much to win and little to lose. When others reap the gains from speculation, taxpayers often are big losers and suffer the greatest losses.

4) Insulating the financial system from transmission of a shock from a GSE to other institutions

OFHEO should consider the payment system implications of the unique access accorded to the GSEs by virtue of the fact that the Federal Reserve acts as their paying agent. The settlement system may be vulnerable to even relatively small shocks, and the special status granted GSE obligations in the system may pose risks to others.

5) Protecting the home mortgage market against the shock of a GSE failure

Fannie Mae and Freddie Mac were instrumental in encouraging the development of a secondary mortgage market that is the model for the rest of the world. This market is now well established, and the many lenders who participate in it insure that the market operates efficiently, and that mortgage funds are always available to American homebuyers. The secondary market can be protected from substantial disruption due to a GSE failure through strengthened oversight, as noted above, and by directing and encouraging the GSEs to limit their portfolios and rely primarily on MBS to fund the housing market.

As the secondary market has matured, Fannie Mae and Freddie Mac have moved into new markets as avenues to maintain their robust growth rates. OFHEO has documented this movement in its annual reports, noting that these GSEs are absorbing an increasing number of functions from the primary mortgage market, using automated underwriting and their proprietary data bases to gain entry into these new lines of business. This “mission creep” introduces new elements of systemic risk. It means that a GSE failure could leave consumers and the primary mortgage market without adequate facilities to conduct appraisals or provide other mortgage-related services that the GSEs have absorbed. With only two GSEs that serve as a shared monopoly in the secondary mortgage market, a failure of either Fannie Mae or Freddie Mac would turn the surviving GSE into a single monopoly power, and this result is likely to be completely unacceptable to policymakers.

In addressing a possible GSE failure, OFHEO needs to give thought now about how it would permit the mortgage market and its auxiliary services to function in such circumstances. Given the manner in which the automated underwriting systems of the GSEs have absorbed functions that formerly were performed by the primary market, OFHEO will need to pay special attention to assuring that the firms in the primary market will have open access to the information-based systems of a failed GSE to serve their customers and the needs of the housing market.

Modest Steps Can Greatly Increase Protection of the Financial System

By more broadly applying the powers that it has today and obtaining stronger statutory authority from Congress, OFHEO can lay the groundwork for a "soft landing" that cushions the impact of a possible GSE loss on the financial community and taxpayers. To achieve this, safeguards must be built in advance, stakeholders must know what to expect during this time of uncertainty, and regulators must have a ready plan of action to deal with a financial shock at a GSE with less risk of contagion to the overall financial system.

We commend OFHEO for conducting its inquiry into GSEs and systemic risk before a financial shock occurs. With the authority it has today as well as considering the issues raised in this letter, OFHEO can assure that mortgage funds are available to American consumers even if the GSEs suffer financial setbacks.

FM Watch and its member trade associations would be pleased to work with OFHEO.

Sincerely,

[signed: W. Mike House]

W. Mike House
Executive Director