

## Frank Challenges Bernanke Reasoning on GSEs

**For Immediate Release:** September 10, 2007

Washington, DC - House Financial Services Committee Chairman Barney Frank (D-MA), sent a letter to Federal Reserve Board Chairman Ben S. Bernanke, on Friday, September 7, 2007, challenging Chairman Bernanke's reasoning on GSEs. The full text of the letter as follows:

September 7, 2007

The Honorable Ben S. Bernanke  
Chairman  
Board of Governors  
The Federal Reserve System  
Washington, D.C. 20551

Dear Mr. Chairman,

I was pleased to read your analysis of the subprime crisis in the speech you gave at Jackson Hole, and I very much agree with you that the originate-to-distribute model needs to be addressed. Indeed, I have been pleased in general to see a growing consensus among various parties of interest in how to deal with the subprime crisis and what we should be doing to diminish the likelihood of a repetition. But there is one element in the position held by the Bush Administration and the Federal Reserve that continues to trouble me, not just because I disagree with it substantively, but because it seems to me to be an example of the triumph of a fairly rigid ideology over the facts of the situation.

In particular, recent events seem to me clearly to demonstrate that Fannie Mae and Freddie Mac have a potential to be helpful in dealing with the mortgage market that exceeds the view that many – including leaders in the Federal Reserve – previously had. One clear example of course has to do with the upper limit on mortgages that they can buy. Months ago, when the House moved to increase that limit – by an amount that I now think is too small – we were told by those on the administration side and their allies that there was no need for this because the market was well able to handle the demand for such mortgages. I do not think that is a position that has been borne out by the experience of the past few months.

But my major concern here has to do with the continued insistence of yourself and the administration that the portfolio limits imposed by OFHEO must be treated as unchangeable, even in the face of events that argue for some flexibility.

And I am particularly troubled because the argument you give against increasing the portfolio caps to accommodate some increase in Fannie Mae and Freddie Mac's role in helping with the

subprime crisis seems to me, frankly, to be contradictory in a way in which I have never previously seen in your approach.

You say that “The current caps on GSE portfolios – which were imposed for safety and soundness reasons – need not be lifted to allow them to accommodate new borrowers. Currently, the GSE portfolios include substantial holdings of GSE-guaranteed mortgage products, which are easily placed in the private secondary market even under current conditions. Thus, the GSEs could readily sell these securities to make space for new mortgages if they wished to do so.”

When you suggest that the GSEs could “make space for new mortgages,” presumably in the subprime category since that is what we are discussing here, by selling some of the securities that are “easily placed in the private secondary market,” you are suggesting that the portfolio amount remain the same, but that its quality be diminished. That is, you appear to be saying here that it would be acceptable for the GSEs to do more in the riskiest subprime market not by increasing the total portfolio, but by selling off easily placed non-subprime mortgages and replacing them in the portfolio with riskier paper.

How is your proposal to substitute the newer sales for conventional portfolio loans in any way consistent with your assertion that the reason for the caps is safety and soundness? Clearly, if safety and soundness was the concern that led you to object to any increase in portfolio, you would hardly be supportive of substituting within the overall portfolio cap riskier mortgages for those that are “easily placed” in the market, presumably because they are of a higher credit quality.

The unpersuasive nature of this argument against raising the portfolio caps leads me to believe that the objection to an increase in the cap is ideological, not driven by safety and soundness. Raising the caps is important for the reason that you implicitly acknowledged – so that we can get the GSEs into the business of helping us with the refinancing of current subprime mortgages that must be part of a response to this situation.

I appreciate the efforts that are being made by various federal regulators, including the Federal Reserve, to persuade those who hold mortgages that flexibility in enforcing the contracts is a good thing, and specifically that prepayment penalties could usefully be waived in cases where the borrowers could then refinance at rates that would allow them to avoid foreclosure. But if there is to be any significant number of these refinancings, Fannie Mae and Freddie Mac will have to play a role in providing some of the liquidity, and it is unlikely that they will be able to do so to any significant degree through securitization. Therefore, the best way to allow them to provide the liquidity needed would be to allow the caps to increase to accommodate some of these refinancings, while simultaneously adopting the legislation that would raise the jumbo rate so that in fact the overall quality could remain the same as mortgages in the higher ranks could be added along with subprime in a way that would provide some balance. The alternative suggestion – namely that we should accommodate the increase in Fannie Mae and Freddie Mac activity in the subprime area by diluting the quality of the existing portfolio seems to me an indication that the real objections to portfolio increases lie elsewhere.

BARNEY FRANK

Chairman

