

The **GSE** REPORT™

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*Special Supplement*

**Fannie Mae, Freddie Mac  
and Systemic Risk**

**April 2001**

## **Fannie Mae, Freddie Mac and Systemic Risk**

As children, many of us lined up a long row of dominoes, then pushed the first one watching how instability in a single block led to cascading collapse. The U.S. financial system is not as easily toppled, but it can happen – especially if policymakers are lax, mistakenly thinking that all is well even as the first financial domino starts to sway. The unprecedented growth of Fannie Mae and Freddie Mac must not create a row of dominos that threaten the stability of our financial system. We should have twin goals that enforce their foundations. First, we must ensure that both of these for profit corporations have comprehensive supervision that keeps them financially stable. Second, we must erect barriers to prevent the transmission of a shock, should either institution wobble, from toppling other financial institutions, and therefore badly damaging our nation's economy.

Only fifteen years have passed since insolvency threatened a housing government-sponsored enterprise (GSE). However, memories are short, and both companies are vastly larger than they were in 1985. As we saw with Long Term Capital Management, even Nobel Prize winners can get it wrong with alarming consequences. Statistically speaking, it is only a matter of time before any management makes costly misjudgments. Almost every company can make major mistakes without imposing stress on our financial system. Even if these companies are large, they are subject to market and government regulation that does not permit financial intermediaries to expose themselves to excessive risk; if such dominoes fall, no others are nearby. Therefore, few companies occupy such strategic ground that their troubles will ripple across the country with alarming speed and danger. Fannie Mae and Freddie Mac are two such companies, and they are weakly regulated.

In 1986, when Fannie Mae and Freddie Mac were one-tenth the size they are today, limited oversight provided adequate protection against market disruption. By the early 1990s, Congress recognized that systemic risk was increasing, and strengthened GSE regulation. Now that Fannie Mae and Freddie Mac are five times larger than they were in 1992, the need for broader regulation is urgent. As these two companies grow larger, systemic risk is not rising proportionately. It's rising exponentially. Today, these two GSEs have grown so large that they need regulation consistent with the "precautionary principle" that compels the development of safety systems that become increasingly robust as danger escalates. Enhanced regulatory powers, strengthening as the companies grow even larger, is in the best interest of workers, savers, investors, and taxpayers.

## **Report Overview**

Fannie Mae and Freddie Mac control two trillion dollars of financial assets in two companies that are connected to a multitude of other financial institutions through many different types of linkage. This means that a financial shock at one of the GSEs will cause shock waves to spread throughout the financial system. Moreover, because the marketplace perceives that obligations of the GSEs carry the implicit backing of the federal government, banks and thrifts do not carry sufficient capital to cover default risk for their holdings of GSE securities. This report has four sections:

- It begins with an overview of the financial vulnerability of the two GSEs, including their rapid growth, high leverage, and supervision by a weak federal regulator. In effect, it shows why many fear the first domino is wobbling.
- It continues with an analysis of some of the major linkages between the GSEs and other financial institutions, including widespread holdings of GSE obligations by banks and thrift institutions.
- It then turns to a discussion of the problem of a GSE or other institution that is considered “too big to fail.” In other words, the institution’s failure would threaten such pervasive systemic damage that the government comes under irresistible pressure to bail it out and protect holders of its obligations from loss.
- Finally, it lays out solutions that should be implemented by the Office of Federal Housing Enterprise Oversight (OFHEO) and recommendations for Congress.

The report’s concluding remarks suggest precautionary steps to take now and in the future to contain systemic risk.

## SECTION ONE: GSE INSTABILITY AND ITS CAUSES

### **Leverage-Fueled Growth and Light Regulation Make the GSEs Unique**

Fannie Mae and Freddie Mac are very large institutions and they are growing rapidly. *They own more first mortgages than all fifty of the top bank holding companies combined!* Together, their annual debt issuances almost equal that of the U.S. Treasury – and soon they will surpass the U.S. government. 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. Also, because they concentrate in a single line of business, there is a chance that one national problem could devalue their portfolios.

Moreover, Fannie Mae and Freddie Mac are exceptionally leveraged, compared to other institutions in the mortgage market. Federal Reserve Chairman Alan Greenspan has warned House Financial Services Capital Markets 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 GSEs Can Fall Victim to Financial Vulnerability**

There are two major scenarios for GSE financial failure. The first would be if the value of the assets that a GSE holds or guarantees – single-family residential mortgages – were to lose sufficient value. This scenario is unlikely to occur suddenly. Moreover, if it did occur, this is likely to be in the context of a prolonged, deep recession.

The second scenario is more probable than the first. This would be the occurrence of a significant loss at a GSE that results in pressure on management to “bet the bank,” *i.e.*, increase financial risk by taking a large gamble to recoup the original loss. Betting the bank occurred at many thrift institutions that incurred losses because of a serious interest rate mismatch in the early 1980s, for example. Such risky gambles often compound initial losses substantially. The problem of a weak regulator is especially important in this scenario: it is not clear that OFHEO has the capacity either to detect the first loss or to act to prevent managers of a troubled GSE from trying to “bet the bank.”

GSE managements do not recognize concerns that their missteps could plunge their companies into insolvency. 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.

LTCM was highly leveraged, so its debt quickly surpassed its asset values when the market plummeted. The New York Federal Reserve Bank brokered a bailout to prevent insured financial institutions from incurring losses on their LTCM investments that would dangerously impair their capital positions.

- 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. 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.

The following are commonly heard fears about GSEs and their financial vulnerabilities that make “betting the bank” more likely:

- 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;
- According to Dow Jones Newswire<sup>1</sup>, the GSEs’ giant derivatives portfolios are “the glue that hold together their enormously leveraged businesses.” In 2000, only \$35 billion in shareholder’s equity supported over \$700 billion of notional

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<sup>1</sup> *Dow Jones Newswire*, January 22, 2001.

derivatives risk. If only a few counterparties fail to perform, or if the GSEs hedge strategies have not adequately covered derivatives risk, this equity could disappear overnight;

- 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 government subsidies.
- They have on retainer an array of lobbyists and ex-government officials that likely would be deployed to limit early intervention efforts by their regulator to manage a troubled GSE.

Finally, a small financial regulator, the Office of Federal Housing Enterprise Oversight, with inadequate statutory authority, supervises Fannie Mae and Freddie Mac. The shortcomings of the regulator include:

- OFHEO is subject to the annual appropriations process. The GSEs have used their lobbying strength to limit OFHEO's appropriations;
- The GAO has found that OFHEO lacks the regulatory enforcement powers that are possessed by other federal regulators, including the bank and thrift regulators and even the Farm Credit Administration, another GSE regulator;
- OFHEO lacks the authority to put a failed GSE into receivership; and
- OFHEO is located within the Department of Housing and Urban Development rather than at the Treasury, a department that would have the stature and motivation to protect OFHEO from political attack.

## SECTION TWO: THE 'DOMINO EFFECT'

### Linkages Can Transmit Shock From Troubled GSEs to Other Financial Institutions

Of course, it is not the prospect of large losses at a GSE alone that creates systemic risk. After all, the stock market 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 and investors that were unleveraged. Therefore, there was no contagion effect. If a GSE stumbles, the same cannot be said. Contagion is likely.

When Continental Illinois failed in 1984, the Comptroller of the Currency warned that over 2,000 banks had made deposits or invested in Continental Illinois obligations and that over a hundred banks might fail if Continental closed without a bailout. Yet, Continental was only a \$41 billion institution, about 25 times smaller than Fannie Mae or Freddie Mac.

Many leveraged financial institutions own a large amount of GSE financial obligations. This creates an environment conducive to the transmission of risk from a GSE to the larger financial system; if a GSE became troubled, holders of GSE debt might panic and try to sell at a loss. As the market value of GSE debt obligations dropped, the capitalization of banks with large holdings of this debt could be threatened to the point that regulators might believe themselves obligated to intervene to close the banks.

In Congressional testimony on March 22, 2000, Gary Gensler, the Undersecretary of the Treasury for Domestic Finance addressed this issue. He declared that there are significant linkages between insured depositories and GSEs. Consequently, he recommended that Congress limit bank and thrift investments in GSE debt obligations to amounts that conform to the "loans to one borrower" rule that applies to other loans. As Gensler declared:

To protect the exposure of banking institutions, current law places limits on an individual bank's credit exposure to any one entity. National banks may hold no more than 10 percent of their capital in the corporate bonds of any one issuer or lend unsecured more than 15 percent of their capital to any one borrower. Most state banks are subject to similar limits. ***Among all debt securities issued by private companies, however, only GSE debt securities are exempt from this investment limit.***

At the hearing, the Undersecretary released official statistics to document that GSE debt has become an excessive percentage of banking system assets. He stated 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, this understates the exposure of the banking system to GSE health. In addition to direct debt, banks *also* held over \$355 billion in mortgage-

backed securities (MBSs) guaranteed by the GSEs. As used here, the term "debt obligation" refers to the unsecured debt issued by a GSE; 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 MBSs. The GSEs also are counterparties to banks and other financial services companies due to their rapidly growing derivatives portfolios, currently at over \$700 billion in notional amount.

### **The Unquantified Cost of Derivatives Risk**

The GSEs are major players in the derivatives market. Counterparty risk can be many times larger than the liabilities on their balance sheets. When Long Term Capital Management was on the brink of default, its investors learned that a default on *any one* of seven thousand outstanding derivatives contracts would automatically trigger a default in all contracts, having a total notional value of *\$1.4 trillion*. At its zenith, LTCM had total assets of approximately \$130 billion and capital of \$4.7 billion standing behind this trillion dollar counterparty arrangement. Fannie Mae is running its own derivatives business with substantially higher leverage than LTCM. The *Wall Street Journal* recently reported that Fannie Mae had a debt-to-equity ratio on its derivatives portfolio of 209 percent. Together, Fannie Mae and Freddie Mac held a notional amount of \$743 billion of derivatives outstanding as of September 30, 2000. OFHEO must quantify and monitor counterparty risk, which may be a major source of market disruption in the event of a GSE failure.

### **One Sick GSE Will Infect the Other**

It is important to note that there is a substantial likelihood of contagion between GSEs. In the event the government does not prevent a GSE failure, investors are likely to try to cash out of their investments in securities of other GSEs as well. Quickly, more than one trillion dollars in debt obligations of all GSEs, and other agency obligations as well, would lose value as panicked investors rushed to sell. Debt obligations are likely to lose much more value than GSE-guaranteed MBSs, which are backed by mortgage collateral and have a source of repayment independent from the GSEs.

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. Excessive purchases by insurance companies, like those of banks, should trouble regulators for the same reason: GSE failure might lead to insurance company insolvencies.

### **Even the Federal Reserve Has GSE Exposure**

The Federal Reserve Board staff should be concerned about the prospect of a GSE failure. GSEs are probably the largest private users of the Federal Reserve payments system, called Fedwire. The Federal Reserve guarantees the settlement of payments to transfer GSE securities and also to make payments to holders of GSE debt obligations

and MBSs. If a GSE becomes unable to meet its obligations, the Fed could find itself at risk on those guarantees.

### **GSE Size and Leverage Add Risk to the System**

Fannie Mae and Freddie Mac do not reduce risk to the financial system. In fact, GSEs help other institutions to exploit regulatory arbitrage, the term Alan Greenspan uses when institutions collectively take advantage of differences in regulatory structures to minimize their total capital cushions and thereby maximize their leverage. GSEs have the lowest capital standards, making it profitable for banks and thrifts to sell mortgages and other assets to them to be held or guaranteed by the GSEs. The equity cushions of financial institutions provide a bulwark against panic. This regulatory arbitrage drains equity capital, the bulwark against panic, from the financial system. It also concentrates mortgage holdings in financial institutions – GSEs – that are subject to less thorough government financial supervision than the alternative holders of these mortgages and therefore increases risk to the financial system as a whole.

### **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 and by directing and encouraging the GSEs to limit their portfolios and rely primarily on MBSs 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 will make the information-based systems of a failed GSE available to the primary mortgage market. For example, OFHEO could request authority for a failed GSE in the future to operate under OFHEO supervision as a type of “bridge bank.” This might permit the mortgage market and its auxiliary services to function while the Congress legislates a new and more competitive secondary mortgage market.

## SECTION THREE: “TOO BIG TO FAIL?”

### The Problem of GSEs Being Considered “Too Big to Fail”

If only shareholder losses are evaluated, Fannie Mae and Freddie Mac are certainly not “too big to fail.” Their combined market capitalization is a small fraction of what NASDAQ investors alone have lost this year. If contagion were not a risk, it would matter little if GSE shareholders lost every penny. The only justification for a bailout is to protect innocent parties from a financial panic. Although Fannie Mae and Freddie Mac dominate the mortgage market, they are considerably smaller than the U.S. giants that dominate the stock market, as recent closing prices demonstrate. 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 absorb both gains and losses privately, 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.

**Table One: Market Capitalization of GSEs Compared to Major U.S. Corporations**

	Jan. 12 Stock Price	Shares Outstanding	Market Capitalization
Microsoft	\$53.5	5,332,338,000	\$285,280,083,000
Intel	\$32.125	6,730,000,000	\$216,201,250,000
AOL	\$46.47	4,327,226,000	\$201,086,192,220
Bank of America	\$49.0625	1,627,537,000	\$79,851,034,063
Fannie Mae	\$77.5	1,007,385,000	\$78,072,337,500
American Express	\$47.9375	1,329,976,000	\$63,755,724,500
Freddie Mac	\$62.4375	695,091,000	\$43,399,744,313

This dispenses with the claims of stockholders. They have no right to expect federal help under any conditions. The high leverage of the GSEs, however, means that much more GSE debt is outstanding than equity. Together, Fannie Mae and Freddie Mac have about one trillion dollars of debt obligations outstanding, plus another \$1.2 trillion of outstanding MBSs. Do debt holders have a legitimate claim to taxpayer funds? As a matter of law, the answer is “no.” 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.”<sup>2</sup>

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

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<sup>2</sup> Freddie Mac Charter Act, Section 306(h)(2).

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.<sup>3</sup>

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.

### **Regulator Diligence Can Minimize the Contagion Effect**

With no legal obligation to do so, the only justification for a taxpayer bailout of GSE debt holders is to avoid contagion. If OFHEO has not taken adequate steps to prevent contagion after a GSE misstep, then it should insist that debt holders take the maximum amount of losses possible before taxpayer funds are committed.

Establishing concentration limits for pension funds also is appropriate. Since the federal government insures most pension plans, it would have a contingent liability to cover losses incurred on GSE debt in these portfolios. There is no reason to regulate purchases by state, local, and foreign governments; however, they need to be protected in advance by a clear warning that, as debt holders, they will not be bailed out, ever.

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<sup>3</sup> 12 U.S.C. § 4503.

## **SECTION FOUR: REDUCING SYSTEMIC RISK**

The amount of disruption that a GSE failure causes depends on the government's reaction speed. If the federal government stops losses before they exceed GSE capital, then disruption can be contained and only minor macroeconomic damage will result. However, the weak state of supervision of Fannie Mae and Freddie Mac makes this an outcome that is far from assured. Fannie Mae and Freddie Mac possess a threatening combination of three factors – size, high leverage and limited financial supervision – that greatly increase the odds that the government will not be able to deal with a high-impact event before it transmits a major shock both to other institutions and throughout the housing market.

### **OFHEO Has Authority to Initiate Change Now**

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 a number of steps that OFHEO can and should take now to reduce the transmission of a financial shock from a GSE to the rest of the financial system. Most important, OFHEO must establish controls to prevent a GSE from “betting the bank” if it gets into financial difficulty. These controls require the establishment of early warning systems to detect any significant change in the risk profile of a GSE. OFHEO should require each GSE to submit a quarterly report on risks, signed and certified by senior GSE officials. The GSE also would be required to report immediately on any changes in risk profile from those in the most recent certified report. OFHEO should require the GSEs to publish these reports publicly at the time they are transmitted so that investors could rely upon them. This publication of risk to investors will extend legal liability to responsible GSE officials for failures to make accurate, material statements about risk in a timely fashion.

Second, OFHEO needs to 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 make arrangements in advance with bank regulators so that it has access to adequate resources in the event of a crisis.

Third, OFHEO needs to prepare policies and procedures now, before any crisis, so that a clear work out strategy is in place. OFHEO can avoid significant missteps if it works out the details of intervention before rather than in the midst of an unfolding crisis. Indeed, it will be at a time of crisis that OFHEO will prove its value to taxpayers. The handbook should specify all stakeholders' rights, including priorities of creditors in the event of OFHEO intervention. In developing stakeholders' rights, OFHEO should use the rulemaking process now to declare it would wind up a failed GSE without committing

taxpayer funds to assist stockholders or debt holders. That publication will place stockholders and debt holders on notice that OFHEO takes seriously its responsibilities under Section 1304 of the 1992 Act, compelling debt holders to take losses rather than imposing them on taxpayers.

Fourth, OFHEO should specify in rulemaking the priority of MBS holders over debt holders and of debt holders over stockholders. The articulation of these priorities will have a salutary effect. Investors will be encouraged to shift their holdings from GSE debt obligations to GSE MBSs. The housing markets will be reassured that, even if investors shift their investments out of debt obligations, MBSs will continue to exist as a stable source of housing funding.

### **New Legislation is Required to Reduce Systemic Risk From GSEs**

OFHEO operates under statutory constraints that inhibit it from preventing a systemic collapse. As numerous commentators have pointed out, OFHEO lacks many of 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 present a comprehensive list of remedial proposals to Congress. The legislative changes fall into three categories:

#### 1) Reducing risk to the financial system from Fannie Mae and Freddie Mac

Two statutory changes could reduce GSE risk to the financial system. First, and most important, GSE capital requirements should conform to those that apply to commercial banks, and assure that the GSEs have capital parity with insured depository institutions under Basel accord guidelines. Banks are subject both to a leverage requirement and to risk-based requirements. Fannie Mae and Freddie Mac also are subject to leverage and risk-based requirements, but at far lower and riskier levels than banks. Increasing capital cushions at Fannie Mae and Freddie Mac will increase the time available to OFHEO to deal with a financial crisis. A larger equity cushion will reduce the pressure on the managers of a troubled GSE to bet the bank. The managers will be discouraged from risk-taking if they still have significant stockholder capital at risk after the GSE has taken the first shock. Under current conditions of very thin capitalization, GSE managers will be under far more pressure to bet the bank in the event of 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. Taxpayers often are big losers when others reap the gains from speculation while they suffer the losses.

Second, Congress can help reduce risk by enacting a statutory provision to limit the amount of debt obligations that each GSE may have outstanding at any time. This limit should be expressed in terms of a fixed dollar amount or, alternatively, in terms of a fixed percentage of the conforming mortgage market as defined by OFHEO each year according to a set formula. Limiting the amount of debt the GSEs can issue will limit the size of GSE portfolios, while leaving the amount of MBSs uncapped. This will shield the residential mortgage market from a GSE shock. If the GSEs' portfolio sizes are limited,

then they will conduct more of their business through mortgage-backed securities and thus will reduce the amount of interest-rate risk that they take. If a shock occurs, the robust MBS market will be largely insulated from problems because MBS holders have a secured interest. This will reduce the extent that a shock to a GSE spills over into the rest of the financial system, and into the housing market in particular.

If stronger market discipline were in place, both the GSEs and holders of GSE securities would become more able to withstand the shock of GSE losses. Treasury Undersecretary Gensler's proposal to limit bank holdings of GSE debt obligations is an essential step, but others are needed. ***The GSEs should be required to issue federally uninsured convertible subordinated debt that automatically converts to equity whenever a GSE fails to meet the statutory standards for adequate capitalization – i.e., if a GSE's capital falls below the minimum capital requirement.*** Unlike the so-called “subordinated debt” that the GSEs have begun to issue, which carry implied federal guarantees like other GSE debt obligations, the proposed convertible subordinated debt would provide a non-federal capital cushion at a time of financial shock. Purchasers of convertible subordinated debt might create a source of market discipline. Under the right circumstances, price changes in these publicly traded obligations could signal both to regulators and investors if there were perceived changes in GSE risk.

A “too big to fail” perception weakens market discipline. Following the Continental Illinois bailout, Congress passed and President Bush signed the FDIC Improvements Act of 1991 (FDICIA), to deal with the problem of too big to fail. The government has created barriers to reduce or eliminate transmission of shocks from large insured depository institutions that potentially are too big to fail to the rest of the financial system. Another important source of market discipline would be the enactment of FDICIA-type provisions to expand the current protections against committing taxpayer money to assist insured depositories to cover Fannie Mae and Freddie Mac as well. Both stockholders and debt holders will become a more significant source of financial discipline on GSE risk-taking if they were more certain that taxpayer money would not be available to bail them out.

Finally, the SEC exemption of GSE securities should be eliminated. The removal of the SEC exemption would increase market discipline by subjecting the GSEs to disclosure rules and other SEC requirements that enhance the quality of information available both to stockholders and to other security holders. The Treasury, SEC, and Federal Reserve Board recommended such disclosures in a Joint Report released in January 1992. Given the rapid growth and market dominance of the GSEs, the need for disclosure parity with other publicly traded companies is critical.

## 2) 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. Many 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 added authority to intervene before, rather than after, the GSE has taken a loss that results in impaired capital. The regulator that oversees the safety and soundness of Fannie Mae and Freddie Mac must have a clear mandate. It must have the explicit authority to initiate interim regulatory steps to mitigate potential losses, and to act promptly in the event it must close a troubled enterprise and wind up its affairs, before losses become large enough to jeopardize the viability of other institutions that invest in GSE debt obligations.

This means that the laws governing Fannie Mae and Freddie Mac need altering to allow OFHEO to place a failed institution into receivership, in conformance with the powers of the federal bank supervisors. If a troubled institution continues to operate, its shareholders have dangerous and asymmetric motivations. Shareholders already face maximum losses, which can only be recouped through making dangerous bets – heads they win, tails the government’s liabilities grow. To contain taxpayer exposure, OFHEO should have the authority to place a failed GSE into receivership and to wind up the institution.

Unfortunately, OFHEO has neither the power to place a failed Fannie Mae or Freddie Mac into receivership nor the express obligation to take prompt corrective action and close the institution at least cost to taxpayers. The absence of these safeguards creates uncertainty about the government’s actions when Fannie Mae or Freddie Mac gets into trouble. One consequence of the contrast between banks and the GSEs is that the government might find itself forced to permit a failing GSE to try to extricate itself from its financial problems, even if this meant greater taxpayer exposure than if the government acted promptly. As with the failing thrift industry in the 1980s, the result could be to compound taxpayer losses and systemic risk.

As a young regulator overseeing only two very large enterprises, OFHEO faces unique situations. For example, it cannot create statistical databases with peer data from other housing enterprises to help it make early identification of problem situations. The Federal Reserve, OCC and FDIC have data and experience gained from overseeing banks and thrifts, and it would be valuable to use their input to develop conforming rules that would apply at a time of crisis so that all parties can anticipate OFHEO's behavior. At the same time, OFHEO should work to make its oversight of such large institutions equal to the authority the OCC and Federal Reserve exercise over the largest institutions under their jurisdiction. In addition, OFHEO’s regulatory authority must expand as GSEs grow. This gives appropriate oversight to the GSEs, consistent with the precautionary principle that finds that systemic risk grows exponentially with the size of GSE debt concentrations on the balance sheets of financial institutions.

Finally, to truly act as an independent and impartial regulator, OFHEO must be freed from any link to the appropriations process by conforming to the manner in which the federal bank supervisors are funded.

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

At least two statutory provisions would reduce the possibility that a shock to a GSE would be transmitted to other institutions in the financial system. Perhaps most important, changes in the manner in which Fannie Mae and Freddie Mac have access to the Fedwire system can act as effective risk insulators. Currently, the two GSEs use the Federal Reserve System as a fiscal agent and also to hold and transfer debt obligations and MBSs through the Fed book-entry system. Unlike other non-bank institutions, the GSEs have direct access to Fedwire. This creates the potential for transmission of risk from a troubled GSE to the Federal Reserve, which guarantees overdrafts on Fedwire. Instead of permitting direct access of Fannie Mae and Freddie Mac to the payments system, it would be helpful to require that they have access only through a properly supervised federally insured bank.

Alternatively, the Federal Reserve may wish to require a private letter of credit to back GSE accounts. The holder of the letter of credit would not hold an agency-status obligation, but instead would be in the position of an unsecured general creditor in the event of a financial mishap. (The lack of agency status for such creditors has already been tested, in the case of the liquidation of one of the failed Farm Credit institutions in the 1980s.) If the letter were properly crafted, then the issuer of such a letter of credit would need to look to the financial strength of the GSE to determine the price that it would charge. By interposing a well-capitalized and well-regulated financial institution between the GSE and the payment system, the risk of transmission of a financial shock from the GSE can be reduced substantially.

Secondly, FDICIA included a special provision that requires the Board of Governors of the Federal Reserve System to impose limits on interbank liabilities, i.e., liabilities that one insured depository owes to another. The law needs to be expanded to cover *interinstitution* liabilities more broadly, including liabilities between GSEs and banks and between GSEs. Again, this change can help to limit the transmission of a shock in the event of crisis.

Another method of reducing contagion is to apply “loans to one borrower” rules to holdings of GSE debt obligations, but not MBSs, by financial institutions. If GSE debt holdings are limited to the amount deemed prudent for banks and thrifts, financial institutions will be better able to absorb the impact that GSE financial troubles would impose on the market.

### **Closing Remarks: Modest Steps Greatly Increase Protection of the System**

The rapid growth and ensuing market dominance of the GSEs means that it is important to address systemic risk now. If appropriate regulatory systems had been put in place in 1992 – when Fannie Mae and Freddie Mac were less than a quarter of the size that they are today and their balance sheets carried only 20 percent of the long term debt

they have now – this growth could have been moderated, reducing today’s dangerous, and growing, level of systemic risk to a tolerable amount.

Establishing protective rules now would not be an idle exercise. Given the widespread distribution of GSE debt obligations among federally insured depository institutions (i.e., banks and thrift institutions) that are also leveraged, the government should 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 when the seemingly improbable eventually occurs.

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 GSE loss. 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.

As new rules are set in place, it is important to include the provision for even stronger regulation if the GSEs continue the pace of growth they have achieved during the past five years. Greater size brings broader market impact. The precautionary principle requires that dynamic steps be taken continuously to offset the heightened danger inherent in relentless GSE debt growth. All stakeholders –taxpayers, other financial institutions, brokerage firms, consumers, and investors, just to name a few – are best served by assuring that Fannie Mae and Freddie Mac remain safe and sound. Falling dominoes should remain a child’s game.

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