McDonald, Oonagh. "The GSEs and the Developing Crisis." *Fannie Mae and Freddie Mac: Turning the American Dream into a Nightmare*. London: Bloomsbury Academic, 2012. 115–141. *Bloomsbury Collections*. Web. 26 Apr. 2023. <<http://dx.doi.org/10.5040/9781780930039.ch-006>>.

Downloaded from Bloomsbury Collections, www.bloomsburycollections.com, 26 April 2023, 13:12 UTC.

Copyright © Oonagh McDonald 2012. You may share this work for non-commercial purposes only, provided you give attribution to the copyright holder and the publisher, and provide a link to the Creative Commons licence.

The GSEs and the Developing Crisis

A little history

Fannie Mae and Freddie Mac sound like someone's aunt and uncle, just up from the country. They are in fact the two most important Government Sponsored Enterprises (GSEs), charged with creating liquidity in the secondary mortgage market. It is hard to understand what role they have in a mature banking system, and why so many Americans think that if they did not exist, it would be necessary to invent them. A little history is necessary to explain why they came into being; more analysis is necessary to explain why they continue to operate in spite of growing unease about the risks they have posed, not just to the mortgage market but to the economy as a whole.

There are five GSEs, comprising Fannie, Freddie, the Federal Home Loan Bank (FHLB) System, the Farm Credit System (FCS) and the Federal Agricultural Mortgage Corporation (Farmer Mac).¹ All had their roots in the Great Depression, as part of Roosevelt's New Deal; they were designed to handle the lack of liquidity in the housing market, and to quell the rising wave of defaults. The National Housing Act was passed in 1934 to seek to strengthen the market, followed by the creation of the Federal National Mortgage Association (Fannie Mae) in 1938, with the aim of combating the unwillingness or inability of lenders to ensure a reliable supply of mortgage credit throughout the country. Fannie Mae's original purpose was to purchase, hold or sell Federal Housing Association (FHA)-insured mortgage loans, originated by private lenders, followed by Veterans Administration (VA) loans after World War II.

The first changes occurred with the 1954 Charter Act, which set out the basic framework under which Fannie Mae operated until 2008, but did not remove it from direct federal control at that stage. The Act also removed government backing for what Fannie Mae borrowed on the market to fund its secondary market operations. It also laid down the means by which its secondary market operations would be transferred to the private sector; proceeds from the gradual sale of common stock were to be used to retire Treasury-owned preferred stock in Fannie Mae. That process was completed in September 1968 so that Fannie Mae could be transformed into a Government Sponsored Enterprise (or private corporation). The Charter Act also divided Fannie Mae into two parts: Ginnie Mae as above, responsible for the then existing special assistance programs; and Fannie Mae, the transformation of

which was completed in 1968. The same Act allowed the issuance of mortgage-backed securities, and provided for HUD's continuing oversight of Fannie Mae's activities to ensure that it fulfilled its public purposes. Ginnie Mae purchases packages of qualifying FHA, VA, RHS (Rural Housing Service) and PIH (Public and Indian Housing) loans, converts them into mortgage-backed securities, and guarantees the timely payment of principal and interest to the lenders. It was the first to introduce MBSs in 1970, and states on its website that it "converts individual mortgages into safe, liquid securities for investors around the world," thus helping to channel global capital into American housing markets, making more mortgages available. These are the only MBSs which are truly guaranteed by the "full faith and credit guaranty of the United States Government." A rider has been added to the effect that "this means that even in difficult times an investment in Ginnie Mae MBSs is one of the safest an investor can make." Ginnie is also closer to the federal government in that the president is appointed by the President and answers to the Secretary of Housing.

The Emergency Home Finance Act 1970 created Freddie Mac and authorized it to create a secondary market for conventional mortgages. Until the Financial Institutions Reform and Enforcement Act of 1989 (FIRREA), Freddie Mac was owned by the Federal Home Loan Bank (FHLB) System; when the Savings & Loans crisis of the late 1980s precipitated the restructuring of the savings industry, Congress transformed it into another independent GSE with an 18-member board and established HUD as its regulator. Both GSEs were then authorized to provide a secondary market for conventional mortgages in addition to government-insured and guaranteed loans.

The key legislation covering the housing GSEs for the years 1992 until 2008 (when it was replaced by the Housing and Economic Recovery Act) was the Federal Housing Enterprise Financial Safety and Soundness Act (FHEFSSA). This created the Office of Federal Housing Enterprise Oversight (OFHEO) as the new regulatory office within HUD, whose main responsibility was to "ensure that Fannie Mae and Freddie Mac are adequately capitalized and operating safely." Under the Act, OFHEO was subject to the Congressional appropriations process but was financed by semi-annual assessments on the GSEs, subject to Congressional approval. HUD has the statutory authority to ensure that the GSEs fulfil their mission of promoting housing and home-ownership opportunities for all. Congress had not been convinced that HUD's regulatory framework sufficiently benefited low- to moderate-income families and those who live in underserved areas, hence the 1992 Act required HUD to develop, implement and enforce a comprehensive housing mission framework and set goals for the GSEs, a process that involved HUD in long and complex discussions with the industry, the GSEs and community advocates, amongst others.

The GSEs' roots lay, not only in the Great Depression and its aftermath, but also in a fragmented banking system with quite different mortgage rates

operating throughout the country. Relatively small banks arranged mortgages, which they then held on their books until maturity. As well as being highly fragmented, the banking system remained relatively static between the 1930s and the 1970s, with restrictions on setting up branches that were so severe that most states at the time either limited branching, or prohibited it altogether. By the early 1970s, only 12 states allowed unrestricted state-wide banking, but between 1970 and 1994, 38 states had deregulated their banking restrictions. Until the 1980s, cross-state ownership of banks was effectively prohibited by the application of the Douglas Amendment to the 1956 Bank Holding Company (BHC) Act. This prevented a BHC from acquiring banks outside the state where it was headquartered unless the target bank's state allowed such an acquisition (which they all refused). This was by and large the situation until the early 1990s and the Riegle-Neal Interstate Banking and Branching Efficiency Act, 1994, which led to the wave of mergers and acquisitions already described, transforming the banking industry in the USA and inevitably leading many to doubt the continuing value of the GSEs.

The structure of the GSEs

The peculiar structure of the GSEs as “hybrid institutions” led to them once being described as “serving two masters, but out of control.”² The reasons for that lie partly in the complex legal structure, making it difficult to amend their Charters or to take legal action against them; to regulate them, control or limit their activities. They are shareholder owned, profit-seeking corporations, created by Congress to help address America's housing needs. The advantage for a hard-pressed government is that they remove housing expenditure from its public-spending balance sheet, providing off-budget, market-based funding, which allows them to continue to grow without going back to Congress. Favored constituencies then receive a benefit for which Congressmen and Senators could claim credit.

The GSEs were owned by their private shareholders and were answerable to their board of directors. Although the government appointed five of the 18 board members, these were not distinguished from the other members by an obligation to represent personal views or those of the Administration. According to their Charters, the GSEs had to serve the public purposes set out in FHEFSSA, under HUD's supervision.

The advantages of GSE status

GSE status carries with it significant advantages, which Fannie Mae and Freddie Mac have exploited to their benefit over the years. Although many

observed and deplored their misuse over the years, those very same advantages made it difficult, if not virtually impossible, to implement the changes they saw were necessary.

As private firms, the GSEs were not covered by the laws applying to government agencies, and their directors, officers and employees did not become federal employees as a result of joining them, so were free from all the constraints on resources, staffing, procurement and procedures applying to federal agencies, even when carrying out public purposes. Because of their special status, the GSEs were free from state laws, and did not have to register or obtain a license in whichever state they chose to conduct business.

Congress was able to provide the housing GSEs with an appropriate and reasonably well-defined public purpose when they were established in 1968 and 1970, in terms of the provision of government-backed credit in view of the imperfections and limitations of the housing credit market at that time. The problem, for the Administration and for various Congressmen and Senators in the following years, lay in seeking to amend the statutory purposes in the light of market developments. Three difficulties lay in the way of redefining or limiting the public purposes for the GSEs in the light of market developments:

- (i) The problems in obtaining sufficient support in Congress or the Senate or for the Administration to find the political will to make the necessary changes.
- (ii) The lack of understanding amongst politicians and their advisors of the consequences of making specific changes to the GSEs' enabling legislation.
- (iii) The tendency of Congress to introduce so-called "technical amendments" put forward by the GSEs but without a full debate on the implications of the proposals, and how these might impact on the existing limits imposed on the way in which the housing GSEs fulfil their public purposes, as well as the means by which they do.³

The GSEs have two further advantages in both expanding their activities and in overcoming any challenges to their right to do so. Fannie Mae's Charter Act authorizes the company to "do all things as are necessary or incidental to the proper management of its affairs and the proper conduct of its business."⁴ Its complex legal framework means that the GSE can always resist a challenge in the courts, responding by claiming that its actions reduced the cost of its public purposes or enabled it to provide the services more efficiently.

The Charter does give HUD considerable authority to direct the activities of the GSEs, including the approval of new programs, when it states: "Except for the authority of the Director of the Office of Federal Housing Oversight ... and all other matters relating to the safety and soundness of the enterprises, the

Secretary of Housing and Urban Development shall have general regulatory power over each enterprise and shall make such rules and regulations as will be necessary and proper to assure that this part and the purposes of the Federal National Mortgage Association Charter Act and the Federal Home Loan Mortgage Corporation Charter Act are accomplished.”⁵ HUD’s lack of will, resources and leadership over the years meant that it could not exercise proper control over them.

HUD’s failed attempts to curtail Fannie and Freddie

In March 2000, William Apgar, Assistant Secretary for Housing, announced a wide-ranging review of the GSEs’ activities. “HUD’s new program review and approval responsibility is an integral part of the Department’s regulatory framework. Considerable resources are being made available ... to ensure that new activities are identified, analysed, and, if appropriate reviewed as new programs. HUD monitors the GSEs’ business activities on an on-going basis and recently requested information on a number of their initiatives, including their mortgage insurance initiatives and their various internet activities and partnerships.” He added, “neither GSE takes the view that these activities constitute ‘new programs’ as defined in current law, and they did not submit them to HUD for approval prior to introducing them to the market ... HUD staff are reviewing the material [which the GSEs finally submitted] to make these determinations.”⁶

Apgar announced that HUD had begun its first review of the GSEs’ automated underwriting systems and appraisal guidelines, since these had become the standards which lenders used to decide whether or not the GSEs would buy the borrower’s mortgage, allowing him/her to receive the most favorable interest rates. In 1999, HUD had requested extensive information about how the systems were developed and how they worked, including how the “scorecards” function in deciding which loans would be accepted. The GSEs provided huge amounts of information and data, which they claimed was highly confidential or proprietary business information. However, the aim was to see whether the systems helped all would-be borrowers, especially minorities, to obtain mortgages on favorable terms; the focus was on “fair lending” and not on the way in which the systems operated. The review itself took over two years to complete.

The decision to conduct such a review caused great excitement in the market. The Mortgage Bankers Association supported HUD’s action, claiming that Freddie Mac’s “HomeSteps Program is not in their charter, not in their mission,” and adding that the “GSEs should introduce new products and services only when they directly relate to their core functions of providing liquidity and stability in the secondary mortgage market.” America’s Community Bankers

wanted HUD to “use its statutory authority to disallow new or modified programs that are inconsistent with the statutory mission of Fannie and Freddie.”⁷ Of course, many lenders, appraisers and others wanted to clip Fannie and Freddie’s wings. Appraisers had already seen incursions into their territory as the automated underwriting systems began to include external-only property inspection reports as part of the decision-making process of loan purchase.

The GSEs eventually provided information, often unsatisfactory in HUD’s view, arguing that much of the information regarding the automated underwriting systems was proprietary, or else they delayed providing it. HUD threatened to use the various enforcement powers at its disposal, if information was not received by the end of January 2000. These included terminating or suspending the Statement of Understanding between HUD and Fannie implementing Fannie’s automated underwriting system for FHA loans; on-site verification of the accuracy and completeness of the information already provided by Fannie; cease and desist proceedings; or civil penalties ranging from \$5,000 per day to \$1m per day for serious violations. In the event, nothing much happened apart from a long-delayed Fair Lending Review, and the excitement died away.

HUD had the power, not only to set goals, but also to monitor and limit the GSEs’ new programs. When it came to it, the department did not act. It had neither the resources nor the will to use its powers under the Charter, knowing that the GSEs would simply use the argument that the new programs helped them cut the cost of mortgages for borrowers. HUD knew just how much political clout the GSEs possessed.

Charter Benefits

1. The Law treats the GSEs as “instrumentalities” of the federal government, rather than as fully private entities. Their Charters mean that they are exempt from all state and local income taxes.
2. They are also exempt from the Securities and Exchange Commission’s registration requirements and fees, and may use the Federal Reserve as their fiscal agent.
3. The US Treasury is authorized to lend \$2.25bn to both Fannie Mae and Freddie Mac, and \$4bn to the FHLBs.
4. GSE debt is eligible for use as collateral for public deposits, for unlimited investment by federally chartered banks and thrifts, and for purchase by the Federal Reserve in open-market operations. GSE securities are explicitly government securities under the Securities Exchange Act, 1934 and are exempt from the provisions of many state investor protection laws. These advantages have not been granted to any other shareholder-owned companies.

5. The much-debated “implicit” government guarantee is one which the government explicitly denies, as stated in a typical disclosure from a Fannie Mae prospectus: “The Certificates, together with the interest thereon, are not guaranteed by the United States. The obligations of Fannie Mae are obligations solely of the corporation and do not constitute an obligation of the United States or any agency or any instrumentality thereof other than the Corporation.” This was essential to comply with the Charter of each GSE. The Fannie Mae Charter includes the following provision:

“The Corporation shall insert in appropriate language in all of its obligations ... clearly indicating that such obligations, 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.”⁸

However, investors looked at the special treatment of GSE securities in their federal charters and concluded that the government would have to back them in the event of any serious problems.⁹ In a way, the statement seemed to hint at an implicit government guarantee, since it merely ruled out an explicit one, and such statements are not required in a prospectus issued by any private company. So, despite such explicit statements, Fannie Mae and Freddie Mac would by a nod and a wink imply that the government would not let them down. Anthony Marra, then deputy general counsel to Fannie Mae, argued in his submission to the Office of the Comptroller of the Currency that “Fannie Mae standard domestic obligations, like Treasuries, typically receive no rating on an issue-by-issue basis, because investors and rating agencies view the implied government backing of Fannie Mae as sufficient indication of the investment quality of Fannie Mae obligations.”¹⁰

But the debt issued and the MBSs guaranteed by the housing GSEs are more valuable to investors because of the perception of the government guarantee and other advantages from the federal government. This is the main way in which the federal government conveys a subsidy to the GSEs. Alan Greenspan noted in a letter to Congressman Richard Baker that “the GSE subsidy is unusual in that its size is determined by market perceptions, not by legislation ... The extent to which the subsidy is exploited is determined by the extent to which the GSEs choose to issue mortgage-backed securities, not by legislation.”¹¹ That implicit guarantee is communicated to investors in the capital markets through all the provisions set out above, including the appointment of some directors by the President of the United States. In addition, although federally chartered and federally insured banks face a limit on the amounts that they can invest in other types of securities, that limit does not apply to GSE securities. “Taken together, those statutory privileges have been sufficient to overcome an explicit denial of federal backing that the GSEs include in their prospectuses.”¹²

In May 2001, the Congressional Budget Office (CBO) noted that GSE securities were rated as “agency securities” and priced below US Treasuries and above AAA corporate obligations, thus reducing the borrowing costs for the GSEs, partly by promoting institutional acceptance. Then it was possible for the CBO to say that decisions by portfolio managers to invest in GSE securities did not have to be justified in terms of credit risk. The characteristics of acceptability and liquidity contributed to the relatively high price investors were willing to pay for GSE securities.¹³ In the event, although investors were wrong about credit risk, the markets were right about the implicit guarantees. Fannie Mae, especially, and Freddie Mac were simply “too big to fail,” and the government took them into conservatorship in September 2008.

Implications of the GSEs’ benefits

Costs and competition

These were spelt out in a paper by Barbara Miles, Specialist in Financial Institutions, Congressional Research Services, sparked off by Freddie Mac’s attempt to enter the mortgage insurance market via a “technical change” to its federal Charter.¹⁴ She noted that the GSE privileges can act as a barrier to entry by competitors and can result in a monopoly. Their exemptions and privileges were only granted to the GSEs to correct certain perceived market failures; once those have been corrected, the privileges then act to hold down the costs of operation for the GSEs, and can act as a barrier to entry by non-favored would-be competitors.

“The GSEs can reap greater-than-competitive profits, even while undercutting pricing of potential competitors. They need only price their products a little below what fully private companies would have to charge.” They only have to increase the business volume or risk in order to increase the subsidies; this obviously provides an incentive to dominate the markets in which they are supposed to operate and also to expand into related markets to the disadvantage of the efficient competitors without GSE charters.

The insurance market which Freddie Mac wished to enter already had a number of insurers and reinsurers, who strongly objected to the proposed competition from Freddie Mac. Freddie could undermine their business, since their costs were inevitably higher, given their lack of special privileges. Miles’s report is interesting in that she was one of the first to recognize the potential for market domination by Fannie Mae and Freddie Mac, later described as a duopoly.

The size and composition of the subsidy

In 2001, the CBO pointed out that the same combination of federal regulatory provisions and implied guarantees enhances the credit standing, market acceptance and liquidity of MBSs guaranteed by Fannie Mae and Freddie Mac.

- (i) The risk-based capital requirements for banks are lower for GSE-guaranteed MBSs than for private label MBSs. They offer a credit guarantee, which the market recognizes as being more valuable than a similar guarantee offered by a private company, reducing the rate of return that investors require on GSE-guaranteed MBSs below the rates required on private label MBSs. The mortgage pooler pays higher prices for mortgages and passes along the lower interest rates to borrowers and to charge higher guarantee fees than private guarantors. Fannie Mae and Freddie Mac undoubtedly made use of the latter benefit, but it is doubtful that borrowers benefited much from the possibility of lower interest rates.
- (ii) The direct benefits of regulatory and tax exemptions, including the lower cost of obtaining credit ratings for debt and MBS issues, are easy to calculate. These had a combined value of \$1.2bn in 2000.
- (iii) The value of the subsidy to General Obligation Debt Securities is more difficult to calculate and requires comparing the rates paid by the GSEs with the rates paid by comparable financial institutions with a credit rating in the range of AA to A. The entire analysis is not an easy one, partly because the rate reduction on GSE securities may vary with the maturity of the credit issued, and the default risk being lower over a short horizon than over a longer time period. A further problem is that it is difficult to determine the proportion of short-term debt, held by Fannie and Freddie, because of their extensive use of derivative securities such as swaps, which effectively transform short-term borrowing into long-term borrowing and vice versa. To calculate the effective quantity of the GSEs' short-term debt, their positions in derivative securities must also be analysed.

But as the CBO notes, not only is that information not publicly available, but it would be difficult to analyse even if it were. Fannie Mae and Freddie Mac reported that the percentage of debt which was effectively short-term after "synthetic extensions" at year-end 1999 was effectively 13% and 7% respectively. Those amounts contrast with the figures for nominal short-term debt of 41% and 49% reported on their respective balance sheets, especially when percentages of effective short-term debt in earlier years are higher, between 20% and 30%. The CBO decided to take the proportion at 20%, and to evaluate the total subsidy using a method designed to capture the total subsidy in a given year, the "capitalised subsidy."

On this basis, the total value of the federal subsidies for GSE debts from 1995 to 2000 for all three housing GSEs increased from \$3.7bn in 1995 to \$10.2bn in 1999, and dropped slightly in 2000 to \$8.8bn in total. Throughout the period, Fannie Mae generally benefited most from the subsidy, except in 1997, when the

FHLB subsidy stood at \$2bn compared with \$1.8bn for Fannie Mae, and again in 1999 when the FHLB issuance of debt benefited to the extent of \$4.5bn.

The subsidies to mortgage-backed securities are more difficult to calculate, but are deduced from the two components of the total subsidy. The first is that the advantage passed through to conforming mortgage borrowers was approximately 25 basis points. The second is the amount retained by the GSEs because of the higher guarantee fees they can charge as a result of their special status, which is approximately 20 basis points, and that they retain 5 basis points. As a result the total subsidy to Fannie Mae and Freddie Mac rose from \$2.5bn in 1995 to \$3.6bn in 2000, a fall from \$4.2bn in 1999 as a result of slowing economic growth. Putting all the calculations together, the subsidy to all three GSEs rose from \$6.8bn in 1995 to \$15.6bn in 1999, before falling back to \$13.6bn in 2000.¹⁵

The CBO Director had sent Fannie Mae and Freddie Mac a copy of the report in advance, for their comments on a confidential basis. The GSEs immediately and publicly attacked the study, as being “quite divorced from market reality,” saying it “should be completely disqualified from serious consideration” and was “fatally flawed.”¹⁶ The Director accused Fannie and Freddie of leaking the report, which of course they denied, but even so they aroused the ire of Congressman Richard Baker, Chairman of the Capital Markets subcommittee of the House Financial Services Committee. “Once more, I find myself forced into the unfortunate position of having to respond to what can only be adequately described as an orchestrated and audacious attack by Fannie Mae and Freddie Mac upon a respected federal government institution and its highest-ranking official ... In return for Mr Crippen’s courtesy [the Director of CBO], Fannie and Freddie have instead embarked on a full-scale assault, in public ... [which] began before even members of Congress for whom the report was produced had a chance to view it ... on top of these pre-emptive strikes ... Fannie and Freddie have gone so far as to accuse the Congressional Budget Office of using ‘inappropriate methodology, inaccurate assumptions and faulty analysis’.”¹⁷

The subsidies continued to increase over time, rising to \$23bn in 2003, an increase of nearly 69% over the \$13.6bn in 2000. That jump in the value of the subsidy was brought about by the GSEs’ rapid expansion in 2001. These estimates are based on the assumption that any increase in the GSEs’ outstanding debt and mortgage backed securities are sustained only until the acquired mortgages mature. Under the alternative assumption that the GSEs’ issued debt and MBSs are reissued when they mature, the federal subsidy for 2003 would be over \$46bn.¹⁸ Some of these estimates on the part of CBO have been challenged, but even Fannie Mae, after initial objections, did not pursue the matter further. Fannie may have realized that their initial reaction was a blunder, and that perhaps the better approach would have been to argue that the subsidy was passed on to borrowers in the form of lower mortgage rates, saving them billions of dollars. In that approach, they were more likely

to keep the support of Congressman Kanjorski, a key Democrat member of the House Financial Services Committee, whose response was that the “numbers themselves were not as significant as to see whether the subsidy is valuable and whether it’s going to the consumer.”¹⁹ That is, of course, the argument which Fannie and Freddie would pursue, regardless of the fact that most of the subsidy went to their shareholders and had little effect on the cost of mortgages.

Risks posed by Fannie Mae and Freddie Mac

Recognizing systemic risk

As the decade progressed, the focus shifted away from the extent of federal subsidies to awareness of the dominance of the GSEs and the increasing necessity to manage their risks. Once again, Barbara Miles was one of the first to recognize the risks involved in the implied government guarantee for the GSEs.²⁰ This was as a result of noting the then size of the outstanding debt of the three housing GSEs, which totalled \$1.7 trillion, compared with publicly held, marketable Treasury debt which was \$2.7 trillion at the end of the first quarter of 2000. At the then rate of growth, GSE debt could surpass Treasury debt by 2003. Adding in Fannie Mae and Freddie Mac’s outstanding guarantees of MBSs, which stood at \$1.21 trillion, their debts were almost equivalent to that of the US Treasury, raising concerns about the risks posed for the economy and the US government.

In the case of the GSEs, the normal business risks, such as interest rate risk, credit risk, business risks, management and operational risks were increased due to the lack of market discipline and the belief that GSE debt was virtually equivalent to Treasury. The GSEs at this stage were often the largest re-purchasers of their own MBSs. When mortgages were securitized and sold, the GSE retained the credit risk on the loans, but sold the interest rate risk to investors. MBSs are less profitable than portfolio holdings as a result; re-purchase restores profit along with the risk. Fannie Mae and Freddie Mac were the largest holders and purchasers of their own MBSs, holding nearly 30% of their own issuances and sometimes re-purchasing a volume equal to or greater than their issuances. This, of course, increased shareholder value but did little to assist the mortgage markets.

Miles also stressed the increase in systemic risk arising from the fact that the GSE Charter allows depository institutions to hold their debt and MBSs without limit, instead of the normal restriction to no more of 15% of capital in loans to a single borrower. In 1999, banks held over \$210bn in GSE debt, which was then about one-third of bank capital, and over \$355bn in MBSs. To this is added systematic risk, due to the legal restrictions on their diversification. They can only depend on one section of the economy, the housing market, and could

diversify away from this without a change in mission. The GSEs positioned themselves in the market by regular issuances of debt in a way that creates an alternative to the Treasury yield curve. “But a major economic drawback to using GSE securities ... is that for the benchmark to function properly, it should reflect only the risks inherent in the economy overall ... but the GSE securities include ... (only) housing sector risks.”²¹

Repeated warnings on the systemic risk of the size of the GSEs’ portfolios

Such warnings were not heeded by Congress, which refused to take steps to reduce the size of the GSEs’ portfolios, and certainly not by Fannie or Freddie. By 2002, their outstanding securities reached \$4 trillion, more than the then entire US public debt, as well as their MBSs, which by then accounted for almost 57% of residential mortgage debt. As the portfolios continued to grow, the new Director of the CBO, Douglas Holtz-Eakin, issued another warning.²² Once again, the risks to the tax payer were spelt out, described in this statement as interest rate, prepayment and operational risks. The housing GSEs offered public assurances that their assumed risks, especially for credit or default losses, were low in relation to their private capital, especially for credit or default losses. Fannie, one analyst suggested, is “essentially the world’s largest hedge fund (albeit an extraordinarily safe one) that profits from the difference between its incredibly low borrowing costs (a by-product of its bonds being implicitly backed by government) and the much higher yield of its \$860bn mortgage portfolio.” As long as Fannie’s borrowing costs remained low and the mortgage-backed securities market stayed open, Fannie’s earnings would continue to grow. This puts it all in a nutshell: the interest rate risk to which they were exposed, and the reason for the portfolio; for the yields.²³

The GSEs refused to recognize their exposure to interest rate risk, since an increase in interest rates would reduce the value of both fixed-rate assets and fixed-rate liabilities, but the value of the assets would be reduced further if the assets have a longer maturity than the liabilities. A rise in interest rates could eliminate their equity capital. The value of a portfolio of fixed-rate mortgages declines when borrowers exercise their right to re-finance and prepay their mortgages in response to a decline in market rates. The prepayment risk and the interest rate risk meant that the GSEs were vulnerable whichever way interest rates went. In order to limit these risks to the tax payer, the statement proposed tougher regulation, and notes that Congress could assist the regulators by increasing the minimum capital standards, or limiting the growth or profitability of the GSEs’ portfolio investments, or requiring the SEC registration of GSE securities, as some members of Congress proposed. Congress did not act on any of these proposals in 2003. Fannie Mae and Freddie Mac opposed any attempt to bring about changes.

In 2005, the CBO Director once again appeared before the Committee on Banking, Housing and Urban Affairs, US Senate.²⁴ The GSEs' two lines of business continued to grow: outstanding MBSs grew from about \$600bn in 1990 to \$2.3 trillion in 2004, whilst total debt, including the obligation of the FHLBs, increased from less than \$300bn to \$2.5 trillion over the same period. The risks were the same as those set out in the 2003 statement, the difference being that Fannie Mae and Freddie Mac offset much of the risk in their investment portfolios by issuing callable long-term debt (which matches the cash flows on mortgage debt), interest rate swaps (matching maturities on assets and debts), and other hedging strategies. Not all of the interest rate risk is covered, since it would be too expensive, and the two GSEs determine the level of risk they retain. Credit risk, though present, was not an immediate concern, masked as it was by low interest rates at that time. The statement set out a similar range of proposals for reducing the risks to the tax payer, the difference this time being that legislation was being considered in the Senate.

The GSEs fight against any attempt to reduce the size of their portfolios

The notion of the GSEs posing “systemic risk” of this kind was firmly rejected by Richard Syron, then Chairman and CEO of Freddie Mac, who saw the argument as merely an excuse to “cut the GSEs down to size,” more because of their arrogance than because of any risk they posed to the nation's housing system. He argued that if the GSEs were forced to reduce their holdings of mortgage backed securities, these would simply be “shifted to someone else's balance sheet”, that is, to one of the largest banks, since 40% of all US banks' mortgage-backed bonds were held by three institutions. This would mean that the systemic risk had only been moved, and not reduced. Outstanding mortgage debt had grown by 80% since 2000: the retained mortgage portfolios of Fannie Mae and Freddie Mac had increased by 75% since then, and the portfolios of the five largest banks and thrifts grown by 132%.²⁵

Of course, Syron did not mention the fact that the GSEs' debts alone included the “implicit government guarantee” and benefited from lower capital requirements than the major US banks to which he referred. Finally, the rate at which the GSEs would be required to sell off their MBSs would or could be staggered, and, at that stage, there was certainly no reason to think that US banks would be the only possible purchasers. Taken together as at the end of 2003, the 9,182 commercial banks and thrifts held \$3.1 trillion in residential mortgage debt (including whole loans, lines of credit and MBSs) or about 40.8% of the then \$7.6 trillion market. The two GSEs' investment portfolios alone accounted for 20.6%. The remaining one-third of residential mortgage debt was held by other US and foreign investors such as mutual funds, pension funds and insurance companies. The other banks and thrifts also

have a larger capital cushion than Fannie Mae and Freddie Mac were required to retain.

Syron's remarks were hardly objective, since the GSEs charged fees for the purchase of mortgages, an important source of their income; he seemed to envisage either a straightforward sale or a cap in order to handle the interest rate risk of the portfolios of mortgages they held. Other methods of constraining GSE risk-taking which may also lead to smaller portfolios included increasing capital requirements or imposing use fees on debt issuance. Each of these has different consequences.

The portfolios continued to grow and the warnings were more insistent

In April, 2005, Chairman Greenspan appeared before the Senate Banking Committee, urging Congress to place limits on the GSEs' portfolio of assets. "Almost all the concerns associated with systemic risk flow from the size of the balance sheets of the GSEs, not from their purchase of loans from home-mortgage originators and the subsequent securitization of these mortgages. We have been unable to find any purpose for the huge balance sheet of the GSEs, other than profit creation through the exploitation of the market-granted subsidy ... We at the Federal Reserve remain concerned about the growth and magnitude of the mortgage portfolios of the GSEs, which concentrate interest rate risk and prepayment risk at these two institutions and makes our financial system dependent on their ability to manage these risks."²⁶

Greenspan pointed out that the GSEs' annual return on equity often exceeded 25%, far in excess of the industry average of 15% among other large private competitors: "... Virtually none of the GSEs' excess return reflects higher yields on assets; it is almost wholly attributable to subsidized borrowings." The response to Greenspan's testimony was muted, with most preferring to leave the matter to a new, stronger regulator with the ability to determine the proper level of holdings if a risk was posed to safety and soundness. The Senate Committee obviously did not understand the risks, and no action was taken: nor was this the only occasion on which Chairman Greenspan warned of the risks. Unfortunately his words fell on deaf ears as far as Congress was concerned, or perhaps just on incomprehension.²⁷

In response to questions at the hearing, Greenspan said, "we do perceive that if the expansion should continue along the lines it's been growing ... and we see no reason that it is going to stop ... something will go wrong ... and since we are sufficiently on the safe side of the systemic risk horizon ... we have time now to make the adjustments in a manner which does not disrupt the economy or the financial system."

By November, 2005, Freddie Mac's retained portfolio grew at an annualized rate of 25.8%, to \$692.8bn. After an 11% decline in October, Freddie Mac

increased its purchases to \$32.8bn, bringing its annualized rate of growth to 6.7%. By the end of November, Freddie Mac's total portfolio size and market capitalization reached \$692.7bn and Fannie Mae reported a retained portfolio of \$715.5bn. This growth continued in the year in which the CBO advised reducing the portfolio limits and some members of Senate and Congress had set regulatory reform bills in train, and indeed during the time when the accounting scandals at both Fannie Mae and Freddie Mac had been brought to light.

But the size of their outstanding debts remained at almost \$1.5 trillion, which was borrowed to buy and carry portfolios of mortgages and mortgage backed securities, exposing them to the prepayment and interest rate risks which the CBO analysed. The risk was hedged in derivative transactions with notional values in trillions of dollars. A study by the Federal Reserve Bank of Atlanta, published in April 2006, argued that the highly leveraged (\$1.4 trillion) investment portfolios continued to pose a systemic risk and potential future social costs, in terms of a GSE failure having the potential to "have an adverse effect on the real economy."²⁸ The authors argued that there were various policy options to be considered: strict portfolio dollar caps; limiting portfolio activity to that required to support the GSEs securitization business and affordable housing missions; or increasing capital requirements or user fees on debt issuance. Each has different implications for GSE risk-taking incentives, portfolio composition and optimal size; for example, charging debt issuance user fees would simply strengthen investors' perception of an implied government guarantee of GSE debt obligations.

"Congress should not set specific limits but should set broad policy goals for regulatory agencies and then direct the agencies to set the specific details of regulatory standards, because the agencies are better versed in the minutiae of specific issues ... Congress could impose a maximum limit on the holding period for mortgage investments that provides more than sufficient time to securitize the assets but is short enough to clearly limit the size of the retained portfolio." On the other hand, if limits mean "putting a cap on the overall size of the retained portfolio it may be best not to leave this to regulatory discretion ... (This) would create an incentive for the politically powerful GSEs to continuously lobby the regulator and influential members of Congressional oversight committees to bring pressure to weaken portfolio constraints." Instead, Congress should "spell out the principles of portfolio limits and require the regulator to promulgate specific regulations."²⁹ In the light of these discussions, the comment of Douglas Duvall, spokesman for Freddie Mac, is interesting. "We continue to believe that our portfolio is central to our mission and it helps us provide a balance between fulfilling our affordable-housing mission and attracting international investments to America's doorstep."³⁰

Meanwhile, the GSEs' resistance to any attempt to curb their portfolios was further undermined by an analysis produced by economists of the Federal

Reserve Board, which showed that they had only helped to reduce US mortgage interest rates by 2 basis points between April 1997 and September 2005, well below their previous estimates of 15 to 18 basis points. The economists concluded that “both portfolio purchases and MBS issuance have negligible effects on mortgage rate spreads” and that “purchases are not any more effective than securitization at reducing mortgage interest rate spreads.”³¹ In their introduction, they point out that “earnings from mortgages held in portfolio clearly benefit GSE shareholders ... In particular, unusually heavy and sustained portfolio holdings might bid up the price of new mortgages, allowing originators to profit more or giving originators greater scope to lower mortgage interest rates paid by new borrowers.”³² It is possible to deduce from their research that the real purpose of the large portfolios was to increase the GSEs shareholders’ profitability (given that the influence on mortgage rates was negligible), and hence the “public benefit” was not obvious.

The battle over the portfolio limits continued throughout 2006 with Treasury Secretary John Snow’s statement that “We need to find a way to give the [GSE] regulators authority to ultimately make a decision on the size of the portfolios.”³³ The Undersecretary of Treasury for Domestic Finance, Randal Quarles, emphasized their concerns: “It is now widely recognized that the GSEs have relied upon their funding advantage to expend the size of their retained portfolios far beyond the levels necessary to achieve their mission. The concentration of risk inherent in these portfolios, along with the GSEs’ thin capital structure, is an important policy concern and a high priority for the Treasury, and we are continuing to urge Congress to take action soon to address these issues.”³⁴

Fannie and Freddie “voluntarily” agree to limit their portfolios after the accounting scandals

Meanwhile, Fannie Mae had signed a consent agreement with OFHEO agreeing to cap its retained mortgage-related portfolio to the December 31, 2005 level of \$727bn, and OFHEO’s Acting Director finally reached an agreement with Freddie Mac on August 1, 2006 to limit its portfolio growth to no more than 2% annually of mission-related assets above the June 30, 2006 limit of \$710.3bn. The growth should be limited to “purchases of multi-family whole loans, private-label asset-backed securities, commercial mortgage-backed securities and other assets that are intended to help [Freddie Mac] to meet its affordable housing goals or subgoals.” In his statement, Director James B. Lockhart III said, “I concur with the decision by Freddie Mac to limit the mortgage portfolio growth as recommended by OFHEO. Freddie Mac has a need to address the size and scope of its portfolio, particularly in the light of current operational problems surrounding accounting and internal controls ... As the Enterprise works to meet its statutory mission, this limit on portfolio

growth provides a public assurance that the Enterprise is committed to fixing its internal controls, reducing operational risks, and improving its accounting, and thereby emerging as a stronger firm.” In June 2006, the US Treasury and HUD announced separate inquiries that could lead to restrictions on Fannie Mae and Freddie Mac’s ability to finance their mortgage-related portfolios.

The Treasury Undersecretary Randal K. Quarles announced at a Women in Housing Finance luncheon that “the time is right for Treasury to review its debt approval process to ensure we continue to act as appropriate custodians of the power that Congress gave us when the Charters of Fannie Mae and Freddie Mac were created ... I have asked the Treasury staff to undertake such a review to ensure that the process by which we exercise this responsibility is appropriate in the light of all circumstances.” Those circumstances included the accounting scandals and the continued weaknesses in the GSEs’ accounting systems, risk management practices, and internal controls: “The Administration’s reform proposals are intended to ensure greater regulatory oversight, appropriate capital requirements, and alleviate systemic risk, and we continue to urge Congress to take action soon to address these issues. We strongly support GSE reform legislation that addresses each of these points, and in particular provides direction to limit the size of the GSEs’ investment portfolios.”³⁵ In effect, this meant that the Administration was supporting Senator Shelby’s bill.

HUD announces its own review

On the same day, Secretary Jackson announced that HUD would conduct a review of Fannie Mae and Freddie Mac’s investments and holdings, including certain equity and debt investments, with a focus on transactions classified on their financial statements as “other assets/other liabilities.” “HUD’s primary concern is whether the GSEs’ investment activities are consistent with their Charter authorities and their public purposes, and whether each is using the profits it derives as a government-sponsored enterprise for the purposes intended.” He also made it clear that he wished to work with Congress in establishing a strong new regulator, but until the legislation was passed, he intended to use the authority under the FHEFSSA to increase the transparency of the GSEs. The statement was immediately welcomed by the American Bankers Association in their press release the following day: “The GSEs’ business activities should remain focused on their mission of helping low- and moderate-income individuals afford homeownership in America. The announced action by HUD is an important step in clarifying permissible GSE activities ... it is an important step towards much-needed transparency to ensure that the GSEs are using their benefits only for legitimate secondary mortgage market purposes.”

The review would examine the reasons for concerns about the size of the portfolios, in the light of the management deficiencies which the accounting scandals had uncovered. The implicit guarantee effectively lowers funding

costs for the GSEs below those of other private companies in a similar financial situation. It also allows for high leverage on the part of the GSEs. Less capital is required to assure investors of safety for any given level of assets. Short-term bonds and loans have lower interest rates than long-term ones, so the GSEs use portfolio management techniques to allow them to borrow using short-term bonds to finance long-term mortgages. The key issue is then the extent to which Fannie and Freddie are able to manage interest rate risk, in particular. As the GSEs move mortgages into their portfolio investments, they increase both the expected returns and risks to shareholders, but only the risks increase for taxpayers. The issue of the risks involved continued to be under discussion. It was not only a question of interest rate risk, but also the GSEs' abilities to manage portfolios or credit risks (often considered to be negligible by many analysts, because they considered the mortgage purchases to consist of prime mortgages).

The Administration again seeks to limit the portfolios

Further attempts were made by the Administration during the summer and autumn to improve the chances of legislation in Senate and Congress. On June 26, 2006 another Treasury Secretary, Assistant Emil Henry, in a speech to the Housing Financial Services Roundtable warned that "unless the portfolios are hedged properly, in a period of significant interest-rate movement, there is a risk to the GSEs that their assets and liabilities will ... become broadly mismatched, which can lead to insolvency." He put the case even more strongly than most, concluding, "Ignoring all the rhetoric and spin, the simple truth is that there is no need for our financial markets to be exposed to this risk. Passionate statements made by the GSEs to the contrary, the GSEs' investment portfolios are not necessary for them to stay true to their mission ... As long as the portfolios of the GSEs are reduced gradually and responsibly, the overall impact to the housing market should be trivial."

And debt issuance

In his testimony before the Congressional Joint Economic Committee, Chairman Ben Bernanke had given his support to the view that the Treasury should consider limiting the debt that Fannie Mae and Freddie Mac can sell if Congress fails to pass the GSE reform legislation. Noting that the Treasury has the power to limit Fannie Mae and Freddie Mac's debt issuance, and perhaps power over the terms and maturities of that debt, the Chairman said, "If we are unable to achieve progress through Congress, I don't think the Treasury should abandon that power. I think the Treasury should consider using it if it believes that the systemic risks being generated by the [GSEs'] portfolios greatly outweigh the benefits that are mandated by the affordable housing mandate." The Treasury, according to some, appears to have that power: "The corporation is authorized

to issue, upon the approval of the Secretary of the Treasury, and have outstanding at any one time obligations having such maturities and bearing such rate or rates of interest as may be determined by the corporation with the approval of the Secretary of the Treasury.”³⁶

After all these statements from the Administration, the Treasury Department announced on November 17, 2006 that it had completed a process by which Fannie Mae and Freddie Mac would submit quarterly debt sales calendars, which would outline the justification for their debt issuance plans and specify the gross and net issuance, before the Treasury would approve the new debt. The process was expected to begin in January 2007, when their plans would be submitted with a senior officer testifying as to their accuracy. When the process was underway early in 2007, the GSEs would submit their sales calendar a month in advance before the beginning of the new quarter so that the Treasury would be able to review the requests and provide the GSEs with their comments so that the GSEs would have sufficient time to make any necessary changes before the beginning of the quarter. The process would also involve annual meetings between GSE managers and Treasury officials to discuss debt issuances. In addition, the GSEs would be required to seek prior Treasury approval for any changes to debt issuances during the quarter. The procedure was designed to add efficiency and transparency to the process, and was not meant to limit Fannie Mae’s and Freddie Mac’s borrowings or limit their future growth, according to Treasury officials.

Emil W. Henry Jr, Assistant Secretary for Financial Institutions, US Treasury had already expressed the Treasury’s concerns about the approval process in a speech to the Real Estate Roundtable in May that year. In his speech, he described the way in which the Treasury’s exercise of its authority had changed over time:

In the mid-1990s, Treasury was actively involved in the scheduling of GSE debt issuances, and every GSE debt issuance was submitted to the Treasury for prior approval. This process was cumbersome, caused considerable strain on Treasury’s staff resources and provided questionable return for this investment of time and staff. Because of these concerns, Treasury announced a new process that eliminated the need for Treasury to schedule each of the GSEs’ securities offerings. This new process was characterized as a voluntary co-operative process that would provide the GSEs with more flexibility to time and size their borrowing transactions. Treasury also made other process changes during this time period. At that time, these changes were viewed as an appropriate response to a process that had become outmoded, especially as the scope of the GSEs’ operations was increasing and certain issuances were becoming more routine and regularized.

Since these changes, the debt approval process has continued to evolve. While Treasury continues to exercise this responsibly, the process we use differs for each of the GSEs and has become less standardized. Depending on the particular GSE, we have developed different procedures as to how their debt issuances are approved. The procedure varies from weekly notices to quarterly notices.

Some of these procedures involve notice of expected versus actual debt issuances. The manner in which the Treasury conveys its approval also varies among the GSEs.³⁷

In his speech, Assistant Secretary Henry also set out the review of Treasury procedures which was about to begin.

This description of the Treasury's role has been quoted at length, partly because it indicates just when the Treasury's approval process changed (in the mid-1990s, during the Clinton Administration), and because of the cautious, ministerial tone and content. One can almost hear the civil servants advising on its content. It was not until Emil Henry had long left office that he was able to describe what constituted the then procedures: "By the mid-2000s, the GSEs' process of debt approval had devolved to a simple notification of the Treasury, without any formal process of debt approval. The process of debt issuance was so rapid that such notifications came to the Treasury weekly, typically on one piece of paper that simply listed proposed issuances without supporting data (such as income statements or balance sheets) upon which to make informed judgments."³⁸ Such a cavalier approach to vast amounts of debt is astonishing, bearing in mind that debt issuance by Fannie Mae and Freddie Mac was at times higher than total US government debt and was triple-A rated on the assumption of the "implicit guarantee".

If the new procedures were intended to ensure that Congress and the Senate agreed on the proposed legislation by the end of 2006, as many believed, then it failed. This was in spite of the combined efforts of Barney Frank, the incoming House Financial Services Committee chairman, Michael Oxley, outgoing chairman, and Treasury department officials to reach a compromise on the issue of portfolio limits, partly by obliging the regulator to consider a number of factors including the size and growth of the mortgage markets in order to determine the rate of growth of the portfolios and to issue an order to that effect. But the legislation failed because of the disagreements between Senate and Congress over the conforming loan limits, an affordable housing fund and the appointment of public interest directors at the FLHBs. The failure was aided and assisted by Fannie Mae's expenditure of \$10.48m to block the bill, according to the *Washington Post* (14/12/06).

More congressional efforts to regulate the GSEs effectively

Proposed legislation in 2007

The process of legislating for regulatory reform of the GSEs had to begin again in the new session of Congress (110th). Chairman Barney Frank announced that a large measure of agreement had been reached with the Treasury concerning the contents of the Federal Housing Finance Reform

Bill (H.R. 1427) in January, 2007 and predicted that it would be passed by the House of Representatives in time for the Easter recess at the beginning of April. The bill was similar to that passed in the last Congress, except for the improvements worked out with Treasury officials towards the end of 2006. Other issues, which were of concern to the Treasury, remained, such as a provision to raise the affordable loan limits to \$625,000, allowing Fannie Mae and Freddie Mac to purchase loans in the high-cost market, a controversial measure. The banking industry strongly opposed this on the grounds that the private sector was already providing sufficient funding for the “jumbo” mortgage market. It was a move which would take them well away from the mission of affordable housing for low- to moderate-income families. The bill also contained provisions for establishing the affordable housing fund, which the Chairman of the Senate Banking Committee rejected.

Discussions continued with the Treasury and between Congress and the Senate throughout February. The original concern with “safety and soundness” and the need to limit the size of the GSEs’ portfolios seemed to have been pushed into the background by loan limits and the affordable housing fund. Chairman Bernanke put this concern back on the agenda in February, when he gave his semi-annual monetary policy report before the Senate Banking and House Financial Services Committee. He suggested that controlling the size of the GSEs’ portfolios might be to link them with the affordable housing goals: “That would be a direct way to create some limits on the GSEs’ rapid expansion, while still having a direct impact on affordable housing ... We need to find some way that we can limit the growth of their portfolios.”³⁹

A few weeks later, Chairman Bernanke set out the reforms the Federal Reserve wished to see in the legislation under consideration. The Bank was concerned about systemic risk, given its responsibility for financial and economic stability, and once again emphasized the benefit of the implicit guarantee, which allows the GSEs to borrow in the open capital market at interest rates only slightly above that paid by the US Treasury and then to purchase assets, especially MBSs, that pay returns considerably better than the Treasury rate; the GSEs can enjoy profits “of an effectively unlimited scale.”⁴⁰ Clearly the GSEs had no incentive to reduce their portfolios and, as a shareholder-owned company, had every incentive to maximize profits. The research conducted at the Federal Reserve Board and elsewhere “found that the GSE portfolios appear to have no material effect on the cost or availability of residential mortgages. At the margin, the GSEs finance their purchases of MBSs by issuing equal amounts of debt, and thus the net supply to the market of housing-related debt is unchanged by GSE purchases. Thus, standard economic reasoning does not predict large effects from these purchases on the mortgage market. Indeed contrary to what would be expected if the GSEs lowered the funding costs of mortgages, over the past decade or so the spread between yields on 30-year fixed mortgages and Treasuries of similar duration

has tended to rise in periods in which the GSEs have increased the share of single-family residential mortgages held in their portfolios, and to fall when the GSE share has fallen.”⁴¹

Despite such research showing the irrelevance of the GSEs, Bernanke acknowledged the received “wisdom” that the GSEs did have a role in providing liquidity and aiding low- to moderate-income families in order to press for essential reforms. However, the situation was obviously causing concern, as by March 2007 the two housing GSEs had \$5.2 trillion of debt and MBS obligations outstanding, exceeding the \$4.9 trillion of publicly held debt; they were also among the most active users of derivative instruments. Bernanke also pointed out that given their advantages, it was not possible for other companies to compete with them, so only regulation and not market discipline could hold them in check. In addition, the capital requirements for Fannie Mae and Freddie Mac were lower than those of banks at only 3.5% of assets.

The Federal Reserve first set out the three requirements in 2004 for effective regulation of the GSEs. The requirements remained the same in 2007. They were:

1. The GSE regulator should have the broad authority necessary to set and adjust the GSEs’ capital requirements, in line with the risks the GSEs posed.
2. (Perhaps the most prescient.) The GSEs should be subject to a clear and credible receivership process, a process that would establish that both the shareholders and the debt holders of a failed GSE would suffer financial losses, as well as a method for resolving a GSE once it is placed in receivership.
3. The GSEs’ portfolios should be anchored firmly to a well-understood public purpose approved by Congress.

In March, the Chairman of the Housing Financial Services Committee Barney Frank introduced the Federal Housing Finance Reform Bill (H.R. 1427). The Treasury reiterated its concerns about increasing the conforming loan level limits in the high-cost markets and the affordable housing fund, but would not oppose the latter, provided the fund would not be controlled by the GSEs themselves, that is, was capped and limited by a sunset provision. The key provisions, as worked out between the Treasury and Congress, included funding the new agency through assessments on the GSEs without regard to the appropriations process; a risk-based capital requirement that is more flexible than the current unworkable statutory scheme which binds the OFHEO. The new regulator would have the authority to raise minimum and critical capital levels; make temporary minimum capital increases for a regulated entity, and establish additional capital and reserve requirements for a particular program or activity.

The new regulator was instructed to establish standards by which the portfolio holdings of the regulated entities or their rate of growth will be deemed to be consistent with their mission and the safety and soundness of their operations. The Treasury had also wanted mandatory receivership, making it obligatory for the regulator to appoint a receiver if:

- (a) the assets of the regulated entity are, and during the preceding 30 calendar days have been, less than the obligations of the regulated entity to its creditors and others; or
- (b) the regulated entity is not, and during the preceding calendar 30 days has not been, generally paying the debts of the regulated entity ... as such debts become due.

The compromise bill did not quite fulfil the Treasury requirements, as it retains mandatory conservatorship authority in certain circumstances but allowed the new regulator to establish a conservatorship or receivership, at his or her discretion, as appropriate, to reorganize, rehabilitate, or wind up the affairs of a critically undercapitalized entity. However, both the Treasury and the Acting Director of OFHEO were prepared to support the bill, which was also welcomed by Senate Banking Committee Chairman, Christopher Dodd, in a statement issued on March 7, 2007: "In my view, there is broad agreement that we should create a new regulator to oversee Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The new regulator ... must have certain core powers. These powers include: the ability to set both minimum and risk-based capital levels for the Enterprises; enhanced enforcement and prompt correction powers; the authority to set and enforce prudential management and internal control standards; the ability to put a GSE into receivership; and authority over both safety and soundness and mission."⁴² He confirmed that the Senate would begin its consideration in the autumn. A regulatory reform bill was in fact introduced by Senators Hagel, Sununu, Dole and Martinez in April.

The House of Representatives passed the Federal Housing Reform Act (H.R. 1427) in June. Senate did not pass any legislation designed to regulate the GSEs in 2007, so the Treasury and the Federal Reserve did not get the powers they considered necessary; instead, external events dominated the rest of the year in the aftermath of the collapse of two Bear Stearns hedge funds. The first sign of trouble came with Bear Stearns' decision to commit up to \$3.2bn to one of two of its hedge funds on June 27, 2007. They had invested heavily in collateralized debt obligations in highly leveraged funds with insufficient insurance in the form of credit swaps, not having seen the extreme deterioration in the subprime market. The decision to inject more capital was in response to Merrill Lynch's seizure of some \$800m in collateral from the fund. At first, it looked as though that decision might have stabilized the market, although much greater doubts were expressed regarding the even more highly leveraged

fund, High Grade Structured Credit Strategies Enhancement Leverage Fund, which had only been set up in August 2006. On July 17, Bear Stearns was obliged to tell investors that they had lost 90% and 95% of the face value of their investments in the funds: the total losses were in the order of \$1.6bn. The focus of attention switched away from regulatory reform to the subprime crisis and protecting or helping subprime borrowers throughout the rest of 2007.

It was not until 2008 that a bill was passed, but it was too late

The lack of proper powers and a new regulator left James Lockhart seeking to manage the OFHEO with “one or two hands tied behind [his] back,” as further troubles hit the GSEs in early 2008. Senate inaction continued, partly due to Senator Dodd’s absence as he made an unsuccessful bid for selection as the Democrat Party’s presidential candidate. That was not the only reason: disagreements remained over the extent of the powers to impose new capital requirements and the Affordable Housing Fund. Both Barney Frank and President Bush called for Senate to pass the necessary legislation for a new powerful regulator, but the moment had passed.

By March, the need for regulatory reform had turned into a wider debate on the subprime mortgage crisis. By July, it became clear that the GSEs were grossly undercapitalized and technically insolvent, and may even require a government bail-out. Their share prices had been falling during the week beginning July 7, but the bail-out itself was, some would claim, caused by remarks made by William Poole during an interview with Bloomberg News on July 10, in which he said that “Congress ought to recognise that these firms are insolvent, that it is allowing them to continue to exist as bastions of privilege, financed by the taxpayer.” This was by no means the first time that the former President of the Federal Reserve Bank of St Louis had raised fundamental questions about Fannie Mae and Freddie Mac, with the Bank’s most recent article noting that “their capital position is thin relative to the risks they assume.”⁴³ Other analysts pointed out the weakness, if not insolvency, of Fannie Mae and Freddie Mac, thus triggering a sharp fall in the GSEs’ share prices (45% and 58% respectively). Emergency action was required. Both Congress and the Senate approved the Housing and Economic Recovery Act and it was signed into law by President Bush on July 29, 2008.

The Act incorporated some of the provisions for regulatory reform of the GSEs which had been debated in Congress and Senate over the years; it took the near collapse of the GSEs and the rapid decline in the housing market for them to act. The Act does not, however, bring about all the reforms for which many proponents of reform have long argued. A new regulator, the Federal Housing Finance Agency, was established, to be independently funded through the assessments of the GSEs and no longer subject to Budget appropriations. The legislation also alters the housing mission to meet new goals established by

the regulator for single- and multi-family home purchasers in low- or very low-income areas and other underserved areas. The portfolio holdings of the GSEs would be established by the regulator in terms of safe and sound operations of the GSEs, and the regulator would also impose prompt corrective actions on the part of the GSEs when necessary.

Most important, the legislation gave the Treasury Secretary Henry Paulson the power to provide explicit government backing to Fannie Mae and Freddie Mac through the purchase of their debt and equity securities, if necessary, to stabilize the financial markets, to prevent the disruption of the availability of mortgages in the markets, and to protect the taxpayer. These were the aims of the brief statement Paulson made on July 13, 2008. However, by September 7, 2008 the situation had changed. His September statement included a reference to what some academics, senior federal officials and analysts had long observed; namely, that “their statutory capital requirements are thin and poorly defined as compared with other institutions,” and in view of all the circumstances, “conservatorship was the only form in which I would commit taxpayer money to the GSEs.” Paulson elaborated the plan: “the primary mission of these enterprises ... will be to proactively work to increase the availability of mortgage finance ... To promote stability in the secondary mortgage market and lower the cost of funding, the GSEs will modestly increase their MBS portfolios through to the end of 2009. Then, to address systemic risk, in 2010, their portfolios will be reduced at the rate of 10% per year, largely through natural run-off, eventually stabilizing at a lower, less risky size.” Further actions would be taken by the Treasury to ensure that each company maintained a positive net worth. They were able to continue channeling funds to the mortgage market, but with the consequence that by 2009, they owned or guaranteed all outstanding mortgages in the United States, and they financed three-quarters of all the new mortgages originated that year.

The decision to put Fannie Mae and Freddie Mac into conservatorship did not take place simply because of the state of the Enterprises, the stock market reactions, or the decline in the US housing market. It was also made because the shares of both Fannie Mae and Freddie Mac, both of which at this time guaranteed half of the \$12bn US mortgage market, had fallen by more than 72% and 77% between the end of 2007 and August 1, 2008.

Creditors and investors alike reacted both by limiting the credit supply and selling the shares. Foreign investors, primarily the Chinese and Japanese central banks, but also other Asian central banks, who held 35–40% of the debt issued by Fannie Mae and Freddie Mac, began to sell. The market capitalization of Fannie Mae was \$7.6bn compared with \$38.9bn at the end of 2007, and of Freddie Mac, \$3.3bn compared with \$22bn at the end of 2007.

It is small wonder that Henry Paulson said these “actions were made necessary by the ambiguities of the GSE Congressional Charters, which have been perceived to indicate government support for agency debt and guaranteed MBSs.

Our nation has heeded these ambiguities for far too long, and as a result GSE debt and MBSs are held by central banks and investors throughout the world, who believe them to be virtually risk-free. Because the US government created these ambiguities, we have a responsibility both to avert and ultimately address the systemic risk now posed by the scale and breadth of the holdings of GSE debt and MBSs.”⁴⁴ The Bush administration accepted what the Chinese and Japanese governments wanted, by putting them into conservatorship, whilst guaranteeing full payments to bond and security holders. But this meant taking on as Treasury liabilities an amount equal to the sum of the entire federal debt of the United States. China, in fact, held up to one-fifth of its currency reserves in Fannie Mae and Freddie Mac debt, which amounted to \$447.5bn as of June 2008. Countries in Asia had stockpiled foreign exchange reserves since the 1997–1998 currency crisis to act as cushion against a run on their exchange rates.⁴⁵

It should come as no surprise that foreign central banks held so much of the GSEs’ debt, since from 1997 onwards, both Fannie Mae and Freddie Mac increased their efforts to sell both debt and MBSs to central banks and foreign institutional investors, seeking higher-yielding non-credit-sensitive assets. In 1997, foreign buyers held about 10% of mortgage investments, and Fannie Mae, scanning international markets in order to find investors for its MBSs, was also seeking to find investors for its debt. A year later, Freddie Mac planned to launch a Five Year Bond, comparable with Fannie Mae’s “Benchmark Notes” of which \$4bn were issued in January 1998, with Freddie Mac following with a \$1bn issue of what came to be called its “Reference Notes”.

Fannie Mae and Freddie Mac were committed to offering large bullet issues across maturities to improve market liquidity. The FHLBanks, on the other hand, did not commit to a regular issue schedule, instead offering larger issues through the Global Note program but retaining more discretion in the timing and size of their Global Bullet debt. The Office of Finance, their fiscal agent, sought to manage the debt program, using their funds to make “advances” to their members as well as purchasing mortgage-related assets in the secondary market. The market for GSE debt (including the FHLBanks) grew rapidly from the late 1990s to \$2.6 trillion in 2003, almost 84% of the Treasury market at that time.

This was not only due to the GSEs’ extensive marketing efforts, but also because the housing market continued to expand with an increase in mortgage debt outstanding from \$3.9 trillion to \$5.6 trillion, a 44% increase. Residential mortgage debt outstanding reached \$10.5 trillion in mid-2006. The growth in debt issuance slowed down in 2003 and 2004, owing to the accounting problems at Freddie Mac and then Fannie Mae, although the FHLB System continued to grow despite problems at some of the member banks. However, growth resumed in 2006 and 2007, so that by the end of 2007, non-US investors held \$1.47 trillion of \$7.397 trillion, of which over 40% was held by foreign

central banks. Other large investors were US commercial banks (\$929bn), life insurance companies (\$388bn), state and local government retirement funds (\$317bn), mutual funds (\$566bn), asset-backed securities issuers (\$378bn) and the GSEs themselves (\$710bn). Of these, the US government was more concerned about foreign investors, and the central banks in particular.⁴⁶ This was just the systemic risk about which Chairman Bernanke expressed such deep concern, and about which Congress and the Senate refused to take the appropriate action, allowing Fannie Mae and Freddie Mac in particular to persuade them that the risk was non-existent. Indeed, Richard Syron had dismissed it as a “side-show.”

At every turn, those who were responsible and in a position to act, failed to take the appropriate actions. Both Alan Greenspan and Ben Bernanke warned the Administration of the risks building up in the GSEs. The Treasury failed to oversee the GSEs’ debt issuance program for too long, even though its powers were limited. The GSEs were issuing debt which, despite the disavowals of the government guarantee, was often greater than the government’s own, a fact which should have caused disquiet. No doubt for successive Administrations, the fact that such huge amounts of debt were “off-balance sheet” meant that they could pretend it was not there; but then “as everyone should have learnt by now ... keeping liabilities off-balance sheet does not make them any smaller or less real.”⁴⁷