

Should Fannie Mae and Freddie Mac be Designated as Systemically Important Financial Institutions?

United States Senate
Committee on Banking, Housing, and Urban Affairs

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Chairman Crapo, Ranking Member Brown, and members of the Committee, thank you for the privilege of appearing today to share my views on whether Fannie Mae and Freddie Mac (the housing Government Sponsored Enterprises, or GSEs) should be designated as systemically important financial institutions (SIFIs). I wish to make three main points:

- There appears to be increased momentum toward reforms that would permit the GSEs to leave conservatorship;
- Fannie Mae and Freddie Mac are engaged solely in an activity – real estate lending – that historically is central to bank failures and financial crises; they are uniquely suited for designation as SIFIs; and
- There may be a regime of administrative reforms involving greater capital, restrictions on portfolio investment, and credit risk transfers (CRTs) that may prove to be a workable substitute for SIFI designation.

Let me elaborate on each in turn.

Both Congress and the Trump Administration continue to explore GSE reform. The Committee Chairman has released an outline of components of legislative reform.¹ In March, the Trump Administration formally joined the GSE reform conversation. The president issued a memo to the Departments of the Treasury and of Housing and Urban Development (HUD) directing both to develop plans for GSE reform that is possible without congressional action.² In particular, the White House memo lays out the goal of “ending the conservatorships of the GSEs upon the completion of specified reforms.” Treasury and HUD are each expected to submit plans to the White House in the near future.

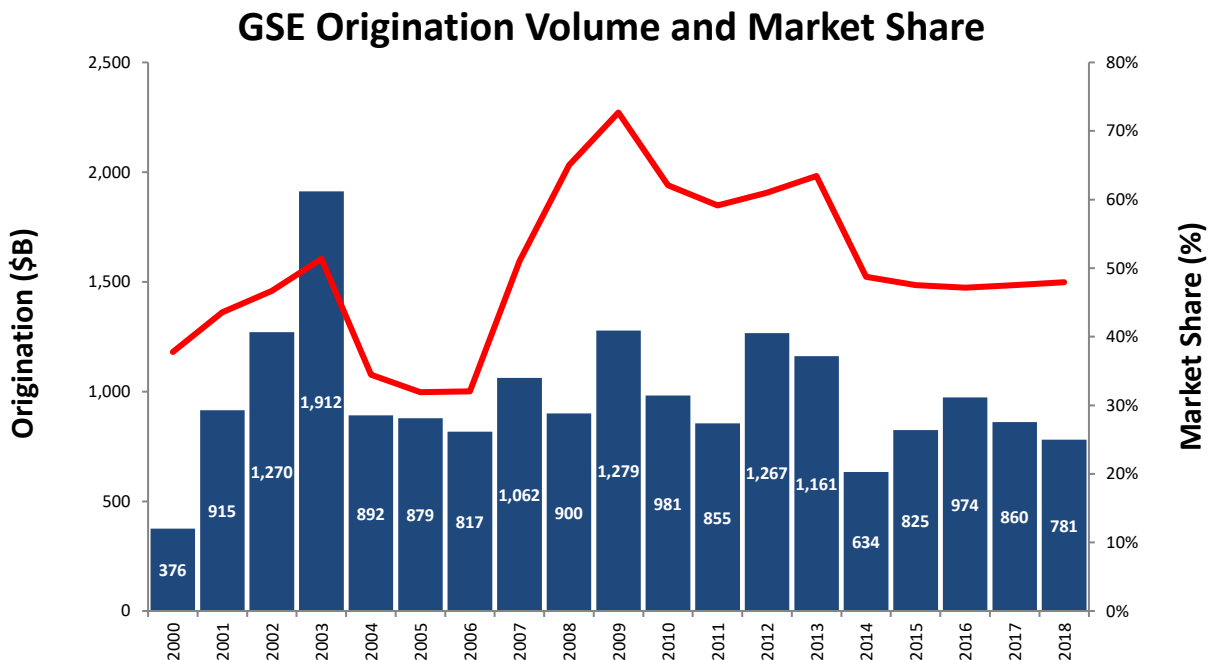
The goal of ending conservatorship for Fannie Mae and Freddie Mac is significant because it is only in this scenario that the question of their SIFI status arises. Statements by the administration, including Federal Housing Finance Agency (FHFA) Director Mark Calabria, suggest that, contingent upon reforms, the most likely exit strategy will be “recap and release,” whereby the GSEs are appropriately capitalized (likely by amending their net profit sweep to Treasury and possibly by some form of public offering) and then returning Fannie Mae and Freddie Mac to the market as fully private entities.

As private entities, the GSEs are engaged solely in a very risky activity – guaranteeing the performance of real estate loans. Indeed, some see real estate lending as the most significant driver – almost the definition – of systemic risk itself. As recent papers by Oscar Jorda, Moritz Schularick, and Alan Taylor for the National Bureau of Economic Research (NBER) have shown, crises can usually be defined as the rising leverage of banks concentrated in real estate lending.³ Charles Calomiris, a professor at the Columbia Business School, has noted since well before the previous financial crisis that the use of short-term debt with procyclical pricing to finance risky and usually illiquid real estate assets is particularly vulnerable to system-wide shock.⁴ This relationship was considered

so particularly fraught with danger that prior to 1913, nationally chartered banks were prohibited from holding any real estate at all.

The GSEs not only participate in a systemically risky activity – they dominate it. As the chart below shows, during the pre-crisis years (2000-2006) the GSEs accounted for an average of 40 percent of the origination market, and closer to 30 percent in the three years immediately prior to the crisis. During and immediately after the financial crisis (2007-2013), the GSEs accounted for, on average, 62 percent of the market, at a time when the GSEs and government loans were the only source of credit in the market.

More worrying, however, this data shows that in recent years GSE market share of the origination market has remained near 50 percent, a level considerably higher than pre-crisis levels. In 2018, the GSEs acquired 50 percent of all newly originated single-family loans, and 47 percent of all multifamily loan originations. Prior to conservatorship, the GSEs' share of the first lien origination volume was roughly 32 percent.⁵ Today, that number is closer to 45 percent, and with Federal Housing Administration (FHA) and Department of Veterans Affairs (VA) loans included, that number is closer to 70 percent. With the private-label mortgage-backed securities market largely nonexistent, the mortgage market is almost entirely dependent on government agencies.



Source: 2019 Mortgage Market Statistical Annual

Finally, Fannie Mae and Freddie Mac continue to be risky, too-big-to-fail institutions. By the end of 2007, they had a combined leverage ratio of 75 to 1; what the GSEs' leverage ratio will be when they exit conservatorship remains to be seen. It seems likely, however, that little will be changed from when I wrote my dissenting statement to the Financial Crisis

Inquiry Commission's report: "As large financial institutions whose failures risked contagion, they were massive and multidimensional cases of the too big to fail problem." ⁶

Fannie Mae and Freddie Mac were put into conservatorship because they were deemed too big to fail, the very concept that underpinned the creation of the SIFI designation. Thus, we would automatically expect the GSEs released from conservatorship to be considered SIFIs.

In the aftermath of the 2007-2008 financial crisis, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Title I, Subtitle A, of Dodd-Frank established a new body, the Financial Stability Oversight Council (FSOC), with statutory responsibilities to ensure the safety and soundness of the financial system at large. ⁷ The key tool in FSOC's toolbox is the designation of financial institutions as SIFIs. Because banking companies with over \$50 billion in assets are automatically considered SIFIs in Dodd-Frank, the key issues involving designation revolved around nonbanks.

Specifically, Section 113 of Dodd-Frank gives FSOC the authority by two-thirds vote (including the chairperson) to bring a nonbank financial company under increased supervision and regulation by the Federal Reserve Board (FRB) if FSOC determines that "material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States."⁸ In making that determination, Dodd-Frank lists 10 criteria for FSOC to consider, but also allows FSOC to consider "any other risk-related factors that the Council deems appropriate."⁹ As such, FSOC has very broad statutory authority when evaluating companies for SIFI designation.

Because Dodd-Frank gives FSOC such expansive authority to set the specific determinants of a SIFI designation, FSOC's operational procedures have largely been set through the regulatory rulemaking process. FSOC announced in March 2019 that it would change its SIFI designation criteria to focus on systemically risky activities. This policy shift is still at the stage of request for comment from stakeholders, and there is little to suggest which activities FSOC will identify for consideration first. As noted, however, guaranteeing the performance of mortgages should be high on any list.

Once designated, SIFIs fall under increased supervision and regulation by the FRB – with higher capital requirements, liquidity requirements and the requirement to undergo annual stress testing. The impact of these additional requirements is clear: SIFIs must set aside more capital, significantly increase compliance staff, and increase technology and data capture processing. As a result, SIFI designation is a significant cost.

In my view, it is difficult to see how the GSEs post-conservatorship could be anything but SIFIs. For some, however, explicit designation has the downside of having FSOC move away from banking, something that produced difficulties in as closely related a field as insurance. It would require the FRB, with zero housing experience, to become the primary regulator. Would the FRB be more effective than the FHFA, formed in 2008 for that very purpose? Others have pointed out that the conflict of interest inherent in being both central banker

that sets interest rates and regulator of the banking system would only be exacerbated by having the housing finance industry also within the FRB purview.

From this perspective, the question is whether there is a potential alternative regime that the FHFA could impose to dissuade FSOC from designating the GSEs as SIFIs. This would require important regulatory (and/or legislative) reforms in order to ensure they are not the housing market force that they were before — and during — conservatorship.

Perhaps there is such a regime, although I am not entirely confident. At least three elements would seem to be essential to such a regime. The first would be SIFI-like capital requirements, above-and-beyond those that might normally emerge from an FHFA rule-making process, that would absorb the risk and provide the buffer against systemic exposures.

The second would be to “de-risk” the basic guarantee business of the GSEs dramatically. By process of elimination, the only candidates able to absorb additional risk are capital market participants. One might imagine an aggressive and effective credit risk transfer regime that relieved the GSEs of risk. The FHFA has already established guidelines governing single-family credit risk sharing by the GSEs. Unfortunately, under the current arrangements, the GSEs retain the first-loss position and credit risk transferees participate in a mezzanine structure put in place 3-9 months after a loan is acquired. A simpler way to have the GSEs reduce their risk exposure could be by implementing a policy similar to private mortgage insurance, in which the loan-level coverage is put in place at origination. This approach would be more effective in transferring risk; it would also have to be used more extensively.

Finally, the GSEs should clearly be prohibited from holding portfolios for investment purposes. In 2007-2008 the dangers of the guarantee business were compounded by large portfolios of mortgage-backed securities – essentially large monoline hedge funds with too little capital and no public purpose.

There may be other elements as well. The most important requirement is to ensure that any future private-sector GSE bears little structural resemblance to the historic Fannie Mae and Freddie Mac that served this nation so poorly.

Thank you, and I look forward to your questions.

Notes

¹ <https://www.banking.senate.gov/imo/media/doc/Housing%20Reform%20Outline.pdf>

² <https://www.whitehouse.gov/presidential-actions/memorandum-federal-housing-finance-reform/>

³ <https://www.nber.org/papers/w16567>

⁴ https://www.aei.org/wp-content/uploads/2018/06/Calomiris-Chen-2018_September-2018-RFS-Submission-Version.pdf

⁵ https://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-may-2019/view/full_report

⁶ http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_hennessey_holtz-eakin_thomas_dissent.pdf

⁷ <https://www.congress.gov/111/plaws/publ203/PLAW-111publ203.pdf>

⁸ 12 U.S.C. § 5323 (a)(1)

⁹ 12 U.S.C. § 5323 (a)(2)(K)