Testimony of
Alex J. Pollock
Distinguished Senior Fellow
R Street Institute
Washington, DC

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

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Fannie and Freddie Are Obviously SIFIs

Mr. Chairman, Ranking Member Brown, and Members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a senior fellow at the R Street Institute, and these are my personal views. I have spent almost five decades working in and on the banking and housing finance system. This included serving as President and CEO of the Federal Home Loan Bank of Chicago 1991-2004, and as a resident fellow of the American Enterprise Institute 2004-2015. I have personally experienced and studied numerous financial cycles, crises and their political aftermaths, and have authored many articles, presentations, testimony and two books on related subjects, including the nature of systemic financial risk.

To begin with the essence of today's question: Are Fannie Mae and Freddie Mac, which guarantee half the credit risk of the massive U.S. housing finance sector, and which have combined assets of $5.5 trillion, systemically important? Obviously, they are. Are they financial companies? Of course. So they are systemically important financial institutions as a simple fact.

This is true if you consider them as two of the largest and most highly leveraged financial institutions in the world, but it is equally true if you consider them as an activity that generates systemic risk. Guaranteeing half the credit risk of the biggest credit market in the world (except for U.S. Treasury securities) is a systemically important and systemically risky activity. Leveraged real estate is, and has been throughout financial history, a key source of credit collapses and crises, as it was yet once again in 2007-2009. The activity of Fannie and Freddie is 100% about leveraging real estate. Moreover, they have been historically, and are today, themselves hyper-leveraged.

To use the words of the Dodd-Frank Act, could Fannie and Freddie "pose a threat to the financial stability of the United States"? They have already demonstrated that they can.

The Financial Stability Board has stated this fundamental SIFI characteristic: "the threatened failure of a SIFI—given its size, interconnectedness, complexity, cross-border activity or lack of substitutability—puts pressure on public authorities to bail it out using public funds."

Fannie and Freddie displayed at the time of their 2008 failure and continue to display the attributes of extremely large size, interconnectedness, complexity, cross-border activity and lack of substitutability. As we all know, in 2008, U.S. public authorities not only felt overwhelming pressure to bail them out, but did in fact bail them out, with ultimately $190 billion of public funds. In addition, they pledged the credit support from the U.S. Treasury which protected and still protects Fannie and Freddie's global creditors.

Fannie and Freddie continue to represent giant moral hazard, as they always have. Since they now have virtually zero capital, they are even more dependent on the Treasury's credit support and its implicit guarantee than they were before.

That Fannie and Freddie are SIFIs in financial reality no reasonable person would dispute.

Yet so far, the Financial Stability Oversight Council (FSOC) has not designated Fannie and Freddie as official SIFIs. To a non-political observer, judging purely on the merits of the case, this would be highly surprising. FSOC's historical inaction in this instance has certainly not added to its intellectual credibility. To Washington observers, naturally, it just seems like ordinary politics.

This hearing requires us to consider how FSOC should deal with the fact of Fannie and Freddie's systemic importance. Should FSOC recognize the reality by formally designating Fannie and Freddie as the SIFIs they so obviously are? Or should FSOC keep ignoring the issue?

I believe FSOC should formally designate Fannie and Freddie as SIFIs and strongly recommend that action. That would be consistent with the clear provisions of the Dodd-Frank Act. In my opinion, the country needs Fannie and Freddie to be integrated into the efforts to understand and deal with systemic risk. Without including Fannie and Freddie, these efforts are woefully incomplete.

Let us consider the SIFI factors of size, interconnectedness, substitutability, leverage, maturity mismatch and liquidity risk, and existing regulation.

<u>Size</u>

In total assets, Fannie is far larger than even the biggest SIFI banks. The following table ranks by size the ten largest existing SIFIs plus Fannie and Freddie. As it shows, Fannie is bigger in assets than JPMorgan Chase and Bank of America, and Freddie is bigger than Citigroup and Wells Fargo. On this combined table of twelve huge financial institutions, Fannie is #1 and Freddie is #4.

Size of Fannie, Freddie and the Largest Ten Existing Official SIFIs

	Total Assets
Fannie Mae	**$ 3.42 trillion**
JPMorgan Chase	2.74
Bank of America	2.38
Freddie Mac	**2.09**
Citigroup	1.96
Wells Fargo	1.89
Goldman Sachs	0.93
Morgan Stanley	0.88
U.S. Bancorp	0.48
PNC Financial Services	0.39
TD Group US	0.38
Capital One Financial	0.37

Sources: S&P Global Market Intelligence; Fannie Mae, 1st Quarter 10-Q 2019; Freddie Mac, 1st Quarter 10-Q 2019

Interconnectedness

The obligations of Fannie Mae and Freddie Mac are widely held throughout the U.S. financial system and around the world. U.S. depository institutions hold well over $1 trillion of their securities. The Federal Reserve itself holds $1.6 trillion in MBS, mostly those of Fannie and Freddie. Could Fannie and Freddie be allowed to fail and impose credit losses on the Fed? Presumably not. Preferential banking regulations promote Fannie and Freddie, including low risk-based capital requirements for their MBS and debt, creating an incentive for depository institutions to hold large exposures to those securities. These low risk-based capital requirements for depository institutions compound the hyper-leverage of Fannie and Freddie themselves, and amplify their systemic risk.

Moreover, U.S. banks are allowed to buy the equity, preferred stock and subordinated debt of Fannie and Freddie, and fund these investments with government-insured deposits. This combination results in systemic double leverage.

The interconnectedness of Fannie and Freddie's mortgage-backed securities and debt with the global financial system became vivid in 2008. As then-Secretary of the Secretary Henry Paulson correctly judged, a default on Fannie and Freddie's obligations would have dramatically exacerbated the financial crisis on a global basis.

As Paulson recounted in his memoir of the crisis, *On the Brink*:

> "From the moment the GSEs' problems hit the news, Treasury had been getting nervous calls from officials of foreign countries that were invested heavily with Fannie and Freddie. These calls ratcheted up after the [2008 HERA] legislation. Foreign investors held more than $1 trillion of the debt issued or guaranteed by the GSEs, with big shares held in Japan, China, and Russia. To them, if we let Fannie and Freddie fail and their investments got wiped out, that would be no different from expropriation. ...They wanted to know if the U.S. would stand behind this implicit guarantee"—and also "what this would imply for other U.S. obligations, such as Treasury bonds."

As Fannie and Freddie reported large losses, Paulson relates that he instructed the Treasury staff to "make sure that to the extent we can say it that the U.S. government is standing behind Fannie Mae and Freddie Mac." In an even more revealing comment, Paulson added, "I was doing my best, in private meetings and dinners, to assure the Chinese that everything would be all right."

Thanks to the overwhelming global systemic risk of not bailing them out, Paulson's assurance turned out to be true for all of Fannie and Freddie's debt and MBS holders. Even those who had bought subordinated debt, thereby intentionally taking more risk, were protected.

Substitutability

Fannie and Freddie's systemic role is critical and cannot be replaced in the short or medium term—there are no substitutes. They play a unique, systemically central role and remain the dominant force in the funding of U.S. mortgages. There are no meaningful competitors because of their huge, ongoing risk subsidies from the government. In 2018, they guaranteed $917 billion in MBS. In the first quarter, 2019 they had a 63% market share of MBS issuance (including Ginnie Mae, the government has a 94% market share.) Their balance sheets represent about half of total U.S. mortgage loans outstanding. Thousands of mortgage originators, servicers, domestic and international investors and derivatives counterparties depend on their continued functioning and government-dependent solvency. This is one reason that the U.S. Congress has been unable to pass any legislation to end their conservatorship.

Leverage

In addition to their massive size, Fannie and Freddie have historically displayed extreme leverage and continue to do so. As of March 31, 2019, their balance sheets show a combined capital ratio of a risible less than 0.2% and they are hyper-leveraged at over 500 to 1. Of course, under the bailout agreement, the government will not let them build retained earnings, but the fact of the hyper-leverage remains.

Maturity Mismatch and Liquidity Risk

The American 30-year fixed-rate, freely prepayable mortgage loan is one of the most complex financial instruments in the world to finance and hedge. Unlike the fixed-rate mortgages of most other countries, the prepayment risk of these mortgages is not offset by prepayment fees. This necessitates a complex derivatives market which trades in the risks of prepayment behavior. Fannie and Freddie together own about $400 billion of mortgages in their own portfolios, on an extremely leveraged basis. They are major counterparties in interest rate derivatives and options markets. Their MBS spread the complex interest rate risks of American 30-year fixed rate mortgages, while concentrating the credit risk of U.S. house prices, now again at an all-time high. The liquidity of Fannie and Freddie's securities and of Fannie and Freddie themselves completely depends on the implicit guarantee of the U.S. Treasury.

Existing Regulation

Fannie and Freddie of course have an existing regulator, the Federal Housing Finance Agency (FHFA). But the FHFA is not, nor is it empowered to be, a regulator of the systemic risk created by Fannie and Freddie for the banking and financial system.

U.S. residential mortgages constitute the largest loan market in the world, with $10.4 trillion in outstanding loans. The risks of this huge market include the holdings by banks of the MBS and debt of Fannie and Freddie. There are no limits on the amount of Fannie and Freddie obligations which can be owned by banks.

As discussed above, the risks of Fannie and Freddie also flow into the banking system because banks are allowed to invest in Fannie and Freddie's equity on a highly-leveraged basis, which creates systemic double leverage. In the financial crisis of 2007-2009, many banks took large losses and a number failed because of their exposure to Fannie and Freddie's preferred stock, an exposure which was encouraged by regulation. This is an issue the Federal Reserve, as a systemic risk regulator, would want to consider.

A major systemic risk is that Fannie and Freddie are by definition 100% concentrated in the risks of leveraged real estate. Indeed, they are by far the largest concentration of mortgage credit risk in the world. Leveraged real estate, needless to say, has a long and painful record of being at the center of banking collapses and financial crises.

Fannie and Freddie's primary regulator is likewise devoted only to housing finance. Such a regulator always faces the temptation to become a cheerleader and promoter of housing and housing finance. This brought down the old Federal Home Loan Bank Board, abolished in 1989, and arguably also the Office of Thrift Supervision, abolished in 2010.

In sum, Fannie and Freddie are huge in size, huge in risk, close to zero in capital, tightly interconnected to thousands of counterparties, and force risk on the U.S. Treasury. They meet the criteria specified by the Dodd-Frank Act and its implementing regulations for designation as a SIFI, both as institutions and considered as a systemically risky activity. They also meet the international criteria of the Financial Stability Board for designation as a Global SIFI.

If Fannie and Freddie are not SIFIs, then nobody in the world is a SIFI, and if any institution is a SIFI, then so are Fannie and Freddie. Addressing their systemic risk through designation as a SIFI would logically match their systemically important role and riskiness.

Conservatorship

In September 2008, as we know, the Federal Housing Finance Agency determined that Fannie and Freddie each were "in an unsafe or unsound condition to transact business," and "likely to be unable to pay its obligations or meet the demands of its creditors in the normal course of business." The government placed them into conservatorship, and thus assumed "all rights, titles, powers, and privileges of the regulated entity, and of any stockholder, officer, or director of such regulated entity with respect to the regulated entity and the assets of the regulated entity."

Conservatorship was never intended to be a perpetual status for Fannie and Freddie, but it continues in its 11th year, an outcome altogether unintended and undesired.

Should designating Fannie and Freddie as SIFIs be delayed because they are in conservatorship? The answer, it seems to me, is clearly No. They are just as systemically important and systemically risky in conservatorship as out of it. They create just as much or more moral hazard. The Conservator cannot manage their systemic risk. Indeed, because of the "net worth sweep" deal between the Treasury and the FHFA as Conservator, Fannie and Freddie are even more highly leveraged than before. Meanwhile, under the Conservator, they continue to expand mortgages with high debt service to income ratios, another form of increased leverage.

The Federal Reserve as Additional Regulator

If—I hope it is when—Fannie and Freddie are formally designated as the SIFIs they economically are, the Federal Reserve will become an additional, systemic risk regulator for them. This seems to me a good idea, since the Fed is the best placed of all existing regulatory agencies to consider the risks Fannie and Freddie pose from the view of the financial system as a whole. Of course, the statute assigns this responsibility to the Fed for all SIFIs. If you don't like this outcome of SIFI designation, should you therefore claim that Fannie and Freddie are not SIFIs?

Suppose we grant that the Fed, like everybody else, has numerous shortcomings. That does not mean that Fannie and Freddie are not SIFIs. Let us concede that the Fed, like everybody else, is far from perfect. It should still take on, as the only available authorized actor, the essential task of understanding and addressing what Fannie and Freddie are doing to systemic risk.

Of course, Fannie and Freddie already have a primary regulator, but so do all other SIFIs. That the FHFA regulates Fannie and Freddie is no more an argument against their being SIFIs than the fact that the Comptroller of the Currency regulates national banks would prevent banks from being SIFIs.

The Fed should be able to consider, and should consider, for such "large, interconnected financial institutions," in the words of the Dodd-Frank Act, "establishment and refinement of prudential standards and reporting and disclosure requirements…taking into consideration their capital structure, riskiness, complexity, financial activities…size, and any other risk-related factors."

For example, the Fed might usefully consider with respect to Fannie and Freddie such questions as:

-Whether their capital requirements and their leverage cause capital arbitrage and thereby increased risk in the financial system as a whole.

-Whether the same risks should be capitalized in the same way between private financial institutions and Fannie and Freddie.

-How Fannie and Freddie's concentration in leveraged real estate risk affects the risk of the financial system.

-How or whether Fannie and Freddie's activities contribute to house price inflation and thereby reduce housing affordability.

-Whether their heavy concentration in California mortgages amplifies earthquake risk.

-How much banking regulations which favor Fannie and Freddie increase the riskiness of banks.

-Whether the double leverage in the financial system created by allowing banks to invest in Fannie and Freddie's equity makes sense.

-Whether Fannie and Freddie's market dominance decreases or increases systemic risk.

-How much risk is being pushed on the Treasury and the taxpayers by Fannie and Freddie, at what economic cost.

I believe is that the Fed as systemic risk regulator of Fannie and Freddie would be a force for sound and well-capitalized housing finance, which would be better understood in the context of its interaction with the rest of the banking and financial system. That should be everybody's goal.

Concluding Questions and Answers

Are Fannie and Freddie SIFIs? Yes, without a doubt.

Do Fannie and Freddie cause systemic financial risk? Yes.

Is the Federal Reserve a reasonable place to try to understand and address the systemic risks? Yes.

Should FSOC recognize these facts by formally designating Fannie and Freddie as SIFIs? Yes.

When? The sooner, the better.

Thank you again for the chance to share these views.