"Mortgage Lending and Systemic Crises:
Defending Macro-stability"

Testimony prepared for

"SHOULD FANNIE MAE AND FREDDIE MAC BE DESIGNATED AS SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS?"

ON

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BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

U.S. SENATE

WRITTEN TESTIMONY

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Chairman Crapo, Ranking Member Brown, and other distinguished members of the Committee:

Thank you for the invitation to testify at today's hearing, "Should Fannie Mae and Freddie Mac be designated as Systemically Important Financial Institutions?" I am the Sussman Professor of Real Estate and Professor of Finance at The Wharton School of the University of Pennsylvania. Together with co-authors, I have researched and written scholarly papers on the stability of the housing finance system. Recent papers, from which this testimony is drawn, are listed at the end of this statement. It is an honor to be here today to discuss the role of the Federal Stability Oversight Council in the prevention of systemic crises derived from the mortgage market.

The Financial Stability Oversight Council (FSOC) has a statutory mandate to identify risks and respond to threats to financial stability. As is evident from the severe financial crisis that led to the Great Recession of 2009, mortgage markets can disrupt stability and have done so in the past. Regulatory oversight and the structure of the housing finance system will be instrumental in determining the likelihood of a repeat of the crisis. Collective oversight of all entities providing mortgages, which the FSOC is uniquely positioned to accomplish, is a necessary component of this oversight.

My comments today, based on my writings in this area, will address why there is a need for such a system-wide oversight. I will also comment on the specific question: "Should Fannie Mae and Freddie Mac be designated as Systemically Important Financial Institutions?" What is important is that this sector is overseen for its potential to undermine macro-economic stability. I also believe for reasons that I will explain that the correct oversight for the GSEs is that they be designated, if and when they are privatized, not as SIFIs but as Systemically Important Financial Market Utilities (SIFMUs).

Under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), FSOC is authorized to designate non-bank financial institutions as systemically important. In addition, under Section 804 of the Dodd-Frank, FSOC is responsible for the designation of financial market utilities that the Council determines are, or are likely to become, systemically important, that is, SIFMUs.

In addition, Section 803 of Dodd-Frank clarifies a disruption to a SIFMU as being a situation "where the failure of or a disruption to the functioning of a financial market utility…could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the United States."

I believe a SIFMU designation is the correct designation because the GSEs provide a structural foundation to the secondary mortgage market. The GSEs are characterized by the considerations established for the SIFMU designation—that is, the aggregate value of transactions processed by the financial market utility, the aggregate exposure of the financial market utility, the relationship, interdependencies, or other interactions of the financial market utility, and the effect that the failure of or a disruption to the financial market utility would have on critical markets, financial institutions, or the broader financial system. All four of these characterize the GSEs.

In the years after the crisis, under the direction of the FHFA (the independent federal agency, established through the Housing and Economic Recovery Act—HERA—as the successor to OFHEO, responsible for supervision, regulation, and housing mission oversight of the GSEs and Federal Home Loan banks), the GSEs have undergone substantial reform. They have wound down their portfolios, increased transparency, and de-risked through tighter credit standards and risk sharing. In 2012, the FHFA called for the GSEs to implement, which they have, credit-risk transfer (CRT) programs to allocate risk to the private sector, to help insure correct pricing of credit risk, and to minimize taxpayer exposure. Fannie Mae and Freddie Mac have issued CRTs with returns tied to the performance of the GSEs' loan pools, hence enabling a private sector pricing of risk, with transparency. Additionally, the GSEs have developed a common security platform to ensure liquidity for the trading of MBS and interest rate risk. While the GSEs are now less risky, the lack of equity capital to absorb losses leaves taxpayers still exposed to credit risk. In order to address the need for equity capital, so-called recap and release proposals have been put forth which would enable the GSEs to raise private capital to reduce further taxpayer risk and end the conservatorship of the GSEs.

Various plans have been proposed for the GSEs' restructuring, including multiple guarantors. I have set forth comments, along with co-authors Richard Cooperstein, Head of Risk Management at Andrew Davidson and Company, and Ken Fears, Senior Policy Representative for Banks, Lending, and Housing Finance at the National Association of REALTORS®, on the increased risk to the system of a multi-guarantor model, in part because the regulatory burden of overseeing the safety and soundness of multiple guarantors increases tremendously. Moreover, as Moody's recently opined, increasing the number of GSEs could lead to weaker underwriting standards or price competition, both credit negatives for the GSEs and ultimately for the taxpayer.

The key functions of the GSEs are to set standards and to provide transparency for the secondary mortgage market. The source of the crisis was the undermining of these standards, and as I have shown along with co-authors in a recent paper referenced below, the underpricing of risk, which led to an unsustainable expansion of bad credit.

With the oversight of the FHFA and with a SIFMU designation, the GSEs are in a position to maintain these functions going forward. In particular, the FHFA can provide oversight on the maintenance of sufficient capital reserves. But the FHFA alone cannot provide the collective oversight of the entities that comprise the mortgage market. To this end, I respectfully propose that the FSOC consider the designation of Fannie Mae and Freddie Mac as SIFMUs. The SIFMU designation can support macro-stability while enabling the GSEs to provide access to sustainable mortgage credit over the long term.

I thank you for the opportunity to testify today. I welcome your questions.

References

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