

Alan Greenspan: Regulatory reform of the government-sponsored enterprises

Testimony by Mr Alan Greenspan, Chairman of the Board of Governors of the US Federal Reserve System, before the Committee on Banking, Housing and Urban Affairs, US Senate, 6 April 2005.

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Mr. Chairman, Senator Sarbanes, and Members of the Committee, thank you for again inviting me to discuss the role of housing-related government-sponsored enterprises (GSEs) in our economy. As I described at length last year, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (hereafter Fannie and Freddie) have contributed importantly to the development of the secondary home mortgage market and thereby to the diversification of funding sources for depository institutions and other mortgage originators. In particular, Fannie and Freddie played a critical role in promoting mortgage securitization - the key to the success of secondary mortgage markets in the United States.¹

The stated intent of the Congress is to use the housing-related GSEs to provide a well-established channel between housing credit and the capital markets and, through this channel, to promote homeownership, particularly among lower-income families. Although prospectuses for GSE debt are required by law to say that such instruments are not backed by the full faith and credit of the U.S. government, investors have concluded that the government will not allow GSEs to default, and as a consequence offer to purchase GSE debt at substantially lower interest rates than required of comparably situated financial institutions without such direct ties to government.² Given this advantage, which private competitors are not able to fully overcome, the housing-related GSEs have grown rapidly in recent years.

The strong belief of investors in the implicit government backing of the GSEs does not by itself create safety and soundness problems for the GSEs, but it does create systemic risks for the U.S. financial system as the GSEs become very large. Systemic risks are difficult to address through the normal course of financial institution regulation alone and, as I will stipulate shortly, can be effectively handled in the case of the GSEs by limiting their investment portfolios funded by implicitly subsidized debt.

The government guarantee for GSE debt inferred by investors enables Fannie and Freddie to profitably expand their portfolios of assets essentially without limit.³ Private investors have granted them a market subsidy in the form of lower borrowing rates. Unlike subsidies explicitly mandated by the Congress, the implicit subsidies to the GSEs are incurred wholly at the discretion of the GSEs.

Because Fannie and Freddie can borrow at a subsidized rate, they have been able to pay banks, thrifts, mortgage companies, and other home mortgage originators slightly higher prices for mortgages than their potential competitors have paid. This edge has enabled Fannie and Freddie to gain gradually but inexorably an ever-larger share of the home mortgage market. Investors have provided Fannie and Freddie with a powerful vehicle for pursuing profits through the rapid growth of their balance sheets, and the resultant scale has given them an advantage that their potential private-sector competitors cannot meet.

But the higher prices that these two GSEs pay for mortgages are only a small part of their subsidy, as evidenced by their persistent and well-above-market returns on equity capital. Their annual return on equity, often exceeding 25 percent, is far in excess of the average approximately 15 percent annual

¹ Under securitization, mortgages are bundled into pools and then turned into securities that can be easily bought and sold along side other debt securities. Mortgage securitization continues to perform this important function, and such securitization techniques now have been applied extensively by the private sector to many other types of financial instruments.

² For example, the government provides the GSEs with a line of credit from the Department of the Treasury, fiscal agency services through the Federal Reserve, exemptions from securities registration requirements, exemptions from bank regulations on security holdings, and tax exemptions.

³ The Boards of Directors of Fannie and Freddie are allowed to invest in almost anything as long as there is some link, direct or indirect, to their mission of supporting conforming mortgage markets. As demonstrated by recent innovations in the home equity lending and asset-backed securities markets, much of the \$9 trillion in household credit can potentially be secured by real estate and thus may be available to the GSEs as investments. Moreover, the GSEs have been allowed to invest in many forms of non-mortgage debt, such as corporate bonds and commercial paper, to the degree the GSEs' can argue such investments support the GSEs' liquidity goals and thus indirectly support mortgage markets.

returns achievable by other large financial competitors holding substantially similar assets. Virtually none of the GSE excess return reflects higher yields on assets; it is almost wholly attributable to subsidized borrowing costs.

The ability of the GSEs to borrow essentially without limit has been exploited only in recent years. At the end of 1990, for example, Fannie's and Freddie's combined portfolios amounted to \$132 billion, or 5.6 percent of the single-family home-mortgage market. By 2003, the GSEs' portfolios had grown tenfold, to \$1.38 trillion or 23 percent of the home-mortgage market. The almost unlimited low credit risk profit potential from exploiting subsidized debt has been available to the GSEs for decades. The management of Fannie and Freddie, however, chose to abstain from making profit-centers out of their portfolios in earlier years, and only during the mid-1990s did they begin rapidly enlarging their portfolios.

Typically in a market system, lenders and investors monitor and discipline the activities, including leverage, of their counterparties to assure themselves of the financial strength of those to whom they lend. However, market discipline with respect to the GSEs has been weak to nonexistent. Because the many counterparties in GSE transactions assess risk based almost wholly on the GSE's perceived special relationship to the government rather than on the underlying soundness of the institutions, regulators cannot rely on market discipline to contain systemic risk.

When these institutions were small, the potential for such risk, if any, was small. Regrettably, that is no longer the case. From now on, limiting the potential for systemic risk will require the significant strengthening of GSE regulation and the GSE regulator. Determining the suitable amount of capital for Fannie and Freddie is a difficult and technical process, and in the Federal Reserve's judgment, a GSE regulator must have as free a hand as a bank regulator in determining the minimum and risk-based capital standards for these institutions.

Beyond strengthening GSE regulation, the Congress will need to clarify the circumstances under which a GSE can become insolvent and, in particular, the resultant position - both during and after insolvency - of the investors that hold GSE debt, as well as other creditors and shareholders. This process must be unambiguous before it is needed. Current law, which contemplates conservatorship and not receivership for a troubled GSE, requires the federal government to maintain GSEs as ongoing enterprises, but other than the symbolic line of credit at the U.S. Treasury, provides no means of financing to do so. Left unresolved, such uncertainties could threaten the stability of financial markets.

World class regulation, by itself, may not be sufficient and, indeed, might even worsen the potential for systemic risk if market participants inferred from such regulation that the government would be more likely to back GSE debt in the event of financial stress. This is the heart of a dilemma in designing regulation for GSEs.

On the one hand, stiffening their regulation might strengthen the market's view of GSEs as extensions of government and their debt as government debt. The result, short of a very substantial increase in equity capital, would be to expand the size of the implicit subsidy and allow the GSEs to play an even-larger unconstrained and potentially destabilizing role in the financial markets.

On the other hand, if we fail to strengthen GSE regulation, we increase the possibility of insolvency and crisis. We at the Federal Reserve believe this dilemma would be resolved by placing limits on the GSEs' portfolios of assets, perhaps as a share of single-family home mortgages outstanding or some other variation of such a ratio. Almost all the concerns associated with systemic risks 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 sheets of the GSEs, other than profit creation through the exploitation of the market-granted subsidy. Some maintain that these large portfolios create a buffer against crises in the mortgage market. But that notion suggests that the spreads of home-mortgage interest rates against U.S. Treasuries, a measure of risk, would narrow as GSE portfolios increased. Despite the huge increase in the GSE portfolios, however, mortgage

spreads have actually doubled since 1997, when comparable data for interest rate spreads on mortgage-backed securities first became available.⁴

A recent study by Federal Reserve Board staff found no link between the size of the GSE portfolios and mortgage rates.⁵ The past year provides yet more evidence, with GSE portfolios not growing and mortgage spreads, as well as the spread between yields on GSE debentures and Treasury securities, declining further. Indeed, while GSE stock prices have fallen substantially and turmoil has continued at the GSEs, mortgage markets have functioned well.

Others have asserted that fixed-rate mortgages would be more difficult, or perhaps even impossible, to obtain without the GSEs' portfolios. But, again, we see little empirical support for this argument. We have found no evidence that fixed-rate mortgages, for example, were difficult to obtain during the early 1990s when GSE portfolios were small. Indeed, the share of adjustable-rate mortgage originations averaged slightly more than 20 percent in 1992, when GSE portfolios were small, and averaged 34 percent in 2004, when GSE portfolios were large; these data suggest that the size of the GSEs' portfolios is unrelated to the availability or popularity of fixed-rate mortgages. As far as we can tell, GSE mortgage securitization, in contrast to the GSE's portfolio holdings, is the key ingredient to maintaining and enhancing the benefits of the GSEs to homebuyers and secondary mortgage markets. And mortgage securitization, unlike the GSE portfolio holdings, does not create substantial systemic risks.

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. Although Fannie and Freddie have chosen not to expand their portfolios significantly this past year (presumably at least partly in light of their recent difficulties), the potential for rapid growth in the future is not constrained by the existing legislative and regulatory regime. It is a reasonable presumption that rapid growth is likely to resume once Fannie and Freddie believe they have resolved their current difficulties.⁶ Without changes in legislation, Fannie and Freddie will, at some point, again feel free to multiply profitability through the issuance of subsidized debt. To fend off possible future systemic difficulties, which we assess as likely if GSE expansion continues unabated, preventive actions are required sooner rather than later.

Limiting the debt of Fannie and Freddie, while comparably expanding their role in mortgage securitization, would be consistent with the original congressional intent that these institutions provide stability to the secondary market for home mortgages and liquidity for mortgage investors. Indeed, in 1989, before the rapid expansion of its portfolio, Freddie testified before the Congress that the need for safe and sound operation and provision of affordable mortgages to homebuyers was inconsistent with holding a substantial portfolio. As argued by Freddie's CEO at that time, by financing mortgages with mortgage-backed securities sold to investors, Freddie avoided interest rate risks and thus could keep mortgages flowing when depository institutions were suffering an interest rate squeeze.⁷ Freddie's message changed after 1989 when it became owned by private shareholders and it began to exploit the risk-adjusted profit-making potential of a larger portfolio.

The creation of mortgage-backed securities for public markets is the appropriate and effective domain of the GSEs. Deep and liquid markets for mortgages are made using mortgage-backed securities that are held solely by investors rather than the GSEs. Fannie's and Freddie's purchases of their own or each other's mortgage-backed securities with their market-subsidized debt do not contribute usefully

⁴ Spreads averaged 148 basis points in 1997 and 280 basis points in 2003.

⁵ See Andreas Lehnert, Wayne Passmore, and Shane Sherlund (2005), "GSEs, Mortgage Rates, and Secondary Market Activities," Board of Governors of the Federal Reserve, Finance and Economic Discussion Series 2005-7, January.

⁶ Press reports indicate that during a recent open conference call, Freddie Mac said it is poised to start growing its portfolio again. For example, see "Freddie Earnings Fell Sharply in 2004; But GSE Sees Growth Potential and Rising Market Share in 2005," Inside MBS & ABS, April 1, 2005, page 4.

⁷ Leland C. Brendsel, Government-Sponsored Enterprises, Hearing before the Subcommittee on Oversight of the Committee on Ways and Means, House of Representatives, the 101st Congress, September 28, 1989.

to mortgage-market liquidity, to the enhancement of capital markets in the United States, or to the lowering of mortgages rates for homeowners.

The bulk of the GSEs' portfolio growth over the past decade has occurred mainly through the acquisition of their own mortgage-backed securities - which reflect the AAA-rating of pools of home mortgages. As I indicated earlier, holding their own securities in portfolio often yielded Fannie and Freddie subsidized annual returns on equity of more than 25 percent, far in excess of the returns to purely private financial institutions from holding such securities.

Limiting the systemic risks associated with GSEs would require that their portfolio holdings be significantly smaller. At the same time, reducing portfolios would have only a modest effect on financial markets. Currently, these portfolios are financed largely by the issuance of GSE debt, which, in turn, is held by investors.

If mortgage-backed securities were sold into the market or allowed to self-amortize - and accordingly GSE debt was redeemed - the transaction from the point of view of the supply and demand for high-quality credit is essentially a wash. In the simplest outcome, the holders of GSE debt would be seen as exchanging their debt instruments for the mortgage-backed securities previously held on GSE balance sheets.⁸ As for homebuyers, whether GSE mortgage purchases are held in GSE portfolios or securitized and sold to investors appears to have no noticeable effect on mortgage rates.

Limitations on portfolio holdings could be imposed gradually over several years and then adjusted upward or downward depending on the growth of the single-family mortgage market. Very short-term Treasury holdings needed for liquidity and other assets employed for business operations could be exempt from these limitations. Such a restriction would provide the GSEs with ample liquidity and would focus the GSEs almost exclusively on the purchase and securitization of mortgages, including mortgages for affordable housing. In other words, this restriction frees the GSEs of the difficulties of hedging large-scale interest rate risk. I should note that, even with such portfolio limits, Fannie and Freddie would likely remain among the most formidable of financial institutions in our country.

As I concluded last year, the GSEs need a regulator with authority on a par with banking regulators, with a free hand to set appropriate capital standards, and with a clear and credible process sanctioned by the Congress for placing a GSE in receivership, where the conditions under which debt holders take losses are made clear. However, if legislation takes only these actions and does not limit GSE portfolios, we run the risk of solidifying investors' perceptions that the GSEs are instruments of the government and that their debt is equivalent to government debt. The GSEs will have increased facility to continue to grow faster than the overall home-mortgage market; indeed since their portfolios are not constrained, by law, to exclusively home mortgages, GSEs can grow virtually without limit. Without restrictions on the size of GSE balance sheets, we put at risk our ability to preserve safe and sound financial markets in the United States, a key ingredient of support for homeownership.

⁸ If GSE debt holders do not want to hold mortgage-backed securities directly because of interest rate and prepayment risks, other forms of collateralized mortgage obligations are available to meet their needs.