



2006-PB-03
March 2006

The Evolution of a Policy Idea: How Restrictions on the Size of the GSEs' Portfolios became the Central Issue in Reform of their Regulation

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Abstract: The portfolios of mortgages and mortgage-backed securities held by Fannie Mae and Freddie Mac have now become the central issue in the legislative battle over improvements in their regulation. But it was not always so. When the notion of improving their regulation was first advanced in 2000, the objective of those who favored tighter regulation was far more limited. Only after it was found that Freddie Mac had violated accounting rules did policy-makers—and particularly Fed chairman Alan Greenspan—begin to suggest that the only way to protect against the systemic risk associated with the GSEs was to limit, reduce or eliminate their portfolios of mortgages and mortgage-backed securities. If this approach is ultimately adopted by Congress, it will substantially reshape their business model and perhaps induce them to give up their government charters.

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What was initially thought to be a futile effort to create a new and stronger regulator for Fannie Mae and Freddie Mac was begun in 2000 by a small group of legislators in the House of Representatives. Although this initiative was at first given virtually no chance of success against the two politically powerful government-sponsored enterprises (GSEs), by the end of 2005 the House had enacted legislation¹—now regarded as weak and ineffectual—that would have been considered inconceivable five years earlier. In the Senate, a far stronger bill emerged from the Senate Banking Committee. This bill contained language that would require the new regulator of the GSEs virtually to eliminate their portfolios of mortgages and mortgage-backed securities (MBS).² By the time Congress convened in 2006, the key issue associated with improving the regulation of the GSEs was whether their new regulator would have this authority.

Whether the GSEs will be able to hold portfolios of mortgages and MBS goes well beyond the simple question of the scope of regulatory authority; a direction from Congress that requires the new regulator to limit or reduce the size of the GSEs' portfolios would profoundly reshape the GSEs and their role in the economy. Because of its adverse effect on their profitability, some believe that limiting the size of the GSEs' portfolios will cause them to abandon their government charters entirely and attempt to privatize. In a relatively few years, then, the debate over the role of the GSEs has moved from futility, to a consensus that improved regulation was necessary, and finally to whether they can be allowed to continue

¹ *Federal Housing Finance Reform Act of 2005*, 109th Cong., 1st sess., H.R. 1461, October 26, 2005.

² *The Federal Housing Enterprise Regulatory Reform Act of 2005*, 109th Cong. 1st sess., S. 190.

to pursue a business model that has brought them, their shareholders, and their managements enormous prosperity. How this happened, and why, is the subject of this paper.

Introduction

When initially introduced in 2000, legislation to control Fannie and Freddie focused principally on the stronger capital requirements, the need to provide their regulator with receivership powers, and control of their expansion into other areas of the financial economy. These issues were controversial enough to make it seem unlikely in 2000 that any legislation would be adopted. Indeed, Congressman Richard Baker, the chairman of the House subcommittee with oversight of the GSEs, had difficulty finding any support within his own subcommittee for legislation that would tighten the regulation of the two huge companies.

Yet, within five years, the atmosphere had changed markedly. The controversial questions of 2000 had melted away and almost all debate, as 2006 began, focused on the issue of portfolio size. In a sense, this was always the central question. By the end of 2005, the GSEs' portfolios of mortgages and MBS had an aggregate value of approximately \$1.5 trillion. Balance sheets of this size, and the borrowings required to sustain them, made Fannie and Freddie very powerful and influential companies. Moreover, since the GSEs—which are viewed in the capital markets as backed by the United States government—enjoyed interest rates only slightly higher than those received by the Treasury itself, the portfolios were enormously profitable. Fannie and Freddie were able to borrow at low rates and buy and hold mortgages that produced substantially higher yields.

At the same time, however, because Fannie and Freddie borrowed the funds to buy these mortgages and MBS in their portfolios, the holding of these assets created substantial interest rate risk. The prepayment option in every U.S. mortgage meant that homeowners could refinance their mortgages whenever interest rates fell, but hold them when interest rates rose. The GSEs, then, were always faced with the problem of predicting whether interest rates would rise or

fall, and without careful hedging they could lose either way. A simple example will illustrate why the GSEs bear risk when interest rate both rise *and* fall. Suppose a GSE borrows funds on which it will have to pay five percent interest for five years, and uses these funds to purchase a pool of mortgages that pays six percent. That would yield a profitable one percent spread. However, if interest rates were to fall to four percent, many of the six percent mortgages in the portfolio would be refinanced; in effect, they disappear. The GSE would receive the cash, of course, but would be left with the problem of investing the five percent funds it has borrowed at the four percent rate that now prevails in the market. For the remainder of the original five year period, the GSE could lose one percent on each new mortgage purchased. The same thing could happen in reverse if interest rates were to rise. In that case, homeowners would keep their mortgages, but at some point the GSE would have to refinance the five percent debt it had originally contracted. If at that time interest rates were, say, six percent, the GSE would have to pay this amount to hold mortgages that were yielding only five percent—again suffering a loss.

Thus, while their portfolios can be very profitable, and the source of much of the GSEs' financial and political power, they were also the source of concern that a serious mistake in predicting the direction of interest rates might result in substantial losses—not only to the GSEs themselves, but also to the taxpayers who might be required to bail them out—and to the economy generally if their financial distress were to spread to other parts of the complex U.S. economic system. This prospect—that the GSEs' financial difficulties might spread to the rest of the economy—has a name: *systemic risk*—and it was the gradual recognition of the relationship between the GSEs' portfolios and systemic risk that helped drive the pressure for limiting the size of the portfolios. But as we will see, this recognition dawned only slowly and became significant only after disclosures that Fannie and Freddie were not complying with accounting rules and were not as well managed as had previously been thought.

The Rise of the Systemic Risk Issue

The GSEs operate in the secondary mortgage market in two different ways. Through a process known as securitization, they assemble pools of mortgages and sell securities—MBS—backed by those pools. In addition, they purchase and hold both mortgages and MBS as investments. In some cases, the GSEs buy back for their portfolios the same MBS they had previously issued and sold to investors. The proponents of placing limits on the size of the GSEs' portfolios argue that the huge sums they must borrow in order to acquire and hold mortgages and MBS create substantial interest rate risk, and that the GSEs could continue to provide whatever assistance they furnish to the secondary mortgage markets through securitization alone. This would virtually eliminate systemic risk, because in the securitization process the GSEs guarantee only that the mortgages in the pool will pay principal and interest at the contracted rates; the holders of the MBS take the rate risk that interest rates will rise or fall. Fannie and Freddie counter that eliminating their authority to accumulate portfolios of mortgages would undercut their ability to function in the secondary mortgage market and ultimately raise the interest rates borrowers would have to pay for mortgage credit. By March 2006, as this is written, all indications were that the legislation would stand or fall on this issue. The administration seemed to be firm in its view that there was no point in passing legislation unless it contained restrictions on the GSEs' portfolios, and Fannie and Freddie's supporters in Congress seemed equally determined not to adopt legislation that contained such a limitation.

Despite its centrality to the debate—and the likelihood of GSE regulatory reform legislation—the issue of systemic risk and limiting the size of the GSEs' portfolios is of relatively recent vintage. Legislation that purported to address and reduce systemic risk was introduced in every Congress since 2000, but only at the end of 2004 did the idea become widely accepted that limiting the size of the GSEs' portfolios was the key to reducing the systemic risk they create. This is remarkable, considering that all the relevant facts were known from the

beginning,³ but no one in the government—including Federal Reserve Chairman Alan Greenspan—seemed to have connected the dots. This paper will explore the development of the idea that the GSE portfolios are the source of their systemic risk, and the corollary idea that in order to address the systemic risk issue it is necessary to place limits on, or even reduce, the size of those portfolios. Because of his central role in the portfolio size issue, this paper will also trace the development of Alan Greenspan’s thinking on this question.

What is Systemic Risk?

The *Analytical Perspectives* section of the President’s 2007 budget, prepared by the Office of Management and Budget (OMB), contains a detailed discussion of systemic risk and the need to limit it by reducing the size of the GSEs’ portfolios.⁴ The 2007 budget defines systemic risk as “the risk that a failure in one part of the economy could lead to additional failures in other parts of the economy—the risk that a small problem could multiply to a point where it could jeopardize the country’s economic well-being. The particular systemic risk posed by the GSEs is the risk that a miscalculation, failure of controls, or other unexpected event at one company could unsettle not only the mortgage markets but other vital parts of the economy.”

The discussion then continues:

To understand this risk, one must understand the interdependencies among the GSEs and other market participants in the financial system. While the interrelationships of the modern financial system permit highly efficient management and dispersion of risk, these interdependencies, if not disciplined by the regulatory and market environment, may allow a failure in one place to immediately disrupt many other sectors.⁵

The document then details how systemic risk is created by the GSEs’ portfolios, noting that investors in GSE debt securities include thousands of banks,

³ See Peter J. Wallison, “The Fannie/Freddie Time Bomb,” *The International Economy*, Fall 2002, 28.

⁴ Office of Management and Budget, *Analytical Perspectives: Budget of the United States Government, Fiscal Year 2007*, 71-74. Available at www.whitehouse.gov/omb/budget/fy2007/pdf/spec.pdf.

⁵ *Ibid.*, 72.

institutional investors such as insurance companies, pension funds and foreign governments, and millions of individuals through mutual funds and 401(k) investments. These investors, OMB notes, act as if GSE securities carry no risk—that the U.S. government will stand behind Fannie and Freddie if they should suffer some kind of financial reverse. Although OMB notes that there is in reality no such explicit guarantee, the belief in ultimate government backing reduces market discipline. This is demonstrated, OMB points out, by the fact that there has been no significant effect on the interest rates paid by Fannie and Freddie on their borrowings even though both, because of accounting problems, have suspended the publication of current financial statements. Thus, the portfolios of Fannie and Freddie can continue to grow even though their financial condition is unknown. OMB then outlines why the growth of the portfolios increases systemic risk:

Although the GSEs' mortgage investments are of relatively low default risk, other types of risk in the GSEs' asset portfolios are substantial. Mortgage portfolios carry considerable interest-rate risk, partly because of the prepayment risk caused by the refinance option available on most mortgages that allows homeowners to prepay their mortgages at any time to take advantage of lower interest rates. This risk can be mitigated—for example, through purchase of interest-rate hedges—but the GSEs protect themselves against only some of the interest rate risk of their portfolios. Moreover, hedges are imperfect. Hedging misjudgments would occur even if the GSEs' policy were to fully hedge the portfolio because predicting interest-rate movements and mortgage refinancing activity is difficult.⁶

Despite an extended discussion of systemic risk, the OMB analysis does not consider all the channels through which financial problems at the GSEs could

⁶ Ibid.

cause substantial harm to the wider economy. OMB's discussion, as is common in considerations of systemic risk, focuses on the dangers to depository institutions, since these have traditionally been regarded as the most likely sources of systemic events and the most likely means by which a failure of some kind in one area of the economy is transmitted to others. Thus, OMB notes: "Contrary to their other investments, banks are required to hold only a small amount of capital against the risk of decline in value or failure of the GSE investment.... Research shows that more than 60 percent of institutions in the banking industry hold as assets GSE debt in excess of half of their equity capital."⁷ OMB's argument, then, is that if one or both of the GSEs should be unable to meet their obligations, the capital of the banking industry will be reduced or depleted. This will cause a decline in lending and a corresponding reduction in economic activity—the definition of a systemic event.

However, Fannie and Freddie are unique entities, and OMB's discussion does not exhaust the ways in which their financial difficulties might be exported to the rest of the economy. To be sure, they have all the attributes of financial institutions—especially their connections through the issuance of debt to the banking system—but they also dominate and are central to the housing industry, a major sector of the real economy. This provides an independent pathway for the financial problems of a GSE to be transmitted to the rest of the economy. In February 2003, the Office of Federal Housing Enterprise Oversight (OFHEO), the regulator of Fannie and Freddie, issued a report that candidly discussed the possibility of a systemic event arising out of the activities of the GSEs, positing several scenarios where severe financial problems at Fannie or Freddie could have systemic effects. The worst-case scenario describes a set of facts that does not seem so remote—given that, as discussed below, we now know of severe deficiencies in the accounting and financial reporting at both Fannie and Freddie. In any event, the OFHEO Report scenario unfolds as follows: "Enterprise A

⁷ Ibid., 74.

unexpectedly incurs large losses...Investors generally do not believe Enterprise A is viable and are uncertain about whether it will default, about the size of any credit losses they may incur, and about the future liquidity of its debt. That uncertainty leads to widespread selling of Enterprise A's debt as well as a large decline in the market prices of its MBS."

The scenario notes that under some circumstances Enterprise B might be able to pick up A's business, so the housing finance system would continue with slightly higher mortgage rates. However, "if Enterprise B cannot expand its activities quickly, a significant short-term decline in mortgage lending, home sales, and housing starts occurs, contributing to problems elsewhere in the economy and increasing the likelihood of macroeconomic losses." ⁸ This scenario might be remote; it might not be. But it points out that a sudden shock at Fannie and Freddie is not the same as a sudden shock at an ordinary bank—even a large one. The systemic danger from a bank's failure is its connections to other financial institutions, particularly other banks. If a bank cannot meet its obligations, other banks might also be unable to meet theirs. In this way, a shock at a large bank can spread through the financial system and cause losses in the real economy as economic activity slows or stops while the crisis continues.

However, a shock at Fannie or Freddie could move differently through the economy. If either of them is unable to function, the housing market could be directly and immediately affected; mortgage rates could rise, financing of housing could slow, housing starts could decline, and all the other industries in the U.S. economy that depend on housing—furniture, appliances, and construction, among many others—could be adversely affected.

Thus, because of their dominance in the housing market, and the importance of that market to the U.S. economy as a whole, a serious financial problem at Fannie or Freddie would be far worse than a similar problem at even the largest

⁸ Office of Federal Housing Enterprise Oversight, *Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO*, February 2003, 98. Available at www.ofheo.gov/Media/Archive/docs/reports/sysrisk.pdf.

banks. In the case of a big bank meltdown, the Fed can always provide additional liquidity to the market—so as to alleviate concern about the availability of funds—but the Fed cannot provide a lifeline for a housing finance system that depends for its functioning on only two companies, and cannot restore the capital of the thousands of banks that held large amounts of Fannie and Freddie debt.⁹ That can only be done by Congress, which would have to rescue Fannie or Freddie, or both, with taxpayer funds.

There is still a third way that a financial problem at either of the two GSEs could cause a systemic event. The huge portfolios of Fannie and Freddie are supported by correspondingly large borrowings. Since they hold only small amounts of capital—the statutory requirement is 2.5 percent for all on balance sheet assets—the total portfolios of the GSEs are supported by borrowings of almost the same size. Portfolios of \$1.5 trillion, then, reflect substantial balance sheet liabilities and, as noted above, this creates a huge potential for loss if interest rates suddenly rise or fall. The GSEs protect themselves against this eventuality by engaging in hedging transactions such as interest rate swaps and other more complicated derivatives transactions. The counterparties in these hedging transactions tend to be large banks and securities firms, and if Fannie or Freddie defaults, these hedges lose value. The counterparty is itself no longer protected against an adverse move in interest rates. This condition may cause the GSEs' counterparties to suffer losses, reducing their capital and the value of their obligations—again causing losses throughout the economy.

⁹ Theoretically, the Fed could purchase Fannie or Freddie debt and thus restore its value, but this would be a very risky proposition, and highly unlikely. One of the reasons it is risky is that, as noted above, there is no legal mechanism for shutting down the financially troubled or insolvent company. The Fed could restore the company's market credibility, but could take significant losses if the company continues to operate and incurs additional losses. In addition, Congress may ultimately decide not to bail out all creditors, and this might especially be true if the Fed's purchases have calmed the market sufficiently so that the crisis is past. Normally, when the Fed floods the market with liquidity in a financial crisis, it purchases riskless U.S. Treasury securities. There is no legal assurance that the holders of Fannie or Freddie securities will be bailed out, and thus no assurance that the Fed will be reimbursed for its losses.

Can a GSE produce a systemic event?

This raises an important question. If in fact Fannie and Freddie are implicitly backed by the U.S. government, why should there be any systemic event arising out of a financial shock? Indeed, in the early 1980s, Fannie Mae was insolvent for an extended period and was still able to obtain funding in the capital markets. There are a number of reasons why Fannie Mae did not face adverse financial market conditions when it became insolvent more than 20 years ago. At the time, the insolvency of large numbers of savings and loan associations (S&Ls) was well known in the markets, and Congress had made clear that it would take whatever steps were necessary to assure stability in the housing finance market. Fannie Mae's condition was not a surprise, and was part of the same syndrome—high interest rates—that had caused the S&L industry to become insolvent. The problems of the S&L industry and Fannie Mae were thus seen as temporary—something that would rectify itself when interest rates declined. Finally, Fannie Mae was considerably smaller than it is today, even in relation to the smaller size of the government at that time. There was little doubt in the markets that the government could bail out Fannie Mae, if necessary, without creating a heavy cost to taxpayers.

If an event with systemic potential should occur today, circumstances would be very different. First of all, it will be a surprise. Because of the weak supervision and lack of transparency at Fannie and Freddie, a serious financial reverse is likely to be a shock to the markets. The markets today are globalized, including many foreign financial institutions and central banks that are large holders of Fannie and Freddie debt. These holders, not fully understanding U.S. politics, will be inclined to dump their securities first and ask questions afterward, driving down prices and possibly causing panic selling among U.S. investors, too. Congress, which alone would have the authority to close the failing institution or provide the financing to sustain it, might not be in session, or if it is there would likely debate about whether the taxpayers should assume all of the losses or share some with the creditors. Since Fannie and Freddie have almost \$4 trillion in

obligations outstanding (their direct debt plus their guarantees of MBS), the question is not without significance or political costs.

Moreover, as noted in the 2003 OFHEO report, "Today, financial information is disseminated much more rapidly, and investors rebalance their portfolios in response to much smaller changes in financial market conditions and economic indicators. Those changes and aspects of the government's relationship to the Enterprises [the GSEs] suggest that it would be possible for the market for the debt of an Enterprise [a GSE] that had serious solvency problems to become illiquid."¹⁰

Accordingly, in the context of an event with systemic potential, there is little comfort that can be taken from the fact that Fannie and Freddie enjoy implicit government support. That support will almost certainly come at some point, but the delays and uncertainties associated with who, if anyone, will actually share losses with U.S. taxpayers could mean that a great deal of damage will be done to the U.S. economy while these questions are resolved.

Connecting Systemic Risk to the GSEs' Portfolios

Although the OMB discussion in the 2007 budget document connects systemic risk to the portfolios held by Fannie and Freddie, until 2004 neither OMB nor any other official body argued that the portfolios should be limited, reduced or eliminated in order to reduce systemic risk. Until that year, while there was frequently expressed concern about systemic risk, OMB, Fed Chairman Greenspan, and the lawmakers directly involved in drafting legislation to improve the regulation of the GSEs, all attempted to address the issue through tougher regulation.

Thus, H.R. 3703, introduced in February 2000 by Congressman Richard Baker, the chairman of the subcommittee of the House Financial Services Committee with jurisdiction over the GSEs, includes a section on "Reduction of Systemic Risk." The elements of this section, however, included only a few modest ideas—

¹⁰ Office of Federal Housing Enterprise Oversight, *Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO*, February 2003, 92. [footnote omitted]

a requirement for an annual review of the GSEs by rating organizations, changes in the risk-based capital test adopted for the GSEs in 1992, and provisions for appointment of a receiver in case either of the GSEs becomes critically undercapitalized. Similarly, H.R. 1409, introduced by Chairman Baker in April 2001, called for a study by the Federal Reserve Board of the GSEs' portfolios, but proposed no specific action to address the systemic risk the portfolios might create.

This pattern was followed again in H.R. 2575, introduced in June 2003. In this case, the purpose of the systemic risk study was made somewhat clearer, with draft language calling for a joint report on the GSEs by the Treasury, Federal Reserve and other financial regulators. One of the topics was "the extent to which the unlimited holdings by federally insured depository institutions of the obligations of the [GSEs] could produce systemic risk issues for the safety and soundness of the banking system."¹¹ But other than this, the bill proposed no steps specifically to deal with the size of the portfolios and their relationship to systemic risk.

The approach was no different in the Senate. A Senate bill, S. 1508, was introduced in July 2003, by Senators Hagel, Sununu and Dole, but again did not propose any specific steps to address systemic risk; its only reference to systemic risk was a request—similar to that in the House bills—for a joint study by the Treasury, Fed and other financial regulators of whether "the unlimited holdings by federally insured depository institutions of the obligations of the [GSEs] could produce systemic risk issues, particularly for the banking system in the United States, in the event of default or failure by [a GSE]."¹² Again, the emphasis at this point was on "unlimited" holdings of GSE securities by banks, not the unlimited portfolios of the GSEs supported by these and other debt obligations.

¹¹ *Secondary Mortgage Market Enterprises Regulatory Improvement Act*, 108th Cong., 1st sess., H.R. 2575, 69.

¹² *Federal Enterprise Regulatory Reform Act of 2003*, 108th Cong., 1st sess., S. 1508, 56.

Others outside Congress were equally unwilling at this point to draw a connection between systemic risk and the GSE portfolios. In 2000, shortly after introducing H.R. 3703, Chairman Baker wrote to Federal Reserve Board chairman Alan Greenspan, asking for his views on whether the GSEs created systemic risk. Although Greenspan would later become the principal advocate for controlling systemic risk through limiting the size of the GSEs' portfolios, he was decidedly cool to the idea in 2000, telling Baker: "As a general practice, we do not comment on any institution or any particular group [of] institutions with regard to systemic risk." Instead, Greenspan emphasized the adverse consequences of the GSE subsidies: "Subsidies accorded to GSEs are, of necessity, at the expense of other federal or private sector initiatives and hence are ultimately financed by households, either through taxes or through the reduced accumulation of wealth."¹³

Indeed, at this point, Chairman Greenspan was not willing to admit that the GSEs were the sources of systemic risk. Testifying at a hearing in July 2000, he was asked whether the GSEs might be creating risk to the financial system because of the absence of market discipline. In response, he remarked: "These GSEs are rather well-run institutions and they have got very good risk management procedures in and of themselves. I think the issue is less that they will run into trouble, that the general impact of their size and growth, as it impacts the rest of the financial system, creates potential imbalances which could create secondary problems. And I think that's the area where a lot of examination has got to be made."¹⁴

By April 2002, however, Chairman Greenspan was beginning to suggest in speeches that the GSEs might be doing more than simply creating "imbalances." He noted in a speech to the Institute of International Finance that "concerns

¹³ Federal Reserve Chairman Alan Greenspan to Congressman Richard Baker, May 19, 2000. Available at <http://bodurtha.georgetown.edu/FreddieMac/articles/Greenspan%20Details%20His%20Concerns%20Over%20Fannie%20Mae,%20Freddie%20Mac.htm>.

¹⁴ House Committee on Banking and Financial Services Administration, *Conduct of Monetary Policy*, 106th Cong., 2nd sess., July 25, 2000. Available from LexisNexis.

have been raised about potential counterparty risk in the large interest rate hedging efforts of the government-sponsored enterprises (GSEs) in support of their secondary mortgage market operations...In this case, the perception of government support may induce the counterparties to GSEs to apply less vigorously some of the risk controls that they apply to manage their over-the-counter derivatives exposures.”¹⁵

The year 2003, however, became a turning point in the approach to the GSEs. In June of that year, Freddie Mac announced that an investigation of its accounting had found misstatements of earnings for prior years. Oddly, the misstatements had *understated* the actual results of Freddie’s operations; the company was either deferring the recognition of its earnings to future years, which might be less favorable, or attempting to hide the degree to which its earnings were vulnerable to the effects of new accounting rules for hedging transactions that had recently taken effect. Whatever the motive, in a move that took the market and everyone else completely by surprise, Freddie’s board dismissed its top two officers. Perhaps most important, only days before the announcement of the management shakeup, OFHEO had reported favorably on Freddie’s condition. To the embarrassment of the regulator, it had apparently been unaware of the controversy over the financial statements and the impending management changes.

Freddie’s announcement, and its failure to notify its own regulator of what was coming, set in motion several other significant events. OFHEO decided that if Freddie had manipulated its accounting it would be best to determine whether Fannie had also done so. It requested and received a special appropriation from Congress to do a “forensic audit” of Fannie’s accounting. This resulted, in the fall of 2004, in a report from OFHEO that accused Fannie of failing to comply with accounting rules and in at least one case overstating its earnings so as to assure

¹⁵ Alan Greenspan, “Finance: United States and global,” speech to the Institute of International Finance, New York, NY (via videoconference), April 22, 2002. Available at www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20020422/default.htm.

that its top officers would receive their bonuses.¹⁶ In a dramatic confrontation at a House Financial Services Committee subcommittee hearing, Franklin Raines, Fannie's chairman, accused OFHEO of misconstruing the accounting rules the company had been accused of violating. When the Securities and Exchange Commission later sided with OFHEO, Raines and Fannie's chief financial officer were compelled to resign.

But the revelations about the GSEs' distorted accounting appear to have had more far-reaching effects than the dismissal of the top officers of the two GSEs. Although Alan Greenspan had earlier referred to the GSEs as "well-run institutions," this could no longer be taken for granted. It seemed possible that if Fannie and Freddie could not get their accounting straight, their complex hedging transactions—which were designed to reduce the risk of their portfolios—were in even greater disarray. The idea that the failure of one or both of the GSEs could occur, and have systemic effects, no longer seemed so far-fetched. Another contributing factor to the rethinking of the GSE problem was a loss of confidence in OFHEO as a regulator, and possibly a loss of confidence that any regulator would be able to understand and control the risks created by the two giant companies. At this point, their portfolios of mortgages and MBS totaled approximately \$1.5 trillion, and their total obligations—including their guarantees of outstanding MBS—were approaching \$4 trillion, a sum that was almost as large as the obligations of the U.S. Treasury itself.

These factors seemed to produce a major change in Greenspan's approach to the GSE problem. In testimony to the Senate Banking Committee in February 2004, the Fed Chairman was more explicit about the risks created by the GSEs than ever before. He began to place emphasis on the possibility that they might make mistakes that could have serious adverse consequences for the economy. Referring to the management of interest rate risk, he noted: "To manage this risk with little capital requires a conceptually sophisticated hedging framework.

¹⁶ Office of Compliance, OFHEO, *Report of Findings to Date Special Examination of Fannie Mae*, September 17, 2004. Available at www.ofheo.gov/media/pdf/FNMfindingstodate17sept04.pdf.

In essence, the current system depends on the risk managers at Fannie and Freddie to do everything just right, rather than depending on a market-based system supported by the risk assessments and management capabilities of many participants with different views and different strategies for hedging risks."¹⁷ Then, for the first time, Greenspan made a tentative foray into the idea of limiting the size of the GSEs' portfolios, by suggesting that the GSEs' issuance of debt be limited. Although he did not call for an outright reduction of the portfolios, limiting the issuance of debt amounts to the same thing. If the GSEs could not issue debt beyond a certain amount, they also could not accumulate portfolios:

Most of the concerns associated with systemic risks flow from the size of the balance sheets that these GSEs maintain. One way Congress could constrain the size of these balance sheets is to alter the composition of Fannie and Freddie's mortgage financing by limiting the dollar amount of their debt relative to the dollar amount of mortgages securitized and held by other investors...this approach would continue to expand the depth and liquidity of mortgage markets through mortgage securitization but would remove most of the potential systemic risks associated with these GSEs.¹⁸

This statement was an important development in the debate over the regulation of the GSEs. From that point on, the Fed chairman was to be the leading spokesman for limiting the size of the companies' portfolios. His views concerning the need for limitations on the GSEs' issuance of debt were then picked up by OMB in the *Analytical Perspectives* statement that accompanied the 2006 budget: "Chairman Greenspan has suggested statutory limits on the dollar amount of the debt held [sic] by Fannie Mae and Freddie Mac relative to the

¹⁷ Senate Committee on Banking, Housing, and Urban Affairs, *Proposals for Improving the Regulation of the Housing Government Sponsored Enterprises*, 108th Cong., 2nd sess., February 24, 2004. Available at www.federalreserve.gov/boarddocs/testimony/2004/20040224/default.htm.

¹⁸ Ibid.

dollar amounts of mortgages securitized and held by other investors.”¹⁹ This statement, prepared late in 2004 and issued shortly after the beginning of 2005, presaged a change in the administration’s position on regulating Fannie and Freddie. From this point on, the focus of the administration’s strategy would be limiting the size of the GSEs’ portfolios—a determination that was only strengthened by the highly negative OFHEO report on Fannie in late 2004. After that, although the Secretary of the Treasury and the Secretary of Housing and Urban Development would both argue in congressional testimony that it was necessary to limit the GSEs’ portfolios, most of the heavy lifting on this subject was done by Fed Chairman Greenspan. As 2005 wore on, Greenspan’s concern about the systemic risk created by the GSEs’ portfolios seemed to grow, and his testimony and other statements became more insistent and detailed. Although his first remarks suggested that their issuance of debt should be curtailed, he soon turned his attention to the size of the portfolios themselves. The Fed chairman, who once spoke dryly about the GSEs as distorting the market because of their subsidies, began to express much more specific concerns. Thus, during testimony before the House Financial Services Committee in February, 2005, in response to a question from Chairman Baker about whether there should be growth restraints on the GSEs, he remarked:

[W]e have examined the purposes of ...the portfolios that Fannie and Freddie are holding...We have found no reasonable basis for that portfolio above very minimal needs...[T]hey should be limited to \$100 billion, \$200 billion—whatever the number might turn out to be in the size of their aggregate portfolios...And over time—I don’t believe that we should have divestiture, but over time, several years, that should be done because

¹⁹ Office of Management and Budget, *Analytical Perspectives: Budget of the United States Government, Fiscal Year 2006*, 93. Available at <http://a255.g.akamaitech.net/7/255/2422/07feb20051415/www.gpoaccess.gov/usbudget/fy06/pdf/spec.pdf> .

these institutions, if they continue to grow...they potentially create ever growing potential systemic risks down the road.²⁰

This apparently off-hand comment reflected a major step—for the first time a government official had suggested a cap, a maximum size, for the GSEs' portfolios. And it was a radical suggestion, since at that point the portfolios were anywhere from 7 to 15 times the size that Greenspan was suggesting. For a while, the question of what number should be used to describe the appropriate size of the portfolios became the principal issue, but it soon became clear that any size was arbitrary—what was important was to establish a formula that would authorize a future regulator to cap the growth or limit the size of the portfolios. Greenspan recognized this, but seemed to have no ready suggestion. In prepared testimony to the Senate Banking Committee in early April, 2005, he implicitly abandoned a specific number but proposed some kind of ratio for determining what the size limitation should be. But in discussing this issue, he made clear that “world class regulation,” the cliché that was in use in Congress up to that time to describe the range of new powers that were to be given to a new GSE regulator, was not a panacea. The only sure way to eliminate systemic risk, he implied, was to address the problem of the portfolios. This, too, broke new ground. Up to that point, no official, including Greenspan himself, had ever suggested that a regulator with all the powers of a bank regulator would not be able to protect the economy and the taxpayers. These were his key points:

World class regulation, by itself, may not be sufficient [to control systemic risk], 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....We at the Federal Reserve believe this dilemma would be resolved by placing limits on the GSEs' portfolios of assets, perhaps as a

²⁰ House Committee on Financial Services, *Monetary Policy Report*, 109th Cong., 1st Sess., February 17, 2005. Available from LexisNexis.

share of single-family home mortgages outstanding or some other variation of such a ratio. Almost all concerns associated with systemic risks flow from the size of the balance sheets of the GSEs...”²¹

It was the Treasury Department that finally developed the language for which Chairman Greenspan was searching. In late May, Treasury submitted to both the House and Senate committees the following draft language:

PORTFOLIO LIMITATIONS.

“(a) ESTABLISHMENT OF LIMITS.--In order to maintain the safety and soundness of the enterprises and to limit systemic risk to the broader financial system--

“(1) the Director, within 1 year from the date of enactment of this Act, and from time to time thereafter, shall adopt regulations in final form *that establish the maximum size of the portfolio* (including, as appropriate, a transition period to conform to such maximum size) that each enterprise may hold; and

“(2) the Director shall ensure that the regulations adopted under paragraph (1) allow each enterprise *to hold only those assets that the enterprise needs to fulfill its mission through-*

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“(A) purchasing mortgage loans from mortgage originators for prompt securitization and sale to parties unaffiliated with the enterprise;

“(B) purchasing and retaining mortgage loans that are necessary to meet the housing goals established for the enterprise under Part 2 of the Federal Housing Enterprises Financial Safety and Soundness Act of

²¹ Senate Committee on Banking, Housing, and Urban Affairs, *Reform of the Government-Sponsored Enterprises*, 109th Cong., 1st sess., April 6, 2005. Available at www.federalreserve.gov/BoardDocs/Testimony/2005/20050406/default.htm.

1992 and that cannot be readily securitized and sold to unaffiliated persons at a commercially reasonable price; and

“(C) purchasing and retaining mortgage related assets (other than those authorized by subparagraphs (A) and (B)) and U.S. Treasury bills only to the extent that the Director determines such actions are necessary for the enterprise to maintain a liquid secondary mortgage market in a way that cannot be achieved through the activities described in subparagraphs (A) and (B) and are consistent with the public interest. [Emphasis supplied]

This language provided a formula for how to determine the allowable size of any GSE holdings or mortgages and formed the basis for a provision in the subsequent Senate bill, S. 190, which passed the Senate Banking Committee on a party-line vote on July 28, 2005. The language of the Senate bill with respect to the GSEs’ portfolios was close to Treasury’s approach, but contained more detailed restrictions. Thus, S. 190 directed the new regulator of the GSEs to “prohibit” each enterprise from acquiring or holding assets other than (1) mortgages and mortgage-backed securities for the purpose of securitization; (2) mortgages acquired to meet affordable housing goals, if such assets are not readily securitized; (3) a limited inventory of mortgages solely for the purpose of supporting the guarantee business; (4) cash; (5) real estate acquired through foreclosure; (6) United States Treasury securities (held for liquidity purposes); and (7) real estate, intellectual property, fixtures, and equipment for use in the business operations of the enterprise. S. 190 is currently awaiting action in the Senate.

Also in July, Chairman Greenspan was uncharacteristically blunt in his assessment of a much weaker House Financial Services Committee bill that did not provide the new regulator with any direct authority to reduce the GSEs’

portfolios. When asked by Congressman Ed Royce of California whether the Committee's bill met the concerns of the Federal Reserve Board, Greenspan—renowned for the obscurity of his responses on monetary policy—responded, “It does not, Congressman...most specifically the issue of the size of the portfolios...And unless and until we can address those issues, I do not think we've appropriately removed what is a very...significant threat to our financial system longer-term.” When asked by Congressman Royce whether no bill would be better than the bill the Committee was considering, Greenspan answered, “That would be my opinion.”²²

Finally, in a letter to Senator Robert Bennett on September 2, 2005, Greenspan reviewed the arguments that were then being made against limitations on the portfolios, dismissing them one by one. Then, he addressed the point that Congress should not tamper with the current structure of residential finance, warning that failure to act on the GSEs' portfolios could endanger the entire US financial system: “In closing, it is certainly true that when dealing with policies that affect so important an institution as home ownership in this country, caution is always commendable. However, caution based on concerns without merit can be counterproductive. Indeed, in the case of the GSEs, excessive caution in reducing their portfolios could prove to be destabilizing to our financial system as a whole and in the end could seriously diminish the availability of home mortgage funds.”²³

This dramatic phrasing of the issue is a far cry from Chairman Greenspan's initial response to this issue five years earlier, when he spoke of the GSEs' creating “imbalances” in the economy. Over the course of five years, his view changed substantially, hardening and becoming more pointed, particularly after it became clear that Fannie and Freddie were manipulating their financial results. Whether the evolution of Chairman Greenspan's views was the cause or the effect of a

²² House Committee on Financial Services, *Monetary Policy and the State of the Economy*, 109th Cong., 1st sess., July 20, 2005. Available from LexisNexis.

²³ Federal Reserve Chairman Alan Greenspan to Senator Robert F. Bennett, September 2, 2005. Available at <http://online.wsj.com/public/resources/documents/Greenspan091505.pdf>

parallel odyssey in legislation is not clear, but there is no question that his forceful advocacy changed the central issue under consideration—from tighter regulation that would have left the GSEs largely intact to a regulatory regime that has the potential to reshape their business model. By eliminating their opportunity to earn substantial profits from acquiring and holding large portfolios of mortgages and MBS, any such legislation could well induce the GSEs to give up their government charters and seek greater profitability as solely private sector companies.

Conclusion

Looking back over the evolution of both Greenspan's views and the legislation that is now before Congress, the most consequential event appears to have been the admission by Freddie Mac that it had manipulated its financial reports. While that disclosure was not in itself earth-shaking, it seems to have set in motion a series of events and rethinking—first on the part of Alan Greenspan, and then in the administration and Congress—that significantly changed both the way the GSEs are viewed and what must be done to address the systemic risk associated with their activities.