Freddie Mac's Retained Portfolio

Comments by Bert Ely on Freddie's talking points are in italics
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High-Level Talking Points:

Freddie Mac's charter has always envisioned that we use both securitization and portfolio investment to fulfill our mission. Fannie Mae was exclusively a portfolio investor for the first 40 years of its existence.

> *Freddie was primarily a mortgage securitizer into the early 1990s. At the end of each year between1985 and 1992, according to OFHEO data, Freddie MBS owned by third parties exceeded Freddie's retained mortgage portfolio by multiples exceeding 10. The peak was reached at the end of 1990 when Freddie MBS owned by third parties was 14.7 times Freddie's retained mortgage portfolio.*

By purchasing mortgages and mortgage-related securities for our retained portfolio, Freddie Mac:

- Provides ongoing liquidity and stability to the secondary mortgage market - exactly what our charter requires us to do.

  > *Fannie and Freddie do not have to own 1/4 to 1/3 of the MBS they have issued to provide that liquidity. At January 31, 2005, Freddie held in portfolio 28.7% of the MBS it had issued as of that date. The most recent comparable percentage for Fannie was 27.6% on June 30, 2005. Also, banks and securities firms are active MBS traders, which alone provides enough ongoing liquidity in the secondary market for MBS.*

- Supports mortgages and mortgage-backed securities (MBS) prices by boosting demand which in turn reduces interest yields. Lower yields result in lower mortgage rates for consumers.

  > *Freddie has to issue debt to finance its MBS purchases, which has the effect of pushing interest rates up. Most likely, the yield-reducing effect of MBS purchases is fully offset by the yield-boosting effect of issuing debt.*

- Stabilizes the market during periods of stress. For example, during the Asian debt crisis in 1998, lending in many sectors was disrupted , and costs rose. But the conventional conforming market continued to provide a steady supply of credit to homeowners.

  > *As Greenspan stated in his Senate Banking Committee testimony on April 6, Fannie and Freddie were merely opportunistic buyers during the Asian debt crisis, as were many other investors. In order to purchase mortgages and MBS,*

Fannie and Freddie either had to sell investments or issue debt, which added to liquidity stress in the markets at that time.

America will need roughly $1 trillion in mortgage funding per year over the next decade to house the next generation of homeowners. To help raise these funds, we need to attract capital from a broad variety of investors from around the world - and we need to offer securities that investors want. Securitization alone is not sufficient to meet this demand because many investors are averse to prepayment risk. Debt securities enable us to attract funds from investors who otherwise would not invest in the US residential mortgage market.

Much of the $1 trillion is mortgage refinance money; the increase in the amount of total mortgage debt outstanding will be less. Wall Street can readily transform Fannie/Freddie MBS into debt instruments of varied fixed maturities that readily meet foreign investors' needs. Further, American asset managers increasingly assist foreign investors in managing prepayment risk, increasing foreign investors' demand for MBS.

Freddie Mac manages our retained portfolio conservatively, dispersing interest rate risk into the capital markets through hedging. We hold capital sufficient to withstand severe interest rate swings, as required by OFHEO' s risk-based capital standards. The effectiveness of our interest rate risk management is demonstrated by our consistently low Portfolio Market Value Sensitivity and duration gap measures , which we disclose to the markets each month.

Hedging greatly concentrates interest-rate risk in Fannie, Freddie, and a handful of large banks and investment firms – this concentration has created the systemic risk concern Greenspan has warned about. MBS widely spreads interest-rate risk, in part because many MBS investors have little or no leverage and therefore don't need to hedge for interest-rate risks – they simply absorb any changes in interest rates in their current investment income. Hence, greater reliance on MBS in funding the mortgages where Fannie and Freddie have assumed the credit risk will reduce the total amount of derivatives outstanding, which in turn reduces systemic risk.

OFHEO currently has authority to take action if either GSE operates in an unsafe or unsound manner. GSE regulatory reform proposals contemplate a regulator able to act swiftly to address any GSE activities that constitute a risk to the financial system.

Key to reducing risk to the financial system is not letting it build up in the first place, which is why Fannie's and Freddie's mortgage portfolio investments should be sharply constrained by the new GSE regulator.

Arbitrarily limiting or reducing the size of GSE retained portfolios would greatly hinder Freddie Mac's ability to provide liquidity and stability to the housing finance market in all economic environments. Additionally, reductions in GSE retained portfolios would transfer mortgage risk to other mortgage investors, especially federally insured depository institutions. Many of these investors manage their interest rate risk much less effectively than does Freddie Mac.

Limiting Fannie's and Freddie's portfolio's to just what is needed for on-going liquidity maintenance will amply equip it with the resources needed to provide liquidity and stability to the housing finance market in all economic environments. Exposure to fluctuating interest rates exists whether depository institutions own Fannie/Freddie debt or MBS. Additionally, depository institutions are exposed to prepayment risk whether they own Fannie/Freddie callable debt or MBS. As noted above, Wall Street can readily create non-callable debt instruments from Fannie/Freddie MBS.

Freddie Mac's retained portfolio grew by only 13 percent during 2004, reflecting market conditions that made buying and holding mortgages more attractive for originators and other investors. We anticipate that in the long run , our retained portfolio will grow in line with growth in mortgage debt outstanding. From year-to-year, our growth will be responsive to the market's need for liquidity and stability and our objectives to earn a good return on deployed capital.

There is no need for Freddie's retained portfolio to continue to grow at the same pace as total mortgage debt outstanding – its retained portfolio should consist only of mortgages it has purchased for securitization purposes. Further, those securitizations should take place in a relatively timely manner.

Additional Information

Benefits of retained portfolios

- Our issuance of debt securities benefits the housing market and lowers the cost of mortgages by giving us access to a wide range of investors. Many investors, particularly those from outside the United States, prefer debt securities to MBS. International investors are often less familiar with 30-year fixed-rate mortgages, because they are not readily available in most other countries. These investors often do not wish to assume the prepayment risk of mortgage-backed securities. Debt securities enable us to attract funds from investors who otherwise would not invest in the US residential mortgage market.

  As noted above, foreign investors are increasingly comfortable owning MBS because their American asset managers and advisors assist them in managing that risk. Also, Wall Street can readily transform MBS into non-callable GSE debt.

- Our ability to purchase mortgages and MBS for our retained portfolio also provides an important safety net for other mortgage investors , particularly federally insured depository institutions. These institutions have substantially increased their mortgage and MBS holdings in recent years because of favorable market conditions and with the knowledge that when these conditions change, they can sell their holdings into the secondary market.

  Wall Street firms are active traders of Fannie/Freddie debt and MBS, providing more than enough secondary market liquidity. The U.S. Treasury does not *provide a secondary market for its debt – it leaves that job to Wall Street. Fannie and Freddie can easily do the same.*

- The retained portfolios of Freddie Mac and Fannie Mae have also helped to convert a large part of the nation s trade deficit into a capital surplus. Jim Miller, the former Federal Trade Commission chairman and Office of Management and Budget director under the Reagan Administration , has argued that a primary reason for the nation supply of liquid, stable and affordable mortgage credit is that Freddie Mac's and Fannie Mae's securities have proven so attractive to foreign investors. According to Miller, GSE securities routinely "insource" between 20 percent and 25 percent of all the dollars our current account deficits send abroad. He calls this a "powerful engine to generate capital for mortgages for American families." He adds, " In part because of Freddie Mac's and Fannie Mae's operations, foreigners invest their dollars in one of the most important and productive sectors of the U. S. economy, providing more and better housing than domestic investment alone could provide.

  Foreign investor purchases of Fannie/Freddie MBS, or debt instruments Wall Street has created from MBS, will provide the same capital-importing function that selling Fannie/Freddie debt to foreign investors performs.

Greenspan's comments in 2-17-05 House Financial Services Committee hearing

- Federal Reserve Chairman Alan Greenspan said in Congressional testimony that he believes substantial future growth in GSE retained portfolios would create a long-term systemic risk for the financial system. He recommended requiring the GSEs to divest most of their retained portfolio holdings over time and placing a cap of $100-200 billion. At the same time, he said twice in response to separate questions that he believes the level of systemic risk posed by the GSEs today is negligible.

  Greenspan's focus was on the potential for systemic risk which arises from the present amount of interest-rate risk Fannie and Freddie have assumed in their mortgage portfolios. That risk rises as their portfolios, and related hedging activities, continue to grow. Sharply restricting Fannie's and Freddie's purchases of mortgages and MBS will lead to a steady shrinkage of their portfolios through the natural process of mortgage principal paydowns and payoffs. There would be no need for Fannie and Freddie to sell massive amounts of MBS and mortgages while they are shrinking their balance sheets.

- Greenspan' comments thus suggest that there is no compelling reason to require reductions in the current GSE retained portfolios today. Future growth in GSE retained portfolios should not be constrained as long as the GSEs operate safely and soundly and maintain capital appropriate to the risks of mortgage investing.

  This statement grossly misrepresents what Greenspan said and recommended.