Limiting the Portfolios of the Housing GSEs

I would like to make it clear to everyone in attendance that the views presented today are my own, and should in no way be construed to represent those of the Republican Policy Committee, Senator Kyl, or the Senate Republican Leadership.

How We Got Here

In my opinion, the events that have transpired in the past several years are the natural consequence of the realization, on the part of the management of both GSEs, that the sole constraint on their growth and profit-making potential is hostile Congressional action. Somewhat ironically, it was by aggressively acting on this realization that Fannie and Freddie heightened their political risk to the point that Congress is now actively discussing whether to limit their investment portfolios.

There is a temptation to regard the accounting and internal control problems at the GSEs as a regulatory failure that could be corrected by enhanced supervision. But I think this view, so prevalent on Capitol Hill, loses sight of the fact that Fannie and Freddie are instrumentalities of the federal government. To speak of their charter on one hand and their regulator on the other creates a practical distinction where one should not exist. It diminishes our understanding of the challenge, and needlessly bifurcates the policy approach we take.

Fannie and Freddie had no trouble attracting capital before they voluntarily registered with the SEC under the 1934 Act in 2002. Neither GSE had any difficulty finding willing buyers of their MBS before they agreed to release information about the composition of the underlying mortgage pools. As of 2001, GSE debt represented 20 percent of the total assets contained in "Government" bond funds. Just months after Fannie Mae disclosed it had overbooked its profits by over $9 billion, with more shoes to drop, it issued $5 billion in preferred stock that was massively-oversubscribed. Financial reporting has ceased, yet yield spreads over Treasuries of senior unsecured debt remain tight, and no credit downgrade is on the horizon. Moody's did recently downgrade Fannie's Bank Financial Strength Rating, but all this means is that the government subsidy Fannie receives on each dollar of new debt has increased in direct proportion to the deterioration in its financial health.

I fail to see the wisdom of simply enhancing regulatory supervision when the GSEs can access the capital markets on such favorable terms without it. Moreover, such an approach would suggest that Congress has no problem with the management of these agencies taking unconstrained bets on the direction of interest rates, but would simply prefer that they not be so opaque about it in the future.

The fact of the matter is that the management of Fannie Mae and Freddie Mac were right: the capital markets treat Fannie and Freddie as agencies of the federal government. My simple proposition is that it is long past time for Congress to do so as well. Otherwise we will just be chasing our tail: creating a new federal agency to regulate these shareholder-owned federal agencies.

<u>Why Portfolio Limits?</u>

Given the evolution of credit markets generally, and the mortgage market in particular, it is difficult to see the rationale for the federal-sponsorship of large, highly-leveraged mortgage bond funds. Perhaps such funds could have been justified when state and federal regulations limited interstate branching and geographic credit risk dispersion, and MBS had yet to reach today's level of acceptance. But improvements in telecommunications, underwriting standards, and financial deregulation have combined to largely erase these barriers to a national, liquid, mortgage resale market.

It is also difficult to see why we need federal agencies to stockpile mortgage bonds when investor appetite for new classes of fixed income assets has been so robust. Since 2000, the total dollar value of non-GSE, asset-backed securities outstanding has grown by 60 percent to $2.8 trillion. Spreads on commercial MBS have tightened as their issuance has soared. And the worldwide search for yield has led hundreds of billions in funds to flow annually into collateralized debt obligations, credit default swaps, and other asset classes that either didn't exist or were judged to be too exotic when Fannie and Freddie began to accelerate their portfolio growth in the early-to-mid 1990s.

In fact, it seems that Fannie and Freddie's portfolios have grown most rapidly at just the time at which the capital markets have become most able and willing to absorb their MBS and attendant interest and prepayment risk. Fannie and Freddie's transformation into mortgage bond funds is perhaps the best evidence we have that their decades-long endeavor to standardize loan documentation and promote mortgage securitization is complete.

In this new post-mission era, Fannie and Freddie use their agency status to issue unlimited amounts of subsidized debt to purchase securities that are already freely traded and widely accepted in the capital markets. Because Fannie and Freddie are far and away the largest purchasers of the mortgages that collateralize these securities, they also need not content themselves with prevailing market returns, but instead exploit asymmetries of information to retain the highest quality loans or pools of loans for their own portfolios. At Fannie Mae this practice is known internally as "keep the best, sell the rest." To other market participants, it is known as the "lemons discount," and could somehow help to explain the 132 basis point widening of mortgage spreads over Treasuries in the 5 years Fannie and Freddie's portfolios grew most rapidly.

This year Congress will have to decide whether to endorse this post-mission arrangement, or to reject it through the establishment of clear limits to the GSEs' portfolios. Without such limits, there can be no doubt that the GSEs will, at some point in the near future, resume the exploitation of their agency status to displace private credit flows and assume more interest rate and prepayment risk. Were they not intending to do so, I find it hard to believe they would commit so much in resources to protect their current status.

Arguments Against

On Capitol Hill, the GSEs and their allies put forward several arguments to defend the status quo. The first, and most oft-repeated, is that portfolio growth reduces mortgage rates. In the words of former Fannie CEO Franklin Raines:

"People who invest in our debt have chosen that they don't want to invest in mortgage-backed securities. So, we actually attract more investors into mortgages than would otherwise be there. So, it's pretty clear from our research that the portfolio has a bigger impact on reducing interest rates than our securitization program."

According to this logic, the GSEs' create demand for mortgage bonds where it would otherwise not exist. Presumably, investors are deterred from purchasing mortgage bonds because they would prefer not to accept the prepayment risk such bonds entail, since both Fannie's debt and MBS are of the same AAA credit quality.

The investor class most frequently cited as unwilling to hold MBS is Asian central banks. Freddie's talking points even go so far as to suggest that portfolio limits could have “a broader economic impact” since agency debt “financed 30 percent of the current account deficit in 2004.” Are we to interpret this to mean that China’s exchange rate policy is designed to accumulate vast holdings of GSE debt? If so, I think portfolio limits are the perfect way to reduce our bilateral deficit and beat back protectionist impulses on the Hill.

Since investors are compensated for prepayment risk through higher yields, and are able to hedge this risk in the roughly the same manner as Fannie and Freddie, the universe of potential buyers of Fannie’s direct obligations who would be unwilling to hold their MBS is likely to be very small, as Professor Jaffee explains. And secondly, and more consequentially, what effect does Fannie’s cherry-picking have on the overall demand for their MBS? If investors opt to hold GSE debt because they (correctly) suspect that Fannie “keeps the best and sells the rest,” then the lack of demand Fannie cites as a rationale for expanding its portfolio is actually a problem of its own making. Moreover, if the GSEs are to continue to serve as the primary intermediaries in this market, wouldn’t make more sense for them to expand their collateralized mortgage obligation business to better match cash flows to investor preferences. I imagine that if they didn’t keep so much high quality collateral for themselves, this task would be far easier.

Another argument forwarded by the GSEs and their allies is that their portfolios provide a buffer in times of financial turmoil, such as in 1998 and immediately after 9/11. Again, since we're talking about AAA credit instruments, this argument is predicated on the notion that other market participants be unwilling to take advantage of the buying opportunity presented by a widening of spreads. This seems far-fetched as private institutions would have precisely the same profit-motive as Fannie and Freddie. As for September of 2001, Fannie's own data suggest that its portfolio purchases as a percentage of total business volume was near the low for the year.

Potential for Congressional Action

Unfortunately, I fear that the argument that will ultimately have the most impact on the Hill is that portfolio limits are "arbitrary." I can already envision a Member or series of Members coming to the floor to ask why it is that Congress is seeking to place arbitrary limits on the American dream. Of course, any hard cap on portfolios, whether set in legislation or by a regulator, would be arbitrary. But by not imposing such a cap, Congress would simply allow the GSEs to increase the value of their subsidy **arbitrarily** through the increased issuance of subsidized debt.

As any student of political-economy can attest, when an existing policy provides valuable and highly concentrated benefits in exchange for costs that are broadly diffused and difficult to perceive, it is extraordinarily difficult to reverse course no matter how compelling the case for doing so. The management at Fannie Mae and Freddie Mac are keenly aware of what's at stake in the coming debate. My hope is that the elected representatives of the U.S. Congress are as well.

Thank you.