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Regulating Fannie Mae and Freddie Mac: Now It Gets Serious

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For well over a year, Congress has been toying with ever tighter regulation of Fannie Mae and Freddie Mac, while studiously avoiding the elephant in the living room—the companies' massive portfolios of mortgages and mortgage-backed securities (MBS). The stated rationale for the effort to create a "world-class regulator" is to reduce the risks—for the taxpayers and the economy generally—associated with these two huge companies. But since it is the portfolios themselves that engender those risks, all the activity in Congress to this point has seemed futile, like bailing furiously while ignoring the hole in the boat. But as the accounting misdeeds of Fannie and Freddie have come to light, and their aura of financial probity and political invincibility has begun to fade, Congress has been emboldened. The idea that the size of Fannie's and Freddie's portfolios might be limited or reduced has moved in from left field (well, maybe right field) and is now, appropriately, the central feature of the debate.

Fannie and Freddie are government-chartered, shareholder-owned public companies. Because of their government charters and many government-provided privileges, they are known as government-sponsored enterprises, or GSEs. The companies carry on their business in two ways. In a process known as a securitization, they buy mortgages from mortgage originators, place them in trusts, and issue securities from these trusts that are backed by the payments of principal and interest on the pooled mortgages. These transactions create what are called mortgage-backed securities (MBS). Fannie and Freddie only guarantee to the holders of MBS that the principal and interest on the mortgages in the trusts will be paid in full and on time. In other words, Fannie and Freddie take only the credit risk on these mortgages; the interest-rate risk—that interest rates will rise and the mortgages will become less valuable, or that interest rates will fall and the mortgages will be prepaid and disappear—is taken by the holders of the MBS. For their guarantee, Fannie and Freddie receive an annual fee as long as the pools remain in existence. In this segment of their business, Fannie and Freddie have guaranteed about $2.2 trillion in mortgages.[1]

In the other part of their business, Fannie and Freddie buy mortgages from originators and hold them in portfolio; they also repurchase for their portfolios some of the MBS that they have already issued. Because they are then the owners of these mortgages and MBS, they have assumed the credit risk, and because they have to borrow the funds to buy the mortgages and MBS, they assume the associated interest-rate risk. Of the two, interest-rate risk is far more significant, and Fannie and Freddie have to enter into large hedging transactions to mitigate it. They assume these substantial risks, and contract for hedging, because their portfolios of mortgages produce by far the greater part of their profits. This is true because, as GSEs, they are accorded favorable rates in the capital markets, and thus can arbitrage between their borrowing costs and the rate they will receive on the mortgages and MBS they hold. Their mortgages and MBS assets are currently worth approximately $1.5

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trillion, and this is also approximately the aggregate amount of their borrowings.

To place this in some perspective, all Treasury debt held by the public totals $4.4 trillion, and all corporate bonds outstanding total $2.9 trillion. Fannie's and Freddie's liabilities—including both their MBS guarantees and their borrowings—come in right in the middle, at $3.7 trillion. Thus, only two companies—both of which are GSEs and implicitly backed by the U.S. government—account for more default risk than all other U.S. corporations combined. The risks for the taxpayers are obvious, but as many commentators have also pointed out, risk of this size, if concentrated in only two companies, poses a danger to the U.S. economic system as a whole—a danger known as systemic risk.

How Fannie and Freddie Lost Their Groove

Congressman Richard Baker (R-La.) has been concerned about the risks created by Fannie and Freddie since 2000, when he first introduced legislation to augment the powers of their regulator. However, the alignment of the political stars was so unfavorable at the time that Baker—then the chairman of the House subcommittee that had jurisdiction over the GSEs—could not find sufficient support for his bill to bring it to formal consideration and possible amendment by the subcommittee (what is known as "mark-up"). Successive bills in 2002 and 2003 met similar fates, although the threat of legislation brought Fannie and Freddie to agree to modest changes in their financial procedures and voluntary registration of their equity securities under the Securities Exchange Act of 1934.

Then, in June 2003, came what in retrospect appears to have been the turning point. As part of the fallout from Enron and WorldCom, Freddie Mac decided to engage new auditors, replacing Arthur Andersen. The new auditors found discrepancies in the company's financial reports, and an independent counsel was engaged to do an investigation. The investigation showed that Freddie had manipulated its earnings in order to reduce reported volatility, and—perhaps more important—one of Freddie's senior managers seemed to have taken steps to obstruct the investigation. As a result, Freddie dismissed its three top officers, an action that apparently came as a complete surprise to the Office of Federal Housing Enterprise Oversight (OFHEO), the company's regulator. OFHEO was embarrassed by its failure to discover on its own the facts that led to the dismissal of Freddie's top officers—or even that there was an internal investigation that might lead to their dismissal—and its ability effectively to regulate the GSEs was publicly called into question.

This event seems to have precipitated major changes in the views and behavior of the three principal government groups that had the power to affect the future of Fannie and Freddie. The administration became engaged, seemingly for the first time, in considering the risks associated with both companies; OFHEO metamorphosed from a butterfly into a wasp; and members of Congress started to take Chairman Baker's legislation more seriously. The result was a compete change in the atmosphere surrounding the GSEs. Suddenly, administration figures—representatives of Treasury, the Department of Housing and Urban Development, the Council of Economic Advisers, and the Office of Management and Budget, among others—began making public statements criticizing the GSEs, questioning their role in the housing market and the risks they were creating for taxpayers and the economy. Federal Reserve chairman Alan Greenspan, citing these same risks, weighed in with letters to lawmakers and testimony supporting stricter regulation and even privatization. OFHEO vowed tougher regulation, and sought and received funds from Congress to do a forensic audit of Fannie, arguing that if Freddie had manipulated its financial results Fannie may also have done so. As a result of these steps and disclosures, the GSEs' share prices, which had been stable over several years, began a significant decline. Investors were either losing confidence in the companies, or were unwilling to absorb the constant headline risk to which the companies were subject.

By early 2004, lawmakers in both the Senate and House were saying that Fannie and Freddie needed a "world class" regulator, and the Treasury Department had formulated a three-part proposal that constituted what it called its minimum requirements for legislation: the new regulator should have authority to raise Fannie and Freddie's capital level, to control their mission, and to appoint a receiver to marshal their assets and pay off creditors in the event of a financial collapse. A weak bill developed by Michael G. Oxley (R-Ohio), the chairman of the House Financial Services Committee, was blown apart just before mark-up by administration opposition. Attention turned to the Senate.

In what turned out to be a huge strategic error, Fannie and Freddie chose to fight legislation in the Senate Banking Committee that embodied the administration's minimum requirements, particularly the receivership provision, in the late spring of 2004. The companies called in their chits and managed to obtain solid Democratic opposition to the bill crafted by the committee's chairman, Richard

Shelby (R-Ala.). The committee also watered down the receivership provision. The partisan nature of the vote to send the bill to the floor virtually assured that it would not be taken up in the Senate unless Fannie and Freddie relented in their opposition, and the administration opposed the committee bill because of the weakened receivership language. Administration spokesmen warned the companies that if they continued to oppose the bill in 2004 there would be a tougher version in 2005, but Fannie and Freddie would not budge. It may be that the GSEs were banking on the defeat of President George W. Bush and on the assumption that a Democratic president would abandon the effort to pass tougher regulation. If that was their thinking, it was an exceedingly costly error.

In the fall of 2004, OFHEO reported that Fannie Mae had also manipulated its accounting, and to a degree far more significant than what Freddie had done. At a dramatic hearing in Richard Baker's subcommittee, Fannie's chair, Franklin Raines, stood by the company's accounting, claiming that Fannie was being victimized by an overzealous regulator and its accounting position would eventually be vindicated by the Securities and Exchange Commission (SEC), which had been asked to review the disputed accounting. The tenor of things in Congress was still so supportive of the GSEs that Armando Falcon, the director of OFHEO, received a far more hostile reception than Raines got in Baker's subcommittee. Nevertheless, most accounting specialists viewed Raines's position as unsupportable, and many questioned his judgment both in making a frontal assault on his regulator and in making statements under oath that might later put him in jeopardy. Weeks later, the SEC's chief accountant dismissed Raines's contentions, famously holding up a piece of paper and telling Raines to his face that Fannie's position on the relevant accounting was not even "on the page" of allowable interpretations. Shortly thereafter, Fannie announced that Raines had resigned as chairman and CEO. Both the Justice Department and the SEC have begun investigations of Fannie's accounting, and the company has dismissed its former auditors and retained an independent counsel to conduct an investigation of its own accounting.

Now, after these events as well as the results of the 2004 election, Fannie and Freddie would be delighted with the Senate committee bill, and as the new Congress began in January 2005, their managements both made statements that they were prepared to accept what they opposed in 2004—even receivership. But it was too late. The world had moved on. Today, the controversial issue before Congress is no longer receivership, but something far more significant.

Portfolio Size Limitations

In February 2005, the House Financial Services Committee heard testimony from Chairman Greenspan on the condition of the economy. After his prepared testimony, in response to a question about the GSEs' portfolios, Greenspan noted, "We have found no reasonable basis for that portfolio above very minimum needs." He then proposed "a $100 billion, $200 billion—whatever the number might turn out to be—limit on the size of the aggregate portfolios of those institutions—and the reason I say that is there are certain purposes which I can see in the holding of mortgages which might be helpful in a number of different areas. But $900 billion for Fannie and somewhat less, obviously, for Freddie, I don't see the purpose of it." Greenspan then articulated his reasons for limiting the GSEs' portfolios: "If [Fannie and Freddie] continue to grow, continue to have the low capital that they have, continue to engage in the dynamic hedging of their portfolios, which they need to do for interest rate risk aversion, they potentially create ever-growing potential systemic risk down the road." He added, "Enabling these institutions to increase in size—and they will, once the crisis, in their judgment, passes—we are placing the total financial system of the future at a substantial risk."[2]

The Fed chairman's statement drew substantial attention, but this was not the first time he had raised and discussed this issue. In February 2004 prepared testimony before the Senate Banking Committee, Greenspan emphasized the substantial interest-rate risk associated with the GSEs' large portfolios of mortgages and that concentrating that risk in only two companies raised issues of systemic risk. He pointed out that Fannie and Freddie could do everything they currently do for the mortgage market through securitization—issuing securities against pools of mortgages, the process by which they create MBS—without bearing any interest-rate risk. Then he continued:

> World class regulation, by itself, may not be sufficient and indeed, as suggested by Treasury Secretary Snow, may even worsen the situation if market participants infer from such regulation that the government is all the more likely to back GSE debt. . . . Most of the concerns associated with systemic risks flow from the size of the balance

> sheets that these GSEs maintain. *One way the 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*. Although it is difficult to know how best to set such a rule, 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 (emphasis added).[3]

Thus, as early as February 2004, Greenspan was telling the Senate committee members that their search for a world class regulator would not produce the reduction in systemic and other risk that they had identified as their goal. Indeed, tighter regulation might make the problem worse. The only way to reduce this risk, he pointed out, was to reduce the size of the GSEs' portfolios of mortgages and MBS.

The Serious Effects of Portfolio Limitations

The informal Greenspan statement in February 2005 got far more attention than his more complete and fully reasoned prepared testimony to the same effect a year earlier. Such are the ways of Washington. A lot had happened in the interim, including the OFHEO's critical report on Fannie's accounting, the SEC's confirmation of the OFHEO's position, and the resignation of Franklin Raines. In 2005, Greenspan's statement opened for debate an issue that Congress had, only a month before, not considered to be within the realm of political discussion. Thus, in January 2005, three Senators—Chuck Hagel (R-Neb.), John E. Sununu (R-N.H.), and Elizabeth Dole (R-N.C.)—had introduced tough new legislation to regulate Fannie and Freddie. The legislation was state-of-the-art at the time, and included a carefully developed "bright line" test that was intended to end Fannie's and Freddie's efforts to break out of the secondary mortgage market as their sole allowable field of operations. But the legislation made no mention of limiting the GSEs' portfolios. After the Greenspan testimony, however, that issue suddenly achieved currency, with lawmakers in both the House and Senate saying that they intended to look carefully at whether such a provision should be included in the legislation they were drafting.

The sudden appearance of this new threat changed the attitude of the GSEs toward the legislation. Although they had begun 2005 offering conciliatory statements and suggesting that they had no serious problems with the regulatory proposals that Congress was then contemplating, the GSEs were clearly alarmed by the idea that their portfolios might be limited or reduced. Fannie and Freddie and their constituent support groups—the homebuilders and the realtors, among others—made clear that they would fight limitations on GSE portfolios, and Senator Charles Schumer (D-N.Y.) and other Democrats made clear that they, too, would oppose any effort to limit this aspect of the GSEs' operations.

For the GSEs, this is clearly a kind of Armageddon. The legislation advanced in the past, no matter how "tough," posed no serious problem for Fannie and Freddie; indeed, although they made a show of opposing it, the legislation might well have improved their position by emphasizing their connection to the government and ending the headline risk they faced from the drumbeat of adverse commentary by members of the administration. With that criticism ended, and the uncertainty associated with the legislative drafting process out of the way, there was hope that their stock prices would revive. Over time, indeed, with their political muscle in Washington, there was a good chance that they would be able to gain control of their new regulator—no matter what its putative authority—as they had successfully controlled the OFHEO until Freddie's surprise disclosure of its accounting problems drove the agency to tough and decisive action.

But a serious proposal to limit the size of their portfolios is of a different order entirely than mere enhanced regulation. Although the exact number is difficult to determine, the GSEs' mortgage portfolios may provide as much as 85 percent of their profits. This seems to be a reasonable estimate, because their net interest income—the amount they earn on the difference between their borrowing costs and the yield on the mortgages and MBS they hold—is about $23 billion, while their fee income from the issuance of MBS is approximately $4 billion.[4] While the actual profit difference from each line of business may not be as great as the difference in the revenues from each line of business, the disparity between the two lines is so large that a serious limitation on the size of their portfolios will clearly cause a major reduction in the GSEs' earning potential and further depress their stock prices. In this sense, the long fight to control the GSEs has finally come to a point of real significance; if they

lose this argument, they will no longer be the second and fourth largest financial institutions in the United States, or among the most highly profitable companies in the S&P 500. At the same time, they will no longer be creating major risks for the taxpayers and the economy.

Can Fannie and Freddie Win This Argument?

The reasons for limiting the GSEs' portfolios are easy to state. Their purpose is to create liquidity in the mortgage market by providing a means for mortgage originators to sell off their mortgages and thus make room in their portfolios for more mortgage loans. But they can do this solely through securitization, which does not involve the substantial interest-rate risk associated with holding a portfolio of mortgage assets. Under these circumstances, allowing Fannie and Freddie to continue on their present course is simply to create risks for the taxpayers, and to the economy generally, in order to improve the profits of their shareholders and the compensation of their managements. It is a classic case of socializing the risk while privatizing the profit. The Democrats and the few Republicans who oppose portfolio limitations could not possibly do so if their constituents understood what they were doing.

What, then, are the arguments advanced by the GSEs? Freddie Mac has been circulating on Capitol Hill a lobbying document that one should assume contains the best case the GSEs can make for retaining large portfolios of mortgages and MBS. The principal elements of this case are summarized in italics below, and counterarguments follow:

1. *The accumulation of large portfolios adds liquidity and stability to the secondary mortgage market.*

Fannie and Freddie currently hold more than a quarter of all MBS they have issued, and the idea that this level of accumulation is necessary to add liquidity to a market is, to say the least, highly counterintuitive. The essence of liquidity is supply—a large number of securities available for purchase or sale. When Fannie and Freddie acquire and hold mortgages and MBS, they reduce the supply available to the market, and hence reduce liquidity.

Moreover, as Chairman Greenspan noted in his February 24, 2004, Senate testimony, liquidity and stability in the mortgage markets can be achieved just as well through securitization, without the extraordinary taxpayer and systemic risks entailed in the GSEs' purchases of mortgages and MBS:

> Limiting the debt of Fannie and Freddie and expanding their role in mortgage securitization would be consistent with the original congressional intent that these institutions provide stability in the markets for residential mortgages and provide liquidity for mortgage investors. Deep and liquid markets for mortgages are made using mortgage-backed securities that are held by non-GSE private investors. *Fannie's and Freddie's purchase of their own or each other's securities with their debt do not appear needed to supply mortgage market liquidity or to enhance capital markets in the United States* (emphasis added).[5]

2. *The GSEs' purchases of mortgages and MBS increases demand, which in turn lowers mortgage interest rates.*

Here Freddie conveniently describes only one side of the transaction. Of course the purchase of mortgages or MBS would reduce rates, but since Fannie and Freddie must borrow virtually every dollar they spend to buy mortgages and MBS, their borrowing has the effect of increasing rates. In the end, it is a wash. As Chairman Greenspan noted in Senate Banking Committee testimony on April 6, 2005:

> A recent study by Federal Reserve Board staff found no link between the size of the GSE portfolios and mortgage rates. 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.[6]

Both facts here are important. Slower mortgage purchases by the GSEs have coincided with lower rather than higher mortgage rates—again breaking any connection between the GSEs' portfolios and lower rates—and the decline in spreads between GSE securities and Treasuries, as GSE borrowing declined, shows that GSE borrowing to purchase mortgages and MBS has the effect of raising interest rates. Greenspan continues:

> Limiting the systemic risks associated with the GSEs would require that their mortgage 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. . . . In the simplest outcome, the holders of GSE debt would be seen as exchanging their debt instruments for mortgage-backed securities previously held on GSE balance sheets. *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* (emphasis added). [7]

3. *GSE purchases of mortgages and MBS stabilize the market during periods of stress. This is what occurred during the Asian debt crisis in 1998, when the GSEs continued buying mortgages and MBS while other buyers held back.*

This is a slightly different claim from the argument covered in item 1 above, in which Freddie contends that in normal times GSE purchases create liquidity and stability in the market. Although a buyer of last resort can add liquidity to a market, this is not the function that Fannie and Freddie are performing. As profit-seeking entities, they buy mortgages when conditions are favorable, not when the market needs support. Although they make a claim to public-spirited motives when they are on Capitol Hill, it is unlikely that they tell their shareholders the same thing. Indeed, if they are in fact buying mortgages when conditions are unfavorable, their managements are violating their fiduciary duty to maximize profits.

In testimony before the Senate Banking Committee on April 21, 2005, Douglas Holtz-Eakin, director of the Congressional Budget Office, addressed the claim that the GSEs provide special assistance to the mortgage market in times of stress: "GSEs' purchases during periods of financial stress appear to have been in response to more profitable opportunities (such as wider interest-rate spreads), but in doing so, the GSEs are displacing other investors who would have responded to those opportunities."[8] In other words, the GSEs turn out to be just one more opportunistic buyer of mortgages when market conditions are right—just as one would expect of profit-seeking shareholder-owned companies—not public-spirited sources of credit in periods of stress. When, in a time of stress, market conditions are adverse, the GSEs will not be there buying mortgages.

4. *Borrowing by the GSEs to create their portfolios is good because it brings capital from abroad into the U.S. residential mortgage market and thus lowers interest rates.*

This is essentially an argument that foreign investors will prefer Fannie and Freddie debt to purchasing the MBS that the GSEs guarantee. Since both GSE debt securities and MBS have the same credit rating, the only reason foreign investors might prefer GSE debt is that they do not want to take the prepayment risk associated with MBS. In fact, Freddie explicitly makes this argument in its lobbying material ("[Foreign] investors do not want the prepayment risk of MBS."[9]). As noted above, when Fannie and Freddie borrow to buy and hold mortgages and MBS, the GSEs are taking the interest-rate risk, a substantial part of which is prepayment risk. Fannie and Freddie hedge some, but not all, of this risk, which is by far the greatest element of the risk they create for taxpayers and the economy generally (also known as systemic risk). On the other hand, when Fannie and Freddie securitize mortgages, the interest-rate risk is taken by investors.

Accordingly, what Freddie is saying in its lobbying material is that it assists the mortgage markets by taking interest-rate risk on behalf of foreign investors who are reluctant to do so. And what this means is that, because of the implicit government backing of the GSEs, U.S. taxpayers are ultimately the ones taking this risk.

To be sure, there might be some justification for this if there were evidence that Fannie and Freddie were actually lowering mortgage interest rates by borrowing to accumulate their large mortgage portfolios. In that case, it might be argued that although taxpayers are taking a risk, they are benefiting as homebuyers. The trouble with this argument is that there is no evidence whatever that the GSEs' portfolios have any significant impact on mortgage rates. As Chairman Greenspan said in his testimony on April 6: "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 to mortgage-market liquidity, to the enhancement of capital markets in the United States, or to the lowering of mortgage rates for homeowners."[10]

Indeed, that statement sums up the economic arguments against the position Freddie Mac advances in its lobbying material. In exchange for enormous risks—risks for the taxpayer and risks to the economic system—the U.S. homeowner gains nothing from the accumulation of portfolios of mortgages and MBS by Fannie and Freddie. Under these circumstances, it seems clear that if the debate in Congress on limiting the GSEs' portfolio is determined solely by the merits of the arguments on each side, Fannie and Freddie will lose. Unfortunately, however,

congressional decisions are not always determined on the merits, and there are disturbing signs that this may be the case with the GSE reform legislation now under consideration.

The Legislation

Shortly after Chairman Greenspan's House testimony in February 2005—in which he reiterated the view that the portfolios of the GSEs should be limited to reduce the risks they create—key lawmakers in both the Senate and House pledged that they would consider his idea seriously. However, the only legislation on this question thus far introduced in either house is seriously deficient. That bill, introduced by Congressman Baker and House Financial Services Committee chairman Michael Oxley early in April 2005, authorizes the GSEs' regulator "to dispose of or acquire any asset or obligation, if the Director determines that such action is consistent with the safe and sound operation of the enterprise or with the purposes of this Act."[11]

This language leaves the regulator with no useful standard, and arguably does not increase at all the authority, currently held by OFHEO, to force the GSEs to divest assets that threaten their safety or soundness. If this language were to be included in the final law, it would fail completely to provide a legal basis for the regulator to act unless he or she could show that the portfolios of the GSEs were a threat to their financial condition. Whatever its purpose, this initial draft was clearly not intended to implement the Greenspan recommendation.

In testimony before the House Financial Services Committee on April 13, 2005, Secretary of the Treasury John Snow found this language deficient and outlined the Bush administration's position on how the issue should be resolved. He proposed that the GSEs' regulator be directed by law to reduce the size of Fannie's and Freddie's portfolios, and he proposed a standard for the regulator to follow. Arguing that Fannie and Freddie could do everything they currently do for the mortgage market through securitization—without the risks created by their portfolios—the secretary suggested that their portfolios should be reduced to the level necessary to assure the effective functioning of their securitization activities, and no more. Although the administration has not advanced specific language to embody this approach, Congress would be well advised to adopt it.

For one thing, it is important to recognize the enormous political power of Fannie and Freddie, and their ability to marshal support from constituent groups such as homebuilders and realtors. If Congress itself cannot summon the political will to overcome the resistance of the GSEs and their support groups, the regulator certainly will not be able to do so. Punting the decision to the regulator may get it off the congressional agenda, but it will leave a serious problem unresolved. Congress must recognize that in order to assure that the GSEs' regulator has the authority to act on an issue as important and controversial as the size of their portfolios, he or she must be given explicit legislative direction. A general statement such as that advanced in the Oxley-Baker bill will not provide this direction, and will leave the regulator essentially powerless to act in the face of massive political opposition. When the committee proceeds to mark up the Oxley-Baker bill, currently scheduled for May 25, it ought to strengthen the language in this portion of the bill so that it conforms to the administration's approach, which both directs the regulator to reduce the size of the portfolios and provides a useful and practical standard for how large the resulting portfolios should be.

The Senate Banking Committee has not yet acted, but one must hope that the committee will take the Greenspan proposal seriously and adopt the administration's approach. As outgoing regulator Armando Falcon said in what is likely to be his final appearance before this committee, "I believe the most prudent course of action would be for Congress to give the regulator explicit authority to regulate the size of the housing Enterprises' portfolios, accompanied by specific statutory guidance on the exercise of such authority."[12] That's exactly what the administration's proposal would do.

The Critical Final Step

After years of trimming around the edges of the GSE problem, Congress—with the help of Chairman Alan Greenspan—has finally come to the nub of the issue. If Congress can bring itself to overcome the furious political opposition of the GSEs and their supporters, it will direct the new GSE regulator to reduce the size of Fannie's and Freddie's portfolios and endorse a workable standard by which to measure the proper size of the smaller portfolios that result. This will solve, finally, the problem of two entities using their implicit government backing to control the residential mortgage market, which creates massive risks for the taxpayers and the economy in general.

If Congress cannot take this essential step, however, no amount of additional authority—given to a purported "world class regulator"—will significantly change the course of events. Fannie and Freddie will continue to grow, and one day—as Alan Greenspan has predicted—there will be a massive default with huge losses to the taxpayers and systemic effects on the economy. We should be grateful that Congress finally has before it a serious proposal that is equal to the seriousness of the problem. But we should also worry about whether Congress can find within itself the political will necessary to see the task through to its logical conclusion.

Notes

1. These figures and those relating to the GSEs' portfolios of mortgages and MBS are from Dwight Jaffee, "On Limiting the Retained Mortgage Portfolios of Fannie Mae and Freddie Mac," preliminary draft of April 25, 2005, delivered at a conference at AEI on April 26, 2005 and available through www.aei. org/event1041.

2. Greenspan testimony, House Financial Services Committee, February 17, 2005, quoted in Canfield Associates, *GSE Report*, February 28, 2005, 3.

3. Senate Committee on Banking, Housing, and Urban Affairs, *Statement of Alan Greenspan*, 108th Congress, 1st session, February 24, 2004, 9–10 (available at http://banking. senate.gov/index.cfm?Fuseaction=Hearings. Detail&HearingID=92, as of May 12, 2005).

4. These are 2004 numbers sourced to the OFHEO, Dwight Jaffee, "On Limiting the Retained Mortgage Portfolio of Fannie Mae and Freddie Mac," 6–7.

5. Senate Committee, *Statement of Alan Greenspan*, February 24, 2004, 10.

6. Senate Committee on Banking, Housing, and Urban Affairs, *Statement of Alan Greenspan*, 109th Congress, 1st session, April 6, 2005, 3 (available at http://banking. senate.gov/index.cfm?Fuseaction=Hearings.Detail& HearingID=14, as of May 12, 2005).

7. Ibid, 4–5.

8. Senate Committee on Banking, Housing, and Urban Affairs, *Statement of Douglas Holtz-Eakin: Aligning the Costs and Benefits of the Housing Government-Sponsored Enterprises*, 109th Congress, April 21, 2005, 8 (available at http://banking. senate.gov/index.cfm?Fuseaction=Hearings.Detail& HearingID=150, as of May 12, 2005) .

9. Freddie Mac, *Freddie Mac's Retained Portfolio: Key to Fulfilling Our Mission,* Mission Statement, April 2005.

10. Senate Committee, *Statement of Alan Greenspan*, April 6, 2005, 5.

11. *To Reform the Regulation of Certain Housing-Related Government-Sponsored Enterprises, and for Other Purposes,* HR 1461, 109th Congress, 1st session.

12. Senate Committee on Banking, Housing, and Urban Affairs, *Statement by Armando Falcon, Jr.: Regulatory Reform of the Housing Government-Sponsored Enterprises*, 109th Congress, April 21, 2005, 5 (available at http://banking. senate.gov/index.cfm?Fuseaction=Hearings.Detail& HearingID=150, as of May 12, 2005).