

**Oral Statement to the
Task Force on Housing and Infrastructure
House Committee on the Budget**

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**Economic Implications of Debt Issued by
Government-Sponsored Enterprises**

Mr. Chairman and members of the Task Force on Housing and Infrastructure, I am pleased to testify this morning on the economic implications of debt issued by government-sponsored enterprises, or GSEs. I request permission to submit additional material to the Committee for inclusion in the record of this hearing, specifically a monograph I co-authored recently, titled "Nationalizing Mortgage Risk: The Growth of Fannie Mae and Freddie Mac." Also, I am testifying today in my own behalf. The statements I will make and the opinions I will offer are my alone and do not necessarily reflect those of any client.

I will begin by addressing the issue of the systemic risk posed by the GSEs, and specifically Fannie Mae and Freddie Mac. Within that context, I will then discuss the amount of GSE obligations federally insured banks and thrifts hold relative to their capital. GSE obligations include mortgage-backed securities, or MBS, the GSEs have guaranteed as well as the debt they have issued. I will close by offering a recommendation.

Systemic risk

Systemic risk arises when the failure of a large financial institution, due to its actual or apparent insolvency, threatens the stability of the financial markets. While the failure of a small institution would not threaten financial stability, the failure of a large institution could. Hence, size matters. Because stable financial markets are essential to the smooth functioning of the economy overall, systemic risk must be treated extremely seriously.

Systemic risk also can arise when a large financial institution begins to suffer funding problems; that is, it experiences difficulty and high cost in rolling over its debt because of financial market fears that the institution might be sliding towards insolvency. That situation arose in the fall of 1998 when a large, highly leveraged hedge fund, Long Term Capital Management, or LTCM, experienced a funding problem. Although LTCM apparently never was actually insolvent, on a mark-to-market basis, there were grave doubts about its solvency in the aftermath of the Russian debt default in the summer of 1998.

Due only to the intervention of the Federal Reserve Bank of New York, LTCM was able to keep rolling over its debt in sufficient quantities to enable it to shrink itself in an orderly manner. Had LTCM been forced to sell its assets at fire-sale prices, in order to pay its maturing debt, chaos would have reigned in the financial markets. Those fire-sale prices would have caused tremendous mark-to-market losses for other financial firms, possibly rendering some of them insolvent. A cascade of losses could have wracked global economic havoc.

I mention LTCM because as big as it was, its outstanding debt at the time of its troubles was less than one-seventh of the amount of debt Fannie and Freddie combined had outstanding at the end of last year. Adding in their MBS, the total outstanding obligations of Fannie and Freddie at the end of 1999, \$2.125 trillion, was 17 times LTCM's obligations when it crashed. Unquestionably, Fannie and Freddie pose serious systemic risks. Clearly, they are too-big-to-fail financial institutions.

The fact that Fannie and Freddie are GSEs makes it nearly certain that the federal government will rescue them should they experience financial problems. History bears out this statement. In January 1988, Congress threw a \$4 billion life ring to the much smaller Farm Credit System, or FCS, even though it was solvent on a book-value basis, after yields on FCS debt over longer term Treasuries went above 100 basis points, signalling that new FCS debt might become virtually unmarketable. In September 1996, Congress averted a possible default on the so-called FICO bonds by extending the FICO bond interest assessment from savings-and-loans, or S&Ls, to all federally insured depository institutions. And of course, starting in 1989, Congress coughed up approximately \$160 billion, drawn from various sources, to ensure that the federal deposit insurance commitment would be met for all failed S&Ls.

Much has been made in hearings held earlier this year by the Capital Markets Subcommittee of the House Banking Committee that a statutorily required stress test will prevent Fannie or Freddie from reaching insolvency. Although the Office of Federal Housing Enterprise Oversight, or OFHEO, has strived valiantly to implement this stress test, the test will not prevent either Fannie or Freddie from creating systemic risk. This is a most important point that Rep. Richard Baker, chairman of the Capital Markets Subcommittee, made in a hearing last Thursday. This is the case because any meaningful deterioration in the financial condition of either Fannie or Freddie, even if neither is insolvent, will create funding problems for both GSEs since they are, for all practical purposes, Siamese twins.

Investments by banks and thrifts in GSE obligations

According to a recent (April 14, 2000) American Banker article, over two-thirds of federally insured banks and thrifts hold more GSE debt and MBS, relative to their capital, than would be permissible for them to hold if GSEs obligations were held to the same loan-to-one-borrower and investment-per-company rules that apply to credit extensions by banks and thrifts to genuinely private organizations. Due to data

limitations, it is not possible to identify the specific GSEs for which banks and thrifts have exceeded the credit limits applicable to private entities. However, given their enormous size, relative to the other GSEs, most banks and thrifts are most overexposed to Fannie and Freddie obligations.

This overexposure has understandably created solvency concerns about banks and thrifts heavily invested in GSE debt and MBS should Fannie or Freddie get into trouble. This is the case because if funding problems drove down the market value of GSE debt, that drop would cause capital reductions in banks and thrifts that would trigger regulatory sanctions that, in turn, would force banks and thrifts to reduce their lending to consumers and businesses. The resulting credit crunch could easily cause a recession, which would magnify the downward spiral. If banks and thrifts continue to hold a proportionate share of the total amount of Fannie and Freddie obligations, then Fannie's and Freddie's continued growth will increase the systemic risk they pose to America's banks and thrifts.

Ironically, the growing presence of Fannie and Freddie obligations on bank and thrift balance sheets further increases the likelihood that the federal government will rescue the GSEs should they experience funding problems because of the adverse effect those problems would have on federally insured depository institutions. Although reforms Congress enacted in the early 1990s have essentially eliminated the taxpayer risk posed by federal deposit insurance, as I explain in a paper titled "Banks Do Not Receive a Federal Safety Net Subsidy," Congress would still understandably be concerned about the credit-crunch effects of Fannie's and Freddie's funding problems.

While GSE obligations owned by banks and thrifts should be subject to the same loan and investment limitations applicable to the obligations of private-sector firms, forcing banks and thrifts to trim their Fannie and Freddie obligations would merely shift systemic risk elsewhere in the financial system, not eliminate it. In any event, the GSE exception to these limitations should be of less concern to Congress than the enormous and ever increasing size of the two undercapitalized GSEs.

What to do about the systemic risks Fannie and Freddie pose

Until such time as Fannie and Freddie can be transformed into genuinely private-sector firms by eliminating their special privileges, Congress must ensure that a reliable mechanism is in place to rescue Fannie and Freddie should one of them stumble financially. Because there are innumerable reasons why they might stumble, some of which lie outside the U.S. financial system, it would be pointless to try to prevent an external event. Instead, if needed, a rescue mission should be executed as quickly and smoothly as possible.

It would be foolhardy to rely upon "market discipline" to prevent a stumble because the exercise of market discipline could collapse the financial markets. We got a whiff of that potential effect in the aftermath of Treasury Under Secretary Gary Gensler's testimony in March before the Capital Markets Subcommittee when yields on Fannie and Freddie debt shot up at the mere suggestion that they are not government-backed institutions.

The two existing rescue mechanisms are grossly inadequate. First, Fannie's and Freddie's Treasury lines of credit, at \$2.25 billion for each institution, pale in light of the total amount of their outstanding debt and MBS. Fannie's line of credit is less than .2% of its outstanding obligations; the comparable figure for Freddie is about .25%. Second, if Congress were out of session and the Treasury lines of credit had been fully drawn, then presumably the Fed could lend to Fannie and Freddie or buy their securities, but to do so, the Fed would have to sell a like amount of Treasury securities. Massive sales of Treasury debt could be highly disruptive to the financial markets.

Key, therefore, to dealing with a Fannie or Freddie funding crisis would be congressional enactment of a line of credit, comparable to the life ring Congress tossed to the Farm Credit System in 1988, that the Treasury Department could draw upon to keep the financial markets funding Fannie and Freddie even if these GSEs were experiencing financial difficulties. That action would give Congress time to resolve their problems in a manner that would minimize the cost of any rescue. As distasteful as this recommendation may seem, going forward with the present limited rescue resources is playing Russian roulette with the U.S. economy.

Mr. Chairman and members of the Task Force, I thank you for your time. I welcome your questions.