# Fannie, Freddie and the Fall-Out: The Future of the Housing GSEs

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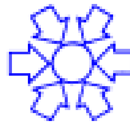

It is a pleasure to meet with you again to discuss an issue that only seems to get hotter. In preparing for this talk, I took a look at the last comments I made to you about the future of the housing GSEs. It was in early 1996 at an equally lovely spot, and I then tried to outline steps community banks needed to take to protect their franchises from the challenges posed by growing GSEs. Since then, of course, Fannie and Freddie have grown – their portfolios are 380 % bigger since we last met, and their market-share has grown apace as well.

In 1996, I suggested that successful banks needed to control the value-added products associated with mortgage lending to ensure that they didn't just get a GSE-dictated fee for mortgage origination. Then, I said that Fannie and Freddie couldn't bend their charters to, for example, couple mortgage origination with insurance products or similar consumer financial services. Oops! Since 1996, of course, Fannie and Freddie have not only become even bigger players in their traditional markets, but also increasingly formidable competitors in new ones. When I said seven years ago that the GSEs couldn't, for example, get into insurance, I guess I read the GSE charter differently than they do – look, for example, at Fannie's 1997 bid to get into credit life insurance, the GSEs ongoing campaign to self-insure against mortgage credit risk and Fannie's most recent ventures into insurance and even consumer lending.

There's been another big change since we last met. Then, I think we all agreed that, even if Fannie and Freddie posed competitive challenges, they were safe-and-sound companies that did not pose undue risk to financial markets. Now, of course, we're not so sure, and the disquieting fear that firms with at least $1.6 trillion in assets between them could get their derivatives bets or corporate governance wrong is a new, major factor driving both public policy and private strategic planning.

This morning, I'll summarize what I think Congress will do to address both the competitive and prudential issues the GSEs – Federal Home Loan Banks included – have aroused in recent years. We'll know a lot more, of course, next week when Treasury Secretary Snow lays out the Administration's plan, but its planks are already evident in the hot debate about GSEs that preoccupied financial Washington in August. Is privatization in the works? I don't think so – and I'm far from certain this would be advisable if it were. However, profound change with sweeping strategic implications is coming – and coming fast.

*Fair is Fair for Fannie and Freddie*

The first big question Secretary Snow will answer next week is what regulatory structure is right for the housing GSEs. In 1992, Congress built a divide-and-conquer scheme for Fannie and Freddie, which these excellent political risk managers have unsurprisingly adapted to their purposes in the intervening decade. Recent events have made clear that the GSEs' regulator must have safety-and-soundness and capital powers comparable to those bank regulators deploy, and I think Treasury will propose this next week and Congress will act on this recommendation.

What will this mean in practice? First, it will mean that the GSEs' regulator has both prudential authority and the power to dictate in what new lines of business the GSEs engage. In 1997, the Basel Committee outlined "core principles" for good bank supervision, arguing that an effective regulator must be able to say what a bank can do so that it doesn't just take the fall on the safety-and-soundness side if a bank gets into risky business. This principle is as true for GSEs as it is for banks.

I see nothing in this new structure that threatens GSE focus on affordable housing. Indeed, a tough regulator would ensure that GSEs focus on affordable housing by blocking any proposed ventures outside the GSEs' stipulated mission. Should there be any fears about ongoing affordable-housing commitment at the new regulator, Congress can and should tell it what needs to be done or affordable-housing goals could remain set by HUD.

Second, the new regulator must take action – and do so quickly – on the GSEs' woeful regulatory capital requirements. Congress also set these in stone in 1992, making it impossible for the GSEs' regulator to change the minimum leverage standards as the Enterprises have increased the riskiness of their mortgages and the size of their portfolios. Congress also dictated the risk-based capital standards down to tiny details – a grave mistake given all the financial market changes – derivatives, anyone? – since then. However, OFHEO seriously compounded these statutory flaws by itself taking a decade to come up with a giant risk-based capital rule that ducks and weaves around all the GSE risk factors to derive risk-based ratios of only a few basis points.

In my opinion, the GSEs should comply with bank-like regulatory capital standards. Right now, they are balanced on the head of a pin. That $1.6 trillion in on-balance sheet assets and an additional $1.7 trillion in off-balance sheet guaranteed MBS is atop only $52 billion in core capital – a leverage ratio of 63 to 1 that makes hedge funds look positively potent. Immediate application of bank core and risk-based standards would put a substantial buffer between the GSEs and taxpayers backing that implicit guarantee. When the bank risk-based capital standards change under Basel II, then those governing the GSEs could change as well. Importantly, more robust capital will have a very beneficial impact on home ownership – the GSEs' whole point, of course. As debt-holders see a better balance sheet, they will likely demand less from the GSEs in exchange for their funds, lowering GSE costs and, thus, mortgage rates as well. GSE shareholders will, of course, take a hit as GSE return-on-equity numbers start to look more like yours, but this will have no bearing on home ownership.

*What of the Home Loan Banks*

Will Treasury recommend that its new regulator also govern the Federal Home Loan Banks? That remains to be seen, but my guess is that the System won't stay out of the line of fire for long. Although Chairman Korsmo has rightly tried to buttress the FHFB's supervisory capability, the Board is years away from an examination force with the size and skills to handle a geographically-diverse $800 billion set of Banks. Indeed, recent news from various parts of the System – the S&P downgrade of the New York Bank

included – is an indication of growing investor concerns that could well translate into a new set of regulatory standards from a new, empowered agency.

Is this a problem for members? I don't think so. In fact, I think credible supervision is the only way the Federal Home Loan Banks can realize the promise of all the new programs Congress authorized in Gramm-Leach-Bliley. Critics of the System stand on firm ground now when they argue that the Banks may not be able to handle interest-rate risk from the MPF or credit risk from expanded small-business or agriculture loan purchase programs. Those defending the System's risk management capabilities also have their credibility undercut by the overall battle against SEC disclosure. Outsiders have to wonder just what would be revealed if SEC-style financials were released that allowed each Bank to be compared to all the others and then to the rest of the financial world.

*Will the Circle Stay Unbroken*

At this point, the question isn't if Fannie Mae and Freddie Mac will get a credible new regulator – even they now expect that there will be one. The hand-to-hand combat under way in Washington has turned from this initially difficult question to the still tougher ones of what the new regulator will be allowed to do and when it will get to do it.

If Treasury proposes and Congress adopts a new supervisory scheme that fixes as many flaws in the current one as possible, then I think Fannie and Freddie will stand on a firmer footing to go back to the business for which they were chartered and on which you rely. Tougher capital standards, of course, will have strategic impact on the GSEs, but they will only make them more like everyone else, not force a new set of burdens on them.

If, however, Congress goes on to more profound change, then the future of the housing GSEs could change dramatically. I recall – like many of you, what happened in 1997 when Congress decided to impose a "user fee" on Sallie Mae. That fee was so costly that the GSE decided it was better off as a truly private concern. Then, of course, it managed to persuade Congress to allow it to privatize over time – getting new powers and little regulation on Day One, with eight years over which to unfold the GSE that still funded the firm's entire operations. Of course, over this period, Sallie has become a far more dominant player in the student loan market – and how could it have been otherwise given that the firm was allowed to have its cake and eat it too.

As I said at the outset, privatization is a puzzling problem. On the surface, free-enterprisers like me like Enterprises freed from the government. The current structure, as has been widely observed, privatizes profit and socializes risk. Taking it apart, though, is tricky and fraught with risk, as the Sallie Mae example amply demonstrates. Any weaning of the GSEs from the federal government must be done with extreme care to avoid market disruptions, adverse housing implications, or the creation of an even larger competitive problem for the rest of the financial services industry.

Thus, what's advisable now – and what I think the Administration will recommend and Congress will do – is regulation that means what it says and gets the GSEs back on the course originally set for them.  With this in place and markets comforted by it, a larger review of whether the G should stay in GSE will begin.