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SHOULD FANNIE MAE AND FREDDIE MAC BE DESIGNATED SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SIXTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE CRITERIA THE FSOC CONSIDERS WHEN DETERMINING WHETHER MATERIAL FINANCIAL DISTRESS AT A NONBANK FINANCIAL COMPANY COULD POSE A THREAT TO THE FINANCIAL STABILITY OF THE UNITED STATES; THE APPLICABILITY OF THESE CONSIDERATIONS TO FANNIE MAE AND FREDDIE MAC RESPECTIVELY; AND ANY OTHER RELEVANT POLICY CONSIDERATIONS THAT THE COMMITTEE SHOULD CONSIDER

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C O N T E N T S

TUESDAY, JUNE 25, 2019

WITNESSES

Additional Material Supplied for the Record

SHOULD FANNIE MAE AND FREDDIE MAC BE DESIGNATED SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

TUESDAY, JUNE 25, 2019

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Mike Crapo, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN MIKE CRAPO

Chairman CRAPO. The hearing will come to order.

Today the Committee returns its focus once again to the state of our housing finance system.

We are quickly approaching the 11-year mark since the Government asserted control of the GSEs, Fannie Mae and Freddie Mac. After all that time, Fannie and Freddie continue to dominate the mortgage market, and taxpayers remain on the hook in the event of the next market turndown.

In recent weeks, FHFA Director Mark Calabria has repeatedly stated, quoting President Kennedy, that "The time to repair the roof is not in the middle of a downpour but when the sun is shining."

I agree with this sentiment. We have a key opportunity right now while the sun shines on our economy and mortgage markets are healthy to put our housing finance system on a durable, sustainable course that can withstand any market cycle.

My strong preference is for comprehensive legislation. However, we are also interested in analyzing some of the options currently available to the Administration to protect taxpayers and put our housing finance system on stronger financial footing.

One of those options is for the Financial Stability Oversight Council, or FSOC, to designate Fannie and/or Freddie as a systemically important financial institutions, or SIFIs, under Title I of Dodd–Frank, thus, subjecting them to supervision by the Federal Reserve and enhanced prudential standards.

Title I of Dodd–Frank authorizes FSOC to subject nonbank financial companies to such supervision if it determines that material financial distress at a particular company could pose a threat to the financial stability of the United States.

Once a designation is made, the additional tools available to the Fed include, but are not limited to, enhanced risk-based and leverage capital requirements; liquidity; risk management and risk committee requirements; stress test requirements; and for institutions that pose a grave threat to financial stability, a debt-to-equity limit.

Section 120 of the Dodd–Frank Act also authorizes the FSOC to make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for a financial activity or practice conducted by nonbank financial companies if the FSOC determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank-holding companies and nonbank financial companies, U.S. financial markets, or low-income, minority, or underserved communities.

Fannie and Freddie are clearly too big to fail. We all know it, and the 2008 bailout proved it.

Today Fannie Mae has a larger balance sheet than any financial institution in the United States and the second largest balance sheet of any public company in the world. Freddie Mac is not far behind.

Collectively they hold $5.48 trillion in assets. That is $5,000 billion.

Additionally, both companies hold far less capital and are far more leveraged than any other currently designated SIFI.

As FHFA Director Calabria recently said, "With a leverage ratio of nearly a thousand to one, their balance-sheet capital cushion is razor thin."

Trillions of dollars of Fannie and Freddie obligations are held by central banks across the world, and the GSEs' economies of scale, proprietary underwriting engines, intellectual property, special congressional charters, and unique role in the marketplace would be nearly impossible to immediately substitute in the event of a market turndown.

In a 2017 speech, Federal Reserve Chairman Jerome Powell publicly referred to Fannie and Freddie as "systemically important."

Despite these considerations, Fannie and Freddie have never formally been designated as SIFIs under Title I of Dodd–Frank by FSOC.

Today we are interested in assessing the viability of a formal designation of the GSEs under Title I of Dodd–Frank, whether in conservatorship or in the event that they someday return to the private market as reformed entities.

In particular, I am interested in determining to what extent a SIFI designation under Title I of Dodd–Frank would result in increased capital levels at the GSEs that can shield taxpayers from liability in the event of a future market turndown, how the Fed and FHFA would coordinate their oversight efforts in the event of a designation under Title I of Dodd–Frank, and the impact a designation under Title I of Dodd–Frank—that such a designation would have on all participants in the broader mortgage market.

I look forward to continuing to work with Members of this Committee, the Administration, and other stakeholders to finally put our housing system on durable, sustainable footing.

Senator Brown.

OPENING STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman, and thanks to the three witnesses.

Home is the center of everything we do. Whether you rent or own, home is where you raise your kids, throw birthday parties, do homework, relax after a hard day's work. It also determines so much else about your life, what school your kids go to, how long it takes to get to work, your access to parks and community resources, whether you are exposed to lead in your walls or in your drinking water.

For many Americans, owning a home is so essential that it has become synonymous with the American dream, but rent and housing costs are rising faster than wages. More than a quarter of renters spend over half their income on housing. It is getting harder for working families to make that dream a reality.

Without the stability and affordability of a long-term fixed-rate mortgage, far fewer families would have a home of their own. That is why Congress chartered Fannie Mae more than 80 years at the height of the Great Depression to make home ownership more accessible and affordable for all American families.

That is why Congress reaffirmed Fannie and Freddie's public purpose in 2008 with the Housing and Economic Recovery Act. In addition to enhancing accountability, that law strengthened Fannie and Freddie's affordable housing missions and duty-to-serve communities that have not been given a fair shot. People of color were systematically excluded from sharing in this Country's housing wealth for most of our history.

I suggest any in the audience and the three at the witness table, if you have not, to read "The Color of Law" by Richard Rothstein. We know Americans of many backgrounds still face housing discrimination. Congress made clear that Fannie and Freddie must address inequities in our housing finance markets.

Today's hearing asks whether Fannie and Freddie should be systematically important financial institutions. They play an important role in the economy today, to be sure. There is not a single person in this room who would disagree with that.

Last year Fannie and Freddie helped more than 3 million families buy or refinance their homes. They made it possible for another million-and-a-half to find an apartment, including nearly 900,000 low- and very low-income renters.

But before we decide how to regulate these important institutions, we should answer a fundamental question: Which Fannie and Freddie are we talking about? Are we talking about the Fannie and Freddie of the early 2000s, which under a weak regulator had spent years focusing too much on making profits for shareholders and too little on stable home ownership for hardworking families? Or are we talking about the Fannie and Freddie of today managed by a strong Federal regulator and which pay all but a modest capital buffer back to taxpayers? Or are we talking about the reformed entities Congress may create for the future, which will have to continue Fannie and Freddie's role addressing the affordable housing crisis we face across the country?

This Committee held two hearings in March where we heard from small lenders and consumer groups and civil rights organizations and lenders and builders and realtors. We received written statements from other critical participants in the housing system.

Across those 2 days, we heard many of these folks coalescing around a few foundational principles for reform. I would like to outline what those were from those hearings.

They told us that any reform should protect access to affordable 30-year fixed-rate mortgages. They should provide a catastrophic Government guarantee. Any reform should structure loan guarantors like public utilities providing a regulated rate of return. Any reform should serve a broad national market. It should serve lenders of all types and sizes equitably. It should maintain a duty to serve all markets and all borrowers. It should maintain affordable housing goals and metrics. It should expand investment in affordable housing, and it should maintain the GSEs' successful multifamily business models and ensure continued or better access for financing of affordable rental housing.

This would reorient Freddie and Fannie to serve the housing needs of families in Cleveland and Boise and Billings and Richmond, rather than maximize profits. It would also require a different type of oversight than we have for the megabanks and shadow banks that poisoned the mortgage market and infected our economy, different than we have for financial interests that are obsessed with stock buybacks and that believe they have no obligation to serve the Nation that bailed them out.

No matter how much money you make or what State you live in, housing is essential. That means our housing market and the entities that make it work are essential. We need a housing system that is built to last, so that it can continue to serve all families across the Country in times good and bad.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you, Senator Brown.

We are joined today by Mr. Alex Pollock, Distinguished Senior Fellow at the R Street Institute; Dr. Douglas Holtz-Eakin, president of the American Action Forum; and the Honorable Susan Wachter, Sussman Professor of Real Estate and Professor of Finance at The Wharton School of the University of Pennsylvania.

I want to thank each of the witnesses for joining us this morning. We appreciate your bringing your expertise and knowledge to the Committee on this critical issue.

We would like to hear from each of you in the order I introduced you. Again, I would like to remind you to try to keep your introductory remarks to 5 minutes so that we will have time to get through all of our questions.

Mr. Pollock, you may proceed.

STATEMENT OF ALEX J. POLLOCK, DISTINGUISHED SENIOR FELLOW, R STREET INSTITUTE

Mr. POLLOCK. Thank you, Mr. Chairman and Ranking Member Brown. It is an honor to be here with the Committee.

To begin with the essence of today's question, "Are Fannie and Freddie Mac systemically important?" They guarantee half the credit risk of the massive U.S. housing finance sector. They have combined assets, as the Chairman said, of $5.5 trillion. They are systemically important, quite obviously. Are they financial companies? Of course, they are. They are systemically important financial institutions as a simple fact, and, Senator Brown, I think that includes the past, present, and future, Fannie Mae and Freddie Mac.

Now, it is true that they are systemically important if you consider them as two of the largest and most highly leveraged financial institutions in the world, but it is equally true if you consider them as an activity that generates systemic risk. Leveraged real estate is and has been throughout financial history a common source of credit collapses and crises.

Fannie and Freddie are giant credit-risk takers on a super-leveraged basis, not just operating intermediaries. Being leveraged credit-risk takers, could they, to use the words of the Dodd–Frank Act, "pose a threat to the financial stability of the United States"? They have already demonstrated that they can.

As Secretary of the Treasury Henry Paulson correctly judged in 2008, a default on Fannie and Freddie's obligations would have dramatically exacerbated the financial crisis on a global basis. I just note that today such a default would also impose credit losses on the Federal Reserve.

As the Chairman said, Fannie and Freddie are, without question, too big to fail. They are systemically important, as my old friend, Susan Wachter agrees, and indeed, no reasonable person would dispute. Yet so far the Financial Stability Oversight Council has not designated them as SIFIs, as the Chairman said.

How should FSOC deal with the fact of Fannie and Freddie's systemic importance? Should they recognize the reality or keep ignoring the issue? I believe FSOC should formally designate Fannie and Freddie as SIFIs under Title I of the Dodd–Frank Act and strongly recommend that action.

My written testimony considers the qualifying factors for SIFIs of size, interconnectedness, substitutability, leverage, maturity mismatch and liquidity risk, and existing regulation.

To mention a few key points, they are enormous in size, as we have already heard. Their systemic role is critical and cannot be replaced in the short or medium term. They are hyper-leveraged at over 500 to 1 as of March 31st but more like a thousand, as the Chairman said, on other dates. They are 100 percent concentrated in leveraged real estate. Their primary regulator is devoted only to housing finance.

Such a regulator always faces the temptation to become a cheerleader and a promoter of housing and its regulated entities. Good historical examples of this are the Federal Home Loan Bank Board, abolished in 1989, and the OTS, abolished in 2010.

In sum, Fannie and Freddie meet the criteria specified by the Dodd–Frank Act and its implementing regulations for designation as a SIFI, both as institutions and as a systemically risky activity.

Designating them a SIFI should not be delayed because they are in conservatorship. They are just as systemically important in conservatorship as out of it. When they are designated as SIFIs, as I hope, the Federal Reserve will become an additional systematic risk regulator for them. This seems to me a good idea.

The Fed is well placed to consider under systemic risk, for example, whether Fannie and Freddie's capital requirements and super-leverage cause capital arbitrage and therefore increased risk in the financial system as a whole. Of course, there are many other important systemic questions.

I believe the Fed as systemic risk regulator of Fannie and Freddie would be a force for sound and well-capitalized housing finance, which would be better understood in the context of its interaction with the rest of the financial system, which we greatly need.

In conclusion: Are Fannie and Freddie SIFIs? Yes, without a doubt.

Do Fannie and Freddie cause systemic financial risk? Yes.

Is the Federal Reserve a reasonable place to try to understand and address the systemic risk? Yes.

Should FSOC recognize these facts by formally designating Fannie and Freddie and SIFIs under Title I? Yes.

When? The sooner the better.

And thank you for the chance to share these views.

Chairman CRAPO. Thank you very much.

Dr. Holtz-Eakin.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, PRESIDENT, AMERICAN ACTION FORUM

Mr. HOLTZ-EAKIN. Chairman Crapo, Ranking Member Brown, and Members of the Committee, it is a privilege to be here today. Thank you very much.

As the Chairman noted, there has been increased discussion of housing market reforms, the housing finance reforms, notably the outline the Chairman produced earlier this year.

The President has issued a memo to Housing and Urban Development and Department of Treasury to deliver to him administrative plans to reform Fannie Mae and Freddie Mac, and both of these efforts presumably would lead to the exit of the GSEs from conservatorship. And at that point, I think it is imperative that they be designated as SIFIs. For many of the reasons that have been laid out so beautifully by Alex, I think this is the only sensible way to go.

Their core activity is the thing that has historically been the most systemically risky activity in the financial system—leveraged lending for real estate. If you just follow the trail from Woodward & Company to Continental Illinois to the savings and loan crisis to the subprime crisis, you find the same activity as the core of financial and banking crises in our history. Not only are Fannie Mae and Freddie Mac engaged in that activity, they dominate that activity. They have extraordinary market presence, are currently buying at 48 percent of all originations. They are responsible for 61 percent of all mortgage-backed security issuances, and all of these are up from their precrisis footprint. I think there is simply no question that their activities are systemically dangerous.

And they have the other characteristics that one associates with SIFIs. They have enormous leverage. I have no idea what the right number is, but it is beyond any reasonable measure of leverage. And they are heavily interconnected. Fannie and Freddie are buying mortgages from over a thousand other financial institutions in the most recent report.

So, given the criteria that the FSOC is currently using for designation, I think there is no question that they should be designated as SIFIs at the moment they exit conservatorship.

Despite that, there are some who have argued against the idea of designation with the notion that perhaps the Federal Reserve might face a conflict of interest, being both a regulator of housing markets and also in setting interest rates for monetary policy, or some would argue that they did not display themselves to be outstanding insurance regulators. They might not be outstanding prudential regulators of a housing finance entity.

And if one were to go down that path and decide against designation, under Title I of Dodd–Frank, it seems to me it is imperative that the FHFA use the powers that it have to create an alternative regime that insulates the housing markets and the broader economy from the threat posed by the GSEs.

They would need to hold SIFI-like amounts of capital, and the FHFA is about to finalize a capital rule for the GSEs. That is an opportunity to display to the FSOC that they have an interest in insulating the financial system against the collapse of these entities by holding more capital.

They are subject to a stress test. Those stress tests should look like the stress tests that the 18 large banks just passed. Those stress tests are done by the Federal Reserve, and they included declines of 25 percent in housing prices and 35 percent in commercial real estate prices. We ought to see the capacity to survive those things.

They should be precluded entirely from holding the portfolios that essentially made them monoline hedge funds and extremely risks prior to the crisis, and they should be de-risked as much as possible through aggressive use of up-front credit-risk transfers, something they have done a modest amount of but which there is a lot more opportunity to.

In short, it may be the case—I am not sure I am convinced, but it may be the case that FHFA could put in place a regime of capital and other provisions that are enough to have the FSOC deem them and avoid designation. So one way or another, the future of Fannie Mae and Freddie Mac cannot look like the ones that we saw prior to the crisis, and the financial system has to be safe from the implications of any distress that they might suffer.

I thank you for the chance to be here today, and I would be happy to answer your questions.

Chairman CRAPO. Thank you.

Ms. Wachter.

STATEMENT OF SUSAN M. WACHTER, SUSSMAN PROFESSOR OF REAL ESTATE AND PROFESSOR OF FINANCE, THE WHARTON SCHOOL OF THE UNIVERSITY OF PENNSYLVANIA

Ms. WACHTER. Chairman Crapo, Ranking Member Brown, and other Members of the Committee, thank you for the invitation to testify at today's hearing, "Should Fannie Mae and Freddie Mac Be Designated as Systematically Important Financial Institutions?"

I am the Sussman Professor of Real Estate and Professor of Finance at The Wharton School of the University of Pennsylvania and have addressed related questions in my research.

It is an honor to be here today to discuss the role of the Financial Stability Oversight Council in the prevention of systemic crises derived from the mortgage market.

The Financial Stability Oversight Council, FSOC, has a statutory mandate to identify risk and respond to threats to financial stability. As is evident from the severe financial crisis that led to the Great Recession of 2009, mortgage markets can disrupt stability and have done so. Regulatory oversight and the structure of the housing finance system may be instrumental in determining whether we have a repeat of the crisis.

My comments today will address why there is a need for systemwide oversight of the mortgage market. I will also address the specific question: "Should Fannie Mae and Freddie Mac be designated as SIFIs?" I believe, for reasons that I will explain, that the correct designation for the GSEs—is SIFMUs, Systemically Important Financial Market Utilities.

Under Title X of the Dodd–Frank Wall Street Reform and Consumer Protection Act, Dodd–Frank, FSOC is authorized to designate nonbank financial institutions as systemically important.

In addition, under Section 204 of Dodd–Frank, FSOC is responsible for the designation of financial market utilities that the council determines are, or are likely to become, systemically important; that is, SIFMUs.

Section 803 of Dodd–Frank clarifies a disruption to a SIFMU as a situation where the failure of a functioning financial market utility could create or increase the risk of significant liquidity or credit problems spreading across financial institutions and markets and thereby threatening the stability of the financial system of the United States.

I believe a SIFMU designation is correct because the GSEs provide a structural foundation to the secondary mortgage market.

The GSEs are characterized by the considerations already established for the SIFMU designation, which are the aggregate value of transactions processed by the financial market utility, the aggregate exposure of the financial market utility, the relationship, interdependencies, or other interactions of the utility, and the effect that the failure or disruption of the utility would have on critical markets, financial institutions, or the broader financial system. This characterizes the GSEs.

In the years after the crisis, under the direction of the FHFA, the GSEs have made major improvements. They have wound down their portfolios. They have increased transparency. They have derisked through higher credit standards and risk sharing.

In 2012, the FHFA called for the GSEs to implement credit-risk transfer programs, which they have and which now cover approximately $80 billion worth of risk.

Additionally, the GSEs have developed a common security platform to ensure liquidity for the trading of MBS and interest rate risk.

While the GSEs are now less risky, the lack of equity capital, private capital, to absorb losses still leaves taxpayers at risk. In order to address the need for equity capital, so-called recap and release proposals have been put forth which would enable the GSEs to raise private capital and to reduce risk and to end the conservatorship. At this point, in contemplation of this, the GSEs should become SIFMUs.

Various plans have been proposed for the GSEs' restructuring, including multiple guarantors. The risk of the future GSEs depends upon whether they remain as currently structured or whether there are additional and perhaps many additional guarantors.

Moody's recently opined that increasing the number of GSEs could lead to weaker underwriting standards or price competition, both credit negatives for the GSEs and ultimately for the taxpayer. In this situation particularly, it would be extremely important to have the oversight that a SIFMU designation provides.

The key functions of the GSEs are to set standards and to provide transparency for the secondary mortgage market. The source of the crisis was the undermining of these standards and the underpricing of risk, which led to an unsustainable expansion of bad credit.

With the oversight of the FHFA and the enhanced oversight of a SIFMU along particularly with the role of the Federal Reserve, the GSEs are in a position to maintain their functions, providing stability to the mortgage market going forward.

But the FHFA alone cannot provide the collective oversight of the entities that comprise the mortgage market. Here, the Federal Reserve is critically important.

Therefore, I respectfully propose that the FSOC consider the designation of Fannie Mae and Freddie Mac as SIFMUs. The SIFMU designation can support macrostability while enabling the GSEs to provide access to sustainable mortgage credit over the long term.

I thank you for the opportunity to testify today. I welcome your questions.

Chairman CRAPO. Thank you very much.

I would like to start with a question for each of you, and I would like you, if you could, to just make this yes or no answers because I want to get on to some further questions.

It seems to me, based on the testimony you have given, that each of you agree that whether based on size or activity, Fannie and Freddie are too big to fail. Agree?

Mr. POLLOCK. Yes.

Mr. HOLTZ-EAKIN. Yes.

Chairman CRAPO. All right. Second——

Ms. WACHTER. I did not say yes.

Chairman CRAPO. So you do not?

Ms. WACHTER. No. I think that under conservatorship, they are not too big to fail. They are under direct Government oversight.

Chairman CRAPO. OK. Then I guess the second part of my question—again, hopefully, a yes or no—is do you believe—whether it is the designation under Title I or Title VIII, do you believe that they should be designated as systemically important institutions?

Mr. POLLOCK. Yes.

Chairman CRAPO. I did not hear a yes from either of the other two of you.

Mr. HOLTZ-EAKIN. Yes.

Chairman CRAPO. OK. And again?

Ms. WACHTER. The systemically important SIFMUs.

Chairman CRAPO. Yes, I understand that, under Title VIII.

Ms. WACHTER. Yes, absolutely.

Chairman CRAPO. SO let me go back—and this would be just for Mr. Pollock and Mr. Holtz-Eakin because you both, I think, agree that a Title I designation would be the preference.

In that context, do you believe that Fannie and Freddie today are adequately capitalized?

Mr. POLLOCK. No. Clearly no.

Chairman CRAPO. Mr. Holtz-Eakin.

Mr. HOLTZ-EAKIN. No, not at all.

Chairman CRAPO. That would mean that a designation should at least require that there be a greater level of capital at Fannie and Freddie?

Mr. HOLTZ-EAKIN. Yeah. I think that is the advantage of a Title I designation over Title VIII. There is no obligation for greater capital under Title VIII.

Chairman CRAPO. Well, that was going to be my next question, and I would like to ask each of you to then comment on why you prefer Title I. And then, Ms. Wachter, I will give you the opportunity to respond as to why that should not be the case.

And, Mr. Pollock, could you go ahead?

Mr. POLLOCK. Thanks, Mr. Chairman.

I think Susan's SIFMU argument is very creative but is misdirected and misinterprets Fannie and Freddie.

If we look at Title VIII, it is directed at exchanges and clearinghouses. The formal title of Section VIII is "Payment, Clearings, and Settlement Supervision". The more appropriate point about Fannie and Freddie, as we have said, is that they are hyper-leveraged credit-risk takers of an amazing scale and thereby systemically risky, taking credit risk as principals on a super-leverage basis. That is a Title I issue, I believe, and so I think they definitely need to be designated and under Title I.

Chairman CRAPO. Thank you.

Dr. Holtz-Eakin.

Mr. HOLTZ-EAKIN. I prefer Title I to Title VIII for two reasons. First, the one thing that it does do, which is to require the holding of greater capital cushions, I think that is an imperative.

The second is that one of the things that it does do under Title VIII is to give those designated access to the discount window at the Fed.

I will just quote former FDIC Chair Sheila Bair in discussing giving them access to discount window. She says, "Not only does it give these firms a real advantage over other nonsystemic competitors, it opens up taxpayers to potential losses and creates moral hazard. Title VIII financial market utilities will very likely become the new GSEs and a new source of system instability." Taking the GSEs and turning them into GSEs on steroids is a bad idea.

Chairman CRAPO. Thank you.

So, Ms. Wachter, would you like to respond to that?

Ms. WACHTER. Yes, I would. Thank you.

The GSEs are not banks. The GSEs are financial utilities. In the sense that they establish standards, they are similar to a clearinghouse in that the standards are critical for the common security platform and the TBA market, in which there are thousands of participants. This is their critical function.

I do not disagree in any way with the two other witnesses on the importance of private capital, and it is, indeed, the function of the FHFA to make sure, along with Treasury, prior to privatization that there be sufficient capital.

And in my proposal that they be considered as SIFMUs, there would be additional enhanced oversight by the Federal Reserve Board on the issue of capital and sufficiency of capital. That absolutely is key. It is just not the only function.

Chairman CRAPO. So do you think that a designation under Title VIII would bring with it a mandate for increased capital?

Ms. WACHTER. Well, the mandate for sufficient capital is already there under FHFA's mandate, but the oversight of the systemic implications and the need for capital varies not only with the GSEs specifically but the interconnectedness of the GSEs with the entire mortgage system, including Ginnie Mae and FHA, including the banking system. This interconnectedness can only be in the vision of the FSOC, and particularly the function of the FSOC as our macroprudential agency. Many countries have such an agency. That is the function of the FSOC.

In the absence of that oversight, the particular agencies that provide the underpinnings will not have the expertise of the other important regulators of the mortgage market at hand.

Chairman CRAPO. Thank you.

Senator Brown.

Senator BROWN. Thank you, Dr. Wachter. Thanks to all three of you.

During hearings the Committee held on housing finance reform in March, a number of witnesses talked about restructuring the GSEs as utilities providing regulated rates of return. The support for the utility model, I think, surprised most of us in both parties, the strong, strong support for it.

The witnesses said that this would stabilize the secondary market and avoid a race to the bottom in Wall Street's underwriting that contributed to the crisis.

My question is, if GSEs were structured as utility with a mission of serving the housing market, how would the risk be different from the risks of private banks and nonbanks?

Ms. WACHTER. As a utility, their mission would be to stabilize the market and to provide access to credit over the long run. It would not be simply to maximize profits, as for private entities, of course, with their shareholders rightfully directing them.

The problem is maximizing profits in the short run often comes at the expense of long-run stability, and particularly, these entities, their purpose, their goal, their mission should be long-run stability.

Senator BROWN. Some have suggested that everything from the Federal Reserve banks and the FOMC and SBA loans should be regulated as SIFIs.

Dr. Wachter, should Government-chartered entities and agencies which serve public purposes be supervised using the same tools as for-profit megabanks operating to serve their shareholders?

Ms. WACHTER. Absolutely not. The purpose of Government is to provide regulation, why would we double up the regulation? That would just be additional bureaucracy. I see no purpose to that.

Senator BROWN. As I mentioned in the first question, most of the witnesses we have had talking about this seem to support or do support the utility model, but some witnesses say that having more entities playing the same role as Fannie and Freddie and guaranteeing mortgage credit risk would help reduce—they argue it would help reduce risk to the system, but during the crisis, we know that we saw every company with ties to the housing market suffer large losses.

So would you expect, Dr. Wachter, having more guarantors would increase or reduce risk in the system?

Ms. WACHTER. It would increase risk, and the reason it would increase risk is that there would be races to the bottom. And also, it would be very difficult to regulate these entities for standards. The more entities you have, the harder it is to regulate for standards, and it is the erosion of standards that led to the crisis.

Senator BROWN. But just sort of intuitive—I am sorry to interrupt.

Ms. WACHTER. Yes.

Senator BROWN. Intuitively, should not more participants mean a better working system?

Ms. WACHTER. No, absolutely not.

If you have more, they are going to look at their share of the market, and that is what they are going to maximize. And they are going to go for increasing their share of the market, and they are going to underprice. They are going to reduce standards. This race to the bottom is exactly how we got where we are.

The competition needs to be for interest rate risk and for credit risk, and we need a utility to set up the mechanism for competition for the pricing of those two risks. And that then gives us the pricing in the secondary market at competitive levels.

The problem with a so-called multi-guarantor system is the competition would only last for the short run, and then we would have underpricing of risk. We would have standards that would be eroded.

If you had a few, that is not a problem, but if you had many, that is a problem, and besides, five or six do not get you to competition. What gets you to competition is a number more like 30 or 100. How would we regulate 30 or 100 entities for standard setting and for rate setting?

Senator BROWN. Last question. During hearings, again, in March, we heard repeatedly, it was essential for every company guaranteeing mortgage risk to serve a broad national market. Would you expect, Dr. Wachter, an entity serving just part of the country to be more risky or less risky than an entity that is required to serve the whole market?

Ms. WACHTER. Absolutely. A small part of the market is far riskier. It is diversification that comes from providing mortgages to the entire market that provides insurance to regions which are far more volatile than the Nation as a whole.

Senator BROWN. Thank you, Mr. Chairman.

Chairman CRAPO. Thank you.

Senator Moran.

Senator MORAN. Mr. Chairman, thank you.

Thank you all for sharing your expertise and intellect this morning.

A commonly held concern with FHFA continuing to serve as the sole regulator of Fannie and Freddie is that they will control their regulator and hold a high degree of influence.

Having said that, one of the key points on the ongoing GSE reform debate centers around the consensus on the need for caps on market share control for current and future federally chartered guarantors.

This is a bit of what you were talking about with Senator Brown. Do you see a multiple guarantor model as sufficient to ensure that Freddie and Fannie do not control FHFA as their sole regulator, and that regulatory decisions will be made best—in the best interest of the secondary mortgage market as a whole?

Ms. WACHTER. Thank you.

Right now, it appears that FHFA is not at the behest of Fannie and Freddie.

Senator MORAN. OK.

Ms. WACHTER. We cannot say what the future will be, but I do believe that the SIFMU designation helps address that problem.

Senator MORAN. Thank you.

Anyone else? Mr. Pollock

Mr. POLLOCK. Thank you, Senator.

As I said in my testimony, I think a danger of a specialized housing regulator is that it becomes captured by the idea of——

Senator MORAN. You did say that.

Mr. POLLOCK ——promoting and cheerleading for housing or be captured by its regulated entities, and therefore, the notion of a systemic level of regulation is also a key, I think. It is quite clear the FHFA is neither empowered nor able to be a systemic risk regulator for the systemic risk created by Fannie and Freddie. That is according to the statute assigned to the Fed.

I will say this, Susan. If you will agree to make Fannie and Freddie SIFIs under Title I, I think we could make them SIFMUs under Title VIII, too——

Ms. WACHTER. OK.

Mr. POLLOCK ——and make them both be SIFIs and SIFMUs.

Senator MORAN. Who says that compromise cannot be found in the U.S. Senate?

[Laughter.]

Mr. HOLTZ-EAKIN. How can I sit between two such reasonable people?

Ms. WACHTER. And you have already said you are not so sure——

Mr. HOLTZ-EAKIN. Yeah.

Ms. WACHTER ——that they should be SIFIs.

Mr. HOLTZ-EAKIN. So I think a couple of things. There is broad agreement that designation is appropriate, and that is a unique position for me. I have been pretty vocal in my concerns about the existence of the FSOC and its inability to actually identity systemic risk, measure it, control it, and so it is on a mission that it may not be equipped to pursue.

This is the one place where systemic risk is historically present. This is the one place I am very comfortable with the designation, and the details of it, I think, are left to be determined.

The second thing I would mention, if there are going to be more entities—and there will be more competition somehow defined among these guarantors—the key issue is how much capital those guarantors are going to hold.

If you have a downturn and you have these sort of large leveraged entities, the number is not going to matter. You are going to have a systemic problem coming out of real estate. We have seen that in history.

If you have a lot of equity behind things, you can have a big downtown and survive it. The best example of that is the dot-com bubble. The collapse of the dot-com bubble was a loss and wealth comparable to the collapse in the housing market. It produced a mild recession in the early 2000s. The collapse of the housing bubble produced the Great Recession. The difference is leverage and debt, and you have to control that. And if you control that, you will control the problem.

Senator MORAN. Thank you.

Mr. Pollock, you impressed me. I noticed the degrees in philosophy. I have never met a philosopher who answered the questions presented as testimony in a way that was so understandable for me by outlining the question and providing a yes answer following each question, so thank you.

Let me ask this one. Expand on the impact of designating Fannie and Freddie as SIFIs. What would the impact be on getting them out of the balance sheet business and back to the guarantee business?

Mr. POLLOCK. Thank you, Senator, for your kind comment and for the good question.

The main effect is putting FSOC in a position to look at Fannie and Freddie as systemic risks, as systemically important, which they obviously are, in my opinion, and to bring in the Federal Reserve as systemic risk regulator of Fannie and Freddie.

Now, if you believe in the theory of the Dodd–Frank Act—and while it may have many shortcomings, I think it is right in this—there is a level of analysis and risk control which is systemic, which is different from individual entity regulation. For that, I think the Federal Reserve relative to Fannie and Freddie would be a good choice. Bring the Fed in through designation as SIFIs under Title I (and maybe as SIFMUs, too) because they then have the systemic view of how Fannie and Freddie are affecting the system as a whole. That is the fundamental theory of Dodd–Frank and why SIFIs are in there in the first place.

Thank you.

Senator MORAN. Thank you, Mr. Chairman.

Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman.

Thank you all for your testimony.

Fannie and Freddie were—are unique entities. Congress chartered them for a specific purpose, which is to enable a strong national housing market to extend the opportunity of home ownership to as many Americans as possible, and it is important to note that all the other systemically important entities, both banks and nonbanks, were entirely private firms.

So, as this Committee continues to consider ways to improve our housing finance system, it is important that we do not lose sight of the critical role that Fannie and Freddie have played in helping millions of American actually own their own home.

In each of your testimonies, you have put forward differing views on why and how we should regulate these entities. So I want to ask you, as we think about the changes needed to preserve housing affordability across the country, can each of you explain how your proposal, whether designating the GSEs as SIFIs or as market utilities, would impact housing affordability in high-cost States like New Jersey as well as nationally?

Mr. POLLOCK. I will start, Senator, if I may.

The fact that Fannie Mae and Freddie Mac are SIFIs and that they will be SIFIs in any form does not, per se, address the affordability question, except that we know that running at hyper-leverage tends to escalate credit and pushing excess credit at markets tends to escalate housing prices. That makes housing less affordable than before, which is one problem with organizations which generate excess credit.

Whatever you do about housing affordability, however, I think it is quite clear what you do not want to do is have deteriorated credit quality as your strategy for affordability. That is just a bad and, indeed, potentially disastrous strategy.

Senator MENENDEZ. I agree, but they are mutually exclusive.

Mr. POLLOCK. The SIFI designation is to ensure high-credit quality of Fannie and Freddie and proper capitalization of their very substantial risks. You do not want to address affordability by making them risky and subject to failure.

Senator MENENDEZ. Anyone else have a quick answer to this?

Ms. WACHTER. Yes, I do. In fact, procyclicality does raise risks over time and the cost of risk. If we can reduce procyclicality, if we can have more systematic stability, less systematic risk, then we will have lower cost of credit, and that will mean more affordable credit.

I believe a SIFMU status with direct oversight of FHFA and enhanced oversight by the Fed will achieve this—then credit risk will decline and mortgage rates will decline, making mortgages more affordable for working families across America.

Senator MENENDEZ. So would that be your view as well if we had the designation without broader housing reform?

Ms. WACHTER. Oh, absolutely. We do not need the designation in the current status. In my mind, it would be redundant. It would be unnecessary. It is not necessary.

I am speaking in contemplation of the privatization of these entities.

Senator MENENDEZ. I see. OK.

Let me just turn a moment, since we have this expertise before us, to the broader topic of housing finance reform because, fundamentally, I believe the role of this Committee is to foster a housing finance system that ensures broad affordability and access.

Without a mandate to serve a national market, will not we risk guarantors cherry-picking regions, borrowers, and products, inevitably leaving some borrowers without any options for mortgage credit?

Ms. WACHTER. That is absolutely correct, Senator, and that is why we need a national system, and that is why we need utilities. We need securitization utilities that are, in fact, underpinning and providing the platform for a national system.

Senator MENENDEZ. Finally, I want to just follow up on the comment you made, Dr. Holtz-Eakin. In your testimony before the Committee in March on non-backed SIFI designations, you said FSOCs focus on entities that might contribute to systemic risk does not pursue the goal of systemic risk itself, and that activity-based regulation, quote, "is substantially better than singling out one or a few large firms or funds for designation, which create disparities and regulation across firms and sectors that could have a very real and unintended economic cost."

So I am trying to understand that testimony in the context of why do you believe that we need to single out Fannie and Freddie for designation when you previously argued against that type of approach.

Mr. HOLTZ-EAKIN. Leveraged real estate lending and the guarantee of such lending is the systemically risky activity historically in the U.S. financial system. That is all they do, and the dominate the market in that.

So using an activity-based designation leads you directly to designating them. I see no difficulty with that whatsoever.

Senator MENENDEZ. Last one, if I may, Mr. Chairman.

What are the specific activities that the GSEs are performing that you believe contribute to that systemic risk?

Mr. HOLTZ-EAKIN. They have historically done two things. They guarantee mortgages, and that is, in and of itself, participating in this systemically risky activity on a large scale.

Prior to the crisis, they also held large portfolios of MBS and, thus, enhanced their exposure to the systemically risky activity.

And, as I mentioned in my oral remarks, they also have other characteristics that people associate with SIFIs. They are highly interconnected. They are large and leveraged. The combination, I think, makes designation literally a no-brainer, and it is unusual for me to be in that position.

Senator MENENDEZ. Thank you.

Chairman CRAPO. Senator Scott.

Senator SCOTT. Thank you, Mr. Chairman.

Thank you to the panel for being here this morning.

I want to continue the discussion on the SIFI designation. Fannie and Freddie have a public mission to support a national market, which includes supporting home ownership and small and midsized towns like those in South Carolina as well as supporting access to credit after national disasters like hurricanes and flooding.

How would the GSEs' ability to support markets with less stable economies or battered by hurricanes be affected by adopting a SIFI capital structure?

Yes, sir.

Mr. HOLTZ-EAKIN. I think the shared vision of those sitting at the table is that they would continue to have that mission, but they would be less exposed to downturns and, thus, reliable in the performance of that mission across the cycle. Reducing that procyclicality, as Dr. Wachter mentioned, is really important.

Mr. POLLOCK. Senator, I would say that if you are better capitalized and managed with an eye to the systemic effect you have on the whole economy, that puts you in a better position to do all the things you mentioned.

Ms. WACHTER. I agree. I think reducing systemic risk is key, and the purpose of the GSEs is to provide national capital, particularly to regions under stress. And to the extent that the system is more stable going forward, they are able to do that.

Senator SCOTT. Thank you.

The GSEs have greatly expanded their programs to share risk with the private market through PMIs, reinsurers, capital markets. SIFI status is supposed to be designed to protect taxpayers by raising capital, but more capital means higher rates. If higher costs drive borrowers to the FHA, how does this protect taxpayer, especially potentially during challenging economies?

Mr. Pollock, your hand is up already.

Mr. POLLOCK. The question of mortgage credit risk and the price of overpriced houses, too highly leveraged, guaranteed by organizations which are themselves hyper-leveraged, has to be seen, in my view, in a systemic way. When the Federal Reserve with a SIFI designation is thinking about the systemic risk, they will have to, as does the FSOC, also think about FHA.

The FHA–Ginnie Mae combination is now as big as Freddie Mac in terms of its mortgage-backed securities. So you have to also think about them, which is another good reason, in my view, to put ourselves in a position where we are taking a systemic overview of this problem. As I said, This is exactly the theory of the Dodd–Frank Act.

Mr. HOLTZ-EAKIN. I guess what I would say is most of the discussion is about FSOC designation and Administration action, FHFA regulation, administrative action.

One reason why I think it is preferable to do housing finance reform legislatively is that you can look comprehensively at the activities of FHA, Fannie, Freddie, Ginnie Mae, and set up appropriate lanes so that if you are going to have a low-income supportive agency, it has the powers and the duty to serve there and not have competition among them.

Ms. WACHTER. Well, I agree that competition will undermine the mission of serving all Americans, particularly those who are first-time borrowers and are having difficulty becoming first-time borrowers.

In that sense, I think managing the system as a whole to prevent future crises is absolutely critical because future crises will raise credit risk and increase the cost of credit going forward. We must manage procyclicality.

It is a systemwide problem. That is why I believe we need all entities that oversee mortgages, including the Fed, to oversee this market together with FHFA, which has now and should have in the future the primary role, including the requirement of sufficient private capital if and when these entities are privatized.

Senator SCOTT. Thank you.

Last question. As it stands, the GSEs use a decades-old scoring model that excludes what I consider to be useful data from consumers, whether it is the rent payments or the utility payments or cell phone bill payments. If we penalize consumers for data that reflects negatively on them, I believe we should give consumers room for redemption when they have positive data.

In South Carolina alone, only 77 percent of adults can be scored under the current model used by the GSEs. An additional 16 percent of South Carolinians can be scored under newer credit-scoring models in the market.

Mr. Pollock, during the comment period with FHFA, you submitted a comment letter on the rule as proposed under then Director Watt. In it, you stated, "The undersigned are pleased to comment in favor of the proposed rule, which we believe represents a fair and reasonable interpretation of Section 310 of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018. Even now, Director Calabria has stated that history proves that competition is the best way to serve consumers. Competition lowers prices, improves quality, and drives innovation."

Given your prior statements, Mr. Pollock, do you believe that allowing consumer data from alternative sources gives a better assessment of a consumer's qualifications for a home loan?

Mr. POLLOCK. Thank you, Senator. You correctly quote my comment letter.

I believe that the competition for credit score suppliers has to be a competition directed toward the credit-risk takers, and the credit-risk takers are, in this instance, Fannie and Freddie.

As the bearers of the credit risk, they need to decide what best predicts and controls credit risk, taking everything into account. We ought to have as much competition as we can. I think the new act provides this, of people taking those ideas to Fannie and Freddie, but in my view, the decision has to be with the credit-risk taker, and that is Fannie and Freddie. That is why they are systemically important.

Senator SCOTT. Certainly, I will summarize my thoughts on our S. 2155 that included my Credit Scoring Competition Act. The fact of the matter is using an outdated, perhaps antiquated system of scoring creditworthiness is perhaps not in the best interest of those folks who find themselves carved out of the opportunity for home ownership who are actually qualified based on their pattern, their credit-scoring patterns.

Thank you.

Chairman CRAPO. Senator Warner.

Senator WARNER. Well, thank you, Mr. Chairman.

Let me start by thanking you and the Ranking Member. As somebody who has spent a lot of time on this issue, I appreciate the fact that you continue both to hold hearings on this. A few more hearings and we may be able to scare away all the Members of the Committee.

[Laughter.]

Senator WARNER. If there is one thing I have learned in 8 or 9 years of trying to wrestle this to the ground, it is extraordinarily complex. There is no simple answers, but do very much appreciate you and the Ranking Member's efforts to try to get us moving forward on this.

Before we get to designation, I want to go back to some of the comments about recap and release and some of Director Calabria's indications. He said that recap and release might be appropriate under right conditions, namely that the GSEs have adequate capital and they shrink their overall footprint.

Obviously, it seems to me that the Director also believes that in his recap and release scheme that the entities should be purely private, with no explicit or implicit guarantee.

And I want to start with you, Professor Wachter, and then hear from all the members of the panel. If we go forward with the recap and release plan without any kind of Government guarantee, explicit or implicit, what would that do to rates?

Ms. WACHTER. That is really for capital markets to determine.

I do think that the capitalization of these entities is absolutely important, as is, their structure. If their structure is one that promotes stability going forward, as Moody's has already opined, the rates are likely to persist where they are with a line of credit, which has, in fact, been in place and is likely to be in place going forward.

The question of explicit credit is an additional question, but I will leave my comments there.

Senator WARNER. Mr. Holtz-Eakin.

Mr. HOLTZ-EAKIN. I do not see how you could not have an implicit guarantee. That ship has sailed, and we put them in conservatorship once. They have been——

Senator WARNER. It appears the Director's comments——

Mr. HOLTZ-EAKIN. The Director's——

Senator WARNER ——if he was to do recap and release, he would see these with a shrunk enterprise and no explicit or implicit guarantee, at least that has been his philosophical points prior to this.

Mr. HOLTZ-EAKIN. I do not disagree.

So, first of all, there cannot be an explicit guarantee. That would require legislation. So the whole question will be, How will markets perceive this? Will they, in fact, see entities which are so well capitalized, so well supervised, that it is impossible to believe that they will ever fail? And if so, they will view them as essentially the same as having the implicit guarantee that it will be safe.

If they are less than that, rates will go up.

Senator WARNER. Mr. Pollock.

Mr. POLLOCK. Senator, it is a great question, and you are right that housing finance reform in general is complex. But I think the SIFI issue is really simple.

On the implicit guarantee, I think there is no way you can take the implicit guarantee away from Fannie and Freddie. The reason you cannot is because they are too big to fail, just as we agreed with the Chairman a little bit ago in this hearing.

In my written testimony, I quote the wonderful line from Secretary of the Treasury Paulson's memoirs of the crisis when he talks about how, when Fannie and Freddie were reporting big losses, he was having dinner with the Chinese, assuring them that everything would be OK. That is a wonderfully compact statement of what it means to have the implicit guarantee. So we are going to have the implicit guarantee.

Senator WARNER. I guess what I would question, this notion that they would be perfectly managed and adequately capitalized and all of these other prerequisites. I think the risk would be dramatic that rates would go up without that guarantee.

I also think as someone who believes deeply that part of the purpose of the entities is to ensure opportunity for first-time homebuyers, access for low- and moderate-income individuals, a recap and release into purely private entities, there would be no guarantee that those functions would continue.

One of the reasons why I am very, very strongly against a straightforward recap and release, I think it would move us way back from where we have been, put us back into a position where both higher rates, no effort to guarantee that kind of access to capital, and candidly, a circumstance that I do not think would be the goals of many at least on this side of the aisle.

My time is running out. Can I get an extra 30 seconds since we are down to just us chickens?

[Laughter.]

Senator WARNER. One of the things, as somebody who was along with Bob—Senator Corker, an author of Title I and Title II, I think this debate back and forth between Title I or Title VIII designation, I think both sides make valid points. Could you do a dual designation, recognizing that these are entities that have such an important purpose that they had been the source of past disruption in the market? Could you both do SIFMU and systemically important—I think you both make cases, I think fairly valid, for your appropriate designations. Why not do both?

Mr. POLLOCK. I think you could, Senator. I recommended that a few minutes ago.

Senator WARNER. I heard you allude to that. I wanted to just——

Mr. POLLOCK. I think you could, yes.

Mr. HOLTZ-EAKIN. I do not know if you can, but I see the point.

Ms. WACHTER. I think it would be redundant. I think the SIFMU status is appropriate. I think the SIFI status is redundant because FHFA is already in the position of overseeing the amount of capital, and we would have the additional prudential oversight of the Fed on top of that.

Mr. POLLOCK. Susan, you are wrecking the consensus we are building here.

Ms. WACHTER. I am sorry. I feel really bad.

[Laughter.]

Mr. HOLTZ-EAKIN. Well, if I could, Senator, I just want to be clear.

Ms. WACHTER. But I am agreeing with you. If I may, I am agreeing with both of you on the need for sufficient capital.

Mr. HOLTZ-EAKIN. Yeah.

Ms. WACHTER. For what reason would the Federal Reserve prudential oversight not deliver sufficient capital? I would like to understand why that would not happen, but I cannot imagine that.

Senator WARNER. Please.

Mr. HOLTZ-EAKIN. I just want to make sure that I was clear.

I agree with you. You should question that any recap and release of the GSEs would be so fantastic that they would not pose some risk. I do not believe that for a second.

I am deeply concerned of a pure recap and release. These were dangerous structures. They did not serve their public purpose well. They allowed private entities to profit at the taxpayer's backing. Going back to that, to me, is an anathema.

So pure recap and release without a lot of reforms should be a nonstarter. I agree with that.

Senator WARNER. Although they purely are entities, and they are financial interests in this country who profited from the downturn and upturn in these issues——

Mr. HOLTZ-EAKIN. I promise you, they write me. I know that.

Senator WARNER ——that still advocate for that simple recap and release that would put us frankly back into a circumstance where times are good, private shareholders gain. Times are bad, taxpayers get stuck with the bill.

Mr. HOLTZ-EAKIN. I agree. That is why I would prefer to see something done legislatively that really does need to do this.

Senator WARNER. Some of us have tried.

Mr. HOLTZ-EAKIN. I know. I am just encouraging you to continue.

And administratively, one of the reasons for designation is we are in a world of second best. What are the things that you can do administratively? Well, that is one.

Senator WARNER. The Chairman has given me a lot of time. I am just going to close. Professor Wachter, I would love to hear back. I understand theoretically why if you are saying if you had Title VIII designation, you would not need Title I designation. But because you have got a series of experts here that have a disagreement, I am not really sure what the harm would be of a dual designation to make sure that there was not any lack of ambiguity that these are extraordinarily significant enterprises and need all the appropriate capital and oversight that would be warranted.

Thank you, Mr. Chairman, for the extra couple minutes.

Chairman CRAPO. I was glad to give you that extra 30 seconds, Senator.

[Laughter.]

Chairman CRAPO. Senator Brown——

Senator WARNER. If there were more folks here, I would have given up my time earlier.

Chairman CRAPO. I hear you. That is why I was so glad.

Senator Brown has asked for his extra 30 seconds now too, and I may even follow that with my own.

Senator Brown.

Senator BROWN. Mr. Chairman did not appreciate being called a chicken either.

[Laughter.]

Senator BROWN. The position that Mr. Pollock and Dr. Holtz-Eakin argue for to many of us, the designation would lead to fewer moderate- and low-income people being able to get loans. That is what I think a number of us think.

So my question to the two of you is, Did either of you publicly oppose the designation, the de-designation of the huge for-profit insurance firms, AIG, Prudential, and MetLife?

Mr. Pollock.

Mr. POLLOCK. I would not, and in fact, I think they were not systemically important firms, but Fannie and Freddie, Senator, in my view, clearly are.

Senator BROWN. Dr. Holtz-Eakin.

Mr. HOLTZ-EAKIN. I opposed their designation, and I thought it was appropriate to de-designate them.

Senator BROWN. OK.

Chairman CRAPO. All right. I will follow that up with my 30 seconds now, and I would also like to direct this to Dr. Holtz-Eakin and Mr. Pollock. And the only reason to focus on them is, Ms. Wachter, you have answered this very well, and I want to get their perspective on this.

It is the question about moving toward a utility model versus a private-sector model as we move Fannie and Freddie out of conservatorship.

Senator Brown is right. There has been a fair number of market participants who have been before us who have recommended that. There is a fair number who had not, and issues relating to making sure that we have as much competition as possible, as we incentivize bringing as much private capital into the market as possible raise questions about how and if we should move to a more utility-type model. And I would just like each of you to comment on this notion of utility versus the private sector-type model.

Mr. HOLTZ-EAKIN. I guess I am not surprised by the support for that sentiment, largely because the current construct makes no sense.

These have—well, we have been through this territory. You have to get something that is neither fish nor fowl and turn it into something useful.

One of the things that Fannie and Freddie do is this MBS issuance and the packaging of that, and their platform is tremendous. And that utility function is inside them. So the question becomes, Do you take something which has been, quite frankly, gold-plated at the taxpayer's expense over the past 10 years and simply turn it to a poly purpose? That is one route. Or do you somehow manage to generate genuine competition in that function, the guarantee and origination of these MBS, which would require a lot of reforms to get it done? And some market participants question whether the playing field would ever be level, given the head start that Fannie and Freddie have in that activity.

So that is a tough call, but I think there is nothing, I think, that can be effectively done administratively. That is one of the reasons, I think, it is important to do a genuine overhaul of the housing finance system and decide where you want that function and how to deliver it.

Chairman CRAPO. Thank you.

Mr. Pollock.

Mr. POLLOCK. Mr. Chairman, I would say the world is full of different models of organization. You have corporations and partnerships and mutual organizations and utility structures and pure Government agencies like, say, Ginnie Mae, a Government corporation, and there are all kinds of pros and cons for different organizations.

But I would say that the essential activity remains guaranteeing huge amounts of credit risk and the thing being guaranteed is leveraged real estate—as Doug and I have said and I think Susan agrees—in fact, the usual mother of all credit crises. Whatever the form is, this thing is going to be systemically important and systemically risky because issuing real estate guarantees in a highly leveraged fashion is risky, and there is nothing you can do to be sure that the thing will not collapse. That is the history of finance forever.

So I think looking at these different organizational forms can be useful and interesting. Many people have argued for a mutual form, for example, like, say, the Federal home loan banks have.

But whatever form this underlying activity takes, it is still going to be a systemically important and systemically risky thing that you are doing. Therefore, we need this designation, in my opinion.

Chairman CRAPO. So Senator Warner has asked for another 30 seconds, but before I give it to him, I want to follow up on that just with one very quick—you can answer this very quickly.

I assume that all of you are saying that whatever the form is that we move out of conservatorship with, that there is going to need to be a very strong and engaged regulator.

One of the questions in looking at the utility-type model is, Does that regulator need literally the power to move to a utility-type model in the sense of, say, for example—and I want this to be a really quick answer—regulating or controlling the rate of return?

I think you have already answered that, Ms. Wachter, that you agreed yes.

Ms. WACHTER. I have. Thank you.

Mr. POLLOCK. And, therefore, you have to set prices, and whether anybody knows enough to set the right price is always a question.

Chairman CRAPO. So you are saying that that needs to be done?

Mr. POLLOCK. Yes.

Ms. WACHTER. If I may then take a moment back, I do not think you need to set prices because the credit risk transfer market sets the price of risk, and the TBA market sets the price of interest rates. And when you have those two, that is more than 90 percent of the price right there.

Chairman CRAPO. All right.

Dr. Holtz-Eakin.

Mr. HOLTZ-EAKIN. I think you have to give them more authorities. They do not have that right now.

Chairman CRAPO. Yeah.

OK. Another 30 seconds, and, Senator Warner, you will be the last 30 seconds.

Senator WARNER. It is short. It will be actually a real 30 seconds.

I think there is agreement there is an extraordinarily important function here. It is explicitly, implicitly very risky. You have got to have enough capital.

If we were to pursue—and I appreciate the Chairman's willingness to look at the model—around utility model, the notion of a utility, though, I think from an efficiency standpoint, you would only need one. You do not need two.

Comments on that?

Ms. WACHTER. There is sometimes more than one utility in a market, and I think it does provide a bit of redundancy. I do not think it is harmful to have two. We could even have three. I just think it would become a regulatory nightmare to have what you really need for competition.

Senator WARNER. But you have said, Professor Wachter, that by the very nature, that is not going to provide competition.

Ms. WACHTER. No, no. It is not providing competition, but rather execution and servicing. There are alternatives. So it is not competition in the setting of rates, but rather competition in the setting of standards. We certainly do not want competition in rate-setting. But some competition in servicing and delivery is useful—borrowers may go to Fannie, Freddie, and the banks as alternatives. And they do compete from that perspective.

Mr. HOLTZ-EAKIN. If you go this route, I think you have one, and you have a very strong regulator for that, the utility.

Right now it is a very strange situation that Fannie and Freddie essentially issuing regulations to their competitors in the mortgage insurance industry. This should stop.

Mr. POLLOCK. Senator, I would say, in general, we know a monopoly is a bad idea, and I think it would be a bad idea in this case too. But if it is a monopoly, it is even more a SIFI than it was before.

Chairman CRAPO. All right. Well, thank you very much. This has been very interesting.

As has been said by many of them here, we deeply appreciate the experience and advice that you have brought to us today, and we will be calling on you for further guidance and information as we move into this.

For Senators who wish to submit questions for the record, those questions are due to the Committee by Tuesday, July 2nd, and as always we ask you as witnesses to respond promptly to those questions, as you can.

Again, we thank you for being here. This hearing is adjourned.

[Whereupon, at 11:17 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN MIKE CRAPO

Today, the Committee returns its focus once again to the state of our housing finance system.

We are quickly approaching the 11-year mark since the Government asserted control of the GSEs Fannie Mae and Freddie Mac.

After all that time, Fannie and Freddie continue to dominate the mortgage market, and taxpayers remain on the hook in the event of the next market downturn.

In recent weeks, FHFA Director Mark Calabria has repeatedly stated, quoting President Kennedy, that "the time to repair the roof is not in the middle of a downpour but when the sun is shining."

I agree with this sentiment. We have a key opportunity right now, while the sun shines on our economy and mortgage markets are healthy, to put our housing finance system on a durable, sustainable course that can withstand any market cycle.

My strong preference is for comprehensive legislation.

However, we are also interested in analyzing some of the options currently available to the Administration to protect taxpayers and put our housing finance system on stronger financial footing.

One of those options is for the Financial Stability Oversight Council, or FSOC, to designate Fannie and/or Freddie as a "systemically important financial institution," or "SIFI" under Title I of Dodd–Frank, thus subjecting them to supervision by the Federal Reserve and enhanced prudential standards.

Title I of Dodd–Frank authorizes FSOC to subject nonbank financial companies to such supervision if it determines that material financial distress at a particular company could pose a threat to the financial stability of the United States.

Once a designation is made, the additional tools available to the Fed include but are not limited to: enhanced risk-based and leverage capital requirements; liquidity; risk management and risk committee requirements; stress test requirements; and, for institutions that pose a grave threat to financial stability, a debt-to-equity limit.

Section 120 of the Dodd–Frank Act also authorizes the FSOC to make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for a financial activity or practice conducted by nonbank financial companies if the FSOC determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, U.S. financial markets, or low-income, minority, or underserved communities.

Fannie and Freddie are clearly too big to fail. We all know it, and the 2008 bailout proved it.

Today, Fannie Mae has a larger balance sheet than any financial institution in the United States, and the second largest balance sheet of any public company in the world. Freddie Mac is not far behind.

Collectively, they hold $5.48 trillion in assets. Five thousand billion.

Additionally, both companies hold far less capital, and are far more leveraged, than any other currently designated SIFI.

As FHFA Director Calabria recently said, "With a leverage ratio of nearly a thousand to one, their balance-sheet capital cushion is razor thin."

Trillions of dollars of Fannie and Freddie obligations are held by central banks across the world, and the GSEs' economies of scale, proprietary underwriting engines, intellectual property, special congressional charters, and unique role in the marketplace would be nearly impossible to immediately substitute in the event of a market downturn.

In a 2017 speech, Federal Reserve Chairman Jerome Powell publicly referred to Fannie and Freddie as "systemically important."

Despite these considerations, Fannie and Freddie have never formally been designated as SIFIs under Title I of Dodd–Frank by FSOC.

Today we are interested in assessing the viability of a formal designation of the GSEs under Title I of Dodd–Frank, whether in conservatorship or in the event that they someday return to the private market as reformed entities.

In particular, I am interested in determining: to what extent a SIFI designation under Title I of Dodd–Frank would result in increased capital levels at the GSEs that can shield taxpayers from liability in the event of a future market downturn; how the Fed and FHFA would coordinate their oversight efforts in the event of a designation under Title I of Dodd–Frank; and the impact a designation under Title I of Dodd–Frank would have on all participants in the broader mortgage market.

I look forward to continuing to work with Members of this Committee, the Administration, and other stakeholders to finally put our housing finance system on durable, sustainable footing.

PREPARED STATEMENT OF SENATOR SHERROD BROWN

Thank you, Mr. Chairman, for holding this hearing and thank you to our witnesses for being here today.

Home is at the center of everything we do. Whether you rent it or own it, home is where you raise your kids, throw birthday parties, do homework, and relax after a hard day's work. It also determines so much else about your life—what school your kids go to, how long it takes to get to work, your access to parks and community resources, whether you're exposed to lead in your walls or in your drinking water.

For many Americans owning a home is so essential that it's become synonymous with the American Dream.

But rent and housing costs are rising faster than wages. More than a quarter of renters spend over half their income on housing, and it's getting harder for working families to make that dream a reality.

Without the stability and affordability of a long-term, fixed-rate mortgage, far fewer families would have a home of their own.

That's why Congress chartered Fannie Mae more than 80 years ago at the height of the Great Depression—to make home ownership more accessible and affordable for all American families.

And that's why Congress reaffirmed Fannie and Freddie's public purpose in 2008 with the Housing and Economic Recovery Act. In addition to enhancing accountability, that law strengthened Fannie and Freddie's affordable housing missions and duty to serve communities that haven't been given a fair shot. People of color were systematically excluded from sharing in this country's housing wealth for most of our history, and we know Americans of many backgrounds still face housing discrimination. Congress made clear that Fannie and Freddie must address inequities in our housing finance markets.

Today's hearing asks whether Fannie Mae and Freddie Mac should be systemically important financial institutions.

They play an important role in the economy today. I don't think there's a single person in this room who would disagree with that.

Last year, Fannie Mae and Freddie Mac helped more than three million families buy or refinance their homes, and made it possible for another 1.5 million to find an apartment, including nearly 900,000 low- and very-low income renters.

But before we decide how to regulate these important institutions, we should answer a fundamental question: which Fannie and Freddie are we talking about?

Are we talking about the Fannie Mae and Freddie Mac of the early 2000s, which, under a weak regulator, had spent years focusing too much on making profits for shareholders and too little on stable home ownership for hardworking families?

Are we talking about the Fannie Mae and Freddie Mac of today, which are managed by a strong Federal regulator and pay all but a modest capital buffer back to taxpayers?

Or are we talking about the reformed entities Congress may create for the future, which will have to continue Fannie and Freddie's role addressing the affordable housing crisis we face across the country?

This Committee held two hearings in March where we heard from small lenders, consumer groups, the civil rights community, lenders, builders, and Realtors. We also received written statements from other critical participants in the housing system.

Across those 2 days, we heard many of these folks coalescing around a few foundational principles for reform. They told us that any reform should:

- Protect access to affordable 30-year fixed-rate mortgages;
- Provide a catastrophic Government guarantee;
- Structure loan guarantors like public utilities, providing a regulated rate of return;
- Serve a broad, national market;
- Serve lenders of all types and sizes equitably;
- Maintain a duty to serve all markets and all borrowers;
- Maintain affordable housing goals and metrics;
- Expand investment in affordable housing; and
- Maintain the GSEs' successful multifamily business models and ensure continued or better access for financing of affordable rental housing.

This would reorient Fannie and Freddie to serve the housing needs of families in Cleveland and Boise, rather than maximize profits.

It would also require a different type of oversight than we have for the megabanks and shadow banks that poisoned the mortgage market and infected our economy. Different than we have for financial interests that are obsessed with stock buybacks and that believe they have no obligation to serve the Nation that bailed them out.

No matter how much money you make or what State you live in, housing is essential—and that means our housing market and the entities that make it work are essential. We need a housing system that's built to last, so that it can continue to serve all families across the country in good times and bad.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF ALEX J. POLLOCK

DISTINGUISHED SENIOR FELLOW, R STREET INSTITUTE

JUNE 25, 2019

Mr. Chairman, Ranking Member Brown, and Members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a senior fellow at the R Street Institute, and these are my personal views. I have spent almost five decades working in and on the banking and housing finance system. This included serving as President and CEO of the Federal Home Loan Bank of Chicago 1991–2004, and as a resident fellow of the American Enterprise Institute 2004–2015. I have personally experienced and studied numerous financial cycles, crises, and their political aftermaths, and have authored many articles, presentations, testimony, and two books on related subjects, including the nature of systemic financial risk.

To begin with the essence of today's question: Are Fannie Mae and Freddie Mac, which guarantee half the credit risk of the massive U.S. housing finance sector, and which have combined assets of $5.5 trillion, systemically important? Obviously, they are. Are they financial companies? Of course. So they are systemically important financial institutions as a simple fact.

This is true if you consider them as two of the largest and most highly leveraged financial institutions in the world, but it is equally true if you consider them as an activity that generates systemic risk. Guaranteeing half the credit risk of the biggest credit market in the world (except for U.S. Treasury securities) is a systemically important and systemically risky activity. Leveraged real estate is, and has been throughout financial history, a key source of credit collapses and crises, as it was yet once again in 2007–2009. The activity of Fannie and Freddie is 100 percent about leveraging real estate. Moreover, they have been historically, and are today, themselves hyper-leveraged.

To use the words of the Dodd–Frank Act, could Fannie and Freddie "pose a threat to the financial stability of the United States"? They have already demonstrated that they can.

The Financial Stability Board has stated this fundamental SIFI characteristic: "the threatened failure of a SIFI—given its size, interconnectedness, complexity, cross-border activity or lack of substitutability—puts pressure on public authorities to bail it out using public funds."

Fannie and Freddie displayed at the time of their 2008 failure and continue to display the attributes of extremely large size, interconnectedness, complexity, cross-border activity and lack of substitutability. As we all know, in 2008, U.S. public authorities not only felt overwhelming pressure to bail them out, but did in fact bail them out, with ultimately $190 billion of public funds. In addition, they pledged the credit support from the U.S. Treasury which protected and still protects Fannie and Freddie's global creditors.

Fannie and Freddie continue to represent giant moral hazard, as they always have. Since they now have virtually zero capital, they are even more dependent on the Treasury's credit support and its implicit guarantee than they were before.

That Fannie and Freddie are SIFIs in financial reality no reasonable person would dispute.

Yet so far, the Financial Stability Oversight Council (FSOC) has not designated Fannie and Freddie as official SIFIs. To a nonpolitical observer, judging purely on the merits of the case, this would be highly surprising. FSOC's historical inaction in this instance has certainly not added to its intellectual credibility. To Washington observers, naturally, it just seems like ordinary politics.

This hearing requires us to consider how FSOC should deal with the fact of Fannie and Freddie's systemic importance. Should FSOC recognize the reality by formally designating Fannie and Freddie as the SIFIs they so obviously are? Or should FSOC keep ignoring the issue?

I believe FSOC should formally designate Fannie and Freddie as SIFIs and strongly recommend that action. That would be consistent with the clear provisions of the Dodd–Frank Act. In my opinion, the country needs Fannie and Freddie to be integrated into the efforts to understand and deal with systemic risk. Without including Fannie and Freddie, these efforts are woefully incomplete.

Let us consider the SIFI factors of size, interconnectedness, substitutability, leverage, maturity mismatch and liquidity risk, and existing regulation.

Size

In total assets, Fannie is far larger than even the biggest SIFI banks. The following table ranks by size the ten largest existing SIFIs plus Fannie and Freddie. As it shows, Fannie is bigger in assets than JPMorgan Chase and Bank of America, and Freddie is bigger than Citigroup and Wells Fargo. On this combined table of twelve huge financial institutions, Fannie is number 1 and Freddie is number 4.

Size of Fannie, Freddie and the Largest Ten Existing Official SIFIs

	Total Assets
Fannie Mae	**$ 3.42 trillion**
JPMorgan Chase	2.74
Bank of America	2.38
Freddie Mac	**2.09**
Citigroup	1.96
Wells Fargo	1.89
Goldman Sachs	0.93
Morgan Stanley	0.88
U.S. Bancorp	0.48
PNC Financial Services	0.39
TD Group US	0.38
Capital One Financial	0.37

Sources: S&P Global Market Intelligence; Fannie Mae, 1st Quarter 10-Q 2019; Freddie Mac, 1st Quarter 10-Q 2019

Interconnectedness

The obligations of Fannie Mae and Freddie Mac are widely held throughout the U.S. financial system and around the world. U.S. depository institutions hold well over $1 trillion of their securities. The Federal Reserve itself holds $1.6 trillion in MBS, mostly those of Fannie and Freddie. Could Fannie and Freddie be allowed to fail and impose credit losses on the Fed? Presumably not. Preferential banking regulations promote Fannie and Freddie, including low risk-based capital requirements for their MBS and debt, creating an incentive for depository institutions to hold large exposures to those securities. These low risk-based capital requirements for depository institutions compound the hyper-leverage of Fannie and Freddie themselves, and amplify their systemic risk.

Moreover, U.S. banks are allowed to buy the equity, preferred stock and subordinated debt of Fannie and Freddie, and fund these investments with Government-insured deposits. This combination results in systemic double leverage.

The interconnectedness of Fannie and Freddie's mortgage-backed securities and debt with the global financial system became vivid in 2008. As then-Secretary of the Secretary Henry Paulson correctly judged, a default on Fannie and Freddie's obligations would have dramatically exacerbated the financial crisis on a global basis.

As Paulson recounted in his memoir of the crisis, "On the Brink":

> "From the moment the GSEs' problems hit the news, Treasury had been getting nervous calls from officials of foreign countries that were invested heavily with Fannie and Freddie. These calls ratcheted up after the [2008 HERA] legislation. Foreign investors held more than $1 trillion of the debt issued or guaranteed by the GSEs, with big shares held in Japan, China, and Russia. To them, if we let Fannie and Freddie fail and their investments got wiped out, that would be no different from expropriation. . . . They wanted to know if the U.S. would stand behind this implicit guarantee"—and also "what this would imply for other U.S. obligations, such as Treasury bonds."

As Fannie and Freddie reported large losses, Paulson relates that he instructed the Treasury staff to "make sure that to the extent we can say it that the U.S. Government is standing behind Fannie Mae and Freddie Mac." In an even more revealing comment, Paulson added, "I was doing my best, in private meetings and dinners, to assure the Chinese that everything would be all right."

Thanks to the overwhelming global systemic risk of not bailing them out, Paulson's assurance turned out to be true for all of Fannie and Freddie's debt and MBS holders. Even those who had bought subordinated debt, thereby intentionally taking more risk, were protected.

Substitutability

Fannie and Freddie's systemic role is critical and cannot be replaced in the short- or medium-term—there are no substitutes. They play a unique, systemically central role and remain the dominant force in the funding of U.S. mortgages. There are no meaningful competitors because of their huge, ongoing risk subsidies from the Government. In 2018, they guaranteed $917 billion in MBS. In the first quarter, 2019 they had a 63 percent market share of MBS issuance (including Ginnie Mae, the Government has a 94 percent market share). Their balance sheets represent about half of total U.S. mortgage loans outstanding. Thousands of mortgage originators, servicers, domestic and international investors and derivatives counterparties depend on their continued functioning and Government-dependent solvency. This is one reason that the U.S. Congress has been unable to pass any legislation to end their conservatorship.

Leverage

In addition to their massive size, Fannie and Freddie have historically displayed extreme leverage and continue to do so. As of March 31, 2019, their balance sheets show a combined capital ratio of a risible less than 0.2 percent and they are hyper-leveraged at over 500 to 1. Of course, under the bailout agreement, the Government will not let them build retained earnings, but the fact of the hyper-leverage remains.

Maturity Mismatch and Liquidity Risk

The American 30-year fixed-rate, freely prepayable mortgage loan is one of the most complex financial instruments in the world to finance and hedge. Unlike the fixed-rate mortgages of most other countries, the prepayment risk of these mortgages is not offset by prepayment fees. This necessitates a complex derivatives market which trades in the risks of prepayment behavior. Fannie and Freddie together own about $400 billion of mortgages in their own portfolios, on an extremely leveraged basis. They are major counterparties in interest rate derivatives and options markets. Their MBS spread the complex interest rate risks of American 30-year fixed-rate mortgages, while concentrating the credit risk of U.S. house prices, now again at an all-time high. The liquidity of Fannie and Freddie's securities and of Fannie and Freddie themselves completely depends on the implicit guarantee of the U.S. Treasury.

Existing Regulation

Fannie and Freddie of course have an existing regulator, the Federal Housing Finance Agency (FHFA). But the FHFA is not, nor is it empowered to be, a regulator of the systemic risk created by Fannie and Freddie for the banking and financial system.

U.S. residential mortgages constitute the largest loan market in the world, with $10.4 trillion in outstanding loans. The risks of this huge market include the holdings by banks of the MBS and debt of Fannie and Freddie. There are no limits on the amount of Fannie and Freddie obligations which can be owned by banks.

As discussed above, the risks of Fannie and Freddie also flow into the banking system because banks are allowed to invest in Fannie and Freddie's equity on a highly leveraged basis, which creates systemic double leverage. In the financial crisis of 2007–2009, many banks took large losses and a number failed because of their exposure to Fannie and Freddie's preferred stock, an exposure which was encouraged by regulation. This is an issue the Federal Reserve, as a systemic risk regulator, would want to consider.

A major systemic risk is that Fannie and Freddie are by definition 100 percent concentrated in the risks of leveraged real estate. Indeed, they are by far the largest concentration of mortgage credit risk in the world. Leveraged real estate, needless to say, has a long and painful record of being at the center of banking collapses and financial crises.

Fannie and Freddie's primary regulator is likewise devoted only to housing finance. Such a regulator always faces the temptation to become a cheerleader and promoter of housing and housing finance. This brought down the old Federal Home Loan Bank Board, abolished in 1989, and arguably also the Office of Thrift Supervision, abolished in 2010.

In sum, Fannie and Freddie are huge in size, huge in risk, close to zero in capital, tightly interconnected to thousands of counterparties, and force risk on the U.S. Treasury. They meet the criteria specified by the Dodd–Frank Act and its implementing regulations for designation as a SIFI, both as institutions and considered as a systemically risky activity. They also meet the international criteria of the Financial Stability Board for designation as a Global SIFI.

If Fannie and Freddie are not SIFIs, then nobody in the world is a SIFI, and if any institution is a SIFI, then so are Fannie and Freddie. Addressing their systemic risk through designation as a SIFI would logically match their systemically important role and riskiness.

Conservatorship

In September 2008, as we know, the Federal Housing Finance Agency determined that Fannie and Freddie each were "in an unsafe or unsound condition to transact business," and "likely to be unable to pay its obligations or meet the demands of its creditors in the normal course of business." The Government placed them into conservatorship, and thus assumed "all rights, titles, powers, and privileges of the regulated entity, and of any stockholder, officer, or director of such regulated entity with respect to the regulated entity and the assets of the regulated entity."

Conservatorship was never intended to be a perpetual status for Fannie and Freddie, but it continues in its 11th year, an outcome altogether unintended and undesired.

Should designating Fannie and Freddie as SIFIs be delayed because they are in conservatorship? The answer, it seems to me, is clearly No. They are just as systemically important and systemically risky in conservatorship as out of it. They create just as much or more moral hazard. The Conservator cannot manage their systemic risk. Indeed, because of the "net worth sweep" deal between the Treasury and the FHFA as Conservator, Fannie and Freddie are even more highly leveraged than before. Meanwhile, under the Conservator, they continue to expand mortgages with high debt service to income ratios, another form of increased leverage.

The Federal Reserve as Additional Regulator

If—I hope it is when—Fannie and Freddie are formally designated as the SIFIs they economically are, the Federal Reserve will become an additional, systemic risk regulator for them. This seems to me a good idea, since the Fed is the best placed of all existing regulatory agencies to consider the risks Fannie and Freddie pose from the view of the financial system as a whole. Of course, the statute assigns this responsibility to the Fed for all SIFIs. If you don't like this outcome of SIFI designation, should you therefore claim that Fannie and Freddie are not SIFIs?

Suppose we grant that the Fed, like everybody else, has numerous shortcomings. That does not mean that Fannie and Freddie are not SIFIs. Let us concede that the Fed, like everybody else, is far from perfect. It should still take on, as the only available authorized actor, the essential task of understanding and addressing what Fannie and Freddie are doing to systemic risk.

Of course, Fannie and Freddie already have a primary regulator, but so do all other SIFIs. That the FHFA regulates Fannie and Freddie is no more an argument against their being SIFIs than the fact that the Comptroller of the Currency regulates national banks would prevent banks from being SIFIs.

The Fed should be able to consider, and should consider, for such "large, interconnected financial institutions," in the words of the Dodd–Frank Act, "establishment and refinement of prudential standards and reporting and disclosure requirements . . . taking into consideration their capital structure, riskiness, complexity, financial activities . . . size, and any other risk-related factors."

For example, the Fed might usefully consider with respect to Fannie and Freddie such questions as:

- Whether their capital requirements and their leverage cause capital arbitrage and thereby increased risk in the financial system as a whole.
- Whether the same risks should be capitalized in the same way between private financial institutions and Fannie and Freddie.
- How Fannie and Freddie's concentration in leveraged real estate risk affects the risk of the financial system.
- How or whether Fannie and Freddie's activities contribute to house price inflation and thereby reduce housing affordability.
- Whether their heavy concentration in California mortgages amplifies earthquake risk.
- How much banking regulations which favor Fannie and Freddie increase the riskiness of banks.
- Whether the double leverage in the financial system created by allowing banks to invest in Fannie and Freddie's equity makes sense.
- Whether Fannie and Freddie's market dominance decreases or increases systemic risk.
- How much risk is being pushed on the Treasury and the taxpayers by Fannie and Freddie, at what economic cost.

I believe is that the Fed as systemic risk regulator of Fannie and Freddie would be a force for sound and well-capitalized housing finance, which would be better understood in the context of its interaction with the rest of the banking and financial system. That should be everybody's goal.

Concluding Questions and Answers

Are Fannie and Freddie SIFIs? *Yes, without a doubt.*

Do Fannie and Freddie cause systemic financial risk? *Yes.*

Is the Federal Reserve a reasonable place to try to understand and address the systemic risks? *Yes.*

Should FSOC recognize these facts by formally designating Fannie and Freddie as SIFIs? *Yes.*

When? *The sooner, the better.*

Thank you again for the chance to share these views.

PREPARED STATEMENT OF DOUGLAS HOLTZ-EAKIN

PRESIDENT, AMERICAN ACTION FORUM

JUNE 25, 2019

Chairman Crapo, Ranking Member Brown, and Members of the Committee, thank you for the privilege of appearing today to share my views on whether Fannie Mae and Freddie Mac (the housing Government Sponsored Enterprises, or GSEs) should be designated as systemically important financial institutions (SIFIs). I wish to make three main points:

- There appears to be increased momentum toward reforms that would permit the GSEs to leave conservatorship;
- Fannie Mae and Freddie Mac are engaged solely in an activity—real estate lending—that historically is central to bank failures and financial crises; they are uniquely suited for designation as SIFIs; and
- There may be a regime of administrative reforms involving greater capital, restrictions on portfolio investment, and credit risk transfers (CRTs) that may prove to be a workable substitute for SIFI designation.

Let me elaborate on each in turn.

Both Congress and the Trump administration continue to explore GSE reform. The Committee Chairman has released an outline of components of legislative reform.[1] In March, the Trump administration formally joined the GSE reform conversation. The president issued a memo to the Departments of the Treasury and of Housing and Urban Development (HUD) directing both to develop plans for GSE reform that is possible without congressional action.[2] In particular, the White House

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[1] *https://www.banking.senate.gov/imo/media/doc/Housing%20Reform%20Outline.pdf*

[2] *https://www.whitehouse.gov/presidential-actions/memorandum-federal-housing-finance-reform/*

memo lays out the goal of “ending the conservatorships of the GSEs upon the completion of specified reforms.” Treasury and HUD are each expected to submit plans to the White House in the near future.

The goal of ending conservatorship for Fannie Mae and Freddie Mac is significant because it is only in this scenario that the question of their SIFI status arises. Statements by the Administration, including Federal Housing Finance Agency (FHFA) Director Mark Calabria, suggest that, contingent upon reforms, the most likely exit strategy will be “recap and release,” whereby the GSEs are appropriately capitalized (likely by amending their net profit sweep to Treasury and possibly by some form of public offering) and then returning Fannie Mae and Freddie Mac to the market as fully private entities.

As private entities, the GSEs are engaged solely in a very risky activity—guaranteeing the performance of real estate loans. Indeed, some see real estate lending as the most significant driver—almost the definition—of systemic risk itself. As recent papers by Oscar Jorda, Moritz Schularick, and Alan Taylor for the National Bureau of Economic Research (NBER) have shown, crises can usually be defined as the rising leverage of banks concentrated in real estate lending. [3] Charles Calomiris, a professor at the Columbia Business School, has noted since well before the previous financial crisis that the use of short-term debt with procyclical pricing to finance risky and usually illiquid real estate assets is particularly vulnerable to systemwide shock. [4] This relationship was considered so particularly fraught with danger that prior to 1913, nationally chartered banks were prohibited from holding any real estate at all.

The GSEs not only participate in a systemically risky activity—they dominate it. As the chart below shows, during the precrisis years (2000–2006) the GSEs accounted for an average of 40 percent of the origination market, and closer to 30 percent in the 3 years immediately prior to the crisis. During and immediately after the financial crisis (2007–2013), the GSEs accounted for, on average, 62 percent of the market, at a time when the GSEs and Government loans were the only source of credit in the market.

More worrying, however, this data shows that in recent years GSE market share of the origination market has remained near 50 percent, a level considerably higher than precrisis levels. In 2018, the GSEs acquired 50 percent of all newly originated single-family loans, and 47 percent of all multifamily loan originations. Prior to conservatorship, the GSEs’ share of the first lien origination volume was roughly 32 percent. [5] Today, that number is closer to 45 percent, and with Federal Housing Administration (FHA) and Department of Veterans Affairs (VA) loans included, that number is closer to 70 percent. With the private-label mortgage-backed securities market largely nonexistent, the mortgage market is almost entirely dependent on Government agencies.

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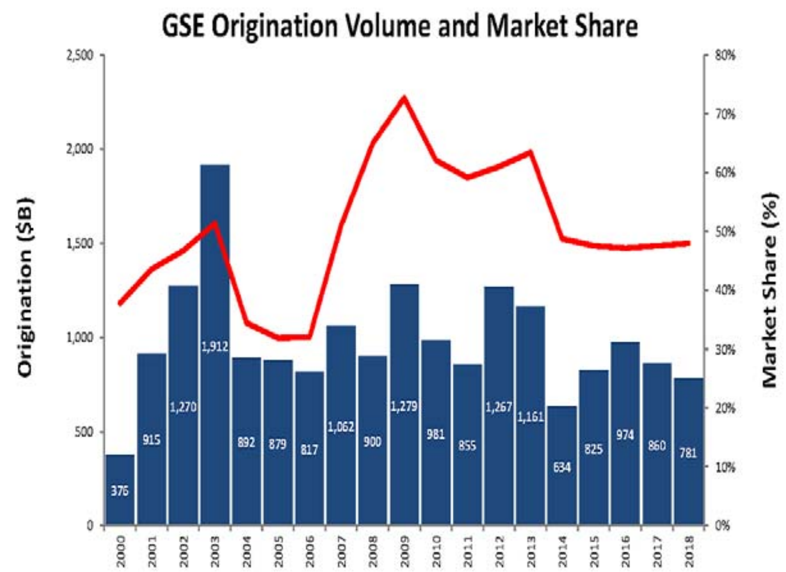
[3] *https://www.nber.org/papers/w16567*

[4] *https://www.aei.org/wp-content/uploads/2018/06/Calomiris-Chen-2018__September-2018-RFS-Submission-Version.pdf*

[5] *https://www.urban.org/research/publication/housing-finance-glance-monthly-chartbook-may-2019/view/full__report*



Source: 2019 Mortgage Market Statistical Annual

Finally, Fannie Mae and Freddie Mac continue to be risky, too-big-to-fail institutions. By the end of 2007, they had a combined leverage ratio of 75 to 1; what the GSEs' leverage ratio will be when they exit conservatorship remains to be seen. It seems likely, however, that little will be changed from when I wrote my dissenting statement to the Financial Crisis Inquiry Commission's report: "As large financial institutions whose failures risked contagion, they were massive and multidimensional cases of the too big to fail problem."[6]

Fannie Mae and Freddie Mac were put into conservatorship because they were deemed too big to fail, the very concept that underpinned the creation of the SIFI designation. Thus, we would automatically expect the GSEs released from conservatorship to be considered SIFIs.

In the aftermath of the 2007–2008 financial crisis, Congress enacted the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank). Title I, Subtitle A, of Dodd–Frank established a new body, the Financial Stability Oversight Council (FSOC), with statutory responsibilities to ensure the safety and soundness of the financial system at large.[7] The key tool in FSOC's toolbox is the designation of financial institutions as SIFIs. Because banking companies with over $50 billion in assets are automatically considered SIFIs in Dodd–Frank, the key issues involving designation revolved around nonbanks.

Specifically, Section 113 of Dodd–Frank gives FSOC the authority by two-thirds vote (including the chairperson) to bring a nonbank financial company under increased supervision and regulation by the Federal Reserve Board (FRB) if FSOC determines that "material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States."[8] In making that determination, Dodd–Frank lists 10 criteria for FSOC to consider, but also allows FSOC to consider "any other risk-re-

[6] *http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_hennessey_holtz-eakin_thomas_dissent.pdf*
[7] *https://www.congress.gov/111/plaws/publ203/PLAW-111publ203.pdf*
[8] 12 U.S.C. §5323 (a)(1).

lated factors that the Council deems appropriate."[9] As such, FSOC has very broad statutory authority when evaluating companies for SIFI designation.

Because Dodd–Frank gives FSOC such expansive authority to set the specific determinants of a SIFI designation, FSOC's operational procedures have largely been set through the regulatory rulemaking process. FSOC announced in March 2019 that it would change its SIFI designation criteria to focus on systemically risky activities. This policy shift is still at the stage of request for comment from stakeholders, and there is little to suggest which activities FSOC will identify for consideration first. As noted, however, guaranteeing the performance of mortgages should be high on any list.

Once designated, SIFIs fall under increased supervision and regulation by the FRB—with higher capital requirements, liquidity requirements and the requirement to undergo annual stress testing. The impact of these additional requirements is clear: SIFIs must set aside more capital, significantly increase compliance staff, and increase technology and data capture processing. As a result, SIFI designation is a significant cost.

In my view, it is difficult to see how the GSEs postconservatorship could be anything but SIFIs. For some, however, explicit designation has the downside of having FSOC move away from banking, something that produced difficulties in as closely related a field as insurance. It would require the FRB, with zero housing experience, to become the primary regulator. Would the FRB be more effective than the FHFA, formed in 2008 for that very purpose? Others have pointed out that the conflict of interest inherent in being both central banker that sets interest rates and regulator of the banking system would only be exacerbated by having the housing finance industry also within the FRB purview.

From this perspective, the question is whether there is a potential alternative regime that the FHFA could impose to dissuade FSOC from designating the GSEs as SIFIs. This would require important regulatory (and/or legislative) reforms in order to ensure they are not the housing market force that they were before—and during—conservatorship.

Perhaps there is such a regime, although I am not entirely confident. At least three elements would seem to be essential to such a regime. The first would be SIFI-like capital requirements, above-and-beyond those that might normally emerge from an FHFA rulemaking process, that would absorb the risk and provide the buffer against systemic exposures.

The second would be to "de-risk" the basic guarantee business of the GSEs dramatically. By process of elimination, the only candidates able to absorb additional risk are capital market participants. One might imagine an aggressive and effective credit risk transfer regime that relieved the GSEs of risk. The FHFA has already established guidelines governing single-family credit risk sharing by the GSEs. Unfortunately, under the current arrangements, the GSEs retain the first-loss position and credit risk transferees participate in a mezzanine structure put in place 3–9 months after a loan is acquired. A simpler way to have the GSEs reduce their risk exposure could be by implementing a policy similar to private mortgage insurance, in which the loan-level coverage is put in place at origination. This approach would be more effective in transferring risk; it would also have to be used more extensively.

Finally, the GSEs should clearly be prohibited from holding portfolios for investment purposes. In 2007–2008 the dangers of the guarantee business were compounded by large portfolios of mortgage-backed securities—essentially large monoline hedge funds with too little capital and no public purpose.

There may be other elements as well. The most important requirement is to ensure that any future private-sector GSE bears little structural resemblance to the historic Fannie Mae and Freddie Mac that served this Nation so poorly.

Thank you, and I look forward to your questions.

PREPARED STATEMENT OF SUSAN M. WACHTER

SUSSMAN PROFESSOR OF REAL ESTATE AND PROFESSOR OF FINANCE, THE WHARTON SCHOOL OF THE UNIVERSITY OF PENNSYLVANIA

JUNE 25, 2019

Chairman Crapo, Ranking Member Brown, and other distinguished Members of the Committee, thank you for the invitation to testify at today's hearing, "Should Fannie Mae and Freddie Mac Be Designated as Systemically Important Financial

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[9] 12 U.S.C. §5323 (a)(2)(K).

Institutions?" I am the Sussman Professor of Real Estate and Professor of Finance at The Wharton School of the University of Pennsylvania. Together with coauthors, I have researched and written scholarly papers on the stability of the housing finance system. Recent papers, from which this testimony is drawn, are listed at the end of this statement. It is an honor to be here today to discuss the role of the Federal Stability Oversight Council in the prevention of systemic crises derived from the mortgage market.

The Financial Stability Oversight Council (FSOC) has a statutory mandate to identify risks and respond to threats to financial stability. As is evident from the severe financial crisis that led to the Great Recession of 2009, mortgage markets can disrupt stability and have done so in the past. Regulatory oversight and the structure of the housing finance system will be instrumental in determining the likelihood of a repeat of the crisis. Collective oversight of all entities providing mortgages, which the FSOC is uniquely positioned to accomplish, is a necessary component of this oversight.

My comments today, based on my writings in this area, will address why there is a need for such a systemwide oversight. I will also comment on the specific question: "Should Fannie Mae and Freddie Mac be designated as Systemically Important Financial Institutions?" What is important is that this sector is overseen for its potential to undermine macroeconomic stability. I also believe for reasons that I will explain that the correct oversight for the GSEs is that they be designated, if and when they are privatized, not as SIFIs but as Systemically Important Financial Market Utilities (SIFMUs).

Under Section 113 of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank), FSOC is authorized to designate nonbank financial institutions as systemically important. In addition, under Section 804 of the Dodd–Frank, FSOC is responsible for the designation of financial market utilities that the Council determines are, or are likely to become, systemically important, that is, SIFMUs.

In addition, Section 803 of Dodd–Frank clarifies a disruption to a SIFMU as being a situation "where the failure of or a disruption to the functioning of a financial market utility . . . could create, or increase, the risk of significant liquidity or credit problems spreading among financial institutions or markets and thereby threaten the stability of the financial system of the United States."

I believe a SIFMU designation is the correct designation because the GSEs provide a structural foundation to the secondary mortgage market. The GSEs are characterized by the considerations established for the SIFMU designation—that is, the aggregate value of transactions processed by the financial market utility, the aggregate exposure of the financial market utility, the relationship, interdependencies, or other interactions of the financial market utility, and the effect that the failure of or a disruption to the financial market utility would have on critical markets, financial institutions, or the broader financial system. All four of these characterize the GSEs.

In the years after the crisis, under the direction of the FHFA (the independent Federal agency, established through the Housing and Economic Recovery Act—HERA—as the successor to OFHEO, responsible for supervision, regulation, and housing mission oversight of the GSEs and Federal Home Loan banks), the GSEs have undergone substantial reform. They have wound down their portfolios, increased transparency, and de-risked through tighter credit standards and risk sharing. In 2012, the FHFA called for the GSEs to implement, which they have, credit-risk transfer (CRT) programs to allocate risk to the private sector, to help insure correct pricing of credit risk, and to minimize taxpayer exposure. Fannie Mae and Freddie Mac have issued CRTs with returns tied to the performance of the GSEs' loan pools, hence enabling a private sector pricing of risk, with transparency. Additionally, the GSEs have developed a common security platform to ensure liquidity for the trading of MBS and interest rate risk. While the GSEs are now less risky, the lack of equity capital to absorb losses leaves taxpayers still exposed to credit risk. In order to address the need for equity capital, so-called recap and release proposals have been put forth which would enable the GSEs to raise private capital to reduce further taxpayer risk and end the conservatorship of the GSEs.

Various plans have been proposed for the GSEs' restructuring, including multiple guarantors. I have set forth comments, along with coauthors Richard Cooperstein, Head of Risk Management at Andrew Davidson and Company, and Ken Fears, Senior Policy Representative for Banks, Lending, and Housing Finance at the National Association of REALTORS, on the increased risk to the system of a multi-guarantor model, in part because the regulatory burden of overseeing the safety and soundness of multiple guarantors increases tremendously. Moreover, as Moody's recently opined, increasing the number of GSEs could lead to weaker underwriting standards or price competition, both credit negatives for the GSEs and ultimately for the taxpayer.

The key functions of the GSEs are to set standards and to provide transparency for the secondary mortgage market. The source of the crisis was the undermining of these standards, and as I have shown along with coauthors in a recent paper referenced below, the underpricing of risk, which led to an unsustainable expansion of bad credit.

With the oversight of the FHFA and with a SIFMU designation, the GSEs are in a position to maintain these functions going forward. In particular, the FHFA can provide oversight on the maintenance of sufficient capital reserves. But the FHFA alone cannot provide the collective oversight of the entities that comprise the mortgage market. To this end, I respectfully propose that the FSOC consider the designation of Fannie Mae and Freddie Mac as SIFMUs. The SIFMU designation can support macrostability while enabling the GSEs to provide access to sustainable mortgage credit over the long term.

I thank you for the opportunity to testify today. I welcome your questions.

References

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Levitin, Adam J., Desen Lin, and Susan M. Wachter, "Mortgage Risk Premiums During the Housing Bubble". *Journal of Real Estate Finance and Economics,* January 2019, available at: *https://link.springer.com/article/10.1007/s11146-018-9682-z*.

Wachter, Susan M. "Credit Risk, Informed Markets, and Securitization". *Economic Policy Review*, Vol. 24, No. 3, March 2019, 5-62, available at: *https://www.newyorkfed.org/research/epr/2018/epr__2018__crt-informed-markets__wachter.html*.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM ALEX J. POLLOCK

Q.1. As you know, Congress and the Administration are determining how to reform the housing finance system. If successors to Fannie Mae and Freddie Mac were no longer shareholder-owned entities, how would that effect your recommendations? What regulatory framework would you recommend if the successors were:

A single Government corporation?

A shareholder-owned public utility?

A mutually owned entity?

A.1. In my opinion, Fannie Mae and Freddie Mac would be systemically important, systemically risky, and without question be SIFIs under Title I of the Dodd–Frank Act, no matter what their ownership structure might be. That is true with their current ownership in which the Government has the majority of the equity and private shareholders a minority, and I believe that FSOC should promptly designate them as the SIFIs they obviously are. It would also be true if Fannie and Freddie were a single Government corporation, a shareholder-owned public utility, or a mutually owned entity or entities. They would be systemically important financial institutions, carrying out an activity which is systemically highly risky, in each case.

Q.2. Do you think it's appropriate for Government entities like the FDIC, the Federal Home Loan Banks, or the Federal Reserve Banks to be designated and regulated as SIFIs?

A.2. If they are systemically important and systemically risky, I believe Government entities can be SIFIs, yes. One of the hardest things for the Government to do is to address the systemic risk created by itself, and the Government creates a lot of systemic financial risk. Thinking about whether various Government entities qualify as SIFIs would be a productive effort.

In the case of the Federal Home Loan Banks, they are 100 percent owned by private shareholders, so I would say that the category, "Government entities" does not apply. They are of course, "Government-sponsored entities."

As the question suggests, the FDIC is part of the Government. Although it does create major moral hazard, and Government insurance corporations can demonstrably become insolvent, the FDIC is not an active credit risk taker and I do not think it qualifies as a SIFI.

The Federal Reserve is a special case. Not the individual Federal Reserve Banks, but the Federal Reserve System as a whole, may fairly be viewed as the biggest SIFI of them all. But since being designated a SIFI means your systemic risk regulator becomes the Federal Reserve, the designation would not achieve anything. As Senator Bunning once asked the Chairman of the Federal Reserve, "How can you regulate systemic risk when you are the systemic risk?"

Q.3. In July 2018, the FHFA proposed capital requirements for Fannie Mae and Freddie Mac. Would the rule as proposed require the Enterprises to maintain enough capital?

A.3. In my opinion, it would not. I believe that Fannie and Freddie's minimum capital requirements should be the same for taking the same risk as those for every other Too Big To Fail SIFI, so there is a single systemic capital standard for mortgage credit. For prime mortgage credit risk, the global standard capital requirement is 4 percent of assets. I believe that 4 percent should be Fannie and Freddie's minimum leverage capital requirement.

Like every other TBTF SIFI, Fannie and Freddie should also have a risk-based capital standard, and have to hold the higher of the two requirements. If Fannie and Freddie take on large amounts of riskier mortgage credit, as they have done in the past, their risk-based capital standard should move above 4 percent, but 4 percent should be the starting point. This means their aggregate equity capital requirement, at 4 percent of $5.5 trillion, would be about $220 billion. I think this a fair and systemically sensible number.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM DOUGLAS HOLTZ-EAKIN

Q.1. As you know, Congress and the Administration are determining how to reform the housing finance system. If successors to Fannie Mae and Freddie Mac were no longer shareholder-owned entities, how would that effect your recommendations? What regulatory framework would you recommend if the successors were:

A single Government corporation?

A.1. For Fannie Mae and Freddie Mac to have successors would require that the GSEs be wound-up. Although GSE reform is of vital concern it is difficult to envisage a world in which Fannie and Freddie do not play a role, such is their market penetration. In any event, for a provider of mortgage-backed securities to no longer be owned by shareholders (a scenario that appears to apply to only one of the three scenarios below) imagines a regulatory framework where secondary mortgage market activities are performed entirely by Government agencies. To my mind this would hardly be the worst reform path for the GSEs. For over a decade the GSEs have acted as de facto agencies playing an active role in modifying mortgages and other policies. Recognizing this fact is preferable to either doing nothing or releasing privatized GSEs back into a marketplace they have unfairly dominated and would continue to dominate with less oversight.

Insofar as a Government corporation (such as the FDIC, or even the U.S. Postal Service) provides market-oriented public services with a view to producing revenues that only cover expenditures, this model would have several advantages over the current status quo. First, it would strip the GSEs of their corporate aspects, including presumably shareholder ownership, recognizing the GSEs as the public bodies the advantages of which they currently enjoy. Second, a pricing structure that simply covers cost would presumably eliminate the need for either the net profit sweep or the line of credit to Treasury.

Q.2. A shareholder-owned public utility?

A.2. Any entity that is both "public" and "shareholder-owned" would appear to have the same murky legal position of the GSEs as currently formed. The utility model would allow the GSEs to make regulated returns and restore their capital, putting them in a better capital position in the event of the next financial crisis. Such an entity would however also have a legal duty to its shareholders to provide a rate of return. The difference between this and full privatization would appear to be that full privatization would both allow for and promote effective competition in this space; competition which would serve to drive down prices and improve services for consumers. It is also worth noting that the utility model, something of an aberration, sprung from the severe up-front infrastructure requirements that would be required to provide the services, an argument more difficult to make for the GSEs, particularly with a dearth of other financial services utilities.

Q.3. A mutually owned entity?

A.3. The only distinction between a mutually owned company and a publicly traded secondary mortgage market participant is that a mutually owned company is owned solely by the consumers of the services it provides. Given the market penetration of the GSEs this would still likely be most Americans. One advantage to the mutual structure would be that mutuals are not typically profit-maximizing structures. Mutuals however usually have a very limited focus or suite of products and operating the GSEs as a mutual may provide logistical challenges. Such a structure of course would have no statutory obligation to meet Government targets including affordable housing.

Q.4. Do you think it's appropriate for Government entities like the FDIC, the Federal Home Loan Banks, or the Federal Reserve Banks to be designated and regulated as SIFIs?

A.4. Designation by the FSOC as a SIFI of course only applies to financial institutions that are publicly traded corporations. The system as currently designed does not encompass any of the aspects of Government, even those providing market-oriented public services. To rebuild the FSOC designation process to include such bodies would be a significant undertaking that would raise many difficult questions including who would regulate the Federal Reserve Banks, themselves the regulators of SIFIs. Appropriate oversight and control over these bodies is exerted via the Federal budgetary and appropriations process.

Q.5. In July 2018, the FHFA proposed capital requirements for Fannie Mae and Freddie Mac. Would the rule as proposed require the Enterprises to maintain enough capital?

A.5. The proposed Enterprise Capital Rule is in large part a hypothetical exercise, as it is impossible to appropriately assess the capital requirements of the GSEs postconservatorship while they remain in conservatorship. The recapitalized Enterprises will presumably have entirely different charters and mandates; they will have fundamentally different balance sheets and risk appetites, both of which will drive significant differences in pricing structures.

Noting that, I have concerns with both of the proposed capital calculations. The 2.5 percent minimum leverage ratio put forward by one aspect of the proposal appears low by comparison to the 5 percent minimum applied to community banks, which have fundamentally less risky business models, let alone the capital requirements that apply to the SIFIs, ranging from 12 to 18 percent. Significant legislative efforts in Congress (both the Johnson–Crapo initiative and the Corker–Warner bill) fixed on 10 percent as being the appropriate gauge. How then to justify 2.5 percent? The second model would require the Enterprises to hold capital equal to 1.5 percent of trust assets and 4 percent of nontrust assets. Although this would require the Enterprises to hold significantly more capital than the 45 basis points required by the 1992 Federal Housing Enterprises Financial Safety and Soundness Act, it would still mean pinning capital requirements to the same law that governed the Enterprises going into the financial crisis; in addition, such a system would allow the Enterprises to "game" the system in asset definition.

More broad concerns remain—Capital requirements are by nature procyclical, which is difficult to square with the countercyclical mandate of the Enterprises. In addition, the FHFA's proposal, does not expressly consider the systemic nature of the Enterprises at all. Further, the FHFA presents a conflicted message on asset diversification, noting that while the monoline nature of the Enterprises' business is, in the view of the FHFA, a positive feature with regard to capital standard setting, at the same time diversity is attractive when it comes to counterparty risk. How can both approaches be valid?

A more extensive answer to this question can be found in my comments for the record that I submitted to the FHFA, which can be found at the following link: *https://www.americanactionforum.org/comments-for-record/enterprise-capital-requirements/*.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARREN FROM SUSAN M. WACHTER

Q.1. As you know, Congress and the Administration are determining how to reform the housing finance system. If successors to Fannie Mae and Freddie Mac were no longer shareholder-owned entities, how would that effect your recommendations? What regulatory framework would you recommend if the successors were:

A single Government corporation?

A shareholder-owned public utility?

A mutually owned entity?

A.1. My recommendations would be unchanged in the cases of (b) and (c) since I believe a mutually owned utility would operate substantially like a shareholder-owned public utility. A single Government corporation need not be a SIFMU, as it would be directly overseen by the Government and would not have shareholders, without regard to the longrun stability of the system. It is the profit-maximizing behavior of private corporations that serve the shareholder which may undermine the future solvency of the entities, to prevent which SIFMU oversight would be necessary.

Q.2. Do you think it's appropriate for Government entities like the FDIC, the Federal Home Loan Banks, or the Federal Reserve Banks to be designated and regulated as SIFIs?

A.2. No, as I indicated in my testimony. [1]

Q.3. In July 2018, the FHFA proposed capital requirements for Fannie Mae and Freddie Mac.

Would the rule as proposed require the Enterprises to maintain enough capital?

A.3. Yes, the proposed rule would be sufficient.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SINEMA FROM SUSAN M. WACHTER

Q.1. If the Government sponsored enterprises were to be designated as systemically important financial institutions (SIFIs), what kind of impact would SIFI capital and regulatory standards have on Fannie Mae and Freddie Mac's ability to provide affordable housing finance for low- and moderate-income borrowers?

A.1. While I have not specifically studied this question, a higher capital standard would require more reserving and would likely impact the G-fee, that is the GSEs' guarantee fee, and therefore the rate charged to borrowers. This would especially have an impact on borrowers if the GSEs were to impose the higher cost of capital onto all borrowers rather than to cross-subsidize the pool to achieve a socially optimal outcome. In the utility approach that I with others have put forth, the requisite capital for stability for the GSEs would be less than otherwise. [1]

Q.2. Do you see a meaningful difference in the overall impact on affordability between a Title I and a Title VIII SIFI designation?

A.2. Yes, I do, because a SIFMU designation would go along with a utility, which would substantially reduce the cost of capital.

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[1] See Pp. 30–31 of the hearing transcript.

[1] See Richard Cooperstein, Ken Fears, and Susan Wachter, "A Vision for Enduring Housing Finance Reform", The National Association of REALTORS, February 7, 2019.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

LETTER SUBMITTED BY THE AMERICAN LAND TITLE ASSOCIATION

AMERICAN LAND TITLE ASSOCIATION

June 20, 2019

The Honorable Mike Crapo
Chairman
Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Crapo and Ranking Member Brown:

On behalf of the American Land Title Association (ALTA)[1], I write to share our comments on the Senate Banking Committee's hearing entitled "Outside Perspectives on the Collection of Beneficial Ownership Information".

We believe the reform the Senate Banking Committee can make which will have the broadest impact to anti-money laundering and countering the financing of terrorism (AML/CFT) is to end the misuse of anonymous shell companies. A requirement for companies to report their beneficial ownership will help law enforcement identify and combat the use of real estate in money laundering.

Under state law, companies are not required to disclose their beneficial owners. In the absence of this simple and logical requirement, the Financial Crimes Enforcement Network (FinCEN) has deputized ALTA members and other financial institutions to collect this information from their customers during certain real estate transactions.

In May, the Financial Crimes Enforcement Network (FinCEN) re-issued its Geographic Targeting Orders (GTOs) for reporting all-cash purchases of residential real estate of title companies. The extended GTOs run from May 15 through November 11, 2019. This is the eighth extension of the GTO's, which are meant to be temporary in nature.

Under the GTO's, title companies collect and report four pieces of information: (1) the name of the purchasing entity; (2) the address of the purchased property; (3) the date of the purchase; and (4)

[1] ALTA is the national trade association representing 6,100 title insurance companies, title and settlement agents, independent abstracters, title searchers and real estate attorneys. With offices throughout the United States, ALTA members conduct title searches, examinations, closings and issue title insurance policies that help protect the property rights of millions of American homebuyers every year.

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the list of beneficial owners of the purchasing entity and copies of their government identifications. The first three pieces of data are information a title company would normally collect or have in its possession in every transaction.

Currently, beneficial ownership information is the only piece of information collected by title companies under the GTOs that they do not need for their own business purposes and cannot verify through a commercially available source.

A beneficial ownership registry should make it easier for title companies to collect this information and file their reports under the GTO. The ability to access the beneficial ownership registry with the customer's permission will reduce the time and cost of GTO filings. ALTA member companies report that the costs of filing reports under the GTO can range from $40-$250 per report.

With a beneficial ownership registry, title companies will be able to verify the beneficial ownership information they receive from their customers. It should also eliminate the need to collect and retain a copy of a beneficial owner's government identification and other personally identifiable information. This will reduce their legal and compliance risk.

Most importantly, a beneficial ownership registry will provide law enforcement with valuable information about anonymous shell companies from the sources with the best knowledge. This will make it easier for financial intelligence to more efficiently utilize its resources for identifying assets of terrorists, drug traffickers, kleptocrats and other bad actors that want to hide assets in the United States.

Thank you for holding this important hearing and the opportunity to share our thoughts on collection of beneficial ownership information. ALTA looks forward to working with you to combat the use of American real estate in money laundering.

Sincerely,

Cornelia Horner

Cornelia Horner
Interim Chief Executive Officer

LETTER SUBMITTED BY THE NATIONAL ASSOCIATION OF FEDERALLY-INSURED CREDIT UNIONS

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June 24, 2019

The Honorable Michael Crapo
Chairman
Committee on Banking, Housing & Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing & Urban Affairs
United States Senate
Washington, DC 20510

Re: Tomorrow's Hearing: Fannie Mae and Freddie Mac as Systemically Important Financial Institutions

Dear Chairman Crapo and Ranking Member Brown:

I write to you today on behalf of the National Association of Federally-Insured Credit Unions (NAFCU) in regard to tomorrow's hearing entitled "Should Fannie Mae and Freddie Mac be Designated as Systemically Important Financial Institutions?" NAFCU advocates for all federally-insured not-for-profit credit unions that serve over 117 million consumers with personal and small business financial service products. NAFCU has long advocated for housing finance reform because the current conservatorship of Fannie Mae and Freddie Mac (the GSEs) is unsustainable in the long term.

NAFCU's Housing Finance Reform Principles (see attached) recognize the importance of a strong, independent regulator for the GSEs. The Federal Housing Finance Agency (FHFA) should be given the tools necessary, in terms of regulatory authority over the GSEs, to ensure the safety and soundness of our current and future housing finance system. NAFCU recognizes and appreciates FHFA Director Dr. Mark Calabria's focus on ensuring the GSEs are well capitalized so that taxpayers will never again have to bail out the mortgage giants in the event of a severe economic downturn. The stability of this nation's housing finance system depends on it.

NAFCU appreciates the Committee's attention to whether the GSEs should be designated as systemically important and we look forward to collaborating with the Committee as you work on this important issue. Should you have any questions or require additional information, please do not hesitate to contact me or Max Virkus, NAFCU's Associate Director of Legislative Affairs, at 703-842-2261.

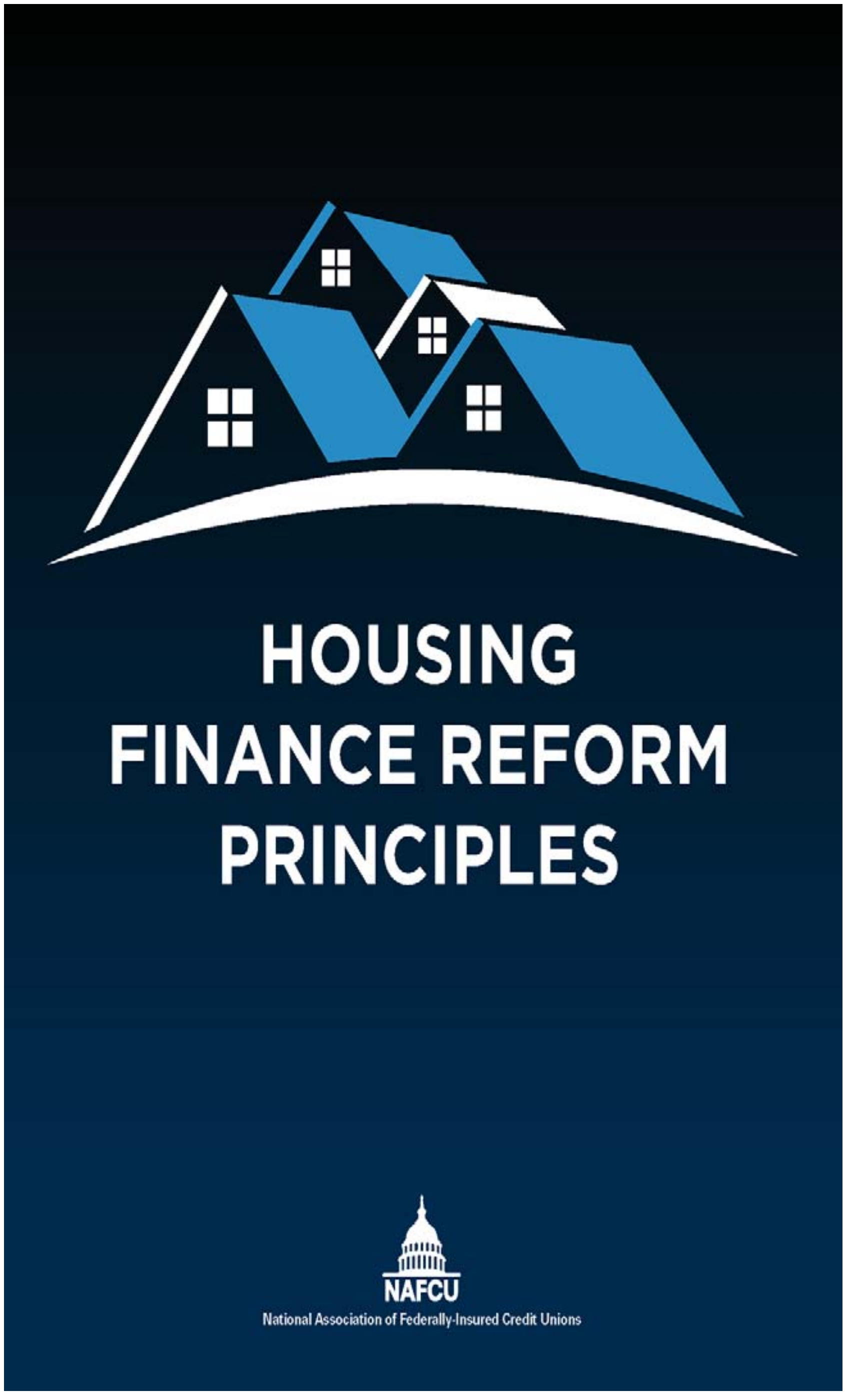
Sincerely,

Brad Thaler

Brad Thaler
Vice President of Legislative Affairs

cc: Members of the Senate Banking Committee

Attachment



HOUSING FINANCE REFORM PRINCIPLES

NAFCU
National Association of Federally-Insured Credit Unions

The National Association of Federally-Insured Credit Unions (NAFCU) is a direct membership association that serves the needs of federally-insured credit unions through unparalleled federal advocacy, education, and compliance assistance. NAFCU and its member credit unions have long supported a vibrant secondary mortgage market that provides equal access to lenders of all sizes. NAFCU's members play a significant role in the mortgage lending industry and strive to provide high-quality loans all while increasing member access to credit.

Since 2008, when the federal government took control of Fannie Mae and Freddie Mac (the government-sponsored enterprises or GSEs) from their stockholders and placed them into conservatorship, the future of the GSEs and the secondary mortgage market has become an important topic of debate among lawmakers and three administrations. NAFCU and its members have been intimately involved in housing finance reform efforts in Congress since that time. Representatives from several of NAFCU's member credit unions have provided testimony on various legislative proposals, including the *Protecting American Taxpayers and Homeowners* (PATH) *Act* and *the Housing Finance Reform and Taxpayer Protection Act* introduced by Senators Bob Corker (R-TN) and Mark Warner (D-VA). These testimonies provided Congress with vital insight into the credit union perspective on the secondary mortgage market. NAFCU also participated in the discussion surrounding the Housing Finance Reform and Taxpayer Protection Act of 2014 (Johnson-Crapo) and has consistently commented on proposals coming out of the Federal Housing Finance Agency (FHFA) to provide the agency with information on the potential affects their proposals may have on credit unions. As the FHFA has become more active in their internal piecemeal efforts at GSE reform, NAFCU has stepped up to the plate as the leader in the credit union industry regarding housing finance reform.

Now, more than ever since the financial crisis, Washington D.C. is abuzz with talk of housing finance reform. This paper outlines NAFCU's principles for the future state of housing finance reform. Although this paper is not an official proposal for GSE reform, NAFCU believes that whatever reform option is ultimately adopted must include these core principles to ensure the safety and soundness of credit unions nationwide. The time has come for Congress to take action on housing finance reform to establish a safe and viable housing market for the foreseeable future.

THE CREDIT UNION PERSPECTIVE

The housing market is a critical aspect of our nation's economy and the future of the housing finance system is of great importance to our nation's credit unions and their 108 million members. In the years since the Great Recession, it has become increasingly clear that the status quo for our housing finance system is an unsustainable long-term option. It is essential that we now devote time to establishing workable principles through which to guide potential housing finance reform efforts.

Before, during, and after the financial crisis, credit unions continued to make quality loans through solid underwriting practices. Regulatory restrictions, however, have made it difficult for credit unions to hedge against interest rate risk. The government-sponsored enterprises are of particular importance to credit unions because they serve as an important management tool to access the liquidity necessary to enable credit unions to serve the mortgage needs of their member-owners. Overall, the GSE securitization process remains a key component of the safety and soundness of credit unions nationwide.

In addition to maintaining access to a healthy and viable secondary mortgage market, fair pricing is equally as critical in ensuring community-based financial service providers have a seat at the table. Credit unions serve communities of varying compositions and believe that the GSEs should continue to do the same and not discriminate against a financial institution based on the type of institution, an institution's asset size or any other geopolitical factors. As such, GSE pricing for loans should be based on loan quality and not quantity.

These general positions underlie the following specific GSE reform principles that NAFCU believes must be a central part of any legislative reform effort. The ultimate goal is to create a thriving and sustainable market for mortgage-backed securities (MBS) that will provide equal access to lenders of all sizes and will not require another taxpayer bailout.



PRINCIPLES FOR HOUSING FINANCE REFORM:

› **A healthy, sustainable and viable secondary mortgage market must be maintained.**
Credit unions must have unfettered, legislatively-guaranteed access to the secondary mortgage market. In order to achieve a healthy, sustainable and viable secondary market, there must be vibrant competition among market participants in every aspect of the secondary market. Market participants should include, at a minimum, at least one GSE, the Federal Home Loan Banks (FHLBs), Ginnie Mae, and private entities.

› **The U.S. government should issue an explicit government guarantee on the payment of principal and interest on MBS.**
The explicit guarantee will provide certainty to the market, especially for investors who will need to be enticed to invest in MBS, and facilitate the flow of liquidity through the market.

› **The GSEs should be self-funded, without any dedicated government appropriations.**
Although the U.S. government should be involved in the secondary mortgage market, the GSEs should not be government-funded mortgage programs. The GSEs' fees should provide the revenue necessary for sustained independent operation. Those fee structures should, in addition to size and volume, place increased emphasis on the quality of loans. Risk-based pricing for loan purchases should reflect that quality difference. Credit union loans provide the high quality necessary to improve the salability of the GSEs' securities.

› **Creation of a FHFA board of advisors.**
A board of advisors made up of representatives from the mortgage lending industry should be formed to advise the FHFA regarding the GSEs and the state of the secondary mortgage market. Credit unions should be represented in such a body.

› **The GSEs should be allowed to rebuild their capital buffers.**
Rebuilding capital buffers ensures the safety and soundness of the GSEs, maintains investor confidence, prevents market disruption, and reduces the likelihood of another taxpayer bailout in the event of a future catastrophic market downturn. The GSEs should be permitted to begin rebuilding capital slowly over a period of several years.

› **The GSEs should not be fully privatized at this time.**
There continue to be serious concerns that in a fully privatized system, in which the GSEs are sold off to the secondary market, small, community-based financial institutions could be shut out of the secondary market. Any privatization efforts should be gradual and ensure that credit unions have continued access to the GSEs and the secondary mortgage market.

› The FHLBs must remain a central part of the mortgage market.

The FHLBs serve an important function in the mortgage market as they provide their credit union members with a reliable source of funding and liquidity. Housing finance reform must take into account the consequence of any legislation on the health and reliability of the FHLBs.

› Credit risk transfer transactions should be expanded and the Common Securitization Platform (CSP) and Single Security retained.

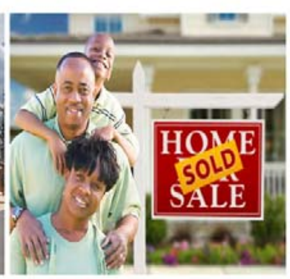
Although there are concerns regarding credit unions' ability to participate in certain credit risk transfer (CRT) transactions, the GSEs should continue to expand CRT as well as initiatives to create deeper mortgage insurance to further disperse risk among private investors. Credit unions should be permitted to participate in transactions such as front-end CRTs through a special purpose vehicle, such as a credit union service organization or the FHLBs. The CSP and Single Security have the potential to simplify the sale of loans to the GSEs and allow greater, more affordable access to the secondary mortgage market.

› The FHFA or its successor should continue to provide strong oversight of the GSEs and the new system, whatever it may look like.

A strong, reliable single federal regulator helps to provide consistency and focus to the GSEs so they can stay on track with their core missions and objectives. The FHFA helps maintain safety and soundness in the secondary mortgage market. A new system should also utilize the current regulatory framework and GSE pricing and fee structures.

› The transition to a new system should be as seamless as possible.

Regardless of whether the GSEs in their current form are part of a new housing finance system, credit unions should have uninterrupted access to the GSEs or their successor(s) and the secondary mortgage market as a whole, in particular through the cash window and small pool options.

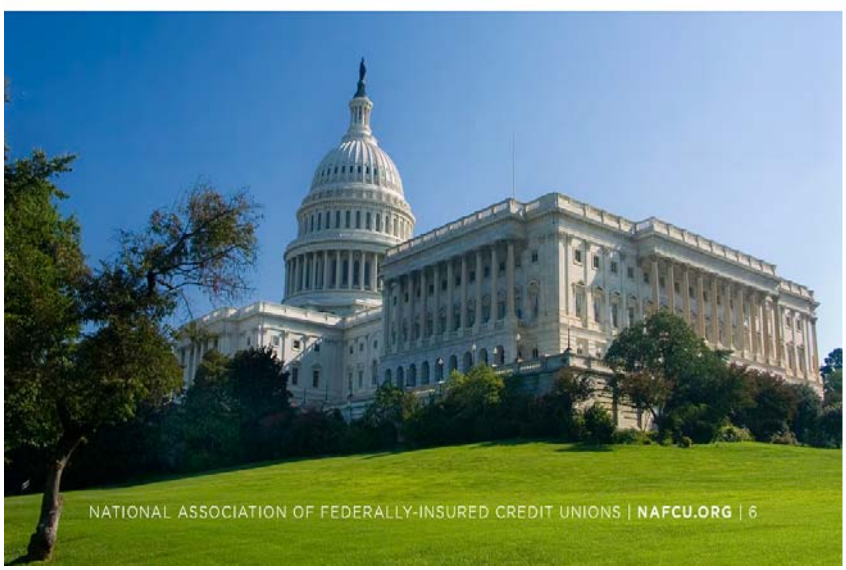



NAFCU'S VISION FOR THE FUTURE OF HOUSING FINANCE

NAFCU's vision is two-fold: continued access to the secondary mortgage market and a level playing field for lenders of all sizes. Currently, the GSEs provide credit unions with the liquidity necessary to offer new mortgages to their member-owners. In the future, credit unions must continue to be able to sell directly to the GSEs without having to aggregate their loans through larger lenders. The GSEs must also continue to offer fair prices and fees.

Although NAFCU does not support full privatization at this time, the GSEs should be permitted to begin rebuilding their capital buffers. This is imperative to preserving liquidity and overall market stability. Additionally, in a new housing finance system, the GSEs should provide an explicit guarantee backed by the full faith and credit of the United States government. If the GSEs are to continue to attract private investors, an explicit guarantee is necessary to ensure market continuity in the event of a financial downturn.

As Congress considers housing finance reform, the process will not be easy and it will be undeniably filled with uncertainties. The above principles provide a concrete foundation for reform. Credit unions play a vital part in the mortgage market and their ability to sell loans to the GSEs must remain uninterrupted through any potential transition to a new housing finance system. Unfettered access to the secondary mortgage market for credit unions with fair pricing based on loan quality as opposed to volume must be maintained to ensure the continued safety and soundness of our nation's housing market.



NAFCU

National Association of Federally-Insured Credit Unions

STATEMENT SUBMITTED BY THOMAS H. STANTON

Thomas H. Stanton
Bethesda, MD 20814
June 27, 2019

The Honorable Mike Crapo, Chairman
The Honorable Sherrod Brown, Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Re: Follow-up to the hearing on "Should Fannie Mae and Freddie Mac be Designated as Systemically Important Financial Institutions (SIFIs)?

Dear Chairman Crapo, Ranking Member Brown, and Members of the Honorable Committee:

I respectfully ask that this comment letter, concerning the question whether Fannie Mae and Freddie Mac should be designated SIFIs, might be entered into the public record. I have been a student of Government-Sponsored Enterprises (GSEs) for several decades. Many of my writings can be found at www.thomas-stanton.com. I first testified before this committee on Fannie Mae and Freddie Mac in 1989,[1] and in 1991 published a book, *A State of Risk: Will Government Sponsored Enterprises be the Next Financial Crisis*? (HarperCollins). While one can't easily predict when a shock will hit the financial system, the structural vulnerabilities of the GSE business model were apparent long before the 2008 Financial Crisis.

The GSE is a complex organizational form and determining an appropriate structure for the home mortgage market poses complex challenges as well. Given the arc of my historical experience, perhaps the best contribution of this statement might be to set forth dynamics of the GSE model that this Committee might consider when contemplating the future of Fannie Mae and Freddie Mac. I believe that there are strong arguments for designating the two multi-trillion dollar GSEs as SIFIs under Title I of the Dodd-Frank Act.

1. The single greatest factor determining financial vulnerability of Fannie Mae and Freddie Mac is the extent that they possess greater leverage than is permitted for competing financial institutions such as commercial banks in the mortgage market.

The Financial Crisis illustrated the systemic vulnerabilities caused by large financial institutions that operate with such high leverage that they cannot survive the major downturns that inevitably occur. Systemic financial vulnerability is compounded when a select few financial firms operate with significantly higher leverage than their competitors. In such a case firms arbitrage across differences in capitalization and send their products to the highest leveraged financial firm

[1] Senate Committee on Banking, Housing, and Urban Affairs, "The Safety and Soundness of Government Sponsored Enterprises," hearing, 101st Congress, October 31, 1989.

because high leverage gives a firm the opportunity to offer better pricing than their better-capitalized competitors. Fannie Mae and Freddie Mac provide major examples of the systemic risk that this can create.

This was already apparent in 1989, when increased capital requirements and government supervision for thrift institutions after the savings and loan debacle drove immense volumes of mortgages from the portfolios of savings and loan associations to Fannie Mae and Freddie Mac because their capital standards and government oversight were much weaker. That example demonstrated the validity of the precept that risk migrates to the place where capital and other prudential standards are lowest. Until they failed, Fannie Mae and Freddie Mac were that place.

It is the disparity in capital requirements, and not only the level of required capital, that this Committee needs to consider when deciding on the future of the two GSEs. Designating them as SIFIs would permit the Federal Reserve to consider the proper amount of capital that they should maintain both to support the mortgage market and to protect the financial system from costly and avoidable systemic harm.

2. The single greatest regulatory weakness of the GSEs is that they are subject to financial supervision from a regulatory agency that supervises only three GSEs.

There is an ample literature on capture of regulatory agencies by vested interests.[2] Much of that literature has developed in the context of utility regulation.[3] The problem is made much more acute when an agency is concentrating on only two multi-trillion dollar companies, especially if the agency – in this case the Federal Housing Finance Agency – operates without backing from a strong department such as the Treasury or Federal Reserve. The current statutory structure of the FHFA, isolating the agency from any strong organizational protector, invites capture, or at least weakness, in the face of strong constituency pressure once memory of the two GSEs' failure fades.

Designation of the two GSEs as SIFIs can help to overcome this infirmity and make the Federal Reserve responsible for ensuring more appropriate prudential capital standards and other safety and soundness measures if the primary regulator has not already done so. Designation of the two GSEs as Systemically Important Market Utilities, as one witness proposed at the hearing, would fail to provide such protection, especially as the language of the applicable provisions of the Dodd-Frank Act, "Title VIII—Payment, Clearing, And Settlement Supervision," greatly constrains the ability of the Federal Reserve to take necessary prudential steps except in exceptionally limited cases, compared to its ability to protect SIFIs and the financial system under Title I of the Act.

[2] Early analyses include, e.g., Marver H. Bernstein, *Regulating Business by Independent Commission* (Princeton University Press, 1955); and George J. Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science*, vol. 2 (Spring 1971), pp. 3-2.
[3] See, Ernesto Dal Bo, "Regulatory Capture: A Review," *Oxford Review of Economic Policy*, Vol. 22, No. 2 (2006), pp. 203-225, at p. 203. ("Much of the literature that is explicitly concerned with regulatory capture has been developed in the context of utility regulation, although a literature on political influence has grown alongside it.")

This type of legislative legerdemain has been a pronounced feature of GSE legislation over the years. Thus, even after enactment of the 2008 Housing and Economic Recovery Act (HERA), authority and discretion of the Federal Housing Finance Agency in many cases remain less explicit, procedurally more cumbersome, and potentially weaker, than the corresponding authority and discretion of a financial regulator such as the Office of the Comptroller of the Currency (OCC) with respect to fundamental matters such as safety-and-soundness enforcement and ability to set bank-type capital standards. FHFA, which has sought to become a more serious regulator since the Financial Crisis, would benefit if its statutory authority were adopted more directly from the authority and discretion afforded the federal bank regulators.

3. The government backing of the two GSEs, and their structure as a duopoly in the secondary mortgage market, give them market power, especially over their customers in the primary mortgage market, and their market power in turn gives the GSEs political power that they can use progressively to weaken any safety-and-soundness authority that their supervising regulatory agency might initially possess.

When designing a GSE, or other organization with government backing such as the idea of a GSE-based public utility that some have proposed, the life cycle of the organization deserves consideration.[4] The political power that is built into the GSE creates a dynamic that, over time, allows the organization to weaken statutory and supervisory controls to the point where substantial risk accumulates even as the organization appears outwardly to be strong and virtually invulnerable. This happened, for example, when the two GSEs proved incapable of publishing accurate financial statements for several years in the mid-2000s.

4. When things go wrong with a GSE or other financial institution specializing in a risky single line of business such as residential mortgages, things tend to go very wrong. Configuring a specialized lender to be a public utility, as one witness proposed, would not significantly diminish this risk.

As federally chartered instrumentalities, GSEs face an unusual form of risk. When times are good, they may dominate their authorized markets, but when unforeseen competition emerges the impact can be substantial. The following observation refers to "mercantilist institutions" such as GSEs that have their charter powers limited by law:

> "Mercantilist institutions thus have quite a different kind of market risk than other companies. They may enjoy oligopoly profits undisturbed for years, only to be confronted suddenly with new technologies that permit nonmercantilist companies rapidly to take away key portions of their customer base....[T]he management risk of a mercantilist institution may jump dramatically when it runs into the limits of its enabling

[4] For a pre-crisis review, see, Thomas H. Stanton, "The Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability, *Public Administration Review*, Vol. 67, No. 5 (Sept. - Oct., 2007), pp. 837-845

> legislation and managers feel themselves forced to take greater risks within their permitted markets."[5]

Precisely this happened to Fannie Mae and Freddie Mac as the Financial Crisis developed. Large mortgage lenders applied new technologies to build pipelines for mortgages that Wall Street could purchase and securitize as private-label securities. Both GSEs faced a dilemma either of needing to lower their credit standards to meet the new competition or of losing relevance to the mortgage market.[6]

Anurag Saksena, Chief Risk Officer at Freddie Mac, explained in an FCIC interview the dilemma facing GSE managers as the mortgage market turned against them:

> "We are a firm which is really concentrated in one segment of the entire financial services industry – mortgage product. Unlike Jamie Dimon [CEO of JPMorganChase], I cannot say hey, Mr. CEO, we are way too concentrated in this product, let's diversify it."[7]

Viewing the failure of their companies, the CEOs of both Fannie Mae and Freddie Mac criticized the monoline GSE business model. Richard Syron, former CEO of Freddie Mac, told the FCIC that, "I don't think that [the GSE] is a good business model…Freddie failed because in my mind it was a non-diversified, one-product company."[8]

Daniel Mudd, former CEO of Fannie Mae, told a congressional committee about other drawbacks of the GSE model:

> "I would advocate moving the GSEs out of No Man's Land. Events have shown how difficult it is to balance financial, capital, market, housing, shareholder, bondholder, homeowner, private, and public interests in a crisis of these proportions. We should examine whether the economy and the markets are better served by fully private or fully public GSEs."[9]

Turning the GSEs into regulated utilities would not significantly reduce their systemic vulnerabilities. To take a currently prominent example, the California regulated utility PG&E,

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[5] Thomas H. Stanton, "Nonquantifiable Risks and Financial Institutions: The Mercantilist Legal Framework of Banks, Thrifts and Government-Sponsored Enterprises," in *Global Risk Based Capital Regulations*, edited by Professors Charles Stone and Anne Zissu, (Irwin Professional, 1994), pp. 57-97, at p. 90.

[6] See, e.g., Fannie Mae, "Single Family Guarantee Business: Facing Strategic Crossroads," June 27, 2005. See also, Thomas H. Stanton, *Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Crisis* (Oxford, 2012), pp. 57-8.

[7] Anurag Saksena, Chief Enterprise Risk Officer, Freddie Mac, Interview, Financial Crisis Inquiry Commission, June 22, 2010.

[8] Richard Syron, Interview, Financial Crisis Inquiry Commission, August 31, 2010.

[9] Daniel Mudd, testimony before the House Committee on Oversight and Government Reform, hearing, "The Role of Fannie Mae and Freddie Mac in the Financial Crisis," December 9, 2008.

which incurred substantial liability for harm from multiple devastating wildfires that it caused,[10] also displayed a pattern of negligent operations and weak oversight reaching back many years.[11]

The monoline nature of Fannie Mae and Freddie Mac and their market dominance in normal times create complacency, resistance to feedback, and political strength that sometimes has made them virtually unaccountable for systemic considerations. SIFI designation under Title I of Dodd-Frank can help to offset the consequent risk to the financial system.

Conclusion

In conclusion, this committee is engaged in an impressive inquiry and search for a business and regulatory model that can assure the United States, and American homeowners and renters, of having a robust and sustainable housing finance sector despite the vagaries of the financial system in which it must operate. Designating Fannie Mae and Freddie Mac as SIFIs would be an important step forward in that process.

[10] Ivan Penn, Peter Eavis and James Glanz, "How PG&E Ignored Fire Risks in Favor of Profits," *New York Times*, March 18, 2019.

[11] National Transportation Safety Board. "NTSB cites Pacific Gas & Electric (PG&E) and government oversight in fatal California pipeline rupture," August 30, 2011.

LETTER SUBMITTED BY THE U.S. MORTGAGE INSURERS

USMI
U.S. Mortgage Insurers

June 24, 2019

The Honorable Mike Crapo
Chairman
Committee on Banking, Housing & Urban Affairs
United States Senate
239 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing & Urban Affairs
United States Senate
503 Hart Senate Office Building
Washington, DC 20510

Dear Chairman Crapo and Ranking Member Brown,

U.S. Mortgage Insurers (USMI)[1] appreciates this opportunity to submit a letter for the record to the Committee on Banking, Housing, and Urban Affairs (Committee) related to your hearing entitled "Should Fannie Mae and Freddie Mac be Designated as Systemically Important Financial Institutions?" It is critical that the Committee, and Congress as a whole, work with the Administration to ensure the U.S. housing finance system operates in a manner that minimizes taxpayer risk exposure and ensures creditworthy Americans have sustainable access to prudent and affordable mortgage finance credit.

Designating Fannie Mae and Freddie Mac (the GSEs) as systemically important financial institutions (SIFIs) would have significant ramifications for the GSEs' capital requirements. A primary element of regulation for financial institutions – whether the GSEs, banks, or insurance companies – is the application and enforcement of a capital framework that promotes financial stability and accounts for the business operations and characteristics of the regulated entity. The GSEs currently use a Conservatorship Capital Framework (CCF) that was developed by the Federal Housing Finance Agency (FHFA) and implemented in 2017 to align the GSEs' business and pricing decisions with economic risk. Further, last year under the leadership of the prior Director, the FHFA issued a notice of proposed rulemaking (NPR)[2] that outlined a risk-based post-conservatorship Enterprise Capital Framework (ECF). The proposed rule for the ECF contemplates whether the GSEs are SIFIs and includes a going-concern buffer, which is akin to a SIFI capital buffer and would require the GSEs to hold additional capital beyond what is required to cover economic losses during a severe financial stress event in order to maintain market confidence. USMI provided comments[3] on the ECF and specifically recommended that: (1) the NPR should be treated as an advance notice of proposed rulemaking (ANPR) and that a revised NPR be issued; and (2) the CCF and the models, back-testing, and assumptions for the NPR should be made publicly available to better inform feedback and perspectives from stakeholders, including market participants and consumer groups.

USMI welcomes the opportunity to comprehensively discuss our comments to the FHFA with Committee staff and would like to succinctly highlight several concerns/recommendations related to the ECF.

- The NPR is bank-centric and the proposed capital requirements are inappropriate for the GSEs whose core business activity is an insurance function.

[1] USMI is a trade association comprising the following private mortgage insurance companies: Essent Guaranty, Inc.; Genworth Mortgage Insurance Corporation; Mortgage Guaranty Insurance Corporation; National Mortgage Insurance Corporation, and Radian Guaranty Inc.
[2] 83 Fed. Reg. 33312 (July 17, 2018).
[3] USMI response to FHFA's NPR on Enterprise Capital Requirements (November 16, 2018). *Available at* https://www.fhfa.gov//SupervisionRegulation/Rules/Pages/Comment-Detail.aspx?CommentId=15312.

- The NPR is excessively conservative in that the ECF does not include the GSEs' guarantee fees (g-fees) on existing books of business and other revenues when determining capital needs.
- The proposed rule is inappropriately procyclical due to the use of mark-to-market loan-to-value (LTV) ratios and updated credit scores.
- The proposed rule's treatment of counterparties is unsuitable and should be reevaluated to properly reflect risk protection and counterparty strength.
  - In particular, the value of mortgage insurance (MI) protection which is currently understated in the ECF.
  - FHFA should develop a consistent and transparent methodology for applying counterparty haircuts.
  - The calculation of capital relief afforded to the GSEs' credit risk transfer (CRT) programs/transactions should better align with the actual risk reduction associated with CRT.

The FHFA's forthcoming capital rule could significantly impact the GSEs' current and future day-to-day business activities, the competitiveness of counterparties and other stakeholders, and most importantly the rule will affect the cost of mortgage credit for millions of Americans. For these reasons and those listed above, USMI and our member companies believe that the NPR should be treated as an ANPR and that a revised NPR should be issued for comment. Further, the CCF and the models, back-testing, and assumptions used to development the original proposal should be made publicly available. Thank you for considering USMI's perspectives and we look forward to serving as a resource for the Committee as it considers these important questions and considerations. Questions or requests for additional information may be directed to Lindsey Johnson, President of USMI, at ljohnson@usmi.org or 202-280-1820.

Sincerely,

Lindsey D. Johnson
President

LETTER SUBMITTED BY THE THE CENTER FOR AMERICAN PROGRESS

Center for American Progress

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June 25, 2019

The Honorable Mike Crapo	**The Honorable Sherrod Brown**
Chairman	**Ranking Member**
U.S. Senate Committee on Banking, Housing, & Urban Affairs	**U.S. Senate Committee on Banking, Housing, & Urban Affairs**
534 Dirksen Senate Office Building	**534 Dirksen Senate Office Building**
Washington, D.C. 20510	**Washington, D.C. 20510**

Dear Chairman Crapo and Ranking Member Brown:

The Center for American Progress ("CAP") is pleased to submit the following statement for the record for today's hearing entitled, "Should Fannie Mae and Freddie Mac be Designated as Systemically Important Financial Institutions?" in the Senate Banking Committee.

The 2007-2008 financial crisis clearly demonstrated that distress at large, complex, and interconnected nonbank financial companies could threaten the broader stability of the U.S. financial system.[1] Certain nonbank financial firms took on excessive risk and engaged in the type of maturity and liquidity transformation that makes traditional banking such a fragile enterprise, but were regulated less stringently and did not have the same public protections as banks.[2] To address this shortcoming, the Dodd-Frank Wall Street Reform and Consumer Protection Act brought the disparate financial regulators together in a new body—the Financial Stability Oversight Council ("FSOC" or "Council")—and gave it the authority to designate nonbank financial companies as systemically important financial institutions ("SIFIs").[3] Designated firms are subjected to consolidated supervision by the Federal Reserve Board ("Fed") and enhanced regulatory safeguards. In addition to analyzing the systemic risk profile of the firm, the Council is required by statute to factor in the extent to which a firm is already regulated when considering a firm for a SIFI designation.

Fannie Mae and Freddie Mac are certainly systemically important, however, there is an existing federal prudential regulatory framework in place for these firms. The Federal Housing Finance Agency ("FHFA") was created in 2008 and given the mandate to ensure the safety and soundness of the Government Sponsored Enterprises. The Housing and Economic Recovery Act

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[1] Sherrod Brown, "Brown Opening Statement at Banking Committee Hearing On FSOC Nonbank Designation," March 14, 2019, available at https://www.brown.senate.gov/newsroom/press/release/brown-opening-statement-at-banking-committee-hearing-on-fsoc-nonbank-designation.

[2] Gary Gorton and Andrew Metrick, "Securitized Banking and the Run on Repo," NBER Working Paper No. 15223, August 2009, available at https://www.nber.org/papers/w15223.

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law 203, 111th Cong., 2nd sess. (July 21, 2010), available at https://www.govinfo.gov/content/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

of 2008 ("HERA") granted the FHFA broad prudential authority to regulate these firms.[4] It is thus unclear why the Director of the FHFA has advocated for Fannie and Freddie to be designated by the Council.[5] Practically, designating Fannie and Freddie would simply place them under the regulatory purview of the Fed. The Fed would have the same type of prudential authority over Fannie and Freddie that the FHFA already retains under HERA. If the current FHFA Director believes the agency lacks the powers necessary to ensure the safety and soundness of these firms, he must be specific about what tools he would like Congress to grant his agency and why the broad authorities bestowed upon the FHFA in statute are insufficient.

Furthermore, it is curious that the Trump FSOC would consider designating Fannie and Freddie after pivoting to a deeply misguided version of an "activities-based" approach to systemic risk regulation.[6] It would seem to suggest a complete incoherence in policy strategy to immediately pursue entity designations of Fannie and Freddie, while shutting down that policy lever for all other nonbank financial firms. It would suggest that the Council views designations as a weapon or a "scarlet letter", only to be used on firms disliked by the Trump administration.

To be clear, there is at least one clear circumstance that would necessitate the designation of Fannie and Freddie: if the FHFA is asleep at the wheel. If the Council determined that the FHFA was not adequately supervising and regulating these firms, it could resort to a designation to place the firms under Fed oversight.

Thank you for your consideration.

Sincerely,

Gregg Gelzinis
Policy Analyst, Economic Policy
Center for American Progress

[4] Housing and Economic Recovery Act of 2008, Public Law 289, 110th Cong., 2nd sess. (July 30, 2008), available at https://www.govinfo.gov/content/pkg/PLAW-110publ289/pdf/PLAW-110publ289.pdf.
[5] Katy O'Donnell, "POLITICO Pro Q&A: FHFA Director Mark Calabria," *Politico*, May 17, 2019, available at https://www.politico.com/story/2019/05/17/fhfa-director-mark-calabria-1453740.
[6] Gregg Gelzinis, "Re: FSOC interpretive guidance on nonbank financial company determinations," Center for American Progress, May 13, 2019, available at https://www.regulations.gov/document?D=FSOC-2019-0001-0017.