January 10, 2016

The Definition of SIFIs Must Include Fannie Mae and Freddie Mac, the Federal Reserve Banks and Open Market Committee, and Large Federal Credit Programs

Alex J. Pollock and Thomas H. Stanton

Dear SIFI Challenge:

We are pleased to respond to the SIFI Challenge with the following propositions:

1. **Fannie Mae and Freddie Mac unquestionably qualify as SIFIs, both under the statutory and FSOC definitions, and in any objective assessment of their financial importance;**

2. **The Federal Reserve Banks also qualify as SIFIs;**

3. **The Federal Reserve Open Market Committee poses vast systemic risk and therefore should be included in any appropriate definition of SIFIs; and**

4. **In support of Deborah Lucas's contention,[1] federal direct loan, loan guarantee, and insurance programs also pose substantial systemic risk, and risk to the taxpayer, and should be included in any appropriate definition of SIFI.**

5. **A SIFI should be defined as "any organization, including a government agency or instrumentality or private company, where the nature, scope, size, scale, concentration, or interconnectedness of the financial activities of the organization, or its financial distress or insolvency, could pose a threat to the stability of the financial system of the United States."**

Background

Along with many different kinds of institutions, Fannie Mae and Freddie Mac failed in the financial crisis of 2007-09. The Dodd-Frank Act created the Financial Stability Oversight Council (FSOC) and directed it to designate major non-bank institutions as systemically important, to designate all banks with assets over $50 billion as SIFIs, and to subject SIFIs to higher capital

[1] Lucas, Deborah, "Evaluating the Government as a Source of Systemic Risk", *Journal of Financial Perspectives*, volume 2, issue 3, Nov. 2014, cited in the Background Information, footnote 32, to this SIFI Challenge.

standards and escalated regulation. FSOC has now issued implementing regulations that set forth six criteria for designating a financial institution as a SIFI: Size; Interconnectedness; Substitutability; Leverage; Liquidity Risk and Maturity Mismatch; and Existing Regulatory Scrutiny.

Pursuant to this authority, in addition to the many large bank SIFIs, FSOC has designated three nonbank financial institutions as SIFIs. It has failed to so designate Fannie Mae and Freddie Mac, or other governmental creators of major systemic risk.

1. **Fannie Mae and Freddie Mac unquestionably qualify as SIFIs, both under the statutory and FSOC definitions, and in any objective assessment of their financial importance.**

In detailed support of this proposition, we attach as an attachment our letters to the Financial Stability Board and to the Secretary of the Treasury, as Chair of FSOC. We appreciate your mention of these letters in the Background Information to this SIFI Challenge. We believe they conclusively demonstrate that Fannie Mae and Freddie Mac are SIFIs beyond any doubt.

Indeed, the failure of the GSEs revealed only some of the problems caused by lack of accurate information (and consequent pricing) with respect to the risks they pose to the financial system and the US taxpayer. On their way to failure the GSEs caused serious market distortions as well. For instance, before the Financial Crisis Fannie Mae and Freddie Mac moved "down market" to purchase riskier mortgages. They thereby contributed to the erosion of market share of the Federal Housing Administration (FHA) and exercised adverse selection that eroded credit quality of the FHA loan portfolio.[2] Even in conservatorship, GSEs remain off-budget so that the costs of their operations, including distortions of the housing market caused by their immense and growing market share, fail to enter policymakers' calculations.

2. **The Federal Reserve Banks also qualify as SIFIs.**

A threshold question is whether the Federal Reserve Banks are "US Nonbank Financial Companies" under the Dodd-Frank Act. They certainly appear to be. Like banks, they are instrumentalities of the United States, are owned and controlled by private parties, are

[2] Dwight M. Jaffee and John M. Quigley, "Housing Policy, Mortgage Policy, and the Federal Housing Administration," chapter 5 in Deborah Lucas, ed., *Measuring and Managing Financial Risk*, University of Chicago Press, 2010, pp. 97-130, at pp. 115-6.

supervised rather than managed by the Federal Reserve Board,[3] and are predominantly engaged in financial activities, including making loans and investments.

FSOC has adopted criteria to implement Section 113 of the Dodd Frank Act.[4] The core question FSOC seeks to answer when it designates SIFIs is whether "material financial distress at the nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to the financial stability of the United States"[5] With respect to the Federal Reserve Banks the answer most certainly is in the affirmative.

In total, the Federal Reserve Banks have assets of $4.5 trillion, together making them by far the largest financial entity in the country. Eleven of the twelve are each bigger than the $50 billion benchmark which automatically designates banks as SIFIs, and eight are more than double the benchmark. Moreover, they run at extremely high leverage—at leverage which would cause any bank to be categorized as significantly undercapitalized. This is true of all Federal Reserve Banks, but especially of the Federal Reserve Bank of New York, which by itself represents $2.5 trillion in assets and is leveraged at 0.51% or 196:1.

The size and leverage of the Federal Reserve Banks are shown in the following table. Equity is defined as including both paid-in capital and surplus.

Federal Reserve Banks as of December 30, 2015

Federal Reserve Banks	Total assets (in billions)	Leverage ratio (total assets to equity)	Capital Ratio (equity to total assets)
Total	$ 4,487	114:1	0.88%
New York	2,545	196	0.51%
San Francisco	556	95	1.05%
Richmond	272	31	3.26%
Atlanta	263	119	0.84%
Chicago	183	173	0.58%
Dallas	161	278	0.36%
Cleveland	135	45	2.24%

[3] See, Federal Reserve Act, "Enumerated Powers," codified at 12 U.S.C. Sec. 248.

[4] Codified at 12 U.S. Code § 5323, "Authority to require supervision and regulation of certain nonbank financial companies."

[5] Financial Stability Oversight Council, "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," *Federal Register*, vol. 77, no. 70, April 11, 2012, at pp. 21637-21662, codified at 12 CFR Part 1310.

Philadelphia	121	55	1.81%
Boston	95	54	1.84%
Kansas City	62	150	0.66%
St. Louis	59	149	0.67%
Minneapolis	35	207	0.48%

The Federal Reserve Banks are deeply intertwined with the banking system, as lenders and as holders of the banks' deposits; the housing finance system, as the largest investors in long-term, fixed rate mortgage assets; the finances of the U.S. government; and the international monetary system. They run exceptionally large maturity mismatches and thus extremely large market risk. Their maturity mismatch relative to their capital would be deemed unsafe and unsound if undertaken by any bank.

Designating them as SIFIs is both appropriate and prudent, but also necessary to any adequate understanding of the systemic riskiness of the overall financial system.

3. **The Federal Reserve Open Market Committee poses vast significant systemic risk and therefore should be included in any appropriate definition of SIFIs.**

The Federal Reserve Open Market Committee is an institution which represents remarkable systemic risk. If it is successful in its monetary and credit efforts (known as "policy" by supporters and "manipulations" by critics), this Committee may be risk reducing. But if it fails, as it often has, it can create more systemic financial and economic risk than any other institution in the world.[6] Its actions, based on the quite debatable theories, models, estimates, forecasts and guesses of a committee, have historically at various times stoked runaway consumer price inflation, and runaway asset price inflation, forced negative real returns on the savings of the American people, reduced real wages, helped inflate disastrous financial bubbles, distorted markets, and led to financial instability. Ironically, all of these actions were taken in the name of promoting stability. Moreover, The Open Market Committee creates systemic risk not only for the United States, but for the entire world, since it commands by fiat the world's dominant currency.

Will the Open Market Committee do better in the future than it often has in the past? Maybe, but maybe not. Designating it as a SIFI would be a prudent step. As with the other government

[6] See, e.g., Friedman, Milton and Anna J. Schwartz, *A Monetary History of the United States, 1863-1960*, Princeton, N.J.: Princeton University Press, 1963, with respect to actions of the Fed in the Great Depression.

institutions we have discussed, understanding systemic financial riskiness is impossible without including the Open Market Committee as a fundamental source of potential instability. Can the Federal Reserve be a successful overseer of itself in this matter? Of course not. Objective and outside assessment of its contribution to systemic riskiness will be required.

4. **Federal direct loan, loan guarantee, and insurance programs also pose substantial systemic risk, and risk to the taxpayer, and therefore should be included in any appropriate definition of SIFIs.**

It has long been understood that government liabilities have the potential to grow to the point that they threaten taxpayers and also financial stability. Writing for the World Bank, Hana Polackova Brixi and Allan Schick point out that:

> "In many countries, the reality or prospect of unbudgeted fiscal risks coming due has been a wakeup call to extend fiscal management beyond the budget to all actions and transactions that put the government in financial jeopardy. … Because contingent liabilities often grow from fiscal opportunism, when policymakers seek to hide the real fiscal cost of their decisions and to reduce the reported budget deficit, bringing them under control may become first of all a question of political will."[7]

In the United States, Federal loans and loan guarantees have grown dramatically. Before the Financial Crisis, some have argued, extending credit was seen as an attractive palliative when taxation and redistribution were nonstarters in our divided political system. Raghuram Rajan, formerly Professor at the University of Chicago Booth School of Business, notes:

> "Easy credit has large, positive, immediate, and widely distributed [perceived] benefits, whereas the [inevitable] costs all lie in the future. It has a payoff structure that is precisely the one desired by politicians, which is why so many countries have succumbed to its lure."[8]

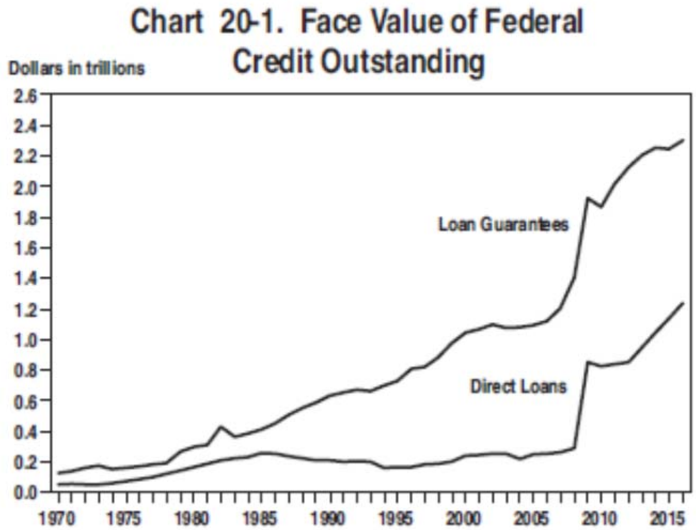
This, Rajan argues, contributed to the housing bubble before the crash in 2007-2009. Then, in and after the financial crisis, the federal government extended yet more credit to finance the bust.

---

[7] Hana Polackova Brixi and Allan Schick, "Introduction," Hana Polackova Brixi and Allan Schick, eds., World Bank, *Government at Risk: Contingent Liabilities and Fiscal Risks*, 2002, p. 2.

[8] Raghuram G. Rajan, *Fault Lines: How Hidden Fractures Still Threaten the World Economy*, Princeton University Press, 2010, p. 31.

The results can be seen in the chart below, from the FY2016 Federal Budget document[9]:



In addition there are substantial and growing federal liabilities from federal insurance programs, including deposit insurance, guarantees of the Pension Benefit Guaranty Corporation, flood insurance, and various specialized forms of insurance such as for the nuclear industry, terrorism risk insurance, and special risk insurance for airlines.

The essential problem is that there is never any free lunch. Although federal government liabilities may seem to be without cost, the costs will appear later—just they did for government housing finance guarantees.

There would be considerable benefits to designating federal credit and insurance programs as SIFIs. Perhaps most importantly, this would create a mandate to account and budget for such programs more accurately than is done today. While the Credit Reform Act of 25 years ago made salutary improvements in budgeting for direct loans and loan guarantees, many improvements remain to be applied. Even more significant, federal insurance programs remain scored on a simple cash basis in the federal budget; this deprives policymakers of virtually any useful information about the true cost of these programs despite their combined financial exposure of trillions of dollars.

In summary, federal loan, loan guarantee, and especially insurance programs all would benefit from the increased accountability that SIFI designation would bring. Designating these as SIFIs would allow the fashioning of appropriate accountability measures for these programs. Placing

[9] *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2016*, chapter 20, "Credit and Insurance," p. 322.

these programs on a proper budget footing would have the positive effect of encouraging allocation of limited federal resources to the highest priority public purposes; ultimately improved accountability might help to prevent a fiscally awkward or even quite harmful impact that could result if the true costs of these programs remain as obscured as they are today.

5. **A SIFI should be defined as "any organization, including a government agency or instrumentality or private company, where the nature, scope, size, scale, concentration, or interconnectedness of the financial activities of the organization, or its financial distress or insolvency, could pose a threat to the stability of the financial system of the United States."**

In conclusion, we respectfully suggest that the definition of SIFI, if it is to capture all the real threats to systemic financial stability, needs to include not only banks and other financial companies, but also the quasi-governmental institutions Fannie Mae and Freddie Mac, the Federal Reserve Banks and the Federal Reserve Open Market Committee, and also government credit and insurance programs of any substantial size.

We propose the following definition: A SIFI should be defined as "any organization, including a government agency or instrumentality or private company, where the nature, scope, size, scale, concentration, or interconnectedness of the financial activities of the organization, or its financial distress or insolvency, could pose a threat to the stability of the financial system of the United States."

Respectfully Submitted,

Alex J. Pollock
Resident Fellow, AEI
American Enterprise Institute
Washington, DC
(As of January 15:
Distinguished Senior Fellow
R Street Institute
Washington, DC)

Thomas H. Stanton
Fellow, Johns Hopkins University

Attachment: Letters to FSOC and the Financial Stability Board Concerning SIFI Designation of Fannie Mae and Freddie Mac

Thomas H. Stanton
1301 Pennsylvania Avenue, NW
Suite 700
Washington, DC 20004

Alex J. Pollock
American Enterprise Institute
1150 17th Street, N.W.
Washington, D.C. 20036

March 31, 2014

The Honorable Jacob Lew
Secretary of the Treasury
Chairman, Financial Stability Oversight Council
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Subject: Designation of Fannie Mae and Freddie Mac as SIFIs

Dear Secretary Lew:

We are writing to you in your capacity as Chairman of the Financial Stability Oversight Council (FSOC), established by the Dodd-Frank Act with responsibility for ensuring the safety and soundness of the financial system. In our letter, we would like to make three fundamental points:

I. **Fannie Mae and Freddie Mac are two of the largest and most highly leveraged financial institutions in the world. Fannie Mae is larger than JPMorgan or Bank of America; Freddie Mac is larger than Citigroup or Wells Fargo. Each of them funds trillions of dollars of mortgages and sells trillions of dollars of debt obligations and mortgage-backed securities (MBSs) throughout the financial system and around the world. The U.S. and the global economy have already experienced the systemic risk of Fannie Mae and Freddie Mac. Their flawed fundamental structure, compounded by serious mismanagement, caused them both to fail and trigger a massive taxpayer bailout in September 2008. Default on their obligations would have greatly exacerbated the financial crisis on a global basis.**

II. **We respectfully urge that Fannie Mae and Freddie Mac be designated as Systemically Important Financial Institutions (SIFIs) so that the protective**

capital and regulatory standards applicable to SIFIs under the law can also be applied to them. These two giant mortgage credit institutions clearly meet the criteria specified by the Dodd-Frank Act and implementing regulations[1] for designation as a SIFI.

III. Fannie Mae and Freddie Mac continue to operate in "conservatorship" and have now amassed an even greater market share than before. Conservatorship status obligates the federal government, absent a change in the law, to return them to shareholder control once they have been stabilized financially. The Congress is considering a variety of legislative measures with respect to the two companies. Whether or not Congress changes the law, it is important for Fannie Mae and Freddie Mac to be designated as SIFIs.

The writers of this letter have studied both historical crises and the most recent financial crisis in some depth, and the roles of Fannie Mae and Freddie Mac, in particular. Thomas H. Stanton has written extensively about Fannie Mae and Freddie Mac. In 1991 he published *A State of Risk: Will Government Sponsored Enterprises be the Next Financial Crisis?* (HarperCollins). He worked with the U.S. Treasury Department and other governmental bodies to seek enactment of improved capital standards and supervision of safety and soundness of the two companies.[2] Regrettably, that effort proved unsuccessful in the long run. After the failure of Fannie Mae and Freddie Mac in 2008, Mr. Stanton served on the staff of the U.S. Financial Crisis Inquiry Commission (FCIC) and had the opportunity to interview former CEOs, senior officers and board members, risk officers, regulators, and policymakers to try to determine and document causes of the collapse of the two companies. After the Commission ended its work, Mr. Stanton published *Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Crisis* (Oxford University Press, 2012).

Alex J. Pollock is a resident fellow at the American Enterprise Institute in Washington DC, U.S.A., where he has worked since 2004. From 1991 to 2004, he was President and CEO of the Federal Home Loan Bank of Chicago, where he led the creation of the Mortgage Partnership Finance program (MPF) of the Federal Home Loan Banks. This program requires mortgage lenders to maintain a permanent credit risk "skin in the game" in mortgages sold; MPF mortgages demonstrated superior credit performance during the collapse of the U.S. housing bubble. Mr. Pollock focuses on financial policy issues and is the author of *Boom and Bust*

[1] Criteria for designating an institution as a Systemically Important Financial Institution are codified at 12 U.S. Code § 5323, "Authority to require supervision and regulation of certain nonbank financial companies." Implementing regulations of the Financial Stability Oversight Council, "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," are found in the *Federal Register*, vol. 77, no. 70, April 11, 2012, at pp. 21637-21662, codified at 12 CFR Part 1310.

[2] Mr. Stanton's 1991 book (at pp. 181-2) first presented the concept of contingent capital that is now being applied to major financial institutions to help improve their safety and soundness.

(2011), as well as numerous articles and Congressional testimony. He is the Lead Director of the CME Group, a director of the Great Lakes Higher Education Corporation, and a Past-President of the International Union for Housing Finance.

Resumes of the writers are presented in the Appendix to this letter.

Detailed Discussion

I. Fannie Mae and Freddie Mac are two of the largest and most highly leveraged financial institutions in the world. Fannie Mae is larger than JPMorgan or Bank of America; Freddie Mac is larger than Citigroup or Wells Fargo. Each of them funds trillions of dollars of mortgages and sells trillions of dollars of debt obligations and mortgage-backed securities (MBSs) throughout the financial system and around the world. The U.S. and the global economy have already experienced the systemic risk of Fannie Mae and Freddie Mac. Their flawed fundamental structure, compounded by serious mismanagement, caused them both to fail and trigger a massive taxpayer bailout in September 2008. Default on their obligations would have greatly exacerbated the financial crisis on a global basis.

Fannie Mae and Freddie Mac are government-sponsored enterprises (GSEs), a distinct organizational form that combines the incentives of a privately-owned firm with public "implicit guarantees" established in their congressional charters and other laws. Their government subsidies, and especially the combination of an implicit government guarantee of their obligations and high leverage permitted in their charters, allowed the two GSEs to expand their market share at a rapid pace. They virtually doubled in size every five years from Freddie Mac's chartering in 1970 to the early 2000s. One result of this rapid growth was that the two companies outran the capabilities of their organizational and technical systems[3] .

Their drive to maintain much higher leverage than was prudent for any lender, combined with the added risk they took during the housing bubble, meant that Fannie Mae and Freddie Mac failed in 2008, and were provided a $187 billion taxpayer bailout. Unlike those firms that successfully navigated the crisis, the leadership at Fannie Mae and Freddie Mac disregarded

[3] Federal Housing Finance Agency (FHFA) officials commented on the state of Fannie Mae's systems to the Financial Crisis Inquiry Commission:

> "John Kerr, the FHFA examiner (and an OCC veteran) in charge of Fannie examinations, labeled Fannie 'the worst-run financial institution' he had seen in his 30 years as a bank regulator. Scott Smith, who became associate director at FHFA…, concurred; …To Austin Kelly, an OFHEO examination specialist, there was no relying on Fannie's numbers, because their 'processes were a bowl of spaghetti.' Kerr and a colleague said that that they were struck that Fannie Mae, a multitrillion-dollar company, employed unsophisticated technology: it was less techsavvy than the average community bank."

Financial Crisis Inquiry Commission, *Final Report of the Financial Crisis Inquiry Commission*, 2011, pp. 321-322 (footnote omitted). See also e.g., Office of Federal Housing Enterprise Oversight. *Report of the Special Examination of Freddie Mac*, 2003; and Office of Federal Housing Enterprise Oversight, *Report of the Special Examination of Fannie Mae*, 2006.

warnings from their risk officers and others within their organizations about the financial mistakes that ultimately brought them down. Freddie Mac's CEO fired his Chief Risk Officer in 2005[4] and officials at Fannie Mae simply disregarded the company's Chief Risk Officer.[5]

The GSE is an organizational form that contains significant fundamental vulnerabilities. Writing in 1994, one of the writers of this letter suggested that GSEs, banks, and thrifts were "mercantilist" institutions, in the sense that their success depended as much on the political process, to expand their asset powers or other aspects of the balance between their benefits and burdens, as on the marketplace:

> "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....Unlike such companies, the management risk of a mercantilist institution may jump dramatically when it runs into the limits of its enabling legislation and managers feel themselves forced to take greater risks within their permitted markets."[6]

Precisely this happened to Fannie Mae and Freddie Mac in the early 2000s. Private-label securitization created a market for subprime and Alt-A mortgages through private-label securitization, and investors bought mortgage-related securities because they failed to understand the risks, both to themselves and to the financial system, and thought they were purchasing high quality "AAA" securities. Fannie Mae and Freddie Mac found themselves under pricing pressure and losing market share as mortgage originators securitized an increasing volume of loans through channels other than the GSEs. That led the two GSEs to take greater risks and make a major contribution to inflating the U.S. mortgage credit bubble in 2005-7, until the bubble reached its limits and burst. Fannie Mae and Freddie Mac themselves had become among the largest purchasers of nonprime loans and subprime private-label MBS.

The two companies are currently in conservatorship, a form of government control under which, in contrast to receivership, calls upon the government to restore the companies to a safe and sound condition to continue their business. Indeed, Fannie Mae and Freddie Mac's market share has become even greater than it was prior to their failure. That makes it appropriate for the FSOC now to designate Fannie Mae and Freddie Mac as SIFIs, in recognition of their continued huge size, extreme leverage, dependence on government credit support, and systemic risk.

---

[4] FCIC interview with Richard Syron, former Freddie Mac CEO, August 31, 2010, available from the FCIC website.
[5] Financial Crisis Inquiry Commission, *Final Report of the Financial Crisis Inquiry Commission*, 2011, p. 182.
[6] 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 Stone, Charles and Anne Zissu, *Global Risk Based Capital Regulations*, Vol. 1, Burr Ridge and New York: Irwin, 1994, pp. 90-91.

II. We respectfully urge that Fannie Mae and Freddie Mac be designated as Systemically Important Financial Institutions (SIFIs) so that the protective capital and regulatory standards applicable to SIFIs under the law can also be applied to them. These two giant mortgage credit institutions clearly meet the criteria specified by the Dodd-Frank Act and implementing regulations[7] for designation as a SIFI.

Many different kinds of institutions, including the two GSEs, failed in the financial crisis. In response the Congress enacted provisions of the Dodd-Frank Act creating the Financial Stability Oversight Council and directing FSOC to designate major non-bank institutions as systemically important, to designate all banks with assets over $50 billion as SIFIs, and to subject SIFIs to protective capital and regulatory standards. FSOC has now issued implementing regulations that set forth six criteria for designating a financial institution as a SIFI:

1. Size;
2. Interconnectedness;
3. Substitutability;
4. Leverage;
5. Liquidity Risk and Maturity Mismatch; and
6. Existing Regulatory Scrutiny.

Pursuant to this authority, in addition to the many large bank SIFIs, FSOC has already designated three nonbank financial institutions as SIFIs. All three are significantly smaller in assets than Fannie Mae and Freddie Mac.

1. Size

By total assets, Fannie Mae is larger than any of the existing bank or non-bank SIFIs, and Freddie Mac would rank fourth among all SIFIs. The following table shows the largest 20 existing SIFIs plus the two GSEs.

Size of GSEs and Largest 20 SIFIs

	Assets ($Trillions)
Fannie Mae	**$3.3**
JP Morgan Chase	2.4
Bank of America	2.1

[7] Criteria for designating an institution as a Systemically Important Financial Institution are codified at 12 U.S. Code § 5323, "Authority to require supervision and regulation of certain nonbank financial companies." Implementing regulations of the Financial Stability Oversight Council, "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," are found in the *Federal Register*, vol. 77, no. 70, April 11, 2012, at pp. 21637-21662, codified at 12 CFR Part 1310.

Freddie Mac	**2.0**
Citigroup	1.9
Wells Fargo	1.5
Goldman Sachs Group	0.9
Morgan Stanley	0.8
Prudential Financial	0.7
American International Group	0.5
General Electric Capital	0.5
Bank of New York Mellon	0.3
U.S. Bancorp	0.3
PNC Financial Services Group	0.3
Capital One Financial	0.3
HSBC North America Holdings	0.3
State Street	0.2
TD Bank US	0.2
BB&T	0.2
Suntrust Banks	0.2
American Express	0.2
Ally Financial	0.2

Source: Top 50 holding companies, National Information Center, Federal Reserve System, Fannie Mae, Form 10-K 2013, Freddie Mac, Form 10-K 2013, Prudential Financial, Inc., Form 10-K Year 2013

2. Interconnectedness

The obligations of Fannie Mae and Freddie Mac are widely held throughout the financial system and around the world, including by official bodies and by financial institutions. U.S. depository institutions hold about $1.4 trillion of their obligations; in addition, the Federal Reserve Banks hold $1.6 trillion in MBS, primarily those of the GSEs. Their obligations are granted preferential risk-based capital treatment, which means bank investors have less capital support against the risk of Fannie Mae and Freddie Mac. Since the two GSEs are themselves extremely leveraged, the combined systemic leverage when banks and the central bank hold their obligations becomes in the aggregate hyper-leverage.

The interconnectedness of GSE debt and mortgage-backed securities with the global financial system became clear in the financial crisis. As then-Secretary of the Secretary Henry Paulson recounted in his memoir of the financial crisis: "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] 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 go wiped out, that would be no different from expropriation. …They wanted to know if the U.S. would stand behind this implicit guarantee"-- and very importantly: "what this would imply for other U.S. obligations, such as Treasury bonds."[8]

In a revealing comment, Paulson added, "I was doing my best, in private meetings and dinners, to assure the Chinese that everything would be all right."[9]

3. Substitutability

Because of their huge ongoing government subsidies, Fannie Mae and Freddie Mac maintain the dominant role in the securitization of U.S. mortgages. Their balance sheets represent about 60% of total mortgage loans outstanding. Thousands of mortgage originators, servicers, investors and derivatives counterparties depend on the continued functioning and solvency of the two companies. Fannie Mae and Freddie Mac's role is critical and cannot be replaced in the short or medium term, as has already been seen in the inability of the U.S. Congress to pass any legislation to deal with ending their conservatorship status in the past five years.

4. Leverage

In addition to their massive size, Fannie Mae and Freddie Mac display extreme leverage. As of yearend 2013, Fannie Mae had $3.3 trillion in assets, compared to only $ 9.6 billion in total equity. It thus operates currently at leverage of 341:1, or with a leverage capital ratio of 0.29 %.[10] In similar fashion, Freddie Mac had about $2 trillion in assets, but only $ 12.8 billion in total equity, with leverage of 153:1 and a leverage capital ratio of 0.65%.[11]

5. Liquidity Risk and Maturity Mismatch

The American 30-year fixed-rate, freely prepayable mortgage loan is one of the most financially complex loans in the world to finance and hedge. Unlike the fixed-rate mortgages of most other countries, the prepayment risk of these mortgages is generally not offset by prepayment fees, which has caused the creation of a complex derivatives market which trades in modeled prepayment behavior. Fannie Mae and Freddie Mac together own about $500 billion of mortgages in their own portfolios, on an extremely leveraged basis, subjecting them to difficult to manage interest rate and prepayment risks. [12] This requires them to be major participants in offsetting derivatives and major counterparties in interest rate derivatives and options markets. Their MBS spread the complex behavior and risk of American 30-year fixed rate mortgages to many other investors and counterparties throughout the U.S. and in other countries.

---

[8] Henry M. Paulson, *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System*, p 159.
[9] Ibid., p. 160.
[10] Fannie Mae Form 10K for the Year 2013, p. 65.
[11] Freddie Mac, Form 10K for the Year 2013, p. 57.
[12] Fannie Mae Form 10K for the Year 2013, p. 99; Freddie Mac, Form 10K for the Year 2013, p. 171.

6. Existing Regulatory Scrutiny

U.S. residential mortgages are the largest loan market in the world. As the 2007-09 global crisis made clear, the entire financial system can be heavily exposed to the risks of this huge market, to an important extent through the widespread purchase of the MBS and debt of Fannie Mae and Freddie Mac. In spite of previous regulations and regulatory expansion, Fannie Mae and Freddie Mac are by far the largest concentration of mortgage loan risk in the world. Moreover, they are also active in the commercial real estate finance.

Real estate has a long and painful record of being at the center of banking collapses and financial crises. Fannie Mae and Freddie Mac concentrate the highly leveraged credit and asset price risk of the American mortgage market, as well as bearing significant interest rate risk.

In short, Fannie Mae and Freddie Mac are huge in size, huge in risk, and close to zero in capital. Protection of the financial system and the taxpayer purse requires additional prudential regulation to match their role: designation as SIFIs.

III. Fannie Mae and Freddie Mac continue to operate in "conservatorship" and have now amassed an even greater market share than before. Conservatorship status obligates the federal government, absent a change in the law, to return them to shareholder control once they have been stabilized financially. The Congress is considering a variety of legislative measures with respect to the two companies. Whether or not Congress changes the law, it is important for Fannie Mae and Freddie Mac to be designated as SIFIs.

In September 2008 the Federal Housing Finance Agency, regulator of Fannie Mae and Freddie Mac, determined that each GSE was considered "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."[13] The government placed the two GSEs into conservatorship, a legal status that allowed the government to assume "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…"[14]

As conservator, the government has a role that is carefully defined by law: the conservator may take actions that are "(i) necessary to put the regulated entity in a sound and solvent condition;

[13] Federal Housing Finance Agency, Memorandum from Christopher Dickerson, Acting Deputy Director, Division of Enterprise Regulation, to James B. Lockhart III, Director, Federal Housing Finance Agency, "Proposed Appointment of the Federal Housing Finance Agency as Conservator of the Federal National Mortgage Association," September 6, 2008, p. 3; and Federal Housing Finance Agency, Memorandum from Christopher Dickerson, Acting Deputy Director, Division of Enterprise Regulation, to James B. Lockhart III, Director, Federal Housing Finance Agency, "Proposed Appointment of the Federal Housing Finance Agency as Conservator of the Federal Home Loan Mortgage Corporation," September 6, 2008, p. 3; both available from the FCIC website.

[14] 12 U.S.C. Sec. 4617(b)(2)(A)(i).

and (ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity."[15]

In other words, in contrast to receivership, which would involve winding up the affairs of a company, conservatorship calls upon the government to restore the companies to a safe and sound condition to transact business. Consistent with this purpose, the government did not eliminate the shareholders of the two companies, a circumstance that has led to some speculation about the eventual value of shareholders' holdings of stock. Conservatorship does not seem intended to be a perpetual status for the two GSEs. Without a change in law, the government may not revoke the charters of the two companies.[16] If Fannie Mae and Freddie Mac again resume operations under private control, they will continue the subsidies and vulnerabilities of the charters that got them into trouble to begin with.

Therefore, it would be prudent to designate the two GSEs (whether or not there is a change in their charters) as systemically important non-bank financial institutions. This would appropriately subject them to higher capital standards and greater scrutiny than at present. Moreover, designating the two GSEs as SIFIs could help to provide policymakers with the appropriate context in which to enact any future legislation with respect to the companies or any successor organizations.

Conclusion

We respectfully request that the Financial Services Oversight Council designate Fannie Mae and Freddie Mac as SIFIs.

Designation as a SIFI subjects the designated institutions to increased requirements for absorptive capacity (capital), clarity of resolution procedures, and supervisory standards. These requirements should apply to Fannie Mae and Freddie Mac. Setting common standards for all SIFIs that compete with one another, such as GSEs and very large commercial banks, would greatly reduce the regulatory arbitrage that led trillions of dollars of mortgage funding to migrate to Fannie Mae and Freddie Mac before, and again since, the crisis.

Fannie Mae and Freddie Mac operate on a hyper-leveraged basis, they continue to rely utterly on government support and thus impose heavy risk on the public finances. The financial system is greatly in need of protection through the enhanced requirements of the SIFI designation.

We respectfully ask that FSOC direct the Office of Financial Research to prepare a full analysis of the financial aspects of Fannie Mae and Freddie Mac as compared to the criteria specified for SIFI designation in the FSOC regulations. Given the demonstrated systemic risk of the two companies and their holdings of over $3 trillion and $2 trillion, respectively, of mortgage risk,

[15] 12 USC Sec. 4617(b)(2)(D).
[16] 12 U.S.C. Sec. 4617(k).

we respectfully ask that FSOC then proceed to designate the two GSEs as systemically important non-bank financial institutions.

Thank you for your consideration of this policy proposal. Attached for your information (Appendix 2) is our companion letter to the Financial Stability Board.

Yours truly,

Thomas H. Stanton

Alex J. Pollock

APPENDIX 1: RESUMES OF THOMAS H. STANTON AND ALEX J. POLLOCK

THOMAS H. STANTON

Thomas H. Stanton has worked on issues relating to government-sponsored enterprises (GSEs), and Fannie Mae and Freddie Mac in particular, for over 30 years. He has written about GSEs, testified before Congress on matters relating to GSEs, and served at the Financial Crisis Inquiry Commission as a staff member responsible for researching Fannie Mae and Freddie Mac. Mr. Stanton is a Fellow of the Center for Advanced Governmental Studies at Johns Hopkins University and has taught there since 1993, including courses on the mortgage market and the financial crisis. He received the Jesse Burkhead Award for Best Article in the journal *Public Budgeting & Finance* in 2008 for an analysis of Sallie Mae, another GSE. Mr. Stanton has been an invited speaker three times at the Conference on Bank Structure and Competition of the Federal Reserve Bank of Chicago. He earned his B.A. degree from the University of California at Davis, M.A. from Yale University, and J.D. from the Harvard Law School.

Mr. Stanton has written extensively about government-sponsored enterprises, including the first book written on GSEs, *A State of Risk: Will Government Sponsored Enterprises be the Next Financial Crisis?* (HarperBusiness, 1991). Based on his analysis in that book, that Fannie Mae and Freddie Mac were too highly leveraged and lacked adequate supervision, he sought legislation to create an effective regulator for the two GSEs. That effort helped lead to enactment of the 1992 law creating the Office of Federal Housing Enterprise Oversight (OFHEO), the predecessor organization to the current regulator of the two GSEs, the Federal Housing Finance Agency (FHFA).[17] The book also presented for the first time (at pp. 181-2) the idea of contingent capital that currently is being applied to major financial firms.
In 2002, he wrote *Government-Sponsored Enterprises: Mercantilist Companies in the Modern Age* (AEI Press). A book review in *Public Budgeting & Finance* called this book “authoritative” and “an indispensable tool for the public finance professor.”[18]

Mr. Stanton’s other writings on government-sponsored enterprises include a 1989 article, “Government Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability," (coauthored with Ronald C. Moe) in *Public Administration Review*, July/August 1989; “Government Corporations and Government Sponsored Enterprises,” Chapter 3 in *Tools of Government: A Guide to the New Governance*, Lester M. Salamon, Editor, Oxford University Press, 2002 (coauthored with Ronald C. Moe); “A Fannie and Freddie for the 21st Century,” *The Wall Street Journal*, June 17, 2003; “The

[17] “…perhaps the most effective advocate for safety and soundness regulation has been a private individual: Thomas Stanton…Stanton’s 1991 book *State of Risk* and his personal lobbying were influential in the legislative process leading to the passage of the [1992 Federal Housing Enterprises Financial Safety and Soundness Act].” Jonathan G.S. Koppell, *The Politics of Quasi-Government*, Cambridge University Press, 2003, p. 107.

[18] *Public Budgeting & Finance*, winter 2003, pp. 114-116.

Life Cycle of the Government-Sponsored Enterprise: Lessons for Design and Accountability," *Public Administration Review*, September/October 2007; "Government-Sponsored Enterprises: Reality Catches up to Public Administration Theory," *Public Administration Review*, July/August, 2009, and "The Failure of Fannie Mae and Freddie Mac and the Future of Government Support for the Housing Finance System," *Journal of Law and Policy*, vol. 18, no. 1, 2009; "What Comes Next After Fannie Mae and Freddie Mac?" *Public Administration Review*, November/December 2013, and two articles in *American Banker*.

Mr. Stanton has prepared studies and reports and supporting analyses on GSEs for a variety of clients including the Government Accountability Office (then the General Accounting Office), Congressional Budget Office, and the Financial Management Service of the U.S. Treasury. He has also testified numerous times before congressional committees on GSEs, including testimony titled, "Fannie Mae and Freddie Mac: What Happened and Where do We Go From Here?" before the House Committee on Government Reform and Oversight, on December 9, 2008.

In 2010-2011 Mr. Stanton served on the staff of the U.S. Financial Crisis Inquiry Commission with lead responsibility for much of the Commission's work concerning Fannie Mae and Freddie Mac. He had the opportunity to interview numerous CEOs, risk officers, loan officers, regulators, and policymakers, including many interviews with officials at Fannie Mae and some with officials of Freddie Mac, including CEOs, senior officers, and risk officers. After the commission ended its work he wrote a book, *Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Crisis* (Oxford University Press, 2012), comparing four firms that successfully navigated the crisis with eight (including Fannie Mae and Freddie Mac) that did not. In March 2013 he was invited to participate in a conference on the financial crisis at the KoGuan Law School of the Shanghai Jiao Tong University and to speak at other universities in Shanghai and Hong Kong. His remarks at that conference have been incorporated into an article, "Why Some Firms Thrive While Others Fail: Governance and Management Lessons From the Crisis" (公司浮沉背后：从次债危机中汲取金融监管与内部治理的经验教训), *Shanghai Jiao Tong University Law Review*, in press, 2014

Mr. Stanton is a specialist in organizational design and management and edited or coedited several books including *Making Government Manageable*, Johns Hopkins University Press, 2004; *Meeting the Challenge of 9/11: Blueprints for Effective Government*, M.E. Sharpe Publishers, 2006; and *Managing Risk and Performance: A Guide for Government Decision Makers*, John Wiley & Sons, 2014. For six years he served as Chair of the Standing Panel on Executive Organization and Management of the National Academy of Public Administration and also served two terms on the Academy's Board of Directors. Mr. Stanton is President-Elect of the Association of Federal Enterprise Risk Management (AFERM) and served as a member of the U.S. federal Senior Executive Service for almost five years.

ALEX J. POLLOCK

EXPERIENCE

Present	**Resident Fellow, American Enterprise Institute, Washington DC,**
	Lead Independent Director, CME Group, Chicago
	Director, Great Lakes Higher Education Corp., Madison, Wisconsin
	Chairman of the Board, Great Books Foundation, Chicago
1991-2004	**President and CEO, Federal Home Loan Bank of Chicago**
1999-2001	**President, International Union for Housing Finance**
1991	**Visiting Scholar, Federal Reserve Bank of St. Louis**
1988-1990	**President and CEO, Community Federal Savings, St. Louis**
1969-1987	**Positions of increasing responsibility in international and commercial banking**

EDUCATION

B.A. cum laude, Williams College, Williamstown, Massachusetts

M.A., University of Chicago

M.P.A., Princeton University

PUBLICATIONS

***Boom and Bust, Financial Cycles and Human Prosperity*, 2011**

More than 200 articles, opinion pieces, Congressional testimony, and conference presentations on housing finance, the role of Fannie Mae and Freddie Mac, banking, central banking, financial systems, risk and uncertainty, the politics of finance, corporate governance, regulation, retirement finance, and other financial issues

The One-Page Mortgage Information Form

"The Mystery of Banking" (poem)

PATENT

Management System for Risk Sharing of Mortgage Pools, 1999

OTHER

Prairie Institute American Enterprise Award, 1998

APPENDIX 2: COMPANION LETTER TO THE FINANCIAL STABILITY BOARD

Alex J. Pollock
American Enterprise Institute
1150 17th Street, N.W.
Washington, D.C. 20036
U.S.A.

Thomas H. Stanton
1301 Pennsylvania Avenue, NW
Suite 700
Washington, DC 20004
U.S.A.

March 31, 2014

Secretariat
Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel, Switzerland
By E-Mail: fsb@bis.org

Subject: Comments on Consultative Document, "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions," 8 January 2014

To the Financial Stability Board:

Thank you for the opportunity to comment on the Consultative Document, "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions," that the FSB issued on January 8, 2014. In our comments we would like to make two main points:

I. **Because non-bank non-insurer global systemically important financial institutions (NBNI G-SIFIs) vary widely, the FSB's work will be enhanced by creating a process for informed parties to submit recommendations for institutions to be designated as NBNI G-SIFIs.**

II. **In keeping with this recommendation, we respectfully urge that the FSB consider two U.S. multi-trillion dollar mortgage credit institutions, Fannie Mae**

and Freddie Mac, and designate them as NBNI G-SIFIs once the FSB has made a final determination of its assessment methodologies. There are compelling reasons for this recommendation:

A. **Fannie Mae and Freddie Mac are two of the largest and most highly leveraged financial institutions in the world. Fannie Mae is larger than JPMorgan or Deutsche Bank; Freddie Mac is larger than Citigroup or Societe Generale or Wells Fargo. Each of them funds trillions of dollars of mortgages and sells trillions of dollars of debt obligations and mortgage-backed securities (MBSs) around the world. The global economy has already experienced the systemic risk of Fannie Mae and Freddie Mac. Their flawed fundamental structure, compounded by serious mismanagement, caused them both to fail and trigger a massive taxpayer bailout in September 2008, but they both continue to operate and now have amassed an even greater market share than before.**

B. Fannie Mae and Freddie Mac clearly meet the criteria specified in the Consultative Document of January 8, 2014, for designation as NBNI G-SIFIs.

C. Fannie Mae and Freddie Mac should be designated as NBNI G-SIFIs so that the protective capital, resolution, and regulatory standards applicable to NBNI G-SIFIs can also be applied to them, in order to reduce the significant risk they pose to the global financial system.

The writers of this letter have studied both historical crises and the most recent financial crisis in some depth, and the roles of Fannie Mae and Freddie Mac, in particular. Alex J. Pollock is a resident fellow at the American Enterprise Institute in Washington DC, U.S.A., where he has worked since 2004. From 1991 to 2004, he was President and CEO of the Federal Home Loan Bank of Chicago, where he led the creation of the Mortgage Partnership Finance program (MPF) of the Federal Home Loan Banks. This program requires mortgage lenders to maintain a permanent credit risk "skin in the game" in mortgages sold; MPF mortgages demonstrated superior credit performance during the collapse of the U.S. housing bubble. Mr. Pollock focuses on financial policy issues and is the author of *Boom and Bust* (2011), as well as numerous articles and Congressional testimony. He is the Lead Director of the CME Group, a director of the Great Lakes Higher Education Corporation, the Chairman of the Board of the Great Books Foundation, and a Past-President of the International Union for Housing Finance.

Thomas H. Stanton has written extensively about Fannie Mae and Freddie Mac. In 1991 he published *A State of Risk: Will Government Sponsored Enterprises be the Next Financial Crisis?* (HarperCollins). He worked with the U.S. Treasury Department and other governmental bodies to seek enactment of improved capital standards and supervision of safety and soundness of the two companies.[1] Regrettably, that effort proved unsuccessful in the long run. After the failure of Fannie Mae and Freddie Mac in 2008, Mr. Stanton served on the staff of the U.S. Financial Crisis Inquiry Commission (FCIC) and had the opportunity to interview former CEOs, senior officers and board members, risk officers, regulators, and policymakers to try to determine and document causes of the collapse of the two companies. After the Commission ended its work, Mr. Stanton published *Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Crisis* (Oxford University Press, 2012).

Resumes of the writers are presented in the Appendix to this letter.

Detailed Discussion

I. Because non-bank non-insurer global systemically important financial institutions (NBNI G-SIFIs) vary widely, the FSB's work will be enhanced by creating a process for informed parties to submit recommendations for institutions to be designated as NBNI G-SIFIs.

Non-bank non-insurer global systemically important financial institutions (NBNI G-SIFIs) vary widely in scope and function. The Consultative Document itself makes this point:

> "Unlike the methodologies for G-SIBs and G-SIIs developed by the Basel Committee on Banking Supervision (BCBS) and the International Association of Insurance Supervisors (IAIS), respectively, methodologies for identifying NBNI G-SIFIs have to be applicable to a wide range of NBNI financial entities that often have very different legal forms, business models and risk profiles."[2]

The financial system includes funding from a wide variety of sources, many volatile. The U.S. Financial Crisis Inquiry Commission surveyed funding from so-called "shadow banks" and found it to include "commercial paper and other short-term borrowing (bankers acceptances), repo, net securities loaned, liabilities of asset-backed securities issuers, and money market mutual fund assets."[3] Reflecting these funding sources, the Consultative Document addresses three types of institution: (1) finance companies, (2) market intermediaries (securities broker-dealers), and (3) investment funds.

Given the central and repeated role of real estate in many financial crises, we believe to these categories must be added mortgage credit institutions. Mortgages often figure in financial crises

[1] Mr. Stanton's 1991 book (at pp. 181-2) first presented the concept of contingent capital that is now being applied to major financial institutions to help improve their safety and soundness.
[2] Consultative Document, "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions," 8 January 2014, p. 5 (footnote omitted).
[3] Financial Crisis Inquiry Commission, *Final Report of the Financial Crisis Inquiry Commission*, 2011, p. 32.

because they combine both long-term claims funded with much shorter-term liabilities, and the price risk of illiquid real estate assets.

The role of NBNI G-SIFIS changes over financial cycles—they grow riskier in a boom. As the US Financial Crisis Inquiry Commission documented, many types of funding vehicles emerged and evolved rapidly in the run-up to the financial crisis of 2008: "[O]ver the past 30-plus years, we permitted the growth of a shadow banking system—opaque and laden with short term debt—that rivaled the size of the traditional banking system."[4]

Similarly, in the run-up to the Great Depression, the role of such institutions also grew substantially. The head of the Federal Reserve Bank of New York, George Harrison testified to the U.S. Congress about borrowing that had fueled excessive stock market speculation in 1928 and 1929. The Federal Reserve tried to dampen speculation, Mr. Harrison said, by raising rates on loans to stock brokers and dealers. However, the Fed action affected only regulated institutions; lenders in what he called the "bootleg banking system," outside of the Fed's purview, only increased their lending as the Fed's actions raised the costs of bank loans:

> "At one time over half the total volume of money borrowed by brokers and dealers was money advanced in that fashion. It was money that was totally outside of the control of the banking system; It was money loaned by lenders who had no responsibility to the money market or to the banking system."[5]

Given the variety of potential NBNI G-SIFIs and the possibility that their contribution to systemic risk can grow rapidly, it would benefit the oversight system of the FSB to create a process, supplementing other processes already in place, to permit and encourage informed people from all countries to file comments about the emergence, growth and riskiness of non-bank non-insurance institutions in the financial sector.

II. In keeping with this recommendation, we respectfully urge that the FSB consider two U.S. multi-trillion dollar mortgage credit institutions, Fannie Mae and Freddie Mac, and identify them as NBNI G-SIFIs once the FSB has made a final determination of its assessment methodologies. There are compelling reasons for this recommendation:

A. Fannie Mae and Freddie Mac are two of the largest and most highly leveraged financial institutions in the world. Fannie Mae is larger than JPMorgan or Deutsche Bank; Freddie Mac is larger than

[4] Financial Crisis Inquiry Commission, *Final Report of the Financial Crisis Inquiry Commission*, 2011, p. xx.
[5] George L. Harrison, Governor of the Federal Reserve Bank of New York, testimony before the Senate Committee on Banking and Currency, hearing on "Operation of the National and Federal Reserve Banking Systems," January 20, 1931, p. 66.

Citigroup or Societe Generale or Wells Fargo. Each of them funds trillions of dollars of mortgages and sells trillions of dollars of debt obligations and mortgage-backed securities (MBSs) internationally. The global economy has already experienced the systemic risk of Fannie Mae and Freddie Mac. Their flawed fundamental structure, compounded by serious mismanagement, caused them both to fail and trigger a massive taxpayer bailout in September 2008, but they both continue to operate and now have amassed even greater market share than before.

Fannie Mae and Freddie Mac are government-sponsored enterprises (GSEs), a distinct organizational form that combines the incentives of a privately-owned firm with public "implicit guarantees" established in their congressional charters and other laws. Their government subsidies, and especially the combination of an implicit government guarantee of their obligations and high leverage permitted in their charters, allowed the two GSEs to expand their market share at a rapid pace. They virtually doubled in size every five years from Freddie Mac's chartering in 1970 to the early 2000s. One result of this rapid growth was that the two companies outran the capabilities of their organizational and technical systems[6] .

Their drive to maintain much higher leverage than was prudent for any lender, combined with the added risk they took in the years just before 2008, meant that Fannie Mae and Freddie Mac failed in 2008, and were provided a $187 billion taxpayer bailout. Unlike those firms that successfully navigated the crisis, the leadership at Fannie Mae and Freddie Mac disregarded warnings from their risk officers and others within their organizations about the financial mistakes that ultimately brought them down. Freddie Mac's CEO fired his Chief Risk Officer in 2005[7] and officials at Fannie Mae simply disregarded the company's Chief Risk Officer.[8]

The GSE is an organizational form that contains significant fundamental vulnerabilities. Writing in 1994, one of the writers of this letter suggested that GSEs, banks, and thrifts were "mercantilist" institutions, in the sense that their success depended as much on the political

---

[6] Federal Housing Finance Agency (FHFA) officials commented on the state of Fannie Mae's systems to the Financial Crisis Inquiry Commission:

> "John Kerr, the FHFA examiner (and an OCC veteran) in charge of Fannie examinations, labeled Fannie 'the worst-run financial institution' he had seen in his 30 years as a bank regulator. Scott Smith, who became associate director at FHFA…, concurred; …To Austin Kelly, an OFHEO examination specialist, there was no relying on Fannie's numbers, because their 'processes were a bowl of spaghetti.' Kerr and a colleague said that that they were struck that Fannie Mae, a multitrillion-dollar company, employed unsophisticated technology: it was less techsavvy than the average community bank."

Financial Crisis Inquiry Commission, *Final Report of the Financial Crisis Inquiry Commission*, 2011, pp. 321-322 (footnote omitted). See also e.g., Office of Federal Housing Enterprise Oversight. *Report of the Special Examination of Freddie Mac*, 2003; and Office of Federal Housing Enterprise Oversight, *Report of the Special Examination of Fannie Mae*, 2006.

[7] FCIC interview with Richard Syron, former Freddie Mac CEO, August 31, 2010, available from the FCIC website.

[8] Financial Crisis Inquiry Commission, *Final Report of the Financial Crisis Inquiry Commission*, 2011, p. 182.

process, to expand their asset powers or other aspects of the balance between their benefits and burdens, as on the marketplace:

> "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....Unlike such companies, the management risk of a mercantilist institution may jump dramatically when it runs into the limits of its enabling legislation and managers feel themselves forced to take greater risks within their permitted markets."[9]

Precisely this happened to Fannie Mae and Freddie Mac in the early 2000s. Private-label securitization created a market for subprime and Alt-A mortgages through private-label securitization, and investors bought mortgage-related securities because they failed to understand the risks, both to themselves and to the financial system, and thought they were purchasing high quality "AAA" securities. Fannie Mae and Freddie Mac found themselves under pricing pressure and losing market share as mortgage originators securitized an increasing volume of loans through channels other than the GSEs. That led the two GSEs to take greater risks and make a major contribution to inflating the U.S. mortgage credit bubble in 2005-7, until the bubble reached its limits and burst. Fannie Mae and Freddie Mac themselves had become among the largest purchasers of nonprime loans and subprime private-label MBS.

In September 2008 the Federal Housing Finance Agency, regulator of Fannie Mae and Freddie Mac, determined that each GSE was considered "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."[10] The two companies are currently in conservatorship, a form of government control under which the government is required to take actions that are "(i) necessary to put the regulated entity in a sound and solvent condition; and (ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity."[11]

---

[9] 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 Stone, Charles and Anne Zissu, *Global Risk Based Capital Regulations*, Vol. 1, Burr Ridge and New York: Irwin, 1994, pp. 90-91.

[10] Federal Housing Finance Agency, Memorandum from Christopher Dickerson, Acting Deputy Director, Division of Enterprise Regulation, to James B. Lockhart III, Director, Federal Housing Finance Agency, "Proposed Appointment of the Federal Housing Finance Agency as Conservator of the Federal National Mortgage Association," September 6, 2008, p. 3; and Federal Housing Finance Agency, Memorandum from Christopher Dickerson, Acting Deputy Director, Division of Enterprise Regulation, to James B. Lockhart III, Director, Federal Housing Finance Agency, "Proposed Appointment of the Federal Housing Finance Agency as Conservator of the Federal Home Loan Mortgage Corporation," September 6, 2008, p. 3; both available from the FCIC website.

[11] 12 USC Sec. 4617(b)(2)(D).

In contrast to receivership, conservatorship calls upon the government to restore the companies to a safe and sound condition and continue their business. Indeed, Fannie Mae and Freddie Mac's market share is now even greater than it was prior to their failure. That makes it appropriate for the FSB now to designate Fannie Mae and Freddie Mac as NBNI G-SIFIs, in recognition of their continued huge size, extreme leverage, dependence on government credit support, and systemic risk.

B. Fannie Mae and Freddie Mac fall clearly within the criteria specified in the Consultative Document of January 8, 2014, for designation as NBNI G-SIFIs.

Many different kinds of institutions failed in the financial crisis, as the two GSEs did. In response governments around the world responded by increasing regulation and supervision, especially of large systemically important financial institutions. Consistent with the global recognition that nonbanks, and not merely banks, pose risks to the global financial system, the FSB has now issued a framework and five indicators for designating a financial institution as an NBNI G-SIFI:

1. Size;
2. Interconnectedness;
3. Substitutability;
4. Complexity; and
5. Global activities (cross-jurisdictional activities).

1. <u>Size</u>

While the numerical criteria for designation of institutions as NBNI G-SIFIs must await further FSB action, it seems likely that the numerical criteria for NBNI G-SIFIs will be consistent with those that the FSB has prescribed for G-SIBs. To date, the FSB has designated 29 banks as G-SIBs.

By total assets, Fannie Mae is larger than any of these G-SIBs, and Freddie Mac ranks among the largest of the G-SIBs, as the following table shows:

SIZE OF GSEs and G-SIBs

	Assets ($ Trillions)
Fannie Mae	**$3.3**
Industrial and Commercial Bank of China	3.1
HSBC	2.7
Group Crédit Agricole	2.6
BNP Paribas	2.5

Mitsubishi UFJ FG	2.5
JPMorgan Chase	2.5
Deutsche Bank	2.4
Barclays	2.3
Bank of China	2.2
Bank of America	2.1
Freddie Mac	**2.0**
Citigroup	1.9
Mizuho FG	1.9
Royal Bank of Scotland	1.8
Société Générale	1.7
Santander	1.6
Group BPCE	1.6
Sumitomo Mitsui FG	1.5
Wells Fargo	1.5
Unicredit Group	1.2
UBS	1.2
ING Bank	1.1
Credit Suisse	1.0
Goldman Sachs	0.9
Nordea	0.8
Morgan Stanley	0.8
BBVA	0.8
Standard Chartered	0.6
Bank of New York Mellon	0.4
State Street	0.2

Source: "Largest 100 banks in the world", SNL Financial
Fannie Mae, Form 10-K 2013
Freddie Mac, Form 10-K 2013
"Top US Banks in Q4'13", SNL Financial

In addition to their massive size, at the top or in the high end of the G-SIB rankings, Fannie Mae and Freddie Mac display extreme leverage. As of yearend 2013, Fannie Mae had $3.3 trillion in assets, compared to only $ 9.6 billion in total equity. It thus operates currently at leverage of 341:1, or with a leverage capital ratio of 0.29 %.[12] In similar fashion, Freddie Mac had about $2 trillion in assets, but only $ 12.8 billion in total equity, with leverage of 153:1 and a leverage capital ratio of 0.65%.[13]

[12] Fannie Mae Form 10K for the Year 2013, p. 65.
[13] Freddie Mac, Form 10K for the Year 2013, p. 57.

In sum, Fannie Mae and Freddie Mac are huge in size, huge in risk, and close to zero in capital. Protection of the global financial system and the taxpayer purse requires prudential regulation to match their role: designation as a NBNI G-SIFI.

2. Interconnectedness

The obligations of Fannie Mae and Freddie Mac are widely held around the world including by official bodies and by financial institutions. U.S. depository institutions hold about $1.4 trillion of their obligations; in addition, the Federal Reserve Banks hold $1.6 trillion in MBS, primarily those of the GSEs. Their obligations are granted preferential risk-based capital treatment, which means bank investors have less capital support against the risk of Fannie Mae and Freddie Mac. Since the two GSEs are themselves extremely leveraged, the combined systemic leverage when banks and the central bank hold their obligations becomes in the aggregate hyper-leverage.

The interconnectedness of GSE debt and mortgage-backed securities with the global financial system became clear in the financial crisis. As then-Secretary of the Secretary Henry Paulson recounted in his memoir of the financial crisis: "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] 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 go wiped out, that would be no different from expropriation. …They wanted to know if the U.S. would stand behind this implicit guarantee"-- and very importantly: "what this would imply for other U.S. obligations, such as Treasury bonds."[14]

In a revealing comment, Paulson added, "I was doing my best, in private meetings and dinners, to assure the Chinese that everything would be all right."[15]

3. Substitutability

Because of their huge government subsidies Fannie Mae and Freddie Mac maintain the dominant role in the securitization of U.S. mortgages. Their balance sheets represent about 60% of total mortgage loans outstanding. Thousands of mortgage originators, servicers, investors and derivatives counterparties depend on the continued functioning and solvency of the two companies. Fannie Mae and Freddie Mac's role is critical and cannot be replaced in the short or medium term, as has already been seen in the inability of the U.S. Congress to pass any legislation to deal with ending their conservatorship status in the past five years.

[14] Henry M. Paulson, *On the Brink: Inside the Race to Stop the Collapse of the Global Financial System*, p 159.
[15] Ibid., p. 160.

4. Complexity

The American 30-year fixed-rate, freely prepayable mortgage loan is one of the most financially complex loans in the world to finance and hedge. Unlike in most other countries, the prepayment risk of these mortgages is generally not offset by prepayment fees, which has caused the creation of a complex derivatives market which trades in modeled prepayment behavior. Fannie Mae and Freddie Mac together own about $500 billion of mortgages in their own portfolios, on an extremely leveraged basis, subjecting them to difficult to manage interest rate and prepayment risks.[16] This requires them to be major participants in offsetting derivatives and major counterparties in interest rate derivatives and options markets. Their MBS spread the complex behavior and risk of American 30-year fixed rate mortgages to many other investors and counterparties in the U.S. and other countries.

5. Global (cross-jurisdictional) activities

U.S. residential mortgages are the largest loan market in the world. As the 2007-09 global crisis made clear, the international financial system can be heavily exposed to the risks of this huge market, especially through the widespread international purchase of the MBS and debt of Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac are by far the largest concentration of mortgage loan risk in the world. Moreover, they are active in the commercial real estate risks of apartment building ("multi-family") finance.

Real estate has a long and painful record of being at the center of banking collapses and financial crises. Fannie Mae and Freddie Mac spread the highly leveraged credit, price, and unique interest rate risks of American real estate to many other national financial systems.

C. Fannie Mae and Freddie Mac should be designated as NBNI G-SIFIs so that protective capital, resolution, and regulatory standards applicable to NBNI SIFIs can be applied to them, in order to reduce the significant risk they pose to the global financial system.

Designation as a SIFI, whether a G-SIB or an NBNI SIFI, subjects the designated institutions to increased requirements for absorptive capacity (capital), clarity of resolution procedures, and supervisory standards that the FSB prescribes for international coordination. These requirements, based on an internationally recognized framework, would aptly apply to Fannie Mae and Freddie Mac. The imposition of common standards for SIFIs that compete with one another, such as

[16] Fannie Mae Form 10K for the Year 2013, p. 99; Freddie Mac, Form 10K for the Year 2013, p. 171.

GSEs and commercial banks, would help to diminish the regulatory arbitrage that led trillions of dollars of mortgage funding to migrate to Fannie Mae and Freddie Mac before and since the crisis.

Fannie Mae and Freddie Mac operate on a hyper-leveraged basis and continue to rely utterly on government support and thus impose heavy risk on the public finances. The global financial system is greatly in need of protection through the enhanced requirements of the NBNI G-SIFI designation.

The Chairman of the Financial Stability Board and Governor of the Bank of England, Mark Carney, has written that "Ending too-big-to-fail" is a priority.[17] Ending too-big-to-fail is an ambitious goal that certainly cannot be achieved without addressing the systemic risk of Fannie Mae and Freddie Mac.

Conclusion

We respectfully request that the Financial Stability Board (1) create a procedure that allows and encourages informed parties to submit recommendations for institutions to be designated as NBNI G-SIFIs, and (2) consider two multi-trillion dollar mortgage credit institutions, Fannie Mae and Freddie Mac, and designate them as NBNI G-SIFIs once the FSB has made a final determination of its assessment methodologies.

We respectfully ask that the FSB prepare a full analysis of the financial aspects of Fannie Mae and Freddie Mac so that they can be designated NBNI G-SIFIs, once the FSB has issued the final version of its Assessment Methodologies. Given the demonstrated global systemic significance of the two companies, their extremely high leverage, their holdings or guarantees of over $3 trillion and $2 trillion, respectively, of mortgage risk, and sales around the world of a commensurate amount of debt obligations and MBSs, we have no doubt that the two institutions will meet those criteria.

Thank you for your consideration of these comments on the Consultative Document.

Yours truly,

Alex J. Pollock

Thomas H. Stanton

[17] Mark Carney, Chairman, Financial Stability Board, "Financial Reforms -- Progress and Challenges," memorandum to G20 Finance Ministers and Central Bank Governors, February 17, 2014, p. 2.