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November 27, 2017

The Honorable Steven Mnuchin
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 Mnuchin:

The Treasury Department has just issued a new review of "Financial Stability Oversight Designations,"[1] and we are writing to you in your capacity as Chairman of the Financial Stability Oversight Council (FSOC) that is responsible for implementing financial stability oversight designations. In the context of FSOC's responsibility to address systemic financial risk, we would like to address a major omission in its past work, and 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 Wells Fargo or Citigroup. They fund trillions of dollars of mortgages and sell trillions of dollars of mortgage-backed securities and debt throughout the financial system and around the world. The U.S. and the global economy have already experienced the reality of the systemic risk of Fannie Mae and Freddie Mac. When their flawed fundamental structure, compounded by mismanagement, caused them both to fail in September 2008, there can be no doubt that without a bailout, default on their obligations would have greatly exacerbated the financial crisis on a global basis.**

[1] Department of the Treasury, "Financial Stability Oversight Council Designations," Report to the President of the United States, November 17, 2017.

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 all of the criteria specified by the Dodd-Frank Act and implementing regulations[2] for designation as a SIFI. They also meet the international criteria of the Financial Stability Board for designation as a Global SIFI (G-SIFI).

III. Fannie Mae and Freddie Mac continue to operate in "conservatorship" and now have an even greater market share than before, based on an effective guarantee of all their obligations and mortgage-backed securities by the U.S. Treasury. Conservatorship status obligates the federal government, absent a change in the law, to return them to shareholder control after they have been stabilized financially. The Congress has, with much accompanying debate but no action so far, considered a variety of legislative reform measures with respect to the two companies. Whether or not Congress changes the law, we believe it is essential for Fannie Mae and Freddie Mac to be designated as SIFIs.

<u>**Detailed Discussion**</u>

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 Wells Fargo or Citigroup. They fund trillions of dollars of mortgages and sell trillions of dollars of mortgage-backed securities and debt throughout the financial system and around the world. The U.S. and the global economy have already experienced the reality of the systemic risk of Fannie Mae and Freddie Mac. When their flawed fundamental structure, compounded by mismanagement, caused them both to fail in September 2008, there can be no doubt that without a bailout, 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 unfortunately combines the incentives of a privately-owned firm with public "implicit guarantees" established in their congressional charters and other laws. Their

[2] 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.

government subsidies, and especially the combination of an implicit, but very real, government guarantee of their obligations and extreme 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 and outran the capabilities of their organizational and technical systems.

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, as is well known, failed in 2008, and were provided a $187 billion taxpayer bailout.

The GSE is an organizational form that contains significant fundamental vulnerabilities. Writing in 1994, one of the writers of this letter, Thomas H. Stanton, suggested that GSEs were "mercantilist" institutions. This means their success depended on politics more than market acumen, in order to run at high leverage, enjoy large taxpayer subsidies, and expand their asset powers and other aspects of the balance between their benefits and burdens:

> "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."[3]

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, and investors, including Fannie Mae and Freddie Mac, bought the resulting mortgage-related securities because they failed to understand the risks, both to themselves and to the financial system. Fannie Mae and Freddie Mac found themselves under pricing pressure and losing market share. That led the two GSEs to take greater risks and make a major contribution to inflating the U.S. mortgage credit bubble in 2005-07, until the bubble collapsed. Fannie Mae and Freddie Mac themselves had become among the largest purchasers of nonprime loans and subprime private-label MBS.

Since 2008, the two companies have been in conservatorship, a form of government control which, in contrast to receivership, calls upon the government to restore the companies to a safe and sound condition and continue their business. Since 2008, the government has guaranteed all the obligations of Fannie Mae and Freddie Mac even more clearly than before. Meanwhile, Fannie Mae and Freddie Mac's market share and leverage have become even greater than they were prior to their failure.

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[3] 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.

This makes it necessary for FSOC now to designate Fannie Mae and Freddie Mac as SIFIs, in recognition of their continued huge size, extreme leverage, utter dependence on government credit support, and systemic risk.

We also point to the emphasis the recent Treasury report gives to parity across financial institutions: "Firms engaged in the same activity should be treated uniformly based on how the activity may contribute to risk. Failure to do so could distort free markets."[4] This is especially true of Fannie Mae and Freddie Mac, which operated with much lower capital requirements than are prescribed for commercial banks and other depository institutions. Failure to correct this disparity allows the markets to arbitrage across different capital requirements to send trillions of dollars of mortgages to the GSEs where capital standards were and are the lowest. The vulnerability of the financial system was and is correspondingly greater.

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 all of the criteria specified by the Dodd-Frank Act and implementing regulations for designation as a SIFI. They also meet the international criteria of the Financial Stability Board for designation as a Global SIFI (G-SIFI).

The two GSEs, and many other institutions, failed in the financial crisis. The Congress enacted provisions of the Dodd-Frank Act creating the Financial Stability Oversight Council and giving FSOC the power to designate major non-bank institutions as systemically important, thus joining all banks with assets over $50 billion as possible SIFIs, and to subject non-bank SIFIs to protective capital and regulatory standards. FSOC has 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, FSOC designated large insurance companies and a finance company to be SIFIs, but so far has ignored the glaringly obvious cases of Fannie Mae and Freddie Mac, which are far larger and far more leveraged than any of the others.

[4] "Financial Stability Oversight Council Designations," p. 9.

We consider how FSOC's own criteria unquestionably show that Fannie Mae and Freddie Mac qualify as SIFIs.

1. Size

In its balance sheet size, Fannie Mae is the largest of any of the existing bank or non-bank SIFIs, and Freddie Mac would rank fourth among all SIFIs at year-end 2016. The following table shows the largest 20 existing SIFIs plus the two GSEs at December 31, 2016.

Size of GSEs and Largest 20 SIFIs

	Total Assets ($Trillions)
Fannie Mae	**$3.3**
JP Morgan Chase	2.5
Bank of America	2.2
Freddie Mac	**2.0**
Wells Fargo	1.9
Citigroup	1.8
Goldman Sachs	0.9
Morgan Stanley	0.8
Prudential Financial	0.8
U.S. Bancorp	0.4
PNC Financial Services	0.4
Capital One Financial	0.4
TD Group US	0.3
Bank of New York Mellon	0.3
HSBC North America	0.3
State Street	0.2
BB&T	0.2
Credit Suisse USA	0.2
Suntrust	0.2
Barclays US	0.2
DB USA	0.2
Ally Financial	0.2

Source: Top 50 holding companies, National Information Center; Federal Reserve System; Fannie Mae, Form 10-K 2016; Freddie Mac, Form 10-K 2016; Prudential Financial, Inc., Form 10-K Year 2016

2. **Interconnectedness**

The obligations of Fannie Mae and Freddie Mac are widely held throughout the U.S. financial system and around the world, including by official bodies and by financial institutions. U.S. depository institutions hold about $1.2 trillion of their obligations; in addition, the Federal Reserve Banks hold $1.8 trillion in MBS, primarily those of the GSEs. Preferential risk-based capital requirements for GSE obligations and MBS create an incentive for depository institutions to hold large volumes of those securities. The low risk-based capital requirements for depository institutions compound the systemic vulnerability created by low capital requirements for GSEs themselves and the result is to amplify risks to the financial system from GSE operations.

Moreover, banks are allowed to buy the equity, preferred stock and subordinated debt of Fannie Mae and Freddie Mac, and fund these investments with government-insured deposits. Since the two GSEs are themselves extremely leveraged, the combined systemic leverage when banks hold their capital, 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 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 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 get 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."[5]

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."[6]

3. **Substitutability**

Fannie Mae and Freddie Mac play a unique role and remain the dominant force in the securitization of U.S. mortgages, reflecting their huge, ongoing government subsidies. In 2016 they guaranteed more than 60% of all MBS issued. Their balance sheets represent about 46% of total U.S. mortgage loans outstanding. Thousands of mortgage originators, servicers, domestic and international 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

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

replaced in the short or medium term. This has been confirmed by the inability of the U.S. Congress to pass any legislation to deal with ending their conservatorship status in more than nine years.

4. Leverage

In addition to their massive size, Fannie Mae and Freddie Mac have throughout their existence displayed extreme leverage and continue to do so. As of year-end 2016, Fannie Mae had $3.3 trillion in assets, compared to only $ 6.0 billion in total equity. It thus operates currently at leverage of 542:1, or with a leverage capital ratio of 0.18%.[7] In similar fashion, Freddie Mac had $2.0 trillion in assets, but only $5.1 billion in total equity, with leverage of 399:1 and a leverage capital ratio of 0.25%.[8]

Their leverage will become infinite when under the terms of the agreement between the FHFA and the Treasury Department, their equity goes to zero in 2018.

5. Liquidity Risk and Maturity Mismatch

The American 30-year fixed-rate, freely prepayable mortgage loan is one of the most financially 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 in general not offset by prepayment fees. This has led to creation of a complex derivatives market which trades in modeled prepayment behavior. Fannie Mae and Freddie Mac together own about $300 billion of mortgages in their own portfolios, on an extremely leveraged basis, which poses difficult to manage interest rate and prepayment risks.[9] They are major counterparties in interest rate derivatives and options markets. Their MBS spread the complex behavior and risk of American 30-year fixed rate mortgages, as well as the behavior of U.S. house prices -- now once again booming in many parts of the country -- to many other investors and counterparties throughout the U.S. and in other countries.

6. Existing Regulatory Scrutiny

U.S. residential mortgages constitute the largest loan market in the world, with $10.4 trillion in outstanding first lien loans. 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 by banks and others of the MBS and debt of Fannie Mae and Freddie Mac, and by allowing ownership of their equity by banks, all of which are granted very low risk-based capital requirements. This is a systemic issue.

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[7] Fannie Mae Form 10K for the Year 2016, p. 55.
[8] Freddie Mac, Form 10K for the Year 2016, p. 11.
[9] Fannie Mae Form 10K for the Year 2016, p. 72; Freddie Mac, Form 10K for the Year 2016, pp. 216.

Also a systemic issue is that Fannie Mae and Freddie Mac are by far the largest concentration of mortgage credit risk in the world. Their regulator has once again promoted their making very low down payment mortgage loans, hardly a safety and soundness emphasis, and an action with potential systemic implications. Moreover, the GSEs also assume commercial real estate credit risk through their multifamily operations.

Leveraged 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 and prepayment risk. In the light of their systemic risk on top of their individual risk, the regulatory scrutiny of the Federal Reserve is certainly advisable.

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

In short, Fannie Mae and Freddie Mac are huge in size, huge in risk, close to zero in capital, tightly connected to thousands of counterparties, and force risk on the U.S. Treasury. Protection of the financial system and the taxpayer purse requires this additional systemic regulation to match their unique role: designation as SIFIs.

III. Fannie Mae and Freddie Mac continue to operate in "conservatorship" and now have an even greater market share than before, based on an effective guarantee of all their obligations and mortgage-backed securities by the U.S. Treasury. Conservatorship status obligates the federal government, absent a change in the law, to return them to shareholder control after they have been stabilized financially. The Congress has, with much accompanying debate but no action so far, considered a variety of legislative reform measures with respect to the two companies. Whether or not Congress changes the law, we believe it is essential for Fannie Mae and Freddie Mac to be designated as SIFIs.

In September 2008 the Federal Housing Finance Agency 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 government placed the two GSEs into conservatorship, and this assumed "all rights, titles,

[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.

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…"[11]

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; and (ii) appropriate to carry on the business of the regulated entity and preserve and conserve the assets and property of the regulated entity."[12]

In contrast to receivership, which could involve winding up the affairs of a company, conservatorship calls upon the government to restore the companies to a safe and sound condition and to continue to transact business. Consistent with this purpose, the government did not eliminate the interests of the shareholders of the two companies, a circumstance that has led to significant speculation, lawsuits and dispute about the eventual value of shareholders' holdings of common and junior preferred stock. Conservatorship was never intended to be a perpetual status for Fannie Mae and Freddie Mac, but it continues into its tenth year, an outcome altogether unintended.

Without a change in law, the government may not revoke the charters of Fannie Mae and Freddie Mac.[13] If the two companies again resume operations under private control without reform of their guarantees and subsidies, they will continue the fundamental 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 Congress 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 capital and risk absorbing capacity, clarity of resolution procedures, and supervisory standards. These requirements should apply to Fannie Mae and Freddie Mac. Setting common standards for all systemically important mortgage risk takers, including GSEs and very large commercial banks,

[11] 12 U.S.C. Sec. 4617(b)(2)(A)(i).
[12] 12 U.S.C. Sec. 4617(b)(2)(D).
[13] 12 U.S.C. Sec. 4617(k).

would greatly reduce the regulatory arbitrage. That arbitrage has led trillions of dollars of mortgage risk to migrate to the taxpayers 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 taxpaying public. The financial system is greatly in need of protection through the enhanced requirements of the SIFI designation.

We respectfully ask that FSOC prepare a full analysis of the systemic risk aspects of Fannie Mae and Freddie Mac as compared to the criteria specified for SIFI designation in the Dodd-Frank law and the corresponding FSOC regulations. Given the demonstrated systemic risk of the two companies and their highly leveraged exposure of over $3 trillion and $2 trillion, respectively, of mortgage risk, 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 proposal.

Yours very truly,

Appendix: Backgrounds of the authors

The writers of this letter have studied both historical financial crises and the most recent 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. 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 distinguished senior fellow at the R Street Institute in Washington DC, where he has worked since 2016, after serving as a resident fellow at the American Enterprise Institute 2004-2015. 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) and *Finance and Philosophy* (forthcoming) as well as more than 400 articles, presentations and Congressional testimony. He is a director of the CME Group and the Great Lakes Higher Education Corporation, and a Past-President of the International Union for Housing Finance.