**Thomas H. Stanton**
**Bethesda, MD 20814**
tstan77346@gmail.com
**(202) 965-2200**
August 28, 2020

Alfred M. Pollard, General Counsel,
Attention: Comments/RIN 2590–AA95,
Federal Housing Finance Agency,
Eighth Floor, 400 Seventh Street SW,
Washington, DC 20219
BY E-MAIL TO: https://www.fhfa.gov/SupervisionRegulation/Rules/Pages/Enterprise-Regulatory-Capital-Framework.aspx

SUBJECT: Comments on FHFA Proposed Rulemaking RIN 2590–AA95, Enterprise Regulatory Capital Framework

Dear Mr. Pollard:

Thank you for the opportunity to comment on the FHFA proposed Enterprise Regulatory Capital Framework. This comment letter makes several points:

I. **Strong capital standards are essential to address the fundamental systemic risk that GSEs pose to financial stability. FHFA is to be commended for seeking to develop capital standards for the GSEs commensurate with those governing their competitors in the secondary mortgage market.** For many reasons, Fannie Mae and Freddie Mac are difficult if not impossible to manage: (1) they are massive in size, (2) they are specialized lenders dealing in the 30 year home mortgage, an inherently risky asset, (3) they have shown a propensity to select their chief officers for political reasons rather than because of expertise in managing a multi-trillion dollar institution or knowledge of the mortgage market, and (4) as a duopoly of profit-driven organizations protected from market discipline by their quasi-governmental benefits, they tend to take risks to maximize short-term profits for shareholders and managers. Because of the vulnerability they create for themselves and the financial system, capital standards for Fannie Mae and Freddie Mac should be significantly higher than those that regulators set for financially diversified financial institutions.

II. **In setting capital standards for the GSEs, FHFA is determining the shape of the mortgage market.** The $ 6 trillion combined asset size of Fannie Mae and Freddie Mac is not a result of the business acumen of their executives. Rather, the bloated size of the

two GSEs is a direct result of their having lower capital standards than their competitors in the mortgage credit market, as well as a perception of Treasury backing, and other government-granted benefits not available to competitors. Low capital standards increase the vulnerability of the two GSEs, and also, because the system moves mortgages to where capital standards are lowest, greatly increase the financial vulnerability of the financial system as a whole.

III. **FHFA should work with other members of the Financial Stability Oversight Council (FSOC) to designate the GSEs as Systemically Important Financial Institutions (SIFIs).** In this way GSE capital standards can be adjusted to reduce the amount of financial risk that is concentrated in these fundamentally vulnerable institutions. By strengthening capital standards, FHFA can help to ensure more sustained service by Fannie Mae and Freddie Mac to the mortgage market, to millions of Americans who depend on it, and to taxpayers who pay for major mishaps.

While this comment letter takes a long view of the need for GSE financial stability, it is also worth noting the painful circumstances that many mortgage borrowers currently face, and the need to set capital standards that anticipate the impact of possibly unprecedented levels of mortgage defaults.

## I. Strong capital standards are essential to address the fundamental risk that GSEs pose to financial stability. FHFA is to be commended for seeking to develop capital standards commensurate with those of their mortgage market competitors. Because of the vulnerabilities of the two GSEs, capital standards for Fannie Mae and Freddie Mac should be higher than those of diversified financial institutions.

Fannie Mae and Freddie Mac are inherently unstable and often unmanageable in their present organizational form with higher leverage than is permitted for their competitors:

(1) They are specialized lenders funding residential mortgages, and especially 30-year home mortgages, which because of their long maturity and prepayment characteristics, are an inherently risky asset class. Unlike diversified financial institutions, the two GSEs are limited by their charters to concentrating entirely in mortgage finance. Even when the housing finance markets are troubled, the two GSEs are unable to diversify into other asset classes. As Richard Syron, Freddie Mac's CEO at the time of the Financial Crisis, told the Financial Crisis Inquiry Commission, "Freddie failed because in my mind it was a non-diversified one product company,"[1]

[1] Richard Syron, Chief Executive Officer, Freddie Mac, Interview, Financial Crisis Inquiry Commission, August 31, 2010.

(2) They are a government-sponsored duopoly. Fannie Mae and Freddie Mac face no competition from more capable firms operating under the same charters and with the same combination of benefits and burdens that the federal government has granted to the two companies. That structure means that the two GSEs tend to depend more on the political system than on the market to try to ensure their profitability.[2] Thus, except perhaps immediately after a debacle such as Fannie Mae suffered in 1981, or as the two GSEs suffered in the Financial Crisis when they went into government hands, GSE chief officers too often may possess greater political proficiency than managerial acumen or knowledge of the mortgage market. Even if GSE executives may be capable at the moment, one cannot expect that to continue in the future.

(3) As a federally protected duopoly in the secondary mortgage market, Fannie Mae and Freddie Mac can wield considerable power. Their government benefits give them market power and market power in turn gives them political power. As the *Washington Post* observed many years ago, "Builders, real estate brokers and bankers across the country rely so heavily on Fannie Mae for mortgage funds that they live in fear of offending the firm and routinely defend it in Washington."[3]

In addition, the GSEs can apply, and in the past have applied, their power to try to enforce compliance on academics, low income housing groups, think tanks, their safety-and-soundness supervisor, and others who might espouse points of view different from the short-term financial interests of the two GSEs. As Daniel Mudd observed upon becoming CEO of Fannie Mae in 2005, one of his early tasks was to end the "jihad" mentality that his company applied to those with differing views. The point here is not to revisit past history, but rather to document how the two GSEs validate Lord Acton's precept that "Power tends to corrupt."

(4) Some history is relevant here. The failure of internal controls at both Fannie Mae and Freddie Mac in the early 2000s helps to illustrate consequences of the combination of political power and complacency that the GSE duopoly structure can generate. Even before the 2008 Financial Crisis, internal controls and accounting systems had failed at Fannie Mae and Freddie Mac. The failures came to light in 2003-4. Both companies took years and spent billions of dollars to restate their financial statements. Freddie Mac restated its earnings by $ 5 Billion and Fannie Mae by about $ 11 Billion. After the failures came to public attention, both companies ousted their CEOs, Chief Financial Officers, and many other senior officers. Had they not been government-sponsored

---

[2]For a recent example of the political environment of the GSEs, see, e.g., Andrew Ackerman, "Trump Administration Criticizes New Fannie Mae, Freddie Mac Mortgage Fee: White House official said new fee would harm consumers," *Wall Street Journal*, August 13, 2020.

[3] David A. Vise, "The Money Machine: How Fannie Mae Wields Power," *Washington Post*, Jan. 16, 1995.

enterprises, with perceived government backing of their obligations regardless of the state of their balance sheets, the two companies would have gone out of business.

Rapid growth meant that Fannie Mae and Freddie Mac outran capabilities of their people and systems. Fannie Mae systematically deprived its internal audit organization of resources. The company tolerated staff shortages and lacked senior officials with the requisite expertise and experience in key parts of the company. The Senior Vice President for Internal Audit had had no experience or formal training as an auditor; the Controller was not a certified public accountant.

The Office of Federal Housing Enterprise Oversight (OFHEO) conducted an in-depth investigation of the failures at Fannie Mae and Freddie Mac. With respect to Freddie Mac, OFHEO found that, as it later found at Fannie Mae: "Simply stated, the quality and quantity of accounting expertise was too weak to assure proper accounting of the increasingly complicated transactions and strategies being pursued by Freddie Mac." These shortcomings as well as the way that the GSEs manipulated their financial disclosures are amply documented in two excellent reports by the Office of Federal Housing Enterprise Oversight.[4] Even as these problems were building, the two GSEs were able to dominate their environment, obtaining support from key members of Congress to keep their regulator weak.[5]

(5) This pattern of political dominance and weak management came to light again in 2008. While many firms with varying organizational forms, failed in the Financial Crisis, Fannie Mae and Freddie Mac were exceptional in their shortcomings. FHFA examiners of Fannie Mae told the Financial Crisis Inquiry Commission (FCIC) how Fannie Mae had outrun the capabilities of its systems:

> "To Austin Kelly, an OFHEO examination specialist, there was no relying on Fannie's numbers, because their 'processes were a bowl of spaghetti.' [John] Kerr [a later examiner in charge of Fannie examinations (and an OCC veteran)] 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."[6]

(6) As when they skimped on personnel and systems before 2008, the structural vulnerability of the two GSEs is compounded by their drive to maintain high returns for their investor-shareholders. This was seen before the Financial Crisis when both GSEs reported

---

[4] OFHEO, *Report of the Special Examination of Freddie Mac*, 2003; and OFHEO, *Report of the Special Examination of Fannie Mae*, 2006.
[5] John Connor, Capital Views: Usually "The Smartest Person in the Room." *Dow Jones Capital Markets Report*, March 6, 2006 .
[6] *Final Report of the Financial Crisis Inquiry Commission*, 2011, pp. 321-322.

substantial purchases of risky mortgage products that they believed would help their bottom line even if they weren't relevant to their public purposes.

In 2007 Freddie Mac reported that, "Total non-traditional mortgage products, including those designated as Alt-A and interest-only loans, made up approximately 30% and 24% of our single-family mortgage purchase volume in the years ended December 31, 2007 and 2006, respectively."[7] Fannie Mae reported that purchases of interest-only and negative amortizing ARMs amounted to 7% of its business volume in 2007 and 12% in each of 2006 and 2005. Moreover, Alt-A mortgage loans "represented approximately 16% of our single-family business volume in 2007, compared with approximately 22% and 16% in 2006 and 2005, respectively."[8] Both companies also invested in highly rated private-label mortgage-related securities that were backed by Alt-A or subprime mortgage loans.[9] There are suggestions that the reported numbers significantly understate the actual extent of these risky investments by the GSEs.[10]

Note that Alt-A loans generally do not count towards the GSE housing goals; the GSEs pursued these risky investments in their pursuit of profit. Once they are released from conservatorship, the same motivation could well drive the GSEs to pursue other similar high-risk/high-short-term reward opportunities that arise as the mortgage markets continue to evolve.

(7) The two GSEs are huge institutions with over $ 6 trillion combined assets on June 30, 2020. Sheer size makes the two companies difficult to manage, even while their high leverage, structural vulnerabilities and incentives make them especially prone to failure. The two CEOs at the time of failure of Fannie Mae and Freddie Mac themselves concur in this view. Former Freddie Mac CEO Richard Syron told the Financial Crisis Inquiry Commission about the GSE as an organizational form that, "I don't think it's a good business model."[11] Daniel Mudd, CEO of Fannie Mae at the time of its 2008 failure, told a congressional committee that:

> "I would advocate moving the GSEs out of No Man's Land. Events have shown how difficult it is to balance financial, capital, market, housing, shareholder, bondholder, homeowner, private, and public interests in a crisis of these

[7] Freddie Mac, *Annual Report*, 2007, pp. 13.
[8] Fannie Mae, *Annual Report*, 2007, pp. 129.
[9] Fannie Mae, *Annual Report*, 2007, p. 93; Freddie Mac, *Annual Report*, 2007, p. 94.
[10] James R. Haggerty, "Fannie, Freddie Executives Knew of Risks," *Wall Street Journal*, December 10, 2008; Lynnley Browning, "Ex-Officer Faults Mortgage Giants for "Orgy" of Nonprime Loans," *New York Times*, December 10, 2008.
[11] FCIC, *Final Report*, p. 41.

proportions. We should examine whether the economy and the markets are better served by fully private or fully public GSEs."[12]

(8) Learning from this clear historical pattern, and to meet its statutory obligations, FHFA should promulgate capital standards that compensate for the vulnerabilities that the two GSEs create for themselves and the financial system. A strong capital cushion can provide an incentive for the GSEs to serve the mortgage market over the longer term rather than trying to go for broke to serve the short-term interests of shareholders by taking greater risks than a weak balance sheet can sustain.[13] The proposed capital framework goes in the right direction in this regard.

## II. In setting capital standards for the two GSEs, FHFA is determining the shape of the mortgage market.

The GSEs have become much larger, in terms of mortgages that they fund, than their competitors. This was not because of the business acumen and management quality of their leaders, but rather was because the GSEs operated at much higher leverage than is permitted to their competitors, and with greater government benefits. The result is that the two GSEs captured a multi-trillion dollar share of the residential mortgage market while frequently achieving much greater returns on equity than other financial institutions. It is well documented that, before they failed and went into government hands, much of the benefit of high GSE leverage went to their shareholders and executives rather than to support homeowners and the mortgage market.

FHFA needs to undo the costly mistake of permitting lower total capital standards for the GSEs than other regulators set for their competitors in the mortgage market. That's because the markets will simply arbitrage across government capital standards and can send literally trillions of dollars of mortgages to the financial firms with the lowest capital requirements and highest leverage. Even if GSE capital standards are raised, but still remain lower than those of other institutions, this systemic capital arbitrage and greater concentration of risk will continue.

Low capital standards not only mean increasing the vulnerability of the two GSEs, but also, because the system moves mortgages to where capital standards are lowest, a significant increase in vulnerability of the financial system as a whole.

Market share is a good measure of the extent that FHFA has succeeded in equilibrating GSE capital standards with those of their market competitors. FHFA should continually monitor the market share of the GSEs and adjust capital standards to ensure that they do not increase their fraction of the market and thereby pose a greater threat to themselves and the stability of the overall financial system. Fannie Mae and Freddie Mac, once released from conservatorship, will

---

[12]House Committee on Oversight and Government Reform, prepared statement of Daniel Mudd, December 9, 2008.
[13] See, e.g., Fannie Mae, "Single Family Guarantee Business: Facing Strategic Crossroads." June 27, 2005.

have a continuing profit-driven incentive to grow ever larger. It is time to reduce and spread that risk so that more of the mortgage market depends on institutions with lower leverage and more diversified portfolios.

Until their charters were changed in 1992 to permit them to grow substantially, the two GSEs were limited by law to providing only “supplementary assistance” to the secondary market for home mortgages. The 1992 statutory change, as often is the case with technical provisions that permit GSE expansion, was adopted virtually without deliberation. Now that the GSEs constitute half of the home mortgage market, it is time to step back and consider what a more stable, sustainable and efficient mortgage finance market might look like. In this capital proposal, FHFA is undertaking to address a key element of this question.

## III. FHFA should monitor the mortgage market share of the GSEs and work with other members of the Financial Stability Oversight Council (FSOC) to designate the GSEs as Systemically Important Financial Institutions (SIFIs).

At their current combined share of about 50 percent of the residential mortgage market, the GSEs have demonstrated their Too-Big-To-Fail characteristics and risk to the financial system. Attached to this comment letter is a letter that Alex Pollock, then a Resident Fellow at the American Enterprise Institute, and the present author sent to the Treasury Department on March 31, 2014. For reasons summarized in that letter, FHFA should prepare and present a formal case to the Financial Stability Oversight Council (FSOC) that Fannie Mae and Freddie Mac should be designated Systemically Important Financial Institutions (SIFIs) and made subject to the added supervision and standards that SIFI status requires. SIFI status would add important protections to the financial system and help protect the well-being of the homeowners, renters, and taxpayers of the United States.

There is one final matter to address: setting higher capital standards does not imply an indifference to the value of homeownership for many Americans. Rather, the purpose of strong capital standards is so that FHFA can help to ensure more sustainable service by Fannie Mae and Freddie Mac to their mortgage market responsibilities.

Respectfully Submitted,

Thomas H. Stanton

Attachments (2)

**Thomas H. Stanton**
**5410 Lambeth Road**
**Bethesda, MD 20814**
**(202) 965-2200**
**www.thomas-stanton.com**

**Thomas H. Stanton** is a former President of the Association for Federal Enterprise Risk Management (AFERM), an organization dedicated to improving risk management in federal agencies and programs. In 2018 AFERM presented him its Hall of Fame Award. He is a Fellow of the National Academy of Public Administration (NAPA), and a former member of the federal Senior Executive Service. In 2017 NAPA awarded him its George Graham Award for Exceptional Service to the Academy.

Mr. Stanton teaches as an adjunct faculty member at the Center for Advanced Governmental Studies at the Johns Hopkins University, where he received the award for Excellence in Teaching. Mr. Stanton has been an invited witness before many congressional committees and subcommittees, including House and Senate committees considering legislation to improve supervision of Fannie Mae and Freddie Mac.

Mr. Stanton's writings on GSEs include:

*A State of Risk: Will Government Sponsored Enterprises be the Next Financial Crisis?* (HarperCollins, 1991)

*Government Sponsored Enterprises: Mercantilist Companies in the Modern World* (AEI Press, 2002)

*Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Financial Crisis* (Oxford University Press, 2012)

"The 2008 Financial Crisis Revisited: Risks and Responses," submitted chapter for *Financial Crises: Types, Causes and Consequences*, Nova Scientific Publishers, forthcoming.

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. <u>Size</u>**

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.

**<u>Size of GSEs and Largest 20 SIFIs</u>**

| | **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. **<u>Existing Regulatory Scrutiny</u>**

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**