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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,

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Attachments (2)

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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.