Remarks at the
Conference of State Bank Supervisors
State Banking Summit and Leadership Conference

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November 6, 2003

I am delighted to be here. I appreciate the opportunity to talk with you. The members of this audience have an important job—helping to ensure the soundness and stability of our financial system. As state bank supervisors, you know that a strong economy requires a strong financial system.

I would like to take this opportunity to talk with you about one part of our financial system—housing finance. The creation of affordable housing opportunities is an Administration-wide priority. Homeownership is an important building block of individual financial security as well as strong communities. As the President has made clear, one of the great strengths of America is that everyone has an opportunity to gain the independence and dignity that come from homeownership. A healthy system of housing finance is critical to ensuring that all Americans have the opportunity to become homeowners. The health of the housing finance sector is important for other reasons as well. It has far-reaching implications for the entire U.S. financial system.

Proper regulation plays a key role in supporting a strong financial system. The Administration has proposed reforms that will give housing finance a regulatory framework as strong as those in place for other financial sectors. I am here today to talk about these reforms—in particular, those involving the "Government-Sponsored Enterprises."

In the 1930s, the federal government created Fannie Mae and the Federal Home Loan Bank System in order to ensure an adequate supply of funds for mortgages. Freddie Mac was added in 1970. Today, these are the three major housing GSEs.

Fannie and Freddie were instrumental in creating a secondary market for mortgages. They did so by becoming heavily involved in mortgage securitization. Securitization involves buying mortgages, bundling them into pools, and selling them back to investors as mortgage-backed securities with guaranteed payments. By pooling mortgages from a geographically diverse area, mortgage securitizers spread risks stemming from defaults in one particular area. By promoting the growth of the secondary market for mortgages, Fannie and Freddie increased the supply of funds for mortgages.

The twelve Federal Home Loan Banks have encouraged mortgage lending by offering short-term loans backed by mortgages to their members—banks and savings institutions. Access to these so-called "advances" provides a way for financial institutions to offer long-term mortgage loans without having to worry about shorter-term fluctuations in the demand deposits that fund such loans.

Although they were created to serve a public purpose, the GSEs are privately owned. Fannie and Freddie are owned by their private shareholders, while the Federal Home Loan Banks are owned by their members—mainly private financial institutions. These private owners receive the profits earned by the GSEs. The decisions made by the GSEs reflect the interest of their owners and managers.

By charter, the housing GSEs enjoy a number of special privileges. For example, the GSEs have lines of credit at the U.S. Treasury. They are statutorily exempt from SEC registration and disclosure requirements faced by other private institutions. They have certain directors appointed by the President. GSE securities are generally viewed as equivalent to U.S. Treasury securities in the regulatory evaluation of banks' safety and soundness.

Privileges such as these confer some monetary benefits to the GSEs, but their direct value appears to be modest. The lines of credit, for example, are relatively small compared to the value of debt on GSE balance sheets. Their function is mainly symbolic.

This symbolism is the point. Together the various charter privileges give rise to an implicit subsidy for the GSEs. The privileges signal a special relationship between the GSEs and the federal government. They feed market perceptions that GSE debt has the backing of the U.S. government. This notion is inaccurate—the charters do *not* require the federal government to bail out a troubled GSE. But, given the perception, investors are willing to accept a lower yield on GSE debt than on the debt of other private companies. This funding advantage is the implicit subsidy to the GSEs.

The subsidy exists even though the government does not write checks to the GSEs to provide it. Nevertheless, the implicit subsidy is real. It has created an advantage over other firms that has allowed the GSE's to dominate the market for certain types of mortgage securities. In particular, the GSEs account for about two-thirds of all mortgages that receive a credit guarantee.

A common way to gauge the GSE funding advantage is to compare interest rates on GSE debt with those on securities from other private companies. The exercise is not entirely straightforward because one must make sure that GSE debt is compared with similar securities from similar sorts of companies. The Congressional Budget Office analyzed the issue carefully in 2001. It concluded that the average spread, across all types of GSE debt securities, was 41 basis points. In modern financial markets, such a funding advantage is enormous.

Most observers believe that the GSEs pass some of the subsidy along to homeowners in the form of lower mortgage interest rates. The Congressional Budget Office compared interest rates on "conforming" mortgages that the GSEs can purchase with those on "jumbo" mortgages that they cannot. The CBO found that interest rates on jumbo loans exceeded those on similar conforming loans by 18 to 25 basis points. But even this range may overstate the benefit conferred on holders of conforming mortgages. Some of the spread likely comes from the greater size and liquidity of the conforming mortgage market.

All told, these estimates suggest that the reduction in conforming mortgage interest rates stemming from the GSEs falls well short of their funding advantage. The Congressional Budget

Office estimates that only about half of the total subsidy provided to the GSEs gets passed on to homebuyers. What happens to the rest of the subsidy? The outcome is exactly what one would expect with a private company—it goes to executive compensation and to shareholder profits.

This situation raises concerns over fairness, but in my view, the larger issue for the policymaking and regulatory community is that the subsidy creates a source of systemic risk for our financial system. This risk arises because the subsidy has allowed the GSEs to become gigantic. From 1995 to 2002, the debt issued by the housing GSEs more than tripled. As of the end of 2002, their total reported debt was $2.2 *trillion*. To put this in perspective, the privately held debt of the federal government is $3.2 trillion. If recent trends continue, GSE debt will soon exceed the privately held debt of the federal government.

The GSEs have used the proceeds from issuing debt to amass enormous portfolios of mortgages and mortgage-backed securities. For example, according to data from Fannie Mae, Fannie and Freddie held more than one quarter of all outstanding mortgage-related securities as of the end of 2002. As a result, Fannie and Freddie now have major interests outside the business of securitizing mortgages. They are now also in the asset management business, with their financial health depending heavily on the performance of these portfolios of mortgage-backed securities.

In some respects, mortgages are a relatively safe asset. The "credit risk"—that associated with borrowers not making payments on their loans—is relatively low. According to Fannie

Mae's 2002 annual report, less than 1 percent of the loans underlying their mortgage-backed securities were charged off.

But holders of mortgages and mortgage securities are exposed to other types of important risks. One such risk is "interest rate risk." When interest rates go up, the values of fixed-rate assets, such as mortgages, go down. Another type of risk is "prepayment risk." This arises because declines in mortgage rates spur refinancing, where borrowers take out new loans at lower rates and prepay their original loans. This reduces the value of a portfolio of fixed-rate mortgages. Together, interest rate risk and prepayment risk leave housing GSEs exposed to losses from both increases and decreases in interest rates.

The GSEs engage in a variety of hedging activities to reduce their exposure to these types of risk. This is fully appropriate. When done successfully, this hedging helps insulate the GSEs' portfolios from interest-rate and prepayment risk.

The available information suggests that the housing GSEs place a high priority on risk management. To date, their efforts appear to have been largely successful. However, policymakers must not be complacent. In our complex and dynamic financial system, even small errors can damage an institution's financial health. And the size and complexity of the assets and operations of the GSEs mean that it is hard even for the companies themselves to keep track of their own situations. What is worrisome is that investors might accept lack of transparency in financial information because they are assured by the implicit public guarantee.

History teaches that even the best minds in financial management cannot entirely eliminate risk. This was shown quite clearly by the severe difficulties encountered by Long-Term Capital Management several years ago. Nor do the GSE shareholders have the incentive to call for eliminating risk. The perception of a government bailout if things go wrong surely enhances any firm's willingness to take on risk and enjoy the associated increase in return. The savings and loan crisis of the 1980s illustrates the adverse incentive effects that can arise as a result of government guarantees.

Risk management is particularly crucial here because the housing GSEs hold relatively small amounts of capital to cushion against unforeseen financial blows. According to the Congressional Budget Office, the ratio of private equity capital to assets is 3.7 percent for Fannie and Freddie. Gauging whether this amount of capital is appropriate is difficult. The Congressional Budget Office found this capital ratio was less than half of that for a group of other large firms engaged in providing financial services.

The enormous size of the mortgage-backed securities market means that any problems at the GSEs matter for the financial system as a whole. This risk is a systemic issue also because the debt obligations of the housing GSEs are widely held by other financial institutions. The importance of GSE debt in the portfolios of other financial entities means that even a small mistake in GSE risk management could have ripple effects throughout the financial system.

There is no way to fully eliminate the underlying risk. It is possible, however, to reduce the risk by ensuring that the housing GSEs are overseen by an effective regulator. The current regulators do not have the tools, or the stature, to deal effectively with the current size, complexity, and importance of the housing GSEs.

The Administration believes that legislation to reform GSE regulation should empower the new regulator with sufficient strength and credibility to reduce systemic risk. A key issue is providing appropriate resources and tools. Inadequate reforms could conceivably increase systemic risk. The appearance of greater oversight without the reality would be a step in the wrong direction.

The new GSE regulator should be granted a permanent funding mechanism by allowing it to assess the entities being regulated. This is how most other financial regulators are funded. The current system of funding the regulators by annual Congressional appropriations makes them dependent on the vagaries of the political process and restricts their ability to respond promptly to unexpected developments.

The new GSE regulator should have broad authority to set both risk-based and minimum capital standards. Minimum capital standards are important because they insure against unanticipated and unquantifiable risks. In some ways, choosing the appropriate minimum capital standards is more difficult than addressing known risks. This is why this task should be left to a regulator who best understands the activities of the GSEs and their interaction with the changing financial environment.

The new GSE regulator should have the authority to reject new GSE activities. The activities of financial institutions are integrally related to their soundness. Indeed, this is why regulators in other key financial sectors generally have this power.

In addition, the new regulator should have the receivership powers necessary to wind down the affairs of a troubled GSE. The current lack of a credible and workable receivership mechanism reinforces the market's perception that the government will bail out the housing GSEs no matter what. Such powers would therefore encourage market discipline. This would in turn limit the risks taken on by the GSEs.

A natural question is how these reforms would affect housing markets. Opponents of reform efforts have issued ominous statements predicting dire consequences. Quite frankly, it is hard for me to see how they come by these conclusions. As I noted earlier, the GSEs likely pass on some of their subsidy to homeowners in the form of lower interest rates on conforming mortgages. But, the magnitude of the effect—18 to 25 basis points according to the Congressional Budget Office—is small relative to normal fluctuations in interest rates. For example, in the past 3 years, the interest rate on fixed-rate 30-year mortgages has moved in a range of more than 250 basis points. Moreover, the actual change in average mortgage rates would likely be far smaller than CBO's estimates, in part because many mortgages are not conforming.

Worries about the supply of funds for mortgages are also unfounded. Thanks in large part to the earlier efforts of Fannie and Freddie, the secondary market for mortgages is now thriving. All indications are that if the housing GSEs were to lose some of their implicit subsidy, private financial institutions would eagerly step in. For example, Washington Mutual and Bank of America currently serve as reliable intermediaries between investors and the originators of mortgages not eligible for GSE purchase. Indeed, pools of privately securitized mortgages more than tripled between 1995 and 2002, reaching $750 billion at the end of last year.

Opponents of regulatory reform suggest that it would conflict with the goal of making homeownership possible for all Americans. This brings me to the issue of affordable housing. By charter, Fannie Mae and Freddie Mac are required to promote affordable housing for low- and moderate-income families. To make sure that this happens, Congress mandated that the HUD Secretary set affordable housing goals. These goals specify the fraction of Fannie and Freddie mortgage purchases that are directed toward low- and moderate-income families and areas. Fannie and Freddie have generally met these goals. However, studies by HUD and independent analysts have shown that the GSEs have historically lagged the primary market in funding mortgage loans for low-income and minority homebuyers. This suggests that the GSEs can be doing more to help these families. With this in mind, the Administration has proposed strengthening the law behind HUD's housing goals. For example, we have proposed adding a home purchase goal in order to ensure that Fannie and Freddie keep funding new homeowners even in periods where high refinancing activity allows the other goals to be met through purchases of refinanced mortgages.

In conclusion, I would like to put the issue in broader perspective. The U.S. economy has gained considerable steam over the past year. Our strong financial system has been an important underpinning of strength throughout the recession and recovery. We must not take this strength for granted. We must ensure that all parts of the financial system are strong. This requires that we take actions now that will ensure the long-term effectiveness of the regulatory structure. Our world-class housing finance sector deserves a world-class regulator. The Administration seeks to create such a regulator for the GSEs in recognition of the important role that the housing sector plays in fostering strong and sustainable economic growth.