

Box 3

US GOVERNMENT-SPONSORED ENTERPRISES AND SYSTEMIC RISK

In recent months, reputational and accounting problems at two US government-sponsored enterprises (GSEs), the Federal National Mortgage Association (FNMA, or “Fannie Mae”) and the Federal Home Loan Mortgage Corporation (FHLMC, or “Freddie Mac”) have lent renewed impetus to the ongoing debate concerning the status of US GSEs and the risks that they pose. The two GSEs are privately owned corporations chartered by the federal government to achieve a public financial purpose. They have a line of credit to the Treasury; they are exempt from state and local taxes, which increases their profit margins; and no Securities and Exchange Commission (SEC) registration of their debt or mortgage-backed-securities (MBS) is

required.¹ In addition, national and state-chartered banks may deal in, underwrite, purchase and hold GSE securities without any limits. As the bonds issued by GSEs offer a small yield spread over US Treasuries, and since they have a favourable capital risk-weighting, many banks may have significant exposures to their debt. GSE debt securities are not backed by “the full faith and credit” of the US government, but given their line of credit, mission and size, most market participants view their securities as having an implicit government guarantee. The US Congress originally created Fannie Mae and Freddie Mac to increase the supply of mortgage credit. They do this essentially by purchasing mortgages from mortgage lenders, which frees up lenders’ capital to extend new mortgage loans. They then hold these mortgages as investments, or package them into MBS and resell them on the market. Thus, in increasing the supply of mortgage credit, the GSEs have also developed a secondary market for MBS. A large portion of their outstanding debt is short term: about 50% at Fannie Mae, and about 30% at Freddie Mac. In addition, their benchmark and reference securities include long-term bullet-subordinated and euro-denominated long-term debt as well as callable securities.² The two GSEs combined either guarantee or own half of all residential mortgages in the US.

Many observers claim however that the two agencies have grown too large, partly as a result of their relatively low funding costs. The mixture of implicit state guarantees as perceived by the market and private ownership is seen as giving rise to risks of moral hazard, perhaps leading to excessive risk-taking. At the same time, these agencies are generally perceived as being too large to fail. According to a report published by the Office of Federal Housing Enterprise Oversight (OFHEO) – the supervisor of Fannie Mae and Freddie Mac – the two are among the largest financial institutions in the world and are systemically important for several reasons.³ Chief among these from a global financial stability perspective is the fact that the two are major players in the OTC financial derivatives market, where they are often favoured counterparties, given their perceived implicit federal guarantees. The market for OTC interest rate derivatives is highly concentrated among a small number of dealers, primarily brokerage firms and commercial banks, which are counterparties for at least one side of virtually all of the contracts of the GSEs. Many of these counterparties are themselves systemically important institutions, so that a failure at either agency could quickly spread through the global financial system, affecting institutions in the euro area as well. In addition, a serious disturbance on the secondary market for agency debt instruments – the trigger for which could be the loss of their implicit guarantee or rating actions against them – could soon disrupt the origination of mortgage loans in the US. Moreover, as agency debt instruments are extensively used as collateral for liquidity management purposes and held in foreign reserve portfolios by a number of central banks, an upheaval could have direct effects worldwide. This could also adversely impact the market value of euro area banks holdings of their bonds, which can be sizeable.

Some have suggested that the GSEs lack adequate capital levels to weather possible disruption in the capital markets.⁴ Others have pointed to the fact that if the GSEs were purely private, i.e.

1 This means that they are not required to file quarterly and annual reports, although listing on the New York Stock Exchange (NYSE) requires them to publish such reports.

2 Debt financing strategies typically function so that debt issuance is used to fund mortgage purchases. Since the late 1990s, GSEs have tried to capture a liquidity premium by replicating many aspects of the Treasury Department’s auction schedule (e.g. minimum issuance, issuance calendars, issuance of benchmark securities, etc.).

3 See OFHEO (2003), “Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO”, February.

4 See, among others, W. Poole (2002), “Financial Stability”, speech presented by the President of the Federal Reserve Bank of St. Louis at The Council of State Governments Southern Legislative Conference Annual Meeting New Orleans, Louisiana, 5 August 2002, published in Economic Review, Federal Reserve Bank of St. Louis, Vol. 84, No 5 (September/October 2002).

if their returns on equity and their returns on assets were similar to those of other large financial institutions, they would hold far fewer of their MBS in their own portfolios, and their capital-to-asset ratios would be higher.⁵ For these reasons, and primarily owing to the systemic importance of these institutions, the US Treasury has been pushing for reform with the aim of strengthening regulatory oversight.

In June 2003, Freddie Mac removed its top three executives (the institution's Chief Executive, Financial and Operating Officers) who had restated financial results since 2000, owing to errors in the calculation of financial derivatives positions. They were also accused of not cooperating fully with the Board's audit committee. In March 2004, Fannie Mae acknowledged derivatives losses of USD 5.3 billion in unrealised losses for open hedges and USD 6.9 billion in realised losses for closed hedges due to falling interest rates. It also seems that Fannie Mae could be forced to recognise a further USD 2.8 billion in additional losses on its derivatives portfolio because of new accounting concerns recently raised by OFHEO, bringing the amount of restated losses to almost USD 12 billion. Such losses were reported on Fannie Mae's balance sheet but not in its earnings or regulatory capital calculations, thanks to the hedge accounting technique.⁶ In recent months, the company has already halved its dividend, raised capital by issuing USD 5 billion in preferred stock, and started to reduce its holdings of mortgages and MBS.

In September 2004, OFHEO issued a report on Fannie Mae's accounting policies. The report deemed the company's capital to be below its statutory minimum requirement, and raised serious concerns about the quality and accuracy of the published financial results, the quality of management supervision and "the overall safety and soundness of the Enterprise".⁷ In criticising Fannie Mae's internal controls, OFHEO pointed out that "the failure by management to properly implement critical accounting policies is due in part to the lack of a sound framework for developing these policies." The report indicated that "dysfunctional and ineffective" accounting policies and internal controls may have been misused to boost the top executives' bonuses, and executives may have misled the regulator about this. Meanwhile, the SEC has announced its own informal inquiry into the allegations put forward by OFHEO. Similarly, the US Justice Department has opened an investigation into fraud at Fannie Mae.

With regard to the three major rating agencies, Fitch Ratings, Moody's and Standard & Poor's affirmed the AAA senior debt ratings of the two GSEs. Rating agencies did, however, place their financial strength rating and their preferred stock and subordinated debt under review for possible downgrade, in 2003 for Freddie Mac and in 2004 for Fannie Mae. In the absence of any material disclosures, ratings were confirmed for the former, with Moody's saying that it highly regarded the institution's risk management capabilities, and believed that the GSE retained strong creditworthiness, with highly sophisticated risk management capabilities and systems in place, and a conservative management philosophy towards risk. Regarding Fannie Mae, at the end of March 2005 Moody's downgraded its financial strength rating from A- to B+ with a stable outlook following the company's announcement of several additional accounting and internal control issues identified by OFHEO.

5 See W. Passmore (2003), "The GSE Implicit Subsidy and Value of Government Ambiguity", available at <http://www.federalreserve.gov/pubs/feds/2003/200364/200364pap.pdf>

6 Under so-called hedge accounting, in certain instances and for certain companies, a loss in derivatives contracts that are closed out before maturity can be designated as losses derived from hedges and can then be amortised over a period of time, instead of all at once.

7 Following the publication of this report, Fannie Mae and OFHEO reached an agreement requiring Fannie Mae to take several corrective actions, and to respect a capital surplus requirement equal to 30% of the minimum capital requirement.

The view of rating agencies has so far been balanced and cautious, weighing on the fact that there have been no substantial changes regarding the GSEs' implicit guarantees; indeed, the negative publicity may amount in the worst case to a downgrade from triple A to double A. For example, Fitch Ratings stated that while the triple A senior debt rating of these GSEs is not untouchable, it would take a combination of events that demonstrated that the government's relationship with the GSEs has been weakened or severed for the GSEs to be downgraded. On the other hand, rating agencies would respond favourably to legislation that creates a strong regulatory framework, as this would reinforce the safety and soundness of the enterprises.