

Testimony of

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Hearing on Taxpayer Exposure in the Housing Markets

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Taxpayer Exposure Through the Dramatic Expansion of Agency Debt

Mr. Chairman, Ranking Member Van Hollen, and members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a resident fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI in 2004, I was the President and CEO of the Federal Home Loan Bank of Chicago from 1991 to 2004. I have both professionally experienced and extensively studied the historical development of mortgage finance, including the remarkable role of agency debt.

The huge debt of the non-budget agencies and government-sponsored enterprises (“agency debt”) fully relies on the credit of the United States, which means by definition exposure of the taxpayers to losses, but it is not accounted for as government debt. As the Federal Reserve carefully notes in its “Flow of Funds” report, non-budget agency and GSE debt is not “considered officially to be part of the total debt of the federal government.”

Not “considered officially,” but what is it really? It puts the federal budget at risk, or more precisely, subjects it to major uncertainties of credit losses. It represents a kind of off-balance sheet financing for the government. The vast majority of agency debt goes to finance housing through Fannie Mae, Freddie Mac, the Federal Home Loan Banks, and the FHA/Ginnie Mae combination. Fannie and Freddie in particular have not unreasonably been characterized as “government SIVs,” which failed.

Agency vs. Treasury Debt

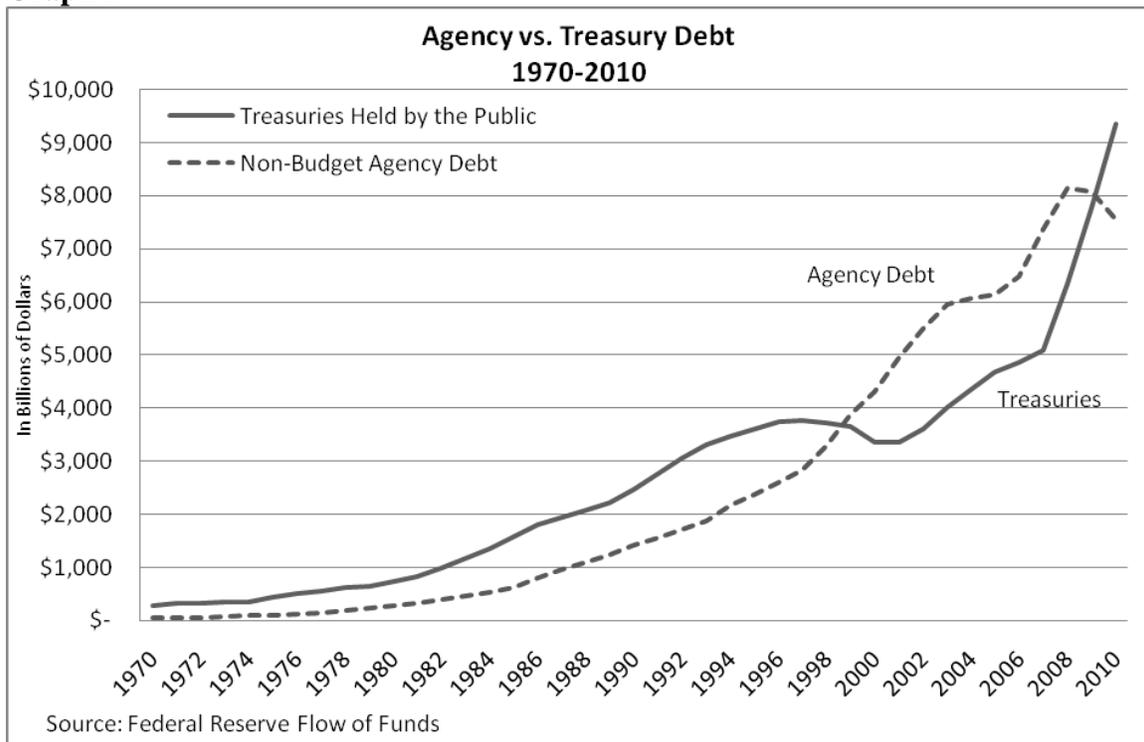
Over the last several decades, we have engaged in a financial experiment, or adventure, of exploding agency debt relative to Treasury securities.

In 1970, Treasury debt held by the public (“Treasury debt”) was \$290 billion. Agency debt totaled only \$44 billion. At the height of the housing bubble in 2006, Treasury debt was up to \$4.9 trillion, but agency debt has inflated to \$6.5 trillion. While Treasury debt had increased 17 times during these years, agency debt had multiplied 148 times.

At the end of 2010, Treasury debt was \$9.4 trillion, and agency debt was \$7.5 trillion.

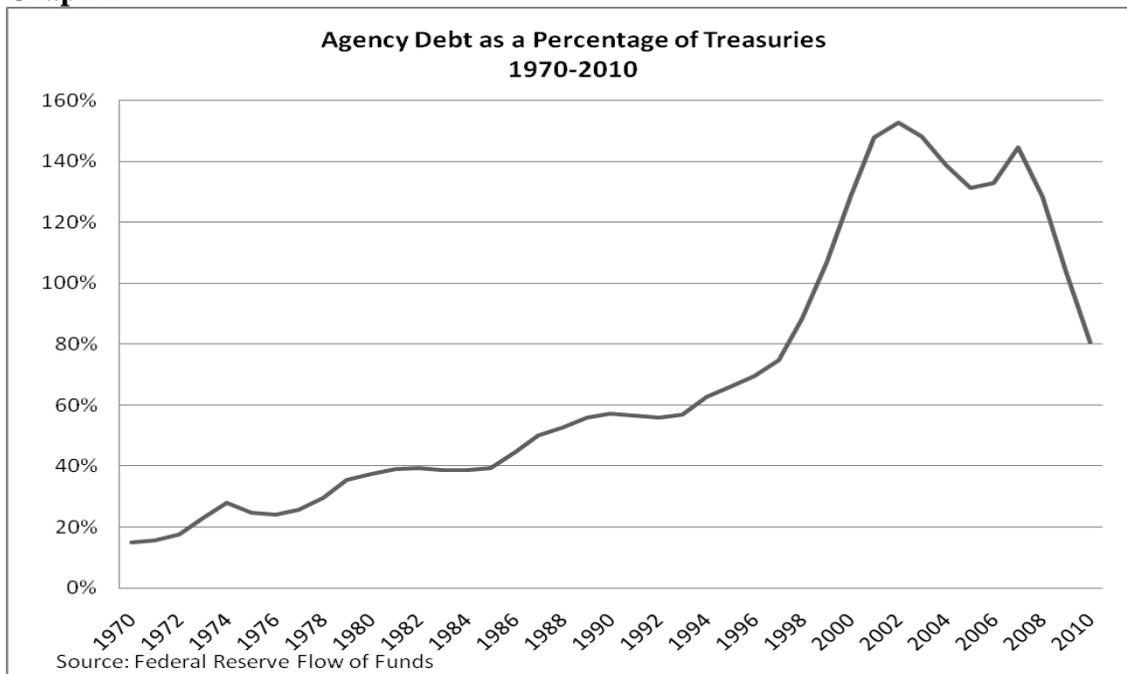
Graph 1 shows the remarkable history of agency vs. Treasury debt.

Graph 1

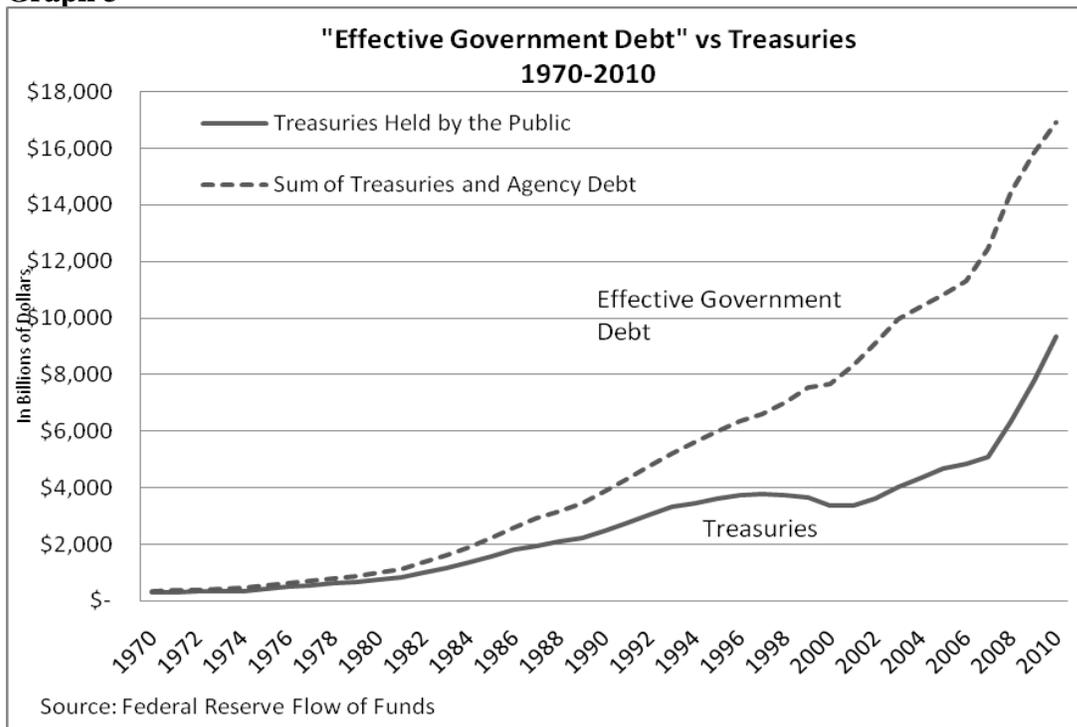


In 1970, agency debt represented only 15% of Treasuries. By the peak of the housing bubble in 2006, this had inflated to 133%. At the end of 2010, agencies were 81% of Treasuries, or about the level of 1997-98, just before the housing bubble, still a notably high level.

Graph 2 (on the next page) displays the trend of agency debt as a rapidly increasing percentage of Treasury debt. The percentage is falling at the end because of the big increases in Treasury debt we all know about.

Graph 2

If we add these two types of debt together, we can get a total of “effective government debt” (debt dependent on government credit) held by the public. Graph 3 compares this “effective government debt” with Treasuries—an instructive comparison.

Graph 3

Increasing the Cost of Treasury Debt

The expansion of agency debt not only imposes risk and realized losses on taxpayers (we do not need to mention the \$160 billion which the U.S. Treasury has been forced to put into Fannie and Freddie to prevent their financial collapse), it also increases the cost of Treasury's direct financing, by creating a huge pool of alternate government-backed securities to compete with Treasury securities, and thus increases the interest cost to taxpayers.

So although agencies are not "officially government debt," they undoubtedly increase the required interest rates on Treasury securities, in my judgment, and thus increase the federal deficit. The greater the amount of agency securities available as potential substitutes for Treasuries, the greater this effect must be. As a manager of a major institutional investor told me recently, "We view Fannie and Freddie MBS as Treasuries with a higher yield—so now we own very few Treasuries."

It is difficult to put an exact number on the counterfactual question of how much this increased cost has been. However, a quantitative suggestion is implied by a recent Federal Reserve analysis (Joseph Gagnon et al., "Large-Scale Asset Purchases by the Federal Reserve: Did They Work?"—FRBNY Economic Policy Review, May 2011). The authors conclude that by taking \$1.7 trillion in securities out of the market by Federal Reserve purchases, of which more than \$1 trillion were purchases of agency securities, the interest rates on ten-year Treasuries were reduced by "somewhere between 30 and 100 basis points."

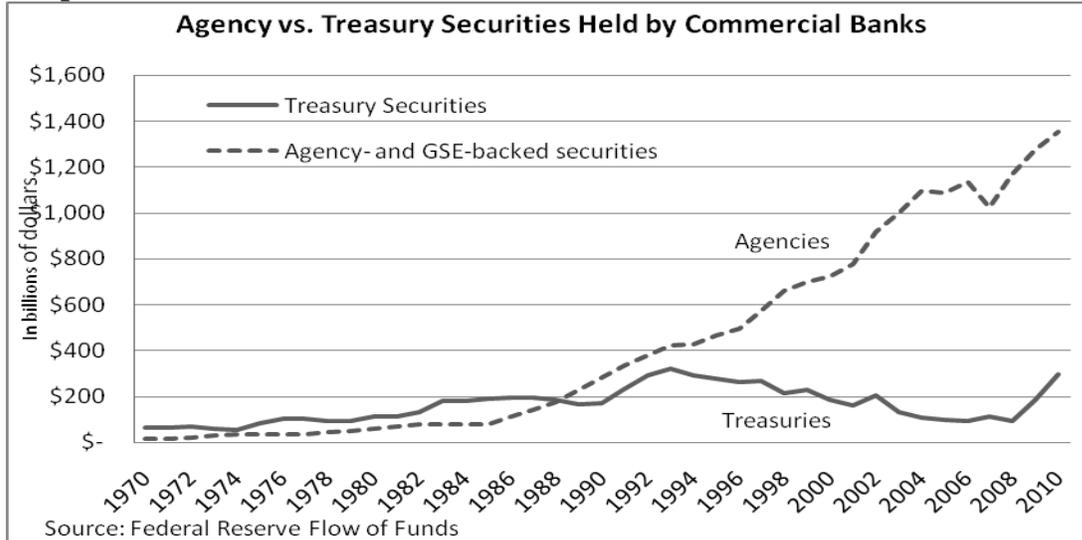
Suppose we run this logic in reverse: if the supply of effective government debt is increased by trillions of dollars of agency debt, perhaps that would *increase* the cost of long-term Treasuries by at least a like amount.

This result depends on the idea that investors will substitute agency debt for Treasuries and thus reduce the demand for Treasuries from what it would have been. We can observe a striking example of this substitution in the aggregate balance sheet of the commercial banks.

In 1970, commercial banks owned \$63 billion in Treasuries and \$14 billion in agency securities. Their Treasury holdings were more than four times their agency holdings. By 2006, at the peak of the bubble, all commercial banks owned only \$95 billion in Treasuries, which was dwarfed by their \$1.14 trillion in agencies. They then had 12 times the investment in agencies as in Treasuries.

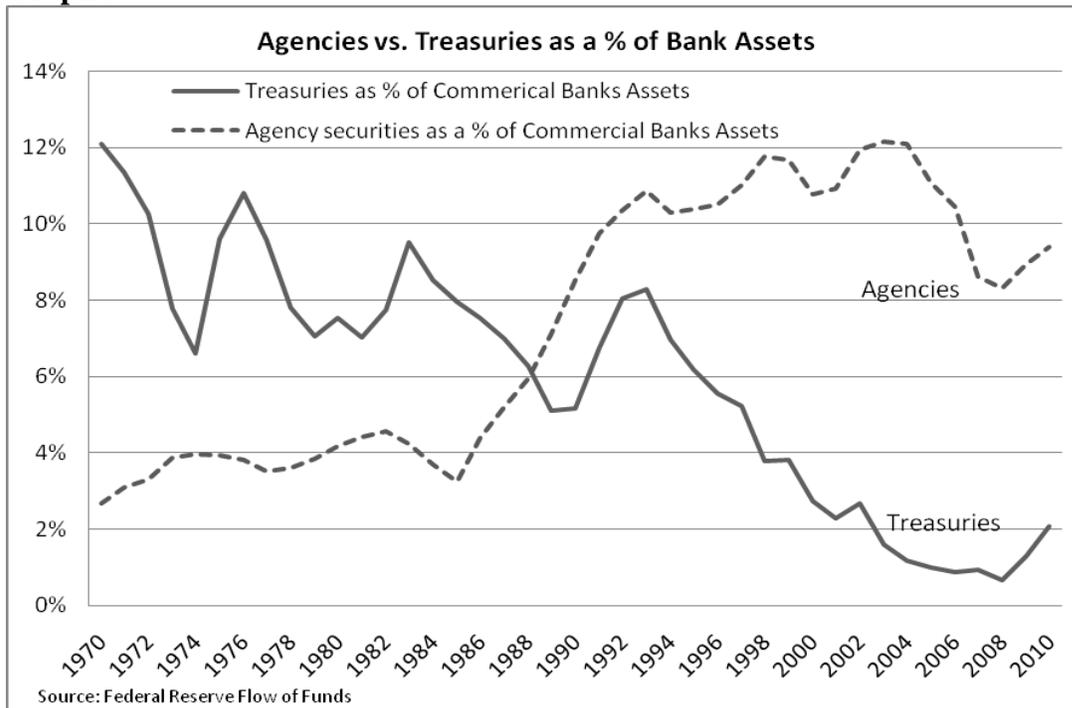
At the end of 2010, the corresponding totals are \$299 of Treasuries and \$1.35 trillion in agencies. This long-term trend of agencies vs. Treasuries in banking investments is shown in Graph 4 (on the next page).

Graph 4



Expressed as a percentage of banking assets, investment in Treasuries falls from 12% to less than 1%, then recovers to only 2% under current circumstances. Meanwhile investments in agencies inflates from less than 3% of banking assets to over 10%, then ended last year at 9.4%. This substitution is shown in Graph 5.

Graph 5



Why Was the Agency Debt Inflation Possible?

How was it possible for agency debt, and the corresponding taxpayer exposure, to grow so much for so long?

Well, bond salesmen, peddling trillions of dollars of Fannie, Freddie and other agency securities to investors all over the world, told them something like this: “You can’t go wrong buying these, because they are really a U.S. government credit, but they pay you a higher yield! So you get more profit with no credit risk.”

In contrast, a senior member of the Financial Services Committee memorably opined that Fannie and Freddie had “no explicit guarantee...no implicit guarantee...no wink and nod guarantee.” Official voices liked to point out that the offering memoranda for GSE debt said right there in bold face type that these securities were not guaranteed by the United States.

Nonetheless, what the bond salesmen said was right, as events have conclusively demonstrated. A good sense of the resulting situation is described by then-Secretary of the Treasury Henry Paulson in his memoir of the financial crisis:

“Foreign investors held more than \$1 trillion of the debt issued or guaranteed by the GSEs.... To them, if we let Fannie or Freddie fail and their investments got wiped out, that would be no different from expropriation. They had bought these securities in the belief that the GSEs were backed by the U.S. government. They wanted to know if the U.S. would stand behind this implicit guarantee—and what this would imply for other U.S. obligations, such as Treasury bonds.”

Note how in this description, the belief that agency debt is simply government debt links to discussion of Treasury securities themselves.

Risk vs. Uncertainty

Of course, using the credit of the United States to make, guarantee, insure or finance mortgage loans through any of the agencies which do so entails credit losses. This in itself is not a problem: if we knew what the losses would be, or knew what they would be within a narrow range, the losses could be easily priced and budgeted for.

For entities subject to the Federal Credit Reform Act, the expected (best guess estimates) of losses must be reflected as costs in the federal budget. This requirement was without doubt a major improvement over previous practice, but it does not address the fact that we do not know what the losses will be. As the Congressional Budget Office points out, the FHA, for example, has often had to increase its estimates of credit losses. In fact, the expansion of leverage created by the very programs in question, may make the losses bigger.

Huge increases in loss estimates characterized the failure of Fannie and Freddie. The limits of the most expert knowledge of the future extent of losses is highlighted by this statement of the then-Director of the Office of Federal Housing Enterprise Oversight: “Let me be clear—both [Fannie and Freddie] have prudent cushions above the OFHEO-directed capital requirements.” This March, 2008 statement was indeed clear, but wrong; only six months later both agencies collapsed.

Two months before the collapse, in July, 2008, the Chairman of the Senate Banking Committee pronounced: “What’s important are facts—and the facts are that Fannie and Freddie are in sound situation.”

As the Congressional Budget Office correctly says: “The expected cost of defaults...do not account for the *uncertainty* about how costly such defaults ultimately will be.” [italics added] We need to consider both, but indeed, the uncertainty, as opposed to the estimated cost, is the hard issue.

To help take the uncertainty into account, the CBO advocates using fair value cost estimates for Fannie, Freddie and the FHA, which draw from the market price for bearing credit loss uncertainty. I believe this is a reasonable thing to do, but even using such estimates, we would have greatly underestimated the losses imposed on the taxpayers by the use of the government’s credit to back agency debt.

Make Treasury Responsible for Managing the Government’s Credit

Managing the issuance of Treasury securities under the circumstances of the last decade, deals with only about half, and sometimes less than half, of the effective government debt.

In contrast, in the 1970s, the Treasury Department was more actively involved with agency debt. That is probably one reason agency debt was proportionally smaller. In those days, for example, it demanded its approval of every individual debt issuance by the Federal Home Loan Banks, as required by the Government Corporation Control Act of 1945.

This Act, which grew out of the sensible worry that government corporations were too free in using the credit of the United States, considered that the Treasury Department should be in control of the government’s own credit and its use by agencies.

It defined among its terms “a mixed ownership government corporation,” reflecting government ownership of some of the capital of the entity, as one form of “government corporation”—this category included and still does include the Federal Home Loan Banks.

The responsibility of the Treasury Department for such corporations is spelled out by the Act with notable rigor—much more so than in the Fannie and Freddie charter acts. Thus:

“Before a Government corporation issues obligations and offers obligations to the public, the Secretary of the Treasury shall prescribe –

- (1) the form, denomination, maturity, interest rate, and conditions to which the obligations will be subject;
- (2) the way and time the obligations are issued; and
- (3) the price for which the obligations will be sold.”

Pretty thorough.

Since 2008, there is no doubt whatsoever that Fannie and Freddie have been and are substantively government corporations. The bulk of their equity capital is owned by the government, although there are small residual private interests in common and junior preferred stock. So Fannie and Freddie are clearly “mixed-ownership government corporations,” in the sense of the Government Corporation Control Act.

I recommend that Congress should amend this Act explicitly to add Fannie Mae and Freddie Mac to its list of mixed-ownership government corporations, thus formally defining them as such.

This would:

--Reflect reality.

--Clarify and emphasize the Treasury’s responsibility to manage the single biggest use by agencies of the credit of the United States.

Make Treasury Responsible for Overseeing the Effects of Agency Debt on the Cost of Treasury Financing

In 1992, when agency debt was up to 56% of Treasuries, there was debate about the resulting effects on increasing the cost of Treasury debt (I am reliably told). The Treasury Department of the time declined to estimate this effect, however, plausibly reflecting the political muscle and hardball political tactics of Fannie in those days.

In the text of the Revenue Act of 1992, passed by the Congress, but not enacted due to a veto, was this useful provision, intended to force the Treasury to focus on the issue:

“The Secretary of the Treasury shall annually prepare and submit to the Committee on Banking, Housing and Urban Affairs of the Senate and the Committee on Ways and Means of the House of Representatives a report setting forth the impact of the issuance or guarantee of securities by Government-related corporations on—

- (1) the rate of interest and amount of discount offered on obligations issued by the Secretary
- (2) the marketability of such obligations.” [internal citations omitted]

To help address the obvious problems created by the inflation of agency debt, I recommend that this provision should be reintroduced and enacted.

In these ways, we could help control, for the future, the exposure of taxpayers created by the use of the government’s credit card by agency debt, the consequent uncertainty of losses, and the overleveraging of the housing sector which resulted in this last cycle.

Thank you again for the opportunity to share these views.