Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

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For Information Contact:

Peter J. Wallison
(202) 862-5864

Statement of the Shadow Financial Regulatory Committee

on

Proposed Legislation to Regulate the GSEs

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Last year, the Senate Banking Committee adopted S. 1508, which established a new regulator (the Federal Housing Enterprise Regulatory Agency, or FHERA), headed by a single administrator, for Fannie Mae, Freddie Mac and the Federal Home Loan Banks (GSEs). The bill also proposed new and tougher regulations for the GSEs, including receivership provisions that would have enabled FHERA to take control of the GSEs when they are critically undercapitalized and recapitalize, restructure or sell them in whole or in part. Although the receivership provisions attracted most of the attention and controversy, and was ultimately watered down because of opposition from Fannie and Freddie, the bill gave FHERA many important new powers. These include authority to increase required capital and to restrict the expansion of the activities of Fannie and Freddie outside the secondary mortgage market. Because of the weakened receivership provision, the administration opposed S.1508 last year, and it was never considered by the full Senate.

This year, a new bill (S. 190)—introduced by Senators Hagel, Sununu and Dole—builds upon the Senate Banking Committees effort last year. It retains FHERA and all the desirable features of S.1508—including the important receivership provision before it was weakened in the Senate committee—and improves many of them in important ways. For example, it requires the regulator to define the line between the primary and secondary mortgage markets, prohibits Fannie and Freddie from entering the primary market, and gives the regulator power to terminate those activities which breach the line, even if they are already underway. It also gives the regulator new powers to prohibit or limit golden parachutes and prohibit indemnification of directors or officers who incur civil liabilities or penalties for violating the law or applicable regulations. Perhaps most important, the bill gives the regulator the power to control Fannie and Freddie's assets and investment portfolio growth. If S. 1508 becomes the baseline for a Senate Banking Committee bill this year, it will be an important step forward.

The Committee has long been on record in favor of the complete privatization of Fannie and Freddie. In the Committee's view, regulation—even tight regulation—will never fully relieve the taxpayers of the potential liability associated with a congressional bailout of either company, and will not fully mitigate the potential systemic losses that a failure of either company might create.

The Committee notes, however, that if Congress is going to insist on regulation as at least a temporary solution, there are several additional provisions that should be included in the bill Congress ultimately adopts. The most important would be a requirement that the new regulator appoint a receiver when one of the GSEs is found to be critically undercapitalized. In both S. 1508 and S. 190, this is discretionary, and we know from experience with the savings and loan crisis that there are strong incentives for the regulator to forbear when a regulated company's capital falls to low levels. In this respect, the new bill should follow the prompt corrective action requirements that Congress adopted in FDICIA after the savings and loan crisis.

In addition, although Congress seems to favor regulation because they believe it will reduce the risks that Fannie and Freddie create for taxpayers and the economy as a whole, neither the original Senate committee bill nor the Hagel, Sununu-Dole bill provides directly and clearly for the elimination of the main source of that risk: Fannie and Freddie's ability to borrow in unlimited amounts for the purpose of acquiring and holding mortgages and mortgage-backed securities (MBS). Borrowing for this purpose is the source of their enormous interest rate and liquidity risk, which far exceeds the minimal credit risk that they take in guaranteeing MBS. While the Hagel-Sununu-Dole bill permits the regulator to establish standards "for the management of asset and portfolio growth," the Committee believes this provision should be strengthened so that the regulator will have the power to limit on the size and compel the gradual divestment of Fannie and Freddie's mortgage and MBS portfolios. Only in this way, and not through tougher regulation, will the risks they create be substantially controlled.

The elimination of Fannie and Freddie's power to buy and hold mortgages and MBS will not significantly impair whatever value they provide to the mortgage market. They can continue to securitize mortgages they purchase from banks and other lenders. As Federal Reserve economists recently noted, the elimination of their power to purchase and hold mortgages and MBS will have a negligible effect on mortgage rates.

There are also a number of additional provisions that would go a great distance toward eliminating the impression among investors that Fannie and Freddie are backed by the government. A few of these are repeal of their exemption from state and local taxes, their so-called line of credit at the Treasury, the authority for national banks to make unlimited investments in their securities, and the fact that their securities may be used to collateralize Treasury's deposits in banks. Other restrictions, that would seem to be appropriate for organizations that receive a government subsidy, include prohibiting political contributions and placing limits on lobbying activities.

Finally, although many studies have shown that Fannie and Freddie do not effectively assist the affordable or low income housing market, Congress may want some subsidized governmental organization to perform this role. Accordingly, the Committee recommends that Congress authorize Ginnie Mae, which currently securitizes Federal Housing Administration and Veterans Administration mortgages, to securitize affordable and low-income mortgages and thus assume one of the activities that Fannie and Freddie are supposed to pursue.