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Statement of the Shadow Financial Regulatory Committee on

Government-Sponsored Enterprises

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The subprime mortgage crisis has brought to light several policy issues associated with the functioning of government-sponsored enterprises, including Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBs). The Shadow Committee has issued a number of Statements in the past advocating the full privatization of Fannie Mae and Freddie Mac (Statements No. 164, 166, 196, 216, and 221), a limitation on the size of their portfolios (Statements No. 196, 216, 218, and 221), and greater scrutiny of the lending practices of the FHLBs and a reform of their structure (Statements No. 144, 159, 164, and 232). The current turmoil in the mortgage markets has demonstrated the need for greater attention in Congress and the Administration to the risks these organizations create for the taxpayers and the economy generally.

Recent reports indicate that Countrywide Bank FSB (Countrywide)—a thrift institution subsidiary of troubled Countrywide Financial—has borrowed $51 billion from the Federal Home Loan Bank of Atlanta. This sum amounts to approximately one-half of the institution's total funding, and was made necessary by a continuing outflow of funds. Another indication of the institution's current difficulties is the fact that it is offering above market rates on deposits. Healthy savings and loan institutions and banks often borrow from their local FHLBs, especially when this source of funds is less expensive than the cost of deposits. In the normal case, this is not a problem, although there are serious questions as to whether banks and S&Ls need another source of funds in addition to insured deposits and the very extensive capital markets.

There is no substantial credit risk to the Atlanta FHLB as a result of this lending; all advances by the FHLBs to their members are fully collateralized by mortgages. However, should the institution fail, the size of the loss to the Federal Deposit Insurance Corporation (FDIC) may be increased. The Atlanta Bank's funding may be enabling Countrywide to remain open when it should be closed because of its losses. We know from the S&L crisis of the late 1980s that allowing insolvent institutions to stay open only compounds their losses, as they take greater risks in an effort to regain their profitability. The existence of the FHLBs as a funding source for weak or failing banks and thrifts thus threatens to increase their losses and the hole that the FDIC will have to fill if they ultimately fail. In addition, by pledging its best assets to the FHLB, Countrywide has increased the FDIC's costs in the event of Countrywide's failure. These costs will fall on all other insured banks and S&Ls, which pay deposit insurance premiums that are the source of the FDIC's funds.

Fannie Mae and Freddie Mac have recently announced substantial quarterly losses because of subprime loans, and advised analysts that they expect these losses to continue at least into the next quarter. Freddie Mac's stock price has declined 41.5 percent since early October, and Fannie's share price decline has also been steep, as investors have become aware that both Fannie and Freddie are exposed to subprime losses. Fannie and Freddie's capital requirement is set by statute at 2.5 percent of assets, and the two institutions together have aggregate capital of approximately $60 billion. At this level, losses on portfolios of almost $3 trillion do not have to be very large before their capital will be seriously impaired or exhausted. Some analysts believe that they may become insolvent. Recently both enterprises announced the sale of preferred stock to raise approximately $7 billion each in new capital.

A few years ago, most people could not imagine that Fannie and Freddie might actually become insolvent because of credit losses. Now it is a real possibility. The danger now is that because of their perceived government backing the capital markets will continue to fund them, enabling them—like the S&Ls in the 1980s—to take risks in an effort to recover their profitability. These risks have the potential to increase their losses, and thus the burden on the taxpayers, who will probably have to bail them out in the event of their insolvency.

Short of fully privatizing Fannie and Freddie, the only way to prevent the build-up of losses would be to give their regulator the authority to monitor and close them down in the event of insolvency. Their regulator, the Office of Federal Housing Enterprise Oversight, does not have this power. Legislation passed by the House of Representatives last May (H.R. 1427) would create a new regulatory structure for Fannie Mae, Freddie Mac and the FHLBs. In particular, it would increase the regulator's power to close down Fannie or Freddie if either enterprise should become insolvent. This legislation has been languishing in the Senate Banking Committee. The Shadow Committee urges the Banking Committee's leadership to consider this legislation promptly and bring the Fannie and Freddie under prompt corrective action rules similar to those under which banks operate.