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Statement of the Shadow Financial Regulatory Committee on

**The Future of the Government-Sponsored Enterprises**

September 15, 2008

On September 7, the Treasury Department and the Federal Housing Finance Agency (FHFA) announced that the FHFA would take over both Fannie Mae and Freddie Mac (the GSEs) as a conservator for each company. As described by the FHFA, as a conservator it is empowered to put a company “in a sound and solvent condition.”

The Shadow Financial Regulatory Committee has a long history of concern about the GSEs, with ten statements beginning in 1990 and continuing through 2008 (Statements No. 61, 75, 131, 164, 166, 196, 216, 218, 221, and 251), all noting that these two institutions were creating substantial and growing risks for the economy and the taxpayers. Now that these risks have turned into real losses—requiring the government’s explicit backing to hold down their interest costs—policymakers should use this opportunity to address the moral hazard and conflicting objectives that arise from a public mission coupled with private ownership which is inherent in the GSE business model. Indeed, in his statement on September 7, Secretary Paulson said that “there is a consensus that these enterprises pose a systemic risk and they cannot continue in their current form.”

The Committee believes that the establishment of the conservatorship must be the beginning and not the end of this process. As the Secretary says, the GSE model must be reformed. After the housing market has been

stabilized and other sources of mortgage financing have become available, there are three plausible outcomes: nationalization, privatization or liquidation. Continuation in GSE status should not be an option.

The best of the three is liquidation. Nationalization is not necessary because the private sector in the modern global financial system is fully capable of providing other and more efficient means of providing mortgage financing. Moreover, there are better ways of promoting affordable housing than by encouraging GSEs to take risks that are not commercially justifiable and hidden from public view. In Australia, for example, the government provides a transparent and direct down payment grant to first time home buyers, who then negotiate mortgage financing under normal commercial standards.

Privatization could be a sensible course, especially if the sale of Fannie and Freddie returns to the taxpayers some of the costs that they will have borne in the bailout. But the Committee is concerned that in light of the history of these companies, and particularly if they are privatized as large entities, they would still be considered too big to fail or otherwise government-backed. Breaking them up into smaller units for privatization would reduce their sale value for the taxpayers, involve difficult questions of dividing their information assets, and still not prevent them from recombining in the future to restore the current undesirable structure.

Accordingly, the Committee believes that liquidation is the most promising course. It allows taxpayers (and shareholders, if the companies return to profitability) to benefit from whatever value remains in the companies, but minimizes the risk of continuing government involvement with their activities.