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Statement of the Shadow Financial Regulatory Committee on
Legislation on Fannie Mae and Freddie Mac

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The bills now before Congress (HR 2575, sponsored by Congressman Baker; HR 2803, sponsored by Congressman Royce; and S. 1508, sponsored by Senators Hagel, Dole and Sununu) contain useful first steps but must go further to address the fundamental issues with respect to Fannie Mae and Freddie Mac. Similarly, the Treasury testimony, while containing useful and constructive ideas, did not address the tough questions. Indeed, the danger is that Congress and the Administration may miss the opportunity for real reform.

The central question raised by the quasi-public status of Fannie and Freddie is whether the taxpayers and the economy itself can be adequately protected, by regulation alone, against the risks these two government-sponsored enterprises (GSEs) create. Not only have Fannie and Freddie now issued over \$1.5 trillion in debt obligations--for which the US government is perceived by many to be the implicit backer--but the very fact that there are only two GSEs, and that they completely dominate the residential real estate finance, adds other dimensions of risk. A major mistake by the management of either company could seriously impair the housing finance process and, through the housing market, adversely affect the economy as a whole. Moreover, if either should suffer substantial losses, the taxpayers could be called upon to make good on their debt obligations. It is important to recall that Fannie and Freddie are receiving a lot of attention today because of a major error of judgment by the management of Freddie Mac. Fortunately, that error will not have systemic consequences, but there is no reason to assume that future errors will be so inconsequential.

In the face of this, Congress and the Administration have proposed little that will protect the taxpayers and the economy. Turning the regulation of Fannie and Freddie over to an agency of the Treasury Department, while marginally better than regulation by the Office of Federal Housing Enterprise Oversight, is

not the right answer over the long run. Congress and the Administration well know that the political power of Fannie and Freddie will make the new agency's effective use of its statutory authority highly questionable. For example, under the various bills and in the Treasury proposal, the new agency will have the authority to increase the minimum capital of Fannie and Freddie, but it is doubtful that it will be able to exercise that authority if the result might conceivably be higher mortgage interest rates. The GSEs have been able in the past to avoid reform by arguing that any change in their status will cause mortgage rates to rise. The lesson of the S&L debacle of the 1980s is clear: regulators will not act on matters that have serious political consequences until a crisis is upon them. Fannie and Freddie are aware of this, and for that reason have not opposed the move for a new regulator—even a regulator located in the Treasury Department with enhanced authorities. The recent increase in Fannie's share price indicates that investors have recognized that the threat of any real restraints on Fannie and Freddie has receded.

There are ways to reduce or eliminate the risks associated with Fannie and Freddie, without more regulation. Their purchase of mortgages and mortgage-backed securities (MBS), which entail substantial interest rate risk, could be prohibited or limited. And the indicia of their government support—including the president's authority to appoint five directors of each company, their so-called line of credit at the Treasury, their exemption from portions of the securities laws and from state and local taxes, among many others—could be severed. These and other privileges and immunities are the source of investors' view that the government will not allow Fannie or Freddie to fail, and account largely for their lower borrowing costs than potential competitors and the absence of significant market discipline.

Unfortunately, the bills now before Congress only call for a study of whether Fannie and Freddie should be permitted to accumulate large portfolios of mortgages or MBS. It was also disappointing that the Treasury would not go even as far as the Clinton Treasury was willing to go when it called for the elimination of the so-called Treasury line of credit.

The Committee has long argued that the only way to protect the taxpayers and the economy against the risks associated with Fannie and Freddie is through the privatization of these companies, by unmistakably cutting their links to the government and their indicia of government support. In this sense, one proposal that the Committee can fully endorse was Secretary Snow's statement that the Administration would favor the elimination of the president's authority to appoint five members of the boards of directors of Fannie and Freddie. Although insufficient in itself, this proposal—by starting the process of privatizing Fannie and Freddie—would at least be a constructive step in the right direction.

Nevertheless, until privatization can be achieved, the Committee believes that it would be preferable to lodge the regulation of Fannie and Freddie in the Treasury Department, that the new agency should be responsive to direction from the Secretary, and that it should be authorized and directed to regulate and supervise Fannie and Freddie as though they were insured banks. This would include raising their capital requirements to levels currently deemed adequate for insured banks, and limiting their activities outside the secondary mortgage market.