**SHADOW FINANCIAL REGULATORY COMMITTEE**

Administrative Office
c/o Professor George Kaufman
Loyola University of Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
(312) 915-7075
FAX (312) 915-7003

COMMITTEE MEMBERS
LAWRENCE CONNELL
Co-Chair
Prather, Seeger, Doolittle & Farmer
GEORGE G. KAUFMAN
Co-Chair
Loyola University of Chicago
RICHARD C. ASPINWALL
Chase Manhattan Bank
GEORGE J. BENSTON
Emory University
FRANKLIN R. EDWARDS
Columbia University
ROBERT A. EISENBEIS
University of North Carolina at Chapel Hill
JOHN D. HAWKE, JR.
Arnold & Porter
PAUL M. HORVITZ
University of Houston
EDWARD J. KANE
Ohio State University
ROGER W. MEHLE
Royer, Mehle & Babyak
ALLAN H. MELTZER
Carnegie-Mellon University
KENNETH E. SCOTT
Stanford Law School

SUPPORTERS INCLUDE
AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH
SARAH SCAIFE FOUNDATION
UNIVERSITY OF NORTH CAROLINA

Statement No. 61

For information contact:
Edward J. Kane
614-292-[illegible]708

Richard C. Aspinwall
212-552-8135

# Statement of the Shadow Financial Regulatory Committee

on

# Limiting Taxpayer Loss Exposure in Government-Sponsored Credit Enterprises

September 24, 1990

Government-sponsored credit enterprises ("GSEs") are financial intermediaries chartered by the federal government to increase the flow of credit to designated types of private borrowers. GSEs operate principally in the areas of housing, agricultural, and educational finance. Five major GSEs are: the Federal National Mortgage Association ("Fannie Mae"), the Federal Home Loan Mortgage Corporation ("Freddie Mac"), the Federal Home Loan Bank System, the Federal Agricultural Mortgage Corporation, and the Student Loan Marketing Association.

Although most of these enterprises are now owned by private stockholders, they nevertheless retain many characteristics of a federal agency. The hybrid private-federal nature of GSEs means that, much as was the case for the Federal Savings and Loan Insurance Corporation, any difficulties these firms encounter in covering their borrowing and guarantee obligations expose federal taxpayers to loss.

Because each GSE has a federal origin and retains many governmental responsibilities, its obligations receive the benefit of an informal federal guarantee. This means that its credit standing is enhanced in quality beyond that which it would deserve strictly on

the basis of its accumulated net worth and risky prospects for future profits. The guarantee extracts a credit subsidy from general taxpayers, in that being able to count on taxpayer backup lowers the interest rate on GSE debt below the level that each entity would have to pay if it were strictly a private corporation.

Assisted (indeed encouraged) by the federal credit subsidy, GSE obligations have grown rapidly in recent years and now aggregate more than $800 billion in amount. In the absence of its perceived guarantee, a GSE's funding cost would move inversely to the market value of its net worth. Hence, when a GSE's capital is low, taxpayer exposure to loss in its obligations can be substantial. For example, although Fannie Mae has since strengthened its balance sheet, research indicates that at yearend 1981 interest-rate-related capital losses on FNMA's mortgage holdings had driven its net worth to a negative value that equalled almost 15 percent of its debt. This negative net worth corresponds to the taxpayer's loss exposure in FNMA.

In May 1990, the Secretary of the Treasury recommended legislation to limit the credit subsidy created by taxpayer loss exposure in GSEs. The principal provision of the Treasury plan is to require that each GSE obtain from at least two nationally recognized credit rating services a triple-A rating that expressly excludes any presumption of federal credit support. The Treasury also recommended the creation of a new "financial safety and soundness regulator" to monitor and enforce GSE compliance with this requirement and to negotiate and oversee a business plan to correct any deficiencies that emerge. A final Treasury recommendation proposed that the value of any credit subsidy that still accrues to each GSE from ongoing federal credit enhancements be disclosed annually as part of the President's budget.

The Shadow Financial Regulatory Committee applauds the Treasury's proposals as a sensible plan for starting the important task of bringing credit subsidies to GSEs under appropriate administrative control. The central feature of the plan is to enlist the analysis of market-driven private credit-rating services to supplement and override the judgments of politically sensitive entities. Credit rating services would have incentives to do this job. To preserve the good reputation on which the rest of its

business vitally depends, a credit service could not afford to give a "bailout-inflated" triple-A rating to a GSE that was not well-capitalized for the business and portfolio risks inherent in its operations.

Top officials of the GSEs prefer to have their debt rated with the benefit of the guarantee and to negotiate standards for assuring the strength of its balance sheet with politically sensitive government officials. Fannie Mae and Freddie Mac executives have argued against the Treasury plan by labeling the proposal an extreme measure whose adoption would disrupt housing and mortgage markets and sharply raise the cost of the ongoing FSLIC bailout. These claims are misleading. They greatly exaggerate both the importance to housing markets of the credit subsidy these firms receive and the extent to which the subsidy passes through to the average homeowner.

Moody's Investors Service has also attacked the practicality of the Treasury plan, claiming that a rating that ignored the relationship between GSEs and the government would be a "spurious product" based on "hypothetical and unrealistic assumptions." The Committee finds this an unconvincing objection. All credit ratings are based on assumptions that are by their nature hypothetical and undertake to analyze a multiplicity of possible events. In contrast, the Standard & Poor's Ratings Group has said that it could in fact perform the necessary analysis. The relevant concern for the rating agencies, which has been clearly noted by Standard & Poor's, is developing safeguards by which to assure that political efforts to influence the ratings GSEs receive do not ultimately corrupt the rating process.