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Statement of the Shadow Financial Regulatory Committee

on the

Protecting Taxpayers from Risks of Government Sponsored Enterprises

September 16, 1991

The Financial Institutions Reform, Recovery and Enforcement Act of 1989 required three governmental agencies to study of the risks posed by government sponsored credit enterprises[1] (GSEs) -- the Department of the Treasury, the Congressional Budget Office, and the General Accounting Office. Following their studies, legislation (H.R. 2900) was introduced to impose federal bank-type regulation, risk-based capital requirements, and early intervention and closure policies on GSEs. This legislation acknowledges that risks to taxpayers are inherent in these institutions' operations. The Shadow Financial Regulatory Committee previously urged action to deal with this situation (see Statement No. 61, September 24, 1990.)

Although GSEs have equity contributed by private shareholders, it is widely believed that the

[1] The five major GSEs are the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Association (Freddie Mac), the Federal Home Loan Bank System, the Federal Agricultural Mortgage Corporation (Farmer Mac), and the Student Loan Marketing Association (Sallie Mae).

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liabilities of these institutions are covered by implicit government guarantees. Consequently, taxpayer funds might be required to cover losses that exceed shareholder-contributed equity. These implicit taxpayer guarantees have contributed to the rapid growth of GSEs, which now have more than $980 billion in outstanding liabilities. Because the guarantees are not priced, current owners and managers enjoy a subsidy.

Taxpayer loss exposure to GSEs has two roots. The first is the lack of adequate monitoring of GSE performance. The second is the absence of clear-cut governmental responsibility for ensuring that prompt corrective actions are taken before GSEs exhaust their shareholder-contributed capital and require taxpayer support. H.R. 2900 does provide for structured early intervention and resolution of troubled GSEs, in the manner that the Committee has long favored for commercial banks and thrifts.

The Committee believes that early intervention and resolution would be sufficient to control taxpayer risk exposure to GSEs, provided that required private capital were sufficient to absorb expected losses, that capital were measured meaningfully, and that the intervention and closure criteria were clearly specified. These provisions would avoid the flaws and distortions in the risk-based capital requirements now applied to banks and thrifts, and that are proposed by H.R. 2900 for GSEs. (See Committee's Statement No. 18, May 18, 1987.)

Higher required capital and early intervention and resolution proposed have several desirable properties. They accommodate the evolution of new GSE activities and products, rely on market discipline to control risk taking, and keep government involvement in GSE decisions to a minimum. To protect taxpayers further, these measures should be coupled with adequate monitoring and reporting systems, which include market-value reporting of the value of assets and liabilities and improved accountability.

To avoid potential conflicts of interest, the Committee urges that government oversight of a GSE's activities not be lodged with an agency charged with promoting the social or private-interest goals that gave rise to that GSE. For example, the Committee is

concerned that HUD's responsibilities for the housing-related GSEs create incentive conflict between the agency and the taxpayer. Should either of the housing GSEs get into financial difficulties and threaten government-housing-support policies, the pressure for regulatory forbearance could result in de facto commitment by HUD of taxpayer funds without proper oversight and government review. Instead, we urge that oversight be lodged either with a new independent agency or with an existing one, such as the Department of the Treasury or the Office of Management and Budget.

Finally, we urge reform of GSEs to reduce to zero taxpayer subsidies to these entities. To assist such reform, we propose that the value of these subsidies be estimated and explicitly recognized in the federal budget.