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Statement of Shadow Financial Regulatory Committee

on

Extending the Credit Reform Act to GSEs

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Government-sponsored enterprises (GSEs) operate principally in the areas of housing, agricultural, and educational finance. These areas receive credit subsidies in various forms. Six GSEs are officially recognized: the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation (FHLMC), the Federal Home Loan Banks, the Farm Credit System, the Federal Agricultural Mortgage Corporation, and the Student Loan Marketing Association. The principal difference between GSEs and government agencies is that private parties own claims to the residual earnings of a GSE.

Weaknesses in the budgetary treatment of government obligations make it easier to transfer subsidies to politically favored sectors through the use of federal guarantees and GSE's than through programs that entail direct expenditures. This is because opposition to enacting or expanding any subsidy program is lessened by delays in acknowledging the costs of the services rendered. The longer the time interval over which the budgetary costs of subsidies can be spread before they become fully scored, the more difficult it is for opponents to mobilize votes against them.

The Shadow Financial Regulatory Committee recommends that the Credit Reform Act of 1990 be amended to require the Office of Management and Budget (OMB) and the Congressional Budget Office (CBO) to measure the annual cost of the credit enhancements that each GSE enjoys. This annual cost should be included in the federal budget and a reserve fund should be established sufficient to absorb the losses that

might occur. This is a prerequisite to rationally evaluating the justification for continuing these enterprises.

In government, budget discipline substitutes for market discipline. But many government credit activities are not properly measured in the federal budget. Budgetary mismeasurement creates incentives that distort the size and shape of individual credit programs and shift risks to taxpayers.

It has been recognized for at least twenty-five years that improving budget discipline for federal credit programs begins with devising an accounting framework that can record the opportunity costs of government loans and guarantees in a timely fashion. Federal credit reform legislation passed in 1990 and implemented in fiscal 1992 creates a framework for measuring the present values of direct loans and statutory guarantees. However, the value of opportunities to borrow from the Treasury and the value of the inferred federal guarantees GSEs enjoy are not yet accounted for in the budgetary process. These borrowing opportunities and inferred guarantees explain why interest rates on GSE debt average at least 100 basis point below rates paid by private borrowers with similar balance sheets. They also explain how mortgage-backed securities issued by FNMA and FHLMC can sell at yields well below rates paid by private issuers with similar balance sheets.

Inferred guarantees exist because government sponsorship creates a presumption that, if a GSE were to become insolvent, political pressures would assign some of the enterprise losses to taxpayers ex post. If and when losses wipe out the market value of the capital contributed by private stakeholders in a GSE, these stakeholders face no further downside risk. The enterprise's downside risk shifts entirely into the implied credit enhancement. Whether or not a GSE actually becomes insolvent, taxpayers need to recognize that Treasury back-up implicitly supplies risk capital that enhances the value of private stakes in the firm. The availability of the implicit finance allows enterprise managers to escape the market discipline of making other arrangements to support their creditworthiness and promises to keep alive for GSE shareholders a claim on the enterprise's future profits in difficult times. This distorted arrangement for sharing risk makes private stakeholders willing to trade upside earning potential for downside risks at terms that disadvantage taxpayers. To balance the allocation of upside and downside risk, government officials should have the duty to force GSE shareholders to subscribe additional equity funds whenever shareholder-contributed capital falls short of an appropriate leverage ratio. Indeed, such a responsibility has been assigned deposit-

institution regulators by the prompt corrective action provisions of the FDIC Improvement Act of 1991.

For Congress and the Treasury to achieve adequate policy control over the federal government's expenditure and capital budgets, effects of GSE policy decisions on explicit and inferred credit enhancements must be measured and deviations from tolerable values must be corrected. Difficulty in observing the value and particularly the interest sensitivity of a GSE's credit enhancement lessens accountability in government. Perfect accountability exists when authorities are immediately and completely answerable for their actions. This requires that official decisions and their consequences be transparent enough for outsiders to monitor and discipline.

Unfortunately, the value of Treasury credit enhancements enjoyed by GSEs cannot be observed directly because they do not trade separately in capital markets. This means that no price for these instruments is established either by exchange specialists or by security dealers. Nevertheless, the value of credit enhancements is imbedded in GSE stock prices, and values can be observed for credit enhancements sold every day by comparable private financial-services firms.

For FNMA and FHLMC, recent legislation has begun the task of improving accountability. In 1992, primary responsibility for overseeing FNMA and FHLMC shifted from HUD to an independent Office of Federal Housing Enterprise Oversight (OFHEO). But the mission of this agency is limited to ensuring the "safety and soundness" of those particular GSEs. Its task is to prevent an explicit taxpayer bailout, not to cost out and control the value of the risk exposure the taxpayer faces from these enterprises. In addition to limitations imposed by its budget, OFHEO's ability to push its focus beyond conducting stress tests for capital adequacy is further restrained by limitations on staff size.

Although difficult, carrying out the Committee's recommendation to measure the cost of GSE credit enhancements is both important and feasible. OMB and CBO staff can appraise and account for the intangible value of a GSE's credit enhancement in two complementary ways. First, appraisers can impute a value from the annualized costs of private credit enhancements that have been issued to a sample of economically comparable private firms. Financial research methods can validate criteria by which to identify the set of comparable credit enhancements in private markets.

Alternatively, the value of each GSE's aggregate credit enhancement may be generated from a financial model. The modeling approach would interpret a GSE's aggregate credit enhancement as a government-contributed equity stake. An accurate measure of this stake should capture two components: the net cost of expected assistance payments discounted at Treasury bond rates, and an additional insurance value for underwriting the downside volatility of the risky obligations that are being supported on the GSE's balance sheet. Under current arrangements, the upside of this volatility flows asymmetrically to the private owners of the GSE's equity.

These budgetary procedures are urgently needed to recognize and value taxpayer subsidies to GSEs that flow through to shareholders, creditors, managers, and customers. Without such procedures, it is not possible to evaluate the efficiency of GSEs in achieving public policy goals relative to other uses of taxpayer funds.