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Statement of the Shadow Financial Regulatory Committee

on

Mortgage Lending by Federal Home Loan Banks

September 22, 1997

The Federal Home Loan Bank (FHLB) of Chicago recently began a program of making fixed-rate mortgage loans through FHLB member institutions to their customers, with the credit risk of the loans borne primarily by the member institutions. Although the loans are serviced by the member institution, they are owned by the FHLB which, therefore, is responsible for managing the interest rate risk. The FHLB expects that this program will increase competition in the secondary mortgage market, now dominated by the Federal National Mortgage Corporation (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC). These government sponsored enterprises (GSEs) charge fees for insuring against credit risk that greatly exceed their historical loss rates in many parts of the country. The FHLB program is designed to provide enhanced incentives for prudent underwriting and effective monitoring of mortgage loans by the member institutions.

The domination of the secondary mortgage market, the largest in the world, by FNMA and FHLMC enables them to obtain substantial monopoly profits for the benefit of their stockholders and management. They also enjoy a subsidy, as a result of implied taxpayers guarantees, in funding their activities by borrowing a rates comparable to government agencies.

The Shadow Financial Regulatory Committee has long been concerned about expansion of GSEs and the potential they pose for distortion of resource allocation, for unfair competition, and for increasing the risk of a taxpayers bailout in case of failure. Of course, the FHLBs are GSEs themselves, and these concerns still exist. In fact, the Committee has called for privatization of the Federal Home Loan Banks (Statement No. 134, May 6, 1996). The Committee believes, however, that this program (called "Mortgage Partnership Finance" by the FHLB of Chicago) has the potential for enhancing competition and thereby increasing efficiency in secondary mortgage market. To avoid an increase in the risk exposure of the U.S. taxpayer, it is essential that regulators require FNMA and FHLMC at least to maintain their capital ratios in this more competitive environment.

Success of the program requires that the FHLB manage the interest rate risk and its share of the credit risk of the mortgage portfolio without suffering significant losses. This is a new activity for the FHLBs. The Committee understands that the intention of the FHLB of Chicago is to implement the program on a gradual basis as experience is developed.

If the program is successful, FNMA and FHLMC may be forced to respond to this competitive pressure by reducing their charges for credit risk. That result would tend to reduce monopoly profits and represent a step in the direction of assuring that lower prices and the funding subsidy inherent in the quasi-agency status of the GSE are passed on the mortgage borrowers.

It is the Committee's policy that member abstain from voting on policy statements in which they have a direct personal or professional involvement in the matter that is the subject of the statement. Accordingly, Peter Wallison and Robert Litan abstained from voting on this statement.