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Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

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For Information Contact:

Edward J. Kane
(617) 552-3986

Peter J. Wallison
(202) 862-5864

Statement of the Shadow Financial Regulatory Committee on The Federal Housing Enterprise Regulatory Reform Act of 2005 (S. 190)

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In July, the Senate Banking Committee adopted S. 190, the Federal Housing Enterprise Regulatory Reform Act of 2005, legislation that would strengthen the regulation of the government-sponsored enterprises Fannie Mae and Freddie Mac (the GSEs). The bill includes many of the provisions of the legislation introduced earlier in the year by Senators Hagel, Sununu and Dole—a bill that was endorsed by the Shadow Financial Regulatory Committee in Statement No. 216, February 14, 2005—but improves on that legislation in several ways. One important change is to require the appointment of a receiver if the liabilities of a GSE exceed its assets, or if a GSE is not meeting its obligations as they come due. This is an improvement over the Hagel-Sununu-Dole bill, which made the appointment of a receiver discretionary and thus left room for forbearance. However, the Committee believes S. 190 should be strengthened further in this respect by requiring the appointment of a receiver if a GSE becomes critically undercapitalized—the same rule adopted in FDICIA for banks and savings and loans associations.

An even more important new element in the bill is a provision that would sharply reduce Fannie and Freddie's portfolios of mortgages and mortgage-backed securities (MBS)—which now aggregate approximately $1.5 trillion—by permitting the accumulation of mortgages only for purposes of securitization. The Shadow Committee previously endorsed the administration's proposal to reduce the GSEs' portfolios (Statement No. 218, May 16, 2005) and strongly endorses this element of S. 190. Holding large portfolios of mortgages and MBS exposes Fannie and Freddie to substantial interest-rate risk, which cannot be fully hedged. Fed chairman Alan Greenspan has emphasized that this exposure may generate systemic risk. In a systemic crisis, the taxpayers could well be asked to bail out these companies.

In the Committee's view, limiting GSE mortgage portfolios to the amount necessary to facilitate securitization is a good policy. While this would eliminate a substantial portion of the risk associated with these two companies, it will not impair in any way their role as intermediaries in the secondary mortgage market. They will still be able to continue their activities through securitization of mortgages—i.e., the creation of MBS—an activity that entails credit risk and not the more significant interest rate risk.

The Committee does not believe there is any need for government-backed activity in the secondary mortgage market, and has long advocated a true privatization of Fannie and Freddie (the severing of all connections with the government, including their government charters). However, if Congress is unwilling to fully privatize these two GSEs, a sharp reduction in the risks they create—through a substantial reduction of their portfolios—is the next best thing.