Review: Increasing the Accountability of Government-Sponsored Enterprises: First Steps

Reviewed Work(s):

Federal Credit Reform and Borrowing by Off-Budget Agencies by Committee on Ways and Means, U. S. House of Representatives

Government-Sponsored Enterprises by Committee on Ways and Means, Subcommittee on Oversight, U. S. House of Representatives

Report of the Secretary of the Treasury on Government-Sponsored Enterprises by Department of the Treasury

Government-Sponsored Enterprises: Government's Exposure to Risks by U. S. General Accounting Office

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Beverly A. Cigler, Editor

Increasing the Accountability of Government-Sponsored Enterprises: First Steps

Thomas H. Stanton
Olwine, Connelly, Chase, O'Donnell & Weyher

Committee on Ways and Means, U.S. House of Representatives, "Federal Credit Reform and Borrowing by Off-Budget Agencies," Hearing, 101st Cong., 1st Sess. (Washington: Government Printing Office, 18 April 1989), 106 pp.

Committee on Ways and Means, Subcommittee on Oversight, U.S. House of Representatives, "Government-Sponsored Enterprises," Hearing, 101st Cong., 1st Sess. (Washington: Government Printing Office, 28 September 1989), 155 pp.

Department of the Treasury, *Report of the Secretary of the Treasury on Government-Sponsored Enterprises* (Washington: Government Printing Office, May 1990), 490 pp.

U.S. General Accounting Office, *Government-Sponsored Enterprises: Government's Exposure to Risks*, (Washington: Government Printing Office, forthcoming).

Spurred by immense losses from the failure of the savings and loan industry, the federal government is moving to increase financial accountability of other federal instrumentalities. The government-sponsored enterprise (GSE) is under serious scrutiny. Two hearings and two recent reports highlight the new mood. On 18 April 1989 the House Ways and Means Committee held the first comprehensive oversight hearing of government-sponsored enterprises in over 30 years.[1] Adopting a focused definition of "government-sponsored enterprise," the committee addressed issues of financial accountability concerning the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal Home Loan Bank System (FHLBS), the Farm Credit System (FCS), the Federal Agricultural Mortgage Corporation (Farmer Mac), and the Student Loan Marketing Association (Sallie Mae).[2]

These institutions fall within the definition of a government-sponsored enterprise as a "privately-owned, federally-chartered financial institution with nationwide scope and limited lending powers that benefits from an implicit federal guarantee to enhance its ability to borrow money."[3] Together, government-sponsored enterprises have some $860 billion of securities outstanding that represent a contingent liability of the federal government.

Increased Accountability

The hearings and reports help to enhance accountability in three important ways. First, effective congressional oversight gives GSE managers an increased personal sense of congressional concerns and the need to reduce financial risk. Second, the Treasury and General Accounting Office (GAO) reports provide sophisticated documentation of the need for effective federal oversight that has been lacking for most enterprises. Third, the Treasury and the GAO have provided guidance to Congress on legislation needed to build a stronger institutional structure to enhance the safety and soundness of the government-sponsored enterprises and to reduce the government's financial exposure from GSE activities.

Congressional Oversight

Actions of the House Ways and Means Committee in 1989 provide a case study of congressional oversight at its best. The full committee heard testimony in March 1989[4] on government-sponsored enterprises and then held its first comprehensive hearings on 18 April 1989. As a part of the 1989 Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), the committee succeeded in adding a provision requiring the Treasury Department to study government-sponsored enterprises and their financial risks in two consecutive annual reports; this prompted the Senate Banking Committee to add a companion provision to FIRREA requiring the General Accounting Office to undertake two similar studies. The first of the Treasury and GAO reports are reviewed here.

Then in September 1989, the Oversight Subcommittee of the Ways and Means Committee, chaired by Representative J. J. Pickle of Texas, heard testimony from the Treasury Department and the U.S. General Accounting Office, from the Chief Executive Officers of Fannie Mae, Freddie Mac, the Farm Credit Bank of Baltimore, Farmer Mac, and Sallie Mae, and from the President of the Federal Home Loan Bank of New York. As Chairman Pickle pointed out in his opening statement, while GSEs involve a federal contingent liability of hundreds of billions of dollars, "neither the unified budget nor any other Federal budget documents show any cost to the Federal Government...from the risks it bears as a result of the activities of these Government-sponsored enterprises" (p. 4).

The hearings provided an opportunity for members of Congress to raise important questions about the kinds of risks taken by these financial institutions and the means the enterprises use to manage and reduce their risk exposure. Most importantly, the committee explored the way that the federal government's implicit guarantee, diminishes market discipline and gives enterprise managers incentives to take risks that can increase the government's exposure.[5] Representative Willis Gradison of Ohio focused attention on possible remedies such as market-value accounting (to improve the quality of information disclosed in financial reports) and increased Treasury supervision.

The Ways and Means Committee activities combined important elements of effective congressional oversight: (1) a clear sense of the intended scope of the inquiry; (2) provision for effective analytic support from the Executive Branch; and (3) an invitation for specific policy recommendations to address the issues of concern to the committee. Of these, the first element was perhaps the most important. Chairman Pickle repeatedly stressed his respect for the public purposes and missions of the various government-sponsored enterprises; the Ways and Means Committee consistently and carefully limited the scope of the Treasury Department study to questions of safety and soundness and financial accountability. This excluded some potentially complicating issues, such as challenges to the fundamental legitimacy of government-sponsored enterprises as instruments of federal policy,[6] that had immense potential to deflect the policy debate from the focused issues of concern to the committee.

The committee's use of the Treasury Department for analytic support was another important step. A variety of Executive Branch agencies are supposed to oversee government-sponsored enterprises. For example, the Department of Housing and Urban Development is responsible for regulating Fannie Mae and Freddie Mac, the Farm Credit Administration (FCA) for supervising the Farm Credit System, and the Federal Housing Finance Board for overseeing the Federal Home Loan Bank System. The perspective of each of these departments or agencies is largely limited by its programmatic responsibilities; none has either the mandate or inclination to look broadly at all GSEs or—except perhaps for the FCA—to separate issues of financial risk from politically charged questions about each enterprise's public purpose.

Finally the Committee emphasized that its focus was institutional in nature: what reforms, both in Executive Branch supervision and in the structure of GSEs themselves (e.g., by increasing the required amounts of capital) would the Treasury recommend in its study? The Ways and Means Committee made clear that it would be open to comprehensive recommendations rather than the kind of piecemeal and ad hoc responses that have characterized the federal government's handling of the thrift institution debacle.

The Treasury and GAO Reports

The activities of the Ways and Means Committee created a ripple effect in Congress and prompted increased attention to government-sponsored enterprises by the Senate Banking Committee as well.[7] Faced with serious interest by two important Committees, both the Treasury and GAO devoted considerable effort to assuring the high quality of their work. Both, however, were limited in their access to data and records; they had to request information from each GSE and were not permitted to conduct independent examination (such as the federal government conducts for banks and thrift institutions with federally-insured deposits) to validate the accuracy of the responses. Given this significant limitation, the quality of the 1990 studies is especially impressive.

The first of the two annual Treasury reports, published in May 1990, carefully tracks the legislative mandate of FIRREA. For each GSE, the Treasury report provides (1) a description, (2) an overview of financial safety and soundness, (3) assessments of business risk, credit risk, interest rate risk, and management and operations risk, (4) analysis of capital adequacy, and (5) discussion of the quality and timeliness of information provided by each GSE to the public and to the federal government. The Treasury also attempted—unsuccessfully as it turned out—to measure the impact of GSE borrowing on the cost of federal government borrowing.

The Treasury Department report provides a veritable checklist of important elements of financial risks and the extent to which each enterprise can or has kept risks under control. Among the more important findings:

- *Fannie Mae*: Fannie Mae's biggest credit risk is a regional or national economic slowdown; about 50 percent of Fannie Mae's outstanding mortgages are concentrated in five states. For large interest rate increases (of three percentage points), the net market value of Fannie Mae's mortgage business turns negative; for even larger interest rate changes Fannie Mae's net worth becomes negative. Fannie Mae's ability to use effectively its new management information system needs improvement. Treasury does not consider Fannie Mae's current leverage an imminent threat, but additional capital is necessary.

- *Freddie Mac*: Freddie Mac's mortgage business is geographically more diversified than is Fannie Mae's, and Freddie Mac manages its credit risk. Under current policies, Freddie Mac's exposure to interest rate risk is small. Freddie Mae has adequate controls, monitoring and information systems. The corporation's current degree of leverage does not seem to present an imminent threat but raises concern for the longer term.
- *The Federal Home Loan Bank System*: The Federal Home Loan Banks face problems associated with declining membership and declining demand for FHLBS funding due to contraction of the thrift industry. The FHLBS has successfully controlled credit risk (it has never suffered a loss on an advance) and has effectively managed interest rate risk. The FHLBS successfully controls management and operations risk and is currently well capitalized.
- *The Farm Credit System*: The Farm Credit System remains exposed to risk of the volatility of the agricultural sector and continues to have credit risk due to its restriction to a single economic sector. The FCS has significantly improved its management of interest rate risk, but needs to do better. The system is exposed to risks associated with lack of board oversight, ineffective internal audit functions, and inadequate management information systems. There is some question whether the borrower stock of the FCS, a major component of the system's permanent capital, is at risk in the way that shareholder equity represents true capital; FCS must build retained earnings to protect against losses.
- *Sallie Mae*: Sallie Mae is not exposed to much business risk or interest rate risk. The corporation is protected from credit risk on its federally guaranteed or reinsured student loan portfolio, but should require collateral in swap transactions sufficient to cover its credit risk exposure. Sallie Mae has adequate controls to manage and monitor its operations, and it has a strong capital base and does not need to increase its capital at this time.

The GAO report similarly analyzes each GSE and (1) its risks and the quality of its risk management, (2) its loss reserves and capital adequacy, and (3) the quality of current federal oversight of its risk-taking and capitalization. It is especially critical of the quality of current federal oversight of government-sponsored enterprises. Among its findings:

- Fannie Mae, Freddie Mac, and Sallie Mae are subject to much weaker monitoring, capital rules, and enforcement actions than are banks with federally insured deposits.
- The FHLBS is subject to minimum capital requirements, monitoring of activities, and enforcement actions that could help the government to control excessive risk-taking; however, it is unclear how the new Federal Housing Finance Board, established in August 1989 to regulate the FHLBS, will implement its authority and whether it will be effective.
- Legislation passed in 1985 gave the Farm Credit Administration powers similar to those of federal bank regulators and made it independent of the FCS.
- Sallie Mae has neither a federal regulator nor federally established capital requirements.

Treasury and GAO Recommendations

The Treasury Department proposals, presented to the House Ways and Means and Senate Banking Committees by Robert R. Glauber, Undersecretary for Finance, consist of four guiding principles and recommendations to reduce risk to the taxpayer and to assure the long-term solvency of GSEs. The four principles are:

1. Each GSE should be adequately capitalized, meet high credit and operational standards, and be subject to effective government supervision;
2. A private market mechanism should be used to evaluate GSE risk; each GSE should obtain a rating equivalent to triple-A, absent any implicit government guarantee, from at least two of the nationally recognized credit rating agencies;
3. GSEs should be supervised for financial safety and soundness by a regulator different from the program regulators; in other words, a financial regulator such as the Federal Reserve, Federal Deposit Insurance Corporation, or the Treasury itself should supervise safety and soundness of the GSEs while agencies such as HUD remain responsible for overseeing the programmatic activities of GSEs such as Fannie Mae and Freddie Mac; and
4. Each GSE should disclose annually the value of the federal government's credit support; this should be measured as the difference between (1) the cost of funds of the GSE and (2) the cost of funds of a corporation that has the credit rating that the GSE has obtained (again, without regard to the government's implicit guarantee).

In testimony, Assistant Comptroller General Richard L. Fogel largely concurred with the Treasury Department's position. However, the General Accounting Office appears more comfortable applying bank-type capital and regulatory requirements than relying upon the rating of private rating agencies to set capitalization levels. If the Treasury's recommendations were adopted and private rating agencies were used, then Fogel recommended that the federal GSE financial regulator examine closely the assumptions used by each rating agency and the appropriateness of the final capital standard. Although the General Accounting Office is expected to issue more definitive recommendations in its 1991 report, Fogel urged the congressional committees to act promptly, if they saw fit, to implement the general substance of the Treasury and GAO reports.

Conclusion

As was the case for thrift institutions, recommendations for enhanced accountability of GSEs emphasize the need for effective federal oversight and increased capitalization. The politics of the thrift industry's legislative efforts are also instructive. As were the thrifts in the 1980s, government-sponsored enterprises today are powerful and resistant to change. Especially some GSEs that would find it difficult or expensive to comply with the Treasury's recommendations may try to hamper passage of implementing legislation. Fannie Mae and Freddie Mac are two of the largest financial institutions in the United States, larger than the nation's largest banks and bank holding companies, and they have concomitant political strength as well. Fannie Mae and the FCS Farm Credit Council each have political action committees.

Statesmanship can be defined as the optimal combination of sound policy and good politics. The Treasury and GAO studies provide an impressive framework for implementing sound policy with respect to GSEs; it remains to be seen how the politics evolve and how much Congress has learned from its experiences with the thrift industry.

* * *

Thomas H. Stanton is a Washington, DC, attorney whose practice includes matters relating to federal credit programs and financial institutions. His recent writings include "Federal Supervision of Safety and Soundness of Government-Sponsored Enterprises," prepared for the Administrative Conference of the United States (forthcoming).

Notes

1. Committee on Government Operations, Executive and Legislative Reorganization Subcommittee, U.S. House of Representatives, "Amending the Government Corporation Control Act," Hearing, 85th Cong., 2nd Sess. (Washington: Government Printing Office, February 1958). Over the years there have been a variety of other hearings with respect to particular issues concerning individual GSES.
2. The Committee also examined the College Construction Loan Insurance Association (Connie Lee). Connie Lee is a joint venture between Sallie Mae and the U.S. Government. It is technically not a government-sponsored enterprise because its borrowings do not carry an implicit federal guarantee; also, it is not completely privately owned.
3. Ronald C. Moe and Thomas H. Stanton, "Government-Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability," *Public Administrative Review*, vol. 49 (July/August 1989), p. 321. Harold Seidman has used the term "government-sponsored enterprise" more broadly. See, e.g., Harold Seidman, "The Quasi-World of the Federal Government," *The Brookings Review*, vol. 6 (Summer 1988), pp. 23-27.
4. Committee on Ways and Means, U.S. House of Representatives, "Budget Implications and Current Tax Rules Relating to Troubled Savings and Loan Institutions," Hearing, 101st Cong., 1st Sess. (Washington: Government Printing Office, 9 March 1989), pp. 344-351, 364-373, Testimony of Thomas H. Stanton.
5. This issue is discussed in Thomas H. Stanton, *Government-Sponsored Enterprises: Their Benefits and Costs as Instruments of Federal Policy*, (Washington: Association of Reserve City Bankers, 1988), pp. 17-21.
6. Such challenges were a part of Reagan Administration policy. See, e.g., Committee on Banking, Finance and Urban Affairs, Subcommittee on Housing and Community Development, U.S. House of Representatives, "To Expand and Reorganize the Federal Home Loan Mortgage Corporation," Hearing, 97th Cong., 2nd Sess. (Washington: Government Printing Office, 3 June 1982), pp. 494-535, Statement of Lawrence A. Kudlow, Office of Management and Budget.
7. Committee on Banking, Housing and Urban Affairs, U.S. Senate, "The Safety and Soundness of Government-Sponsored Enterprises," Hearing, 101st Cong., 1st Sess. (Washington: Government Printing Office, 31 October 1989). This brief hearing included testimony from Treasury Under Secretary Glauber, a representative of the Standard & Poor's Corporation (a major rating agency) and other experts.