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

Reviewed Work(s):

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

Government Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks by U. S. General Accounting Office

Controlling the Risks of Government Sponsored Enterprises by Congressional Budget Office

Recommendation 91-6: Improving Supervision of the Safety and Soundness of Government Sponsored Enterprises by Administrative Conference of the United States

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Increasing the Accountability of Government-Sponsored Enterprises: Next Steps

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

Department of the Treasury, *Report of the Secretary of the Treasury on Government Sponsored Enterprises* (Washington, D.C.: Government Printing Office, April 1991), 106 pp.

U.S. General Accounting Office, *Government Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks* (Washington, D.C.: Government Printing Office, May 1991), 136 pp.

Congressional Budget Office, *Controlling the Risks of Government Sponsored Enterprises* (Washington, D.C.: Government Printing Office, April 1991), 281 pp.

Administrative Conference of the United States, "Recommendation 91-6: Improving Supervision of the Safety and Soundness of Government Sponsored Enterprises," 1 CFR 305.91-6 (Adopted June 14, 1991).

The federal government is beginning to come to grips with the immense contingent liability represented by government sponsored enterprises ("GSEs") In 1991, the Treasury Department, U.S. General Accounting Office (GAO), and Congressional Budget Office (CBO) submitted reports discussing ways to improve financial accountability of government sponsored enterprises. The Administrative Conference of the United States concluded a two-year review of ways to enhance supervision of safety and soundness of government sponsored enterprises and made its own recommendations.

By midsummer 1991, both the House and Senate were considering legislative proposals to strengthen federal oversight of enterprises. Among the bills under consideration were H.R. 2900, the "Government-Sponsored Housing Enterprises Financial Safety and Soundness Act of 1991," introduced by ranking members of the House Banking Committee; S. 1282, "The Government Sponsored Enterprises Financial Safety and Soundness Act of 1991," introduced at the administration's request; and S. 1621, the "Federal Enterprise Regulatory Act," that embodies most of the recommendations of the 1991 GAO report. The House Ways and Means Committee, that had initiated congressional oversight of the issue, also retained a continuing interest.

The five government sponsored enterprises under scrutiny are 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). Together they represent a contingent liability of over one trillion dollars for U.S. taxpayers.

The term "government sponsored enterprise" can be defined as a privately owned, federally chartered financial institution with nationwide scope and specialized lending powers that benefits from an implicit federal guarantee to enhance its ability to borrow money (Stanton, 1991a, p. 3; See also Moe and Stanton, 1989, p. 329. Harold Seidman has used the term government sponsored enterprise more broadly; Seidman, 1989, pp. 77-80. These definitional questions are discussed in the 1991 CBO Report, p. 2, and by Musolf, 1991, p. 132).

As was discussed in an earlier TOPS article on government sponsored enterprises (Stanton, 1990), the focused definition of the term has helped to clarify for policymakers the many common characteristics of GSEs with banks and thrift institutions.

All three kinds of financial institution are federal instrumentalities. An instrumentality of the federal government can be defined as an institution that is privately owned and serves a public purpose that is defined by federal law. (The public purposes of banks, thrifts, and government sponsored enterprises and their definition in federal law are reviewed in Stanton, 1991b, pp. 10-11).

Most importantly, government sponsored enterprises benefit from an implicit federal guarantee with financial consequences comparable in essential respects to federal deposit insurance. Thus, the 1991 CBO Report states, "The

objective of federal supervision of the safety and soundness of GSEs is most similar to the objective of the supervision of depository institutions. In both cases the government is protecting itself as the ultimate guarantor of the institution's liabilities" (p. 36).

As with banks and thrift institutions, government sponsored enterprises raise two kinds of issues for the federal government: (1) the need to assure their safety and soundness despite operation of a federal guarantee that tends to undercut market discipline, and (2) the need to specify the proper scope of their permitted lending and other financial activities. Unlike ordinary corporations, the business activities of banks, thrifts and GSEs are fixed by federal law. They are mercantilist institutions. When the market changes, they must come back to the Congress for permission to change their activities (de Soto, 1989, chap. 7).

The 1991 reports and recommendations focus largely on the first issue, leaving to the congressional authorizing committees and subcommittees any tradeoffs that might be made between financial soundness and the scope and extent of financial services that the enterprises are expected to provide to their constituents.

With some variations, the 1991 reports and recommendations sound several common themes:

- The federal guarantee of enterprise obligations may be implicit, but it is very real. The Treasury report states: "As a result of the belief that Congress would use taxpayer funds to prevent the failure of a GSE, investors ignore the usual credit fundamentals of the GSEs and look to the Federal Government as the ultimate guarantor of GSE obligations.... Because GSEs are insulated from the private market discipline applicable to other privately owned firms, more effective Government regulation can provide sustained outside discipline to these entities" (1991 Treasury Report, pp. 1-2).
- The federal contingent liability for activities of government sponsored enterprises is growing rapidly. The CBO report shows that enterprise obligations and mortgage-backed securities have gone from $38.9 billion outstanding in 1970 to $176.9 billion in 1980, and $980.1 billion in 1990. That 25-fold growth over 20 years includes creation of new enterprises, notably Freddie Mac in 1970 and Sallie Mae in 1972 (1991 CBO Report, Table 3, p. 12).
- Federal supervision of Fannie Mae, Freddie Mac and Sallie Mae must be significantly improved. The Department of Housing and Urban Development (HUD) lacks the ability to set and enforce effective capital standards, lacks institutional capability, and lacks necessary enforcement powers. The department has never used its existing authority to examine the financial condition of Fannie Mae or Freddie Mac; Sallie Mae has no financial regulator at all (1991 GAO Report, pp. 40-41; 1991 Treasury Report, pp. 41-46; 1991 CBO Report, pp. 35-47).
- The Farm Credit Administration (FCA), restructured since the failure of the Farm Credit System in the mid-1980s, generally has the necessary institutional capacity, administrative authority, and enforcement powers to supervise the safety and soundness of the Farm Credit System; one exception is the authority of the FCA with respect to Farmer Mac, that is too limited in some significant respects (*Ibid.*)
- The Federal Housing Finance Board (FHFB) has the statutory authority to supervise safety and soundness of the Federal Home Loan Bank System; however, the authority of the Federal Housing Finance Board in some respects is too extensive and intrusive (1991 CBO Report, pp. 232-234; 1991 GAO Report, pp. 33-34; 1991 Treasury Report, pp. 21-27). For example, the FHFB is authorized to approve budgets of each Federal Home Loan Bank and the salaries of Federal Home Loan Bank presidents.
- GSEs must be subject to effective capital standards. The GAO and Treasury propose that one component of capital be based upon so-called stress tests of credit and interest rate risk involved in the GSEs' lending activities. Another component of capital would be based upon the regulators' assessment of management and operations risks and other nonquantifiable kinds of risk that may emerge as markets evolve. As with capital standards for banks and thrifts, the safety and soundness supervisor of GSEs should have authority to adjust capital standards according to the riskiness of the individual institutions (1991 GAO Report, pp. 58-78; 1991 Treasury Report, pp. 10-13. The CBO presents options rather than recommendations; 1991 CBO Report, pp. 62-68).

  Application of such capital standards would require increases in capitalization of Fannie Mae and Freddie Mac, and of Farmer Mac when it begins operations. Sallie Mae is already well capitalized for its risks and the home loan banks are probably over-capitalized. FCS institutions except for Farmer Mac are already largely subject to bank-type risk-based capital standards (1991 GAO Report, pp. 68-74; 1991 Treasury Report, pp. 19-20, 23-24, 29-31, 43; 1991 CBO Report, pp. 96-98, 164-171, 225-231, 257-258).

The reports do differ in their judgments about the appropriate agency to supervise safety and soundness of GSEs. The U.S. General Accounting Office strongly favors a single regulator structured in a manner similar to the Federal Deposit Insurance Corporation (FDIC) to supervise safety and soundness of all government sponsored enterprises; oversight of programmatic aspects of enterprise activities would be left with program departments and agencies. For example, HUD would continue to oversee the programmatic activities of Fannie Mae and Freddie Mac (1991 GAO Report, pp. 43-57).

In 1990, the Treasury Department had recommended that enterprises be supervised for safety and soundness by a regulator different from the program regulator; in 1991, the Treasury backed off of this recommendation and now suggests that few changes be made in the existing location of GSE oversight. Treasury proposes that an "arm's-length bureau" be established at HUD for Fannie Mae and Freddie Mac, that Treasury supervise safety and soundness of Sallie Mae, and that the Federal Housing Finance Board and Farm Credit Administration continue to supervise the FHLBS and FCS (including Farmer Mac), respectively. Treasury also recommends that legislative language be added to assure the primacy of safety and soundness over potentially conflicting programmatic goals of HUD and the FHFB (Compare the *1990 Report of the Secretary of the Treasury on Government Sponsored Enterprises*, pp. 7-11 with 1991 Treasury Report, pp. 7-15).

The Congressional Budget Office, while not making an express recommendation, finds the GAO approach superior to that of the Treasury, and favors creation of a central regulator, especially compared with leaving oversight of Fannie Mae and Freddie Mac at HUD. The Administrative Conference of the United States does not express an opinion as to where the regulatory authority should be located.

Treasury's change of position between 1990 and 1991 highlights the problem of regulatory capture. There is considerable anecdotal evidence—but virtually no documentation—that the Treasury came under substantial political pressure to change its mind and agree to retaining HUD as the regulator of Fannie Mae and Freddie Mac. (*Inside Mortgage Capital Markets*, 1991, p. 3 and 1991b, p. 3).

Given the conspicious financial and management failures in the administration of HUD's own programs (see e.g., Moe, 1991), it would otherwise be curious that Treasury would select that department to supervise the two largest financial institutions in the United States, Fannie Mae and Freddie Mac. In contrast to a centralized regulator with considerable institutional capacity and independence, as was recommended by the GAO, HUD is particularly vulnerable to political pressure applied through the housing subcommittees of the House and Senate Banking Committees. The subcommittees have traditionally been very congenial to Fannie Mae and Freddie Mac and to the housing interest groups supportive of the two enterprise (See e.g., House Housing Subcommittee, 1990 and Senate Housing Subcommittee, 1990). Moreover, the Treasury proposal leaves considerable authority with the HUD Secretary to affect the activities of the new safety and soundness bureau. Under the Treasury proposal, the Secretary would have authority to approve regulations and the new bureau's budget, for example.

Perhaps mindful of the poltical pressure that it itself had endured, the Treasury highlights the problem of regulatory capture in its 1991 report:

> The principal GSEs are few in number; they have highly qualified staffs; they have strong support for their programs from special interest groups; and they have significant resources with which to influence political outcomes. A weak financial regulator would find GSE political power overwhelming and even the most powerful and respected government agencies would find regulating such entities a challenge (1991 Treasury Report, p. 8).

The 102nd Congress is now beginning to translate the Treasury, GAO, and CBO reports and the Administrative Conference recommendations into legislation. Underlying the legislative process are policy and political issues of the greatest importance.

The policy lessons of the thrift debacle have been learned and applied to GSEs in the 1991 reports and recommendations. The Treasury, GAO, CBO, and the Administrative Conference of the United States sound a major common theme in their conclusions: effective federal supervision and meaningful capital standards must accompany federal credit support such as deposit insurance and the implicit guarantee of enterprise obligations.

There is also a basic political question: does the federal government have the ability to impose fair but effective financial supervision upon financial institutions that use a federal guarantee to amass overwhelming financial and political leverage? That question was placed into perspective by the expensive collapse of the thrift industry, abetted by the dominance of the thrifts and their powerful trade associations over the relevant congressional committees. The same question now remains to be answered for the GSEs; the 1991 reports and recommendations of the Treasury, GAO, CBO and Administrative Conference provide a good benchmark for measuring how much the Congress has learned.

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