

CBO TESTIMONY

Statement of
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Mr. Chairman, I appreciate the opportunity to appear before this Subcommittee to discuss the Congressional Budget Office's (CBO's) report, *Controlling the Risks of Government-Sponsored Enterprises*. My testimony will summarize our conclusions about the risks posed by each GSE and federal supervision of their safety and soundness, and examine various policy options, including the proposals advanced by the Treasury Department and the General Accounting Office, that could enable the government to limit its exposure more effectively.

THE GOVERNMENT'S CURRENT EXPOSURE TO RISK_____

The five enterprises--the Farm Credit System, the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal Home Loan Bank (FHLB) System, and the Student Loan Marketing Association (Sallie Mae)--achieve their public purposes by borrowing on the strength of an implicit federal guarantee. The implicit guarantee transfers to the government a large portion of the risk that creditors normally bear. Federal risk bearing conveys an implicit federal subsidy and creates a permanent potential for federal losses.

CBO has concluded that two of the GSEs--the FHLBs and Sallie Mae--currently pose a minimal risk of loss to the federal government. The two largest enterprises--Fannie Mae and Freddie Mac--are reasonably well capitalized relative to, and pose a low level of risk of loss to the government from, their exposure to credit risk and interest rate risk. The Farm Credit System's financial condition and overall risk have improved substantially since the government last provided assistance in 1987, but the system remains quite vulnerable and continues to expose the government to more risk than any other enterprise. CBO has not assessed the exposure to management and operations risks of any of the GSEs, however, and therefore cannot offer definitive conclusions about their overall exposure to risk or the adequacy of their capital.

CURRENT FEDERAL SUPERVISION OF SAFETY AND SOUNDNESS

The government can minimize its risk of loss by imposing statutory limits on the risks that each GSE can take, by empowering a federal agency to supervise the activities of the enterprise to ensure that its operations are safe and sound, and by imposing capital standards or taking other actions to require its owners and creditors to bear a significant portion of its overall risk.

The objective of federal supervision of the safety and soundness of GSEs is quite similar to the aim of supervision of depository institutions. In both cases, the government is protecting itself as the ultimate guarantor of the liabilities of the financial institutions.

CBO has concluded that federal supervision of the safety and soundness of the **FHLB** system by the Federal Housing Finance Board (FHFB), and of the Farm Credit System by the Farm Credit Administration (FCA), is generally adequate to protect the government against large increases in its exposure to risk. The FHFB has a statutory mandate to ensure that the **FHLBs** are adequately capitalized and operate in a safe and sound manner, and has ample statutory authority to prevent the system from suffering significant losses. The FCA has a mandate to ensure the safety and soundness of the banks and associations of the Farm Credit **System**, and has essentially the same statutory authority over those institutions as the federal bank and thrift regulatory agencies have with respect to federally insured depository institutions. The FCA's powers with respect to the Federal Agricultural Mortgage Corporation (Farmer Mac), which is an independent part of the **system**, are somewhat more limited, however. Both supervisory agencies also assess the enterprises for the cost of their activities, set the size of their staffs and budgets, and determine the compensation of their

employees. These powers give them sufficient institutional capacity to conduct examinations and to fulfill their safety and soundness mandates.

CBO believes, however, that federal supervision is inadequate to ensure that Fannie Mae, Freddie Mac, and Sallie Mae will not increase their exposure to risks or lower their capitalization in the future. Specifically, the Department of Housing and Urban Development (HUD) has no clear statutory mandate to assure the safe and sound operation of Fannie Mae and Freddie Mac, and the extent of its current statutory authority is disputed. This disagreement could be a source of conflict if the department attempted to set a capital standard for those two GSEs that was more restrictive than the leverage ratio their charters now impose, to enforce such a standard, or to take other action if either enterprise began to falter.

To be confident about the overall exposure to risk of Fannie Mae and Freddie Mac and the adequacy of their capital, the government would have to conduct thorough examinations of their operations in order to verify the data provided by the two GSEs and to assess their exposure to management and operations risks. Although HUD has created a Financial Institutions Regulatory Board to articulate supervisory issues and options for the Secretary and has allocated five staff positions to support the board, the department

does not have the institutional capacity at present to conduct such examinations or monitor effectively the activities of the two enterprises.

With respect to Sallie Mae, no federal agency has a statutory mandate or the authority to supervise its safe and sound operation. The Treasury has authority to examine the GSE's financial records and is required to report annually to the President and the Congress on the enterprise, but has fulfilled the requirement by transmitting copies of Sallie Mae's annual report. Periodic Congressional oversight is the most significant form of federal monitoring and control of the GSE.

The publicly traded stock issued by Fannie Mae, Freddie Mac, and Sallie Mae subjects their activities to market discipline. Since Fannie Mae and Freddie Mac appear to be relatively well capitalized at present, and Sallie Mae is quite well capitalized, this discipline encourages prudent management and provides some protection for the government. If one of the three GSEs suffered significant losses, however, owners and management might believe they had little stake in the firm and would have an incentive to increase risk significantly.

In summary, if the Congress desires to strengthen the ability of federal agencies to ensure that Fannie Mae, Freddie Mac, and Sallie Mae pose a low risk of loss to the government, it would be appropriate to enact legislation to enhance federal supervision of the safety and soundness of these GSEs. Legislation to privatize Sallie Mae may be an attractive alternative if the benefits of converting the enterprise to fully private status are judged to exceed the costs of doing so. If the Congress concludes, however, that the government's risk of loss from Fannie Mae, Freddie Mac, and Sallie Mae is sufficiently low at present to justify relying on the market discipline provided by stockholders and the federal monitoring that is possible under current law, no legislation may be the preferred course of action.

CHOOSING THE SUPERVISORY AGENCY OR AGENCIES_____

If legislation is deemed necessary, an issue arises about what executive branch agency or agencies should supervise the safety and soundness of the GSEs? The Congress could leave the responsibility for supervising the enterprises where it is at present, create a new agency to supervise all the GSEs, or move supervision of Fannie Mae and Freddie Mac from HUD to the FHFB.

Leave Supervision with the Current Agencies

One strategy, advocated in the Treasury **Department's** recent report, would allow the four agencies that now monitor the GSEs to retain their current responsibilities. The Congress would enact legislation to strengthen the Farm Credit Administration's authority with respect to Farmer Mac, enhance HUD's institutional capacity and its statutory mandate and authority to supervise the safety and soundness of Fannie Mae and Freddie Mac, clarify that safety and soundness is the primary objective of the Federal Housing Finance Board with respect to the **FHLBs**, and strengthen the Treasury's ability to supervise Sallie Mae.

The principal argument for this strategy is that it can be accomplished easily, as the **FCA**, HUD, and the FHFB already have expertise in agricultural and housing finance. The most important objection is that some of these agencies may not have sufficient stature to withstand efforts by the GSEs to dominate their decisions or capture them. Capture could lead an agency to allow an enterprise to take excessive risks or to maintain a level of capital that did not adequately protect the government from those risks.

This concern is most frequently voiced about HUD's ability to supervise the two largest **GSEs--Fannie Mae and Freddie Mac**. One possible way to reduce the risk of their capturing the department would be to establish an independent supervisory agency within HUD to supervise the two enterprises, as the Treasury has recommended. The relationship between the Secretary and the director of the new agency, who would be appointed by the President and confirmed by the Senate, would be modeled after the relationship between the Secretary of the Treasury and the Comptroller of the Currency.

The agency would perform its functions under the general direction of the Secretary of HUD, but would have a clear statutory mandate and the statutory authority necessary to ensure the safe and sound operation of Fannie Mae and Freddie Mac. The Secretary would retain the current authority to approve new mortgage purchase programs and to require the two GSEs to devote a reasonable portion of their purchases to low- and moderate-income housing, provided they earned reasonable returns. CBO believes that HUD is unlikely to be able to use the latter authority to require the enterprises to engage in subsidized activities at the expense of safety and soundness.

By separating the responsibility for supervising Fannie Mae and Freddie Mac from HUD's other activities, this proposal could increase the

likelihood that appropriate action would be taken to protect the government if either GSE engaged in excessively risky activities or began to incur large losses. However, the new agency's director probably would be a less prominent official than the Secretary, and the latter, therefore, might have leverage over the agency's decisions. The Secretary might be able to use this leverage to influence the agency's decisions about capital requirements and other safety and soundness issues. The Office of Management and Budget would have to approve any regulations the agency proposed, and the General Accounting Office (GAO), other federal agencies, and private analysts could monitor its performance. Both forms of outside scrutiny could provide some protection against the risk of capture. Nonetheless, the creation of an independent agency within HUD, as the Treasury has proposed, would not eliminate this risk.

Create a New Agency to Supervise All GSEs

A second option, which the GAO and some private analysts advocate, would be to create a new, independent agency to supervise the safety and soundness of all the enterprises. Such an agency would have greater responsibility, would be accountable to a broader **range** of interests, and could be more visible than

are the agencies that currently supervise GSEs. The agency would be primarily responsible for protecting the interests of the general taxpayer, who arguably is more interested in preventing any particular GSE from imposing losses on the government. It would also be ultimately accountable for any losses that any of the five enterprises might impose on the government in the future. The breadth of its mandate could make its activities more visible than those of the separate agencies that now are responsible for one or two. In combination, these factors would probably minimize the possibility that one GSE or a pair of the enterprises could dominate the decisions of the agency's leadership.

Such an agency, however, might not simultaneously develop sufficient expertise in housing, higher education, and agriculture to supervise all the GSEs effectively. A lack of expertise could lead to adopting standardized monitoring and capital requirements that did not account for the differences among the enterprises and could reduce the benefits they provide to the borrowers they serve. Making the FCA a division of the agency, however, would give it significant expertise in agricultural finance. The agency could also be required to streamline the supervisory process for GSEs that it determined exposed the government to a sufficiently low amount of risk, in order to minimize the regulatory burden on them. CBO's report describes in

detail a model of a streamlined supervisory process for low-risk GSEs. The Congress could also provide statutory guidance to the agency regarding capital requirements and the use of enforcement powers, options that are discussed later in this statement.

Move Supervision of Fannie Mae and Freddie Mac
to the Federal Housing Finance Board

A less far-reaching change would be to move supervision and program regulation of Fannie Mae and Freddie Mac from HUD to the FHFB. The board might be able to develop more extensive expertise in housing finance than a centralized supervisor of all GSEs, and it could set comparable capital requirements for the three housing enterprises. However, the FHFB would have to take into account the significant differences in the ownership, activities, and tax status of the three enterprises. The Congress probably would want to distinguish carefully between the FHFB's statutory authority over the FHLBs and its authority over Fannie Mae and Freddie Mac. The board would also have to develop expertise in issues that are unique to the latter two enterprises.

Private Assessments of GSE Risks

Another way to address the capture issue would be to obtain private assessments of the government's exposure to the risks of each GSE. Private risk assessments could reduce the possibility that a supervisory agency would allow an enterprise to take excessive risks, neglect to report losses or noncompliance with federal capital requirements, or take little or no action if the enterprise was in trouble.

CBO has identified three possible approaches. First, a supervisory agency could be required to report regularly its assessments of a GSE's exposure to credit risk and interest rate risk and estimates of its mark-to-market net worth, where appropriate. The enterprise would be required to make available simultaneously the empirical data on which the supervisory agency had based its findings. Second, the government could hire private credit-rating agencies to rate the government's exposure to the risk of each GSE, as Standard & Poor's Corporation recently did for the Treasury Department. Third, if an enterprise was adequately capitalized, it could be required to issue subordinated debt that did not carry an implicit federal guarantee. Variations in the market value of that debt could indicate investors' perceptions of the enterprise's risks.

Each of these sources of information could provide some private-sector discipline of the federal supervisory process. Obtaining the assessments could have costs, however. Also, private parties may not be as well informed as a properly motivated supervisory agency that regularly examined a GSE, understood the enterprise's techniques for measuring and managing risk, and developed its own stress tests. Private assessments could still be valuable if there were significant concerns about whether an agency would stay well informed, would publicize problems quickly, and would act to protect the government from excessive risk or to minimize losses.

In summary, if the Congress desires above all to minimize the risk that one or more GSEs would be able to influence the supervisory process at the expense of safety and soundness, the single-agency option GAO proposes would be the most likely to achieve that objective. If concerns exist about the possibility that a single agency would not develop sufficient expertise to supervise each enterprise effectively, then enhancing the statutory mandate and authority and the institutional capacity of the agencies that now are responsible for monitoring and regulating the GSEs might be more appropriate. Private assessments of enterprise risks could provide additional discipline to the supervisory process, but would have potential costs.

FEDERAL CAPITAL REQUIREMENTS

Another issue is whether federal capital standards should be imposed on GSEs, and, if so, how they should be designed. Capital can protect the government both prospectively and retrospectively from losses that an enterprise incurs. Prospectively, capital gives a GSE's owners and managers a stake in its performance, thereby limiting their incentives to ignore the potential costs to the government of bearing excessive risks. Retrospectively, capital is the deductible on the government's implicit guarantee of the institution's obligations.

The government now imposes effective capital standards on two **GSEs**-- the Farm Credit System and the FHLB system. The FCA has required Farm Credit System institutions to have permanent capital equal to at least 7 percent of risk-adjusted assets by 1993. Two types of federal capital standards require the FHLB system to maintain high levels of capital. The members of the system must hold stock in a FHLB as a condition of membership and to obtain advances. Federal regulations impose a minimum capital standard on the system as a whole, requiring aggregate capital levels to be at least 8 1/3 percent of the system's outstanding consolidated obligations.

The charters of Fannie Mae and Freddie Mac impose a leverage ratio on **them**--a ceiling on the ratio between the assets that each holds in portfolio and its regulatory capital, which includes subordinated debt and reserves to cover loan losses. Because these restrictions ignore each **enterprise's** mortgage-backed securities, however, they cannot control the risks of the two GSEs.

The government could more effectively limit its exposure to the risks of Fannie Mae, Freddie Mac, and Sallie Mae by imposing binding, risk-based capital standards on them. CBO agrees with the GAO, the Treasury, and others that such requirements should incorporate the use of stress tests--computer simulations of how the GSEs would perform in "worst-case" economic **scenarios**--to assess their exposure to credit risk and interest rate risk. Stress tests can take into account the unique features of each enterprise and empirical data on the performance of the loans they finance, and can provide simple and easily understood criteria for capital adequacy. Developing and using stress tests requires considerable sophistication. It would be appropriate, therefore, for the Congress to delegate to supervisory agencies the responsibility for setting risk-based standards for Fannie Mae, Freddie Mac, and Sallie Mae.

If the Congress decided to set binding federal capital requirements on Fannie Mae, Freddie Mac, and Sallie Mae, issues would arise about the role of private rating agencies, what kind of guidance to provide supervisory agencies, whether to establish a statutory minimum capital standard, how to treat management and operations risks in a risk-based standard, and whether to set comparable requirements for the three housing GSEs.

The Role of Rating Agencies

If the Congress gave a supervisory agency or agencies authority to set risk-based capital standards for Fannie Mae, Freddie Mac, or Sallie Mae, it might want to allow the enterprises to reach a "safe harbor" from such requirements by receiving an acceptably high rating from two credit-rating agencies. This option would create the danger that a supervisory agency would be unable to require a GSE to increase its capital even if the agency discerned risks that the rating agencies had not uncovered. This concern could be addressed by requiring that an enterprise obtain a very high rating in order to reach the safe harbor. Recognizing this concern, the Treasury has proposed that triple A (Aaa) be the necessary rating.

Providing Guidance About Setting a Risk-Based Standard

The Congress might also want to provide some statutory direction about how a supervisory agency would develop a risk-based capital standard for a GSE. One option would be to require that the agency use stress tests and give it the flexibility to develop ones that it deemed appropriate. This alternative would allow the agency to adapt the stress tests to reflect changes in the overall risk of the economy and in analytic techniques. Another option would narrowly limit the agency's discretion in statute. The stressful economic conditions on which a capital requirement would be based would be specified in law to some degree.

This alternative would enable the Congress to decide the severity of the economic stresses that the GSE should be able to survive, but would set a precedent of micromanaging the supervisory agency's decisions with respect to the adequacy of the GSE's capital. It could weaken the agency's incentive and ability to take independent action to assure the safe and sound operation of the enterprise.

Establishing a Statutory Minimum Capital Requirement

The Congress could also establish a statutory minimum capital requirement for a GSE, as the Congress has done for federally insured savings and loans. Such a standard would protect against supervisory errors in setting a risk-based capital standard, against the risk of an agency being captured by the enterprise(s) it supervised, and against a GSE's exposure to management and operations risks. A statutory minimum standard for Fannie Mae and Freddie Mac could be expressed in terms of their mark-to-market net worth and the market value of all the assets they financed, or in terms of Generally Accepted Accounting Principles (GAAP).

CBO has concluded that Fannie Mae and Freddie Mac have the ability to increase significantly their **capitalization--as** a percentage of all assets **financed--in** the next five years without issuing additional stock. The Congress could be sure that the GSEs achieved at least a portion of the increases, and thereby reduced the government's exposure to risk, by enacting a sufficiently high statutory minimum capital standard. It would be important, however, to endow HUD or another supervisory agency with sufficient institutional capacity and statutory authority to be sure that the GSEs did not increase their risk, which would negate the benefits of higher capitalization. Also, to

achieve the rates of return that they target, the two enterprises might have to increase their prices, which could increase slightly the interest rates on the mortgages they finance. Increases in the efficiency of mortgage origination and servicing that are likely to occur in the next decade could offset most of the increase, however.

An objection to enacting a statutory minimum capital standard is that a supervisory agency might find it very difficult to impose a risk-based capital requirement that was higher than the minimum, even if it believed that more capital was necessary to protect the government. If the agency was captured, however, its ability to set a meaningful risk-based standard would be limited. A statutory minimum may therefore be the best available protection against this risk. Another factor is that the Congress has no clear criterion to determine what an appropriate statutory minimum standard should be. A supervisory agency that performed thorough examinations would seem to be in the best position to judge how much capital should be required to cover a GSE's management and operations risks.

Treatment of Management and Operations Risks in a Risk-Based Standard

Another issue is how risk-based capital requirements can protect the government from a GSE's exposure to management and operations risks, which cannot be measured with precision. One approach, which both the GAO and the Treasury advocate, would direct the supervisory agency to develop a risk-based standard that required an enterprise to maintain capital equal to a percentage of all the assets it financed to cover these risks. This allowance would be in addition to the amount required, on the basis of stress tests, to protect against the GSE's exposure to credit risk and interest rate risk.

Giving the supervisory agency the flexibility to determine the percentage would acknowledge that the assumptions of any stress tests, particularly about how a GSE would behave in an extreme economic environment, are uncertain. This alternative would also recognize that if an enterprise's management and operating systems deteriorated significantly, financial losses might accumulate without showing up on its balance sheet as a decline in capital. But the agency could set a management and operations risk component that was high, thereby imposing a significant additional cost on a GSE that performed well on stress tests. To minimize this potential cost,

the government could allow the enterprise to comply with this portion of the capital standard by issuing subordinated debt that exposed investors to risk, as the GAO has proposed.

Setting Comparable Capital Standards for the Three Housing GSEs

Fannie Mae and Freddie Mac hold much less capital, as a proportion of assets financed, than the FHLB system, even though the system is exposed to less risk than either of the other two GSEs. The resulting difference in the government's exposure means that FHLB advances provide a smaller implicit federal subsidy to lenders that borrow from the system than do Fannie Mae and Freddie Mac's purchases of the mortgages they are eligible to buy. The lower implicit subsidy is one of several factors that enable the latter two GSEs to dominate the market for conventional mortgages, particularly fixed-rate loans, that they are eligible to purchase. Other important factors include the economies of scale and other operating efficiencies of Fannie Mae and Freddie Mac, the inefficiencies of some depository institutions, and federal capital requirements for banks and thrifts, which require more capital for whole mortgages than for mortgage-backed securities issued by the GSEs.

Setting comparable federal capital requirements for the three housing finance GSEs would eliminate the disparity in the implicit federal support that each provides to the lenders they serve. Doing away with the disparity would be a small step toward enabling thrifts and other lenders to compete on an equal footing with Fannie Mae and Freddie Mac in the market for financing conventional mortgages.

The government could set comparable capital standards for the three housing GSEs by requiring them to obtain the same high rating (where the rating measured the government's exposure to risk) from at least two private credit-rating agencies, or to have enough capital to pass the same credit and interest rate stress tests and to maintain comparable amounts of capital to cover their exposure to management and operations risks. A choice about the appropriate level of capitalization would be a judgment about the relative risks and benefits of these GSEs. Making the standards comparable could involve lowering the capitalization of the FHLB system, raising the capitalization of Fannie Mae and Freddie Mac, or both.

ENFORCEMENT POWERS AND OTHER REMEDIES _____

Another issue is what remedies supervisory agencies should have if GSEs fail to comply with federal regulations. The FCA and the FHFB already have extensive enforcement powers over the banks and associations of the Farm Credit System and over the FHLBs, respectively. The FCA's enforcement powers, which are modeled after those of the bank and thrift regulators, are the most explicit. They include the authority to issue cease and desist orders, including temporary orders, issue capital directives, remove directors and officers, and require payment of civil money penalties. The FCA also has the authority to appoint a conservator or a receiver for a failing institution. The FCA's authority over Farmer Mac is somewhat more limited, however. The FHFB also has a broad range of explicit and implicit enforcement powers, as well as the authority to liquidate and reorganize a FHLB.

Selecting and Limiting the Use of Enforcement Powers

The Congress could give HUD, the Treasury, or a new agency established to supervise all GSEs additional or more explicit powers to enforce capital standards or limits on the risks taken by Fannie Mae, Freddie Mac, or Sallie

Mae. One approach would be to provide the most important of the powers that the FCA and the bank and thrift regulators have. These powers would imply a variety of less draconian and implicit enforcement tools, such as letters of agreement, and would give a supervisory agency sufficient leverage to deter or stop excessively risky activities or unsafe and unsound practices.

In granting these explicit enforcement powers to a supervisory agency or agencies, the Congress could use statutory language or legislative history to be reasonably sure that the agency would not abuse them and that the enterprise could anticipate how they would be used. To prevent abuses, the Congress might want to direct the agency to use the powers only to address safety and soundness concerns, and to prohibit their use to promote programmatic objectives. The supervisory agency could also be required to issue regulations that defined certain conditions that it would consider to be unsafe and unsound practices. These conditions would be considered grounds for seeking a cease and desist order or applying other specific sanctions. Of necessity, the agency would have to retain the authority to act in other cases as well, even where the offending practices had not been defined beforehand. Without such flexibility, its ability to correct previously unforeseen practices that it deemed to be unsafe and unsound would be compromised.

Considerable care would have to be taken in devising legislative language and history to avoid undue restriction or ambiguities that would result in the courts rather than the Congress determining the scope of the enforcement powers of a GSE supervisory agency. Another approach would be to rely on the protections against arbitrary actions provided in the Administrative Procedure Act, supplemented by a requirement that judicial review be offered to enterprises against whom enforcement actions are taken.

Another, more restrictive approach would be to limit enforcement actions to situations in which Fannie Mae or Freddie Mac was not in compliance with its capital requirement. If HUD and either GSE could not agree on a recapitalization plan, the department would have to seek legislation. This approach would assume that Fannie Mae and Freddie Mac are unlikely to suffer significant losses without the government detecting them, and that large losses would occur slowly enough to allow a recapitalization plan to be carried out, even if legislation was necessary. The option would reduce the possibility that HUD could set capital requirements that were excessively high or would intervene in the operations of the two GSEs, even though they met capital standards.

Dealing with an Insolvent GSE

The Congress would probably want to assist Fannie Mae, Freddie Mac, or Sallie Mae if one of these GSEs suffered large losses and would not be viable without assistance, rather than allow a supervisory agency to liquidate it. This preference suggests that it would be appropriate to allow a supervisor of the safety and soundness of any of these enterprises authority to appoint a conservator for the enterprise if it was insolvent or near insolvency, but not authority to appoint a receiver. A conservator could be directed to continue any of the GSE's operations, such as financing fixed-rate residential mortgages with mortgage-backed securities, whose risks are known with a reasonable degree of accuracy. The supervisor could be required to submit, within a predetermined period after a conservator was appointed, a plan for recapitalizing or otherwise lowering the risk of the enterprise. The advantage of giving the agency the power of **conservatorship** rather than relying on the legislative process is that swift action might prevent the enterprise from increasing the risk of its activities in order to gamble its way back to financial soundness.

REGULATION AND ACHIEVEMENT OF PUBLIC PURPOSES

These proposals to strengthen federal supervision of GSEs raise the issue of how the Congress can ensure that regulators will take into account the consequences of their policies on the ability of the GSEs to achieve their public purposes effectively. An agency charged with supervising the safety and soundness of an enterprise could conceivably act in such a way as to damage the GSE's ability to serve the lenders and borrowers that the Congress created it to help. For example, a supervisory agency could intervene unnecessarily in the day-to-day operations of an enterprise or impose excessively high capital requirements on it.

My testimony has identified several specific ways in which the Congress can adapt the bank and thrift model of supervision to ensure that the burdens of federal regulation of Fannie Mae, Freddie Mac, Sallie Mae, and perhaps the FHLBs are minimized. These modifications include directing agencies to streamline the supervisory process for low-risk GSEs, providing guidance to agencies in setting capital standards, and selecting and limiting the use of enforcement powers.

If legislation is enacted, the rule-making process will provide a forum for public discussion of the effect that proposed regulations would have on a GSE's achievement of its public purposes. Congressional oversight hearings will certainly serve a similar function. The two most controversial areas could well be efforts to define some unsafe and unsound practices in advance and proposed capital standards that required enterprises to increase their capitalization. Because most of the GSEs currently pose a low level of risk to the government, a supervisory agency is unlikely to require an enterprise to increase its capitalization rapidly enough to disrupt significantly its ability to achieve its public purposes.

CONCLUSION

In conclusion, Mr. Chairman, I will reiterate the main points I have made this morning:

- o If the Congress desires to strengthen the ability of federal agencies to ensure that Fannie Mae, Freddie Mac, and Sallie Mae pose a low risk of loss to the government, it would be appropriate to enact legislation to enhance federal supervision of the safety and soundness of these

GSEs. The burdens of subjecting each enterprise to closer federal monitoring and control could be reduced by directing its supervisory agency to streamline the supervisory process if the agency determined that the government's exposure to risk was low, by directing the agency to use stress tests or providing other guidance about setting risk-based capital requirements, and by selecting and limiting the use of enforcement powers.

- o GAO's proposal to centralize regulation of all GSEs in a single agency would have the best chance of minimizing the risk that one or more of the enterprises would be able to influence the supervisory process at the expense of safety and soundness. If concerns exist about the possibility that a single agency might not develop sufficient expertise to supervise each enterprise effectively, however, then enhancing the statutory mandate and authority and the institutional capacity of the agencies that now are responsible for monitoring and regulating the GSEs might be more appropriate. Private assessments of enterprise risks could provide additional discipline to the supervisory process.
- o The government could more effectively limit its exposure to the risks of Fannie Mae, Freddie Mac, and Sallie Mae by imposing risk-based

capital standards on them. The Congress might also want to address issues about the role of private rating agencies, what kind of guidance to provide supervisory agencies in setting capital requirements, whether to impose a statutory minimum capital standard, how to treat management and operations risks in a risk-based requirement, and whether to set comparable capital standards for the three housing GSEs.