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 three housing GSEs and current 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 to risk more effectively.

The Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank (FHLB) System, like the other GSEs, 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 a subsidy and creates a permanent potential for federal losses. Although the government is not in any immediate danger from any of the enterprises, the volume of their outstanding obligations is staggering--over $1 trillion. Over 90 percent of these securities have been issued by the three housing GSEs.

The government can minimize its risk of loss by imposing statutory limits on the risks that a 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 supervising depository institutions. In both cases, the government is protecting itself as the ultimate guarantor of the liabilities of the financial institutions.

FEDERAL NATIONAL MORTGAGE ASSOCIATION AND FEDERAL HOME LOAN MORTGAGE CORPORATION

Fannie Mae and Freddie Mac, which are by far the largest GSEs, support the housing sector by linking mortgage lenders to the capital markets. CBO has concluded that these two enterprises are reasonably well capitalized and subject the government to a low level of risk of loss with respect to their exposure to credit risk and interest rate risk, and appear to be well managed and to operate efficiently. There are substantial questions, however, about whether the Department of Housing and Urban Development (HUD), which has general regulatory authority over them, has either the institutional capacity

to conduct adequate examinations and monitoring or the statutory authority to assure that the enterprises are adequately capitalized and operate safely.

Activities. **Risks.** and Capitalization

Fannie Mae and Freddie Mac purchase home mortgages from lenders. Both GSEs finance most of the mortgages they buy with mortgage-backed securities (MBSs), and Fannie Mae also finances a sizable portfolio of mortgages and other assets with debt. Although Fannie Mae suffered losses in the early 1980s because of high interest rates, the enterprise has been consistently and highly profitable in recent years. Freddie Mac has always been profitable.

In the 1980s, Fannie Mae and Freddie Mac expanded their activities dramatically as thrift institutions had fewer incentives to hold mortgages in their portfolios. Today, these two GSEs enjoy a dominant position in the secondary market for the conventional mortgages they are eligible to purchase, particularly fixed-rate loans. Their significant market power arises from the implicit federal subsidies they receive, their nationwide operations, an ability to convert mortgages to MBSs with great efficiency, economies of scale, and federal capital requirements for depository institutions that favor securitization

of mortgages. The implicit subsidies Fannie Mae and Freddie Mac receive and the large outstanding volume of their MBSs increase the value of the securities. Competition between the GSEs and among the lenders they serve passes this benefit on to borrowers and has reduced the interest rates on fixed-rate mortgages that the enterprises can purchase by about 0.3 percentage points (30 basis points).

Fannie Mae and Freddie Mac are exposed to comparable credit risk. The mortgages they finance are protected by borrowers' down payments, property appreciation, insurance, and agreements by lenders. Fannie Mae's financial difficulties in the early 1980s induced it to purchase some riskier mortgages in the hope of earning higher returns. These loans performed significantly worse than those financed by Freddie Mac in the same period. Since the major changes in Fannie Mae's underwriting guidelines in 1985, however, the two GSEs' guidelines for single-family mortgages have been virtually identical, and the single-family loans each has purchased have had quite similar risk-related characteristics and geographic distributions. The performance of the mortgages each enterprise has purchased since 1985 has also been comparable. If Fannie Mae and Freddie Mac continue to compete vigorously, they will probably be exposed to similar credit risk. Competition

induces them to maintain similar underwriting guidelines and prices in order to avoid a deterioration in the quality of the loans that lenders sell them.

Fannie Mae was exposed to significant interest rate risk in the late 1970s and early 1980s, but has reduced its exposure greatly in the last decade. Today, each GSE's exposure is a function of its strategy for financing the mortgages it buys. Fannie Mae finances loans with debt whenever it expects to earn enough on average to compensate for the risk that changes in interest rates will produce low returns. The GSE began issuing large amounts of debt that it can prepay, or call, in 1989, and plans to increase the percentage of its long-term debt that is callable. Callable debt raises its interest expense, but reduces its exposure to interest rate risk by stabilizing its net interest income. Freddie Mac has consistently taken very little interest rate risk by financing nearly all the mortgages it purchases with **MBSs.**

Perhaps the greatest risk to Fannie Mae and Freddie Mac is a nationwide recession or depression that would significantly increase the default losses on their mortgages and lower their income from MBS guarantee fees. The GSEs and the Office of Management and Budget have used stress tests that simulate the performance of mortgages in an economic downturn to assess the severity of their exposure to this risk. The results of the stress tests

imply that the enterprises would be able to survive such conditions for an extended period.

Other analyses suggest that large changes in interest rates are unlikely to harm Fannie Mae and Freddie Mac significantly. Freddie Mac's financing strategy insulates it from almost all risk of loss. Although Fannie Mae's portfolio makes it more exposed, its higher ratio of capital to assets and MBSs and the profitability of its portfolio provide some protection against its greater exposure to interest rate risk.

Both enterprises are currently in compliance with the capital standards they impose on themselves. Moreover, each has the capacity to increase its capitalization significantly over the next five years by retaining earnings and without selling additional stock. If the GSEs achieve these potential increases and do not raise their overall risk, the federal government's risk exposure will decline.

The publicly traded stock issued by Fannie Mae and Freddie Mac subjects their activities to some market discipline. Since the two GSEs appear to be relatively well capitalized at present, this discipline encourages prudent management and provides some protection for the government. If one of the

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.

CBO's conclusions about the credit risk, interest rate risk, and capitalization of Fannie Mae and Freddie Mac are based on data provided by them. To be confident about the enterprises' risk exposure and capitalization, the government would have to conduct a thorough examination of their operations to verify the data they provided and to assess their exposure to management and operations risks.

HUD's Supervision and Regulation of Fannie Mae and Freddie Mac

The Department of Housing and Urban Development has had general regulatory authority over Fannie Mae since 1968, and acquired the same authority over Freddie Mac in 1989. HUD has no clear statutory mandate to assure the safe and sound operation of the GSEs, however, and the extent of its statutory authority is disputed. This disagreement could be a source of conflict if the department attempted to set a capital standard for the GSEs that was more restrictive than the leverage ratio their charters now impose,

or to enforce such a standard or take other action if either enterprise began to falter. Although HUD has created the Financial Institutions Regulatory Board to articulate supervisory issues and options for the Secretary and has allocated staff positions to support the board, the department does not have sufficient institutional capacity to conduct examinations of the GSEs or to monitor their activities effectively.

The department can require Fannie Mae and Freddie Mac to devote a portion of their mortgage purchases to low- and moderate-income housing, if the loans provide the GSEs with a reasonable economic return. The department is unlikely to use this authority to jeopardize the safety and soundness of the GSEs. HUD's authority to disapprove new mortgage purchase programs is a source of conflict with the enterprises, however, since the department asserts a right to consider the effect of new activities on competition with other financial institutions and on consumers, whereas Fannie Mae and Freddie Mac do not believe that HUD has such authority.

The principal purpose of the Federal Home *Loan* Bank **(FHLB)** System is to provide loans to depository institutions that finance lending for residential mortgages. The system exposes the government to a minimal amount of risk, but is at a critical juncture. Financial markets have evolved since the system was created in the 1930s, and fully private firms (in concert with the Federal Reserve, Fannie Mae, and Freddie Mac) can now provide the services once provided only by the FHLBs, although at a somewhat higher cost in some cases. Thus, the government must decide whether the system is still needed to provide these services. If the Congress opts to preserve the FHLB system, it may wish to take several steps to improve the system's viability and to help level the playing field in the nation's system of housing finance.

Activities. Risk. and Capitalization

The FHLB system provides a variety of services to its member/owners, which are primarily thrifts but also include commercial banks, credit unions, and insurance companies that have more than 10 percent of their portfolios in home mortgages and related assets. The system's most important activity is

providing loans (called advances) to its members for short-term liquidity and to finance housing. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) required the banks to make a one-time payment of $2.1 billion from their retained earnings, as well as a fixed annual payment of $300 million, to help cover the interest and principal payments on debt issued by the Resolution Funding Corporation (REFCORP) to finance a portion of the cost of resolving insolvent thrifts. FIRREA also directed the banks to devote minimum amounts each year to subsidize advances made to institutions that finance affordable housing for low- and moderate-income families.

The FHLB system's exposure to credit risk is very low, primarily because most of the system's assets are advances, which are collateralized with high-quality assets. In almost 60 years of operation, no member of the FHLB system has ever defaulted on an advance. The banks have also controlled their exposure to interest rate risk relatively successfully in the past, and current measures of interest rate risk show that changes in interest rates would have only small effects on their financial condition.

The demand for FHLB advances has fallen recently and is expected to continue to decline, but this trend is unlikely to cause a significant increase in

the system's exposure to risk. The FHLBs should be able to reduce their costs enough to match the decline in income caused by the shrinkage of their assets. Demand for advances is likely to continue to fall for two reasons. First and foremost, the traditional industry served by the system--the savings and loan industry--is shrinking, which implies that fewer advances will be needed in the future by that industry to meet liquidity and other needs. Second, certain provisions of FIRREA impede recruiting new members into the system and inadvertently have created some destabilizing dynamics. As new members decide not to join the system, gross income from advances falls with the shrinkage of the thrift industry. As it does, the fixed payments to REFCORP and for affordable housing take an ever larger fraction of the system's income, which causes dividend yields on FHLB stock to drop and justifies the original decisions of potential members not to join.

The FHLB system is well capitalized, with the book value of capital averaging about 7 percent of assets at the end of 1990. Two types of federal capital standards require the system to maintain high levels of capitalization. First, members must hold stock in a FHLB as a condition of membership and to obtain advances. Second, 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.

Federal Supervision and Regulation of the FHLB System

The Federal Housing Finance Board (FHFB) has ample statutory authority to prevent the system from suffering significant losses. The FHFB has been given broad powers, including the authority to determine the compensation of the members of the board of each FHLB, to suspend or remove board members or any bank employee, and to liquidate or reorganize a bank if necessary. The FHFB has the final word on each bank's budget, quarterly dividend payments, and applications for new members.

The FHFB is a relatively new agency. A definitive assessment of its performance, therefore, is not yet possible. The FHFB was created in 1989 to replace the Federal Home Loan Bank Board (FHLBB), which regulated the FHLB system (and the thrift industry) throughout most of its history. In its first full year of operation, the FHFB experienced some difficulties in accomplishing its goals, but none of these problems threatened the safety and soundness of the system. Many of the problems reflected the inevitable difficulties of developing a new agency, and the board has taken steps to address some of them.

Issues About the Future of the FHLB System

Although the FHLB system exposes the government to little credit risk or interest rate risk, issues can be raised about the system's future. The system plays a much less important role in overcoming imperfections in the nation's housing finance system than it has in the past. Consequently, the Congress may wish to consider phasing out the FHLBs. Eliminating the system would raise the cost of funds to thrifts somewhat and could adversely affect federal support for affordable housing if alternative programs were not funded. The effect on the thrifts' cost of funds would not be large, because the high capitalization of the system has limited its ability to provide significant implicit subsidies to its members. Reducing the system's capital standards could raise its ability to subsidize mortgage lenders (which would increase its role in the housing finance system), but at a cost of increasing the government's exposure to risk.

If the FHLB system is preserved, the Congress may wish to take steps to improve its viability. The most important step would be to require the system to devote a proportion of its income, rather than fixed amounts of money, to cover REFCORP's financing costs and subsidize affordable housing. This change would raise prospective dividends on FHLB stock and enhance

the system's ability to attract new members. In addition, the Congress may wish to consider reducing (or eliminating) the preferential treatment given to members of the FHLB system with 70 percent or more of their assets in home mortgages. Such a change could increase the membership of commercial banks in the system. Most of these banks have less than 70 percent of their portfolios in home mortgages but, because of their size, may have substantial holdings of mortgages in dollar terms. A third option, which is discussed in more detail later in this statement, would be to set comparable capital requirements for the system and for the two other housing GSEs.

CHOOSING THE SUPERVISORY AGENCY OR AGENCIES

The reports issued by CBO and the Department of the Treasury, as well as the General Accounting Office's (GAO's) forthcoming report, have identified a variety of approaches to improving the government's ability to ensure that the GSEs achieve their public purposes while imposing minimal risk of loss on taxpayers. With respect to the housing GSEs, the first general issue concerns what agency or agencies should supervise their safety and soundness. The Congress could address this issue by leaving the responsibility for supervising the enterprises where it is at present, by creating a new agency to supervise

all the GSEs, or by moving supervision of Fannie Mae and Freddie Mac from HUD to the **FHFB.**

Leave Supervision with the Current Agencies

The first option, advocated in the Treasury's recent report, would allow the agencies that now monitor the GSEs to retain their current responsibilities. In the housing area, the Treasury proposes that the Congress enact legislation to enhance HUD's institutional capacity and its statutory mandate and authority to supervise the safety and soundness of Fannie Mae and Freddie Mac, and to clarify that safety and soundness is the primary objective of the Federal Housing Finance Board with respect to the **FHLBs.** The principal argument for this option is that it can be accomplished easily, as these agencies already have expertise in housing finance.

The most important objection is that HUD may not be able to withstand efforts by Fannie Mae and Freddie Mac to dominate its decisions or capture it. Capture could lead the department to allow one or both of the enterprises to take excessive risks or to maintain a level of capital that did not adequately protect the government from those risks. To reduce this risk, the

Treasury has recommended the establishment of an independent supervisory agency within HUD to supervise Fannie Mae and Freddie Mac. 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. As I indicated earlier in this statement, 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, however, and the 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. To reduce this risk, the Congress could require the agency to streamline the supervisory process for GSEs that it determined exposed the government to a sufficiently low amount of risk. 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.

FEDERAL CAPITAL REQUIREMENTS

A GSE's capital can protect the government both prospectively and retrospectively from losses that the enterprise incurs. Prospectively, capital gives the 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 enterprise's obligations.

As mentioned earlier in my statement, the government now imposes effective capital standards on the FHLB system. 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 and Freddie Mac 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 HUD or another supervisory agency the responsibility for setting risk-based standards for the two GSEs.

If the Congress decided to set binding federal capital requirements on Fannie Mae and Freddie Mac, issues would arise about the role of private rating agencies, what kind of guidance to provide HUD or another supervisory agency, 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 HUD or another supervisory agency authority to set risk-based capital standards for Fannie Mae and Freddie Mac, 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 the supervisory agency would be unable to require either 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 HUD or another supervisory agency would develop a risk-based capital standard for Fannie Mae and Freddie Mac. 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 the housing GSEs, 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 capture, and against 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 their capitalization significantly, measured on a GAAP basis 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 HUD or another supervisory agency to develop a risk-based standard that required Fannie Mae and Freddie Mac 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 each enterprise's exposure to credit risk and interest rate risk.

Giving HUD or another agency the flexibility to determine the percentage would acknowledge that the assumptions of any stress tests, particularly about how Fannie Mae and Freddie Mac would behave in an extreme economic environment, are uncertain. This alternative would also recognize that if either 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 <u>Comparable</u> 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 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.

Two differences between Fannie Mae and Freddie Mac, on the one hand, and the FHLBs, on the other, would have to be addressed in setting comparable standards. First, Fannie Mae and Freddie Mac are subject to

federal income taxation, but the FHLBs are not. Interest paid on the banks' obligations is also exempt from state and local income taxation. Second, the FHLBs are implicitly taxed to subsidize affordable housing and to pay part of the costs of servicing the Resolution Funding Corporation's debt.

ENFORCEMENT POWERS AND OTHER REMEDIES

Proposals to enhance the statutory authority of HUD or another agency to supervise the safety and soundness of Fannie Mae and Freddie Mac raise the issue of what remedies the agency should have if the GSEs failed to comply with capital requirements or other federal regulations. The **FHFB** already has a broad range of explicit and implicit enforcement powers over the FHLBs, as well as the authority to liquidate and reorganize a bank.

Selecting and Limiting the Use of Enforcement Powers

The Congress could give HUD or another agency additional or more explicit powers to enforce capital standards or limits on the risks Fannie Mae and Freddie Mac take. One approach would be to provide explicitly the most

important of the powers that the bank and thrift regulators have--the ability to issue cease and desist orders, including temporary orders, issue capital directives, and remove directors. These powers would imply a variety of less draconian and implicit enforcement tools, such as letters of agreement, and would give the agency sufficient leverage to deter or stop excessively risky activities or unsafe and unsound practices.

In granting these explicit enforcement powers to the agency, the Congress could use statutory language or legislative history to be reasonably sure that the agency would not abuse them and that Fannie Mae and Freddie Mac 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 agency's enforcement powers. 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 an enterprise against which 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 or another agency 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. However, the department might not be able to require Fannie Mae and Freddie Mac to correct unsafe and unsound practices it identified, unless the GSE was undercapitalized.

Dealing with an Insolvent GSE

The Congress would probably want to assist Fannie Mae or Freddie Mac 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 HUD or another agency to appoint a conservator for either 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 Fannie Mae and Freddie Mac raise the issue of how the Congress can ensure that HUD or another supervisory agency will take into account the consequences of their policies on the ability of the GSEs to achieve their public purposes effectively. The agency could conceivably act in such a way as to damage either enterprise'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 either GSE or impose excessively high capital requirements on it.

My testimony has identified several specific ways in which the Congress can ensure that the burdens of federal regulation of Fannie Mae and Freddie Mac are minimized. These modifications include directing HUD or another agency to streamline the supervisory process for the GSEs if it concluded they posed a low level of risk to the government, providing guidance to the agency in setting capital standards, and selecting and limiting the use of enforcement powers. As discussed in CBO's report, these options may also be appropriate for the **FHLB** system.

If legislation is enacted, the rule-making process will provide a forum for public discussion of the effect that proposed regulations would have on Fannie Mae and Freddie Mac's achievement of their 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 to propose capital standards that required the enterprises to increase their capitalization. Because the two GSEs currently pose a fairly low level of risk to the government, HUD or another supervisory agency is unlikely to require either 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:

- If the Congress desires to strengthen the government's ability to ensure that Fannie Mae and Freddie Mac 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.

- GAO's proposal to centralize regulation of all GSEs in a single agency would have the best chance of minimizing the risk that Fannie Mae or Freddie Mac would be able to influence the supervisory process at the expense of safety and soundness. If concerns exist about the possibility that a centralized regulator might not develop sufficient expertise to supervise Fannie Mae and Freddie Mac effectively, however, then enhancing HUD's statutory mandate and authority and its institutional capacity to supervise them might be more appropriate. Private assessments of the risks of the enterprises could provide additional discipline to the supervisory process and reduce the risk of capture.

- The government could more effectively limit its exposure to the risks of Fannie Mae and Freddie Mac by imposing binding, 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.