Regulating Housing GSEs: Thoughts on Institutional Structure and Authorities

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Three government-sponsored enterprises (GSEs) play a significant role in the U.S. housing markets: the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank System (FHLB System). Congress created each of these entities, and their federal charters include numerous provisions that result in lower operating and funding costs.[1] These GSEs' primary public contribution with respect to housing is to use their federal benefits to reduce mortgage interest rates faced by homebuyers with "conforming" mortgages.[2] The U.S. Congressional Budget Office (CBO) (2004) estimates that for 2003 the gross benefit accruing to the three housing GSEs was $23.0 billion, the net benefit to homebuyers was $13.6 billion, and the residual benefit to GSE equity holders was $9.4 billion.[3]

The three housing GSEs have grown rapidly over the past decade and now constitute three of the five largest financial institutions in the United States.[4] As of year-end 2002, they held or guaranteed over $4.1 trillion in primarily mortgage-related assets. The three housing GSEs are also highly leveraged compared to federally insured banks and thrifts. In the aggregate, the former operated with a ratio of total capital to total assets of 3.7 percent as of year-end 2002 while the latter maintained a ratio of 9.2 percent on the same date. As their large absolute sizes and small capital ratios indicate, the housing GSEs fund their portfolios primarily by issuing significant quantities of debt. Further, they manage the attendant market risks by acting as major participants in derivatives markets.[5]

Arguably, the housing GSEs have achieved their scale and can operate in such a leveraged manner because their obligations (debt and mortgage-backed securities) benefit from an implied federal guarantee arising from their charter benefits and from past government actions.[6] Indeed, the financial reporting of the yields on GSE obligations usually refers to them as "government agency" issues.[7] As a result, the housing GSEs are able to borrow at interest rates that are more favorable than those of AAA-rated corporate borrowers though not quite as favorable as the interest rates at which the U.S. Treasury can borrow. Without the implied guarantee, the GSEs' ratings probably would be in the A to AA range.[8]

The presence of the implied federal guarantee is the central issue with respect to not only the housing GSEs' business operations but also their regulation. The implied guarantee allows the federal government to channel additional funds to the conforming mortgage market without an annual appropriation. While the implicit guarantee provides most of the benefits that the housing GSEs transmit to homebuyers, it also represents a contingent liability to taxpayers in the event that an enterprise becomes insolvent and the government elects to provide financial assistance. Some have looked at the question of the public benefits and costs of housing GSEs and concluded that privatization is most appropriate (Calomiris 2001; White 2003a). However, since this recommendation is unlikely to be adopted in the near term, it seems reasonable that the federal government should seek jointly to maximize benefits to homebuyers and minimize taxpayer risk while recognizing that these objectives may be conflicting. The federal government attempts to maximize benefits and minimize risks by way of a two-part regulatory system (described below) that does not seem to be functioning as intended (U.S. Office of Management and Budget 2004, 80–85).

Concerns about taxpayer liability associated with the housing GSEs were recently renewed in the wake of a $5 billion accounting restatement by Freddie Mac in 2003. This, in turn, led to various legislative proposals to reorganize housing GSE regulatory oversight that are an active concern for Congress and the Bush administration. This article discusses these proposals, identifies the points of contention, and then evaluates these points, drawing on lessons from U.S. banking regulation.

It's important to note that the current legislative approach assumes that the most effective method of reducing taxpayer risk is to strengthen housing GSE regulation. As a theoretical matter, however, this method's effectiveness is unclear, especially relative to the complete absence of a safety-and-soundness regulatory regime. For housing GSEs, expected taxpayer losses are calculated as the product of the probability of insolvency, the probability of bailout, and the expected dollar losses in the event of default. The presence of a safety-and-soundness regulatory regime likely serves to reinforce the perception of an implicit guarantee and hence influences each of these components. First, regulation itself is likely to reduce the probability of insolvency; but the implied guarantee affects this probability in two different ways: a positive "moral hazard effect" and a negative "charter value effect" (Frame and White 2004). Regulation is also likely to increase the probability of a bailout, and this likelihood is reflected in the implied guarantee. Finally, since it probably strengthens the implied guarantee, regulation may also influence the dollar value of losses to the extent that it allows the housing GSEs to grow larger and hold relatively less capital than they otherwise would. Regulation would therefore likely reduce the probability of insolvency (although this prediction depends on how sensitive the housing GSEs are to changes in their charter value), increase the probability of a bailout, and increase the size of potential shortfalls. Overall, whether housing GSE regulation results in more or less taxpayer risk is an open empirical question.

The Current Regulatory Structure

The current regulatory structure for the housing GSEs has been in place for just over a decade. The U.S. Department of Housing and Urban Development (HUD) and an independent agency within HUD, the Office of Federal Housing Enterprise Oversight (OFHEO), regulate Fannie Mae and Freddie Mac. The Federal Housing Finance Board (Finance Board) exclusively regulates the FHLB System.

HUD is the mission regulator of Fannie Mae and Freddie Mac and is broadly charged with ensuring that these enterprises are enhancing the availability of mortgage credit by creating and maintaining a secondary market for residential mortgages. HUD is also required to establish goals and monitor compliance for Fannie Mae's and Freddie Mac's financing of housing for low- and moderate-income families, housing in central cities, and other "underserved areas."

OFHEO is the safety-and-soundness regulator for Fannie Mae and Freddie Mac and hence is authorized to set risk-based capital standards, conduct examinations, and take enforcement actions if unsafe or unsound financial or management practices are identified. A director nominated by the president for a five-year term and confirmed by the Senate leads OFHEO. The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 established this safety-and-soundness regulator. Prior to this, HUD maintained exclusive regulatory oversight responsibilities over Fannie Mae and (for 1989–92) Freddie Mac. Before the passage of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, Freddie Mac was the responsibility of the Federal Home Loan Bank Board (FHLBB).

The Finance Board was established by FIRREA in 1989 as the regulator of the FHLB System, thereby replacing the FHLBB. The Finance Board supervises each of the FHLB System banks and their collectively owned financing arm, the Office of Finance, to ensure that they operate in a safe and sound manner and that they carry out their housing finance mission related to community investment and affordable housing. A five-member board governs the Finance Board, which is an independent agency within the executive branch. The president appoints four full-time members with the advice and consent of the Senate for seven-year terms, designating one of the four as chair.[9] The secretary of HUD is the fifth member.

All three regulators (OFHEO, HUD, and the Finance Board) have been criticized for a perceived lack of effectiveness. Examples of this include (1) the lengthy delays that OFHEO experienced in issuing and finalizing its risk-based capital regulation for Fannie Mae and Freddie Mac and (2) HUD's and the Finance Board's failure to propose regulatory limits on nonmortgage investments made by the respective housing GSEs under their purview. Studies by the U.S. General Accounting Office (GAO) (1997a, 1998a, 1998b, 1998c) evaluate the regulatory effectiveness of HUD, OFHEO, and the Finance Board. More recently, in testimony before the House Financial Services Committee on September 10, 2003, Treasury Secretary John Snow remarked that there is a "general recognition that the supervisory system for the housing GSEs neither has the tools, nor the stature, to effectively deal with the current size, complexity, and importance of these enterprises." In light of these criticisms and recent financial and accounting revelations at Fannie Mae and Freddie Mac (which are reviewed in the box on page 90), a number of legislative proposals were introduced in Congress during 2003 to enhance the safety-and-soundness regulation of the housing GSEs.

Legislative Response

During the summer of 2003, several members of Congress introduced bills aimed at strengthening the current supervisory and regulatory framework for Fannie Mae and Freddie Mac: H.R. 2575 (Representative Baker), H.R. 2803 (Representative Royce), S. 1508 (Senators Hagel, Sununu, and Dole), and S. 1656 (Senator Corzine).[10] While the approaches to regulatory reform vary somewhat, all of the legislative proposals would

- abolish OFHEO and create a new regulator in the Treasury Department,
- increase the budget autonomy of the new regulator,
- transfer some oversight responsibilities from HUD to the new regulator,
- increase regulatory discretion in setting certain capital standards, and
- enhance enforcement authorities.

Nott and Jickling (2003) include a detailed side-by-side comparison of each bill's provisions.

Treasury Secretary Snow first presented the Bush administration's views on GSE regulatory

1. See, for example, U.S. Congressional Budget Office (2001, 13–14) for a discussion of the various benefits afforded the three housing GSEs. The charter acts for these institutions can be found at 12 U.S.C. sec. 1716 et seq. (Fannie Mae), 12 U.S.C. sec. 1451 et seq. (Freddie Mac), and 12 U.S.C. sec. 1421 et seq. (Federal Home Loan Banks).
2. Conforming mortgages are those with balances below the legal limits on the size of mortgages that Fannie Mae and Freddie Mac can buy. For single-family mortgage loans, the conforming loan limit was $300,700 in 2002 and $322,700 in 2003 and is $333,700 in 2004.
3. These estimates were based, in part, on parameter values presented in CBO (2001). See also Passmore (2003) for benefit estimates consistent with the CBO studies. See Fannie Mae (2001), Freddie Mac (2001), Toevs (2001), and Pearce and Miller (2001) for various criticisms of the CBO's methodology.
4. As of year-end 2002, the five largest U.S. enterprises (ranked by total on-balance-sheet assets) were: (1) CitiGroup, (2) Fannie Mae, (3) JPMorgan Chase, (4) the FHLB System, and (5) Freddie Mac.
5. See, for example, Jaffee (2003) for a discussion of interest rate risk management at Fannie Mae and Freddie Mac.
6. By law, GSE securities are required to include language indicating that they are not guaranteed by, or otherwise an obligation of, the federal government. However, past government actions suggest otherwise. During the late 1970s and early 1980s, Fannie Mae was insolvent on a market value basis and benefited from supervisory forbearance. Also, in the late 1980s, the Farm Credit System (another GSE) required a taxpayer bailout totaling $4 billion. The U.S. General Accounting Office (1990, 90–91) discusses both of these episodes, and Kane and Foster (1986) provide estimates of the degree of insolvency for Fannie Mae during its financial distress.
7. This labeling is likely related to the fact that GSE securities are considered government securities under the Securities and Exchange Act of 1934.
8. Fannie Mae and Freddie Mac do receive AA– ratings from Standard and Poor's in terms of their risk to the government. However, such ratings incorporate whatever government support or intervention the entity typically enjoys during the normal course of business. See Frame and Wall (2002) for a discussion.
9. At least one of the four appointees is to be chosen from an organization representing consumer or community interests in banking services, credit needs, housing, or financial consumer protection.
10. There was also a House Financial Services Committee manager's amendment to H.R. 2575 released in preparation for an October 8, 2003, markup that was subsequently canceled. Three related bills were introduced in 2003 that would remove certain statutory benefits afforded Fannie Mae and Freddie Mac. First, H.R. 2022 (Representatives Shays and Markey) would repeal the enterprises' exemption from registering their securities with the Securities and Exchange Commission (SEC). Second, H.R. 2117 (Representative Pete Stark) would eliminate Fannie Mae's and Freddie Mac's statutory exemption from state and local income taxes. Finally, H.R. 3071 (Representative Ron Paul) would repeal several aspects of all three housing GSEs' charters: (1) the state and local income tax exemption, (2) the president's authority to appoint directors to these GSEs' boards of directors, (3) the Treasury secretary's authority to approve GSE debt issues, (4) the Treasury secretary's discretionary authority to purchase GSE obligations, and (5) certain other provisions that confer favorable investment status on GSE securities.

BOX

Recent Events

Two recent events spurred Congress to consider seriously whether changes should be made to the oversight of the housing GSEs. The first was a disclosure by Fannie Mae, suggesting that the enterprise had a significant exposure to interest rate movements. The second was the uncovering of accounting misstatements at Freddie Mac, which resulted in the departure of several top executives from the institution.

Fannie Mae's Duration Gap

In October 2000, Fannie Mae and Freddie Mac announced six voluntary initiatives intended to enhance their market discipline, increase liquidity, and improve transparency.[1] In terms of disclosures, the two GSEs subsequently began reporting certain interest rate risk measures on a monthly basis, including their *duration gap*, or the difference between the weighted-average durations of their assets and their liabilities.[2]

Fannie Mae's duration gap was scrutinized during the summer of 2002 as it exceeded its target range (plus or minus six months) for three consecutive months—suggesting a considerable exposure to future interest rate movements.[3] Specifically, between July and September 2002, Fannie Mae's duration gap was minus nine months, minus fourteen months, and minus ten months, respectively, reflecting a considerable shortening in the effective duration of its assets.[4] According to the Shadow Financial Regulatory Committee (2002), given Fannie Mae's leverage position, a duration gap of minus fourteen months would have implied that a 1 percentage point decline in interest rates could result in a 40 percent decline in its capital.[5] To reduce its duration gap, Fannie Mae relied on portfolio growth and hedging—that is, a combination of mortgage commitments, mortgage purchases, hedging with swaps and swaptions, and callable debt issues (Haviv 2002).

Following the September 2002 duration gap announcement, OFHEO reportedly sent a letter to Representatives Richard Baker and Paul Kanjorski indicating that it had increased its oversight of Fannie Mae's mortgage portfolio and duration gap (Canfield & Associates Inc. 2002b). In this letter, OFHEO required a plan to correct the imbalance and to monitor Fannie Mae's duration gap management for the following six months. In a September 2002 letter, Representative Baker reportedly then criticized OFHEO for not addressing Fannie's growing risk sooner: "OFHEO's recognition of Fannie Mae's problem is overdue and your delaying allowed unacceptable levels of risk to continue for far too long" (Canfield & Associates Inc. 2002a).[6]

Freddie Mac's Accounting Irregularities

In January 2003, Freddie Mac announced that it would restate its earnings for the previous three years—after its new auditor recommended certain changes to the enterprise's accounting policies—and that these restated earnings would be materially higher.[7] The restatement was originally characterized as a simple disagreement about the application of generally accepted accounting principles (GAAP) focusing primarily on how to value certain derivative transactions and the classification of mortgage assets between available-for-sale and trading accounts via certain resecuritization transactions. This perception was altered, however, when in June 2003 Freddie Mac announced that its three top executives had left the company. Furthermore, a July 2003 report commissioned by Freddie Mac's board of directors found that management had "encouraged the use of complex, capital-market transactions and, to a lesser extent, reserve adjustments, for purposes of achieving strong, steady earnings growth" (Baker-Botts LLP 2003, 5).[8] Simply put, the report suggests that Freddie Mac engaged in earnings management. The accounting restatement, released in November 2003, resulted in an upward adjustment in cumulative earnings through year-end 2002 of $5.0 billion.[9]

Following the June 2003 management shakeup, OFHEO Director Armando Falcon sent a letter to Freddie Mac's board of directors outlining actions—beyond the personnel changes—required of the board related to the enterprise's restatement process.[10] The letter also indicated that OFHEO dispatched a special investigation team to Freddie Mac to look at the restatement process, management's progress in implementing the action plan, and employee misconduct.[11] This investigation culminated in a December 2003 report by OFHEO that included sixteen recommended actions for Freddie Mac and OFHEO to take and imposed a $125 million fine on the company.[12]

In the wake of the accounting travails at Freddie Mac are a number of federal investigations and class action lawsuits, which are summarized in Freddie Mac (2003). The investigations include inquiries from OFHEO, the Internal Revenue

Service, the Securities and Exchange Commission (SEC), the U.S. Attorney's Office (Eastern District of Virginia), and the U.S. Department of Labor. Class action lawsuits, which allege violations of federal securities laws and regulations, have been brought by (among others) the Ohio Public Employees Retirement System and the State Teachers Retirement System of Ohio.

1. General information about the initiatives can be found on Fannie Mae's Web site at <www.fanniemae.com>, including a seventh initiative announced in 2002 (mandatory Securities and Exchange Commission disclosures). See also Frame and Wall (2002) for an analysis of the original six initiatives in the context of current thought and practice from the banking industry.
2. While the duration gap is a commonly used measure of the exposure of a portfolio to changes in interest rates, it is not well suited for measuring changes in portfolio value that are due to large interest rate movements, nor does it necessarily provide a good measure of risk for a portfolio with many embedded options, such as those associated with mortgage prepayments. See Cohen (1993) and Saunders (2000) for detailed discussions of the limitations of duration gap. Frame and Wall (2002) argue that "value at risk" would be a superior risk measure for Fannie Mae and Freddie Mac to report.
3. Fannie Mae (2002) notes that, over long horizons, its duration gap falls within its target range only about two-thirds of the time. Freddie Mac, by contrast, has yet to report a duration gap outside of plus or minus one month. However, the duration gaps for Fannie Mae and Freddie Mac are not directly comparable since the two enterprises compute their figures differently.
4. Media reports during this time suggest that this widening of the duration gap was due to unprecedented refinancing activity spurred by declining long-term interest rates.
5. The statement also noted that more complicated measures of interest rate risk exposure could imply a lesser exposure to loss.
6. Representative Baker reportedly also noted in the letter that he had originally made his concerns known about Fannie Mae's duration gap in December 2001 following an announcement that the gap was minus ten months.
7. PricewaterhouseCoopers replaced Arthur Andersen as Freddie Mac's auditor in March 2002.
8. Baker-Botts LLP (2003) details each of the groups of transactions originally in question and evaluates the extent to which they complied with GAAP and, if not, who was responsible for their undertaking and improper accounting treatment.
9. This cumulative increase was the product of the following changes: \$4.3 billion in 2002, –\$1.0 billion in 2001, \$1.1 billion in 2000, and \$0.6 billion for pre-2000 reporting years. See <www.freddiemac.com/news/archives/investors/2003/restatement_112103.html>.
10. This letter is available at <www.ofheo.gov/media/pdf/OFHEOLETTER67031.pdf>.
11. OFHEO has also undertaken a review of Fannie Mae's accounting practices. Indeed, shortly after announcing this review, Fannie Mae disclosed an accounting error totaling \$1.2 billion.
12. This report is available at <www.ofheo.gov/media/pdf/specialreport122003.pdf>.

reform in testimony before the House Financial Services Committee on September 10, 2003 (Snow 2003a). In it, Secretary Snow stated that the new agency's powers should be "comparable in scope and force to those of other world-class financial supervisors," and he recommended several changes in the structure and powers of the safety-and-soundness regulator for Fannie Mae and Freddie Mac.[11] These recommendations included (1) under certain conditions, locating the new regulatory agency within the Treasury; (2) funding the agency by assessments that are outside of the appropriations process; (3) giving the agency prior approval over new activities; (4) providing the agency with the authority to direct, if necessary, the liquidation of an enterprise's assets (that is, receivership authority);[12] and (5) giving the agency discretionary powers to adjust risk-based capital standards.

In testimony on October 16, 2003, before the Senate Banking Committee, Secretary Snow (2003b)

11. Testimony at the same hearing from HUD Secretary Mel Martinez also made clear that the Bush administration supports HUD's continued involvement in GSE mission oversight, particularly with respect to affordable housing goals. In his testimony, Secretary Martinez outlined a number of suggested changes to mission oversight: (1) creating a new GSE Housing Office within HUD that is independently funded by the GSEs to establish, maintain, and enforce the housing goals; (2) granting HUD new administrative authority to enforce its housing goals; (3) instituting enhanced civil money penalties for failure to meet housing goals; (4) explicitly providing that the GSEs act to increase homeownership; and (5) expanding HUD's authority to set housing goals and subgoals beyond the three currently established for moderate-income, geographic area, and special affordable housing. This testimony is available at <http://financialservices.house.gov/media/pdf/091003mm.pdf>.
12. Secretary Snow added, however, that rescinding a GSE charter would still require an act of Congress.

reiterated his earlier suggested changes, clarified the terms under which the Bush administration would support moving housing GSE oversight to the Treasury Department, and offered additional changes. He noted that Treasury would accept responsibility for the new safety-and-soundness agency if the agency had "adequate elements of policy accountability" to Treasury, including clearing regulations, clearing testimony for policy consistency, and reviewing the annual budget.[13] Secretary Snow also stated that the new regulator should have the authority to review and modify both minimum leverage and risk-based capital requirements and have well-defined receivership authority. His testimony also offered support for moving FHLB oversight into this new regulatory agency. In his testimony, Secretary Snow emphasized that he was not "presenting a wish list of reforms that we would like to see enacted, but rather the minimum elements that are needed in a credible regulatory structure."[14]

Arguably, the housing GSEs have achieved their scale and can operate in a leveraged manner because their obligations benefit from an implied federal guarantee arising from charter benefits and past government actions.

On September 25, 2003, representatives of both Fannie Mae and Freddie Mac testified before the House Financial Services Committee (hereafter Raines 2003 and Gould 2003, respectively). Both enterprises offered their general support for legislative efforts modeled on the administration's proposal, including the creation of a new safety-and-soundness regulator in Treasury with a funding base outside of the appropriations process and with the ability to adjust risk-based capital formulas. Raines (2003) and Gould (2003) did, however, express concerns about whether the new Treasury regulator or HUD would have new program approval, the scope of these new program approval authorities, and the possibility of the new regulator's having receivership authority.[15]

Despite what appeared to be a broad consensus on GSE regulatory reform, efforts quickly stalled. A legislative markup scheduled for October 8, 2003, in the House of Representatives was halted because the Bush administration withdrew its support for the bill, but Representative Baker reportedly laid the blame for the derailment of reform on Fannie Mae and Freddie Mac (Inside Mortgage Finance 2003).

Legislative activity concerning housing GSE oversight was rekindled in early 2004 in the Senate with two hearings and a new bill that passed the Committee on Banking, Housing, and Urban Affairs.

On February 24, 2004, Federal Reserve Chairman Alan Greenspan testified about the role of the housing GSEs in the U.S. economy. He opined that Congress should create a housing GSE regulator with (1) authorities on par with federal banking regulators, (2) the ability to set appropriate capital standards, and (3) a clear receivership process. Chairman Greenspan also expressed concern about the growth and scale of the mortgage-related portfolios at Fannie Mae and Freddie Mac, which he said has resulted in significant concentrations of mortgage-related interest rate and prepayment risks at these two institutions. He argued that these concentrations are attributable, at least in part, to the implicit federal guarantee of housing GSE debt obligations, which serves to lessen market discipline and allow these institutions to issue lower-cost debt and hold less equity capital than comparable fully private firms. Chairman Greenspan then opined that continued expansion and risk concentration was likely to result in "systemic disruptions" and that preventative action, such as limiting the size of Fannie Mae's and Freddie Mac's debt outstanding (as a percentage of mortgages securitized and held by outside investors), was in order.

The Senate Banking Committee subsequently heard testimony from representatives of the three housing GSEs although their positions were materially unchanged from those stated during the previous Senate and House hearings.[16] Following the hearings, the committee members worked to craft legislation, albeit on a partisan basis. Ultimately, on April 1, 2004, the Senate Banking Committee reported out the Federal Housing Enterprise Regulatory Reform Act (FHERRA), generally along party lines.[17]

In terms of institutional structure, the FHERRA creates a new independent regulatory agency called the Federal Housing Enterprise Supervisory Agency, which would be funded outside of the appropriations process, that succeeds the authority of OFHEO, HUD (except for fair housing responsibilities), and the Finance Board. A director, who is nominated by the president and confirmed by the Senate for a six-year term, would head the new agency. The director, in turn, would appoint three deputy directors: one for Fannie Mae and Freddie Mac regulation, one for FHLB regulation, and one for housing and mission goals. The agency would also include a board consisting of the director, the secretaries of HUD and Treasury, and the chair of the SEC.[18] The board does not exercise executive authority but does meet four times a year to review (and report on annually) the safety and soundness of the three housing GSEs, their overall operational status and performance in carrying out their missions, and the operations, resources, and performance of the agency.

In terms of institutional authorities, the FHERRA authorizes the new agency to

- set minimum capital requirements (risk-based and leverage);
- approve new mortgage programs;
- monitor and enforce strengthened housing goals;
- take prompt corrective actions related to the level of capitalization of a housing GSE;
- establish a conservatorship or receivership for a "critically undercapitalized" enterprise although Congress has a forty-five-day option to disapprove a receivership; and
- take other enforcement actions similar to those authorized for federal bank regulators (for example, cease and desist orders and civil money penalties).

The bill creates an effective date for the new regulatory agency of one year after the date of enactment although supervision by OFHEO and the Finance Board would seemingly terminate upon enactment. Thus, it appears that there would be a one-year gap in regulatory oversight.

The Bush administration commented on the FHERRA in a joint statement by Treasury Secretary Snow and HUD Secretary Jackson.[19] The secretaries noted concern about the amendment that provided for the congressional option to reject a decision to put an enterprise into receivership, stating that it "could reinforce the false impression that the American taxpayer provides an implicit guarantee to these entities." Given the opposition to the current form of the FHERRA from both Democrats and the Bush administration, particularly concerning receivership provisions, the prospects of new housing GSE oversight legislation passing in 2004 appear slim.

Enhancing Housing GSE Oversight, Safety, and Soundness

This section evaluates the key changes to housing GSE oversight suggested by members of Congress, the Bush administration, and the enterprises themselves. To that end, we generally focus on intent, rather than the specific wording in proposed legislation that may or may not result in expected changes. Moreover, while each of the legislative proposals contains myriad provisions, we examine those likely to result in a significant change to regulation of the housing GSEs.

The regulatory changes proposed during the 108th Congress generally pertain to either institutional design (for example, where the regulator is located, how the regulator is funded) or institutional authorities (for example, discretion to alter capital requirements, the ability to appoint conservators and receivers). In terms of institutional design, our analysis draws on previous discussion by the GAO (1997b), while the GAO (2001) provides a detailed comparison of institutional authorities for federal banking regulators, OFHEO, and the Finance Board. Carnell (2004) also examines issues pertaining to institutional design and authorities for the housing GSEs.

Institutional design. The broad points of discussion in the legislative debate concerning institutional design of a new safety-and-soundness regulator for the housing GSEs have been about three related issues: the location of this regulator, the funding

13. Secretary Snow added that the new agency should have independent responsibility over specific matters of supervision, enforcement, and access to federal courts.
14. N. Gregory Mankiw, Chairman of the Council of Economic Advisers, also publicly provided the Bush administration's views in a speech on November 6, 2003 (Mankiw 2003). In it, Mankiw argued that the new safety-and-soundness regulator should have a permanent funding mechanism, the authority to set both risk-based and minimum capital standards, the authority to reject new GSE activities, and receivership powers.
15. Raines and Gould also presented similar testimony before the Senate Banking Committee on October 16, 2003.
16. Franklin Raines (chairman and chief executive officer of Fannie Mae), Richard Syron (chairman and chief executive officer of Freddie Mac), and Norman Rice (president and chief executive officer of the FHLB of Seattle) provided the Senate testimony on February 25, 2004.
17. The vote was 12 to 9, with all committee Republicans and one Democrat (Zell Miller of Georgia) in favor of the bill.
18. This inclusion of executive branch authority on the board of an independent agency parallels the pattern of the Resolution Trust Corporation Oversight Board, which Congress established in 1989 in FIRREA. That board consisted of the secretaries of the Treasury and HUD, the chairman of the Federal Reserve System, and two presidential appointees. Also, the current structure of the Finance Board includes the secretary of HUD as one of the board members.
19. This statement is available at <www.treasury.gov/press/releases/js1294.htm>.

mechanism for the regulator, and whom the regulator should supervise.

The important trade-offs with respect to each issue relate to the desired levels of "regulatory independence," "political independence," and "prominence in government." Regulatory independence refers to the relationship between the regulator and the regulated and is concerned with limiting the potential for regulatory capture. It is influenced by the set of regulated institutions (that is, how many there are and how diverse their interests are) and the scope of the regulatory body's mission. Political independence refers to the relationship between the regulator and the executive and legislative branches of government and the regulator's ability to withstand external pressures generally. Prominence alludes to the stature of the regulator when testifying, when proposing and carrying out regulatory actions, and when taking public positions generally.

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Location of the GSE regulator. All of the legislative proposals in 2003 involved abolishing OFHEO and replacing it with a new office housed within the Treasury Department. The desire to move safety-and-soundness regulation for housing GSEs to Treasury, however, became quite contentious in 2003 after the Bush administration insisted that the legislation include provisions that would make the proposed bureau less "independent" than the other two financial regulatory bureaus currently housed in Treasury—the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS). Specifically, the administration would like the new agency to clear regulations and congressional testimony through Treasury. According to Snow (2003b), Treasury's direct involvement in policy guidance is important for two reasons. First, unlike the other Treasury bureaus, the new agency would be responsible for only a handful of very large financial institutions, thereby increasing the possibility of regulatory capture. Second, each of the housing GSEs benefits from an implied federal guarantee, which reduces market discipline; for this reason, Treasury feels that it needs the power to monitor the new regulator's policies so that they are not "reinforcing any such market misperception of an implied guarantee." However, Snow also highlighted the importance of protecting the independence of the agency over specific matters of supervision, enforcement, and access to federal courts.

Some policymakers are wary of Treasury's position and believe that the new GSE regulator should be as independent as the OCC and the OTS. For example, at a September 25, 2003, hearing, Representative Carolyn Maloney's written statement noted that "without the ability to take independent positions before Congress, the authority of the new regulator will constantly be in question and different parties will attempt to influence regulatory outcomes by appealing to higher levels in the Treasury Department."[20] At the same hearing, OFHEO director Armando Falcon's written testimony stated that regulators "should be objective, nonpartisan, and protected from political interference" and that "this is especially critical when regulators must make difficult and sometimes politically unpopular decisions."[21]

An alternative to placing housing GSE oversight in a cabinet department would be to locate it in an independent agency outside the executive branch. This approach is taken in the FHERRA and is consistent with the recommendation of the GAO (1997b), which concluded that there should be a single, stand-alone housing GSE regulator for Fannie Mae, Freddie Mac, and the FHLBs that spans both mission and safety-and-soundness responsibilities. As noted above, the FHERRA appears to meld the existing structures of many independent agencies by having both a director responsible for executive decision making and a board, which includes cabinet secretaries, that reviews and reports to Congress about the state of the housing GSEs and their regulator. An agency modeled in this way has a bit more political accountability and prominence in government than other independent agencies do.

An alternative to creating a new agency, of course, would be to merge housing GSE oversight responsibilities into an existing financial regulatory agency. Indeed, one option would be to transfer oversight responsibilities for Fannie Mae and Freddie Mac to the Finance Board. However, the current structure of the Finance Board poses a special problem since it is required by statute to appoint members to the twelve FHLBs' boards and otherwise become involved in their business (see GAO 1998a). Such involvement in the future, as well as in the past, could compromise the Finance Board's independence in the sense that the agency does not have an arm's length relationship with its regulated entities. Another option, which would not suffer from the same perceived lack of regulatory independence, would be to merge GSE oversight into an existing independent financial regulatory agency such as the Federal Reserve or the Federal Deposit Insurance Corporation (FDIC). Little of the current discussion has focused on these options, however, and Carnell (2001b) raises several policy concerns with respect to merging GSE oversight into the Federal Reserve.

Should a housing GSE safety-and-soundness regulator be in the executive branch, or should it be an independent agency? The "regulatory independence" of a housing GSE regulator will largely be unrelated to whether it is housed in a cabinet department or an independent agency. Nevertheless, an exclusive regulator may be seen as susceptible to capture because it will be overseeing no more than three institutions, two of which (Fannie Mae and Freddie Mac) have essentially identical charters and hence similar interests. An existing regulator—with a large and diverse constituency—would be perceived as having more "regulatory independence."

The primary argument for an independent agency is that independence buffers the agency from political pressures. While this argument may be true with respect to the direct pressures of a presidential administration, such independence surely does not buffer the agency from other political influences; more importantly, this independence also removes the agency from the direct line of political responsibility.[22] Further, independent agencies are often less prominent in government, a consideration that, among other things, may negatively affect its ability to recruit and retain high-quality staff. Unless they are involved in a high-profile issue (such as the current corporate governance issues that have embroiled the SEC), independent commissions and boards are often less well known and understood than an executive branch cabinet department, whose secretary always carries the authority of the presidential administration.

Agency funding. As noted above, OFHEO's assessments on Fannie Mae and Freddie Mac are currently subject to the annual congressional appropriations process; the regulator has long argued that this process hinders its ability to conduct effective long-term planning and its general resource flexibility. The Finance Board and each of the federal banking agencies are funded outside of the appropriations process, using fees collected from the regulated institutions rather than using general tax receipts.[23]

All of the legislative proposals introduced in the 108th Congress authorized the director of the new entity to collect annual assessments, although four (H.R. 2575, H.R. 2803, S. 1508, and S. 1656) maintain the requirement that the monies be placed in a fund at the Treasury.[24] Analysis provided in Nott and Jickling (2003) suggests that the result of this requirement is that the new office actually would not be removed from the appropriations process.[25] By contrast, the legislative language found in the FHESSA and the House Financial Services manager's amendment is similar to the language that applies to other

20. This statement is available at <http://financialservices.house.gov/media/pdf/092503ma.pdf>.
21. This testimony is available at <http://financialservices.house.gov/media/pdf/092503af.pdf>.
22. Arguably, the extent of the savings and loan debacle was exacerbated by the location of the S&Ls' regulator and insurer (the FHLBB) as an independent agency that was not directly part of the executive branch. This location outside the executive branch made it easier for the Reagan administration to accede to Congress's willingness to ignore the growing problems of the thrift industry and its insurance fund for most of the 1980s. See White (1991).
23. The federal banking regulators are primarily funded by examination fees (OCC and OTS), deposit insurance premiums (FDIC), and interest on securities (Federal Reserve). The Securities and Exchange Commission and the Commodity Futures Trading Commission also collect fees for various services although they both have spending limits imposed through the appropriations process.
24. According to Nott and Jickling (2003), there were also differences among the bills in terms of what the appropriations could cover: "all reasonable costs and expenses of the office" (House manager's amendment, S. 1508, and S. 1656) or costs of the director "with respect to regulation and supervision" (H.R. 2575, H.R. 2803). The latter language could, in theory, expose the regulator to regular challenges from the enterprises about the appropriateness of the assessments. Moreover, with the exception of the House Financial Services manager's amendment, the bills do not address the regulator's funding requirements during a crisis. In general, regulators have found it important to maintain working capital to carry out elevated supervision in a crisis, above and beyond normal costs. For example, Congress authorized the OTS to maintain a working capital fund for emergency circumstances that allows the agency to collect fees and assessments in excess of actual expenses to help maintain such a fund. The manager's amendment authorizes the GSE regulator to maintain a working capital fund in the "amount the Director deems necessary."
25. Nott and Jickling (2003) point out that the Constitution states that no monies can be drawn from the Treasury except by appropriation. The effect of this provision, the authors contend, is to retain an appropriations requirement, which allows appropriations committees to cap or otherwise restrict the use of funds by an agency.

bank regulators and would completely remove the new regulator from the appropriations process. Speaking for the Bush administration, Treasury Secretary Snow argued that the new agency should be adequately funded by assessments on the regulated entities (for instance, Snow 2003a). However, the agency budget and fee assessments should be subject to review by the administration to avoid any long-term temptation to "gold-plate" agency operations and to ensure the appropriate allocation of resources among the agency's responsibilities.

Previous analyses by the GAO (1997b) and Carnell (2004) conclude that funding for housing GSE regulation should come from the regulated entities and outside of the appropriations process. The primary argument in favor of directly assessing the regulated entities for the costs of supervision is that it may improve the stability of funding by keeping an agency away from the political vagaries that could accompany explicit annual budgetary appropriations decisions by Congress. This consideration may be particularly important for a regulator that focuses on only a handful of large and politically powerful entities, like the housing GSEs. Thus, regulatory funding outside of the appropriations process would help with the problem of regulatory independence.

The primary argument for an independent housing GSE regulator is that independence buffers the agency from political pressures.

However, without some countervailing force, a regulatory agency with levying authority may have an incentive to ratchet fees upward annually. In the case of depository institutions, charter competition provides some countervailing power against such behavior because these institutions may switch charters if they feel that they are being overcharged for their supervision. The housing GSEs, as congressionally chartered entities, do not have this option. Another drawback to assessments on the regulated entities is that shrinkage in the assessed base would reduce the regulator's funding even if the regulator's responsibilities had not changed.

The argument in favor of immersing a regulatory agency in the annual appropriations process (in which its budget would come from general tax revenues rather than specific assessments on its regulated entities) would be that the regulatory agencies are little different from the other areas and functions of the federal government and that the democratic process (which includes budgetary appropriations) inevitably (and properly) reflects political pressures from the parties who are involved. However, one could argue that the current procedure that applies to OFHEO—whereby that agency's budget is subject to the annual appropriations process but the revenue bill is then sent to Fannie Mae and Freddie Mac for payment—may be the worst of all possible arrangements because it intensifies the enterprises' incentives to lobby in favor of smaller budgets for the safety-and-soundness regulator.

All housing GSEs? The Bush administration and some members of Congress have expressed support for combining the safety-and-soundness supervision for all of the housing GSEs into a single agency. Nevertheless, only the FHERRA and one of the 2003 legislative proposals (H.R. 2803) consolidated safety-and-soundness supervisory authority for all three enterprises.

Although Fannie Mae and Freddie Mac generally operate differently from the FHLBs, the risks they manage (for example, interest rate risk associated with holding long-term, fixed rate mortgage-related assets) and the missions they fulfill are similar. The GAO (1997b) and Carnell (2004) outline four advantages of combining the housing GSEs' oversight. The first is that a single regulator would likely have more independence from the firms it regulates because these institutions have different business models and interests, which, in turn, could create a healthy tension that serves to reduce the probability of regulatory capture. Second, a combined regulator would be larger and more prominent in government, with such stature helping to attract and retain qualified staff. Third, some economies of scale and scope could be achieved through joint supervision. Finally, a single regulator would help ensure consistent regulatory treatment, which could foster more competitive equity across housing GSEs to the potential benefit of mortgage borrowers.

Alternatively, multiple regulators offer varying forums within which new ideas, new institutional forms, and new regulatory procedures can be developed and implemented.[26] This concept, which is consistent with the dual banking system of federal and state chartering and regulation, is generally perceived to be a net benefit.[27] However, one mitigating factor in the context of GSE regulation is that, unlike in banking, the regulated entities cannot select their supervisory authority. As a result, regulatory competition in this context may serve only to tilt the competitive balance toward one set of institutions without the other set's being able to take advantage of any regulatory changes.

Institutional authorities. There appears to be a legislative consensus that, so long as the federal implied guarantee remains, there should be a strong safety-and-soundness regulatory system applied to the housing GSEs. Further, as noted by White (2003b), the experience of the past two to three decades of depository institution regulation has yielded the clear lesson that an effective safety-and-soundness regime includes (among other things) both minimum capital requirements and limitations on activities. Minimum capital requirements should (1) be gauged to the risks that are inherent in the institution's assets and activities (that is, risk-based capital); (2) be measured on a market value accounting (mark-to-market) basis; (3) be a basis for supervisory actions, such as the appointment of a conservator or a receiver (as well as less drastic actions, such as restrictions on growth or capital distributions); and (4) include a tranche of subordinated debt. Activities limitations are justified primarily by the possibility that the regulator has little expertise in setting capital requirements or judging managerial competence with respect to the activities in question.

In addition to disputes over the location, funding, and structure of a new housing GSE regulatory structure, debate persists over the proposed agency's authorities. The main areas of contention involve whether the regulator should have responsibility for approving new activities proposed by the housing GSEs, whether the regulator should have discretion in setting regulatory capital requirements, and whether the regulator should have certain enforcement powers, particularly receivership authority.

New activities approval. As noted above, HUD currently has oversight responsibilities for Fannie Mae's and Freddie Mac's housing mission, which to this point has included new program authority and compliance with affordable housing goals. Under current law, HUD is required to approve or reject any new mortgage program that either GSE proposes.[28] HUD can reject new programs if the department determines that it would result in a charter violation or is not in the public interest.[29] HUD must approve or reject such proposals within forty-five days of submission, with one fifteen-day extension allowed if additional information is required, or else the proposals are automatically approved. In short, the burden is on HUD to determine quickly whether there are sufficient reasons to keep Fannie Mae or Freddie Mac from proceeding with any new initiative.

The GAO (1998b) concluded that, at that time, HUD had not fully implemented a process under its general regulatory and new mortgage program approval authorities to ensure that Fannie Mae's and Freddie Mac's activities were consistent with their housing missions. The report further questioned whether HUD had the capacity to evaluate sophisticated financial products that may be associated with new mortgage program applications. While the number of new mortgage program approvals has been modest (there were three between 1995 and 2000), HUD has elected not to review major new initiatives such as entry into the subprime market and the implementation of automated underwriting systems (Fishbein 2003).[30]

In the recent legislative debate, there has been interest in moving the new program authority function from HUD to the new safety-and-soundness regulator or expanding the regulatory scope for limiting new activities.[31] The Bush administration has

26. As a concrete example, consider the FHLBs' development of mortgage purchase programs in the late 1990s that compete with Fannie Mae and Freddie Mac (Frame 2003). If the FHLBs had been under OFHEO's regulatory purview rather than the Finance Board's, approval might well not have been forthcoming.
27. See, for example, Scott (1977) and Rosen (2003). For similar arguments that apply to securities regulation, see Gramm and Gray (1994) and Wall and Eisenbeis (2000).
28. A "new mortgage program" is defined as one that is "significantly different from programs that have been approved, or that represent an expansion (in terms of the dollar volume or number of mortgages or securities involved) of programs previously approved."
29. A third criterion was if OFHEO determined that the program would risk significant deterioration of the financial condition of the enterprise. However, this provision expired twelve months after OFHEO's risk-based capital rule became effective.
30. In addition, there is no public information on new programs that may have been informally proposed but were then informally vetoed and never attracted public attention.
31. Under four of the bills, new program authority would be transferred to the new office: Three bills (the FHERRA, H.R. 2803, and S. 1508) do this outright while another does this with a provision to consult with the secretary of HUD (S. 1656). Another bill (H.R. 2575) proposes to maintain authority with the secretary of HUD but expand the authority to all new "activities" instead of just "programs" and removes the current forty-five-day time limit that HUD must meet in order to avoid automatic approval of a proposed new program. The House Financial Services manager's amendment retains prior approval authority with HUD but expands the HUD secretary's authority to both new and ongoing programs. All five bills retain the HUD secretary's authority for affordable housing goals.

supported such provisions on the grounds that new program authority is closely related to safety and soundness and that other financial regulators have this authority (Snow 2003b; Mankiw 2003).[32] Fannie Mae and Freddie Mac as well as other interested parties have expressed a great deal of concern about moving the new program authority to the safety-and-soundness regulator as well as expanding the scope for imposing limitations. This concern has arisen for two reasons. First, moving new program authority away from HUD is viewed as a potential threat to housing as a public policy priority. Second, expanding the scope for imposing limitations is viewed as unnecessary micromanagement that could stifle mortgage market innovation.[33]

There appears to be a legislative consensus that, so long as the federal implied guarantee remains, there should be a strong safety-and-soundness regulatory system applied to the housing GSEs.

Both the GAO (1997b) and Carnell (2004) advocate combining the safety-and-soundness and mission regulation of Fannie Mae and Freddie Mac and then conjoining them with the responsibilities of the Finance Board, which already oversees all aspects of FHLB regulation. Their reasoning is threefold. First, it would promote accountability by both the regulator and the housing GSEs since divided responsibilities create the potential for the regulated entities to pit the regulators against each other.[34] Second, joint responsibility would simplify compliance on the part of the housing GSEs. Finally, insofar as GSE policy must account for both mission and safety and soundness, giving one agency both responsibilities would promote better-informed decision making (Carnell 2004).

There are two primary issues related to new activities approval. The first issue is the interests of the safety-and-soundness regulator in limiting activities for which capital standards and managerial competence standards cannot be set.[35] Such interests argue strongly for the safety-and-soundness regulator's having responsibility for the approval of any new programs or activities. The second focuses on efficiency considerations related to so-called "mission creep," or the tendency of a GSE to want to grow larger by taking on new activities. Specifically, one would want to examine carefully whether the expansion into an activity is due to the inherent efficiency of the GSEs' operations or whether it simply represents an extension or leveraging of the GSEs' special advantages.[36]

Capital standards. Fannie Mae and Freddie Mac are currently subject to three statutory capital standards. First, the *minimum capital standard* requires each enterprise to hold total capital equal to at least the sum of 2.5 percent of on-balance-sheet assets plus 0.45 percent of off-balance-sheet guarantees. Second, the *critical capital standard* is the level of capital below which OFHEO is generally required to appoint a conservator, which is total capital equal to at least the sum of 1.25 percent of on-balance-sheet assets plus 0.25 percent of off-balance-sheet guarantees. Finally, the *risk-based capital standard* requires each enterprise to hold enough capital to cover the credit (default) and interest rate risks inherent on and off the balance sheet plus another 30 percent of this sum for management and operations risk. The risk-based standard is based on an OFHEO-developed stress test model, the broad parameters of which (including the 30 percent add-on) are dictated by statute.

As noted above, consistent with current banking practice, the Bush administration supports giving the new safety-and-soundness regulator the discretion to set minimum and risk-based capital levels rather than having them set in statute (Snow 2003b; Mankiw 2003). In contrast, Raines (2003), speaking on behalf of Fannie Mae, believes that its minimum capital requirement should remain set in statute and at current levels.

Consistent with the Bush administration's proposal, the FHERRA would provide the new housing GSE supervisor with the authority to set both minimum leverage and risk-based capital requirements. None of the previous bills introduced during the 108th Congress had included discretion in setting both capital standards.[37]

As a general matter, Congress establishes broad policy goals for regulatory agencies and then directs the agencies to set the specific details of regulatory standards. An important reason for this is that agency personnel are better versed in the minutia of specific issues and are better suited to adapt regulatory standards as theory and practice evolve. The establishment of prudential capital standards would seem to fit this mold. And as noted above, federal bank regulators already have this important authority.[38]

Enforcement authorities. Financial regulators are responsible for ensuring that the institutions they supervise operate in a safe and sound fashion. To that end, each regulator has an array of enforcement tools at its disposal, although statutory differences exist across regulators. The GAO (2001) provides a side-by-side comparison of the prompt corrective action (PCA) provisions and general enforcement authorities of the U.S. federal bank regulators, OFHEO, and the Finance Board. This comparison of regulatory enforcement authorities suggests that these authorities are weaker for the housing GSE regulators than for federal banking regulators.

With respect to PCA provisions, the Finance Board does not have statutory provisions that specify the actions that should be taken in the event that an individual FHLB becomes undercapitalized. The range of enforcement actions available to OFHEO is largely dependent on the capital classification of Fannie Mae or Freddie Mac. Four classifications exist: (1) *adequately capitalized*, if both the risk-based and minimum capital levels are met; (2) *undercapitalized*, if the minimum level is met but not the risk-based; (3) *significantly undercapitalized*, if only the critical capital level is met; and (4) *critically undercapitalized*, if none of the levels is met by an enterprise. If an enterprise is adequately capitalized, there are no prescribed supervisory actions.[39] An undercapitalized enterprise must have a capital restoration plan approved by OFHEO and may not make any capital distributions that could result in further slippage.[40] For a significantly undercapitalized enterprise, a capital restoration plan and any capital distributions must be approved. In this category, restrictions may be placed on growth and certain activities, new capital may be required, and, should the capital restoration plan not be approved or followed, OFHEO is authorized to appoint a conservator to take over operations. For a critically undercapitalized enterprise, OFHEO is required to appoint a conservator unless such an appointment would have an adverse impact on financial markets or is not in the public interest.

There are material differences in OFHEO's PCA scheme relative to that for federal bank regulators. According to the GAO (2001), OFHEO's PCA scheme provides for regulatory action later (in terms of capital classification), has fewer required actions imposed, provides the regulator with more discretion in determining specific actions to take, and has more notice and comment periods. Hence, Carnell (2001a) concludes that the PCA rules governing Fannie Mae and Freddie Mac are conspicuously weaker than those governing FDIC-insured depository institutions.[41]

32. For example, the OCC and OTS act as safety-and-soundness regulators for national banks and thrifts, respectively, but also enforce mission requirements like the Community Reinvestment Act.
33. For example, Raines (2003) opines that "H.R. 2575 would stifle innovation in the mortgage market by requiring prior approval for any new 'program, activity, business process, or investment that directly or indirectly provides financing or other services to conventional mortgages.' It would replace the current standard, which is to review any program that is 'significantly different' from a program already in place in 1992, with a standard that sanctions a virtually limitless scope of review. The provision would also allow HUD to reject new programs even if they comply with our charter and are in the public interest."
34. See Wall and Eisenbeis (2000) for a more general discussion of the relative merits of "internal" versus "external" regulatory conflict resolution.
35. See the discussion by White (1996), Shull and White (1998a, 1998b), and White (2003b) on this point, where the concept of "examinability and supervisability" is introduced.
36. To the extent that effective capital requirements (discussed below) bring the GSEs' capital levels closer to those consistent with their borrowing rates, these efficiency concerns should diminish. But they will not entirely disappear since the GSEs get other benefits besides unduly favorable borrowing rates, and corporate imperatives for growth are generally quite strong.
37. The House Financial Services manager's amendment provides the supervisor with authority to set risk-based capital levels while minimum leverage requirements remain set in statute. Two of the other bills (H.R. 2575 and S. 1508) allow for greater regulatory discretion regarding capital by permitting the director of the new office to (1) apply alternative economic scenarios in the risk-based capital stress test, including assumptions pertaining to interest rates, home prices, and new business, and (2) increase the required minimum and critical capital levels for the enterprises by regulation or order. S. 1508 also requires that the risk-based capital standard be similar to those used by federal banking regulators. H.R. 2803, on the other hand, offers no provision to amend the capital standard requirements currently set in statute while S. 1656 mandates that the director review the adequacy of current risk-based capital standards and, if necessary, make recommendations to Congress for changes in the statutory levels.
38. However, as an indication of Congress's fears that the bank regulators might be reluctant to implement prompt corrective action forcefully, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 specified that an institution is deemed "critically undercapitalized" if its ratio of tangible equity to total assets is less than or equal to 2 percent.
39. However, cease and desist orders may still be issued for conduct that seriously threatens the enterprise's capital base.
40. If no plan is approved or an approved plan is not complied with, OFHEO is authorized to downgrade an enterprise's classification.
41. Carnell (2001a) illustrates this in the following way: An undercapitalized bank cannot increase its total assets unless the bank has an acceptable capital restoration plan, the asset growth comports with the plan, and the bank's capital ratio increases at a rate sufficient to enable the bank to become adequately capitalized within a reasonable time. However, no statute bars Fannie Mae and Freddie Mac from continuing to grow while undercapitalized even if they have no capital restoration plan or if the growth conflicts with such a plan. The PCA provision authorizes growth restrictions only against a significantly or critically undercapitalized GSE and makes such sanctions purely discretionary.

In terms of non-PCA enforcement authorities, the GAO (2001) found that similar powers are available to federal bank regulators, OFHEO, and the Finance Board to address significant safety-and-soundness concerns. However, the study highlighted important differences between the bank regulators and OFHEO regarding certain aspects of their cease and desist powers, removal and prohibition authorities applicable to officers and directors, and receivership and litigation powers. The remainder of this section focuses on receivership power, which is the enforcement authority that has garnered the most attention in the current debate. For undercapitalized institutions, bank regulators must appoint a receiver, appoint a conservator with the FDIC's concurrence, or take other action with FDIC concurrence that best serves PCA (GAO 2001). Indeed, Carnell (2001a) argues that bank receivership laws facilitate a relatively rapid, efficient, and orderly resolution of claims against a failed or failing bank. Specifically, as receiver, the FDIC is empowered to operate or liquidate the bank; if the bank is insolvent, its shareholders lose their ownership interest, and creditors may incur losses. A conservator, by contrast, is appointed to conserve rather than dispose of the assets.

The current legislative approach assumes that the most effective method of reducing taxpayer risk is to strengthen housing GSE regulation, but as a theoretical matter the efficacy of this approach is unclear.

OFHEO has the authority to appoint a conservator for a significantly undercapitalized enterprise and (after notice) must generally appoint one for a critically undercapitalized enterprise. However, unlike the bank regulators, OFHEO lacks the authority to place an enterprise into receivership. Without such authority vested in OFHEO, Congress would ultimately have to determine the allocation of losses because Fannie Mae and Freddie Mac are exempt from the bankruptcy code (Carnell 2001a, 2004). The lack of a predefined mechanism for dealing with losses generated by the failure of either Fannie Mae or Freddie Mac likely serves to increase the probability that at least some losses would be borne by taxpayers. The Finance Board, by contrast, has the statutory authority to liquidate or reorganize an FHLB whenever the Finance Board finds that the efficient and economical accomplishment of the purposes of the Federal Home Loan Bank Act will be aided by such action.

The Bush administration supports well-defined receivership authorities for housing GSE regulators (Snow 2003b; Mankiw 2003). Fannie Mae and Freddie Mac, by contrast, are against them (Raines 2004; Syron 2004). As noted above, the FHERRA includes receivership authority for the new housing GSE supervisor, albeit with a forty-five-day option clause for Congress to intervene and rescind the receivership decision. Two earlier legislative proposals (H.R. 2575 and the House Financial Services manager's amendment) provided for receivership while the remaining three did not. In our view, it seems straightforward that a "world-class financial regulator" should have receivership powers.

Conclusions

The housing GSEs are large, highly leveraged financial institutions that receive several economically significant benefits. On the heels of a massive accounting restatement by Freddie Mac in 2003, a reorganization of the housing GSEs' regulatory structure is an active legislative topic. The current legislative approach assumes that the most effective method of reducing taxpayer risk is to strengthen housing GSE regulation, but as a theoretical matter the efficacy of this approach is unclear.

This article reviews the recent controversies concerning GSE regulation, including the issues of institutional design and authorities. With respect to institutional design, we have tried to outline the inherent trade-offs and appreciate that there may not be a clearly dominant approach. However, previous analyses provided by the GAO (1997b) and Carnell (2004) do reach some conclusions that merit serious consideration. As for institutional authorities, we think that the regulator should have (1) responsibility for the approval of new programs and other activities, (2) the discretion to set both minimum and risk-based capital requirements, (3) receivership authority, and (4) other enforcement authorities comparable to the federal banking agencies.

As of April 2004, Congress had passed no legislation with respect to the GSEs' regulatory structure, but these legislative proposals remain alive in the 2004 legislative session. How Congress balances its focus on housing with the safety-and-soundness concerns at the GSEs bears close attention.

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