October 25, 2005

Analysis: H.R. 1461 (As Modified by the Manager's Amendment)

On May 25, 2005, the House Financial Services Committee reported its version of H.R. 1461, the Federal Housing Finance Reform Act of 2005. Since then, the bill has been amended in a variety of places, most significantly concerning the affordable housing funds created by the bill. This memorandum refers to the version of the bill dated September 16, 2005, as modified by the manager's amendment dated October 19, 2005.

While the bill makes two improvements to the regulatory structure of OFHEO today, it contains flaws that make it a poor substitute for current law. Moreover, given the likelihood that the Congress will not again revisit GSE reform for many years after the next round of legislation is enacted, H.R. 1461 represents a lost opportunity for more serious regulatory reform.

Consider those parts of H.R. 1461 that improve upon current law, those that are seriously flawed compared to current law, those that are weaker than the regulatory authority available to the federal bank regulators, those that represent a lost opportunity for regulatory reform, and the opportunities these changes will present for Fannie Mae and Freddie Mac, at the expense of the private sector.

I. Improvements on Current Law

H.R. 1461 improves on current law in three areas.

- Funding the Regulator

  Current law: Currently the Office of Federal Housing Enterprise Oversight (OFHEO), the safety-and-soundness regulator of Fannie Mae and Freddie Mac, and the GSE oversight functions of the Department of Housing and Urban Development (HUD), both are funded through the appropriations process. Fannie Mae and Freddie Mac have reportedly used their influence over the appropriations process to deny funding for important OFHEO activities, most recently the OFHEO Special Examination of Fannie Mae.

  H.R. 1461: H.R. 1461 combines the functions of OFHEO, the GSE-related functions of HUD, and the functions of the Federal Housing Finance Board (FHFB) with respect to the Federal Home Loan Banks, into a single regulator, the Federal Housing Finance Agency. This

agency is funded through assessments on the regulated GSEs without regard to the appropriations process.

The Comparable Federal Bank Regulatory Structure: This feature of H.R. 1461 would bring oversight of the GSEs into line with the funding process of the federal bank regulators. They are funded by assessments without regard to the appropriations process.

- Strengthening Some Supervisory Powers

  Current law: OFHEO's authority vis-à-vis Fannie Mae and Freddie Mac is much weaker than the authority available to the federal bank regulators.

  H.R. 1461: H.R. 1461 strengthens the new regulator's authority in a number of places. The risk-based capital test is more flexible than the unworkable statutory scheme that binds OFHEO. The new regulator will have authority to place a failed GSE into receivership. A number of the cumbersome procedural requirements and preconditions that hamper OFHEO's exercise of enforcement authority have been removed. For example, unlike OFHEO, the new regulator has authority to bring enforcement actions directly, rather than being required to work through the Attorney General. Finally, the regulator will have authority to deal with wrongdoing by lower-level employees and, in a limited way by contractors such as accountants and attorneys, to a greater extent than OFHEO can today.

  The Comparable Federal Bank Regulatory Structure: As will be discussed further below, the supervisory authority of the new regulator remains inferior to the authority of the federal bank regulators. Under H.R. 1461, the GSE regulator has limited authority to adjust minimum capital requirements for the GSEs. The regulator may not withdraw or cancel the charter of a failed GSE that is in receivership. The regulator lacks authority to issue and enforce directives. The regulator also lacks authority to deal directly with violations that include abetting violations without actually committing them.

- Affordable Housing

  Current law: HUD recently strengthened the affordable housing goals under current law. However, the statutory definitions are weak. For example, current law defines "low-income" borrowers with incomes up to 80 percent of the area median income and "very-low income" as incomes up to 60 percent of the area median income. In addition, HUD lacks the ability to enforce GSE compliance with the housing goals.

H.R. 1461: Changes the definition of "very-low income" to 50 percent of the area median income. This helps to target GSE performance on a lower income category of borrower than before. The bill creates a duty of the GSEs to lead the industry in developing loan products and flexible underwriting guidelines to facilitate a secondary market for mortgages on manufactured housing for very-low, low- and moderate-income families and preservation of affordable housing for low- and moderate-income families. The bill also strengthens the regulator's enforcement powers with respect to the affordable housing goals.

The Comparable Federal Bank Regulatory Structure: The Community Reinvestment Act (CRA) holds banks to more stringent affordable housing standards than H.R. 1461 applies to the GSEs. The CRA defines "low income" as income that is less than 50 percent of the area median and "moderate income" as between 50 percent and 80 percent of the area median income. The bank regulators possess extensive authority and leverage to assure that banks meet their CRA goals.

Opportunities for the GSEs: The language with respect to the multifamily special affordable housing goal would allow the GSEs to argue that they have authority to guarantee tax-exempt and taxable bonds of housing finance agencies. This, in turn, can help them to justify their expansion into other comparable areas, such as guaranteeing bonds that states and localities issue for other purposes, such as community development. Especially but not solely because of the regulator's duty under the bill to encourage expansion of the GSEs, discussed below, the regulator is unlikely to disapprove these new activities and thereby may allow the GSEs to become major participants in the financial guaranty business.

In summary, H.R. 1461 does make several improvements over current law. However, given OFHEO's success in utilizing its current limited powers, these improvements should not come at the expense of creating significant regulatory weakness in other parts of the bill.

II. Serious Flaws

Unfortunately, H.R. 1461 does contain some significant flaws, compared to current law.

- Duty to Encourage GSE Activities That Minimize the Cost of Housing Finance

Current Law: Currently OFHEO and HUD operate under statutory mandates that are clear, even if they are weak. OFHEO is clearly responsible for safety and soundness oversight of Fannie Mae and

Freddie Mac and HUD is responsible for mission oversight. Neither agency is responsible for promoting the GSEs that it regulates.

H.R. 1461: H.R. 1461 provides that a principal duty of the new regulator shall be "to ensure that …the operations and activities of each regulated entity foster…national housing finance markets that minimize the cost of housing finance…" (Section 102). Because Fannie Mae and Freddie Mac operate with generous government subsidies, their activities usually lower the cost of any housing finance activity in which they engage. That means that H.R. 1461 places the regulator in a position of being required to encourage the expansion of the GSEs. This creates untenable pressure on the regulator's safety and soundness and mission oversight responsibilities. The Financial Services Committee report language attempts to mitigate the impact of this language, but does not fully do so.

The Comparable Federal Bank Regulatory Structure: The federal bank regulators do not operate under a statutory responsibility to promote the institutions that they regulate. The former FHLBB, which failed to regulate the savings and loan industry effectively in the 1980s, was bound by a statutory mandate that required the FHLBB to promote the institutions that it regulated. The Congress learned its lesson from the S&L debacle and deleted this statutory language. The lesson is that it is difficult for a regulator to protect taxpayers and the American public when it is saddled with a mandate to encourage expansion of the institutions that it regulates.

Opportunities for the GSEs: The GSEs will be able to apply this principal duty of the regulator in numerous areas, arguing for example for an expansive reading of the ambiguities in the bill's expansion of the conforming loan limit in areas that are designated high-cost. The GSEs also will be able to import this expansive duty into the regulator's reading of the "public interest" test for new programs and activities under the bill. Finally, the GSEs will have an opportunity, when litigating against the regulator, to argue that the statute mandates that a court should read the regulator's principal duty as expanding GSE activities wherever they can use their government subsidies to lower the costs of mortgage finance, even by a slight amount.

- Increase in Conforming Loan Limits

  Current Law: Fannie Mae and Freddie Mac currently are limited by their charter acts to purchasing mortgages that do not exceed a size that is determined annually based on an annual survey of house prices. The current conforming loan limit for single-family homes is $ 359,650. Because the applicable index is based on the price of new homes, it increases much faster than the price of all homes, including resale homes.

Also, the statute is designed with a ratchet effect, so that the conforming mortgage limit can increase when prices go up, but will not decrease when prices drop.

H.R. 1461: H.R. 1461 would allow the regulator to select an appropriate house price index other than the current index, subject to review by the GAO. The bill also would allow the conforming loan limit to drop as well as increase, depending on the annual change in house prices. Finally the bill allows the conforming loan limit to increase for so-called high cost areas, where the median house price exceeds the median house price used in the index. The conforming limit for such areas would become the lesser of (1) the median house price, or (2) 150 percent of the conforming loan limit that otherwise would apply. This year, for example, 150 percent of the conforming loan limit is almost $ 540,000. To qualify for a $ 540,000 mortgage, a homeowner probably needs to earn $ 150,000-$200,000 annually.

The Comparable Federal Bank Regulatory Structure: Unlike GSEs, banks are diversified lenders. They are subject to statutory limitations on their asset powers ands also to limitations that their regulators may set.

Opportunities for the GSEs: Especially when read together with the principal duty of the Director to encourage expansion of the GSEs, discussed above, the regulator will be under pressure to adopt a narrow definition of the ambiguous term “area” in this section of the bill. This will push the regulator to define a high-cost “area” as a small area such as a census tract. That reading of the bill would mean that high cost neighborhoods in the United States could be deemed “high-cost” and a proper area for the GSEs to fund mortgages up to the new high-cost limit ($ 540,000 or the median housing price).

- Approval of New GSE Activities

Current Law: Currently, Fannie Mae and Freddie Mac may not undertake a new program without obtaining the prior approval of HUD. The statutory framework has a number of shortcomings: (1) the regulator must disapprove the new program within 30 days (plus a possible 15 day extension), or the program is deemed to have been approved, (2) HUD’s prior approval authority is limited to new mortgage *programs*, which are defined to mean mortgage programs, (3) the GSEs often contend that new activities do not constitute new programs subject to the prior approval requirement, and (4) the GSEs are not required to submit complete information before the 30-day clock begins to run. HUD has not been energetic in exercising its prior approval authority.

H.R. 1461: The bill makes a number of changes. For new programs, it requires that the GSEs submit completed applications and that the Director publish notice and invite public comment regarding the proposed new program. If the Director has not approved the new program within 30 days after the close of the 30-day comment period, the program will be deemed to be approved. The bill grandfathers the GSEs' automated underwriting systems (AUS) in existence on the enactment date of the legislation and counseling and education activities of the GSEs, whether or not these were properly reviewed and approved by HUD. The bill also authorizes the regulator to disapprove new GSE activities, a broadly defined term, in a process roughly comparable to the current process for approving new programs today (i.e., no requirement that the notice given by the GSEs contain complete information; deemed to be approved if the regulator has not disapproved within 30 days of receiving notice).

The bill grandfathers all GSE activities through 2006, which are not subject to review by the regulator. Because of its wording, the bill creates an inference that GSE "business operations" are neither new programs nor new activities subject to review and approval. Finally, the bill expressly prohibits aggrieved parties from bringing private rights of action to enforce the prior approval provisions of the bill.

The Comparable Federal Bank Regulatory Structure: The process of regulatory approval of bank activities is different both from current law and from the processes in H.R. 1461. However, in contrast to GSE supervision, the supervision of banks places the regulator in a position to monitor closely bank activities and to proscribe or limit those that the regulator does not approve.

Opportunities for the GSEs: Again, when read in connection with the principal duty of the regulator to encourage expansion of the GSEs, the regulator is likely to read this section as authorizing expansion of GSE programs and activities except in the most egregious circumstances. Then the GSEs will be able to add incrementally to their AUS with new components as they become available, for example automated valuation models to substitute for many appraisals and their own self-insurance to substitute for title insurance.

- Affordable Housing Funds of Fannie Mae and Freddie Mac

Current Law: Under current law, the Federal Home Loan Banks set aside 10 percent of their income for an affordable housing program that provides funding so that their members may subsidize affordable housing according to requirements established by law. Fannie Mae and

Freddie Mac are not required to establish funds for affordable housing and have not done so.

H.R. 1461: The bill would require Fannie Mae and Freddie Mac to set aside for an affordable housing fund 3.5 percent of their after-tax income in the first two years after the effective date and 5 percent for the three following years. Each of the two GSEs would control and manage its own fund and allocate funding according to regulations that the regulator would promulgate.

The bill does state that nothing in this subpart shall be construed to authorize the GSEs to engage in activities beyond the authority in their charter acts. Most importantly, the bill does not prohibit the GSEs from discriminating against potential recipients of their affordable housing funding.

The Comparable Federal Bank Regulatory Structure: Instead of contributing to an affordable housing fund that they would control, banks are subject to requirements of the Community Reinvestment Act (CRA) to make mortgage and other loans and provide funding for low income people and communities. It would be far preferable to subject the GSEs to CRA-type requirements in the secondary market than to permit the GSEs to allocate potentially huge amounts of money to their friends and supporters.

Opportunities for the GSEs: The affordable housing fund would allow the GSEs to allocate billions of dollars to those organizations and in those political districts where they seek to wield influence. Conversely, they will be able to deny these funds to organizations or in political districts where policymakers may espouse policy positions different from those of the GSEs. It would be far superior to devolve these funds to state housing finance agencies or through some other mechanism that does not allow the GSEs to control the allocation of these large sums of money.

Even though the bill does state that nothing in this subpart shall be construed to authorize the GSEs to engage in activities beyond the authority of their charter acts, the wording of the affordable housing fund section raises the issue of mission creep. It would allow the GSEs to expand their authority by funding "public infrastructure activities" in connection with the housing activities that they fund.

These parts of H.R. 1461 represent serious flaws that require the regulator to promote the institutions that it regulates (one of the principal duties of the regulator), greatly expand the market share of Fannie Mae and Freddie Mac (increase in the conforming loan limit), weaken the current prior approval authority of the regulator (by

grandfathering GSE programs and activities, whether or not properly approved), and create an opportunity for the GSEs to wield potentially billions of dollars of influence by allocating funds to their political friends and away from those whom they disfavor (the affordable housing funds). Taken together, these flaws in H.R. 1461 far outweigh the positive features noted above.

III. Weak Regulatory Authority

While H.R. 1461 does make some improvements in the regulator's enforcement authority, as noted above, the authority of the regulator remains inferior to that of the federal bank regulators. Given the demonstrated failure of internal controls at Fannie Mae and Freddie Mac, and the clear perception that some senior officials completely disdained their weak regulator, the supervisory structure should be stronger, if anything, than that for banks, rather than weaker.

- Minimum Capital Requirements

  Current Law: Under current law, minimum capital requirements for Fannie Mae and Freddie Mac are set at fixed percentage amounts. However, OFHEO has used its cease-and-desist authority to require Freddie Mac to increase its minimum capital to 30 percent above the amount prescribed in the law. OFHEO negotiated a similar agreement with Fannie Mae.

  H.R. 1461: Provides that the regulator, with notice and comment, may issue regulations to establish a minimum capital standard for the GSEs that is higher than the amounts fixed by statute. The regulator may by order increase capital requirements with respect to a program or activity of a GSE to assure safety and soundness. The regulator also may, by order, increase the minimum capital level for a GSE for a temporary period, provided that the regulator meets one of several preconditions that are specified in the bill. This may be weaker than current law in some respects.

  The Comparable Federal Bank Regulatory Structure: The federal bank regulators have simple and effective authority over minimum capital: "Each appropriate Federal banking agency shall have the authority to establish such minimum level of capital for a banking institution as the appropriate Federal banking agency, in its discretion, deems to be necessary or appropriate in light of the particular circumstances of the banking institution." This simple provision, found at 12 U.S.C. Section 3907(b), is far superior to the more complex provisions of H.R. 1461.

  Opportunities for the GSEs: It appears that the language of H.R. 1461 would require the regulator to reopen the order with Freddie Mac and

the agreement with Fannie Mae because those arrangements may not meet the tight preconditions that the bill requires. In general, the regulator will lack the authority and leverage to get a GSE to increase capital temporarily to address a problem such as the recent accounting and internal control failures at Fannie Mae and Freddie Mac, unless it can make the case that these tie directly to safety and soundness. Even if that is the reality, the case can be hard to document and insulate against litigation. The prospect of litigation by the GSEs, again bolstered by the argument that higher capital would violate the Director's principal duty to encourage expansion of the GSEs, is likely to protect the GSEs from the kinds of supervisory responses that are common for banks that have such operational problems.

- Enforcement Authority

  Current Law: As was noted above, the statutory framework for OFHEO is far weaker than for the federal bank regulators.

  H.R. 1461: As was noted above, H.R. 1461 does improve in a number of respects on the enforcement powers in current law. However, the bill continues to be weaker than the statutory authority granted by law to the federal bank regulators. For example, H.R. 1461 permits the regulator to place a failed GSE into receivership, but leaves the authority to withdraw or cancel the GSE's charter with the Congress. Also, H.R. 1461 would prevent enforcement of orders with respect to some matters, such as assessments to fund the regulator, examinations, and prudential management standards, while permitting enforcement of orders in other areas. Other subtle deletions or changes in wording from the bank regulatory language mean that the GSE regulator's powers are weaker than they should be. For example, the absence of a definition of the term "violation" such as is found in the laws for bank regulators, means that the regulator will be limited in its ability to deal with potentially serious wrongdoing, such as when an accountant or employee abets a serious violation without directly committing it.

  The Comparable Federal Bank Regulatory Structure: The federal bank regulators have a more complete toolbox than does the GSE regulator under H.R. 1461. H.R. 1461 contains a number of smaller drafting issues that do not complicate the statutory framework of the federal bank regulators. In addition, a federal bank regulator may cancel or withdraw the charter of a failed financial institution and may issue and enforce capital directives. The regulatory relationship between the federal regulators and banks is much more constructive than the relationship between the GSE regulator and the GSEs under this bill, because, at a time of controversy, the bank regulators can call on a full and tested panoply of supervisory authorities.

Opportunities for the GSEs: The problem with loose and missing supervisory language is that it invites a GSE to litigate rather than comply with a regulator's requests and orders. Litigation at a time of financial crisis is potentially damaging to taxpayers because of the likelihood that a filing GSE would lose money and possibly compound its losses. Litigation would mean that the bank regulatory term "prompt corrective action" loses its promptness when applied to the GSEs.

IV. The Lost Opportunity for GSE Regulatory Reform

The Congress last undertook a major review of the regulatory structure for the GSEs in 1992. It is unlikely that the Congress will seek to revisit this issue once legislation is enacted to address the recent failings of Fannie Mae and Freddie Mac. As desirable as it might be to update the statutory framework from time to time, the GSEs are simply too powerful to make this a positive exercise for the Congress to engage in frequently.

Federal Reserve Chairman Alan Greenspan has been clear that the GSEs cannot continue to evolve in their present directions without creating significant risk to the financial system. Four elements are required to address that risk. Clearly, the regulator must be strong and must operate with a full set of regulatory tools, comparable to those of the federal bank regulators. Second, the GSEs must not be permitted to continue their untrammeled expansion into new activities and new parts of the market. Third, the GSEs must be subject to bank-type regulation with respect to their capitalization. These three elements are discussed above. The fourth major element of regulatory reform is that the GSEs must limit their portfolios.

- Portfolio Limits

  Current Law: Current law does not expressly require the GSEs to limit their portfolios. However, there are provisions of current law that were originally designed to limit GSE holdings. Thus, the Fannie Mae charter act states that the GSE should conduct its operations in such a manner "as will reasonably prevent excessive use of the corporation's facilities…" (See Fannie Mae charter act, Section 304(a) (1), 12 U.S.C. Section 1719 (a) (1)). However, the GSEs have largely or completely ignored these statutory limitations.

  H.R. 1461: H.R. 1461 provides that the regulator may review individual assets and liabilities of the GSEs and require a GSE to dispose of an asset for purposes of safety and soundness of the GSE or inconsistency with the GSE's charter purposes. However, this provision does not permit the regulator to limit GSE portfolios for reasons of systemic risk.

The Treasury has proposed a provision that would permit the regulator to limit the GSE portfolios, provided that they each retain enough of a portfolio to continue their current levels of service to the housing markets (largely through securitization), and to affordable housing in particular, and to operate safely and soundly. H.R. 1461 does not contain this proposal or anything similar.

The Comparable Federal Bank Regulatory Structure: The FDIC Improvements Act (FDICIA) directly addresses the systemic risk posed by banks. It provides that, except for tightly limited circumstances, the federal bank regulators shall intervene with a failing financial institution and close it with least cost to the taxpayer. This is possible because federal deposit insurance, which covers only a fraction of a bank's liabilities, is not as comprehensive as the perception of an implied government guarantee of GSE obligations. While the application to GSEs of the FDICIA approach would be attractive as a matter of policy, it would have far greater implications for the housing markets than would a simple limitation of GSE portfolios.

Opportunities for the GSEs: The absence of a provision limiting GSE portfolios means that, once they get their accounting and internal controls rebuilt, the GSEs can continue to grow their portfolios by potentially hundreds of billions of dollars annually. This can bring benefits to the GSEs' bottom line for quite some time until the markets unexpectedly change. Then, as Chairman Greenspan has warned, financial risk can spread from the GSEs to the rest of the financial system at great cost not only to taxpayers, but also to the many people, firms, and governments whose investments depend on a stable financial system.

In summary then, this is the time to enact statutory improvements in GSE supervision that are called for to address the conspicuous failings of Fannie Mae and Freddie Mac and the risks that they pose to the larger financial system. H.R. 1461 would in places improve current law. Unfortunately, when taken as a complete package, the bill fails either (1) to improve on current law, or (2) to address the critical issues of financial and systemic risk that the Congress needs to address if the GSEs are to play a constructive role in the housing finance system in the future.