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## H.R. 1461 and S. 190: A Checklist of Important Issues

The House and Senate committees have passed GSE reform bills that seem likely to be considered by the full House and Senate and, in potentially altered form, possibly by a conference committee. This memorandum seeks to provide a checklist to people who are reviewing the two bills. It summarizes important issues and recommendations based on the two bills in their current states.

### I. General Provisions

#### A. Funding the Regulator

Both H.R. 1461 (Section 106) and S. 190 (also Section 106) remove the regulator completely from the appropriations process. This is the single most important improvement made by the two bills, compared to current law.

Recommendation: Add to the final bill a provision that allows the Director to increase the assessment that a regulated entity must pay to cover unexpected costs such as a special examination report or enforcement actions. That language might read as follows:

“(x) SPECIAL CIRCUMSTANCES.—If at any time, as a result of increased costs of regulation of a regulated entity that is not classified (for purposes of subtitle B) as adequately capitalized, or as the result of supervisory or enforcement activities *under this title* for a regulated entity, the amount available from any semiannual payment made by such regulated entity pursuant to subsection (b) is insufficient to cover the costs of the Agency with respect to such entity, the Director may make and collect from such entity an immediate assessment to cover the amount of such deficiency for the semiannual period. If, at the end of any semiannual period during which such an assessment is made, any amount remains from such assessment, such remaining amount shall be deducted from the assessment for such regulated entity for the following semi-annual period.” (italics added)

Note: This language is similar to language found in Section 106 of S. 190 except that it is adjusted in the italicized words to permit an assessment to be increased also to cover the costs of a special examination report, such as was an issue recently with Fannie Mae.

#### B. Regulatory Transition (the “one-year gap”)

Both H.R. 1461 and S. 190 provide that operations of OFHEO and the FHFB shall be wound up starting on the date of enactment of the new law. However, H.R. 1461 (in

Section 185) permits the new regulator to begin operations only after one year has elapsed. By contrast, S. 190 (in Section 163) permits the new regulator to begin operations immediately upon enactment. H.R. 1461 creates a one-year regulatory gap during which time neither the old regulator nor the new one may examine or bring new supervisory actions to assure the safe-and sound operations of the housing GSEs.

Recommendation: Adopt the effective date of Section 163 of S. 190 which permits the new, superior, regulatory structure to begin immediately upon the date of enactment of the new law. There is no reason for delaying improvements.

Note: An immediate effective date reflects the legislative language of FIRREA, which created a new agency, the Office of Thrift Supervision immediately upon enactment, while abolishing two agencies and transferring their functions to the new agency.

### **C. Organizational Structure of the Regulator**

Both S. 190 and H.R. 1461 create a regulatory agency headed by a Director. Each bill also creates an oversight board (Section 103 of each bill). S. 190 provides for a four member board, consisting of the Director, the Chair of the SEC, and the Secretaries of the Treasury and HUD. H.R. 1461 creates a five member board, consisting of the Director, the Secretaries of the Treasury and HUD, and two citizens who serve as full-time board members. H.R. 1461 provides for the board, and the two citizen board members, to have staff.

The problem with the structure created in H.R. 1461 is that it creates full-time board members with staff who will not have enough to do. This is likely to create an atmosphere of political jockeying and an effort to expand the powers of the board. The result is likely to be a much less efficient regulatory organization and less accountability.

Recommendation: The organizational structure for the regulator that is provided by Section 103 of S. 190 should be adopted. In particular, (1) the oversight board should consist only of the Director, the Chair of the SEC, and the Secretaries of the Treasury and HUD, and (2) the authority of the board should be limited by the following language of Section 103 of S. 190: “The Board may not exercise any executive authority, and the Director may not delegate to the Board any of the functions, powers, or duties of the Director.”

## **II. Supervision of Safety and Soundness**

Both H.R. 1461 and S. 190 make improvements on current law in a number of areas relating to safety and soundness. However, a number of issues remain to be addressed to help bring the regulatory framework for the housing GSEs up to the level of the authority granted by law for federal supervision of banks and thrifts.

### **A. Principal Duties of the Director (role conflict)**

Both H.R. 1461 and S. 190 (in Section 102 of each bill) prescribe principal duties of the Director including a duty to ensure that each regulated entity operates in a safe and sound manner. However, H.R. 1461 includes a provision that seriously weakens the regulator’s duty in this regard. That provision creates a principal duty of the regulator to ensure that the operations and activities of each regulated entity foster “liquid, efficient, competitive, and resilient national housing finance markets *that minimize the cost of housing finance...*” (italics added).

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 House Financial Services Committee’s report language, while welcome, does not completely alleviate this issue.

Recommendation: Strike the italicized language, above, in Section 102 of H.R. 1461 that relate to minimizing the cost of housing finance and instead use the comparable provision from Section 102 of S. 190.

### **B. Principal Duties of Director (systemic risk)**

While both H.R. 1461 and S. 190 (in Section 102 of each bill) prescribe principal duties of the Director including a duty to ensure that each regulated entity operates in a safe and sound manner, neither bill includes a principal duty of the Director to ensure that each regulated entity operates in a manner that does not create unacceptable levels of systemic risk.

Recommendation: Add a new principal duty of the Director “to ensure that the regulated entities and their operations and activities do not create unacceptable levels of systemic risk to the financial markets;”

### **C. Prudential Management and Operations Standards**

Both H.R. 1461 (in Section 102) and S. 190 (in Section 108) require the Director to establish prudential management and operations standards for each regulated entity. This is a welcome addition to the regulatory framework. However, while H.R. 1461 includes a standard with respect to, “(7) management of any asset and investment portfolio;”

S. 190 has different wording of the comparable standard, with respect to “(6) management of asset and investment portfolio *growth;*” (italics added).

The language of H.R. 1461 is superior because it does not provide statutory encouragement for growth of investments and portfolios which are, as Chairman Greenspan and others point out, potential sources of serious systemic risk caused by the GSEs.

Recommendation: Accept the wording of Section 102 of H.R. 1461 in this regard, in place of the comparable language of Section 108 of S. 190.

#### **D. Minimum Capital Levels**

Both H.R. 1461 (Section 112) and S. 190 (Section 110) improve on current law by authorizing the regulator to set a minimum capital standard that is higher than the current statutory levels (2.5 percent of on-balance sheet assets and 0.45 percent of MBSs and other off-balance sheet obligations). This is an important improvement. However, the authority of the Director with respect to minimum capital standards would remain significantly inferior to the authority of the federal bank regulators.

Recommendation: Adopt language based directly on the authority of the federal bank regulators found at 12 U.S.C. Section 3907(b). That language would read as follows:

“ The Director shall have the authority to establish such minimum level of capital for a regulated entity as the Director, in its discretion, deems to be necessary or appropriate in light of the particular circumstances of the regulated entity.”

Note: This language would allow the Director to adjust the minimum capital level according to the circumstances of each individual entity, such as was done by OFHEO when it increased capital requirements for Fannie Mae and Freddie Mac after discovery of the failure of their internal controls. It is not clear that OFHEO would have prevailed under current law if one of the enterprises had objected. The above language would remove that uncertainty.

#### **E. Enforcement and Jurisdiction**

Both S. 190 (Section 154) and H.R. 1461 (Section 164) permit the regulator to apply to federal district court for enforcement. However, Section 164 of H.R. 1461 contains serious limitations, both because it does not permit enforcement of *orders* issued by the regulator and because of the narrow scope of matters that the regulator may enforce in court. For example, the peculiar wording of Section 164 of H.R. 1461 would prevent enforcement of regulatory matters authorized by Subtitle A of the 1992 Act, e.g., with respect to important matters such as examinations or the prudential management and operations standards. These are serious shortcomings.

Recommendation: Adopt the language of Section 154 of S. 190 rather than the language of Section 164 of H.R. 1461.

#### **F. Issuance and Enforcement of Subpoenas**

Both H.R. 1461 (Section 168) and S. 190 (Sections 154 and 158) improve the authority of the regulator to enforce subpoenas, especially by removing the requirement in current law that the regulator must work through the Attorney General of the United States.

However, Section 158 of S. 190 is important to include in the final legislation because it also expands the authority of the regulator to issue subpoenas to include grounds comparable to those available by law to the federal bank regulators.

In addition, the language of Section 154 of S. 190 avoids peculiar wording of Section 168 of H.R. 1461 that would prevent enforcement of subpoenas issued with respect to subtitle A of the 1992 Act, i.e., with respect to important matters such as examinations or the prudential management and operations standards.

Recommendation: Adopt the language of Section 158 of S. 190, expanding the authority of the regulator to issue subpoenas. Also adopt the language of Section 154 of S. 190 instead of the language of Section 168 of H.R. 1461. The new regulator should have enforcement authority no weaker than that of the banking agencies.

Note: The difficulties that OFHEO had subpoenaing Leland Brendsel show some of the shortcomings of current law with respect to subpoenas. See, *United States of America v. Leland Brendsel*, 301 F. Supp. 2d 518, decided February 2, 2004.

### **G. Receivership**

H.R. 1461 and S. 190 (in Section 144 of each bill) both add receivership powers with respect to Fannie Mae and Freddie Mac. Broad receivership authority already exists with respect to the Federal Home Loan Banks. However, both bills prohibit the receiver from terminating the charter of either Fannie Mae or Freddie Mac. In addition, S. 190 affirmatively requires the regulator, when acting as receiver, to convey the charter of a failed enterprise to a successor enterprise. This aspect of Section 144 of S. 190 greatly weakens market discipline that receivership otherwise would provide and strengthens the perception of an implied government guarantee of the obligations of Fannie Mae and Freddie Mac.

Also, in the event Fannie Mae or Freddie Mac were in receivership, it is important that, as secured creditors, MBS-holders would have a clear priority over holders of unsecured enterprise obligations. To ensure that the market continues to place value on the guarantees, there must be some evidence that the enterprise in receivership could pay on a guarantee if needed. The safest approach would be to dedicate the revenue from guarantee fees to the mortgage securitization and guarantee operations as a priority, rather than make them available to general or other creditors of the enterprise.

Recommendation: Provide the regulator with the full receivership authority that is available by law to the federal bank regulators. In any event, do not accept the provisions of Section 144 of S. 190 that weaken market discipline by requiring the creation of a successor enterprise to take over the charter of a failed enterprise.

Also, Clarify that after appointment of a receiver, all cash flow from guarantee fees, regardless of the date the guarantee was first made, shall be solely for the benefit of MBS holders until their claims are satisfied.

### **III. Portfolio Limits/Systemic Risk**

Chairman Greenspan and Treasury Secretary Snow have been emphatic in their expressions of concern about the growth of GSE portfolios and the systemic risk that this is likely to cause, especially once the GSEs rebuild their internal controls and regain the confidence to grow their portfolios at their past rates of expansion.

The Treasury has submitted language authorizing and requiring the regulator to limit the portfolios of Fannie Mae and Freddie Mac; S. 190 (Section 109) includes a softened version of the Treasury provision. Because the GSEs can continue to issue mortgage-backed securities virtually without limit, the housing market would be unaffected either by the language of S. 190 or by the Treasury language.

Recommendation: Enact either the Treasury language or the language of Section 109 of S. 190 that authorizes and requires the regulator to limit the portfolios, but not the MBS businesses, of Fannie Mae and Freddie Mac.

### **IV. GSE Mission Creep**

Both H.R. 1461 and S. 190 would allow the enterprises substantial opportunity to increase their market activities. The provisions that would do this are the sections of the two bills dealing with (1) new program approval, and (2) the conforming loan limits.

#### **A. Prior Approval of GSE Programs**

Current law, especially as administered by HUD, has proved ineffective in providing an effective process for reviewing and approving or disapproving new activities by Fannie Mae and Freddie Mac. It is not clear that the prior approval sections of either H.R. 1461 or S. 190 (Section 122 of each bill) in fact does improve on current law. By contrast, the Treasury has submitted to the Congress draft language that would make a significant improvement over current law.

Section 122 of H.R. 1461 makes some improvements on aspects of current law, but also has serious shortcomings. Among these, the bill grandfathers the enterprises' automated underwriting systems (AUS) in existence on the enactment date of the legislation and their counseling and education activities, whether or not these were properly reviewed and approved by HUD. The bill also grandfathers all other 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.

Section 122 of S. 190 also makes improvements on current law that are offset by shortcomings. First, and most important, the definition of “product” subject to review and approval is very narrow because of the language of Section 122 that limits review to “products” and then specifies that products do not include “any modification to the mortgage terms and conditions or mortgage underwriting criteria relating to the mortgages that are purchased or guaranteed by an enterprise.” This is a potentially very narrow definition. Also, the deletion of the “bright line test” (that S. 190 contained in its introduced form but that the Committee removed from the reported bill) creates an inference that the Committee rejected any notion of confining the GSEs to the secondary mortgage market rather than acquiescing in their expansion into the primary mortgage market as well.

Recommendation: The Treasury language is far superior. If this is not possible, then the committees should try to negotiate a provision that improves on the processes prescribed by current law without (1) restricting the definitions of what is currently subject to approval, including ongoing activities, or (2) grandfathering enterprise activities beyond the provisions that already exist in the 1992 Act.

## **B. Conforming Loan Limits**

Both S. 190 (Section 126) and H.R. 1461 (Section 123) permit the Director to select a different index from the one currently prescribed by law that sets the conforming loan limit each year. In addition, the bills allow the conforming loan limit to decline as well as increase; under current law only increases are allowed. Note that, while other outcomes are possible, this provision could allow the regulator to select an index that increases even more quickly than the current index.

H.R. 1461 also 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 about \$ 539,000. To qualify for a \$540,000 mortgage, a homeowner probably needs to earn at least \$150,000-\$200,000 annually. S. 190 does not include this provision, but there are reports that an effort may be made on the Senate floor to attach it.

Recommendation: It is best to remain with current law, especially with respect to the proposed increase in the conforming loan limit for high-cost areas. High-income homeowners earning \$150,000-\$200,000 annually do not need the benefit of a government subsidy provided through a GSE.

## **V. GSE Affordable Housing Funds**

H.R. 1461 (Section 128) requires the enterprises to set aside five percent of their after-tax income for an Affordable Housing Fund. The enterprises each would control their own

fund and would be required to allocate monies from the funds according to criteria set forth generally in the bill. Further, the 3.5% of GSE income allocated during the first year under this bill is not subject to the same restrictions as money allocated in later years. S. 190 does not include any provision for an Affordable Housing Fund, but there are reports that this could be added on the Senate floor.

Whether or not to include an Affordable Housing Fund provision has become a partisan issue. If an Affordable Housing Fund provision becomes part of the legislation, then it will be essential to assure that the enterprises do not control the money in the funds. Otherwise they can wield billions of dollars of fund monies to reward their friends – market participants, low income groups, and special congressional districts – and punish their enemies. The enterprises have a long record of such behavior.

Recommendation: The following are three recommended improvements to make the Affordable Housing Fund more palatable and also more effective in serving affordable housing needs without funding advocacy groups.

- The enterprises should not control the funds that are to be used for affordable housing. Instead, the Affordable Housing Fund monies should be sent directly and promptly to state housing finance agencies (HFAs). Devolution to the states is an important way to assure geographic (rather than political) dispersion and that affordable housing funds in fact meet the highest priority needs of states and localities.
- The bill should include a new section that prohibits discrimination by the enterprises in their activities, including the Affordable Housing Fund. Language to deal with this issue might be:

**“SECTION (X). DISCRIMINATION**

“No enterprise or enterprise-affiliated party shall discriminate against or interfere with the business relations of any individual or organization because that individual or organization has acted, or indicated intent to act, or has joined, or indicated intent to join in association with others, to oppose any act or practice of the enterprise by any lawful means. The Director shall include in the examination of each enterprise’s internal controls a review of potentially retaliatory activity under this section. The Director shall establish a process for reviewing allegations of such activity and making determinations as to their validity, and shall take appropriate action to enforce the provisions of this section.”

- The funding mechanism should change from an assessment of 5% of after-tax profits to an assessment some appropriate percentage of outstanding enterprise debt. This helps to meet the concerns expressed by Chairman Greenspan that the enterprises could merely increase their portfolios to pay for the Affordable Housing Fund. It also would help to address industry’s concern that the GSEs

will simply expand into new lines of business, at the expense of the private sector, in order to “grow” the Affordable Housing Fund.

## **VI. Technical Issues**

In addition to the larger issues noted above, a number of technical issues in the two bills deserve careful scrutiny. Those issues include the following:

1. Definition of the term “Violation”: S. 190 (Section 2) includes a definition of “Violation”, to mean “any action (alone or in combination with another or others) for or toward causing, bringing about, participating in, counseling, or aiding or abetting a violation.”

H.R. 1461 does not include this definition.

Recommendation: The final legislation should include this definition, which is consistent with the definition in banking law.

2. Federal Financial Institutions Examination Council (FFIEC): H.R. 1461 (Section 116) makes the new regulator a member of the FFIEC. S. 190 does not include this provision.

Recommendation: Include this provision in the final legislation.

3. Reviews of Regulated Entities: Both H.R. 1461 (Section 109) and S. 190 (Section 105) amend the heading of the section of the 1992 Act that authorizes the regulator to retain rating agencies to conduct reviews of the enterprises. However, only H.R. 1461 actually changes the statutory text to make this change effective (and also to expand its application to all regulated entities).

Recommendation: Adopt the language of Section 109 of H.R. 1461 to make this provision effective.

4. Corporate Governance: H.R. 1461 (Section 114) codifies in statute the provisions of the final governance regulation that OFHEO has issued. S. 190 (Section 151) takes a different approach; it authorizes the Director to issue a cease-and-desist order if a regulated entity receives a less-than-satisfactory rating in its most recent examination report for corporate governance (or other factors specified in that section).

Recommendation: The approach of S. 190 is superior because it allows the definitions of proper governance practices to evolve, as they are likely to do for all corporations. The final legislation should include the approach of Section 151 of S. 190 rather than codifying particular governance practices in the statute.

5. Enterprise Contributions to Nonprofit Entities: H.R. 1461 (Section 105) requires the Director to issue regulations so that the enterprises disclose contributions to nonprofit organizations. S. 190 does not include this provision. This provision is a useful step in increasing transparency of contributions that the enterprises use to wield influence.

Recommendation: Adopt the reporting language of Section 105 of H.R. 1461.

6. Critical Capital Levels: S. 190 (Section 141) Authorizes the Director to establish by regulation critical capital levels for the enterprises that are *different from* the numerical levels established by the 1992 Act. This section also requires the Director to establish critical capital levels for the FHLBs. H.R. 1461 does not contain this provision.

Recommendation: Adopt the language of Section 141 of S. 190, but reword it slightly to authorize the Director to establish by regulation critical capital levels for the enterprises that are *higher than* the numerical levels established by the 1992 Act. This is important because the critical capital levels are already very low.

7. Enforcement (Protection Against Premature Litigation): As was noted above, both S. 190 (Section 154) and H.R. 1461 (Section 164) permit the regulator to apply to federal district court for enforcement. However, the enforcement provisions of both bills omit language from the comparable banking law provision (found at 12 U.S.C. Section 1818(i)) that states that, “but except as otherwise provided in this section or under [other designated sections] of this title no court shall have jurisdiction to affect by injunction or otherwise the issuance or enforcement of any notice or order under any such section, or to review, modify, suspend, terminate, or set aside any such notice or order.”

This provision helps to protect the federal bank regulators from premature litigation concerning an enforcement action. Given the record of OFHEO’s difficulties in litigation against the enterprises and their affiliated parties, this language could be important to assure a smooth process.

Recommendation: Include the omitted language from federal banking law in the enforcement provision that is finally enacted.

8. Prejudgment Attachment: H.R. 1461 (Section 163) provides that, “In any action brought pursuant to this title, or in enforcement actions, the court may, upon application of the Director or the Attorney General, issue a restraining order that prohibits a subject person from removing funds or dissipating assets or other property.” S. 190 does not have this provision, which moves current law closer to federal banking law.

Recommendation: Include Section 163 of H.R. 1461 in the final legislation.

Note: The case of *Leland C. Brendsel v. OFHEO*, 339 F. Supp. 2d 52, decided August 30, 2004, shows the limits of current law. That case held that OFHEO was precluded from freezing assets pending the outcome of administrative proceedings.

9. Separation From Service: Section 1377 of the 1992 Act provides that the regulator may bring an enforcement action against a director or executive officer of an enterprise if the regulator serves notice within two years of when the director or executive officer ceases to be associated with the enterprise. S. 190 (Section 157) amends this provision to apply to parties within six years of separation from the enterprise. This conforms to federal banking law (12 U.S.C. Section 1818(i)(3)), where it was found that a two-year period is too short to permit wrongdoing to come to light, be investigated, and for notice of formal charges to be served within the time limit. This change would prevent the regulator from filing charges in haste to meet a short deadline. The regulator should be able to investigate and learn the facts before charging someone with wrongdoing.

Recommendation: Adopt Section 157 of S. 190 in the final legislation.

10. Reference to Subpoena Authority: H.R. 1461 and S. 190 (Section 144 of each bill) contain a technical error in the cross reference that permits the regulator, as conservator or receiver, to issue subpoenas. H.R. 1461, at page 166, lines 18 and 20, and S. 190 at page 78 lines 13 and 15, refer to “section 1348.” Section 1348 is subpoena authority relating to the affordable housing goals. The reference intends to be to section 1379D (this is Section 1379B in current law; both bills would renumber it as 1379D.)