The *GSE* REPORT ™

Special Supplement

GSE Reform:

Analysis of the December 2006 Compromise Proposal

January 2007

The 109th Congress adjourned without taking action on a GSE reform bill. Both the Treasury and Capitol Hill participants in the negotiations indicated that agreement was close. After the end of the congressional session, Barney Frank (D-MA), the incoming Chairman of the House Financial Services Committee, stated that Treasury and he had agreed on the framework for legislation in 2007.

Former Federal Reserve Chairmen Alan Greenspan and current Chairman Benjamin Bernanke have 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:

- First, the regulator must operate with a full set of regulatory tools, comparable to, if not stronger than those of the federal bank regulators.
- Second, the GSEs must not be permitted to continue their untrammeled expansion into new activities and new market segments.
- Third, the GSEs must be subject to bank-type regulation with respect to their capitalization.
- Fourth, the GSEs must limit their portfolios to help reduce the systemic risk from their ever larger scale of operations.

The latest public version of the legislation being negotiated at the end of the 109th Congress was a set of Treasury amendments to H.R. 1461, the House-passed version of the GSE reform legislation, referred to herein as the "Compromise Proposal." When it submitted its Compromise Proposal on December 1, Treasury indicated that three items were still open:

- The House-passed increase in conforming loan limits;
- the House-proposed creation of an affordable housing fund; and
- issues concerning directors of the Federal Home Loan Banks.

This *Special Supplement* presents an analysis of the Compromise Proposal. From the perspective of safety and soundness and protection of the financial system, the Treasury Amendments proposed on December 1 represent a considerable improvement to the House-passed version of H.R. 1461. From the perspective of mortgage lenders (but not mortgage or title insurers[1]), the prior approval provisions of the Treasury Amendments are weaker than the language in H.R. 1461. Moreover, the technical language of H.R. 1461, as incorporated in the Compromise Proposal, with respect to the regulator's enforcement powers is weaker than the language of S. 190, the bill reported by the Senate Banking Committee.

This memorandum –

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[1] The Compromise Proposal includes language from S. 190 on prior approval by the regulator. That language limits the definition of products subject to the regulator's prior approval, except for products that, among other characteristics, "create significant new exposure to risk for the…holder of the mortgage." This particular language protects the interests of the mortgage and title insurance industries.

- examines those provisions in the Compromise Proposal that improve upon current law;
- those provisions that are seriously flawed compared to current law;
- those provisions 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.

Now is an opportune 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 may pose to the larger financial system. Congress last amended the regulatory structure of Fannie Mae and Freddie Mac in 1992 (the "1992 Act"). It is unlikely that Congress will seek to revisit this issue once legislation is enacted to address the recent failings of the GSEs. 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 Congress to engage in frequently. That means that policymakers will need to enact the best possible statutory framework now.

The Compromise Proposal would improve current law in a number of respects. Unfortunately, when taken as a complete package, the Compromise Proposal is weaker than the statutory framework that is in place for banks and other federally regulated financial institutions and does not seem adequate to address the critical issues of financial and systemic risk that Congress needs to address if the GSEs are to play a constructive role in the housing finance system in the future.

I. IMPROVEMENTS TO CURRENT LAW

The Compromise Proposal improves on current law in several areas. First are the improvements on current law found in H.R. 1461, and then additional improvements found in the Compromise Proposal.

<u>Improvements contained in the House-passed version of H.R. 1461</u>

- 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), 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: The House-passed bill, 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: The House-passed bill strengthens the new regulator's authority in a number of places. The risk-based capital test is more flexible than the current 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 Goals

Current law: Under current law, 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: The House-passed bill 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. H.R. 1461 creates a duty for 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 H.R. 1461 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.

Thus, H.R. 1461 did make several improvements over current law. In addition the Treasury Amendments add other improvements.

<u>Treasury's Proposed Improvements to H.R. 1461</u>

- Authority over Capital Levels

Current law: OFHEO's authority vis-à-vis Fannie Mae and Freddie Mac to establish, maintain, and enforce capital requirements is much weaker than the authority available to the federal bank regulators. The minimum capital level is set firmly by statute at levels much lower than the levels that apply to banks or thrifts or other finance companies.

The Treasury Amendments to H.R. 1461: The Treasury's language is far superior to current law. It would permit the regulator to set higher minimum (but not critical) capital levels than those specified by the statute, "to the extent needed to ensure that the regulated entities operate in a safe and sound manner." In addition, the Treasury language would permit the regulator, by order, to increase the capital level of a regulated entity on a temporary basis if the regulator makes certain determinations (such as that an unsafe or unsound condition exists). Also, the regulator would be authorized, by order or regulation, to establish such capital or reserve requirements with respect to any program or activity of a regulated entity "to ensure that the regulated entity operates in a safe and sound manner, with sufficient capital and reserves to support the risks that arise in the operations and management of the regulated entity."

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 superior to the Treasury Amendment.

- Mandatory Receivership

Current law: Currently Fannie Mae and Freddie Mac are not subject to being placed into receivership, even if they fail financially. Instead, OFHEO has power to place a GSE into conservatorship, but under a limited statutory framework.

The Treasury Amendment to H.R. 1461: The House-passed version of H.R. 1461 gives the regulator authority to place Fannie Mae or Freddie Mac into receivership. The bill does not, however, give the receiver authority to "revoke, annul, or terminate the charter of a regulated entity."

The Treasury Amendments would add language to the receivership provision that makes it mandatory for the regulator to appoint a receiver if

> "(i) the assets of the regulated entity are, and during the preceding 30 calendar days have been, less than the obligations of the regulated entity to its creditors and others; or
> (ii) the regulated entity is not, and during the preceding 30 calendar days has not been, generally paying the debts of the regulated entity …as such debts become due."

The Comparable Federal Bank Regulatory Structure: Under applicable law, the receiver of a failed bank or thrift institution has authority to wind up the affairs of the institution, sell its assets, and pay off insured depositors. This authority is more comprehensive, with greater regulatory discretion, than would be available under the Compromise Proposal.

- Structure of the Regulator

Current law: OFHEO is structured to be an independent agency within HUD. The Director is accountable to OMB, but otherwise is largely exempt from Executive Branch accountability. Under this structure, the Director is within the Executive Branch but essentially has no friends at the Cabinet level, except perhaps the Secretary of the Treasury.

The Treasury Amendments to H.R. 1461: The House-passed bill seeks to structure the regulator on the model of the current Federal Housing Finance Board ("FHFB"). Under H.R. 1461, the Director would chair a Housing Finance Oversight Board consisting of the Secretaries of the Treasury and of HUD, or their designees, plus two full-time members

appointed by the President and confirmed by the Senate for three year terms. Board members may have staff. The legislative language is ambiguous as to how much executive authority the board may exercise. The board must testify annually to Congress regarding safety and soundness of the GSEs and other matters.

H.R. 1461 is flawed in that it replicates the flawed structure of the FHFB. At the FHFB, the full-time appointed board members do not have enough to do. This can lead to political divisions and micromanagement of the agency and its work.

The Compromise Proposal adopts the structure proposed in S. 190, as reported by the Senate Banking Committee. It strikes the two appointed members from the board and makes clear that, "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."

This structure is important because it creates accountability of the Secretaries of the Treasury and HUD to assure that the regulator has the capacity to do its job of assuring that the GSEs are operating safely and soundly. It does this without replicating the shortcomings of the full time board membership of the FHFB.

- Directors of Fannie Mae and Freddie Mac

Current law: Under current law five of the eighteen members of the Fannie Mae and Freddie Mac boards of directors are appointed by the President of the United States. The remaining 13 directors on each board, a sizeable majority, are elected by shareholders.

The Treasury Amendments to H.R. 1461: H.R. 1461 would not change this arrangement. The Treasury Amendment would strike the presidentially-appointed directors from the boards of Fannie Mae and Freddie Mac. Under current law, the appointed directors perceive their obligations to be largely to shareholders, so the governance of Fannie Mae and Freddie Mac would not suffer from boards of directors entirely elected by shareholders.

Also, the Treasury Amendments would amend the governance structure of the Federal Home Loan Banks. Treasury states that this change, however, has not been resolved in negotiations with the House.

II. Serious Flaws

Unfortunately, H.R. 1461, even with the Treasury Amendment, 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.

The Treasury Amendments to H.R. 1461: The House-passed bill 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).[2] Since 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 report language attempts to mitigate the impact of this language, but does not fully do so. Nor is it at all certain that, while helpful, the final Conference Report would include the Committee report language that accompanied H.R. 1461.

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 Federal Home Loan Bank Board (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. 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 H.R. 1461's expansion of the conforming loan limit in areas that are

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[2] H.R. 1461 sets forth the principal duties of the Director as follows:

''SEC. 1313. DUTIES AND AUTHORITIES OF DIRECTOR.
''(a) DUTIES.—
''(1) PRINCIPAL DUTIES.—The principal duties of the Director shall be—

''(A) to oversee the operations of each regulated entity; and
''(B) to ensure that—
''(i) each regulated entity operates in a safe and sound manner, including maintenance of adequate capital and internal controls;
''(ii) 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 (including activities relating to mortgages on housing for low and moderate- income families involving a reasonable economic return that may be less than the return earned on other activities);
''(iii) each regulated entity complies with this title and the rules, regulations, guidelines, and orders issued under this title and the authorizing statutes; and
''(iv) each regulated entity carries out its statutory mission only through activities that are consistent with this title and the authorizing statutes."

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 $417,000. Since the applicable index is based on the price of new homes, it increases much faster than the price of all homes, including the resale existing 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.

The Treasury Amendments to H.R. 1461: Treasury indicates that this issue has not been resolved in negotiations with the House. 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 over $625,000. Using a 30-year fixed rate mortgage loan product, a borrower would need to earn over $200,000 annually to qualify for a $625,000 30-year fixed-rate mortgage.

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: When read together with the principal duty of the Director to encourage expansion of the GSEs, discussed above, the regulator, under Section 102 of the Compromise Proposal, will be under pressure to adopt a narrow definition of the ambiguous term "area" in this section of H.R. 1461. 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 ($625,000 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 entire programs (i.e. products, services, activities, undertakings and offerings). (This is far broader than the more limited definition in the Compromise Proposal which limits the regulator to being able to review only mortgage products, which does not include services, activities, undertakings or offerings.)
(3) The GSEs often contend that new activities do not constitute new programs subject to the prior approval requirement.
(4) The GSEs are not required to submit complete information before the 30-day clock begins to run.

Possibly because of the limitations of the current statute, HUD has not been energetic in exercising its prior approval authority. Moreover, current law essentially precludes OFHEO from using its examination authority to determine whether the GSEs have violated the prior approval requirements.

H.R. 1461: The House-passed bill makes a number of changes to current law. 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 allows the GSEs to continue their automated underwriting systems (AUS) in existence on the enactment date of the legislation and counseling and education activities, whether or not these were properly reviewed and approved by HUD. H.R. 1461 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 states that GSE activities that have not been "materially" changed from those on the date of enactment are not subject to review by the regulator except for charter violations or safety and soundness. 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.

H.R. 1461 expressly prohibits aggrieved parties from bringing private rights of action to enforce the prior approval provisions of the bill. The wording of Section 164 of the House-passed bill precludes the regulator from going directly to court to enforce an order

with respect to prior approval. H.R. 1461 also does not include a provision authorizing the new regulator to examine the GSEs to determine whether they have violated the prior approval requirements.

The Treasury Amendments to H.R. 1461: The Treasury Amendments weaken further the terms in H.R. 1461. The language instead largely adopts the text of the prior approval provision of the Senate Banking Committee bill, S. 190.

S. 190 requires that the GSEs submit a written request for approval of a product. The request shall describe the product in such form as the Director shall require. The Director shall publish notice and invite public comment regarding the proposed new product. If the Director has not approved the new product within 30 days after the close of the 30-day comment period, the product will be deemed to be approved.

If a GSE determines that any new activity, service, undertaking, or offering is not a product, than it shall provide notice to the regulator before commencing. The regulator shall immediately determine whether the new activity, service, undertaking or offering relates to or involves a product. If the regulator notifies the GSE that it does involve a product, than the GSE shall withdraw its request or shall submit a request for approval of the new product. The regulator may impose conditions in connection with the approval of any product.

S. 190 allows the GSEs to continue to offer their automated underwriting systems (AUS) in existence on the enactment date of the legislation, including any upgrade to the technology, operating system, or software to operate the underwriting system. This does not affect the regulator's authority, however, to review products or activities for –

(1) safety and soundness, and
(2) consistency with the GSE's statutory mission.

Unfortunately, the term "product" in S. 190 is narrower than the current prior approval of a GSE "program." For example, under current law a "program" that is subject to prior approval would include a mortgage-related service. A service is not a "product." In addition, the provision states that changes to mortgage terms and conditions are not included in the definition of "product" (except for changes that would increase the risk borne by a GSE, as discussed in the footnote, above). S. 190 also does not include a provision authorizing the new regulator to examine the GSEs to determine whether they have violated the prior approval requirements.

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. In contrast to GSE supervision, however, the supervision of banks places the regulator in a position to examine and 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 services and activities except in the most egregious circumstances, such as the unlikely event that they would involve safety and soundness. 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. While current law would have required Fannie Mae to obtain prior regulatory approval for its new mortgage customization patent, the Treasury compromise language likely would not. That is because the patent likely relates to a new Fannie Mae service rather than to a product. (It is important to note, however, that neither H.R. 1461 nor the Compromise Proposal will change the fact that the mere application and holding of the patent is a charter violation.)

- 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.

The Treasury Amendments to H.R. 1461: Treasury indicates that this issue has not been resolved in negotiations with the House. H.R. 1461 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.

Under H.R. 1461, each of the two GSEs would control and manage its own fund and allocate funding according to regulations that the regulator would promulgate. There are reports, however, that the House is now contemplating an affordable housing fund that would not be controlled by the GSEs.

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. H.R. 1461 does appear, however, to encourage the GSEs to guarantee tax-exempt and taxable housing bonds and engage in other activities that would not seem to be in the public interest.

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 large amounts of money to those who support and do not question their business goals.

Opportunities for the GSEs: The House-passed version of 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. If an affordable housing fund is part of any final bill, it would be preferable to devise a mechanism that does not allow the GSEs to control the allocation of these large sums of money. There are reports that the House negotiators plan to change this provision to assure that the GSEs do not control the funds.

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 provisions in H.R. 1461, as amended by the Treasury Amendments, represent flaws that require the regulator to promote the institutions that it regulates (one of the principal duties of the regulator), possibly to expand the market share of Fannie Mae and Freddie Mac (increase in the conforming loan limit, which has not yet been resolved in the negotiations), and weaken the current prior approval authority of the regulator (by limiting prior approval to products). These flaws deserve attention once negotiations resume.

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.

- Enforcement Authority

Current Law: The current statutory framework for OFHEO's enforcement powers is far weaker than for the federal bank regulators.

The Treasury Amendments to H.R. 1461: H.R. 1461, modified by the Treasury Amendments, does improve the enforcement powers in current law. The Compromise Proposal, however, 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, Sections 164 and 161 of H.R. 1461 do not allow the regulator to go directly to court to enforce orders other than cease-and-desist orders. This would make it difficult to enforce orders with respect to some matters, such as the

prudential management standards, prior approval of new products, assessments to fund the regulator, and examinations, while permitting more direct enforcement of orders in other areas. The enforcement language of S. 190 is far superior in these respects.

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 or the Compromise Proposal. H.R. 1461 contains a number of technical drafting issues that do not comport with the statutory framework of the federal bank regulators.[3] 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 the Compromise Proposal, because, at a time of controversy, the bank regulators can call on a full and tested panoply of supervisory authorities that will not be available to the new regulator.

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.

- Portfolio Limits

Current Law: Current law does not expressly require the GSEs to limit their portfolios. There are provisions of current law, however, 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)). The GSEs have ignored these statutory limitations.

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[3] For example, Section 164 of H.R. 1461 authorizes the regulator to go to court to enforce orders and notices under subtitles B (capital and prompt corrective action) and C (enforcement powers). This section expressly omits enforcement of orders under Subtitle A (supervision and regulation). Subtitle A includes the regulator's authority to set prudential standards (Section 102 of the bill), require reports (Section 104), assess and collect funds for the regulator's operations (Section 106), requirements that the two GSEs register a class of securities with the SEC (Section 115), and conform to governance requirements (Section 114) and new program approval requirements (Section 122). While it may be possible for the regultor to work around some of these omissions, it would be preferable for the legislation to give the new regulator clear authority.

H.R. 1461: The House-passed bill 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. This provision, however, does not permit the regulator to limit GSE portfolios for reasons of systemic risk.

The Treasury Amendments to H.R. 1461 would require the Director to issue regulations in 180 days to "establish standards by which the portfolio holdings or rate of growth of the portfolio holdings, of the enterprises will be deemed to be consistent with the mission and the safe and sound operations of the enterprises." In developing the standards, the Director is to consider a range of factors. In addition the Director may, by order, make temporary adjustments to those standards for Fannie Mae or Freddie Mac, "such as during times of economic distress or market disruption." Finally the Director may, by order, require an enterprise to dispose of or acquire any asset, if the Director determines that such action is consistent with the purposes of the 1992 Act or the GSE charter acts.

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. The application of the FDICIA approach to GSEs might have greater implications for the housing markets than would a simple limitation of the GSEs' portfolios.

Opportunities for the GSEs: Given their political power, particularly after they have rebuilt their accounting and internal controls, the GSEs are likely to be able to wield sufficient influence to make the regulatory process difficult at best. Without meaningful standards, the GSEs then could 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 former 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.

IV. Conclusion

In summary it is important for the Treasury and Congress to assure that the GSEs are subject to the full panoply of bank-type supervisory controls.

Several immediate priorities emerge from this analysis. It will be especially important to address:

- The principal duty of the Director to ensure that the GSEs "minimize the cost of housing finance";
- the prior approval language, which is much more permissive of GSE expansion than is current law;

- the language that would greatly expand the GSEs' market share by increasing the conforming loan limit in many areas; and
- the statutory language so that the regulator will have supervisory powers that are at least as strong as those of the bank regulators, especially with respect to capital standards and enforcement powers.

Small flaws in the language can have significant implications when applied in practice. The hiatus before the 110th Congress takes up GSE reform gives policymakers time to pay close attention to those details, as well as to the larger policy issues inherent in this legislation.