

The ***GSE*** REPORT™

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**Special Supplement**

**First Attempt To Enhance GSE Safety and Soundness:  
A Dangerous Placebo**

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## **FIRST ATTEMPT TO ENHANCE GSE SAFETY AND SOUNDNESS: A DANGEROUS PLACEBO**

Recently, Fannie Mae and Freddie Mac announced that they are voluntarily adopting six ways to improve their risk management and disclosure practices. The GSEs' new initiative is described in a document entitled, "Enhancing GSE Capital Strength, Risk Management, and Market Discipline."

If the contents of the document agreed with its title, then the taxpayers could relax. If the GSEs' capital bases were meaningfully enlarged, then the probability of taxpayers having to pay would be proportionately reduced. If the Enterprises agreed to reduce the levels of risk they absorbed, then the chances of losses would be diminished. Finally, if market forces led to early warning that the GSEs were close to default, then taxpayer losses also could be contained. However, the action items proposed do none of these things. If the announcement causes policymakers to drop their guard, then it is worse than doing nothing. It's like giving a very sick person a placebo.

The GSEs are playing politics with safety and soundness and financial risk. By creating an illusion of progress, the GSEs' voluntary initiative undermines OFHEO in its efforts to foster practices that will protect taxpayers from unsafe or unsound GSE conditions. The GSEs' initiative creates a false impression that safety and soundness of Fannie Mae and Freddie Mac have been augmented. The fundamental difference between illusion and reality will become apparent to the Congress the next time a GSE gets into financial trouble.

Moreover, by undercutting OFHEO's role as the government's agent in supervising the GSEs, the GSEs' voluntary initiative is likely to reduce the financial accountability of Fannie Mae and Freddie Mac. In the future, it is imperative that such proposals be vetted and approved in close consultation with the Treasury Department and other expert parties before the American taxpayers are declared to be risk-free.

The GSEs' voluntary initiative has six elements that its authors claim will improve the safety and soundness of the GSEs. But when the GSEs' work product is graded based on whether their proposals will cure the problem, it would not even rate a "D".

These are the six proposals in the document describing the GSEs' voluntary initiative. Here are their grades:

	<b>Grade</b>
• issuance of subordinated debt	F
• maintenance of increased liquidity	F
• voluntary running of a capital stress test	D
• interest rate disclosure	C-
• credit risk disclosure	C-
• publication of an annual rating	F

## **Grade for the Subordinated Debt Proposal: F**

### **Proposal defect: In a crisis, the GSEs need more Equity, not Debt**

*The Placebo:* Under the announcement, Fannie Mae and Freddie Mac would issue subordinated debt, debt obligations that are to be repaid only after the holders of senior debt have been paid. This subordinated debt would be “externally rated” and publicly traded. The GSEs would issue subordinated debt in an amount that would grow, over a three-year transition period, to four percent of on-balance sheet assets. According to one report, the two GSEs might issue \$15 billion in such debt.

The GSEs’ voluntary initiative points to a 1999 Federal Reserve Board staff study titled, “Using Subordinated Debt as an Instrument of Market Discipline.” For banks, many reformers have advocated using subordinated debt as a market test of the perceived safety and soundness of the financial institution.

*The Reality:* For banks, this is a good idea. It turns subordinated debt holders into watchdogs because the federal government backs the insured deposits of a bank, but does not guarantee the bank’s subordinated debt obligations. It also insulates taxpayers somewhat from claims on the FDIC trust fund. Such claims would be paid only after subordinated debt holders, like shareholders, lose all their money.

For GSEs, the issuance of subordinated debt creates only the illusion of real medicine. In reality, no market discipline is administered. The GSEs’ voluntary initiative is wrong to call such subordinated debt a “capital cushion.” Why? Investors treat existing GSE debt as though it has an implied federal guarantee, in part because they are viewed as “too big to fail.” Technically, GSE debt is not formally guaranteed, but it trades as if it were. The new subordinated debt will be viewed in the same fashion. Therefore, its purchasers will not become watchdogs and also will expect to be paid, dollar for dollar, just like other investors in the event of default. The idea of “market discipline” under these circumstances is an illusion.

Finally, the GSEs’ subordinated debt initiative does not in any way limit the amount of debt the Enterprises can issue.

*A Better Idea:* Congress could use subordinated debt to help create a genuine capital cushion and boost GSE market discipline. It could require each GSE to issue subordinated debt that automatically converts to equity in the event a GSE ceases to be adequately capitalized as specified by statute. Investors who purchase securities with this conversion feature will be at risk if the GSE operate unsoundly. This will give them the incentive to carefully monitor their investments. If the value of such securities falls, then government regulators and policymakers will have early warning that default risk is escalating. Then GSE subordinated debt could create better market discipline, and not merely an illusion.

## **Grade for the Liquidity Management Proposal: F**

### **Proposal defect: The Risk to Taxpayers is inadequate oversight, not inadequate liquidity**

*The Placebo:* The GSEs would agree to maintain at least three months' of liquidity, such as a reserve of securities easily convertible to cash, assuming no access to the debt markets.

The GSEs' voluntary initiative argues by analogy with how banks should be regulated. It notes that the Basel Committee on Banking Supervision recommends one-to-three months of liquidity for commercial banks. It further notes that GSEs have no current regulatory requirements to maintain liquidity.

*The Reality:* As with their idea of non-convertible subordinated debt, the analogy with banks is inappropriate. When a bank begins to fail, liquidity is an important issue because the bank will face great difficulty in obtaining funds from the private market. If a GSE fails, as the Farm Credit System did in the mid-1980s, it can use its implicit government guarantee to obtain virtually unlimited amounts of money by issuing debt in the federal agency debt market. In other words, requiring enhanced liquidity does not significantly enhance the safety and soundness of a GSE nor prevent any GSE from unlimited access to the debt markets. In any event, the two GSEs already hold investment portfolios that already exceed the test specified by the GSEs' voluntary initiative.

*A Better Idea:* The 1992 Federal Housing Enterprises Financial Safety and Soundness Act gave only weak enforcement powers to the Office of Federal Housing Enterprise Oversight (OFHEO). The Congress should amend those provisions to give OFHEO the enforcement powers that are available to other federal bank regulators. This will give OFHEO the power to limit the access of a failing GSE to the federal agency debt market, and to attach conditions to such access. If the GSEs knew that OFHEO had such authority, then prudence would require them to keep a more liquid portfolio than they now do to deal with unforeseen financial contingencies.

## **Grade for Voluntary Application of a Risk-Based Capital Stress Test: D**

### **Proposal defect: Self-Regulation should be in addition to, not in lieu of, independent and effective oversight from OFHEO**

*The Placebo:* The two GSEs would agree to implement for themselves the risk-based capital tests that 1992 Act requires OFHEO to implement. The GSEs would voluntarily disclose the parameters that they use in their tests and would disclose the results quarterly. The GSEs' voluntary initiative points to papers published by two Basel Committees concerning the application of risk-based capital standards to banks.

*The Reality:* Again the analogy with banks is misplaced. Largely in response to heavy lobbying from the GSEs themselves, the 1992 Act prescribes strict parameters for a stress test that limits the amount of capital that the GSEs could be required to hold if they were subject to a more robust risk-based test. In fact, under the stress test prescribed by the 1992 Act, the GSEs will fail long before they fail to meet their stress test. Federal bank regulators would not approve of banks limiting their risk-based test according to such unscientific parameters. The GSEs want it both ways: they want a limited risk-based test and they want to design it their own way to comply with that test.

Furthermore, unlike federal bank regulators, OFHEO has a limited budget subject to annual Congressional appropriations. Therefore, OFHEO is unlikely to have the ability to administer its own capital regulation and to examine the validity of the risk-based tests that the GSEs independently will invent. The illusion of safety created by this element is especially dangerous. By overtaxing OFHEO, this change will reduce the quality of OFHEO's implementation of the risk-based test that the law requires for the GSEs.

*A Better Idea:* If the GSEs now agree that it is appropriate for them to adopt the Basel system, then they should follow all of the Basel accords, not pick and choose the ones they like. Like Fannie Mae and Freddie Mac, thrift institutions specialize heavily in mortgages. By regulation, thrift institutions are subject to risk-based capital standards based on the Basel accords. A review of the Basel documents cited in the document describing the GSEs' voluntary initiative, and other documents such as the January 21, 1999, speech of William McDonough, President of the Federal Reserve Bank of New York, reveals a wide chasm between the practices of commercial banks and thrifts and the weak disclosures touted by the GSEs under their new voluntary initiative.

Congress should give OFHEO the same flexible authority available to federal bank regulators and the Office of Thrift Supervision to apply capital standards to the GSEs. Congress also should require OFHEO to adopt Basel-type regulations on risk-based capital. The Congress also needs to remove OFHEO from the constraints of the appropriations process and establish an independent source of funding, as is now done for bank regulators.

### **Grade for the Interest Rate Risk Disclosure Element: C-**

**Proposal Defect: The sensitivity test set in the document describing the GSEs' voluntary initiative is too modest**

*The Placebo:* The GSEs would disclose sensitivity to interest rate risk monthly. The disclosure would measure the impact on the GSEs' financial condition of both a 50 basis-point shift in interest rates and a 25 basis-point change in the slope of the yield curve.

*The Reality:* Disclosure of sensitivity to interest rate changes is good. However, the specific sensitivity test proposed is too weak to ascertain growing risk. For example,

the 1992 Act prescribes that OFHEO design a risk-based capital test that takes into account a 600 basis point swing in interest rates. A monthly review that is limited to only a 50 basis-point shift in interest rates and a 25 basis-point change in the slope of the yield curve is too narrow to evaluate the dynamics of changing prepayment risk in the GSEs' portfolios.

*A Better Idea:* The Congress should direct OFHEO to prescribe appropriate interest rate disclosures. These should include multiple scenarios of changes in the level of interest rates as well as changes in the yield curve. One possible disclosure risk requirement might be changes in interest rates of up to 300 basis points by 100 basis point increments and disclosures for larger shifts in the slope of the yield curve.

The House Banking Committee could do this in a request letter to OFHEO; OFHEO already has authority to require the GSEs to make reports on their financial condition and no new statutory authority is needed. Only the setting of parameters by an independent federal regulator can assure that the GSEs do not set themselves a low test of interest rate sensitivity and then proclaim their success in meeting that low test.

#### **Grade for the Credit Risk Disclosure Element: C-**

**Proposal defect: Voluntary sensitivity limits that the GSEs adopt are unlikely to adequately disclose their loss risk**

*The Placebo:* The GSEs would disclose their exposure to credit risk each quarter. This would consist of a sensitivity analysis of the GSE's financial stability if property values fell overnight by five percent.

*The Reality:* Again, the GSEs have set the test dangerously low. By law, the GSEs must assure that any mortgage with a loan-to-value ratio of less than 80 percent carries mortgage insurance. The risk to the GSEs is related to the dispersion of home price changes as well as the average change in home prices. Large price changes in a segment of the portfolio may have a greater impact on credit losses than the average losses across the entire portfolio. Indeed, the United States endured a rolling recession in the 1980s and early 1990s that involved much greater declines in property values in certain regions.

*A Better Idea:* Congress should direct OFHEO to prescribe appropriate credit risk disclosures. These should include multiple scenarios of changes in the level of home values as well as the prospect of deep regional changes comparable to historical experience. The House Banking Committee also could do this in a request letter to OFHEO; there is no need to change the law. Only the setting of parameters by an independent federal regulator can assure that the GSEs do not set themselves a low test of credit risk sensitivity and then proclaim their success in meeting that low test.

## **Grade for the Publication of an Annual Rating Element: F**

**Proposal defect: OFHEO, not the GSEs, should request this rating – and it should request this independent rating every year in addition to risk-based capital evaluations, not in lieu of them**

*The Placebo:* The GSEs would obtain and disclose an annual rating from a nationally recognized statistical rating organization until risk-based capital regulations are implemented. The rating would be based upon “risk to government,” and would attempt to disregard the effects of the government’s implied backing of GSE obligations.

*The Reality:* OFHEO already has authority to require such a rating. However, OFHEO’s 1996 experience demonstrated that the rating depends upon the assumptions that the rating agency makes. A second problem is that the GSEs will provide these ratings only until implementation of risk-based capital regulations. In this case, the GSEs’ voluntary initiative will allow the GSEs to argue against improvements to OFHEO’s proposed risk-based capital regulations on grounds that they are not really needed because the GSEs and the hired rating agencies are nicely regulating the GSEs without OFHEO.

*A Better Idea:* Have OFHEO, rather than the GSEs, commission the rating so that the government will establish the assumptions. The GSEs have the capacity to bring considerable pressure to bear on a rating agency. Unlike the usual rating in the private marketplace, there is no private investor that will be disappointed if a rating agency emerges with a rating of “risk to the government” based on “rosy” assumptions. That weakens the ability of the rating agencies to withstand GSE influence.

***This first attempt at strengthening the safety and soundness regulation of Fannie Mae and Freddie Mac does not make the grade. The details of the GSEs’ voluntary initiative, however, can be structured to truly enhance GSE Capital Strength, Risk Management, and Market Discipline. Congress, the Treasury, OFHEO, the Federal Reserve and other expert parties should carefully consider these details in the upcoming months.***

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