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**Improved Regulatory Structure and Minimum
Capital Standards are Needed for
Government-Sponsored Enterprises**

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Before the
Subcommittee on Policy Research and Insurance
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives



IMPROVED REGULATORY STRUCTURE AND MINIMUM CAPITAL
STANDARDS ARE NEEDED FOR GOVERNMENT-SPONSORED ENTERPRISES

Summary of Statement By
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In response to a request from the Honorable Ben Erdreich, Chairman, House Subcommittee on Policy Research and Insurance, Committee on Banking, Finance, and Urban Affairs, GAO presented its recommendations for improving federal oversight and capital rules for government-sponsored enterprises (GSE).

GAO found that shortcomings in current federal oversight of GSEs inhibit the government's ability to identify future problems that could lead to taxpayer losses and to deal with any such problems. Current federal regulators lack sufficient authority and responsibility to enforce safety and soundness rules and require minimum capital based on the risks undertaken by the GSEs. In addition, the current regulatory structure lacks sufficient prominence in government and independence from GSEs and the markets they serve to effectively and efficiently protect the government's interest in GSEs.

GAO recommends that Congress establish an independent Federal Enterprise Regulatory Board to oversee the activities of GSEs. The Board would be headed by a Board of Directors comprised of three voting members--a presidentially appointed Chairperson, the Secretary of the Treasury, and the Chairman of the Federal Reserve System--and three nonvoting members--the Secretaries of Agriculture, Education, and Housing and Urban Development. GAO recommends that the Board be given the authority and responsibility to establish and enforce rules of safe and sound operations, and monitor compliance with these rules.

GAO also recommends that Congress direct the Board to establish minimum required capital standards based on the risks GSEs undertake. GAO's preferred standard would include the sum of capital levels determined by (1) empirically-based tests of a GSE's capital adequacy to withstand credit and interest rate risk in stressful economic environments and (2) a ratio of capital to assets that establishes a level of capital for management, operations, and business risks.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss federal oversight of government-sponsored enterprises (GSE). The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 required two GAO reports on this subject; one in 1990 and another in 1991. As you may recall, in our first report,¹ we described the GSEs' purposes and operating methods, the financial risks they bear, and how they are regulated. We concluded that the sheer size of the GSEs' financial obligations, now over \$1 trillion, their public purposes, and the probability that the federal government would assist a financially troubled GSE, make it appropriate for the government to (1) supervise GSE risk-taking activities and (2) establish minimum levels of capital. We were concerned that federal oversight of GSEs--particularly for Fannie Mae, Freddie Mac, and Sallie Mae--was inadequate to identify, prevent, or contain the effects of problems like those that led to taxpayer losses in the thrift industry and Farm Credit System. We said that this year we would recommend specific improvements for federal oversight of GSEs.

¹See our report Government-Sponsored Enterprises: The Government's Exposure to Risks, (GAO/GGD-90-97, Aug. 15, 1990).

In my testimony today, I will discuss the major recommendations contained in our May 22, 1991 report.² We recommend that Congress (1) provide a GSE regulator with appropriate enforcement authorities, (2) establish a new federal regulatory structure to administer GSE oversight, and (3) establish reasonable capital rules based on the risks undertaken by the GSEs. We also plan to issue later this year a third report on the results of our audit of internal risk control procedures at Fannie Mae, Freddie Mac, and Sallie Mae.

ADDITIONAL OVERSIGHT AUTHORITIES NEEDED

Our first report on GSEs found several shortcomings in federal oversight of various GSEs.

- The Department of Housing and Urban Development (HUD) does not have clear authority to set capital rules based on the risks undertaken by Fannie Mae and Freddie Mac. Nor does HUD have the range of specific enforcement authorities typically granted to bank regulators; moreover, HUD has not fully used the authorities it has been granted. Finally, inherent conflicts could exist between HUD's housing goals and its goals as a financial regulator.

²See our report Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks, (GAO/GGD-91-90, May 22, 1991).

- Sallie Mae has no federal regulator overseeing its financial activities; it also has no minimum capital requirement.
- The Farm Credit Administration lacks specific authority to set capital standards for Farmer Mac.
- The statutory capital rules for the Federal Home Loan Banks require a capital-to-outstanding-debt ratio that considers neither the risks of off-balance sheet activities nor the relative riskiness of various bank assets.

To adequately protect the government's objective that GSEs carry out their public purposes safely and soundly, we recommend that the GSE regulator have authorities and responsibilities to

- establish rules that clearly define regulatory expectations and promote the safe and sound accomplishment of GSEs' purposes. These should include, but not be limited to, rules that define minimum capital levels, prohibit unsafe activities, set minimum boundaries of a sound financial condition, and establish information reporting requirements. The rules should be established using procedures that conform to the Administrative Procedures Act, including requirements for public comment before adoption of rules.

- monitor financial performance and compliance with regulations to provide an adequate understanding of the GSE's operations, condition, and the potential risk to the government. The regulator should have unimpeded, timely access to all information, systems, and personnel. While such monitoring is necessary to keep the regulator well informed, it should be done as non-intrusively as possible. Monitoring should increase when conditions warrant.
- act in a timely manner to enforce charter restrictions, regulations, and capital requirements. Enforcement actions should result from a fair and reasonable process. Enforcement authorities should be sufficiently broad, and some enforcement actions should be mandatory when pre-specified conditions are met.
- levy assessments to cover oversight and supervision costs.

These authorities should supplement, not obstruct, the existing corporate governance at each GSE. The regulator normally would not need to involve itself in a GSE's business affairs--that is, it would not approve operating strategies, budgets, salaries, hiring, and the like. Under current charters, such powers normally are assigned to the GSEs' boards of directors. We would not change that. Permitting corporate governance the freedom to

manage the GSEs allows them to quickly respond to changes in the marketplace and serve their customers.

Under normal conditions, regulatory activity would usually consist of performance monitoring to ensure that corporate governance is working effectively and according to established regulations. Prompt interventions by the regulator would be warranted when corporate governance processes were not working as intended or when the GSE was experiencing financial or managerial difficulties.

SINGLE INDEPENDENT REGULATOR FAVORED

Recent regulatory experiences during the thrift and Farm Credit crises indicate that an effective GSE regulator should be structured so that it is both prominent in government and objective. These characteristics should give the regulator the visibility and the capability to act promptly and effectively if a GSE experiences severe difficulties. The regulatory body should be independent from the GSEs, their competitors, and all advocacy responsibilities. To avoid possible conflicts of interest, a GSE regulator should not also regulate the market served by the GSE. Finally, fairness demands that GSEs facing similar risks receive similar regulatory treatment.

To achieve these goals, we propose a single regulator, which we call the Federal Enterprise Regulatory Board. The Board would have three voting members--a full-time chairperson appointed by the President, the Secretary of the Treasury, and the Chairman of the Federal Reserve System. The chairperson would serve as the Chief Executive Officer of the regulatory staff. The chairperson should serve a fixed-length term and be an individual familiar with government, who has a respected record of achievement. The Secretary of the Treasury would provide financial expertise and represent the administration's views. The Federal Reserve Chairman would provide an independent view and expertise in the workings of financial markets.

To provide advice on specific agriculture, education, and housing programs and markets, the Board would have three nonvoting members--the Secretaries of Agriculture, Education, and HUD. The Secretaries would provide their views and perspectives on public policy issues. Their nonvoting status should protect the arm's-length nature of the Board by minimizing the possibility that these members use the GSEs to address public concerns not envisioned by GSE charters.

REGULATORY CAPITAL REQUIREMENTS
SHOULD BE BASED ON RISKS UNDERTAKEN

Requiring that GSEs maintain a minimum amount of capital provides several public benefits. Foremost, it provides some assurance of

a buffer adequate to absorb unforeseen GSE losses and to prevent taxpayer losses. Also, a capital standard gives GSE shareholders a greater incentive to demand that management not take undue risks. Finally, a capital standard provides the government a way to influence a GSE's risk-taking without involving itself in the GSE's daily business operations.

To accomplish these objectives, GSE capital requirements should (1) be based on all risks they undertake, (2) provide an adequate buffer for possible GSE losses, (3) be clear and prospective, and (4) be equitable for competing GSEs. Because Farm Credit System banks compete directly with commercial banks, their capital requirements should continue to be patterned after bank risk-based capital rules. For the other GSEs, the new Federal Enterprise Regulatory Board should establish minimum capital standards that are based on the sum of (1) empirically-based measurements of the capital needed to withstand credit risk and interest rate risk losses in stressful economic environments, commonly known as "stress tests," and (2) an amount equal to a proportion of a GSE's obligations (leverage ratio), both on- and off-balance sheet, so that capital is held for management, operations, and business risks.

Where possible, the capital standard should be based on empirical evidence and should use the best available measurement methods. The "stress tests" are especially applicable for financial firms

in a single line of business, like GSEs, because economic environments adverse to such firms are relatively easy to identify compared with firms in multiple lines of business like banks. The specific measurements, assumptions, and ratio levels should be left to the new Board's discretion, to provide the flexibility needed to revise rules during the evolution of markets, technologies, and GSE operations. Such flexibility is currently missing for Fannie Mae and Freddie Mac, where the capital rules have become outdated now that off-balance sheet activities are commonplace.

The proposed standard needs to be the sum of the amount needed to meet the "stress test" requirement and that needed to meet the leverage ratio requirement. It must provide sufficient capital to provide a buffer against possible losses arising from all sources of risk.

CONCLUSION

I recognize that some will argue that increased regulation of GSEs is unnecessary because none of the GSEs now pose an imminent financial threat to the government. Available evidence suggests the GSEs are now generally in sound condition. However, future changes in management strategies, economic downturns, or other adverse events could precipitate future GSE losses. The speed with which a firm can go from apparently sound to

financially imperiled was vividly demonstrated in the thrift industry, the Farm Credit System, and Fannie Mae in the early 1980s. The time to act to improve the regulatory structure and the safety and soundness of GSEs is when the situation is calm. History has shown that regulatory improvements are more difficult to design and implement in a crisis environment, after huge losses have occurred.

That concludes my prepared statement. My colleagues and I would be pleased to answer any questions.

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