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## Testimony

Before the Subcommittee on Capital Markets, Securities  
and Government-Sponsored Enterprises, Committee on  
Banking and Financial Services  
House of Representatives

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For Release on Delivery  
Expected at  
10:00 a.m., EDT  
on Thursday  
July 24, 1997

# HOUSING ENTERPRISES

## Advantages and Disadvantages of Creating a Single Housing GSE Regulator

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# Housing Enterprises: Advantages of Creating a Single Housing GSE Regulator

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GAO's testimony, based on its recent report,<sup>1</sup> discusses the advantages and disadvantages of creating a single regulator for the housing government-sponsored enterprises (GSE)—the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank System (FHLBank System). Currently, the Federal Housing Finance Board (FHFB) oversees the safety and soundness and the mission compliance of the FHLBank System. The Office of Federal Housing Enterprise Oversight (OFHEO), an independent office within the Department of Housing and Urban Development (HUD), oversees the safety and soundness of Fannie Mae and Freddie Mac. The Secretary of HUD has general regulatory power over Fannie Mae and Freddie Mac.

GAO reviewed its past and ongoing work related to these GSEs and their regulators, and solicited the views of housing, GSE, and regulatory officials. In GAO's 1991 and 1993 reports on GSEs, it identified five criteria that a GSE regulatory agency structure should meet to facilitate effective oversight.<sup>2</sup> The criteria specify that a GSE regulatory agency's structure should provide for (1) objectivity and independence from the GSE, (2) prominence in government, (3) economy and efficiency, (4) consistency in regulation of similar markets, and (5) separation of primary and secondary market regulation.

GAO determined that the housing GSE regulators would be more effective if the regulatory function was combined and one regulator was authorized to oversee both safety and soundness and mission compliance. GAO's analysis of different regulatory structures indicated that an independent, arm's-length, stand-alone regulatory body headed by a board would best fit its criteria for an effective regulatory agency structure. Although there have been changes in the structure of regulatory oversight for the housing GSEs since GAO first established its criteria, neither OFHEO, HUD, nor FHFB meets all five criteria. A single housing GSE regulatory agency could be more independent and objective than separate regulatory bodies and could be more prominent than any one alone. Although the GSEs operate differently, the risks they manage and their missions are similar. A single regulator should be better able to assess the competitive effect of specific mission requirements, such as special housing goals, and new programs or

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<sup>1</sup>Government-Sponsored Enterprises: Advantages and Disadvantages of Creating a Single Housing GSE Regulator (GAO/GGD-97-139, July 9, 1997).

<sup>2</sup>Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991); and Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness (GAO/GGD-94-38, Dec. 8, 1993).

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**Summary**  
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initiatives on all three housing GSEs and better ensure consistency of regulation for GSEs that operate in similar markets.

# Housing Enterprises: Advantages of Creating a Single Housing GSE Regulator

Mr. Chairman and Members of the Subcommittee:

We are pleased to appear here today to discuss our recently issued report on creating a single regulator for the three housing government-sponsored enterprises (GSE) — the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Bank System (FHLBank System).<sup>3</sup> First, I will discuss the advantages and disadvantages of creating a single housing GSE regulator. Second, I will discuss the question whether both safety and soundness and mission oversight should be vested in that regulator. Third, I will discuss several possible regulatory structures. Finally, I will briefly mention one other issue that is important in considering how best to regulate the housing GSEs.

As you know, the current regulatory arrangement for the housing GSEs involves three regulators. The Office of Federal Housing Enterprise Oversight (OFHEO) regulates the safety and soundness of Fannie Mae and Freddie Mac. HUD regulates Fannie Mae's and Freddie Mac's mission compliance and has general regulatory authority over matters not made exclusive to OFHEO by statute. The Federal Housing Finance Board (FHFB) regulates both the safety and soundness and mission compliance of the (FHLBank System).

In our 1991 and 1993 reports on GSEs, we identified criteria that a GSE regulatory agency structure should meet in our view to facilitate effective oversight.<sup>4</sup> These criteria were: (1) objectivity and independence, (2) prominence in government, (3) ability to achieve economy and efficiency, (4) ability to provide consistency in regulation, and (5) ability to separate primary and secondary market regulation. On the basis of work we have done subsequently, we believe those criteria remain sound. In addition to reviewing our past work in light of the current regulatory structure and GSE activities, as well as ongoing work related to these GSEs

<sup>3</sup>Government-Sponsored Enterprises: Advantages and Disadvantages of Creating a Single Housing GSE Regulator (GAO/GGD-97-139, July 9, 1997).

<sup>4</sup>Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (GAO/GGD-91-90, May 22, 1991); and Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness (GAO/GGD-94-38, Dec. 8, 1993).

and their regulators,<sup>5</sup> we solicited views of housing, GSE, and regulatory officials.

Our ongoing work has strengthened our belief that the housing GSE regulators would be more effective if combined and authorized to oversee both safety and soundness and mission compliance. Although there have been changes in the regulatory oversight of the housing GSEs since we first established our criteria, neither OFHEO, HUD, nor FHFB meet all of the criteria. In particular, we note that FHFB is not completely an arm's-length regulator, as it is still involved in governance of the FHLBank System. In addition, regulation of Fannie Mae's and Freddie Mac's mission compliance is the responsibility of HUD, while their safety and soundness is the responsibility of OFHEO. Our analysis of different regulatory structures indicates that an independent, arm's-length, stand-alone regulatory body headed by a board would best fit our criteria for an effective regulatory agency structure for the housing GSEs.

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## **We Continue to Support a Single Housing GSE Regulator**

We continue to support the creation of a single housing GSE regulator as recommended in our 1993 report. Although we recognize that the housing GSEs operate and are structured differently, the risks they manage are similar. We believe valuable synergies could be achieved and expertise could be shared. Both OFHEO and FHFB evaluate how the enterprises manage credit, interest rate, and other risks. In addition, OFHEO's current work in setting capital standards and developing a stress test for its GSEs could be useful in evaluating the risks to the FHLBank System and the adequacy of its capital.

We also believe that a single housing GSE regulator could foster competition among the three GSEs while providing consistent rules and interpretations. FHFB recently approved three FHLBank pilot programs that involve services Fannie Mae or Freddie Mac could have or already does provide. OFHEO officials told us they independently assessed the competitive impact of these programs on Fannie Mae and Freddie Mac. However, had a single regulator been responsible for all three GSEs, a single assessment could have combined consideration of all competitive effects and better ensured consistency of regulatory oversight. We recognize that because of possible conflicting interests of the housing GSEs

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<sup>5</sup>See *Government-Sponsored Enterprises: Development of the Federal Housing Enterprise Financial Regulator* (GAO/GGD-95-123, May 30, 1995); a study required by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. In addition, Section 430 of the Department of Veterans Affairs/Department of Housing and Urban Development Appropriations Act of 1997 required us to assess OFHEO's operations and determine whether its resources are adequate and being used appropriately to fulfill its critical safety and soundness mission. This work is ongoing.

in pursuing their lines of business and missions, such an assessment could be difficult. However, we believe the process could be handled more effectively and efficiently within one regulatory body.

The most often identified disadvantage of creating a single housing GSE regulator is the potential disruption in operations of the existing regulatory agencies, especially for a relatively new agency like OFHEO. On the other hand, these effects should be short term and the outcome should result in more effective regulation in the long run.

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## **Regulation of Mission and Safety and Soundness Would Be More Effective If Combined**

In our May 1991 report on GSEs, we stated that regulation of a GSE's mission cannot be effectively separated from safety and soundness, and we still support this position.<sup>6</sup> A regulator that performs both roles must, however, be fully independent and at arm's length from the GSEs it regulates. We strongly believe that the independence this would provide is imperative to ensure objectivity. As we noted in 1991, there is a distinction between a safety and soundness regulator that confirms a GSE's compliance with its statutory purposes as articulated by Congress and one that participates in the corporate governance of a GSE.

As you know, FHFB still participates in FHLBank System business, which we have stated in previous work and continue to believe is inappropriate for a regulator and presents potential for conflict.<sup>7</sup> For example, FHFB is required to appoint six directors to each bank's board and, until just last month, approved applications for the Affordable Housing Program.<sup>8</sup> While FHFB has delegated some duties related to FHLBank System management to the FHLBanks, the Chairman of FHFB told us FHFB cannot fully delegate these types of duties because of statutory constraints.

Some critics of combining mission and safety and soundness have voiced concerns that doing so could create regulatory conflict for the regulator. It seems to us, however, that the tension caused by having both private and public characteristics could be best understood and accounted for by having a single regulator that has complete knowledge of financial condition, regulates the mission goals Congress sets, and assesses efforts

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<sup>6</sup>GAO/GGD-91-90, pages 29-31. In commenting on the 1991 report, Fannie Mae, Freddie Mac, and FHFB all agreed with our position that safety and soundness could not be effectively separated from statutory activities (mission). HUD took no position.

<sup>7</sup>GAO/GGD-91-90 and GAO/GGD-94-38.

<sup>8</sup>The Affordable Housing Program Regulations are set forth at 12 C.F.R. Part 960. The Board's approval procedures are contained in 12 C.F.R. § 960.5.

to fulfill them. The link between mission and safety and soundness is established in the housing GSEs' charters. All three housing GSEs' charters acknowledge that economic considerations of the activities undertaken cannot be ignored, especially where special mission requirements, such as low-income housing goals, are addressed.

Given the current financial strength of Fannie Mae, Freddie Mac, the FHLBank System and the overall economic environment, we determined that, for now, there would be little tension between mission compliance and safety and soundness concerns. However, should economic conditions change for the worse, more tension could be created as the GSEs try to provide acceptable returns to their owners while continuing to comply with their special mission requirements. In this situation, we believe it is important that a regulator be responsible for both to help ensure adequate balance is maintained.

In our report, we also point out that combining mission and safety and soundness regulation would facilitate assessing Fannie Mae and Freddie Mac for the cost of overseeing their compliance with housing goals. Currently, the cost of Fannie Mae's and Freddie Mac's mission oversight is borne by the taxpayer as part of HUD's budget. However, OFHEO's and FHFB's costs are paid by their respective enterprises through assessments. In addition, of course, oversight by one regulator could facilitate congressional monitoring of the housing GSEs.

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## **Possible Structures for a Single Regulatory Agency**

The third area of our report that I will address is the possible structure for a single regulatory agency. A single regulator for housing GSEs could be a stand-alone agency or an independent office within an executive branch agency, such as HUD or Treasury. The agency could be led by a board or a single director. What is important in our view, is to ensure that it has the independence and prominence that would allow it to act independently of the influence of the housing GSEs, which are large and politically influential institutions.

One of the primary advantages of creating a stand-alone agency, rather than an independent agency within a department, is that it should be better able to establish independence and be further removed from the potential political influence of a cabinet-level department and from the specific interests of its parent organization. In addition, a stand-alone agency, because it would not be affiliated with a government department



that has a particular focus, may be in a better position to ensure that safety and soundness and mission are equitably overseen.

The advantages and disadvantages of having a new regulator that is set up as an independent office within an executive branch agency would depend on the agency. HUD and Treasury would be the most appropriate agencies because of their roles in housing and finance. Although OFHEO has functioned independently within HUD, having the housing GSE regulator within HUD creates the potential for conflict with HUD's role as a housing promoter. However, HUD's expertise in housing and the housing finance system would be an advantage.

If the office were created within Treasury, it could benefit from Treasury's financial and regulatory expertise and prominence. In addition, this affiliation would also reinforce the importance of safety and soundness oversight as the regulator's top priority. On the other hand, Treasury's objectivity and arm's-length status could be questioned because of its two specific responsibilities relating to GSEs: (1) power to approve the timing and terms of new GSE debt issuances<sup>9</sup> and (2) ability to authorize use of conditional lines of credit held by the GSEs.<sup>10</sup>

Closely related to the stand-alone versus independent office structure, we considered a board versus a single director structure for governing a single regulatory agency. We found that the board structure best fits our criteria for an effective regulator for many of the same reasons that a stand-alone agency is preferable to an executive branch agency.

We believe one advantage would be that a new regulator led by a board would best be able to establish the requisite independence in government and would also allow Congress to provide balance for the regulator's decisionmaking body. Both HUD and Treasury could be represented on a board, providing a structure where any potential conflicts could be addressed. A disadvantage of a board structure is that it may make determining individual accountability for actions difficult. This potential

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<sup>9</sup>For years, Treasury scheduled GSE offerings to prevent timing conflicts among the GSEs that might prove to be disruptive to the government securities market. On March 8, 1996, however, Treasury eliminated its scheduling procedures for GSE securities offerings. GSEs have developed a voluntary, cooperative scheduling system that eliminated the need for Treasury's queuing process. Treasury's statutory authority to approve the timing and terms of GSE securities has not changed.

<sup>10</sup>The FHLBank System has a \$4 billion line of credit with Treasury, while Fannie Mae and Freddie Mac each have a \$2.25 billion line of credit. However, use of the lines of credit is subject to Treasury's discretion.

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inefficiency could be addressed by placing a presidentially appointed chair or chief executive officer in charge of daily operations.

Among the financial regulators, we could not find any examples of stand-alone agencies that were not headed by boards or commissions or independent offices that were not headed by single directors. It seems there are good reasons for these structures being linked. That is, although a stand-alone agency structure provides independence and prominence in government, the board structure has the advantages of allowing different perspectives, providing stability, and bringing prestige to the agency, as well as allowing Congress to provide balance for the regulator's decisionmaking body by requiring that members have certain expertise.

In closing, Mr. Chairman, I want to mention one additional issue that may need to be addressed in your deliberations.

If a single regulator for the housing GSEs were created, you may want to consider whether it should be included or excluded from the appropriations process. Most financial institution regulators, including OFHEO and FHFB, assess the institutions they oversee for the cost of regulation. Thus, they are not funded from tax revenues and typically are not subject to appropriations. OFHEO, however, is subject to the appropriations process and has less control than some other regulators over its resources. The appropriations process could subject the agency to budgetary pressures that could conflict with the agency's needs as a safety and soundness regulator. On the other hand, we recognize that the appropriations process does provide an additional mechanism for congressional oversight.

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

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# Related GAO Products

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Government-Sponsored Enterprises: Advantages and Disadvantages of Creating a Single Housing GSE Regulator, [GAO/GGD-97-139](#), July 9, 1997.

Housing Enterprises: Investment, Authority, Policies, and Practices, [GAO/GGD-97-137R](#), June 27, 1997.

Comments on “The Enterprise Resource Bank Act of 1996”, [GAO/GGD-96-140R](#), June 27, 1996.

Housing Enterprises: Potential Impacts of Severing Government Sponsorship, [GAO/GGD-96-120](#), May 13, 1996.

Letter from James L. Bothwell, Director, Financial Institutions and Markets Issues, GAO, to the Honorable James A. Leach, Chairman, Committee on Banking and Financial Services, U.S. House of Representatives, Re GAO views on the “Federal Home Loan Bank System Modernization Act of 1995,” B-260498, Oct. 11, 1995.

FHLBank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness, [GAO/T-GGD-95-244](#), Sept. 27, 1995.

Housing Finance: Improving the Federal Home Loan Bank System’s Affordable Housing Program, [GAO/RCED-95-82](#), June 9, 1995.

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Farm Credit System: Repayment of Federal Assistance and Competitive Position, [GAO/GGD-94-39](#), March 10, 1994.

Farm Credit System: Farm Credit Administration Effectively Addresses Identified Problems, [GAO/GGD-94-14](#), Jan. 7, 1994.

Federal Home Loan Bank System: Reforms Needed to Promote Its Safety, Soundness, and Effectiveness, [GAO/GGD-94-38](#), Dec. 8, 1993.

Improved Regulatory Structure and Minimum Capital Standards are Needed for Government-Sponsored Enterprises, [GAO/T-GGD-91-41](#), June 11, 1991.

Government-Sponsored Enterprises: A Framework for Limiting the Government’s Exposure to Risks, [GAO/GGD-91-90](#), May 22, 1991.

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**Related GAO Products**

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Government-Sponsored Enterprises: The Government's Exposure to Risks, [GAO/GGD-90-97](#), Aug. 15, 1990.

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