Federal Supervision of Safety and Soundness of Government-Sponsored Enterprises

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I. FINANCIAL INSTITUTIONS WITH FEDERAL CREDIT BACKING AND THE NEED FOR EFFECTIVE SUPERVISION OF SAFETY AND SOUNDNESS

A. Introduction

The Federal Government provides credit support to a variety of financial institutions today. Commercial banks, thrifts, and credit unions benefit from federal deposit insurance, and government-sponsored enterprises (GSEs or enterprises) benefit from an implicit guarantee of their obligations and mortgage-backed securities. All of these institutions are instrumentalities of the United States; they are privately owned and serve public purposes that are specified by federal law.[1] Because the Federal Government's credit backing removes much of the usual market discipline, effective government regulation is essential to help contain risk-taking by such financial institutions and to help assure their long-term viability.[2]

While there is considerable and growing literature concerning the supervision of safety and soundness of banks and thrift institutions, much less has been written about GSEs. This Article addresses issues, and particularly the administrative aspects, of federal supervision of GSEs. The Article summarizes the institutional and administrative law frame-

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1. Moe & Stanton, *Government-Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability*, 49 PUB. ADMIN. REV. 321, 321-29 (1989); T. STANTON, A STATE OF RISK 205-07 (1991) [hereinafter STATE OF RISK].

2. These lessons have been derived from experiences with a variety of financial institutions whose borrowing is implicity or explicitly backed by the Federal Government. *See, e.g.*, Mark J. Flannery, "Deposit Insurance Creates a Need for Bank Regulation," *Business Review* 17-27 (Jan./Feb. 1982); Black, Miller & Posner, *An Approach to the Regulation of Bank Holding Companies*, 51 JOURNAL OF BUSINESS 379-412 (1978); RISK AND CAPITAL ADEQUACY IN COMMERCIAL BANKS Ch. 6 (S. Maisel, ed. 1981); Frederick T. Furlong & Michael C. Keeley, "Bank Capital, Regulation and Asset Risk," *Economic Review* (Spring 1987); *see also* Kevin E. Villani, "The Federal Forecast," *Secondary Mortgage Markets* 26-33 (Spring 1985); and UNITED STATES GENERAL ACCOUNTING OFFICE, GOVERNMENT-SPONSORED ENTERPRISES: A FRAMEWORK FOR LIMITING THE GOVERMENT'S EXPOSURE TO RISKS (1991) [hereinafter 1991 GAO REPORT].

work for federal supervision of banks and thrift institutions today and examines how this framework might be applied to GSEs as well.

After describing the GSEs today, Section I of this Article compares the institutional and legal characteristics of the GSEs with those of banks and thrift institutions. Section II examines the financial risks involved in enterprise lending and the need for the Federal Government to regulate safety and soundness to compensate for missing market discipline. Section III reviews the institutional and administrative elements of effective financial supervision. Section IV surveys federal oversight of enterprise safety and soundness today, including the administrative difficulties of setting or enforcing some enterprise capital requirements. Section V reviews the findings and recommendations of the 1990 and 1991 reports on GSEs by the United States Treasury Department (Treasury) and United States General Accounting Office (GAO) and the 1991 report by the Congressional Budget Office (CBO), and examines some of the regulatory and administrative issues involved. Section VI looks briefly at federal oversight of the programmatic mission of each enterprise and explores the issue of possible regulatory conflict between effective federal supervision of safety and soundness and executive branch oversight of public purposes. Section VII concludes with some practical observations.

B. Government-Sponsored Enterprises as Instruments of Federal Policy

The Federal Government uses GSEs to fund loans to borrowers, such as homebuyers, students, and farmers, who are considered unable to obtain credit on normal commercial terms. Today there are eight GSEs that fund almost a trillion dollars of loans to homebuyers, farmers, students, thrift institutions, the insolvent Federal Savings and Loan Insurance Corporation (FSLIC), and the Resolution Trust Corporation (RTC). The eight enterprises are the Farm Credit System (FCS),[3] the Federal National Mortgage Association (Fannie Mae),[4] the Federal

3. 12 U.S.C. §§ 2001-2279aa (1988). The Federal Land Banks (FLBs) were established in 1916, the Federal Intermediate Credit Banks (FICBs) in 1923, and the Banks for Cooperatives (BCs) in 1933. The Agricultural Credit Act of 1987 combined the FLBs and FICBs into Farm Credit Banks (FCBs). The FCBs and BCs, together with their cooperative associations, constitute the Farm Credit System (FCS). Pub. L. No. 100-233, 101 Stat. 1568 (1988).

4. 12 U.S.C. §§ 1716-1723d (1988 & Supp. I 1989). The Federal National Mortgage Association (Fannie Mae) had its origins in the National Housing Act of 1934, Pub. L. No. 73-479, 48 Stat. 246, which authorized the establishment of National Mortgage Associations. In 1938, the Reconstruction Finance Corporation established Fannie Mae as a subsidiary. Fannie Mae's charter was codified in the Housing Act of

Home Loan Mortgage Corporation (Freddie Mac),[5] the Student Loan Marketing Association (Sallie Mae),[6] the Federal Home Loan Bank System (FHLBS),[7] the Federal Agricultural Mortgage Corporation (Farmer Mac),[8] the Financing Corporation (FICO),[9] and the Resolution Funding Corporation (REFCORP).[10]

1. *Defining the Term "Government-Sponsored Enterprise"*

GSEs have special characteristics, including a combination of private and governmental attributes, that have tended to confuse observers. On the one hand, enterprises share attributes with public institutions: they are established by Congress;[11] they issue debt obligations that possess most of the characteristics of Treasury securities;[12] they are governed by boards that usually include governmentally appointed directors;[13] they have lines of credit to the Treasury;[14] their obligations are implicitly guaranteed by the Federal Government, creating potentially open-ended claims on federal funds;[15] they are considered instrumentalities of the Federal Government with charters that preempt some state laws

1954, Pub. L. No. 83-560, 68 Stat. 590. The Housing and Urban Development Act of 1968, Pub. L. No. 90-448, 82 Stat. 536, partitioned Fannie Mae into a privately financed secondary market institution, today's Fannie Mae, and a government agency called the Government National Mortgage Association (Ginnie Mae).

5. 12 U.S.C. §§ 1451-1459 (1988 & Supp. I 1989). The Federal Home Loan Mortgage Corporation (Freddie Mac) was established in 1970 by the Emergency Home Finance Act, Pub. L. No. 91-351, 84 Stat. 451 (1970).

6. 20 U.S.C. § 1087-2 (1988). The Student Loan Marketing Association (Sallie Mae) was established in 1972 by the Education Amendments of 1972, Pub. L. No. 92-318, 86 Stat. 265.

7. 12 U.S.C. §§ 1421-1449 (1988 & Supp. I 1989). The Federal Home Loan Banks were established in 1932 by the Federal Home Loan Bank Act, ch. 552, § 2, 47 Stat. 725 (1932).

8. 12 U.S.C. § 2279aa (1988). The Federal Agricultural Mortgage Corporation (Farmer Mac) was established by the Agricultural Credit Act of 1987, Pub. L. No. 100-233, 101 Stat. 1586 (1988).

9. 12 U.S.C. § 1441 (1988 & Supp. I 1989). The Financing Corporation (FICO) was established by the Federal Savings and Loan Insurance Corporation Recapitalization Act of 1987, Pub. L. No. 100-86, 101 Stat. 585.

10. 12 U.S.C. § 1441b (1988 & Supp. I 1989). The Resolution Funding Corporation (REFCORP) was established by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183.

11. *See supra* notes 3-10 and accompanying text (providing details of history and legislation of various government-sponsored enterprises (GSEs)).

12. STATE OF RISK, *supra* note 1, at 41-44.

13. UNITED STATES DEPARTMENT OF THE TREASURY, REPORT OF THE SECRETARY OF THE TREASURY ON GOVERNMENT-SPONSORED ENTERPRISES 4 (1990) [hereinafter 1990 TREASURY REPORT]; STATE OF RISK, *supra* note 1, at 41-42.

14. STATE OF RISK, *supra* note 1, at 41-44.

15. *Id.* at 205-07.

and taxes;[16] and, because of their federal instrumentality status, they probably cannot go bankrupt under the Federal Bankruptcy Code.[17]

On the other hand, enterprises also possess many of the characteristics of private companies. They are privately owned;[18] they sell stock to private individuals and institutions;[19] their employees are exempt from federal civil service and procurement laws;[20] they are free to make a profit;[21] and their operations do not depend upon regular federal appropriations.[22]

The following definition is intended to resolve some of this confusion: A GSE is a privately owned, federally chartered, financial institution with nationwide scope and specialized lending powers that benefit from an implicit federal guarantee to enhance its ability to borrow money.[23]

2. *Volume and Growth of Enterprise Lending*

Enterprise growth can be quite rapid. Sallie Mae, for example, grew from $2.8 billion in assets in 1980[24] to $41.1 billion in 1990,[25] and grew by seventeen percent in 1990 alone.[26] Fannie Mae and Freddie Mac today are huge institutions. At the end of 1990, Fannie Mae had $133 billion of assets plus $300 billion in guaranteed mortgage-backed securities,[27] and Freddie Mac had $41 billion of assets plus $316 billion in guaranteed securities.[28] Fannie Mae grew by $80 billion in 1990 alone.[29] These characteristics make these institutions larger than the largest United States banking institutions in their total volume of lending activity (assets plus guarantees).[30] Today, Fannie Mae and Freddie Mac fund roughly one out of four residential mortgages in the United

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16. *Id.* at 206.
17. *Id.*
18. 1990 TREASURY REPORT, *supra* note 13, at 4; STATE OF RISK, *supra* note 1, at 41-44.
19. STATE OF RISK, *supra* note 1, at 41.
20. *Id.* at 15.
21. *Id.*
22. *Id.*
23. Moe & Stanton, *supra* note 1, at 321-29.
24. 1990 TREASURY REPORT, *supra* note 13, at F6.
25. *Id.;* UNITED STATES DEPARTMENT OF THE TREASURY, REPORT OF THE SECRETARY OF THE TREASURY ON GOVERNMENT-SPONSORED ENTERPRISES A51 (1991) [hereinafter 1991 TREASURY REPORT].
26. 1991 TREASURY REPORT, *supra* note 25, at A53.
27. *Id.* at A43, 3.
28. *Id.* at A33, 3.
29. *Id.* at A43, 3.
30. Telephone interview with Bank Analyst, *Standard & Poors* (June 1990). *See also* STANDARD & POORS 1990 FINANCIAL INSTITUTIONS RATIOS: FOURTH QUARTER (1990).

States.[31]

Table 1 shows the volume of enterprise securities outstanding over the years. The CBO calculates that enterprise securities have gone from $38.9 billion outstanding in Fiscal Year 1970 (FY 70)[32] to $176.9 billion in Fiscal Year 1980 (FY 80)[33] and $980.1 billion in Fiscal Year 1990 (FY 90).[34] That twenty-five-fold growth over twenty years includes creation of new enterprises, notably Freddie Mac in 1970 and Sallie Mae in 1972.[35]

A variety of reasons explain this dramatic growth in enterprise activity. First, GSEs may borrow virtually unlimited amounts of money in the federal agency credit market on favorable terms.[36] They are exempt from state laws and taxes applicable to many competitors.[37]

As federal instrumentalities, they are not subject to burdensome requirements such as state doing-business laws.[38] They are also free from federal securities registration requirements[39] and, indirectly, are permitted to avoid most state securities requirements.[40]

Moreover, enterprises are exempted by federal law from all state and local taxes, except real property taxes.[41] Some enterprises have additional tax benefits. The Federal Home Loan Banks (FHLBs), FICO, REFCORP, Farmer Mac, and the Farm Credit Banks (but not the FCS Banks for Cooperatives) are exempt from federal income taxes,[42] and federal law exempts investors in securities of Sallie Mae, Farmer Mac, FCS, FHLBs, FICO, and REFCORP from state and local taxes on their interest income.[43] These benefits increase the ability of a GSE to operate without many of the constraints and costs facing their private competitors.[44]

31. State of Risk, *supra* note 1, at 14.
32. Congressional Budget Office, Controlling the Risks of Goverment-Sponsored Enterprises 12 (1991) [hereinafter CBO Report].
33. *Id.*
34. *Id.*
35. *Id.*
36. State of Risk, *supra* note 1, at 36.
37. *Id.* at 79-81.
38. *Id.*
39. *Id.* at 77; 1990 Treasury Report, *supra* note 13, at 4.
40. State of Risk, *supra* note 1, at 77.
41. 1990 Treasury Report, *supra* note 13, at 4.
42. *Id.* at 4; State of Risk, *supra* note 1, at 77.
43. State of Risk, *supra* note 1, at 77.
44. *Id.* at 75.

TABLE 1
GOVERNMENT-SPONSORED ENTERPRISE SECURITIES OUTSTANDING AT THE END OF THE YEAR
(In billions of dollars)

	1970	1975	1980	1985	1986	1987	1988	1989	1990
Farm Credit System									
Banks for Cooperatives	1.9	3.8	8.6	9.4	8.6	9.9	11.9	12.6	13.3
Farm Credit Banks[1]	11.4	24.3	51.8	60.6	54.3	45.6	41.1	42.4	41.9
Federal Home Loan Bank System	10.5	16.4	37.3	75.6	89.6	116.4	136.5	136.8	117.9
Freddie Mac									
Debt	*	5.6	4.7	11.8	13.4	17.5	24.8	24.1	28.4
Mortgage-backed Securities	*	1.6	17.0	100.5	169.2	212.6	226.4	272.9	316.4
Fannie Mae									
Debt	15.2	30.0	54.9	94.0	93.6	97.1	105.5	116.1	123.4
Mortgage-backed Securities	*	*	*	55.0	97.2	140.0	178.3	228.2	299.8
Sallie Mae	*	0.3	2.7	13.4	17.1	21.4	27.0	33.6	39.0
Total	38.9	82.0	176.9	420.3	542.9	660.5	751.4	866.7	980.1

SOURCE: CONGRESSIONAL BUDGET OFFICE, CONTROLLING THE RISK OF GOVERNMENT-SPONSORED ENTERPRISES (Apr. 1991) Table 3, p. 12.

1. Before 1987, composed of the Federal Intermediate Credit Banks and the Federal Land Banks.
* Not yet operating.

With the exception of a congressional or administrative limit, there are few constraints on enterprises to prevent them from issuing ever increasing amounts of debt and other securities.[45] On the lending side, enterprises seem limited only by the size of their statutorily permitted markets and by competition from other institutions with governmental support.[46] By FY 90, outstanding enterprise securities amounted to $855 billion,[47] compared to $726 billion in federally backed deposits in savings and loan institutions.[48] Table 1 shows how several of the enterprises—Fannie Mae, Freddie Mac, and Sallie Mae—have more than doubled in size in five years.[49] The rate of enterprise growth is likely to present a serious policy issue for Congress.

3. *The Implicit Federal Guarantee of Enterprise Obligations*

As perhaps their most valuable competitive advantage, enterprises benefit from implicit Federal Government backing for their corporate guarantees and obligations.[50] This federal credit support permits enterprises to obtain virtually unlimited funds at very low cost, close to the rates at which the Treasury itself borrows money.[51] The Federal Government provides this credit support through an ingenious device. Even though enterprises are privately owned and managed, federal law accords their obligations the financial attributes of Treasury obligations;[52] similarly, the law provides their guaranteed securities the attributes of federally guaranteed securities.[53]

Like Treasury obligations, enterprise obligations, with some variations, have the following characteristics:

a. For most enterprises, they may be issued only upon approval of the Secretary of the Treasury, who also approves terms such as interest rates and maturities;[54]
b. They are exempt from regulation by the Securities and Ex-

45. *Id.* at 36.
46. *Id.*
47. UNITED STATES OFFICE OF MANAGEMENT AND BUDGET, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1992, PART TWO 204 (1991).
48. *Id.*
49. CBO REPORT, *supra* note 32, at 12.
50. STATE OF RISK, *supra* note 1, at 76.
51. *Id.* at 45.
52. *Id.* at 41-43; Hunter, *The Federal National Mortgage Association: Its Response to Critical Financing Requirements of Housing*, 39 GEO. WASH. L. REV. 818, 828-30 (1971).
53. STATE OF RISK, *supra* note 1, at 41-43.
54. 1990 TREASURY REPORT, *supra* note 13, at 4; STATE OF RISK, *supra* note 1, at 41-43.

change Commission (SEC) except to the extent that United States government securities are regulated;[55]

c. They are lawful investments for federally supervised institutions, including banks, thrift institutions, and credit unions, and have favorable government-type status in the portfolios of these institutions;[56]

d. They are lawful investments for federal fiduciary, trust, and public funds;[57]

e. They are issuable and payable through the facilities of the Federal Reserve Banks;[58]

f. They are eligible collateral for Federal Reserve advances and discounts and are eligible to be bought and sold in Federal Reserve open market operations;[59] and

g. For most enterprises, they are exempt from state and local taxation.[60]

The single biggest difference between enterprise securities and Treasury obligations is the nature of the issuer; enterprises are privately owned and are not part of the Federal Government.[61] The enterprises have additional characteristics that strengthen the perception of governmental backing:

a. They are federally chartered instrumentalities of the United States;[62]

b. They usually have an explicit line of credit with the Treasury;[63] and

c. They are controlled by boards that—for most enterprises—include some governmentally-appointed directors.[64]

Taken together, these attributes amount to an implicit federal guar-

55. STATE OF RISK, *supra* note 1, at 41-43. At the May 13, 1991, meeting of the Council of the Administrative Conference of the United States, Securities and Exchange Commission (SEC) Chairman, Richard Breeden, proposed eliminating the SEC exemption for enterprise securities, arguing that this would enhance market information. No action has been taken on this recommendation.

56. *Id.*

57. *Id.*

58. *Id.*

59. 1990 TREASURY REPORT, *supra* note 13, at 4; STATE OF RISK, *supra* note 1, at 41-43.

60. STATE OF RISK, *supra* note 1, at 41-43.

61. *Id.*

62. *Id.*

63. *Id.*

64. 1990 TREASURY REPORT, *supra* note 13, at 4; STATE OF RISK, *supra* note 1, at 41-43.

antee that enterprises will not be allowed to default on their obligations. The Federal Government makes a strong statement to investors by conferring on enterprise securities the same preferred investment status as Treasury obligations. The exemption from the usual SEC registration laws removes investor protections considered necessary for all but the usual corporate securities.[65] The exemption from investment restrictions on banks and thrift institutions is otherwise limited to federally backed securities.[66] Investors perceive that the Federal Government would not permit these exemptions from basic investor protection unless enterprise securities were extremely safe.[67]

This means that investors look primarily to the implicit federal backing as a guarantee of an enterprise's creditworthiness, rather than looking at its balance sheet. Thus, while borrowing costs did rise somewhat for FCS,[68] even after the enterprise recorded $4.6 billion of losses in 1985 and 1986,[69] FCS obligations remained eligible investments for "AAA"-rated debt.[70]

Over time, the market becomes even more confident of the likelihood of the government backing GSE obligations.[71] As the value of outstanding enterprise obligations increases, so does the inability of the Federal Government to intimate that it would not stand behind this debt.[72]

When the Continental Illinois National Bank failed in 1984,[73] for example, the Federal Government not only stood behind FDIC-insured deposits,[74] but also protected uninsured bank creditors,[75] and even creditors of the parent holding company.[76] The Comptroller of the Currency told Congress of fears of a domestic and possibly international

65. STATE OF RISK, *supra* note 1, at 44.
66. *Id.*
67. *Id.*
68. UNITED STATES OFFICE OF MANAGEMENT AND BUDGET, SPECIAL ANALYSIS OF THE BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 1987, SPECIAL ANALYSIS F, FEDERAL CREDIT PROGRAMS F27-28 (1986) [hereinafter SPECIAL ANALYSIS F].
69. *Id.*
70. STANDARD & POOR'S CORPORATION, *Farm Credit System's 'AAA' Eligibility Monitored*, STANDARD & POOR'S CREDIT WEEK 13 (July 20, 1987) [hereinafter *Farm Credit Eligibility*].
71. STATE OF RISK, *supra* note 1, at 26.
72. *Id.*
73. I. SPRAGUE, BAILOUT: AN INSIDER'S ACCOUNT OF BAILOUTS AND RESCUES 152 (1986).
74. *Id.* at 155.
75. *Id.* at 209-10.
76. *Id.*

financial crisis if all Continental Illinois creditors were not protected.[77] The Comptroller of the Currency concluded that because of their size alone, the Federal Government could not permit the failure of any of the nation's largest money center banks,[78] many of which are significantly smaller than GSEs.[79] Continental Illinois was the nation's seventh largest banking organization.[80] It was a $41 billion institution,[81] and was about one-tenth of the size of Fannie Mae today.[82]

In summary, then, the federal backing of enterprise obligations may be implicit, but it is very real. As in the case of FCS, taxpayers literally have billions of dollars at stake if an enterprise fails to meet its obligations.

C. *Overview of the Enterprises and Their Development*

Enterprises have a long tradition as instruments of federal policy. The earliest enterprises were started with capital contributions from the Federal Government that were later repaid or forgiven when the government sold or gave all of its stock to private shareholders.[83] The following discussion provides an overview of the origins and development of the eight enterprises.

1. *The Farm Credit System*

The oldest enterprise is the Farm Credit System (FCS), which had its origins in 1916.[84] At that time, the Federal Government established the Federal Land Banks and affiliated cooperative associations to encourage the flow of credit for farm mortgage loans.[85] FCS was ex-

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77. *Inquiry into Continental Illinois Corp. and Continental Illinois National Bank: Hearings Before House Subcomm. on Financial Institutions Supervision, Regulation and Insurance, House Comm. on Banking, Finance and Urban Affairs*, 98th Cong., 2d Sess. 287-88, 299-300 (1984) [hereinafter *Continental Hearings*].

78. *Id.*

79. *Compare* 1 STANDARD & POOR'S CORPORATION, STANDARD & POOR'S BANK BOOK CD RATINGS (1989) (providing data on size of money center banks) *with* 1990 TREASURY REPORT, *supra* note 13 (providing data on enterprise size).

80. JACKSON, PUBLIC RESCUE OF PRIVATE LIABILITIES: THE CONTINENTAL ILLINOIS CASE 5 (1985).

81. *Id. See generally* STAFF OF SUBCOMM. ON FINANCIAL INSTITUTIONS, SUPERVISION, REGULATION AND INSURANCE OF THE HOUSE COMM. ON BANKING, FINANCE AND URBAN AFFAIRS, 98TH CONG., 2D SESS., CONTINENTAL ILLINOIS BANK: REPORT OF AN INQUIRY INTO ITS FEDERAL SUPERVISION AND ASSISTANCE 24 (Comm. Print 1984) [hereinafter CONTINENTAL REPORT].

82. CBO REPORT, *supra* note 32, at 12.

83. Hunter, *supra* note 52, at 829.

84. Federal Farm Loan Act, ch. 245, 39 Stat. 361 (1916) (codified in 12 U.S.C. §§ 657-659 (repealed)).

85. *Id.*

panded in 1923 with the creation of the Federal Intermediate Credit Banks (FICBs) and Production Credit Associations to make farm operating loans,[86] and in 1933 with the Banks for Cooperatives, to lend to agricultural producer cooperatives.[87] FCS banks, either directly or through their affiliated associations, make loans and provide a variety of other financial services to their borrowers.[88] The associations have assumed an increasing role in FCS under recent provisions of the law.[89] From the beginning, FCS institutions—banks and associations—have been structured as cooperatives owned and controlled by their borrowers.[90]

2. *The Federal Home Loan Bank System*

The second oldest enterprise, the Federal Home Loan Bank System (FHLBS) was established in 1932 to provide funds to the thrift industry,[91] which had been heavily damaged in the Great Depression.[92] The Federal Home Loan Banks (FHLBs) were authorized to make cash advances,[93] that is loans secured by collateral provided by the borrower, to thrift institutions. FHLBS is owned and controlled by thrift institutions, and a few other specialized housing lenders, under legislation requiring all thrifts to purchase minimum amounts of stock in FHLB serving their geographic district.[94]

Due to the Depression, thrifts found themselves faced with large-scale withdrawals of deposits.[95] At the same time, deflation in real estate made it impossible to sell their portfolios of mortgages that those deposits had funded.[96] FHLBS' cash advance system permitted thrifts to use their mortgages as collateral and to borrow funds from FHLBs.[97]

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86. Amendments to Federal Farm Loan Act, ch. 252, 42 Stat. 1473 (1923).
87. Amendments to Federal Farm Loan Act, ch. 9, 47 Stat. 14 (1932); Exec. Order No. 6,084 (1933) (codified in 12 U.S.C. §§ 665, 781 (repealed)).
88. *See supra* note 3 (explaining composition of FCS).
89. *See generally* Farm Credit Amendments Act of 1987, Pub. L. No. 100-233, 101 Stat. 1568 (1988).
90. G. HOAG, THE FARM CREDIT SYSTEM: A HISTORY OF FINANCIAL SELF-HELP (1976).
91. Federal Home Loan Bank Act, ch. 522, 47 Stat. 725 (1932).
92. FEDERAL HOME LOAN BANK BOARD, A GUIDE TO THE FEDERAL HOME LOAN BANK SYSTEM 8 (1987) [hereinafter FHLBS GUIDE].
93. 12 U.S.C. § 1430 (1988 & Supp. I 1989).
94. *Id.* §§ 1424-1426.
95. FHLBS GUIDE, *supra* note 92, at 8.
96. R. BRUMBAUGH, JR., THRIFTS UNDER SIEGE: RESTORING ORDER TO AMERICAN BANKING 8-12 (1988).
97. *Id.*

Over time, FHLBS' advances became an inexpensive source of funds for many thrifts.[98] From 1966 until the mid-1980's, federal law limited the interest rates thrifts paid on their deposits.[99] FHLBS' advances were especially valuable to substitute for lost deposits whenever market rates or interest rates rose above the regulatory ceiling and depositors closed their accounts to invest elsewhere, such as in higher yielding money market accounts.[100] Today, FHLBS' advances provide a valuable source of funds for thrift institutions and a few commercial banks and credit unions engaged in residential mortgage lending.[101] Large thrifts tend to use FHLBS' advances much more than smaller thrifts;[102] altogether, roughly half of the institutions that are members of FHLBS also receive advances.[103] FHLBS member institutions may borrow routinely from FHLBS[104] and advances can have maturities up to twenty years.

3. *Fannie Mae*

In 1934, the Roosevelt Administration proposed the creation of national mortgage associations to provide a secondary market for residential mortgages.[105] Under the original legislation,[106] any incorporator willing to commit the necessary capital and to accept the benefits and limitations of the federal legislation was authorized to obtain a federal charter for a national mortgage association.[107] Largely because of opposition from the thrift industry,[108] the benefits of a national mortgage association charter were quite limited.[109] This compounded the general

98. 1990 TREASURY REPORT, *supra* note 13, at C16.

99. Regulation Q of the Federal Reserve Board, "Interest on Deposits," 12 C.F.R. § 217 (1991).

100. P. HENDERSHOTT & K. VILLANI, REGULATION AND REFORM OF THE HOUSING FINANCE SYSTEM (American Enterprise Institute for Public Policy Research 1977).

101. 1990 TREASURY REPORT, *supra* note 13, at C13-14.

102. T. STANTON, GOVERNMENT SPONSORED ENTERPRISES: THEIR BENEFITS AND COSTS AS INSTRUMENTS OF FEDERAL POLICY 12-13, n.45 (Association of Reserve City Bankers 1988) [hereinafter BENEFITS AND COSTS].

103. 1990 TREASURY REPORT, *supra* note 13, at C12.

104. 12 U.S.C. § 1430 (1988 & Supp. I 1989).

105. National Housing Act, ch. 847, 48 Stat. 1246 (1934).

106. *Id.* at 1252.

107. *Id.* at 1246.

108. *See Hearing on National Housing Act Before the Senate Comm. on Banking and Currency*, 73d Cong. 2d Sess., National Housing Act 94 (1934) (statement of Maco Stewart).

109. For example, the final legislation increased capital leverage ratios and removed tax exemptions that had been contained in the original bill. SEMER, EVOLUTIONS OF FEDERAL LEGISLATIVE POLICY IN HOUSING; HOUSING CREDITS, HUD: HOUSING IN THE SEVENTIES WORKING PAPERS I 29 (1976).

economic hesitancy prevalent after 1929, and no private incorporators ever sought a charter.[110]

Instead, in 1938, the Reconstruction Finance Corporation, an arm of the Federal Government, chartered the National Mortgage Association of Washington,[111] quickly renamed the Federal National Mortgage Association or FNMA, as a mortgage lending subsidiary.[112] Fannie Mae was later transferred to the predecessor agency of the Department of Housing and Urban Development (HUD),[113] and in 1968 was divided into a government agency, the Government National Mortgage Association (Ginnie Mae),[114] and a privately owned Fannie Mae.[115] Fannie Mae has an eighteen-member Board of Directors;[116] thirteen elected by their shareholders and five appointed by the President of the United States.[117]

For decades Fannie Mae has served housing finance by purchasing and holding residential mortgages in portfolio.[118] The Emergency Home Finance Act of 1970[119] permitted Fannie Mae to deal in conventional mortgages,[120] such as those with private mortgage insurance, and not just in mortgages insured by the Federal Housing Administration (FHA)[121] or guaranteed by the Veterans' Administration (VA).[122] In 1981, after rising interest rates caused substantial losses from its portfolio lending business,[123] Fannie Mae followed the example of Ginnie Mae and Freddie Mac and began guaranteeing mortgage-backed securities as a means of funding home mortgages.[124]

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110. JONES, FIFTY BILLION DOLLARS: MY THIRTEEN YEARS WITH THE RFC (1932-1945) 148-49 (1951).

111. National Housing Act Amendments of 1938, ch. 13, 52 Stat. 24.

112. Bartke, *Fannie Mae and the Secondary Mortgage Market*, 66 NW. U.L. REV. 17, 18 (1971).

113. Department of Housing and Urban Development Act, Pub. L. No. 89-174, 79 Stat. 670 (1965).

114. Housing and Urban Development Act of 1968, Pub. L. No. 90-448, 82 Stat. 536.

115. *Id.*

116. 12 U.S.C. § 1723(b) (1988).

117. All shareholder-elected and publicly appointed directors of enterprises have a fiduciary duty to enterprise shareholders and the corporation. BENEFITS AND COSTS, *supra* note 102, at 26-27.

118. 1990 TREASURY REPORT, *supra* note 13, at A1-6.

119. Pub. L. No. 91-609, 84 Stat. 1770 (1970).

120. 12 U.S.C. § 1717(b)(2) (Supp. I 1989).

121. *Id.* § 1717(b)(1).

122. *Id.*

123. UNITED STATES DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, 1987 REPORT TO CONGRESS ON THE FEDERAL NATIONAL MORTGAGE ASSOCIATION 100 (1989) [hereinafter 1987 HUD REPORT].

124. 12 U.S.C. § 1719(d) (Supp. I 1989).

4. Freddie Mac

In 1970, the thrift industry persuaded Congress to create the Federal Home Loan Mortgage Corporation[125] (Freddie Mac) as a second enterprise to support home mortgages in the secondary market. For many years, only FHLBs and then thrift institutions, were permitted to own Freddie Mac stock.[126] The law was revised in 1988 to permit sale of Freddie Mac stock to the general public as well.[127] Another recent change concerns Freddie Mac's corporate structure. From 1970 until recently, Freddie Mac's Board of Directors consisted of the three federal officials that also constituted the Federal Home Loan Bank Board (FHLBB).[128] In the 1989 legislation abolishing FHLBB,[129] Freddie Mac obtained a shareholder-controlled Board of Directors patterned after Fannie Mae.[130]

From its inception, Freddie Mac chose a strategy of funding home mortgages by guaranteeing mortgage-backed securities.[131] Today its mortgage portfolio is a small part of its total lending activities.[132] It remains to be seen whether the change in Freddie Mac's Board of Directors, and the 1988 change from thrift-shareholders to general investor-shareholders, will affect this lending strategy. In contrast to its earlier years, Freddie Mac will now face shareholder pressure to maximize short-term returns,[133] and possibly to increase its risk-taking and income from increased portfolio lending.[134] Today, Fannie Mae and Freddie Mac operate under similar charter legislation and provide secondary market service to the same kinds of residential lenders, including thrift institutions, mortgage bankers, and commercial banks.[135]

5. Sallie Mae

Congress created the Student Loan Marketing Association (Sallie Mae) in 1972[136] to enhance financial support for federally guaranteed student loans.[137] At the time, guaranteed student loans seemed small,

125. Pub. L. No. 91-351, 84 Stat. 451 (1970).
126. 12 U.S.C. § 1453 (Supp. I 1989).
127. Pub. L. No. 100-628, 102 Stat. 3726 (1988).
128. 12 U.S.C. § 1452(a) (Supp. I 1989).
129. *Id.*
130. *Id.*
131. *Id.* § 1455.
132. 1990 TREASURY REPORT, *supra* note 13, at B7-8.
133. STATE OF RISK, *supra* note 1, at 22-23.
134. *Id.*
135. 1990 TREASURY REPORT, *supra* note 13, at A4-5.
136. Pub. L. No. 92-318, 86 Stat. 261-264 (1972).
137. 20 U.S.C. § 1078 (Supp. I 1989).

expensive to service, and generally unattractive for commercial banks and other private lenders.[138] Sallie Mae was authorized to purchase student loans and to make advances, that is, loans secured by student loans, to lenders.[139] Over time, Sallie Mae expanded its activities to include funding student loans that are not federally guaranteed and home equity loans that homeowners may use to pay for their childrens' education.[140] Sallie Mae is controlled by a Board of Directors consisting of seven members elected by financial institutions, seven by educational institutions, and seven appointed by the President of the United States.[141] Sallie Mae has developed economies of scale, including sophisticated loan origination and servicing software for primary lenders.[142] The government has now expanded the kinds and amounts of student loans[143] and has increased the subsidies paid to lenders in the guaranteed student loan program.[144] These changes, and Sallie Mae's conspicuous success, have shown lenders that student loans can be a very profitable business, in contrast to their earlier reputation in the lending community.

6. *Farmer Mac*

The Federal Agricultural Mortgage Corporation (Farmer Mac) was established in 1988[145] to provide a secondary market for agricultural loans, essentially serving much of the same market as FCS.[146] Farmer Mac guarantees mortgage-backed securities (MBS) issued by private lenders,[147] including farm credit institutions, as well as those securities which are based on pools of agricultural mortgages with characteristics specified in the law.[148] The FCS institutions, commercial banks, insurance companies, and other rural lenders originate and service the loans in the MBS pools.[149]

In 1990, Farmer Mac obtained an expansion of its charter author-

138. 1990 Treasury Report, *supra* note 13, at F1-2.
139. 20 U.S.C. §§ 1082-1087 (Supp. I 1989).
140. *Id.*
141. *Id.* §§ 1082-1087(c)(3).
142. 1990 Treasury Report, *supra* note 13, at F32-33.
143. *Id.* at F1-3.
144. *Id.* at F1-2.
145. Pub. L. No. 100-233, 101 Stat. 1686 (1988).
146. 12 U.S.C. § 2279aa (1988).
147. General Accounting Office, Federal Agricultural Mortgage Corporation: Secondary Market Development and Risk Implications (1990) [hereinafter 1990 GAO Farmer Mac Report].
148. *Id.*
149. *Id.*

ity[150] authorizing it to act as a pooler of loans guaranteed by the Farmers Home Administration, to issue debt to fund a portfolio, and to secure such loans.[151]

Farmer Mac stock is owned by commercial rural lenders and FCS institutions.[152] The Farmer Mac Board consists of fifteen members, five elected by FCS shareholders, five by commercial lender-shareholders, and five appointed by the President of the United States.[153] Control by shareholders that are customers of Farmer Mac means that Farmer Mac will be oriented to the needs of its lender-users rather than to investors seeking to maximize Farmer Mac's profits.

7. *FICO and REFCORP*

Unlike the enterprises described thus far, the Financing Corporation (FICO)[154] and Resolution Funding Corporation (REFCORP),[155] are bail-out corporations for the federal funds insuring thrift institution deposits.[156] Unlike traditional enterprises that exist to extend commercial loans and expect to be repaid, these two institutions[157] were intended to fail commercially. FICO and REFCORP are limited to purchasing FSLIC and RTC securities that are expected to have no market value.[158] It would be cheaper if the Treasury simply borrowed funds with an explicit federal guarantee and saved perhaps half of a percentage point in interest compared to the cost of the enterprise obligations.[159]

The Office of Management and Budget (OMB), over the objections of CBO,[160] has described the funding corporations as "privately

150. 12 U.S.C. § 2279aa(3)(B) (1988).

151. The statutory change permits Farmer Mac or an affiliate to act as a loan pooler, certified under 12 U.S.C. § 2279aa-5 of the Farmer Mac Charter Act, but only for Farmers' Home Administration loans.

152. 12 U.S.C. § 2279aa-2 (1988).

153. *Id.*

154. 12 U.S.C. § 1441 (Supp. I 1989).

155. *Id.* § 1441b.

156. Stanton, *Government Sponsored Enterprises*, 9 PUB. BUDGETING & FIN. 76, 81-86 (1989).

157. In addition to the Financing Corporation (FICO) and the Resolution Funding Corporation (REFCORP), the FCS Financial Assistance Corporation was created in 1988 to perform a similar function for the bail-out of FCS institutions. 12 U.S.C. § 2278b (Supp. I 1989). However, its obligations are expressly guaranteed by the Federal Government and it is therefore not a government-sponsored enterprise. *Id.* § 2278b-6.

158. 12 U.S.C. § 1441b (Supp. I 1989).

159. STATE OF RISK, *supra* note 1, at 146, 199.

160. R. REISCHAUER, CONGRESSIONAL BUDGET OFFICE, COST ESTIMATE, H.R. REP. NO. 54, 101ST CONG., 1ST SESS., PT. 7, at 4-5 (1989) [HEREINAFTER CBO COST ESTIMATES].

owned,"[161] so that they do not increase the reported federal deficit in the short term.[162] However, these corporations will add to the deficit over the next thirty years when the debtholders make good on the federal guarantee and turn to the Federal Government for payment of interest that the two corporations cannot pay by themselves.[163] These institutions were created simply to defer the impact on the federal budget of paying to recapitalize failed financial institutions in a more straightforward manner.

When pushed to this extreme, enterprises lose their original public purpose and become simply an instrument to pass today's financial burdens on to future generations. Because the two enterprises are subject to virtually complete governmental control in the conduct of their operations, and because an analysis of these two enterprises by CBO and GAO indicates that they are governmental rather than privately-owned entities,[164] FICO and REFCORP will be excluded from the present discussion.[165]

D. *Enterprises Compared to Banks and Thrift Institutions*

Enterprises have many institutional and legal characteristics in common with other federally backed financial institutions such as commercial banks and thrift institutions. Like commercial banks and thrifts with federal deposit insurance, enterprises are federal instrumentalities rather than federal agencies;[166] they are privately owned and serve public purposes that are specified by federal law. National banks, federally chartered thrifts, and enterprises all operate under federal charters that preempt a variety of state laws and some taxes; all three types of financial institutions use federal credit support in the form of insurance or a

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161. *Id.*

162. *Id.*

163. STATE OF RISK, *supra* note 1, at 146-48.

164. T. STANTON, BUDGETARY CONSEQUENCES OF USING A GOVERNMENT SPONSORED ENTERPRISE TO PROVIDE FINANCIAL ASSISTANCE TO THE FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION, *reprinted in* THE THRIFT INSTITUTION CRISIS AND ITS POTENTIAL IMPACT ON THE FEDERAL BUDGET, House Comm. on the Budget, 101st Cong., 1st Sess. (1989); CBO COST ESTIMATE, *supra* note 160, at 4-5; *Federal Credit Reform and Borrowing by Off-Budget Agencies: Hearings Before the House Ways and Means Comm.*, 101st Cong., 1st Sess. (1989) (statement of Charles A. Bowsher, Comptroller General of the United States).

165. REFCORP and FICO are also properly excluded from this Article because they present quite different safety and soundness concerns from the other enterprises because of government rather than private control over their decisions. Unlike the other enterprises that have virtually open-ended access to federal credit and thereby raise issues of moral hazard, the dollar limits of REFCORP and FICO have been capped in their enabling legislation.

166. MOE & STANTON, *supra* note 1, at 323-24.

guarantee that helps to reduce their cost of funds.[167]

Table 2 compares characteristics of GSEs with those of commercial banks and thrifts with federally insured deposits. Like banks and thrifts, GSEs are subject to control through federal oversight rather than direct federal management.[168] They lack the close federal nexus that would subject the corporation to constitutional due process requirements.[169] Similarly, they are not subject to civil service and federal procurement requirements, the Administrative Procedure Act and the Freedom of Information Act (FOIA),[170] or federal budget accountability and controls.

As with banks and thrift institutions, GSEs raise two issues for the Federal Government: (1) the need to assure their safety and soundness despite operation of a federal guarantee that tends to undercut market discipline, and (2) the need to specify the proper scope of their permitted lending and other financial activities. This Article focuses largely on the first issue, although Section VI, below deals with some aspects of the second.

II. SUPERVISION OF SAFETY AND SOUNDNESS OF GOVERNMENT-SPONSORED ENTERPRISES: AN ANALYTIC FRAMEWORK

A. *The Risks Involved in Enterprise Lending*

Financial institutions are subject to a variety of risks. Some of these are associated with lending activities generally and others relate to the specialized kinds of lending by a particular enterprise. Different analysts may categorize risks somewhat differently,[171] and new forms of risk are recognized as markets change. Two kinds of risk involve more

167. *Id.* at 325.

168. *Id.* at 324.

169. *See* Roberts v. Cameron-Brown Co., 556 F.2d 356 (5th Cir. 1977); Northrip v. Federal Nat'l Mortgage Assoc., 527 F.2d 23 (6th Cir. 1975) (noting failure of nexus requirement for due process argument).

170. *See* Rocap v. Indiek, 539 F.2d 174 (D.C. Cir. 1976) (holding that Freddie Mac was subject to Freedom of Information Act (FOIA) because of direct federal control of its activities). The 1989 thrift legislation removed the direct federal control over Freddie Mac that had been critical to the court's finding that Freddie Mac was subject to FOIA. *See also* Federal Home Loan Mortgage Corporation, Notice of Withdrawal of Prior Notice Regarding Providing Information Concerning Organization, Rules and Access to Records, 55 Fed. Reg. 24,313 (1990) (stating that Freddie Mac is not subject to FOIA).

171. *Compare* UNITED STATES DEPARTMENT OF THE TREASURY, MODERNIZING THE FINANCIAL SYSTEM: RECOMMENDATIONS FOR SAFER, MORE COMPETITIVE BANKS (1991) [hereinafter 1991 TREASURY BANK REPORT] *with* STATE OF RISK, *supra* note 1, at 154-57.

TABLE 2

GOVERNMENT-SPONSORED ENTERPRISES COMPARED TO COMMERCIAL BANKS AND THRIFT INSTITUTIONS WITH FEDERALLY-INSURED DEPOSITS

CHARACTERISTICS	GSE	COMMERCIAL BANK	THRIFT
Nature of Federal Control	Oversight	Oversight	Oversight
Ownership	Private	Private	Private
Personnel	Private Sector	Private Sector	Private Sector
Federal Procurement Laws and Regulations	No	No	No
Administrative Procedure Act	No	No	No
Freedom of Information Act	No	No	No
Constitutional Due Process Requirements	No	No	No
Federal Budget	Off-Budget	Off-Budget	Off-Budget
Profit Orientation	Usually	Yes	Yes
Shareholder Control	Yes	Yes	Yes
Specialized Lender	Yes	No	Yes
Geographically Diversified	Some Enterprises	Some Banks	Usually Not

fundamental factors than the others: the institution's management and its market.

1. Management Risk

Management risk is the risk associated with the employment of managers who are not of sufficient quality to manage the institution well.[172] While managers of most enterprises today appear to be of high quality, unforeseen problems may arise because of increasing financial pressures or through changes in control. Management risk may be the single most important factor in the performance of a financial institution.[173]

2. Market Risk

Enterprises are specialized lenders, and this specialization may create vulnerability if the particular sector served suffers economic adversity. FCS, for example, was harmed by the decline in American agriculture in the early 1980's.[174] Fannie Mae and Freddie Mac might be affected if there were a general decline in housing prices and a consequent decline in credit quality of some mortgages.[175]

Because they are specialized lenders, one problem for enterprises is the way external factors can suddenly affect their entire portfolios. Lenders with diversified portfolios are not as vulnerable to these factors.[176] In addition to the types of risk that affect lenders generally, enterprises must deal with particular risks related to their specialized activities. Mortgage lenders, for example, face prepayment risk.[177] A significant decline in interest rates may cause prepayment of a substantial part of the higher-yielding loan assets held by a portfolio lender such as Fannie Mae. The uncertainty of mortgage prepayment rates may also create risk for issuers of special kinds of mortgage-backed

172. STATE OF RISK, *supra* note 1, at 154.

173. *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY, BANK FAILURE: AN EVALUATION OF THE FACTORS CONTRIBUTING TO THE FAILURE OF NATIONAL BANKS (1988) [hereinafter BANK FAILURE]; R. CLARKE, BANKING IN TROUBLED TIMES: WHAT HURTS? WHAT HELPS? (1988) (discussing management in financial institutions).

174. GENERAL ACCOUNTING OFFICE, FARM CREDIT SYSTEM: ACTIONS NEEDED ON MAJOR MANAGEMENT ISSUES (1987) [hereinafter 1987 FCS REPORT].

175. *See* N.G. MANKIW & D.N. WEIL, THE BABY BOOM, THE BABY BUST, AND THE HOUSING MARKET (1988) (predicting significant decline in real housing prices in future years).

176. For example, thrifts suffered much more than banks from the jump in interest rates after 1979.

177. STATE OF RISK, *supra* note 1, at 156.

securities such as some multi-class collateralized mortgage obligations.[178]

3. Credit Risk

Financial institutions are also susceptible to credit risk. Credit risk is the risk that a borrower will fail to make timely payments of principal and interest on a loan held or guaranteed by a GSE or other lender.[179] Credit risk applies both to loans held in enterprise portfolios and to those in pools of guaranteed mortgage-backed securities.[180] Because an enterprise guarantees timely payment of principal and/or interest to investors in its obligations and guaranteed mortgage-backed securities,[181] it must make all required payments and then seek recourse from the borrower, servicer, originator, or insurer of a delinquent loan.[182] If a borrower defaults on a loan, the enterprise must supervise the process of foreclosing on collateral or otherwise reducing its losses.[183]

4. Interest Rate Risk

Interest rate risk involves the risk of losses when interest rates change.[184] If an institution funds a portfolio of long-term loans with short-term borrowings, or vice-versa, the institution may experience either profit or loss when there are changes in the relationship between long- and short-term interest rates. This type of interest rate risk affects an enterprise's portfolio lending, but not its guarantee of mortgage-backed securities.[185]

A second kind of interest rate risk involves the effect on a lender's business when interest rates rise or decline significantly.[186] For example, a drop in interest rates may persuade borrowers to refinance their mortgage loans, thereby reducing the yield on mortgage portfolios. A significant increase in interest rates may reduce the volume of new business as borrowers are discouraged from taking out new loans.[187]

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178. *Id.*
179. *Id.* at 155.
180. 1990 TREASURY REPORT, *supra* note 13, at A24-42.
181. STATE OF RISK, *supra* note 1, at 46.
182. *Id.*
183. *Id.*
184. 1990 TREASURY REPORT, *supra* note 13, at B37.
185. STATE OF RISK, *supra* note 1, at 55-56.
186. *Id.* at 129-32.
187. *Id.*

5. *Operations Risk*

Operations risk includes the ability of a lender to manage its business effectively.[188] Enterprises are multi-billion dollar institutions that often grow by billions of dollars a year in net new business.[189] Sophisticated computer operations are required to assure that the lender manages the millions of transactions that may occur every month to process loan payments and distribute payments in turn to holders of guaranteed mortgage-backed securities and enterprise obligations. Another aspect of operations risk is that portfolios can sometimes contain assets of significantly different quality from what management information systems lead the institution's management to believe.[190] One of the principal problems affecting Continental Illinois National Bank was this aspect of operations risk.[191]

For Sallie Mae and other guaranteed student loan lenders, servicing risk is an important part of operations risk.[192] The increasing number of defaults on guaranteed student loans[193] has led the United States Department of Education to withdraw its guarantee when the student loan holder has failed to exercise due diligence in dealing with delinquent loans and attempted to prevent defaults.[194] As a result, student loan holders must actively oversee the servicing of their portfolios to an even greater extent than those who deal in other kinds of loans.

B. *The Implicit Federal Guarantee and its Effects on Enterprise Risk-taking*

1. *Causes of Excessive Risk-taking*

While managers may in fact be prudent, it must be recognized that an incentive to take excessive risk is inherent in the implicit Federal Government backing that permits GSEs to issue and guarantee billions of dollars of securities.[195] Because the Federal Government guarantee

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188. Kutler, *Operations Risks Termed Critical by Wachovia Chief*, AM. BANKER 38 (May 24, 1988).

189. CBO REPORT, *supra* note 32, at 40.

190. CONTINENTAL REPORT, *supra* note 81, at 73.

191. *Id.;* MCCOLLOM, THE CONTINENTAL AFFAIR: THE RISE AND FALL OF THE CONTINENTAL ILLINOIS BANK 262-63 (1987).

192. 1990 TREASURY REPORT, *supra* note 13, at F22.

193. GENERAL ACCOUNTING OFFICE, STUDENT LOANS: CHARACTERISTICS OF DEFAULTED BORROWERS IN THE STAFFORD STUDENT LOAN PROGRAM (1991).

194. Gerhardstein, *Some Lenders Stop Issuing Student Loans*, AM. BANKER 2 (Aug. 6, 1990).

195. *See infra* notes 207-37 and accompanying text (giving instances of imprudent practices abetted by Federal Government's backing).

removes much of the usual market discipline, effective government regulation of safety and soundness is essential to help constrain enterprise risk-taking and assure the institution's long-term viability.[196] The presence of the government guarantee allows investors to disregard the creditworthiness of an enterprise or the low quality of the loans it may make. Instead, investors look largely to the implicit government promise which backs their assurance.[197]

Managers of a typical non-government, commercial corporation that does not enjoy federal backing are highly sensitive to investors' perceptions of the company's creditworthiness. Such sensitivity provides an important marketplace constraint on risk-taking for a variety of reasons. First, shareholders have a long-term interest in protecting and enhancing their capital investment in the company. For an enterprise, however, the financial stake of investors tends to be very low compared to the volume of enterprise activities. In 1990, for example, both Fannie Mae and Freddie Mac maintained shareholder equity amounting to less than one percent of their assets and mortgage-backed securities outstanding.[198]

Second, shareholders of a GSE may increase their returns by increasing risks and leveraging these benefits by greatly increasing the ratio of outstanding debt to shareholder equity.[199] The Federal Government receives no compensation for bearing increased risks for enterprise activities, but potentially has unlimited liability if an enterprise fails.[200]

Third, it should be emphasized that enterprise management may in fact develop prudent business policies. However, the implicit federal guarantee provides considerable incentive to seek extra returns by taking excessive risks.[201] Heads, the corporation and its shareholders win; tails, the United States taxpayer is called upon to pay for any big mistakes. There is ample room within enterprise charter acts for managers to take risks if they are so inclined.[202]

Fourth, market discipline is derived normally from investors other

196. *See supra* note 2 (discussing problems caused by Federal Government's backing).

197. STATE OF RISK, *supra* note 1, at 164-66 (citing Standard & Poor's ratings with and without implicit guarantee).

198. 1991 TREASURY REPORT, *supra* note 25, at A35, A45.

199. STATE OF RISK, *supra* note 1, at 169-71.

200. BENEFITS AND COSTS, *supra* note 102, at vi.

201. *See supra* note 2 (explaining financial institution risk-taking).

202. Besides the traditional kinds of credit and interest rate risk on loan portfolios, enterprises authorized to issue mortgage-backed securities can segment these securities into higher- and lower-risk parts. *See* Vartan, *A Double Whammy of Volatility*, N.Y. Times, May 11, 1987, at D10.

than shareholders. Without the Federal Government's backing, a corporation is subject to considerable restraint when it issues debt obligations or guarantees securities. For the typical non-government, commercial company, debtholders and purchasers of guaranteed securities will limit the company's risk by demanding increasing returns for themselves if shareholders increase risk and attempt to increase leverage. Before investors rely upon the corporation's obligation or guarantee, they require assurances about the company's financial backing. Before purchasing unsecured debt obligations of a private corporation, investors require assurances about the corporation's balance sheet, including credit quality of assets it holds, the corporation's debt-to-equity ratio, and the corporation's general creditworthiness. Similarly, before purchasing loan-backed securities issued or guaranteed by a private corporation, investors require assurances about the credit quality of the underlying loans, the credit quality of the loan pools, and the particular safeguards to assure that, in case of default, investors have sole recourse to the mortgage assets.

However, investors in enterprise securities are unlikely to provide such market discipline because the enterprise relies on the Federal Government's backing to sell its obligations and guarantees.[203] Investors in enterprise securities are spared the need to examine the creditworthiness of the corporation, its assets, or asset pools, or the quality of the corporation's management.[204] Instead, they can be expected to rely largely upon the implicit federal backing upon which the obligations and guarantees will be based.[205] Reliance upon the Federal Government, rather than upon an enterprise's creditworthiness and asset quality, can induce greater risk-taking by an enterprise than by a private company in a similar line of business. The federal guarantee assures that an enterprise has an extensive market for its debt obligations even if it may be undercapitalized or if it may inadequately police the assets which it buys or guarantees.[206]

2. *Excessive Risk-taking by Some Enterprises*

a. Farm Credit System

These concerns are not merely hypothetical. FCS banks adopted an

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203. *See supra* notes 52-82 and accompanying text (noting government's backing of enterprise obligations and securities).
204. STATE OF RISK, *supra* note 1, at 41-43.
205. *"AAA Investments" Implied U.S. Support*, STANDARD & POOR'S CREDIT WEEK 19-20 (Nov. 28, 1988) [hereinafter *"AAA Investments"*].
206. *Farm Credit Eligibility*, *supra* note 70, at 13.

average-cost pricing policy for loans[207] that permitted FCS institutions to use long-term debt to fund variable rate loans on the basis of FCS average debt funding costs.[208] As interest rates rose during the 1970's,[209] new debt tended to be priced somewhat higher than the average price of outstanding debt.[210] By pricing loans based on average costs rather than new debt costs,[211] FCS institutions could offer borrowers lower priced loans than were available from competing lenders.[212] By 1981, FCS banks were pricing their real estate loans almost five percentage points below the rates of their commercial competitors.[213]

This policy provided immediate rewards to FCS managers and their borrower/shareholders. Managers were rewarded by increasing market share and were able to construct lavish new office buildings, hire staff, and generally expand the organization.[214] FCS shareholders, unlike shareholders in corporate institutions, received their benefits largely in the form of lower loan rates, rather than from stock dividends,[215] thus giving them an incentive to take out a greater than optimal volume of loans from FCS banks.[216]

As the agricultural economy went into depression,[217] loan delinquencies and defaults rose significantly.[218] As interest rates declined,[219] average cost pricing became impossible to sustain.[220] The high volume of outstanding long-term debt issued by FCS at times of high interest rates[221] soon reflected itself in higher rates for borrowers, which drove

207. GENERAL ACCOUNTING OFFICE, FARM CREDIT SYSTEM: ANALYSIS OF FINANCIAL CONDITION 3 (1986) [hereinafter 1986 FCS REPORT].

208. FCS banks priced their loans on the basis of the average cost of their outstanding debt. In a period of generally rising interest rates, such as during much of the 1970's, average-cost pricing provided borrowers with low price loans while permitting the banks to record a profit. Commercial competitors, by contrast, usually price their loans based on the current cost of funds, which tends to be higher than average-cost pricing while interest rates are rising. The result was a significant increase in FCS market share over the 1970's as farm borrowers flocked to FCS banks in preference to commercial banks.

209. 1986 FCS REPORT, *supra* note 207, at 3, 30.

210. *Id.*

211. *Id.*

212. *Id.* at 13, 15; *The Farm Credit Fix*, NAT'L. J. 1512-17 (June 13, 1987).

213. 1986 FCS REPORT, *supra* note 207, at 13, 15.

214. STATE OF RISK, *supra* note 1, at 160.

215. 1986 FCS REPORT, *supra* note 207, at 3, 30.

216. STATE OF RISK, *supra* note 1, at 160.

217. 1987 FCS REPORT, *supra* note 174.

218. 1986 FCS REPORT, *supra* note 207, at 23.

219. *Id.* at 13-17.

220. *The Farm Credit Fix*, *supra* note 212, at 1515.

221. 1986 FCS REPORT, *supra* note 207, at 18.

creditworthy borrowers to refinance their loans and take their business away from FCS and to competing lenders.[222]

Starting in 1985, FCS began reporting huge annual losses.[223] The Governor of the Farm Credit System Administration announced that FCS required a massive infusion of federal funds within eighteen to twenty-four months to remain in business.[224] Even after this announcement, the implicit federal guarantee was perceived as being so strong[225] that FCS continued to sell its debt at a price lower than most private corporations.[226] Congress has already taken steps to pay for FCS losses resulting directly from excessive FCS risk-taking that initially provided substantial benefits to FCS managers and shareholders.

b. Fannie Mae

Fannie Mae underwent a similar experience, but with a happier ending. In the 1970's, short-term interest rates were less expensive than long-term rates.[227] Fannie Mae purchased billions of dollars of long-term mortgages and funded them with short-term debt.[228] The price difference between short- and long-term debt allowed shareholders to receive immediate returns higher than those that would be expected had the long-term securities been funded on a more matched-maturity basis.[229] This funding system was only possible because of the implicit government guarantee that allayed concerns of Fannie Mae's debtholders about the extra risk involved. Without the implicit guarantee, these debtholders would have become increasingly unwilling to lend money inexpensively to Fannie Mae because of the growing interest rate risk in its operations.[230]

Starting in 1979, short-term borrowing costs rose dramatically relative to long-term rates.[231] Fannie Mae's debt costs soon exceeded re-

222. *The Farm Credit Fix, supra* note 212, at 1515.

223. 1985 FARM CREDIT ADMIN. ANN. REP. 39.

224. *Id.*; *Farm Credit System Buried in Bad Loans, Seeks Big U.S. Bailout*, Wall St. J., Sept. 4, 1985, at 1.

225. *"AAA Investments", supra* note 205, at 13.

226. SPECIAL ANALYSIS F, *supra* note 68, at F22-23.

227. GENERAL ACCOUNTING OFFICE, FEDERAL NATIONAL MORTGAGE ASSOCIATION IN A CHANGING ECONOMIC ENVIRONMENT 30-31 (1985) [hereinafter 1985 FNMA REPORT].

228. *Id.*

229. *Id.*

230. UNITED STATES DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, 1986 REPORT TO CONGRESS ON THE FEDERAL NATIONAL MORTGAGE ASSOCIATION 100 (1987) [hereinafter 1986 HUD REPORT].

231. 1985 FNMA REPORT, *supra* note 227, at 30-31.

turns on its portfolio of long-term mortgages[232] which were bearing relatively low interest rates.[233] By 1981, Fannie Mae had a market-value negative net worth of $10.8 billion.[234] Fortunately, with energetic new management strategies and declining interest rates,[235] Fannie Mae avoided the fate of FCS. Again, while the Federal Government reaped few of the benefits from Fannie Mae's risky funding strategy, it stood to lose if that strategy had failed.[236]

The current spate of firm bankruptcies is an important reminder that it is all too easy for a non-government, commercial enterprise to fail in the marketplace. Without the discipline of the marketplace to impose ever increasing costs on the sale of debt, enterprises are especially at risk. The government guarantee dampens vital market signals and this allows even those enterprises that may have poor balance sheets to continue to sell obligations and guarantees at favorable interest rates.

Both FCS and Fannie Mae consistently recorded substantial profits in the years before the potential risk exposure turned into actual corporate losses. If a high-risk strategy for such an enterprise is successful, benefits accrue primarily to the shareholders. If the high-risk strategy fails, the Federal Government is under virtually irresistible pressure to make good on its guarantee. The failure of hundreds of thrifts with federally insured deposits provides the starkest example of the federal guarantee undermining market discipline that otherwise would limit losses as an institution begins to falter.[237]

C. *Regulation of Safety and Soundness to Compensate for Missing Market Discipline*

In the absence of full market discipline, effective government regulation is essential to contain enterprise risk-taking and ensure its long-term viability.[238]

232. 1986 HUD REPORT, *supra* note 230, at 100.
233. *Id.* at 102.
234. *Id.* at 100.
235. *Id.* Most importantly, Fannie Mae's charter permitted the company to issue mortgage-backed securities, thereby providing a source of income that was relatively insensitive to changes in interest rates. Freddie Mac had issued such securities in large volumes throughout the 1970's and thus, was not harmed by the 1979 jump in interest rates.
236. UNITED STATES DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, 1987 REPORT TO CONGRESS ON THE FEDERAL NATIONAL MORTGAGE ASSOCIATION 27-28 (1987) [hereinafter 1987 FNMA REPORT].
237. *See generally* E. KANE, THE GATHERING CRISIS IN FEDERAL DEPOSIT INSURANCE (1985) (noting financial consequences of federal guarantee of bank and thrift deposits).
238. *See supra* note 2 (explaining financial institution risk-taking).

Regulation is not an assured solution for problems caused when the government's implicit guarantee distorts market incentives. As demonstrated in the regulatory history of FCS[239] or of thrift institutions governed by FHLBB,[240] regulators are often located in the same political and psychological environment as the institutions they regulate.

In particular, Congress may be sensitive to constituencies interested in increasing rather than reducing the Federal Government's risk exposure. For example, even as FCS banks struggled to keep their portfolios above water, desperate farm borrowers were able to persuade members of Congress[241] to pressure FCS banks to be lenient in handling delinquent loans.[242] Similarly, FHLBB came under considerable pressure to refrain from promptly closing thrift institutions with negative net worth because that threatened to accelerate the Federal Government's risk exposure.[243]

There is another problem with regulation. Regulators have not been very successful in detecting high risk problems in time.[244] Regulators tend to be sensitive to the type of risk that caused problems in the past rather than today's emerging problems.[245] Indeed, management has an incentive to shift risk away from regulated and into unregulated areas.[246] The Continental Illinois National Bank's failure shows that regulation is not complete protection against the Federal Government's risk exposure.[247]

Failure of hundreds of thrift institutions provides a clear lesson about the potential costs of allowing regulated institutions to dominate the regulators.[248] Even with the emergence of possible new tools such as risk-related federal insurance premiums,[249] prudent supervision of

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239. HOUSE COMM. ON AGRICULTURE, FARM CREDIT ACT AMENDMENTS OF 1985, REPORT TO ACCOMPANY H.R. 3792, H.R. REP. NO. 425, 99th Cong., 1st Sess. (1985).

240. R. BRUMBAUGH, JR., *supra* note 96, at 24-27.

241. *See infra* note 612 (citing sources which discussed Farm Credit legislation).

242. *Farm Credit System Under Orders to Get Tough, Is Hampered by Lawmaker Pleas for Leniency*, Wall St. J., May 26, 1986, at 34.

243. H.R. 133, 100th Cong., 1st Sess., 71 CONG. REC. H3149-65 (daily ed. May 5, 1987).

244. KANE, *supra* note 237, at 16; Address by E. Kane, Reforming Regulatory Incentives: Banks, Thrifts & GSEs, National Taxpayers Union Foundation Conference (Feb. 11, 1991).

245. J. SINKEY, JR., HANDBOOK FOR BANKING STRATEGY 347-380 (R. Aspinwall & R. Eisenbeis ed. 1985).

246. STATE OF RISK, *supra* note 1, at 168.

247. *See* CONTINENTAL REPORT, *supra* note 81 (citing failure of supervision and of institution's own management).

248. R. BRUMBAUGH, JR., *supra* note 96, at 74-79.

249. R. Van Order, *User Fees and Mortgage Markets*, 6 HOUSING FIN. REV. 93, 94 (1987). Farm Credit System institutions have begun to pay risk-related premiums into a fund of the FCS Insurance Corporation. 12 U.S.C. § 2277a (Supp. I 1989). It is

GSEs is a necessary but only partial substitute for the market discipline that is lacking.

III. THE ELEMENTS OF EFFECTIVE SUPERVISION OF SAFETY AND SOUNDNESS

A. Analytic Overview

Effective supervision of GSEs may be summarized as having several distinct elements. First, the regulator must be institutionally capable of overseeing safety and soundness of large institutions involving huge numbers of often complex transactions. Second, the regulator must be motivated to ensure safety and soundness, and must not have conflicting missions that might impede that motivation.[250] Third, the discretion of the regulator should be confined to safety and soundness issues, and structured to assure that the regulatory authority is properly used.

1. Elements of Effective Supervision: Banks and Thrifts

In analyzing these elements, federal supervision of bank and thrift institution safety and soundness provides a useful model. First, as the experience of the bank and thrift regulators has shown, institutional capability may be enhanced by freeing the agency from federal budget constraints, personnel ceilings, and civil service salary levels. It is difficult, if not impossible, to staff a financial regulator within the current federal staffing and salary limits. Assessing enterprises for the costs of financial supervision provides a source of funds for meeting staffing needs. As discussed below, the Farm Credit Administration (FCA) and the Federal Housing Finance Board (FHFB) are already funded by such assessments.

Second, the regulation of enterprise safety and soundness must not be impeded by conflicting responsibility for promoting the programmatic mission of an enterprise. It was not helpful, to give but one example, for thrifts to be regulated by FHLBB that was statutorily required to promote the industry that it was also supposed to supervise.[251] The Treasury and GAO reports provide ample documentation for this caveat.[252] The legislative process provides the appropriate means to

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not at all clear that the level of insurance premium is sufficient to cover the actuarial risk of loss to the fund.

250. GENERAL ACCOUNTING OFFICE, GOVERNMENT SPONSORED ENTERPRISES: THE GOVERNMENT'S EXPOSURE TO RISKS 97 (1990) [hereinafter 1990 GAO REPORT]; 1990 TREASURY REPORT, *supra* note 13, at 10.

251. 12 U.S.C. § 1465 (repealed 1989).

252. 1991 GAO REPORT, *supra* note 2, at 45; 1990 TREASURY REPORT, *supra* note

make trade-offs between the public purposes of each enterprise and safety and soundness. These trade-offs, while properly informed by analysis provided by executive agencies, are political rather than administrative in nature. They involve issues of political benefits that are far too value-laden for an administrative agency to address effectively on a decision-by-decision basis. Once there is a legislated agreement on trade-offs between an enterprise's public mission and the need for safety and soundness, the administrative agency should be required to implement the statute fully with respect to safety and soundness.

Third, many of the administrative issues concerning financial supervision have already been addressed in the course of regulating safety and soundness of thrifts and banks.[253] The economic consequences of federal deposit insurance are comparable in essential respects to those of the federal backing of enterprise obligations and MBSs.[254] To the extent that the bank regulatory model is appropriately adapted, it may be possible to avoid repeating some of the difficulties that faced federal bank regulators in earlier years.[255] Congress recognized this parallel with federal bank regulation in the 1980's when it restructured FCA[256] and provided FCA with the institutional capabilities, supervisory authority, and enforcement powers of bank regulatory agencies.[257] GAO in its 1990 report similarly views bank supervision as a useful model.[258]

It is also true that some modifications in the bank supervisory model are appropriate, to the extent that GSEs differ from banks. The most

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13, at 10.

253. W. Todd & A. Watts, Current Intervention and Closure Options of Federal Banking Agencies (unpublished manuscript, Federal Reserve Bank of Cleveland) [hereinafter Intervention and Closure Options].

254. 1990 GAO REPORT, *supra* note 250, at 4; 1991 GAO REPORT, *supra* note 2, at 28.

255. *See* Financial Institutions Advisory Act of 1966, Pub. L. No. 89-695, 80 Stat. 1028 (concerning need for cease-and-desist powers); 1983 International Lending Supervision Act, Pub. L. No. 98-181, 97 Stat. 1278 (concerning need for capital directives).

256. 12 U.S.C. § 2221 (1988).

257. *See* HOUSE COMM. ON AGRICULTURE, FARM CREDIT ACT AMENDMENTS OF 1985, REPORT TO ACCOMPANY H.R. 3792, H.R. DOC. NO. 425, 99th Cong., 1st Sess. (1985).

258. The 1990 GAO Report stated that:

> GAO compared the monitoring and capital regulatory structure used for banks with that used for government-sponsored enterprises because both groups present similar concerns to the government. In both situations, the government is interested in the financial firm's viability in part because the government may suffer financial losses from large-scale failure. In addition, federal ties can promote unsafe risk-taking on the part of banks, just as they can with government-sponsored enterprises.

1990 GAO REPORT, *supra* note 250, at 4.

important difference is in the numbers of institutions; there are only a few GSEs compared to the thousands of banks with federally insured deposits. Consequently, the government can customize certain regulatory requirements without creating difficulties that might occur if enterprises were more numerous. On the other hand, there is a danger in customizing too much. The government must set and enforce objective standards and apply these even against institutions whose officers and directors are well-known and well-regarded in Washington. Once the government stops applying objective standards within a clear conceptual framework, it will find itself on a slippery slope. Each regulatory action will then tend to be seen in personal terms rather than as an institutional requirement that necessarily accompanies the government's guarantee of hundreds of billions of dollars of enterprise obligations.

In addition, many enterprises tend to rely on large volumes of repetitive transactions involving standardized types of loans, rather than holding portfolios of many types of loans with unique attributes.[259] To the extent that this is the case, the government may be able to spell out some regulatory requirements in advance rather than addressing safety and soundness questions largely on an ad hoc basis through the examination process.

Aside from their limited number and large size, enterprises seem analytically quite similar to banks and thrifts. In the confines of their charters, they are permitted to take excessive risks by dealing, for example, in derivative mortgage-backed securities.[260] Management information and control systems may also involve significant risks.[261] Well run institutions may be able to manage such risks and protect shareholders and taxpayers. As the guarantor of enterprise obligations and mortgage-backed securities, the government must be assured of the institution's ability in this regard.[262] Bank-type disclosure requirements and examination seem to be useful, if not completely effective, ways to

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259. STATE OF RISK, *supra* note 1, at 44-47.

260. Sanborn, *Stripped MBS's: They're No Myth*, FREDDIE MAC REPORTS 5 (Aug. 1989).

261. 1990 TREASURY REPORT, *supra* note 13, at A65.

262. *Roundtable Hearing on the Safety and Soundness of Fannie Mae and Freddie Mac, Judging Freddie Mac's Capital Adequacy Before the Subcomm. on Housing and Urban Affairs, Senate Comm. on Banking, Housing, and Urban Affairs*, 101st Cong., 2d Sess. 258 (1990) (statement of Mark J. Flannery). Mr. Flannery noted: "Though the firm's charter confines it to a relatively limited set of activities, there is ample room within that charter's provisions to increase the business risk undertaken. In this regard, I believe that the most appropriate policy response is carefully *monitoring* Freddie Mac's performance and management decisions." *Id.* at 264 (emphasis in original).

determine whether an institution is taking excessive risks.[263]

2. *Extent of Government Supervision*

Given the need for effective government supervision, the next issue addressed is the appropriate extent of that supervision. Given a capable and properly motivated regulator, the form of safety and soundness supervision follows logically from the Federal Government's role as implicit guarantor. In their seminal article, Black, Miller, and Posner[264] argue that efficient government supervision should resemble the measures adopted by a private guarantor imposing controls on a firm whose obligations it guarantees or by a private lender overseeing the creditworthiness of a borrower.[265]

A private lender is concerned about the borrower's capital, leverage, and general management ability. The lender will require disclosure of material events[266] and may even insist on direct supervision of the borrower's business.[267] The lender does not attempt to substitute for the borrower's judgment in general business decisions,[268] but attempts to prevent actions such as increasing riskiness of business activities that benefit the borrower at the lender's expense.[269] This approach is directly applicable to the regulation of GSEs to protect the government's financial stake in enterprise safety and soundness.

Federal supervision of banks and thrift institutions today fits neatly within the analytical framework of Black, Miller, and Posner. The expensive lessons of the financial regulatory failures of the 1980's have resulted in significant institutional and administrative improvements,[270] especially with respect to regulation of thrift institutions. This framework and these lessons are also applicable to GSEs.

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263. FEDERAL DEPOSIT INSURANCE CORPORATION, DEPOSIT INSURANCE FOR THE NINETIES: MEETING THE CHALLENGE 127-40 (1989) [hereinafter FDIC STUDY]; Neuberger, *How to Close Troubled Banks*, FED. RESERVE BANK OF SAN FRANCISCO WEEKLY NEWSLETTER (Dec. 7, 1990).

264. Black, Miller & Posner, *supra* note 2, at 379-412.

265. *Id.* at 382; RISK AND CAPITAL ADEQUACY IN COMMERCIAL BANKS, *supra* note 2, at 385-86.

266. Thus, private investors require disclosure of material events and material changes to financial conditions.

267. Black, Miller & Posner, *supra* note 2, at 384.

268. *Id.*

269. *Id.*

270. Financial Institution Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183.

B. Institutional Capability

Institutional capability is the ability and incentive of a regulator to intervene in the activities of the GSE to address safety and soundness concerns. Most importantly, the regulator must have a clear and unassailable mandate to protect the financial interests of the govenment, even when these are adverse to those of the regulated institution and its shareholders.[271]

The regulator must also have the requisite ability to: (1) obtain relevant information; (2) make appropriate judgments; (3) intervene appropriately; and (4) defend itself in litigation if necessary. This involves both administrative authority, discussed below, and the requisite institutional capability. The federal regulator must possess a large, well trained staff that is capable of making sophisticated financial and legal decisions.

FHLBB, for example, suffered from lack of institutional capability during much of the 1980's. As one senior FHLBB official noted, "We had amateurs chasing professionals. Our examiners didn't understand the implications of many sophisticated financial transactions until they turned into losses."[272] Today, the Office of Thrift Supervision (OTS), successor to FHLBB, benefits from a substantial increase in the number of examiners and their qualifications undertaken by FHLBB in the last years of its existence.[273]

Both OTS and the federal bank regulators obtain the requisite institutional capacity through provisions in the law that exempt them from the budget, staffing, and salary ceilings that badly constrain many federal agencies.[274] The Federal Deposit Insurance Corporation (FDIC), for example, derives its funds from assessments on the regulated institutions, and thereby avoids the federal appropriations process.[275] FDIC also sets its own staffing ceilings, and again avoids the federal budget process.[276] Finally, FDIC sets its own salary schedules, in general con-

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271. 1991 GAO REPORT, *supra* note 2, at 30, 38.

272. Interview with Senior FHLBB official, in Washington, D.C. (May 31, 1989).

273. From June 1985 to June 1988, FHLBB almost doubled its examination and supervisory staff, from 1,063 to 2,068, and also greatly improved the education and training of those examiners. *Hearings on Regulation and Insurance Before the Subcomm. on Financial Institutions Supervision of the House Comm. on Banking, Finance, and Urban Affairs*, 101st Cong., 1st Sess. 20 (1989) (statement of M. Danny Wall, Chairman, FHLBB).

274. OFFICE OF MANAGEMENT AND BUDGET, CIRCULAR A-11, § 11.2 (July 2, 1990) [hereinafter CIRCULAR A-11].

275. 12 U.S.C. § 1817 (Supp. I 1989).

276. CIRCULAR A-11, *supra* note 274, § 11.2.

formity with the salary levels of other federal bank regulators.[277]

Two of the GSE regulators, FHFB and FCA, similarly fund themselves through assessments on the financial institutions they regulate,[278] and also set their own salary ceilings, consistent with those of the federal bank regulators.[279] FHFB sets its own staffing ceilings, but FCA is limited by a provision of federal appropriations law.[280] FHFB and FCA are also free from controls by OMB.[281] In contrast, HUD has none of these capabilities. HUD depends on federal appropriations,[282] is subject to OMB controls and staffing ceilings,[283] and is limited to civil service salary schedules.[284] Table 3, found later in the Article, summarizes these elements of institutional capability for each regulator.

A word of caution is merited about the use of statutory exemptions from usual government agency restrictions on budget, staffing levels, and salaries: the far superior approach would be to create special salary levels within the civil service for officials with exceptional financial expertise, and to fund and staff the financial regulators through the usual budget and appropriations processes. Some thrift institutions and FCS institutions today complain about the burden of assessments to fund their regulators. This might become a political issue.[285] Nevertheless, given clear evidence of the inability of traditional processes to provide adequate institutional capability for FHLBB and for many parts of the government today,[286] it is appropriate to fund and staff each enterprise regulator according to the precedent established by today's OTS and the federal bank regulators.[287] Otherwise, the Federal Government will

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277. 12 U.S.C. § 1833 (Supp. I 1989).
278. *Id.* §§ 1422b(c), 1438(b) [FHFB]; *Id.* §§ 2250, 2279aa-11(d) [FCA].
279. *Id.* §§ 1733(b), 2245(c) [FCA]; *Id.* § 1422b(b) [FHFB].
280. *See* Rural Development, Agriculture, and Related Agencies Appropriations Act, Pub. L. No. 101-161, 103 Stat. 981 (1990).
281. CIRCULAR A-11, *supra* note 274, § 11.2; 12 U.S.C. § 1422b(c) (Supp. I 1989).
282. *See* Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act, Pub. L. No. 101-144, 103 Stat. 844-54 (1990).
283. CIRCULAR A-11, *supra* note 274, § 11.2.
284. *See* 5 U.S.C. § 3132(a)(1) (1988 & Supp. I 1989) (exempting FDIC as government corporation and OTS and FCA by name from civil service laws with respect to senior executive service).
285. Also, if enterprises were to decline in size, the regulators' assessment base would also decline, possibly forcing cuts in supervisory staff at a time when more intensive oversight might be needed.
286. Address by Charles A. Bowsher, Comptroller General of the United States, *An Emerging Crisis: The Disinvestment of Government*, The James E. Webb Lecture, National Academy of Public Administration, in Washington, D.C. (Dec. 2, 1988).
287. *See supra* notes 274-81 and accompanying text (noting freedom of these insti-

remain without the capability to supervise the use or misuse of the funds raised by some one trillion dollars in federally backed enterprise securities.[288]

C. Statutory Mandate

The safety and soundness regulator has a task that is not always popular. To be effective it may have to intervene to prevent excessive risk-taking.[289] Tensions can become especially great when an institution begins to falter.[290]

To act effectively, the regulator must have a clear mandate to act to protect taxpayers against excessive risk of financial loss. To avoid unnecessary controversy at a time of urgency, the mandate should include appropriate statutory authority and legislative direction. Again, the bank regulatory model lends itself to supervision of enterprise safety and soundness; those statutory provisions have been tested politically, as well as financially, and in litigation.

The importance of a mandate to act is seen in the experiences of HUD and FCA during the 1970's. Warning signs were present both before Fannie Mae faltered in 1979[291] and before FCS failed in the mid-1980's.[292] Yet, in both cases, the relevant federal agency lacked the mandate to heed these warnings and make considered decisions to deal with them.[293] Instead, the warning signs seem simply to have dissipated without causing further deliberation.

Robert Elliott, HUD General Counsel and also a publicly appointed director of Fannie Mae, warned in 1976 of the dangers of "the money market risk (borrowing short, lending long) being taken with each net addition to assets and liabilities [by Fannie Mae.]"[294] It was precisely

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tutions from usual governmental constraints on budgets, staffing, and salaries).

288. 1990 TREASURY REPORT, *supra* note 13, at 5.

289. To borrow the felicitous comment of William McChesney Martin from another context, the regulator may be required to take away the punch bowl just when the party gets going. W. GREIDER, SECRETS OF THE TEMPLE 328 (1987).

290. Lincoln Sav. & Loan Ass'n v. Wall, 743 F. Supp. 901 (D.D.C. 1990).

291. *See infra* notes 294-95 and accompanying text (noting concerns expressed about Fannie Mae's interest rate exposure).

292. *See infra* notes 297-99 and accompanying text (noting concerns expressed about possible financial risks that could affect FCS).

293. 1985 FNMA REPORT, *supra* note 226, at 100-02; H.R. REP. NO. 425, 99th Cong., 1st Sess. (1985).

294. *Memorandum For: FNMA Board of Directors; The Corporation's Ten Percent Annual Target for Assets Growth* (April 23, 1976) *reprinted in, Secondary Market Operations of the Federal National Mortgage Association and the Federal Home Loan Mortgage Association: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong., 2d Sess. 395-411 (1976) (statement of Robert R. Elliott).

this borrowing short-lending long mismatch that caused Fannie Mae's financial difficulties a few years later.[295]

In 1979, Donald E. Wilkinson, Governor of FCA, prepared a strategic planning paper that considered possible "shocks" that might shake FCS.[296] He described the first possible shock, as follows:

> A sudden decline in land values on local, regional, or national levels. A reduction in commodity prices causing a decline in farm income affecting all commodities could affect land values across the country. . . . Unusual speculative demands might also affect prices in urban fringe areas. The System needs to be ready for events of this nature.[297]

It was precisely such a decline in commodity prices, farm income, and land values that brought down FCS a few years later.[298] In the case of both enterprises, the warning signs were ignored. Neither HUD nor FCA had the necessary mandate or the capability to act on the basis of such warnings, especially during times of growth and apparent profitability of each enterprise.[299]

D. *Administrative Authority*

Another important element of safety and soundness supervision is the extent of statutory authority conferred upon the regulatory agency. Federal financial supervision of banks and thrifts includes five major components: 1) financial disclosure and reporting requirements;[300] 2) examination of financial condition and risk-taking;[301] 3) effective capital requirements, including minimum capital standards and risk-based standards;[302] 4) enforcement powers, including authority to disapprove high-risk activities;[303] and 5) ability to deal with a faltering or failing institution.[304] Each of these is based on statutory provisions that have been improved over the years to address shortcomings that had become apparent.[305]

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295. 1986 HUD REPORT, *supra* note 230, at 101-02.

296. STRATEGIC PLANNING COMMISSION FEDERAL INTERMEDIATE CREDIT BANK, AGRICULTURES'S ENVIRONMENT: A TEN YEAR LOOK 95-101 (1979).

297. *Id.*

298. *Hearings Before the Subcomm. on Conservation and Credit of the House Comm. on Agriculture*, 99th Cong., 1st Sess. 508-15 (1985) (statement of Donald E. Wilkinson).

299. 1987 FNMA REPORT, *supra* note 236, at 100-02; H.R. REP. NO. 425, 99th Cong., 1st Sess. (1985).

300. FDIC STUDY, *supra* note 263, at 130-31.

301. *Id.* at 127-40.

302. 1991 TREASURY BANK REPORT, *supra* note 171.

303. FDIC STUDY, *supra* note 263, at 140-47.

304. *Id.* at 147-49.

305. Financial Institutions Advisory Act of 1966, Pub. L. No. 89-695, 80 Stat.

The institutional framework for safety and soundness must address the fact that some of the enterprises are huge institutions. Fannie Mae and Freddie Mac hold or guarantee literally hundreds of billions of dollars of loans.[306] If either faltered or failed, the consequences would be serious indeed. Today, the government's risk is distributed between two huge secondary mortgage market institutions that have become the mainstays of the residential mortgage market, in place of hundreds of failed and failing thrift institutions.[307]

With so many eggs in only two baskets, the government must be empowered to act promptly in the event of a crisis. Ground rules must be specified in advance, relating to the authority to examine and audit, to set and enforce sanctions, and ultimately to intervene in management decisions if an institution begins to fail. Although the likelihood of outright failure may be remote, the potential cost of such failure is immense; the government must define the nature and extent of its authority beforehand, and also the nature of the events that would trigger use of such exceptional authority. Thus, bank-type regulatory authority to appoint a conservator or receiver, incorporating by reference the standards used by the federal bank regulators in taking such action, may be appropriate if only because it provides a defined (and partially litigated) set of powers and conditions. Consider each of the elements in turn.

1. *Financial Disclosure and Reporting Requirements*

a. The Need for Information

Federal disclosure and reporting requirements must be tailored to the government's role as guarantor of the debtholders and thus as their surrogate, insofar as financial risk is concerned. Equity holders have ample information about the risks and returns of stock ownership of the investor-owned enterprises. Wall Street investment firms churn out special and periodic reports reflecting even small changes in financial circumstances that might affect enterprise stockholders. However, equity holders tend to be interested in issues such as financial leverage (debt-to-equity ratios) and returns on equity that are not completely useful to debtholders or to the Federal Government as the debtholders' guaran-

1028; 1983 International Lending Supervision Act, Pub. L. No. 98-181, 97 Stat. 1278; 12 U.S.C. §§ 1818, 3706 (1988 & Supp. I 1989).

306. 1990 TREASURY REPORT, *supra* note 13, at 5.

307. *Id.*

tor and surrogate.[308] Thus, stock equity analysts have been notably unsuccessful in predicting bank failures.[309] As one study points out:

> The most startling finding of this review is that it did not uncover a single case of a bank stock analyst expressing strong concerns before T_r [the time when serious problems should have been apparent to a careful observer] about the problems that later became evident. In the great majority of cases the stocks were being recommended for purchase or hold, often because of growth in earnings or interstate banking potential. Negative comments generally related to the stock being overpriced rather than concern about future problems.[310]

As the surrogate for debtholders, the Federal Government requires timely and accurate information about (1) the financial condition of each enterprise, and (2) the extent that the amount of enterprise risk exposure is increasing, either because of management decisions or as a consequence of external market circumstances.

b. Supervisory Requirements

Meaningful disclosure of the government's risk exposure is an important first step. Each enterprise should be required to provide a quarterly report of condition, similar to federally-insured depository institutions. Banks and thrifts are required to file quarterly reports of condition and income with their federal regulator, and also to report material changes in financial circumstances. The regular reports provide basic financial information in somewhat greater detail than is usually found in annual reports to shareholders. Such reports should be supplemented by full disclosure of current off-balance sheet activities such as the issuance or guarantee of pass-through securities. Today, for example, Fannie Mae undertakes much of its lending by guaranteeing hundreds of billions of dollars of mortgage securities.[311] However, the contingent liability from these securities is not included on its balance sheet.[312]

In one respect, GSEs are well situated to improve upon disclosures now required of banks and thrifts. In particular, market value accounting,[313] used to supplement usual reports based on historical cost ac-

308. Randall, *Can The Market Evaluate Asset Quality Exposure in Banks?*, NEW ENGLAND ECON. REV., Federal Reserve Bank of Boston 11 (July/Aug. 1989); Simons & Cross, *Do Capital Markets Predict Problems in Large Commercial Banks?*, NEW ENGLAND ECON. REV., Federal Reserve Bank of Boston 51 (May/June 1991).

309. *Id.*

310. *Id.*

311. 1990 TREASURY REPORT, *supra* note 13, at 5.

312. STATE OF RISK, *supra* note 1, at 130, 132-36.

313. Market value accounting is based upon the market value of assets and liabilities of an institution revalued periodically. This compares to cost accounting that

counting, can provide significant useful information for financial regulators.[314]

Market value accounting is an important means of addressing issues such as the interest rate mismatch seen in earlier periods of Fannie Mae's and FCS's operations. Ultimately, market value accounting should also provide a means to accelerate recognition of credit quality problems that otherwise do not have to be accounted for until loans are actually foreclosed.[315]

In addition to market value accounting, each enterprise should report its credit risk, interest rate risk, and business risk. A variety of techniques are presently available. Credit risk, for example, may be estimated through a worst-case-scenario analysis similar to that used by rating agencies such as Standard & Poor's.[316] Credit quality may be assessed by evaluating an enterprise's loan portfolio and loan pools backing its mortgage-backed securities.[317] Interest rate risk can be measured by simulations of the market value of an enterprise for a range of interest rates.[318] Application of rigorous reporting requirements including market value accounting may result in the publication of unfavorable information.[319] However, as the experience of FCS in the mid-1980's has shown,[320] GSEs can continue to issue debt obligations even after such disclosure. The government's implicit guarantee is strong enough that investors in enterprise obligations are unlikely to be discouraged even when market value accounting reveals a low net worth or other measures show a high degree of risk.[321] While equity holders may be adversely affected, it is also in their interest to learn

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records historical values of assets and liabilities as of the date they were purchased, incurred, or otherwise recognized.

314. *See* 1990 TREASURY REPORT, *supra* note 13, at B44 (showing how market value calculations may be used to measure institution's susceptability to changing interest rates).

315. G. BENSTON, R. EISENBEIS, P. HORVITZ, E. KANE, G. KAUFMAN, PERSPECTIVES ON SAFE AND SOUND BANKING 203-05 (American Bankers Association 1986).

316. *See generally* STANDARD & POOR'S CORP., STRUCTURED FINANCE CRITERIA (1988) (noting Great Depression scenario used to analyze credit risks).

317. 1990 GAO REPORT, *supra* note 250, at 42-46.

318. In this regard, an excellent model is found in the 1990 SECRETARY OF THE TREASURY ON GOVERNMENT SPONSORED ENTERPRISES ANN. REP. Chart 2, found in the chapter on Freddie Mac, shows an interest rate sensitivity curve that could usefully be generated for each GSE. *Id.* at B44.

319. Thus, many thrifts had a negative market net worth long before their Generally Accepted Accounting Principles (GAAP) net worth dropped to zero. R. BRUMBAUGH, JR., *supra* note 96, at 62-63.

320. SPECIAL ANALYSIS F, *supra* note 68, at F27-28.

321. For example, FICO 30 year bonds sell at narrow spreads above the Treasury's despite showing a balance sheet with a negative GAAP net worth. STATE OF RISK, *supra* note 1, at 147.

promptly of adverse material changes in the financial condition of an enterprise. Prompt disclosure can help management and federal regulators become sensitive to problems, and the need to contain risk, before either grows to unmanageable proportions.

There would probably be few significant costs in generating market-based accounts.[322] Market value estimates may be made more easily for relatively standardized enterprise loans such as guaranteed student loans, residential mortgages, or collateralized thrift advances, as compared with the difficulties of application to bank portfolios consisting of a wide variety of assets.[323]

At relatively little cost, the Federal Government may use the reports of the individual enterprises to generate estimates of risk exposure for all enterprise operations.[324] Summarized in an annual report, these estimates could permit federal policymakers to devote special attention to enterprises incurring notable excess risk. Risk assessments should be made for particular activities of each enterprise, thereby permitting the regulator to report to Congress on enterprise lines of business that the regulator considers excessively risky, especially compared to the public benefits.

In 1990 the Treasury proposed a disclosure requirement tailored expressly to the government's role as a surrogate for debtholders.[325] The Treasury recommended requiring each enterprise to obtain a financial rating of its obligations, without regard to the implicit federal guarantee, from two nationally recognized rating agencies.[326] This information may help compensate for missing debtholder surveillance by substituting the type of disclosure used by investors in debt obligations of financial institutions, when those debt obligations are not backed by the Federal Government.

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322. G. Benston, *supra* note 315, at 215-21 (reviewing benefits and costs for banks). For enterprises the costs are likely to be less than for banks because of the relative homogeneity of most enterprises' lending activities.

323. White, *The Case for Mark-to-Market Accounting*, Secondary Mortgage Markets 2-4 (Summer 1990). Many of the arguments against applying mark-to-market accounting to banks and thrift institutions do not apply to GSEs to the extent that their assets are much easier to value, because they are purchased in the secondary market. Garvelink, *The Case Against Mark-to-Market Accounting*, Secondary Mortgage Markets 5-7 (Summer 1990).

324. A good model for such a report is the 1990 Treasury Report, *supra* note 13.

325. 1990 Treasury Report, *supra* note 13, at 9-10.

326. Among the nationally recognized agencies are Standard & Poor's, Inc., Fitch Investor Services, Moody's Investor Services, and Duff & Phelps Credit Rating Co.

2. *Examination of Financial Condition and Risk-taking*

a. The Need for Examination

Unfortunately, self-reporting is not always accurate. Indeed, self-reporting is likely to be least effective at a time when an institution gets into financial difficulty, and managers are concerned about the market consequences of publishing unfavorable information.

This means that enterprise reports should be supplemented by periodic examination. Examination is essential to provide accurate information to the government before possible problems grow to unmanageable proportions. Examination permits the regulator to investigate the policies and procedures and financial controls used by the enterprise and to verify that management is properly implementing them to assure financial soundness. Examination can address management practices relating to asset quality, interest rate risk, management information and control, and other aspects of enterprise risk-taking. As was seen in problems of federal oversight of thrift institutions and banks, examination requires adequate staffing by capable federal officials.[327]

b. The Scope of Examination

Examiners seek to ascertain the financial state of an institution, the quality of its management and its compliance with laws and regulations, and to identify whether corrective actions may be needed. Examiners evaluate asset quality such as credit risk, institution profitability, capital levels, and quality of management information and control systems.[328] Thrift institution examiners pay special attention to the extent an institution incurs interest rate risk from its loan portfolio.[329] There is a consensus among bank regulators that the single most important factor in bank safety and soundness is the quality of bank management, its abilities, policies, procedures, and controls.[330]

Bank regulatory agencies conduct their examinations both on-site

327. COMBATTING FRAUD, ABUSE, AND MISCONDUCT IN THE NATION'S FINANCIAL INSTITUTIONS: CURRENT FEDERAL EFFORTS ARE INADEQUATE, H.R. REP. NO. 1088, 100th Cong., 2d Sess. 13-15 (1988).

328. *Id.*

329. This is true because interest rate mismatches wiped out the net worth of a substantial number of thrifts between 1979 and 1981.

330. *Id.*; *Failed Financial Institutions: Reasons, Costs, Remedies and Unresolved Issues, Hearings Before the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 1st Sess. (1989) (statement of Frederick D. Wolfe, Assistant Comptroller General, GAO); BANK FAILURE, *supra* note 173; R. CLARKE, *supra* note 173.

and off-site.[331] For example, the Comptroller of the Currency now maintains a continuous on-site presence at the largest money center banks,[332] most of which are much smaller than the largest enterprises, such as Fannie Mae and Freddie Mac. Federal regulators increasingly recognize the importance of examining the financial environment and the ability of an institution to withstand changes in that environment.[333] Problems with financial institutions in various regions of the United States, and with specialized lenders such as thrift institutions in various parts of the country, reflect the need to monitor such market risk. FDIC calls this approach a "forward-looking form of supervision."[334]

> Because of the way banks now function, supervisors must focus more on risk and the root causes of risk before serious problems develop. Instead of just looking at individual transactions, increased attention is given to systems and controls. On-site examinations remain the most important element in the process, but they must be augmented by the best possible system of off-site monitoring and other participatory endeavors. Instead of performing onsite examinations based on a fixed examination cycle policy, more emphasis is now placed on identifying economic and industry risk and identifying individual banks that exhibit symptoms of higher risks. Supervisory resources are concentrated on these risks . . . .[335]

For all of its importance, the examination process has its limitations. To cite but one prominent example, bank examiners failed to detect the deteriorating quality of loans held by Continental Illinois National Bank.[336] A congressional staff report criticized federal examiners for focusing on loans with the highest apparent risk.[337] The examiners failed to take a fully representative, statistically valid sample of all loans to compare the examiners' ratings of the sample loans with the bank's assessment of the same loans.[338]

Another problem with bank examination is the problem of "regula-

331. FDIC STUDY, *supra* note 263, at 27-31.

332. *Id.* at 128.

333. This issue was raised many years ago in FLANNERY & GUTTENTAG, FEDERAL RESERVE BANK OF CHICAGO, IDENTIFYING PROBLEM BANKS: PROCEEDINGS OF A CONFERENCE ON BANK STRUCTURE AND COMPETITION 1-32 (1979). Flannery and Guttentag call banks subject to market risks "Beta banks," in contrast to "Alpha banks," or institutions with a relatively high probability of failure even without a change in market environment. Flannery and Guttentag suggest that the regulator of an institution particularly subject to market risk should attempt to identify potential future shocks and the extent that the institution should be and actually is prepared to weather such shocks.

334. FDIC STUDY, *supra* note 263, at 125.

335. *Id.*

336. CONTINENTAL REPORT, *supra* note 81.

337. *Id.*

338. *Id.* at 91-92.

tory lag."[339] Examiners tend to "go by the book," and examination manuals are designed to detect the forms of risk which caused past problems rather than present or future problems. The situation is exacerbated because managers may have an incentive to shift risk into areas less susceptible to detection by examiners.

3. *Setting Effective Capital Requirements*

a. Capital Adequacy Standards for Financial Institutions

Investor capital serves two important functions. First, financial institution managers may have more inclination to be prudent to the extent that they have shareholder capital at stake in lending decisions.[340] To some extent, shareholders have a long-term interest in protecting and enhancing their investment in the company. Second, capital serves as a buffer that absorbs financial losses before federal funds are needed.[341] Capital is the equivalent of the "deductible" portion of the federal insurance that backs banks and thrift institutions, and implicitly backs GSEs.[342]

Alone, some financial institutions will maintain much lower levels of capital than are adequate to protect the Federal Government's stake as the guarantor of federally-insured deposits of enterprise obligations.[343] This is so because shareholders can benefit from high leverage;[344] they may object to an issuance of new stock as diluting shareholder returns as the company's profits are spread over a larger number of shares. As shareholder leverage increases, the government loses the protection of a cushion of capital that buffers against downside losses.[345]

Similar to any financial creditor, the government must protect against increases in its risk position by placing a limit on risk-taking by GSEs. The government may use a variety of measures to limit risk in GSEs. For this reason, capital standards are very important in protecting the government and taxpayers against loss from the government-backed obligations of financial institutions.[346]

Only slowly have the economic debates on these issues taken practi-

339. J. SINKEY, *supra* note 245, at 347-80.
340. 1991 TREASURY BANK REPORT, *supra* note 171, at II-2.
341. *Id.*
342. *Id.*
343. *Id.*
344. At high leverage, profits of an institution are spread over a smaller amount of shareholder capital, thereby increasing returns.
345. 1991 TREASURY BANK REPORT, *supra* note 171, at II-2.
346. Mitchell, *Capital Adequacy at Commercial Banks*, ECON. REV. 17-30 (Sept.-Oct. 1984) (Federal Reserve Bank of Kansas City).

cal form. A major step has been the introduction of risk-based capital requirements to supplement today's minimum capital adequacy requirements.[347] Under the Basle Accords[348] negotiated by banking regulators from twelve different countries including the United States,[349] risk-based capital standards are to be applied according to the credit risk of loan assets held or guaranteed by a financial institution.[350] The risk-based standards are applied on an asset-by-asset basis.[351]

To deal with the various kinds of risk on an institution-wide basis, and especially interest rate risk and management and operations risk, the financial institution regulators impose a minimum capital standard of three percent and adjust that standard upwards according to the risk profile of an institution. Only an institution with a very low risk profile and the highest possible supervisory rating, would be eligible for the three percent minimum.[352] A commercial bank must meet both capital requirements. The risk-based capital standards will set the binding level for banks with riskier loan portfolios, while the minimum capital standards will set the level for banks with less risky assets.[353] Regulations of the three commercial bank regulators expressly state that they will impose higher capital requirements upon individual institutions if examination reveals special risks such as concentration on a single kind of loan.[354]

The system of capital requirements remains imperfect. Improvements constantly are being proposed. FHLBB, for example, sought to capture some interest rate risk in its risk-based capital regulations proposed in December 1988.[355] The 1989 Financial Institutions Act[356] re-

347. GENERAL ACCOUNTING OFFICE, INTERNATIONAL BANKING: IMPLEMENTATION OF RISK BASED CAPITAL ADEQUACY STANDARDS (1991) [hereinafter 1991 INTERNATIONAL BANKING REPORT].

348. BASLE COMMITTEE ON BANKING REGULATIONS AND SUPERVISORY PRACTICES, INTERNATIONAL CONVERGENCE OF CAPITAL MEASUREMENT AND CAPITAL STANDARDS 1 n.1 (1988).

349. *Id.*

350. *Id.*

351. *Id.*

352. 1991 TREASURY BANK REPORT, *supra* note 171, at II-7. Institutions that do not receive the highest possible supervisory rating would be required to hold at least four or five percent capital. *Id.*

353. Minimal Capital Ratios, 55 Fed. Reg. 38,797 (1990); Capital Adequacy Guidelines: Minimum Tier 1 Leverage Measure and Transition Capital Standards, 55 Fed. Reg. 32,828 (1990).

354. *Id.*

355. Federal Home Loan Bank Board, Regulatory Capital Requirements for Insured Institutions, 53 Fed. Reg. 51,000-820 (proposed Dec. 31, 1990); Regulatory Capital Interest Rate Risk Component, 55 Fed. Reg. 53,529-71 (1990).

356. Financial Instutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 101 Stat. 183.

quires that thrift capital requirements be phased in so that they will be at least as stringent as those applicable to national banks.[357] The federal bank regulators are also attempting to devise ways to include interest rate risk in capital standards. Finally, it is appropriate to apply minimum capital ratios expressly to off-balance sheet activities, as has been done for the risk-based standards.[358]

b. Making Capital Standards Comparable Across Financial Institutions

It is important that enterprise capital requirements be established in the context of bank and thrift capital standards. Today's financial markets are highly integrated. Financial institutions can shift risks among themselves to take advantage of pricing opportunities and also to benefit from the least onerous federal capital requirements. Consider, for example, a commercial bank with a portfolio of residential mortgages. Under the risk-based capital requirements now being implemented, commercial banks will have to set aside risk-based capital amounting to four percent of the value of the good quality residential mortgages they hold.[359]

By contrast, if the commercial bank swaps its mortgages for Fannie Mae or Freddie Mac mortgage-backed securities, it will be required to set aside capital amounting to only 1.6% of its holdings of those securities.[360] Except for the enterprise guarantee, the mortgages and mortgage-backed securities would have the same financial characteristics such as amount, yield, and maturity.

Similarly, a bank will be able to sell agricultural mortgages into a pool and purchase corresponding Farmer Mac mortgage-backed securities. Depending on whether the bank has managed to eliminate recourse on the mortgages, this could reduce risk-based capital requirements from eight percent of the assets (agricultural mortgages have a 100% risk-weight) to 1.6%.[361]

The federal bank regulators have now agreed on minimum capital requirements,[362] in addition to the risk-based capital requirements,[363]

357. *Id.* § 301; 12 U.S.C. § 1425 (1988).

358. *See supra* note 348 (citing Basle Accords).

359. Under the Basle Accords and the implementing regulations, such mortgages are in the 50% risk-weight category. Risk-based capital is calculated by multiplying the risk-weight percentage by an eight percent base capital amount.

360. Fannie Mae and Freddie Mac mortgage-backed securities are given a 20% risk-weight.

361. Farmer Mac mortgage-backed securities will have a 20% risk-weight.

362. *See supra* note 353 (citing regulations setting new minimum capital

that may change the amount and extent of this advantage for particular institutions. In any event, enterprises will provide a way for some banks and thrifts to reduce the capital requirements on their asset portfolios.

As noted below, Fannie Mae, Freddie Mac, and Farmer Mac are not subject to capital requirements on the mortgage-backed securities they guarantee.[364] This means that their mortgage-backed securities provide a vehicle for financial institutions to reduce the overall level of private capital required by the Federal Government even though in many cases the government may retain the same overall level of exposure to credit risk. The locus of that credit risk has merely shifted from a commercial bank or thrift with federally insured deposits to a GSE with an implicit federal guarantee of its mortgage-backed securities. As the international financial regulators determined in designing the Basle Accords on risk-based capital requirements, capital standards must be coordinated across financial institutions to avoid creating such adverse consequences.[365]

Again, as discussed below, in 1990 the Treasury proposed a somewhat different approach to setting capital standards. The Treasury suggested requiring each enterprise to obtain and maintain a high investment grade rating.[366] In the process, the institution would be required to maintain enough capital to meet the standards of the rating agency.[367] In 1991, the Treasury modified its proposal and suggested instead that the regulator set risk-related capital requirements and that an enterprise receiving the highest rating ("AAA") would be exempt from most regulatory and capital requirements.[368] Suffice it to note here that for some institutions such as Freddie Mac and Farmer Mac, with negligible interest rate risk, an "AAA" standard would probably require less capital than is required of banks and thrift institutions.[369] On the other hand, enterprises with large portfolio operations, such as FCS and Fannie Mae, would probably find bank-type capital requirements easier to meet.[370]

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standards).

363. *Id.*

364. 12 U.S.C. § 1719(b) (Supp. I 1989) [Fannie Mae]; *id.* § 1452(b)(5) [Freddie Mac]; *id.* §§ 2279aa-2(b)(1), 2279aa-4 [Farmer Mac].

365. 1991 INTERNATIONAL BANKING REPORT, *supra* note 347, at 8-9.

366. 1990 TREASURY REPORT, *supra* note 13, at 9.

367. *Id.*

368. 1991 TREASURY REPORT, *supra* note 25, at xxiii.

369. 1987 HUD REPORT, *supra* note 123, at 45-51.

370. *Id.*

Finally, CBO suggests that so-called "stress tests"[371] might be appropriate for helping to set effective capital standards. Unfortunately, such stress tests depend on analysis of scenarios based on past experience.[372] Such scenarios do not adequately project future patterns of financial stress. Most importantly, stress tests cannot predict how an institution's managers may react to stress caused by unforeseen financial pressures.[373]

Again, the experience of thrift institutions is instructive. In the early 1970's few would have anticipated the jump in interest rates that began in 1979;[374] even fewer could have foreseen the way that thrift managers—often new managers that took control after the institutions faltered—would gamble with federally backed funds.[375] As the Treasury concluded in its review of Fannie Mae's stress tests and suggested capital guidelines, "Fannie Mae's management may know that it plans to manage carefully its interest rate risk and credit exposure; however, guidelines are not the same as an outside discipline which would encourage prudent risk management."[376]

4. *Enforcement Powers*

a. Introduction

While some of the enforcement powers of federal banking agencies and of FCA are potentially far-reaching, there is a substantial body of case law concerning limits on regulatory authority to use them. Because the original powers granted to bank regulators, such as authority to impose cease-and-desist orders, proved inadequate by themselves to control risk-taking by financial institutions, Congress has strengthened these powers. Congress increased the regulators' power by permitting

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371. Congressional Budget Office, Controlling the Risks of Government Sponsored Enterprises 182 (1991) [hereinafter Controlling Risks].

372. For example, changes in the yield curve can be as important as changes in the general level of interest rates.

373. 1990 Treasury Report, *supra* note 13, at A79.

374. R. Brumbaugh, Jr., *supra* note 96, at 36.

375. *Id.* at 159-70.

376. 1990 Treasury Report, *supra* note 13, at A79. The Treasury also found that Fannie Mae's stress test lacked sufficient rigor:

> Fannie Mae has selected one scenario, in hindsight, with assumptions tailored to that one experience. As the above analysis indicates, changing only one of the underlying assumptions, *ceteris paribus*, can have significant consequences on the capital needed to withstand the scenario. If more than one assumption were altered to reflect a more severe environment, as may be the case in another adverse scenario, the impact on Fannie Mae's capital requirements would be compounded.

Id. at A78.

them to impose capital directives,[377] by clarifying that the regulator may use cease-and-desist orders to impose affirmative conditions,[378] and by increasing the amounts of civil money penalties regulators may impose.[379]

As has been learned from experiences with banks and thrift institutions, enforcement powers must be strong enough to permit prompt action while protecting the rights of managers of affected institutions and providing ample and prompt opportunity to obtain redress from any regulatory abuses. Moreover, use of the statutory standards already applicable to banks, thrifts, and farm credit institutions will provide the affected parties with some sense of their rights and authority in the event that enforcement powers are contemplated or applied.

Note that, except for business plans established under 12 U.S.C. section 3709 to restore capital to required levels, use of bank-type enforcement powers would not permit the regulator to second-guess or micromanage enterprises' business plans. Instead, the regulator would concentrate upon designated activities considered to constitute unsafe or unsound practices and seek to correct those explicitly. The arms-length relationship of the regulator means that business decisions must be left to the regulated institution except as they constitute a direct financial risk to taxpayers. Finally, GSEs tend to be huge financial institutions. Their large size means that a regulator can be effective only if controls are available that permit exercise of leverage in a variety of small ways. The Fannie Mae Charter Act, for example, was deliberately designed to permit the regulator such leverage.[380]

As HUD itself has found out in dealing with Fannie Mae, the large size of a GSE means that the regulator cannot apply draconian measures without throwing financial markets into disarray. The use of such leverage is also inherent in the relationship of federal regulators to banks, and especially to large banks.[381]

For example, as noted in Table 5, FDIC does not have express statutory authority to limit dividends or to disapprove risky activities in advance. Instead, FDIC will cite risky activities or excessive dividend payments in examination reports. If the level of these payments or ac-

377. 12 U.S.C. § 3907 (Supp. I 1989).

378. *Id.* § 1818(b)(6).

379. The 1989 Financial Institutions Reform, Recovery, and Enforcement Act, Pub. L. No. 101-73, § 907, 103 Stat. 462.

380. *Housing and Urban Development Act of 1968: Hearing Before the Senate Comm. on Banking and Urban Affairs*, 89th Cong., 2d Sess. (1968) (statement of Robert C. Weaver, Secretary, HUD).

381. C. GOLEMBE & D. HOLLAND, FEDERAL REGULATION OF BANKING, 1986-1987 231-32 (1986).

tivities is high enough to constitute an unsafe or unsound practice, the regulator may curtail them informally, such as through a memorandum of understanding with the institution's board of directors, or formally through a cease-and-desist order.

b. The Bank Supervisory Model

The federal bank regulators and FCA have a variety of enforcement tools at their disposal, including cease-and-desist orders, civil money penalties, removal of directors and senior managers, disapproval of payment of dividends, and authority to impose capital directives. Each of these enforcement powers represents a balance between the interests of taxpayers in assuring safety and soundness and the interest of the regulated institution. Section III E below, discusses the body of administrative law precedents that helps to protect against misuse of enforcement powers by a supervisory agency.

i. Cease-and-Desist Orders

Federal banking agencies,[382] under 12 U.S.C. section 1818, are authorized to issue cease-and-desist orders against institutions or affiliated parties[383] with respect to unsafe or unsound practices or violations of law, regulations, written agreements, or written conditions imposed by the agency.[384] The cease-and-desist order is a flexible enforcement tool. The federal banking agency may require the affected party to refrain from actions or to take affirmative corrective steps. Section 1818(b)(6) lists the following types of affirmative action: restitution for certain losses, restrictions on growth, disposal of loans or other assets, recission of agreements or contracts, employment of qualified officers and employees (who may be subject to approval by the agency), and other action that the banking agency finds appropriate.[385]

The banking agencies have used cease-and-desist orders to address a variety of banking problems, ranging from violations of law and weak management to unsound loan administration. Such orders have also included provisions that restricted payment of dividends and required the

382. The term "appropriate federal banking agency" includes the Comptroller of the Currency, Board of Governors of the Federal Reserve System, FDIC, and Director of the Office of Thrift Supervision. 12 U.S.C. § 1813(q) (Supp. I 1989).

383. The term "institution-affiliated party" is defined in 12 U.S.C. § 1813(u) (Supp. I 1989).

384. For the cease-and-desist powers of the Farm Credit Administration, see 12 U.S.C. § 2261 (Supp. I 1989).

385. 12 U.S.C. § 1818(b)(6) (1988 & Supp. I 1989).

development of programs to improve earnings.[386]

The agency is required to provide notice and the opportunity for hearing for the institution or affiliated party to contest the issuance of an order. Once a cease-and-desist order becomes final, it is enforceable by court order.[387] The federal banking agency may also punish violations by imposing civil money penalties as discussed below.[388]

ii. Temporary Cease-and-Desist Orders

If the federal banking agency determines that an institution-affiliated party is engaging in unsafe or unsound practices or violating laws, regulations, outstanding orders, written agreements, or written conditions imposed by the agency, and that these practices or violations are "likely to cause insolvency or significant dissipation of assets or earnings . . . [or] are likely to weaken the condition of the depository institution or otherwise prejudice the interests of its depositors prior to the completion of [cease-and-desist proceedings under 12 U.S.C. section 1818(b)]," the agency may issue a temporary cease-and-desist order.[389] The temporary order may require an institution or party to refrain from actions or to take affirmative action to prevent further harm pending completion of the cease-and-desist proceedings. Temporary cease-and-desist orders are effective and enforceable pending completion of the cease-and-desist proceedings. Within ten days after an institution or party has been served a temporary cease-and-desist order, that institution or party may apply to a United States district court for an injunction setting aside, limiting, or suspending the order pending completion of the administrative proceedings.[390] The federal banking agency may apply to the United States district court for an injunction to enforce its temporary order.[391]

Finally, 12 U.S.C. section 1818(c)(3) permits the federal banking agency to issue a temporary order requiring regulated institutions to place their books and records in a complete and accurate state so that the agency may determine the financial condition of that institution or the details and purposes of transactions having a material affect on the

386. For an excellent overview, see INTERVENTION AND CLOSURE OPTIONS, *supra* note 253.
387. 12 U.S.C. § 1818(i)(1) (Supp. I 1989).
388. *Id.* § 1818(i)(2).
389. *Id.* § 1818(c).
390. *Id.* § 1818(b).
391. *Id.* § 1818(d). For the temporary cease-and-desist powers of the Farm Credit Administration, see 12 U.S.C. §§ 2262-2263 (1988).

financial condition of the institution.[392] This temporary order is enforceable or may be challenged in district court in the same manner as other temporary cease-and-desist orders.

iii. Removal, Prohibition, and Suspension of Parties Affiliated With the Institution

Under 12 U.S.C. section 1818(e), a federal banking agency is permitted to remove an affiliated party from office in the institution and from participation in the institution's affairs.[393] The agency must determine that a violation or an unsafe or unsound practice or a breach of fiduciary duty that causes financial harm or results in financial gain "involves personal dishonesty on the part of the party or demonstrates willful or continual disregard by the party for safety and soundness of the institution."[394]

The banking agency must provide written notice of intention to remove the party from office, or to remove or prohibit participation by such party, and provide opportunity for the party to contest the agency's findings at a hearing. Again, under 12 U.S.C. sections 1818(h) and (i), the affected party may obtain judicial review in district court; the appropriate federal banking agency may apply to district court to enforce its orders.[395]

iv. Civil Money Penalties

Section 1818(i)(2) provides for a graduated system of civil penalties.[396] A federal banking agency, by written notice, may assess or impose civil penalties on institutions for violations of law, regulation, final or temporary orders, written conditions imposed, or written agreements. The agency may impose greater penalties on institutions and institution-related parties that recklessly engaged in unsafe and unsound practices, systematically breaching fiduciary duties in such a way as to cause more than minimal loss to the institution or which resulted in pecuniary gain or other benefit, or that knowingly or recklessly caused substantial loss to an institution or resulted in pecuniary gain or other benefit.[397] Section 1818(i)(2)(e) states that the federal banking

392. 12 U.S.C. § 1818(c)(3) (Supp I. 1989).
393. *Id.* § 1818(e).
394. *See id.* § 1818(e)(1). For the removal powers of the Farm Credit Administration, see 12 U.S.C. §§ 2264-2265, 2270 (1988).
395. 12 U.S.C. §§ 1818(h), (i)(1) (Supp. I 1989).
396. *Id.* § 1818(i)(2).
397. For the powers of the Farm Credit Administration, see 12 U.S.C. § 2268 (1988).

agency shall provide written notice and opportunity for a hearing within twenty days after issuance of a notice of assessment.[398] The agency, in determining the amount of penalty imposed, shall consider mitigating factors specified in section 1818(i)(2)(g).[399]

v. Capital Directives

Under 12 U.S.C. section 3907, the federal banking agencies are required to establish minimum capital levels.[400] The banking agencies, at their discretion, may deem the failure of an institution to maintain its capital at or above the prescribed minimum level to be an unsafe and unsound practice within the meaning of 12 U.S.C. section 1818.[401] Section 3907(b)(2) authorizes the banking agencies to issue a directive to an institution failing to meet its capital requirements. "Such directive may require the banking institution to submit and adhere to a plan acceptable to the federal banking agency describing the means and timing by which the banking institution shall achieve its required capital level."[402]

Directives, and plans submitted pursuant to such directives, are enforceable in district court under the provisions of 12 U.S.C. section 1818(i) to the same extent that a final effective outstanding order issued under 12 U.S.C. section 1818(b) is enforceable.

Before this provision was added by the 1983 International Lending Supervision Act, banks could disregard regulators' requests for increased capital. "Because increasing capital often hurts bank shareholders by diluting earnings, bankers' responses [before 1983] to requests for additional capital were based on a careful weighing of the costs of compliance and non-compliance."[403]

It is possible that Congress will again strengthen enforcement powers relating to maintenance of adequate capital. Some bank supervisors are concerned that they have insufficient authority to require exceptionally risky banks to increase capital to appropriate levels.

> They contend that the litigious nature of U.S. business coupled with the standards of evidence required in administrative law proceedings make it almost impossible to impose any penalties on banks whose activities are both legal and profitable. That is, the mere potential to suffer losses through, for example, ex-

398. 12 U.S.C. § 1818(i)(2)(E) (Supp. I 1989).
399. *Id.* § 1818(i)(2)(G).
400. *Id.* § 3907.
401. For the powers of the Farm Credit Administration to impose capital directives, see 12 U.S.C. § 2154(b) (1988).
402. 12 U.S.C. § 3907(b)(2)(B)(i) (Supp. I 1989).
403. Mitchell, *supra* note 346, at 19.

cessive concentration in commercial real estate may not be sufficient grounds to sustain a supervisory order to increase capital. Only actual losses are grounds to sustain such an order, and by that time it may be too late to avoid insurance losses. Some supervisors go so far as to say that this is *the* problem which has caused insurance costs to go out of control.[404]

vi. Other Enforcement Provisions

Section 1818(n) provides for ancilliary powers including the authority to administer oaths and affirmations, to take or cause to be taken despositions, and to issue subpoenas and compel the appearance of witnesses and production of documents. These powers are enforceable in court.[405]

5. *Requirement of Safeguards or Disapproval of Enterprise Lines of Business that Appear Too Risky*

Due to enterprises' huge size and specialized lending activities, it may be appropriate to add to the range of bank supervisory practices. Because of their specialized lending, the first indications of loss from risky activities may be followed quickly by losses affecting a large part of an institution's business. By contrast, a diversified lender may not face the same potential problems—of interest, credit, or operations risk, for example—sweeping away much of its business at once.

Thus, it may be easiest to address risk-taking by enterprises before, rather than after, losses occur. Today, federal regulators of several GSEs may have considerable statutory authority to approve or disapprove business activities of the regulated institutions. On the one hand, prior approval authority may help to protect taxpayers against financial loss resulting from risky activities. On the other hand, such prior approval authority should not be permitted to degenerate into a form of micromanagement of business decisions by responsible enterprise managers. The heavy use of prior approval authority by FCA before FCS failed in 1985 stands as a warning of the kind of problems that can be caused by excessive use of such authority.

If structured carefully, prior approval authority may be a useful safety and soundness tool. For example, if sophisticated models are available to project interest rate risk and credit risk, and possibly other forms of risk, such models could help in setting standards for a regula-

404. 1991 TREASURY BANK REPORT, *supra* note 171, at I-15 (emphasis in original).
405. 12 U.S.C. § 1818(n) (Supp. I 1989).

tor's exercise of prior approval. A regulator might require, for example, that the interest rate risk or credit risk of a proposed new business activity be confined to specified limits, as reflected in the relevant models, or that the new activities be accompanied by levels of capital commensurate to the likely risk. The regulator might supplement this prior approval with special reporting requirements or examinations to assure that, as the programs are implemented, risks are not substantially greater than initially projected.

It is probably not useful—except for possibly extreme cases such as an application to trade highly volatile derivative securities[406]—for approval to be sought or granted on a product-by-product basis. Most GSEs are huge institutions. So long as reasonably projected losses are significantly less than the available shareholder capital, those losses are likely to be borne by shareholders rather than by taxpayers. On the other hand, the regulator has the responsibility to protect taxpayers against the unknown risk of entry by the enterprise into new and untried businesses on a large scale. As the thrift debacle and the experience of some failed banks have shown, substantial losses can place pressure on previously prudent managers to compound financial risks in an effort to extract themselves from a difficult situation. To protect against abuse of regulatory discretion, this decision should be subject to judicial review in the same way that cease-and-desist orders and other agency actions are reviewable. For a safety and soundness regulator, the legislative history might clarify that the prior approval power should be confined to addressing issues of financial soundness and be used to limit unnecessary risk-taking.

6. *Ability to Deal With a Faltering or Failed Institution; Authority to Appoint a Conservator or Receiver*

A major lesson from the thrift industry debacle is that the likelihood of irresponsible behavior increases substantially as the proportion of shareholder-contributed capital reaches low levels.[407] When an institution is well capitalized,[408] the regulator should not be involved with

406. Sanborn, *Stripped MBSs: They're No Myth*, FREDDIE MAC REPORTS (Aug. 1989). The article counsels: "[I]nvestors should proceed with caution. Strips are more volatile than other MBSs, and have a relatively short performance history. Other unexpected events, such as sudden rate drops or an inverted yield curve can lead to undesirable consequences if the strips are not properly matched." *Id.* at 5.

407. R. BRUMBAUGH JR. *supra* note 96, at 59-70.

408. *Compare* STATE OF RISK, *supra* note 1, at 180-82 (stating that risk-based and minimum capital requirements for commercial banks provide one possible benchmark for making such determination) *with* 1991 GAO REPORT, *supra* note 2, at 32-33 (pro-

day-to-day management affairs.[409] As capital levels drop, the regulator will have to become more actively involved.

Like other federally-backed financial institutions, GSEs do not automatically go out of business when they fail.[410] An enterprise can continue to issue huge volumes of government-guaranteed debt and mortgage-backed securities unless constrained by a statutory provision such as a minimum capital requirement.[411]

The experience of FHLBB with thrift institutions shows the importance of permitting the Federal Government to intervene before the net worth of a federally-backed institution drops to zero.[412] Once zero net worth is reached, however, the problems that plague the enterprise are likely to continue to create substantial negative net worth.[413] One valuable concept considered by FHLBB was to permit the federal regulator to appoint a conservator or receiver for a failing institution once its capitalization had declined to a specified point.[414]

E. *Confining and Structuring Supervisory Discretion*

Just as important as authorizing and empowering the regulator to act decisively is the need to define and structure the supervisor's administrative discretion and to provide for impartial review to protect against abuse. The regulatory agency's enabling legislation can help to define the scope of authority. This was accomplished for FCA, for example, in the 1985 Farm Credit Amendments, when FCA was changed from a virtual component of FCS, involved in day-to-day management decisions, into an arms-length financial regulator.[415] On the other hand, the limited initial grant of authority to FCA to supervise Farmer Mac, 12 U.S.C. section 2279aa-11(a), expanded somewhat in 1990 amend-

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posing risk related enterprise capital standard essentially combining two bank-type capital requirements).

409. *Id.* at 38-39; Neuberger, *How to Close Troubled Banks*, FED. RESERVE BANK OF SAN FRANCISCO WEEKLY LETTER 1 (Dec. 7, 1990)].

410. STATE OF RISK, *supra* note 1, at 2.

411. The Fannie Mae Charter Act contains a debt-to-asset limit that precludes issuance of new obligations if, as a result, the outstanding debt of the enterprise would exceed its assets. This provision is ineffective in limiting losses because it fails to preclude issuance of guaranteed mortgage-backed securities by the enterprise, even if its net worth is zero or negative. The Freddie Mac Charter Act does not contain this limitation at all. *Compare* 12 U.S.C. § 1719(b) (Supp. I 1989) [Fannie Mae] *with* 12 U.S.C. § 1452(b)(5) (Supp. I 1989) [Freddie Mac].

412. Neuberger, *supra* note 409, at 3; 1991 TREASURY BANK REPORT, *supra* note 171, at X13-22.

413. Neuberger, *supra* note 409, at 3.

414. Under the FHLBB proposal, that point would have been reached when capital dropped to 1.5% of assets based on book value.

415. 12 U.S.C. § 2252 (1988).

ments, stands as a warning that confinement of discretion should not be so great as to hamper an agency from being effective.

The Administrative Procedure Act (APA) provides an important check on abuse of agency discretion. Part VII of the APA, 5 U.S.C. sections 701-706, permits adversely affected parties to obtain judicial review of agency action; section 706 sets forth the appropriate standard of review.

1. *Confining the Supervisor's Discretion to Apply Enforcement Powers*

The courts have been active in reviewing enforcement actions by the bank supervisory agencies to help protect against misuse of the supervisors' statutory powers. Under 12 U.S.C. section 1818, bank supervisory agencies are authorized to issue cease-and-desist orders, and otherwise apply enforcement powers to deal with "unsafe or unsound practices." The term "unsafe or unsound practices" was authoritatively defined in the legislative history of the Financial Institutions Supervisory Act of 1966, as follows:

> Like many other generic terms widely used in the law, such as "fraud," "negligence," "probable cause," or "good faith," the term "unsafe or unsound practices" has a central meaning which can and must be applied to constantly changing factual circumstances. Generally speaking, an "unsafe or unsound practice" embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.[416]

While the term "unsafe or unsound practices" must be applied to an evolving variety of specific fact patterns, judicial decisions have given considerable context to its application.[417] As the decisions emphasize, the legislative history of cease-and-desist orders and other enforcement

416. 64 CONG. REC. 26,474 (daily ed. Oct. 18, 1966) (Memorandum prepared by FHLBB Chairman, introduced by Senator Robinson). MCorp Fin., Inc. v. Board of Governors, 900 F.2d 852, 863 (5th Cir. 1990) (defining term "unsafe or unsound practices").

417. *See* Gulf Fed. Sav. & Loan Assoc. of Jefferson Parish v. FHLBB, 651 F.2d 259 (5th Cir. 1981) (holding that alleged practices must be directly related to institution's financial integrity and Federal Government's risk); First Nat'l Bank of Eden v. Department of Treasury, 568 F.2d 610, 611 (8th Cir. 1978) (indicating that unsafe and unsound practices encompass what may be generally regarded as conduct deemed contrary to accepted standards of banking operations which might result in abnormal risk or loss to banking institution or shareholders); Otero Sav. & Loan Assoc. v. FHLBB, 665 F.2d 279, 288 (10th Cir. 1981) (holding that cease-and-desist authority does not give regulator mandate to address competitive balance among financial institutions).

powers shows a congressional intent to balance a variety of factors including financial risk to the government against the interest of financial institutions in receiving fair treatment from the government and in "receiving a reasonable degree of protection from arbitrary government action."[418]

In exercising authority under the law, a federal bank regulator must attempt to maintain this balance. A federal agency is entitled to some deference. However, the regulator "must not become so obsessed with protecting the integrity of the national banking system that individual banks are arbitrarily treated."[419] Under the APA,[420] actions of a federal regulator will be overruled by the courts if they are arbitrary, capricious, or abuses of discretion. Moreover, the regulator may not merely assert reasons to justify enforcement actions; the regulator must make findings supported by subtantial evidence. Finally, although the regulator has considerable discretion to fashion appropriate remedies, courts will scrutinize those proposed remedies and apply the arbitrary and capricious standard.[421] Similar limitations apply to a regulator's discretion in reorganizing or closing a failing or failed institution.[422]

Courts in recent cases have articulated the principle that a regulator may be bound by earlier regulatory agreements and have begun to define the contours of this principle.[423] It would also be appropriate for the Congress to supplement these judicial decisions with legislative history, perhaps comparable to that of the 1966 Financial Institutions Supervisory Act, that sets further limitations on the regulator's discretion. Especially if the safety and soundness regulator of GSEs is separate

418. Financial Institutions Supervisory Act of 1966, Pub. L. No. 89-695, 1966 U.S. CODE CONG. & ADMIN. NEWS 3534 (providing legislative history of Financial Institutions Supervisory Act of 1966).

419. First Nat'l Bank of Bellaire v. Comptroller of Currency, 697 F.2d 674, 681 (5th Cir. 1983).

420. 5 U.S.C. § 706 (1988).

421. *First Nat'l Bank of Bellaire*, 697 F.2d at 681.

422. *See* MCorp Fin., Inc. v. Board of Governors, 900 F.2d 852, *reh'g denied*, 911 F.2d 730 (5th Cir. 1990) (noting that court will not require plaintiff to exhaust administrative remedies, where only issue is legal and does not require factual development; government will be enjoined from prosecuting administrative actions under 12 U.S.C. section 1818); Sterling Sav. Ass'n. v. Ryan, 751 F. Supp. 871 (E.D. Wash. 1990) (stating that court will enjoin government from placing institution into conservatorship or receivership where institution is likely to prevail on merits of its defense to such action).

423. *Compare* Security Fed. Sav. Bank v. Office of Thrift Supervision, 747 F. Supp. 656 (N.D. Fla. 1990) and Far West Fed. Bank v. Office of Thrift Supervision, 738 F. Supp. 1559 (D. Ore. 1990) *with* Flagship FSC v. Wall, 748 F. Supp. 742 (S.D. Cal. 1990); *See* Washington Fed. Sav. & Loan v. FHLBB, 526 F. Supp. 343 (N.D. Ohio 1981) (holding that regulator must base decision to appoint receiver on facts that related to specific statutory ground for such appointment).

from the program regulator, it might be useful for the legislative history to specify that enforcement powers must be exercised solely to address concerns about the risk to the Federal Government and taxpayers, and not with respect to other policy considerations such as competitive balance among financial institutions.

2. Structuring the Supervisor's Discretion

The issue of structuring discretion of a federal financial supervisor is more difficult. Federal financial regulators such as FDIC and the Office of the Comptroller of the Currency, and also FCA since 1987, have long been reluctant to issue many regulations containing self-imposed limitations on their authority.[424]

Such reluctance is based upon years of difficult experience. As lawmakers and regulators have fashioned categories of proscribed conduct, new technologies[425] and market-based developments[426] have provided the supervised institutions with the means to engage in practices that comply with the letter of the law while eviscerating the intended regulatory effect.[427]

One regulatory response has been to attempt to retain maximum unfettered discretion without being confined by implementing regulations.[428] While this response may be appropriate for bank regulators given the thousands of institutions they must supervise, it is arguably less appropriate for supervising the safety and soundness of GSEs.

The large size of several enterprises, and the reliance of most on large volumes of similar transactions, permit a regulator to specify in advance some limits on risk-taking and unsafe and unsound practices. Otherwise, the housing or student loan markets, for example, might be unnecessarily buffeted by unforeseen swings in regulatory policy.

One useful approach would be for the enterprise regulator to use the informal rulemaking process to specify some kinds of unsafe and unsound practices and conditions that would be considered grounds for seeking a cease-and-desist order, restricting payment of dividends, or applying other specified sanctions. As Professor Kenneth Culp Davis has argued, "agencies through rulemaking can often move from vague or absent statutory standards to reasonably definite standards, and

424. For an early example, see K. C. DAVIS, DISCRETIONARY JUSTICE: A PRELIMINARY INQUIRY 120-26 (1971).
425. R. LITAN, WHAT SHOULD BANKS DO? 33-59 (1987).
426. *Id.*
427. *Id.*
428. K.C. DAVIS, *supra* note 424, at 120-26.

then, as experience and understanding develop, to guiding principles, and finally, when the subject matter permits, to precise and detailed rules."[429] Out of necessity, these bright lines must be accompanied by a clear regulatory statement that the adminstrative agency reserves authority to act in other cases as well, even though the supervisor has not defined the offending practices beforehand in regulations.[430] The large size of the enterprises makes rulemaking especially important to supplement the exercise of management's authority when required reports or periodic examinations reveal examples of excessive risk-taking or unsafe or unsound conditions of a kind that could not have been specified beforehand.

One other caveat must also be mentioned. As developments occur in the marketplace, and innovations take place in financial services, concepts of excessive risk inevitably will change as well. The recent *Franklin Savings*[431] case, in which a federal judge found that the Office of Thrift Supervision had failed to comprehend the nature of sophisticated hedge transactions,[432] stands as an important warning about the need for the regulator promptly to abandon or modify concepts of excessive risk when they are no longer current.[433] However, market developments may also add to the list of enterprise practices considered excessively risky, just as the federal bank regulators learned the dimensions of interest rate risk in the 1970's[434] and sovereign risk in the 1980's.[435]

Even if all contingencies cannot be predicted in advance, the use of informal rulemaking can help set some clear limits on risk-taking and protect the regulated institutions against rapid changes in regulatory philosophy. It will be important to assure that, in devising such regulations, the financial regulator is confined to safety and soundness issues, and not to the other more politically volatile issues of public purpose that, as is argued in Section VI below, are more properly left for con-

429. *Id.* at 219. *See* 1991 GAO REPORT, *supra* note 2, at 34-35 (noting enterprise regulator should use rulemaking to help "define regulatory expectations in sufficient detail to enable the GSE to determine the regulatory consequences of its business decisions").

430. For example, FDIC accompanies its few regulations concerning unsafe and unsound practices with a clear reservation of authority to take, "whatever action it deems necessary and desirable to deal with specific acts or practices which, although they do not violate the provisions of this part, are considered detrimental to the safety and sound operation of the bank engaged therein." 12 C.F.R. § 337.11 (1991).

431. Franklin Sav. Ass'n & Franklin Sav. Corp. v. Office of Thrift Supervision, 934 F.2d 1127 (1991).

432. *Id.*

433. *Id.*

434. R. BRUMBAUGH, JR., *supra* note 96, at 36.

435. H. KAUFMAN, INTEREST RATES, THE MARKETS, AND THE NEW FINANCIAL WORLD 81-89 (1986).

gressional decision.

IV. Federal Supervision of Enterprise Safety and Soundness Today

Federal supervision of safety and soundness of most enterprises today falls far short of the quality of bank and thrift supervision. Information is generally limited, and regulators often lack the resources, the mandate, and the full complement of statutory powers to address safety and soundness issues and to set effective capital requirements.

A. *The Quality of Federal Information*

There is no single source of information within the Federal Government about GSEs.[436] This is unfortunate, because regulation of enterprises involves issues of law, economics, and finance that merge in unusual ways. Statistics are often unavailable except from the enterprises themselves.

Information about particular enterprises is collected by a variety of federal agencies and organizations. HUD collects information from Fannie Mae and Freddie Mac;[437] FCA receives reports of conditions from farm credit institutions;[438] and FHFB collects information from FHLBs.[439]

OMB provides a central source of expertise on a variety of federal programs, but does not dedicate the same resources to GSEs.[440] As privately owned, off-budget entities, enterprises are beyond the scope of direct OMB authority.[441] OMB publishes an annual report on enterprise activities in the Appendix to the federal budget,[442] with numbers

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436. STATE OF RISK, *supra* note 1, at 163.

437. UNITED STATES DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, 1988-89 REPORT TO CONGRESS ON THE FEDERAL NATIONAL MORTGAGE ASSOCIATION (1990). *See* 24 C.F.R. § 81, subpart C & app. B (1991) (setting forth reporting requirements for Fannie Mae); UNITED STATES DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, NOTICE OF PUBLIC HEARING ON REGULATION OF FANNIE MAE AND FREDDIE MAC, 55 Fed. Reg. 25,377 (1990).

438. 12 U.S.C. §§ 2254, 2279aa-11 (1988). *See* 12 C.F.R. § 621, subpart B (1991) (describing Farm Credit Administration, including requirements for reports of condition and performance).

439. *See* 12 U.S.C. § 1440 (1988) (stating regulator shall require FHLBs to submit reports of condition at least annually).

440. For example, Office of Management and Budget examiners review budgets and programs of executive agencies but have not validated information provided by GSEs independently.

441. 1967 PRESIDENT'S COMMISSION ON BUDGET CONCEPTS 29-30 (finding that GSEs are not to be included in federal budget process if they are completely privately owned).

442. FISCAL YEAR 1992, BUDGET OF THE UNITED STATES, pt 4. "These [program

generated by the enterprises themselves; OMB does not independently verify their accuracy.

This has led to significant misperceptions. In the fiscal year 1986 (FY 86) budget, for example, Freddie Mac estimated that its FY 86 activities would result in a net increase of outstanding mortgage-backed securities of $10.6 billion.[443] In fact, this estimate was over $40 billion below the actual increase in outstanding mortgage-backed securities that year, which amounted to $54.9 billion.[444] The practice of accepting enterprise information without further analysis may change as OMB acts to implement its new statutory mandate[445] to report annually as a part of the President's budget submission on the financial condition of the GSEs and the financial exposure of the government.[446]

Within the legislative branch, CBO and GAO continue to increase the allocation of resources to analysis of GSEs and their activities. The 1989 Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA)[447] has improved on this state of affairs, at least in the short term. Provisions of FIRREA required the Treasury and GAO to publish annual reports, in 1990 and 1991, on the type and degree of risks involved in activities of each enterprise,[448] as well as their market value net worth.[449] GAO is also required to determine appropriate capital standards that might be applied to each enterprise.[450] In 1990, Congress also requested that CBO study GSEs, their risk-taking, and alternative approaches to federal oversight.[451]

B. The Supervision of Enterprise Safety and Soundness Today

Even with the regulatory failures of FHLBB and FCA in the mid-1980's, the lessons of those failures have not been applied properly to regulation of enterprise safety and soundness.

One area in which the lesson has been learned is the newly strength-

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budgets] are not reviewed by the President; they are presented as submitted by the enterprises." *Id.* at 1223-29.

443. FISCAL YEAR 1986, BUDGET OF THE UNITED STATES, app., V-14.

444. FISCAL YEAR 1988, BUDGET OF THE UNITED STATES, app., IV-12.

445. Budget Enforcement Act of 1990, Pub. L. No. 101-508, § 13501(f), 104 Stat. 1388.

446. For Fiscal Year 1992, see FISCAL YEAR 1992, BUDGET OF THE UNITED STATES, *supra* note 442, at pt.2, 226-67.

447. Financial Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 101-73, 103 Stat. 183.

448. *Id.* §§ 1404, 1004 (citing reports by Treasury and GAO, respectively).

449. *Id.*

450. *Id.*

451. Budget Enforcement Act of 1990, Pub. L. No. 101-508, § 13501(c), 104 Stat. 1388.

ened FCA. FCA regulates Farmer Mac and the farm credit institutions under statutory powers similar to those of the federal bank regulators.[452] FCA can bring cease-and-desist proceedings, suspend or remove FCS institution officers and directors, impose civil money penalties, set and enforce capital adequacy standards, and appoint conservators or receivers.[453] The Agency is permitted to assess the regulated FCS institutions for supervisory costs, including the cost of examinations, and to pay FCA expenses from those assessments.[454]

While HUD possesses some statutory authority, until recently it has been reluctant to supervise the safety and soundness of Fannie Mae.[455] HUD has general regulatory authority to ensure that the purposes of the Fannie Mae and Freddie Mac charters are carried out,[456] but lacks a clear mandate to supervise Fannie Mae's or Freddie Mac's financial soundness.[457] HUD also lacks the resources to supervise the institutions effectively. Unlike other financial institution regulators such as FDIC,[458] HUD is not authorized to assess Fannie Mae or Freddie Mac the cost of maintaining a capable regulatory staff that is compensated at competitive levels comparable to salaries of the staff of federal bank regulators. Also, HUD is not authorized to bring its own litigation to court; instead, it must turn to the Department of Justice to bring suit. HUD is likely to be overwhelmed by responsibility for two enterprises

452. 12 U.S.C. §§ 2001 *et seq.* (1988).

453. *Id.* § 2154(b) (1988) (setting forth capital directives); *id.* §§ 2261-2263 (laying out cease-and-desist orders); *id.* §§ 2264-2265 (explaining removal of directors or officers); *id.* § 2268 (enumerating civil money penalties); 12 U.S.C. § 2783 (1988) (laying out appointment of conservator or receiver); *id.* § 2154(a) (stating capital standards).

454. 12 U.S.C. §§ 2250, 2279aa-11(d) (1988).

455. For example, HUD's 1986 REPORT TO CONGRESS ON THE FEDERAL NATIONAL MORTGAGE ASSOCIATION (June 29, 1987) states:

> GAO's first specific point was that the Federal Government should have a permanent oversight function on FNMA's operations. This, however, is inconsistent with HUD's regulatory rationale which, again, is grounded in legislative history and HUD experience. GAO does not specifically state the role which would be performed by an oversight staff, but it is doubtful that it could exist without becoming a "watchdog." Congress never intended for HUD to exercise such a role and the Department's negative experience in trying to control FNMA closely during the late 1970's highlights the futility of trying to do so.

1986 HUD REPORT, *supra* note 230, at 167-68.

HUD was responding to the 1985 Report of the United States General Accounting Office. UNITED STATES GENERAL ACCOUNTING OFFICE, THE FEDERAL NATIONAL MORTGAGE ASSOCIATION IN A CHANGING ECONOMIC ENVIRONMENT (1985). *See also, Financial Institutions Reform, Recovery and Enforcement Act of 1989: Supplemental Report, H.R. Rept. 101-54, House Comm. on Banking, Finance and Urban Affairs,* 101st Cong., 1st Sess., pt. 3, at 3 (1989).

456. 12 U.S.C. § 1723a(h) (1988).

457. 1985 FNMA REPORT, *supra* note 227, at 100-102.

458. 12 U.S.C. § 1817 (Supp. I 1989).

with combined lending amounting to over $800 billion dollars and growing by some $100 billion annually.[459]

During the 1980's, responsibility for overseeing Fannie Mae shifted among various HUD offices,[460] without HUD developing an experienced supervisory staff able to monitor and regulate financial risk-taking by the enterprise. Indeed, in 1989, HUD lacked even a single full-time official responsible for overseeing Fannie Mae and Freddie Mac.[461] HUD has never exercised its examination authority over Fannie Mae, even though that authority has been available since 1968.[462] HUD has concentrated on national housing policies, such as a controversy over Fannie Mae's support of low-income housing in the late 1970's,[463] rather than on narrower matters such as Fannie Mae's financial safety and soundness.

With passage of FIRREA, HUD has devoted increasing attention to the issue of safety and soundness of Fannie Mae and Freddie Mac.[464] On June 21, 1990, HUD published a notice of hearings on regulations to deal with a variety of matters including capital adequacy, reporting requirements, and enforcement mechanisms.[465] The hearings were divided into two parts, with Fannie Mae and Freddie Mac presenting their views privately to HUD,[466] followed by a public hearing for other witnesses on July 20, 1990.[467]

FIRREA created FHFB,[468] to oversee safety and soundness and the activities of FHLBS.[469] FHFB today has only a few examiners[470] to

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459. 1991 GAO REPORT, *supra* note 2, at 23; Knight, *Bailout of S&L's Spurs Probes of Other Programs: Hill Examines Taxpayer Liability in Huge U.S.-Backed Enterprises*, Wash. Post., Oct. 15, 1989, at H1-4.

460. *Id.* at H4.

461. *Id.*

462. 1991 GAO REPORT, *supra* note 2, at 23.

463. 24 C.F.R. §§ 81.16, 81.17, 81.18 (1991).

464. *Second Roundtable Hearing on the Safety and Soundness of Fannie Mae and Freddie Mac: Hearings Before Senate Subcomm. on Housing and Urban Affairs of the Senate Banking Comm.*, 101st Cong., 2d Sess. 13-14 (1990) (statement of Alfred A. Dellibovi, Under Secretary, HUD).

465. 55 Fed. Reg. 25,377 (1990).

466. United States Department of Housing and Urban Development, Hearings on the Federal National Mortgage Association and Federal Home Loan Mortgage Corporation Regulations, in Washington, D.C., (July 16, 1990) (unpublished reporter's transcript).

On July 20, 1990, HUD announced that a transcript of the Fannie Mae and Freddie Mac testimony would be made public at a later date. That transcript, with some deletions, was made available several months later.

467. This was announced in 55 Fed. Reg. 25,377 (1990).

468. Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 101-73, § 702, 103 Stat. 413 (codified at 12 U.S.C. § 1422a (Supp. I 1989)).

469. *Id.* § 1422a(a)(3)(D).

470. CBO REPORT, *supra* note 32, at 234.

inspect the entire FHLBS and its $166 billion of loan assets.[471] Sallie Mae has no financial regulator at all.[472]

Tables 3, 4, and 5 summarize the relevant statutory provisions providing each enterprise regulator with institutional capability and administrative authority. Each Table also lists comparable statutory authority of FDIC, a federal bank regulator, thus providing context for the analysis.

Table 3 summarizes provisions relating to institutional capability. FCA and FHFB have virtually all of the benefits available to the FDIC: (1) funding from assessments on the regulated institutions, rather than federal appropriations;[473] (2) freedom from executive branch budget controls;[474] (3) freedom to set their own staffing ceilings except that an appropriations act periodically sets FCA staff ceilings;[475] and (4) freedom to set salary schedules above civil service levels, at levels comparable to those paid by the federal bank regulators.[476] Only HUD, responsible for supervising the two largest enterprises, lacks these statutory benefits.[477] HUD is funded by federal appropriations, subject to executive branch budget controls, limited to staff ceilings specified in the federal budget process, and limited to salaries at civil service levels.

Table 4 summarizes the regulatory authority provided for each enterprise regulator. FCA has statutory authority closest to that available to federal bank regulators, including authority to prescribe reports, examine financial condition,[478] set binding capital requirements,[479] and appoint a conservator or receiver.[480] The statutory authority of FCA with respect to Farmer Mac is less clear in some important aspects because of the language of 12 U.S.C. section 2279aa-11 and some of

471. 1991 TREASURY REPORT, *supra* note 25, at A22.

472. The Higher Education Act, 20 U.S.C. § 1087-2(h)(2) (1988) provides that:

> Nothing in this section [with respect to Department of Education and Treasury approval of Sallie Mae obligations] shall be construed so as to authorize the Secretary of Eduation or the Secretary of the Treasury to limit, control, or constrain programs of the Association or support of the Guaranteed Student Loan Program by the Association.

Id.

473. *See supra* note 279 and accompanying text (laying out means of funding).

474. *See supra* note 282 and accompanying text (detailing freedom from controls).

475. *See supra* notes 280-81 and accompanying text (explaining staff ceilings).

476. *See supra* note 280 and accompanying text (citing examples of salary regulations).

477. *See supra* notes 283, 285 and accompanying text (explaining need for such capacity).

478. 12 U.S.C. §§ 2254(b), 2757(a), 2279aa-11(c) (1988).

479. *Id.* §§ 2254(a), 2279aa-11.

480. *Id.* § 2154(a).

the related legislative history.[481]

FHFB also has supervisory authority similar to that of the federal bank regulators.[482] Again, it is HUD that lacks authority, to set binding capital requirements or to appoint a conservator or receiver.[483] Moreover, HUD's express authority, to examine Fannie Mae and Freddie Mac, for example, is less complete than that of the other regulators.[484] This might lead to unnecessary controversy should HUD decide to examine the two enterprises. At a time of financial urgency, such a controversy might disrupt the regulator's effective performance.

Table 5 sets forth some of the major enforcement powers available to the various regulators. Again, FCA is closest to the bank regulators in the range of its powers. The other enterprise regulators lack most of the express enforcement powers available to FDIC. As a result, in the troublesome event of clear non-compliance by an enterprise, the Federal Government lacks the power to apply most of the sanctions that have been used to deal with other non-complying financial institutions. Rather than address such matters through federal agency action, the regulators must turn to Congress at a time of exigency to obtain necessary new authority. In a sense, this occurred when FCS failed in 1985. Congress fashioned remedial statutory provisions,

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481. *Id.* § 2183 (relating to FCS institutions other than Farmer Mac). *Compare* 134 CONG. REC. S10,799 (daily ed. Aug. 3, 1988) (statement of Senator Leahy) *with* 136 CONG. REC. S10,824-25 (daily ed. July 26, 1990) (statements of Senators Lugar and Leahy).

482. 12 U.S.C. §§ 1440, 1446 (Supp. I 1989).

483. Fannie Mae Charter Act, 12 U.S.C. §§ 1716-1723d (Supp. I 1989); Freddie Mac Charter Act, 12 U.S.C. §§ 1451-1459 (Supp. I 1989).

484. Compare HUD's authority under 12 U.S.C. § 1723a(h) (1988) with that of the FHFB under 12 U.S.C. § 1440 (1988). Section 1723a(h) states that, "[t]he Secretary may examine and audit the books and financial transactions of the Corporation and he may require the Corporation to make such reports on its activities as he deems advisable." 12 U.S.C. § 1723(a)(h) (1988).

Section 1440, by contrast, states that:

> [T]he Board shall from time to time, at least annually, require examinations and reports of condition of all Federal Home Loan Banks in such form as the Board shall prescribe and shall furnish periodically statements based upon the reports of the banks to the Board. For the purposes of this chapter, examiners appointed by the Board shall be subject to the same requirements, responsibilities, and penalties as are applicable to examiners under the National Bank Act [12 U.S.C. § 12 *et seq.* (1988)] and the Federal Reserve Act [12 U.S.C. § 221 *et seq.* (1988)], and shall have, in the exercise of functions under this chapter, the same powers and privileges as are vested in such examiners by law.

12 U.S.C. § 1330 (1988).

TABLE 3

INSTITUTIONAL CAPACITY

REGULATOR	SOURCE OF FUNDS	EXECUTIVE BRANCH CONTROL OF BUDGET	SETS OWN STAFFING CEILINGS	SETS OWN SALARY SCHEDULES COMPARABLE TO BANK REGULATORY AGENCIES
FDIC	Assessments on Regulated Institutions	No, OMB Circular A-11, § 11.2	Yes	Yes, 12 U.S.C. § 1833(b)
FCA	Assessment on Regulated Institutions 12 U.S.C. §§ 2250, 2279aa-11(d)	No, OMB Circular A-11, § 11.2	No, Limited by Annual Appropriations Act	Yes, 12 U.S.C. §§ 1733(b), 2245(c)
FHFB	Assessments on Regulated Institutions 12 U.S.C. §§ 1422b(c), 1438(b)	No, 12 U.S.C. § 1422b(c)	Yes, 12 U.S.C. § 1422b(b)	Yes, 12 U.S.C. § 1422b(b)
HUD	Federal Appropriations	Yes	No	No

Note: The Federal Government has not established a financial regulator for Sallie Mae.

TABLE 4

SUPERVISORY AUTHORITY

REGULATOR	PRESCRIBE REPORTS	EXAMINE	SET BINDING CAPITAL REQUIREMENTS	APPOINT A CONSERVATOR OR RECEIVER
FDIC	Yes, 12 U.S.C. § 1817(a)	Yes, 12 U.S.C. § 1820(b)	Yes, 12 U.S.C. § 3907(a)	Yes, 12 U.S.C. § 1821
FCA	Yes, 12 U.S.C. §§ 2254(b), 2257a, 2279aa-11(c)	Yes, 12 U.S.C. §§ 2254a, 2279aa-11	Yes, 12 U.S.C. § 2154(a); less clear for Farmer Mac	Yes, 12 U.S.C. § 2183; but not for Farmer Mac
FHFB	Yes, 12 U.S.C. § 1440	Yes, 12 U.S.C. § 1440	No, but see 12 U.S.C. § 1436(a) setting statutory capital levels	May liquidate or reorganize 12 U.S.C. § 1446
HUD	Yes, 12 U.S.C. §§ 1452(b)(4), 1723(a)(h)	Yes, 12 U.S.C. §§ 1452(b)(4), 1723(a)(h)	No (see discussion in text)	No

Note: The Federal Government has not established a financial regulator for Sallie Mae.

TABLE 5

ENFORCEMENT POWERS

REGULATOR	CAPITAL DIRECTIVES	ISSUE CEASE AND DESIST ORDERS	REMOVE DIRECTORS OR OFFICERS	IMPOSE CIVIL MONEY PENALTIES	RESTRICT DIVIDENDS	DISAPPROVE RISKY ACTIVITIES
FDIC	Yes, 12 U.S.C. § 3907(b)	Yes, 12 U.S.C. § 1818(b)-(d)	Yes, 12 U.S.C. § 1818(e)	12 U.S.C. § 1818(i)	Not Directly	Not Directly
FCA	Yes, 12 U.S.C. § 2154(b)	Yes, 12 U.S.C. §§ 2261-2263	Yes, 12 U.S.C. §§ 2264-2265	Yes, 12 U.S.C. § 2268	Not Explicitly; but see 12 U.S.C. § 2154(a)(d)	Yes, for financially related services; otherwise, not directly
FHFB	Not explicitly; but see 12 U.S.C. § 1432(a)	Not explicitly; but see 12 U.S.C. §§ 1432(a), 1422(b)(a)(1)	Yes, 12 U.S.C. § 1422(b)(a)	No	Yes, 12 U.S.C. § 1436(a)	Yes, 12 U.S.C. § 1432(a)
HUD	No	No	No, but see 12 U.S.C. § 1723(b) (President may remove Fannie Mae director for good cause)	No	Yes, 12 U.S.C. § 1452(b)(3)	Yes, for Fannie Mae: 12 U.S.C. § 1717; ambiguous for Freddie Mac: 12 U.S.C. § 1452(b)

Note: The Federal Government has not established a financial regulator for Sallie Mae.

but only after taxpayers had taken losses that could have been prevented.[485]

C. *Current Enterprise Capital Requirements*

The Federal Government has not set consistent capital requirements for GSEs.[486] Today, Fannie Mae is subject to a debt-to-capital ratio.[487] However, the statute permits Fannie Mae to count subordinated obligations as a part of its capital, and, in contrast to banks, the subordinated obligations are implicitly backed by the Federal Government. This renders the capital requirement virtually meaningless.[488]

FIRREA now applies similar requirements to Freddie Mac.[489] Freddie Mac especially will benefit from the fact that the statutory debt-to-capital requirement does not apply to off-balance sheet activities.[490] As a consequence, the debt-to-capital requirement will apply to Freddie Mac's $41 billion of assets, but not to its $316.4 billion of guaranteed mortgage-backed securities outstanding at the end of 1990.[491]

The absence of capital standards is reflected in the low capitalization of Fannie Mae and Freddie Mac today. Fannie Mae, for example, at the end of 1990 had only $3.9 billion of shareholder capital to support $433 billion of assets and guaranteed securities;[492] Freddie Mac had only $2.1 billion of shareholder equity to support $357 billion of assets

485. The Agricultural Credit Act of 1987 created an FCS Financial Assistance Corporation to provide government-guaranteed funds to recapitalize the FCS. Under the Act, the FCS institutions are obligated to repay these funds. 12 U.S.C. § 2278 (1988).

486. 1990 TREASURY REPORT, *supra* note 13, at 97.

487. 12 U.S.C. § 1719(b) (1988).

488. As one investment analyst has pointed out:

> Contrary to appearances, however, Fannie Mae has little reason to view capital requirements as a prospective constraint on its future operations. What makes HUD's requirement a red herring is that Fannie Mae is allowed by statute to include subordinated debt in its computation of regulatory capital. While the company's debt-to-equity ratio on a GAAP basis is 45:1, on a regulatory basis, including subordinated debt, it is currently 18:1. Thus, Fannie Mae can always improve its regulatory capital ratio further by raising additional subordinated debt. Fannie Mae pays only 10 to 15 basis points more for subordinated debt than for other debt instruments; the public markets perceive Fannie Mae's subordinated debt as implicitly backed by the Federal Government, which would almost certainly prove correct if Fannie Mae ran into trouble.

FIRST BOSTON CORPORATION, A FLURRY OR RECENT ARTICLES TAKES SWIPES AT FANNIE MAE; NO REASON FOR INVESTOR CONCERN; MAINTAIN BUY OPTION 2 (1989). *See also* 1990 TREASURY REPORT, *supra* note 13, at A72-74, B60-62; 1990 GAO REPORT, *supra* note 250, at 100-01.

489. 12 U.S.C. § 1452(b)(5) (Supp. I 1989).

490. *Id.*

491. 1991 TREASURY REPORT, *supra* note 25, at A33.

492. *Id.* at A45.

and guarantees.[493] This is substantially below the capital requirements established for commercial banks by FDIC, Comptroller of the Currency, the Federal Reserve Board, or OTS in the case of thrifts.[494]

FCA is responsible for setting capital standards for FCS institutions.[495] FCA has promulgated regulations requiring that most FCS institutions meet minimum risk-based capital requirements.[496] Those requirements involve a minimum ratio of permanent capital to risk-weighted assets of seven percent, to be achieved by 1993.[497] They also provide forbearance criteria for institutions that do not meet the capital adequacy standards during a transition period.[498] The 1990 Treasury Report raises the question whether FCS borrower stock is truly at risk in the same way that investor equity capital would be.[499] FCA has not set any capital standards for Farmer Mac, the newest GSE, and would benefit from express authority to do so by regulation.

FHLBS is required by its charter act to maintain a capital reserve,[500] and has maintained substantial capital, amounting to over seven percent of assets at the end of 1990.[501] Sallie Mae has no capital requirements at all, but on its own has maintained capital that at the end of 1990 amounted to 2.8% of its assets.[502]

V. The Treasury and General Accounting Office Reports: Calls for Increased Financial Accountability of Government-Sponsored Enterprises

A. *The 1990 Treasury Department Report*

In May 1990, the Treasury Department published the *Report of the Secretary of Treasury on Government-Sponsored Enterprises* (Treasury Report).[503] The Treasury reviewed the safety and soundness of each enterprise.[504] In accordance with its specific statutory mandate,[505]

493. *Id.* at A33.
494. 1990 TREASURY REPORT, *supra* note 13, at A86-87 [Fannie Mae], B72-73 [Freddie Mac].
495. 12 U.S.C. § 2154(a) (1988).
496. 12 C.F.R. § 615.5200, subpt. H (1991).
497. *Id.*
498. *Id.*
499. 1990 TREASURY REPORT, *supra* note 13, at D53-55.
500. 12 U.S.C. §§ 1430(b), 1426(c) (1988 & Supp. I 1989); 12 C.F.R. § 910.1 (1991).
501. 1991 TREASURY REPORT, *supra* note 25, at A24.
502. *Id.* at A52.
503. *See* 1990 TREASURY REPORT, *supra* note 13.
504. The enterprises include Fannie Mae; Freddie Mac; FHLBS; FCS; Farmer Mac; and also Connie Lee, which is not a GSE but a joint venture between the United States Government and Sallie Mae.

the Treasury reviewed the capitalization of each enterprise as well as specific kinds of risk: credit risk, interest rate risk, management and operations risk, and business risk.

In producing the Treasury Report, the Treasury operated under significant limitations. Most importantly, the Treasury relied on self-reporting by each enterprise; Treasury officials did not independently verify the accuracy of responses.[506] Also, the statute contained extensive confidentiality requirements that precluded the Treasury from exchanging information within the Federal Government, for example, with HUD, FCA, or the Department of Education. In spite of these limitations, the quality of the 1990 Treasury Report is especially impressive.

For each enterprise, the Treasury Report provides: (1) a description; (2) an overview of financial safety and soundness; (3) assessments of business risk, credit risk, interest rate risk, and management and operations risk; (4) an analysis of capital adequacy; and (5) a discussion of the quality and timeliness of information provided by each GSE to the public and to the Federal Government. The Treasury also attempted, although unsuccessfully, to measure the impact of enterprise borrowing on the cost of Federal Government borrowing.[507]

The Treasury Report provides a veritable checklist of important elements of financial risks and the extent to which each enterprise can or has kept the risk under control. The Treasury Report found, among other things, that Fannie Mae's biggest credit risk is a regional or national economic slowdown;[508] about fifty percent of Fannie Mae's outstanding mortgages are concentrated in five states.[509] For large interest rate increases of three percentage points, the net market value of Fannie Mae's mortgage business turns negative;[510] for even larger interest rate changes, Fannie Mae's net worth becomes negative.[511] Fannie Mae's ability to use its new management information system effectively needs improvement.[512] The Treasury does not consider Fannie Mae's

505. The Treasury study was authorized and directed by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Pub. L. No. 100-73, § 1404, 103 Stat. 551.

506. The Treasury, however, did test responses for internal consistency. 1990 TREASURY REPORT, *supra* note 13, at A65.

507. 1990 TREASURY REPORT, *supra* note 13, at 27-33. *See also*, 1991 TREASURY REPORT, *supra* note 25, at 47-52.

508. 1990 TREASURY REPORT, *supra* note 13, at 13.

509. *Id.*

510. *Id.*

511. *Id.*

512. The Treasury reported, for example, that "Fannie Mae has not yet developed the ability to query the system for data in an accurate, consistent or timely manner."

current leverage an imminent threat, but additional capital is necessary.

The 1990 Treasury Report reveals that Freddie Mac's mortgage business is geographically more diversified than is Fannie Mae's, and Freddie Mac manages its credit risk.[513] Under current policies, Freddie Mac's exposure to interest rate risk is small.[514] Freddie Mac has adequate controls, monitoring, and information systems.[515] The corporation's current degree of leverage does not seem to present an imminent threat but raises concern for the long term.[516]

According to the Treasury Report, FHLBs face problems associated with declining membership and declining demand for FHLBS funding due to contraction of the thrift industry.[517] FHLBS has successfully controlled credit risk, as it has never suffered a loss on an advance,[518] and has effectively managed interest rate risk.[519] FHLBS successfully controls management and operations risk and is currently well capitalized.[520]

The Treasury Report indicates that FCS remains exposed to the volatility of the agricultural sector and continues to experience credit risk due to its restriction to a single economic sector.[521] FCS has significantly improved its management of interest rate risk, but futher improvement is still needed.[522] Some institutions in the system are exposed to risks associated with the lack of effective oversight by their boards of directors, ineffective internal audit functions, and inadequate management information systems.[523] There is some question whether the borrower stock of FCS, a major component of the system's permanent capital, is at risk in the way that shareholder equity represents true capital;[524] FCS must build retained earnings to protect against losses.[525]

The Treasury Report reveals that Sallie Mae is not exposed to much

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1990 TREASURY REPORT, *supra* note 13, at A65.

513. 1990 TREASURY REPORT, *supra* note 13, at 15.

514. *Id.*

515. *Id.* at 16.

516. *Id.*

517. *Id.* at 17.

518. 1990 TREASURY REPORT, *supra* note 13, at 17.

519. *Id.*

520. *Id.* at 18.

521. *Id.* at 19.

522. *Id.*

523. 1990 TREASURY REPORT, *supra* note 13, at 20.

524. *Id.*

525. *Id.* at 20.

business risk or interest rate risk.[526] The corporation is protected from credit risk on its federally guaranteed or insured student loan portfolio,[527] but should require collateral in swap transactions sufficient to cover its credit risk exposure.[528] Sallie Mae has adequate controls to manage and monitor its operations,[529] and it has a strong capital base and does not need to increase its capital at this time.[530]

B. The 1990 General Accounting Office Report

GAO, operating under a legislative mandate similar to that of the Treasury, released its report (GAO Report) in August 1990.[531] For each GSE, the GAO Report analyzes: (1) its risks and the quality of its risk management; (2) its loss reserves and capital adequacy; and (3) the quality of current federal oversight of its risk-taking and capitalization.[532] GAO is often critical of the quality of current federal oversight of GSEs. In particular, GAO concluded that:

> Fannie Mae, Freddie Mac, and Sallie Mae are not subject to (1) adequate federal monitoring of their risk-taking, (2) minimum capital rules that are risk-based, or (3) adequate enforcement authorities. We are concerned that the government would not be prepared to prevent or mitigate losses from the future crisis facing Fannie Mae, Freddie Mac, or Sallie Mae.[533]

GAO found that Fannie Mae, Freddie Mac, and Sallie Mae are subject to much weaker monitoring, capital rules, and enforcement actions than are banks with federally insured deposits.[534] FHLBS is subject to minimum capital requirements, monitoring of activities, and enforcement actions that seem to provide reasonable means for the government to control excessive risk-taking.[535] It is unclear how the new FHFB will implement its authority and whether it will be effective.

The GAO Report also notes that legislation passed in 1985[536] gave FCA powers similar to those of federal bank regulators and made it independent of FCS. The Report found that Sallie Mae has neither a

526. *Id.* at 23.
527. *Id.*
528. 1990 TREASURY REPORT, *supra* note 13, at 23.
529. *Id.*
530. *Id.*
531. The General Accounting Office operated under the provisions of the Financial Institutions Reform, Recovery and Enforcement Act of 1989, Pub. L. No. 100-73, § 1004, 103 Stat. 509 (codified at 12 U.S.C. § 1833a (1988)).
532. 1990 GAO REPORT, *supra* note 250.
533. *Id.* at 90.
534. *Id.* at 97.
535. *Id.* at 99.
536. *Id.* at 98.

federal regulator nor federally established capital requirements.[537]

C. 1990 Treasury and GAO Recommendations

The 1990 Treasury proposals, presented to the House Ways and Means and Senate Banking Committees by Robert R. Glauber, Under Secretary for Finance,[538] consisted of four guiding principles and recommendations to reduce risk to the taxpayer and to assure the long-term solvency of GSEs. The four principles are:

> 1. Each enterprise should be adequately capitalized, meet high credit and operational standards, and be subject to effective government supervision;[539]
> 2. A private market mechanism should be used to evaluate enterprise risk; each enterprise should obtain a rating equivalent to "AAA", absent any implicit government guarantee, from at least two of the nationally recognized credit rating companies;[540]
> 3. Enterprises should be supervised for financial safety and soundness by a regulator different from the program regulators; in other words, a financial regulator such as the Federal Reserve, FDIC, or the Treasury itself should supervise safety and soundness of the enterprises while agencies such as HUD remain responsible for overseeing the programmatic activities of enterprises such as Fannie Mae and Freddie Mac;[541] and
> 4. Each enterprise should disclose annually the value of the Federal Government's credit support. This should be measured as the difference between (1) the cost of funds of the enterprise and (2) the cost of funds of a corporation that has the credit rating that the enterprise has obtained, again, without regard to the government's implicit guarantee.[542]

In 1991, the Treasury presented recommendations varying somewhat from those of 1990. The Treasury recommended that the regulator set risk-related capital requirements, rather than requiring that all enterprises obtain a "AAA" rating.[543]

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537. 1990 GAO Report, *supra* note 250, at 103.
538. *Risks and Oversight of Government Sponsored Enterprises: Hearings Before the Subcomm. on Oversight of the House Ways and Means Comm.*, 101st Cong., 2d Sess. (1990) (statement of Robert R. Glauber, Under Secretary for Finance, Treasury) [hereinafter Testimony of Robert R. Glauber].
539. 1990 TREASURY REPORT, *supra* note 13, at 7.
540. *Id.* at 8-9.
541. *Id.* at 10.
542. *Id.* at 11.
543. 1991 TREASURY REPORT, *supra* note 25.

In 1990 testimony, Assistant Comptroller General Richard L. Fogel[544] largely concurred in the Treasury's position. However, GAO recommends applying bank-type regulatory requirements and risk-based capital standards rather than relying upon the ranking of private rating companies to set capitalization levels.[545] If the Treasury's recommendations were adopted and private rating companies were used, then Fogel recommended that the enterprises' federal financial regulator closely examine the assumptions used by each rating company and the appropriateness of the final capital standard.[546] In 1991, GAO presented its recommendations in more detail.[547]

The reports raise a range of administrative issues, relating to institutional regulatory structure, capital standards, and supervisory matters.

D. Regulatory Issues Raised by the Two Reports

The two 1990 reports raised a range of administrative issues, especially relating to the preferred institutional regulatory structure.

1. Separating Program Regulation from Financial Supervision

In 1990, both the Treasury and GAO recommended separating program regulation of enterprises, such as separating the supervision of the extent and manner in which the enterprises serve their public purposes from federal supervision of safety and soundness.[548] With respect to HUD, the GAO Report noted: ". . . [W]e are concerned about inherent conflicts between HUD's housing policy goals and its goals as a financial regulator. Recent history with the thrift crisis and the Farm Credit crisis has illustrated the disastrous effects of having regulators both promote the industry and be responsible for financial oversight."[549]

The Treasury Report, possibly to preserve comity within the executive branch, refrained from criticizing existing regulators such as HUD or FCA. The Report recommended, however, that as a general principle, "the program regulator should be different from the implementer

544. *Risks and Oversight of Government Sponsored Enterprises: Hearings Before Subcomm. on Oversight of the House Ways and Means Comm.*, 101st Cong., 2d Sess. 11 (1990) (testimony of Richard L. Fogel, Assistant Comptroller General) [hereinafter Testimony of Richard L. Fogel].

545. 1990 GAO REPORT, *supra* note 250, at 104; 1991 GAO REPORT, *supra* note 2, at 41, 58.

546. Testimony of Richard L. Fogel, *supra* note 544.

547. These are contained in 1991 GAO REPORT, *supra* note 2.

548. 1990 TREASURY REPORT, *supra* note 13, at 10; 1990 GAO REPORT, *supra* note 250, at 107.

549. Testimony of Richard L. Fogel, *supra* note 544.

of financial safety and soundness standards."[550]

Both reports refer to the history of financial regulators[551] and the problems that can beset a federal regulator when its role as promoter of the mission or industry served by institutions conflicts with its role as protector of the institutions' safety and soundness. Each recommends that the programmatic regulator continue to supervise the benefits of enterprise activities, but that a separate regulator oversee enterprise safety and soundness.[552]

2. *Centralizing Financial Supervision of all Enterprises in a Single Agency*

In 1990 testimony, Treasury Under Secretary Robert Glauber[553] pointed to FRB, FDIC, or the Treasury itself as suitable locations for the function of supervising enterprise safety and soundness.[554] Regulation of safety and soundness of all GSEs would thereby be centralized within a single federal agency. Issues involving the allocation of enterprise benefits and the extent to which GSEs should be permitted to engage in new kinds of activities, would be left to Congress, or to the appropriate executive department oversight agency, such as HUD.[555]

Under Secretary Glauber's 1990 recommendation raises some institutional issues. If the financial regulator were located in the Treasury, it might be structured as a distinct office similar to the Office of the Comptroller of the Currency, or the recently created Office of Thrift Supervision. Alternatively, the centralized regulator might be structured as an independent agency responsible for supervising safety and soundness of all enterprises, similar to FDIC.

The centralized regulator would develop long-term expertise in assessing and regulating financial soundness of the enterprises. Especially important, the regulator would apply lessons learned from one GSE in overseeing the others and in providing guidance to Congress about structuring proposed new enterprises. The enterprises would no longer be treated as unique financial institutions, embodying public and private characteristics capable of engendering considerable confusion among federal policymakers.

There are arguments against centralized regulation of the various en-

550. 1990 TREASURY REPORT, *supra* note 13, at 10.
551. The history of the Farm Credit Administration before 1985, and FHLBB were mentioned.
552. 1990 TREASURY REPORT, *supra* note 13, at 23.
553. Testimony of Robert R. Glauber, *supra* note 538.
554. *Id.*
555. *Id.*

terprises. Traditional constituencies of the enterprises are concerned about the consequences of such regulation, even if it is limited to considerations of financial soundness. For example, Henry Schechter, then Director of the AFL-CIO Office of Housing and Monetary Policy, contended that, "[t]here would be a loss of sympathetic understanding for the various types of financing programs to meet housing and other special needs, and perhaps prejudice toward greater restrictiveness than is necessary to avoid excessive risks."[556]

Similarly, supporters of FCS institutions[557] point out that regulation of their unique cooperative structure requires a special sensitivity to the significant differences between cooperative principles and operations and those of traditional profit-oriented corporations.[558] Sallie Mae is likely to oppose subjecting that corporation to any supervision at all, especially given Sallie Mae's tradition of exceptional financial soundness.[559] Finally, it can be argued that a centralized regulator would lack necessary knowledge of the specialized markets for mortgages and farm credit now found in HUD and FCA.

There are political reasons why centralizing the regulation of enterprises may not succeed. Some congressional committees fear partial loss of authority over enterprises now completely within their jurisdiction.[560] As an alternative to centralized regulation of the financial soundness of all of the enterprises, Congress might attempt to fashion a common regulatory structure for each enterprise under capable individual regulators. This, however, would make them even more prone to regulatory capture than would be the case for a centralized financial regulator. Indeed, in 1991 the Treasury itself seemed to succumb to political pressure[561] and proposed, instead of a centralized regulator, that HUD continue to oversee Fannie Mae and Freddie Mac. This would be done, the Treasury suggested, through a new "arms-length

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556. Letter from Henry B. Schechter to Thomas H. Stanton, Esq. (May 12, 1987); 1990 TREASURY REPORT, *supra* note 13, at 10.

557. Supporters include the Farm Credit Council, a private lobbying group representing FCS institutions.

558. Discussions with author at the Farm Credit Council Annual Meeting (Jan. 22, 1990).

559. *See supra* notes 505-09 and accompanying text (describing Sallie Mae's successful management of credit and interest rate risk and adequate capitalization).

560. Letter from House Committee Chairmen Henry Gonzalez, E. "Kika" de la Garza and Augustus F. Hawkins to House Speaker Thomas S. Foley (June 11, 1990), *reprinted in Secondary Mortgage Markets: Hearings Before Subcomm. on Housing and Community Development of the House Comm. on Banking, Finance and Urban Affairs*, 101st Cong., 2d Sess. 226 (1990).

561. *New Treasury Report on GSEs Proposes Remarkably Palatable Regulatory Scheme for Fannie Mae and Freddie Mac*, INSIDE MORTGAGE CAPITAL MARKETS 3 (May 3, 1991).

bureau."[562]

VI. Federal Programmatic Oversight of Enterprises and Their Public Purposes

A. *Enterprises and Their Public Purposes*

Enterprise benefits consist of the public purposes served by enterprise lending. Depending on its particular structure, an enterprise may use its borrowing advantages to reduce borrowing costs and improve loan terms for homebuyers, farmers, thrift institutions, or other borrowers in its designated market. Many times enterprises are created to serve carefully targeted purposes. Over time, however, a number of enterprises have obtained statutory changes permitting service to a much broader market with less apparent connection to priority credit needs.[563] Controversy over enterprise benefits can become politically charged, involving the contending interests of various types of borrowers seeking federally supported credit, enterprise competitors, firms doing business with the enterprises, and the enterprises themselves. Not all claimants for inexpensive federally supported credit can be accommodated. Indeed, much of the value of federally supported credit is in the edge it provides borrowers over others, especially competitors, lacking access to such credit.

It turns out that the federal departments and agencies overseeing the performance of public purposes of the enterprises have little, if any, authority to place enterprises into conflict with the requirements of a safety and soundness regulator. None of the program overseers—HUD, FCA, FHFB, or the Department of Education—has a mandate to compel enterprises to act to the detriment of safety and soundness. Thus, the Fannie Mae and Freddie Mac charter acts state that "the Secretary [of HUD] may require that a reasonable proportion of the corporation's mortgage purposes be related to the national goal of providing adequate housing for low and moderate income families, but with reasonable economic return to the corporation."[564] By its plain meaning, a "reasonable economic return" would include a return sufficient to permit the corporation not only to make a reasonable profit, but also to maintain the necessary capital associated with the loans.

562. 1991 Treasury Report, *supra* note 25, at xxi. As this Article went to press, the Administration's legislation was introduced in the Senate as Government-Sponsored Enterprises Financial Safety and Soundness Act of 1991, S.1282, 102d Cong., 2d Sess. (June 12, 1991).

563. *See* Benefits and Costs, *supra* note 102, at 12-13.

564. 12 U.S.C. §§ 1723a(h), 1452(b)(2) (Supp. I 1989).

Similarly, FCA does not have a programmatic mission that would contradict its safety and soundness responsibilities. Thus, 12 U.S.C. section 2207 provides that FCS institutions shall prepare a program of providing credit and services to "young, beginning, and smaller farmers and ranchers."[565] The relevant FCA regulations include the provision that "capital resources with which to withstand risk and staff resources capable of providing specialized servicing shall be major considerations in program development."[566] FCA is also responsible for assuring that activities of Farm Credit institutions remain within the bounds of their charter act. Similar to HUD's authority over Fannie Mae and Freddie Mac, FCA has no authority to compel FCS institutions to engage in particular kinds of lending.[567]

The role of FHFB in overseeing provision of credit to support community investment and affordable housing establishes a useful model for balancing service to a high priority public purpose, on the one hand, with safety and soundness, on the other. FHLBS program, established by the 1989 Financial Institutions Reform, Recovery and Enforcement Act, provides that each FHLB shall set aside a specified amount of money to support community investment and low income housing. The statutory scheme enables FHFB, in contrast to HUD and its powers over Fannie Mae and Freddie Mac, to require that each FHLB offer interest subsidies and other support to low income and community borrowers. However, the law carefully circumscribes the financial risks and any potential impact on safety and soundness by specifying limits to the aggregate amount of the subsidy to be provided by FHLBs.[568] Finally, the Department of Education has no regulatory authority over Sallie Mae with respect to safety and soundness or Sallie Mae's performance of its public purposes.[569]

The creation of an enterprise results from a political process and also involves subsequent congressional changes in the scope of enterprise activities. This allocation of enterprise benefits, can involve the politics of contending interests. In 1983 and 1984, Fannie Mae sought congressional approval to expand its mortgage lending powers.[570] The request

565. 12 U.S.C. § 2207 (1988).

566. 12 C.F.R. § 614.4165 (1991).

567. Indeed, FCS went through a very unhappy period from 1939 to 1953 when FCA was a part of the Department of Agriculture. This period was marked by considerable controversy because the Department of Agriculture, similar to HUD in the late 1970's, sought to impose external programmatic objectives onto the government sponsored enterprise that it regulated. G. Hoag, *supra* note 90, at 196-198, 249-256.

568. 12 U.S.C. § 1430(i)(5) (Supp. I 1989).

569. 20 U.S.C. §§ 1087-1092(h)(2) (Supp. I 1989).

570. State of Risk, *supra* note 1, at 12; *Legislative Proposals Concerning FNMA*

precipitated a legislative confrontation among Fannie Mae's competitors[571] including Freddie Mac, lenders doing business with Fannie Mae,[572] and the real estate industry.[573] The Reagan Administration also joined the fray,[574] advancing arguments on behalf of its government-wide opposition to expansion of federally-supported credit. Congress rejected much of the Fannie Mae request, in large part due to the opposition of companies active in the markets Fannie Mae proposed to enter.[575]

In short, the issue of allocating enterprise benefits, and reallocating those benefits, can be highly charged politically. The scope of authorized enterprise activities reflects a balance of power among interested constituencies, many of whom are close to the congressional authorizing committees responsible for enterprise legislation.

B. Congressional Oversight of the Way Enterprises Serve Their Public Purposes

The issue of enterprise benefits is too unwieldy for a federal agency to handle without congressional direction. In 1987, FHLBB attempted to limit Freddie Mac to a $75 billion annual level of loan purchases.[576] Although many in the thrift industry supported this measure,[577] Congress decisively rejected the FHLBB action and enacted legislation precluding the regulator from imposing such ceilings.[578] By the end of 1987, Freddie Mac exceeded the fairly generous FHLBB ceiling and continued its rapid growth.[579] Today, Freddie Mac has over $300 billion in mortgage-backed securities outstanding,[580] and is larger in its lending activities than any major money center bank in the United States.

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and FHLMC: Hearings Before the Subcomm. on Housing and Community Development of the House Comm. on Banking, Finance and Urban Affairs, 98th Cong., 1st Sess. (1983). *See also* 12 U.S.C. § 1454(c) (Supp. I 1989) (prohibiting limitations on mortgages purchased).

571. *Id.*

572. *Id.*

573. *Id.*

574. *Id.*

575. Secondary Mortgage Market Enhancement Act of 1984, Pub. L. No. 98-440, 98 Stat. 1698.

576. Letter from FHLBB to Leland Brendsel, Acting President, Freddie Mac (Mar. 4, 1987).

577. *FHLMC Growth Constraints Would Best Serve Shareholders*, SAVINGS INSTITUTIONS 29-33 (Aug. 1986).

578. 12 U.S.C. § 1454(c) (Supp. I 1989).

579. 1990 TREASURY REPORT, *supra* note 13, at 5.

580. 1991 TREASURY REPORT, *supra* note 25, at 3.

Another major example concerns Fannie Mae and its regulator, HUD. In the late 1970's, HUD demanded that Fannie Mae increase its support of low-income homebuyers in central cities.[581] In 1978, HUD proposed regulations requiring Fannie Mae to direct at least thirty percent of its mortgage purchases to housing for low- and moderate-income families,[582] and thirty percent of its commitments to mortgages on properties in central cities.[583] In the face of intense industry opposition, HUD rescinded its proposed regulatory requirements.[584] As the regulator noted:

> HUD received 1,233 comments on the proposed regulations. Of these, all but 16 were negative. The opponents of the regulations included more than a dozen national industry trade associations, many individual members of Congress, the congressional rural caucus (140 members), and many local and regional trade associations . . . [w]ith the help of numerous supporters, FNMA thwarted HUD's efforts to channel the corporation's activities towards greater support for low- and moderate-income housing and housing in older urban areas. [D]uring this period, in the mid-to-late 1970's when FNMA's financial security did not seem to be threatened, the Department tried but failed to channel FNMA'S activities into specific areas of public policy concerns.[585]

While examples may be found of a regulator successfully redirecting enterprise benefits, the basic point remains: for any significant change in allocation of enterprise benefits, it is rare that an administrative agency can succeed without congressional backing. This conclusion is bolstered by a practical consideration. Many details of the scope of enterprise authority are spelled out in the enabling legislation so that significant redirection of enterprise benefits will tend to require congressional involvement in any event. An agency's role in this regard would be limited to assuring that an enterprise properly observes the legal limits imposed by Congress and does not engage in ultra vires acts.[586] While matters of safety and soundness might be delegated, congres-

581. *Carter's Cactus Flower At HUD*, FORTUNE, Nov. 6, 1978, at 112-13.

582. 43 Fed. Reg. 7,659 (1978).

583. *Id.*

584. *Compare* 43 Fed. Reg. 7,659 (1978) *with* Conventional Mortgages in Central Cities, 24 C.F.R. § 81.16, and Conventional Mortgage Purchases Related to Housing for Low- and Moderate-Income Families, 24 C.F.R. § 81.17 (1991).

585. 1986 HUD REPORT, *supra* note 230, at 166 (citing UNITED STATES DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, ANALYSIS OF THE DEVELOPMENT OF THE REGULATIONS GOVERNING THE OPERATIONS OF THE FEDERAL NATIONAL MORTGAGE ASSOCIATION (undated)).

586. For government-sponsored enterprises, ultra vires acts may not be subject to correction by shareholder litigation or other judicial intervention. *See* First Am. Fed. Sav. & Loan Ass'n v. Student Loan Mktg. Ass'n, No. 84-1014 (E.D.N.C. 1985) (holding that neither Sallie Mae shareholders nor competitors have private cause of action to enjoin allegedly ultra vires acts).

sional committees like to keep the allocation of benefits to themselves.

C. *Enhancing Congressional Oversight of Enterprise Public Purposes*

Although the ultimate decision concerning the allocation of enterprise benefits rests with Congress, responsible agency or departmental support may contribute considerably to the quality of congressional oversight. The technical details of enterprise charter acts are arcane and susceptible to misunderstanding by any but the most experienced practitioners in the field. A knowledgeable regulator may assist members of Congress to make informed decisions. Too often, misinformation prevails. For example, the House of Representatives in 1986 passed a bill to create a new enterprise, the Corporation for Small Business Investment (COSBI).[587] Buried in that bill was a provision permitting COSBI to act "without regard to any other law,"[588] except as Congress expressly applied such laws to the COSBI charter act.[589] It is unlikely that members of Congress understood that they were voting to create a corporation that arguably would be exempt from civil and even criminal laws that normally apply to all legal persons. Proponents of the bill told congressional staff the complicated provision was mere technical "boiler plate."[590] On this understanding, leading members of the House and Senate introduced the bill several times over several years with that language included.[591]

Congressional committees would especially benefit from technical analysis and recommendations concerning the structure of the federal legislation governing an enterprise. The legislative structure profoundly affects the way in which an enterprise allocates its benefits and the extent to which it passes on its borrowing advantages by lending at favorable rates to its customers. Congress also needs to oversee the allocation of enterprise benefits as markets change over time. Benefits provided by an enterprise under its charter legislation should be evaluated periodically in terms of (1) the degree that it passes on its borrowing advantages to ultimate borrowers, rather than keeping the benefits for shareholders, and (2) the degree that its benefits flow to borrowers with the highest priority credit needs.

Today's enterprises differ significantly in these two respects. Because

587. H.R. CONF. REP. NO. 1012, 99th Cong., 2d Sess. 265-66 (1986).
588. H.R. 5300, 99th Cong., 2d Sess., § 9010 (1986).
589. *Id.*
590. Interview with Senate Small Business Committee Staff Member (Jan. 1988).
591. STATE OF RISK, *supra* note 1, at 194.

of the structure of the federal guaranteed student loan program and because of its own pricing policies, Sallie Mae passes on virtually none of its borrowing advantages and tax benefits to students in the form of lowered interest rates on student loans.[592] Instead, its benefits accrue almost exclusively to the corporate shareholders.[593] At the other extreme, FCS banks have engaged in overly generous loan pricing during certain periods in the past,[594] and have actually passed to borrowers greater benefits than FCS could afford to sustain.

The enterprises also differ significantly in the degree to which they meet the highest priority credit needs. Congress generally begins by trying to target the benefits of enterprise activities to meet specific perceived public priorities.[595] Over time, as markets and policies change, and as enterprises seek to expand their permitted activities, Congress tends to react by expanding the statutory purposes.[596]

Again, Sallie Mae stands at one extreme. Originally established to provide a secondary market for guaranteed student loans, Sallie Mae has used its statutory authority as the basis for making large-scale advances of funds, collateralized by home equity loans, to financial institutions.[597] Not only are most home equity loans unrelated to credit needs of most students, but the financial institutions may use the advances to support virtually any authorized lending activities, ranging from foreign loans to industrial loans.[598]

Besides its broad express powers, Sallie Mae is authorized "to undertake any . . . activity the Board of Directors of the Association determines to be in furtherance of the programs of insured student loans [or uninsured student loans] authorized under this part or will otherwise support the credit needs of students."[599] This is a much broader provision than is provided for the other enterprises or even for other federally chartered financial institutions.[600]

592. B. BOSWORTH, A. CARRON & E. RHYNE, THE ECONOMICS OF FEDERAL CREDIT PROGRAMS 146-47 (1987).

593. *Id.*

594. 1986 FCS REPORT, *supra* note 207, at 13-15.

595. BENEFITS AND COSTS, *supra* note 102, at 12-14.

596. STATE OF RISK, *supra* note 1, at 107-12.

597. *Id.* at 52.

598. *Id.*

599. 20 U.S.C. § 1087-2(d)(1)(E) (1988). In 1986, Congress amended the law to prohibit Sallie Mae from owning or operating a depository institution. *Id.* § 1087-2(d)(1)(E)(ii).

600. Fannie Mae, for example, is limited to its express powers plus authority "to do all things as are necessary or incidental to the proper management of its affairs and the proper conduct of its business." 12 U.S.C. § 1723(a) (1988). National banks are limited to express powers plus "all such incidental powers as shall be necessary to carry on the business of banking." 12 U.S.C. § 24 (1988). By contrast to the restrictive court

Questions of public purpose are among the most difficult to address for GSEs. The continuing question for Congress is whether the benefits of an enterprise, in terms of public purposes actually served, are targeted to the most deserving borrowers from among the many who could make a claim for federally supported credit. Other public purpose questions arise from the peculiar characteristics of GSEs. To what extent is an enterprise the best instrument to serve public purposes Congress considers important? Even if Congress is free legally to confine or redirect the public purposes served by an enterprise, to what extent is it free politically if this would adversely affect the investment of enterprise shareholders?

Congressional oversight would be aided immensely if the responsible congressional committees required the relevant administrative agency or executive department to prepare an annual report of the allocation of benefits of enterprise activities and recommendations for improvement. Given the tendency of regulators to be captured by the regulated institutions, such a report might preferably be generated by a central source with analytic capabilities such as CBO or the Treasury.

Finally, the congressional consideration of benefits and costs of enterprise operations might be enhanced by including a long-term sunset provision in each enterprise charter act.[601] A twenty-year sunset, as was provided in the charters of the First and Second Banks of the United States,[602] would seem to be an appropriate period of time. Twenty years is long enough to permit an enterprise to lend billions of dollars to its directed beneficiaries, but short enough to permit in-depth congressional review of the inevitable political and economic changes over that period of time. In summary then, federal control of enterprise benefits is best left to congressional oversight committees with analytic support from the appropriate agencies or departments. By contrast, the limited function of supervising safety and soundness is best delegated to an administrative agency with the resources and statutory mandate to do a good job.

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interpretations of such incidental power provisions, the broad grant of authority to Sallie Mae is surprising.

601. *See* Union Pac. R.R. v. United States, 99 U.S. 700 (1878) [Sinking Fund Cases] (stating that Congress reserves authority to amend federal charter of corporation to alter rights, privileges, or immunities it has granted by that charter); Fahey v. O'Melveny & Myers, 200 F.2d 420 (9th Cir. 1952).

602. An Act to Incorporate the Subscribers to the Bank of the United States, ch. 10, 1 Stat. 191 (1791); An Act to Incorporate the Subscribers to the Bank of the United States, ch. 44, 3 Stat. 266 (1816).

VII. CONCLUSION

The case for imposing effective financial regulation is strong. The example of hundreds of failed thrift institutions looms before us, along with conclusive evidence that the problem was greatly magnified by the government's failure effectively to regulate financial safety and soundness. The recent financial breakdown of FCS also provides evidence of regulatory shortcomings that contributed to taxpayer losses.

Unfortunately, regulatory lapses are not accidental. Indeed, they reflect a serious dynamic that must be overcome to implement the proposals presented above. The dynamic evolves as follows: when times are good and financial institutions profitable, Congress and the executive branch perceive no special need for preventative supervision of safety and soundness. "If it ain't broke, don't fix it," is a potent piece of conventional wisdom. Calls for strict regulation tend to come only after something goes wrong.

By then, of course, it may be too late. Given the volume of enterprise activity, literally billions of dollars of mistakes may have been made before problems come to light. Consider the evolution of the perceived state of FCS over only four years. Until 1982, FCS was viewed as a premiere GSE. It spent much of that year rebutting efforts of the Reagan Administration to remove its implicit federal guarantee and make FCS into a fully self-supporting institution in the private sector.[603] In 1983, FCA did report on some loan losses, but noted that "overall these loan losses represent a small percentage of the loans outstanding."[604] In 1984, FCA reported financial stress, but explained that "despite this stress the system was able to cover its losses in 1984 and remains financially sound."[605] In 1985, FCS called upon Congress for financial help; the system reported a $2.7 billion loss for the year.[606] In 1986, FCS reported an additional $1.9 billion in losses,[607] and in 1987 Congress authorized up to $4 billion to bail out the system.[608]

After FCA announced the pending FCS insolvency, Congress began to insist on more strict regulations to curb FCS losses.[609] By then, it was too late for a ranking agriculture committee member to ask the

603. STATE OF RISK, *supra* note 1, at 185.
604. 1983 FCA ANN. REP. 2 (1984).
605. 1984 FCA ANN. REP. 1 (1985).
606. 1985 FAC ANN. REP. 2, 21 (1986).
607. 1986 FAC ANN. REP. 23 (1987).
608. The Agricultural Credit Act of 1987 created the Farm Credit System Financial Assistance Corporation. 12 U.S.C. § 2278b (1988).
609. *See also, supra* note 485 (citing Agricultural Credit Act of 1987 creating Farm Credit Banks and Farm Credit Associations, and assisting FCS).

FCS regulator, "As the Governor—and I guess the buck stops at your desk in this organization—why didn't you do something about unsafe and unsound banking practices?"[610]

If it is unappealing to impose effective regulation in good times, circumstances may also be adverse in bad times. When bad times hit, the damage may already be done. Attention then shifts to the plight of the people and institutions that may be in trouble, along with the failed financial institution. Especially if borrower defaults or delinquencies are involved, considerable pressure may be brought to bear on the regulator to forebear from forcing foreclosure on the loans. As desperate farm borrowers contacted their members of Congress, borrower relief became a major theme in the 1987 Farm Credit legislation.[611]

Such pressure for leniency was also apparent in federal efforts to deal with thrift institution insolvencies. Indeed, with congressional support,[612] FHLBB significantly reduced its capital requirements in the early 1980's to accommodate thrifts in financial difficulty.[613] While this strategy permitted the regulator to avoid applying enforcement measures against many troubled thrifts,[614] it permitted unsafe and unsound financial practices of hundreds of insolvent institutions to continue and even accelerate.[615] Because insolvency or failure may signal a pattern of financial mismanagement, action to impose financial discipline after the fact usually comes too late to forestall harm.

Thus, there are compelling practical reasons to justify effective regulation of financial soundness. Today, the opportunity exists to learn from past regulatory failures and impose regulation of safety and soundness, before another enterprise gets into trouble. In today's unusual economic environment, financial viability is an essential goal for any financial institution or federal credit program. With signs of weakness in government credit programs and private institutions, including

610. *Agricultural Credit Conditions: Hearings Before the Subcomm. on Conservation, Credit, and Rural Development of the House Comm. on Agriculture*, 99th Cong., 1st Sess. 343 (1985).

611. *Farm Credit System Under Orders To Get Tough, Is Hampered By Lawmaker Pleas for Leniency*, Wall St. J., May 29, 1986, at 34. *See* H.R. CON. RES. 310, 99th Cong., 2d Sess (1986), S. CON. RES. 138, 99th Cong., 2d Sess. (1986) (stating House and Senate concern with agricultural loan restructuring). The House resolution passed on May 14, 1986. The Senate resolution was introduced the same day with 61 co-sponsors. The Agricultural Credit Act of 1987, Pub. L. 100-233, § 102, 101 Stat. 1569 (1989) calls upon FCS institutions to restructure rather than foreclose on distressed farm loans.

612. R. BRUMBAUGH, JR., *supra* note 96, at 42-47.

613. *Id.*

614. *Id.*

615. *Id.*

record numbers of failing banks and thrifts, safety and soundness should not be presumed.

Congressional committees should retain the power to allocate benefits from enterprise lending, but they will serve themselves and their constituents by delegating effective financial regulation to a hard-nosed regulatory agency and by imposing meaningful capital requirements. That is far wiser than risking the need to stand over the ruins of a once proud financial institution and ask a weak regulator, "Why didn't you regulate safety and soundness?"