Recommendation 91-6

Improving the Supervision of the Safety and Soundness of Government-Sponsored Enterprises

(Adopted June 14, 1991)

The federal government has established and chartered numerous "government-sponsored enterprises"[1] (GSEs) to facilitate the flow of credit to certain categories of borrowers, such as homebuyers, farmers and students. GSEs do this by raising funds in the capital markets to make or purchase loans or by guaranteeing securities based on pools of loans. GSEs share many attributes of private companies: they are privately owned, sell stock, are generally profit-making institutions, and are exempt from federal civil service, procurement and appropriations restrictions. However, they also share many characteristics of public institutions. They usually have some government- appointed directors on their boards; they have charters that preempt some state laws and exempt them from many taxes; and, for many of them, the federal Treasury is statutorily authorized to invest in stated amounts of their securities. Moreover, their obligations and mortgage-backed securities are implicitly (but not explicitly) guaranteed by the federal government, thus raising the value of these securities while creating at least some risk for the taxpayers by virtue of the implicit guarantees of almost one trillion dollars in the aggregate.

In July 1989, the Administrative Conference began a study of the structures and procedures employed by the government to oversee the safety and soundness of these institutions.[2] During the pendency of the study, numerous other legislative and executive branch studies of the operations of the GSEs have been completed.[3] The Conference has been informed by all of these studies in its consideration of this recommendation and it recognizes the desirability of

[1] A Government-sponsored enterprise is a privately owned, federally chartered financial institution with nationwide scope and specialized lending powers that benefits from an implicit federal guarantee to enhance its ability to borrow money. See Stanton, *Administrative and Legal Aspects of Federal Supervision of Safety and Soundness of Government Sponsored Enterprises*, Report to the Administrative Conference (May 1991) at 3 [hereinafter, Stanton Report].

[2] Stanton Report, *supra* note 1.

[3] Congressional Budget Office, *Controlling the Risks of Government-Sponsored Enterprises* (April 1991); General Accounting Office, *Government-Sponsored Enterprises–The Government's Exposure to Risks,* (GAO/GCD-90-97) (August 1990); General Accounting Office, *Government- Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks* (GAO/GCD-91-90, May 1991); Office of Management and Budget, *Budget of the United States Fiscal Year 1991*, Chapter VI, pp. 231-255; Treasury Department, *Report of the Secretary of the Treasury on Government-Sponsored Enterprises* (May 1990); Treasury Department, *Report of the Secretary of the Treasury on Government-Sponsored Enterprises* (April 1991).

the current examination of these institutions. In so saying, the Conference wishes to make clear it implies no special concern about the financial condition of any of these entities. Indeed, the studies concluded they pose no imminent financial threat. But in the past some GSEs have encountered financial difficulties, and concerns have been raised about the capital adequacy of some GSEs and their possible vulnerability to economic downturns. Accordingly, it is prudent to ensure that adequate federal supervisory mechanisms are in place before, rather than after, they might be needed.

Issues of Supervisory Agency Organization and Procedure

At present, three federal agencies are responsible for overseeing the major GSEs: The Farm Credit Administration (which supervises the Farm Credit System and the Federal Agricultural Mortgage Corporation (Farmer Mac), the newly-created Federal Housing Finance Board (which oversees the Federal Home Loan Bank System), and the Department of Housing and Urban Development (which oversees the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). One major GSE, the Student Loan Marketing Association (Sallie Mae), has no overseer.

The general consensus among the various studies of GSEs is that additional oversight of GSE risk-taking and capital levels is needed. With respect to regulatory organization or procedure, the studies recognize the need for a better system of monitoring to ensure that the federal government obtains timely information on the risks undertaken by GSEs. They also urge that each GSE be subject to effective federal supervision, including appropriate enforcement authority, and generally recommend the primacy of safety and soundness regulation over program regulation. Indeed, the General Accounting Office has suggested the centralization of the financial supervision of all enterprises in a single (existing or new) agency.[4]

Although the Conference does not have an opinion on what would constitute the optimum structure,[5] it does feel strongly that however the regulatory authority is organized, the agency or agencies should be given adequate supervisory authority and enforcement tools to do the job. Several of the studies reference the bank regulatory model as a suitable starting point for

[4] 1990 GAO report, *supra note* 2 at 107, and 1991 GAO report at 4, 47-57.

[5] The Conference wishes to emphasize that the GSEs studied are not fungible entities. Each has its own particular characteristics, and any regulatory scheme should be implemented with this in mind.

designing an effective system of government oversight.[6] If the banking regulatory model were applied, some modifications would be appropriate. Most important, for those GSEs with low risk profiles, a less intrusive, more streamlined oversight process would be appropriate-including assessment of management quality and operations risk and use of computerized financial models to examine credit and interest rate risk. Because capital would be adequate and risks low, the supervisory agency would not become involved in management decisions of the GSE.

At least several of the GSEs would seem to be likely candidates for such streamlined oversight. As an institution's risk profile worsened, however, or if factors develop that prevent effective use of this process, then more intensive financial examination might be invoked. If an institution's risk profile worsened even further, then appropriate enforcement powers, including the authority to issue capital directives and cease-and-desist orders, would be available. Similarly, the supervisory agency would have authority to reorganize the affairs of a failing institution and thereby reduce the chance that losses might be compounded.

It would be helpful for the GSEs as well as the public to have a better sense of the applicable supervisory objectives and standards as they develop. Thus, the supervisory agencies should promulgate such guidelines through notice-and-comment rulemaking.

The Conference recognizes that GSEs are undergoing the study and scrutiny their importance warrants. This recommendation is an attempt to add a procedural, comparative framework to executive and legislative proposals for strengthening their oversight.

Recommendation

The Conference recommends the following principles should apply to federal supervision of safety and soundness of government-sponsored enterprises (GSEs):

1. *Institutional capacity*. Each GSE should be supervised for safety and soundness by a federal agency. Any federal agency responsible for supervising safety and soundness of one or

[6] See, e.g., the 1990 GAO report, *supra note* 2 at 4 104, and the 1991 Treasury report, *supra note* 2 at 10. Congress has already provided that the Farm Credit System is supervised by an agency with the institutional capabilities and range of administrative authority and enforcement powers available to bank regulators.

more GSEs should be funded so it is capable of overseeing the activities of often large institutions involving great numbers of often complex transactions.

2. *Administrative authority and enforcement powers*. A federal agency responsible for supervising GSE safety and soundness should have the express authority to (a) Examine financial condition (including collecting such financial information as may be desirable) and risk-taking by the institution, (b) set and enforce effective risk-related and minimum capital requirements, (c) enforce necessary safety and soundness measures with cease-and-desist orders and other enforcement powers available to financial regulators, and (d) reorganize the affairs of a failing institution.

3. *Supervision*. A federal agency responsible for supervising GSE safety and soundness should obtain prompt and timely information and develop and maintain risk ratings of each GSE it supervises. Only if an institution's risk profile is significant should the agency extend its involvement to management issues; as necessary to protect the financial integrity of the GSE.

4. *Promulgation of guidelines*. A federal agency responsible for supervising GSE safety and soundness should, to the extent feasible, develop guidelines for invoking its supervisory and enforcement powers. These guidelines should be promulgated through notice-and-comment rulemaking.

Citations:

56 FR 33852 (July 24, 1991)

__ FR _____ (2011)

1991 ACUS 36