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Risks and Oversight of Government-Sponsored Enterprises

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Community Development
Committee on Banking, Finance and Urban Affairs
House of Representatives

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Summary of Statement By
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In response to a request from the Honorable Henry B. Gonzalez, Chairman, House Subcommittee on Housing and Community Development, Committee on Banking, Finance and Urban Affairs, GAO presented its preliminary findings on the purpose and general activities of Government-Sponsored Enterprises (GSE), the risks they face as well as those the government faces from a GSE failure, and the need for appropriate oversight and capital standards for GSEs.

GAO did not become aware of anything in its preliminary review to suggest that any GSE is in danger of immediate failure but did not conduct an independent test of the financial vulnerabilities of government-sponsored enterprises. Nevertheless, caution dictates that the government not wait for a crisis before protecting its interests.

The government protects its interests in some GSEs through federal oversight, including monitoring of their risks, reasonable capital standards, and enforcement of safe and sound practices. This, however, is not the case for Fannie Mae, Freddie Mac and Sallie Mae. Furthermore, the close ties between the government and these GSEs weaken the discipline that creditors normally provide to private firms. The lack of appropriate federal or private discipline for these three GSEs make the federal government vulnerable to losses from any serious future GSE problems that may arise.

GAO believes that a better system of oversight, some reasonable risk-based capital rules, and appropriate enforcement authorities are needed for Fannie Mae, Freddie Mac and Sallie Mae. In general, this system needs to assure that the federal government obtains timely information on the risks undertaken by certain GSEs as well as proper oversight, including congressional oversight. This oversight should be designed to keep emerging problems from imposing losses on taxpayers and develop appropriate responses quickly so that major unanticipated losses can be contained. We have not yet formed an opinion on the precise way this can best be accomplished. We plan to continue our analysis and make recommendations in this regard in our final 1991 report.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss our preliminary findings on government-sponsored enterprises (GSE). We share your concern about the safety and soundness of GSEs. They are very large financial organizations, established by Congress, that undertake a variety of risks to accomplish certain public policy purposes. Their operations have become critical to the finance of housing, agricultural, and student lending. The securities GSEs issue are perceived by investors to have safety comparable to U.S. Treasury securities. Given their public policy links to the government, a GSE experiencing serious financial difficulties could pose tough and possibly expensive decisions for the Congress, like those it faced during the Farm Credit and thrift crises. No one wants to see those experiences repeated.

Our preliminary work on GSEs has involved learning about their operations, the risks they face, and how they measure and control risks. We have also examined how they might transmit the risks they take to the government. My testimony today will describe the purpose and general activities of GSEs, the risks they bear, and how they are regulated. I will then discuss our concerns about the need for appropriate oversight and capital standards for GSEs.

GSEs--WHO THEY ARE, THE RISKS THEY BEAR, AND HOW THEY ARE OVERSEEN

GSEs were created by Congress to correct certain flaws in our financial system that made it difficult for creditworthy borrowers to finance homes, agricultural businesses, or college educations.

One major credit problem that GSEs were designed to solve was the uneven availability of credit throughout the country. When banks depended primarily on local deposits for their lending, creditworthy borrowers living in areas of rapid economic growth had trouble borrowing money when the local deposit base was insufficient to meet the lending demands. The national credit markets that GSEs created have helped to solve this problem.

Another problem that GSEs were designed to solve was the difficulty in attracting large-scale investment funds to agriculture, housing, or student lending. Large-scale investors tended to prefer investments in large denominations that could be easily converted into cash. However, mortgage, agriculture, and student loans tended to be small and could not easily be traded. Furthermore, the risks involved in such lending activities were hard to assess because lending practices varied throughout the country, the loan payments could be unpredictable, and the collection procedures could be difficult. GSEs overcame these problems by offering securities attractive to large-scale

investors and, in turn, making these investor funds available to local lenders who want to make mortgage, agriculture, or student loans.

GSEs can be grouped in a variety of ways. One way of grouping them is by their market sector--that is, agriculture, housing, or higher education lending. These market distinctions are important because the general economic climate of the market sector in which GSEs lend typically affects their financial health. Another grouping is by their operating style--portfolio lenders (which hold loans), guarantors, or those that use both techniques. Portfolio lenders borrow money at one rate and lend it at another. They can be vulnerable both to loan defaults and changes in interest rates. By contrast, guarantors enhance the credit quality of financial products for a fee. They are less vulnerable to changes in interest rates than portfolio lenders but equally vulnerable to loan defaults. Table 1 lists the GSEs that we studied, the year(s) each was created, its market sector, and its style of operations.

Table 1:

GSEs INCLUDED IN THIS STUDY

GSE Name	Year Created	Market Sector	Style of Operation
Farm Credit Banks	1916/ 1988	Agriculture	Portfolio lender
Banks for Cooperatives	1933	Agriculture	Portfolio lender
Federal Home Loan Banks	1932	Housing	Portfolio lender
Federal National Mortgage Association (Fannie Mae)	1938/ 1968	Housing	Portfolio lender and guarantor
Federal Home Loan Mortgage Corporation (Freddie Mac)	1970	Housing	Portfolio lender and guarantor
Student Loan Marketing Association (Sallie Mae)	1972	Education	Portfolio lender
College Construction Loan Insurance Association (Connie Lee)	1986	Education	Guarantor
Federal Agricultural Mortgage Corporation (Farmer Mac)	1988	Agriculture Rural Housing	Guarantor

GSE Risk Exposure and Control Mechanisms

The Financial Institutions Reform, Recovery and Enforcement Act required that we study four types of risks to which GSEs are exposed:

-- Interest rate risk is the possibility of losses from changes in interest rates. GSEs that operate as portfolio lenders

have a greater potential exposure to interest rate risk than GSEs that operate strictly as guarantors.

-- Credit risk is the possibility of losses from borrowers failing to repay their loans or other parties, like mortgage insurers, failing to honor claims.

-- Business risk is the possibility of losses from factors largely beyond the GSEs' control, such as crop failures from droughts or new legal requirements that may alter the way a GSE does business.

-- Management and operations risk is the possibility of losses resulting from poor decisions or indecisiveness on the part of a GSE's managers.

GSEs deal with these risks in the normal course of business and use their existing capital to cover any losses they may incur. If the losses exceed available capital, the GSE could fail, thereby posing a problem for the government.

Our preliminary work, which did not include an independent test of the financial vulnerabilities of GSEs, suggests that no GSE is currently in danger of immediate failure. I will briefly describe each GSE's current risk exposure and its related control mechanisms:

-- From a consolidated perspective, the Farm Credit System of Farm Credit Banks, Banks for Cooperatives, and their related associations were able to report profits in 1988 and 1989 after 3 years of losses caused by a serious agricultural recession and resulting loan defaults, high exposure to interest rate risk, and management weaknesses. Most of these profits have resulted from reversing loss reserves taken in prior years. The Agricultural Credit Act of 1987 provided System institutions up to $4 billion in federal assistance which has alleviated any immediate concerns about System viability. However, the information we reviewed suggested that certain System institutions continue to have serious financial difficulties and, in total, System institutions report that about 14 percent of their $49 billion in loans outstanding at the end of 1989 were high-risk loans. In addition, the Farm Credit Administration has identified weaknesses in the management of institutions that hold over 60 percent of the System's assets. Furthermore, the System's health depends heavily on the general state of agriculture. Farm Credit institutions have recently developed systems that should enable them to better control their interest rate risk. In addition, new risk-based capital requirements are being phased-in that are somewhat analogous to those being implemented in the banking and thrift industries.

-- The Federal Home Loan Banks have historically presented little risk of failure. Their conservative lending policies provide a substantial cushion for losses. Future profitability, however, will be dampened because part of the Federal Home Loan Banks' earnings will be used to help pay the costs of thrift failures and to fund new affordable housing programs.

-- Fannie Mae faced financial troubles serious enough to result in losses for 4 years in the early 1980s. Legislation was enacted in 1982 that lengthened Fannie Mae's tax loss carryback, qualifying it for refunds that a Fannie Mae official estimated to be $25 million. Fannie Mae was able to recover from its problems and posted record profits in 1989. Its financial difficulties resulted primarily from interest rate changes. Fannie Mae reports that its exposure to interest rate risk has been greatly lessened although not eliminated. Its losses from credit risk have also declined from unusually high levels experienced in the mid-1980s. Fannie Mae is rebuilding its capital base and has recently announced the planned addition of $2 billion in capital. It plans to hold capital sufficient to withstand, on a national basis, its default experience from mortgages originated in Texas in 1981 and 1982.

-- Freddie Mac has consistently reported profitable operations. Freddie Mac generally avoids interest rate risk by limiting

its portfolio lending, preferring instead to create mortgage-backed securities that pass interest rate risk on to the security investor. Freddie Mac's credit losses from its guarantees have been generally lower than industry averages. Freddie Mac's policy is to hold capital sufficient to absorb, for a period of at least 7 years, the effects of housing defaults comparable to those experienced during the Great Depression. Currently, Freddie Mac says it holds sufficient capital to withstand such losses for 10.5 years.

-- Sallie Mae's financial performance has been consistently profitable. Because most of Sallie Mae's student loans are guaranteed by state and non-profit agencies and reinsured by the Department of Education, it has experienced minimal credit losses. Its policy is to minimize losses from changes in interest rates by borrowing funds with interest rate payments that adjust parallel with the interest it earns on its student loans. Sallie Mae has decreased its capital holdings since 1984 from about 5 percent of assets to about 3 percent in 1989.

-- Connie Lee expects little or no losses from credit risk and is not exposed to interest rate risk in its current business of bond reinsurance. Connie Lee's capital level is set by management to conform to private market standards for the highest quality bond insurers.

-- Farmer Mac has prepared credit standards and methods of operations but has not yet guaranteed any securities.

Government's Oversight Approaches Vary

The day-to-day management and control of risk-taking is largely controlled by GSE managers and owners. For some GSEs, the government protects its interest by monitoring GSE risk-taking, setting minimum capital levels, and exercising enforcement authorities to prevent GSEs from continuing practices thought to be unsafe. But for other GSEs, the government does very little to learn about unnecessary risks and guard against them. Let me briefly describe how the government oversees GSE risk-taking and capital.

-- The Farm Credit System and Farmer Mac are overseen by an independent federal regulator, the Farm Credit Administration. The Farm Credit Administration has established risk-based capital rules, modeled after those applicable to commercial banks, for Farm Credit Banks and Banks for Cooperatives. It also examines Bank operations annually, and has a full range of enforcement authorities to stop System institutions from engaging in highly risky practices.

-- The Federal Housing Finance Board regulates the Federal Home

Loan Banks. It was created in August 1989 with authority to monitor the risk-taking of Banks and enforce safe practices. To date, however, no board members had been confirmed and the Secretary of the Department of Housing and Urban Development (HUD) serves with the full power of the Board of Directors. Currently, it is unclear how effective the Federal Housing Finance Board will be as an independent regulator for safety and soundness.

-- Fannie Mae is subject to oversight by HUD. In August of 1989, HUD also received authority to oversee Freddie Mac when the Federal Home Loan Bank Board (Freddie Mac's former Board of Directors) was abolished. HUD does not have the full range of explicit enforcement authorities typically available to bank regulators and has never used the audit authority it has to oversee Fannie Mae. Furthermore, HUD officials told us, and we agree, that it is unclear whether HUD has authority to establish risk-based capital standards for Fannie Mae and Freddie Mac. They do, however, have the authority to require less capital than the statutory debt-to-capital formula specifies.

The statutory debt-to-capital standards currently applied to Fannie Mae and Freddie Mac are not based on the risks they undertake. As Table 1 noted, Fannie Mae and Freddie Mac operate both as portfolio lenders and as guarantors. The

debt-to-capital standard requires that capital be held for borrowings they make as portfolio lenders. The standard does not require capital to be held on their guarantees of $500 billion in mortgage-backed securities. Furthermore, although their portfolio lending operations expose them to interest rate risk, the standard does not require capital for such risks.

We are also concerned with the fact that the statutory capital standard is broadly defined to include owner equity, loss reserves, and subordinated debt equally. From the government's perspective, owner equity represents the best protection to the government against unexpected losses because owners have incentives to protect their personal investment from losses. By contrast, loss reserves account for expected defaults and subordinated debt involves borrowings from creditors that must be repaid to avoid default. In the final analysis, Fannie Mae and Freddie Mac can increase their risks without a commensurate increase in equity capital.

HUD officials say that in the future they plan to strengthen their monitoring and oversight of Fannie Mae and Freddie Mac. Nevertheless, we 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.

-- Sallie Mae is not routinely overseen by any federal agency nor is it subject to federally established capital rules.

-- Connie Lee, like other insurers, is subject to state regulation that oversees its risk-taking and capital levels. Unlike other enterprises, Connie Lee has no federal ties that may promote unsafe risk-taking and expose the federal government to losses.

THE GOVERNMENT NEEDS TO IMPROVE ITS APPROACH FOR OVERSEEING CERTAIN GSEs

The sheer size of GSEs' financial obligations--over $800 billion--their public policy purposes, and the probability--in view of the precedents of Farm Credit and Fannie Mae--that the federal government would assist a financially troubled GSE, make it appropriate for the government to oversee their risk-taking activities and establish appropriate capital levels.

The situation that we found is that the government oversees some GSEs but not others. The agricultural enterprises and the Federal Home Loan Banks each have a regulator with certain authorities to monitor risk-taking and set capital rules. Connie

Lee's activities, like those of other private insurers, are regulated by state authorities and also appear to be disciplined by private creditors. However, Fannie Mae's, Freddie Mac's, and Sallie Mae's risk-taking and capital levels are not closely overseen by the government. Furthermore, GSE ties with the government have weakened the discipline that creditors normally provide to completely private financial firms because these ties provide investors with a reasonable assurance that their claims will be honored by the federal government should a GSE fail.

With inadequate federal oversight and weakened private market discipline, GSE risk-taking and capital are largely controlled by owners and managers. In financially troubled times after capital is depleted, owners and managers may have incentives to take unusual risks in a last-ditch effort to recover. General creditors may be willing to lend GSEs the funds needed to take these unusual risks if they expect to be protected from loss by federal assistance.

The Farm Credit and thrift crises vividly demonstrate the effects of inadequate federal oversight of the risk-taking and capital of financial institutions. The government did not have adequate monitoring capability or capital rules in place to learn about the Farm Credit crisis in time to prevent it from becoming serious. For thrifts, capital regulations were largely unenforced, and oversight and supervision were weak. As a

result, the crisis reached unprecedented proportions. After each financial crisis, legislation reformed and strengthened the supervisory role of the financial regulators, making them more independent and giving them responsibilities for establishing risk-based capital rules. But the regulatory reforms were enacted too late to avoid large taxpayer losses.

While we did not become aware of anything in our preliminary review to suggest that any GSE is in danger of immediate failure, changes in management strategies, economic downturns, or other adverse events could precipitate future GSE losses. The speed with which a firm can go from an apparently sound position to one that is financially imperiled was seen in the thrift industry, the Farm Credit System, and Fannie Mae in the 1980s. Thus, caution dictates that the government not wait for a crisis before protecting its interests. By strengthening oversight and establishing risk-based capital rules in the current favorable environment, the potential for future financial crises can be reduced.

We think a better system of monitoring, some reasonable capital rules, and appropriate enforcement authorities are needed for Fannie Mae, Freddie Mac, and Sallie Mae. In general, this system needs to assure that the federal government obtains timely information on the risks undertaken by certain GSEs as well as proper oversight, including congressional oversight. This

oversight should be designed to keep emerging problems from imposing losses on taxpayers and develop appropriate responses quickly so that major unanticipated losses can be contained. We have not yet formed an opinion on the precise way this can best be accomplished. We plan to continue our analysis and make recommendations in this regard in our final 1991 report.

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