

An hourglass-shaped graphic with a globe in the top bulb and another globe in the bottom bulb. The hourglass is light blue and has a dark blue cap at the top. The globe in the top bulb is dark blue, while the globe in the bottom bulb is light blue. The text is centered within the hourglass.

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February 2, 2009

Congressional Research Service

Report RS21724

GSE Regulatory Reform: Frequently Asked Questions

N. Eric Weiss, Specialist in Financial Economics

January 5, 2009

Abstract. This report summarizes the most frequently asked questions regarding the current government-sponsored enterprises (GSEs) regulatory reform debate.

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GSE Regulatory Reform: Frequently Asked Questions

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Congressional Research Service

7-5700

www.crs.gov

RS21724

Summary

Government-sponsored enterprises (GSEs) are privately owned, congressionally chartered financial institutions created for specific public policy purposes. The three largest GSEs, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (FHLBanks), were created by Congress to increase liquidity and improve the distribution of capital available for home mortgage financing. To enhance their ability to borrow money in the capital markets, Congress granted them several statutory benefits not available to other private financial institutions. These benefits have contributed to the market perception that the government implicitly backs the debt securities of the GSEs.

Events, including the use of improper accounting practices at Fannie Mae and Freddie Mac, raised serious concerns about the adequacy of the current regulatory environment for the housing-related GSEs. The Housing and Economic Recovery Act of 2008, P.L. 110-289, which was enacted on July 30, 2008, creates an independent regulator for Fannie Mae, Freddie Mac, and the FHLBanks with enhanced regulatory flexibility and enforcement tools. The new regulator, the Federal Housing Finance Agency (FHFA), placed Fannie Mae and Freddie Mac under conservatorship and took control of them on September 7, 2008.

This report summarizes the most frequently asked questions regarding GSE regulatory reform. It will be updated as events warrant. For related information, see CRS Report RL34623, *Housing and Economic Recovery Act of 2008*, by N. Eric Weiss et al. and CRS Report RL33756, *Fannie Mae and Freddie Mac: A Legal and Policy Overview*, by N. Eric Weiss and Michael V. Seitzinger.

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Who Currently Regulates Fannie Mae, Freddie Mac, and the FHLBanks?

The Housing and Economic Recovery Act of 2008, P.L. 110-289, created a new, unified regulator for Fannie Mae, Freddie Mac, and the FHLBanks—the Federal Housing Finance Agency (FHFA). The act provides for a one-year transition to transfer work, staff, and other resources from the previous regulators. Until the first FHFA director is nominated by the President and confirmed by the Senate, the director of the Office of Federal Housing Enterprise Oversight (OFHEO) is also the head of FHFA. James B. Lockhart, who was OFHEO director, continues and is FHFA director. Regulatory staff from OFHEO and the Department of Housing and Urban Development (HUD) are being transferred to FHFA.

In 1992, the Federal Housing Enterprises Financial Safety and Soundness Act (the Safety and Soundness Act, P.L. 102-550) separated the oversight of Fannie Mae's and Freddie Mac's mission compliance from safety and soundness. HUD was given housing mission oversight of Fannie Mae and Freddie Mac, including approval authority for any new program and enforcement of compliance with affordable housing goals. OFHEO, an independent agency within HUD, was assigned responsibility for the financial safety and soundness of the enterprises. OFHEO set capital requirements, conducted annual risk-based examinations, and generally enforced compliance with safety and soundness standards.

The Federal Home Loan Bank System, which comprises 12 regionally based banks, was regulated by the Federal Housing Finance Board (FHFBoard). This independent agency combined mission compliance with financial safety and soundness regulation. All of this authority (including employees) is transferred to FHFA. OFHEO and FHFBoard are abolished one year after enactment of the act, which occurred July 30, 2008.

What Special Authority Do Treasury and the Federal Reserve Have?

Between July 1, 2008 and July 15, 2008, as Congress was considering final passage of H.R. 3221, which became P.L. 110-289, the price of the publicly traded stock of Fannie Mae and Freddie Mac declined 64% and 68%, respectively.¹ Media reports raised doubts about the ability of Fannie Mae and Freddie Mac to sell new bonds to finance their portfolios. Concerns such as this led Treasury Secretary Henry M. Paulson, Jr. to suggest expanding the Treasury's existing authority to lend Fannie Mae and Freddie Mac \$2.25 billion each. The final act was revised to give the Secretary of the Treasury emergency authority to purchase an unlimited amount of obligations and other securities from Fannie Mae, Freddie Mac, and the FHLBanks. The Secretary is to determine the terms of the transaction, but the GSEs are not required to sell obligations or securities to the Secretary. This gives the Secretary a wide range of options. At one

¹ On July 1, 2008, Fannie Mae's shares closed at \$19.59, and Freddie Mac's closed at \$16.21. On July 15, 2008, Fannie Mae's shares closed at \$7.07; Freddie Mac's closed at \$5.26. Later in July, the price of each company's stock increased, but both remained below their July 1 prices. Since the GSEs were placed in conservatorship, their stock prices have been below \$1.00.

extreme, he can choose to do nothing. Alternatively, Treasury could lend the GSEs billions of dollars and negotiate collateral requirements such as mortgage-backed securities and mortgages from the GSEs' portfolios. Another option would be for Treasury to obtain control of the GSEs by purchasing stock and then totally change their legal structure.² The Secretary's emergency authority expires on December 31, 2009.

FHFA is directed to consult with the Federal Reserve about the potential risks to the nation's financial system presented by the housing GSEs. FHFA is authorized to share information with the Federal Reserve. This authority expires December 31, 2009.

What Special Authority Does FHFA Have?

The FHFA can place a GSE under conservatorship to preserve its assets and to put it in a sound financial condition. With the financial backing of the Treasury and Federal Reserve, FHFA announced on September 7, 2008 that Fannie Mae and Freddie Mac had agreed to be placed under conservatorship with the FHFA as the conservator. The FHFA replaced senior management at both Fannie Mae and Freddie Mac.

What is Conservatorship?

Conservatorship is a special legal status under which the GSEs are taken over and managed by the FHFA acting for the federal government. The goal is to preserve the assets of the GSEs and to return them to a safe and sound status. FHFA, as conservator, has suspended dividend payments to common and preferred stockholders. The holders of bonds, including mortgage-backed securities, continue to be paid on schedule. For more information see CRS Report RS22950, *Fannie Mae and Freddie Mac in Conservatorship*, by Mark Jickling.

What Are Some Options for the Future Status of Fannie Mae and Freddie Mac?

Congress has many options that it might consider concerning the future status of Fannie Mae and Freddie Mac. First, it could view the current turmoil in the mortgage and financial markets as an aberration and make no change. Second, it could modify the charters to change the relationship between the GSEs and the federal government. Third, it could repeal the Fannie Mae and Freddie Mac charters, turning them into stockholder-owned corporations with no connection to the federal government. Fourth, it could combine Fannie Mae and Freddie Mac with the FHLBanks. Fifth, it could merge the GSEs with the Federal Housing Administration and the Government National Mortgage Association (Ginnie Mae).

Another issue that Congress might wish to address independent of any change in the status of Fannie Mae and Freddie Mac is dividing the GSEs into more than two. A second alternative to

² Possible new legal structures range from converting the GSEs to government corporations to breaking them into 10 or more competing entities.

dividing Fannie and Freddie would be to create new GSEs. A third alternative would be to abolish the GSEs.

What Is the Maximum Mortgage that the GSEs Can Purchase?

The Economic Stimulus Act of 2008, P.L. 110-185, allows the GSEs to purchase mortgages made between July 1, 2007, and December 31, 2008, in high-cost areas as long as the amount of the mortgage is \$729,750 or less. This allows the GSEs to purchase these mortgages after December 31, 2008. However, provisions in Fannie Mae's and Freddie Mac's charters prevent them from purchasing mortgages that are more than one year old.

The Housing and Economic Recovery Act of 2008, P.L. 110-289, allows the GSEs to purchase mortgages made on or after January 1, 2009, subject to a maximum, which is the lesser of 115% of the median area house price or 150% of the national limit. With the national conforming loan limit set at \$417,000 in 2009, the maximum limit in high-cost areas is \$625,500.

What Is the Portfolio Limitation Issue?

Fannie Mae and Freddie Mac carry portfolios of mortgage loans (their combined total was more than \$1.4 trillion in 2007) that they finance by selling corporate bonds, profiting from the difference between the interest earned on the portfolio and that paid out on the agency-rated bonds.³ They can also repackage the loans and sell them as mortgage-backed securities (MBS), earning a guarantee fee. In 2007, Fannie Mae and Freddie Mac had a total of slightly more than \$3.5 trillion in MBS outstanding.⁴ The portfolios are a principal source of the GSEs' profits, which creates an incentive to grow them. Further, the implied (or inferred) government guarantee for their debt has allowed the GSEs to grow the portfolios without the limits that markets would impose on other financial corporations. The GSEs maintain that the profitability of the portfolios allows them to better meet their housing mission goals (see below); proponents of a new housing trust fund also see those profits as enabling a new grant program for very low-income housing.

Carrying large portfolios, however, as opposed to dispersing mortgage-backed securities broadly through a secondary market, concentrates risk in the GSEs. While that risk can be ameliorated through the use of hedges such as derivatives, arguably it still represents greater systemic vulnerabilities than would a broader distribution of mortgages. As a result, the Federal Reserve, with responsibility for overall stability of the financial sector, has called for reducing the current size of the GSEs' portfolios, and limiting their future growth both in the interests of safety and soundness of the GSEs themselves, and to prevent possible future systemic problems.⁵ The act

³ OFHEO, *Report to Congress 2008*, p. 116, available at <http://www.ofheo.gov/media/annualreports/ReporttoCongress2008.pdf>.

⁴ OFHEO, p. 116.

⁵ *GSE Portfolios, Systemic Risk, and Affordable Housing*, Speech of Federal Reserve Chairman Ben S. Bernanke to Independent Community Bankers of America, March 6, 2007, available at <http://www.federalreserve.gov/newsevents/speech/Bernanke20070306a.htm>.

allows the new regulator to require the GSEs to dispose of assets and to place other restrictions on the GSEs' portfolios.⁶

What Are the Benefits and Difficulties of a Single Regulator?

Benefits of a single regulator for all the housing GSEs have been widely recognized in the academic and policy communities.⁷ It was argued that a single regulator is likely to be more prominent than the GSE regulators it replaces and could provide more consistent regulation across the housing sector. Furthermore, given the business differences between the FHLBanks on the one hand and Fannie Mae and Freddie Mac (the enterprises) on the other hand, it was also argued that the risk that the regulators will be dominated by those they oversee (sometimes called regulatory capture) may be reduced.

Changing the regulatory structure nevertheless involved important decisions on several institutional details. There were significant differences in supervisory powers across the housing GSE regulators that were folded into a single regulator. For instance, the FHFBoard oversaw both mission and safety and soundness for the FHLBanks, while for Fannie Mae and Freddie Mac these functions were split between OFHEO and HUD. The FHFBoard could take enforcement actions based on any unsafe or unsound practice, while OFHEO's regulatory responses were defined strictly in terms of capital adequacy requirements. FHFBoard had the authority to merge FHLBanks, effectively liquidating one or more, but OFHEO could only appoint a conservator based on the capital classification of an enterprise.⁸ The act authorized FHFA to appoint a conservator or receiver for Fannie Mae or Freddie Mac, which effectively gives FHFA the authority to liquidate Fannie or Freddie. FHFA can require FHLBanks to merge.

How Does FHFA's Budget Process Compare to Those of Other Financial Regulators?

FHFA is funded through annual assessments collected from Fannie Mae, Freddie Mac, and the FHLBanks. Unlike OFHEO, FHFA's assessments are not subject to the Congressional appropriations process. This is similar to the appropriations process for federal bank regulators.

OFHEO argued that being subject to Congressional appropriations impaired its ability to conduct effective long-term planning and reduced its flexibility in resource management. For instance, during periods when the government operated under a continuing resolution, OFHEO was forced

⁶ CRS Report RL34623, *Housing and Economic Recovery Act of 2008*, by N. Eric Weiss et al.

⁷ For instance, the U.S. Government Accountability Office has been recommending the creation of a single housing GSE regulator for many years. For a comprehensive analysis of the costs and benefits of such a proposal, see U.S. Government Accountability Office, *Government-Sponsored Enterprises: Advantages and Disadvantages of Creating a Single Housing GSE Regulator*, GAO/GGD-97-139, July 1997, available at <http://www.gao.gov/archive/1997/gg97139.pdf>.

⁸ For a summary of differences between the GSEs and their regulation, see Table 1 in CRS Report RL32815, *Federal Home Loan Bank System: Policy Issues*, by Edward V. Murphy.

to cut back on its activities. The agency also claimed that it was unable to respond quickly to important regulatory concerns without stretching thin its ability to conduct its primary safety and soundness responsibilities. Because of instances such as these, OFHEO consistently argued that were its budget and assessments exempt from the congressional appropriations process, the agency could adapt more easily to changes in the enterprises' activity and respond to regulatory concerns in a more timely manner. If the condition of one of the GSEs requires closer FHFA scrutiny and forces FHFA to incur additional expenses, the new Act grants FHFA the authority to increase its assessments on the specific GSE.

What Is FHFA's Statutory Authority over Capital Standards?

The range of enforcement actions available to FHFA is defined in terms of the capital adequacy requirements for Fannie Mae and Freddie Mac. The Housing and Economic Recovery Act of 2008 authorizes the FHFA to set risk-based and minimum capital standards. Unlike OFHEO, the FHFA has the authority to modify these standards by regulation, which allows capital requirements to be adjusted to reflect changes in perceived risk.

What Are the Housing Mission Goals?

The housing mission goals are one part of the GSEs' overall mission to support housing finance. For Fannie Mae and Freddie Mac, the goals will be set by the FHFA, taking into account that the GSEs need to make a profit (although profitability may be less than for non-goal housing finance). There are four single-family housing goals and one multifamily housing goal for Fannie Mae and Freddie Mac. In addition, the enterprises are required to provide FHFA with sufficient information to determine if minorities are charged a different interest rate than nonminorities.

Fannie Mae and Freddie Mac are each to be given annual percentage goals for their purchases of conventional, conforming, single-family, owner-occupied, purchase money mortgages financing housing for (1) low-income families (incomes at or below 80% of area median family income), (2) very low-income families (incomes at or below 50% of area median family income), and (3) families that reside in low-income areas. A fourth goal is to be created for the purchase of refinance mortgages by low-income families.

In addition, there is an annual multifamily special affordable housing goal for mortgages on multifamily housing that is affordable to low-income families. There is a subgoal for units affordable to very low-income families. Units financed with state housing finance agency bonds will count towards these goals. Within the multifamily special affordable housing goal, FHFA is to establish additional requirements for the smaller multifamily housing projects.

The affordable housing goals for the FHLBanks require that each FHLBank give away at least 10% of annual net income for affordable housing.⁹ The program has proven to be popular among nonprofits, in part because of the perceived relative lack of red tape in its execution, and in part

⁹ For more information on the FHFBoard directives and definitions, see the FHFBoard website at http://www.fhfb.gov/fhfb/fhlbp_housing_ahp.htm.

because of the infusion of new money into low-income housing projects throughout the country. The act allows the FHFA to set goals for the FHLBanks that are consistent with those set for Fannie Mae and Freddie Mac.

The GSE housing mission goals currently remain in place for Fannie Mae and Freddie Mac despite their being under conservatorship.

What Is the Housing Trust Fund?

At least three factors—the value of the implied subsidy to Fannie Mae and Freddie Mac; the failure of their percent-of-business housing goals to put Fannie Mae and Freddie Mac ahead of the private-sector market in meeting the needs of low-income households; and the popularity and effectiveness of the FHLBanks' give-away housing goals—have been mentioned in conjunction with provisions in the act that create a similar program for Fannie Mae and Freddie Mac. The act requires Fannie Mae and Freddie Mac to annually contribute 4.2 basis points (0.042%) of the unpaid principal of mortgages purchased in each year to a new Housing Trust Fund. In calendar year 2007, Fannie Mae and Freddie Mac purchased \$1.2 trillion in mortgages, which under the new rules would have jointly contributed \$500.8 million to the trust.¹⁰ The contributions can be suspended if they would cause severe financial problems for an enterprise.

In each year, 25% of the contribution goes to support a reserve fund for HOPE for Homeowners bonds. During the first three years, a decreasing percentage (100%, 50%, 25%) of the other 75% will go for the HOPE program. Of this other 75% (as adjusted in the first three years), 65% goes to the Housing Trust Fund; 35% goes to a Capital Magnet Fund to provide competitively awarded grants to support affordable housing for primarily extremely low-, very low-, and low-income families.

The FHFA has suspended Fannie Mae's and Freddie Mac's contributions to the trust fund while they are in conservatorship.

The differences between the sets of GSEs make direct replication of the FHLBank program problematic. The FHLBanks, for example, have a cooperative structure—as opposed to the unitary, publicly held form of Fannie Mae and Freddie Mac—such that the FHLBank program necessarily operates through, and not in competition with, the primary lenders who are their member-owners. The ability to deal with the resultant different incentives would depend on the extent to which the regulator, as opposed to the GSEs themselves, had authority to oversee the affordable housing programs. The FHLBanks' housing goal program is unchanged by the act.

What Was the Bush Administration's Position?

The Bush Administration supported creation of a new, single regulator for all three GSEs.¹¹ To accomplish this aim, the Bush Administration outlined the minimum elements it considered

¹⁰ Mortgage purchases are reported in Office of Federal Housing Enterprise Oversight, *2008 Report to Congress*, p. 111.

¹¹ *Analytic Perspectives*, Budget of the U.S. Government for FY2009, p. 75, available at <http://www.whitehouse.gov/omb/budget/fy2009/>.

critical to establish a strong and credible regulator. The recommendations included (1) transferring authority for approving new activities from HUD to the new regulator; (2) removing the new agency's budget from the congressional appropriations process; (3) giving the new agency broad authority to set both minimum and risk-based capital standards; and (4) providing the new agency the authority to direct, if necessary, the liquidation of a GSE's assets.

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