

Thomas H. Stanton
Olwine, Connelly, Chase,
O'Donnell & Weyher
1701 Pennsylvania Avenue, N.W.
Suite 1000
Washington, D.C. 20006
U.S.A.
1-202-835-0500

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ABSTRACT

International Accords on Supervision of
Safety and Soundness of Financial Institutions:
Government Sponsored Enterprises and the
Need for a More Comprehensive Framework

The globalization of financial markets has fostered a welcome increase in international cooperation among national financial regulators. The Basle Accords on risk-based capital, a product of the Committee on Banking Regulations and Supervisory Practices, are an important step towards establishment of comparable requirements among the major countries. It is now appropriate not only to expand the range of safety and soundness issues subject to international agreement, but also to assure that the international negotiations apply to the proper range of financial institutions. For the United States, at least, some very significant institutions have been left out.

This paper focuses on the omission of government sponsored enterprises from the Basle negotiations. These privately-owned institutions are some of the largest

lenders in the United States, and several -- Fannie Mae, Freddie Mac, and Sallie Mae -- sell their debt obligations and other securities in the international credit markets; the United States government provides an implicit guarantee of these securities that makes them attractive to overseas investors desiring high credit quality. Like federal deposit insurance, this governmental backing creates moral hazard and makes it imperative that capital adequacy standards be applied to government sponsored enterprises.

Analytically, these government sponsored enterprises can be considered to be special kinds of commercial banks. Both enterprises and commercial banks are privately owned and controlled. Government sponsored enterprises benefit from an implicit governmental guarantee that resembles federal deposit insurance in the way it lowers the institutions' funding costs and creates moral hazard. The one major difference between enterprises and commercial banks is the extent that some of the largest enterprises are free from effective financial supervision and capital adequacy requirements.

For the international community, as for the U.S. government, the issue is a simple one of benefits and costs. Effective federal supervision of safety and soundness and proper capital standards for government sponsored enterprises would not be a costly proposition. To the extent that such supervision and standards are

warranted for other large financial institutions to reduce the remote but possibly unpleasant occurrence of liquidity or credit problems, they are warranted as well for government sponsored enterprises. Government sponsored enterprises must be brought within the framework of the Basle Accords not only to protect the international financial system from unnecessary surprises, but also to protect the integrity of the Basle Accords themselves.

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The globalization of financial markets has fostered a welcome increase in international cooperation among national regulators of financial institutions. The Basle Accords on risk-based capital, a product of the Committee on Banking Regulations and Supervisory Practices, are an important step towards establishment of comparable requirements among major countries. It is now appropriate not only to expand the range of safety and soundness issues subject to international agreement, but also to assure that the international negotiations apply to the proper range of financial institutions. For the United States, at least, some very significant institutions have been left out.

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This paper first presents an overview of government sponsored enterprises and their financial characteristics. It turns out that enterprises can best be understood as special kinds of commercial banks. They are privately owned institutions with governmental credit support that lowers their cost of funds. The paper then reviews the quality of today's regulatory supervision of enterprise safety and soundness, including capital standards. Here, enterprises differ significantly from commercial banks; effective governmental oversight is largely absent, and some enterprises are subject to no effective capital requirements at all. The paper continues by sketching some of the national and international implications of this state of affairs, and concludes by arguing that the United States and other countries have a stake in addressing safety and soundness of government sponsored enterprises in future international negotiations.

A. Government Sponsored Enterprises as Special Kinds of Commercial Banks

The United States government charters government sponsored enterprises to serve sectors of the economy such as housing, agriculture, and education, whose borrowers are considered worthy of special federal credit support. The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) provide a secondary market for residential mortgage loans, the Federal Home Loan Bank System (FHLBS) lends to thrift institutions, the Student Loan Marketing Association (Sallie Mae) provides a secondary market for student loans, the Farm Credit System (FCS) lends to agricultural borrowers, and the Federal Agricultural Mortgage Corporation (Farmer Mac) will provide a secondary market for agricultural mortgages.

Analytically, these government sponsored enterprises can be considered to be special kinds of commercial banks. Enterprises are special in the sense that they are specialized lenders limited by law to serving certain kinds of borrowers and to performing specified lending functions. They resemble commercial banks in important ways. Both kinds of institution are privately owned and controlled; both are considered to be instrumentalities of the federal government, with a public purpose in addition to their private purposes; and both have federal government credit backing. The U.S. government provides an implicit guarantee of enterprise borrowing that resembles federal deposit insurance for banks in the way it lowers the institutions' funding costs and creates moral hazard.

The Government Guarantee

The implicit federal guarantee is an ingenious device. It permits enterprises to obtain virtually unlimited funds at very low cost, close to the rates at which the U.S. Treasury itself borrows money. Even though enterprises are privately owned and managed, federal law gives their obligations the financial attributes of Treasury obligations; similarly, the law confers the attributes of federally-guaranteed securities upon mortgage-backed securities (MBS) guaranteed by several enterprises.

Because of these attributes, the markets infer an implicit federal guarantee that enterprises will not be allowed to default on their obligations. The federal government makes a strong statement to investors by conferring upon enterprise securities the same preferred investment status as U.S. Treasury obligations. An exemption from the usual securities registration laws and oversight by the U.S. Securities and Exchange Commission removes investor protections considered necessary for all but the most secure securities. Similarly, an exemption from investment restrictions on banks and thrift institutions, so that they may hold enterprise obligations and MBS without limit, is otherwise permitted only for holdings of federally-backed securities. Investors perceive that the government would not permit these exemptions from basic investor protection unless enterprise obligations and MBS were extremely safe.

Often, federal law requires an enterprise to disclaim governmental backing for its obligations. It is the absence of an express statement of governmental backing, whether or not

accompanied by such a disclaimer, that what makes the government guarantee implicit rather than explicit. This is similar to the system of U.S. government deposit insurance that, until 1989, was not based upon an express statutory commitment of the full faith and credit of the United States.

As with deposit insurance, the government's guarantee may be implicit, but it is very powerful. Investors look primarily to the implicit federal backing as a guarantee of an enterprise's creditworthiness, rather than looking towards its balance sheet. Thus, while borrowing costs did rise somewhat for the Farm Credit System, even after the enterprise recorded \$4.6 billion of losses in 1985 and 1986, Farm Credit System obligations remained eligible investments for AAA-rated debt.

Moral Hazard

The implicit government guarantee of enterprise obligations has many of the same effects as governmental deposit insurance for banks and thrift institutions; most importantly, government backing creates moral hazard. Shareholders of a government sponsored enterprise can increase their returns by increasing risks and can leverage these benefits by greatly increasing the ratio of outstanding debt to shareholder equity. The federal government receives no compensation for bearing increased risks from enterprise activities, but has potentially unlimited liability if an enterprise fails.

While enterprise management may in fact develop prudent business policies, the implicit federal guarantee provides

continuing incentive to seek extra returns by taking excessive risks. Heads, the corporation and its shareholders win; tails, the U.S. taxpayer is called upon to pay for most of the big mistakes.

As with other large financial institutions, the perception of implicit governmental backing is strengthened because of the large size of many of the government sponsored enterprises. The U.S. government considered the Continental Illinois Bank to be "too big to fail." Continental Illinois had assets of \$41 billion when the government closed it. Enterprises are even larger and failure of an enterprise could have even greater domestic and international consequences. Today, Fannie Mae and Freddie Mac are America's largest financial institutions, with total assets and off-balance sheet lending of over \$300 billion each. The Appendix shows how total enterprise obligations and MBS outstanding have more than doubled every five years since 1970, and now amount to almost a trillion dollars.

The ripple effects of insolvency of a government sponsored enterprise would probably be much stronger than would have been the case with the Continental Illinois Corporation. Enterprise securities are widely held by banks, thrifts, and pension funds, and are extensively used as collateral for repurchase ("repo") transactions and in Federal Reserve Bank open market transactions; they are eligible collateral for advances from the Federal Reserve Banks. Moreover, if the U.S. government even intimated that it would not stand behind the obligations of any particular enterprise,

the value of all enterprise securities -- the whole trillion dollars -- would plummet.

In summary then, the governmental backing of enterprise obligations may be implicit, but it is very real. As was the case of the Farm Credit System, that was bailed out with U.S. government funds in the late 1980's, American taxpayers may have literally billions of dollars at stake if an enterprise fails to meet its obligations. This public risk exposure is perhaps the most important characteristic that enterprises share with commercial banks.

B. Supervision of Safety and Soundness of Government Sponsored Enterprises

Governmental Oversight

One major difference between government sponsored enterprises and commercial banks is the extent that most enterprises are free from meaningful financial supervision. Fannie Mae and Freddie Mac are supposed to be overseen by the U.S. Department of Housing and Urban Development (HUD). That department, distinctly incapable of managing its own financial affairs, is unable to undertake the responsibility of effectively supervising the two largest financial institutions in the United States. The department has never used its examination authority over Fannie Mae, even though that authority has been available since 1968.

Since the failure of the Farm Credit System, the Farm Credit Administration, a government agency, has been restructured to be a serious financial regulator. It regulates the farm credit

institutions and Farmer Mac under statutory powers similar to those of the bank regulators. The regulator has its hands full as the Farm Credit System attempts to return to long-term financial viability; the agency currently has administrative orders outstanding with respect to farm credit institutions that contain over 60 percent of the System's loan assets.

The 1989 thrift institution legislation created the new government agency, called the Federal Housing Finance Board to oversee safety and soundness of the Federal Home Loan Bank System. So far, no members of the Board have been installed in their posts, and control of the agency rests with the Department of Housing and Urban Development. Finally, Sallie Mae has no financial regulator at all.

Capital Standards

The federal government has not been consistent in setting meaningful capital standards for government sponsored enterprises. Fannie Mae and Freddie Mac are subject to a debt to-capital ratio. However, the statute permits the enterprises to count subordinated obligations as a part of their capital; in contrast to banks, subordinated obligations of a government sponsored enterprise are implicitly backed by the federal government. This renders the capital requirement virtually meaningless. Both institutions also benefit from the fact that the debt-to-capital ratio does not apply to off-balance sheet activities. That means that some \$500 billion in mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac are not subject to the capital adequacy ratio.

The absence of capital standards is reflected in the low capitalization of Fannie Mae and Freddie Mac today. Fannie Mae, for example, at year-end 1989, had only \$3.0 billion of shareholder capital to support \$352 billion of assets and guaranteed securities. Freddie Mac had only \$1.9 billion of shareholder equity to support \$308 billion of assets and guarantees. This is substantially below the risk-based capital requirements established by the Basle Accords for financial institutions in the G-10 countries.

The Farm Credit Administration is responsible for setting capital standards for Farm Credit System institutions. That regulator has applied a minimum risk-based capital requirement to farm credit institutions. These requirements are, superficially at least, close to those set forth in the Basle Accords. Farm credit institutions are required to achieve a minimum ratio of permanent capital to risk-weighted assets of seven percent, by 1993. However, the weak condition of the Farm Credit System is reflected in generous forbearance criteria for institutions that do not meet the capital adequacy standards. The Farm Credit Administration has not set any capital standards for Farmer Mac, the newest government sponsored enterprise and there is some question whether the relevant legislation permits the regulator to impose such requirements.

The Federal Home Loan Bank System is required by its charter act to maintain a capital reserve and has maintained substantial capital, amounting to almost eight percent of assets at year-end 1989. Sallie Mae has no capital requirements at all, but

on its own, has maintained capital that at year-end 1989 amounted to about 2.9 percent of its assets.

In summary, several government sponsored enterprises are poorly supervised and some of the largest are thinly capitalized. This is a matter of concern not only for the American taxpayer but also for the international financial community.

C. The Case for Including Government Sponsored Enterprises in International Accords

The increasing trend towards regulatory cooperation has been prompted by recognition of the fact that the international community can be adversely affected by major financial institution failures in any one country. Financial institutions today are able to shift risks to the regulatory system least equipped to deal with them.

These factors, combined with the ability of banks to shift their operations to particular countries less stringent regulatory requirements, have given rise to a range of collaborative efforts among financial institution regulators of the G-10 and other countries.

While government sponsored enterprises are not able to shift their lending activities offshore, their operations do affect the international community. Fannie Mae, Freddie Mac, and Sallie Mae actively sell their obligations and other securities to international investors. Often, these securities are denominated in yen or other currencies rather than dollars. Because the U.S. government implicitly guarantees enterprise obligations and

mortgage-backed securities, these securities are attractive to international investors seeking high credit quality.

International Investors

It turns out that international investors have a stake in enterprise safety and soundness, even if the government of the United States stands behind its implicit guarantee. Foreign security-holders, and especially holders of unfamiliar kinds of securities such as subordinated debt obligations, convertible debt obligations, and mortgage-backed securities, may be unsure of their rights. Even holders of ordinary enterprise debt obligations may be confused by the express disclaimer of government backing that often appears on the face of enterprise obligations and offering circulars.

In the event of international alarm about a faltering enterprise, overseas investors may well take such language more seriously than do U.S. investors who are more aware of the likely irrelevance of that disclaimer. If an enterprise ever began to fail, the result could well be a transfer of these securities at disadvantageous prices from foreign holders to arbitrageurs in the United States who understood the strength of the government's backing. The recent book about Salomon Brothers, Liars Poker, nicely conveys the cheerful opportunism of such securities traders as they invested heavily in farm credit debt that others were unloading after that enterprise failed in the mid-1980's.

Observe that this result could occur again even if -- as informed analysts expect -- the government of the U.S. did stand

behind its implicit guarantee. The amount of time it takes to arrange a bailout of a complex and large financial institution is sufficiently long that foreign holders of enterprise securities would have ample chance to sell in a state of uncertainty.

In the event of financial failure of an enterprise, international uncertainty could persist literally for years. The Farm Credit System announced in 1985 it could not meet its obligations without an infusion of government money, but the United States government only enacted the enabling legislation in 1988. In the interim, the U.S. Congress spent considerable time trying to devise accounting gimmicks and other ways to avoid paying for the bailout.

As federal instrumentalities, government sponsored enterprises are not subject to the provisions of the Bankruptcy Code of the United States. The major enterprises selling their securities in international markets, Fannie Mae, Freddie Mac, and Sallie Mae, operate under legislation that omits authority for a regulator to appoint a conservator or receiver to reorganize or wind up a failing or failed institution. That means there is probably no alternative to the cumbersome legislative process, and no way to help give more prompt certainty to investors in securities of such an enterprise.

The Financial Payment System

Even absent circumstances of insolvency, users of the international payment system have a stake in the liquidity of

government sponsored enterprises. Fannie Mae and Freddie Mac are the two largest single users of the Federal Reserve book entry system. Failure of a management information system of an enterprise, for example, could complicate timely payment of principal and interest on literally hundreds of billions of dollars of obligations and mortgage-backed securities through the Federal Reserve book entry system. While the Federal Reserve System -- most likely the Federal Reserve Bank of New York, at least initially -- is likely to make payments on behalf of an enterprise that happens to suffer unexpected liquidity problems due to a systems failure, the financial markets could well be unsettled. Liquidity problems of an enterprise could also affect international investors trading securities and receiving payments through a system such as Euro-Clear or Cedel. Unlike other financial institutions that use these payment systems, Fannie Mae, Freddie Mac, and Sallie Mae are not subject to effective governmental supervision and examination of their safety and soundness or of their computer systems.

In 1990, for the first time, the U.S. government has undertaken preliminary examination of the management information and control systems of government sponsored enterprises. The U.S. Treasury Department has studied each enterprise and submitted its report to Congress. In one of its more striking findings, the Treasury reported that "Fannie Mae has not yet developed the capability to query (its integrated management information) system in an accurate, consistent, or timely manner."¹ While this is not a

¹ / Report of the Secretary of the Treasury on Government Sponsored Enterprises, May 1990, p. a-65.

definitive analysis of the quality of Fannie Mae systems, it is also not reassuring. The Treasury report does indicate that Freddie Mac and Sallie Mae have systems of high quality.

For the international community, as for the U.S. government, the issue is a simple one of benefits and costs. Effective federal supervision of safety and soundness of government sponsored enterprises is not a costly proposition. To the extent that such supervision is warranted for other large financial institutions to reduce the remote but possibly unpleasant occurrence of liquidity or credit problems, it is warranted as well for government sponsored enterprises.

Reducing the Impact of the Basle Accords on Capital Adequacy

Another major issue arises from the ability of financial institutions to shift risks among themselves to reduce their capital burdens. It turns out that government sponsored enterprises provide a convenient means for American commercial banks and other financial institutions to reduce the impact of the Basle Accords on the levels of risk-based capital they must hold.

Consider the \$500 billion of mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac. A commercial bank or thrift institution in the United States can securitize its portfolio of residential mortgages and transform those mortgages into a Fannie Mae- or Freddie Mac-guaranteed pool of mortgage-backed securities. The thrift or bank is permitted to reduce its risk-based capital applicable to that loan portfolio from the 50 percent risk-weight

category (applicable under the Basle Accords to high quality residential mortgages) to the 20 percent risk-weight category (applicable to United States government-backed securities of the enterprises).

The bank retains the same interest rate exposure and management and operations risk that it had on its original mortgage portfolio. However, it has shifted its credit risk to Fannie Mae or Freddie Mac; those institutions are not subject to the risk-based capital requirements. The fee for securitizing the mortgage portfolio is set at a low enough level to permit the bank to profit from the transaction considering the reduction in its net capital requirements. Banks of the other G-10 countries by contrast may not have available governmentally-backed institutions that provide such a convenient means of avoiding the Basle capital requirements by transferring credit risk.

In short, government sponsored enterprises must be brought within the framework of the Basle Accords not only to help protect the international financial system from unnecessary surprises, but also to protect the integrity of the Basle Accords themselves. Future issues to be addressed by the Basle committee include deposit insurance premiums, means of dealing with interest rate and other kinds of risk, and other important matters that should be addressed comprehensively for major financial institutions, including government sponsored enterprises, in the G-10 countries.

D. Conclusion: International Regulatory Myopia

In their seminal work, "Disaster Myopia in International Banking," Professors Jack M. Guttentag and Richard J. Herring analyze why financial institutions, regulators, and policy makers underestimate the need for protection against the remote possibility of financial risks that have high potential consequences. The inattention of the financial regulators of the Basle Committee to safety and soundness of government sponsored enterprises reflects a remarkable combination of the factors Guttentag and Herring consider conducive to disaster myopia.

To begin with, the major government sponsored enterprises themselves can reap significant competitive benefits because of their current exemption from binding capital requirements. Within the United States, for example, thrift institutions are selling tens of billions of dollars of residential mortgages because of an inability to comply with the new international capital standards recently applied to them by federal legislation. Fannie Mae and Freddie Mac, exempt from those requirements, are growing by tens of billions of dollars a year as they purchase mortgages in the secondary market.

Enterprises can gain significant benefits from increasing their leverage, even at the cost of reducing a capital cushion that could help them withstand unanticipated shocks. Freddie Mac shareholders benefit from a leverage of 1:161 of shareholder equity to total lending (portfolio lending plus mortgage-backed securities). This is greater leverage, on an order of magnitude, than is permitted in the United States for other financial

institutions such as banks and thrifts. Fannie Mae's shareholder equity amounts to less than one percent of total assets and mortgage-backed securities.

Guttentag and Herring also point out that debtholders and others outside of a financial institution tend to be given a false sense of security if they believe that the institution will be protected by its government against the full consequences of a shock. This is true generally for financial institutions with government backing, and particularly for government sponsored enterprises because of the implicit governmental guarantee.

As Guttentag and Herring conclude, government supervision of financial institutions is necessary, because only the government has the requisite financial stake in protecting against the full magnitude of risk exposure (beyond the thin capitalization available for several of the enterprises.) The U.S. government bears the brunt of major potential losses, without benefitting from higher returns from riskier strategies such as high leverage and virtually unconstrained growth.

Omission of government sponsored enterprises from the international negotiations leading to the Basle Accords on risk-based capital reflects a form of myopia that may have affected the Basle Committee itself. The committee consists of representatives of the G-10 countries who are designated by the financial regulatory authorities of each country. At the end of successful negotiations, such as led to the risk-based capital requirements, these negotiators can look around the international conference table with

confidence that all of them have made concessions to assure and improve the international regulatory framework. The myopia arises, of course, because some of the financial institutions most in need of such a supervisory framework were not seen during the bargaining process. Their regulator, if they had one at all, was not even present at the table. A survey of other countries may reveal that, as is true for government sponsored enterprises in the United States, those regulators are the ones that should be brought to the table first; their regulated institutions may be the ones most in need of international standards to substitute for weak national legislation that provides the international financial community inadequate protection against unpleasant surprises.