

HISTORY AND EVOLUTION OF  
GOVERNMENT SPONSORED  
ENTERPRISES

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## **History and Evolution of Government Sponsored Enterprises**

The history of government sponsored enterprises is important for several reasons. First, the history of specialized institutions such as the Farm Credit System reveals how market risk is a recurring issue; good times bring expansion and prosperity, and can lead a lender to reduce its credit standards and other safeguards, so that the institution is especially vulnerable in bad times. Second, federal controls on safety and soundness have undergone many variations over the years. Often, an enterprise may have been established with a sound legal framework for safety and soundness that was gradually weakened over time, by legislative changes as well as market developments that undercut controls. For example, Fannie Mae's debt-to-capital ratio, effective as a measure of capitalization in 1968 was not updated to take account of the Corporation's issuance of huge volumes of guaranteed mortgage-backed securities in the 1980's.<sup>1</sup>

Observing such developments over time helps to renew analytical sensitivity to the practical and political context that can undermine even a well designed institutional and legal structure. Ultimately, the success of a financial institution depends on the quality of its management; often, regulation and other externally imposed requirements such as capital standards provide merely a second line of defense, to help limit losses when an institution falters.

Finally, historical trends show how government sponsored enterprises may be created in the context of a variety of political exigencies. The most important of these seem to be the imperative of federal deficit reduction and the demands of various constituencies to have an

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<sup>1</sup> Robert Reischauer, Director of the Congressional Budget office, made a similar point in the context of 1991 hearings on legislation to increase federal supervision of government sponsored enterprises:

“. . . [The Government is going through a period in which there is an unusual degree of attention on Government-Sponsored Enterprises in no small measure because of the fiascos that occurred in the savings and loan and the bank areas.

That won't always be true. What you want to do is set up a system that will operate effectively, provide the taxpayer with the protection that we want to ensure that the Government has when the spotlights go off, when the cameras are no longer running, when nobody knows who the chairperson is of this regulatory agency or that regulatory agency, and nobody cares.

Because that's when the GSE's can get into trouble.

Committee on Banking Housing and Urban Affairs, United States Senate, "Legislative proposals to ensure the safety and soundness of government-sponsored enterprises," hearings, July 11, 1991, p. 95.

enterprise to serve their own needs, comparable to existing enterprises that already serve their competitors.

A. Early Financial Institutions

Government sponsored enterprises share common characteristics with other federal financial instrumentalities such as commercial banks, thrifts and credit unions whose deposits are insured by the federal government. National banks, for example, and government sponsored enterprises both trace their antecedents back to the earliest federally chartered financial institution, the first Bank of the United States. That bank was authorized to serve the entire nation and to make virtually any kinds of loans.<sup>2</sup> Government sponsored enterprises feature the former characteristic (nationwide scope) and national banks the latter (virtually unrestricted kinds of loans).

Indeed, the legal case law for both kinds of institutions, and for thrifts, other commercial banks and other federal instrumentalities as well, stems from two great cases involving the second Bank of the United States, McCulloch v. Maryland and Osborn v. Bank of the United States.<sup>3</sup> Obligations of the first and second Banks of the United States (BUS) were eligible for use in payment of obligations to the United States government. There remains some controversy about the extent that the market value of United States Bank obligations derived from this feature in its charter act, and the extent that market value largely determined by the financial soundness of the institution.<sup>4</sup> However, other than this feature, and except for federal investment in BUS stock, implicit federal backing was absent from BUS obligations.

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<sup>2</sup> See, “An Act to Incorporate the Subscribers to the Bank of the United States,” Approved February 25, 1791, 1 Statutes-at-Large, 191.

<sup>3</sup> McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819); and Osborn v. Bank of the United States, 22 U.S. (9 Wheat.) 738 (1824).

For national banks, see e.g., First Nat’l Bank v. Missouri, 263 U.S. 640 (1924); First Nat’l Bank v. Fellows, 244 U.S. 416 (1917); Easton v. Iowa, 188 U.S. 220 (1903); Davis v. Elmira Sav. Bank, 161 U.S. 275 (1896).

For government sponsored enterprises, see e.g., Smith v. Kansas City Title & Trust Company, et al., 255 U.S. 180 (1920); Federal Land Bank v. Bismarck Lumber Co., 314 U.S. 95 (1941); Federal Land Bank v. Priddy, 29 U. S. 229 (1935); Fahey v. O’Melveny & Meyers, 200 F.2d 420 (9th Cir., 1952); and Ass’n of Data Processing, Inc. v. Federal Home Loan Bank, 568 F.2d 478 (6th Cir., 1977); Northrip v. Federal Nat’l Mortgage Ass’n., 527 F.2d 23 (6th Cir., 1975); Rust v. Johnson, 597 F.2d 174 (9th Cir., 1979).

<sup>4</sup> Bray Hammond, Banks and Politics in America From the Revolution to the Civil War p. 424 (1957); Albert S. Bolles, The Financial History of the United States From 1789 to 1860, pp. 339-342 (1882).

The second Bank of the United States foreshadowed many of today's government sponsored enterprises in the structure of board of directors, consisting of a majority of shareholder-elected directors and a minority of publicly-appointed directors. While use of such publicly appointed directors has more logic for government sponsored enterprises than for the Bank of the United States, the idea remains in disfavor among public administration professionals and others.<sup>5</sup> Finally, the charters of both Banks of the United States included a 20-year sunset provision providing that operations of the BUS would terminate unless the charter were extended.

After President Andrew Jackson's war with the Bank of the United States, in which he vetoed the legislation to recharter the second Bank, the federal government left banking issues largely to the states. Only with the advent of the Civil War, and the need for money to support the Union struggle, did the federal government enact the National Currency Act of 1863 and the National Bank Act of 1864, and reenter the field with federally chartered financial institutions. The national bank system departed from the model of the Bank of the United States and took on decentralized form. The National Bank Act provided that any responsible group of incorporators meeting legal requirements were permitted to obtain a federal charter, without obtaining special enabling legislation that had been a feature of the Banks of the United States and that remains a feature of government sponsored enterprises today.

The national bank system flourished alongside state chartered banks. Then, starting with the Panic of 1907 federal government began exploring a variety of new institutional reforms. The Federal Reserve Act, signed into law in 1913, created a large but decentralized institution with many of the attributes of a government sponsored enterprise. The Federal Reserve System today is a federally chartered, privately-owned institution with nationwide scope and limited lending powers. However -- and this is an important distinction -- instead of issuing securities with an implicit guarantee, the Federal Reserve System issues federal reserve notes that trade as legal tender of the United States.

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<sup>5</sup> National Academy of Public Administration, Report on Government Corporations, p. 32 (1981), and Herman Schwartz, "Governmentally Appointed-Directors in a Private Corporation The Communications Satellite Act of 1962," pp. 350-364 (1965).

The logic for use of government appointed directors for government sponsored enterprises relates to the government's goal of promoting distribution of benefits to constituencies intended to be served by the enterprise. Nevertheless, allocation of benefits through carefully drafted charter act provisions appears to be a more effective means of directing enterprise benefits than the use of publicly-appointed directors. In any event, for purposes of assuring safety and soundness, public directors add little more federal control than would be available from any other members of the board of directors of an enterprise. See, e.g., Thomas H. Stanton, A State of Risk (New York: Harper Business, 1991), pp. 207-208.

## B. The Farm Credit System -- The First Government Sponsored Enterprise

In 1916, President Wilson signed into law the Federal Farm Loan Act, creating the Federal Land Bank System as antecedent for the first government sponsored enterprise. Impetus for the Federal Land Banks (FLBs) came from concern that,

“the National Banking System now in vogue . . . meets the needs of the merchant, the manufacturer, and of commerce generally. It is well-nigh useless to the farmer. It is to meet his wants that the new system of National Banks is to be inaugurated, the advantages accruing to the government being in every sense, if the motives of Congress are to be looked to incidental.”<sup>6</sup>

The needs of agricultural borrowers, especially with respect to mortgage loans on real estate were so pressing, said one proponent, that it was appropriate to launch the Federal Land Banks as “a second National Bank System.”<sup>7</sup>

The Federal Land Banks were structured along cooperative lines to be owned by the farmer-borrowers. The federal government would purchase stock to the extent farmers were unable or unwilling to do so. There were 12 Federal Land Banks, each serving one geographic district. The borrowers made their loans through cooperatively structured National Farm Loan Associations.

In its early form, the Federal Land Bank System benefited from some of the attributes of government sponsored enterprise, but did not have a federal guarantee, either implicit or explicit, of its debt. Instead, federal law exempted Federal Land Bank bonds from federal, state, and local taxes. The Agricultural Credits Act of 1923 established the Federal Intermediate Credit Banks (FICBs) to provide intermediate-term lending, usually to finance farm operating expenses.

The 1920's were not good for agriculture. Farm prices and farm income fell precipitously from their high levels during the First World War. After some recovery, they started on a slow decline that lasted into the 1930's. As farm production increased, farm demand plummeted, depressing U.S. farm prices and income. The impact on the Federal Land Banks was severe. By 1929, only 17,000 farmers borrowed a total of \$64 million down from a 1922 high of 74,000 farmers who had borrowed \$234 million. Then came the stock market crash of 1929 and the collapse of rural finance. The FICBs, created amidst this agricultural decline, never really got off the ground as a significant source of funds for agriculture.<sup>8</sup>

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<sup>6</sup> Senator Thomas J. Walsh, “Federal Farm Loan Act: An Address,” Senate Document No. 524, 64th Cong., 1st Sess., August 5, 1916, pp. 5-6.

<sup>7</sup> Ibid.1 p. 7.

<sup>8</sup> A good historical overview of the FCS is provided by W. Gifford Hoag, The Farm Credit System: A History of Financial Self-Help, esp. Chaps. 22-30 (1976)

Franklin Roosevelt took office as President of the United States on March 4, 1933. He promptly sought and obtained enactment of the Emergency Farm Mortgage Act, signed into law on May 12, 1933. Among other provisions, the Farm Credit Administration (FCA) was created to oversee the FLB and the FICB systems. The Federal Land Banks were authorized to issue federally guaranteed bonds. The federal government also purchased larger amounts of FLB and FICB stock.

On June 16, 1933, President Roosevelt signed the Farm Credit Act of 1933, creating a private cooperative Farm Credit System including the restructured Federal Land Bank and Federal Intermediate Credit Bank systems and a new system of Banks for Cooperatives (BCs). Under the revised structure, each of the farm credit districts was served by a Federal Land Bank, a Federal Intermediate Credit Bank, and a Bank for Cooperatives plus the Central Bank for Cooperatives. The revitalized Farm Credit System, in tandem with a newly created Federal Farm Mortgage Corporation, a government agency, was used as the vehicle for large scale federal support for agricultural borrowers. By 1935, the Federal Land Banks, for themselves and on behalf of the Federal Farm Mortgage Corporation, held 48 percent of all farm mortgage debt.

From 1940 to 1953, the FCA, the regulator of the banks of the Farm Credit System, was placed in the Department of Agriculture. During this period, the government continued to have a substantial ownership stake in each of the FCS institutions. The Farm Credit Act of 1953 took the Farm Credit Administration functions out of the Department of Agriculture and reorganized the FCA into an independent agency governed by the Federal Farm Credit Board. The Board was composed of 13 members, 12 nominated from the farm credit districts and appointed by the President of the United States with the advice and consent of the U.S. Senate, and a 13<sup>th</sup> member designated by the Secretary of Agriculture. The Federal Farm Credit Board approved rules and regulations prescribing the operations of FCS institutions, their examination and supervision, and specifying how the FCA was to carry out its supervisory, advisory, and policy functions. The Board also appointed the Governor of the FCA to serve as Chief Administrator.

With the regulatory board essentially dominated by the FCS banks themselves, FCA regulation was lax. FCS banks were permitted to use loose accounting standards that obscured the low quality of many loans made by FCS banks. Moreover, the FCA was statutorily required to delegate its examination powers over FCA associations to the FCS banks themselves, making it difficult for FCA, the Congress, or anyone else to determine the actual financial condition of the system. FCA also lacked enforcement powers unless problems had already emerged. While the FCA became involved in day-to-day decisions of the FCS banks, it essentially abdicated its mission of assuring the financial soundness of the FCS system. In the 1953 Act, Congress also requested the Board to submit plans for farmers to become cooperative full owners of the FCS by substituting farmer-cooperative capital for the stock of the federal government.

The FCS system grew rapidly, with the land banks averaging a 28 percent rate of growth annually in the years 1953 to 1968. In 1967, the President's Commission on Budget Concepts established a new principle for treatment of government sponsored enterprises. Enterprises were

required to be “completely privately owned” in order to be excluded from the federal budget.<sup>9</sup> This report came at an awkward time for the Johnson Administration, that found itself under pressure to reduce domestic expenditures because of the Vietnam War. Among other measures, the Administration decided to sell the government’s stock in the Farm Credit System to help meet deficit reduction targets. As a result, in 1968, the Farm Credit System became a completely privately-owned government sponsored enterprise and, under the principles of the President’s Commission on Budget Concepts, remained outside the federal budget.

Congress updated the charter of the FCS in the Farm Credit Act of 1971. The 1971 Act expanded the kinds of activities permitted to the land banks, for example, by increasing the loan-to-value ratio permitted for FCS loans, to permit FCS institutions to assume more of the credit risk on such loans. It also expanded other FCS lending authority, permitting the FCS to provide credit-related services and to make loans to businesses providing farm related services, and to non-farm rural homeowners. The net result of these changes was to increase substantially the proportion of total farm mortgage debt funded by the Federal Land Banks. The 1971 Act retained the structure of FCS control over the FCA regulator. The Farm Credit System expanded even more rapidly than before, and increased its outstanding loans by 43 percent in the two years, 1973-1975, for example.

After a peak in the late 1970’s, the agricultural economy went into steep decline. At its high point, at year-end 1982, the Farm Credit System extended a total of \$85.9 billion in agricultural loans. Then, for reasons including inability to handle interest rate risk and credit risk, the FCS failed financially. By 1985 the system announced it could not meet its obligations without an infusion of federal funds.

Some FCS institutions had been more prudent than others, and also may have been located in areas less vulnerable to declines in farm incomes and land prices, and these institutions successfully dealt with the adverse economic circumstances. However, because of the joint-and-several liability of all FCS institutions for FCS consolidated obligations, permitting the system to issue consolidated obligations for the enterprise as a whole, the entire system was technically insolvent by 1985.

In two major pieces of legislation, the Farm Credit Amendments Act of 1985 and the Agricultural Credit Act of 1987, the Congress completely restructured the FCS and made its regulator, the FCA, into an arms-length regulator no longer dominated by the farm credit institutions.<sup>10</sup> The 1987 legislation also provided for creation of the Farm Credit System Financial Assistance Corporation to provide up to \$4 billion to restructure or close insolvent FCS institutions. The Federal Land Banks and Federal Intermediate Credit Banks were merged into

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<sup>9</sup> Report of the President’s Commission on Budget Concepts, pp. 29-30 (1967).

<sup>10</sup> See e.g., Anne Dewey, “The Farm Credit System,” Federal Bar News & Journal, Vol. 36, pp. 287-289 (1989); House Committee on Agriculture, “farm Credit Act Amendments of 1985,” Report 99-425, pp. 35, 112-113 (1985).

one set of institutions, one serving each of the 12 farm credit districts, called Farm Credit Banks. Many of the banks for cooperatives were merged into several banks for Cooperatives authorized to serve all farm credit districts.

Today the Farm Credit System is continuing to rebuild. At year-end 1991, the volume of outstanding FCS loans (after allowance for loan losses) amounted to \$49.9 billion, and the volume continues to exhibit little growth.

### C. The Great Depression and Creation of the Federal Home Loan Bank System

The Great Depression cut a swath through the thrift industry. More than 1,700 thrifts failed, and their depositors lost \$200 million, or about one-third of the value of their deposits. Even healthy thrifts experienced depositor runs that forced them to close their doors.

The thrift industry turned to Congress and the Hoover Administration for relief. Thrift industry advocates pointed to the benefits of the Federal Reserve System for commercial banks, and the Farm Credit System for rural borrowers, and asked for similar federal credit support for thrift institutions and urban areas.<sup>11</sup> The Federal Home Loan Bank Act of 1932 established the Federal Home Loan Bank System (FHLBS). The U.S. government funded the FHLBS by purchasing \$125 million in stock. The 1932 authorized the FHLBs to lend money to thrift institutions, which they began doing in December 1932, and to raise money by selling bonds, which they began doing in April 1937.<sup>12</sup>

Meanwhile, the Home Owners' Loan Act of 1933 created the Home Owners' Loan Corporation to channel billions of dollars into thrift institutions to help refinance mortgage loans on more favorable terms. The Banking Act of 1933, among other provisions, created the Federal Deposit Insurance Corporation to insure deposits of commercial banks, and the National Housing Act of 1934 established the Federal Savings and Loan Insurance Corporation (FSLIC) similarly to provide deposit insurance for thrifts. The FHLBS became one part of a congeries of federally chartered institutions serving the thrift industry, consisting of Federal Home Loan Bank Board, the FSLIC, and later, Freddie Mac. Between 1948 and 1951, the FHLBS redeemed its government-owned stock, and thereupon became completely owned by its member thrift institutions.

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<sup>11</sup> House Committee on Banking and Currency, Hearings: Creation of a System of Federal Home Loan Banks, March 16, 1932, pp. 12-17 (Statement of Representative Robert Luce) and pp. 28-29 (Statement of William E. Best, President, United States Building and Loan League). See also, Senate Committee on Banking and Currency, Hearings: Creation of a System of Federal Home Loan Banks, January 14, 1932, p. 42 (Testimony of John Sprunt Hill).

<sup>12</sup> See e.g., Federal Home Loan Bank System, A Guide to the Federal Home Loan Bank System, Chapter 1 (1987).



The 1934 Act gave the Federal Home Loan Bank Board (and now its successor organization for purposes of overseeing the FHLBS, called the Federal Housing Finance Board) authority to establish 12 FHLB district banks, each serving thrift institutions in a geographical district of the United States. A leading court decision, Fahey v. O'Melveny & Myers, upheld the right of the FHLBB to change the geographical boundaries of Federal Home Loan Banks and to shift the offices to different geographic locations.<sup>13</sup>

For many years, starting in 1966, thrifts had a special need for FHLBS advances, to substitute for the cyclical outflow deposits at times when interest rates rose higher than federally regulated interest rate ceilings on savings accounts. The federal government began removing these interest rate ceilings in 1980, but the volume of FHLB advances continued to accelerate, from \$48 billion at year end 1980 to \$175 billion at year-end 1988. Loans from the Federal Home Loan Banks to thrift institutions are secured by mortgages or (under expanded authority contained in the Garn-St. Germain Financial Institutions of 1982) other marketworthy collateral. Because the FHLBS insisted on over-collateralization and has taken a variety of steps to assure the creditworthiness of its loans, the FHLBS has never taken a loss on an advance made to a thrift institution.

In the mid-1980s, the FHLBS was authorized to carry out functions not germane to this paper, that made the FHLBS part of the system of federal regulation and super vision of thrift institutions. Under direction of the FHLBB, each district bank employed examiners and other enforcement officials to oversee the lending activities of the thrifts located in that geographic district. The inherent conflict-of-interest in this arrangement, for example, because FHLBS examiners were required to examine institutions that owned and controlled the district bank that paid their salaries, were criticized by a variety of commentators, including the U.S. General Accounting Office.<sup>14</sup> Under the new Financial Institutions Reform, Recovery and Enforcement Act of 1989, this arrangement was terminated and responsibility for supervision of thrift

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<sup>13</sup> 200 F.2d 420 (9th Cir. 1952). That case appears to leave the government considerable discretion to alter the terms of its relationship with an enterprise:

“... neither the bank nor its association members, although they are nominally stockholders, acquire under the provisions of the Bank Act, any vested interest in the continued existence of said bank or any legally protected private rights which would enable them to invoke the due process clause.” 200 F.2d at 446.

See also, Union Pacific Railroad Co. v. U.S. (Sinking Fund Cases), 99 U.S. 700 (1878) (Congress reserves authority, by way of amendment, to alter the rights, privileges, and immunities it has granted to a corporation in its charter).

<sup>14</sup> See e.g., U.S. General Accounting Office, “Failed Financial Institutions: Reasons, Costs, Remedies, and Unresolved Issues,” Statement of Frederick D. Wolf, Director, GAO Accounting and Financial Management Division, Before the House Committee on Banking, Finance, and Urban Affairs, January 13, 1989, p. 41.

institutions was transferred from the FHLBS to a newly created Office of Thrift Supervision in the Department of the Treasury.

Following a precedent set in 1987 legislation when government assessed the FHLBS to fund FICO, the 1989 Act assessed the FHLBS another several billion dollars to fund Refcorp. The 1989 Act created a new regulator for the FHLBS called the Federal Housing Finance Board, and added a new statutory requirement that the FHLBS provide a certain amount of below-market rate funding for low-income housing and community investment projects. While the FHLBS remains well capitalized despite these assessments these actions came at an awkward time for the FHLBS. Starting in 1988, FHLBS advances to member institutions declined substantially, to \$80.3 billion at year-end 1991, as the government's efforts to close insolvent thrifts gained momentum. The 1989 Act addressed the problem of a diminished thrift industry by expanding the opportunity of membership in the FHLBS to banks and other lenders that specialize in residential lending. By year-end 1991, the 2,966 member institutions of the FHLBS included 438 commercial banks, 11 credit unions, 7 industrial loan companies and one insurance company. Nevertheless, the financial future of the FHLBS remains closely entwined with that of the thrift industry.

#### D. Fannie Mae as an Offshoot of the Reconstruction Finance Corporation

As a part of the 1934 National Housing Act, the Roosevelt Administration sought to foster creation of a number of new secondary mortgage market institutions, to be called national mortgage associations. As secondary market institutions, national mortgage associations would raise funds in the capital markets and purchase mortgages from thrifts and other mortgage lenders. Under the Administration proposal, associations were to benefit from the ability to issue bonds exempt from federal, state, and local taxes and from a national charter that preempted state laws. National mortgage association obligations were not to be backed by a federal guarantee, either explicit or implicit.

The purpose of national mortgage associations was to overcome the serious imperfection in mortgage markets in the United States, whose consequences were already apparent. Investors on the East Coast with excess funds to lend found it difficult to provide those funds to the mortgage markets of the Mid-West and West where construction was taking place and there was considerable need. This market imperfection was signaled by the much higher mortgage interest rates being charged, especially in smaller communities, in the Mid-West and western states, compared to the East. Commercial banks (even to the extent they were willing to lend money after the adverse experiences of the Great Depression) and thrift institutions were strictly limited in the geographical locations they could serve, and the Roosevelt Administration saw national mortgage associations as institutions to overcome this problem.<sup>15</sup>

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<sup>15</sup> Committee on Banking and Currency, House of Representatives, "National Housing Act," Hearings on H.R. 9620 (Statement of Winfield W. Riefler) (1934).

The legislation ran into considerable opposition, especially from the savings and loan industry.<sup>16</sup> In its final form, the National Housing Act permitted creation of national mortgage associations, but without special tax benefits or federal credit support. Given the strong competition from savings and loan associations that had both a federal tax exemption and (thanks to another title of the 1934 Act) federal deposit insurance, it is not surprising that no national mortgage associations were ever formed under the Act.

But the problem of serious geographic imperfections in the mortgage market remained, along with the even larger problem of unwillingness of lenders to invest heavily once again in the residential mortgages that had proved so vulnerable during the Depression. In 1938 the Roosevelt Administration took another approach, and chartered the National Mortgage Association of Washington, soon renamed the Federal National Mortgage Association, as a subsidiary of the Reconstruction Finance Corporation, to provide a secondary market for FHA-insured mortgages.

At the close of World War II, the Federal National Mortgage Association (FNMA or “Fannie Mae”) was also given authority to deal in VA-guaranteed mortgages, and in 1954 Congress rechartered the agency as a mixed-ownership federal corporation. Fannie Mae’s preferred stock was to be held by the government and its common stock was to be privately held. The 1954 Act provided that Fannie Mae would eventually take steps to become a privately-owned institution.

In 1968, Fannie Mae felt the impact of the report of the 1967 President’s Commission on Budget Concepts. To avoid having to count Fannie Mae as a part of the federal budget, the Johnson Administration decided to sell the government-held Fannie Mae stock and place the secondary market operations completely into private hands. Title VII of 1968 Housing and Urban Development Act, enacted in substantially the form recommended by the Administration, divided Fannie Mae into two institutions, one governmental and the other private. The Government National Mortgage Association (Ginnie Mae), a government agency within the U.S. Department of Housing and Urban Development, was created to carry on the special assistance (i.e., provision of deeper subsidies for lower-income households) and federal asset management and liquidation functions that had been performed by Fannie Mae. The secondary market operations were given to a new Fannie Mae, the Federal National Mortgage Association, that was to be a completely privately owned government sponsored enterprise.

The legislation provided the new Fannie Mae with a board of directors consisting of a majority of shareholder elected members, and a minority of members appointed by the President of the United States, in part to represent the constituent groups -- real estate, housing, and mortgage banking -- that Fannie Mae was supposed to serve.

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<sup>16</sup> See e.g., *Ibid.*, p. 171 (Statement of Representative Reilly on objections from thrift institutions in his congressional district), and Semer, Milton P., Julian H. Zimmerman, John M. Frantz, and Ashley B. Foard, “Evolution of Federal Legislative Policy in Housing: Housing Credits,” Housing in the Seventies Working Papers, Vol. 1 (Washington, D.C.: GPO, 1976) at pp. 28-38.

The 1968 Fannie Mae charter act attempted to give the Department of Housing and Urban Development, Fannie Mae's regulator, a variety of tools for supervising the safety and soundness of the corporation, and also for overseeing the distribution of its financial benefits.

The controls that could be used for safety and soundness included (1) authority to require Fannie Mae to report on its condition; (2) authority to examine Fannie Mae's books and records; (3) capital requirements that were potentially binding constraints on the corporation; (4) authority to disapprove payment of dividends, after taking into account the capitalization and financial state of the corporation; (5) authority for the U.S. President to remove directors for cause; and (6) general regulatory authority conferred on the Department of Housing and Urban Development. The legislative history provided that the Secretary of Housing and Urban Development could intervene in the internal affairs of the corporation as necessary "to protect the financial interests of the Federal Government or as otherwise necessary to assure that the purposes of the FNMA Charter Act are carried out."<sup>17</sup>

The charter act also included other regulatory authority, especially the authority of the Secretary of Housing and Urban Development to approve new lines of business for Fannie that related to Fannie Mae's implementation of its public purposes, but that could also be used to deal with issues of safety and soundness. The Secretary of the Treasury also had authority to approve Fannie Mae issuance of obligations and mortgage-backed debt and other mortgage-backed securities (MBS).

Despite these statutory provisions and the legislative history, the Department of Housing and Urban Development failed to focus on the safety and soundness of the enterprise. As the General Accounting office reported in 1985,

"HUD officials responsible for oversight and regulation are unsure of the nature of their role . . . HUD officials told us that they have no clear sense of what regulations are needed to ensure the charter purposes are achieved, the specific FNMA activities HUD should regulation, or whether HUD should or could develop the capability and expertise to be a 'watchdog' over FNMA's risk management activity. Finally, HUD officials do not believe the Department presently has the capacity or expertise to perform certain functions which might be expected of a financial institution regulator such as monitoring Fannie Mae's interest rate risk."<sup>18</sup>

For example, HUD never used its authority to examine and audit the books and financial transactions of the corporation.<sup>19</sup> In 1989, the Washington Post reported that HUD lacked a

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<sup>17</sup> House Report (Banking and Currency Committee) No. 1585, June 25, 1968 [to accompany H.R. 17989], reprinted in U.S. Code Congressional and Administrative News, p. 2873 (1968).

<sup>18</sup> U.S. General Accounting Office, "The Federal National Mortgage Association in a Changing Economic Environment," p. 116 (April 15, 1985).

<sup>19</sup> Fannie Mae Charter Act, Section 309(h), 12 U.S.C Sec. 1723a (h).

single official with full-time responsibility for overseeing Fannie Mae.<sup>20</sup> The one Fannie Mae director that was ever removed was the first chief executive officer of Fannie Mae, who was removed by President Nixon, in part to provide for appointment of a politically more amenable CEO instead.<sup>21</sup>

Indeed, Fannie Mae's biggest controversies with its regulator have taken place with regard to policy issues essentially unrelated to safety and soundness. For example, from 1977 to 1980, the Department of Housing and Urban Development and Fannie Mae engaged in a protracted public conflict over implementation of the section of the Fannie Mae charter act stating that "the Secretary may require that a reasonable portion of the corporation's mortgage purchases be related to the national goal of providing adequate housing for low and moderate income families, but with reasonable economic return to the corporation."<sup>22</sup> In the 1980's Fannie Mae engaged in a dispute with the department when HUD sought to limit Fannie Mae's financing activities on grounds that the enterprise was exceeding its authority merely to provide "supplementary assistance" to the residential mortgage market. Fannie Mae ultimately prevailed with passage of FIRREA that contained a provision deleting the restriction of Fannie Mae's activities to "supplementary assistance."<sup>23</sup>

Given this track record, it is not surprising that over time, and sometimes over HUD's objections, Congress began to remove elements of HUD's statutory authority.<sup>24</sup> In 1982, for example, Congress removed the a restriction on Fannie Mae's ability to issue subordinated debt obligations that count for purposes of capital calculations. In contrast to subordinated debt obligations of other financial institutions, the subordinated obligations of a government sponsored enterprise carry the same implicit government guarantee as senior obligations, and therefore render illusory any capital requirements that permit subordinated debt to count as capital.

Fannie Mae is another government sponsored enterprise that has run into some financial difficulty during its history. In the 1970's, Fannie Mae adopted a strategy of funding its long-term lending with short-term borrowing. A sudden increase in interest rates in 1979, made this approach financially untenable. By 1981, Fannie Mae's market value net worth was a negative \$10.8 billion. Since then, the corporation has recovered its position, and the U.S. Department of

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<sup>20</sup> Jerry Knight, "Bailout of S&Ls Spurs Probes of Other Programs: Hill Examines Taxpayer Liability in Huge U.S. Backed Enterprises," Washington Post, October 15, 1989, pp. H-1, at p.H-4.

<sup>21</sup> See e.g., Richard W. Bartke, "Fannie Mae and the Secondary Mortgage Market," Northwestern University Law Review, Vol.66, No. 1 (1971), pp. 56-57.

<sup>22</sup> 12 U.S.C. Sec. 1723a (h).

<sup>23</sup> Financial Institutions Reform, Recovery, and Enforcement Act of 1989, Sec. 731(m)(1), amending 12 U.S.C. Sec. 1716.

<sup>24</sup> The U.S. General Accounting Office, "The Federal National Mortgage Association in a Changing Economic Environment," op cit., pp. 104-106.

Housing and Urban Development now estimates that since 1985 Fannie Mae has had a positive market value net worth. Today, Fannie Mae has a sizeable mortgage-backed securities business in addition to a large mortgage portfolio with some interest-rate sensitivity.

In the late 1980's, a combination of events, including financial difficulties of the Farm Credit System and the catastrophic failure of the thrift industry, led to increased concerns about safety and soundness of government sponsored enterprises. The 1989 FIRREA legislation required the U.S. Treasury Department and the U.S. General Accounting Office (GAO) to study the government's potential financial exposure from each enterprise and to recommend appropriate legislative approaches. The 1990 Omnibus Budget Reconciliation Act (OBRA) required a similar report from the Congressional Budget Office (CBO).<sup>25</sup> Congressional consideration of these reports helped create the basis for enactment of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, revising the supervisory structure for Fannie Mae, Freddie Mac and the Federal Home Loan Bank System.

#### E. Freddie Mac and Developments in Housing Finance

In the 1970 Emergency Housing Finance Act, Congress expanded Fannie Mae's charter to include authority to deal in conventional mortgages as well as those insured or guaranteed by the FHA or VA. A separate title of that law also created Freddie as a new government sponsored enterprise with powers similar to those of Fannie Mae.

As with the creation of the Federal Home Loan Bank System in 1932, Freddie Mac came into being at the behest of the savings and loan industry. Thrift institutions saw Fannie Mae as dominated by their competitors, the mortgage bankers. The savings and loan industry sought a secondary market institution more responsive to its own particular needs and desires.<sup>26</sup>

Under its original charter, Freddie Mac was expressly limited to providing a secondary market for mortgages purchased from thrift institutions and commercial banks. It was not permitted to serve other lenders, notably the mortgage bankers were already served by Fannie Mae. Today, these restrictions have been removed and Fannie Mae and Freddie Mac both serve the range of mortgage originators. Over time, Fannie and Freddie Mac have limited themselves almost completely to serving the market for conventional mortgages, and today the secondary market for FHA/VA mortgages is served almost exclusively by Ginnie Mae.

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<sup>25</sup> The five reports include two from the Treasury, Report of the Secretary of the Treasury on Government Sponsored Enterprises, issued in 1990 and 1991, two from the GAO, Government Sponsored Enterprises: The Government's Exposure to Risks (August 1990) and Government Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks (May 1991), and one from the CBO, Controlling the Risks of Government Sponsored Enterprises (April 1991).

<sup>26</sup> Richard W. Bartke, "Home Financing at the Crossroads - A Study of the Federal Home Loan Mortgage Corporation," 48 Indiana Law Journal, at p. 11 (Fall 1972).

In 1971, Freddie Mac began selling participation certificates, a form of pass-through mortgaged-backed security (MBS). Pioneered by Ginnie Mae, the pass-through MBS enables the security holder to receive timely payments of interest and principal from the mortgages in a pool; each security represents a proportionate share of the entire pool. The guarantor of a mortgage-backed security, in this case Freddie Mac, is responsible for assuring payment of principal and interest to MBS security holders.

In contrast to Fannie Mae, that until 1981 remained exclusively a portfolio lender (i.e., purchasing and holding mortgages in a portfolio), Freddie Mac placed virtually all of its mortgages into pools of mortgaged backed securities. This strategy protected Freddie Mac almost entirely from the interest rate risks that hit portfolio lenders, including Fannie Mae and most thrift institutions, starting in 1979. The cost of this strategy to Freddie Mac was that it did not reap the profits available from betting on interest rates; the benefit was that Freddie Mac could weather the period of high interest rates without the near collapse suffered by Fannie Mae.

The 1970 Act gave Freddie Mac an unusual corporate structure. Freddie Mac stock was owned exclusively by Federal Home Loan Banks; its Board of Directors consisted of the three government officials who were the members of the Federal Home Loan Bank Board. This gave Freddie Mac some of the attributes of a federal agency<sup>27</sup> in addition to its status as a federal instrumentality.

In 1988 Congress permitted Freddie Mac stock to be publicly transferable, and in 1989 the Financial Institutions Reform, Recovery, and Enforcement Act gave Freddie Mac a shareholder-controlled board, with a minority of publicly appointed directors, patterned on that of Fannie Mae. The 1989 Act also removed some of Freddie Mac's government agency characteristics such as the provision that "the corporation shall be entitled to all immunities and priorities . . . to which it would be entitled if it were the United States or if it were an unincorporated agency of the United States."<sup>28</sup>

Today the major difference between Fannie Mae and Freddie Mac is financial: Freddie Mac conducts about ninety percent of its business through mortgage backed securities while Fannie Mae continues to maintain and build a substantial mortgage portfolio to supplement its now sizeable MBS line of business. It remains to be seen whether Freddie Mac will continue this policy over the coming years and resist the temptation to play the yield curve by building a portfolio of mortgages that permits it to seek extra profits by lending long and borrowing short.

#### F. Sallie Mae and the Market for Guaranteed Student Loans

In 1972 the federal government created a new enterprise, Sallie Mae, to provide a secondary market for guaranteed student loans. Unlike home mortgages, student loans are often small and unattractive to service. In part because they are not collateralized, student loans may have substantially higher default rates than the mortgages or other secured loans that constitute the assets of other government sponsored enterprises. Even though student loans may be

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<sup>27</sup> See e.g., 5 U.S.C. Secs. 101, 103, and Rocap v. Indiek, 539 F.2d 174 (D.C. Cir., 1976).

<sup>28</sup> 12 U.S.C. Sec. 1456(a).

guaranteed by federal government, servicing can become especially expensive for low-balance loans and those most likely to go into delinquency or default.

Sallie Mae initially funded its activities by borrowing from the Federal Financing Bank (FFB). In 1981 Sallie Mae began issuing its own debt obligations carrying an implicit federal guarantee. It continues to have several billion dollars in obligations outstanding to the FFB.

Sallie Mae is controlled by a 21-member board of directors; seven directors are chosen by educational institutions and seven by lenders dealing in student loans, and seven are appointed by the President of the United States. The President of the United States also designates one of the directors to be chairman of the Sallie Mae board. Sallie Mae's non-voting stock is publicly traded and the Corporation is one of the most profitable of the enterprises. In 1988, for example, Sallie Mae reported a 41 percent return on common stockholders' equity (31 percent assuming conversion of convertible subordinated debt).

Unlike the other enterprises, that tend to lower borrowing costs in their designated markets, Sallie Mae is not designed to provide a subsidy to the student borrowers whose loans it funds.<sup>29</sup> Instead, because of the structure of the guaranteed student loan program, student borrowers pay a stated rate of interest (currently 7-9 percent) regardless of the borrowing costs of the financial institution that buys and holds those loans. The difference between the stated interest and the return to lenders under the guaranteed student loan program, called the special allowance, is paid by the U.S. Department of Education out of a revolving fund supported by federal appropriations.

Sallie Mae's conspicuous success as a holder of guaranteed student loans has had a beneficial effect by providing a model for other lenders that previously did not consider guaranteed student loans a profitable line of business. Nevertheless, at least one group of analysts has concluded that "thus far, Sallie Mae has not succeeded in creating an active secondary market for student loans, and the efforts to involve the private sector has proved very costly."<sup>30</sup> Given the increasing cost of the guaranteed student loan program, a variety of

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<sup>29</sup> As Sallie Mae's former President and Chief Executive officer informed a Senate oversight subcommittee,

"We are a private corporation and as such, with stockholders and bond holders, we have a fiduciary responsibility to those individuals . . . . We are not charged with subsidizing the guaranteed student loan program or subsidizing the students."

Senate Committee on Labor and Human Resources, Subcommittee on Education, Arts and Humanities, "Oversight of Student Loan Marketing Association (Sallie Mae)," Hearing, August 12, 1982, p. 135. (Statement of Edward A. Fox, Sallie Mae President and Chief Executive Officer).

<sup>30</sup> Barry Bosworth, Andrew Carron, and Elisabeth Rhyne, The Economics of Federal Credit Programs, (Washington, DC: The Brookings Institution, 1987) pp. 143-149.



commentators have proposed a more efficient structure including repeated proposals to scrap the Federal Guaranteed Student Loan Program in favor of federal direct lending to students.

Sallie Mae's profitability is especially remarkable given the corporation's traditional reluctance to take on financial risk. Although guaranteed student loans do involve some servicing risk, because the federal government will not honor its guarantee if the servicer has not exercised due diligence in tempting to mitigate a default, the federal guarantee means that the loans have virtually no credit risk. Moreover, Sallie Mae carefully hedges against interest rate risk by using interest rate swaps and a variety of other sophisticated financing techniques.

One issue for Sallie Mae's future involves its substantial rate of growth. At year-end 1991 Sallie Mae held \$22.2 billion of guaranteed student loans and, through advances to primary lenders, funded an additional \$9.7 billion of student loans. Together that amounts to roughly half of the amount of guaranteed student loans out standing. In 1979, Sallie Mae was a \$1.2 billion financial institution; by 1989 it had grown to over \$30 billion in size. It is unclear whether the enterprise can continue to grow at such a pace while maintaining its traditional standards of credit quality.

#### G. Farmer Mac and the Distress of the Farm Credit System

The creation of Farmer Mac, the Federal Agricultural Mortgage Corporation, is best understood in the context of the financial problems of the Farm Credit System. In the late 1970's and early 1980's, the Farm Credit System substantially expanded its market share by offering inexpensive farm loans, especially mortgage loans, with interest rates far below what private lenders could afford to offer. This occurred in good part because of the structure of the Farm Credit Banks as a cooperative rather than investor-owned set of institutions. Borrowers purchased stock based on a percentage of their loan (between five and ten percent) and controlled the FCS banks by electing directors on a one-member, one-vote basis. With their primary interest in low-interest loans, rather than in shareholder dividends based on bank profitability, FCS shareholders were motivated to expand FCS lending aggressively. This had serious consequences for the pricing of FCS loans.

By 1981, Farm Credit System Banks were pricing their real estate loans at almost five percentage points below those of competing commercial lenders. This enabled the Farm Credit System to increase its share of agricultural loans just as the agricultural economy went into decline.

When the Farm Credit System ran into serious financial problems, exacerbated by its generous lending policies and lack of financial prudence, commercial banks and other rural financial competitors were not pleased about using federal funds for a bailout. In return for their support of the 1987 farm credit assistance legislation, Congress created Farmer Mac as a

federally supported secondary market for agricultural loans originated and serviced by commercial lenders as well as by farm credit institutions.<sup>31</sup>

When it began operations, Farmer Mac was expected to guarantee securities based on pools of agricultural loans. However, after several years of difficulty, Farmer Mac sought and in late 1991 obtained an expansion of its charter act authority, to engage in portfolio lending as well as the guarantee of securities backed by loans.<sup>32</sup>

Farmer Mac is designed to be controlled by its users. It is governed by a 15-member board of directors, five members elected by commercial banks and other financial institutions, five elected by Farm Credit System institutions, and five appointed by the President of the United States.

In its guarantee function, Farmer Mac performs the same financial function for agricultural mortgages that Ginnie Mae performs for FHA/VA residential mortgages. Like Ginnie Mae, Farmer Mac guarantees mortgage-backed securities issued by other entities. The Farmer Mac structure envisions emergence of a small group of so-called certified agricultural mortgage marketing facilities, or mortgage poolers. These poolers will purchase mortgages from originating lenders and issue the securities to be guaranteed by Farmer Mac.

Like Fannie Mae and Freddie Mac, Farmer Mac will bear interest rate risk on its portfolio but not on the guarantees that it provides. It will bear substantial credit risk and must assure that claims against its guarantee do not exceed the capitalization required under the Farmer Mac charter act. Like other farm credit institutions, Farmer Mac is supervised for safety and soundness by the Farm Credit Administration. The 1991 legislation that expanded Farmer Mac's authority also established a special Office of Secondary Market Oversight within FCA that is authorized to carry out the supervision of Farmer Mac and to set risk based capital standards within limits specified by law. Finally, while other FCS institutions are jointly and severally liable for FCS obligations, Farmer Mac is not part of this arrangement. It is not yet clear that, especially with current low levels of demand for credit in the agricultural sector, Farmer Mac can attain the kind of financial presence that is provided by the other enterprises.

#### H. The Financing Corporation, the Resolution Funding Corporation, and the Thrift Debacle

In 1987, Congress and the Reagan Administration created the Financing Corporation (FICO) of the Federal Home Loan Bank System. Unlike the other enterprises, FICO had no commercial purpose. Instead, its mission was to issue up to \$10.8 billion of 30-year debt to help provide funds for the insolvent Federal Savings and Loan Insurance Corporation. The 1989 FIRREA legislation created yet another enterprise, the Resolution Funding Corporation, to issue

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<sup>31</sup> See e.g., "Tough Foes for 'Farmer Mac'," New York Times, September 17, 1987, p. D-1.

<sup>32</sup> See Carol Matlack, "Farmer Mac's Lobbyists Save the Day," National Journal, January 4, 1992, p. 26.

up to \$30 billion of obligations carrying an implicit government guarantee. Refcorp debt is expressly guaranteed as to payments of interest, and implicitly guaranteed as to payments of principal and interest. Both Refcorp and FICO rely upon an initial contribution of funds from the Federal Home Loan Bank System, used to purchase 30-year zero coupon Treasury obligations intended to assure that funds will be available to pay for the principal portion of the 30-year debt issued by the two enterprises. Both FICO and Refcorp are tightly controlled by the federal government and limited in their functions so that they do not involve kind of safety and soundness questions and issues of moral hazard from the other enterprises. The activities of FICO and Refcorp properly belong in the budget of the United States government because these entities do not meet the test of private ownership established in the 1967 Report of the President's Commission on Budget Concepts.<sup>33</sup>

#### I. Other Proposed Government Sponsored Enterprises

The creation of FICO and Refcorp signals a new form of federal budget impetus for creation of new government sponsored enterprises. Because government sponsored enterprises not included within the federal budget, Congress can create them to serve intended purposes and constituencies without running afoul of Gramm-Rudman restrictions and other budgetary constraints. The major controversy over creation of Refcorp, for example, was whether it would be less costly for the U.S. government simply to use Treasury borrowing instead of slightly more expensive enterprise borrowing. Opponents of Treasury borrowing objected to the necessary waiver of Gramm-Rudman deficit reduction targets that would be required when the government issued additional Treasury debt; use of Refcorp permitted the government to raise the funds without such an express waiver.

Among the congressional committees considering creation of a new government sponsored enterprise are the two small business committees. In 1986, the House passed legislation to create a "Corporation for Small Business Investment" (COSBI) to support activities of small business investment companies.<sup>34</sup> The legislation died in conference committee. In 1988, the House and Senate Small Business Committees held hearings on similar legislation that was reported out of the House Small Business Committee but did not pass either house. In 1989, the House Small Business Committee announced consideration of a new enterprise, to be called the Venture Enhancement and Loan Development Administration for Smaller Undercapitalized

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<sup>33</sup> This is elaborated more fully in Thomas H. Stanton, "Budgetary Consequences of Using a Government Sponsored Enterprise To Provide Financial Assistance to the Federal Savings and Loan Insurance Corporation," Committee on the Budget, U.S. House of Representatives, January 26, 1989, at pp. 328-337.

<sup>34</sup> Contained in Title IX of the Omnibus Budget Reconciliation Act of 1986, H.R. 5300, passed by the House of Representatives, September 24, 1986. For an analysis of strengths and weaknesses of the 1986 COSBI legislation, see Thomas H. Stanton, "Pending Legislation Would End Impasse Over SBA Program," Legal Times, p. 24, October 6, 1986.

Enterprises (“Velda Sue”).<sup>35</sup> Velda Sue would provide a secondary market for a variety of small business loans originated by private lenders, and also would include as an affiliate institution the Corporation for Small Business Investment. It is not clear whether the Clinton Administration will favor creation of new government sponsored enterprises to serve high priority public purposes. One area where creation of an enterprise has been discussed involves provision of credit support for infrastructure loans

Finally, a number of members of Congress have become sensitive to the federal exposure created by government sponsored enterprises, even if the contingent liability is not formally recorded in the federal budget. In late 1992, the Congress passed legislation requiring careful analysis of the proposed structure of federal financial supervision for any proposed new government enterprises. The bill was attached to a much broader tax bill that President Bush vetoed in late 1992.<sup>36</sup>

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<sup>35</sup> See H.R. 3179, introduced August 4, 1989.

<sup>36</sup> See H.R. 11, Revenue Act of 1992, Title XIII - Federal Debt Management Responsibility, reprinted in Congressional Record, October 5, 1992, at pp. H12395-6.