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Government-Sponsored Enterprises (GSE's) - Sallie Mae [1]

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36TH STORY of Level 1 printed in FULL format.

The Washington Post

December 1, 1992, Tuesday, Final Edition

SECTION: FIRST SECTION; PAGE A6

LENGTH: 500 words

HEADLINE: Sallie Mae Unveils Student Loan Rate-Cut Program;
Critics Call Agency's Move a Minor Concession Amid Political Pressure for Dramatic Change

SERIES: Occasional

BYLINE: Mary Jordan, Washington Post Staff Writer

BODY:

Several million college students would get a reduced rate on their college loans if they make monthly payments on time under a new program announced yesterday.

The Student Loan Marketing Association, known as Sallie Mae, the nation's largest servicer of college loans, estimated that prompt payments would result in a $ 985 saving for those with a $ 20,000 loan. The saving on a $ 5,000 loan would be $ 250.

Critics said the unusual move by the quasi-governmental agency is a minor concession to student debtors. It comes at a time when the current loan system is under siege by the incoming administration.

President-elect Clinton said during the campaign that he wanted to scrap the entire current student loan system. Among other things, that could lead to the elimination of the banks and guarantors like Sallie Mae that charge costly administrative fees.

The loan program also has been under attack by Congress, which this year approved a new pilot program to make the government a direct lender. Many members of Congress have said they are fed up with the current system, which is highly complex and has been hemorrhaging money to students who skip out on loans. High administrative costs also have drained the program, critics say.

" Sallie Mae faces a very serious threat from the proposal to go to direct lending," said Thomas H. Stanton, a Washington lawyer who specializes in government credit programs. The federally chartered corporation owns about one-third of all the outstanding insured education loans, or about 5 million loans for students and their parents.

Consumer advocate Ralph Nader said the new incentive program -- not applicable to loans currently being repaid -- "is hardly a charitable breakthrough."

Nader said the lenders and servicers received a "windfall" of profits from college students recently because the loan rate remained relatively high compared to plunging interest rates. Nader said Sallie Mae is doing "less than what banks are doing for homeowners with adjustable rate mortgages now."

Lydia Marshall, senior vice president of Sallie Mae, said the incentive plan has been under development for a long time and "has nothing to do with direct lending" or Clinton's proposal, called the National Trust Fund.

Further, she said, the current system, which took years to develop, could turn out to be "complementary" to the Clinton plan when the details are known.

Some officials involved in the transition say that almost every detail of Clinton's proposal -- which also would allow students to repay student loans by working as police officers or community service workers -- is still under discussion.

The new program rewards students who pay the first 48 monthly payments on time by then reducing their interest rate by 2 percentage points.

Since mid-1988, the student lending rate has been 8 percent for the first 48 months and 10 percent after that.

Currently, about 80 percent of Sallie Mae's student loans are not being paid on time.

TYPE: NATIONAL NEWS

SUBJECT: COLLEGES AND UNIVERSITIES; STUDENT FINANCIAL AID; STUDENTS; INTEREST RATES; LOANS AND MORTGAGES

ORGANIZATION: STUDENT LOAN MARKETING ASSOCIATION; SALLIE MAE

NAMED-PERSONS: BILL CLINTON; THOMAS H. STANTON; RALPH NADER

CO: STUDENT LOAN MARKETING ASSOCIATION;

TS: SLMAJ (NASDAQ); SLM (NYSE);

IND: 131 PERSONAL CREDIT; 391 PERSONAL SERVICES;

11TH STORY of Level 1 printed in FULL format.

PR Newswire

December 7, 1992, Monday

SECTION: Financial News

DISTRIBUTION: TO BUSINESS EDITOR

LENGTH: 1034 words

HEADLINE: SALLIE MAE PRESIDENT SAYS CLINTON'S STUDENT LOAN PROPOSALS CAN BEST BE MET THROUGH EXISTING PRIVATE CAPITAL-BASED SYSTEM

DATELINE: WASHINGTON, Dec. 7

KEYWORD: bc- Sallie-Mae -Clinton

BODY:

Student Loan Marketing Association (Sallie Mae) (NYSE: SLM) President and Chief Executive Officer Lawrence A. Hough today stated that President-elect Clinton's proposals for enhancing post-secondary education loan programs can readily and best be achieved through continued reliance on providers of private capital and service. And, he called upon those providers to work creatively with the incoming Clinton administration and Congress to achieve those goals. "We can be the President-elect's best allies in accomplishing his policy objectives," he said.

"The present system of private capital-based educational credit, supplied through the competitive marketplace of the private sector economy, continues to be the best vehicle through which to serve the nation's students and their families," he said. "It has provided an irreplaceable outreach network, a distribution structure which reaches into thousands of American communities to offer ready access to information and to loan funds."

Addressing the annual student loan conference of the Consumer Bankers Association in Arlington, Va., just outside the nation's capital, Hough urged participants to join the debate about how Clinton's ideas for change will be delivered.

"We must not be wary of departures from the present, if the alternative relies on private capital and leaves in the marketplace opportunities for us as potential participants," he said. "In the spirit of closer examination and open-mindedness, let's examine the underlying policy direction which emerged from this fall's campaign."

The president-elect, he said, had called for more manageable student loan repayment through income contingent repayment and loan cancellation for national service, broader access to loan support, and national service. All of those public policy objectives could best be achieved, Hough told the bankers, through partnership with private sector lenders.

With regard to new loan repayment mechanisms, Hough said: "Manageable repayment is a goal our industry has had for years." The industry, he noted, had implemented graduated repayment and loan consolidation plans, despite regulatory and programmatic impediments. "The competitive drive that propels the industry's players through these tough issues holds that if you solve a problem before I do, you win in the market. We all are seeking service and product distinctions that will allow us to better serve the customer."

To achieve Clinton's ambition that there be an income contingent payment alternative for students, the new administration could "utilize the current, in-place, national delivery system and have income contingent repayment in place by the fall," or it could "wait years for the implementation of the (recently legislatively mandated) direct loan pilot, a program that is only a concept, and whose student borrowers will not be in the position to realize any repayment benefits until late in this decade."

Moreover, Hough suggested that such borrower service add-ons as income contingent payment would add substantial cost to any direct lending program. "The Department of Education will have to pay a substantial increment to the service fee for every innovation it wished to add to the requirements of the RFP (Request For Proposal). ... This is the stark difference between 'pay for service' government contracting and public/private partnerships where the output driven competition of the marketplace consistently delivers solutions which improve continuously and do so at an overall declining cost to the government."

With regard to the incoming administration's proposals to expand access, he said, legislation enacted last summer provides for access to the existing loan programs by virtually all post-secondary education students. If the call for expanded access also envisions higher individual loan limits, Hough cautioned that increases beyond those recently enacted could result in more defaults, especially for those who borrow heavily and subsequently drop out of school.

Income contingent payment does not change the fact, as some have suggested, he said. "As a basic tenet, the borrowers who have incurred indebtedness in excess of 80 percent of starting salary, 25- year income contingent schedules, assuming likely salary increases, will fail to retire the indebtedness in the majority of cases," he noted.

If loan amounts are increased, Hough stated, they should be accompanied by intensified student retention and borrower counselling efforts. "This is an area we understand well," he said. "If there is to be even greater amounts of borrowing, it is only thorough the banking community that it can be delivered with a clear understanding of the borrower's responsibilities for repayment."

Addressing the third aspect of Clinton's proposals for post- secondary education, Hough urged that the education credit industry "offer immediate support for national service by committing to work quickly to implement provisions for partial or whole loan cancellation." He suggested the industry could also process all national service benefits, whether in the form of vouchers or awards.

Beyond addressing the incoming administration's post-secondary education platform, Hough challenged assertions that replacing the present, private capital-based student loan programs with a program funded directly by the federal government would produce savings, as suggested by a recent GAO report. "The savings attributed to direct loans reported 10 days ago by GAO are problematic," Hough said. "The GAO's promised savings would not be achieved in today's rate environment. At present rates, we believe the GSLP would save the same amount as the GAO analysis claimed for direct loans."

Sallie Mae, a federally chartered, shareholder owned corporation, is the nation's major financial intermediary serving the education credit market. It is the largest provider of funds for student and parent loans. It also finances academic plant and equipment. CONTACT: Gisela Vallandigham, 202-298-3147, or Ross Kleinman, 202-298-3013, both of Sallie Mae

ORGANIZATION: Student Loan Marketing Association

TICKER-SYMBOL: SLM

GEOGRAPHIC: District of Columbia

INDUSTRY: Banking; Financial Services

CO: STUDENT LOAN MARKETING ASSOCIATION;

TS: SLMAJ (NASDAQ); SLM (NYSE);

IND: 131 PERSONAL CREDIT; 391 PERSONAL SERVICES;

The 1992 Campaign

White House

Bush Proposes Expansion Of Student Loan Program

By ANDREW ROSENTHAL
Special to The New York Times

Agence France-Presse

President Bush speaking yesterday at Dieruff High School in Allentown, Pa., where he proposed expanding the student loan program.

ALLENTOWN, Pa., April 16 — Responding to election-year criticism of his record as the self-proclaimed "Education President," President Bush today proposed expanding the Federal student loan program to include everyone who wants to take classes, even part time, and to give anyone up to $25,000 in loans at rates that would vary with income.

The White House presented Mr. Bush's proposal as a major new initiative, but it seemed motivated as much by politics as by policy, as Mr. Bush moves closer to the possibility of a campaign against Gov. Bill Clinton of Arkansas. Mr. Clinton, who has made universal access to Government loans for education a centerpiece of his campaign, immediately criticized Mr. Bush's proposals.

> The President offers a plan that Congress has already rebuffed.

The President's plan is a retooled version of one already rebuffed by Congress. Figures supplied by the White House indicated that Mr. Bush expected it to increase the number of Americans seeking student loans by only about 2 percent a year.

Mr. Bush unveiled his plan during an appearance at a high school in this Lehigh Valley town. The White House said the announcement and Mr. Bush's visit here were not motivated by the primary election in Pennsylvania on April 28, during which Mr. Bush hopes to clinch the Republican nomination.

Strongly Different Ideas

There are important differences between Mr. Clinton's ideas and Mr. Bush's. The Democrat is advocating creation of a Government "trust fund" that would lend money to anyone who wants to attend college. The loans would be repaid either on a sliding scale depending on income or through a term of national service.

Mr. Bush opposes such a fund and instead his plan seeks to expand access to private loans or loans made by the Student Loan Marketing Authority, a quasi-governmental agency known as Sallie Mae. Those loans are currently available only to those who attend classes on a full-time or part-time basis. There would be no minimum amount of study under Mr. Bush's proposal for a person to qualify for a loan.

"Think of the working mother, balancing her responsibility for her family and her job against her own hopes for the future," Mr. Bush said today. "She'd take one college course at a time, but she doesn't qualify right now for the grant or loan that would help pay tuition. Our lifetime education and training account would help her get back into the classroom."

It would also permit Sallie Mae to sell up to $100 million in bonds next year to make loans to students at interest rates and repayment schedules that would depend on a recipient's income after completing the study.

Up to $25,000

Any person could borrow up to $25,000 during his or her lifetime from this fund, Mr. Bush said, but no more than $100 million in loans could be made in any year. There currently is no limit on student loans, but they are made at interest rates determined by the market, not income.

Administration officials said they had not yet worked out the sliding rate in any detail but said that, for example, Mr. Bush's might allow a borrower with an income of about $15,000 a year to obtain a loan for an interest rate as low as 3 percent, while one with an income of more than $50,000 could pay as much as 13 percent. Students with family incomes under $50,000 a year can currently obtain loans at a fixed rate of 8 percent.

Mr. Bush also proposed making Government "Pell grants," which average about $1,800 a year, available to part-time students.

Thomas Scully, an official of the White House's Office of Management and Budget, told reporters that the proposal, if enacted, would produce an additional 125,000 student loans in 1993, an increase of only about 2.3 percent over the 5.5 million loans that already are expected to be made next year.

It would increase Pell grants by about 100,000, or some 2.7 percent of the 3.7 million grants expected to be made next year.

The Administration expects a total of $16 billion in student loans and $6 billion in Pell grants to be made in 1993.

MEMORANDUM

To: Robert Gordon
From: Bob Shireman
Date: December 29, 1992
Re: **Your request for background on Sallie Mae**

Enclosed are memos and background material on the Student Loan Marketing Association. I have also enclosed my description of a pending GAO audit of the student loan program, which will raise important questions about the role of guaranty agencies.

As we discussed, it is worth encouraging Sallie Mae, the guaranty agencies, and the banks to present their own ideas for radically restructuring the student loan program. So far, they have been reluctant to propose anything that eliminates other players in the system, but as their fear of extinction increases, so will their willingness to present real alternatives that save money. You will note (from the enclosed New York Times article) that President Bush moved in this direction with his "Lifelong Learning" proposal. Sallie Mae did not support the proposal, and the details did not make any sense, but the concept of retaining Sallie Mae *or* some of the guaranty agencies (or maybe even banks) could still yield some savings over the current system.

Some thoughts on Sallie Mae's role

1. Capital. Sallie Mae makes most of its money through arbitrage. It borrows money from investors at very low rates (because of the implied federal backing), and uses the money to purchase student loans from banks. It then receives payments from borrowers (and/or from the federal government) at rates that are guaranteed (by the government) to be significantly higher than Sallie Mae's cost of funds. (The Consumer Bankers Association document is the best overview of all of Sallie Mae's federal benefits; CBA considers Sallie Mae to be unfair competition). It's close to a no-lose situation for Sallie Mae.

Under direct lending, capital availability is not a problem, so this Sallie Mae role is not necessary. POSSIBLE ALTERNATIVES: Allow Sallie Mae to make loans directly (instead of purchasing loans from banks) while significantly reducing the special allowance payment; and/or, increase Sallie Mae's share of the risk on the loans (however, increased risk-sharing results in reduced loan access for students).

2. Loan Collection. The only real risk to Sallie Mae is in loan collection, though the risk is minimal. By all accounts, Sallie Mae is a very efficient collector of payments on student loans, and this is no doubt in part because of its profit motive.

Under direct lending, if collections are being made by the IRS, this Sallie Mae role is unnecessary. If some loans are still being collected in the conventional manner, the government could still contract for loan collection by profit-making entities (including Sallie Mae).

3. Market Signals. Banks refuse to make loans for certain types of schools and students if it results in a lower purchase price when they try to sell their loan portfolio to Sallie Mae. Sallie Mae pays less for smaller loans and for loans involving schools with high default rates, because the profit margin is lower. Through this process, prospective students at some "bad" schools may be discouraged from attending, or at least won't take out a loan that may result in a default and taxpayer cost. However, other students, who could benefit from further education, may be discouraged as well. (The CBA document complains that Sallie Mae's success has been achieved "by abandoning concern and commitment to low-income, high-risk student loan borrowers.")

Under direct lending, some increase in "lower profit" loans is likely, although the amount is unknown, and whether that is good or bad is an open question. It is crucial, however, that schools be better screened before they are allowed to participate in the program. Fortunately, additional tools are available under direct lending for overseeing school quality and spotting problems early. POSSIBLE ALTERNATIVES: Guaranty agencies and/or states could play a greater role in determining whether particular students or schools should receive a loan.

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Briefing Report to the Chairman, Subcommittee on Postsecondary Education, Committee on Education and Labor, House of Representatives

September 1991

STUDENT LOANS

Direct Loans Could Save Money and Simplify Program Administration

GAO/HRD-91-144BR

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United States General Accounting Office

GAO

Report to Congressional Committees

January 1992

STAFFORD STUDENT LOANS

Lower Subsidy Payments Could Achieve Savings Without Affecting Access

GAO/HRD-92-7

United States General Accounting Office

GAO

Fact Sheet for the Chairman, Committee on Labor and Human Resources, U.S. Senate

March 1992

STAFFORD STUDENT LOAN PROGRAM

Correspondence Schools' Loan Volume Declines Sharply

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United States General Accounting Office

GAO

Briefing Report to the Chairman, Committee on Labor and Human Resources, U.S. Senate

November 1992

GUARANTY AGENCY SOLVENCY

Can the Government Recover HEAF's First-Year Liquidation Cost of $212 Million?

GAO/HRD-93-12BR

United States General Accounting Office

GAO Testimony

For Release
on Delivery
Expected at
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Improved Regulatory Structure and Minimum Capital Standards are Needed for Government-Sponsored Enterprises

Statement of
Richard L. Fogel
Assistant Comptroller General
General Government Programs

Before the
Subcommittee on Policy Research and Insurance
Committee on Banking, Finance and Urban Affairs
U.S. House of Representatives

GAO/T-GGD-91-62

GAO Form 160 (12/87)

IMPROVED REGULATORY STRUCTURE AND MINIMUM CAPITAL STANDARDS ARE NEEDED FOR GOVERNMENT-SPONSORED ENTERPRISES

Summary of Statement By
Richard L. Fogel
Assistant Comptroller General
General Government Programs

In response to a request from the Honorable Ben Erdreich, Chairman, House Subcommittee on Policy Research and Insurance, Committee on Banking, Finance, and Urban Affairs, GAO presented its recommendations for improving federal oversight and capital rules for government-sponsored enterprises (GSE).

GAO found that shortcomings in current federal oversight of GSEs inhibit the government's ability to identify future problems that could lead to taxpayer losses and to deal with any such problems. Current federal regulators lack sufficient authority and responsibility to enforce safety and soundness rules and require minimum capital based on the risks undertaken by the GSEs. In addition, the current regulatory structure lacks sufficient prominence in government and independence from GSEs and the markets they serve to effectively and efficiently protect the government's interest in GSEs.

GAO recommends that Congress establish an independent Federal Enterprise Regulatory Board to oversee the activities of GSEs. The Board would be headed by a Board of Directors comprised of three voting members--a presidentially appointed Chairperson, the Secretary of the Treasury, and the Chairman of the Federal Reserve System--and three nonvoting members--the Secretaries of Agriculture, Education, and Housing and Urban Development. GAO recommends that the Board be given the authority and responsibility to establish and enforce rules of safe and sound operations, and monitor compliance with these rules.

GAO also recommends that Congress direct the Board to establish minimum required capital standards based on the risks GSEs undertake. GAO's preferred standard would include the sum of capital levels determined by (1) empirically-based tests of a GSE's capital adequacy to withstand credit and interest rate risk in stressful economic environments and (2) a ratio of capital to assets that establishes a level of capital for management, operations, and business risks.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to discuss federal oversight of government-sponsored enterprises (GSE). The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 required two GAO reports on this subject; one in 1990 and another in 1991. As you may recall, in our first report,[1] we described the GSEs' purposes and operating methods, the financial risks they bear, and how they are regulated. We concluded that the sheer size of the GSEs' financial obligations, now over $1 trillion, their public purposes, and the probability that the federal government would assist a financially troubled GSE, make it appropriate for the government to (1) supervise GSE risk-taking activities and (2) establish minimum levels of capital. We were concerned that federal oversight of GSEs--particularly for Fannie Mae, Freddie Mac, and Sallie Mae--was inadequate to identify, prevent, or contain the effects of problems like those that led to taxpayer losses in the thrift industry and Farm Credit System. We said that this year we would recommend specific improvements for federal oversight of GSEs.

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[1]See our report Government-Sponsored Enterprises: The Government's Exposure to Risks, (GAO/GGD-90-97, Aug. 15, 1990).

In my testimony today, I will discuss the major recommendations contained in our May 22, 1991 report.[2] We recommend that Congress (1) provide a GSE regulator with appropriate enforcement authorities, (2) establish a new federal regulatory structure to administer GSE oversight, and (3) establish reasonable capital rules based on the risks undertaken by the GSEs. We also plan to issue later this year a third report on the results of our audit of internal risk control procedures at Fannie Mae, Freddie Mac, and Sallie Mae.

ADDITIONAL OVERSIGHT AUTHORITIES NEEDED

Our first report on GSEs found several shortcomings in federal oversight of various GSEs.

-- The Department of Housing and Urban Development (HUD) does not have clear authority to set capital rules based on the risks undertaken by Fannie Mae and Freddie Mac. Nor does HUD have the range of specific enforcement authorities typically granted to bank regulators; moreover, HUD has not fully used the authorities it has been granted. Finally, inherent conflicts could exist between HUD's housing goals and its goals as a financial regulator.

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[2]See our report Government-Sponsored Enterprises: A Framework for Limiting the Government's Exposure to Risks, (GAO/GGD-91-90, May 22, 1991).

-- Sallie Mae has no federal regulator overseeing its financial activities; it also has no minimum capital requirement.

-- The Farm Credit Administration lacks specific authority to set capital standards for Farmer Mac.

-- The statutory capital rules for the Federal Home Loan Banks require a capital-to-outstanding-debt ratio that considers neither the risks of off-balance sheet activities nor the relative riskiness of various bank assets.

To adequately protect the government's objective that GSEs carry out their public purposes safely and soundly, we recommend that the GSE regulator have authorities and responsibilities to

-- establish rules that clearly define regulatory expectations and promote the safe and sound accomplishment of GSEs' purposes. These should include, but not be limited to, rules that define minimum capital levels, prohibit unsafe activities, set minimum boundaries of a sound financial condition, and establish information reporting requirements. The rules should be established using procedures that conform to the Administrative Procedures Act, including requirements for public comment before adoption of rules.

-- monitor financial performance and compliance with regulations to provide an adequate understanding of the GSE's operations, condition, and the potential risk to the government. The regulator should have unimpeded, timely access to all information, systems, and personnel. While such monitoring is necessary to keep the regulator well informed, it should be done as non-intrusively as possible. Monitoring should increase when conditions warrant.

-- act in a timely manner to enforce charter restrictions, regulations, and capital requirements. Enforcement actions should result from a fair and reasonable process. Enforcement authorities should be sufficiently broad, and some enforcement actions should be mandatory when pre-specified conditions are met.

-- levy assessments to cover oversight and supervision costs.

These authorities should supplement, not obstruct, the existing corporate governance at each GSE. The regulator normally would not need to involve itself in a GSE's business affairs--that is, it would not approve operating strategies, budgets, salaries, hiring, and the like. Under current charters, such powers normally are assigned to the GSEs' boards of directors. We would not change that. Permitting corporate governance the freedom to manage the GSEs allows them to quickly respond to changes in the marketplace and serve their customers.

Under normal conditions, regulatory activity would usually consist of performance monitoring to ensure that corporate governance is working effectively and according to established regulations. Prompt interventions by the regulator would be warranted when corporate governance processes were not working as intended or when the GSE was experiencing financial or managerial difficulties.

SINGLE INDEPENDENT REGULATOR FAVORED

Recent regulatory experiences during the thrift and Farm Credit crises indicate that an effective GSE regulator should be structured so that it is both prominent in government and objective. These characteristics should give the regulator the visibility and the capability to act promptly and effectively if a GSE experiences severe difficulties. The regulatory body should be independent from the GSEs, their competitors, and all advocacy responsibilities. To avoid possible conflicts of interest, a GSE regulator should not also regulate the market served by the GSE. Finally, fairness demands that GSEs facing similar risks receive similar regulatory treatment.

To achieve these goals, we propose a single regulator, which we call the Federal Enterprise Regulatory Board. The Board would have three voting members--a full-time chairperson appointed by the President, the Secretary of the Treasury, and the Chairman of the Federal Reserve System. The chairperson would serve as the Chief Executive Officer of the regulatory staff. The chairperson should serve a fixed-length term and be an individual familiar with government, who has a respected record of achievement. The Secretary of the Treasury would provide financial expertise and represent the administration's views. The Federal Reserve Chairman would provide an independent view and expertise in the workings of financial markets.

To provide advice on specific agriculture, education, and housing programs and markets, the Board would have three nonvoting members--the Secretaries of Agriculture, Education, and HUD. The Secretaries would provide their views and perspectives on public policy issues. Their nonvoting status should protect the arm's-length nature of the Board by minimizing the possibility that these members use the GSEs to address public concerns not envisioned by GSE charters.

REGULATORY CAPITAL REQUIREMENTS SHOULD BE BASED ON RISKS UNDERTAKEN

Requiring that GSEs maintain a minimum amount of capital provides several public benefits. Foremost, it provides some assurance of a buffer adequate to absorb unforseen GSE losses and to prevent taxpayer losses. Also, a capital standard gives GSE shareholders a greater incentive to demand that management not take undue risks. Finally, a capital standard provides the government a way to influence a GSE's risk-taking without involving itself in the GSE's daily business operations.

To accomplish these objectives, GSE capital requirements should (1) be based on all risks they undertake, (2) provide an adequate buffer for possible GSE losses, (3) be clear and prospective, and (4) be equitable for competing GSEs. Because Farm Credit System banks compete directly with commercial banks, their capital requirements should continue to be patterned after bank risk-based capital rules. For the other GSEs, the new Federal Enterprise Regulatory Board should establish minimum capital standards that are based on the sum of (1) empirically-based measurements of the capital needed to withstand credit risk and interest rate risk losses in stressful economic environments, commonly known as "stress tests," and (2) an amount equal to a proportion of a GSE's obligations (leverage ratio), both on- and off-balance sheet, so that capital is held for management, operations, and business risks.

Where possible, the capital standard should be based on empirical evidence and should use the best available measurement methods. The "stress tests" are especially applicable for financial firms in a single line of business, like GSEs, because economic environments adverse to such firms are relatively easy to identify compared with firms in multiple lines of business like banks. The specific measurements, assumptions, and ratio levels should be left to the new Board's discretion, to provide the flexibility needed to revise rules during the evolution of markets, technologies, and GSE operations. Such flexibility is currently missing for Fannie Mae and Freddie Mac, where the capital rules have become outdated now that off-balance sheet activities are commonplace.

The proposed standard needs to be the sum of the amount needed to meet the "stress test" requirement and that needed to meet the leverage ratio requirement. It must provide sufficient capital to provide a buffer against possible losses arising from all sources of risk.

CONCLUSION

I recognize that some will argue that increased regulation of GSEs is unnecessary because none of the GSEs now pose an imminent financial threat to the government. Available evidence suggests the GSEs are now generally in sound condition. However, future changes in management strategies, economic downturns, or other adverse events could precipitate future GSE losses. The speed with which a firm can go from apparently sound to financially imperiled was vividly demonstrated in the thrift industry, the Farm Credit System, and Fannie Mae in the early 1980s. The time to act to improve the regulatory structure and the safety and soundness of GSEs is when the situation is calm. History has shown that regulatory improvements are more difficult to design and implement in a crisis environment, after huge losses have occurred.

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

Copies of GAO reports cited in this statement are available upon request. The first five copies of any GAO report are free. Additional copies are $2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

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