

**The Administrative Conference of the United States:
A Resource to Help Policymakers Deal With
The Legal Framework of Third Party Government**

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Thomas H. Stanton
Attorney at Law
801 Pennsylvania Avenue, NW
Suite 625
Washington, DC 20004
(202) 965-2200

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By Thomas H. Stanton
(202) 965-2200

Good afternoon. It is a pleasure to join this distinguished group today to discuss the relationship of administrative law to the issue of third-party government. There are several goals for this conversation:

First, to show, by using a case study, how the legal framework of third party government can be so complex that it is difficult for policymakers to address or even to understand;

Second, to suggest that the Administrative Conference of the United States (ACUS), a small but valuable agency the Congress abolished in a fit of parsimony some years ago, is the type of resource that policymakers need to help understand third party government; and

Third, respectfully to recommend that we should consider beginning a movement to bring back the Administrative Conference.

I. The Essential Role of Law in Establishing the Relationship of Government to Third Parties That Carry Out Public Purposes

The law plays an essential role in the administration of third-party government. Under our constitutional system the law defines the relationship of the government to the third parties that the government seeks to use to carry out public purposes. Other disciplines play important roles in the analysis of third party government. Economics helps policymakers to assess the costs and benefits of particular arrangements. Public Administration seeks to assess whether such arrangements enhance or detract from the capacity and accountability of a particular agency to administer its programs. *But lawyers play the fundamental role of helping to draft, interpret, and enforce the laws, regulations, and legal instruments that define the actual relationship between the government agency and the third parties that it uses to help administer its programs. The law creates the relationship of government to third parties while the other disciplines merely describe that relationship.*

The law uses at least three types of instrument to create the third party relationship:

1. The contract is used in procurement relationships. A contract spells out the roles, rights, and responsibilities of government vis-à-vis the private contractor;

2. The legal agreement is used in the administration of tools of government such as loan guarantee programs or grants. An agreement spells out the roles, rights, and responsibilities of government vis-à-vis private parties such as lenders or grantees; and
3. The charter authorizes enterprises and nonprofit entities to carry out public purposes as instrumentalities of government. A charter spells out the responsibilities and permitted powers of the chartered organizations, and the nature of benefits that the government grants in return.

All three of these types of instrument involve legal complexities that require a rare combination of (1) specialized legal knowledge and (2) a larger sense of the policy context that is affected by changes in particular legal provisions.

II. Case Study: The Complex Legal Framework of Government Sponsored Enterprises

Of the three types of instrument, the charter is perhaps the most venerable, dating back to the Middle Ages. The case study of the chartering of government sponsored enterprises (GSEs) can illustrate how the legal framework shapes the activities, performance, and accountability of private institutions that carry out public purposes.¹

I should disclose that, some years ago, the Administrative Conference of the United States commissioned me to conduct a study of federal supervision of government-sponsored enterprises.² The Administrative Conference recognized, as I am arguing here, that the purview of administrative law is broad enough to address the relationship of the government to third parties such as GSEs.

As ACUS understood in its review of federal supervision of GSEs, legal scholarship can help to clarify issues concerning third-party government that may not be as accessible to other academic disciplines. Especially because lawyers are so practical, our recommendations can have considerable influence in the policy process.

The GSE as a Tool of Government

The government sponsored enterprise is a federally chartered privately owned institution that benefits from the perception that the government stands behind its financial obligations. This perception, known as an implicit government guarantee, permits a GSE to raise money at rates close to those of the U.S. Treasury. In return for

¹Much of this discussion anticipates portions of my forthcoming book, *Government Sponsored Enterprises: Mercantilist Companies in the Modern World*, Washington, DC: AEI Press, 2002.

² That study appeared in published form as, Thomas H. Stanton, "Federal Supervision of Safety and Soundness of Government-Sponsored Enterprises," *The Administrative Law Journal*, summer 1991.

statutory privileges, including tax benefits and regulatory exemptions as well as reduced borrowing costs, the GSE is confined by its charter to serving specified kinds of borrowers through a limited range of financial services.

There are six privately owned GSEs -- Fannie Mae, Freddie Mac, the Federal Home Loan Bank System, the Farm Credit System, Sallie Mae and Farmer Mac. Two other institutions -- the Financing Corporation and Resolution Funding Corporation -- are governmental bodies that were given GSE attributes so that their provision of over a hundred billion dollars to fund the savings and loan bailout would not appear in the federal budget.

GSEs have achieved many beneficial results, including market innovations and provision of huge amounts of credit to selected constituencies such as farmers, homebuyers and students. GSE proponents point out that (except for some tax advantages) GSEs have achieved these benefits largely without drawing upon budgeted governmental funds. The off-budget nature of the federal subsidy for GSEs makes this form of institution very attractive as a policy tool.

Because of the implicit federal backing, GSEs have become some of the largest financial institutions in the United States. Fannie Mae and Freddie Mac together fund over \$ 2 *trillion* of home mortgages, either in their portfolios or through mortgage-backed securities; the Federal Home Loan Bank System holds about half a trillion dollars of loans to member financial institutions and investment assets; the Farm Credit System holds about \$ 100 billion in assets and Sallie Mae about \$ 50 billion. Implicit federal backing enables GSEs to grow rapidly; on average the combined size of the GSEs has more than doubled every five years since Fannie Mae was made a GSE in 1968.

Table 1 shows their combined growth, in terms of their outstanding debt obligations plus outstanding mortgage-backed securities, between 1970 and 2000:

Table 1

1970	1975	1980	1985	1990	1995	2000
\$15.2 Billion	\$ 37.2 billion	\$ 76.6 billion	\$ 261.3 billion	\$ 768.0 billion	\$ 1.3 trillion	\$2.3 trillion

Source: CBO (1991) and OFHEO (2000)

The Issue of GSE Incentives

The disadvantages of GSEs as tools of government relate to the incentives that are inherent in the GSE structure and the lack of accountability of GSEs to the government and taxpayers that create and subsidize them. Consider first incentives and then accountability.

The major subsidy to a GSE derives from its favorable borrowing costs, which creates perverse incentives: its value to GSE owners increases as a GSE takes financial risks. This means that shareholders in an enterprise benefit from reducing their own equity contribution compared to the volume of GSE business that is backed by the implicit government guarantee. The government has the opposite financial interest because shareholder capital helps to absorb financial losses before holders of GSE obligations call upon the government to honor its implicit guarantee; as with federal deposit insurance, shareholder capital is the “deductible” portion of the insurance policy that the federal government provides for a financial institution.

Thus, Fannie Mae and Freddie Mac offer shareholders the opportunity to leverage their stock to a greater degree than is possible for shareholders of virtually any financial institutions in the United States. At year end 2000 Fannie Mae and Freddie Mac had capital ratios (i.e. a ratio of shareholder equity to assets and guaranteed securities) of about 1.5 percent. By contrast the government would require that a bank or thrift institution with federal deposit insurance and a similar book of business should have capital of over four percent.

For investor-owned GSEs, one problem of incentives relates to the potential difference in interests of shareholders from those of the borrowers from a GSE. The Congressional Budget Office recently reported that the federal subsidy to Fannie Mae and Freddie Mac is very inefficient. The GSEs keep a substantial part of the benefits for their shareholders, who receive generous returns on their equity, rather than reducing further the cost of home mortgages.

Managers and owners of the investor-owned GSEs have an incentive to serve only the most profitable parts of their charters, regardless of public value. The U.S. Department of Housing and Urban Development (HUD) reports that Fannie Mae and Freddie Mac today provide credit for a disproportionately low percentage of low-income and moderate-income homebuyers, compared to other lenders in their markets. As HUD reported concerning the two largest GSEs,

"[T]heir share of the affordable housing market is substantially smaller than their share of the total conventional conforming market. Lower income families, certain minorities, central-city residents, and immigrant populations continue to be underserved by Fannie Mae and Freddie Mac."³

An earlier GAO report concluded with an observation similar to HUD's that, "The enterprises continue to trail the primary market" in most categories of service to groups and locations with affordable housing needs.⁴

³ Statement of William C. Apgar, Assistant Secretary for Housing and Federal Housing Commissioner, before the House Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises, March 22, 2000, p. 1 of prepared text.

⁴ US General Accounting Office, *Federal Housing Enterprises: HUD's Mission Oversight Needs to be Strengthened.* GAO/GGD-98-173, July 1998, p. 59.

To take another example, the Federal Home Loan Banks had an investment portfolio (i.e., a source of income without regard to public purpose) at year end 1995 that exceeded the volume of credit that they provided to their members in furtherance of their statutory purposes. The investment portfolio has now declined in relative, but not absolute terms.

Indeed, some actions of GSEs can be seriously detrimental to public purposes. The Farm Credit System is a cooperative that is owned and controlled by its borrowers. This GSE provided inexpensive loans, priced below its own cost of funds, to farmers in the late 1970s. The easy credit contributed directly to thousands of farm failures in the 1980s when the agricultural economy declined and farmers could not repay their extensive debts. In the process, the Farm Credit System itself failed. The Congress created an off-budget Farm Credit System Financial Assistance Corporation to lend money to the FCS until the agricultural economy could turn around and the system could return to financial health and repay the assistance.

More recently, GSEs found that they could enhance their earnings by issuing exotic and sometimes unpredictable securities known as derivatives. Derivative securities offered unknowledgeable investors such as the treasurer of Orange County, California, the opportunity to hold securities with high credit quality (because of the government's implicit backing), high financial risk, and potentially high yields. The Federal Home Loan Banks, Fannie Mae, Freddie Mac, Sallie Mae and the Farm Credit System all have issued billions of dollars of so-called structured notes and other derivative securities. The problem of disclosure and accountability is compounded because the charters of the GSEs exempt them from jurisdiction of the Securities and Exchange Commission.

The Issue of Accountability

GSEs today wield considerable political power. Some members of Congress, especially some on the relevant authorizing committees, have shown themselves to be very responsive to GSE requests. When the U.S. Treasury Department drafted a report on desirability and feasibility of privatizing Fannie Mae and Freddie Mac, the two GSEs applied considerable influence to assure that only a weak document would emerge. When the Congressional Budget Office issued a report that the GSEs found uncongenial, one of the enterprises responded with personal attacks upon the quality of the analysts who prepared and reviewed the report.

Their considerable influence makes it difficult to assure continuing public benefits from GSEs or to protect taxpayers against the immense financial contingent liability that they create. The new financial regulator for Fannie Mae and Freddie Mac has only a small staff to assess the activities of the two GSEs and their two trillion dollars of assets and mortgage-backed securities. The entire office has a tiny annual budget compared to the resources that would be allocated by a comparable federal bank or thrift institution regulator to supervise large financial institutions.

With respect to public benefits, the original purpose of the Federal Home Loan Bank System is disappearing along with the savings and loan industry that the Banks formerly served. Yet the government has neither an exit strategy for the Federal Home Loan Banks nor the political strength to implement such a strategy. Instead, the congressional banking committees have enacted a variety of charter expansions to try to engraft new public purposes upon the outmoded framework of the old system.

Fannie Mae and Freddie Mac have expanded their financial activities to the point that they now provide mortgage technologies to facilitate the financing of high-income and other types of mortgages that would appear to be beyond the intended limitations of their congressional charters. Again, in a pattern similar to the gridlock that often has occurred on legislation concerning powers of commercial banks, the Congress seems unable to act.

One notable contrast involves the 1996 legislation to withdraw GSE status from Sallie Mae. The Congress enacted the legislation after extensive negotiations among the affected constituencies. Sallie Mae itself promoted the legislation because of a sense that the burdens imposed by its charter, including a special fee that helped to offset many of the advantages of GSE status, outweighed the benefits. Sallie Mae is now engaged in a leisurely transition to give up its GSE status, perhaps by 2008.

The Complicated and Unusual Legal Structure of GSEs

The issue of accountability of GSEs can relate directly to the intricate nature of the laws that charter GSEs and establish their relationship to the government in ways that may not be well understood by policymakers.

Legislation in 1999 illustrates the dangers of a process of congressional enactment of provisions whose consequences only the GSEs may understand. In that year the Congress enacted, and the President signed, an amendment to the Freddie Mac charter act that was so untenable that lawmakers felt obliged to reverse it in new legislation only two weeks later.

In the closing days of the 105th Congress, Freddie Mac secured enactment of a charter amendment that would have allowed it to bear the financial risk on low-down payment mortgages, rather than requiring them to be covered by private mortgage insurance. Since 1970, both the Freddie Mac and Fannie Mae charters provided that, when they purchased a conventional mortgage, each GSE would need to be sure that private mortgage insurance covered any credit risk above an 80 percent loan-to-value ratio. Freddie Mac sought a charter change to permit it to assume that credit risk and eliminate any requirement for private mortgage insurance.

Freddie Mac obtained the support of the then-Chairman of the Senate Banking Committee, who obtained the addition of the Freddie Mac charter amendment to a bill in a House-Senate conference committee, at the final stages of the legislative process. The President signed the bill into law shortly thereafter. If it had remained in effect, the

amendment would have permitted Freddie Mac to take over much of the core business of many mortgage insurance companies. Faced with a drastic drop in their companies' value, the mortgage insurance industry mounted a hasty and successful campaign to reverse the provision.⁵

Other examples could be recited to document that GSE legislative provisions are arcane and often poorly understood by the legislators who sponsor them and the relevant congressional committees. Seemingly small changes in a GSE charter can have substantial implications for the financial system. Policymakers often don't appreciate how small changes to a GSE charter, when backed by the government subsidy for GSEs, can cause sweeping changes in the financial markets. GSEs can make an appealing argument for change to lawmakers, for example that some expansion of authority will enable the GSE to offer more services at lower cost. This argument, based as it is on the ability of the GSE to funnel government subsidies into the new activities, can obscure the larger implications.

The consequences are particularly serious when statutory provisions involve government oversight of safety and soundness. While private competitors of the GSEs may scrutinize legislation that affects them, it is primarily the government, on behalf of taxpayers, that has a direct stake in the quality of supervision of the safety and soundness of a GSE.

The most recent example is H.R. 1409, the "Secondary Mortgage Market Regulatory Improvements Act," introduced on April 5, 2001. On its face, it would improve the government's statutory basis for addressing GSEs' safety and soundness. Among other provisions, it transfers to the Federal Reserve Board responsibility for supervision of Fannie Mae and Freddie Mac. However, instead of basing the government's authority on well-tested statutes applicable to federal bank regulators, H.R. 1409 builds on the dubious foundations of the current statutory structure for oversight of Fannie Mae and Freddie Mac.

This can create problems. The congressional sponsor of H.R. 1409 stated in a press release that, "Congressional appropriations approval is not required" to provide funds for the GSE regulator. That is not the case. The bill would continue to require that assessments of fees by the regulator shall be placed in a fund in the Treasury. The Constitution states, in Article I, Section 9, that, "No money shall be drawn from the Treasury, but in consequence of appropriations made by law..."

Even if a court should find that the money going into the Treasury fund were private, the regulator still would need an appropriation to get it out. A court would be buttressed in this conclusion because of other parts of the assessments provision as well.

⁵ Connor, John. "Freddie Mac May Get Authority to Buy Riskier Down-Payment Mortgages." *Wall Street Journal*, October 7, 1998, p. B2; and Dao, James. "D'Amato's Mortgage Measure Faces a Repeal by Congress; His Plan Favored a Campaign Contributor." *New York Times*, October 20, 1998, p. A28.

Thus, the congressional sponsor, even if he were to succeed against the odds in getting his bill enacted, would not achieve the results that he intends. The trap hidden in this provision is likely to spring only if the affected parties find themselves in a time of crisis or controversy. If it would behoove lawyers somewhere in government to analyze the statutory framework to assure that, if legislation is ever enacted to transfer regulatory authority to the Fed, that the Fed will receive a full regulatory toolbox before it tries to carry out its nominal supervisory authority.

The Role of the Administrative Conference of the U.S.

This unfortunate lack of access to knowledgeable sources, especially on Capitol Hill, stands in contrast to the early 1990s, when the Administrative Conference was available to assist policymakers to understand both the existing relationship of GSEs to government and the context of that relationship that called for significant reform. The ACUS committee report on supervising safety and soundness of government sponsored enterprises had a direct impact on the establishment of a new regulator, the Office of Federal Housing Enterprise Oversight, to supervise the two largest GSEs, Fannie Mae and Freddie Mac.

The ACUS study was invaluable in providing policymakers with the cachet of a respected organization of administrative law experts whose recommendations could be accepted without doubt as to their quality and legitimacy. Of course the political process created a regulator that was much weaker than is needed; nevertheless, ACUS made a major contribution to informing the public debate and assuring a better outcome than otherwise might have occurred.

Let us conclude then with a specific suggestion. The Administrative Conference of the United States is an organization whose voice is sorely missed in deliberations concerning the legal framework of third-party government. I respectfully urge you to consider placing on the agenda of the Administrative Law Section an initiative (1) to restore the Administrative Conference of the United States, and (2) to include the issue of third-party government high on the list of priority subjects to be deliberated by the new organization. GSEs are only some of the tools of third-party government that would benefit from thoughtful legal analysis in a form that is accessible to policymakers from a source that is accepted by them as balanced and legitimate.

Thank you.