Congress Overhauls Regulatory Regime for Fannie Mae and Freddie Mac

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Introduction

Acting on a broad consensus that government-sponsored enterprises (GSEs) need a strong well-funded and independent federal regulator, Congress has overhauled the regulatory oversight of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The Housing and Economic Recovery Act (HR 3221) creates an independent and unified regulator of the GSEs with broad powers analogous to federal banking regulators, and with a free hand to set appropriate capital standards, and a clear and credible process sanctioned by Congress for placing a GSE in receivership. The Act also holds the GSEs to SEC reporting requirements comparable to other large, complex public companies.

The reform of the GSE regulatory regime is contained in Division A of the Act, which is called the Federal Housing Finance Regulatory Reform Act. The provisions take effect immediately. Fannie Mae is the Federal National Mortgage Association and Freddie Mac is the Federal Home Loan Mortgage Corporation.

The measure has two principal components. First, it significantly increases the strength of the regulator of the two major federal housing government-sponsored enterprises, Fannie Mae and Freddie Mac. Second, it deals with the Federal Home Loan System, which was seen as less in need of drastic change.

The housing GSEs are uncommon institutions with a unique set of duties and stakeholders. They are chartered by Congress, limited in scope, and subject to congressional mandates, yet they are publicly-traded companies with all the earnings pressure the markets can apply. Treasury Secretary Henry Paulson has called the GSEs an odd construct with a difficult mandate to simultaneously serve both a public mission and private shareholders.

Fannie Mae and Freddie Mac are currently the largest sources of mortgage finance in the United States. Additionally, they are among the largest participants in the derivatives market, arising from their need to hedge the risks associated with their combined trillion dollar portfolios. Through their debt exposure and derivative contracts, they affect an extensive network of financial institutions.

The creation of mortgage-backed securities for public markets has been the domain of Fannie Mae and Freddie Mac. They operate in the secondary mortgage market by providing credit guarantees on mortgage-backed securities or by directly investing in mortgages and mortgage-related securities through their retained mortgage portfolios.

Overview of Reforms

As the systemic risk posed by the GSEs grew, the need for a strong and independent federal regulator with authority to control their risk exposure and ensure their adequate capitalization became critical, especially as the mortgage industry began to deteriorate over the last 18 months.

The new federal regulator for the GSEs will have enhanced authority to raise capital standards, set strict prudential standards, including internal controls, and enforce these new standards and promptly take corrective action. The new regulator will oversee, and can directly restrict, executive compensation at Fannie Mae and Freddie Mac.

The Act establishes the Federal Housing Finance Agency (FHFA), an independent agency, to oversee Fannie Mae, Freddie Mac and the Federal Home Loan Banks. FHFA is empowered with broad regulatory powers over the operations, activities, corporate governance, safety and soundness, and mission of the GSEs. The measure provides new and more flexible authority to establish minimum and risk-based capital requirements.

There will be a new and powerful federal regulator of the GSEs, the Director of the Federal Housing Finance Agency. Appointed by the President, the Director will oversee the operations of the GSEs and ensure their safe and sound operation as well as oversee their housing mission. The Director will establish prudential management and operational standards for each GSE. The Director is given enforcement authority for failure to meet those standards; and will also have general regulatory authority.

The Act also increases Treasury's authority under existing lines of credit to Freddie Mac, Fannie Mae, and the Federal Home Loan Banks for the next 18 months, giving Treasury standby authority to buy stock or debt in those companies. To use the authority, the Secretary must make an emergency determination that use of the authority is necessary to stabilize markets, prevent disruptions in mortgage availability, and protect taxpayers.

The authority also provides enhanced oversight of the enterprises while the standby facility is in place, with the Federal Reserve consulting with the new regulator on the safety and soundness of and risks posed by the GSEs. As part of the enhanced oversight, the new regulator must specifically approve, disapprove or modify executive compensation at all of the GSEs. A regulated entity may be required to withhold compensation from an executive officer during a review of the reasonableness and comparability of compensation, and may take into consideration any wrongdoing by the officer.

New authority is also provided to establish critical capital levels and capital classifications, and specify supervisory actions to be taken regarding undercapitalized, significantly undercapitalized, and critically undercapitalized regulated entities. The Act provides for expanded conservatorship and receivership authority similar to that of federal bank regulators. It also gives FHFA clear enforcement authority, including cease and desist, removal, subpoena and civil money penalty authority.

The Act includes provisions transferring supervisory and regulatory authority to oversee the Federal Home Loan Bank System to the FHFA, and requires the FHFA, in regulating these banks to recognize the distinctions between the enterprises and the banks. The Act also clarifies the ability of the Federal Home Loan Banks to voluntarily merge, and provides clear regulatory authority regarding the liquidation or reorganization of a bank. It also provides temporary authority for the bank members to use a portion of the bank's affordable housing program funds (to be established by regulation) to help refinance mortgages for borrowers at risk of foreclosure.

The Act abolishes the current regulators of the GSEs, the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board, and provides for continuation and coordination of actions during the transition between agencies, and establishes the process for, and rights of, employees in the transfer of functions, resources and personnel of the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board into the FHFA.

The Road to Reform

Fannie Mae and Freddie Mac were chartered by Congress in order to create a secondary market and increase liquidity in the home mortgage markets. Through their charters, the GSEs are granted special privileges not available to other private-sector firms. Both enterprises have a line-of-credit with the Treasury Department and they are exempt from state regulation and state income taxation. The enterprises are able to borrow funds at a lower rate than other financial institutions primarily due to the perception that their debt is backed by the federal government.

Fannie Mae and Freddie Mac are the dominant institutions in the secondary mortgage market. They buy residential mortgages from lenders and finance the purchases either by issuing debt securities or by packaging mortgages in the form of mortgage-backed securities, on which they guarantee payment for a fee. Purchasers of the debt and the mortgage-backed securities include mutual funds, major financial institutions, pension funds, insurance companies, individual investors, and central banks. Up to now, the safety and soundness of the enterprises has been regulated by the Office of Federal Housing Enterprise Oversight (OFHEO).

The Federal Home Loan Bank System was established by Congress to provide liquidity to home mortgage lenders. The banks issue debt for which they are jointly and severally liable, and use the proceeds principally to make advances to their members. Member institutions primarily secure advances with residential mortgages and other housing-related assets. Up until now, the federal home loan banks have been supervised by the Federal Housing Finance Board, an independent agency of the executive branch.

The System fulfills its mission by providing members with access to funding, technical assistance, and special affordable housing and community development programs. The System encompasses twelve separate, regional Federal Home Loan Banks, each of which is a member-owned cooperative. There are over 8,000 members in the System comprised of commercial banks, savings institutions, credit unions, and insurance companies.

Over the last decade the Federal Home Loan Bank System has undergone considerable change. Membership in the System was extended to commercial banks and they now make up the overwhelming number of members of the System. The Federal Home Loan Banks greatly expanded their investment portfolios and some banks aggressively moved into the mortgage investment business, which moved them away from their traditional wholesale funding activities for members.

In December 2003, OFHEO released a report on the special examination of Freddie Mac finding that the enterprise disregarded accounting rules, internal controls, disclosure standards, and ultimately, the public trust in the pursuit of steady earnings growth. Furthermore, the report found that the board of directors was complacent and failed to exercise adequate oversight. It was determined that Freddie Mac had misstated its earnings by $5 billion between 2001 and 2003.

OFHEO initiated a special examination of Fannie Mae shortly after completing its exam of Freddie Mac. A report of initial findings on Fannie Mae in September 2004 cited internal control deficiencies, violations of GAAP accounting standards, earnings manipulations to meet compensation targets, and questionable management oversight. Fannie Mae disputed these findings and sought a review of OFHEO's findings by the SEC.

The SEC concurred with OFHEO's findings of GAAP violations and directed Fannie Mae to restate its earnings for 2001-2003. As a result, Fannie Mae was forced to recognize nearly $12 billion in losses and has reorganized its senior management.

In 2006, the seminal Rudman report on Fannie Mae concluded that the accounting, financial reporting and internal audit operations of the second largest financial services company in the country were inadequate, both qualitatively and quantitatively. The team led by former Senator Warren Rudman also found that the resources dedicated to these functions were insufficient and that senior managers in critical accounting, financial reporting and internal audit roles either were unqualified for their positions or failed to carry out their roles properly.

According to then House Financial Services Committee Chair Michael Oxley, the Rudman report underscored the need for a new, combined regulator for the GSEs, with the tools and funding needed to prevent abuses from developing and permit swift enforcement action

These cumulative events demonstrated to Congress that the GSEs did not have reliable financial controls to manage their operational risk. The failures in controls, particularly in such highly-leveraged institutions, jeopardized not only the GSEs' safety and soundness, but also the entire financial system.

Federal Housing Finance Agency

The Federal Housing Finance Agency will be headed by a Director, appointed by the President and confirmed by the Senate for a 5-year term. The Director can be removed for cause by the President.

The Director must have a demonstrated understanding of both financial management and the capital markets, including the mortgage-backed securities market and housing finance. There is a three-year look back provision under which a person who has served as an executive officer or director of any GSE or GSE-affiliated party at any time during the preceding 3-year period cannot serve as the FHFA Director. The Director must also be a U.S. citizen.

On a transitional basis, the Act names the current regulator of the GSEs, the Director of the Office of Federal Housing Enterprise Oversight, as the Director of the new agency until a Director is appointed by the President and confirmed by the Senate.

The Act creates the Federal Housing Finance Oversight Board to advise the Director on strategy and policy with regard to carrying out his or her statutory duties. The board may not exercise any executive authority; and the Director may not delegate to the board any of his or her powers or duties.

The measure mandates an oversight board of four members composed of the Director, the Treasury Secretary, the HUD Secretary and the SEC Chair. Any member of the board may require a special meeting of the board. Otherwise, the board will meet quarterly. The board must testify annually before Congress on a number of matters involving the GSEs, including their safety and soundness and any material deficiencies in their operation. The testimony must also include an evaluation of the performance of the regulated entities in carrying out their respective missions, as well as a discussion of their overall operational status.

With regard to Fannie Mae and Freddie Mac, the Act establishes an independent regulator and makes the GSEs function more like private corporations. The new regulator will review and set portfolio limits, establish minimum capital requirements, and review new programs and products. More broadly, the Act authorizes the new regulator to supervise the GSE portfolios for safety and soundness. Any new financial products developed by the GSEs must be approved by the Director after a finding that the product is in the public interest and consistent with the safety and soundness of the GSE.

FHFA will issue and enforce prudential management and operations standards for the GSEs, including credit, interest rate, and market risks, internal controls, liquidity, and investments. FHFA may also require a GSE to withhold compensation from an executive officer during a review of the reasonableness and comparability of compensation, and may take into consideration any wrongdoing by the officer.

The Act also empowers FHFA to adjust minimum and risk based capital levels. The agency may increase the minimum capital level through regulation or, if there is a serious safety and soundness concern, temporarily through an order. FHFA may also establish capital or reserve requirements with respect to particular programs or activities as the agency considers appropriate. The measure also authorizes the regulator to adjust the portfolio holdings of the GSEs. This could be done for either the purpose of increasing safety and soundness of the enterprise or fulfilling the housing mission.

Securities Exchange Act

The Act adds a new Section 38 to the Securities Exchange Act of 1934 to require the registration of the securities of the GSEs. For Fannie Mae and Freddie Mac, the statute provides that no class of their equity securities will be exempt from the registration provisions of the Exchange Act, and also provides that there will be no exemption from the books and records, internal accounting controls, beneficial ownership reporting, proxy, tender offer, insider reporting, and short-swing trading provisions of the 1934 Act.

As of July 18, 2008, Freddie Mac and Fannie Mae have voluntarily registered their common stock under the Exchange Act and are now subject to the Act's periodic and current reporting requirements. The Federal Home Loan Banks are directed by Section 38 to register a class of their common stock under the Exchange Act within 120 days of enactment and thereafter maintain such registration.

Section 16(a) is the insider reporting statute of the Exchange Act, which requires corporate officers and directors and 10 percent shareholders to file public reports in connection with trading in the equity securities of their companies. Section 16(a) reflects a legislative belief that prompt publicity is a potent weapon in the battle to curb the abuse of inside information. Section 16(a) is also designed to give investors information about purchases and sales by insiders that might indicate the insider's private opinion about the company.

SEC rules under Section 16(a) and federal court rulings deem officers with significant policymaking duties as subject to Section 16 reporting. These officers include: CEO, President, CFO, Controller, and any vice president in charge of a principal business unit or division or function, such as sales or finance. Section 16(a) generally requires directors, officers and 10 percent equity holders to report their purchases and sales of securities by the end of the second day following the transaction.

The SEC has adopted three basic forms for insider reporting. Form 3 is an initial statement of beneficial ownership of securities, which represents the insider's initial disclosure of holdings in the company's securities. Form 4 is used to report each transaction resulting in a change in beneficial ownership of any class of the issuer's equity securities. Form 5 is an annual report disclosing the insider's total beneficial ownership as of the end of the company's fiscal year.

An insider's failure to timely file a Section 16(a) report is subject to the company's disclosure obligation in the annual report and proxy statements. The company must identify by name its insiders who reported transactions late or failed to file required reports, and must disclose the number of delinquent filings and transactions for each such insider.

Sarbanes-Oxley Act

The new Exchange Act Section 38 also imposes some Sarbanes-Oxley governance requirements on the federal home loan banks by requiring them to comply with the audit committee independence mandates of the Sarbanes-Oxley Act and the SEC rules adopted under it. Specifically, the federal home loan banks must have independent audit committees whose members cannot accept consulting fees or become affiliated persons of the banks.

The Act amends Section 105(b) of the Sarbanes-Oxley Act by adding the Federal Housing Finance Agency to the list of those federal agencies with which the Public Company Accounting Oversight Board (PCAOB) may share information without loss of confidentiality.

As originally passed, Section 105(b) allows the PCAOB to share confidential and privileged information gathered during inspections and investigations with the SEC, and state and federal attorneys general. The GSE reform measure adds the Federal Housing Finance Agency to the list of governmental agencies with which the Board can share that information.

Federal Home Loan Banks — Exemptions from Securities Laws

The Act specifically exempts Federal Home Loan Banks from a number of provisions of the federal securities laws. The banks are exempt from the issuer repurchase and proxy provisions of the Exchange Act and related SEC regulations. They are also exempt from the broker-dealer registration and clearance and settlement provisions of Exchange Act Sections 15 and 17A. In addition, they are exempt from the entire Trust Indenture Act.

The members of the federal home loan bank system are exempt from compliance with the beneficial ownership reporting and insider reporting provisions of the Exchange Act and related SEC regulations with respect to their ownership of or transactions in the capital stock of the federal home loan banks.

Except to the extent that Exchange Act Section 38 requires registration of securities, the Act also provides that the capital stock issued by each of the federal home loan banks under Section 6 of the Federal Home Loan Bank Act are exempted securities within the meaning of Securities Act Section 3(a)(2) and Exchange Act Section 3(a)(12)(A).

Similarly, debentures and bonds issued by the federal home loan banks are exempted securities within the meaning of Securities Act Section 3(a)(2) and government securities within the meaning of Exchange Act Section 3(a)(42) and Investment Company Act Section 2(a)(16).

A person effecting transactions for members of the federal home loan bank system that effects transactions in the capital stock or other obligations of a bank, for the account of others or for that person’s own account, is a “broker” or “dealer” as defined in the

Exchange Act, but is excluded from the definition of “government securities broker” and “government securities dealer” under Exchange Act Section 3(a)(43) and (44).

The housing act exempts the Federal Home Loan Banks from periodic reporting requirements under the securities laws pertaining to the disclosure of related party transactions that occur in the ordinary course of the business of the banks with members and the unregistered sales of equity securities. Also, SEC tender offer rules will not apply in connection with transactions in the capital stock of the Federal Home Loan Banks.

The Act directs the SEC to adopt regulations in the public interest regarding the exemptions. In issuing regulations, the SEC must consider the distinctive characteristics of the Federal Home Loan Banks when evaluating the accounting treatment with respect to the payment to the Resolution Funding Corporation and the role of the combined financial statements of the banks. In its rulemaking, the Commission must also consider the accounting classification of redeemable capital stock and the accounting treatment related to the joint and several nature of the banks’ obligations.

Internal Controls

The Director must establish standards, by regulation or guideline, for each regulated entity relating to the adequacy of internal controls and information systems taking into account the nature and scale of business operations. Similarly, the Director must establish standards for the independence and adequacy of internal audit systems.

The Director must provide to the Comptroller General an assertion as to the effectiveness of the internal controls that apply to financial reporting by the Agency, using the standards established in Section 3512(c) of Title 31, United States Code, which requires internal controls providing for, among other things, the complete disclosure of the organization’s financial results.

Risk Management

The documented accounting and corporate governance problems that emerged at Freddie Mac and Fannie Mae raised fundamental questions about their risk management practices. In response, the Act mandates robust and extensive risk management practices for the GSEs.

The Director must establish, by regulation or guidance, standards providing for systems that accurately measure, monitor, and control market risks and that establish limitations on market risk. The standards must also contain overall risk management processes, including adequacy of oversight by senior management and the board of directors. There must be processes and policies to identify, measure, monitor, and control material risks, including reputational risks, and adequate, well-tested business resumption plans for all major systems with remote site facilities to protect against disruptive events.

In addition, since the GSEs are large users of derivatives, the Director must issue standards to manage credit and counterparty risk, including systems to identify concentrations of credit risk and prudential limits to restrict exposure of the regulated entity to a single counterparty or groups of related counterparties.

If the Director finds that a GSE failed to meet a risk management standard, he or she must require the GSE to submit an acceptable plan specifying the actions the GSE plans to take to correct the deficiency. If a GSE fails to submit an acceptable plan, or fails in any material respect to implement a plan accepted by the Director, the Act mandates that the Director must order the GSE to correct the deficiency.

Until the GSE corrects the deficiency, the Director may prohibit the GSE from permitting its average total assets during any calendar quarter to exceed its average total assets during the preceding calendar or restrict the rate at which the average total assets of the entity may increase from one calendar quarter to another.

The Director can also require Fannie Mae or Freddie Mac to increase its ratio of core capital to assets. In the case of a Federal Home Loan Bank, the Director can order an increase in its ratio of total capital to assets. Finally, as a catch all, the Director can require the GSE to take any other action that he or she determines will better carry out the Act's purposes.

Freddie Mac and Fannie Mae both got into trouble with accounting irregularities in part because of the complexities under GAAP rules of accounting for derivatives positions and rules determining which assets should be reported at market and which should be reported at amortized historical cost. Thus, sound risk management requires that GSEs base decisions on market values. According to St. Louis Fed President William Poole, the reason is simple. Fannie Mae and Freddie Mac pursue policies that inherently expose the firms to an extreme asset-liability duration mismatch. They hold long-term mortgages and mortgage-backed securities financed by short-term liabilities. Given this strategy, they must engage in extensive operations in derivatives markets to create synthetically a duration match on the two sides of the balance sheet. In turn, these operations expose the firm to a huge amount of risk unless the positions are measured at market value.

In his view, financial firms have an intense interest in reforming the GSEs. One reason is that banks and other financial firms, and many non-financial firms, hold large amounts of GSE obligations and GSE-guaranteed mortgage-backed securities.

Portfolio Management

Within 180 days of enactment, the Director must by regulation, establish standards governing the GSE portfolio holdings to ensure that the holdings are backed by sufficient capital and consistent with the mission and the safe and sound operations of the enterprises. In establishing such criteria, the Director must consider the ability of the enterprises to provide a liquid secondary market through securitization activities and the portfolio holdings in relation to the overall mortgage market. The Act also authorizes the

Director, by order, to make temporary adjustments to the established standards for an enterprise or both enterprises, such as during times of economic distress or market disruption.

The Act requires the Director to monitor the portfolio of each enterprise. The Director may require an enterprise, under such terms and conditions that he or she determines to be appropriate, to dispose of or acquire any asset, if the Director determines that such action is consistent with the purposes of the Act or any of the authorizing statutes.

Risk-Based Capital Standards

The Director must adopt regulations setting risk-based capital standards for the GSEs to ensure that they operate in a safe and sound manner, maintaining sufficient capital and reserves to support the risks that arise in their operations and management. The Director may order an increase in the minimum capital level for a regulated entity on a temporary basis based on a determination that such an increase is necessary and consistent with the prudential regulation and the safe and sound operations of a GSE. The Director must rescind any temporary minimum capital when it is determined that the circumstances or facts no longer justify such.

With regard to a temporary increase in the minimum capital level, the Act requires the Director to adopt standards for imposing such an increase, as well as standards for determining when rescission of those standards is appropriate. The Director must also adopt regulations establishing a reasonable time frame for periodic review of any temporary increase in minimum capital for the purpose of making the determination to rescind.

This section does not eliminate current risk-based capital regulations, which will remain in effect unless amended by the Director. (See House Report No. 109-171.)

Reporting of Fraudulent Loans

GSEs must submit to the Director a timely report upon their discovery that they have purchased or sold a fraudulent loan or financial instrument, or suspect a possible fraud relating to the purchase or sale of any loan or financial instrument. The Director must require each GSE to establish procedures designed to discover any such transactions. The Act provides a safe harbor for any GSE making a good faith report on fraudulent loans or financial instruments.

Executive Compensation

The Director has broad power to approve, disapprove, or modify the executive compensation of the GSEs, as defined under SEC Regulation S-K. The Director may require a GSE to withhold compensation for wrongdoing by an executive of a regulated entity. The Director may consider any factors he or she deems relevant in determining to withhold compensation, including any wrongdoing on the part of the executive officer, and that wrongdoing includes any fraudulent act or omission, breach of trust or fiduciary duty, violation of law, rule, regulation, order, or written agreement, and insider abuse with respect to the regulated entity. Also, the approval of an agreement or contract does not preclude the Director's ability to make such a determination. (See House Report No. 109-171.)

Golden Parachutes

The Director may prohibit or limit any golden parachute payment or indemnification payment pursuant to factors that he or she must set out by regulation. The Act lists several factors that the Director should consider in prohibiting golden parachutes. For example, the Director should consider if there is a reasonable basis to believe that the party has committed any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the GSE that has had a material effect on its financial condition. The Director should also consider if the party is substantially responsible for the insolvency of the regulated entity or for the troubled condition of the GSE as defined in the regulations.

Further, the Director should consider whether there is a reasonable basis to believe that the party has violated any applicable provision of federal or state law or regulation that has had a material effect on the GSE's financial condition. Also to be considered is whether the party was in a position of managerial or fiduciary responsibility; and the length of time that the party was affiliated with the GSE and the degree to which the golden parachute reasonably reflects compensation earned over the period of employment and a reasonable payment for service.

The Act defines "golden parachute payment" to mean any payment in the nature of compensation by any regulated entity for the benefit of any affiliated party pursuant to an obligation that is contingent on the termination of such party's affiliation with the regulated entity; and is received after the GSE becomes insolvent, has a receiver appointed, or the Director determines that the entity is in a troubled condition.

Golden parachutes are not involved when a payment is made pursuant to a qualified retirement plan or a Director-determined bona fide deferred compensation plan or by reason of death or disability.

The Act defines "indemnification payment" to mean any payment by a GSE for the benefit of any person who is or was an affiliated party, to pay or reimburse such person for any liability or legal expense with regard to any administrative proceeding or civil action instituted by the FHFA which results in the assessment of a civil money penalty, or the removal of the party from GSE office, or is required to take any affirmative action to correct certain conditions resulting from violations or practices, by order of the Director.

Treasury Authority to Buy GSE Securities and Extend Credit

The measure authorizes the Treasury to increase the already existing line of credit to Freddie Mac and Fannie Mae for the next 18 months, as well as giving Treasury standby authority to buy securities in these companies to provide confidence in them and stabilize housing finance markets. Subject to the terms in the instrument, the Act empowers Treasury to sell any security acquired through the standby authority.

While the GSEs currently meet the capital and liquidity requirements set by their regulator, Congress believes that the severe market turmoil demands the standby authority in order to increase market confidence and enable the enterprises to continue raising capital. (See remarks of Rep. Jackson-Lee, Cong Rec. July 23, 2008, H7009.)

The Act requires Treasury to make an emergency designation before using the authority, essentially certifying that it is acting to provide stability to the financial markets, prevent disruptions in the availability of mortgage finance, protect taxpayer, and facilitate an orderly restoration of private markets. No spending on GSE securities would occur unless the Treasury Secretary certifies that there is an emergency requiring immediate action. (See remarks of Rep. Jackson-Lee, Cong Rec. July 23, 2008, H7009.)

Upon exercising this authority, Treasury must report to Congress as to the necessity for the purchase and the determinations made with regard to it, as well as the size, terms, and probability of repayment or fulfillment of other terms of purchase.

Approval of Financial Products

New GSE financial products must be approved by the Director under specified statutory approval standards. The Director must determine that the product is in the public interest; and is consistent with the safety and soundness of the enterprise or the mortgage finance system.

In a colloquy on the House floor, Rep. Barney Frank, Chair of the Financial Services Committee, assured that nothing in the Act changes existing federal law with regard to the authority of the OCC and the Office of Thrift Supervision and their right to regulate and oversee a depository institution’s products and services. (See remarks of Rep. Frank, Cong. Rec., July 23, 2008, H6997.)

The Act also sets out the procedure for obtaining approval of a new financial product. The GSE must submit a written request to the Director that describes the product in a form to be adopted by the Director. Upon receipt of a request for product approval, the Director must immediately publish notice of the request for a 30-day public comment period. Within 30 days of the close of the public comment period, the Director must approve or deny the product, specifying the grounds for the decision in writing. If the Director fails to act within the 30-day period, the enterprise may offer the product.

The Director may condition a product's approval on terms or limitations that the enterprise would have to comply with in order to offer it. The Director may also temporarily approve the offering of a product without a public comment period upon a finding that the existence of exigent circumstances makes such delay contrary to the public interest.

An enterprise that believes a new activity is not a product must provide written notice of the activity to the Director and await his or her determination as to whether the new activity is a product. If the Director does not make such a determination within 15 days, the enterprise may commence the new activity.

Receivership

Under current law, OFHEO has the authority to place Fannie Mae or Freddie Mac into conservatorship but not into receivership. A consensus has been building that an effective receivership mechanism, similar to that held by other safety-and-soundness regulators, should be implemented for the GSEs in order to impose market discipline sufficient to ward off the prospect of a GSE falling into significant financial distress.

Thus, Congress gave the new GSE regulator all the receivership authority that is necessary to direct the liquidation of assets and otherwise direct an orderly wind down of an enterprise. The FHFA can even institute mandatory receivership actions under certain circumstances. Such receivership authority was established in full recognition that the Congress has retained to itself, in the case of Fannie Mae and Freddie Mac, the power to revoke a charter.

Specifically, the Act gives the Director discretionary authority to appoint the Agency as conservator or receiver for the purpose of reorganizing, rehabilitating, or winding up the affairs of a GSE. The Act specifies a number of circumstances as grounds for exercising this discretion, including that the GSEs assets are less than its obligations, that there has been a substantial dissipation of assets due to violations of law or unsafe or unsound practices, that a willful violation of a final cease and desist order has occurred, and that there is critical undercapitalization.

The Director must place a GSE into mandatory receivership upon determining that its assets are, and during the preceding 60 calendar days have been, less than the obligations of the regulated entity to its creditors and the GSE has not been paying its debts as they come due. The GSE can obtain federal court review of the appointment of a conservator or receiver.

Enforcement

The Act gives the Director broad enforcement authority. The Director may initiate cease-and-desist proceedings and impose substantial civil monetary penalties. The Director must establish standards and procedures governing the imposition of civil money penalties that provide a GSE with notice and the opportunity for a hearing. In determining the amount of a penalty, the Director must consider a number of factors specified in the Act, including the gravity of the offense, any prior offenses; the ability to pay, the injury to the public; and the deterrence of future violations.

If an enterprise fails to pay the imposed penalty, the Director may bring an action in the federal district court for the District of Columbia to obtain a monetary judgment against the enterprise and such other relief as may be available. The monetary judgment may, in the court's discretion, include attorney fees and other expenses incurred by the government in connection with the action. In such an action, the validity and appropriateness of the order imposing the penalty will not be subject to review.

The Director has the authority to compromise, modify, or remit any civil money penalty which may be, or has been, imposed under the Act.

Assessments

The Director must obtain funding for reasonable costs and expenses on an annual basis through assessments on the regulated entities. The amounts received by the Director are not to be considered government funds or appropriated monies.

Congress intends that, in making annual assessments and disbursing funds for agency expenses, the Director should, as much as possible, have assessments from Fannie Mae and Freddie Mac be used for supervision of those regulated entities and assessments from the Federal Home Loan Banks be used for supervision of those entities. (See House Committee Report No 109-171.)

Independent Directors

The Act requires that federal home loan banks have 40 percent independent directors on their boards. At least two of the independent directors must have more than four years of experience in representing consumer or community interests on banking services, credit needs, housing, or financial consumer protections. Independent directors that are not public interest directors must have demonstrated knowledge of, or experience in, financial management, auditing and accounting, risk management practices, derivatives, project development, or organizational management, or such other knowledge or expertise as the Director may provide by regulation.

In an effort to prevent conflicts of interest, the Act provides that no independent director may, during the term of service on the board, serve as an officer of any federal home loan bank or as a director, officer, or employee of any member of a bank, or of any person that receives advances from a bank

Required Reports

The Director can require a GSE to submit regular reports, including financial statements determined on a fair value basis, on the financial condition, management, activities, or operations of the GSE. A GSE that fails to submit a report required by the Director is subject to a tiered level of penalties. Where the GSE maintains procedures adapted to avoid any inadvertent error and the violation was unintentional and a result of such an error, the fine can be up to $2000 a day until the report is provided. But, the penalty can be up to $1 million a day when the GSE committed the violation knowingly or with reckless disregard for the accuracy of the information or report.

Study of Securitization

Under securitization, mortgages are bundled into pools and then turned into securities that can be bought and sold along side other debt securities. The Director must conduct a study and report to Congress on the securitization of home mortgage loans purchased from member financial institutions under the Acquired Member Assets programs. In conducting the study, the Director must establish a process for the formal submission of comments.

The study must encompass the benefits and risks associated with securitization and the potential impact of securitization on liquidity in the mortgage and broader credit markets, as well as the ability of the Federal Home Loan Banks to manage the risks associated with such a program. The study must also report on the impact of a securitization program on the existing activities of the banks, including their mortgage portfolios and advances; and the joint and several liability of the banks and the cooperative structure of the Federal Home Loan Bank System.

In conducting the securitization study, the Director must consult with the Federal Home Loan Banks, the banks' fiscal agent, representatives of the mortgage lending industry, and practitioners in the structured finance field.

The report must be submitted to Congress within one year. It must include policy recommendations based on the Director's analysis of the feasibility of mortgage-backed securities issuance by a Federal Home Loan Bank and the risks and benefits of such a program.

About the Author

James Hamilton is a Principal Analyst at Wolters Kluwer Law & Business, a leading provider of corporate and securities information, and a prolific blogger (Jim Hamilton's World of Securities Regulation at http://jimhamiltonblog.blogspot.com/). Hamilton has been tracking, analyzing and explaining securities law and regulation for nearly 30 years as an analyst for CCH. He has written and spoken extensively on federal securities law and has been cited as an authority by a federal court. His analysis of the Sarbanes-Oxley Act, the *Sarbanes-Oxley Manual: A Handbook for the Act and SEC Rules,* is considered a definitive explanation of the Act. His other works include the popular guidebook *Responsibilities of Corporate Officers and Directors under Federal Securities Law*, the *Guide to Internal Controls*, and the monthly newsletter *Hedge Funds and Private Equity: Regulatory and Risk Management Update*. In addition to his many books and articles, Hamilton serves as a leading contributor to the industry-standard publication, the *CCH Federal Securities Law Reporter*. Hamilton received an LL.M. from New York University School of Law.