REVIEW OF THE OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT AND FEDERAL HOUSING FINANCE BOARD

JOINT HEARING

BEFORE THE

SUBCOMMITTEE ON
OVERSIGHT AND INVESTIGATIONS

AND THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE AND
GOVERNMENT SPONSORED ENTEREPRISES

OF THE

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REVIEW OF THE OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT AND FEDERAL HOUSING FINANCE BOARD

Tuesday, July 13, 2004

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittees met, pursuant to call, at 2:59 p.m., in Room 2128, Rayburn House Office Building, Hon. Sue Kelly [chairwoman of the Oversight and Investigations subcommittee] presiding.

Present: Representatives Baker, Royce, Kelly, Paul, Capito, Hensarling, Garrett, Murphy, Brown-Waite, Frank, Kanjorski, Gutierrez, Inslee, Ford, Hinojosa, Lucas of Kentucky, Clay, Scott and Bell.

Chairwoman KELLY. [Presiding.] This hearing of the Subcommittee on Oversight and Investigations will come to order. I welcome Chairman Baker, and we are actually holding a joint hearing here.

This afternoon, the Financial Services Committee continues its series of oversight hearings on the federal agencies within the committee's jurisdiction by conducting a review of the Office of Federal Housing Oversight, the OFHEO, and the Federal Housing Finance Board, the FHFB.

OFHEO is an independent agency and the primary regulator for Fannie Mae and Freddie Mac, two of the world's largest financial institutions. The agency's primary mission is to ensure the capital adequacy and financial safety and soundness of the government-sponsored enterprises.

The Federal Housing Finance Board is an independent agency that regulates the 12 federal home loans banks and also ensures that they operate in a safe and sound manner. Their roles are critically important to American taxpayers, homeowners and investors. Fannie Mae, Freddie Mac and the federal home loan banks provide valuable services to homeowners by increasing liquidity in the home mortgage markets. Their significance to and impact on our economy cannot be overstated, spanning across the entire scope of the financial services sector from the bond markets, mutual funds, and pension funds, to relationships with financial institutions, insurance companies, individual investors, central banks and other institutions in foreign countries. We must ensure that they are functioning well and serving the needs that Congress intended.

Over the last few years, the government-sponsored enterprises have been the focus of increased attention. This committee has a strong interest in overseeing their regulation. As we face a growing economy that has been fueled by the housing sector, Congress must ensure that these entities have effective and efficient oversight. Since the housing sector continues to be the engine that drives our economy currently, our government must ensure that we do not disrupt the steady flow of low-cost funds to homebuyers, while protecting the taxpayers.

Today, the committee welcomes the Director of the Office of Federal Housing Enterprise Oversight, Mr. Armando Falcon. We are very interested in OFHEO's annual report to Congress, as well as the agency's recent 2004 budget request for $59.2 million. While this figure represents a significant increase for the agency, it is important that the OFHEO be well funded and well staffed to oversee these extremely complicated institutions. The committee supports OFHEO's request and would like to hear more about how it plans to use these funds, including the creation of a new Office of Compliance and an Office of Chief Accountant.

The committee is also pleased to welcome the Chairman of the Federal Housing Finance Board, Mrs. Alicia Castaneda. Today marks Chairman Castaneda's first appearance before the Financial Services Committee, and we welcome you. We welcome your testimony on the state of the Financial Board and the 12 federal home loan banks. We look forward to hearing your vision for the future of your agency.

While we are pleased with the tremendous strides that OFHEO and the Finance Board have taken to strengthen their oversight role, the two agencies really remain ill-equipped to handle the oversight of the GSEs. In order to protect taxpayers, investors, and homebuyers and restore confidence in the GSEs, we believe that these entities need a single world-class regulator to oversee their operations and financial well-being.

I am hopeful that Congress and the Administration can reach a consensus for reform that strengthens the oversight of the GSEs and continues to encourage homeownership. In the meantime, OFHEO and the Finance Board have been very active with a number of proposals aimed at strengthening the oversight and operations of the GSEs. The committee is very interested in learning more about these reforms today, in addition to the nature and status of the accounting restatements and other supervisory actions. Specifically, OFHEO and the Finance Board have been very active in the area of corporate governance. OFHEO recently circulated a rule that would, among other things, separate the CEO and chairman functions and require periodic audit partner and audit firm rotation.

Since its work on Sarbanes-Oxley, this committee has taken a great interest in pursuing the highest levels of integrity in corporate governance, and we would like to hear your views on these issues. As you know, the General Accounting Office has found that mandatory audit firm rotation for publicly traded companies may be inefficient and potentially is disruptive. Given the consolidation in the accounting industry and the highly complex nature of the GSEs, the committee would like to hear more about this proposal and what precedent it sets for publicly traded companies.

Similarly, the Finance Board just voted unanimously to require the 12 home loan banks to register with the SEC. While the increased disclosure is generally preferable, we would like to know more about the significance of this requirement, since the stock of the home loan banks is not publicly traded like the other GSE stocks. In the absence of reform legislation, the committee is also interested in how the regulators intend to handle other issues such as receivership.

During the debate over regulatory restructuring, there was considerable discussion about whether a new regulator should be vested with receivership powers similar to those held by other financial regulators. The committee would like to know whether OFHEO plans to address this issue. The issue of multi-district membership is also significant, considering the recent acquisitions that several large federal home loan bank members, which have spurred petitions to the Finance Board to allow members of the system to maintain membership in more than one federal home loan bank. Since the issue has an impact on the way affordable housing contributions are measured among the federal home loan banks, it is important that we know how the Finance Board plans to address the multi-district membership.

Finally, the Department of Housing and Urban Development has recently proposed increasing the housing goals of Fannie Mae and Freddie Mac. The proposal requires the firms to increase the percentage of mortgage loans they finance for low-and moderate-income borrowers, from 50 percent to 57 percent by the year 2008. While this is neither the role of OFHEO nor the focus of today's hearing, the committee does have an interest in determining the impact that this proposal could have on the safety and soundness of these entities. I hope you can address this issue today.

I would like to thank my colleague and co-chair of today's hearing, Representative Richard Baker. Chairman Baker's work on these issues has been crucial to the reform efforts and has greatly benefited the American people. The subcommittees thank the witnesses for their testimony. The American people will undoubtedly benefit from your views and this important oversight.

Without objection, all members's opening statements will be made part of the record. We turn now to Mr. Gutierrez.

[The prepared statement of Hon. Sue W. Kelly can be found on page 38 in the appendix.]

Mr. GUTIERREZ. Good afternoon, and thank you, Chairwoman Kelly, for this hearing, the latest in a series of oversight hearings on financial services regulators. On this particular occasion, we are pleased to be joined by Chairman Baker and Ranking Member Kanjorski of the Capital Markets Subcommittee, where the witnesses before us usually testify. So let me start by extending a warm welcome to Director Armando Falcon and Chairwoman Alicia Castaneda. They actually wrote this out phonetically for me.

[Laughter.]

Chairwoman KELLY. Maybe they think you have become too anglicized.

Mr. GUTIERREZ. Maybe so. It is the first time I have needed it. They know I am bad with names.

Later this week, the Oversight Subcommittee will be having a hearing regarding the need for diversity at executive levels in the financial services industry. I wish that today's panel were a more typical sight in this hearing room. I hope and trust that one day that will be the case across America.

Many of my colleagues have expressed a great deal of concern about the appropriate level of authority that should be exercised over GSEs by Fannie Mae and Freddie Mac and the Federal Home Loan Bank. Most of the legislative focus has been on Fannie and Freddie and OFHEO. However, I want to focus for a moment on the Federal Housing Finance Board, which just recently entered into a written agreement with the Federal Home Loan Bank of Chicago in my hometown. For those of you less familiar with the federal home loan bank system, each of the 12 home loan banks serves the member institutions in its districts. The Chicago bank services financial institutions in Illinois and Wisconsin, but that is not all. The Chicago bank pioneered a program known as mortgage partnership finance, or MPF, which provides financial institutions with a source of liquidity and risk management, and an alternative to the secondary market.

The Chicago bank started the MPF program in 1997 and now administers the back-office functions for eight other home loan banks participating in the program. The three remaining banks have started similar versions. The Chicago bank is necessarily engaged in a more sophisticated and complex transaction than some of the other regional banks, due to its commitment to success. The MPF program has been good for Chicago and good for the federal home loan bank system. I think the program will continue to benefit banks and consumers for many years to come.

Last month, the Chicago bank entered into a written agreement with its regulator. This agreement requires that the Chicago bank present the Finance Board with a detailed business and capital plan and how they are going to manage that business, taking into consideration not merely regulatory minimums in the setting of capital standards, but factors such as interest rate movement. As many of you are aware, I am deeply concerned about the potential effects that the rising of interest rates will have, but my focus has generally been on the consumers who are struggling to pay their mortgage or credit card bills at the current rates, and will have a much harder time as rates increase.

While these consumers have little flexibility and often no alternatives, it is certainly reasonable to expect institutions to have plans in place to hedge against inflation-rate fluctuations. What this written agreement between the Finance Board and the Chicago bank illustrates is the power that the regulator has in the federal home loan bank system. In this case, it was a reasonable and appropriate exercise of that power. However, the Finance Board's predecessor was not always so judicious. As we know, the federal home loan bank system and its regulator, the Finance Board, has huge power over them. In fact, back when there was a Federal Home Loan Bank of Los Angeles, at one point the Federal Home

Loan Bank Commissioner decided that there should not be one, and it merged the bank with another.

You know, the Finance Board could do that today if they wanted to. They could merge or move the banks. When the Los Angeles bank sued, they lost because the court found that even if the orders to liquidate the bank, transfer its assets and readjust the bank district had been motivated by malice of the Federal Home Loan Bank Commissioner, if the auditors were otherwise justified by legal purpose, they were not otherwise illegal or subject to attack on their validity. That is pretty broad-based power.

That is power. The Finance Board clearly has it and seems to be using it appropriately at the moment, keeping in mind its obligation to serve the public good. I only wish that some agencies like the OCC would have similar power, and did not seem so afraid to use their power and fulfill their duty to the public when it requires them to act against the desires of their regulated institutions.

I want to thank you, Chairwoman Kelly and Mr. Baker and Mr. Kanjorski, for calling this hearing. I look forward to the testimony of our witnesses at this hearing.

Chairwoman KELLY. Thank you very much, Mr. Gutierrez.

Mr. Baker?

Mr. BAKER. Thank you, Chairwoman Kelly. I certainly appreciate your courtesy and cooperation in conducting this hearing. It is highly appropriate from an Oversight and from a Capital Markets perspective that the two committees focus on this particular responsibility. I appreciate the opportunity to work with you and Mr. Gutierrez.

As to Mr. Kanjorski's and my responsibility, there is no question that the committee has spent considerable time and effort in first attempting to understand functions of GSEs, and secondly examining the regulatory adequacy of the current structure.

To both the Director and the Chairwoman today, I extend my appreciation for all your efforts over the past months, particularly Mr. Falcon, over many years of difficulty. I appreciate your commitment to bring about accountability. I will be very brief in my opening statement, as I have a fair number of questions I would like to move to, and certainly would want to hear the testimony of both our witnesses and move the hearing along.

With that, I would yield back the balance of my time.

Chairwoman KELLY. Thank you very much.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Madam Chairman.

We meet today to examine the recent actions and pending proposals at the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board. These two regulatory bodies help to ensure that Fannie Mae, Freddie Mac and the federal home loan banks continue to fulfill their public mission of advancing homeownership.

Our nation's system of housing finance is not only extremely successful, but it is also the envy of the world. More than 68 percent of Americans presently own the homes in which they live. Government-sponsored enterprises have contributed greatly to this accomplishment.

This success, however, should not stop us from asking whether and how we can do a better job with respect to regulating the housing government-sponsored enterprises and conducting congressional oversight regarding these matters. We should always examine ways by which we can improve regulatory efficiency and lower mortgage rates.

As you know, Madam Chairman, I am also one of the few remaining members of this committee who participated in the entire congressional battle to resolve the savings and loan crisis. I am therefore acutely aware of the need to protect taxpayers from risk. It is in the public's interest that we ensure that the housing government-sponsored enterprises continue to operate safely and soundly. We must further ensure that these public-private entities achieve their public responsibilities for advancing homeownership opportunities.

As we proceed today, I hope that our distinguished witnesses will share their views on corporate governance. I know that the Federal Housing Finance Board has carefully studied these issues in recent years and has worked to improve the performance and accountability of federal home loan bank executives and board directors.

Nevertheless, I have heard concerns about the need to improve the expertise on the boards, such as requiring at least one director to have experience with derivatives. I have also previously proposed extending the terms of directors from 3 years to 4 years to increase institutional memory at the federal home loan banks. I am additionally aware that one federal home loan bank may soon have no representative on its board with more than 3 years of experience, assuming that none of its current directors are reappointed later this year.

In recent months, the Office of Federal Housing Enterprise Oversight has also released its proposed minimum standards for corporate governance. These standards have sparked considerable debate, particularly regarding the decisions to separate the CEO and chairman functions and to mandate the rotation of external auditors. In addition, I am very concerned about the failure of the Bush Administration to appoint directors to serve on Fannie Mae's and Freddie Mac's boards. As a result of this decision, each board has five fewer individuals to serve than they usually had.

The failure to appoint presidential representatives on these boards has increased the burden that each of the remaining directors must carry. Moreover, it is important to note that three of the five presidential appointees on each of these boards had to represent particular concerns or have specific backgrounds, such as experience in the housing industry. Unfortunately and counter to congressional intent, neither Fannie Mae nor Freddie Mac is now benefiting from receiving these diverse viewpoints.

In closing, Madam Chairman, as I said at our very first hearing on GSE regulations in March 2000, we need to have strong, independent regulators that have the resources they need to get the job done. I continue to support strong GSE regulation. A strong regulator, in my view, will protect the continued viability of our capital markets, ensure against systemic risk, and expand housing opportunities for all Americans. I therefore look forward today to hearing from the leaders of the two regulatory entities overseeing the safety and soundness of the housing government-sponsored enterprises, and yield back the remainder of my time.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 44 in the appendix.]

Chairwoman KELLY. Thank you very much, Mr. Kanjorski.

Mr. Garrett, do you have an opening statement?

Mr. GARRETT. Just to thank you for holding the hearings. I will defer my opening statement because there are three areas that I will be interested to see whether they are touched upon with regard to the comments we receive today. First of all, I am just coming from another meeting with regard to the money we are spending, and that is budgetary issues and the amount of money being requested. Secondly is GSEs involvement in foreign nations; and finally, with regard to the status of special examinations ongoing at Fannie Mae.

So I will be interested to hear your testimony on that, and probably will have follow-up questions at the conclusion. Again, thank you to the Chairs for holding the hearing.

Chairwoman KELLY. Thank you.

Mr. Hinojosa?

Mr. HINOJOSA. Thank you, Chairwoman Kelly.

I want to thank you for calling this hearing. It gives us an opportunity to hear form both witnesses. I look forward to your remarks. Thank you.

With that, I yield back the balance of my time.

Chairwoman KELLY. Thank you.

Mr. Scott?

Mr. SCOTT. Yes, just a couple of opening remarks, Ms. Chairlady.

Chairwoman KELLY. That is okay. We know what you mean.

[Laughter.]

Mr. SCOTT. Certainly in view of the fact that OFHEO is the primary regulator of Fannie Mae and Freddie Mac, and that your mission is to ensure the capital adequacy and financial safety and soundness of these two entities, last year Freddie Mac had one of the largest corporate financial restatements of earnings and saw the ouster of its top executives. The Office of Federal Housing Enterprise Oversight followed with an examination of Freddie Mac's accounting and management practices and a forensic audit is currently being conducted at Fannie Mae.

This committee has heard testimony that OFHEO was basically asleep at the switch and did not catch these accounting schemes early enough. There is general agreement that OFHEO needs to be strengthened in order to ensure the safety and soundness of these GSEs as they expand rapidly and rely on complicated accounting methods.

As we know, legislation has stalled which would consolidate the functions of OFHEO and the Federal Housing Finance Board at the direction of the Administration. I believe that several of the issues that will be discussed today, including appropriations to fund the regulators and the authority to issue regulations, would be addressed if Congress were able to pass GSE legislation. If I understand right, you are asking for perhaps 50 percent more in funding, an increase of over $20 million from what you asked for last year.

So with that being said, I look forward to hearing the panel's testimony on the current safety and soundness of the GSE, and their current commitment to affordable housing goals.

I yield back the balance of my time.

Chairwoman KELLY. Thank you, Mr. Scott.

Ms. Capito?

Mrs. CAPITO. I have no questions, Madam Chairwoman. I look forward to the testimony.

Chairwoman KELLY. Thank you.

We now turn to our panel. The subcommittees are pleased to have with us the Director of the Office of Federal Housing Enterprise Oversight, Mr. Armando Falcon, and the Chairman of the Federal Housing Finance Board, Ms. Alicia Castaneda.

Director Falcon was confirmed as the head of the Office of Federal Housing Enterprise Oversight in 1999. As Director, he heads the federal agency responsible for ensuring the financial health of Fannie Mae and Freddie Mac. Mr. Falcon leads a diverse staff of examiners, financial analysts, IT professionals, attorneys and external affairs experts. Prior to this appointment, Mr. Falcon served for 8 years on the legal staff of the House Banking Committee.

Chairman Castaneda was confirmed by the Senate in December 2003. Ms. Castaneda brings more than 28 years of commercial banking experience to the Federal Housing Finance Board, most recently as senior vice president at Bank of America. Chairman Castaneda is the first Hispanic to be appointed to the Federal Housing Finance Board and is the first woman to serve as a director since the Finance Board became full-time in 1990. For that, madam, I certainly congratulate you heartily.

The committee thanks both witnesses for their appearance and testimony. Without objection, your written statements will be made part of the record. You will each be recognized for a 5-minute summary of your testimony. If you have done this before, you know that the box on the table has green, yellow and red lights. The green light means you have a full 5 minutes. The yellow light means you have 1 minute, and please start to summarize. The red light means your time is up.

Let us go to our first witness, Mr. Falcon.

STATEMENT OF HON. ARMANDO FALCON, JR., DIRECTOR, THE OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Mr. FALCON. Madam Chairwoman, Mr. Chairman, and Ranking Members Gutierrez and Kanjorski, thank you for the opportunity to testify at today's oversight hearing. You mentioned my time working here at the committee. It is always a pleasure to be back in this hearing room, sometimes more pleasurable than others, but I do appreciate the opportunity to be here.

My testimony will discuss the financial condition of the enterprises as reported in OFHEO's 2004 annual report, the importance of additional resources to strengthen the regulatory supervision and my efforts to reshape OFHEO to meet the demands of the future.

OFHEO is required to report annually on the financial safety and soundness of each enterprise, including the results and conclusions of the annual examinations of the enterprises. OFHEO fulfills this requirement through the annual report to Congress submitted each June 15. This year, OFHEO has adopted a CAMELS approach in the report on the condition of the enterprises. The federal banking regulators employ the CAMELS methodology as a summary for an institution's financial condition. CAMELS is an acronym for six areas of evaluation: capital adequacy, asset quality, management, earnings, liquidity and sensitivity. I will briefly review OFHEO's assessment in each category.

First, capital. Capital provides the means by which the enterprises withstand adverse economic conditions or situations. OFHEO monitors and assesses the capital position of Fannie Mae and Freddie Mac on an ongoing basis. Both enterprises exceeded their minimum and risk-based capital requirements for all quarters in 2003 and were classified as adequately capitalized.

Second, asset quality. OFHEO evaluates the credit risk management practices of each enterprise for both single-family and multifamily lines of business. As part of that evaluation, OFHEO conducts selected sampling and targeted reviews. Those reviews evaluate whether the practices of the enterprises meet safety and soundness standards and adequately protect the enterprise from the risk of loss associated with counter-party default. Based upon examination activities to date, it is the overall conclusion of OFHEO that Fannie Mae and Freddie Mac have strong asset quality and prudent credit risk management practices.

Third is management. OFHEO evaluates management of the enterprises in accordance with OFHEO's regulation, guidances and prudential standards applied in the course of an examination. Regarding Freddie Mac, OFHEO conducted a special examination of the events leading to the enterprise's restatement and replacement of senior management. Late last year, I submitted a report on the special examination of Freddie Mac. The report details a pattern of inappropriate conduct and improper management of earnings that led to the restatement and management restructuring of the company. As a result of the findings of the special examination, Freddie Mac agreed to implement corrective measures and pay civil money penalties of $125 million as part of a consent order with OFHEO. During the period of the consent order, the board of directors at Freddie Mac has elected a new chairman and has hired a number of senior executives as its management team. The company is making good progress on its remediation obligations and we will provide a full assessment on management in our next annual report.

Regarding Fannie Mae, OFHEO concluded that the overall management of operational risk at Fannie Mae comports with applicable safety and soundness standards, but that judgment may be subject to change as a result of a special examination. OFHEO has initiated a special examination of the accounting policies and practices at Fannie Mae. The scope of this review includes accounting policies and controls at the enterprise, including the identification of any control weaknesses or unusual transactions. Pending completion of that examination, a definitive assessment of Fannie Mae management must be deferred.

Fourth, earnings. OFHEO assesses enterprise earnings by analyzing the magnitude, trends, sources and quality of earnings, with particular attention to factors that may cause earnings to change in the future. Earnings in 2003 were strong for both Fannie Mae and Freddie Mac, amounting to $7.9 billion and $4.9 billion respectively. Fannie Mae's reported income represented a 71 percent increase from 2002, while Freddie Mac's was down 52 percent. However, the underlying economics of both enterprises was relatively stable.

Their two principal lines of business, credit guarantee and portfolio investment, continue to perform well at each enterprise, without deterioration in their risk characteristics. Credit losses remain exceptionally low, while spreads between interest rates earned on assets and interest rates paid on debt remain more than ample. OFHEO has been monitoring Freddie Mac's progress in compiling and issuing already delayed quarterly financial statements for 2004. We will continue to work with the company to resolve problems so that investors receive accurate and full disclosure of financial information on a timely basis.

Fifth, liquidity. We found that both companies demonstrated reliable access to sufficient sources of funds on cost-effective terms to remain liquid and meet their obligations throughout 2003.

Sixth is sensitivity. This describes the exposure and vulnerability of a company's earnings and capital movement in interest rates. I will summarize this point. We basically found that both companies have adequately managed their exposure to sensitivity risk.

Let me move to our budget now. OFHEO is seeking a total budget of $59 million to more fully staff a reorganized supervisory program. This budget supports 237 positions, compared to the 178 supported in our 2004 budget. It is an increase of 59 new positions, fully 85 percent of which are directly allocated to supervision of the two enterprises. These new examination and capital analyst positions will enhance and strengthen OFHEO's regulatory efforts by adding very necessary depth and breadth in our supervisory staff. I want to thank the leadership of the Financial Services Committee for their support for OFHEO's 2005 budget. Your support has been and continues to be critical to our success.

Also, as you mentioned Madam Chairwoman, we have reorganized OFHEO by doing basically three things: creating a new Office of Chief Accountant, a new Office of Compliance, and we have restructured the examination program to create two teams, one assigned to each enterprise led by an examiner-in-charge. We think these changes will help us best prepare OFHEO for any challenges that might arise in the future and make our program a more effective and strengthened supervisory program. My written testimony has more about the rationale underlying those actions.

Finally, we continue to flesh out our regulatory infrastructure project. The main rule we have pending right now are amendments to an already existing corporate governance rule. Some of the major changes in this rule have been mentioned by the committee, namely the separation of the chairman and CEO function, requiring auditor firm rotation, limiting the term of service on the board, and requiring higher standards for board independence. The comment period is closing on that rule, and we will take all comments into consideration and then promulgate a final rule as soon as possible.

Thank you, Madam Chairwoman and members of the subcommittees for your time. I appreciate it, and I will answer any questions at the right time.

[The prepared statement of Hon. Armando Falcon Jr. can be found on page 50 in the appendix.]

Chairwoman KELLY. Thank you, Mr. Falcon.

Just to remind both of you, your full written statements will be made part of the record and have been read by a number of us.

Now, we turn to you, Ms. Castaneda. Please push the button and pull the microphone as close to you as you can so we can pick up your voice.

STATEMENT OF ALICIA CASTANEDA, CHAIRMAN, THE FEDERAL HOUSING FINANCE BOARD

Ms. CASTANEDA. Thank you, Chairwoman Kelly and Ranking Member Gutierrez. Thank you as well, Chairman Baker and Ranking Member Kanjorski.

This is my first appearance before Congress since I joined the Federal Housing Finance Board and became its Chairman in April. I am honored to appear before your two subcommittees to discuss the Federal Housing Finance Board and its oversight of the federal home loan bank system. I am speaking today as Chairman and my remarks do not necessarily represent the view of my board colleagues.

I came to the Finance Board after 28 years in commercial banking, experience that is proving very valuable in my new role as Chairman of the independent regulatory agency charged with oversight of the 12 federal home loan banks and the Office of Finance. As you know, the banks are government-sponsored enterprises and their members comprise more than 8,000 commercial banks, savings and loans, insurance companies and federally insured credit unions.

Today I can say with full confidence that the Finance Board is fulfilling the duties Congress gave it in the Federal Home Loan Bank Act: to ensure that the federal home loan banks operate in a financially safe and sound manner, carry out their housing finance mission, and remain adequately capitalized and able to raise funds in the capital markets.

Over the past 2 years, the Finance Board has made great strides in enhancing our capabilities to carry out these duties. The clearest evidence can be seen in the tripling of our examination staff. However, bank supervision is more than just examinations. We have also hired highly qualified mortgage specialists, bank analysts, community development specialists, accountants and economists. We are upgrading our technology and systems. These all contribute significantly to our oversight and supervision of the federal home loan banks.

While the agency has indeed come a long way, there is still more to do. I can assure this committee that, as Chairman, I am committed to a course of constant improvement. My intention is to continue building our staff, adding necessary resources, and fostering a world-class regulatory culture at the Finance Board.

As a regulator, the Finance Board's job is to do what needs to be done, when it needs to be done. That has been my approach since I joined the Board in January, and it will be as long as I remain on the Board, which leads me to several recent developments that I think reflect our regulatory approach.

First, the Finance Board last month voted unanimously to require the home loan banks to register with the Securities and Exchange Commission under the Securities Exchange Act of 1934. The federal home loan banks are among the biggest debt issuers in the country, issuing roughly $500 billion in bonds annually in recent years. The home loans banks collectively had $765 billion in debt outstanding as of March 31, 2004.

Given these facts, the Finance Board called for consistent, enhanced and transparent disclosures from the individual banks to help achieve market discipline. Because investors in that market, as well as the banks' members and the public should and will know more about the risks faced by these financial institutions.

Registration will also ensure that home loan bank disclosure standards are fully comparable to those of the other housing GSEs and large private financial institutions. Based on my experience as a banker and fixed-income trader, I believe this will help ensure that the banks are not disadvantaged in their access to capital markets. For all these reasons, we adopted the regulation, and the registration process is now under way. Each bank will be required to first file with the SEC by no later than June 30, 2005 and to have their registrations effective by no later than August 29, 2005.

A second recent development occurred on the supervisory front. On June 30, the Finance Board and the Federal Home Loan Bank of Chicago entered into a written agreement to address certain shortcomings in the bank's risk management, internal audit, capital management, and accounting and financial recordkeeping practices.

These shortcomings were identified in recent Finance Board examinations of the bank. After a series of incremental steps dating back several years, my colleagues and I on the Finance Board determined that a formal written agreement was the necessary and appropriate next step to improve the bank's management and oversight of these issues.

Third, and finally, let me describe what the Finance Board is doing with respect to the affordable housing program. Beginning in 1990, Congress required the federal home loan banks to set aside 10 percent of their profits for low-income housing. Since its inception, the AHP program has provided some $2 billion in grants and subsidies for affordable housing.

The Finance Board is committed to ensuring that these programs operate in a safe and sound manner and help fulfill the home loan banks' housing finance mission. We are currently conducting a system-wide review of the home loan banks' AHP programs to help evaluate what they are doing in this area. We are also building a corps of examiners to focus solely on the affordable housing program, and have added new community development specialists to further assist in examinations.

Mr. Chairman, Madam Chairman, members of the subcommittees, thank you for allowing me this opportunity today to outline our activities at the Federal Housing Finance Board. I believe we have attained a level of expertise, experience and capabilities that makes the Finance Board an accomplished, effective financial regulatory agency, one that serves the public in the way Congress intended, through rigorous oversight of the federal home loan banks and their housing finance and affordable housing missions.

Thank you, and I will delighted to answer any questions.

[The prepared statement of Hon. Alicia R. Castaneda can be found on page 46 in the appendix.]

Chairwoman KELLY. Thank you very much, Ms. Castaneda.

Director Falcon, I understand that Fannie and Freddie have a policy which is just now being enforced that requires deductibles for wind damage insurance coverage to be less than 2 percent. In New York, comprehensive homeowners coverage has not been readily available or affordable, so a special advisory panel in New York strongly recommended deductibles as high as 5 percent to increase the availability of insurance coverage in certain areas. These recommendations were approved by the State of New York as a result of a series of special reports commissioned by the State legislature.

I want to know if you are aware of the problem and of the costly impact it is having on the homeowners in New York, and if you will consult with New York's State Insurance Commissioner to try to resolve this.

Mr. FALCON. Madam Chairwoman, I was not aware prior to your mentioning this, but I will absolutely go back and take a look at it. As we look at the risk to the enterprises of different mortgage programs, we look at not just the risk, but the ability to manage the risk of the mortgages. They mitigate risks through the use of credit enhancements and other techniques. Certainly, we will look into the rationale underlying this policy judgment and report back to you on whether or not there is some way that possibly the risk of this, if they are excessive, can be mitigated through certain means.

Chairwoman KELLY. I wish you would, sir, because your policy flies in the face of what the State legislature in New York passed, so it is important that we make these two laws congruent in any way possible. If you would get back to me on that, I would greatly appreciate it.

Chairman Castaneda, the Administration has indicated it will not make any presidential appointments to Fannie Mae and Freddie Mac's boards of directors. Is it their intent to also not appoint directors of the federal home loans banks, the 12 federal home loan banks? What is going to happen if the Finance Board's appointment process, what is going to happen to it actually, for this coming round of vacancies?

Ms. CASTANEDA. I have not heard anything from the White House regarding that issue. By statute, the Finance Board has to appoint some of the directors at each one of the banks. But to answer your question, I have not heard anything from the White House.

Chairwoman KELLY. I wonder, ma'am, if you would be willing to make an inquiry?

Ms. CASTANEDA. I certainly will.

Chairwoman KELLY. So that perhaps you would better answer that question. I think that is an important point that we need to clarify. You heard Mr. Kanjorski in his opening comments mention that also. There is some concern about how this is all going to work, and we would be very interested if you could help us understand that, please.

Ms. CASTANEDA. I will make sure that the Finance Board staff will come back with an answer to you.

Chairwoman KELLY. Thank you.

I want to ask you both, the Financial Services Committee spearheaded corporate governance reforms in the Sarbanes-Oxley rules. I would like to ask you about some of the new corporate governance proposals your agencies are considering, which our committees are still reviewing. How closely have your agencies worked with the SEC on these issues, like the accounting restatements, the SEC registration, auditor rotation, separation of the CEO and the chairman? These are areas where we are all interested in hearing what you have to say about whether you have been closely working with the SEC on resolving issues there.

I am asking both of you. Take your pick.

Mr. FALCON. I will go ahead and go first. We do consult with the SEC on various issues. We did consult with the SEC on our current corporate governance rule. I am not suggesting that they endorse it or oppose it, but we did consult with them during the drafting process of the amendment that we have issued.

In addition, we work closely with the SEC on a variety of other matters. We work closely with them in preparation for Fannie Mae's and Freddie Mac's announcement to voluntarily register with the SEC. I think we consult as necessary, and certainly the SEC, I feel from their standpoint, recognizes our responsibility at OFHEO to do our job as a matter of safety and soundness, while they do their job as a matter of investor protection.

Chairwoman KELLY. The reason I am asking this is that the primary role of your agencies is to protect the taxpayers through safety and soundness oversight on the GSEs. The SEC's primary responsibility is to protect investors. These are two very different goals. Because of that, that is the genesis of my question. Basically, we took a very serious look for instance at the audit firm rotation during the Sarbanes-Oxley debate. Some of these other things I really would like to hear more about from you.

I do not understand how, given the consolidation of the accounting industry that we are in, we are looking now at the final four firms. I do not see how this is going to get structure to avoid conflicts of interest. Deloitte is doing a forensic audit of OFHEO. PWC audits Freddie Mac. KPMG audits Fannie. Ernst and Young is working with Fannie Mae's law firm on the special audit. I am not sure how this is all working. I am not sure that this committee is clear on that, and I would really appreciate hearing back from you.

I am out of time. I am going to turn now to Mr. Gutierrez.

Mr. GUTIERREZ. Thank you.

I want to welcome you both here once again, and to say to Director Falcon, you are always welcome to come back. I enjoyed serving together with you on the Banking Committee. It was the Banking Committee before they changed its name mysteriously.

I have a question for Chairwoman Castaneda. The financial services industry has evolved as the barriers to interstate banking have been removed. Consolidation in the financial services industry continues as large-and mid-size banks from different parts of our country merge or acquire one another. One of the most recent examples of this trend is the merger of Bank One in Chicago with J.P. Morgan Chase in New York. Under the current finance board rules, individual bank members of the FHLB system are not permitted to belong to more than one FHLB. If two members merge or one acquires the other, the surviving bank must withdraw from membership in one of the home loan banks districts.

The concern I and other members have is the impact that such a rule has on the distribution of affordable housing program funds, which are linked to business and profits of each of the FHLBs. While a new merged bank continues to do retail business in both of the eight FHLB districts, all advances and mortgage purchases must be conducted only through one of the FHLBs, where it retains its membership. When the Finance Board asked for comments on this issue some time ago, the Chicago Home Loan Bank proposed a compromise that would apply in the limited circumstances in which a bank belonging to one home loan bank is acquired or merged with a bank belonging to a different one.

In this case, the surviving bank retains its membership. The surviving bank emerged, Bank One, J.P. Morgan, the survivors unfortunately for Chicago is J.P. Morgan Chase. It gets to retain them. The advantages of this proposal is that it helps better ensure that funds supporting affordable housing are retained and distributed in the district where they were generated. Can I just have your thoughts on this compromise and your thoughts in general on this issue?

Ms. CASTANEDA. Thank you, Congressman Gutierrez, and thank you very much for pronouncing my last name so well. I give you a 10.

[Laughter.]

Finance Board rules do not prevent a federal home loan bank from funding projects from outside their districts. As a matter of fact, the Finance Board rules approve and most of the banks now do allow funding from out-of-district projects. So when a merger occurs, it is very likely that all the funding for a particular community be comprised of in-district and out-of-district funding. That said, I cannot forecast whether the total funding of the bank district that loses a member could have less funding for particular projects.

The data that the Finance Board has collected shows that it is very common for a federal home loan bank that loses members in one year to gain new members in the following year. The overall impact of merger and acquisitions on affordable housing funding has generally balanced out through the time and across the system. In other words, the data shows that there has not been any significant impact because of the mergers and acquisitions.

I would be more than happy to have the Finance Board staff share some of this data with your staff.

Mr. GUTIERREZ. I would appreciate it, because I guess when you are the loser, I mean in one of these situations, we have New York, we have Chicago and we have the home loan bank. We have raised issues outside of your concern when banks do those kinds of things. In Chicago, we are wondering where are the jobs going to go; where is the corporate giving of the institution. It has a harmful impact. We would just like to get that information from you to see that we do not lose, specifically around housing programs, which we have seen. I have friends at Freddie and Fannie that are not too crazy about what the federal home loan bank does, but I think more competition is good competition. I want to make sure that competition does not get somehow sidetracked.

Thank you very much, Chairwoman Castaneda, and welcome once again Director Falcon.

Mr. FALCON. Thank you, Congressman.

Ms. CASTANEDA. Thank you.

Chairwoman KELLY. Thank you.

Chairman Baker?

Mr. BAKER. Thank you, Chairwoman Kelly.

Mr. Falcon, it has been some time since we visited. I appreciate your participation here today.

I have a series of questions that I would just like to give to you, and then as time permits have you respond today or as you are comfortable in writing at a later time. I understand that you are moving forward with finalization of your proposed corporate governance reforms. Both GSEs have filed statements of some objection to a number of the provisions. Have you set a deadline for completion of this corporate governance reform? If so, could you at the appropriate time inform the committee as to how you intend to achieve that end conclusion?

Number two, I continue to be very interested in the ongoing forensic accounting review now under way at Fannie Mae. It is my opinion, based on other revelations in public operating companies over the past several years, that if the corporation is not cooperative in disclosure that an accounting overview of some effectiveness may be questionable in its outcome. Therefore, do you believe the enterprise is making information, documents, access to personnel available in a timely and appropriate manner to meet your concerns and those of the auditor?

Number three, in response to your specific corporate governance reform relative to reasonable and appropriate executive compensation, Mr. William McDonough, Chairman of the Public Corporation Accountability Oversight Board, appeared before the committee recently and said something to the effect that executive compensation is an area where congressional review would be highly appropriate, and if either the compensation committees or shareholders cannot bring about appropriate reform, that Congress should act.

To that end, I note in the response, particularly by Fannie, to that specific recommendation, and I am relying on an American Banker article that states that the term “appropriate” is not defined by your proposal and therefore does not allow companies to determine what standards will apply when determining compliance. The law prohibits executive compensation that is not reasonable and comparable, that is the 1992 law which Fannie is suggesting as appropriate language. “Comparability” would therefore mean disclosure of executive compensation levels. There has been some controversy surrounding disclosure of the top 20 executives’s compensation for either or both enterprises.

I will follow this discussion with a specific letter asking that in order to achieve Fannie's suggested comparability standard that you make available to the committee Fannie, Freddie, at whatever level, 10 or 20, it does not matter to me, and in addition some single line of financial service industry comparable. For example, a sophisticated S&L, if there is nobody of asset size comparable, but who has a single line of business principally. I will follow this hearing up with a letter on that matter.

In the time remaining, I want to plow new ground which we have not previously talked about, relative to what are known as guarantee fees, fees which the enterprises charge originators when purchasing loans. A cursory review of data I have been able to obtain, and I certainly do not have access that you would have, indicates that the GSEs credit loss ratios have declined due to improvements in their underwriting and risk management, meaning they are not taking as many poor people as they used to take, apparently, while loan loss reserves in the same period of review have declined principally attributable to reduced losses.

However, it appears that the guarantee fees that mitigate potential losses have remained constant in the historic decline of losses, and at the same time declining loan loss reserves. Where is the money going? If it is not going to build up loan loss reserves, and by way of disclosure it is my understanding, let's just pick the year 1995, that the average G rate was 22 basis points, with a credit loss ratio of 5 basis points. Today, it is down to a .6 basis point CLR with a G fee rate of 20.2. The difference being in 1995 there was a return on equity of 21 percent; today in the case of this GSE, it is 50 percent.

At the same time from 1995 to 2003, loan loss reserves as a percentage of assets have declined from .25 basis points down to .08. The public policy concern I have is that the money is not flowing the loan loss reserve account to insulate against the three-fold increase in asset value on Fannie's side, a six-fold increase on the Freddie side. At the same time, the loss ratios have dropped, meaning the risk to the enterprises has for some reason been mitigated, but yet the income flow net to the corporation would appear on its surface to have been increased rather dramatically.

I do not have access to the cash-flow numbers to indicate to me what this means to the corporation in terms of gross or net returns on equity, but I would very much appreciate some detailed analysis of this area of business and again a report back to the committee, not in any urgency, but the first of the year, after the first of the year. My time has expired. I will wrap both of those requests into a single letter. If you have a chance to just touch on the corporate governance reform issues and the compliance with forensic accounting requests, and with the Chairwoman's diligence, maybe with those two you can jump in. Thank you.

I appreciate the Chairlady's tolerance.

Chairwoman KELLY. Thank you, Mr. Baker.

Mr. Frank?

Mr. FRANK. Thank you, Madam Chair.

We are probably guilty. Part of my frustration in dealing with these issues is that we have before us two entities which are very important with regard to affordable housing, a crisis in this country. But our own committee structure fails to fully take account of that. We had a very important hearing today on homelessness and housing for the Housing Subcommittee. Now we have two other subcommittees, and the Housing Subcommittee is not part of it. I regret that. The media that cover these institutions, particularly the GSEs, tend to be more in the financial area than the housing area, and I really hope we can increase attention to that.

To Chairwoman Castaneda, let me say that Mr. Gutierrez's question is my question. I understand your argument that it sort of balances out, but I do not want to rely on that. The affordable housing program of the federal home loan bank is one of the best things we have. Director Falcon in fact was here under the leadership of Chairman Gonzalez when we enacted that. It was hard-fought and it is an excellent program. But it follows the CRA principle, which is money raised by the banks in an area which then contributes to FHLB profits are to be spent in the area. That is very important. I was here when we did that under Mr. Gonzalez's leadership.

At that point, bank mergers were not a big deal, particularly with thrifts. Now, mergers are a big deal. Back then, we were called the Committee on Banking. If we ever change the name again, I think we are going to change the name to the Committee on the Bank, because there will probably only be one.

[Laughter.]

But what this has meant is that there is a consolidation, and we are losing the principle that money generated in one place should be in another. I know there are people who are worried about domination by some large entities. I do not see any problem. I want to continue to pursue this with you. I am just saying that particularly where there has been a merger, an entity that was bought up, that had been a member of a federal home loan bank, that that portion of what it earned should be credited to its regional bank and not elsewhere. I intend to keep pursuing that.

The second point I want to make to both of you, and it touches both, but more to Director Falcon, is one of the tensions we have had. There are tensions involved in the way we do things. We were talking just as an example, but touching on some of what you do, in predatory lending, there is a tension between doing away with predatory lending and redlining. We did not used to have predatory lending. We had redlining. You go too far in one direction here you can lose things.

Here, the tension is between safety and soundness on the one hand, financial stability, and on the other hand getting into housing. I must say to Director Falcon, as he knows, one of the concerns some of us have with some of the legislative proposals that come from the Administration is the fear that, and I think the Administration has been somewhat inconsistent. On the one hand, they talk about the need to do more affordable housing, where I am supportive; but on the other, to put so much emphasis administratively and elsewhere on safety and soundness, that we would lose that.

I have one specific example relevant to both of you. It is relevant to Fannie and somewhat to Freddie. It is relevant to the New York Federal Home Loan Bank, and that is the issue of manufactured housing. Without manufactured housing, you will not get significant homeownership among moderate-income people. It is a very important resource. It has been historically underutilized. It has been ridiculed. We are coming to an understanding of the importance of manufactured housing.

It is not either/or. I am very proud of my relationship with the homebuilders. We need both. But clearly, manufactured housing is improving in quality, and we have not in a regulatory way quite caught up with that, I mean in terms of property laws, et cetera. But here is the problem: Your New York regional bank was downgraded by one of the rating agencies because of its manufactured housing. Director Falcon, you have raised questions about manufactured housing. I understand that manufactured housing has a problematic past, but the quality of the housing has significantly increased; our understanding of it has increased.

What I would urge both of you is, I need you both to reassure me, that we are going forward and are going to find a way to encourage the entities under your various supervisions to go forward in manufactured housing. What I am afraid of is that a focus only on the problems with the past financial inventory is going to drive them out of it. I must say I think that that has been one of my concerns about OFHEO. I need people to reassure me, for me to feel comfortable about this, that we are going to recognize it.

Let's put it this way. There has got to be a way to deal with whatever problem that used to be there with manufactured housing, and that we will not let the hangover from some of the bad practices be a deterrent to them going aggressively forward in the future. I think that is a very important test, frankly, for both regulators, of your ability to preserve financial soundness without impinging on the affordable housing issue, which we all say we are for.

Let me start with Director Falcon.

Mr. FALCON. Thank you, Congressman.

Like you, I believe very much in the mission of the two companies that we regulate. I believe in their housing mission, including this area with manufactured housing. Our concern about it was related to the accounting for these assets, not so much just these, but impairments in general. They apply primarily to the portfolio of manufactured housing loans. What we have sought to do is put in place the proper accounting for those assets if and when they did deteriorate. In the case of these, they did.

I will pledge to you that we do seek to strike the balance between safety and soundness, cognizant of the mission of these two companies. I believe the mission of my agency is in some regards also a housing mission, not just a safety and soundness mission. So we are very aware of that. I think all the employees of the agency feel that way.

Mr. FRANK. If I might just make a specific suggestion, which is, if you feel the need for some reason to talk about the manufactured housing, nothing stops you from saying, and we say this in the context of believing that going forward they should remain an important part of the portfolio and encourage them to do that. When all people hear are the negatives, it drives away the enterprises; it drives away lenders; it accumulates.

Mr. FALCON. That is right. It is just a matter of going forward and making sure there are adequate risk management practices in place, so that if this type of asset does experience higher than normal defaults or losses, that there are adequate enhancements in place so that the losses are not excessive.

Mr. FRANK. Can I say this, I also believe, and my own view with regard to the GSEs, particularly Fannie and Freddie, they are given certain government advantages. I do not think every individual product line has to be profitable. We want a cumulative profit, so I hope we would also say, look, if there is a danger of things not going too well in the one area in the affordable housing area, that can be made up for elsewhere. This is not a case where every individual line has to show this kind of profit.

Mr. FALCON. In the case of Fannie and Freddie, that provision is specific in their charters, that for affordable housing-type of mortgages, they could expect a lower rate of return than they would on other types of assets. So that is specifically contemplated in their charters.

Mr. FRANK. Okay. I just hope that when we do the supervision, we keep reminding people of that, because that tends to get lost.

Chairman Castaneda?

Ms. CASTANEDA. Thank you, Congressman Frank. It is good to see you again.

I also have to say, like Director Falcon, our mission is not only to ensure that the banks operate in a safe and sound manner, but to promote housing finance. I can tell you at the Finance Board, we very much encourage the banks to promote manufactured loans. We do it three ways. Federal home loans banks can accept manufactured loans as collateral for their advances. Two, the federal home loan banks can buy manufactured loans. And number three, they can also buy mortgage-backed securities guaranteed by manufactured loans. So we do promote the manufactured loans business.

Mr. FRANK. Thank you.

Chairwoman KELLY. Thank you very much, Mr. Frank.

Mr. Paul?

Mr. PAUL. Thank you, Madam Chairman.

I appreciate the opportunity for these hearings and your emphasis on this very important matter. I also want to point out that Chairman Baker, I think has been talking about this, maybe for years or a decade. So he was on to something, and I think his warnings were very important and are very important. It also points out that Congress moves awfully slow.

So if we were developing a problem, and I truly believe we have been developing a problem that is now much worse, I would say that if we have been concerned, especially Chairman Baker, for 10 years, I imagine during that period of time it has gotten much, much worse.

I see it as a financial time bomb, to tell you the truth. The only discouraging thing about our discussions that we have here in the committee is for the most part we talk about the technical solutions, the job you have as regulators, and believing that it is a technical problem. I think it is much, much more fundamental. We rarely deal with the fundamentals. I would like to emphasize a little bit about the fundamentals.

As a matter of fact, I would not want your jobs for anything. If we are facing a problem, which many people in this country think we are, your responsibility is to provide safety and soundness, I mean, I see it as practically an impossible task if this things starts to unwind, and I believe it is going to unwind. It involves trillions of dollars and derivatives. It is just a huge monstrosity.

And yet, it seems like we are not even working in that direction. We did early on talk a little bit about how the $2 billion line of credit distorts the interest rates and you get a benefit, and it is estimated by CBO that that is probably a $15 billion a year benefit. Even that in itself is minor, because the other part that we do not talk about is the willingness of the Federal Reserve in these past several years to buy GSE debt. Oh, they do not hold it. They are there. That is a message to the world and to the country that the Federal Reserve, although they talk about cleaning up the mess, they themselves contribute to the bubble mentality that, you know, if Congress does not bail us out quickly enough, the Federal Reserve is there because they have done it in the past. They certainly did it at the time of Y2K.

Also, the Federal Reserve has expressed concern about what is happening. They talk about their daylight overdrafts that you have. They have proposed that we get rid of that. That is important, but that too is minor and I think technical. But overall, I think the housing bubble comes from easy credit, which is totally out of your control. That is what we live with. Artificially low interest rates at 1 percent create the bubble mentality, whether it is in the stock market or the housing market. This is where the real fault is. I do not know how we will ever address that as regulators.

Then we sort of add onto it through these special deals, which nobody can be opposed to because it is helping the poor people. So we ask you to make 10 percent of your loans to people that are the least creditworthy, who are the most likely to default if there is a correction, putting more pressure on your job as well as on the taxpayer. So the whole thing is, as far as I can see, total distortion of the marketplace. I am a believer in the market, and that we should try to get back to that.

So my question basically is, how do you see the fundamentals compared to the technical approach to this? And do you think there is a possibility of a puncture of a bubble? To me, the most vulnerable thing that we are facing is when the foreign governments and foreign entities stop buying our debt, and you have no control of that, and we do not have control of it. They bought $10 billion last week of GSEs, and the dollar is going down. When it goes down precipitously, and they quit buying or they dump dollars, what in the world are we going to do to contain the collapsing bubble?

Mr. FALCON. Congressman, we track home price appreciation quarterly through our house price index, which we do release to the public. Our economists do track it and are aware of the historical trends and causes of price bubbles. My economists who have looked at this with lots of experience, believe that we do not currently have a price bubble in home prices. If anything, if there was a change in interest rates in an adverse way, it might lead to some regional depreciations. As far as an overall price bubble, they do not see it. Because of our strong housing finance system, which is I think the envy of the world, there are many other countries that are trying to replicate what we have done here in the United States.

There is strong support for homeownership and the ability of individuals to obtain credit. Whether or not it is too easy or not, I do not have an opinion on that. But we do see that in the current environment, with the ability of individuals to purchase homes, which does not in turn support home prices, that we are not in a situation where there could be a large deflation in home values or a price bubble, as you pointed out. That is our experience at this point in time. We continue to monitor it going forward as we put out more house price indices.

Ms. CASTANEDA. I think you have a very good point, Congressman. That is true not only for GSE debt, but for a lot of the debt issued in the United States. We do depend a lot on foreigners to buy a lot of these instruments. My job as a regulator is to make sure that the federal home loan banks will continue to operate in a safe and sound manner. Your remark, then, how do we do that? Well, that is my job. As long as I am the Chairman of the Housing Finance Board, that is what I am going to do. If I can ensure that the Finance Board ensures then that the banks are operating in a safe and sound manner, we will not give any reasons for these foreign investors to stop buying the federal home loan bank debt.

Mr. PAUL. Thank you.

Chairwoman KELLY. Thank you, Mr. Paul.

Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Madam Chairman.

Madam Chairwoman, the past practices of the appointments of boards of directors of the federal home loans banks has been by your board. It has generally had a bipartisan structure to it. Recently in this Administration, almost overwhelmingly all the vacancies have been appointed to one party, your party. It is something that troubled me. I understand politics, but I understood that the congressional authority for the appointment of the members of the board of the various banks was vested in the Finance Board. You said, well, I will have to talk to the White House. Did I misunderstand the structure of the law that the Congress appointed? I thought that authority rested with the Finance Board.

Ms. CASTANEDA. That is correct, Congressman.

Mr. KANJORSKI. Do you abdicate your role as the Finance Board and pass that on to the White House, contrary to congressional intent?

Ms. CASTANEDA. No. By statute, the Finance Board elects the public interest directors. It is the Finance Board responsibility to elect these directors. I can also tell you that this will be an issue that I am going to working with my other colleagues in the next few weeks.

Mr. KANJORSKI. But in response to one of the member's questions, you said you are going to be talking to the White House about this, indicating that the names of the appointees come from the White House, and that the clearance is through the White House. Did I understand you to say that?

Ms. CASTANEDA. No, I did not say that today. Again, we have by statute to appoint the public interest directors. This is an issue that I am going to be addressing with the other board members.

Mr. KANJORSKI. Do you think there is any reason to have public interest directors on the federal home loan bank system?

Ms. CASTANEDA. I think the public has to be represented at the board of directors of the federal home loan banks.

Mr. KANJORSKI. Do you think those appointments should be partisan or nonpartisan?

Ms. CASTANEDA. I think those appointments should be based on the qualifications and the skills of the individuals.

Mr. KANJORSKI. Is it peculiar in your mind that maybe out of 60 or 70 appointments, that 97 percent come from one party and only about 3 percent from the other party? Is that just by chance, do you think? Or do you think that is by political decision?

Ms. CASTANEDA. Congressman, I was not aware of the specific numbers that you are talking about.

Mr. KANJORSKI. In the last 3 years, I am aware of only one director of my party that was reappointed to a board. It is not so much I am worried about Republican or Democrat, although that tends to indicate that we are losing the intent of Congress to have real independent directors. We are having political directors, and I think that is the worst of all worlds, but you do believe we should maintain that policy of having independent outside directors on that board.

Would you state an opinion that Fannie Mae and Freddie Mac, whether they derive some benefit from being government-sponsored enterprises where it may be of value to have outside independent directors appointed by the President or some other appointing authority, as opposed to all internally elected?

Ms. CASTANEDA. Again, I can see some advantages why perhaps the regulators should not be appointing members to the boards of the institutions it regulates. On the other hand, I do believe it is very important in the case of the federal home loan banks to have board members that represent the public interest.

Mr. KANJORSKI. And you would agree that the public interest in the United States is pretty much represented by two political parties, so that it would not be unusual to have, say, three Republicans when the majority of the country or the Congress is in that party, and maybe two Democrats when they are in the minority, and then vice-versa when the pendulum changes, that we try and balance it that way.

How would you go about defending the policy of this Administration to be so partisan in the appointments?

Ms. CASTANEDA. I believe the board of directors should be elected based on their qualifications.

Mr. KANJORSKI. We are talking about the appointments now.

Ms. CASTANEDA. The appointments, regardless of whether they are appointed by——

Mr. KANJORSKI. Do you think on the basis of, say the last 3 and a half years under this Administration is peculiar and not followed by prior Administrations that tried to balance the appointments, that the Congress should take some action and require that there be a balance of appointments, so many Republicans and so many Democrats, depending on the makeup or persuasion of the White House?

Ms. CASTANEDA. Well, obviously Congressman, if the Congress decided and this is the right thing to do, Congress could do it. As far as the numbers, and you are referring to the last 3 years, I am not aware of that, sir. I was not at the Finance Board.

Mr. KANJORSKI. One of the greatest criticisms, I have a tendency to meet with a lot of directors from across the country of the 12 banks when they are in Washington, and one of the crying needs, they say, is institutional memory and experience. Some of them, and in my opening statement I indicated there is one federal home loan bank that will not have anyone with more than 3 years experience sitting on its board of directors. Is that healthy or unhealthy?

Ms. CASTANEDA. I think that is one of the issue, and my understanding it is included in the House relief bill, the number of years that each board of director will serve on the board, as well as the compensation. I can tell you that last year the Finance Board did a system-wide review on corporate governance, and a lot of these issues were raised. I do believe that in both issues, the compensation and increasing the number of years——

Mr. KANJORSKI. Do you think perhaps the Congress should commission a study or establish a commission to start looking at the corporate governance of your organization and the various federal home loan banks to see whether or not we should update some of the problems that we have out there?

Ms. CASTANEDA. Obviously, Congressman, if that is something that you do feel like that is the right thing to do.

Mr. KANJORSKI. Well, as a matter of good corporate governance, would you say we are adhering in these GSEs to the same stringent conditions we are imposing on other institutions, private institutions, like separating the chairman and the CEO in the mutual fund? It would seem to me here is a direct group of institutions that have a quasi-public involvement and the Congress is not exercising its influence.

Chairwoman KELLY. Actually, you have gone longer than anyone else has spoken. If you want to answer that question, ma'am?

Did you ask that question to your satisfaction? We will let her answer and then that is it.

Mr. KANJORSKI. On that individual question. I was going to get the Director on something.

Chairwoman KELLY. If you want to wait, if we have the time, we will try to go back on a second round.

Thank you very much, Mr. Kanjorski.

Mr. Hensarling?

Mr. HENSARLING. Thank you, Madam Chair.

Mr. Falcon, recently there was a press article about one of the GSEs. I believe it was Fannie Mae, engaging in a joint venture to try to set up a secondary mortgage market in Egypt, I believe. I was curious if you had seen the press clip or are you familiar with the matter, and whether or not the article was accurate? If so, is that something that you view as an activity that is within the scope of their charter? Is this a matter of concern or not of concern to your office?

Mr. FALCON. I think it would be a very serious concern if a company was contemplating investing the mortgages in any other country. However, as far as this international activity is essential to their core mission, which is the provision of liquidity to the U.S. mortgage market, the answer is no. Does that mean is it not permissible under the terms of their charters? I think that is a question that HUD will have to answer. I cannot. It is HUD's prerogative to opine on whether or not is it appropriate under the terms of the charter.

Mr. HENSARLING. Speaking of HUD, there has been a proposal to raise the low-and moderate-income affordable housing goal targets for Fannie and Freddie. I think it ratchets up from 50 percent to 57 percent in 2008. I would be curious about your opinion as to the impact on the primary mortgage market and the secondary mortgage market. Essentially, what are going to be the costs and the benefits to the system should this all go through?

Mr. FALCON. The increases in the affordable housing goals, our review of this is limited to questions of safety and soundness. On that point, we would look at the activities that both companies would engage in as they tried to meet new goals. Now, these goals are certainly very ambitious, and whether or not the companies can meet these new goals will remain to be seen, if they do in fact get implemented as final goals for the two companies over the next 4 years. We will look at the companies closely to make sure that they do not engage in excessive risk in order to meet the goals.

As far as the merits of the goals, that is for HUD to decide when they decide what to go final with. My own opinion is basically I do support the affordable housing mission of these two enterprises very much so. While these are ambitious goals, I do not think it would be a stretch for the companies to embrace these goals, but not engage in excessively risky activities or limit their activity in non-affordable housing areas just in order to meet these goals.

There are provisions in statute that if it turns out that it is not feasible to meet these goals, that the secretary can find so and then they are excused from meeting the goals, or they can work out a plan down the road on how they can work towards meeting them. So I view these as goals and not mandates. They are certainly ambitious, but they are worth trying to achieve.

Mr. HENSARLING. Let's move the conversation to corporate governance for a moment. OFHEO has proposed a number of corporate governance changes for the GSEs. Fannie already is a publicly traded entity, so they are having to comply with Sarbanes-Oxley. I believe that Freddie has asserted that it will register with the SEC soon, so assumingly they will be under Sarbanes-Oxley as well. So can you explain in greater detail the need to go beyond the corporate governance provisions in Sarbanes-Oxley?

Mr. FALCON. What we have done is we have taken our experience derived from the Freddie Mac accounting problems and the management issues which we found gave rise to those accounting and earnings management problems. We have released a very detailed report on what happened, and what we thought the remedies were to try to minimize the likelihood of that happening in the future. The corporate governance rule simply embodies what, based on that experience, we think is the best practice for these two companies. If it goes beyond Sarbanes-Oxley in some regard, then so be it.

My responsibility is to ensure the safety and soundness of these two companies. Sarbanes-Oxley was designed corporate-wide to try to raise the standards in corporate governance. I have to determine what is necessary for me to ensure that these two companies can remain safe and sound.

I am not suggesting that what we have in our corporate governance rule should be applied corporate-wide. I am simply saying that based on our experience, with these two companies at this point in time, that this is the best approach to safety and soundness, and that is why we have proposed this.

I am not saying that we have closed the door on the outcome on these issues, because we are in the rulemaking process, but we will take all comments into account in determining what the best policy is.

Mr. HENSARLING. Thank you. I appear to be out of time.

Chairwoman KELLY. Thank you, Mr. Hensarling.

Mr. Hinojosa?

Mr. HINOJOSA. Thank you.

I want to address my question to Director Falcon. I am very pleased that you have been reorganizing OFHEO so as to be able to carry out your mission. I want to ask you some questions about that reorganization, because in looking at your statement I see that you say that you have reorganized into two fully staffed units. How many examiners and accountants make up each of those two units?

Mr. FALCON. When they are fully staffed, they will probably approach about 40 or 45 per unit.

Mr. HINOJOSA. Okay. Then you go on to say that in that reorganization you plan to possibly rotate that group of staff members. What does that mean? How many years, 2, 5, 10 ?

Mr. FALCON. We have not worked out the details on that yet. We are still implementing this transition to this new format. But it may be as short as 3 years. It may be as long as 5 years perhaps.

Mr. HINOJOSA. How will you ensure that there is continuity and institutional memory of what you have learned about Fannie Mae and Freddie Mac?

Mr. FALCON. Let's take for example the area of credit risk. We will have a team of people examining the credit risk of each company. The team may be anywhere from five to ten examiners by the time we are done. We would not just lift them all and switch them at the same time. What we would do is maybe move one or two into the other company's credit risk area, and move the others over, so that you always have a core group that maintains the institutional memory. This allows us to ensure that the examiners can continue to increase their skills and knowledge by looking at the other company, and not necessarily stay within that area, but possibly move to interest rate risk, operational risk or some other aspect of the examination program.

I think this is the best way of making sure that our examiners continue to grow as examiners, and at the same time limit any possibility that there could be personal relationships that develop between examiners and anyone that they deal with continually at the companies.

Mr. HINOJOSA. I commend you for that. I commend you because there needs to be continuity. There needs to be that understanding of each of the organizations. We are interested in increasing homeownership. We are not interested in being so conservative that we are not willing to take some risk, because Fannie Mae and Freddie Mac are businesses. Rather, these GSEs are businesses and they have to have risk. We have risk in all other areas where we lend money to our businesses, small, medium or large. If we are going to increase homeownership, we are just going to have to find a way in which to do it efficiently, adequately and in a way that we are indeed encouraging homeownership, especially from working families that have been paying rent for years and years and years, and built up no equity whatsoever.

So I am pleased to hear that that is your mindset, and know that I do not want to be negative, as I heard from one of the members of the other side of the aisle, because in business you have to take risks. You just have to be well-organized.

For Chairwoman Castaneda, talking about your finance board and building a corps of examiners, do we give you enough money in the budget that you have to work with to be able to have staff, and to be able to train these members, directors of your board to adequately oversee and get the job done that they have to carry out?

Ms. CASTANEDA. Thank you for the question, Congressman. The Finance Board is different than OFHEO. We do control our own budget. We do not depend on taxpayers' money. What we do is we assess all the federal home loan banks, the 12 federal home loan banks, for our expenses.

As far as whether we have enough budget, enough money, yes we do. One of the things we have been doing in the past few years is increasing not only our staff, but also our infrastructure. I can tell you that right now we have 70 very highly qualified, skilled individuals, hard at work in the supervision and the examination of the 12 federal home loan banks and the office of finance.

Mr. HINOJOSA. Thank you for that explanation. I am pleased that we do not have to give you money to run that board. If that is the case, then I would like to echo some of the comments that were made by Mr. Kanjorski. That is that there needs to be representation of the public in ways that you would have people who are of both parties or more parties, simply because I was concerned to hear that over 95 percent or 97 percent are of one party. That lack of inclusivity is a weakness of representation of the public.

I believe that your responsibility of making affordable housing programs successful needs the input of women, of minorities, Democrats and Republicans. We certainly have a long way to go to be able to get minorities into the 60 percent and 70 percent of homeownership. I think that you have the responsibility as Chairwoman of that board to move in that direction and get courageous and make the changes necessary so that it is reflecting the makeup of our country.

Chairwoman KELLY. Thank you very much.

Mr. HINOJOSA. I commend all of you for the work you are doing.

Chairwoman KELLY. Thank you very much.

Ms. Capito?

Mrs. CAPITO. Thank you, Madam Chairwoman.

I would like to ask Chairwoman Castaneda a question. I want to go back to the issue of the multi-district membership. I represent the state of West Virginia. We are covered by the Federal Home Loan Bank of Pittsburgh, and 35 percent of our market share financial institutions fall within the other jurisdictions of other federal home loan banks, the largest one being BB&T Bank, which is chartered in North Carolina.

It has come to my attention that while this bank has been able to have access to the affordable housing program, there has been no access to the first-time homebuyers downpayment assistance program or the economic development growth enhancement program. We are concerned about the availability of those funds and the ability for that large institution in our State to be able to work with the federal home loan bank.

You mentioned in your previous statement that they are allowed to offer all products in all services areas of the banks they are chartered in. Is that correct?

Ms. CASTANEDA. What I said is that Finance Board rules do not prevent the federal home loan bank from funding projects outside the districts.

Mrs. CAPITO. Do you have any plans to look at this issue in any more depth? Because in a State like West Virginia, you said, well, it is all going to even out. Well, I do not think that the consolidations are going to occur. They are not going to be consolidating in West Virginia, unfortunately. They are going to be consolidating in New York and other places. How is that going to balance out?

Ms. CASTANEDA. Again, I would also be delighted to share the data that I was preparing earlier. As far as we can tell, the mergers and acquisitions impact on affordable housing funding has not been very significant.

Mrs. CAPITO. Let me ask just another follow-up then. For instance, let's take BB&T for an example, if BB&T as an institution gets the same amount of money under the affordable housing program, do they then decide which areas of their service area it goes to? Or does the federal home loan bank have some jurisdiction over whether some of that funding gets to West Virginia or not?

Ms. CASTANEDA. They can request that the federal home loan bank, in this case of Pittsburgh, to forward the funds to a place outside the Pittsburgh district.

Mrs. CAPITO. Okay. Has there been any investigation into letting larger and consolidated entities have membership in different banks, instead of just single membership?

Ms. CASTANEDA. The multi-district issue has not been before the board since I cam in January, so I have not had the opportunity to study the issue very closely. My understanding is the issue is really whether the Finance Board has the authority to change multi-district rules, at least without there being any specific concern regarding the safety and soundness of the federal home loan bank system of any particular bank, or for that matter the housing finance mission.

Again, multi-district rules are determined by statute. Congress could certainly make any changes it believed appropriate. What I can tell you also is that the Finance Board staff will be available to assist you on this issue either for reviewing the multi-district issue or coming up with any different plans. We are available.

Mrs. CAPITO. Thank you. I look forward to your sharing the data with my office so we can work together on this issue. Thank you.

Ms. CASTANEDA. I will make sure that that happens.

Mrs. CAPITO. Thank you.

Chairwoman KELLY. Thank you very much.

Mr. Scott?

Mr. SCOTT. Yes, thank you, Madam Chairwoman.

Mr. Falcon, first let me ask you about funding. You are currently asking for $20 million and increasing your funding for staffing purposes. Your budget goes through what looks to me like a tangled web. You have to get the appropriations process through Congress, but your funds are derived from having semiannual assessments placed upon Fannie Mae and Freddie Mac, two entities that you regulate. All of this is going on at the same time that the Administration is working feverishly to remove you completely from the appropriations process.

I would like to have your comments on how it is to operate within such a tangled web of your finances, and detail for us if you will how you can meet these needs while you continually have to rely on this rather haphazard means of financing?

Mr. FALCON. Thank you, Congressman. That is a very good question, because this I think goes to the heart of the ability of the agency to fulfill its mission over the long term. I think the fact that the agency, unlike every other safety and soundness regulator, has to go through the appropriations process has hindered the agency in the past from fully fulfilling its mission. It hinders long-term planning. It hinders the ability to respond quickly to certain budgetary needs. As we saw with the need to quickly staff-up to deal with the Freddie Mac problem, we did not have adequate funds to do so, so we had to get additional appropriations for that. The same thing arose with Fannie Mae where we needed a separate appropriation for that activity.

It hinders our ability to staff-up, because we cannot plan on hiring anyone this year until we are certain that we will have the funds next year in order to continue hiring those individuals, even if we find the funds in the current year. In addition, when there is a continuing resolution, especially a long-term one as there was in the 2004 fiscal year, even though we are planning for growth, hiring and doing additional testing and reviews of the two companies, a CR keeps us operating at last year's level, which prevents us from taking on the additional responsibilities and activities that we would like to. In the case of 2004, that went on for a 4-month period.

I very much hope that we are not forced into that situation again this year. I think it would very dramatically affect some of the ongoing activities that OFHEO has, including the Fannie Mae review, as well as our effort to staff-up on a timely basis in key areas like examinations and capital analysis.

Mr. SCOTT. Thank you. Let me talk for a moment also about the Fannie Mae review. I happen to believe that Fannie Mae and Freddie Mac are performing an extraordinarily important mission in providing access to housing for lower-and middle-income Americans. Earlier this year, you instituted an examination of accounting policies and programs of Fannie Mae to see if you could identify any control weaknesses or unusual transactions, to take a look at internal controls, to look at the role of management, and the board of directors and its implementation of its relevant policies and procedures.

Could you share with this committee your findings thus far?

Mr. FALCON. Congressman, like you I support very much the mission of Fannie Mae and Freddie Mac. However, that very important public mission does not give them license to violate accounting rules or engage in this conduct. If we find any type of violation of accounting rules or misconduct, we will take appropriate action to correct and prevent that misconduct from happening going forward. I am not in a position, however, to give you any updates other than in one area where we were prepared to take action as soon as we came to a conclusion about it. It was the area of impairments and how they account for impairments.

This primarily affected their manufactured housing portfolio and their portfolio of aircraft leases. It will result going forward in the write-down of those assets of approximately $300 million or so, but we have not determined the final numbers yet.

If you would allow me, I would like to withhold any comment on other findings until I am in a better position to be able to do so.

Mr. SCOTT. I will certainly do that, but please make note that I am very interested in moving forthrightly to remove any cloud on Fannie Mae's or Freddie Mac's operations in view of a public who is in great need of the implementation of their mission. I only hope that you and others and your board of examinations would take that in mind so that we realize that the longer we dally with this, there is a great need that is not being fulfilled as much as it should. I would be very interested if, off the record or at anytime while in private, that I might be able to receive some information that could allay some of our concerns, I would be glad to receive those.

Chairwoman KELLY. Thank you very much, Mr. Scott. I am sorry, your time is up, sir.

Mr. SCOTT. Okay.

Chairwoman KELLY. If we get into a second round, you are welcome to stay and do that.

Mr. Murphy?

Mr. MURPHY. I thank you, Madam Chairwoman.

Chairman Castaneda, I have a question I want to ask you. It is really related to high-profile scandals that have highlighted our need for government reform. Congress has taken some meaningful steps, most notably the Sarbanes-Oxley legislation, to ensure that sort of accountability in America's boardrooms and corporations.

When we look specifically at the federal home loan banks, we see a lot of extensive board turnover, where I think there is a real need to build continuity in these boards. To address this issue, there are a number of legislative initiatives that have been proposed to improve this governance of the federal home loan bank system. One of these includes extending the members's terms from 3 years to 4 years, and lifting a statutory limit on compensation. Can you tell me your thoughts, if you support these provisions? If so, why and what do you believe they would do?

Ms. CASTANEDA. Thank you for the question, Congressman.

As I have mentioned before, that was one of the issues that was raise during the system-wide corporate governance review that the Finance Board did last year. I am very much aware that it is included in the House bill, and I do believe that extending the term of service from 3 to 4 years would allow the board member to be able to a much better job.

The federal home loans banks are very unique institutions. I do believe it takes time for any member, even if you have a lot of banking and financial background, to get enough information and knowledge to serve. So I do believe then that a 4-year term is much more reasonable.

Mr. MURPHY. So you are saying that is based upon the time it takes to ramp-up to that level of knowledge. Do you think that also puts people in a position of helping them make wise judgments in the long term as well, rather than trying to rush, if they are dealing with that 3-year term here, to try and do things? I am thinking of this in light of some comments made before that perhaps some of these appointments may be politically based, but I am wondering if when people have long-term positions, does that work positively or negatively towards some of those accusations about political actions?

Ms. CASTANEDA. I think the more time you have with the board, the more familiar you will be with all the issues, the better you will be able to understand what you are trying to accomplish. In that sense, yes I do believe that then extending the term of service, it makes sense.

Mr. MURPHY. I just wanted that comment.

Thank you very much, Madam Chairwoman.

Chairwoman KELLY. Thank you, Mr. Murphy.

Mr. Bell?

Mr. BELL. Thank you very much, Madam Chair, and my thanks to both of you for your testimony here today.

Ms. Castaneda, a recent issue, as you are well aware, is simultaneous membership of one financial institution in multiple FHLB districts. As has already been pointed out today, today's economy trends toward mergers and consolidation, particularly in the financial sector.

I am wondering how much has this environment contributed to the push for multi-district memberships, and how will multi-district membership affect access to low-cost mortgages and housing? And if you have any information that is particular to Texas, I would very much appreciate your sharing that, too.

Ms. CASTANEDA. Again, Congressman, the multi-district issue has not been before the board since I came in January, so I have not had the opportunity to study the issue very closely. What I would like to tell you again, like I have expressed it to some of the other members here this afternoon, is that the Finance Board will be available to assist you in any way regarding this issue. We have also collected some data regarding the affect of mergers and acquisitions, and the affordable housing program funding which I will be delighted to have the Finance Board staff to get in touch with your staff and share that information.

Mr. BELL. Thank you.

Earlier, one of my colleagues painted a rather nightmarish and doomsday scenario for what could happen in this area, and one of the reasons offered for that doomsday scenario was programs that have been offered for the least creditworthy individuals who were most likely to default. That statement contrasts with some of the information I have been provided in my district regarding the success of some of those programs designed for the last creditworthy individuals or other low-income individuals. Since you all really did not have an opportunity to comment on the entire doomsday scenario which was offered, I would like to give you that opportunity now and see if you share any of those opinions or what your response would be.

Mr. Falcon?

Mr. FALCON. Relative to home price appreciation?

Mr. BELL. That, and any of the other comments that were made as to the looming disaster in this area. Do you agree with that?

Mr. FALCON. We have studied the issues related to a system at risk, and we discussed earlier issues related to home price appreciation. I would never come here and say to you that there will never be a failure of either of these companies. You never know if an event could happen or if you must miss something. But what you have to do is to try to make sure that you have put adequate resources, adequate staffing, adequate expertise and adequate authorities in the hands of the right leaders to make sure that we are doing everything possible to make sure that doomsday scenarios do not in fact happen.

I think with the growth of OFHEO's budget, with the additional staffing, with the way we are restructuring our regulatory program, I think we have taken great strides in trying to strengthen the oversight of these two companies to very much reduce the likelihood that there will be any kind of systemic event arising from these two companies.

A healthy Fannie Mae and Freddie Mac in fact can have stabilizing effects on our economy. So we need to make sure that there are not problems with these two companies that could possibly have a destabilizing affect externally. That is why I continue to press for the need for adequate resources and for every authority necessary at OFHEO, similar to what every other safety and soundness program has to ensure that we do have all the tools and resources necessary to make sure that we can reduce the likelihood, and come as close as possible to eliminating the likelihood, that there could be a systemic crisis in the housing sector of the economy or otherwise.

Mr. BELL. Ms. Castaneda?

Ms. CASTANEDA. Congressman, I do not have enough information for me to make a comment. I would like to come back to you on that issue, if I may.

Mr. BELL. Ms. Castaneda, opponents of FHLB's SEC disclosure rule have been vocal in decrying its authority to enact those changes. I was wondering if you could comment specifically on the Finance Board's jurisdiction in this matter?

Ms. CASTANEDA. You are right, Congressman. I have heard a lot of comments after our board resolution. The finance board looked at all of the issues raised by the banks and the other commenters. We made a decision that the best thing to do was to ask the banks to register with the SEC. Congress has given the mandate to the Finance Board to ensure that the banks operate in a safe and sound manner. The Finance Board ensures then the banks can raise money in the capital markets. Registering with SEC will reassure investors that there are no differences between the standard disclosures followed by the other two GSEs that could hamper the ability of the federal home loan banks to raise funds in the capital markets.

Additional disclosure would also enhance safety and soundness. It would provide more information to the analysts, to the member banks, and that would add market discipline to the banks and to the system.

Mr. BELL. Thank you, Madam Chair.

Chairwoman KELLY. Thank you, Mr. Bell.

Mr. Royce?

Mr. ROYCE. Thank you, Madam Chair.

Over the past year or so, this committee has spent a great deal of its time looking at the 14 housing government-sponsored enterprises. Last year, I authored legislation to create one regulator for Fannie Mae and Freddie Mac and the federal home loan banks. I felt such legislation was needed because the GSEs are too large and too important to our nation's housing and financial markets not to have world-class regulation.

Now, in the interim, I believe Congress needs to recognize that both the Finance Board and OFHEO are not operating under the most optimal statutory constraints, and only congressional action can make the necessary fixes. The bottom line is that until Congress acts, we are the ones that would and frankly should be held responsible, should be held accountable if a crisis were to occur in one of the GSEs. Let me be clear in saying that I do not know of any looming financial crisis, but the fact of the matter is that this committee should take prudent steps to ensure that such an event could not occur.

I would like to see this committee take the bill reported out of the Senate Banking Committee and mark it up over here. I am sure there would be amendments, and the American people would then have a record as to who supports what and why. So I respectfully suggest that the committee take up the bill passed in the Senate Banking Committee this past spring, because I think Congress needs to act.

In the meantime, the regulatory agencies must continue to perform their duties and for some time I have been very concerned about the federal home loan bank system's entry into the retained mortgage business. The MPF and MPP programs I think expose the federal home loan bank system to interest rate risk which can be very, very complex to manage. So I was very pleased to see the Finance Board recently demand that the Chicago bank have robust risk management systems and procedures in place. I just wanted to tell you, Chairwoman Castaneda, that I think that is a job well done.

I want to ask you a follow-up question to that, and that is, is the Finance Board going to be demanding the same level of risk management at the other 11 home loan banks?

Ms. CASTANEDA. Thank you, Congressman, an excellent question. I can assure you that at the Finance Board we are very vigilant in the oversight of all the federal home loan banks. We will take any necessary steps as we just did with the Chicago bank if we think it is necessary to do it.

Mr. ROYCE. Let me ask you this. What is the comfort level at the Finance Board with the internal risk-based capital test at each of the 12 federal home loan banks?

Ms. CASTANEDA. Capital requirements is one of the most important issues for the Finance Board. It is at the top of our supervisory agenda. As you know, after the GLB Act, all of the banks have to have a new capital structure. Most of the banks have implemented that new capital structure. As I said before, it is at the top of our supervisory agenda. We are monitoring not only the level, but also the composition of the capital of each one of the federal home loan banks.

Mr. ROYCE. Let me ask you about how the bank systems are approaching this. Are the banks measuring their exposure to mortgage assets in a consistent way across the system? Is there a consistency in this? Are there different approaches being applied in these different federal home loan banks?

Ms. CASTANEDA. Obviously, each federal home loan bank is different. They have their own structures as far as, you were talking about the mortgage loans.

Mr. ROYCE. Right.

Ms. CASTANEDA. For some of the banks, the mortgage loan portfolio is a much larger portion of their asset base, as in the case of Chicago, for example. But as far as how do we measure the interest rates at each one of the federal home loan banks, our supervisory effort is the same for each bank.

Mr. ROYCE. Thank you, Chairwoman.

Thank you for this hearing.

Chairwoman KELLY. Thank you, Mr. Royce.

Mr. Falcon, I wanted to just go back for a minute. Chairman Baker asked you for a response, to report back to the committee. I just simply need to do a bit of business here, with unanimous consent so moved.

Chairman Baker, if you would like to have a second round here, please feel free.

Mr. BAKER. Just a brief follow-up. I would ask a couple of questions of the Director that he did not have an opportunity to answer in the earlier round. First was with regard to the ongoing forensic accounting audit of Fannie Mae, and as to your opinion whether the agency is providing access to documents, personnel or other matters as may be deemed appropriate to the accounting firm or to your own inspectors as appropriate, given the circumstance they find themselves in. Are they being cooperative in your view?

Mr. FALCON. I think the cooperation has been spotty, but there are many demands we have placed on them for documents and to employees for scheduled interviews. Given that we find that cooperation has been less than adequate, whether it is deadlines being met or data submissions not being complete, we have taken steps to address those problems and will continue to be as forceful as necessary to make sure we do get full cooperation.

Mr. BAKER. Let me ask further that as significant events occur which you feel are not helpful to the audits and conclusion, if you would take this as a formal request to let us know. We certainly want to be helpful to you in encouraging a cooperative environment to get to an appropriate assessment of financial condition.

Secondly, given the stated objection of both GSEs to your corporate governance reforms, do you have a date certain, or how do you intend to proceed as to the implementation of your recommendations?

Mr. FALCON. Right now, we are analyzing the comments we have received, and we will decide whether or not to make changes to the proposed rule in light of comments that we received, and then draft the final rule which will then be submitted to OMB. If they determine it is a major rule that needs to be cleared by OMB, then we will have to wait for their review of it.

Mr. BAKER. As to your part, as to your date of submission to OMB, is that a year-end goal?

Mr. FALCON. Absolutely. I am hopeful we can get our part of it done within 1 or 2 months.

Mr. BAKER. Terrific.

I have one other element that we have not previously talked about, or at least not recently. Some on the committee have expressed support for the enterprises's efforts with regard to facilitating access to credit for first-time, low-income minority women. In looking at the portfolio of housing assets held, what percent, if you know, exceed 95 percent LTV? My expectation would be that first-time, low-income homebuyers are not likely to have $3,000 cash for a 97 percent loan for downpayment, plus another $2,500 or $2,800 in closing costs or $5,000 or $6,000 available in cash to make that acquisition, which means to me that most first-time homebuyers are going to be that 97, 98, 100 percent LTV first-time home acquisition.

My suspicion, having looked at these numbers some time ago, is that the bulk of assets held by the enterprises are a typical $250,000 home, two wage-earners, 25 or 30 percent down, people who have gone to their second, maybe third homes. That is where the bulk of the enterprises's assets are invested, as opposed to that description of that low-income first-time homebuyer. Is that characterization still close to accurate, or can you respond to it there? Do you need to take time to look at it?

Mr. FALCON. I think I will need some time to look at it, rather than give you some numbers off the top of my head which might not be accurate. I would prefer to defer, if I can.

Mr. BAKER. Let me refer you to Freddie Mac's annual financial report to shareholders about 3 years ago, in which they broke it out by percentage of housing investment held. I specifically asked the Freddie person at that time, who appeared before the committee, why there was such a small amount held in 95 percent excess of LTV. The explanation at that point, some years ago, was that the portfolio has not seasoned. I asked if it needed Tabasco or pork fat, or what we needed to get it over the top. I never got a response.

I just thought it might be appropriate for you to return to that. Many members of the committee assume that the principal line of business for these enterprises is to help low-income individuals. My suspicion is that it is not the case.

I thank you very much for your leadership and hard work in this area. I yield back, Madam Chair.

Chairwoman KELLY. Thank you very much.

I want to thank this panel very much for their patience with this hearing this afternoon. The Chair notes that some members may have additional questions for this panel, which they may wish to submit in writing. So without objection, the hearing record will remain open for 30 days for the members to submit written questions to these witnesses and place their responses in the record.

I really thank you for your patience. With that, this hearing is adjourned.

[Whereupon, at 5:07 p.m., the subcommittees adjourned.]

A P P E N D I X

July 13, 2004

Statement of Chairwoman Sue Kelly
Joint Hearing
Subcommittee on Oversight and Investigations
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
"Review of the Office of Federal Housing Enterprise Oversight and Federal Housing Finance Board"
July 13, 2004

This afternoon, the Financial Services Committee continues its series of oversight hearings on the Federal agencies within the committee's jurisdiction by conducting a review of the Office of Federal Housing Enterprise Oversight (OFHEO) and the Federal Housing Finance Board (FHFB).

OFHEO is an independent agency and the primary regulator for Fannie Mae and Freddie Mac, two of the world's largest financial institutions. The agency's primary mission is to ensure the capital adequacy and financial safety and soundness of the government sponsored enterprises (GSEs). The Federal Housing Finance Board is an independent agency that regulates the 12 Federal Home Loan Banks and also ensures that they operate in a safe and sound manner. Their roles are critically important to American taxpayers, homeowners and investors.

Fannie Mae, Freddie Mac and the Federal Home Loan Banks provide valuable services to homeowners by increasing liquidity in the home mortgage markets. Their significance to, and impact on, our economy cannot be overstated – spanning across the entire scope of the financial services sector from the bond markets, mutual funds, and pension funds to relationships with financial institutions, insurance companies, individual investors, central banks, and other institutions in foreign countries. We must ensure that they are functioning well and serving the needs that Congress intended.

Over the last few years, the government sponsored enterprises (GSEs) have been the focus of increased attention, and this Committee has a strong interest in overseeing their regulation. As we face a growing economy that has been fueled by the housing sector, Congress must ensure that these entities have effective and efficient oversight. And, since the housing sector continues to be the engine that drives our economy, our government must ensure that we do not disrupt the steady flow of low cost funds to homebuyers, while protecting taxpayers.

Today, the Committee welcomes the Director of the Office of Federal Housing Enterprise Oversight (OFHEO), Mr. Armando Falcon. We are very interested in OFHEO's annual report to Congress, as well as the agency's recent 2004 budget request for $59.2 million. While this figure represents a significant increase for the agency, it is important that OFHEO be well funded and well staffed to oversee these extremely complicated institutions. The Committee supports OFHEO's request and would like to hear more about how the agency plans to use these funds, including the creation of a new Office of Compliance and an Office of Chief Accountant.

The Committee is also pleased to welcome Chairman of the Federal Housing Finance Board, Ms. Alicia Castaneda. Today marks the Chairman Castaneda's first appearance before the Financial Services Committee. We welcome your testimony on the state of Finance Board and the 12 Federal Home Loan Banks and look forward to hearing your vision for the future of the agency.

While we are pleased with the tremendous strides that OFHEO and the Finance Board have taken to strengthen their oversight role, the two agencies remain ill-equipped to handle oversight of the GSEs. In order to protect taxpayers, investors and homebuyers and restore confidence in the GSEs, these entities need a single, world-class regulator to oversee their operations and financial well being. I am hopeful that Congress and the Administration can reach a consensus for reform that strengthens oversight of GSEs and continues to encourage homeownership.

In the meantime, OFHEO and the Finance Board have been very active with a number of proposals aimed at strengthening the oversight and operations of the GSEs. The Committee is very interested in learning more about these reforms today, in addition to the nature and status of the accounting restatements and other supervisory actions.

Specifically, OFHEO and the Finance Board have been very active in the area of corporate governance. OFHEO recently circulated a rule that would, among other things, separate the CEO and Chairman functions and require periodic 'audit partner' and 'audit firm' rotation. Since its work on Sarbanes-Oxley, this committee has taken great interest in pursuing the highest levels of integrity in corporate governance, and we would like to hear your views on these issues. As you know, the General Accounting Office has found that mandatory audit firm rotation for publicly traded companies is inefficient and potentially disruptive. Given the consolidation in the accounting industry and the highly complex nature of the GSEs, the Committee would like hear more about this proposal and what precedent it sets for publicly traded companies.

Similarly, the Finance Board just voted unanimously to require the 12 Home Loan Banks to register with the SEC. While increased disclosure is generally preferable, we would like to know more about the significance of this requirement since the stock of the Home Loan Banks is not publicly traded like the other GSEs.

In the absence of reform legislation, the Committee is also interested in how the regulators intend to handle other issues, such as receivership. During the debate over regulatory restructuring there was considerable discussion about whether a new regulator should be vested with receivership powers similar to those held by other financial regulators. The Committee would like to know whether OFHEO plans to address this issue.

The issue of multi-district membership is also significant considering the recent acquisitions of several large Federal Home Loan Bank members, which have spurred petitions to the Finance Board to allow members of the System to maintain membership in more than one Federal Home Loan Bank. Since the issue has an impact on the way affordable housing contributions are measured among the Federal Home Loan Banks, it is important that we know how the Finance Board plans to address multi-district membership.

Finally, the Department of Housing and Urban Development has recently proposed increasing the housing goals of Fannie Mae and Freddie Mac. The proposal requires the firms to increase the percentage of mortgage loans they finance for low- and moderate-income borrowers from 50% to 57% by 2008. While this is not the role of OFHEO, nor the focus of today's hearing, the Committee does have an interest in determining the impact that this proposal could have on the safety and soundness of these entities. I hope that you can address this issue today.

I would like to thank my colleague and co-chair of today's hearing, Rep. Richard Baker. Chairman Baker's work on these issues has been crucial to reform efforts and has greatly benefited the American people.

The Subcommittees thank the witnesses for their testimony. The American people will undoubtedly benefit from your views and this important oversight.

Prepared, not delivered

Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Oversight and Investigations
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

Review of the Office of Federal Housing Oversight and the Federal Housing Finance Board

July 13, 2004

I want to thank Subcommittee Chairs Kelly and Baker for convening this hearing to review the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board. These agencies are critical to ensuring that our housing finance system remains strong and well-managed. I would also like to welcome Chairman Castaneda in her first appearance before this Committee.

Last year, serious accounting irregularities were discovered at Freddie Mac. As a result, several executives lost their positions and Freddie was forced to restate its books. OFHEO, initially caught flat-footed, launched a massive investigation which got to the bottom of the problems at Freddie.
OFHEO issued a comprehensive report, entered into a consent agreement with Freddie, and fined the GSE $125 million. I want to commend Director Falcon for all the hard work he has done over the past year. I am encouraged to see a reinvigorated OFHEO and hope that the agency will continue to closely monitor the activities of the GSEs.

The Federal Home Loan Bank System had its own problems last year. Several banks experienced unexpected losses and were forced to make changes to the composition of their balance sheets. The Finance Board is becoming more aggressive in its oversight of the federal home loan bank system. Last month's decision to sanction one of the banks for inadequate risk management was a clear sign that the Finance Board is taking its safety and soundness role seriously.

I still believe that there can be improvements to the oversight of the GSEs. Fannie Mae, Freddie Mac, and the 12 Federal Home Loan Banks issue trillions of dollars in debt. Market participants believe that they have the backing of the Federal government in the event of a failure; that means if there is a crisis at any of these enterprises the taxpayers will be on the hook for the losses. In fact, there is no government backing. The GSEs deny it in every of their securities issuance, and the Administration denies it in all of its public statements.

This Committee and the Senate Committee have worked hard to craft a new regulator for the GSEs that would have the powers and authorities vested in a world-class regulator. Unfortunately, neither the GSEs nor the Administration have been willing to agree to a compromise to improve oversight.

I am glad to see progress in the regulation of the GSEs, but I hope that all parties can come together and at some point and agree that better supervision is in the best interests of the housing market, the GSEs, and the U.S. taxpayers. I want to thank the witnesses for joining us today and I look forward to your testimony.

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July 13, 2004

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
Hearing to Review the Office of Federal Housing Enterprise Oversight (OFEHO) and Federal Housing Finance Board (FHFB)

Thank you, Mr. Chairman, for holding this important hearing and for your continued leadership on this issue and the overall topic of reforming the regulatory structure governing Government Sponsored Enterprises (GSEs).

Both the Office of Federal Housing Enterprise Oversight (OFEHO) and the Federal Housing Finance Board (FHFB) play a critical role in the oversight and regulation of the home loan industry. Accordingly, each agency has taken affirmative steps to ensure an increased accountability of the respective GSEs under their supervision. I applaud OFEHO's hiring of the accounting firm Deloitte and Touche to monitor Freddie Mac's accounting practices; such action will help prevent further accounting failures. I was also pleased to see the FHFB's enactment requiring Home Loan Banks to register their holdings with the Security and Exchange Commission. The steps taken by both agencies indicate a commitment to maintaining the integrity of the home loan and mortgage industry.

However, further steps might be necessary to improve the regulation of GSEs. I am looking forward to a discussion today of potential solutions to this problem; including a proposal to create an independently funded agency that would combine the duties now carried out by OFHEO and the FHFB. Such an agency could possibly continue the progress OFHEO and FHFB have made, while increasing the authority and resources they lack.

I look forward to hearing from Directors Falcon and Castaneda on this issue, and hope progress is made to improve the regulatory oversight of Fannie Mae and Freddie Mac. Our housing GSEs are assigned the task of providing an important service to the public; for that reason, it is critical that they be accountable to the public with respect to their financial and managerial activities.

I thank you again, Mr. Chairman, for assembling us here this afternoon. I look forward to an informative discussion.

OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

OVERSIGHT HEARING ON THE OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT AND THE FEDERAL HOUSING FINANCE BOARD

TUESDAY, JULY 13, 2004

Mr. Chairman, we meet today to examine the recent actions and pending proposals at the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board. These two regulatory bodies help to ensure that Fannie Mae, Freddie Mac, and the Federal Home Loan Banks continue to fulfill their public mission of advancing homeownership.

Our nation's system for housing finance is not only extremely successful, but it is also the envy of the world. More than 68 percent of Americans presently own the homes in which they live. Government-sponsored enterprises have contributed greatly to this accomplishment.

This success, however, should not stop us from asking whether and how we can do a better job with respect to regulating the housing government-sponsored enterprises and conducting congressional oversight regarding these matters. We should always examine ways by which we can improve regulatory efficiency and lower mortgage rates.

As you know, Mr. Chairman, I am also one of the few remaining Members of this Committee who participated in the entire congressional battle to resolve the savings and loan crisis. I am therefore acutely aware of the need to protect taxpayers from risk. It is in the public's interest that we ensure that the housing government-sponsored enterprises continue to operate safely and soundly. We must further ensure that these public-private entities achieve their public responsibilities for advancing homeownership opportunities.

As we proceed today, I hope that our distinguished witnesses will share their views on corporate governance. I know that the Federal Housing Finance Board has carefully studied these issues in recent years and has worked to improve the performance and accountability of Federal Home Loan Bank executives and board directors.

Nevertheless, I have heard concerns about the need to improve the expertise on the boards, such as requiring at least one director to have experience with derivatives. I have also previously proposed extending the terms of directors from three years to four years to increase institutional memory at the Federal Home Loan Banks. I am additionally aware that one Federal Home Loan Bank may soon have no representative on its board with more than three years of experience, assuming that none of its current directors is reappointed later this year.

In recent months, the Office of Federal Housing Enterprise Oversight has also released its proposed minimum standards for corporate governance. These standards have sparked considerable debate, particularly regarding the decisions to separate the CEO and chairman functions and to mandate the rotation of external auditors.

(more)

In addition, I am very concerned about the failure of the Bush Administration to appoint directors to serve on Fannie Mae and Freddie Mac's boards. As a result of this decision, each board has five fewer individuals to serve than they usually had.

The failure to appoint presidential representatives on these boards has increased the burden that each of the remaining directors must carry. Moreover, it is important to note that three of the five presidential appointees on each of these boards had to represent particular concerns or have specific backgrounds -- such as experience in the housing industry. Unfortunately and counter to congressional intent, neither Fannie Mae nor Freddie Mac is now benefiting from receiving these diverse viewpoints.

In closing, Mr. Chairman, as I said at our very first hearing on GSE regulation in March 2000, "we need to have strong, independent regulators that have the resources they need to get the job done." I continue to support strong GSE regulation. A strong regulator, in my view, will protect the continued viability of our capital markets, insure against systemic risk, and expand housing opportunities for all Americans. I therefore look forward today to hearing from the leaders of the two regulatory entities overseeing the safety and soundness of the housing government-sponsored enterprises and yield back the remainder of my time.

Testimony of Alicia R. Castaneda
Chairman, Federal Housing Finance Board,
Before the Subcommittee on Oversight and Investigations
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
House Committee on Financial Services
July 13, 2004

Testimony of Alicia R. Castaneda
Chairman, Federal Housing Finance Board
Before the Subcommittee on Oversight and Investigations
Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises
House Committee on Financial Services
July 13, 2004

Thank you, Chairman Baker and Ranking Member Kanjorski. Thank you, as well, Chairwoman Kelly and Ranking Member Gutierrez. Good afternoon.

This is my first appearance before Congress since I joined the Federal Housing Finance Board and became its Chairman in April. I am honored to appear before your two subcommittees to discuss the Federal Housing Finance Board and its oversight of the Federal Home Loan Bank System.

I came to the Finance Board after 28 years in commercial banking, experience that is proving very valuable in my new role as Chairman of the independent regulatory agency charged with oversight of the 12 Federal Home Loan Banks and the Office of Finance.

As you know, the Banks are government-sponsored enterprises, and their members comprise more than 8,000 commercial banks, savings and loans, insurance companies and federally insured credit unions.

Today, I can say with full confidence that the Finance Board is fulfilling the duties Congress gave it in the Federal Home Loan Bank Act: To ensure that the Federal Home Loan Banks operate in a financially safe and sound manner, carry out their housing finance mission, and remain adequately capitalized and able to raise funds in the capital markets.

Over the past two years, the Finance Board has made great strides in enhancing our capabilities to carry out these duties. The clearest evidence can be seen in the tripling of our examination staff.

However, bank supervision is more than just examinations. We have also hired highly qualified mortgage specialists, bank analysts, community development specialists, accountants and economists. We are upgrading our technology and systems. These all contribute significantly to our oversight and supervision of the Federal Home Loan Banks.

While the agency has indeed come a long way, there is still more to do. I can assure this committee that, as Chairman, I am committed to a course of constant improvement. My intention is to continue building our staff, adding necessary resources, and fostering a world-class regulatory culture at the Finance Board.

As a regulator, the Finance Board's job is to do what needs to be done, when it needs to be done. That's been my approach since I joined the Board in January, and it will be as long as I remain on the Board.

Which leads me to several recent developments that I think reflect our regulatory approach.

First, the Finance Board last month voted unanimously to require the Home Loan Banks to register with the Securities Exchange Commission under the Securities Exchange Act of 1934.

The Federal Home Loan Banks are among the biggest debt issuers in the country, issuing roughly $500 billion in bonds annually in recent years. The Home Loan Banks collectively had $765 billion in debt outstanding as of March 31, 2004.

Given these facts, the Finance Board called for consistent, enhanced and transparent disclosures from the individual Banks to help achieve market discipline. Because investors in that market, as well as the Banks' members and the public, should and will know more about the risks faced by these financial institutions.

Registration will also ensure that Home Loan Bank disclosure standards are fully comparable to those of the other housing GSEs and large private financial institutions. Based on my experience as a banker and fixed income trader, I believe this will help ensure that the Banks are not disadvantaged in their access to capital markets.

For all these reasons, we adopted the regulation, and the registration process is now under way. Each Bank will be required to first file with the SEC by no later than June 30, 2005, and to have their registrations effective by no later than August 29, 2005. A second recent development occurred on the supervisory front. On June 30th, the Finance Board and the Federal Home Loan Bank of Chicago entered into a written agreement to address certain shortcomings in the Bank's risk management, internal audit, capital management, and accounting and financial recordkeeping practices.

These shortcomings were identified in recent Finance Board examinations of the Bank. After a series of incremental steps dating back several years, my colleagues and I on the Finance Board determined that a formal written agreement was the necessary and appropriate next step to improve the Bank's management and oversight of these issues.

Third, and finally, let me describe what the Finance Board is doing with respect to the Affordable Housing Program.

Beginning in 1990, Congress required the Federal Home Loan Banks to set aside 10 percent of their profits for low-income housing. Since its inception, the AHP program has provided some $2 billion in grants and subsidies for affordable housing.

The Finance Board is committed to ensuring that these programs operate in a safe and sound manner and help fulfill the Home Loan Banks' housing finance mission. We are currently conducting a System-wide review of the Home Loan Banks' AHP programs to help evaluate what they are doing in this area. We are also building a core of examiners to focus solely on the Affordable Housing Program, and have added new community development specialists to further assist in examinations.

Mr. Chairman, Madame Chairman, members of the subcommittees, thank you for allowing me this opportunity today to outline our activities at the Federal Housing Finance Board.

I believe we have attained a level of expertise, experience and capabilities that makes the Finance Board an accomplished, effective financial regulatory agency, one that serves the public in the way Congress intended – through rigorous oversight of the Federal Home Loan Banks and their housing finance and affordable housing missions.

Thank you.

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STATEMENT OF

ARMANDO FALCON, JR.
DIRECTOR
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Hearing On

A Review Of The Office Of Federal Housing Enterprise Oversight And
Federal Housing Finance Board

before the

Subcommittee On Capital Markets, Insurance, And Government Sponsored
Enterprises
and the
Subcommittee On Oversight And Investigations

of the

Committee On Financial Services
U.S. House Of Representatives

July 13, 2004
2128 Rayburn House Office Building

Chairwoman Kelly, Ranking Member Gutierrez, Chairman Baker, Ranking Member Kanjorski, and members of both Subcommittees, thank you for the opportunity to testify at today's oversight hearing on the Office of Federal Housing Enterprise Oversight (OFHEO) and the Federal Housing Finance Board (FHFB). My testimony will briefly discuss the current financial condition of the Enterprises, the importance of strengthening the regulatory environment in which the Enterprises operate, and my efforts to reshape OFHEO to meet the demands of the future. Much of my remarks this afternoon will focus on the issues facing the GSEs and the initiatives that OFHEO has taken and is taking to address these issues. My remarks represent my views and not necessarily the views of the President or the Secretary of Housing and Urban Development.

Condition of the Enterprises

The Act creating OFHEO requires the agency to report annually on the "financial safety and soundness of each enterprise, including the results and conclusions of the annual examinations of the enterprises..." OFHEO fulfills this requirement through an Annual Report to Congress submitted each June 15. Let me summarize the findings of the 2004 Annual Report.

The supervisory activities of OFHEO include an annual risk-based examination program, special investigative reviews, and our assessments of each enterprise's compliance with capital and other regulatory standards. OFHEO's examinations apply methodology similar to that used by the safety and soundness regulators for large and complex banks. As with the large national bank examinations, OFHEO's examiners use a risk-based approach that emphasizes evaluating Enterprise risk management processes as well as transactional testing. At the end of 2003, there were 58 examiners conducting the risk-based accounting and compliance exams of Fannie and Freddie. By year-end 2005 the staff devoted to such examination is expected to increase to 98.

This year, OFHEO has chosen to use the CAMELS model to report the results and conclusions of the annual examinations of Fannie Mae and Freddie Mac. The federal depository regulators (the Federal Reserve, the FDIC, the OCC, the OTS, and the NCUA) employ the CAMELS methodology as a convenient summary for an institution's financial condition at the time of the examination. CAMELS is an acronym referring to six components of the condition of the enterprises that have been evaluated through OFHEO's supervisory programs. The six areas evaluated were: Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Sensitivity to market and interest rate risks. OFHEO applies a similar means of evaluating the six component areas of the CAMELS as the depository regulators.

Capital

Capital provides the means by which the enterprises withstand adverse economic conditions or situations. OFHEO monitors and assesses the capital position of Fannie Mae and Freddie Mac on an ongoing basis. OFHEO's capital authority is promulgated in the 1992 Act through the establishment of two assessments of capital: minimum and risk-based. These quantitative measurement tools, along with the results of examinations and special examinations, provide the basis for OFHEO's capital supervision of the Enterprises.

Fannie Mae and Freddie Mac exceeded their minimum and risk-based capital requirements for all four quarters in 2003. Based upon these quantitative results and the conclusions of examination and other investigative activities, and discussions with management, OFHEO concludes that Fannie Mae and Freddie Mac were adequately capitalized as of year-end 2003 and through first quarter 2004. We have the right, however, to undertake prior period reassessments of capital adequacy when supervisory activities warrant. Freddie Mac has restated its earnings for 2003 and is expected to complete its restatement of 2004 earnings sometime in 2005. Fannie Mae, as OFHEO has indicated for the last two quarterly capital classifications, is currently under a special accounting examination that may result in earnings restatements that could affect the calculation of the company's capital requirements.

Asset Quality

During the course of each examination cycle, examiners from OFHEO evaluate the mortgage credit risk management practices of each enterprise for both the single-family and multifamily lines of business. OFHEO reviews the structure of each enterprise for managing mortgage credit risk, and through selected sampling and targeted reviews evaluates whether the practices of the enterprises meet safety and soundness standards and adequately protect the enterprise from the risk of loss resulting from borrower or counterparty default.

Based upon examination activities to date, it is the overall conclusion of OFHEO that Fannie Mae and Freddie Mac have strong asset quality and prudent credit risk management practices. Notwithstanding this overall assessment, OFHEO has directed management at each enterprise to address specific aspects of credit risk management and also identified opportunities to improve existing practices. These areas are addressed in more detail in the Annual Report. In addition, although OFHEO considers Fannie Mae's asset quality and credit risk management practices to be sound, these and other subjects are the focus of a current and more intensive examination

Management

OFHEO evaluates management of the enterprises in accordance with OFHEO's regulations, guidance policies, and standards of prudence and safe and sound practices. As this Committee is well aware, OFHEO conducted a special examination of the events leading to the public announcement on June 9, 2003 of the termination, resignation, or retirement of the three principal executive officers of Freddie Mac. The special examination was ordered to supplement an ongoing OFHEO examination of the financial condition of Freddie Mac and the company's decision to restate its financial reports for 2000, 2001, and 2002. OFHEO released a report on the special examination detailing a pattern of inappropriate conduct and improper management of earnings that led to the restatement and management restructuring of the company. I provided the Subcommittee on Capital Markets with details on the findings and conclusions of the special examination during my last appearance before the subcommittee in January of this year. As a result of the findings of the special examination, Freddie Mac agreed to implement corrective measures and pay a civil money penalty of $125 million as part of a Consent Order with OFHEO.

To date, Freddie Mac is in compliance with that agreement, having met all of OFHEO's deadlines on individual requirements. Roughly half of the agreement has been implemented and the company has been cooperating well with our agency in accomplishing our common goal of remediation.

Examples of Freddie Mac's compliance with the OFHEO order include: providing us with an auditor's review of the design, assessment and evaluation of the financial controls of the company; engaging an outside consultant to review internal controls with respect to reporting processes from the company to its board and senior management; reporting to OFHEO on the functions and oversight of the chief risk officer and the chief compliance officer; and hiring an outside consultant to review the current and future staffing needs of the internal accounting function and its ongoing oversight by management.

Additionally, Freddie Mac has developed procedures regarding appropriate management oversight of the business purpose of certain transactions along with the maintenance of records detailing that business purpose. It has submitted to OFHEO a plan of actions the Enterprise will take to address the adequacy of its public disclosure and the oversight of such disclosure. Freddie Mac has revised its corporate bylaws, adopted codes of conduct for the Board and employees, consulted with OFHEO concerning the structure of the Board (including term and age limits for board members), adopted a corporate succession plan, and submitted to OFHEO a specific plan to foster a management culture that gives appropriate consideration to operational stability and legal and regulatory compliance.

During the period of the Consent Order, the Board of Directors of Freddie Mac has elected a new Chairman and has hired a number of senior executives as its new management team.

Based on an annual examination conducted in 2003, OFHEO concludes that the overall management of operational risk at Fannie Mae comports with applicable safety and soundness standards; however, this conclusion could be impacted by the results of the special accounting review. In addition, OFHEO did suggest certain enhancements to Fannie's practices. These included: correcting a perceived weakness in the computer security review process, and improving the distribution of internal policies over the intranet. Both recommendations have been implemented.

In 2004, OFHEO initiated a special examination of accounting policies and practices at Fannie Mae. The scope of this review includes accounting policies and controls at the enterprise, with an emphasis on identification of any control weaknesses or unusual transactions. When completed this review will shed light on the adequacy of Fannie Mae's internal controls, including the role of management and the board of directors in overseeing implementation of relevant policies and practices. Pending completion of that examination an assessment of Fannie Mae management must be deferred.

Earnings

OFHEO assesses enterprise earnings by analyzing the magnitude, trends, sources, and quality of earnings with particular attention to factors that may cause earnings to change in the future. Potentially important factors include: risk characteristics of existing positions, market trends, the effects of accounting practices, the effects of unusual economic conditions, and changes in fair value net worth. OFHEO also reviews management systems, practices, and strategies for controlling costs, projecting earnings and anticipating and responding to market developments.

Earnings in 2003 were strong for both Fannie Mae and Freddie Mac, amounting to $7.9 billion and $4.9 billion, respectively. Since the adoption of FAS 133 in 2001, earnings have been volatile at both enterprises. This is especially the case for Freddie Mac because past accounting irregularities forced it to abandon use of many hedge relationships for accounting purposes and to mark most asset values to market. Fannie Mae's reported income represented a 71 percent increase from 2002, while Freddie Mac's was down 52 percent. However, the underlying economics of both enterprises was relatively stable.

Their two principal lines of business, credit guaranty and leveraged mortgage asset investment, continued to grow and prosper at each enterprise, without deterioration in their risk characteristics. Credit losses remain exceptionally low, while spreads between interest rates earned on assets and interest rates paid on debt remain more than ample.

Fair value gains (defined as increases in net assets on fair value balance sheets, adjusted for dividends and other net capital payouts) were also strong for both enterprises last year. Fannie Mae achieved gains of $11 billion, and Freddie Mac had gains of $6 billion. This measure provides an alternative perspective on the year's financial performance that avoids partial mark-to-market issues associated with reported earnings. However, the results at both enterprises benefited from changes in the relative prices of assets and liabilities that will reverse as instruments mature.

Freddie Mac expects to release the company's 2003 annual report in September 2004 and to hold the 2003 shareholders meeting in November 2004. The company has announced its intention to provide quarterly and full year results for 2004 by March 2005. The company has not yet announced when it will report full year and quarterly earnings for 2005.

OFHEO has been monitoring the progress of the restatement of earnings very closely and is receiving regular updates from Freddie Mac management. OFHEO has strongly urged the company to file timely financial statements as soon as possible, recognizing that the company has brought enormous resources to bear on the re-statement problem. OFHEO will continue to work with the company to see that investors receive accurate and full disclosure of financial information on a timely basis. Until remediation efforts at Freddie Mac have taken full effect, the company remains exposed to operation and other risks. Therefore, until the company is a timely filer of GAAP - consistent financial statements, it must continue to keep a significant capital surplus in place under the terms of the OFHEO letter of January 28, 2004.

Liquidity

During the course of the annual examination cycle, OFHEO evaluates liquidity management at the enterprises in accordance with OFHEO's regulations and guidance, and standards of prudence and safe and sound practices. Foremost in OFHEO's assessment is a determination of the level of risk to the earnings of the enterprise and capital that arises from its ongoing ability to meet obligations without incurring unacceptable losses.

OFHEO's overall assessment of enterprise liquidity came to three primary conclusions: (1) Fannie Mae and Freddie Mac have policies and procedures governing their management of liquidity risk, (2) Fannie Mae and Freddie Mac demonstrated reliable access to sufficient sources of funds on cost-effective terms to remain liquid and meet their obligations throughout 2003, (in Freddie Mac's case this access was demonstrated during a challenging and highly unusual operating environment) and, (3) Fannie Mae and Freddie Mac continue to evolve and refine their liquidity contingency plans with strategies and implementation procedures including during adverse market scenarios.
In the case of Fannie Mae these findings are subject to the findings and conclusions of the special examination currently underway.

Sensitivity

Inherent in the business model of the enterprises is the role of financial intermediary and the ability to accept and manage financial risks. One such risk is the exposure of its earnings and capital to movements in interest rates. OFHEO evaluates interest rate risk arising from differences between the timing of interest rate changes and the timing of cash flows (repricing risk); from changing rate relationships among yield curves that affect the activities (basis risk) of the enterprises; from changing rate relationships across the spectrum of maturities (yield curve risk); and from interest rate related options embedded in the products (option risk) of the enterprise. OFHEO also evaluates the impact of hedging strategies and products employed by the enterprise. It is these movements of interest rates in combination with the hedging strategies employed by the enterprises that affect the reported financial performance and the underlying economic value of their portfolios.

In 2003, volatility in the debt markets affected the interest rate risk positions of Fannie Mae and Freddie Mac. Management of both enterprises was required to respond by rebalancing this exposure to that volatility. During the 2003 examination, OFHEO focused on the risk management policies and practices of Fannie Mae and Freddie Mac and the effects that this had on their risk profiles and whether the quantity of interest rate risk being assumed by the two companies posed a supervisory concern. Routine examination activities were augmented by testing in specific areas affecting interest rte risk management.

Strengthening the Regulatory Environment

Since OFHEO's FY 2004 Budget was submitted, the regulatory environment of the Enterprises has changed dramatically, and OFHEO's funding requirements have also changed. One of the most important reasons for the increased funding that the agency is seeking relates to issues raised by two special examinations that the agency has initiated.

The special examination of Freddie Mac identified serious internal management control issues and accounting weaknesses at Freddie Mac and led to subsequent enforcement actions by OFHEO. The report of the special examination at Freddie Mac concluded that OFHEO must ensure that Freddie Mac establish an adequate remediation plan and allocate the necessary resources to establish a new corporate culture that rewards integrity and the acceptance of responsibility while penalizing any failure to meet appropriate standards of conduct. OFHEO is currently overseeing corrective actions being taken by Freddie Mac and will continue to evaluate their operational effectiveness.

Late in FY 2003, OFHEO announced plans to conduct a special examination of accounting practices at Fannie Mae. That examination is currently underway and as issues of concern to the agency are identified, we will address them immediately. When OFHEO determined the accounting for impairment of assets was incorrect, OFHEO took action to implement the correct accounting practice. I will notify the Committee if and when we have more to report regarding this ongoing special examination.

As a result of the events at Freddie Mac and to strengthen overall supervision activities, OFHEO requested and received a total of $39.9 million in FY 2004, including $32.4 million contained in the President's 2004 budget and $7.5 million in a budget amendment that was transmitted September 12, 2003. The increase of $7.5 million was allocated to three supervisory initiatives.

One was to support the litigation of enforcement actions against the former CEO and Chairman of the Freddie Mac board, and the former Chief Financial Officer. These enforcement actions are currently being litigated in administrative and related court proceedings, requiring increasing amounts of internal and external resources for legal support, discovery and litigation management.

Another was to support the hiring of an accounting firm to assist in the examination of accounting practices at Fannie Mae. OFHEO awarded a contract to the international accounting firm, Deloitte and Touche in March 2004 for a comprehensive examination of applied accounting policies at Fannie Mae. This examination is currently being undertaken and larger resources than anticipated are required to complete it. OFHEO is seeking additional funds in FY 2005 to support this initiative.

Finally, additional funds were allocated to strengthen and add capacity to OFHEO's supervisory program. These funds are being used in FY 2004 to hire additional staff supporting a restructured, more focused program of supervision.

OFHEO is seeking $59.2 million in the FY 2005 budget to more fully staff this new reorganized program. We will continue to enhance supervisory programs concentrating on the annual examination, special compliance examinations, and examinations of accounting treatments and the management and analysis of enterprise capital. This 2005 budget supports 237 positions, compared to the 178 positions supported by the FY 2004 budget. This is an increase of 59 new positions, fully 85 percent of which are directly allocated to supervision of the activities of the enterprises. These new positions will enhance and strengthen OFHEO's regulatory efforts and will add the necessary depth and breadth in supervision staff to ensure that OFHEO serve as an early warning system for control and management problems, accounting treatments and business practices, and for any emerging financial issues.

I want to thank the leadership of the Financial Services Committee for their support for OFHEO's FY 2005 budget request. As the committee with jurisdiction over the GSEs and their issues, the members of this committee recognize the importance of having a fully funded regulator as Congress wrestles with the long term issues of GSE reform. As long as OFHEO has the responsibility for regulating Fannie and Freddie, I will continue to advocate the full funding that such regulation demands.

Reorganizing OFHEO

I have implemented some organizational changes to strengthen OFHEO's supervisory program. First, OFHEO reorganized the annual examination function into two fully staffed units, one for Freddie Mac and one for Fannie Mae, each headed by an examiner-in-charge. The dedication of staff to one or the other of the enterprises will result in the development of greater expertise in the operations, structure, and regulatory issues of that particular company. After a number of years, the staff will rotate between enterprises to further expand their expertise as they compare and contrast the methods of operation and businesses. This targeted approach also fosters improved responsibility and accountability for examination activities at each enterprise. Rotation helps assure that an independent review of the company will never be compromised by the inevitable development of personal relationships over time.

Second, I created two new offices: an Office of Compliance and an Office of Chief Accountant. The Office of Compliance at OFHEO is generally analogous to the Division of Enforcement at the SEC. It receives referrals from other parts of the agency, including the examiners, and has the ability to conduct in-depth examinations of problems that have been identified elsewhere. The Office is responsible for identifying and investigating emerging issues and potential weaknesses of the enterprises and recommending corrective, preventive and enforcement actions as appropriate. Locating the function of in-depth examination in a dedicated office frees our regular examination teams to conduct their annual examinations of the enterprises without being forced to choose between continuing a comprehensive exam or devoting their resources and expertise to an in-depth follow up.

The Office of the Chief Accountant advises the Director and OFHEO staff on all accounting matters that concern the enterprises. The Office is responsible for developing OFHEO accounting policy; monitoring and participating in the development and evolution of generally accepted accounting practices and helping OFHEO offices responsible for examination, research or policy development understand and apply the often complex standards of modern accounting. The Office will also develop policy on safety and soundness issues related to accounting and financial reporting and accounting policies of the enterprises. The Office will coordinate the use of accounting resources within the agency to ensure the best and most efficient use of those resources.

As part of the restructuring of the agency, OFHEO has been aggressively hiring examiners and accountants, as well as necessary support and administrative personnel to support the enhanced program of examination and follow up that is being conducted as both enterprises. It is my belief that the increasingly complex nature of the businesses of the enterprises demands that OFHEO be fully staffed with the expertise necessary to carry out our responsibilities in a comprehensive manner. While OFHEO has made progress in FY 2004 in strengthening its supervision function, additional funding is required in 2005 to fully implement the kind of robust, proactive oversight that Congress expects.

Regulatory Agenda

In addition to the restructuring of the agency, OFHEO also continues to implement a regulatory infrastructure project designed to provide the agency with a framework of regulations and guidances for the comprehensive and consistent supervision of the enterprises. A major example of this is our recently proposed corporate governance regulation.

The lessons learned by OFHEO through the special examination process provided new insights as to the best practices for both Enterprises. As a result of the findings and the recommendations contained in the Report of Special Examination of Freddie Mac, as well as developments in law, supervision and industry standards, OFHEO is undertaking to amend its corporate governance regulation to enhance the minimum corporate governance standards applicable to Fannie Mae and Freddie Mac. Among the highlights of this proposal are: separation of the Chairman and CEO functions, requiring audit firm and audit partner rotation, limiting the term of service of board members, and requiring higher standards for board independence.

The comment period has closed on this regulation and OFHEO received 19 comments that we will consider in working to a final rule. While I cannot comment on final actions, the agency will carefully review the comments and will give them full weight in moving to a final rule.

That concludes my statement. I will be happy to take your questions.

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