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PROPOSALS FOR IMPROVING THE REGULATION OF
THE REGULATION OF THE HOUSING GOVERNMENT SPONSORED ENTERPRISES

S. HRG. 108–849

PROPOSALS FOR IMPROVING THE REGULATION OF THE HOUSING GOVERNMENT SPONSORED ENTERPRISES

HEARINGS

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED EIGHTH CONGRESS

FIRST AND SECOND SESSIONS

ON

ESSENTIAL ELEMENTS AND PROPOSALS OF REGULATORY REFORM, RESOLUTION OF ACCOUNTING ISSUES, AND FUNDING OF A NEW OVERSIGHT OFFICE

OCTOBER 16, 23, 2003, FEBRUARY 10, 24, AND 25, 2004

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

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Available at: http://www.access.gpo.gov/congress/senate/senate05sh.html

U.S. GOVERNMENT PRINTING OFFICE

21–980 PDF WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
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PROPOSALS FOR IMPROVING THE REGULATION OF THE HOUSING GOVERNMENT SPONSORED ENTERPRISES

THURSDAY, OCTOBER 16, 2003

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:12 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

I would first like to welcome Treasury Secretary Snow and HUD Secretary Martinez again to the Committee. They are no strangers here. It is a pleasure to have both of you back. That will be our first panel.

Our second panel of witnesses will be Franklin Raines, Chairman and Chief Executive Officer of Fannie Mae; George D. Gould, Director of Freddie Mac; and Norman Rice, President and CEO of the Federal Home Loan Bank of Seattle.

Today's hearing focuses upon a very important topic: improving the regulation of the housing Government Sponsored Enterprises, or GSE's, as they are commonly known.

The mission of the housing GSE's is one I strongly support. Federal Home Loan Bank advances are a vital link to the capital markets for financial institutions nationwide. The secondary mortgage market access that Fannie Mae and Freddie Mac provide also serves as an important source of liquidity for our Nation's mortgage market. By enhancing liquidity, the Enterprises make possible the lending activity that is critical to economic growth and to expanding homeownership.

The enterprises are large institutions. Collectively, Fannie Mae and Freddie Mac carry $1.6 trillion in assets on their balance sheets and have outstanding debt of almost $1.5 trillion. The Federal Home Loan Bank System is not far behind, with combined assets of over $780 billion and outstanding advances to member institutions of $495 billion.

Due to the importance of the housing GSEs' mission and the size of the assets, I believe that the Enterprises require a strong, credible regulator. I remain concerned that the current regulatory structure for the housing GSE's is neither strong nor credible.

In July, this Committee examined OFHEO's oversight of Fannie Mae and Freddie Mac and their accounting practices. I remain troubled by the fact that OFHEO never detected the complete breakdown in the accounting and audit function at Freddie Mac. While this breakdown did not directly implicate Freddie Mac's financial strength, I believe the integrity of financial data is a vital barometer of safety and soundness. The breakdown in internal controls that produced Freddie Mac's accounting mishap was a managerial failure that, if duplicated in a different function, could have had catastrophic implications. Sound corporate governance and management is a key element of safety and soundness.

In September, the Subcommittee on Financial Institutions held a hearing on the current oversight of the Federal Home Loan Bank System, and I want to commend Senator Bennett for his leadership and foresight in having that hearing. That hearing raised many questions regarding the current oversight of the Federal Home Loan Banks. I am hopeful that we will be able to expand upon some of those questions today.

Several Members of this Committee have put forth proposals to reform the regulation of the housing enterprises, and I want to recognize the efforts of Senators Hagel, Dole, Sununu, and Corzine in that regard. Your efforts have given this Committee a solid foundation upon which to build. I again want to thank all of the witnesses for appearing before the Committee today. We look forward to your testimony.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Mr. Chairman, thank you for convening this important hearing. We were originally scheduled to hear Secretary Snow on this very day with respect to the exchange rates and manipulation of currency to gain trade advantage. This is, of course, very much a pressing issue now, and the President goes to the Far East and will be meeting with officials in Japan and China. Of course, the subject of this hearing is an important issue as well, and I recognize that the Treasury has not yet come forth with its exchange rate report. I understand it will come by the end of the month and that you have rescheduled a hearing with Secretary Snow for October 30.

Chairman SHELBY. Absolutely, right here.

Senator SARBANES. And I look forward to that hearing and discussing that subject, in depth with the Secretary.

I take it we will have the report before that hearing, Mr. Secretary?

Secretary SNOW. Senator, I originally intended, to have the report with the testimony.

Senator SARBANES. All right. So we will have it before or at the hearing.

Secretary SNOW. Yes.

Chairman SHELBY. Will it be contemporaneous with the hearing?

Secretary SNOW. Contemporaneous with the hearing, right.

Chairman SHELBY. Okay.

Senator SARBANES. On today's subject, Mr. Chairman. The entities that we are examining—Fannie Mae, Freddie Mac, and the

Federal Home Loan Banks—together with the Federal Housing Administration, have made the American home finance system the deepest, most liquid, and most innovative system in the world.

These GSE's collect capital from around the globe to invest in mortgages for homeowners and rental properties here in America. They have helped to create the historically high homeownership rates we are currently enjoying in this country. About two-thirds of all Americans own their homes.

I might mention, since I see Secretary Martinez at the table, I heard the story on the radio this morning of your people in Florida. They own their home, but they do not own the land on which their home is located. These are these trailer homes in Florida.

Senator MARTINEZ. Yes, sir.

Senator SARBANES. Now they are going to redevelop high-cost condominiums. These people are being told they have to move their trailers, which they have not done in 25 years. Apparently they will just fall apart if they try to move them. You have a lot of elderly down there. It seems to me it is a problem HUD better look at. I hope you are doing that.

Mr. Chairman, you mentioned the size and complexity of the GSE's. I will not repeat those figures, but they obviously make the point. That, together with the central role they play in the smooth running of our mortgage markets, obviously means that we have a special responsibility in this Committee to ensure the public that the institutions are well-regulated, properly supervised, and thoroughly examined.

We are fortunate that at least thus far, as best we know, the problems at Freddie Mac appear to be governance and accounting problems rather than risk management problems. And the issues at the Federal Home Loan Banks, some of them, while serious, are still relatively small in nature. But it is appropriate that we look carefully at these issues.

I look forward to working with my colleagues to try to craft a piece of legislation that provides for strong safety and soundness with respect to the GSE's.

Finally, Mr. Chairman, let me say the Administration has requested an additional $7.5 million for OFHEO to conduct reviews of accounting practices at the Enterprises it regulates. I very strongly support that request, and I hope we will be able to work to make sure the appropriators include this additional funding in the fiscal year 2004 budget.

While we are deliberating on creating a new, more effective regulatory structure, I think we need to make certain that the current regulator is adequately funded in order to address the immediate situation which they confront. And I very much hope that that appropriation will make its way through the process and that the Administration's request will be positively addressed.

Thank you very much.

Chairman SHELBY. Senator Bennett.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman. I appreciate your holding these hearings. I think they are probably some of the more significant hearings we will hold this year, not because there is a crisis with respect to Fannie, Freddie, and the Federal Home Loan Banks in this area, but because we need to be alert to the possibility that a crisis might arise.

We have to recognize with some significant approval the job that Fannie and Freddie have done. The fact that some Federal Home Loan Banks want to get into that market more aggressively than they have been illustrates how important it is. Markets are working. They are working in ways that benefit Americans, and as Senator Sarbanes has indicated, Americans have a higher degree of homeownership than any other industrialized country. And the success of Fannie and Freddie is a large reason why that is the case.

But as they grow, people get nervous. As the numbers get into the trillions, even Congress begins to pay attention. And it is very appropriate that we air all of the issues as thoroughly as this hearing and other hearings will do, and that we look at the question of appropriate regulation in as careful a manner as we possibly can.

So, I congratulate you on holding the hearings. I look forward to the witnesses. I think it is a demonstration of the seriousness of the topic that we have two Cabinet officers as our first witnesses and three CEO's as our second panel of witnesses. This is not an issue that should be dealt with by the second team, and we are very glad that we are getting the first team here, both with this panel and the one that will follow. And I look forward to hearing what they have to say with great interest.

Chairman SHELBY. Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman. I appreciate the fact you are holding this very important hearing, and I welcome Secretary Martinez and Secretary Snow.

As we all know, the Government Sponsored Enterprises have played an invaluable role in stabilizing and improving the availability of funds to support homeownership in our country. This has resulted in the United States having one of the highest homeownership rates in the world, and strong and effective oversight of the GSE's is clearly an important part of their long-term success.

As we begin to delve into how to strengthen our GSE regulators, it is increasingly clear how complicated this task may be, especially if we decide to change the regulator for the Federal Home Loan Banks as well. It is my hope, Mr. Chairman, that you intend to hold several more hearings on this matter so that we can fully debate the many issues and hear from other stakeholders in the housing industry as well as housing experts on this matter. For example, proposals such as allowing the new regulator to set the minimum capital standard for the GSE's are worthy of their own hearing so that this Committee can better understand the ramifications of such a change in the housing market.

Needless to say, I look forward to this morning's testimony and hope it can help this Committee begin to decide what we can do to strengthen the regulation of our housing GSE's.

Thank you very much, Mr. Chairman.

Chairman SHELBY. I believe Senator Dole was here much earlier.

STATEMENT OF SENATOR ELIZABETH DOLE

Senator DOLE. Thank you, Mr. Chairman.

First of all, I would like to reiterate something we all believe in: Homeownership is a cornerstone in the foundation of the American Dream. Each of us here today is committed to ensuring that every American can one day own his or her own home. Homeownership creates wealth and improves our neighborhoods and communities to the greater benefit of us all.

It is for this reason that we committed to strengthening every step in the mortgage process. This past June, when the Freddie Mac board removed its three highest executives, we learned of violations of generally accepted accounting principles at the GSE in order to hide profits so as to minimize volatility in earnings. That is an unacceptable practice that must never happen again.

While the uncovering of this scandal will result in the eventual restatement of earnings for the past 3 years, I fear that the clear lack of oversight could result in a coverup of potential future losses. Changes should be made to prevent this.

During the last Congress, the Banking Committee passed the Sarbanes-Oxley corporate accountability law to ensure greater transparency of our Nation's corporations. It strikes me as ironic that the next scandal would occur at a Government Sponsored Enterprise.

Let me be clear: Fannie Mae and Freddie Mac serve very important roles in our mortgage finance system by providing liquidity in the market. They were given a charter that, in 2001, the Congressional Budget Office estimated to be worth a $10.6 billion annual subsidy. With these built-in advantages, Fannie Mae and Freddie Mac have been able to increase homeownership, especially for low-income and minority families. We all support this goal and will ensure that such efforts continue.

We must take steps to guard against the potential of any more scandals and to ensure that these organizations can continue their important mission. Because of the recent recognition that the current regulator lacks the tools and the mandate to adequately regulate these enterprises, I have introduced legislation with Senators Hagel and Sununu to create a world-class regulator in the Department of the Treasury. A consensus has formed in support of this initiative, and I strongly urge all of my colleagues to take a look at our legislation.

As we move forward on this issue, it must be remembered that the operations of these housing enterprises entail a certain degree of risk. Fannie and Freddie do a tremendous amount of hedging with derivatives, such as interest rate swaps. Together, they held more than $1 trillion worth of these interest rate swaps in 2002. A February OFHEO study concluded that not only might the GSEs' demand for hedges outstrip supply in the near future, but also that a financial problem at one GSE could quickly spread to counterparties.

Clearly, this is not a situation we can afford to ignore, and we certainly cannot make only half an effort. I want to thank Chairman Shelby for scheduling this hearing and, in doing so, making this issue a priority. I look forward to working with my colleagues as we seek to properly address the need for a well-funded, well-equipped, world-class regulator for Fannie Mae and Freddie Mac.

Finally, let me thank Secretaries Snow and Martinez for coming here today to discuss this issue. We thank you both for your time, your dedicated service, and for your interest in working with us on this issue of such importance to all Americans.

Thank you.

Chairman SHELBY. Senator Corzine.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman. I appreciate your holding this hearing, and I welcome the witnesses. I would concur with the view that it obviously speaks to the importance of this issue that we have the leaders of the appropriate organizations to be here, both in this panel and the next. GSE's play an essential role, in my view, in aiding our economy and aiding one of those parts of our economy that has been a bright spot not only in recent years but also for a very extended period of time as our economy has been the strongest in the world over a period of history. Homeownership is a cornerstone of the American Dream, as Senator Dole mentioned, and that is both for individuals and our communities. And the size and the complex nature of the structures of the GSE's—and they truly are complex within any kind of context of one looking at a financial institution—account for billions of dollars of mortgage finance dollars. And the critical role they play in our housing market does require the oversight by a credible, capable regulator that is up to the job of providing rigorous oversight.

In my mind, the current system of supervision has failed to meet those standards, and I think the ongoing accounting issues at Freddie Mac and those that are now appearing at some of the Federal Home Loan Banks attest to that.

To that end, I introduced legislation several weeks ago that I believe evolves the regulatory structure in a way that meets the problem without undermining the successful role that the GSE's play specifically in the housing market and for our economy in general. There are really four key elements to this legislation I proposed, actually common with a number of the other discussions that others have put forward: Establish a new, independent regulator that is credible and capable; assuring safe and sound capital; promoting transparency through enhanced disclosures; and taking an incremental approach as opposed to a one-shot approach to consolidating the supervision of the Federal Home Loan Bank System under the regulatory framework contained in the bill.

I do believe we have to be careful here that we do not tinker with a system that has actually produced an enormous capacity to promote homeownership in this Nation. I think it has been absolutely key to that effort. And I understand that there are others that have proposals. I look forward to working with all on the Committee and certainly you, Mr. Chairman, and the Ranking Member. Doing this right is more important than doing it immediately. I concur with Senator Bennett that while there are serious problems and ones that we need to address, I do not think we are dealing with a crisis here. It is one that I think needs to be addressed in a way that makes certain that our markets continue to have the breadth and depth that these two institutions and actually the Federal Home Loan Banks have helped fund.

I will leave the balance of my statement for the record, but I have tried to be detailed about the nature of the proposal that I have laid down. Hopefully, we will all have continuing discussions on this, and I am sure we will.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

Senator Enzi.

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Thank you, Mr. Chairman. I appreciate your holding this hearing and the Secretaries for being here for it.

The past decade has brought tremendous change to the housing industry. The increase of homeownership for families has been one of the great success stories of our economy. In Wyoming, the housing market presents many difficulties. Rural housing needs are ever increasing, affordable housing in atypical places like Jackson are in great demand, and the unique challenges of home lending to our Native American tribes are but a few of the issues that Wyomingites face.

In Wyoming, the Government Sponsored Enterprises have greatly helped to pull together the necessary financing and community backing to make homeownership in these challenging environments possible. Fannie Mae, Freddie Mac, and the Federal Home Loan Bank of Seattle have worked closely with nearly 50 community banks in the State to find creative solutions that are essential in helping families achieve the American Dream.

While the Government Sponsored Enterprises have facilitated and expanded the homebuying opportunities for families, the Enterprises, overall, engage in very complex and intricate financial transactions. At this time, the financial stability of the housing enterprises does not appear to be in jeopardy. However, I believe the regulators of the Enterprises should have the tools and resources necessary to oversee the complex financial transactions.

In early August, I sent a letter to Secretary Snow, together with Senators Bennett, Johnson, and Schumer, supporting the move of the financial oversight responsibilities of the Office of the Federal Housing Enterprise Oversight, OFHEO, to the Department of the Treasury, providing that the new regulator was sufficiently financed. I still support that move.

Since that time, the issues surrounding the move of the regulator have become more complex. Recently, there have been calls to add the regulator of the Federal Home Loan Bank System to the proposed regulator. While I believe that the Federal Finance Housing Board needs to improve its financial oversight over the Federal Home Loan Banks, I also believe that bringing the two regulators together just because they regulate Government-sponsored entities is shortsighted.

Fannie Mae and Freddie Mac operate quite differently than the Federal Home Loan Banks. Any proposal to bring the regulators together must recognize their unique differences and must place sufficient firewalls to keep the regulatory oversight of the two systems separate. I strongly encourage that we review this matter more thoroughly before rushing to a judgment.

Again, I thank you for being with us today, and I would also like to thank the distinguished second panel for being with us as well. I look forward to their testimony.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Schumer.

STATEMENT OF SENATOR CHARLES E. SCHUMER

Senator SCHUMER. Thank you, Mr. Chairman. I appreciate the opportunity to say something here. I will be brief and ask unanimous consent that my opening statement be put in the record.

Chairman SHELBY. Without objection, your opening statement will be made part of the record.

Senator SCHUMER. Thank you. And I want to thank the Secretary for being here as well.

I would just make one point here. What is vital to me here is that Fannie and Freddie be able to continue in their mission to perform—to fill in niches in the market that the private sector may not be able to fill in or it takes 10 years to fill in afterwards.

I have found in my State, when we have particular problems in suburban areas, for instance, where costs have gone way up and policemen, firemen, and teachers cannot afford a home, Fannie and Freddie have been the only group to devise policies, working with banks, that will fill in those gaps and make it easier for those people to live there rather than commute 100 miles away. Or in our inner city, we have some poor people who have—these are Hassidic Jews who have 10 or 12 children and are very poor. And they continue to live in the city. It is very hard for them to make out.

Again, Fannie and Freddie have filled in the lurch. If we go to a strictly actuarial standard here, I think we will lose those things. And so I am deeply concerned, Mr. Secretary, that while I have no problem giving Treasury an oversight responsibility in terms of safety and soundness—and I want to make sure that capital requirements—which, as you may know, I have been very much involved with when we wrote the old S&L law as a way to strengthen the S&L industry—are strong. I would feel very strongly—I would fight very strongly against the mission parts of Freddie and Fannie, the approval of new products going to Treasury, which has a more actuarial point of view, than to HUD—and I love both of you dearly; this has nothing to do with either of you—than to HUD, which cares about the housing mission. And that will guide much of what I do.

I think you can have both. You do not have to throw out the baby with the bath water. You can tighten up the actuarial oversight of Fannie and Freddie, given their importance, and still maintain the vigor of their mission. And having the actuarial part in Treasury and the mission part in HUD makes a great deal of sense to me.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Hagel.

STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you. And welcome to our panelists this morning. It is always helpful and a pleasure to see the Secretaries of Treasury and HUD with us. And we also appreciate the second panel, President Rice, Director Gould, and Chairman Raines. We look forward to their testimony.

As we discuss significant changes to the supervision of Fannie Mae, Freddie Mac, and perhaps to Federal Home Loan Banks, I think it is important to reflect on why we are here. What is our central purpose in the reform we are considering? Confidence.

Confidence in the regulation of Fannie Mae and Freddie Mac is critical for the future. The accounting and management problems discovered at Freddie Mac earlier this year shed light on a problem that some of us have been concerned about for some time. We must do a more responsible job of regulating Fannie Mae and Freddie Mac, we owe it to the residential mortgage market, we owe it to the investors, and we owe it to the American taxpayer.

Congress created Fannie and Freddie and provided them with an implied Government backing. Congress must, therefore, provide a world-class regulator. Our goal here is to create a strong, independent regulator with the tools necessary to effectively examine two of the world's largest financial institutions and the expertise to minimize the risk to investors and the public.

In introducing the Federal Enterprise Regulatory Reform Act, S. 1508, Senators Sununu, Dole, and I offered one model, a beginning for an effective new regulator. And I want to highlight two principles contained in our bill, and the Administration's proposal, which are, in my opinion, essential to a credible regulator for Fannie and Freddie.

First, the new regulator at the Treasury Department must have the authority to approve new programs and ensure Fannie and Freddie continue to focus on their core missions as defined and established by the Congress of the United States. I agree with Secretary Martinez that HUD should focus its energies on setting and enforcing meaningful, affordable housing goals for Fannie and Freddie. Treasury needs the authority to approve the new programs.

Second, an effective regulator must have broad authority over capital standards and the ability to adjust them as appropriate to balance risk and ensure safety and soundness. I am not advocating for immediately increasing the amount of capital that Fannie and Freddie must hold, but I strongly favor giving the new regulator the ability to do so when it believes it is appropriate.

Some have recently asserted that too much attention on safety and soundness will undermine Fannie and Freddie's ability to play a leading role in affordable housing. I believe just the opposite to be true. The more soundly these companies are capitalized, the stronger they will be perceived in the marketplace. Higher confidence by investors leads to lower interest rates for homebuyers. Mr. Chairman, to be effective, a world-class regulator needs these two components.

Finally, I want to comment on another important aspect of the reform we are considering, that is, the inclusion of the Federal Home Loan Bank System under the same new regulator that we construct for Fannie and Freddie. While I am not opposed to including the Federal Home Loan Banks, they differ significantly, greatly, as Senator Enzi has just mentioned, from Fannie and

Freddie. And these differences must be addressed and factored into any new regulatory reform we consider. Unlike Fannie and Freddie, the banks are cooperatives, owned by member institutions in their assigned States. They are locally controlled and sensitive to the unique and varied financial needs of local communities and issue their debt securities through a central Office of Finance, which is operated by the 12 Banks collectively.

While a consensus seems to be forming around inclusion of the Federal Home Loan Banks, that does not mean we have to do it right away or in the same bill as Fannie and Freddie. This is an option. It surely is an option. As with all reform, it is more important that we do it right than we do it quickly.

Again, Mr. Chairman, I appreciate your holding the hearing, and I also look forward to our witnesses and working with them through this process. Thank you.

Chairman SHELBY. Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman. I will be brief. I know we want to get to the witnesses.

I share the concern that has been raised by, I think, all of my colleagues with regard to the failure of OFHEO to pick up on the problems that have come to light recently and the impetus for this hearing. I appreciate the Chairman holding this hearing and the important issues that we are dealing with. I will just make a couple of brief comments on a couple of the issues that have already been raised.

First, I am very interested in the proposal to include the Federal Home Loan Banks in the regulatory system that we are considering establishing. I recognize the differences that exist and I am very concerned that as we approach this matter, we recognize those differences and assure that whatever we establish does not overlook the fact that very different approaches need to be taken with regard to the regulation and oversight of the Federal Home Loan Banks vis-á-vis Fannie and Freddie.

That having been said, I can also see some very significant benefits of having them both housed at Treasury and having a system where an independent regulator oversees the operations of both, because although there are major differences, there are also increasing numbers of similarities in the types of activities and objectives that both are seeking to address. And I am looking forward today very closely to listening to the testimony on that issue.

Second, with regard to the question of where the authority over missions and programs of the GSE's should be housed, I tend to see the validity, as several of my colleagues, most recently just Senator Hagel, have indicated, that the authority over the new programs, the new missions, needs to be with the financial regulator in Treasury. I will listen very carefully to testimony and points brought up on both sides of that issue, but it seems to me that we need to be certain that the regulatory system we put into place is one in which there is fairness, there is that balanced playing field that we always talk about in different contexts as we have different types of entities being regulated in the same arena, and that we make certain that the scope of regulatory authority is sufficient for effective regulation and oversight to be accomplished.

With that, Mr. Chairman, I will withhold the rest of my comments and concerns until a later time. Thank you.

Chairman SHELBY. Thank you.

Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman.

To Secretary Snow, Secretary Martinez, welcome. It is good to see you both. We thank you for your presence here and for your stewardship, your responsibilities.

Before I talk just a little bit about some areas where I think there seems to be general consensus, and maybe a couple of areas where there is not, let me just say that some of you may recall hearing the old adage, "If it ain't broke, do not fix it." I have said that once or twice. Maybe some of you have as well. "If it ain't broke, do not fix it." I think what applies here, instead of that approach, is an approach that says, "If it is not perfect, make it better."

We have a wonderful ability in this country to generate capital and provide that capital for housing, and it is not broken. It is not perfect, and we can make it better, and my hope is that we will.

The problems that led to the passage of the Sarbanes-Oxley legislation are in many cases created when companies understated expenses and they overstated revenues. And they were deceitful about it. There was not enough disclosure or transparency. They got into trouble and, frankly, created a lot of problems for our country and led to the passage of the legislation.

This is not that kind of situation. The problem they had at Freddie Mac was a problem, for the most part, where they were not overstating revenues, but where they actually were understating revenues, and in some cases overstating expenses. Quite a different problem. I guess if you are going to have a problem, that is the better problem to have. But it is not right. It is not the right thing to do.

I want to mention three or four areas where I think there is general consensus for us to go forward, and one of those is the idea that we need to create an independent, strong regulator, and there seems to be consensus that it should be in Treasury. Second is that the regulator should not be subject to the annual appropriations process. A third area of general consensus, it seems at least to me, is that affordable housing goals should remain the purview of HUD. And, finally, the housing mission of the GSE's should not be changed. Not everybody agrees with those, but I think for the most part there is consensus around those points.

There are a number of areas where there is not a consensus. I will mention maybe three. One is the ability of the new regulator to set minimum capital standards. Second would be the location of program approval authority and the standard for those new programs. And last is the inclusion or whether or not we should include within this new regulatory scheme Federal Home Loan Banks in any kind of approach or the way we change business.

My hope, Mr. Chairman and colleagues, is that what is going to flow from these hearings, this hearing today and maybe those that follow it, is that some of the items—if you put two columns together where there is general consensus and areas where there is not consensus, we will be able to move maybe by the end of the day some of those items under lack of consensus, maybe move a couple of those over to the column where there is consensus. And if we can do that with a few of those today, we will have done good work.

Thank you.

Chairman SHELBY. Senator Sununu.

STATEMENT OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you very much, Mr. Chairman.

What is the saying? "Everything has been said, but not everyone has had a chance to say it." But I will do my best to make a couple of additional observations that I do think are important as we begin this hearing.

As Senator Bennett said, we are here because we must be alert that a crisis might arise. We are trying to be proactive. We are trying to do the right thing in dealing with this important regulatory issue for the GSE's.

We have heard about some significant accounting issues, cases where in the Federal Home Loan Banks we have had portfolio losses. And I happen to believe that misleading investors is always wrong. I do not care whether you understate profits or overstate profits or intentionally suggest that things are not as good as they really are. That is always wrong. And the credibility and reliability of our capital markets depend on effective regulation to ensure confidence.

Let us all agree that the affordable housing issues that HUD has traditionally dealt with are very important, and the role that the GSE's might play in affordable housing is important. And those are issues that we will probably want to continue to deal with regardless of the final dispensation of this legislation. But let us also understand that the record has shown that the GSE's have actually lagged the markets in meeting affordable housing targets and goals. And I would ask unanimous consent that I be allowed to submit the documentation, studies, evaluations put together by HUD to that effect.

Chairman SHELBY. Without objection.

[The information follows:]

Senator SUNUNU. That does not mean that they have not done important work in affordable housing, but it means that if we try to look at it objectively and on a statistical level, they have not always provided the kind of leadership that we might expect from a Government-chartered institution.

This is about safety and soundness of the GSE's and ultimately the credibility and strength in our capital markets. It is about having an effective regulator. And I very much appreciate the work and the discussion and dialogue that has already taken place, the legislation submitted by Senator Corzine, the discussions that I have had with other Members of this Committee that have not necessarily signed on to legislation but are approaching this in, I think, a very, very thoughtful way.

We have to be careful of a couple things: One, that we not allow politics to prevent us from doing the right thing for the GSE's themselves, for the taxpayers, and for the housing markets; and, second, that we not just accept a bill because we want to check it off our list and say we passed legislation dealing with the GSE regulation issue and now we can get on to something else.

No bill would be far better than a poorly written bill. I believe this very strongly. If we pass legislation that is all form and no substance, we will be doing a disservice to the consumers, a disservice to investors, a disservice to taxpayers, and I think ultimately a disservice to the GSE's themselves, Fannie, Freddie, the Federal Home Loan Banks, because the employees at those important and fine institutions, their leadership, and their management want to operate in an environment of credibility, confidence, and certainty, just like any other participant in the private sector of the capital markets.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Stabenow.

COMMENTS OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you, Mr. Chairman. I would ask that my statement be included in the record.

Chairman SHELBY. Your statement will be made part of the record.

Senator STABENOW. Thank you. I would like to offer a slightly different view than my colleague who just spoke in that, first of all, I think the secondary mortgage market is essential to our housing sector and that, in fact, there has been great success, and I welcome the opportunity to in the future submit for the record evidence as to why these very important GSE's have been so significant in terms of providing housing opportunities to people.

We know that there is a growing interest in strengthening our housing finance regulators. I share that. We need a highly respected independent regulator for Fannie Mae and Freddie Mac, and that the Federal Home Loan Bank, of course, needs to be soundly regulated. But I appreciate the Chairman's comments at hearings in the past in terms of moving forward in a thoughtful manner, as the Chairman and the Ranking Member have done on other issues. And I am hopeful that we will move forward in a thoughtful manner and address what are legitimate concerns without, as they say, throwing the baby out with the bath water, because I believe that we have had many great successes for the American people through the systems that have been in place and providing housing which is so critical to all of us.

I welcome the Secretaries to be with us today as well. I look forward to your testimony.

Chairman SHELBY. Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman, for holding this very important meeting. I would also like to thank all of our witnesses for testifying today.

Everyone on this Committee was very troubled at what happened at Freddie Mac. Most troubling for me was the fact that OFHEO had no idea, until Freddie brought it to their attention, what was going on there. No idea.

While I am happy that Freddie was able to self-police, I was astonished by OFHEO's attitude which seemed to come down to say, yes, we need more money, but the system worked. OFHEO's testimony reminded me of Kevin Bacon's character in "Animal House," standing on the corner shouting, "Remain calm. All is well," right before he is run over by the mob.

[Laughter.]

I am certainly happy that we have all come to the conclusion that Freddie and Fannie need to have a new regulator. But there are many pitfalls ahead of us. Nobody here wants to do anything that would harm our housing market, and this new regulatory structure could harm it if we do not do it right.

We should not simply rearrange the deck chairs on the Titanic. We should not simply move OFHEO into Treasury and let it run the same way. But we also must remember who is affected by what we are doing.

We have few large banks in Kentucky—few. We do not have the guys who compete with Fannie and Freddie. We have the guys who work with them. They use GSE products to make loans to underserved areas so they can bring the dream of homeownership to those who otherwise would not be able to afford it.

They also use GSE products for CRA compliance. They are scared to death that this will be harmed by this legislation. I want to make sure that they are not.

I have just one other major concern. On September 9 of this year, Assistant Secretary Abernathy was up here. I asked him if all GSE's, including the TVA, should have to register with the SEC. He said, "That is our position, yes." I have the videotape if you would like to see it.

I understand that someone above his pay grade, which I assume is you, Secretary Snow, has said that TVA is not a GSE, and so that the statement did not apply. This is very troubling to me. If TVA, which was established by the Federal Government, runs itself as a quasi-public enterprise and is not a GSE, what is it? If the TVA is not Government-sponsored, who sponsors it? If it is not an enterprise, what is it?

Also help me comprehend why the Administration wants the Federal Home Loan Banks, which have a regulator and who do not sell public stock, to register with the SEC, while at the same time it does not call on TVA, which has over $26 billion in public traded debt and no regulator, to register with the SEC. I cannot comprehend the Administration's position on this.

I do look forward to further discussions on this question very shortly, since I will have a chance to question you in the question and answer period. I want to thank you for coming. We deeply appreciate your appearance here.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. First of all, Mr. Chairman, I would like to thank you for holding this hearing.

I would like to borrow a cliché from the medical community, and that is, “An ounce of prevention is worth a pound of cure.” And I think that my colleagues Senator Hagel as well as Senator Sununu hit upon the keyword, which is “confidence.” We simply must have confidence in the secondary markets as well as the GSE’s. The GSE’s themselves will benefit with confidence. The investors will benefit with confidence. With good confidence, the users benefit. Homeowners certainly are beneficiaries as well as the taxpayers.

So, I am delighted that we are having this hearing. Fannie Mae and Freddie Mac were chartered by Congress as Government Sponsored Enterprises to create a secondary mortgage market which has served us well. It is one of the things that has separated us from other parts of the world who are struggling with housing. We have housing now at an all-time high, and a lot of it is due to the fact that we have a very viable secondary mortgage market.

Although they are private companies owned by shareholders, the GSE’s retain certain Government ties. For example, they have access to a line of credit at the Treasury Department and are exempted from paying State and local income taxes. In exchange for these benefits, they are required to serve all markets and must meet certain affordable housing goals. Since their creation Fannie Mae and Freddie Mac have been an important source of homeownership for all Americans.

Over the years, the GSE’s have evolved into very large, very complex financial institutions. Because of their size, complexity, and importance to the financial markets, they demand the highest levels of oversight and scrutiny. Currently, the Office of Federal Housing Enterprise Oversight, referred to as OFHEO, is charged with ensuring the financial safety and soundness of the GSE’s. But recent events have clearly demonstrated that OFHEO as currently structured is insufficient as a regulator. This causes me great concern due to the implications of homeownership, the markets, and because of the belief and implied Government backing of the GSE’s.

Accordingly, the Bush Administration proposed creating a new regulator for the housing GSE’s. The new regulator would be an independent agency with the Department of the Treasury, similar to other Federal financial regulators, such as the Office of the Comptroller of the Currency and the Office of Thrift Supervision. I strongly support creation of a new regulator within the Treasury Department because they have better financial expertise to oversee the complex financial transactions in which the GSE’s engage.

In order to be an effective regulator, the new agency must have a broad set of powers comparable to other financial regulators, including additional enforcement powers and litigation authority. I also believe the regulator must have the ability to set capital standards for the GSE’s. While we have found many areas of agreement, there are still many issues to be resolved, including mission regulation and inclusion of Federal Home Loan Banks. While I believe that we should move quickly in this debate, we must do so with care and deliberation. We must ensure any changes strengthen oversight of the GSE’s and work to promote access to housing.

I would like to welcome our witnesses today, particularly Secretary Snow and Secretary Martinez. I know this Committee will work closely with you as we continue to address the GSE reform.

Thank you for being with us here today, and I look forward to your testimony.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Chafee.

COMMENT OF SENATOR LINCOLN D. CHAFEE

Senator CHAFEE. I just want to thank you, Mr. Chairman for holding this important hearing.

Chairman SHELBY. Mr. Secretary, both of you, Secretaries Snow and Martinez, we welcome you again to the Committee. Your written testimony will be made part of the record in its entirety.

Secretary Snow, you may proceed as you wish.

STATEMENT OF JOHN W. SNOW SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary SNOW. Thank you very much, Mr. Chairman, Ranking Member Sarbanes, and Members of the Committee. I greatly appreciate the opportunity to appear before you today with Secretary Martinez—can you hear me, Senator?

Chairman SHELBY. Bring it up closer to you.

Secretary SNOW. I greatly appreciate the opportunity to appear today before you with Secretary Martinez to address what is really a vitally important subject, a subject that raises complex and important issues and a subject that touches on something that has been mentioned in all of your statements a subject that is critically important, and that is homeownership in America. It is an important building block of individual financial security. It is also a building block for strong communities, as has been mentioned. So promoting housing opportunities, particularly for lower-income people, is a critically important national objective.

Our national system of housing finance, as has been pointed out as well, plays a critical role in doing that. So we need a strong, resilient housing finance system. And to have that strong, resilient housing finance system, you need a regulator with credibility. A strong, credible regulator contributes importantly to having a strong, resilient housing finance market, which in turn promotes housing opportunities.

But we have in the GSE's entities which are very large not just in terms of housing finance, but are very large in terms of the total U.S. financial system. And that is where we run into the fundamental issue we have to keep our eye on throughout these discussions. And it goes to the issue that Senator Hagel mentioned, that Senator Sununu mentioned, that others mentioned, of the so-called implied governmental guarantee. And that implied governmental guarantee can complicate the performance of the entire financial system of the United States.

We need a world-class regulator to watch that issue, to watch the soundness and safety of housing finance and the relationship of housing finance to the resiliency of our financial markets.

As Senator Allard said—and this is the situation we are dealing with here—an ounce of prevention. We do not face, in my view, any current crisis, but we never want to get close to the point where we would face that problem.

The best insurance against ever getting there, at the same time the best insurance of having a strong, resilient finance market which promotes strong homeownership, is a sound regulator.

In my extended testimony, I laid out what I think are the elements of a strong regulator. Some of you have mentioned them. Senator Hagel mentioned them. First, a sound regulator, in the context that I am talking about, a strong regulator who is focused both on soundness and safety of housing, but in the context of the soundness and resilience of the entire financial system, that regulator has to have a say on new products and new lines of business. Any strong financial regulator has that. Nowhere in the world is there a strong financial regulator who does not have an important say on the lines of business of the entities that it regulates.

Second, that strong, effective regulator has to have an important say on capital standards, and it has to have the ability to adjust the capital standards to whatever the circumstances are that dictate a change in those standards. A good regulator has flexibility. A good regulator responds to the circumstances that that regulator finds call for action. And so a second element here would be flexible control over capital standards.

Third, I think the regulator needs to have appropriate wind-down authorities; that is, if for some reason one of these entities got into difficulty, just like any other private sector entity, there needs to be the ability to pay the creditors. Wind-down authority, but wind-down authority recognizing that you, the Congress, have chartered these entities.

Fourth, I would suggest that the proposal would be stronger and better if it did include the Federal Home Loan Banks. They, too, are part of this very large housing finance market. They, too, have implications for the resiliency and soundness of our entire financial system. They are engaged in activities that are very similar to those of the other housing GSE's. There are some important differences. They would need to be recognized in the legislation. I would acknowledge that. But I think if we are going to deal with this issue really effectively, we should also look at including the Federal Home Loan Banks.

Finally, there is the question: Where should this new, strong regulator be? Our focus is with the strong regulator rather than its venue, and I have said in the House that if the Congress, if the Senate Banking Committee wants to consider Treasury, we are happy to have that discussion. But only if—and I need to be really clear on this because of the enormous problems that can develop otherwise for the financial system in the United States—only if the Treasury adds some value and avoids the implication that the implied guarantee is being reinforced, because in that lies real trouble.

So we would say if the Congress, if the Banking Committee wishes to consider Treasury, we would suggest you only do so if you put Treasury in a position to have some real say with the new regulator, a real say so that if there is confusion about this entity's being in Treasury and thus creating a larger governmental hug, a reinforced implied guarantee, we can disabuse the markets of that impression.

Now, how do we do that? We would say that Treasury should have a say on new regulations. It should have a say on testimony. And it should have a say on budget.

But let me conclude simply by saying the important issue here is a strong regulator. There were suggestions to have that strong regulator be an independent body. Wherever you go on that path, I would suggest the important thing is to make sure the new regulator really has credibility, really can do the job, really has the tools that all world-class financial regulators have, a say over new products, a say over capital standards, and a clear say over wind-down authority.

I thank you very much.

Chairman SHELBY. Secretary Martinez.

STATEMENT OF MEL MARTINEZ SECRETARY U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Secretary MARTINEZ. Mr. Chairman, thank you very much. Ranking Member Sarbanes and distinguished Members of the Committee, it is a pleasure to be here today, with my colleague Secretary Snow, to talk about this important set of proposals of regulations for the Government Sponsored Enterprises.

Before proceeding to talk about that, I want to just take a brief moment to thank the Committee for your support yesterday of the American Dream Downpayment Initiative. The President and I were in Dinuba, California, yesterday talking about homeownership and the importance of downpayment assistance, and your move yesterday on that legislation is an important step in that direction of creating homeownership opportunities for more American families. So we thank the leadership of the Committee and all of the Committee Members for your support.

We believe that Congress, at this point in time, has not only an opportunity, but also really an obligation to move forward in this area of reform of the regulatory oversight of the GSE's. Fannie Mae and Freddie Mac have a vital public role to play in providing homeownership opportunities to low- and moderate-income families. The fact that we are a Nation of homeowners reflects the beneficial impact of the role these companies were created to perform, has on American life. The Bush Administration is committed to creating opportunities for homeownership in America, and that is why we believe it is important that these companies fulfill their mission. The best way to ensure that they do so is through real and lasting reform that enhances their financial regulation, while preserving and expanding their commitment to affordable housing.

The Administration is committed to a society where every individual has the opportunity to gain the independence and dignity that comes from homeownership. This commitment is embodied in the President's budget proposals which have consistently increased funding for successful initiatives, like the HOME Investment Partnership Program, housing counseling, and the Self-Help Homeownership Program. The commitment is embodied in the President's challenge to the housing industry to join with us in creating

5.5 million new minority homeowners by the end of the decade. It is embodied in the Blueprint for the American Dream Partnership, through which HUD has brought together the private, public sector and not-for-profit and the Government agencies to meet the President's challenges.

Fannie Mae and Freddie Mac are founding members of the Blueprint Partnership, and we appreciate their pledge to invest billions of dollars to lift more families into homeownership.

The Administration's commitment to homeownership opportunities is not confined to our activities at HUD. It begins with the President and stretches across the whole of the Federal Government, and our proposal today reaffirms that commitment.

Our reform proposal is consistent with this Administration's commitment to do everything necessary to foster a healthy and vibrant housing industry, which today accounts for roughly 14 percent of the Nation's gross domestic product. The potential impact of Fannie Mae and Freddie Mac upon the economy and housing programs makes it critical that we ensure their safety and their soundness.

To be effective, a regulator charged with overseeing prudential operations, including safety and soundness, needs the proper tools to do its job. Currently, safety and soundness regulation is divided with new program approval authority being at HUD and financial oversight of the Office of Federal Enterprise Oversight. It is clear to us that both elements of safety and soundness regulation need to be consolidated in a single regulator. Splitting this regulation between two regulators weakens each one.

The decision of whether to approve or deny any new activity is based partly on its effect on the prudence of a company's operations. It makes little sense to have one entity deciding whether or not to approve a new activity while another determines whether that activity meets the prudential operation test.

New activities oftentimes directly impact the housing and mortgage markets, and for that reason, the Administration believes that HUD should retain a consultative role. Other new activities do not involve housing or mortgage market issues and are therefore most appropriately addressed by a strengthened regulator. As part of its consultative role, HUD will provide the benefit of its regulatory experience in such issues, and I do not see establishing a new and stronger regulator, potentially at the Treasury Department, as something that will harm the housing market. I see the opposite result: A strengthened housing finance system continuing to provide homeownership opportunities for all Americans.

We are not proposing to alter the Congressional charter of Fannie Mae and Freddie Mac, nor do we have any intention of stifling innovation in the marketplace. Just as other financial institutions are subject to new activity approval, yet have been leaders in mortgage innovation, so too can Fannie Mae and Freddie Mac thrive under the Administration's proposal. Any new business activity that Fannie Mae and Freddie Mac wish to undertake will be reviewed with respect to consistency with the charter act, with respect to whether it is in the public interest and with respect to safety and soundness. The Federal Housing Enterprise Financial Safety and Soundness Act recognizes the need to take all of these concerns into account in the review process.

While prudential operations, regulation, including safety and soundness regulation, should be exercised by a single, independent regulator, the Administration strongly supports retaining and enhancing the housing goals at HUD.

Congress established Fannie Mae and Freddie Mac to provide market liquidity and to facilitate the financing of affordable housing for low- and moderate-income families. Congress also mandated that the HUD Secretary set housing goals to ensure that those needs are met.

The affordable housing goals require Fannie Mae and Freddie Mac to focus on individuals in those communities most in need. This includes very low-income families and low-income families in low-income areas, low- and moderate-income families and underserved areas, such as central cities and rural areas.

Today, the low- and moderate-income housing goal requires that at least half of all Fannie Mae and Freddie Mac mortgage purchases benefit families in this income bracket. As the President's budget noted in February, numerous HUD studies and independent analyses have shown that the GSE's have historically lagged the primary market, instead of led it, with respect to funding mortgage loans for low-income and minority homebuyers. The GSE's have also accounted for a relatively small share of the first-time minority homebuyers.

The national home purchase goal we have proposed is a tool to specifically promote affordable homeownership. As the Members know, low interest rates in recent years have led to a boom in refinancings. Although Fannie Mae and Freddie Mac provide liquidity in refinancing, the share of funding they provide for home purchases declines during years in which refinancings are high. Our intent is not to saddle Fannie Mae and Freddie Mac with a series of stifling mandates as the opponents of reform have suggested, but to ensure, through a national home purchase goal, that they do not overlook those to whom they owe their primary devotion. This goal will certainly not unduly limit the ability of Fannie Mae and Freddie Mac to serve the refinance market or the multifamily market.

Allow me to also clarify this proposal for a new goal, as some confusion has arisen over it. HUD is not asking for the authority to set overall home purchase levels for Fannie Mae and Freddie Mac, but instead is asking for the authority to ensure that the home purchase activity that takes place be equitably distributed among central cities and rural ares, low- and moderate-income families, special affordable homebuyers, and first-time homebuyers, just as HUD does for the existing housing goals. That is why HUD has asked for the authority to establish home purchase subgoals corresponding to these four categories, similar to the subgoal authority it presently has under the three existing goals. HUD is not asking for the authority to set home purchase subgoals in individual metropolitan and regional markets. HUD seeks only to set national subgoals so that Fannie Mae and Freddie Mac's home purchase efforts are fairly spread among these four categories. HUD also asks that these subgoals be enforceable.

HUD is the appropriate agency to develop and enforce the housing goals. Institutionally, our mission is devoted to furthering the goals of affordable housing and homeownership, and HUD has the most expertise of any Federal agency in this area. Furthermore, the housing industry looks to HUD as the agency in which this authority should reside.

In the Administration's proposal, HUD will not only retain authority to set meaningful housing goals, but will also be better equipped to ensure that Fannie Mae and Freddie Mac meet them. There will be sufficient funding, more accountability for Fannie Mae and Freddie Mac, and strengthened housing goals.

One of the ways in which the Administration proposal has proposed strengthening HUD's housing goal authority is by creating a new GSE Housing Office within HUD, funded by the GSE's, to establish, maintain, and enforce housing goals. We also need to improve the Secretary's enforcement authorities with respect to these goals and have proposed doing so.

It is also very important, Mr. Chairman, that fair housing requirements and enforcement that pertain to Fannie and Freddie remain at HUD, given HUD's expertise in fighting housing discrimination. HUD will have full enforcement power for those authorities in the same way it enforces the Fair Housing Act.

A strengthened regulator is in everyone's best interests, and we strongly encourage it. The importance of Fannie and Freddie in the housing financial system is undeniable, and real reform is necessary to ensure the public of the ability of the two companies to make low-cost mortgage financing available to low- and moderate-income families.

We look forward to working with the Committee as we develop a set of new proposals to have a strong regulator for these very important institutions.

Chairman SHELBY. Mr. Secretary, thank you.

Secretary Snow, assuming that the new GSE regulator were placed within the Treasury Department, in terms of independence, should the new regulator differ from the OCC or OTS model? And, if so, why?

Secretary SNOW. Mr. Chairman, I think there should be some differences.

Chairman SHELBY. Why?

Secretary SNOW. Basically, because the OCC regulates 2,000 national banks and has little risk of what the economists and political scientists call regulatory capture. The size of few of these entities approaches the size of the two large GSE's.

Chairman SHELBY. But in aggregate, they are larger, are they not?

Secretary SNOW. And——

Chairman SHELBY. Wait a minute.

Secretary SNOW. Well, in the aggregate, but there are far more than one or two banks. But the more important point is they are not issuing debt that is treated as agency debt that has a perception of some Government guarantee.

Now, we do not believe there is any Government guarantee, and we go out of our way to say there is not a Government guarantee, but yet the market has a perception. I think it is terribly important that if the entity is in Treasury, the Treasury Department be in a position to continuously avoid the confusion, as Treasury is issuing its own debt, that Treasury is also party to the debt of an entity which has no Government backing. That is the essential distinction here. We need to be on guard against this perception. It is a perception. It is not, in our view, a reality, but it is a perception of an implied guarantee.

Chairman SHELBY. But the trend in financial institutions generally dealing with regulation has been to insulate regulators from what we call political pressure; that is, like OCC and OTS. Why should we buck the trend?

Secretary SNOW. Well, in a number of ways we are doing that. We are suggesting that the President forego the ability to appoint members of the boards of Fannie and Freddie. We think that would be an important way to insulate.

We are suggesting that the budgets not come before the Congress any more. They are not dependent on authorizations and appropriations. That insulates it. We are saying that with respect to day-to-day operations, supervision, investigations, proceedings, the regulator be entirely stand-alone. But with respect to policy, we think the Treasury needs to be in a position to have a say or else there could be this very dangerous thing of a widening of that perception of an implied guarantee.

Chairman SHELBY. Mr. Secretary, you also mention in your testimony that you would like the new regulator of the GSE's to have the same product review authorities as the banking regulators have today, but with respect to both OCC and the Fed, banks are only required to notify their respective regulator after they have engaged in new activity. There is no preapproval standard in the bank regulatory world that I know of. How do you rationalize that?

Secretary SNOW. Well, I do not think we are asking for a prior approval. We just need the ability to weigh in.

One of the things I have learned about regulatees is if they know they are being watched by a regulator, they tend to talk to the regulator in advance of doing what they might otherwise do. So I think there would be good communications on new products and activities.

Chairman SHELBY. But you are not asking for prior approval.

Secretary SNOW. We are not asking for it and do not think we need it.

Chairman SHELBY. Secretary Martinez, since we have 13–14 Senators, I am going to try to enforce the 5-minute rule starting with myself. So you will have to be quick.

Secretary MARTINEZ. All right, sir.

Chairman SHELBY. The mission of Fannie Mae and Freddie Mac is expanding homeownership and the housing goals are a barometer of that mission.

Secretary MARTINEZ. That is correct.

Chairman SHELBY. Do you believe that the current housing goals are sufficient to fulfill the GSE's mission here?

Secretary MARTINEZ. No, sir, I think we should have an expanded goal of home purchase goal, and that goal would allow us to not only have the underserved areas, rural and central city, the low- and moderate-income and special affordable housing, but also a home purchase goal to ensure that they are involved even in refinancing booms with first-time homebuyers.

Chairman SHELBY. How do you see the dividing line between encouraging affordable mortgage lending and credit allocation? How do we make sure the goals are insulated from the political process?

Secretary MARTINEZ. Well, I believe even now that they are, and I think they are set for a 3-year period of time. I think we can continue to do that, and I think it is important that we have the GSE's sticking to their charter. It is important that the mission for which they were chartered is being enforced.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Secretary Snow, I would like to pursue very quickly this implied guarantee issue.

First of all, let me ask you this question. Is it your view that Treasury is immune from political pressure?

[Laughter.]

Secretary SNOW. On a relative scale, absolutely.

Senator SARBANES. What does that mean?

Secretary SNOW. Just that; that we live in Washington, DC, and I get calls from members of this body and members of other bodies, and I listen to them, but basically the Department of the Treasury has a long tradition of standing for some very important ideas.

Senator SARBANES. Why are the OCC and the OTS, which are "in the Treasury," independent on a whole range of things—regulation, budget, statements to the Congress? They do not go through the Treasury.

Secretary SNOW. You know, they did at one time.

Senator SARBANES. I am hearing you are arguing that this entity, whatever it is called, should go through the Treasury; is that correct?

Secretary SNOW. Yes, very strongly I am recommending that, very strongly—not meekly and quietly, but strongly, in full voice.

Senator SARBANES. What is the rationale on OCC and OTS?

Secretary SNOW. Well, as I suggested earlier in response to Chairman Shelby's question, Senator, there is really a very different set of circumstances here. One, this is a new regulator, and it regulates entities that are very large individually relative to the markets. They are entities that are perceived—perceived—to enjoy an implied guarantee of the full faith and credit of the United States, and the Treasury Department is in the business of making the market for the U.S. debt. It is important that the integrity of what Treasury does is fully protected and that there is no confusion on that score.

Senator SARBANES. Why would there not be more confusion? Why wouldn't locating this regulator in the Treasury, with the Treasury having the authority over the GSE's and all of these respective areas, heighten the perception that there is an implied guarantee? It would seem to me that it is, in fact, increasing the likelihood of that perception because of this extensive Treasury involvement, an involvement well beyond what Treasury has with respect to the OCC and the OTS.

Secretary SNOW. Senator, I think it would do precisely what you are saying, unless you establish that new entity in a relationship to the Treasury, where Treasury could disabuse the markets of that at any opportunity, whenever the risk of that misapprehension became visible.

Senator SARBANES. What does that mean?

Secretary SNOW. That means the Treasury needs to be in a position to articulate the fact that what the role of the GSE's is and avoid confusion in the marketplace if, in fact, there is a perception that we stand behind their debt instruments.

Senator SARBANES. Now, do you agree with Secretary Martinez that the goals for the GSE should be set by HUD?

Secretary SNOW. The overall housing goals?

Senator SARBANES. The goals, yes.

Secretary SNOW. Yes, absolutely.

Senator SARBANES. So, whether it is going to be 50 percent or 60 percent or 70 percent, HUD would decide; is that correct?

Secretary SNOW. Yes.

Senator SARBANES. Now, why wouldn't the program, the programmatic content of the GSE's activities be an appropriate thing for HUD to do?

Secretary SNOW. You mean the new lines of business, getting into——

Senator SARBANES. Yes, the programs that they are going to carry out.

Secretary SNOW. Programs, right. Well, I think the programs, as I understand what Secretary Martinez said, would be with the GSE regulator, they would have the primary say.

But on the broad program activity that they are engaged in today, their goals, that remains under HUD.

Senator SARBANES. How about the narrow program activity?

Secretary SNOW. The new program activity, which will be narrower than the base they are operating on, should be under the strong new regulator, wherever, Senator, that new strong regulator is.

Senator SARBANES. And why is that?

Secretary SNOW. Why is that?

Senator SARBANES. It affects safety and soundness?

Secretary SNOW. It is prudential. It affects not only safety and soundness of the housing finance market——

Senator SARBANES. Does not the goal set—my time is running. That is why I am pushing here—does not the goal setting affect safety and soundness?

Secretary SNOW. Goal setting is related to safety and soundness, but it is——

Senator SARBANES. Well, suppose HUD increases the low- and moderate-income requirement from 50 percent to 60 percent, does that not have safety and soundness implications, significant ones?

Secretary SNOW. It certainly could, and they should be——

Senator SARBANES. And that is going to be left with HUD; is that correct?

Secretary SNOW. Yes, but then subsequently those would be taken into account, Senator, by the new regulator and appropriate adjustments made in the risk-based capital standards.

Senator SARBANES. Well, then the same thing could be done with program activity, could it not, if the program activity was left with HUD?

There is considerable concern, and presumably we will have another hearing—

Chairman SHELBY. We are going to have another hearing.

Senator SARBANES. —to hear from those elements. There is considerable concern that Treasury is insensitive to the housing objectives, and indeed that there are some within Treasury that may be, in fact, antagonistic; that HUD has traditionally been the place where concerns for housing goals have been reflected, housing objectives, and that moving the program approval, which is, in effect, the subcategory to the goals, carries with it the possibility of undercutting the housing mission, which everyone here keeps saying is so important, and where such a good job has been done, and it is vital to the functioning of our economy, and we have the greatest homeownership rate, and so forth.

Secretary SNOW. Senator, I think everyone has said it is important. There have been some questions about how effectively it is being carried on, but the housing opportunities remain the broad objective, right? To achieve the housing objectives, you need a strong, resilient housing finance system. That is promoted by a strong regulator, as Senator Hagel was suggesting. But the strong resilient housing finance system is part of this much bigger thing, of which it is a large part, called the U.S. financial system, and we also need to get those relationships right and make sure there are not prudential risks to the soundness of the U.S. financial system.

Chairman SHELBY. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

I think Senator Sarbanes has gone directly to the issue that probably will cause the most controversy in the Committee as we try to draft this bill, and that is the relationship between the new regulator in Treasury and HUD. You made a statement that I think we would like to clarify. You said there will be no prior approval. There is prior approval now. HUD has prior approval, and presumably that will stay. The controversy, as I understand it, comes from the definition of what requires prior approval and the addition of the word "activities," and there is a lot of heartburn as to what activities might be stretched to mean.

Can we clarify that?

Secretary SNOW. What we have in mind when we talk about approval authority in the strong financial regulator is lines of business, is the GSE extending the lines of business that it is engaged in. The regulator needs to make sure that those extensions of its lines of business are consistent with its charter, consistent with the public interest, consistent with soundness and safety, and I would also say, Senator, consistent with this larger question of the resiliency of the financial system as a whole. So it is new lines of business is what I primarily have in mind.

Senator BENNETT. Is it not true that HUD currently requires prior approval for new lines of business?

Secretary MARTINEZ. The new lines of business, and I think partially going back to the very excellent point that Senator Sarbanes was getting at, I think I should add has only, it is a sporadic thing. I think in the last decade maybe only six times has a new product line been in the approval process, while goals are something that has to be followed on a daily basis, and I think that is a crucial difference and distinction between the two.

HUD now will require prior approval, does not require prior approval, but they must come to us once a product is being launched. And so it is an ill-defined system as it currently is utilized, quite honestly.

Senator BENNETT. As I understand it, you must affirmatively stop the new program.

Secretary MARTINEZ. Correct. So that is not prior approval.

Senator BENNETT. In other words, if you do not take any action. Well, it is prior approval in a sense. You have the right to veto it.

Secretary MARTINEZ. I have the right to come back and say stop it. That does not mean that before it is launched they come to me and say, "Here is a product. Please approve it before we launch it," although that has occurred in the past, also.

Senator BENNETT. Have you ever stopped it?

Secretary MARTINEZ. There has been one that was withdrawn and five that were not stopped. That, by the way, largely, precedes my time at HUD.

Senator BENNETT. You have said that the GSE's have lagged the market rather than led it, which is an interesting statement. Can you tell us why? Does anybody have any idea why that would be the case? And to the point, does it have anything to do with safety and soundness? Usually, people that are a little more conservative because they want to be absolutely sure they are not taking that much of a risk will lag a market, and it is the real risktakers who lead it. Is that an indication of what we are dealing with here that we need to pay attention to?

Secretary MARTINEZ. No, sir, I do not think it has to do with the market as such. I think part of it could be explained in that or is explained by suggesting that they do not deal in the subprime market. However, even when including subprime numbers, they would still lag the primary markets.

So, in any event, no matter how you look at it, I am not sure I can answer the question of why, and I do not think it relates to safety and soundness, but I think it is a very well-known point that our research would back strongly.

Senator, I have also been helped and have a little better answer for the prior question.

Senator BENNETT. Okay.

Secretary MARTINEZ. Programs require prior HUD approval; products do not.

Senator BENNETT. Okay.

Secretary MARTINEZ. The real problem comes in distinguishing between what is a program and what is a product, and the statute currently is too vague for that to make it really enforceable.

Senator BENNETT. That is the whole concern here, is the vagueness that we try to deal with.

A final question. Have they ever missed their goals? You say they have lagged the market, but have they ever missed their goals?

Secretary MARTINEZ. Yes, they have. From 1993 to 1995, they missed their goals. In more recent history, they have met their goals.

Senator BENNETT. My time is up. Thank you.

Chairman SHELBY. Senator Reed.

Senator REED. Thank you very much, Mr. Chairman.

As a preliminary point, Senator Stabenow asked me to submit to the record a letter from Fannie Mae.

Chairman SHELBY. Without objection, it is so ordered.

Senator REED. Thank you very much, Mr. Chairman.

[The Fannie Mae letter follows:]

Senator REED. Secretary Martinez, you are proposing to put together an Oversight Office within HUD that is going to be presumably staffed with very skilled individuals with financial experience as well as detailed experience in housing. Why could not these individuals review the programmatic and product lines that are being offered?

Secretary MARTINEZ. They could. The question really is, is that the best way to do this or should safety, soundness, and new product lines all be combined in one regulator?

Right now we have a divided house. OFHEO does certain things, HUD does the new program approval. We believe that a strong regulator would have all of the ability to do all of those particular items, not have it separated. By separating it, I think you weaken the regulator.

Senator REED. Well, it would seem to me that there has to be collaboration between the two entities. Otherwise you would be——

Secretary MARTINEZ. And the bill proposes that collaboration. It suggests that Treasury would consult with HUD in new program approval.

Senator REED. Why could HUD not consult with Treasury with respect to safety and soundness? Moreover, I would think, if Treasury has the safety and soundness responsibilities, that is the trump card in everything. They would be on a daily basis dealing with these different GSE's, where you would be dealing on a periodic basis, looking at products and programs.

Secretary MARTINEZ. We would be looking at their goals as well.

Senator REED. And goals.

Secretary MARTINEZ. And the Fair Housing goals, too.

Senator, I believe that one thing that the Secretary and I are very firm and very strong in an opinion is that it all should be in one place. Again, as he said in his testimony, and I think in answer to a direct question, you might debate the way that could happen, but inevitably I think it should all be under one regulator.

Senator REED. Well, but it seems that we are saying that, but we are giving you responsibilities, in fact, you are asking for enhanced responsibilities with respect to goals——

Secretary MARTINEZ. Yes.

Senator REED. So right away it is not one-stop-shopping; it is you have a role, and then Treasury has a role. But, again, I do not think there is anything that is chiseled in concrete here, and I think we have to look going forward with respect to these hearings and evaluation as to whether these functions should be in one place or the other because there is going to be two centers of gravity for this regulation, both HUD and Treasury.

Secretary MARTINEZ. A regulator of financial institutions typically can also deal with their new product lines, and I think that is what makes that important distinction is that here we are dealing with very important financial institutions that from time to time, not on a continuing basis, but from time to time, may choose to go into a new product line. As they do that, then I think that new regulator should have the ability to examine that.

Senator REED. Well, this becomes an almost philosophical debate. I mean, the question is how do the goals relate to programs and products, how do the programs and products relate to financial safety and soundness, and that is something we will thrash through.

Secretary Snow, do you believe that this new financial regulating entity should have sole discretion to set both the risk base and the minimal capital standards?

Secretary SNOW. Yes.

Senator REED. What about just simply allowing that entity to have responsibility for risk-based capital standards, which is usually the measure of the real test for safety and soundness?

Secretary SNOW. We think that the regulator should have broad flexibility with respect to capital standards, generally, the risk-based capital standards, as well as the minimum capital standards, and I think that is consistent with good regulatory practice.

I am worried about "hard-wiring" capital requirements in a statute because of the fact that we just cannot perceive fully when we are passing a law the circumstances that the entities will find themselves in or the capital requirements that will be prudential, given those circumstances.

So, I think it is better to have a strong, capable regulator, sophisticated in what it is doing, who uses good flexibility and discretion.

Senator REED. Well, I think the flexibility comes in with risk-based capital. That is why we have a risk-based capital measure and a basic static capital measure sometimes it is called. But have you evaluated the impact on the housing market and investor markets if you have a complete ability to change capital requirements at any time?

Secretary SNOW. Well, a good regulator approaches the capital—and we are talking about a good regulator here, a strong regulator, an intelligent regulator, a sophisticated regulator—that regulator will approach that issue with enormous sophistication and care knowing that it is the essential ingredient of a financial institution's regulatory system. So that strong regulator will approach it with prudence and care.

Senator REED. Well, we should just pass the statute calling for prudence and care.

[Laughter.]

Senator SARBANES. But you would remove the capital standard that is now in statute enacted by the Congress; is that correct?

Secretary SNOW. That is right. I would. I would. I would give the new regulator broad authority over capital, both minimum capital and risk-based capital.

Chairman SHELBY. Mr. Secretary, but what if we had a regulator that wanted to kill the housing market, for various reasons? That could be a dangerous situation.

Secretary SNOW. Senator, it would be a very dangerous situation, just as it would be if you had a capital markets regulator that wanted to kill the capital markets or a bank regulator who wanted to kill banks. I hope we do not confirm those sorts of people.

Chairman SHELBY. I hope not too.

Senator Hagel.

Senator HAGEL. Secretary Snow, following in line with the statutory capital structure conversation, you mentioned in your testimony I think, Secretary Martinez and others here this morning have referenced differences—I mentioned it in my statement—differences between the Federal Home Loan Bank capital structure versus Fannie and Freddie. You noted, of course, as we all are aware, that there are significant differences.

Could you frame up for us, as we are working our way along this process, whether obviously one of the questions, once we get to a point where we can agree on a new regulator or a new process, a new home, all that we have been talking about, the question whether Federal Home Loan Banks should be included. Obviously, the capital structure is different.

Secretary SNOW. Right.

Senator HAGEL. What are your thoughts about how we could address that? Where should we be looking? Can you make this fit with one regulator? Would it be too bifurcated, complicated? Open it any way you want and take it where you want.

Secretary SNOW. Let me try and address it. I think, as a general proposition, it makes sense to have one regulator, but the regulator would have probably two divisions. It would have a division that, because of the differences that you are alluding to, specializes in Fannie and Freddie, and then a division which is the division for the Federal Home Loan Banks.

And there are a lot of issues that would have to be dealt with in any legislation. One is the role of the Secretary of Housing and Urban Development, who is currently on the board, I believe, on the Federal Housing Finance Board. Also, one would have to deal with this important issue that under the Federal Housing Finance Board is the so-called Office of Finance. And the Office of Finance controls the issuance of the Federal Home Loan Banks' notes. That would have to be clarified because you would not want the new regulatory entity being seen as issuing the notes.

So, I acknowledge there are a number of important issues that would have to get dealt with. There are a lot of details and policy issues, but I would see it having merit; that is, the inclusion in one entity having merit conceptually because they are so interrelated and similar in terms of the fundamental bottom line of what they do. They are issuing large amounts of debt to support the housing market, and they are doing so with some notion in a part of the market that maybe they are supported in some way by the Government, with a Government back stop.

And that complicated set of issues I think is best dealt with in one place rather than bifurcated, but I would see the Agency needing to have a division that focused on Fannie and Freddie and another division focused on the Federal Home Loan Banks just to take into account these differences.

Senator HAGEL. Secretary Martinez, would you have an observation, comment, thought on any of this?

Secretary MARTINEZ. No, sir. I think Secretary Snow pretty well covered anything I would have to say on it.

Senator HAGEL. Let me address the obvious tension that is always connected, woven into the fabric of agencies like Fannie and Freddie, the two different commitments; one being the commitment to the affordable housing goals that Secretary Martinez referred to, Senator Sarbanes has referenced in his questions versus the other commitment of shareholders' equity, maximizing that shareholders' equity and profits.

Do you see any dynamic here, other than a healthy tension between the two, any conflict, any issues that you think, as we are dealing with possible changes, and enforcement structures?

Secretary MARTINEZ. I think that is a tension that should be recognized, and when I hear commentary that suggests that somehow these are Government entities that almost are in the grant business or something like that, I mean that is really misplaced. These are investor-owned entities chartered by the Federal Government to achieve a certain purpose. And one of the things I think it is important to note, while recognizing the importance and the value of what they have done is the fact that they have lagged the market in some very important areas that are part of their charter.

I just believe that should be recognized, there exists that tension and that they are investor-owned entities who have a fiduciary responsibility to their shareholders.

Senator HAGEL. Secretary Snow, I know my time is up, but if the Chairman would indulge me, if you had a comment, I would appreciate it.

Secretary SNOW. No, I will associate myself with the Secretary's comments.

Senator HAGEL. The Chairman likes that.

[Laughter.]

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Corzine.

That is what we do here in the Congress. It works very well.

[Laughter.]

Senator CORZINE. Thank you. Let me start with a couple of perceptions. First of all, I concur with the line of questioning that I heard from the Chairman and the Ranking Member with regard to the implied guarantee. I have a hard time understanding how making clearance policy statements through the Secretary of the Treasury is a means to protect against the misperception in the marketplace that there is an implied guarantee.

I think foregone board appointments or budgets coming to Congress is a long way from what I think really gets the market to believe that there may be something like an implied guarantee, like State taxation exemption, lines of credit, and other issues. I do not think this is the heart of the issue, and I think we are really talking about, I think you could have that independent regulator. I would presume that you would, if I asked you the question, Mr. Secretary, whether you think the SEC is a world-class regulator, you would, I would hope, come to the conclusion that it is and its independence is such that—I will not ask you that, so you do not have to answer it—but I think the perception issue is not on the subjects that we are talking about, and I am not sure exactly, and it needs to be explored.

Second of all, I think all of us are confused—I am more confused today than I was when I sat down here—about these definitions of mission goal, programs, activities, and which ones will fall under the rubric of what the new regulator works on, and all of us need to bring real clarity to this so that there is not a misperception on that.

And then I have, I will ask the question on this, I have this perception problem that there is not enough emphasis on disclosure with respect to the discussion we are having today. I actually do not think it should be voluntary that the 1934 Act is in operation here. I think that there are some standards of disclosure that, given the whole arrangements we have seen on corporate governance and concerns that have evolved in recent days that should be as much a centerpiece of the new regimen that we are putting together, and I would be curious about that.

And then I just have to ask the question on Federal Home Loan Bank. Do you foresee, under this new formulation, and I actually believe one regulator is fine, but are you visualizing a demutualization of the Federal Home Loan Bank System at some point in this process and more to a shareholder organization?

Secretary SNOW. Senator, let me try and respond quickly to each of those four points.

On the demutualization, no, that is not what is contemplated. On the 1934 Act, we agree with you. We are pleased that Fannie has gone under it. Freddie has indicated it will—the sooner, the better. We are sorry it has gotten delayed. We think the Federal Home Loan Banks Board should be under the 1934 Act as well.

Senator CORZINE. Disclosure of interest rate risk, credit risk, a whole series of these issues.

Secretary SNOW. The whole 1934 Act—yes.

Then, on the clarity of programs versus activities versus lines of business, that is really what we would see the statute doing, the new statute. That is our proposal, that the statute lay that out so that we know that the regulator has clear authority over this, and the HUD Secretary has clear authority over that. So we are seeking that clarity.

And on the first one, the perception issue, I mean, I will grant my biggest concern in talking about Treasury as the entity where the new regulator is housed as a bureau is that we add to the confusion in the marketplace about this perceived or implied guarantee. That is troublesome, and it is why I am far less focused on having it in Treasury than I am in having that strong regulator. And there are some proposals that I have seen for an independent regulator like the Federal Reserve Board or something, a new regulator.

My concern is much more with having that strong regulator than having it in Treasury, and my comments on Treasury were only to indicate the dangers really of putting it in Treasury. I think Treasury, because we have some expertise in financial markets generally, could bring something to bear on the regulator that could be helpful and integrate its activities with the overall financial markets, but I also perceive very much the risk you are talking about and that others have talked about.

Chairman SHELBY. Senator Dole.

Senator DOLE. Secretary Snow, Fannie and Freddie have both publicly stated that they want to see legislation with a stronger safety and soundness regulator. In your talks with them, what initiatives do they advocate that would make their regulator stronger?

Secretary SNOW. They seem to be, and they are going to be on later so the question may be better to them, but I think there is some real agreement that a new strong regulator would make sense, would remove some of this volatility in the market, and might actually help, in a real way, to improve housing finance. And in the discussions I have had, I have pretty much laid out, as I did today, what we think should be included in that, and I think they better respond as to what parts of that they can live with, rather than my trying to interpret it, if you do not mind.

Senator DOLE. Secretary Martinez, some have raised questions about how the consultative process on GSE programs, activities, and products between HUD and Treasury might work. Would you describe for the Committee how you believe the process would work and any concerns that you might have, would you raise those for us.

Secretary MARTINEZ. HUD must be consulted prior to any final determination as to whether the activity is permissible or not, and so this process will ensure that any review of a new GSE activity and the potential impact that it will have on affordable housing or housing goals will be fully considered; in other words, will be a participant in the decisionmaking. And I think the important considerations of meeting the housing goals and the impact on the housing market we think will be fully considered through that consultative process that is envisioned.

Senator DOLE. Secretary Snow, would you comment on the impact of increased capital authority on holders of Fannie and Freddie debt and also what capital controls do the major U.S. financial regulators have?

Secretary SNOW. All of the major U.S. financial regulators, to the best of my knowledge, have broad authority with respect to capital adequacy of the financial institutions and, in fact, capital adequacy is the principal regulatory tool in the tool kit of financial regulators.

I do not have in mind any precise change in the capital adequacy numbers. That, I would leave to a regulator, and the regulator may find that the current capital standards are perfectly adequate. My only point on capital adequacy standards is the regulator should have broad flexibility. I do not enter that with any preconception as to what those capital standards should be.

Senator DOLE. As you know, our legislation gives the new regulator authority to limit nonmission-related assets. Your department supplied me with a copy of your suggested language to restrict investments if they fail to meet your 12 operational and managerial standards. I take it that you are then in agreement with S. 1508 on this point.

Secretary SNOW. Yes. I would have to say before I give full assent, I would like to make sure I have read it, but if the Treasury staff gave it to you, and it is based on that, I am sure I do agree.

Senator DOLE. Would you share with the Committee the reasons why the Treasury believes this authority is necessary.

Secretary SNOW. Yes. This authority is necessary so that these entities do not abuse their charters, that they live within their charters. A regulator needs to be ever mindful of what the charter is, and what the limits of the charter are, so that the entities do not go beyond those charter limitations. That is the basic point I would make.

Senator DOLE. Secretary Snow, if the regulator is put under the Treasury Department and is completely independent, what is the advantage to having the regulator at Treasury?

Secretary SNOW. The advantage of having it at Treasury is that Treasury is involved in all of the financial markets and brings a deep knowledge of the U.S. and world financial markets, how they operate, their complexities, and their condition. And that would be the value that would be added by having this entity at Treasury, if the statute did not block us from providing hat value.

Off-setting that is the risk that we have talked about, that being in Treasury might further signal to the market, improperly, that the Federal Government stands behind these entities, and that is the line we are walking here.

Senator DOLE. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Schumer.

Senator SCHUMER. Thank you, Mr. Chairman, and thank you for being here both, Mr. Secretaries.

First, just a comment. I am concerned, obviously, about the legislation that the Administration has suggested, and I do not think there is any doubt that there are some in the Administration who do not believe in Fannie and Freddie altogether. Let the private sector do it. That would be an ideological position. And my worry is that we are using the recent safety and soundness concerns, particularly with Freddie and with a poor regulator, as an excuse or as a straw man to curtail Freddie and Fannie's mission.

I do not see that safety and soundness, which is important to every one of us, necessarily requires a regulation by the safety and soundness regulator of what Fannie and Freddie does. After all, banks decide on their own products, and then it is the regulators that decide the capital standards and other types of regulation that keep them safe and sound.

And I could see a Treasury regulator who does not like Fannie and Freddie saying you cannot do any new products as the marketplace changes and gradually strangling them. So, I worry about this. Now, I am not going to ask you to comment on that. You have made your point clear, but I think we are using safety and soundness or some may be using safety and soundness as an excuse to constrict Fannie and Freddie's goal and mission in housing because they do not like a GSE to begin with; that they would rather just have the private sector do it, but I have another question for you.

It is on a different subject, but you are here, and it is an issue of great concern to me, and that is China's currency manipulation.

I have three questions. I will ask them seriatim and ask you for your answers.

First, I was very, very disturbed, as were many of us, that despite the legal requirement that Treasury issue its report on exchange policies yesterday, that such a policy was not issued. Now, I know we have said we are going to do it October 30, but what that leads me to believe is we were afraid to issue a report right before the President went to see the Chinese, Japanese, Taiwanese, and other leaders and an indication of soft-peddling this; that, oh, yes, we will tell the American public we care about this, but we do not want to embarrass our friends in Asia by issuing a report that says they manipulate the currency the day or the week before the President meets with them. It is very convenient that it is extended for 15 days after the trip is over.

And I just worry about that as an indication of fear, or reluctance is a better word, to confront the Chinese, particularly, but others as well, on currency manipulation.

So my first question is why was there the delay?

Second, let me ask you directly, do you and does Treasury now believe that China has engaged in currency manipulation? You have probably seen the report already because it was just delayed at the last minute.

And, third, and maybe most importantly, what if China continues just to say, no, despite your entreaties? We all read how the Chinese said they were not going to change this before you even landed on their soil to talk with them. They refused the President's entreaties. What should we do? Should we just stand here and say, "Shucks, the Chinese are not doing the right thing?"

Some of us on this Committee, I think there are four of us on this Committee, and many others—five of us on this Committee, three Republicans, two Democrats—who believe we should impose a tariff on China's goods to make up for the currency manipulation.

Yesterday, the Bipartisan Commission on U.S.-China Economic Security Review said the following: They said, The Commission found that China, in violation of both IMF and WTO obligations, is, in fact, manipulating its currency for trade advantage, and this is the important point, "The Commission further urges the Congressional leadership to use its legislative powers to force action by the U.S. and Chinese Governments to address these unfair and mercantilist trade practice."

So, A, why was the report delayed; B, do you—yes or no—believe China manipulates the currency; and, C, what should we do if China continues to refuse to do anything in light of the thousands, the millions of jobs that we are losing all over this country?

Thank you, and you can have the rest of the time.

[Laughter.]

Secretary SNOW. I will just answer briefly and look forward to a fuller discussion on October 30 when I am up here with the report.

The delay is just straightforward. The GSE legislation was scheduled, and I think the report and my testimony should go hand-in-hand, so there is no confusion about it. Whether we view China as manipulating their currency is the subject of the report, which will be released on October 30. In the meantime, I have had, as you know, and the President will be having, extensive conversations with the Chinese political and economic leadership on that question.

And since my time is up, I will look forward to reviewing that with you in detail on October 30.

Senator SCHUMER. What about the third question? What should we do if the Chinese continue to do nothing?

Secretary SNOW. Well, Senator, this is a discussion, a serious discussion that takes some time. We are making progress. We are making some real progress. And I think the best thing we can do is continue to press hard and come to that bridge if we ever come to it, but press hard now for the reforms that make sense, and that you have talked about and Senator Dole has talked about and other Members of this Committee have talked about, including the Chairman.

Senator SCHUMER. Thank you, Mr. Chairman.

Chairman SHELBY. Mr. Secretary, I hope the President does better than we did, the two of us, when we went to China and Japan.

Senator SCHUMER. I hope he does better than I did right now.

[Laughter.]

Chairman SHELBY. Well, you have raised some questions.

Senator Sununu.

Senator SUNUNU. Thank you, Mr. Chairman.

First, as Senator Sarbanes pointed out, we like to do in Congress, let me associate myself with the remarks of Senator Corzine. You raised some very important points about disclosure that he included in his legislation. I apologize to him for not delving into those now, but I do want to ensure that we deal with these as we move forward with legislation because disclosure is an important part of investor confidence, and I agree with him very much on those issues.

Second, there is a lot of discussion about the question of affordable housing goals, product and program approval, and I want to get into this important issue a little bit more.

It seems to me that the affordable housing goals and the affordable housing mission is extremely important. I believe under the Treasury proposal those goals would be set by HUD, as they should be. As I said in my opening statement, we should look at ways to strengthen and improve the way that those goals are set and whether or not HUD needs even more power in dealing with affordable housing issues.

But housing goals are a matter of public policy. There is a public policy goal that could be set in statute, but it is a matter of public policy. The question of products, activities, and business lines are questions of means for attaining those public policy goals, and they absolutely do affect safety and soundness, in my opinion, and I want to explore some specifics of the ways that they might affect safety and soundness.

I have a list of activities, products, programs, whatever we want to call them for the time being, that are offered by the GSE's, and I want to list them for you, Mr. Secretary, and get some comment here.

A desktop originator, where a GSE can go directly through to mortgage brokers; HomeStore.com, where a GSE engages in a direct joint venture with realtors, which raises questions about mortgage origination, which is something that the GSE's are prohibited from; Home Stay, where a GSE offers, for borrowers, credit insurance, two-tiered insurance products, where GSE's can take a portion of mortgage insurance risk for a portion of the mortgage insurance premium; issuance of retail callable bonds; a product called Payment Power, where, in this case I believe it is Fannie Mae, can allow borrowers to skip a certain number of payments over the life of the mortgage.

My question is do not these kinds of products, whether they are insurance related, consumer related, dealing with prepayment issues, do they not affect the risk profile of the entities that are engaged in these lines of business?

Secretary SNOW. Senator, I am not an authority on these products or the nature of them, but certainly a strong regulator would be in a position to evaluate whether extension into those products creates risks that require changes in capital standards. I am not in a position to do that, but certainly there is a relationship between the products you get into, the size of your exposures, and the amount of capital that is appropriate to those exposures, yes.

Secretary MARTINEZ. If I may comment, Senator, the proposal that we have proposed will do away with the distinction between program and product, and instead it would make all new activities subject to review by the financial regulator, which we think is an important consideration.

Senator SUNUNU. I believe that is an important point, and I am not prepared to say—I agree with you wholeheartedly, but I think the more general point that definitions matter and language matter has already been revealed here as to what we are defining as a product, what we are defining as a program, and I hope, and I expect, that that is something that the legislation will try to deal with in a clearer way because it does not seem to have been written with the clarity we would want.

To that end, Secretary Martinez, have any of the programs that I just read, and I hesitate to call them programs, but have any of these required or received clearance from HUD?

Secretary MARTINEZ. I am being told—I cannot firsthand tell you, but I am being told by Mr. Weicher of the Housing Commission that the answer is, yes.

Senator SUNUNU. They have had to be approved, they have had to receive clearance?

Secretary MARTINEZ. Payment power and Homestay, payment power has been approved, and Homestay apparently is under review and will be.

Senator SUNUNU. Those will be two of the five that you mentioned?

Secretary MARTINEZ. Yes.

Senator SUNUNU. Thank you.

Let me talk about another specific product and, again, one that certainly raises concern only in that it certainly seems to affect risk profile, and that is the approval for GSE's to acquire acquisition, development, and construction loans. This would be lending against development properties, perhaps against land that could certainly be used for housing, but could also be used for projects of a commercial nature.

This would, one, seem to be a business line that can affect the underlying risk profile of the company or the entity that is involved in it; and, two, would seem to at least raise questions about whether or not it is in keeping with the mission.

I would like each of you to comment on, again, whether this is a product line, a program, an activity that affects risk profile and issues regarding mission.

Secretary MARTINEZ. I think it affects risk profile, and I think it clearly also affects mission. I think it also should be noted this product was approved by HUD in 1992 as a pilot program, and then last summer it was approved as a permanent program, but I do believe that both areas are affected by the product.

Senator SUNUNU. I appreciate that, and what we need to get at with the legislation is simply to make sure that business lines, activities, products, programs, as we hope would be clearly defined, the ability to look at these, to consider these, as they affect safety and soundness, are included in that strong regulator. I cannot think of any other regulator that would not have the authority over decisions that so directly affect safety and soundness.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

I want to take Secretary Snow back to, even though this is a hearing on GSE's relating to housing, but we have got to talk about GSE's that are unregulated completely. What would it take for this current Administration to call for some regulation of the Tennessee Valley Authority—gouging their customers, raising rates without any approval? Because they do that if they have no regulator whatsoever—they do not have one; having $26 billion in debt, publicly traded debt—this is publicly traded—which is AAA rated, and guess why it is AAA rated—because everybody thinks that the Federal Government is backing the debt; or are we going to have to wait until something like Enron happens in the Tennessee Valley?

Secretary SNOW. Well, Senator, I must confess to you I am not an authority on TVA. It is different from Fannie and Freddie in the sense that it is wholly owned by the U.S. Government.

Senator BUNNING. We own it.

Secretary SNOW. Yes, we own it. We do not own Freddie and Fannie. They are publicly owned.

Senator BUNNING. We do not own the Federal Home Loan Banks either.

Secretary SNOW. No, we do not. They have a different ownership structure, but they are not owned by the Federal Government.

Senator BUNNING. They are owned by stockholders, which are the banks themselves.

Secretary SNOW. The banks, exactly. So the first distinction is TVA is a wholly owned agency, instrumentality of the U.S. Government. I agree with you, it sells debt into the public markets. The borrowing authority of TVA, if my recollection serves me, and I want to confirm this, is treated by OMB as budget authority for purposes of the Federal budget. So there is that element of oversight on it. It is governed I think by three——

Senator BUNNING. Commissioners.

Secretary SNOW. Yes sir, commissioners appointed by the President——

Senator BUNNING. The President of the United States.

Secretary SNOW. —confirmed by the Senate, I think.

Senator BUNNING. Yes, but there is a big, big problem here because, when OMB tells them to reduce their debt, the $10 or $12 billion, they do not pay any attention to OMB.

So the need for regulator, a regulator, if we are making a new regulator to take care of Freddie, and Fannie, and the Federal Home Loan Bank, which I do not agree with, but we should take a look at some that are totally and completely unregulated.

Secretary SNOW. Senator, you have me at an enormous intellectual and knowledge-based disadvantage here. Could I bone up on this subject and come and talk to you, so I would know what I am talking about when I have that discussion?

Senator BUNNING. Yes, you can.

Secretary SNOW. Thank you.

Senator BUNNING. I would be more than happy.

Let me ask you one more question, then, since my time is not up. Why does Treasury call on the Federal Home Loan Banks to register with the SEC? Which I agree with, by the way.

Secretary SNOW. We do because there are investors who buy their securities; the Federal Home Loan Banks do issue debt, and it is important to have disclosure. So you are asking me why not TVA, and I told you I am going to get into that.

Senator BUNNING. I am asking you——

[Laughter.]

You have answered my question, and I appreciate that very much.

Thank you, Mr. Chairman.

Chairman SHELBY. Since I come from a State where TVA is partly represented, I have a lot of questions about it, too, but I will save them for another day, though, and probably for another Committee.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

I am not sure that I agree entirely with your statement that transferring the regulatory provisions from HUD over to Treasury implies that there is a greater backing by the Federal Government on these loans.

It seems to me that the issue comes right down to too big to fail. Fannie and Freddie have taken over so much of the market and have become such big entities, that I think the thought is, is that because they have such an impact on our economy, the Congress could not allow them to fail. I would be interested in hearing your comments on this.

Secretary SNOW. I agree, Senator. It is that if they failed, there is a perception that the full faith and credit of the United States stands behind them, and that means the U.S. Treasury. And the concern would be that if Fannie and Freddie came to the U.S. Government, with the perception of "too big to fail," or the belief of an implied guarantee or the sense that the Federal backing was there, or that the Federal Government was a back stop, that perception would be heightened. That is what I am saying.

It is not as large a perception when the entities are in HUD because HUD does not have the responsibility of the U.S. Treasury to go into the credit markets, with the full faith and credit that lies behind it, so that is precisely the issue.

Senator ALLARD. Mr. Chairman, I also would now like to pursue this idea that you are going to have the expertise there to have a top-flight regulatory——

Secretary SNOW. Right.

Senator ALLARD. I see Fannie Mae and Freddie Mac standing out and using derivatives and some rather unusual financial instruments to manage the dollars that they have. When regulators manage derivatives, many of them have Ph.D.'s. My understanding is that these qualified individuals are sometimes difficult to find in Government agencies because there is such a demand for them in the private sector.

Secretary SNOW. That is right.

Senator ALLARD. Would you explain to me how you are going to put together a highly qualified regulatory agency? I think OFHEO has the same problem in hiring personnel with the expertise necessary to properly regulate Fannie and Freddie, whether they can do it top flight. How is Treasury's situation different from current OFHEO?

Secretary SNOW. Senator, you put your finger on a very, very good issue. What I was talking about is the fact that the Treasury Department has people who are deeply knowledgeable about the condition of the credit markets, directly involved in making the $2-trillion-a-year debt market for U.S. Treasuries, and have an awful lot of expertise about financial matters.

The regulatory agency in Treasury would draw on that broader expertise about the condition of financial markets here and abroad to address, the whole question of systemic risks. But the agency would need to be augmented, with its own experts, just as the Fed has a number of experts on derivatives. Really, you need people trained in options theory, and Black-sholes, and derivative mathematics. You would have to attract those people there, clearly. The new regulator would need, as the Fed does, to have the authority to attract people who are high-powered and financially knowledgeable people. I agree with you.

Senator ALLARD. How are you going to attract these qualified individuals and maybe Secretary Martinez would like to comment.

Secretary MARTINEZ. I just wanted to comment, also, because whether the regulator, the Treasury, or the office that we envision at HUD for the portion of regulating the HUD will continue to have, we also believe that it should be financed, as most regulated entities are, by the regulated entity, which will give us a little more flexibility in terms of salary, compensation packages, and the way in which we could attract a competent staff to do this very, very important job, which right now what HUD does in this arena, we are not properly staffed to do.

Senator ALLARD. I have another "nuts and bolts" question. How are you going to transfer these dollars budgetwise? In other words, how are you going to handle the transfer of the Agency? Are you going to retain the money that is allocated to HUD or will this be transferred over to Treasury? If the Director is going to increase his regulatory ability, it seems that he will need to request an increased amount of dollars. Have you discussed that?

Secretary MARTINEZ. There is no question that OFHEO, and all that goes with it, including its budget, would go to Treasury, and there is no dispute or discussion about that. So they would have the wherewithal of current OFHEO, to begin with.

In addition to the added authority now from the new law, which would permit us to seek, for the regulated entities, to finance in fact the regulation.

Senator ALLARD. Any comment, Secretary Snow?

Secretary SNOW. No, I agree, Senator. You are putting your finger on a very important issue. You have to have sophisticated, knowledgeable people. Those people have alternatives, and high-paying alternatives. We have to be able to attract them. And as Secretary Martinez said, I think taking this off the budget and making the Agency self-financing, as we have suggested, would give us much greater latitude to attract the people that are needed.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman SHELBY. I have some questions, but since we have a second panel, I am going to submit my questions for the record.

Senator Sarbanes.

Senator SARBANES. Mr. Chairman, I will forbear, as well, because I know we have people who have been waiting.

Chairman SHELBY. I want to thank both Secretaries for being here——

Senator CARPER. Mr. Chairman, I do have just a couple of questions I would like to ask. I have not had a chance to ask anything, if I could. Thank you.

I am not going to be here for the second panel. I understand that Fannie Mae and Freddie Mac may have a different take on whether the GSE's lagged the market on affordable housing. I hope, when they speak, that we will hear from them about whether they are going to, how they want to respond to this charge, and I would look forward to what they have to say on that.

Two questions. Two quick ones.

Secretary MARTINEZ. Could I comment on that issue, Senator?

Senator CARPER. Sure.

Secretary MARTINEZ. Business there is one thing that I think should be on the record, which is that our research would indicate that the GSE's have 42 percent of all loans in the mortgage market, of which only 15 to 17 percent go to first-time minority homebuyers.

FHA, by contrast, has only 16 percent of loans, of which 34 percent are for minority and first-time homebuyers.

Senator CARPER. Good. Thanks for that point.

I know this has been raised, at least indirectly, by others, and I want to come back. I have heard from constituents in my State, as have my colleagues. They include the home builders, they include realtors, they include other affordable housing groups, and they are, for the most part, in opposition to transferring program approval from HUD to Treasury.

And I am just going to ask you to take a minute and speak to the concerns that have been expressed to us by these groups which were that the Treasury would be less sympathetic to housing needs than HUD. What do we say to them? How do you go about reassuring these people, these constituents, that moving program approval to a new agency would not impact Fannie Mae or Freddie Mac's ability to design new products, new initiatives, to meet unique housing needs in Delaware or in other States.

Secretary SNOW. Well, Senator, I would start——

Senator CARPER. What reassurance can you offer?

Secretary SNOW. Maybe Secretary Martinez should lead on this, since this is his area.

Secretary MARTINEZ. I believe, Senator, that new product approval is not essential to the function, day-to-day, of the GSE's. It is something that, from time to time, comes up, and as it does, it has a very, very direct impact on their safety and soundness.

When those issues would arise, and it is sporadic, it is not daily, and they are on very specific market areas that they wish to go into, that are new, that they are not today doing, so, if they are doing a great job today, only for expansion, growth and continued ability to provide a return to their investors is a new product necessary. So, for those sporadic instances when that will come up, the Treasury is the perfect place or the new regulator is the perfect place for that to take place.

HUD would be consulted in that process. So we would have our input as it relates to housing needs and, secondarily, as it relates to housing goals, we will ensure that they continue that vital part of their charter, which has to do with meeting low-income, minority homebuyers, first-time homebuyers, and underserved areas.

Secretary SNOW. Senator, I work, as Secretary Martinez does, for the President of the United States, who is as deeply committed to housing, as any President I am aware of. It is a matter that comes up regularly. I have heard him say to the Secretary, "How are we doing on those housing goals? Why cannot we get there faster?" And he would not countenance for a moment the Treasury Department playing a role which was not entirely consistent with his objectives for strengthening homeownership in the United States. It is a goal I share.

You say, well, Administrations come and go, how do you know the next one will be that way? I think the Secretary said it well. Getting the soundness and safety of the finances of the GSE's and the housing markets right helps, not hinders, the homeownership objectives. So having a strong regulator in place will reassure the markets and should make the markets more favorable to housing finance, not less favorable, which should help the spreads, help the costs, and help ownership, ultimately.

Senator CARPER. Secretary Snow, one last quick question. Under the regulatory structure that I understand you are proposing, could there be some potential for a conflict of interest for Treasury, if Treasury participates in the debt markets as a participant, and this potential role as regulator of GSE's, who would also be participating in the debt market?

Secretary SNOW. Well, today, there is a consultative process. I do not think there would be a serious problem along those lines, but today we recognize the need for a consultative process, and that consultative process works well.

Senator CARPER. All right. Thanks very much.

Thanks, Mr. Chairman.

Chairman SHELBY. Thank you.

I thank both of you, again.

Our second panel will be Franklin Raines, Chairman and CEO of Fannie Mae; George Gould, Director of Freddie Mac; Norman Rice, President and Chief Executive Officer, Federal Home Loan Bank of Seattle.

Gentlemen, your written testimony will be made part of the record in its entirety. We will start with Mr. Raines. Welcome back to the Committee. You have spent a lot of time here, and we appreciate it. If you could sum up. I know the day is moving on, and we appreciate your patience. This is a very important hearing. We are going to have another hearing. We think we should hear from the housing people and others and have a balanced approach to what we are doing, and perhaps we will learn a lot.

Mr. Raines.

STATEMENT OF FRANKLIN D. RAINES
CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FANNIE MAE

Mr. RAINES. Thank you very much, Mr. Chairman, Senator Sarbanes, and Members of the Committee, for this opportunity to speak with you today. I am delighted to have the chance to share my views on strengthening the financial regulation of Government-sponsored housing enterprise which Fannie Mae supports.

Fannie Mae supports legislation to create a safety and soundness regulator as a bureau in the Treasury Department. I believe there is a broad consensus that having a strong, credible, well-funded financial regulator is in the best interests of the housing finance system, the financial markets, and homeowners.

First, there is a broad consensus that the American housing finance system is the best in history and the envy of the world, that the housing finance system is critical to the economy, that the secondary mortgage market is the backbone of the system and that Fannie Mae plays an essential role in the system.

Second, I think there is a broad consensus that the housing finance system is, and will continue to be, strong, stable and operating at peak performance and that regulatory reform efforts do not arise from a need, urgent or otherwise, to “fix the system.”

Third, there is a broad consensus that thanks to the performance of the housing finance system, housing helped to boost the economy when the economy needed boosting the most. Last year alone, homeowners withdrew about $140 billion of their growing equity wealth and plowed $80 billion of it back into the economy, boosting consumer confidence and spending.

All together, housing-related activities accounted for 9.4 million jobs and contributed $2.3 trillion to gross domestic product, which was nearly 22 percent of GDP.

And, finally, given that the housing finance system is so strong, efficient, and essential to the economy, there is also broad consensus that any legislation that would affect the system should begin and end with two critical goals in mind: First, do no harm to housing and homeowners; and, second, ensure that any legislation that goes forward serves to strengthen the housing finance system.

We are prepared, and look forward, to working with the Congress and the Administration to achieve a broad consensus on legislation to ensure that we have a strong, credible, well-funded financial regulator. But, today, as the Committee requested, I wanted to focus these few oral remarks on a couple of key issues pertaining to the legislation to move our financial regulator to the Treasury.

First, I believe that a safety and soundness regulator at Treasury must have the powers and resources necessary to ensure effective oversight. To ensure adequate resources, I believe the new Treasury bureau should be funded independent of the appropriations process. We do believe, for the sake of funding accountability, that Congress should also include some transparent review mechanism or process, such as notice and comment, to ensure that the assessments levied are reasonable.

As for the review of regulations and testimony, I believe those are questions for the Congress and the Administration to resolve.

Regarding our capital requirements, Fannie Mae supports maintaining our minimum capital at the current statutory level, but giving the new regulator more flexibility in setting risk-based capital. The minimum capital requirement established by Congress in 1992 is appropriate for a low-risk business model, and requiring capital in excess of our risk would reduce the flow of mortgage finance to homebuyers and undermine our mission.

That said, we agree with Treasury that our financial regulator, like others, should have the authority to continuously evaluate the risk we face and adjust our risk-based capital requirements accordingly.

Today, our financial regulator has this flexibility through the risk-based capital requirement that Congress enacted in 1992, which is determined by a statutory stress test. This test, administered every quarter, computes how much capital we would need to survive a severe economic shock and a prolonged economic crisis, and Fannie Mae has met this stress test every quarter.

While recognizing the need for stability in capital standards, we support Treasury's proposal to provide our financial regulator with fuller and more flexible authority to ensure that our risk-based capital requirement remains consistent with our risk profile.

On the matter of prompt corrective authority, I believe the authority Congress provided in 1992 is appropriate for Fannie Mae and Freddie Mac, but at the same time, we would support enhancing the enforcement authorities of the new financial regulator at Treasury beyond those available to OFHEO. We would support granting the new regulator cease and desist powers, the ability to levy civil money penalties, and the authority to suspend and remove company officers and directors comparable to what bank regulators have.

We also believe that a clear distinction of the separate rule and authority of HUD and Treasury would be in the best interests of housing and Fannie Mae. Currently, HUD regulates our housing mission. OFHEO, an independent bureau of HUD, regulates our safety and soundness. These separate regimes are mutually supportive and neither undermines the other.

For example, HUD has the authority to ensure that new mortgage programs are consistent with our charter and housing mission, and OFHEO has the authority to ensure that new mortgage programs do not harm our safety and soundness. This is an appropriate distinction and one we believe can, and should, continue as our financial regulator moves to become a bureau in the Treasury.

Thus, we agree with most of the housing industry organizations that HUD should continue to oversee our housing mission and, at the same time, it is critical that a world-class regulator at Treasury has the authority to review all aspects of our operations, including new and ongoing activities, and disallow anything that poses a safety and soundness risk.

Whether the Committee chooses to house the mortgage approval authority with Treasury or HUD, the standard of program approval I believe is crucial. The current standard has fostered an unprecedented era of innovation in the mortgage industry, and under this authority, HUD is authorized to review major new programs to determine whether they come within our charter and mission.

Indeed, on several occasions since 1992, Fannie Mae has presented new programs for HUD to review and approve. For example, at the urging of Congress, we sought and received HUD's approval to invest in energy efficient home loans. The current regime does not require HUD to review each and every mortgage innovation. This tacit support for innovation has allowed us to work with lenders and housing partners to create mortgage initiatives, options, and features, all of which are consistent with our charter, to fulfill our mission and respond to the market and to lender and consumer needs in a timely way.

In this way, Fannie Mae has led the market in mortgage innovation, such as automated underwriting, low downpayment mortgages, and creative mortgage initiatives, but we rarely, if ever, innovate a loan. Behind virtually every new innovation we introduce, there is a lender or a housing partner who has asked for our investment, and we have responded to them. And we work with mortgage bankers, nonprofits and community organizations, local housing agencies, minority outreach groups, faith-based institutions, and others to help create creative new ways for lenders to reach and serve more families.

Our ability to innovate is crucial to many mortgage lenders. They feel free to develop new products to reach underserved communities because they know that Fannie Mae will purchase their innovative loans in a secondary market, and smaller lenders, such as independent community banks, depend on our innovations to access the secondary mortgage market and build up a competitive mortgage business to serve their unique markets.

With the freedom to innovate, we have been able to respond to specific challenges. President Bush challenged the private sector to help achieve this minority homeownership initiative, to create 5.5 million new homeowners. And Fannie Mae responded instantly by boosting our commitment of capital to minority families from $420 billion to $700 billion. We have also included new initiatives for new Americans and links to immigration programs and faith-based organizations.

As American continues to grow and change, the housing industry lenders and homebuyers will need a new generation of innovation. We believe the appropriate standard for mortgage program review, wherever housed, is that there should be a bias for allowing innovation, unless it is clearly contrary to our charter.

One last comment I would make relates to the housing goals. Under the 1992 Act, HUD has assigned regulatory affordable housing goals for Fannie Mae and has created goals that are more ambitious than those that are required of most other financial companies. They require us to devote a fixed percentage of our business in three distinct areas: low- and moderate-income families, underserved communities, and special affordable housing for very low-income families.

HUD has considerable flexibility in setting the goals. And over the years, they have consistently raised these goals, and we have met all of the current goals every year that they have been in place. HUD can also use its authority to focus our efforts on specific high-priority items, which they have, in fact, done.

In conclusion, as Congress considers legislation to ensure a world-class financial regulator for Fannie Mae, I believe there is a lot at stake. The U.S. housing finance system is indisputably the best in the world, but we have an opportunity to make it better.

There is widespread consensus that housing is crucial to the economy and that Fannie Mae is crucial to housing. There is also widespread consensus for moving our financial regulator to Treasury and providing our regulator with the authority and powers to ensure our financial safety and soundness, and Fannie Mae stands ready to work with the Congress and the Administration to achieve this goal.

Chairman SHELBY. Mr. Gould.

STATEMENT OF GEORGE D. GOULD
PRESIDING DIRECTOR, FREDDIE MAC

Mr. GOULD. Thank you, Mr. Chairman.

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, my name is George Gould. I have served on Freddie Mac's board since 1990 and am currently the Presiding Director and Chairman of the Governance and Finance Committees. From 1985 through 1988, I served as Undersecretary for Finance at the Department of the Treasury.

Freddie Mac plays a central role in financing homeownership and rental housing for the Nation's families. Given the importance of housing to the economy, it is critical that our regulatory structure provide world-class supervision. Before expressing our views on specific proposals, I just would like to say a few words about Freddie Mac.

The deficiencies in the company's previous accounting and disclosure are unacceptable, plain and simple. While the board has taken many steps to address these weaknesses, I will be the first to acknowledge that more can be done and will be done.

First, the board is extremely "hands on" with regard to getting the restatement done and done right. Since March, the committee responsible for the restatement has met on a weekly basis, and as we announced last month, we expect to release restated earnings for prior years in November.

Second, we are moving aggressively to ensure these problems never occur again. We have added highly qualified accounting personnel and strengthened our control infrastructure, and we have brought in independent experts to review best practices and proposed remediation. For example, we have engaged former SEC Division of Corporation Finance Chief David Martin to help us with disclosure. The board is fully committed to implementing the recommendations of independent experts.

Now, I would like to comment on key aspects of regulatory restructuring. I would like to recognize Senators Hagel, Corzine, Sununu, and Dole for helping to get these important discussions underway.

Freddie Mac strongly supports the creation of a strong, effective regulatory structure. It is good for the GSE's, it is good for markets, and it is good for consumers. Difficulties in moving legislation forward are regrettable, but not insurmountable. We are committed to doing whatever it takes to get an effective regulatory structure in place.

The Committee has requested our views on a number of issues starting with regulatory structure and independence. Freddie Mac supports the creation of a new regulatory office within Treasury. We also support providing both the new regulator and HUD authority to assess the GSE's outside of the annual appropriations process.

With regard to independence, we support applying the same operational controls as apply to the relationships between Treasury, and the OCC and the OTS.

With regard to capital, we strongly believe the new regulatory structure continue to tie its capital to risk. The GSE's are subject to both the traditional leverage ratio—our so-called regulatory or minimum capital—and a dynamic risk-based capital stress test that requires us to hold enough capital to survive 10 years of severe economic stress. Few other institutions could meet such a high standard.

To ensure that the GSE's remain at the forefront of risk and capital management, the new GSE regulator should have greater discretion with regard to the risk-based capital standard.

Additional discretion is not needed with regard to GSE minimum capital, however. Bank regulators need discretion to change capital requirements, given the diversity of the business lines banks are engaged in. In contrast, GSE's are restricted to one line of business, residential mortgages. Compared to commercial lending or loans to foreign governments, long-term, fixed-rate mortgages are one of the safest financial assets around. Even comparing mortgages alone, Freddie Mac's mortgage credit losses are consistently lower than those for banks.

Given this low-risk profile, regulatory discretion to change minimum capital is unwarranted. Raising minimum capital would not increase the safety of the housing finance system; rather, it would hamper our ability to serve housing markets and raise costs for homeowners.

With regard to new program approval, we believe HUD should retain its authority to approve new programs in keeping with its housing mission. At the same time, however, we believe the new regulator within Treasury should have authority to review and veto any new program that raises safety and soundness concerns.

We also urge the Committee to maintain a new program standard, not a new activity standard. In saying that, based on earlier discussion, I note that there seems to be a little confusion about the definition of those terms, but I think there is some precedent to indicate what programs HUD dealt with in the past. Requiring the regulator to provide advance approval of each and every new activity significantly exceeds the standard required of banks and could chill innovation and mortgage lending.

Freddie Mac supports parity of supervisory and enforcement powers among financial institutions. Although an array of powers currently exist, we would support providing the new regulator additional authority, such as new removal and suspension authority and new authority to assist civil money and criminal penalties.

Now, let me say a few words about mission oversight. In 1992, Congress established three GSE affordable housing goals: An income goal, a geographic goal, and a special goal for unmet needs as determined by HUD.

HUD has significant discretion to establish and adjust these goals and has raised them markedly over the years. Today, 50 percent of our mortgage purchases must be dedicated to meeting these needs. The GSE affordable housing goals are the toughest of any financial institution. Additional statutory goals could simply balkanize the mortgage market.

And I may say, departing slightly from my written and oral comments, that within Freddie Mac, at least, our Economic Department would disagree with Secretary Martinez' conclusion that we are lagging the market. If you compare apples-to-apples and oranges-to-oranges, we do not believe we are. FHA has a different mission. Therefore, its percentage would obviously be different from ours, and we are limited statutorily, and by safety and soundness standards, to certain parts of the market which, when you put it all together, makes us look like we are lagging, but within our universe, we do not feel we are.

HUD also has significant enforcement powers. Not only can HUD require the submission of a housing plan should we ever fail to meet one of our goals, but it can also require a housing plan if it determines there is a good chance that we might miss a goal. By contrast, bank regulators cannot bring enforcement proceedings against an institution failing to meet its CRA obligations.

Considering that we consistently have met the goals since they have become permanent, and that existing powers already are the industry's toughest, we respectfully suggest no additional powers are needed.

In summary, Freddie Mac is prepared to embrace significant enhancements which will make our regulatory structure stronger. Building these enhancements into existing law would give the new regulator supervisory and enforcement powers comparable to those of bank regulators. The new structure would also maintain the tougher GSE regulatory requirements, including program approval standards and a risk-based capital stress test.

Our mission regulator would continue to oversee the most challenging, quantitatively affordable housing goals in the industry, with more than adequate powers to enforce them. Taken together, this enhanced GSE regulatory structure would be strong, solid, and credible. It is essential to maintaining the confidence of the Congress and the public.

I would look forward to working with Chairman Shelby, Ranking Member Sarbanes, and other Members of this Committee as you move forward to address these issues, and I will be obviously happy to answer any questions the Committee may have.

Chairman SHELBY. Thank you.

Mr. Rice.

STATEMENT OF NORMAN B. RICE PRESIDENT AND CHIEF EXECUTIVE OFFICER FEDERAL HOME LOAN BANK OF SEATTLE

Mr. RICE. Thank you. Good afternoon, Chairman Shelby, and Ranking Member Sarbanes, and Members of the Committee. I am Norman Rice, President and Chief Executive Officer of the Federal Home Loan Bank of Seattle, and I would like to thank you for the opportunity to speak today on behalf of the Council of Federal Home Loan Banks.

I will just start this afternoon by commending Congress for the process now underway regarding regulatory restructuring of the housing GSE's. It is also important to note that the Bank System continues to work toward voluntary SEC registration, pending resolution of some critical accounting and reporting accommodations. For example, the Seattle Bank's Board of Directors, at our September 2003 meeting, adopted a resolution calling for SEC registration, and we are now moving to make that happen. The bottom-line goal for our 12 banks is to provide complete and transparent financial disclosures that are considered no less than best in class.

While there remain differences of opinion within our system on the matter of regulatory reform, we have reached consensus on four principles that we believe must serve as a framework for specific action and represent our bottom-line concerns as Congress moves forward on legislation.

Principle No. 1: Preserve and reaffirm our mission. We strongly believe any legislation should accomplish the following regarding the mission of the Bank System: Provide cost-effective funding to members for use in housing finance and community development; preserve our regional affordable housing programs; support housing finance through advances and mortgage programs; and allow for innovative new business activities that advance our mission.

Principle No. 2: Create a strong and independent regulator. Safety and soundness of the Bank System is our number one concern. This is neither a partisan nor an ideologically driven endeavor. It is for this reason we ask that Congress protect the Bank System through the creation of a strong and independent regulator. This is absolutely consistent with the role of other bank regulatory agencies in which the regulator responsible for safety and soundness has free and unfettered authority to determine policy, rulemaking, adjudicative, and budget matters.

We strongly believe that a regulator lacking true independence may eventually find itself pursuing other agendas, not the will of Congress, nor what is demanded to ensure safety and soundness.

Principle No. 3: Preserve the Bank System funding. It is critical that we ensure that nothing is done to any of the housing GSE's that would increase their cost of funds and, correspondingly, increase costs for financial institutions and consumers. Therefore, any legislation must: Preserve the role and function of the Office of Finance, which issues our system's debt; It must ensure that neither the U.S. Treasury, nor the independent GSE regulatory unit, has the ability to impede or limit our access to the capital markets without cause; And it must not limit the financial management tools available to the GSE's to prudently manage risk.

Principle No. 4: Recognize and reaffirm the unique nature of the Bank System. We believe any legislation must preserve the cooperative ownership of the Bank System, joint and several liability, and the regional structure that assures we are locally controlled and responsive to the needs of our communities.

Regardless of the regulatory structure established by Congress, we believe these principles must be considered as you move forward in your policymaking. So, in closing, I would like to put forward some ideas that reflect my own thinking on these matters.

I believe there are two threshold issues that could help Congress attain its goal of protecting the public interest in the housing GSE's.

First, there is much that separates the Federal Home Loan Banks from the two other housing GSE's: Our mission is broader, incorporating economic and community development. We have different capital requirements; The Bank System is cooperatively owned and capitalized by our members, while the other housing GSE's must meet the earnings expectations of Wall Street; The other two housing GSE's pay Federal income tax, but the Federal Home Loan Banks pay special taxes, equivalent to a Federal corporate income tax rate of 26 percent.

These are not inconsequential differences. Yet, despite these differences, we increasingly have more in common. All three housing GSE's are managing increasingly complex sets of financial, operating, and accounting risks. And in my view, all three would benefit from more rigorous oversight of these activities.

Second, the choices you make on regulatory reform must be based on the underlying philosophy about the housing GSE's. In your judgment, is the public interest best advanced by encouraging competition or encouraging market domination? In the end, I believe the Nation's home lenders will better serve the Nation's homebuyers if there are choices and competition in the secondary mortgage market. Full-fledged competition among GSE's is a way to more prudently manage growth and disburse risk among more investors.

As one of 12 Federal Home Loan Bank presidents, my responsibility is to protect and enhance this cooperative and the overall public interests invested in our Bank System—the same process that each of you bring to this process.

I would like to thank you for your time this afternoon, and I would be also happy to answer any of your questions you may have regarding my testimony.

Chairman SHELBY. Thank you very much.

Mr. Raines, the minimum capital threshold of 2.5 percent that Fannie Mae and Freddie Mac are subject to is often compared, as we know, to the 4-percent-minimum capital standard the banks and thrifts must meet. Do you believe that is a fair comparison?

Mr. RAINES. I do not believe it is a fair comparison, for several reasons.

First, the minimum capital requirement that we have applies not just the 2.5-percent on-balance sheet, but also there is a 45 basis for off-balance sheet items, which banks do no count off-balance sheet items in the calculation of their so-called minimum capital.

But more importantly, banks are in a far more risky business than we are.

Chairman SHELBY. Elaborate on that for the record. We basically know that a first mortgage on a home is probably one of the safe investments. I mean, it is not perfect, but it is pretty safe. Would you compare it to some of the other risks that banks take.

Mr. RAINES. Yes, sir. I think the simple comparison is to compare capital to losses. If you compare our capital to our losses on an annual basis, we have 450 times more in minimum capital than in our annual losses. A typical bank has 15 times.

Chairman SHELBY. Four hundred fifty times?

Mr. RAINES. Four hundred and fifty times as much minimum capital as our losses, a typical bank 15 times, a typical large bank, 12 times.

Chairman SHELBY. And how long is this 450? Is this this year or what about the last——

Mr. RAINES. It has been maintained for many, many years.

Chairman SHELBY. It remains constant.

Mr. RAINES. And, indeed, even if you just look at banks' residential mortgages, banks lose 30 times as much on their residential mortgages as we do. So, even if we do not count their investments overseas, their investments in leases, their investments in a wide range of riskier things, if we just look at residential mortgages, they have 30 times the losses that Fannie Mae has.

Chairman SHELBY. You do not make credit card loans, do you?

Mr. RAINES. We do not do that. Indeed, if we were to turn the equation around and say maybe banks should have the same level of capital that we have compared to losses, it gives you an idea of how high bank capital would have to go, even on their mortgages, if they had to have 30 times the capital that they have today.

So that is why it is very important to relate capital to risk. The most dangerous thing I think you can do in the financial system is require excess capital for the risk that is being taken because what that does is it diminishes the flow of capital into the marketplace. And so what you need to do, I believe, is to match capital with risk, and Fannie Mae and Freddie Mac, throughout our entire history, have had far lower risk profiles than comparable banks.

Chairman SHELBY. Both you and Mr. Gould have expressed your opposition clearly to a change in statutory minimum capital guidelines, but at the same time, you have generally expressed support for strengthening the authority of the new regulator using bank regulators as a model.

Why would it not make sense to allow the new regulator, if we create one, to have more discretion over the minimum capital standard?

Mr. RAINES. The major reason, I believe, is that the minimum capital standard is this capital standard relates to our mission, and it is saying how much it is that you think Fannie Mae should do.

If you double the minimum capital standard, without any change in risk, you are saying Fannie Mae can do half as much, and I believe that should stay with Congress.

But where it comes to risk, we believe that a regulator should have extensive ability to change the capital standard. Indeed, I have to say to you, and I am a very trusting person, but I have to say to you I wonder what would be the reason to raise our minimum capital standard if our risk has not gone up? What would be the reason? And the only reason I can think of is that the regulator will just have a different view of how active we should be in the housing market.

Chairman SHELBY. But, on the contrary, if the risk were not there, could a regulator not lower the risk capital?

Mr. RAINES. In theory, the regulator could lower it. We are not asking for it to be increased, and we are not asking for it to decrease. We are asking for our capital to be related to risk.

Chairman SHELBY. And if you could quantify your capital, just Fannie Mae, and I will ask Mr. Gould, what is this 2.5 percent? How many billions of dollars are you talking about?

Mr. RAINES. It is about $30 billion currently.

Chairman SHELBY. This is Fannie Mae.

Mr. RAINES. This is Fannie Mae. But on top of that, we have also pledged to issue another 1.5 percent against our assets in subordinated debt. So, if you calculate all of the capital, all of the risk-bearing capital that we have, we have 4 percent capital—2.5 percent that is equity and another 1.5 percent which is subordinated debt, which if we were a bank would be counted as part of the overall capital calculation.

We have 4-percent capital if you are talking about risk bearing.

Chairman SHELBY. For a lot less risk, you are saying.

Mr. RAINES. For a lot less risk, and it is important to remember that, when everyone talks about the risk to others, remember the first people who lose their money are the Fannie Mae shareholders. They have $30 billion as the first line——

Chairman SHELBY. Well, that is the way it should be, is it not?

Mr. RAINES. Exactly. That is why they keep me on my toes.

Chairman SHELBY. Mr. Rice, uniform capital standards for housing GSE's. You state that it is your view the capital requirements be standardized for all three housing GSE's. Are you proposing a 4-percent minimum, a 2.5-percent or regulatory discretion? What are you really saying?

Mr. RICE. I believe in regulatory discretion, but I do want to state that the Federal Home Loan Banks have had zero credit losses—zero—ever, and we are required to hold 4 percent minimum capital.

So, I would hope, with the discretion of an independent regulator, they would understand that there is some imbalance in the minimum capital standards, and maybe they would lower it to a level closer to the other housing GSE's.

Chairman SHELBY. On the other hand, the Federal Home Loan Banks can make advances based on collateral beyond mortgage-related assets; is that correct?

Mr. RICE. That is correct.

Chairman SHELBY. Would that not argue that the capital standard for the Federal Home Loan Banks should be different and perhaps more rigorous? In other words, you have got more risk than——

Mr. RICE. Well, Congress allowed us to have expanded collateral for other loans to be made to rural farmers and the like.

Chairman SHELBY. But that does not mean you do not have more risk.

Mr. RICE. No, I am not saying that, but I am saying that the collateral standards and the management of that credit is as important in managing that risk.

All I am saying is that we have a different minimum standard, and I think it would be important for the new regulator to evaluate those standards and make some determination rather than the status quo.

Chairman SHELBY. Mr. Rice, your written statement notes that the Bank System is working toward voluntary SEC registration, pending resolution of critical accounting and reporting issues.

I am also familiar with the study completed by First Manhattan which indicates that there may be significant costs associated with registration, and I want to enter that study into the record and share it with my colleagues.

[The First Manhattan study follows:]

Mr. RICE. I would appreciate it.

Chairman SHELBY. What factors do you believe that we need to consider, if we agree with the need for disclosure, which I think we do, yet want to be mindful of any structural factors unique to the Federal Home Loan Bank System?

Mr. RICE. The Federal Home Loan Banks have always, by statute, been jointly and severally liable for each other's debt. Under SEC registration, it appears that this situation could give rise to the need for each Federal Home Loan Bank to create an additional on-balance sheet liability. Additionally, Federal Home Loan Bank stock would be characterized, under current regulations, as being mandatory or redeemable. Those have real consequences on our balance sheet for our members, and we want to get clarification of those issues.

So the issue is not about not disclosing, it is how we disclose, and then the impact of those disclosures on our members. Our board has directed us to move quickly on this issue, but we do think there are areas of differences we would like to resolve with the SEC.

Chairman SHELBY. But the key to disclosure is how you disclose.

Mr. RICE. Exactly.

Chairman SHELBY. So, in other words, what do you disclose, and if you have transparency, that is going to be better for the regulator, it is going to be better for your members, is it not?

Because you are looking for the truth of your financial condition.

Mr. RICE. Well, transparency is what we all believe in.

Chairman SHELBY. And disclosure.

Mr. RICE. And disclosure, and there is no doubt about it. There are unintended consequences for the way we are structured from other publicly held corporations, and all we want to do is to talk to SEC about those differences and recognize them.

Chairman SHELBY. Thank you for your indulgence.

Mr. GOULD. Mr. Chairman, might I comment on capital from a slightly different point of view, but I think an important one for what this Committee is considering?

Chairman SHELBY. Yes.

Mr. GOULD. I think capital has often been a shorthand way of looking at protecting the overall risk which Secretary Snow commented on to the financial system a number of times when he was here, and that is of course true. That is the first capital to be lost if there is a problem, and risk-based capital, trying to relate it to the risk nature of where you are buying loans or holding assets, but I think there is another very important aspect of it, a subtlety to the risk aspect, which is, to me, the most important thing the regulator must look at is how well the companies themselves control the risk of what they are doing, how well does Freddie Mac control its interest rate risk exposure in terms of its retained portfolio and how well do we evaluate and monitor the credit risk of our securitized portfolio because there the numbers are very large.

This is a very important factor, as we go forward and try to provide more minority housing and fulfill our low-income mission, so a strong regulator, in my mind, is defined in other ways, besides other ways, as someone who is able to evaluate the risks of how we manage ourselves internally because that, in the end to me, involves much larger numbers than merely the amount of capital.

Chairman SHELBY. How much of our portfolio do you keep and you do not secure? Do you securitize everything?

Mr. GOULD. No, sir.

Chairman SHELBY. I thought you kept a lot of stuff.

Mr. GOULD. Yes, we do.

Chairman SHELBY. That is where the risk comes, is it not?

Mr. GOULD. Well, a different type of risk.

Chairman SHELBY. It is risk.

Mr. GOULD. They are the same securities. Yes, sir, it is risk, but the retained mortgages and the ones we securitize are the same product. In securitizing them, we have taken the risk in our guarantee of those securities that they are good in a credit sense. For the same type of mortgage that we retain, our risk is that we do not finance properly or do not hedge properly the interest rate risk of having to finance those retained mortgages in the market and yet have those mortgages a fixed rate of return financed in a fluctuating or volatile public market, which we do, and we believe very successfully and safely, with a certain amount of derivatives.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Mr. Gould, your comment just now about a strong regulator evaluating the internal controls of the entities that he is regulating, that is the point you are making.

Mr. GOULD. Yes, the economic controls within the company.

Senator SARBANES. I take it that is, in effect, a fairly strong criticism of OFHEO in terms of its oversight over Freddie Mac.

We would not be here today, I do not think, but for the Freddie Mac experience.

Mr. GOULD. I would not, personally, characterize it as a strong criticism because their prime mission is safety and soundness, and there is no question, before or during the accounting problem or now, of Freddie Mac's safety and soundness. Indeed, I think anyone will testify that our safety and soundness, in terms of economic risk, and hedging and credit risk, is first rate, best in class.

Senator SARBANES. If you are not reporting accurately, does that not carry with it a huge potential to impact on the perception of your safety and soundness?

Mr. GOULD. Certainly, the perception I would not argue with you, Senator, and perceptions in markets are extremely important. And Freddie Mac, what the Freddie Mac issue is really about is the timing of the recognition of income. When you get right down to the core issue, that is what it is. Should these earnings have been recognized in earlier years or should they have been amortized over certain assets into future years? And basically that is what you are getting to.

And the answer of our new auditor, in particular, is we should have recognized that income in earlier years, but that is a long way from safety and soundness and a long way from the systems we built to control our economic risk. And, very frankly, Freddie Mac simply did not build its accounting, both its accounting abilities, both in a technical sense and in a personnel sense, in the same way that fortunately it built all of its economic risk organization.

Senator SARBANES. Mr. Rice, if a new regulator is developed for Fannie and Freddie that carries with it the message that they are under enhanced safety and soundness regime, and the Federal Home Loan Banks are not part of that new regime, with I think a growing perception that the regulator of the Federal Home Loan Banks is really not up to standard, what would the impact of that be on the Federal Home Loan Banks?

Mr. RICE. You started your question with "perception," and if that perception moves to the Street, then it could have consequences on the cost of funds. There could be a difference, and you might be able to feel it.

I think that is one of the reasons why a large number of banks have said, if you are going to move in this direction, here are the principles we want, and we would like to be included based on that framework.

Senator SARBANES. I guess it is the concern about that development that has led at least some of Federal Home Loan Banks to now be in favor, on certain terms, of being included with the other GSE's in this regulatory arrangement; is that correct?

Mr. RICE. There are those concerns, yes.

Senator SARBANES. So from the point of view of the Federal Home Loan Banks, or at least some of them as they analyze it, being left out has a potential of a significant downside to it; is that correct?

Mr. RICE. The more people talk that way the more momentum is create but there is nothing quantifiable at this point.

Senator SARBANES. I am not talking that way. I am just asking.

Mr. RICE. There is nothing quantifiable that could show you those kind of metrics. But I do believe that the cost of funds might be affected, but I have no proof or empirical data to show you that.

Senator SARBANES. Then let me ask this question of all of the panel members. Fannie and Freddie have been under the same regulator. They do the same line of work. The issues are all co-terminus, so to speak. The Federal Home Loan Banks are somewhat different. They do some things that Fannie and Freddie do, and they do other things that Fannie and Freddie do not do. Fannie and Freddie would not be permitted to do some of those activities.

Now if you are all brought in under one regulatory structure, it seems to me you confront a problem of how do you harmonize this situation. So, I would be interested in hearing from each of you what you think the problems of harmonization would be and how they might be resolved. Mr. Rice, why don't I start with you and we will just go across the panel?

Mr. RICE. I think the best way was the one that was articulated by Secretary Snow, even though I would like an independent regulator—he said, have two deputies to view the functions of the two structures, because they are different. I think to recognize the difference within the organization and let the regulator then lead would be the best way to do it.

Senator SARBANES. Mr. Gould.

Mr. GOULD. I think you would have to have a pretty good-sized staff in order to harmonize it because you are, as you suggest, Senator, looking at certain different activities and a regulator would have to come to conclusions as to the safety and soundness of each of those different missions. I think, however, there is a common denominator which is the safety and soundness of how they finance themselves and how they manage risk; interest rate risk or core credit risk. So the Treasury does have, certainly, expertise in that area, but I think it would have to be staffed more broadly than just the two GSE's because of the different level of opportunities they have to make loans.

Senator SARBANES. Mr. Raines.

Mr. RAINES. Senator, I think the problem is broader than that of my compatriots here. I think that there would need to be a very clear standard that similar activities would be regulated in a similar way. Otherwise it raises the question, which regulatory scheme is really the best one? That raises a number of issues I think would have to be resolved.

First of all, the question of mission. If you look back in 1992, Fannie Mae had 87 percent of its assets were owning single family mortgages and the rest were liquidity primarily. If you look today, 90 percent of our assets are owning single family mortgages but we have had an extensive debate about whether Fannie Mae has been in new businesses or not.

If you look at the same thing with the Federal Home Loan Banks, for some of the Federal Home Loan Banks in 1992, 100 percent of their assets were either advances or investment securities. Today, in at least one of the banks, advances are a minority of what they do. So there would have to be a question first on mission. What do we mean by mission? And could Fannie Mae, if we were to harmonize, does that mean Fannie Mae could go wholly into an entirely new business that is completely different from the holding of mortgages, if the harmonization were to go that way? I would think that would not be the interest because there has been so much concern that we have already gone into things that are far beyond our charter.

The second point that comes up is on capital. We had a discussion on capital, and I have to correct myself. We only have 357 times as much capital as our losses, not 450.

But on the question that Norm Rice brought up on capital. The capital that the Federal Home Loan Banks have today would not count as capital for Fannie Mae because it would be considered a kind of puttable preferred. It would not count at all as being acceptable capital for Fannie Mae. That is a big difference. The Federal Home Loan Banks believe they have an enormous amount of capital but under our capital standard it would count for zero. Someone would have to resolve, what does that mean?

Similarly with regard to housing goals. Today, Fannie Mae has housing goals which are percentage of business goals and we invest more money in low-income housing tax credits than the entire Federal Home Loan Bank System invests in their affordable housing program. And we pay Federal income taxes. So we do all three and the Federal Home Loan Banks do one. Now which way are you going to harmonize?

Mr. RICE. That is why you need two.

Mr. RAINES. I think the problem is, if we are both going to be in the business of providing a secondary market and owning and guaranteeing the mortgages, then presumably we would have the same standards apply. I think these are tough questions. I think that before we embark on this you would want to either have the Congress answer them, or certainly empower the regulator to insist that the same standards be applied if you are in the same business. Certainly within this small group of GSE's that should not be too much to ask for.

So, I think there are some very profound issues and I do not want to presume to say, doing it our way is the best way or their way is the best way. But there are very different standards that are being applied now and I would think that we would want to pick one to apply to all these entities, at least as far as it goes to the owning of mortgages.

Mr. RICE. I would just come back to the whole question that because we are a cooperative and because our members are on our board and we service our members, if our members are desirous of a product, we have that product approved by our regulator and we are providing the type of product that our members want.

I would call it mission leap rather than mission creep and I do believe we can do it and we have managed it well. In the short term, $1.75 million from this new activity has gone to our affordable housing programs and created almost 385 units of housing. So we are still providing the mission that we were chartered, and I think we are moving in a way that really makes a difference.

Advances are a product. I have no problem if Fannie Mae wants to move into advances. I just think that the regulator ought not to be so overburdened with restrictions at the beginning. These are things that I think an independent regulator has to come to grips with. But I do think that there is a way to manage this in a way that maintains the character of the system that we have and recognizes the differences, because that is what is at risk is the differences. So by having a single regulator with maybe two divisions under it still maintains the integrity of what the Federal Home Loan Banks is and allows I think for good regulation.

Chairman SHELBY. Senator Bennett.

Senator BENNETT. Thank you very much, Mr. Chairman. The more I sit here, the more I realize I need to sit here.

[Laughter.]

First, I asked a question of the previous panel, have they ever missed their goals? Mr. Gould, you came back fairly strongly and said you disagree and that you have not missed your goals. Mr. Raines, do you also disagree that you have not missed your goals?

Mr. GOULD. I have said that there is disagreement with the study that Mr. Martinez was citing as to our not leading, but lagging. In terms of meeting our goals, as my testimony says, since those goals have been permanent we have met them every time. There were some temporary goals in the early to mid-1990's that we did not meet.

Senator BENNETT. That was the period of time that he cited, 1993 to 1995.

Mr. GOULD. Yes, sir, that is correct.

Senator BENNETT. Mr. Raines, do you have a comment on that?

Mr. RAINES. Yes. The current goal structure we have met every year. In the first year that they established the goals, they had a different goal called a central cities goal, in the very first year, which we did not meet nor, I believe, did Freddie Mac meet. But that goal was then eliminated. So when we are talking about, have we met our goals, if you look at the goals that we have had over this period we have met them every year.

But I agree with George Gould on the question of leading the market, that we believe the data clearly shows that we do lead the market. But let us be clear of what that means.

Senator BENNETT. I wanted to get more clarification on that.

Mr. RAINES. What leading the market means is that we are acquiring a greater share of a type of loan than the market creates. Now that may sound like an easy thing to do, but we are in the business of buying loans that other people have originated and which they have voluntarily decided to sell. So leading the market is not just simply our opening up the doors and saying, give us the loans you have. Indeed, if you look at our major lenders, if we only relied on our single family lenders we could not even meet the HUD goals, let alone lead the market.

But also, this Committee has instructed other lenders, particularly depositories, that they are to lead the market. So when they acquire loans that may fit our goals, if they decide to hold them then they are leading the market and we are unable to lead the market. So the fact that we lead the market is a big deal. It is not a small thing.

This debate, I hope you understand, between us and HUD on the statistics, which we can go over with your staff with the statistics, is a question of, they believe we might be behind the market by 1 percent, and we believe we might be ahead of the market by 1 percent. So this is not a question of wholly failing. This is a difference between 41 percent and 42 percent.

But the important thing is the fact that Fannie Mae and Freddie Mac can even come close to the market on this kind of a detail is an indication of the kind of effort we make because we can only buy loans that people voluntarily want to sell to us. We cannot make them sell them to us. Indeed, we have to induce them to originate the loans. Then we have to induce them to sell them. And then we have to induce them to sell them to us. All of which goes into leading the market.

So when we say we lead the market, it is not as though we just opened up the doors and business came in. It is a very hard thing to do when you do not originate the loans yourself.

Senator BENNETT. So everybody has to lead the market. It is a little like Lake Woebegone where everybody is above average.

Mr. RAINES. Yes.

Senator BENNETT. Let me ask about the cost of funding. GSE's are successful largely due to their access to relatively low-cost funding. So how would the different issues relating to creating a new regulator and possibly moving program authority—these are the two fundamental issues I keep hearing over and over again; what role is HUD going to have? What role is the regulator going to have? I think there is general agreement agreeing with Senator Carper, here is the list of things that we all agree on, and there is general agreement that there needs to be stronger regulation; a higher class, world class—whatever that means—regulator for everybody. And there is general agreement that that, for the GSE's at least, should be in Treasury. Mr. Rice is not quite sure he is ready to move in that direction yet. I can understand that.

But how would the different issues related to creating a new regulator and then moving the program authority out of HUD affect your access to low-cost funding?

Mr. RAINES. I think the impact on funding is not nearly what has been spoken about. I think that is an issue of mission. I think it is far more important, in terms of the balance between safety and soundness and mission, to get the program approval right. Because if you freeze Fannie Mae or if you had frozen us 10 years ago and said that innovation is now going to be subject to a bureaucratic procedure, we never could have done all the refinances that were done last year when 10 million loans went through our automated underwriting system, and giving people loan approvals in two minutes rather than 2 weeks. We could never have done what we have done in the last couple of years. It just would not have happened.

I think it goes to the mission and our capability to serve the market. But I do not believe that moving our regulator to Treasury is going to increase our access to the market. I do not believe it will harden in any sense the implied guarantee, which I never quite understood what an implied guarantee is. Nor do I think it would be harmful, whether or not the Federal Home Loan Banks were in or out of the Treasury apparatus. I think the most important thing is that we have a strong and safe and sound—strong regulator so that the investors believe that their interests are being taken care of.

I view this as a continuum. Before 1992, we essentially did not have a safety and soundness regulator. In 1992, this Committee led the way in creating one. Now here we are 11 years later to improve on it. So, I view this as more of a continuum than an abrupt change that is going to change the market's perception of Fannie Mae, Freddie Mac or of the Federal Home Loan Banks.

Senator BENNETT. Mr. Rice, do you want to comment?

Mr. RICE. The only thing I would add is that the System has had zero credit losses—and we are regulated for safety and soundness by the Finance Board, we have had an exemplary activity and a record in this whole area because we have had a very good safety and soundness regulator. I do believe that I share some of the same opinions that Mr. Raines has, and that is that it is the performance and the examination and the supervision of our activities that really does resonate with the Street.

The Street does not really ask you, who is your regulator? They really look at your financial statements and the condition of how you run your operations and that is the measure of your success. We think we have a good success record as we exist today. I think that is the reason some of the banks are questioning whether this new configuration as something that is necessary.

But I do think that all of us are realists. If you are going to create a new regulatory structure, we would like to see if maybe there could be some consistency. But I do not believe we all need to be the same. One size does not fit all, especially for the Federal Home Loan Banks, and especially for the cooperative nature in which it operates. So when you try to make these distinctions to bring this all together in one lump sum, I think that is not something that legislation can really do. You are going to have to rely on the independent regulator, who should be outside of Treasury, making those determinations which will allow you to get the accountability that Congress needs.

Senator BENNETT. Thank you. Thank you very much.

Chairman SHELBY. Senator Sununu.

Senator SUNUNU. Thank you, Mr. Chairman. Welcome to each of you. Mr. Raines, I very much appreciate, one, the time you have spent on this issue. You have spent time with me. Your staff has been very generous with my staff and that is very helpful. I think everyone on the Committee understands how important these issues are to you as businessmen and your employees, but also how important they are to the capital markets. So thank you for that.

I also very much appreciate the emphasis you place on the definition and the language that is going to be used by any regulator regarding products, programs, and activities. I very much agree with that. We want to be, first and foremost, as clear as possible. We may end up with language that is not exactly the way you would write the statute. No surprise. But I very much agree that language is important, more important than exactly where the regulator overseeing those new business lines are. We want to get that right so that you can innovate, so that you can respond to changes in the market and new technologies. So, I want to emphasize that I very much agree with you there.

Certainly, as you well know, the legislation that Senator Hagel, Senator Dole, and I have introduced I think largely agrees with the perspective that you place on enforcement—you talked about that in your testimony—on independence, which you have talked about and emphasized in your testimony, and a number of other issues. So, I think we can all appreciate that there is a good deal of consensus here.

Mr. Gould, I think you suggested that the accounting issues do not affect safety and soundness. The misstatements of accounting, profits, do not affect safety and soundness; is that correct?

Mr. GOULD. I have said the accounting issues we have had do not affect safety and soundness. I am not making a generalization of that statement.

Senator SUNUNU. Sure. I want to explore that a little bit because I think a $3 billion misstatement of profit does affect safety and soundness. I would imagine it affects your access to the capital markets, and it certainly affects the interest rate at which you can borrow and the expectation of investors. Would that not be part and parcel of affecting safety and soundness?

Mr. GOULD. It might ultimately. I do not think it has affected our safety and soundness now. I do not know what tense we are speaking in, Senator. Are we talking about present tense, future tense, or past tense?

Senator SUNUNU. We are talking about past tense in terms of accounting misstatements that have occurred, a $3 or $4 billion misstatement of the timing of profits earned by Freddie Mac——

Mr. GOULD. Have not affected our safety and soundness.

Senator SUNUNU. And whether or not that accounting issue in particular or that type of accounting issue would affect safety and soundness.

Mr. GOULD. It has not affected our safety and soundness in a past tense or in a current tense. Could it affect our safety and soundness in a future tense? Absolutely. That is why we have a number of steps of remediation to try to prevent anything like that happening again. In a sense this is, as someone said earlier, a high class problem. It happens to be more earnings. But it is also possible, in theory, if steps were not taken to correct it, that it might go the other way sometime and that certainly affect the perception and the reality of safety and soundness. So it is something that must be corrected.

Senator SUNUNU. I appreciate that, although I will qualify my own reaction as I did earlier, the fact that it was an understatement of earnings does not make it any better, any more acceptable, does not denigrate the fundamental problems than if it were an overstatement.

Mr. GOULD. I agree with you totally. I might say though, since you are on that subject and we are talking about accounting, and I think that this is very important for this Committee to understand. I am not passing judgment on whether it is good or bad, the new accounting rules under GAAP, but the fact is it introduces, particularly for someone like Freddie and Fannie, a high degree of volatility in earnings, quarterly earnings and yearly earnings, high degree compared to the past which, again since we have discussed perceptions, is something that we are both going to have to work on trying to explain the realities of the underlying economics of our companies rather than merely GAAP.

Because Freddie's transgression here has been not following GAAP. Part of the problem has been the fact that we do not think GAAP is the best explanation of the nature of our economics. But we must follow GAAP. Those are the rules. But in an accounting sense, the future will look different from the past even with all the accounting corrected.

Senator SUNUNU. I appreciate your concern with the accounting standards and I understand in concept, in principle, your concern. But this is usually the part of the hearing when we all run for cover behind Senator Enzi. If we start getting into FASB and GAAP standards then most all of us are out of our element. But your points are very well taken. Also I want to be clear, I very much understand that you are more sensitive than anyone else in this room to the issues created by the past misstatements.

Mr. Raines, you stated that you, Fannie Mae, or the GSE's, are asking for capital to be related to risk. I totally agree. But I do not see how moving regulatory authority for a minimum capital standard to be inconsistent with ensuring that capital is related to risk. Those are not mutually exclusive, are they?

Mr. RAINES. I think that there is a concern that if you have a risk-based capital standard that you are setting gauged risk; why did you move the minimum capital standard? Our minimum capital serves a very different purpose than minimum capital in banks. Banks do not have an effective risk-based capital standard. What they call risk-based capital is simply a leverage requirement applied asset class by asset class. But it does not go up and down with changes in the economy. It does not go up and down with changes in interest rates. It has no stress test involved in it. So in their case, the only lever they have to move is the minimum capital in order to be able to affect the bank.

Senator SUNUNU. I appreciate that. I appreciate the differences between banks, and your testimony about the differences in portfolios and business activities; very important and very well taken. But it just would seem to me, and I suppose most people looking at this from a common sense perspective would say, whatever capital standards exist in order to ensure and match with safety and soundness should be the responsibility of whatever new regulator is envisioned by this Committee.

Again, I can understand your point that there are differences between banks and that banks may not have the risk-based capital standard. But whether we are talking about minimum capital or risk-based capital, it would seem to me to make sense that the new regulator have responsibility.

Mr. RAINES. Then, Senator, if that is the Committee's view then my recommendation would be, abolish the minimum capital standard and simply have a risk-based capital standard, which would be entirely based on risk and we would not have to have the discussion about whether minimum goes up or down. Because in our case, minimum capital is in some ways an anomaly, as to why you even have a minimum capital standard if you have got a risk-based capital standard. So there is another way to avoid the confusion, which is to eliminate the minimum capital standard.

Senator SUNUNU. Are you recommending that?

Mr. RAINES. No. My recommendation is to leave the capital standard that Congress has created in law and leave it the way it is and allow the regulator great flexibility in changing risk-based capital. I am not proposing a big change. I am trying to have as few changes as possible so we can actually get something done. But based on your logic, there is an alternative solution. Rather than giving the regulator authority to move it around, get rid of it and have the entire focus based on risk-based capital.

Senator SUNUNU. My logic is that whatever capital standards exist should be the responsibility of the new regulator. Your logic is that nobody else has a minimum capital standard, and therefore, we ought not to deal with it.

With regard to the Federal Home Loan Banks, if they are included in the legislation, are you recommending that we include your proposal to tax them?

Mr. RAINES. What I recommend is that if the Committee is going to include the Federal Home Loan Banks, that the Committee address these substantive issues as to whether or not they should be—as it relates to their mortgage programs, not to their advances, but as it relates to their mortgage programs—operating under the same rules that we do.

Senator SUNUNU. Which would be a significant change to their charter.

Mr. RAINES. Absolutely. But they have moved into a significantly new business. Just as if we moved into a significantly new business I think you would want to revisit our charter.

Senator SUNUNU. But moving them to a new regulatory authority does not mean they are moving into a new business.

Mr. RAINES. Some of them have already moved——

Senator SUNUNU. The question is, if we move them into a new regulatory authority, should we tax them? You seem to say, yes, because we should revisit the charter issues associated with the Federal Home Loan Banks because we are moving them into this new regulatory authority.

Mr. RAINES. No, because the Congress of the United States, I do not believe, is going to take up this issue again any time soon. If you move them into a new regulator you are essentially saying that you are comfortable with the Federal Home Loan Banks having $100 billion today, and potentially $500 billion in a few years, owning of mortgages under an entirely different scheme than you have established for Fannie and Freddie.

Senator SUNUNU. So by extension, should we revisit the issue of the tax status with regard to State and local taxes for the GSE's, and the Treasury line of credit as well?

Mr. RAINES. If we move into a different business.

Senator SUNUNU. If we move Fannie and Freddie into a new regulator?

Mr. RAINES. No. If we moved into a new business I think you should revisit our charter. But we cannot move into a new business under our charter. They have moved into a new business that is entirely different from the business that they were in the last time Congress reviewed their charter.

Senator SUNUNU. So your point seems to be that you want to revisit these issues of charter and taxation because they have moved into new businesses, not because we are considering including them in a new regulator.

Mr. RAINES. Both.

Senator SUNUNU. There is an important distinction to be made here.

Mr. RAINES. It is both of those. But I agree with you. If the Congress was not taking up this issue, then I would not come up here and say, I would like you to take up the issue. But if Congress does take up the issue of the Federal Home Loan Banks, I think this is the one time you are going to deal with it for the next 5 or 10 years, and I think if you do not deal with it now it will never be dealt with.

Senator SUNUNU. But this same exact argument could be made, by someone that wanted to make it, that for those very reasons, because we are talking about these issues, that we should have on the table Treasury line of credit for the GSE's, that we should have on the table applicability of State and local taxes. As you well know, in approaching this I think many people, including me, have said that maybe those ought not to be addressed specifically in this legislation.

Mr. RAINES. There has been no hesitancy in this town for people to raise those issues about Fannie Mae and Freddie Mac. If we were to move into a new business I would expect them to raise them, and I would expect Congress to address them. But nothing has changed in terms of our business since 1992. Congress addressed that issue in 1992. There has been no new argument made with regard to them since 1992. That is why I am saying, I do not see a need for Congress to go into that.

A lot has changed with the Federal Home Loan Banks since 1992; a lot has changed. And a lot has changed since the last time Congress legislated a few years ago with regard to this issue. And the Banks are proud of the change. So this is not hidden. The only question I am raising, a change has occurred. If you are going to now legislate on the Federal Home Loan Banks, it seems to me that change should be addressed.

Senator SUNUNU. I want to salute Mr. Rice for his discipline at the other end of the table and make note that——

[Laughter.]

Mr. RAINES. It is a Seattle characteristic.

Senator SUNUNU. I do not think the Chairman would have moved on without giving you an opportunity to respond.

Mr. GOULD. And you noticed, I tried to stay out of the argument.

Mr. RICE. I was trying to. I have a hole in my tongue.

The Fifth Circuit Court of Appeals confirmed the System moving into this mortgage purchase area. They said it was consistent with the mission, and the System's housing mission. And the Finance Board authorized us to move into this area. So it was not as if somehow we just moved into this area. We had a lot of people giving us scrutiny, and that precedent is there.

As a matter of fact, it is interesting, this is the hard part with the regulatory structure. Some people want things left as they are as we move forward into the new regulatory structure and some people want them changed. I do not think that you can have it both ways.

I think at the end of the day we are in a business that our members wanted and that is what we respond to.

I would just say that we do have taxes, we pay RefCorp, which is a percentage of our income. And we have AHP, our Affordable

Housing Program, 10 percent of our net income that is mandatory. And we have no tax shelters.

Chairman SHELBY. I think you used the phrase earlier creeping mission or something like that.

Mr. RICE. Mission leap.

Chairman SHELBY. Mission leap. Well, we hope you are not leaping, any of you leaping toward the taxpayers. That is what we worry about, as you know, and that is why we need strong regulators and strong standards.

Mr. Raines, you have indicated that you support such a change, but there is a need for stability in capital standards. How would you define stability in capital standards?

Mr. RAINES. I think the stability that we would look for is to simply leave it to the regulator to decide when it would be necessary to change the risk-based capital standards. They just became effective this year. I would hate to see the Committee, or the Congress, mandate that the regulator make a change. And so I would leave it to the judgment of the regulator as to how rapidly they would want to make a future change.

But there was some discussion at some points about mandating, that they throw out the existing standard and create a wholly new one. And having just gotten it, after 10 years, we think that would be precipitous.

Chairman SHELBY. You would have to be careful in doing that.

Mr. RAINES. You would have to be careful, but we are not looking for any limitation on the ability of the regulator to make a change. We just do not want there to be a mandate that by some date they have to come up with a brand new standard that we would then have to adjust to.

Chairman SHELBY. So basically, would you be comfortable, whatever that comfort level might be, with language on risk-based capital similar to that accorded to the bank regulators?

Mr. RAINES. In terms of how they set the risk-based capital?

Chairman SHELBY. Yes.

Mr. RAINES. We are comfortable—I hesitate on the bank regulator because we have some many examples. But we are comfortable that they have broad authority to do that.

Chairman SHELBY. We know you are different, your mission is different.

Mr. RAINES. Yes, we believe that they should have broad authority, keeping in mind the best practices that have been developed over time, and that they apply their best judgment to that. So we are in favor of a lot of latitude on risk-based capital because it has to evolve and change as the risk posture changes.

Chairman SHELBY. Senator Bennett, would you like to ask any more questions?

Senator BENNETT. Thank you, Mr. Chairman, and I thank Senator Sununu for his diligence and his penetration in his questioning. I just have one quick comment, more or less to get it off my chest than to discover anything.

Mr. Gould, I believe that accounting is an art, not a science. I believe accounting is a philosophy, not an exact procedure. And the assumption everywhere is exactly the reverse. The assumption is that you count the number of beans in the jar and they are what they are, and any statement of a different number of beans in the jar is dishonest. And accounting is very, very clear and straightforward.

What people who have not run businesses do not realize is that there are a whole bunch of jars sitting on the shelf and you put a bean in the wrong jar, many times because your auditor tells you the second jar is where that bean belongs even though you want to put it in the first jar.

And my understanding of what happened at Freddie Mac was that your auditor, who was Arthur Andersen that no longer exists, was telling you that proper accounting required you to report what you reported. And then when Arthur Andersen, who made some very, very serious accounting mistakes in their advice to Enron, ceased to exist, your new accountant said no, they are in the wrong and let us put it here. And this is not a matter of misleading anybody. It is simply a matter of making a philosophical choice as to which jar the bean goes into that turned out to be the wrong choice.

Now I do not want to lead you, but is that——

Mr. GOULD. Well, that would apply to a good bit of all that is wrong, Senator. I can say that with absolute certainty.

There are probably some other instances of transactions where on reflection, with the help of our new auditor, our people internally would say gosh, we were following the wrong policy, albeit that a number of those may have been passed upon by Arthur Andersen. I am not trying to exonerate everything or whitewash what had been done. But I will just give you one example.

We changed auditors and Price Waterhouse comes in and looks at 140 accounting policies and decides to change 130 of them. Now that is not saying that 130 of them are necessarily dead wrong. That is saying they felt best practice and the proper way to do it was to change 130, and that is one of the reasons this restatement has taken so long.

But you are absolutely correct, there is subjectivity in accounting rules. There is no bright line, often. Sometimes there is a bright line and sometimes Freddie Mac went over that bright line.

But the fact is that there was a lot of subjectivity to it, a lot of art form. In fact, sometime if we had a lot of time, perhaps you and I could have a philosophical discussion of what are earnings? What reflects the underlying economics of a business best? And that is not an easy question to answer. So you are correct certainly, sir, in that respect.

Senator BENNETT. Well, I just simply, in this discussion, want to make it very clear that there is a difference, and it is a very significant difference, between the Enrons where people are greedy and stupid—and usually those two go together—and deliberately cooked the books to achieve a result that was not sustainable from the economics. And then accounting challenges that come because of philosophical differences between accountants.

And this is one of the challenges that a regulator is going to have to deal with, because the regulator is going to have to decide how the books should be kept, in many instances.

Mr. GOULD. Again, I want to be very careful that I am not exaggerating here. Freddie Mac made some errors and that is undeniable, particularly as to whether or not certain things conformed with GAAP or the business purpose of certain things. A lot of it was, as suggested, differences of opinions. But there were some mistakes made and those mistakes have been corrected and the remediation has included not only correcting those mistakes but also ensuring it will not happen again by changes in personnel and systems.

Senator BENNETT. That is why I raised the question, because I wanted to be clear to what extent it was just you were following the advice of your auditor, and what extent you made mistakes. And you have made it clear that there was both.

Mr. GOULD. I wish I could say it was entirely someone else's fault, but that would not be an honest statement.

Senator BENNETT. Thank you. I appreciate that.

Chairman SHELBY. Mr. Gould, is that restatement date, is that in November now?

Mr. GOULD. Yes, sir.

Chairman SHELBY. I know it slipped.

Mr. GOULD. It has been a moving target, but it is now November.

Chairman SHELBY. Are you going to make it? I think the world would like to know.

Mr. GOULD. I certainly do not want to perjure myself in any way here. No, yes. I feel a very high degree of confidence that we will have it completed. The last glitch has been largely a systems——

Chairman SHELBY. Sure, we know you have to go back and do a lot of things.

Mr. GOULD. Yes, we had to go back to 1998 and review some numbers because of a systems glitch. But the fact is that I am quite confident that it will be November, yes, sir.

Chairman SHELBY. Thank you.

Senator BENNETT. If I could just interject, Mr. Chairman, you have announced your intention to register with the SEC, as Fannie Mae has already done. Is your registration with the SEC delayed by your ability or inability to meet these deadlines?

Mr. GOULD. Yes, sir. Our ability to register with the SEC is contingent upon having current financials and we do not have those, and will not have current financials for probably the middle of next year.

Senator BENNETT. So your registration is not a lack of will or a dragging of the feet, it is simply the mechanics of getting numbers.

Mr. GOULD. Precisely. We thought we would have been there by now.

Senator BENNETT. I see. Thank you.

Chairman SHELBY. Sir, do you anticipate November, if you meet the deadline, the news is going to be upward and out and good news as far as——

Mr. GOULD. Well, I expect it will be really——

Chairman SHELBY. I know you are not going to say what.

Mr. GOULD. The news that we have already tried to announce to the public in several releases, we have given a range of our expectations.

Chairman SHELBY. It is going to be a gain, not a loss?

Mr. GOULD. Oh, yes. It is going to be——

Chairman SHELBY. It is going to be a substantial——

Mr. GOULD. There are few things I am totally sure of, but I am totally sure of that.

Chairman SHELBY. Would it be a substantial one?

Mr. GOULD. Yes, sir. I think we have said it would be something, a $4.5 billion after tax number, or maybe somewhat higher, I believe, was the nature of our public announcements.

Chairman SHELBY. Senator Crapo, I know you have been gone and busy.

Senator CRAPO. Since I have not been here, maybe you should let Senator Sununu go ahead.

Senator SUNUNU. Thank you. If we were to extend Senator Bennett's line of questioning, I am afraid the next question would be when is an economic hedge not an economic hedge? And I think my friend Peter would be the only person who would enjoy that discussion. So, I am going to change the subject.

Mr. Gould, is the prepayment rate in the mortgage-backed security portfolio that Freddie Mac holds different than the prepayment rate associated with the mortgage-backed securities that are sold into the secondary market?

Mr. GOULD. Not intentionally, but there has been a period here, which I believe has now been almost entirely corrected, when it appeared that that actually occurred. And to the best of my knowledge, the research internally that we undertook to see why that was happening, it had to do in particular with a number—or several, not a number, several people who were very large sellers of mortgages to us. And we happened to securitize those. And it would appear that, for whatever reasons in their initiation of those mortgages, they had a population that prepaid earlier. But there was a differential, that is correct.

Senator SUNUNU. There were unusual demographics in two distinct blocks of mortgages that were rolled into a mortgage-backed security? Is that correct?

Mr. GOULD. There were.

Senator SUNUNU. Was it coincidence that you had this type of a prepayment demographic rolled into one security? Or was it good fortune?

Mr. GOULD. You have to look at, to answer that question properly, our pattern of mortgages purchases. We have steady customers who sell us mortgages on a regular basis. And occasionally we have large financial institutions who originate mortgages that will sell us a large bundle of mortgages.

You can get as technical as you wish, but the fact is that in a very steep yield curve, a lot of these banks find it more profitable to hold mortgages than they did with a flatter curve, so they accumulate mortgages and hold for a while because it is economic to them. And then they might crawl up and say how would you like $20 billion of mortgages?

So there are periods when you buy a large pool of mortgages and then you turn around with those mortgages and either retain some of them for your own portfolio, or you securitize some of them. So it is not a steady, even pattern. So once in a while you can have instances where there may be difference of demographics or geography that particular affects some issue of mortgage-backed securities. Yes, sir.

Senator SUNUNU. A final question. Mr. Raines, you talked about in your testimony the assessment fees or the fees that are used to finance a new regulator. I did not see in your testimony a final number. How much? How much do you think we should provide for the new regulator? How much is enough for them to do a good job?

Mr. RAINES. I think that should be left up to the regulator, with some supervision by some outside entity that would simply have a reasonableness test or simply have them announce publicly what it is going to be and give an opportunity for people to comment.

But I do not think that there should be any artificial limitation on their resources, but I just worry. Having been a former budget director, I worry a little bit about when you have an unlimited source of money, that you have an unlimited need.

Senator SUNUNU. Fannie Mae does not represent an unlimited source of money. That is a slight exaggeration.

Mr. RAINES. I think that some believe that to be true, and I just hope it is not our regulator who has that belief.

Senator SUNUNU. Let me ask it a slightly different way. The $30 million that is currently appropriated for OFHEO, is that enough?

Mr. RAINES. Well, they have asked for more. And we have had a policy of never commenting in the appropriations process on what their appropriations should be. So we have never taken a position one way or another. We have left it up to the appropriators to pick the right number.

Senator SUNUNU. Thank you. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman.

Let me first apologize to the members of the panel. I had other obligations that took me away, and so I was not able to be here when you made your presentations, although I have read your testimony and am familiar with it.

I want to use my time here talking to Mr. Rice about the Federal Home Loan Bank issue. You thought you were going to get off the seat.

Mr. RICE. I sure did.

Senator CRAPO. I apologize if these things have already been addressed by others, but it is my understanding that there is not consensus among the Federal Home Loan Banks as to whether they support the establishment of a new independent regulator, as you do. Could you tell me why there is that lack of consensus?

Mr. RICE. First of all, as I said earlier in my testimony, there is consensus around the four principles that I laid out. And that is clear. Three banks have no desire to be under Treasury and believe that the status quo is fine.

I think if you asked any individual bank president, no one would say that we have something broke that needs to be fixed. But if we are talking about the future and where we are going to go, I think there are more presidents who say if you are going to make a change this is the way you should do it. And that is where we are moving.

I think that if Congress were to create an independent regulatory agency outside of Treasury, there may be more banks who would work to be supportive. I think the big issue is to get consensus over the idea of whether it is an independent regulatory agent under Treasury.

Senator CRAPO. So independence really is the critical issue?

Mr. RICE. Yes, it is. And I think it is important, no matter how you shape it, regulator should have independence. And I think also having the flexibility to make changes to consider who we are and move in that direction. Because you are going to have a strong regulator.

Senator CRAPO. We have had some testimony, or actually some comments that were made earlier by some of the members of the panel, of the Senate panel here, to the effect that there are differences between Fannie and Freddie and the Federal Home Loan Banks. How would you—and I know you probably went into this some—but how would you propose that this independent regulator approach those differences?

Mr. RICE. Well, one of the things I believe is, first of all, to recognize that there are differences and therefore shape the organization of the agency in a way that recognizes how we do our business and how we move forward.

There are some people who want to say that maybe we could have consistency across all the housing GSE's. I do not think you can because the cooperative nature of the Federal Home Loan Banks lends itself to a different type of structure. And I think that we want to have a regulator who understands that.

So, I would see something along the lines of where there would be a regulator with divisions. One would deal with the Federal Home Loan Bank and the other would deal with the Fannie and Freddie. I think there will be some things that they will have to look at across those three GSE's, but I still think it is the regulator that would have to shape that.

Senator CRAPO. So there would be a benefit to having the single regulator, but that there should be divisions among that regulator's focus?

Mr. RICE. I think so.

Senator CRAPO. Can you just tell me briefly, for a minute, how the Federal Home Loan Banks accomplish their affordable housing mission?

Mr. RICE. By statute, 10 percent of our net income goes toward affordable housing. And that was crafted by Congress, to achieve those objectives. We use our affordable housing allocation to target households and neighborhoods with incomes lower than those that qualify even under the housing goals for HUD.

Each bank has an advisory committee that sets standards and objectives within that 10 percent affordable housing goal and then we allocate along those lines. We have about 50 percent of our affordable grants go for multifamily and 50 percent go for single family, but under those guidelines.

Basically, the banks are collectively the largest source of private funding for affordable housing, and we probably are the largest contributor to Habitat for Humanity.

So we are consistent in this area and we like the 10 percent that we have. I do not know what would happen if you move us into a new regulatory agency. Would we go under HUD's goal? Or would you keep the 10 percent affordable housing goal that we have? I think it is cleaner and easier to manage with our 10 percent.

Senator CRAPO. All right. Thank you very much.

I have other questions for each member of the panel, and perhaps the Chairman would allow us to submit questions.

Chairman SHELBY. We will. We are going to keep the record open. Senator Sarbanes and I have a number of questions.

Senator CRAPO. And again, Mr. Chairman, I appreciate your cooperation here. I had to leave for an extended period of time and I appreciate the fact that you were still going when I got back so I could ask some of my questions.

Chairman SHELBY. Important hearings.

Senator CRAPO. Thank you.

Chairman SHELBY. Thank you.

As I said earlier, we are going to continue some hearings. We want to hear from the housing end of this because I think the mission of Fannie Mae and Freddie Mac and the Federal Home Loan Bank are very important. We know they are different. We believe, I think most people believe here, that a strong regulator is important, a regulator that knows what is going on, that has the means to know what is going on.

But I think we have to balance this. I think Senator Reed said it fairly well earlier. We might have two centers of gravity here. We are all interested in housing, from the President of the United States to every Member of Congress. And we realize how important that is, not only socially but also to our economy. So we have to balance this.

I think we can do this. We know it is difficult to do but we are trying to make sure that we are not part of the problem down the road. I think all of you recognize this.

We thank you for your patience, and the hearing is adjourned.

[Whereupon, at 2:03 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF SENATOR CHARLES E. SCHUMER

Thank you Mr. Chairman, Ranking Member Sarbanes, and our distinguished panel. Thank you for coming. This is an important subject, one of the most important topics before our Committee in some time. I have only a brief statement to make.

You know there is an old expression, "if it ain't broke, don't fix it." I think some of us here in the Senate believe that when we try to fix things that are not really broken, we can end up doing more harm than good.

In today's hearing we are considering potential large-scale changes in one of the few areas that is working in our economy—housing. It is a critical area to get right for the country, and it is an area where Fannie Mae and Freddie Mac play a vital role.

We had an accounting issue at Freddie Mac—but we should note that it was a problem some of us would love to have, they had understated their earnings! I agree we need to address the issue of the best regulation of Fannie Mae and Freddie Mac for all the stakeholders involved. But I have not heard why that should lead us down the path of potentially changing capital standards or changing the method and authority for approving the kinds of business Fannie and Freddie can engage in or potentially politicizing the management of the GSE's. That seems to be going too far—to run the risk of fixing what is not broken.

It seems that instead of treading carefully, if we rush to judgement now we could be opening the door to all sorts of changes unrelated to the specific problem at hand, and going down a path that may not be where we want to head.

So, I will be very interested to hear Treasury's specific evidence that the capital standards at the GSE's—minimum and risk based capital—are too low or too high. I hope they will share that data with us today or in the future. I did not see it in Secretary Snow's testimony.

I am also very interested in whether Treasury can give us a report or findings that show where the current "new program approval" authority, which is today at HUD, has consistently broken down or hurt the economy.

I am also curious to hear the level of capital that Fannie or Freddie would be required to hold under the Basel I and the proposed Basel II Accords. Are their current capital amounts too high or too low versus these standards? I am assuming Treasury has done that analysis or will do that analysis shortly.

We are all also very sensitive to the impact of that a change in capital could have to the GSE's ability to fulfill their vital housing mission and to their stock prices. They are after all publicly held companies.

So, I hope Treasury will walk us through an analysis of what a potential change in minimum capital standards, some have suggested these levels should double, would mean in terms of Fannie's and Freddie's ability to fulfill their housing mission.

For example, how many units of housing could be impacted if they need to hold funds in reserve and not put them into the housing market? And what would be the impact on the stock prices, since any capital reserves would come out of the companies earnings?

Again, I am assuming Treasury has done all this analysis—it seems critical to the decisions we need to make. But to date I have not seen it.

Mr. Chairman, if we do not have that data and have fully aired those findings—and they are but a few examples of the consideration needed to carefully address these issues—I wonder how we can know whether or not we have a problem or whether or not we should make changes. If we do not have any data to look at—if it is all simply conjecture—one opinion versus another—do we risk making some enormous and potentially damaging mistakes?

It seems like a dangerous way to make public policy in one of the few areas that is working in the economy.

Mr. Chairman, you and Ranking Member Sarbanes, have always chosen a careful and considered approach, and I trust you will lead us in that direction again. I look forward to future hearings on this important subject.

PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Thank you, Mr. Chairman. Today's hearing is an important opportunity to re-examine the regulatory structure in place for Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System.

Ever since accounting problems were reported at Freddie Mac earlier this year, there has been a growing interest in strengthening our housing finance regulators.

I agree that there is room for improvement, but I also think that it is extremely important that we move deliberatively and cautiously. The secondary mortgage market is so essential to our housing sector and to our greater economy that it would be inappropriate to make sweeping changes without extensive study and broad consensus.

Mr. Chairman, when I raised this caution at our first hearing on accounting at Freddie Mac, you were quick to agree that we must move cautiously and judiciously and I very much appreciate that we are of the same mind on this.

I want to see Fannie Mae and Freddie Mac with a highly respected, independent regulator. I want the Federal Home Loan Banks to be soundly regulated, too. And, I think there are several things that we can do to achieve that end. And, that is part of what today's hearing is all about.

I appreciate that Secretary Martinez and Secretary Snow have agreed to come up and share their thoughts on this issue. And, I appreciate our second panel for appearing before us today as well.

I want to work with all of my colleagues to come to a bipartisan consensus on what legislative changes if any are needed in the housing finance regulatory system.

The Chairman, from FCRA to the American Dream Downpayment Act, has shown that he is a consensus-builder and that he listens to everyone on this panel. I know that he will want to move forward on regulatory reform in the same way we have on so many other important issues under his leadership.

While we may not be able to move on legislation this year, it is more important that we begin a discussion and a debate. And, we let the GSE's, the regulators, the markets, and the public know that while there is no explosive financial disaster before us today, this Committee is working together to ensure that our GSE's and the Federal Home Loan Banks will always be safe and sound and fulfill the missions with which they are tasked. Thank you, Mr. Chairman.

PREPARED STATEMENT OF JOHN W. SNOW

SECRETARY, U.S. DEPARTMENT OF THE TREASURY

OCTOBER 16, 2003

Thank you Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee for inviting Secretary Martinez and me to appear before you today.

Homeownership is an important building block of individual financial security as well as strong communities. Our national system of housing finance plays a key role in promoting homeownership. We might call it one of the economic wonders of the world. Playing a prominent role in the vitality of our housing finance system are the Government Sponsored Enterprises (GSE's): Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. They need to be strong and healthy so that they can play that important role today and be here to continue that important role in the future. That is why Secretary Martinez and I are here today.

As the President has made clear, one of the great strengths of America is that everyone has an opportunity to gain the independence and dignity that come from homeownership. And, Secretary Martinez and I share the commitment made by the President to expand homeownership to 5.5 million more minority homeowners by the end of the decade.

There is a general recognition that the existing supervisory system for these enterprises does not have the tools, stature, authority, or resources to reach that goal. The regulatory structure is ill-equipped to deal effectively with the current size, complexity, and importance of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. As we attempt to remedy this situation, we must be mindful that we have two core objectives that should guide us: A sound and resilient financial system, and increased homeownership opportunities for less advantaged Americans.

To serve both of these objectives we need to devote careful attention to the resilience of our system of housing finance. These enterprises play such a major role in our housing finance system and housing finance is so important to our national economy that we need a strong, world-class regulatory agency to oversee their prudential operations, including safety and soundness, consistent with maintaining healthy national markets for housing finance.

On September 10, in testimony before the House Financial Services Committee, we called upon Congress to create a new and stronger regulatory system for Fannie Mae, Freddie Mac, and ideally the Federal Home Loan Banks. At that time, I outlined the Administration's recommendations for the essential, minimum requirements for a credible regulator for these enterprises. At that same hearing, Secretary

Martinez outlined measures that the Administration would desire to increase homeownership opportunities. Today, I renew that request, and I will highlight some of the key elements that the Administration believes are essential to reform of the supervision of these important housing Government Sponsored Enterprises. Without these reforms, any new regulatory system would be little improved from the inadequate system we have today. In doing so, I must emphasize that we are not presenting a wish list of reforms that we would like to see enacted. We are presenting the minimum elements that are needed in a credible regulatory structure, a structure that can ensure that our housing finance system remains a strong and vibrant source of funding for expanding homeownership opportunities in America. There may be additional reforms worthy of consideration, and I look forward to discussing them, but the reforms that Secretary Martinez and I are presenting today are the foundation for an enduring program of housing finance to help provide an effective regulatory system for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

Essential Elements of Regulatory Reform

To begin with, we must make sure that we keep our eye on the crucial task of getting the regulatory structure right. In general, the legislative objective should be to create a strong, credible, and well-resourced regulator with all of the powers, authority, and stature needed to do its job. In this regard, the new agency's powers should be comparable in scope and force to those of other world-class financial regulators, fully sufficient to carry out the agency' mandate, with accountability to avoid dominance by the entities it regulates. This means that the new agency should have general regulatory, supervisory, and enforcement powers with respect to the Enterprises. In my September 10 testimony, I outlined the broad parameters of the new agency's powers and presented a list of specific items that should be included.

Each of these reforms should be placed in context. The Administration wants Fannie Mae, Freddie Mac, and the Federal Home Loan Banks to be models of the highest corporate governance standards, rather than exceptions to the rule. The Administration is committed to make sure that corporate governance and oversight remain strong and effective. That requires that there be great clarity that the people running large companies are there to serve the interests of the shareholders and that their incentives and loyalties be clearly aligned in this way. One man cannot serve two masters. Fannie Mae and Freddie Mac are large, experienced, publicly traded enterprises that have grown significantly and taken important places in our capital markets. The Administration is committed to make sure that the directors of publicly traded corporations like Fannie Mae and Freddie Mac are elected by their shareholders, rather than selected by the President.

Location of the Agency

While in my statement on September 10, the Administration did not make a request that the new regulatory agency be made a bureau of the Treasury Department, I did say that such a recommendation could be contemplated and would be supportable if the new agency were established with adequate elements of policy accountability to the Secretary of the Treasury. The necessary arrangement would allow the agency to draw upon the resources of the department for depth of policy guidance, stature, and authority, assuring that the regulated enterprises remain focused on their important housing duties, operating within prudent bounds that will ensure sustained financial vigor to continue to fulfill their housing finance roles.

To allow the Treasury Department to provide real value to the new regulatory agency, at a minimum, the new agency should be required to clear new regulations through the Department. The existing independent regulator for Fannie Mae and Freddie Mac currently clears its new regulations through the Office of Management and Budget (OMB), so it would not be novel for the new agency as a bureau of the Treasury to clear its new regulations with the Treasury Secretary as well as OMB. The Treasury Department should also have review authority over the new agency's budget to ensure that resources are being properly allocated. And to ensure policy consistency, a new Treasury bureau should clear its policy statements to the Congress through the Department. Nevertheless, in any such arrangement, the new supervisory agency should have independent responsibility over specific matters of supervision, enforcement, and access to the Federal courts.

The direct involvement of the Treasury Department in providing policy guidance to the new regulatory agency is important for a number of reasons.

First, unlike the Treasury Department's other financial institution regulatory bureaus, the new regulatory agency would only be responsible for regulating a very limited number of very large financial institutions, ranging in size from more than $30 billion in assets to more than $700 billion in assets. This increases the possibility of regulatory capture, and makes the oversight of overall policy development by the Treasury Department vital.

Second, even though the obligations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are not backed by the full faith and credit of the U.S. Government, market participants have come to believe that some sort of implied guarantee exists, weakening market discipline of the Enterprises. Market discipline is an essential element of any regulatory oversight regime, the first line of regulation of commercial banks and thrifts. A weakening of market discipline is inconsistent with our goal of a resilient housing finance system, particularly if it weakens the sensitivity of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks to the demands of the housing markets. Therefore, it is vitally important that the Treasury Department be able to monitor the new regulator's policies to ensure that such policies are not reinforcing any such market misperception of an implied guarantee.

The Administration's proposal strengthens the Department of Housing and Urban Development's oversight of the GSE's' housing goals. However, we need a credible, single regulator to do the important job of overall prudential supervision of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, one that will help ensure that the Enterprises are healthy today and strong tomorrow. We need a regulator that has all of the tools and stature and resources to do the job, that is independent with regard to supervision and enforcement, but that has accountability in the formulation of policy.

New Activities Approval

The Administration has proposed that the authority for approving new activities of the housing enterprises be transferred from HUD to the new regulatory agency. This proposal is consistent with availability of one of the central tools that every effective financial regulator has—the ability to say "no" to new activities that are inconsistent with the charter of the regulated institutions, inconsistent with their prudential operation, or inconsistent with the public interest.

The Federal Reserve has this kind of authority for bank holding companies, the Comptroller of the Currency has comparable authority for national banks, and the Office of Thrift Supervision has similar authority for savings associations. The current financial regulator for Fannie Mae and Freddie Mac lacks that authority, one of its most serious weaknesses. If we are serious about creating an effective, credible financial regulator, it must have the authority, in consultation with the Secretary of HUD, to review new activities as well as to review their ongoing activities.

Innovation has been fostered and encouraged under the review authorities that our Nation's banking regulators have, and we see no reason why providing similar authority to the new regulatory agency would stifle innovation by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

Capital Requirements

While we are not recommending a statutory change to the current capital requirements, we believe that the regulator should have broad authority with regard to setting the capital requirements of the Enterprises, both with respect to risk-based capital and minimum capital. Authority for setting capital standards needs to be flexible enough to employ the best regulatory thinking, conscious of the Enterprises' own measures of risk, so that the regulator can direct Fannie Mae, Freddie Mac, and the Federal Home Loan Banks to each maintain capital and reserves sufficient to support the risks that arise or exist in its business. We want the regulator to have the authority to increase minimum and risk-based capital requirements if warranted. Providing the new regulatory agency flexibility in regard to setting risk-based capital requirements would be an important and necessary improvement over the current awkward risk-based capital regime that applies to Fannie Mae and Freddie Mac.

Receivership/Conservatorship

Should sufficiently troubling circumstances require it, the new regulatory agency should have more than the powers associated with conservatorship. It should have all receivership authority necessary to direct the orderly liquidation of assets and otherwise to direct an orderly wind down of an enterprise, in full recognition that Congress has retained to itself, in the case of Fannie Mae and Freddie Mac, the power to revoke a charter. Providing the new regulatory agency the ability to complete an orderly wind down of a troubled regulated entity also encourages greater market discipline, which is consistent with our goal of a resilient housing finance system that responds to the needs of customers in the housing markets.

Federal Home Loan Bank System

The importance of our housing finance markets requires that all of the housing enterprises be included in a single program of world-class supervision. We see the need for this for the Federal Home Loan Banks just as we see it for Fannie Mae and Freddie Mac. While including the Federal Home Loan Banks in a program of world-class supervision presents some significant issues of policy and important details that must not be glossed over, that does not mean that their inclusion should be avoided at this time. This does not require that the supervisory structure of the housing GSE's be identical in all respects, but it does require that the new regulator have the same caliber of authorities, stature, powers, and resources for enforcement and supervision of all of its regulated entities.

Since September 10, when Secretary Martinez and I testified on this subject before the House Financial Services Committee, tremendous progress has occurred in developing a consensus. There now appears to be an emerging consensus for providing a new supervisory structure for the Federal Home Loan Banks. Today, we are very encouraged that this can be achieved, as part of a new regulatory system for Fannie Mae and Freddie Mac.

Conclusion

In conclusion, let us consider once again our purpose here this morning. It is to consider how best to promote the strength and resilience of our housing finance markets, in order to continue our progress in advancing homeownership throughout the Nation. The housing-related Government Sponsored Enterprises were created by Congress to assist in achieving that goal. Our aim must be to give them the first class quality of supervision that the importance of their charge requires. To accomplish that purpose, the fundamental elements that the Administration has proposed are essential.

PREPARED STATEMENT OF FRANKLIN D. RAINES

CHAIRMAN AND CEO, FANNIE MAE

OCTOBER 16, 2003

Chairman Shelby, Senator Sarbanes, and Members of the Committee, thank you for inviting me here today to share my views on legislation to strengthen the safety and soundness regulation of Fannie Mae.

A strong safety and soundness regulator is in the best interest of Fannie Mae, homeowners, and the financial system. I am here to voice support for legislation that creates a new world-class safety and soundness regulator within the Department of the Treasury. There is a strong and growing community of support for legislation that focuses on strengthened financial regulation and does not directly or indirectly change our mission, status, or charter.

The impact of what you do here can be enormous, for the economy as a whole and for expanding affordable homeownership and affordable rental housing in particular. First, as you know, the home mortgage refinance wave of the last 2 years has allowed millions of families to increase their savings or raise their standard of living. Federal Reserve Chairman Alan Greenspan has noted that last year close to 10 million households "cashed out" almost $200 billion of their accumulated home equity, using as much as half of that amount for consumption. Home mortgage refinance provided the single largest stimulus to the economy last year, and it made difficult economic times more manageable for families across the Nation. Our ability to use technology and to draw private capital into the home mortgage market was critical to ensuring that lenders were able to meet refinance demands effectively and efficiently.

Second, we as a society have a long-held commitment to homeownership. Congress has reflected that commitment by making homeownership a public policy priority, in tax policy, in policy affecting Government Sponsored Enterprises, and in the commitment to FHA and other Government programs. Recent public policy commitments have reaffirmed the importance of homeownership. Just this month, the House of Representatives overwhelmingly passed legislation to provide downpayment assistance to cash-strapped families.

President Bush has made expanding homeownership a priority for his Administration. Last summer, he called on the private sector to partner with Government to create 5.5 million new minority homeowners this decade. Fannie Mae stepped up to the plate to meet that challenge. We committed $700 billion in financing for minority borrowers, and are forming partnerships in communities across the Nation to bring mortgage financing to underserved minority communities.

Enacting legislation that will strengthen safety and soundness regulation of Fannie Mae and Freddie Mac can enhance our role in promoting a smooth functioning mortgage finance industry. Ultimately that leads to more homeownership opportunities for more Americans.

Since I testified before the House Financial Services Committee on this issue on September 25, the debate over changing our regulatory framework has moved on from general principles to specific issues. Rather than repeat my recent testimony, I would like to specifically address the questions posed by the Committee in its invitation requesting my appearance here today.

The Structure and Mission of the New Regulator

Safety and soundness regulation of privately capitalized, privately managed companies has a singular mission. That mission is to ensure that institutions have the ability to manage the risks they face. As long as a company is managing risk properly, safety and soundness regulation should not dictate day-to-day business operations or routine management decisions. Private companies thrive when management is allowed to innovate and experiment, and even to see a new innovation fail, as long as that failure does not put the Enterprise at risk. Companies that take no risks and do not innovate cannot evolve to meet the demands of consumers and improve living standards for all Americans.

This distinction between supervision and management is the foundation of commercial regulation throughout the marketplace. In the financial services sector, our public policy has found the right balance between private management and public supervision. And the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 struck the right balance between private management of Fannie Mae and Freddie Mac and public supervision to ensure that management does not put the companies at risk of failure.

The financial services industry has evolved dramatically over the last 11 years, as financial institutions have merged and broadened their lines of business. The housing finance industry has evolved as well, developing products and technology that have given both homebuyers and mortgage investors more choices at lower costs. It is appropriate that, 11 years later, Congress reexamine the safety and soundness regime it built in 1992 to see if that balance is still correct.

Striking the right balance between appropriate and effective safety and soundness oversight and avoidance of micromanagement is important when considering the powers of the new regulator. The new Treasury bureau should be charged with the full authority to ensure that the Enterprises are operating in a safe and sound manner, and that they remain adequately capitalized. World-class safety and soundness regulation is designed to help ensure that financial institutions do not mismanage the risks they face in a way that threaten the financial viability of the companies.

At the same time, Congress should not open the door for the regulator to prescribe, outside the necessities of safety and soundness oversight, how the Enterprises conduct their businesses—whether it be the management of credit and counterparty risk, management of interest rate exposure, issuance of subordinated debt, or adequacy of liquidity and reserves, to name just some of the issues the Enterprises must manage. The modern best-practices regulatory approach to these issues, as reflected in the practices of the OCC and OTS, for example, is for the regulator to issue guidelines ensuring that the regulated financial institutions have adequate policies and procedures addressing these prudential matters. The regulated entities are then examined against these standards. This approach not only avoids micromanagement, but also ensures necessary flexibility for examination staff. In fashioning the new regulator's duties and responsibilities, Congress should follow the evolving best practices used by regulators for the rest of the industry.

Funding

To ensure adequate resources, a new Treasury bureau should be funded independent of the appropriations process. Over the last 11 years, OFHEO has steadily increased its budget and grown its examination staff. Today, OFHEO has a staff of 40 examiners, or 20 per institution. This is comparable to the size of the typical onsite OCC exam team dedicated to any of the largest OCC-regulated banks. OFHEO's current budget includes a plan to expand to 66 examiners over the next year.

While independent funding will ensure that the new regulator has the necessary resources to do its job, there must be some review of that independent assessment, to ensure that the regulator does not assess the companies in an arbitrary way. In the banking system, the ability of any bank at any time to change charters engenders a regulatory competition that prevents excessive assessments. Fannie Mae and

Freddie Mac will not have an option to move to a different charter, and therefore some other mechanism must be developed.

There are many different ways to achieve this objective. Fundamentally, it should involve some wider review within the Administration of the new agency's budget. Congress could mandate transparency for the new agency's funding by requiring it to release for notice and comment a proposed budget and resulting assessment. This would be similar to the approach used by the National Credit Union Administration. Or the increase from year to year could be based on an objective index. Of course, we would support the agency's ability to obtain additional funding mid-year if necessary.

Currently, OMB authority to apportion agency funds is an important check in ensuring the most effective and economical use of resources. Their authority covers agencies funded both through the appropriations process and outside of it, and we believe it would be an important level of review that should be adopted for the new safety and soundness regulator.

A new regulator must not only have necessary resources, but those resources must also be spent appropriately. Today, the OCC and the OTS devote more than three quarters of their budgets to examination and supervision. This emphasis in their budgets is evidence of these agencies' focus on examination and supervision to monitor continuously the safety and soundness of the regulated enterprises. A new regulator for the Fannie Mae and Freddie Mac should have a similarly clear focus on examination and supervision, with a similar division of resources to ensure the regulator's priority remains on on-site, daily oversight of the safety and soundness of the operations of the regulated companies.

Independence

The independence of the new regulator is also an issue of discussion in the current legislative debate. In particular, policymakers today differ over the independence of the new regulator with respect to funding, testimony, and regulation. As I stated earlier, we do believe that there must be some review of the assessments the regulator levies on the company, to ensure the budget fully funds the regulatory mission of the agency but does not include arbitrary assessments. Because we cannot change regulators the way banks can, we favor outside review of the new regulator's budget.

With regard to the issuance of regulations, currently OFHEO's regulations are reviewed by OMB. That practice does afford broader policy input into any proposed regulation, and we believe that broader input has value. The third issue, review of testimony, raises important questions that Congress and the Administration will have to address directly and resolve.

The Powers of a New Regulator

The new regulator must have the powers necessary to carry out its role. The current debate over these powers has focused on capital, prompt corrective action, and new program approval. Let me take up each of those issues separately.

The Appropriate Capital Regime

Capital requirements are a fundamental part of financial regulation. The approach Treasury put forward in testimony before the House Financial Services Committee focuses on ways to give the regulator more flexibility in aligning capital requirements with the risks Fannie Mae takes on, while ensuring that we can continue to fulfill our mission. It is this balance that Congress struck in 1992, and it is a balance Congress should maintain in any proposed legislation.

As you know, Fannie Mae has two capital standards, a minimum capital (or leverage) requirement, and a risk-based capital requirement. The minimum capital requirement sets a floor and also incorporates the indefinable, non-quantifiable risk present with any institution. Fannie Mae must hold the greater of the minimum capital requirement or the risk-based capital requirement.

Minimum capital is defined as the sum of 2.50 percent of on-balance sheet assets and 0.45 percent of mortgage-backed securities guaranteed by, but not owned by, Fannie Mae. Including capital for off-balance sheet obligations distinguishes Fannie Mae's minimum standard from the bank leverage ratio, which requires that banks hold capital only against on-balance sheet assets.

Calculated in the same manner as the bank leverage ratio, Fannie Mae's core capital was 3.3 percent of on-balance sheet assets, or $30.7 billion, as of June 30, 2003. Furthermore, beginning in 2001, Fannie Mae has issued subordinated debt as a supplement to our equity capital. Subordinated debt can act as a risk-absorbing layer on top of core capital and can serve as a market signal of a corporation's credit risk. Fannie Mae's subordinated debt outstanding totaled $11.5 billion at June 30, 2003, or 1.2 percent of on-balance sheet assets. Thus the sum of core capital and outstanding subordinated debt represented 4.5 percent of on-balance sheet assets at the end of the second quarter, or $42.2 billion.

Fannie Mae's minimum capital requirement should be viewed in the context of the limited business in which we operate. By law, we invest only in residential mortgages, which are less risky than many bank investments such as consumer debt, commercial real estate, or foreign debt. Furthermore, our book of business is more geographically diverse than most banks, and we are required to have loss-sharing agreements on higher-risk loans.

As a result, Fannie Mae has far lower losses than other lenders. For instance, Fannie Mae's credit losses in 2002 were 0.5 basis points of our total single-family mortgages. That compares with bank credit losses on mortgages of 15 basis points in 2002. Furthermore, while Fannie Mae's losses have trended sharply lower in the last 5 years, banks' losses on mortgages have not followed a similar pattern.

The further an institution moves away from specialization in mortgages, the greater the level of losses relative to capital. Reflective of our low level of risk, Fannie Mae's capital was 357 times its credit losses for the first two quarters of 2003. The thrift industry, which also specializes in mortgages, had a comparable ratio of 47:1, less than one-seventh the capital coverage that Fannie Mae had. Large commercial banks, on the other hand, had a capital coverage ratio of only 15:1, with the entire banking industry at 18:1.

The question for policymakers is not how to eliminate credit risk from the system. That is not possible. The question is how do institutions manage this risk, and what capital is necessary to cover the risk. In the event of a credit crisis, Fannie Mae is in a much stronger position to survive than are the other potential holders of mortgage credit risk. If credit losses were to increase by a factor of 20, Fannie Mae would have sufficient capital to cover the resulting losses. The average bank wouldn't.

For these reasons, Fannie Mae's minimum capital requirement should remain set in statute at 2.5 percent for on-balance-sheet assets and 0.45 percent for off-balance-sheet assets. Doing so supports Fannie Mae's mission of bringing low-cost capital to housing. Increasing minimum capital absent any increase in risk raises the cost of capital to housing and undercuts our ability to fulfill our mission of constantly providing liquidity in all markets and through all economic conditions. Quite simply, if you raise capital requirements for the same level of risk, you will substantially reduce the impact Fannie Mae can have in fulfilling its mission.

Of course, a key responsibility of a safety and soundness regulator is to evaluate continuously the risks the company faces and adjust capital requirements accordingly. Financial regulators achieve this goal through a risk-based capital standard. In Fannie Mae's case, this requirement is determined by a statutory "stress test," computing the capital needed to survive a prolonged adverse economic environment, assuming no new business and adding a 30 percent capital cushion for operations risk. The regulation that implements this standard has been in place for one year, after 10 years of development. Fannie Mae has met the requirements of that rule every quarter.

A world-class regulator must have the ability to adjust this risk-based capital requirement to reflect both changes in the economy and in the risks facing an institution. Under the current statute, our regulator has considerable flexibility to adjust the standard. The Administration has asked for additional flexibility in this area. We support giving the regulator more flexible authority in this area, while recognizing that there is a need for stability in capital standards, which should not be subject to frequent change. Additional flexibility in altering the risk-based capital standard will ensure that the regulator can require the companies to hold appropriate levels of capital consistent with the risks they take.

Location and Standard for New Program Approval

To carry out our mission effectively, Fannie Mae must be able to harness the innovation and efficiency of the private sector to promote affordable housing as a clearly articulated public policy goal. The standard Congress created in 1992 has fostered an environment of unprecedented innovation in the mortgage industry over the last 10 years.

In a constantly changing interest rate environment and faced with unprecedented volumes of business, Fannie Mae and the mortgage finance industry have created a revolution in underwriting, product innovation, and streamlined technology processes, to produce significant gains in lending to low- and moderate-income and other traditionally underserved borrowers. We have automated our underwriting, reducing mortgage origination costs by an average of $800, and enabling applicants to get an answer from a mortgage lender in minutes rather than weeks. Our improved credit analysis has helped us to develop mortgage products for credit-impaired borrowers who previously had little access to conventional mortgages. We have worked with lenders to develop low-downpayment loans, bringing homeownership within reach of Americans who can afford a monthly mortgage payment but do not have savings for a 20 percent downpayment. Much of this innovation is driven by our lender customers, who routinely challenge us to add features to match their offerings, and to partner with them to increase access and efficiency.

Some of our competitors have decried innovation as somehow outside our charter. But the facts are these: In 1992, when our charter was last revised, mortgages made up 86 percent of Fannie Mae's total assets. Another 11 percent was devoted to maintaining necessary liquidity and the remaining 3 percent consisted of other assets. In 2002, mortgages made up 90 percent of Fannie Mae's total assets. Another 7 percent was devoted to our liquidity portfolio and—just as in 1992—only 3 percent consisted of other assets. Clearly, our devotion to our mission has not changed. The innovations we have pioneered or adopted from others are not only within our charter; but they are also necessary to meet our charter obligations. We cannot serve our mission of making homeownership more affordable unless we can innovate continuously to create products and processes that better serve the industry and homebuyers.

The mortgage market today provides consumers with a wider variety of products than ever before, and therefore is better poised to meet the individual financing needs of a broader range of homebuyers. This has been possible because the program approval requirements in the 1992 law respect the need for innovation. Lenders have felt free to innovate and develop new products to reach underserved communities because we have been able to review the products and, whenever possible, assure them that we will purchase these loans in the secondary market. Without that secondary market outlet, lenders would have to assume more risk and expense in developing innovative mortgage products that are vital for reaching new markets.

There is a consensus in the housing industry that innovation is best protected by maintaining HUD's role as mission regulator for Fannie Mae and Freddie Mac. Many of our lender partners and leaders in the housing industry, such as the National Association of Home Builders, the National Association of Realtors, the Independent Community Bankers of America, the Enterprise Foundation, LISC, and Self-Help Credit Union, fear that moving program approval authority away from HUD could diminish housing as a public policy priority, and create a barrier to innovation that hinders us from achieving our mission within our charter. We share those concerns, and as a result we support maintaining HUD's authority to review new programs.

The current debate over whether program approval authority should be housed at HUD or at the new Treasury bureau misses a critical point. Maintaining HUD's role as mission regulator to review new programs does not diminish the power and authority of the safety and soundness regulator on matters of financial risk. In our view, a world-class financial regulator must have the ability to address any issues that pose a risk to safety and soundness. The new regulator will have on-site examination staffs continually reviewing and assessing programs, products and business processes at Fannie Mae. Just like a bank regulator, the new bureau could examine any activity in detail at any time, and address any activity it found to pose a safety and soundness risk, even if it has been approved by HUD for charter compliance.

Wherever Congress decides to locate the program approval authority, our greatest concern is that the process and standard allow Fannie Mae the freedom to work with lenders to create innovative mortgage products that meet consumers' needs. Lenders eager to reach underserved communities have developed mortgage features that make homeownership more affordable to these communities. Before they make these innovative mortgages available, they want to know that Fannie Mae will purchase them in the secondary market.

If new legislation creates a bureaucratic process in which every new mortgage "product" or "activity" must be formally approved before we can tell a lender we will buy it, or every process innovation to improve efficiency must first be vetted by some third party, then innovation to address tough housing problems will come to a screeching halt. Without a secondary market partner, lenders will be less able to pursue the creative partnerships that are critical to meeting Congress' public policy goal of bringing homeownership opportunities to underserved communities. Any new program approval regulatory regime must ensure Fannie Mae's continued freedom to work with lenders, non-profits, community organizations and local governments to develop new products and new business processes without intrusive regulation that seeks to replace business judgment with the government's judgment.

Prompt Corrective Action Authority

In determining the appropriate and necessary powers to ensure a world-class regulator for Fannie Mae, there has also been some debate over what prompt corrective action, or PCA, powers a new regulator should have.

Congress created a PCA regime for OFHEO one year after creating a PCA regime for bank regulators, purposely altering the bank regime to make it appropriate to Fannie Mae and Freddie Mac. Because Fannie Mae and Freddie Mac differ from banks, Congress crafted a prompt corrective action regime for OFHEO that focuses specifically on how Fannie Mae and Freddie Mac operate in the secondary market without importing those wholly inapplicable aspects of the bank-like PCA regime.

Interestingly, prompt corrective action is not the preferred method of supervisory enforcement by banking regulators. In fact, capital deterioration is seen as a lagging indicator of problems at banks. Thus, bank regulators often take action pursuant to their cease and desist, civil money penalty, and suspension and removal authority long before a bank would be subject to PCA. As reflected in its enforcement regulations and as we have seen by the recent actions it has taken, OFHEO has considerable enforcement authority. Fannie Mae supports the enhancement of these authorities by giving the new regulator cease and desist and civil money penalty authority consistent with the authority of bank regulators. Fannie Mae also supports the addition of express authority for the new regulator to suspend and remove personnel from the Enterprise for violations of laws, regulations, final cease and desist orders and written agreements.

As part of our PCA regime, Congress specifically provided for the authority of our regulator to appoint a conservator should an enterprise become significantly or critically undercapitalized. By providing for a conservatorship process in the 1992 Act, Congress, and in particular this Committee, made clear its preference that an enterprise be privately recapitalized rather than liquidated in order for the important mission of the Enterprise to be protected. Moreover, Congress reserved, as Fannie Mae and Freddie Mac's chartering body, the right to extinguish those charters.

We welcome Congress' discussion of potential enhancement of the conservatorship powers enumerated in the 1992 Act. Certainly, we believe a conservator for an enterprise should be able to take such actions as may be necessary to put the Enterprise in a sound and solvent condition as well as those that are appropriate to carry on the business of the Enterprise and preserve and conserve the Enterprise's assets and property.

HUD's Continuing Oversight Role

Finally, the Committee has asked for our thoughts on HUD's role in the oversight of the Fannie Mae and Freddie Mac. As I stated earlier, I support maintaining HUD's authority to review new programs for charter compliance, and I share the concerns of the housing industry that moving this authority from HUD to the Treasury Department could diminish the overall public policy commitment to homeownership as a national priority.

Let me comment on legislative proposals regarding HUD's authority with regard to housing goals. HUD sets housing goals as a regulatory requirement to ensure that Fannie Mae focuses particular attention on low- and moderate-income borrowers and underserved areas. We have consistently exceeded those goals every year since 1994. The agency is currently developing proposed goals for next year and beyond.

Over the years, HUD has sought to establish goals that require the company to stretch beyond levels we might otherwise achieve, without threatening our safety and soundness or jeopardizing the liquidity of the mortgage finance system. HUD relies on predictions of market size to establish these goals. This kind of forecasting is not easy and predictions are likely to be inexact. The record-breaking refinance boom of the last 2 years, for instance, has resulted in a dramatically different mortgage market from the one envisioned when the current goals were set in 2000, substantially increasing the difficulty we face in meeting them.

Setting goals in the midst of changing markets requires flexibility—for HUD in setting the goals and for Fannie Mae in meeting them. HUD's recasting of the goals in 2000 is an example of the flexibility it has under current law. The Department increased all three housing goals. The goal for Fannie Mae's purchase of loans to low- and moderate-income borrowers, for instance, was increased from 42 percent in 1999 to 50 percent in 2001. In addition, the new goals created bonuses that gave Fannie Mae the incentive to pay special attention to financing small multi-family properties and owner-occupied 2–4 unit properties, which HUD identified as having particular value to underserved groups and which it believed would benefit from increased participation by Fannie Mae and Freddie Mac.

Fannie Mae also has flexibility under the current structure. We must meet three national goals through a combination of our single-family and multi-family businesses, including all types of business—both refinances and purchase money mortgages—that we engage in. And we must pursue this focus on affordable lending while serving the broader market. Under the current framework, Fannie Mae has been able to achieve both objectives, though it has been very difficult in some years.

Going forward, it is critical that Congress not change the structure of housing goals in a way that would fragment the market Fannie Mae serves. The mortgage market in the United States is a national market, with mortgage rates essentially the same in every community in America. Indeed, Fannie Mae and Freddie Mac were founded to, among other things, provide stability in the secondary market for residential mortgages and promote access to capital throughout the Nation by increasing the liquidity of mortgage investment and improving the distribution of investment capital. A series of regional goals, as some have suggested, could disrupt the free flow of capital into certain areas in favor of others and place these founding principles at risk. In addition, the proliferation of national goals would similarly begin to fragment the market among a number of competing credit priorities and weaken our ability to bring efficiencies to the market.

Therefore, it is essential that our affordable housing requirements drive us to expand access to underserved communities without undermining our support for the broader market. The Administration's proposal, which appears to establish a series of home purchase goals and give the Secretary open-ended authority to set or amend additional national goals would, we believe, undermine our ability to support the broader market.

Conclusion

I have tried to respond to the specific issues that have been at the center of the legislative debate over the last few weeks. I am sure there are other issues I have not addressed, and I look forward to discussing these topics with you as well.

We as a society have long made homeownership a national policy priority. And the work of the Congress to address that priority has been an unprecedented success. We have the most effective and efficient home mortgage market in the world, continually working to make homeownership affordable to an ever larger number of Americans.

I have attached the testimony delivered to the House Financial Services Committee last month, which lays out the steps Congress has taken and the steps we have taken that together have expanded homeownership opportunities for millions of America's families. I believe Congress has an opportunity this year to build on this success, by creating a new financial regulator that will ensure the continued health of the mortgage finance market and enable us to continue bringing low-cost financing to millions of American homeowners.

PREPARED STATEMENT OF GEORGE D. GOULD

PRESIDING DIRECTOR, FREDDIE MAC

OCTOBER 16, 2003

Thank you, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. Good morning. It is a pleasure to be here today. My name is George Gould.

I have served on Freddie Mac's board since 1990 and am currently the Presiding Director and Chairman of the Governance and Finance Committees. I am also Vice Chairman of Klingenstein, Fields & Company, a firm that manages individual assets and estates. Prior to joining this firm, I served as Undersecretary for Finance at the Department of the Treasury from 1985 to 1988. At the request of President Reagan, I chaired the Working Group on Financial Markets to examine the effect of the October 19, 1987 stock market crash.

I welcome the opportunity to be here today to discuss key aspects of a strengthened regulatory structure for Freddie Mac and Fannie Mae. Freddie Mac plays a central role in financing homeownership and rental housing for the Nation's families. Our job is to attract global capital to finance America's housing. Given the importance of housing to our economy, and the importance of housing finance to global capital markets, it is critically important that our regulatory structure provide world-class supervision. Hence, I would like to recognize Senators Hagel, Corzine, Sununu, and Dole for their legislative efforts in this regard. We commend them for helping to get these important discussions off the ground.

Before expressing our views on specific proposals, I would like to say a few words about the resolution of Freddie Mac's accounting issues and steps we are taking to ensure these problems never occur again. I would also like to recount Freddie Mac's long track record supporting strong, credible regulatory oversight.

Resolution of Accounting Issues

On January 22, 2003, Freddie Mac announced, in conjunction with our new independent auditor, PricewaterhouseCoopers, the need to restate earnings for 2000, 2001, and 2002. In our June 25, 2003 press release, we described the major factors leading to the need to restate earnings, a copy of which is provided for the record. In stark contrast to other recent corporate restatements, we expect Freddie Mac's restatement to show a large cumulative increase in earnings for the prior years. As we announced last month, we expect to release restated earnings for prior years in November. We deeply regret this delay, which was largely due to a systems error uncovered during the final validation of results.

While the restatement will represent an important milestone, we remain determined to bring our financials completely up to date as quickly as possible. Once we resume timely reporting of our financials next year, we will proceed with our commitment to complete the process of voluntarily registering our common stock with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 so that we become a reporting company under that Act. We are irrevocably committed to the voluntary agreement we announced last summer to submit to the periodic financial disclosure reporting requirements that apply to registrants. Freddie Mac reaffirmed this commitment in a letter to Treasury Secretary John Snow on July 14, 2003.

I would like to briefly mention steps we are taking to ensure problems like these never happen again. While the Board has taken many important steps to date, I will be the first to acknowledge that more can be done—and will be done.

First, the Board is extremely "hands on" with regard to getting the restatement done—and getting it done right. The committee responsible for overseeing the restatement has met weekly since March, and the Board is in constant communication with management. We are also overseeing the implementation of a comprehensive remediation plan.

Second, we are moving aggressively to address weaknesses in our disclosures and related processes. We have added highly qualified accounting personnel and we are working to strengthen our control infrastructure. In addition, we have brought in independent experts to review best practices and propose remediation. For example, we have engaged former SEC Division of Corporation Finance chief David Martin to help us with disclosure. The Board is fully committed to implementing his recommendations, as well as those of other independent experts.

Regulatory Oversight Structure

Freddie Mac has long supported strong regulatory oversight. In October 2000, Freddie Mac and Fannie Mae announced a set of public commitments to ensure that the two GSE's remain at the leading edge of financial risk management and risk disclosure. These commitments, which I will describe in greater detail below, continue to represent a high standard that few other financial institutions can meet.

In May 2001, we appeared before a Senate Subcommittee and announced we had implemented five of the six commitments, with the sixth being implemented the following month. In June 2001, we testified before a House Subcommittee that a strong regulator is essential to maintaining the confidence of the Congress and the public that we can meet our mission. We outlined key principles for effective regulatory oversight and pledged to work with the Congress in that regard. Those principles are as follows:

- First, the regulator must be highly credible. We continue to firmly believe that the GSE regulator must have supervisory expertise, be adequately funded and be independent in its judgments. Credibility is absolutely fundamental to the continued confidence of the Congress, the public and the markets.
- Second, the regulator must support housing. Not only is housing an important public policy objective, but it has also been an economic powerhouse for the past several years. The necessity of expanding affordable housing opportunities is more urgent than ever. Over the next 10 years, America's families will need an additional $8 trillion to fund their mortgages. By innovating new mortgage products and new mortgage investment vehicles, Freddie Mac will open doors for the homebuyer of the future, who is more likely to be a low-income, minority, or immigrant family, eager to realize the American Dream. We continue to work diligently to fulfill our commitment to President Bush to significantly expand the number of minority homeowners by the end of the decade.

- Third, and very importantly, the regulator must enjoy strong bipartisan support. In this regard, I would like to commend Chairmen Shelby and Oxley for the joint statement they recently issued. In the statement, they pledged to seek a timely bipartisan resolution of questions relating to regulatory restructuring.

With these principles in mind, today I will comment briefly on key aspects of the regulatory structure under consideration in this Committee. The Committee has requested our views on a number of issues, starting with regulatory structure and independence.

Structure and Independence

Freddie Mac would strongly support the creation of a new regulatory office within the Department of the Treasury, if Congress were to determine that this would enhance our safety and soundness oversight. We recommend that the new regulator have a Director appointed by the President, with the advice and consent of the Senate, for a 5-year term of office.

To ensure that the new regulator is able to exercise independent judgment, we would support applying the same operational controls as apply to the relationships between the Secretary of the Treasury and the Office of the Comptroller of the Currency and the Office of Thrift Supervision.[1] It is difficult to justify why the GSE regulatory structure should differ so strikingly from other regulators—at the risk of politicizing our mission and the critical role we play in global financial markets.

Funding of New Oversight Offices

We also are prepared to support providing both the new regulator and the Secretary of HUD authority to assess Freddie Mac outside the annual appropriations process to pay for the costs and expenses of carrying out their respective responsibilities vis-á-vis the GSE's. Additionally, we recommend that the General Accounting Office regularly report to the Congress on the efficacy of the new regulatory structure and the reasonableness of the costs relative to other world-class financial regulators so that neither unnecessarily raise the cost of homeownership.

Capital Adequacy

Adequate capital is the touchstone of investor confidence and is key to our ability to attract low-cost funds to finance homeownership in America. Freddie Mac's regulatory capital requirements incorporate two different measures: A traditional (leverage) capital requirement and a risk-based capital stress test that requires Freddie Mac to hold capital sufficient to survive 10 years of severe economic conditions. Freddie Mac consistently has exceeded both stringent capital standards.

Freddie Mac's capital requirements were developed in keeping with our charter, which restricts us to lower-risk assets than banks. Since 1994, charge-off losses at the five largest banks have been, on average, 17 times larger each year than charge-offs at Freddie Mac. Even in these banks' best year, charge-offs were more than five times higher than Freddie Mac's worst year.[2] Limiting the comparison to mortgage assets, the residential mortgages found in bank portfolios typically entail greater risk than those in Freddie Mac's portfolio. Banks tend to hold a higher proportion of second mortgages, adjustable rate mortgages, subprime mortgages, and uninsured mortgages with high loan-to-value ratios. These historically present greater risk than the fixed-rate conforming loans that are the core of Freddie Mac's business. In 2002, FDIC-insured institutions had an average charge-off rate of 11 basis points on their mortgage portfolios, compared to 1 basis point for Freddie Mac.[3]

In addition to our low exposure to mortgage credit risk, Freddie Mac maintains an extremely low interest-rate risk profile. Our risk management framework has performed exceptionally well through a number of challenging interest-rate cycles—and recent months are no exception. Despite the most turbulent market environment in 8 years, our average monthly duration gap was just one month in July. Maintaining a low-risk profile that is durable through time is the hallmark of Freddie Mac's disciplined approach to managing interest-rate risk.

Given this lower risk exposure relative to banks, we agree with Secretary Snow's testimony before the House last month that the GSE minimum capital requirement is adequate and need not be changed. The GSE's' minimum capital requirements are

[1] See 12 U.S.C. §§ 1, 250, 1462a(b)(2), (3), and (4).

[2] Federal Financial Institutions Examination Council, *Consolidated Reports of Condition and Income* and Freddie Mac annual reports for 1994 to 2001. For 2002 Freddie Mac credit information, see *http://www.freddiemac.com/news/archives/investors/2003/4qer02.html.*

[3] Federal Financial Institutions Examination Council, *Consolidated Reports of Condition and Income* and Freddie Mac. *See http://www.freddiemac.com/news/archives/investors/2003/4qer02.html.*

commensurate with our lower risk profile and the limitations of our charter. In addition, our rigorous risk-based capital stress test ensures that our risks remain low throughout a sustained period of severe economic conditions. According to an analysis prepared by L. William Seidman, former Chairman of the FDIC, the stringent risk-based capital standard applicable to Freddie Mac could be extremely challenging if applied to most other financial institutions.[4] More recently, the CapAnalysis Group, LLC, concluded that the risk-based capital stress test is "a much more stringent test for judging the safety and soundness of a financial institution than is a traditional capital-requirements test."[5]

Regulator Discretion on Risk-Based Capital

Conclusions about appropriate capital determinations will continue to evolve in the years ahead. Accordingly, our regulator must have adequate discretion to ensure that Freddie Mac's capital standard keeps pace with these developments. Although the basic parameters of the risk-based capital stress test are set in law, our present regulator has significant discretion in adjusting the risk-based capital requirements. Additional discretion, such as provided to Federal banking agencies, could help ensure the GSE risk-based capital standard remains at the forefront of financial sophistication, while continuing to tie capital to risk.

Discretion must be balanced with continuity, however. A key component of a stable financial market is a stable regulatory environment. Unnecessarily changing the risk-based capital standard harms those who made investment decisions based on a particular set of rules, only to find later that the rules were changed. This sort of "regulatory risk" increases costs that are ultimately borne by mortgage borrowers. Therefore, until such time as an overhaul of the risk-based capital stress test appears warranted, the regulator should be encouraged to continue to apply the existing risk-based capital rule. The rule has been in effect for less than one year and has yet to show signs of need for reform.

We also believe the new regulator should be encouraged to gather information over the entire business cycle before making changes. This could be accomplished by requiring that the current rule remain in place for a period of time and expressing Congressional intent to this effect. When a new rule appears warranted, policymakers should ensure that certain fundamental principles remain firmly intact. Any future capital standard must continue to:

- Tie capital levels to risk;
- Be based on an analysis of historical mortgage market data;
- Remain operationally workable and as transparent as possible; and
- Accommodate innovation so the GSE's can carry out their missions.

It is imperative that any changes to the rule be accomplished through notice-and-comment rulemaking, with an adequate comment period for all interested parties to express their views, followed by an adequate transition period for the GSE's to make any necessary adjustments to comply with new requirements.

In summary, Freddie Mac supports granting the regulator greater discretion to set risk-based capital levels that accurately reflect the risks we undertake. However, changing risk-based capital standards unnecessarily, capriciously or frequently will reduce the amount of mortgage business the GSE's can do, resulting in higher costs for homeowners and renters.

Mission Oversight and New Program Approval

We believe that the HUD Secretary should retain all existing GSE mission-related authority consistent with HUD's mission to expand homeownership and increase access to affordable housing. Specifically, HUD should retain authority to ensure that the purposes of the GSE's' charters are accomplished and continue to have regulatory, reporting, and enforcement responsibility for the affordable housing goals, just as under current law. Additionally, HUD should retain existing fair housing authority.

We also believe that, in keeping with its housing mission, HUD should retain its authority to approve any new programs of Freddie Mac and Fannie Mac. HUD alone has the expertise to determine whether new mortgage programs are in keeping with our charter and statutory purposes. In this vein, we also urge the Committee to maintain a new *program* standard—not a new *activity* standard. Requiring the regulator to provide advance approval of each and every new activity significantly exceeds the standard required of banks and would chill innovation in mortgage

[4] L. William Seidman, et al., *Memorandum to Freddie Mac,* March 29, 2000.

[5] The CapAnalysis Group, LLC, *OFHEO Risk-Based Capital Stress Test Applied to U.S. Thrift Industry* (March 17, 2003), p.1.

lending. Our ability to lower housing costs for homeowners and renters is directly linked to our expertise in managing mortgage credit risk and our distinguished record of bringing innovative products and services to market.

Supervisory and Enforcement Parity

The current legislative structure provides our safety and soundness regulator an array of supervisory and enforcement authorities to ensure that Freddie Mac is adequately capitalized and operating safely.[6] If Congress were to deem it appropriate, we would support providing the GSE safety and soundness regulator authorities similar to those accorded to the Federal banking agencies. These enhanced powers would include broadening the individuals against whom the regulator could initiate cease-and-desist proceedings; new authority to initiate administrative enforcement proceedings for engaging in unsafe and unsound practices; new removal and suspension authority and authority to impose industry-wide prohibitions; and new authority to assess civil money and criminal penalties.

Conservatorship

In the unlikely event of extreme financial distress, we believe conservatorship is the right approach. Although we believe that current law provides ample convervatorship powers, we would be willing to consider whether additional authorities could enhance Congress' and the public's confidence in our safe and sound operation. We agree with Secretary Snow's testimony before the House that steps beyond potential enhancements to conservatorship would appropriately be left to the Congress and not to the GSE regulator.

Market Discipline Commitments

In October 2000, Freddie Mac and Fannie Mae announced a set of six public commitments to ensure the GSE's adhere to a high standard of financial risk management. Excluding the commitment to adhere to an interim risk-based capital standard (which was rendered obsolete with the completion of the current risk-based capital stress test) these commitments are as follows:

- Periodic issuance of publicly traded and externally rated subordinated debt on a semiannual basis and in an amount such that the sum of core capital and outstanding subordinated debt will equal or exceed approximately 4 percent of on-balance-sheet assets. Because subordinated debt is unsecured and paid to the holders only after all other debt instruments are paid, the yield at which our subordinated debt trades provides a direct and quantitative market-based indication of our financial strength.
- Maintenance of at least 5 percent of on-balance sheet assets in liquid, marketable, non-mortgage securities and compliance with the Basel Committee on Banking Supervision Principles of Sound Liquidity Management, which requires at least 3 months' worth of liquidity, assuming no access to new issue public debt markets. Because of the critical importance of liquidity to the achievement of our mission—and the importance of non-mortgage assets to this liquidity—the GSE's' non-mortgage assets should not be singled out for onerous regulatory treatment.
- Public disclosure of interest-rate risk sensitivity results on a monthly basis. The test assumes both a 50 basis-point shift in interest rates and a 25 basis-point shift in the slope of the Treasury yield curve—representing an abrupt change in our exposure to interest-rate risk.
- Public disclosure of credit risk sensitivity results on a quarterly basis. The disclosure shows the expected loss in the net fair value of Freddie Mac's assets and liabilities from an immediate nationwide decline in property values of 5 percent.
- Public disclosure of an annual independent rating from a nationally recognized statistical rating organization.

In July 2002, the GSE's made an additional commitment to voluntarily register their common stock with the Securities and Exchange Commission under the Securities Exchange Act of 1934 so that both companies will become reporting companies under that law. Freddie Mac is fully committed to completing this process as soon as our financial statements are brought up to date.

Freddie Mac would support giving the regulator authority to ensure we carry out these important public commitments. Taken together, they significantly enhance the degree of market discipline under which the GSE's operate. Robust and frequent credit and interest-rate risk disclosures, combined with the release of annual independent ratings and the issuance of subordinated debt, constitute an important "early warning system" for investors.

[6] "Comparison of Financial Institution Regulators' Enforcement and Prompt Corrective Action Authorities," GAO–01–322R, January 31, 2001.

Affordable Housing Goals

I would now like to say a few words about mission oversight. Freddie Mac's mission is to ensure a stable supply of low cost mortgages for America's families—whenever and wherever they need them. This mission defines Freddie Mac and what we are trying to accomplish. Our business model flows directly from our Congressional charter, which requires us to focus exclusively on financing residential mortgages.

Meeting the annual affordable housing goals is a key aspect of our meeting our mission. Established in 1993 and increased in 1995 and 2000, the three affordable housing goals specify that significant shares of Freddie Mac's business finance homes for low- and moderate-income families and families living in underserved areas. In 2000, HUD specified that 50 percent of Freddie Mac's mortgage purchases must qualify for the low- and moderate-income goal,[7] 31 percent must be of mortgages to borrowers in underserved areas,[8] and 20 percent must be of mortgages to low- or very-low income borrowers or those living in low-income areas.[9] Freddie Mac has successfully met all the permanent housing goals, which are the highest and toughest of any financial institution.

The existing statutory and regulatory structure provides great discretion to our mission regulator to determine the goals—and creates strong incentives for us to achieve them. The HUD Secretary currently has the regulatory authority to establish and adjust the housing goals. In the event a GSE fails to meet one or more of the goals—or there is a substantial probability that a GSE will fail one or more of the goals—the Secretary is authorized to require the submission of a housing plan. Further, the Secretary may initiate a cease-and-desist proceeding and impose civil money penalties for failing to fulfill the housing plan. By contrast, bank regulators do not have authority to bring enforcement proceedings against an institution that is not meeting its CRA obligations. These are strong incentives for the GSE's to strive to meet the goals year after year—to say nothing of the reputational "penalty" for failing to meet a goal.

Considering that we have consistently met the permanent affordable housing goals, and that existing powers already are the industry's toughest, additional enforcement authority seems completely unnecessary. Additional enforcement authority would add little to the legislative and regulatory incentives that Congress and HUD have put in place. Therefore, we respectfully suggest that no additional authority is needed.

Conclusion

Freddie Mac has long supported strong regulatory oversight. It is critical to the achievement of our mission. As we have stated on previous occasions before the Congress, our core principles for the creation of a new regulatory structure are credibility, commitment to the GSE housing mission and a high degree of bi-partisan support.

As I have outlined today, Freddie Mac is prepared to embrace significant enhancements that will make our regulatory structure stronger, in many cases, than the bank regulatory model. Building these new enhancements into existing law would give the new GSE regulator comparable supervisory and enforcement powers as bank regulators. In addition, it would impose tougher regulatory requirements in many areas, including program approval standards and a risk-based capital stress test. Our mission regulator would continue to oversee the most challenging, quantitative affordable housing goals in the industry—with tremendous powers to enforce them. Taken together, this enhanced GSE regulatory structure is strong, solid, and credible. It is key to maintaining the confidence of the Congress and the public that we can meet our vital mission while remaining at the forefront of capital and risk management.

[7] Low- and moderate-income families have incomes at or below 100 percent of the area median income.

[8] Underserved areas are defined as (1) for OMB-defined metropolitan areas, census tracts having a median income at or below 120 percent of the median income of the metropolitan areas and a minority population of 30 percent or greater; or a median income at or below 90 percent of median income of the metropolitan area; and (2) for nonmetropolitan areas, counties having a median income at or below 120 percent of the State nonmetropolitan median income and minority population of 30 percent or greater; or a median income at or below 95 percent of the greater of the State nonmetropolitan median income or the nationwide nonmetropolitan median income.

[9] Low-income areas refer to census tracts in which the median income is at or below 80 percent of the area median income. Low-income families have incomes at or below 80 percent of area median income, while very low-income families have incomes at or below 60 percent of the area median income.

Thank you for the opportunity to appear today. I look forward to working with Chairman Shelby, Ranking Member Sarbanes, and the Members of this Committee to secure the future of our housing finance system and, with it, the dreams of millions of families.

PREPARED STATEMENT OF NORMAN B. RICE

PRESIDENT AND CHIEF EXECUTIVE OFFICER, FEDERAL HOME LOAN BANK OF SEATTLE

OCTOBER 16, 2003

Good morning Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. I am Norman B. Rice, President and Chief Executive Officer of the Federal Home Loan Bank of Seattle.

I would like to thank Chairman Shelby and the Committee for the opportunity to speak today on behalf of the Council of Federal Home Loan Banks, and the more than 8,000 member financial institutions that partner with us in building healthy communities and economies across our country.

I think it is appropriate for me to start this morning by commending Congress for two things regarding the Federal Home Loan Bank System.

The first is for creating the 12 banks under the authority of the Federal Home Loan Bank Act of 1932. Congress created the banks to both stabilize and improve the availability of funds to support homeownership in this country. And the banks have delivered an unmatched legacy of innovation and service to the U.S. housing market for the last 70 years.

The second is for the current work underway regarding regulatory restructuring of the housing GSE's. Clearly, Congress has the right and responsibility to scrutinize the regulatory oversight of the housing GSE's, and to ensure that they provide the Nation's network of community-based financial institutions with the safest, soundest source of residential mortgage and community development credit possible.

Like the Members of this Committee, the 12 Federal Home Loan Banks seek world-class regulatory oversight of our system. After all, our members have almost $40 billion in private capital invested in our banks. Due to our joint and several liability, we seek the same quality oversight and transparency that are of paramount concern to you, the U.S. Treasury, bondholders, and the public.

Along with the regulatory reform process now underway, the Bank System is also working toward voluntary SEC registration, pending resolution of critical accounting and reporting accommodations.

On September 17, 2003, the Federal Housing Finance Board issued a proposed regulation that would require the 12 banks to register their stock with the SEC under Section 12(g) of the 1934 Securities and Exchange Commission Act. Under this regulation, the Federal Home Loan Banks would also be required to submit periodic and current reports such as 10–K's, 10–Q's and 8–K's.

Each bank has until January 15, 2004 to provide comments on the proposed regulation to the Finance Board.

The Seattle Bank Board of Directors, at our September 2003 meeting, adopted a resolution calling for voluntary SEC registration, and we are now moving to make that happen.

In addition, over the last year, the system's SEC Task Force has met several times with SEC officials to discuss the resolution of outstanding accounting and reporting issues we believe are necessary to accommodate the unique cooperative structure of the Bank System.

The bottom line: The goal of the Federal Home Loan Banks is to provide complete and transparent financial disclosures that are considered no less than "best in class."

So, I am pleased to sit before you today representing the collective intent of the Federal Home Loan Banks to work diligently toward that goal as the process and debate around regulatory reform moves forward.

Among the 12 Federal Home Loan Banks you will find at least three banks—Boston, Cincinnati, and Indianapolis—that do not support direct regulatory oversight by the U.S. Treasury. These banks strongly believe that because the Bank System and Treasury are competitors in the capital markets—and Treasury provides an emergency line of credit to the banks—a systemic conflict of interest would be created. Therefore, they support maintaining the current regulatory structure provided by the Federal Housing Finance Board, which was approved by Congress in 1989 when finalizing FIRREA legislation.

While there remain clear differences of opinion within the Bank System on the matter of regulatory reform, we have reached consensus on four principles that we believe must serve as a framework for specific action and represent our bottom-line concerns as Congress moves forward on legislation.

These principles are as follows:

Number 1—Preserve and reaffirm our mission.

Mission is everything. Otherwise, why should any of the housing GSE's exist? We strongly believe that any legislation should accomplish the following regarding the mission of the Bank System:

- Provide cost-effective funding to members for use in housing finance and community development.
- Preserve our regional affordable housing programs, which create housing opportunities for low- and moderate-income families. Since the inception of our Affordable Housing Programs in 1991, the Bank System has contributed more than $1.7 billion in grants to communities across America.
- Support housing finance through advances and mortgage programs.
- Allow for innovative new business activities that advance our mission without creating a cumbersome process that prevents us from responding in a timely way to the needs of our member financial institutions and the marketplace.

Number 2—A strong and independent regulator.

Safety and soundness of the Bank System is our number one concern. This is neither a partisan nor an ideologically-driven endeavor. It is for this reason we ask that Congress protect the Bank System through the creation of a strong and independent regulator. This is absolutely consistent with the role of other bank regulatory agencies, in which the regulator responsible for safety and soundness has free and unfettered authority to determine policy, rulemaking, application, adjudicative, and budget matters.

The primary responsibility of the regulator is to implement policy made by the Congress, and to do so in a safe and sound manner. We strongly believe that a regulator lacking true independence may eventually find itself pursuing other agendas, not the will of Congress, nor what is demanded to assure safety and soundness.

Number 3—Preserve Bank System funding.

The reason a GSE can advance its housing mission more effectively than fully private companies is simple—we have a cost of funds advantage due to our GSE status. It is critical that we ensure that nothing is done to any of the housing GSE's that increases their cost of funds and, correspondingly, increases costs for financial institutions and consumers.

In fact, we are convinced that strong, independent, and skilled regulatory oversight will give greater confidence to investors and continue to help us advance our housing finance mission.

Therefore, any legislation must:

- Preserve the role and function of the Office of Finance.
- Ensure that neither the U.S. Treasury, nor the independent GSE regulatory unit, has the ability to impede or limit our access to the capital markets without cause.
- Not limit the financial management tools available to the GSE's to prudently manage the financial risks inherent in our funding and business activities.

Although the shared service of the Office of Finance should be owned and operated by the Federal Home Loan Banks—and the banks should establish its governance principles and scope of operations—we believe the OF must be subject to the regulatory authority of any new regulator.

Number 4—Preserve the unique nature of the Bank System.

While all three GSE's have much in common, we believe it is important to both recognize and preserve the unique nature of the FHLBanks.

Therefore, any legislation must:

- Preserve the cooperative ownership of the Bank System and the joint and several liability that is the underpinning of the Bank System.
- Preserve the unique regional structure of the 12 banks that assures we are locally controlled and responsive to the financial and economic development needs of our local communities.

Regardless of the regulatory structure established by Congress, we believe these principles must be considered as you move forward in your policymaking.

In closing, I would like to put forward some thoughts that reflect my own thinking on these matters.

I believe there are two threshold issues that can help you attain your benchmark purpose of protecting the public interest in the housing GSE's.

First, there is much that separates the Federal Home Loan Banks from the two other housing GSE's, and these differences must be fully recognized and factored into any regulatory reform measures being considered.

Let me list what I consider to be the key differences:

- Our mission is somewhat broader than the other housing GSE's, incorporating economic and community development.
- There are different capital requirements, with the FHLBanks required to hold 4 percent capital and the others required to hold a lower percentage.

  When new capital rules were established by Congress through Gramm-Leach-Bliley, there was wide agreement among economists that the Federal Home Loan Banks were required to hold too much capital against advances.

  Given that the Bank System has NEVER suffered a credit loss on advances, a 4 percent minimum requirement, we believe, is excessive. It is important to keep in mind that requiring too much capital can sometimes work against the goal of safety and soundness. If an enterprise is underleveraged, it can create pressure to take greater risk in order to generate better return on equity.

  In the secondary mortgage business, the likelihood of credit losses within the Bank System has increased. However, Fannie Mae and Freddie Mac, who get paid a fee to put credit risk on their books, are required to hold less capital, while the Federal Home Loan Banks—who compensate lenders for keeping the credit risk on their own books—are required to hold nearly twice as much capital. We believe capital requirements should be standardized for all three housing GSE's.
- The Bank System is cooperatively owned and capitalized by our members, while the other housing GSE's must meet the earnings and stock valuation expectations of Wall Street investors.
- Two housing GSE's pay Federal income taxes, but the Federal Home Loan Banks pay special taxes equivalent to the Federal corporate income tax rate of 26 percent. We are required to contribute 10 percent of our net income for affordable housing grants while the other GSE's have affordable housing goals.

  This is a highly efficient way of passing on our GSE subsidy, to directly impact affordable housing and economic development in the communities we serve. Though we appreciate the goals the other housing GSE's maintain, we believe—as do most—the best way of passing along our GSE subsidy is through our Affordable Housing Program and the direct 10 percent contribution made by each of the 12 Federal Home Loan Banks annually.

  The Bank System, in 2002, generated $199 million to award as AHP grants and subsidies, and over the last 13 years has awarded more than $1.7 billion in grants and subsidies, making the banks one of the largest sources of private funding for affordable housing in the Nation.

  The Affordable Housing Program targets incomes lower than those established by the housing goals administered by HUD. Affordable Housing Program subsidies must be used to fund the purchase, construction or rehabilitation of:
- Owner-occupied housing for very low-income, or low- or moderate-income (no greater than 80 percent of area median income) households; or

Rental housing in which at least 20 percent of the units will be occupied by and affordable for very low-income (no greater than 50 percent of area median income) households.

AHP subsidies may be in the form of a grant (direct subsidy) or a below-cost interest rate on an advance from a Federal Home Loan Bank member institution. In supporting home purchases, AHP funds may also be used for downpayment assistance for income-eligible, first-time homebuyers.

These are not inconsequential differences.

But, in fact, we increasingly have more in common. Most importantly for purposes of this discussion, we are all managing increasingly complex sets of financial, operating, and accounting risks. For example, all three housing GSE's pursue very sophisticated interest rate risk management strategies. And, all three would benefit from more rigorous oversight of these activities.

In my view, as business activities and associated risks converge among the GSE's, so, too, must the regulatory oversight evolve and adapt to a more complex world, and to greater scrutiny by Congress, the marketplace, and the American people.

Also, the choices you make on regulatory reform must be based on an underlying philosophy about the housing GSE's. In your judgment, is the public interest best advanced by encouraging competition among the housing GSE's or encouraging market domination by them?

It should come as no surprise that I have some views on this topic.

At the urging of the bank members of our system—the Nation's home lenders who own our cooperative—we have chosen to compete. That's why we jumped with both feet into the mortgage purchase business. In the end, the Nation's home lenders will better serve the Nation's homebuyers if there are choices and competition in the secondary mortgage market.

We welcome that competition because we are convinced we have a better way to meet our Congressionally mandated housing mission—to create homeownership opportunities. Because we are a cooperative, we are not beholden to the kinds of expectations of Wall Street investors, and because of the way we purchase mortgages, more of the risk is dispersed to those best able to manage the risk.

From a public policy point of view, full-fledged competition among GSE's is a way to more prudently manage GSE growth and to disperse risk among more investors.

The decisions you are about to make on regulatory reform and oversight will directly influence how this country best serves our network of community banks and consumers, and how we best protect the public interest and investment in the housing GSE's.

It is my job, as a President and CEO of one of the 12 Federal Home Loan Banks, to preserve and enhance the strength, integrity and value of our Bank System, and continue its legacy of service to our member financial institutions and the communities they serve.

Every day, I remind myself that I work for a cooperative that has, at its core, a public mission of making our communities better places to live and work. I do not own any part of this bank; it is owned by our members, and we are, at all times, fully accountable to them.

My role is to protect and enhance this cooperative, for the good of our financial institutions, our communities and the overall public interest invested in the Federal Home Loan Banks—the same purpose that each of you bring to this process.

I look forward to continuing to work closely with Members of Congress and the U.S. Treasury as we look for new and better ways of strengthening the oversight and value of our housing GSE's.

Thank you for your time this morning. I would be happy to answer any questions you may have regarding my testimony.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM JOHN W. SNOW

Prompt Corrective Action

Q.1. Clearly, OFHEO and the Finance Board do not have the complete arsenal of prompt corrective action tools that the OCC and other bank regulators have. In fact, the Finance Board has no statutory Prompt Corrective Action authority.

Do you believe that a new regulator must have the same Prompt Corrective Action tools as the bank regulators? Has the Administration given any thought as to how to fashion Prompt Corrective Action triggers for the Federal Home Loan Bank System, given its unique capital structure? I would be interested in any input that you might want to offer.

A.1. Prompt Corrective Action requirements are important for ensuring that financial institution regulators take the necessary regulatory actions at appropriate times depending on the financial condition of their regulated entities. Such requirements provide greater assurance that financial problems will be corrected before it becomes too late. The Prompt Corrective Action provisions that are in place for bank regulators provide a good model for evaluating and developing such requirements for a new regulator for the housing Government Sponsored Enterprises (GSE's).

Receivership/Conservatorship Authority

Q.2. Your written testimony indicated that the new regulatory agency should have more than the powers associated with conservatorship.

Which are the particular receivership authorities that you believe would be necessary? If the primary intent of a conservator is to maintain the ongoing business value of an enterprise, wouldn't broader receivership powers be unnecessary? What impact would receivership authority have on the ability of the GSE's to access the debt markets?

A.2. The Administration has proposed that the new regulatory agency for the housing GSE's should have broader powers than those associated with conservatorship. In particular, the new regulatory agency should have all receivership authority necessary to direct the orderly liquidation of assets and otherwise to direct an orderly wind down of an enterprise, in full recognition that Congress has retained to itself, in the case of Fannie Mae and Freddie Mac, the power to revoke a charter. The Finance Board has the authority to liquidate a FHLBank under certain circumstances.

We would not expect that providing the new regulatory agency with receivership authority would have an undue negative impact on the ability of the housing GSE's to access debt markets. Providing the new regulatory agency with the ability to complete an orderly wind down of a troubled regulated entity should encourage greater market discipline as creditors would have to evaluate fully their investment decisions. As with the powers granted to bank regulators, we would expect that the new regulatory agency could use its authority to place an entity in conservatorship if that was the appropriate course of action. However, if financial circumstances were sufficiently troubling, placing an entity in conservatorship and maintaining the ongoing business value may not be the appropriate course of action. The broad goals of financial regulation in this regard should be to promote a resilient housing finance system. Maintaining the operations of an entity that is no longer viable is inconsistent with that goal. We look forward to working with the Committee in developing specific receivership authorities for the new regulatory agency.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM JOHN W. SNOW

Q.1. It is my understanding that if a new GSE regulating entity is created as an office within the Department of the Treasury, you would approve such a proposal only if Treasury had the power to approve its testimony, clear all of its proposed regulation, and maintain full control of its budget.

If we are to establish a world-class regulator for the GSE's, isn't it important that such a regulator be an independent entity, like the Office of the Comptroller of the Currency (OCC), rather than an office within the Treasury Department, in order to ensure that its decisions are insulated from partisan politics and have greater credibility in the investor community? Furthermore, you stated that you believed that it was necessary for Treasury to have these powers over the new regulator in order to disabuse the investor community of any perceived Government backing. Wouldn't placing the regulator within Treasury with these powers increase that perception?

A.1. The degree of independence for a new GSE regulatory agency is vitally important with regard to specific matters of supervision, enforcement, and access to the Federal courts. The ability of the new regulatory agency to take actions regarding supervision and enforcement outside of the political process is important for ensuring that the new agency can properly oversee the operations of its regulated entities. Without such independence, a regulator may be prevented from taking the appropriate regulatory actions if such actions have unpopular political consequences. Likewise, providing the new regulatory agency with access to the Federal courts provides it with a necessary tool to perform its duties, and such access is consistent with the powers of our Nation's other financial regulators. Permanent budget authority is also an important component of independence for the new GSE regulatory agency.

While political independence for the new regulatory agency is important, the structure and location of the new regulatory agency deserves special consideration. Drawing upon the statements of those who have recommended placing the new regulatory agency within Treasury, it seems that it is believed that the Treasury would lend stature, authority, depth of experience, and a broader perspective to the new agency. None of those things would be available if Treasury is walled off from the policymaking processes (approving testimony, clearing proposed regulations, and having review authority over the budget) of the new agency.

Establishing a new regulatory agency for the housing GSE's within the Treasury Department does create the potential for reinforcing any market misperception of an implied guarantee of GSE obligations. That is why it is vitally important that the Treasury

Department be able to monitor the new regulator's policies to ensure that such policies are not reinforcing any market misperception of an implied guarantee and that such policies encourage greater market discipline of the GSE's. In that regard, Treasury approval of the new agency's policies will ensure that there is no confusion between Treasury debt, which is backed by the full faith and credit of the U.S. Government, and GSE debt, which does not have such backing.

Q.2. Do you believe that the current GSE minimum capital standard of 2.5 percent is too low or too high? Please explain in detail.

Has Treasury performed an analysis of the impact a change in the GSE minimum capital standard might have both on the housing and the investor markets? If so, please submit this analysis for the record. On what basis do you believe the decision to increase or decrease the minimum capital requirement should be made? Please describe how you envision the process to work. Do you believe that the Director of the proposed financial regulating entity should have the sole discretion to set both the risk-based and minimum capital standards? Why would allowing the regulator to have discretion over risk-based capital be insufficient to maintain safety and soundness for the GSE's?

A.2. The current minimum capital standards for Fannie Mae and Freddie Mac are set in statute at 2.5 percent of on-balance-sheet obligations and 0.45 percent for certain off-balance-sheet obligations. We believe that the new regulatory agency should have broad authority with regard to setting the capital requirements of the Enterprises, both with respect to risk-based capital and minimum capital. It is not a question of whether the current standard is too high or too low, but rather that the authority for setting capital standards needs to be flexible enough to employ the best regulatory thinking, conscious of the Enterprises' own measures of risk, so that the regulator can require that its regulated entities maintain capital and reserves sufficient to support the risks that arise or exist in its business.

In regard to the impact a change in the GSE minimum capital standard might have both on the housing and the investor markets, we would not expect the new regulatory agency to initiate such a change unless the risks undertaken by the GSE's warranted such a change. In that regard, changes in capital standards should go toward strengthening the financial position of the GSE's and further promoting our goal of a strong and resilient housing finance system that serves the needs of our Nation's homeowners. In addition, we would expect that any such changes to capital standards would go through the standard notice and comment rulemaking process that all financial regulatory agencies employ.

Similar to the authority of our Nation's other financial institution regulators, the new regulatory agency for the housing GSE's should also have the authority to adjust the GSEs' minimum capital standards. Minimum capital standards provide protection against the general, indefinable, perhaps unforeseen risks that are present with any financial enterprise. Financial institution regulators rely on both minimum and risk-based capital standards in evaluating the financial health of their regulated entities. While risk-based capital standards are more finely tuned to the particular risks of a financial institution, the methodology for determining such standards is subject to its own unique set of risks. One such risk is model risk—the risk that the financial models underlying the risk-based capital standard turn out to be incorrect. Model risk is a key indefinable or unforeseen risk that risk-based capital standards will not adequately capture. Thus, not providing the new regulatory agency with the ability to adjust minimum capital standards would limit new agency's effectiveness as a financial regulator.

Q.3. Current law provides that if one or both of the GSE's were in serious financial trouble, they would be placed in conservatorship, meaning that the Office of Federal Housing Enterprise Oversight (OFHEO) would attempt to financially restructure the GSE's to maintain their assets. In your testimony, you recommended changing this authority to "enhanced receivership," directing the new regulator to liquidate the assets of the GSE's with "appropriate wind down authority." Why do you believe that the current conservatorship authority should not be kept? Why is it not in the public interest to maintain the assets of the GSE's, instead of liquidating them to private entities?

A.3. The Administration's proposal regarding receivership does not envision eliminating the new regulatory agency's authority to place an entity into conservatorship, but rather it provides the new regulatory agency with the receivership authority necessary to direct the orderly liquidation of assets and otherwise to direct an orderly wind down of an enterprise, in full recognition that Congress has retained to itself, in the case of Fannie Mae and Freddie Mac, the power to revoke a charter. Such receivership authority is necessary because if financial circumstances were sufficiently troubling, placing an entity in conservatorship and maintaining the ongoing business value may not be the appropriate course of action. The broad goals of financial regulation in this regard should be to promote a resilient housing finance system. Maintaining the operations of an entity that is no longer viable is inconsistent with that goal.

Q.4. How does Treasury plan to regulate the process for new program and activity approval of the GSE's? In your testimony, you asserted that you believed Treasury did *not* recommend prior approval of new products and activity, but you did recommend giving Treasury the ability to withhold prior approval of new programs. Please elaborate on this. What criteria would Treasury propose for approval of new programs and activity? Please describe them in detail. How would this process differ from the current process administered by HUD? How would Treasury propose defining the difference between new programs and new activity? Many policy experts believe there is an unavoidable tension between maintaining safety and soundness and aggressively pursuing affordable housing goals. In reviewing new GSE programs and activity, how would Treasury balance safety and soundness of the GSE's with their housing mission objectives? What expertise in *housing* finance does Treasury have, that HUD does not, to justify Treasury becoming the new program and activity regulator?

A.4. The Administration has proposed that the authority for approving new activities of the housing enterprises be transferred from the Department of Housing and Urban Development (HUD) to the new regulatory agency. This proposal is consistent with availability of one of the central tools that every effective financial regulator has—the ability to say "no" to new activities that are inconsistent with the charter of the regulated institutions, inconsistent with their prudential operation, or inconsistent with the public interest. The current financial regulator for Fannie Mae and Freddie Mac lacks that authority, one of its most serious weaknesses, and if we are serious about creating an effective, credible financial regulator, it must have the authority to approve new activities.

As long as we are going to maintain a bifurcated regulatory structure for Fannie Mae and Freddie Mac, there may be some tension between mission regulation and safety and soundness regulation. As it relates to new activities approval, the Administration's proposal addresses this tension by providing the Secretary of HUD with a consultative role in reviewing new activities. Through this consultative process, HUD would continue to have an important role to play in providing its expertise on new activities that have a direct impact on the housing and mortgage markets.

The Administration's proposal for regulatory reform of the housing GSE's also strengthens the authority of HUD to promote the housing goals of Fannie Mae and Freddie Mac. In particular, HUD would continue to have responsibilities for setting the affordable goals for Fannie Mae and Freddie Mac and enforcing the Fair Housing Act. Under our proposal, HUD would also be provided explicit enforcement authority over the housing goals to ensure that Fannie Mae and Freddie Mac are meeting their housing promotion requirements.

In terms of the process for new activities, it is important to understand that Treasury's formal role in approval of new activities would only arise in those few cases when a new activity was such a departure from existing norms as to require formal promulgation of a new regulation. That is to say that variations within the GSEs' current secondary market activities that clearly are authorized by statute may not require any Treasury review of proposed regulatory changes by the new agency. In fact, we would not expect approval of new activities to require new regulations in most cases.

Q.5. In your testimony, you argued that including the Federal Home Loan Bank (FHLB) System in GSE regulatory reform would be better than keeping them out. However, you mentioned that there were significant differences between the FHLBanks and the other housing GSE's. What differences between the FHLBanks and the other housing GSE's do you believe are significant with respect to their regulation and would you specifically address such differences in legislation reforming their oversight? Please explain in detail.

A.5. The importance of our housing finance markets requires that all of the housing GSE's be included in a single program of world-class supervision. We see the need for this for the Federal Home Loan Bank System just as we see it for Fannie Mae and Freddie

Mac. There are some differences between the FHLBanks and the other housing GSE's that require special consideration as changes to their regulation are considered. Some of these include: Debt issuance of FHLBanks by the Office of Finance; how the differing capital structures of the housing GSE's are addressed; and how the cooperative ownership structure of the FHLBanks would be addressed. While some of these issues may need to be addressed specifically with legislation, another useful way to account for the unique characteristics of housing GSE's is to create two divisions within the new regulatory agency—one division specializing in Fannie Mae and Freddie Mac and one in the FHLBanks. We look forward to working with the Committee on these issues.

RESPONSE TO A WRITTEN QUESTION OF SENATOR SUNUNU FROM JOHN W. SNOW

Q.1. Secretary Snow, if you are calling for the GSE's to comply with bank-like capital standards, are you suggesting the elimination of the .45 percent capital charge that Fannie Mae and Freddie Mac currently hold for off-balance-sheet assets, such as mortgage-backed securities that they guarantee? Are you calling for a new capital requirement to be imposed on the off-balance-sheet assets of banks?

A.1. We are not suggesting the elimination of any particular capital requirement nor are we suggesting new capital requirements for banks. The key aspect of our housing GSE regulatory reform proposal with respect to capital requirements is that we believe that the regulator should have broad authority with regard to setting the capital requirements of the Enterprises, both with respect to risk-based capital and minimum capital. Given the unique nature of mortgage guarantee business of Fannie Mae and Freddie Mac such authority could be used to set minimum capital standards for those obligations even though they are off-balance-sheet obligations. The new regulatory agency's authority for setting capital standards needs to be flexible enough to employ the best regulatory thinking, conscious of the Enterprises' own measures of risk, so that the regulator can direct its regulated entities each to maintain capital and reserves sufficient to support the risks that arise or exist in its business. One such risk is clearly the credit risk associated with the GSEs' guarantees of mortgage-backed securities, and the new agency should have authority to require capital for that risk.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM JOHN W. SNOW

Q.1. As I said in my opening statement, I am very concerned about the unintended consequences this legislation may have on small banks. I am especially concerned that they may find themselves limited in products they can use to make loans to underserved populations and for CRA compliance. Do I have your commitment today to do what we can to ensure small banks are not adversely affect by this legislation?

A.1. In developing our approach to regulatory reform for the housing GSE's we have been focused on two core objectives: Promoting a sound and resilient financial system, and increased homeownership opportunities for less advantaged Americans. Small banks form an important component of our housing finance system, and we do not see any reason why improving the regulation of the housing GSE's would have a negative impact on their operations. In contrast, we would expect that improvements in the regulatory oversight of the housing GSE's would help to ensure that we have a system in place that serves the needs of small banks and their customers both today and in the future, and I am committed to that result.

Q.2. As you know, the OCC and the Fed require banks to notify their respective regulator after they have engaged in a new activity. Why do you think the OCC/Fed model would not work for the GSE's?

A.2. The Administration has proposed that the authority for approving new activities of the housing enterprises be transferred from HUD to the new regulatory agency, and we do think that the OCC model for new activity approval is an appropriate model for the new regulatory agency. The key element is flexibility: Flexibility in bringing new products on line and flexibility to provide fully adequate supervision.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MILLER FROM JOHN W. SNOW

Q.1. Secretary Snow, the initial thinking after Freddie's problems erupted was to put Fannie and Freddie's regulator into Treasury to bring confidence to the market. Is this still a timely rationale for moving the regulator into Treasury or have the markets calmed themselves regarding Fannie and Freddie and this issue has died?

A.1. While the recent problems experienced by Freddie Mac highlighted problems with the housing GSEs' current regulatory oversight regime, the rationale for regulatory reform goes beyond these recent events. Because housing finance is so important to our national economy, we need to have a world-class regulatory agency to oversee the GSE's in a manner that is consistent with maintaining healthy national markets for housing finance. There is a general recognition that the supervisory system for the housing GSE's has neither the tools, stature, authority, nor resources to deal effectively with the current size, complexity, and importance of these enterprises. As with all forms of Government regulation, policymakers should continually evaluate where improvements can be made. It is in that regard that the Administration is recommending improvements to the oversight of our housing finance system.

Q.2. Secretary Snow, Treasury is now interested in including the Federal Home Loan Banks in a bill. I was confused after your testimony today because in it you say "that all housing enterprises be included in a single program of world-class supervision." But in your response to Senator Hagel you said there should be two divisions, one for the Banks and one for Fannie and Freddie. Do you mean one bureau with two divisions or two bureaus? Please clarify what you mean. What is your thinking for the structure you propose?

A.2. The key point is that whatever the structure of the new housing GSE regulatory agency, the new agency should have the same set of enforcement tools and the same overall financial supervisory regime in place for all of its regulated entities. At the same time, the underlying statutory authority and business operations of Fannie Mae and Freddie Mac in comparison to the FHLBanks is different, so some specialization in regulation may be necessary. One way to address these issues would be to create one regulatory agency with two divisions. One division would be responsible for Fannie Mae and Freddie Mac, and the other division would be responsible for the FHLBanks. Under such a structure, benefits in financial oversight could be achieved through the sharing of best practices in examination procedures and overall measurement of risk, while at the same time the unique characteristics of each of these entities could also be considered.

Q.3. Secretary Snow and Secretary Martinez, if Fannie and Freddie are put into Treasury, you discuss wanting new program and/or new activity review. The GSE's are concerned that this might impede their ability to be creative and innovative with new mortgage products. Do you agree?

A.3. We see no reason why the GSEs' innovation should be stifled under a process whereby the new regulatory agency has authority to approve new activities. Our Nation's bank and thrift regulators have fostered and encouraged innovation using the same type of approval authority, and we see no reason why providing similar authority to the new regulatory agency would stifle innovation by housing GSE's.

Q.4. Secretary Snow, the GSE's are concerned that giving the regulator greater discretion to change risk-based capital standards might result in higher costs for homeowners and renters. Has Treasury considered this concern and what is your response?

A.4. In developing our approach to regulatory reform for the housing GSE's we have been focused on two core objectives: Promoting a sound and resilient financial system, and increased homeownership opportunities for less advantaged Americans. To serve both of these objectives we need to devote careful attention to the resilience of our system of housing finance. Housing finance is so important to our national economy that we need a strong, world-class regulatory agency to oversee the prudential operations of the GSE's and the safety and soundness of their financial activities consistent with maintaining healthy national markets for housing finance.

In providing the new regulatory agency with the discretion to change risk-based capital standards, we would not expect the new regulatory agency to initiate such a change unless the risks undertaken by the GSE's warranted such a change. In that regard, changes in capital standards should go toward strengthening the financial position of the GSE's and further promoting our goal of a strong and resilient housing finance system that serves the needs of our Nation's homeowners today and in the future, ultimately increasing home affordability.

Q.5. Secretary Snow, do you know if anyone in the Government has studied or is studying what the cost or impact to the Federal Home Loan Banks will be of registering their stock with the SEC?

(If he says no. You might suggest that some staff attention be given to this issue.)

A.5. The FHLBanks have raised the concern of potential costs or unintended effects of registering with their stock with the SEC. It is my understanding the FHLBanks and the SEC continue to discuss details (for example, how the joint and several liabilities of the FHLBanks will be described) regarding concerns the FHLBanks have raised with registration. I am confident that these types of concerns can be worked out, which would then remove any remaining impediment to the FHLBanks' registering with the SEC.

As it relates to studying the issue of cost or impact on the FHLBanks, it is difficult to see how providing greater financial disclosure to the market could have a negative impact on the FHLBanks unless such disclosure reveals new information to financial market participants that raises questions regarding the FHLBanks' credit quality.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM MEL MARTINEZ

The mission of Fannie Mae and Freddie Mac is expanding homeownership, and their housing goals are a barometer of that mission.

Q.1.a. Do you believe the current housing goals are sufficient to fulfill the GSEs' mission? If yes, then why change the current system?

A.1.a. No, HUD believes the current goals are not sufficient to ensure that the GSEs' focus on expanding homeownership. Goals must be dynamic to ensure that areas where there is a need can be adequately targeted. Under the Administration's proposal, HUD would receive enhanced authority to establish and enforce housing goals for the GSE's. This enhanced authority would include the ability to establish an annual home purchase goal for the GSE's which could be specifically targeted to first-time homebuyers, low- and moderate-income homebuyers, homebuyers in underserved areas, and homebuyers of special affordable housing. Other proposed enhancements include the ability to add, modify, or rescind existing goals as needed to better serve housing needs. In addition, to ensure that this function is given significant attention, the Administration also proposes establishing a new office within HUD, with the costs of regulation to be funded, as with other financial regulators, through assessments on the regulated entities, the GSE's.

Q.1.b. What do you see as the dividing line between encouraging affordable mortgage lending and credit allocation? How do we make sure these goals are insulated from the political process?

A.1.b. Congress chartered both Fannie Mae and Freddie Mac to fulfill certain public purposes, including providing ongoing assistance to the secondary market for residential mortgages, which includes activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities. The Department's housing goals for the GSE's are in furtherance of these purposes and reflect Congress's objectives. In return for confining their businesses to meeting these objectives, the GSE's receive substantial benefits, estimated by the Congressional Budget Office in May 2001 at $10.6 billion per year.

With enactment of the Federal Housing Enterprises Financial Safety And Soundness Act, FHEFSSA, in 1992, Congress clarified the GSEs' public purposes further by establishing specific affordable housing objectives and mandating that HUD establish quantitative targets under each goal. As a result of these actions, the requirement for improved performance and accountability in affordable mortgage lending and the requirement to allocate credit for these purposes are the same thing. In setting annual targets for each GSE under the FHEFSSA and to ensure that the Enterprises are able to provide liquidity to residential mortgage markets as intended by their charter acts, HUD evaluates the level of each goal against six factors as set forth in the FHEFSSA. These factors include the size of the market for each goal, the GSEs' past performance under the goals, and the GSEs' ability to lead the market. The purpose of these considerations is to assure that the goal levels are appropriate. The process and methodology that HUD relies upon in making its determinations weigh these considerations based on objective market data and are published for evaluation, review, and comment in each proposed rule for new goals. This transparent process ensures that goal levels are established in an environment that is objective and insulated from undue political influence.

Q.1.c. How would the home purchase goal proposed by the Administration differ, operationally, from the current housing goals?

A.1.c. The Administration's proposal would allow HUD to establish, through regulation, four components of an annual home purchase goal for single-family dwelling units. These components would include first-time homebuyers; low- and moderate-income homebuyers; homebuyers in central cities, rural areas, and other underserved areas; and homebuyers of special affordable housing. The components, expressed as percentages of each GSE's home purchase mortgage business, would be established at levels that would increase the GSEs' secondary market financing of home purchase mortgages serving the charter missions of the GSE's and the goals established by the FHEFSSA. The components would be enforceable as goals.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM MEL MARTINEZ

Q.1. In your September 10 House Financial Services testimony, you said that you felt that it was important to place new program and activity approval authority with the proposed new regulator entity at Treasury. You said it should be moved to Treasury because you felt that such authority impacted the safety and soundness of the GSE's.

You have proposed the creation of a new oversight office within HUD to oversee affordable housing goals. With an appropriate level of funding and a staff skilled in evaluating the financial implications of new programs and activities, why do you believe that such a HUD office would be unable to effectively regulate new program and activity approval?

A.1. The Administration's proposal provides for establishing a new regulatory office within the Treasury Department. The new office, consistent with Treasury's experience as a financial regulator, would be responsible for overseeing the GSEs' safety and soundness. The new office also would have authority to review GSE activities that frequently present safety and soundness issues as primary concerns. Because new activities may also have mission implications, the new office will be required to consult with HUD in its reviews. This approach allows HUD to retain a key role as the GSEs' mission regulator while also ensuring that the new safety and soundness office has all the tools necessary to function as a world-class regulator.

In your testimony, you have argued that the GSE's lag the private market in lending to minority and first-time homebuyers. It is my understanding that the studies you cite include data from the Home Mortgage Disclosure Act (HMDA), which doesn't reflect purchases of seasoned loans, and includes data from the private market that includes a higher percentage of the subprime market than the GSE's.

Q.2.a. Can you cite for the record a study that compares minority and first-time *conventional* loan borrowers using data that includes seasoned loans that definitively demonstrates that the GSE's lag the private market among borrowers with similar income, credit, wealth, and racial profiles?

A.2.a. HUD and private researchers have published numerous studies on the GSEs' performance in funding affordable home purchase mortgages. These studies concluded that both Fannie Mae and Freddie Mac have lagged the primary market in purchasing loans for groups covered by the housing goals: Low- and moderate-income and special affordable borrowers and borrowers living in underserved areas. HUD's most recent study analyzed GSE and market data through the year 2000.

This response presents updated data for 2001 and 2002 and includes analysis of first-time homebuyers. The analyses reported in the tables below compare characteristics of loans originated in the conventional conforming market, as shown in HMDA data, with characteristics of loans purchased by the GSE's, as shown in the data they have provided annually to HUD.

Loan characteristics (such as underserved area loans) are presented in the form of percentage shares of loans originated in the conventional conforming market, as compared with corresponding percentage shares of loans purchased by Fannie Mae or Freddie Mac. The percentage shares (or ratios) for the market are limited to loans originated during the current year, adjusted to exclude loans originated by "B and C" subprime lenders. As explained below, the GSEs' purchases include both (a) current-year, newly originated mortgages and (b) prior-year, seasoned mortgages, for which percentage shares can be presented in alternative ways.

Question 2(a) raised the issue of the GSEs' purchases of seasoned loans. It is not possible to provide consistent comparisons including seasoned loans as well as newly originated loans, because the market data, provided under the Home Mortgage Disclosure Act (HMDA), do not include the seasoned loans that are available for purchase by the GSE's. There are different ways to treat seasoned loans when comparing the GSEs' purchases to market originations. The most appropriate and most consistent is to exclude seasoned loans from the GSE data for the year in which they are purchased by the GSE's, and count them instead in the year in which they are originated. This approach is taken in the accompanying Tables 1 and 2. Table 1 reports the GSE data on an "origination-year" basis. This is the closest in concept to the market data, which are also presented on an "origination-year" basis. The GSE data in Table 1 for the year 2001 include all the GSEs' purchases through 2002 of loans originated during 2001; in other words, it includes the GSEs' purchases of 2001 originations during both 2001 and 2002. Thus, in Table 1, seasoned loans (that is, 2001 mortgage originations purchased by the GSE's in 2002) are reallocated back to their year of origination. This places them on a comparable basis with the HMDA market origination data. As shown in Table 1, low- and moderate-income families accounted for 41.7 percent of the GSEs' purchases (through 2002) of 2001 mortgages. Table 1 also shows that low- and moderate-income families accounted for 42.9 percent of the mortgages originated in the conventional conforming market during 2001. Thus, for low- and moderate-income loans, the GSEs' purchases of 2001 originations lagged the 2001 origination market.

The percentages reported in Table 1, taken together, show that the ratios for each of the GSE housing goals (indicated as "Both GSE's") were behind the market ratios in both 2001 and 2002. Freddie Mac lagged behind both the market and Fannie Mae, except in 2002 when Freddie Mac equaled Fannie Mae in the special affordable category. Fannie Mae's mortgage purchase ratios lagged behind the market ratios, except in 2002 when Fannie Mae surpassed the market in the low- and moderate-income category.

Table 2 compares the GSEs' ratios with market loan origination ratios for three race/ethnicity categories. Again, the ratios for "Both GSE's" were behind the market ratios for African American borrowers, Hispanic borrowers, and all minority borrowers in both 2001 and 2002. During 2001 and 2002, Fannie Mae's ratios lagged behind the market in the African American category but exceeded or equaled the market in the other two categories (Hispanic and All Minorities). Freddie Mac's ratios fell below the market in all three race/ethnicity categories in both 2001 and 2002.

Tables 3 and 4 repeat the analyses in Tables 1 and 2, except that the GSE data are expressed on a "purchase year" basis. This means that all the GSEs' purchases in a particular year are compared to mortgages originated in the market in that same year. Thus, in this analysis, the GSEs' data for 2001 include not only their purchases during 2001 of mortgages originated during 2001, but also their purchases of prior-year, or so-called "seasoned mortgages," such as mortgages originated during 1999 or 2000. These ratios for the GSE's are not as directly comparable to the market ratios as are the ratios in Tables 1 and 2. They measure the overall purchase activity of the GSE's during 2001, rather than the purchases of the GSE's of loans originated in 2001.

Using this "purchase year" approach, Table 3 compares the percentage shares of goal-qualifying mortgages in the GSEs' purchases and market originations. It shows that all of the GSE housing goal category ratios (indicated as “Both GSE’s”) were behind the market ratios in both 2001 and 2002. Freddie Mac lagged behind Fannie Mae, while Fannie Mae’s mortgage purchase ratios equaled or exceeded the market ratios in 2002. Table 4 compares the GSEs’ ratios with market loan origination ratios for three race/ethnicity categories. Again, the ratios for “Both GSE’s” were behind the market ratios for African American borrowers, Hispanic borrowers, and all minority borrowers in both 2001 and 2002. However, Fannie Mae’s ratios exceeded the market in two of three racial/ethnicity categories in 2001 and all three racial/ethnicity categories in 2002, while Freddie Mac’s ratios fell below the market in both years.

As explained above, the GSEs’ ratios in Tables 3 and 4 include their purchases of loans originated both in the current year and in prior years. The GSEs’ purchases of loans originated in prior years typically tend to include a greater share of goals-qualifying mortgages than do their purchases of loans originated in the year of purchase by the GSE. Thus, the GSE percentages tend to overstate the GSEs’ performance in a particular category, relative to a consistent concept of loans originated in a given year (as presented in Tables 1 and 2).

Tables 3 and 4 present the comparisons in the way that HUD traditionally has reported the GSEs’ performance, even though the data are not as comparable as the origination-year basis. Throughout the 1990’s the GSE’s lagged the market by such a substantial margin that the differences in coverage between the GSE and market data did not affect the result materially and did not change the basic conclusion. The GSEs’ improvement in very recent years, and the renewed public interest in their performance, has led HUD to refine the analysis and make the comparisons as precise as possible. These comparisons, as mentioned, appear in Tables 1 and 2.

Table 5 compares the GSEs’ funding of mortgages for first-time homebuyers with market loan originations for first-time home buyers. This table shows that first-time homebuyers represented 37.6 percent of market loan originations, compared with 26.5 percent of the GSEs’ purchases; thus, the GSE’s fell substantially short of the market originations ratio for first-time homebuyers over the period 1999–2001. For minority first-time homebuyers, the GSE ratio was 6.2 percent, compared to a market originations ratio of 10.6 percent. For African American and Hispanic first-time homebuyers, the GSE ratio was 3.8 percent, compared to a market originations ratio of 6.9 percent. For first-time homebuyers, particularly first-time minority homebuyers, both GSE’s substantially lagged the private conventional conforming market. HUD has not previously published this comparison.

Table 1

Market/GSE Performance Comparisons for 2001 and 2002 in Housing Goal Categories
Market and GSE Analysis by Year of Loan Origination

Market

	Low-mod qualifying	Underserved areas	Special Affordable qualifying
2001	42.9%	25.2%	15.6%
2002	45.2%	26.4%	16.3%

GSEs

Both GSEs

	Low-mod qualifying	Underserved areas	Special Affordable qualifying
2001	41.7% (-)	23.3% (-)	14.0% (-)
2002	45.0% (-)	25.3% (-)	15.8% (-)

Fannie Mae

	Low-mod qualifying	Underserved areas	Special Affordable qualifying
2001	42.3% (-)	23.8% (-)	14.4% (-)
2002	45.4% (+)	25.5% (-)	15.8% (-)

Freddie Mac

	Low-mod qualifying	Underserved areas	Special Affordable qualifying
2001	40.6% (-)	22.4% (-)	13.5% (-)
2002	44.4% (-)	25.0% (-)	15.8% (-)

The symbols (-), (=), and (+) indicate direction of difference, if any, relative to the market.

Market percentages are for current-year mortgage originations, based on HMDA data. GSE percentages are for GSEs' mortgage purchases, based on GSE loan-level data provided annually to HUD. GSE percentages for 2001 represent GSE purchases (in 2001 or 2002) of loans originated in 2001. GSE percentages for 2002 represent GSE purchases in 2002 of loans originated in 2002.

The analysis is limited to conventional conforming home purchase mortgages for owner-occupied 1-4 unit properties in Metropolitan Areas. Properties with missing affordability data are excluded from the analysis for Low- and Moderate Income and Special Affordable categories.

Table 2

Market/GSE Performance Comparisons for 2001 and 2002 By Race/Ethnicity
Market and GSE Analysis by Year of Loan Origination

Market

	African American	Hispanic	All minorities
2001	5.0%	8.7%	20.8%
2002	5.3%	9.9%	23.2%

GSEs

Both GSEs

	African American	Hispanic	All minorities
2001	4.1% (-)	8.0% (-)	20.0% (-)
2002	4.3% (-)	8.7% (-)	22.3% (-)

Fannie Mae

	African American	Hispanic	All minorities
2001	4.6% (-)	8.7% (=)	21.5% (+)
2002	4.9% (-)	10.0% (+)	24.2% (+)

Freddie Mac

	African American	Hispanic	All minorities
2001	3.4% (-)	6.9% (-)	17.8% (-)
2002	3.4% (-)	6.6% (-)	19.0% (-)

The symbols (-), (=), and (+) indicate direction of difference, if any, relative to the market.

Market percentages are for current-year mortgage originations, based on HMDA data. GSE percentages are for GSEs' mortgage purchases, based on GSE loan-level data provided annually to HUD. GSE percentages for 2001 represent GSE purchases (in 2001 or 2002) of loans originated in 2001. GSE percentages for 2002 represent GSE purchases in 2002 of loans originated in 2002.

The analysis is limited to conventional conforming home purchase mortgages for owner-occupied 1-4 unit properties in Metropolitan Areas. Properties with missing race/ethnicity data are excluded from the analysis.

Table 3

Market/GSE Performance Comparisons for 2001 and 2002 in Housing Goal Categories
Market Analysis By Year of Loan Origination and
GSE Analysis by Year of Purchase

Market

	Low-mod qualifying	Underserved areas	Special Affordable qualifying
2001	42.9%	25.2%	15.6%
2002	45.2%	26.4%	16.3%

GSEs

Both GSEs

	Low-mod qualifying	Underserved areas	Special Affordable qualifying
2001	42.2% (-)	23.5% (-)	14.7% (-)
2002	44.8% (-)	26.3% (-)	16.1% (-)

Fannie Mae

	Low-mod qualifying	Underserved areas	Special Affordable qualifying
2001	42.9% (=)	24.4% (-)	14.9% (-)
2002	45.3% (+)	26.7% (+)	16.3% (=)

Freddie Mac

	Low-mod qualifying	Underserved areas	Special Affordable qualifying
2001	41.3% (-)	22.3% (-)	14.4% (-)
2002	44.0% (-)	25.8% (-)	15.8% (-)

The symbols (-), (=), and (+) indicate direction of difference, if any, relative to the market.

Market percentages are for current-year mortgage originations, based on HMDA data. GSE percentages are for GSEs' mortgage purchases (including purchases of seasoned loans), based on GSE loan-level data provided annually to HUD. Because these ratios for the GSEs include seasoned loans and the market ratios include only current-year mortgage originations, the GSE ratios tend to overstate the GSEs' business shares in each category, compared to mortgage origination activity in a given year.

The analysis is limited to conventional conforming home purchase mortgages for owner-occupied 1-4 unit properties in Metropolitan Areas, excluding mortgages on second homes. Properties with missing affordability data are excluded from the analysis for Low- and Moderate Income and Special Affordable categories.

Table 4

Market/GSE Performance Comparisons for 2001 and 2002 By Race/Ethnicity Market Analysis By Year of Loan Origination and GSE Analysis by Year of Purchase

Market

	African American	Hispanic	All minorities
2001	5.0%	8.7%	20.8%
2002	5.3%	9.9%	23.2%

GSEs

Both GSEs

	African American	Hispanic	All minorities
2001	4.6% (-)	7.9% (-)	20.3% (-)
2002	4.7% (-)	9.0% (-)	22.7% (-)

Fannie Mae

	African American	Hispanic	All minorities
2001	5.2% (+)	8.5% (-)	21.9% (+)
2002	5.4% (+)	10.4% (+)	24.9% (+)

Freddie Mac

	African American	Hispanic	All minorities
2001	3.9% (-)	7.0% (-)	18.3% (-)
2002	3.5% (-)	6.6% (-)	18.9% (-)

The symbols (-), (=), and (+) indicate direction of difference, if any, relative to the market.

Market percentages are for current-year mortgage originations, based on HMDA data. GSE percentages are for GSEs' mortgage purchases (including purchases of seasoned loans), based on GSE loan-level data provided annually to HUD. Because these ratios for the GSEs include seasoned loans and the market ratios include only current-year mortgage originations, the GSE ratios tend to overstate the GSEs' business shares in each category, compared to mortgage origination activity in a given year.

The analysis is limited to conventional conforming home purchase mortgages for owner-occupied 1-4 unit properties in Metropolitan Areas, excluding mortgages on second homes. Properties with missing race/ethnicity data are excluded from the analysis.

Table 5

First-time Homebuyer Mortgages* as a Share of All Conventional Conforming Home Purchase Mortgages, for GSEs' Purchases and Market Originations 1999-2001 Averages

	Fannie Mae	Freddie Mac	Both GSEs	Market
All Race/Ethnicity Groups	26.5%	26.5%	26.5%	37.6%
African American and Hispanic	4.0%	3.4%	3.8%	6.9%
Minority	6.6%	5.8%	6.2%	10.6%

* The first-time homebuyer concept for the market analysis is homebuyers who have never owned a home. The concept for the GSEs is purchasers who have not owned a home within the previous three years.

The market analysis is based on GSE, HMDA, and American Housing Survey data. Because the ratios for the GSEs include seasoned loans and the market ratios include only current-year mortgage originations, the GSE ratios tend to overstate the GSEs' business shares in each category, compared to mortgage origination activity in a given year.

Q.2.b. If you are able to definitively demonstrate such a difference between the GSE's and the private market exists, please describe why such a difference exists, considering that it is in GSE's financial interests to buy as many conventional loans as possible.

A.2.b. In the past, the GSE's generally focused on borrowers with traditional backgrounds and living in suburban settings, as Congress observed in the early 1990's: "Inadequate access to mortgage credit is a particular problem which results, in large part, from the vestiges of redlining and the unintended consequences of the Enterprises' orientation toward suburban and "plain vanilla" mortgages." [1]

The GSE's have made significant changes in their underwriting guidelines in recent years and, in conjunction with primary lenders, have introduced a variety of new products and programs for nontraditional buyers. Thus, major gains have been made by the GSE's in serving traditionally underserved borrowers and neighborhoods. However, HUD and others believe that additional steps could be taken by the GSE's, without damaging their safety and soundness, to reach out further to this market.

For example, research on the GSEs' mortgage purchases has found that many of their goal-qualifying loans have rather low loan-to-value ratios. This has raised concerns that some nontraditional borrowers who are unable to make high downpayments are not able to obtain conventional loans that could be purchased by the GSE's, thereby forcing these borrowers to more expensive loans, such as FHA-insured loans. In this regard, there are indications that both GSE's understand the importance of improving access for borrowers with low downpayments. For example, Fannie Mae recently announced a plan for a joint venture with a mortgage insurer to increase such purchases.

Q.2.c. Why hasn't HUD updated the affordable housing goals yet using its current authority? When do you plan on updating them?

A.2.c. HUD is currently working on establishing new affordable housing goals. However, determinations regarding the market share, upon which each goal is based are highly dependent upon current census data. Complete data from the 2000 census has only recently become available. HUD's regulations state that housing goals will remain in effect until such time as a new regulation is promulgated. The Department anticipates that new goals will be in place for 2005. With respect to rulemaking for affordable housing goals and other HUD regulatory responsibilities, it is important to remember that the Department has limited staff that it can devote to these regulatory activities, because it lacks the ability to fund its regulatory activities through assessments on the GSE's. Other financial regulators do have assessment authority. The Administration's proposal, which will establish a dedicated office and staff to carry out HUD's regulatory responsibilities and which will provide for funding based upon fee assessments on the GSE's, will markedly improve HUD's ability to carry out its functions.

[1] Senate Report 102–282, May 1992, p.38.

Q.3.a. How does HUD currently define the difference between new programs and new activity and/or products?

A.3.a. HUD relies on the current statutory definition in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (FHEFSSA), as well as its legislative history, in making determinations about what is subject to review as required under the FHEFSSA. Section 1303 of the FHEFSSA defines a "new program" as—

> any program for the purchasing, servicing, selling, lending on the security of, or otherwise dealing in, conventional mortgages that (A) is significantly different from programs that have been approved under this Act or that were approved or engaged in by an enterprise before the date of the enactment of this Act [10/28/92]; or (B) represents an expansion, in terms of dollar volume or number of mortgages or securities involved, of programs above limits expressly contained in any prior approval.

The legislative history states that "[n]ew products or programs that differ from existing programs because of insignificant variations in mortgage characteristics, technical improvements, or those, generally, that represent recombinations of features used in existing programs need not be submitted for approval."[2] There is no statutory definition or legislative history that differentiates "activities" from either "products" or "programs."

Q.3.b. Is there a problem with this definition? Why or why not?

A.3.b. The current definition is imprecise. It is often difficult to make the distinction between products and programs for regulatory purposes. Both GSE's have relied upon the imprecise language to determine for themselves that nearly all initiatives are either products, mortgage features, or other activities that do not fall within the meaning of "new programs" as defined in FHEFSSA. As a result, even though the current statute requires the GSE's to receive prior approval from HUD before instituting a new program, they rarely seek this approval.

Q.3.c. If there is a problem with this definition, how would you propose changing it?

A.3.c. The Administration is proposing the creation of a world-class regulatory office within the Treasury Department with authority over both safety and soundness and the review of new and ongoing activities of the Enterprises. The Administration's proposal for new activity review better delineates the scope of oversight authority by removing the definitional distinctions that have contributed to confusion and misunderstanding in the past.

Q.4.a. You sent the Congress legislative language that would give the HUD Secretary the authority to rescind housing goals that Congress has established for these companies by only giving 30 days notice. By my reading of this language, you could rewrite the goals set by Congress simply by determining in your opinion that there are other housing needs. Why does HUD need the power to rescind housing goals with 30 days notice?

A.4.a. The Administration's proposal would not authorize HUD to rescind housing goals upon a 30-day notice. Under the Administration's proposal, HUD may only establish, modify, or rescind a goal by regulation, with formal notice and comment. Therefore, if HUD

[2] Senate Report 102–282, May 15, 1992, p.15.

rescinds a goal or establishes a new goal, it can only be done by notice and comment rulemaking.

A new goal would not become effective until at least a year after it was promulgated by a final rule, that is, following at least a 1-year transition period. For example, a new goal established by a final rule promulgated on October 1, 2004, would be made effective on January 1, 2006.

Under the Administration's proposal, HUD could establish necessary implementation requirements for the transition, for example, procedures for reporting on the transitional goal or for applying the goal requirements. These transition requirements could be established by notice only after providing the GSE's at least 30 days to comment. The Administration's proposal is modeled on the transition language for establishing the goals under FHEFSSA. Accordingly, the 30-day period is only relevant to the GSEs' opportunity to comment on the establishment of transition requirements for goals established through rulemaking.

Q.4.b. In your testimony, you argued that there should be a new first-time homebuyer goal. Wouldn't such a goal damage the housing refinancing or multifamily markets? Why not?

A.4.b. Under the Administration's proposal, the Enterprises could continue to purchase any volume of multifamily and refinanced single family mortgages that they desire with no adverse impact on their ability to achieve a first-time homebuyer goal. The reason for this lies in the way goals are established and performance under them is calculated.

The Administration's proposal applies only to loans to buy homes that are purchased or securitized by the GSE's. There would not be a numerical target for the total number of home purchase loans, nor would there be a home purchase loan target in terms of the percentage of total GSE business that would be devoted to home purchase loans. Instead, the number of home purchase loans would be left to the business judgment of the GSE's. Whatever that number may be in a given year, some specified percentage of those loans would be for first-time homebuyers.

The performance of the Enterprises under this component would be calculated by dividing the number of home purchase mortgages *that are for first-time homebuyers* by the total number of home purchase mortgages acquired, including *both first-time and repeat homebuyers.* The inclusion of other types of mortgages in the calculation, such as refinance mortgages, would indeed cause a corresponding drop in the reported percentage of first-time home purchase mortgages acquired and could possibly deter the Enterprises from purchasing these types of mortgages. This is not what the Administration proposes.

Helping families become homeowners is an important public purpose of the GSE's, and home purchase loans are their "bread and butter" business. The housing goals do not now recognize the importance of homeownership. The Administration believes that they should.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR BUNNING FROM MEL MARTINEZ

Q.1. As I said in my opening statement, I am very concerned about the unintended consequences this legislation may have on small banks. I am especially concerned that they may find themselves limited in products they can use to make loans to underserved populations and for CRA compliance. Do I have your commitment today to do what we can to ensure small banks are not adversely affected by this legislation?

A.1. The Administration's GSE regulatory reform proposal provides that the new GSE regulatory office responsible for safety and soundness regulation will have the authority to make determinations with regard to the permissibility of new GSE activities. In carrying out this review authority, the new regulator must consult with HUD. The Administration believes that this new procedure will ensure that in any review of GSE activities, the GSEs' safety and soundness, as well as the GSEs' affordable housing mission, will be fully considered. Small banks, such as those in Kentucky that have expressed their concerns to you, serve important roles in funding affordable housing loans through their CRA programs. The Administration fully understands the extent to which CRA lenders, such as small banks, rely upon the GSE's to purchase seasoned portfolios of CRA-eligible loans and to offer products that meet those obligations. For these reasons, the Administration is confident that its regulatory proposal is the right approach. HUD's consultative role in new activity review along with enhanced goal-setting and enforcement authority will continue to provide strong oversight with respect to each GSE's affordable housing mission.

Q.2. As you know, the OCC and the Fed require banks to notify their respective regulator after they have engaged in a new activity. Why do you think the OCC/Fed model would not work for the GSE's?

A.2. With respect to the OCC/Fed model for regulation, the Department will defer to the Treasury Department because it is more familiar with the specifics of these models. However, I would like to point out that in developing its current proposals, the Administration followed the model previously established by Congress wherein prior approval was determined to be the appropriate method of regulation for Fannie Mae and Freddie Mac. (This approach was instituted under Fannie Mae's Charter in 1968 and Freddie Mac's Charter revision in 1989. The 1992 Act reaffirmed the Department's authority for prior review.) The GSE's are limited-purpose corporations. At the time the 1992 regulatory legislation was enacted, it was apparent that the GSE's had also grown substantially since their creation, both absolutely and relative to the mortgage market. No single bank commands the market share that Fannie Mae and Freddie Mac do. Collectively, the Enterprises currently account for more than 70 percent of the conventional conforming mortgage market and between 40–50 percent of the entire mortgage market. In addition, the enterprises' mortgage-backed securities are widely held by other financial institutions in this country. These levels of concentration are so significant, and the implications of any unsafe enterprise activity so widespread, that the risk of significant financial impact extends well beyond the Enterprises themselves to the Nation's entire financial system. Given these implications and restrictions, the Administration believes that Congress was correct in mandating a prior approval review.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MILLER FROM MEL MARTINEZ

Q.1. Secretary Snow and Secretary Martinez, if Fannie and Freddie are put into Treasury, you discuss wanting new program and/or new activity review. The GSE's are concerned that this might impede their ability to be creative and innovative with new mortgage products. Do you agree?

A.1. HUD understands that the ability of the GSE's to innovate new products is important to achieving their public purposes. The Administration's proposals are intended to strengthen regulation in a manner that ensures prudent oversight without impeding either GSE's business operations or their ability to innovate in carrying out their public purposes. As the Department responsible for ensuring that the GSE's carry out their affordable housing mission, HUD has an interest in supporting the GSEs' ability to develop the tools necessary for this purpose. The Administration's proposed procedure for reviewing new activities requires that HUD serve in a consultative capacity, thereby helping to ensure that new activities are consistent with the GSEs' public purposes and that reviews are conducted expeditiously. The Administration's new procedure will also ensure that in reviewing new activities, the GSEs' safety and soundness, as well as their affordable housing mission, will be fully considered.

Q.2. Secretary Martinez, you do not discuss the Federal Home Loan Banks in your statement. I wonder if you have any opinion about them regarding their housing mission and moving their regulator into Treasury?

A.2. Fannie Mae and Freddie Mac share many characteristics with the Federal Home Loan Banks (FHLBanks). Congress created all of these enterprises to serve specific public purposes, and they all have a housing mission. We welcome a discussion on this issue and look forward to working with Congress, the FHLBanks, and other interested parties regarding the appropriate regulatory structure for the FHLBanks.

RESPONSE TO A WRITTEN QUESTION OF SENATOR SHELBY FROM FRANKLIN D. RAINES

Q.1. The Administration has proposed that the new regulator have all the receivership authority necessary to direct the orderly liquidation of assets. What difficulties would you see in moving to receivership powers akin to those held by the FDIC? What impact would receivership have on the ability of the GSE's to access the debt markets?

A.1. The receivership powers granted by Congress to the FDIC primarily protect the FDIC insurance deposit fund. The FDIC, as receiver, is charged with closing and/or selling a failing institution and giving priority to the claims of insured depositors. The charter of the troubled bank or thrift is extinguished. The receivership powers of the FDIC under Section 11 of the Federal Deposit Insurance Act (FDI Act) are complex and have been subject to extensive interpretation by the FDIC.

The FDIC is not required to put a bank or thrift into receivership; it may also elect to put an institution into conservatorship under Section 11 of the FDI Act in an effort to return the institution to financial health. The FDIC can also avoid putting an institution into receivership if the FDIC, the Fed, and the Treasury determine (in consultation with the President) that putting a bank or thrift into receivership "would have serious adverse effects on economic conditions or financial stability and any action or assistance . . . would avoid or mitigate such adverse effects . . . ." 12 U.S.C. 1823(c)(4)(G).

Simply importing all of the FDIC's receivership powers under Section 11 of the FDI Act into the GSE legislation raises several issues.

First, many of the provisions of Section 11 serve primarily to protect insured deposits, which the GSE's do not have. It is unclear exactly how those sections might be applied to the GSE's.

Second, H.R. 2575's provision on "enhanced conservatorship" appears to import all of the FDIC's powers as a receiver without providing any of the protections that exist for insured banks or thrifts. The proposal does not provide for an exception similar to the one that would apply to large banks or thrifts that might prevent those institutions from being placed into receivership by the FDIC. Given the importance of the GSE's to the housing markets, the serious consideration that would be given, for example, to Citibank before putting the institution into receivership, would be appropriate for the GSE's.

H.R. 2575 also does not appear to protect expressly certain types of contracts in the event of receivership. The "qualified financial contract" exception to the FDIC's receivership powers (and the FDIC's interpretations thereof) was adopted to provide certainty to financial markets as to the treatment of these contracts by a receiver or conservator for an insured depository institution. Similar protections are included in the U.S. Bankruptcy Code for application in nondepository institution bankruptcies. In addition, the FDIC has provided by regulation (12 CFR 360.6), subject to the requirements therein, assurances to the markets and holders of mortgage-related securities issued by insured depository institutions that the FDIC will not reclaim, for the receivership or conservatorship estate, mortgage loans transferred by an insured depository institution into a securitization. Absent such express protections tailored to the GSEs' business, wholesale importation of the FDIC's receivership powers into GSE receiverships could, for example, impair the value and liquidity of the mortgage-backed securities issued in existing GSE securitization transactions, thus unnecessarily increasing costs and decreasing liquidity. Therefore, we believe that express protections for certain contracts and securitizations are critical to providing certainty to the markets and insuring that the cost of raising funds for the secondary mortgage market is not unnecessarily increased.

Creating uncertainty is not necessary to enhance the power of the conservatorship provisions of the 1992 Act if such enhancement is Congress' goal. For example, specific and additional grants of authority could be given to a GSE conservator within the framework of the 1992 Act and by including express limitations on repudiation or recharacterization of GSE contracts in the 1992 Act.

We note that our answers above do not change the point made in our testimony before the Committee on October 16, 2003. We do not see any need for any change to the conservatorship provisions that exist in the 1992 Act. In 1992, Congress affirmatively rejected the receivership model for the GSE's in favor of the conservatorship model. The legislative history of the 1992 Act makes clear that Congress considered and rejected the receivership option for the Enterprises. The Senate Committee Report notes that the version of the 1992 Act first passed by the Senate (which contained conservatorship provisions substantively similar to those eventually enacted) "does not contain authority to appoint a receiver for the Enterprises." The Report explains:

> The Committee determined that providing for the appointment of a conservator was sufficient. This judgment takes account of the important role that the Enterprises play in our Nation's economy . . . . The Enterprises are clearly distinguishable from even the largest depository institutions, each of which may cease to be able to compete as a provider of financial services with varying degrees of economic impact. If the appointment of a conservator for an enterprise were ever to become imminent, the Congress would have the opportunity to consider the reasons for the Enterprise's condition and the options then available to address that condition. The legislation provides for continuing reports to the Congress on the capital condition of the Enterprises, so the Committee expects the Congress will have more than ample notice to proceed deliberately in considering any possible future action with respect to the enterprises.

Senate Report, 102–282, at 16.

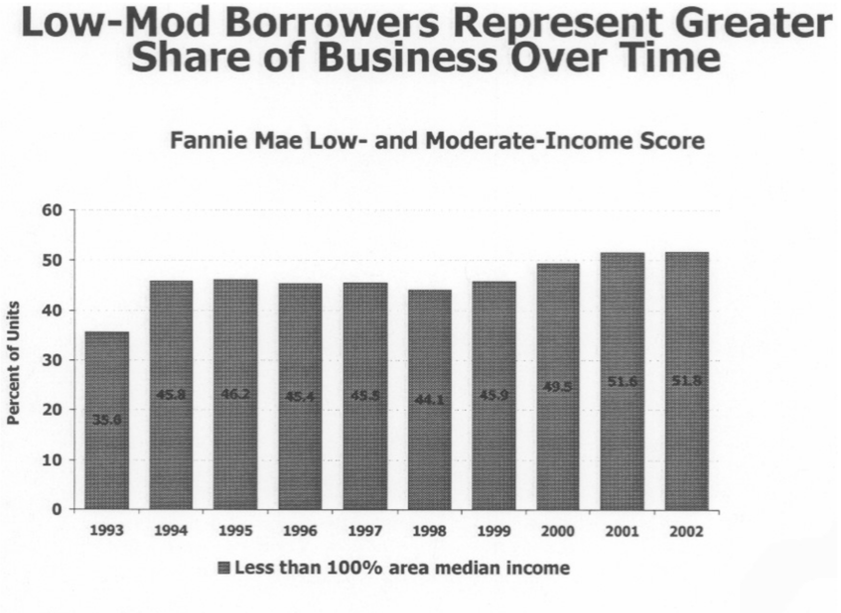
The conservatorship powers Congress authorized in 1992 are very broad and would permit the conservator to run the institution on a day-to-day basis, including selling off assets, until the GSE returned to financial health or Congress took some other action. Pursuant to the 1992 Act, a conservator has "all of the powers of the shareholders, officers, and directors" of Fannie Mae or Freddie Mac. 12 U.S.C. 1369A(a). In addition, a conservator may (i) avoid any security interest taken by a creditor with the intent to hinder, delay, or defraud the company or its creditors, (ii) enforce any contract notwithstanding a provision of the contract providing for the termination of the contract upon the appointment of a conservator, and (iii) receive a stay in a judicial action or proceeding for up to 45 days. OFHEO also may require that a conservator set aside and make available for payment to creditors amounts that may be safely used for such purpose; all similarly situated creditors must be treated similarly. The appointment of a conservator does not affect OFHEO's authority under the 1992 Act to oversee the companies and to impose requirements and restrictions based on the capital-based classification system.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM FRANKLIN D. RAINES

Q.1. I realize that the GSE's have continued to meet their affordable housing goals. However, in light of the rising housing costs in many communities across the Nation, do you believe the current goals are sufficient to expand homeownership in high-cost communities across the country? Why or why not?

A.1. The current goals are only one measure of Fannie Mae's efforts to make homeownership more affordable in communities across the country. We believe the current goals are very demanding, particularly in the current business environment, and they are ensuring that we continue to expand homeownership. The low- and moderate-income goal applies across the Nation, including in high-cost communities, and to reach and exceed that goal we innovate to create products and partnerships that make homeownership more affordable to low- and moderate-income families everywhere.

Many low- and moderate-income renters aspire to homeownership, but they often face daunting barriers such as the difficulties in accumulating a downpayment or qualifying for an affordable mortgage, especially with imperfect credit. Fannie Mae has worked with lenders and community partners to develop products and services to overcome these barriers. We have developed automated underwriting that has lowered the costs of mortgage originations, new low-downpayment products that help people get into homes with as little as $500 down, and products with flexible underwriting that serve credit blemished borrowers. We have worked to expand employer-assisted housing programs; many employers—especially in high-cost areas—have found it is in their interest to help employees afford a home as part of the employer's recruitment and retention strategies. These initiatives make homeownership more affordable in high-cost areas and help us meet our regulatory requirements. The results are clear, as shown below:


Low-Mod Borrowers Represent Greater Share of Business Over Time

Fannie Mae Low- and Moderate-Income Score

Source: Fannie Mae

The affordable housing goals set by HUD do not limit us to serving only targeted borrowers. They require us to devote a percentage of our business to these populations, but our mission is to serve a broader market. Our charter mandates that we provide liquidity to the market for residential mortgages, including, but not limited to, mortgages that qualify for the affordable housing goals. By attracting low-cost funding to the mortgage market and creating liquidity, we reduce the interest rate on all conforming mortgages by at least 0.25 percentage points. We serve this entire market in a way that expands liquidity and reduced mortgage rates for all conforming mortgages, while focusing special attention on low- and moderate-income borrowers.

Q.2. Are there any new affordable housing goals you would support adding to those currently authorized? If so, please describe them.

A.2. HUD sets housing goals as a regulatory requirement to ensure that Fannie Mae focuses particular attention on low- and moderate-income borrowers and underserved areas. We have consistently met or exceeded the current goals. The Agency is developing proposed goals for next year and beyond.

Over the years, HUD has sought to establish goals that require the company to stretch beyond levels we might otherwise achieve, without threatening our safety and soundness or jeopardizing the liquidity of the mortgage finance system. HUD relies on predictions of market growth to establish these goals. This kind of forecasting is not easy and predictions are likely to be inexact. The refinance boom of the last 2 years, which exceeds anything foreseen by HUD when these goals were set, highlights that fact.

It is critical that the housing goals structure allows Fannie Mae the ability to make business decisions based on actual market conditions. Under the structure created by the 1992 Act, HUD has considerable flexibility in establishing the goals in its rulemaking process, and can use that authority to focus our efforts toward specific high-priority portions of the market.

HUD's recasting of the goals in 2000 is an example of that flexibility. The Department increased all three housing goals. The goal for Fannie Mae's purchase of loans to low- and moderate-income borrowers was increased from 42 percent in 1999 to 50 percent in 2000. In addition, the new goals that gave Fannie Mae an incentive to pay special attention to financing small multifamily properties and owner-occupied 2–4 unit properties.

Going forward, it is critical that housing goals are not increased to the point that they threaten our safety and soundness or undermine our ability to serve a market that includes middle-class as well as low-income borrowers. Today, we work to expand the universe of Americans who can afford to purchase a home by increasing low-cost funding available for mortgages for middle class families, as well as for underserved communities. Goals that become too numerous or narrow can lead to fragmentation in the market and credit allocation. This would distort Fannie Mae's business and undermine the critical role we play in the market.

Q.3. If Congress were to establish an independent regulator and with a well-respected impartial Director to head it, why shouldn't that Director be able to raise minimum capital standards, if he or she believed it to be necessary to ensure the safety and soundness of the GSE's? Please explain.

A.3. Fannie Mae operates under two capital requirements—a minimum capital, or leverage, requirement and a risk-based capital requirement. Each quarter, Fannie Mae must meet both requirements.

The leverage requirement, also known as minimum capital, does not change based on the risk of the assets a financial institution. Instead, the leverage limit serves as a capital "floor" based on the general risk of an entity. Fannie Mae and Freddie Mac's leverage ratio, set by statute, is 2.5 percent for on-balance-sheet assets and 0.45 percent for off-balance-sheet assets. Unlike the bank leverage ratio, the GSE's leverage test requires capital support for off-balance-sheet, as well as on-balance-sheet, exposures. Fannie Mae's capital as a percentage of on-balance-sheet assets (as the bank ratio is calculated) was 3.4 percent on June 30, 2003. Including outstanding subordinated debt, that figure rises to 3.9 percent of on-balance-sheet assets. Bank regulators set minimum capital requirements, typically requiring a bank to hold 5 percent capital against on-balance-sheet assets, regardless of how risky those assets are, in order to be considered well-capitalized. The leverage measure ignores all off-balance-sheet assets, although a bank may have significant off-balance-sheet exposures.

Fannie Mae invests only in U.S. residential mortgages, which are far less risky than many bank investments like consumer debt, commercial real estate, or third-world debt. Thus, having a leverage limit for Fannie Mae and Freddie Mac that is somewhat lower than the leverage limit for banks makes sense if the average risk of Fannie Mae and Freddie Mac's assets is lower than the average risk of banks' assets. Experience shows that in fact the risks of holding a mortgage are a fraction of the risk of other loans. Furthermore, Fannie Mae's book of business is more geographically diverse than those of most banks, and the company is required to obtain mortgage insurance or other credit enhancements against higher risk loans.

This lower risk is reflected in the comparable capital-to-loss ratios of Fannie Mae and commercial banks. For the first half of 2003, Fannie Mae's ratio of capital to credit losses, on an annualized basis, was 357. By comparison, large commercial banks had a capital coverage ratio of only 17.7, and for the whole banking industry the ratio was 14.5.

Increasing minimum capital when there is no increase in risk raises the cost of funds to housing and undercuts our ability to fulfill our mission.

Q.4. In [Director] Falcon's testimony from the October 23, 2003 GSE hearing, he described adjusting the minimum capital requirement as a "fail-safe" mechanism, because the risk-based capital standard cannot quantify all of the potential risks to the GSE's. Do you believe the current risk-based capital does not quantify all of the potential risks to the GSE's? Why or why not? What is your response to the notion of the need for a "fail-safe" mechanism?

A.4. No capital standard can quantify all the risks a financial institution faces. However, the risk-based standards applied to Fannie Mae and Freddie Mac are the most comprehensive in the industry and come much closer to covering all the risks the companies face than the capital standards that are applied to banks.[1] These risks include credit risk, interest-rate risk (including prepayment risk), and operations risk.

Credit Risk

Fannie Mae and Freddie Mac are required to have enough capital to survive Depression-era credit conditions that last for 10 years. Such conditions over that period of time have never been seen in the country at large, at least in modern times.

The coverage of credit risk in bank capital standards is, in contrast, less sophisticated—as is admitted by bank regulators worldwide. As a result, in a process commonly known as Basel II, the international bank capital standard setters are in the process of updating capital rules to make them more responsive to risk, although this effort will probably take several more years to implement.

Interest Rate Risk

In the companies' RBC requirement, the draconian and prolonged credit shock is coupled with dramatic and sustained changes in interest rates. Indeed, an econometric study conducted for Fannie Mae by Nobel laureate Joseph Stiglitz and colleagues found that "the probability of the stress test conditions occurring is less than one in 500,000."[2]

Banks do not have an interest-rate component in their risk-based capital requirements. Interest-rate risk tends to be the largest risk in mortgage lending, particularly for a portfolio with geographic diversification. The standards applied to Fannie Mae cover this risk comprehensively; those for banks do not cover it at all.

Operations Risk

To some extent, operational risk is the unquantifiable risk that is not covered by the credit and interest rate risk components of the stress test. In OFHEO's risk-based capital requirements, there is a 30 percent add-on to the stress test to provide an extra cushion to the capital already required by the stress test.

Currently, banks do not have a requirement covering operational risk. Basel II contemplates adding one, but it will be lower than that applied to the GSE's. The add-on charge for banks is likely to be around 9 percent to 12 percent, roughly one-third of that applied to Fannie Mae.[3]

[1] "Primary emphasis is placed on a risk-based capital standard that ***reflects risks more accurately than bank and thrift standards by directly incorporating interest rate risk and by disaggregating credit risk to a much finer degree.*** The standard for GSE's also explicitly sets an acceptable limit for those risks: Survival for a 10-year period in an environment with credit losses equal on a national basis to the worst actual experience on a regional basis and sustained interest rate movements more threatening than any experienced in GSE history. At the same time, substantial allowance is made for other, less quantifiable risks. ***The result is a more forward looking standard, less tied to current, and sometimes misleading, balance sheet data."*** *Federal Housing Enterprises Regulatory Reform Act of 1992,* Report of the Senate Banking Committee, May 15, 1992 at 19 (emphasis added).

[2] *Implications of the New Fannie Mae and Freddie Mac Risk-Based Capital Standard,* Joseph E. Stiglitz, Jonathan M. Orszag and Peter R. Orszag, Fannie Mae Papers, Volume 1, Issue 2, March 2002 at 2. Paper available at *http://www.fanniemae.com/global/pdf/commentary/fmpv1i2.pdf.*

[3] *Regulatory Treatment of Operational Risk,* Basel Committee, September 2001.

In addition to the distinctive structure of their risk-based capital requirement, the minimum leverage ratio for Fannie Mae and Freddie Mac is unique in that it requires capital support for off-balance-sheet, as well as on-balance-sheet, exposures.[4] As the Senate Banking Committee reported with regard to the minimum capital requirements in the 1992 Act:

> "[T]he risk-based measure is supplemented by a more traditional minimum capital standard, ***which actually bears more in common with the risk-based measures for banks and thrifts, in that it explicitly covers the very sizable off-balance-sheet risks of the GSE's."***[5]

The leverage requirement for banks does not have a similar provision. Banks often have large off-balance-sheet exposures, and those exposures have been increasing in recent years, partly in an effort to avoid the leverage requirement that would apply if they were held on balance sheet.

Additionally, it is appropriate that the leverage ratio for banks provides an additional cushion against interest rate and prepayment risks since, as outlined above and unlike the Fannie Mae stress test, bank risk-based capital requirements do not include a component for these risks.

Thus, to the extent that the minimum capital requirement is regarded as a "fail-safe" mechanism, Fannie Mae has one that is tailored to our operations and consistent with the level of risk we manage.

In order to judge the appropriateness of the mandated requirements for the GSE's, they have to be viewed within the context of the companies' restrictive charters. Fannie Mae is a private company with a single purpose—to promote homeownership through secondary market operations in residential mortgages. Confined as we are to residential mortgages, Fannie Mae is exposed to less credit risk than a typical large complex bank, operating in many countries around the world and investing in a range of asset classes that carry more risk and are more difficult to manage. Were the GSE charters as broad as a bank's, Congress would undoubtedly have required Fannie Mae to meet the same capital standards as banks.

It should also be recognized that OFHEO has a panoply of supervisory powers to deal with problem situations, from cease-and-desist orders, to civil money penalties, limitations on dividends, and a requirement to hold additional reserves against particular assets. These protections complement the capital requirements. And they reflect the practice in the banking industry where regulators have the power to set special individual capital requirements but rarely use that power, preferring to use their other supervisory powers instead.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HAGEL FROM FRANKLIN D. RAINES

Q.1. In a format similar to your annual report, please tell us what the fair value of Fannie Mae's shareholders' equity would have been on a quarterly basis for the last 12 quarters, using the defini-

[4] As of June 2003, Fannie Mae's core capital equaled 3.32 percent of total balance sheet assets.

[5] Senate Banking Committee, *id.* (Emphasis added)

tion of fair value that you have been applying in your most recent annual reports.

A.1. At the end of every year, GAAP requires us to provide the market value of our financial instruments. We go a step further by reporting the market value of all our assets and liabilities at the end of each calendar year. The estimated fair value of our net assets (net of tax effect) was $22.1 billion as of December 31, 2002, $22.7 billion as of December 31, 2001, and $20.7 billion as of December 31, 2000. Our fair value as of year-end 2003 will be included in our 2003 Form 10–K, which is due by March 15, 2004. Like many other large financial institutions, we believe this fair value balance sheet is an imperfect means to determine our profitability and value as an ongoing enterprise. We do not primarily use mark-to-market valuation measures to run our business or prepare a full fair value balance sheet on a quarterly basis.

We run our business on the basis of core business results, which rely on historical cost accounting. Assets and liabilities are booked at their initial value and the cost is amortized and the income recognized over time. We believe this traditional approach to accounting provides the best representation of how our business operates.

Mark-to-market valuation, on the other hand, takes a snapshot of the market value of an asset or liability at a specific moment in time. This would be useful for certain investors such as hedge funds that trade securities in the market every day, because that is how they would determine the net value of their business on a given day.

But for portfolio investors like Fannie Mae, especially those that hold assets to maturity, marking to market is not a very meaningful way to measure our performance. Indeed, it might be misleading for management—and investors—to value our performance solely on a mark-to-market basis, for a very important reason.

Mark-to-market accounting produces paper gains and losses that a held-to-maturity enterprise may never realize. That is why financial regulators generally do not consider these noncash, unrealized gains or losses in judging a company's financial strength, or in judging whether it meets regulatory capital requirements.

Q.2. With reference to the $16.09 billion of "cashflow hedging results" losses in your equity account, as reported in your quarterly statement, exactly what proportion of those losses are either realized, unrecoverable, or not recoupable because you have closed out the derivatives at a loss, and paid out the loss amount in cash? Are these losses likely to reverse themselves as the hedges come to maturity?

A.2. We provide on a quarterly basis our cashflow hedging results according to GAAP requirements. As you may be aware, these numbers have become very volatile since the implementation of Financial Accounting Standards Number 133 (FAS 133), *Accounting for Derivative Financial Instruments and Hedging Activities.* The details behind these numbers are not publicly disclosed and are confidential and proprietary.

FAS 133, Accounting for Derivative Financial Instruments and Hedging Activities, became effective for Fannie Mae in January 2001 and requires companies to record the current market value of derivative instruments on their balance sheets. Unfortunately, the standard can often result in an incomplete or distorted picture of a corporation's financial position. This is particularly true for investors who use derivative instruments extensively in their interest rate risk management.

The reason is that FAS 133 requires all derivatives to be recorded at their current market value, while other assets and liabilities do not obtain the same treatment. Financial statements produced under FAS 133 include a mix of treatments—some assets and liabilities are reported at their current value, while others are reported at historical cost. As a result, financial statements under GAAP can give an incomplete picture of a company's net worth and overall risk position.

Q.3. It has been alleged that permitting a regulator to review and approve Fannie and Freddie's new activities will stifle your innovation. Yet this country's banks are the most innovative in the world and they operate under a system in which their regulator has this authority. Please explain to us how reviewing Fannie and Freddie's new activities would stifle your ability to innovate.

A.3. Under current law, Fannie Mae must submit a new program approval request to HUD if an initiative is "significantly different" from a program that has been previously approved or is a program in which Fannie Mae had not engaged prior to passage of the 1992 Act. HUD may deny approval of any new program if our charter does not permit it or if the Secretary determines that the activity is not in the public interest. HUD generally has 45 days within which to approve a new program request. This short time frame for decisionmaking is crucial to timely market innovation.

Some recent proposals have suggested that a regulator should review all of the "new activities" of Fannie Mae. In H.R. 2575, for example, the term "activities" is broadly defined to include "any program, activity, business process, or investment that directly or indirectly provides financing or other services related to conventional mortgages." This definition could require prior regulatory approval for every change in underwriting standards made by Fannie Mae or every transaction in which we engage to buy mortgages.

Banks and other entities regulated by Federal financial regulators are not generally subject to prior approval requirements for their activities. In the banking context, "activity" means line of business. The Gramm-Leach-Bliley Act contains a list of "activities" financial institutions may undertake without prior approval, such as insurance, securities underwriting, and merchant banking. Particular changes in the way in which an institution engages in one of these lines of business are also not subject to prior approval. In adopting this regulatory structure for banks, Congress has recognized that innovation within permitted lines of business benefits consumers and the economy as a whole. Financial institution regulation is biased against time consuming preapproval processes, and instead focuses on prudently imposed limitations and safety and soundness principles, compliance with which is evaluated by financial institution examiners.

A comparable regulatory structure, if applied to Fannie Mae, would recognize that we have one main business line, mortgages, and would require no prior approval for new products or processes related to that line of business. The new regulator would, like bank regulators, rely on examiners, conducting on-site continuous examinations, to review all ongoing activities to determine that they are safe and sound and within our charter. Under the bank model, if Fannie Mae were to go into a broad new line of business, the company would be required to seek prior approval from its regulator.

The mortgage market today provides consumers with a wider variety of products than ever before, and therefore is better poised to meet the individual financing needs of a broader range of homebuyers. This has been possible because the program approval requirements in the 1992 law respect the need for innovation. Lenders have been able to innovate and develop new products to reach underserved communities because we have been able to review the products and, whenever possible, assure them, in a timely manner, that we will purchase these loans in the secondary market.

Imposing intrusive or cumbersome regulatory requirements or processes would put the Government—not the private sector—in the position of deciding or delaying which products are brought to market. This lack of predictability and potential for delay would inhibit our ability to work with our lender partners to support innovation to expand homeownership opportunities. Without that secondary market outlet, lenders would have to assume more risk and expense in developing innovative mortgage products that are vital for reaching new markets.

Q.4. Your company charges a "guarantee fee" for each mortgage sold to Fannie. It seems those guarantee fees continue to be high while your credit losses shrink. If losses are down, why the need for proportionately higher guarantee fees, and how much does this ultimately mean out-of-pocket to the individual mortgage customer?

A.4. Fannie Mae's guaranty fee has to cover the full costs of guaranteeing mortgages. These costs include:

- Insurance (credit) losses;
- The costs of credit enhancements where Fannie Mae pays other parties to share possible losses, thereby dispersing risk;
- The administrative costs of running the business; and
- The cost of capital needed to support the business.

The proportion of the guaranty fee designed to cover expected losses is generally not the largest component of that fee. Best practice for financial institutions requires that they hold economic capital against the risks they face. Economic capital is an amount of capital sufficient to prevent company insolvency in bad economic times. In the case of Fannie Mae's guaranty business, best practice requires holding sufficient capital to withstand stressful economic conditions. That capital has to earn a competitive return—or it would not be attracted in the first place.

As shown in Exhibit 1, insurance is somewhat unusual in that returns above the average occur more often than those below the average. (In more formal statistical terms, the median is greater than the mean.)

Typically, in insurance, losses in very bad times tend to be greater than profits in good times. (Loss distributions are said to have “fat tails.”) And, in guaranteeing loans as in other insurance, it takes many profitable outcomes to cover the losses from a single bad outcome (Exhibit 2). Thus, over a long period of time, there must be more occurrences of good outcomes to counterbalance the fewer, but weightier, bad outcomes.

Exhibit 1

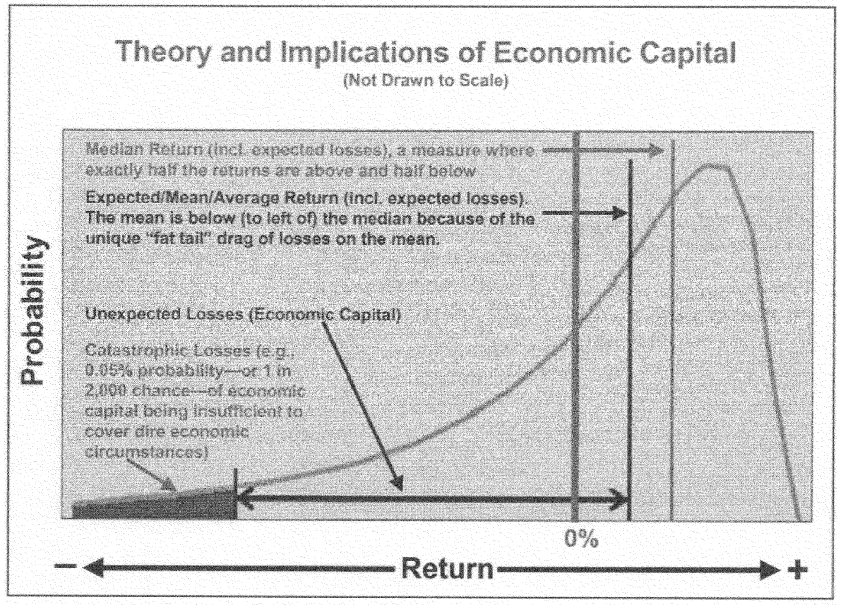
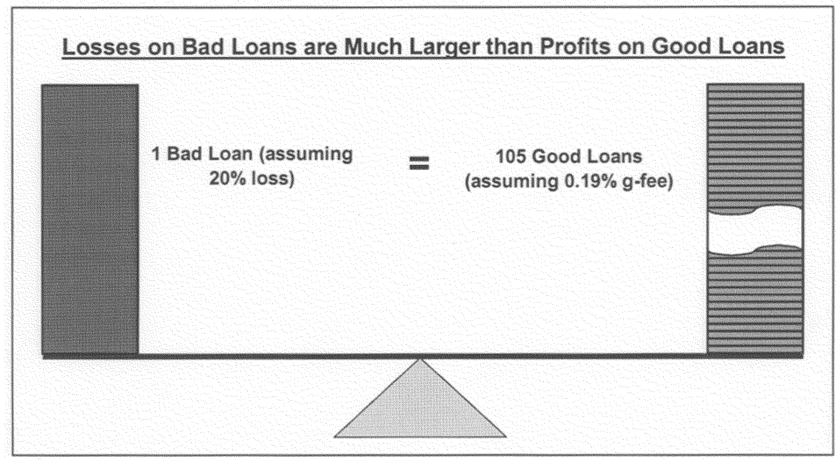


Exhibit 2


Losses on Bad Loans are Much Larger than Profits on Good Loans
1 Bad Loan (assuming 20% loss)
=
105 Good Loans (assuming 0.19% g-fee)

And most crucially it means that one cannot look at the results from an individual year (or even from a particular cohort of business) to judge the adequacy of profits. Currently, Fannie Mae's portfolio is very strong from a credit perspective, and one should expect very good outcomes and low credit losses. Fannie Mae, like other insurers, looks beyond expected outcomes, to the unlikely possibility that a severe credit event could occur, leading to much higher levels of defaults. Holding sufficient capital to withstand such an event is a business and regulatory requirement. To do otherwise would rightly be regarded as an unsafe and unsound business practice. We compete for capital in the broader marketplace, and therefore this capital held against a potential credit event must earn the return it could have earned on a similarly risky investment elsewhere.

Fannie Mae's 10–K clearly breaks out the different components of income and expense to the credit guaranty business. In 2002, total pretax guaranty fee income was $3.2 billion, credit-related expenses were $92 million, and administrative expenses were $1.5 billion (including $638 million in Federal income taxes). The credit-related expenses were indeed at record lows, as were delinquency and default rates for Fannie Mae.

These surprisingly low credit expenses cannot be taken for granted. Credit expenses are expected to increase. Note that administrative expenses, excluding taxes, are almost 10 times as large as credit-related expenses. Although Fannie Mae is highly efficient (these administrative expenses were incurred on a book of business that averaged $1.8 trillion in 2002), the charged guarantee fee must be sufficient to cover these expenses as well.

Q.5. The Administration has proposed eliminating Presidential appointed members from your Boards and leaving the appointment responsibility in the hands of your shareholders. What are your thoughts on this?

A.5. We have seen many benefits from the presence of Presidential directors on the board of Fannie Mae. They have well represented the interests of the company's shareholders and helped advance our mission. Indeed, our board is seen as a leadership model of stakeholder representation on corporate boards. Our experience has been very good over the years with our Presidential directors and our preference would be to retain them. Ultimately, this will be an issue for the Congress and Administration to decide.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR MILLER FROM FRANKLIN D. RAINES

Q.1. Do you want to be under Treasury or do you want a beefed up independent regulator? If you were put into Treasury do you want [Fannie Mae/Freddie Mac and the FHLBank System] to be together under one bureau or do you prefer two separate bureaus and why?

A.1. Fannie Mae supports legislation to create a new safety and soundness regulator for Fannie Mae and Freddie Mac as a bureau of the Treasury Department, funded independently of the appropriations process.

While recent events raise fresh questions about FHLBank regulation, it is also true that including the FHLBank System in regulatory reform legislation would complicate the legislative process. At a minimum, there are many questions Congress would have to answer before incorporating the Banks into any new regulatory structure. For instance, the Congress would have to decide whether to focus the Bank System on its traditional mission of providing advances or to endorse the Banks' recent ventures into acquiring mortgages. There are questions as to whether the current FHLB regulatory structure is consistent with the new lines of business the Banks are undertaking.

However, if Congress decides to include the FHLBanks in a reform proposal, we believe that Fannie Mae, Freddie Mac, and the Bank System should be placed under the umbrella of a single regulator, and that the FHLBanks mortgage acquisition activities should be subject to the same set of safety and soundness regulations that apply to Fannie Mae and Freddie Mac. Such a regime would best be served by a single bureau that could institute comparable regulatory requirements for comparable activities.

Q.2. In your view, what is the difference between new program and new activity standards?

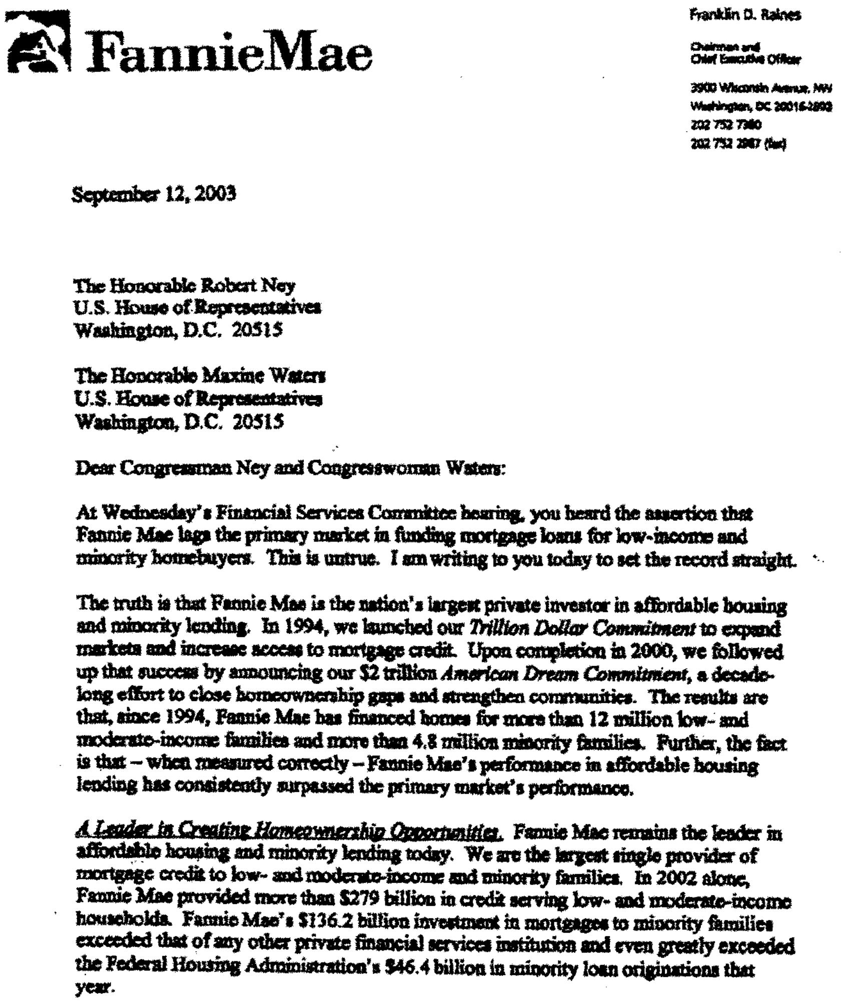
A.2. Under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, the standard for HUD prior approval of "new programs" is simple: The current law says the Secretary must disapprove a "new program" if it does not comply with our charter or is not in the public interest. The 1992 Act also established time limits for consideration of new program requests by the Secretary. A "new program" is generally defined by the 1992 Act as a *broad and general plan or course of action* for purchasing or dealing in mortgages that is significantly different from programs previously approved by HUD or engaged in prior to enactment of the 1992 Act.

Secretary Snow described the concept of a “new program” very well in his recent testimony before the Senate: New programs are akin to *“new lines of business.”*

Some proposals have suggested that a regulator should review all of the “new activities” of Fannie Mae. In H.R. 2575, for example, the term “activities” is broadly defined to include “any program, activity, business process, or investment that directly or indirectly provides financing or other services related to conventional mortgages.” This definition is so broad that it could encompass every change in underwriting standards made by Fannie Mae or every transaction in which we buy mortgages.

Bank regulators do not mandate prior approval for “activities” in the manner some have suggested would be appropriate for Fannie Mae’s “activities.” In the banking context, the term “activities” is used to mean “lines of business.” The Gramm-Leach-Bliley Act contains a list of preapproved “activities” financial institutions may undertake. The “activities” listed in the statute are broad lines of business, including insurance business, securities underwriting business, and merchant banking business.

Any proposal requiring prior notice for Fannie Mae’s “activities,” as defined in H.R. 2575, clearly has no parallel in current banking law.



FannieMae

Franklin D. Raines

Chairman and
Chief Executive Officer

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September 12, 2003

The Honorable Robert Ney
U.S. House of Representatives
Washington, D.C. 20515

The Honorable Maxine Waters
U.S. House of Representatives
Washington, D.C. 20515

Dear Congressman Ney and Congresswoman Waters:

At Wednesday's Financial Services Committee hearing, you heard the assertion that Fannie Mae lags the primary market in funding mortgage loans for low-income and minority homebuyers. This is untrue. I am writing to you today to set the record straight.

The truth is that Fannie Mae is the nation's largest private investor in affordable housing and minority lending. In 1994, we launched our *Trillion Dollar Commitment* to expand markets and increase access to mortgage credit. Upon completion in 2000, we followed up that success by announcing our $2 trillion *American Dream Commitment*, a decade-long effort to close homeownership gaps and strengthen communities. The results are that, since 1994, Fannie Mae has financed homes for more than 12 million low- and moderate-income families and more than 4.8 million minority families. Further, the fact is that – when measured correctly – Fannie Mae's performance in affordable housing lending has consistently surpassed the primary market's performance.

A Leader in Creating Homeownership Opportunities. Fannie Mae remains the leader in affordable housing and minority lending today. We are the largest single provider of mortgage credit to low- and moderate-income and minority families. In 2002 alone, Fannie Mae provided more than $279 billion in credit serving low- and moderate-income households. Fannie Mae's $136.2 billion investment in mortgages to minority families exceeded that of any other private financial services institution and even greatly exceeded the Federal Housing Administration's $46.4 billion in minority loan originations that year.

Our growth in minority lending over time has been extraordinary. Comparing 1993 to 2002, loans to African Americans increased 219 percent and loans to Hispanics increased 234 percent, while our loans to non-minorities increased by only 62 percent.

Fannie Mae has pledged to invest at least $700 billion to finance mortgages for minority families between 2000 and 2009 in support of the President's initiative to expand minority homeownership. As of the end of June 2003, we had invested $381 billion toward that commitment, helping 2.8 million minority families – by far the largest single contribution of any one of HUD's "Blueprint Partners."

Leadership In Affordable Rental Housing and Community Development. Our leadership in the financial services industry extends well beyond the provision of mortgage credit to homeowners. For example, we are the nation's largest investor in multifamily and single-family rental housing. In 2002, Fannie Mae provided mortgage financing supporting more than 1,000,000 units of rental housing in single-family and multifamily properties, of which more than two-thirds served renters with incomes below 80 percent of area median incomes. We are also the nation's largest investor in the Low-Income Housing Tax Credit (LIHTC). In 2002, we committed more than $1.6 billion in LIHTC investments to support the production and preservation of an estimated 37,500 homes affordable to very low-income families. In addition, we are the nation's largest investor in mortgage revenue bonds (MRBs), another important source of low-cost capital for affordable housing. Our 2002 investment of more than $4.2 billion in these bonds made possible affordable financing for an estimated 90,463 families. Through the end of 2002, Fannie Mae's American Communities Fund (ACF) has closed more than $725 million in commitments on more than 216 transactions making a tangible difference in communities across the country. And none of the ACF, LIHTC, or MRB investments count against our HUD goals – a very important point when trying to assess leadership in the market.

Leadership in Bringing Innovation to Mortgage Markets. Market leadership is about qualitative as well as quantitative contributions. Fannie Mae has been an innovative leader in the affordable housing field. We were at the forefront of the mortgage industry expansion into low-downpayment lending, creating the Fannie 97 mortgage in 1994 as the first widely available and standardized 3 percent down-payment mortgage product and offering loans with as little as a $500 contribution from the borrower today. Our low-downpayment lending has increased twenty-fold over this time. Our investments in technology have increased the underwriting flexibilities available through our product offerings, expanded markets for our lender partners, and – by reducing the cost of originations – enhanced affordability for the home buyer. More recently, we have launched new efforts to serve borrowers with blemished credit histories. Our Expanded

Approval and Timely Payment Rewards mortgages are examples of how we help conventional mortgage lenders broaden their markets to serve borrowers previously left only to subprime lenders. Along with our industry-leading anti-predatory lending guidelines, we have introduced this product in a prudent and responsible manner as part of our strategy to expand responsible lending and combat abusive lending practices.

Fannie Mae has also contributed nearly $500 million since 1996 to the independent Fannie Mae Foundation, the largest corporate foundation devoted to housing and community development in the country. This funding has enabled the Foundation, among other things, to carry out consumer education and outreach efforts that have led to more than 9 million families receiving important multilingual information about credit, mortgages, and the homebuying process.

Leadership in Comparison to the Primary Market. One last measure of market leadership is a comparison of Fannie Mae's affordable housing performance in our single-family business to the Home Mortgage Disclosure Act (HMDA) data used to describe the primary market. We lead the market on this basis also.

HUD uses this HMDA-based approach for measuring market leadership. Over the years, Fannie Mae has disagreed with HUD's methodology primarily because the Department has used a definition of the primary market that over-weights subprime lending, which has not traditionally been available to Fannie Mae. Done correctly, a HMDA-based market leadership analysis shows that we have consistently led or matched the conventional market in the past. I have attached several charts to illustrate this point.

In 2001, 43.1 percent of Fannie Mae's single-family business served low- and moderate-income borrowers compared to 42.0 percent for the conventional conforming market as described by HMDA data. A total of 23.0 percent of Fannie Mae's business served minority homebuyers compared to 21.3 percent for the conventional conforming market. We led the conventional conforming market in lending to African Americans, 5.2 percent to 4.4 percent, and matched the market in lending to Hispanics at 9.0 percent. These comparisons are based on owner-occupied, home purchase mortgages in MSAs – the appropriate subset for comparisons between HMDA data and Fannie Mae's performance.

Moreover, even using HUD's methodology and including half of subprime lending in the comparison market, the 2001 data reveals that Fannie Mae still would have led the market in lending to low- and moderate-income households (43.1 percent to 42.7 percent), minority borrowers (21.9 percent to 20.8 percent), and African-American borrowers (5.2 percent to 5.0 percent).

Fannie Mae's affordable lending performance in 2002 was also excellent, with the percentages of our single-family business serving low- and moderate-income and minority borrowers increasing over the exceptional 2001 levels. For owner-occupied, home purchase lending in metropolitan areas, Fannie Mae achieved a 45.7 percent level in low-mod lending (representing a total investment of $69.3 billion for these borrowers), a 26.2 percent level in minority lending ($46.1 billion), a 5.4 percent level in lending to African Americans ($8.3 billion), and 11.0 percent level in lending to Hispanics ($18.3 billion). The 2002 HMDA data for the market was released in August, but cannot be fully analyzed until HUD provides its list of subprime lenders reporting to HMDA – which we expect to receive in October.

Criticism of our support for first-time homebuyers is based on weak, outdated data. HMDA does not identify first-time homebuyers; therefore, HUD's analysis must use other data sources that are not true mortgage market estimates. Moreover, the HUD analysis covers the period from 1997 to 1999. When one looks at 2001 and 2002, Fannie Mae's average annual number of loans to minority first-time homebuyers increased by more than 40 percent. In 2002, Fannie Mae financing helped more than 351,000 families purchase their first homes, 30 percent of whom were minority households. While 24 percent of our non-minority purchase money investments helped first-time homebuyers, 33 percent of such lending to African-Americans helped first-time homebuyers, 31 percent of such lending to Hispanics went to first-time homebuyers, and 33 percent of such lending to all minorities went to first-time homebuyers.

FHA remains a powerful force in supporting first-time homebuyers, especially among minorities. However, loans insured by FHA do not count in our housing goals and therefore should be excluded from market comparisons, something HUD's first-time homebuyer analysis did not do. Our steady emphasis on increasing low downpayment options for conventional borrowers is having an impact in the market even with this heavy FHA influence. For instance, in 1996, FHA accounted for 56 percent of all very low downpayment purchase money mortgages either insured by FHA or financed by Fannie Mae. Five years later, in 2001, FHA's share had dropped to only 26 percent while Fannie Mae's share had grown to 74 percent, demonstrating the increasing role we are playing in providing affordable credit to new homebuyers.

The record outlined above demonstrates true market leadership. We wanted to ensure that you had the facts at your disposal. Our commitment to our mission is unmatched by that of any other financial institution. No one in the financial sector – including FHA – provides more capital to finance homes for minorities or low and moderate-income borrowers than Fannie Mae. Going forward, we want to work with you to shape legislation that ensures a strong world-class regulator, but does not impede our ability to pursue our mission and continue to lead the market in the innovative provision of affordable credit to underserved communities.

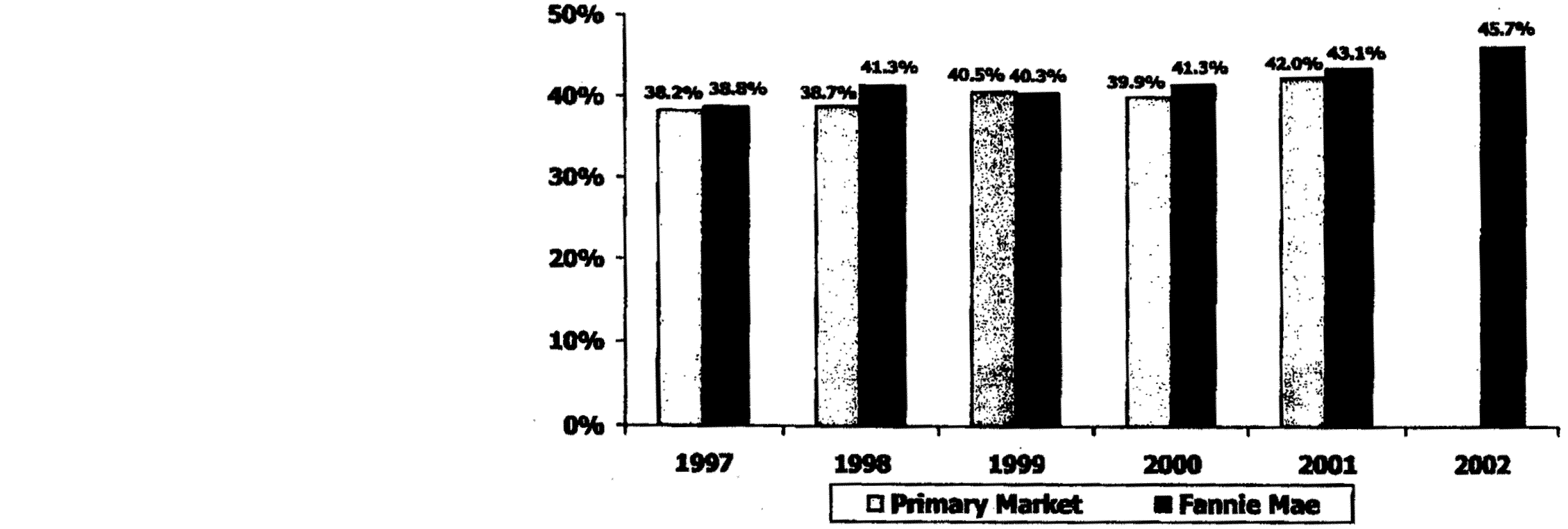
Very truly yours,

FDR/md

cc: The Honorable Michael Oxley w/Enclosures
The Honorable Barney Frank w/Enclosures

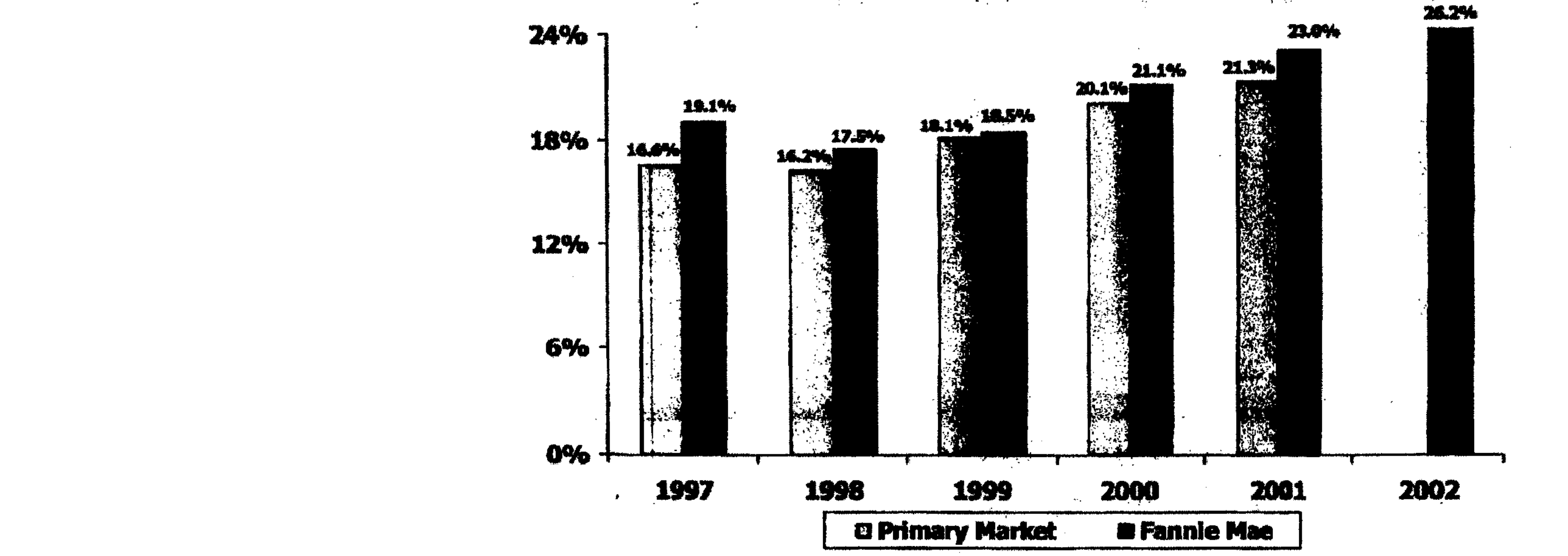
Enclosures

Fannie Mae and Primary Market Performance
Low-Mod Lending



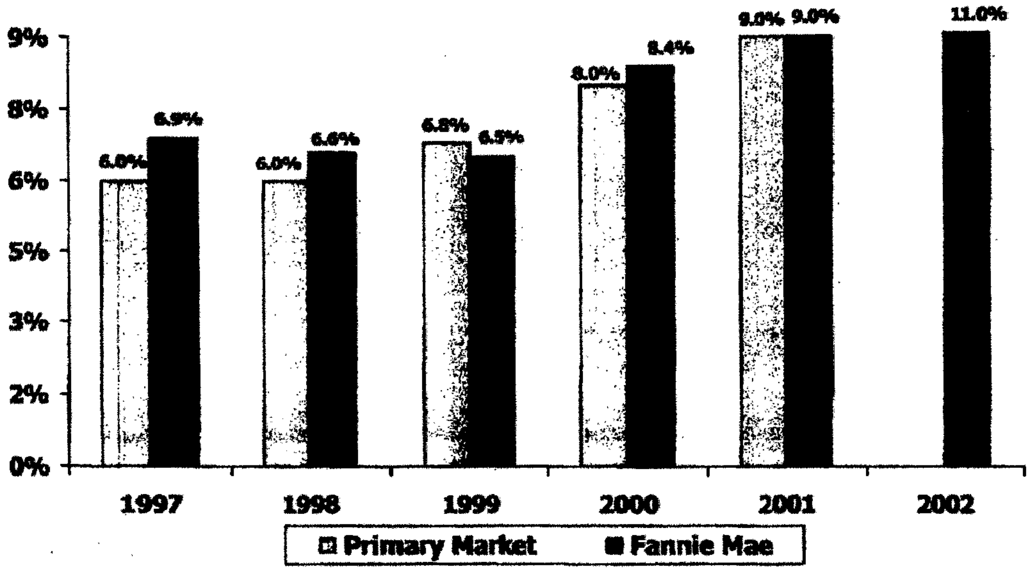
Source: FMIS data for Fannie Mae and Home Mortgage Disclosure Act data for the conventional conforming primary market. Compares single-family, owner-occupied, purchase money mortgages in Metropolitan Statistical Areas. Primary market excludes subprime lending. Manufactured housing lending included in 2001 primary market.

Fannie Mae and Primary Market Performance Minority Lending



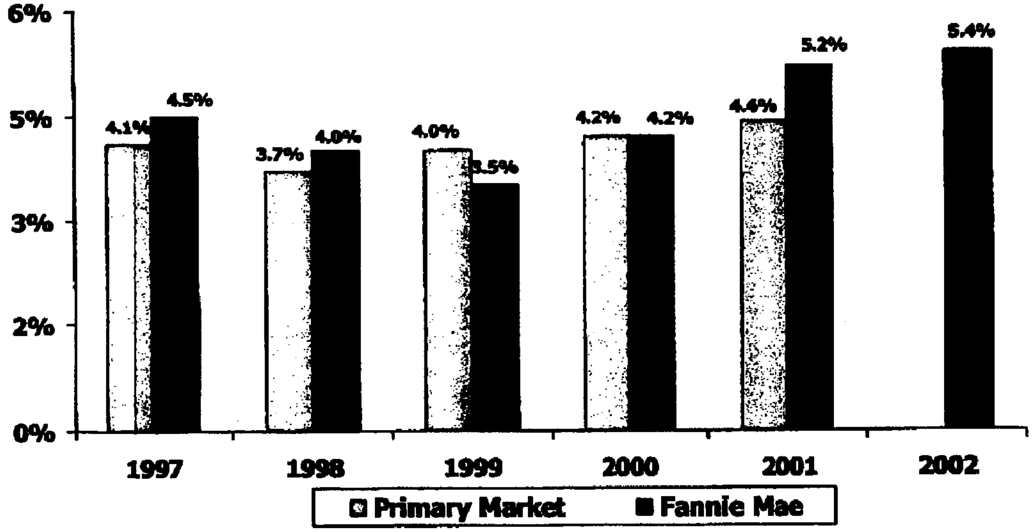
Source: FMIS data for Fannie Mae and Home Mortgage Disclosure Act data for the conventional conforming primary market. Compares single-family, owner-occupied, purchase money mortgages in Metropolitan Statistical Areas. Primary market excludes subprime lending. Manufactured housing lending included in 2001 primary market.

Fannie Mae and Primary Market Performance
Hispanic Lending



Source: FMIS data for Fannie Mae and Home Mortgage Disclosure Act data for the conventional conforming primary market. Compares single-family, owner-occupied, purchase money mortgages in Metropolitan Statistical Areas. Primary market excludes subprime lending. Manufactured housing lending included in 2001 primary market.

Fannie Mae and Primary Market Performance African-American Lending



Source: FMIS data for Fannie Mae and Home Mortgage Disclosure Act data for the conventional conforming primary market. Compares single-family, owner-occupied, purchase money mortgages in Metropolitan Statistical Areas. Primary market excludes subprime lending. Manufactured housing lending included in 2001 primary market.

Potential Costs Related To The SEC Registration Of The FHLB's Stock

White Paper Document

October 15, 2003

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Introduction

This document provides FMCG's views on the financial costs that would likely follow SEC registration of FHLB's stock. It should help the FHLBs as they advise their Boards, their Members, and other constituents on the implications of voluntary registration as proposed by the FHFB.

On September 17, FHFB, the regulator for the 12 FHLBs, proposed "to adopt a regulation requiring each Federal Home Loan Bank (Bank) to prepare and make public certain disclosures relating to its business and financial condition. Each Bank will satisfy these disclosure requirements by voluntarily registering a class of its securities with the Securities and Exchange Commission (SEC) under the provisions of section 12(g) of the Securities Exchange Act of 1934. By voluntarily registering a class of its securities, each Bank will subject itself to the 1934 Act's periodic disclosure regime, as interpreted and administered by the SEC."[1]

[1] Federal Register, Vol 68, No. 180

FMCG analyzed the potential cost implications of the proposal and presents its findings in three categories:

A. Bank Compliance Costs of SEC registration

B. Liquidity Costs of SEC registration

C. Bank Funding Costs of SEC registration.

FMCG estimates the following potential costs related to SEC registration.

A. **Compliance**. Incremental compliance costs are not likely to be material compared to the overall size of the business. FMCG's estimates for these costs are in the range of $5–$8mm for the initial filing and $5–$9mm per annum thereafter

B. **Liquidity:**

– *FHLB System liquidity.* The increased possibility of a disruption in debt issuance creates a real cost via the need to hold a permanently higher level of liquidity in the System. The precise cost of this additional liquidity depends both on the potential duration of any issuance or funding cost disruption and the source of the additional liquidity. At the extremes, the permanent per annum costs range from $109mm to $727mm. FMCG's most likely estimate is an ongoing extra cost of between $300mm and $500mm per annum or a permanent 4–7 bp increase in the funding cost of the System

– *Member liquidity.* Should the FHLB System become more exposed to funding disruptions (as could be more likely with SEC registration), prudent Member institutions would eventually change their liquidity management strategy to lower their reliance on FHLB System liquidity. Should Members respond to a perceived need to diversify their sources of liquidity by, say, substituting 20% of their current, unused borrowing capacity at FHLBs with Treasury bonds (which would be used to access the Fed discount window), Member institutions would, collectively, see their own liquidity management costs increase by $500mm per annum.

continued ...

C. **Funding**. SEC registration *may* have adverse effects on the market perception of the FHLB System as a GSE.[1] Some traditional investors in FHLB debt use the absence of a need to register with the SEC as a definition of GSE status. Therefore, for a time, they may be prevented from buying new issues and may have to sell current holdings. Despite evidence that Fannie Mae and Freddie Mac have registered without apparent incident in this regard, the System may face wider debt spreads for a time around any date of SEC registration. FMCG estimates that the lifetime cost[2] from an increase in the FHLB System's spreads (a worst-case perceived impairment of the GSE status in the eyes of investors) is $250mm for each potential month wherein a substantial number of investors come to view System debt as *not* issued by a GSE under their current investment guidelines *and* the System continues to fund itself as usual. At the outside as much as a three months time ($750mm) may be needed for investors to adjust their investment portfolio definitions on what is a qualified GSE would be issued at a 24 bp incremental annual yield during this time. The worst-case estimate of lifetime expense of $750mm would raise the total borrowing cost of the System by approximately 5 bp initially. This 5 bp cost would decline as new debt issued during the transition period matures.

[1] Government-Sponsored Enterprise

[2] The lifetime cost is defined as the total increase in funding cost over the contractual term to maturity or the term to earliest call date

Most of the costs of SEC registration are likely to be “passed through” to homeowners:

- The FHLBs are unlikely to absorb the costs of SEC registration given their already modest earnings[1]

- Members would also have limited incentives to absorb incremental liquidity costs they would incur, especially at this point in the economic cycle.

[1] ROEs for FHLBs range from 4% to 9%. This is substantially lower than the 15-20% ROE expectation at well-performing Member banks

A. Compliance

SEC registration brings along incremental compliance costs in the range of $5–$9mm/year.

These incremental costs, which are largely administrative and legal in nature, are expected to be relatively small given that the FHLBs are already:

- Regularly audited by external audit firms
- In compliance with the FHFB reporting requirements, which are generally consistent with the requirements of the SEC in form and content.[1]

SEC Registration Compliance Costs[2]

Cost component[3]	*One time costs ($mm)*	*Ongoing Costs ($mm)*
Legal	**2.6–5.2**	**1.3–3.9**
Administrative	**2.1–2.9**	**3.3–4.6**
System reconfiguration	0.2–0.3	NA
Report Publishing	1.9–2.6	1.9–2.6
Additional Staff	NA	1.1–1.6
Other Administrative Expenses	NA	0.3–0.4
Total	***4.7–8.1***	***4.6–8.5***

Note: FMCG's estimates do not include intangible costs such as additional burden on the executive management time, diminished focus on those disclosures that are of most interest to the Members, etc.

[1] Code of Federal Regulations, 12 CFR 985.6(b)(1), 12 CFR 989.4

[2] Ranges reflect estimates by FMCG, FHLB, and Grant Thornton study: "Going public…"

[3] Cost components do not include SEC registration fees since such fees are not applicable under the provisions of section 12(g) of the Securities Exchange Act of 1934

B. Liquidity

Events occurring at one FHLB that are material for it, may not be material for the System. Yet, under separate information disclosures (as opposed to System-wide ones), the System's funding could be disrupted temporarily.

An analysis of this effect is provided on the following pages. This analysis presumes that the System

- Might be delayed in issuing new debt (due to an SEC inquiry); or
- Would rather forego new debt issuance when investors may be unnecessarily concerned about an SEC mandated disclosure for a Bank that is not material for the System.

An alternative, but less likely strategy would be to continue issuing debt during this period at a higher than normal cost.[1]

[1] This approach would likely to be more expensive as higher debt costs would need to be paid over the life the newly issued securities. (Hence, these costs have not been estimated here)

Disclosures being made at Bank-level rather than at the System-level could lead to some Bank-level events being disclosed that are immaterial to the System as a whole.

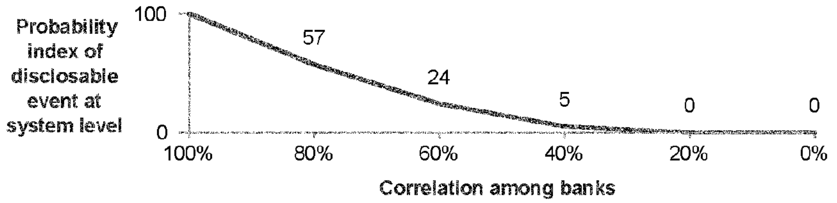
Such disclosure practices could have the following unintended consequences:

- Increase the likelihood of debt issuance problems relative to what is “appropriate” for the System

- Put the System at a substantial disadvantage to Fannie and Freddie, neither of which needs to disclose “region-specific” events unless they are material in amount at the company-wide level.

The chart below illustrates how disclosable events that are material at the individual Bank-level may not be material at the System-level.

The relative size and lack of perfect correlation between events at the individual Banks has been factored into this illustration. Also factored into the analysis is the historical likelihood of a specific FHLB incidences. (See Appendix A, Section 1 for detailed calculations).



Interpretation: At 40% correlation of events among the 12 FHLBs, a material event at one FHLB has only a 1 in 20 likelihood of being material at the System-level. This likelihood is lower still, if correlations are less than 40%. Also consider that none of the five known Bank-specific problematic episodes that have occurred over the last 6 years[1] were: (1) material enough to cause a System-wide reportable event, or (2) related to the same underlying type of event (i.e., historically there has been low correlation of adverse events[2] among the individual FHLBs).

[*] The index value corresponds to the probability of disclosable event at the System-level given that there is a disclosable event at the Bank-level

[1] FMCG knows of 5 Bank-specific events that have taken place since 1997 as disclosable at Bank-level

[2] Recent, contemporaneous (but unrelated) problems at the FHLBs of New York, Pittsburgh, and Atlanta are historically unusual

Faced with the increased likelihood that a Bank-level disclosure might unnecessarily raise investor concerns[1], the System may choose to either issue debt at higher costs[2] or to fund Member requests out of a liquidity "facility." (It would usually be uneconomic to do the former if the latter option exists.)

The potential for temporary debt issuance delays induced by disclosures mandated by Bank-level SEC registration of FHLB stock creates, therefore, quantifiable liquidity costs.

1. *FHLBs* — prudent liquidity management would dictate that FHLBs should carry additional liquidity to ensure that they are able to meet the demands of their Members for Advances in the event of debt issuance delays and/or temporary, unwarranted spikes in debt costs

2. *Members* — prudent Members would decide to diversify their sources of contingency liquidity (by changing liquidity providers) if they begin to believe that System funding may be disrupted

3. *Knock-on effects* — actions by both the FHLBs and the Members may cause undesirable systemic effects.

[1] When from a System-wide perspective, no cause for concern is present
[2] Provided that there is no SEC-mandated delay in new debt issuance

1. FHLBs

Prudent liquidity management requires addressing the increased possibility of delays in debt issuance by maintaining additional liquidity to be able to meet new demands for Advances and roll-overs of maturing debt.

The System issued about $5.2B of debt per business day in 2002. Despite this substantial amount of daily debt issuance, the System maintains only 5 days worth of liquidity[1] *under normal conditions*, in an effort to keep down carry costs and to focus its balance sheet on helping Members fund mortgages.[2]

FMCG's work with Member banks suggests the need for each FHLB to manage liquidity under stressed conditions. Should the System's funding become disrupted for any reason — many Members will take note:

- At the first sign of a FHLB-specific or a System-wide problem, some Members will draw on available FHLB liquidity so that they can maintain their own liquidity
- Each time this happens, more Members will ask to take down more of their "available" funds to insure they have the funding they need during and shortly after the System-wide disruption.

Hence, SEC registration increases the chances of funding disruptions and accelerated demands for Advances; therefore, SEC registration increases the need for liquidity.

[1] 12 CFR Ch. IX (1-1-03 Edition) Article 932.8

[2] Key Congressional Members (most notably former Senate Banking Committee Chairman Sarbanes and former House Banking Committee Chairman Leach) historically criticized the Banks for owning high levels of non-mission related assets. (Bank Presidents' Conference, Report of the Research & Planning Committee: "The Implications of SEC Registration on the FHLB System, the FHLBs, FHLB Members and US Housing Policy", 5/30/03, p.6)

The amount of extra liquidity needed by each Bank could be as high as the need to address a 60-day suspension of debt issuance.

Although the duration of the suspension period (or avoidance period if debt costs have spiked) cannot be precisely estimated, consider that:

- Regulatory requirement for liquidity (5 days) is an absolute minimum beyond which liquidity levels should not fall even under reasonably adverse scenarios
- Suspensions in the equity markets (used as a proxy for debt markets) averaged 12 days for 1997–2002 period, excluding situations that involved corporate fraud
- Consider liquidity held by non-GSE financial institutions funded with a larger than average share of wholesale funds as another prudent perspective (e.g., 90 days at JPMChase).

Incremental System Liquidity Needs

Number of days of normal funding needs	***Incremental liquidity needs****
10	$52B
15	$78B
30	$156B
60	$312B

Incremental liquidity needs should cover both normal demands for rolling over maturing debt and extraordinary demands by Members who become concerned about future access to Advances

* Incremental liquidity costs are proportional to the number of days of additional required liquidity

Incremental liquidity needs can be met through (1) increasing on-balance-sheet liquid assets or (2) purchasing a liquidity back-up facility, which would be converted into a short-term loan facility in the event of a suspension.

FMCG expects that a mix of various options will need to be used depending on the availability of the facilities and their pricing.[1] The table below summarizes the extreme ranges of potential liquidity costs. (See Appendix B, Section 2 for details of calculations.)

Liquidity Costs

Method	***10 days***	***15 days***	***30 days***	***60 days***
Grow on-balance sheet liquid assets				
Using Treasury assets	$121mm	$182mm	$364mm	$727mm
Using commercial paper assets	$69mm	$104mm	$208mm	$416mm
Purchase liquidity back-up facility				
Obtained at System-level	$18mm	$27mm	$55mm	$109mm
Obtained at Bank-level	$37mm	$55mm	$111mm	$221mm

FMCG's best estimate (a blend of on- and off-balance sheet) = $300-$500mm

At a permanent level of $400mm in liquidity costs, System debt costs would have risen by approximately 6 basis points.

[1] GE, for example, had to assemble a 90-bank syndicate to obtain a $54B back-up facility for its CP conduit. Assembling a $320B liquidity back-up facility may be impossible. Further, a back-up facility of large size could drive prices up significantly compared to the average prices used in the analysis

Case study

In FMCG's view, the ROE impact of obtaining incremental liquidity will lower the desirability of the System membership at the margin.

The table below summarizes a case study of the effects of maintaining additional liquidity on the ROE for FHLB-NY. (Maintaining additional liquidity would have somewhat similar, proportional effects on the other Banks.)

Effects Of Holding Additional Liquidity On The ROE Of The FHLB-NY

Method	***10 days***	***15 days***	***30 days***	***60 days***
Grow on-balance sheet liquid assets				
Using Treasury assets	5.4%	5.1%	4.5%	3.5%
Using commercial paper assets	5.5%	5.3%	4.9%	4.2%
Purchase liquidity back-up facility				
Obtained at System-level	5.8%	5.8%	5.7%	5.6%
Obtained at Bank-level	5.8%	5.7%	5.6%	5.2%

Holding liquid assets is more expensive than using a back-up facility; assets need to be capitalized and capital must be paid an appropriate dividend

Memo: FHLB-NY's 2002 ROE was 5.9%

Members may choose to reduce their dependency on FHLB-supplied liquidity if they come to believe that SEC registration may lead to funding disruptions.

Many Members view FHLBs as their dominant source of secondary liquidity,[1] but SEC registration may cause them to become more diversified:

- In the current regulatory environment:
  - The FHLBs have less fettered access to the capital markets
  - Members can reasonably assume that FHLB funding will be available (unless there is a known credit problem at the Member)
- Under the SEC regime:
  - FHLBs may be temporarily denied access to funding markets, as a result Members could be denied Advances through no problem of their own
  - Prudent Members could change their liquidity management strategy to decrease their dependency on the FHLB System as a liquidity contingency source.

[1] Survey responses to the FMCG/RMA Study of Enterprise-Wide Risk Measurement and Management, 2002–2003.

A change in Members' liquidity strategies would lower the profit margins of some Member institutions.

FMCG estimated the probable lost profit for Member institutions that diversified some of their otherwise predominant dependence on FHLB-provided liquidity.

If Members decide to lower their unused FHLB borrowing capacity by 20% (while maintaining the same interest rate risk posture), and rely instead on Treasuries as liquidity collateral, the aggregate cost to Member institutions could reach nearly $500mm per annum. (See Appendix A, Section 3 for detailed calculations.)

Increased propensity for liquidity disruptions may precipitate undesirable knock-on effects.

One was mentioned earlier — the need for higher levels of FHLB liquidity will lower FHLB stock dividends. This could cause some members to reduce their use of the System. In addition, two other potential knock-on effects are possible:

- *Increased use of Fed funds markets.* FHLBs already account for 40% of the Fed Funds market and the increased demand by FHLBs for Fed funds to satisfy additional liquidity needs may stress this market (causing the Fed funds rate to rise). Given that the Fed funds market participants represent the majority of the US financial institutions, any System-wide contagion effect would likely be significant (but difficult to quantify)

- *Reconsideration of issuance of optioned debt.* FHLBs are known by investors to have relatively better skills in deciding when to call their debt giving them substantial financial flexibility and funding advantages. Liquidity considerations may cause the FHLBs to be inefficient in exercising the call options that are "in the money" because funding disruptions may constraint the FHLBs' ability to rollover debt. As a result, FHLBs may reconsider future issuance of optioned debt leading to higher funding costs and A/L risk management inefficiencies. Further, liquidity concerns may limit Members in their exercise of options where System debt is the replacement.

C. Funding

The proposed SEC registration may have adverse effects on the market's perception of the FHLB System. To the degree that this is true, registration would thereby lead to higher funding costs.

Three conflicting points of view have, however, been espoused:

- *The SEC registration will increase transparency of the System and lead to lower funding costs.* FMCG has not found evidence that market makers or institutional investors in Consolidated Obligations believe that SEC registration would *lower* the yield on COs

- *The effect of the SEC registration is likely to be neutral or possibly even positive given Fannie and Freddie experiences.* Fannie and Freddie's spreads (to Treasuries) tightened slightly after they voluntarily accepted SEC registration. This spread tightening, however, coincided with a market rally; the market effects can not be clearly distinguished from the impact of the SEC registration[1]

- *The SEC registration could diminish the market's perception of GSE status, thus causing the System's cost of funds to rise.* For some investors, exemption from SEC registration is one key indicator of GSE status. Until the sets of indicia [that vary widely across such significant investor groups as municipalities, supranationals (e.g. the World Bank), and foreign-based investors] change, an increase in the System's cost of funds is possible for technical reasons that could prevent otherwise willing investors from purchasing System debt.

[1] Some market observers say that SEC registration has a benign warranted effect other than a small positive one that is transitory in nature as it is associated with a return to political normalcy after a period of "sturm and drang" linked to this "hot potato" issue

The potential for a funding cost impact hinges on the degree to which investors believe that the FHLB System's status as a GSE is being impaired by the SEC registration.

To size the potential funding costs increases associated with the loss of GSE status, consider this case: at the worst, investors that have "no SEC-registration" indicia would stop purchasing System debt and some would be forced to sell. Further, those investors who recognize that the change in indicia is a temporary occurrence would demand a higher yield on System debt presuming that FHLB System may call all of its debt issued due to this indicia "dislocation" at the first call date.

At a minimum, there could be little or no effect on spreads. (Fannie Mae's and Freddie Mac's recent experience with SEC registration appears to support this point of view.) Yet, a worst case is possible: during a transition period, System debt could trade in line with other AAA-rated financial institutions[1] rather than other GSEs. If so, the System could pay as much as $250mm more in total debt cost over the life time of debt issued during each month that investors using no SEC registration as a GSE indicia are prevented from purchasing System debt. (See Appendix B for details of calculations.)

As it takes time to change investment policies, a sudden change to SEC registration could create three months ($750mm) or so of added total debt costs. Thus, a range of from $0mm to $750mm in cost (and the uncertainties involved) could follow from temporary funding spread increases.

These estimates would come down materially if the System elected to issue shorter-term debt then implied by its normal mix (something it would be likely to do). Accordingly, the incremental bp cost spread over the System's entire debt base could be well below 5 bp.

[1] Recently Standard & Poor's lowered its long-term counterparty credit rating on FHLB-NY to AA+ from AAA. The AAA ratings on the senior debt of the COs of the FHLBs have not been affected by this action, as those ratings are based on the GSE status of the FHLB System. Because much of FHLB debt is "callable", it is possible that investors may require additional yield (beyond AAA) to offset the embedded credit option

In addition to the potential for "GSE indicia" problems, SEC registration may cause periodic accounting issues to arise that, while "red herring" in nature, could raise additional investor concerns.

SEC registration would bring the FHLBs under regulation that is intensely focused on new policy development for firms far different than FHLBs. FMCG's review suggests that investor concerns could initially arise due to:

- *Joint & several liabilities*: SEC registration could require accounting changes whereby each FHLB would need to add an additional liability on its balance sheet to reflect the fair value of its joint and several liability for the combined debt of all FHLBs[1]

- *Redeemable capital/FAS 150 disclosures*: The SEC has informed the FHLBs that its capital would be characterized as puttable or "redeemable."[2] Further, if a Member submits a redemption request, the stock subject to that request would thereafter be accounted for as a liability.[3] Should a Member submit a sizable request, the FHLBs could be required, under GAAP, to present their capital stock as impaired. Such disclosures could cause concern to any number of investors

- *Other pending accounting issues:*

  — Future treatment of REF Corp. payments

  — Use of combined vs. consolidated accounting.

[1] Statement of Alex J. Pollock to the Senate Subcommittee on Financial Management, the Budget, and International Security, July 21, 2003

[2] Dana A. Yealy, FHLB Pittsburgh

[3] After FASB completes Phase II of its FAS 150 project, all of the FHLBs' capital can be subject to this treatment because prospectively all Members could ask for redemptions

The System will need to seek GAAP accounting “exceptions” from the SEC; accounting issues will inevitably arise when applying GAAP to the FHLBs, which are essentially cooperatives.

SEC turnaround time, limited attention, and lack of familiarity with cooperative structures could exacerbate investor perception problems.

Investor reactions to accounting anomalies will increase the potential for additional debt cost increases. No estimate has been provided here (during the time needed to get investors comfortable with new, odd accounting disclosures, the System would more likely draw on liquidity rather than issue new debt to concerned investors at abnormally high spreads).

Appendix A: The Methodology For Calculating The Potential Increase In Liquidity Costs Related To SEC Registration Of FHLBs' Stock

This appendix describes the methodologies used to estimate the potential liquidity effects of SEC registration on FHLBs and Members:

1. The effect of SEC registration on the probability of suspension of the System's funding
2. The impact of SEC registration on FHLBs' liquidity costs
3. The impact of SEC registration on Members' liquidity costs.

1. The Effect Of SEC Registration On The Probability Of Suspension Of The System's Funding

An issue receiving little attention is the fact that there are disclosable events at the Bank-level that may not be material at the System-level. The question is, how many of these events could arise?

Here are the facts that were used to determine System-level liquidity costs:

- To date there have been no System-level events because of low correlation among FHLB-specific events. There have, however, been 5 Bank-specific events that *might* have had to be disclosed in SEC mandated filings over the last six years

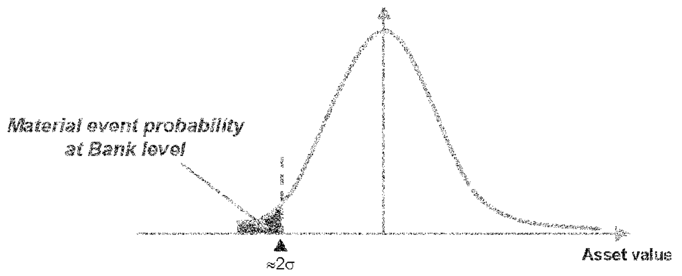
- How low is the correlation among the FHLBs? — No one really knows, simulations show that at low correlation levels (prior events have all been individual, Bank-specific, managerial issues), Bank-specific events have low probability of resulting in System-level disclosures.

Hence, there is the potential for an important *adverse* difference relative to Fannie Mae and Freddie Mac, each of which is required to disclose information only at the holding company level not for each of its regional geographies.

The analysis consists of the following four steps:

a. Model a material event as a significant impairment in an individual FHLB's asset value as:

Asset Distribution At The Bank Level



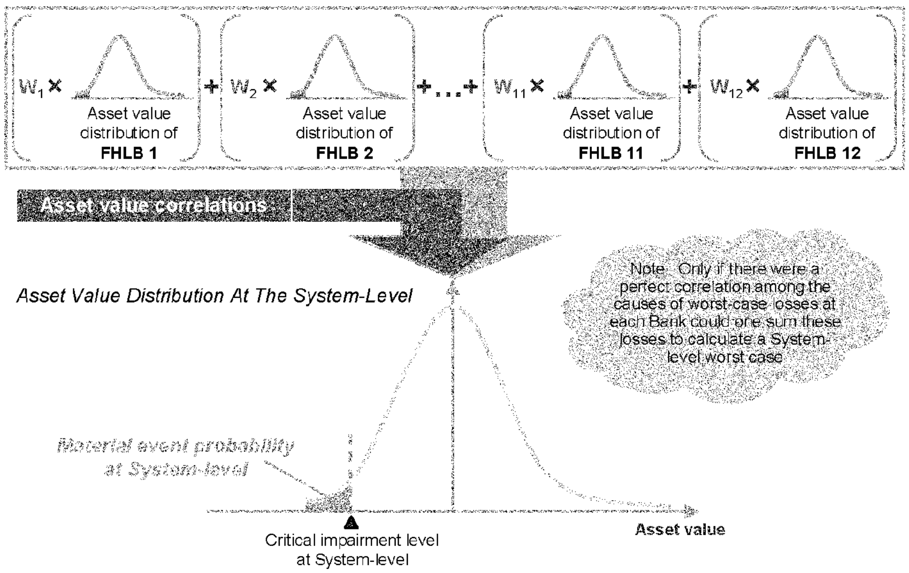
b. Construct Bank-level asset value probability distributions:

- Calculate relative sizes as % share of the asset values of each FHLB in the System
- Assume that each FHLB's asset values are normally distributed
- Assume that recent FHLB experience on the incidence of Bank-specific events holds into the future. Note: Based on an FMCG-known statistic of individual FHLB events that the SEC could view as disclosable, 5 Bank-specific events[1] have taken place since 1997. (This corresponds to a 1.74% probability of having an event material for individual FHLB happen once a quarter or an approximately 2 standard deviation (2σ) event in a normal distribution.)

[1] "Events" cover issues related to regulatory interventions or atypically large bond portfolio or interest rate risk losses (e.g., the recent experiences at the FHLBs of New York, Pittsburgh, and Atlanta)

c. Build the asset distribution at the System-level for various correlation levels

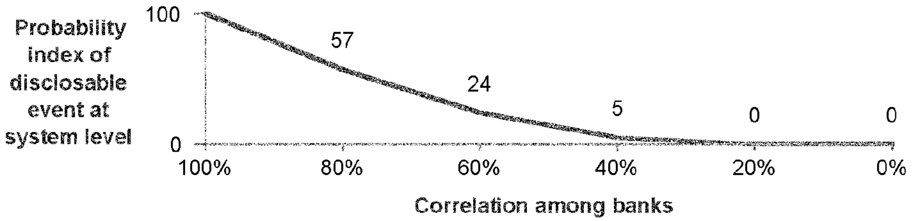
Exhibit 1: High Level Process Map Of the Methodology


W1 ×
Asset value distribution of **FHLB 1**
+
W2 ×
Asset value distribution of **FHLB 2**
+ . . . +
W11 ×
Asset value distribution of **FHLB 11**
+
W12 ×
Asset value distribution of **FHLB 12**
Asset value correlations
Asset Value Distribution At The System-Level
Note: Only if there were a perfect correlation among the causes of worst-case losses at each Bank could one sum these losses to calculate a System-level worst case
Material event probability at System-level
Critical impairment level at System-level
Asset value

Note: W represents the relative size of each FHLB in the System

d. Calculate the probability of material event at the System-level given a material event at the Bank level from the constructed System-level asset distribution

The relative size and lack of perfect correlation between events at the individual Banks has been factored into this illustration. Also factored into the analysis is the historical likelihood of a specific FHLB incidences.



Interpretation: At 40% correlation of events among the 12 FHLBs, a material event at one FHLB has only a 1 in 20 likelihood of being material at the System-level. This likelihood is lower still, if correlations are less than 40%. Also consider that none of the five known Bank-specific problematic episodes that have occurred over the last 6 years[1] were: (1) material enough to cause a System-wide reportable event, or (2) related to the same underlying type of event (i.e., historically there has been low correlation of adverse events[2] among the individual FHLBs).

The rapid decline in the relative probability of material event at the System-level shows that relative sizes and diversification among FHLBs reduce significantly the probability of material events at the System.

* The index value corresponds to the probability of disclosable event at the System-level given that there is a disclosable event at the Bank-level

[1] FMCG knows of 5 Bank-specific events that have taken place since 1997 as disclosable at Bank-level

[2] Recent, contemporaneous (but unrelated) problems at the FHLBs of New York, Pittsburgh, and Atlanta are historically unusual

2. The Impact Of SEC Registration On FHLBs' Liquidity Costs

The incremental liquidity can be attained in two ways:

a. Grow on-balance-sheet liquid assets

b. Purchase liquidity back-up facility.

a. *Grow On-Balance-Sheet Liquid Assets*

The incremental liquidity can be obtained by growing on-balance sheet liquid assets by purchasing either Treasuries or Commercial Paper. Both alternatives are analyzed.

i. Grow on-balance-sheet liquidity by holding short-term Treasury assets funded with 3-year, fixed-rate COs swapped to floating rates[1]:

– Estimate the cost of funding Treasuries, say, with 90-day maturities with 90-day, floating-rate System debt:

- FHLBs' 3-year fixed rate CO yield (C) is 2.46%[2]
- The 3-year "pay-floating, receive-fixed" interest swap rate (S) is 2.57%[3]
- The cash flows are as follows:

3-month Treasury	***3-year fixed CO yield***	***3-year "pay floating, receive fixed" swap***
$+T_t$	-C	$+S - LIBOR_t$

continued ...

[1] Long-term funding is needed to ensure investments can be used for other than redeeming, contemporaneous liabilities, creating floating-rate debt out of fixed-rate COs keeps the Banks' asset/liability risks unchanged

[2] Bloomberg, Yield curve for FHLB issues as of 9/19/2003

[3] Bloomberg as of 9/19/2003

- Debt negative carry is:

  = T_t - C + S - LIBOR_t

  = -(LIBOR_t - T_t) + S - C

  = -TED[1] + S - C

  = -20 bp + 257 bp - 246 bp

  = -9 bp

- The dollar cost of negative carry is thus calculated as (Liquidity need × 9 bp)

— Estimate the cost of equity:

- Additional equity investments are needed to maintain the System-mandated 1/21 leverage ratio[2]
- Cost of equity is:

  = Pre-tax equity hurdle rate[3] - Equity credit rate[4]

  = 6.12% - 3.11%[5] = 3.01%

- The dollar cost of equity is calculated as (Additional equity to support expansion of the liquidity portfolio × 3.01%)

— Estimate the liquidity cost = (Negative carry of debt) + (cost of carry of additional equity)

continued ...

[1] The TED spread is the interest rate differential between Treasuries and LIBOR. Bloomberg, as of 9/19/2003

[2] The analysis assumes that the bank capital adequacy is bound by the leverage ratio hence risk-adjusted capital is not reflected in calculations

[3] The hurdle rate is the minimum required return on equity that the investor expects to earn for the given risk level. Since FHLBs' equity is redeemed at par, the return on equity is equal to the dividend yield. The dividend yield is 4.5% based on 2002 dividend. FHLB Combined Annual Report, 2002, issued by Office of Finance. The pre-tax hurdle rate (6.12%) is calculated as 4.5% / (1-tax rate). The tax rate for the System is assumed to be 26.5%

[4] The equity credit rate is the foregone matched funding cost due to funding with capital.

[5] 5-year Treasury rate, Federal Reserve Release H.15, as of 9/19/2003

Grow On-Balance-Sheet Treasury Assets

	Liquidity costs			
Method	***10 days***	***15 days***	***30 days***	***60 days***
Liquidity need	**$52B**	**$78B**	**$156B**	**$312B**
New treasury assets required				
Cost of debt negative carry	-9 bp	-9 bp	-9 bp	-9 bp
Dollar cost of negative carry	($47mm)	($70mm)	($140mm	($280mm)
Memo: Equity investment needed	$2.5B	$3.8B	$7.4B	$15B
Cost of equity	3.01%	3.01%	3.01%	3.01%
Dollar cost of equity	($74mm)	($112mm)	($223mm	($447mm)
Total cost	**($121mm)**	**($182mm)**	**($364mm**	**($727mm)**

continued ...

ii. Grow on-balance-sheet liquid Commercial Paper (CP) assets and fund them with 3-year COs swapped to floating rates[1]:

– Estimate the cost of carry:

- FHLBs' 3-year fixed-rate CO yield (C) is 2.46%[2]
- The 3-year "pay-floating, receive-fixed" interest swap rate (S) is 2.57%[3]
- The spread of CP over Treasuries is 10 bp[4]
- The cash flows are as follows:

3-month CP	***3-year fixed CO yield***	***3-year "pay floating, receive fixed" swap***
$+CP_t$	-C	$+S - LIBOR_t$

- Debt carry is:

$= CP_t - C + S - LIBOR_t$

$= (CP_t - T_t) - (LIBOR_t - T_t) - C + S$

$= (CP_t - T_t) - TED^5 - C + S$

= 10 bp - 20 bp - 246 bp + 257 bp = 1 bp

- The dollar value of positive carry is calculated as (Liquidity need × 1 bp)

continued ...

[1] Long-term funding is needed to ensure investments can be used for other than redeeming, contemporaneous liabilities, creating floating-rate debt out of fixed-rate COs keeps the Banks' asset/liability risks unchanged

[2] Bloomberg, Yield curve for FHLB issues as of 9/19/2003

[3] Bloomberg as of 9/19/2003

[4] Federal Reserve, Release H.15 as of 9/19/2003

[5] Bloomberg, as of 9/19/2003

- Estimate the cost of equity:
  - Additional equity investments are needed to maintain the System-mandated 1/21 leverage ratio[1]
  - Cost of equity is:

    = Pretax equity hurdle rate[2] - Equity credit rate[3]

    = 6.12% - 3.11%[4] = 3.01%
  - The dollar cost of equity is (Additional equity to support expansion of the liquidity portfolio x 3.01%)
- Estimate the liquidity cost = (Negative carry of debt) + (Cost of carry of additional equity)

continued ...

[1] The analysis assumes that the bank capital adequacy is bound by the leverage ratio hence risk adjusted capital is not reflected in calculations

[2] Hurdle rate is the minimum required return on equity that the investor expects to earn for the given risk level. Since FHLBs' equity is redeemed at par, the return on equity is equal to the dividend yield. The dividend yield is 4.5% based on 2002 dividend. FHLB Combined Annual Report, 2002, issued by Office of Finance. The pre-tax hurdle rate (6.12%) is calculated as 4.5% ÷ (1 - tax rate). The tax rate for the System is assumed to be 26.5%

[3] Equity credit rate is the foregone matched funding cost due to funding with capital

[4] 5-year Treasury rate, Federal Reserve, as of 9/19/2003

Grow On-Balance-Sheet Commercial Paper Assets

	Liquidity costs			
Method	***10 days***	***15 days***	***30 days***	***60 days***
Liquidity need	**$52B**	**$78B**	**$156B**	**$312B**
Growing commercial paper assets				
Value of debt positive carry	1 bp	1 bp	1 bp	1 bp
Dollar value of positive carry	$5mm	$8mm	$16mm	$31mm
Memo: Equity investment needed	$2.5B	$3.8B	$7.5B	$15B
Cost of equity	3.01%	3.01%	3.01%	3.01%
Dollar cost of equity	($74mm)	($112mm)	($223mm)	($447mm)
Total cost	**($69mm)**	**($104mm)**	**($208mm)**	**($416mm)**

b. Purchase Liquidity Back-Up Facility

A liquidity back-up facility could be obtained either by the System (through the Office of Finance) or by each individual FHLB.

In FMCG's view, this approach can only be used to solve part of the liquidity equation, i.e., there may not be sufficient vendors of lines to meet FHLBs' needs.[1]

i. The price of liquidity back-up facility obtained at the System-level:

- The AAA ratings on the senior debt of the COs are based on the GSE status of the FHLB System
- Recent prices for 364-day facility for AAA-rated institutions average about 3.5 bp
- The dollar cost of facility is calculated as: (Liquidity need × Price of the facility)

ii. The price of liquidity back-up facility obtained at any individual FHLB-level:

- Should the back-up facility be obtained at the Bank-level, the Bank could be a more likely user of a back up line than the System as a whole
- The price of a 364-day facility for an individual bank is guesstimated to be double that for the System (about 7 bp)
- The dollar cost of facility is calculated as: (Liquidity need × Price of the facility)

[1] GE, for example, had to assemble a 90-bank syndicate to obtain a $54B back-up facility for its CP conduit. Assembling a $320B liquidity back-up facility may be impossible. Further, a back-up facility of large size could drive prices up significantly compared to the average prices used in the analysis

The dollar liquidity costs through a liquidity back-up facility are calculated for various liquidity contingency scenarios shown below:

Liquidity Back-Up Facility

	Liquidity costs			
Method	***10 days***	***15 days***	***30 days***	***60 days***
Liquidity need	**$52B**	**$78B**	**$156B**	**$312B**
Back up line cost (per annum)				
System level:				
Cost of facility (bp)	3.5 bp	3.5 bp	3.5 bp	3.5 bp
Cost of facility ($)	$18mm	$27mm	$55mm	$109mm
Bank-level				
Cost of facility (bp)	7 bp	7 bp	7 bp	7 bp
Cost of facility ($)	$37mm	$55mm	$111mm	$221mm

Note: The sizable range of costs between the System obtaining the line or all of the individual Banks getting back up lines is consistent with the diversification benefits of handling liquidity issues at the System-level rather than at each Bank.

3. The Impact Of SEC Registration On Members' Liquidity Costs

This section describes the methodology used to estimate the potential liquidity costs of SEC registration on Members.

The liquidity impact on Members can be estimated as follows:

a. *Estimate the amount of excess capacity Members have in the System:*

- Members can draw up to 20x their equity investment in the System in Advances. As of 12/31/2002, Advances were 13.9x the equity investments by Members. This suggests that there is 6.1x equity investment, or $215B of idle borrowing capacity available to Members[1]

- Members currently use this excess capacity as a liquidity back-up facility. Accessing the unused capacity requires Members to hold enough pledgeable assets to cover collateral requirements on the Advances, including required haircuts. We make the reasonable assumption that Members hold enough pledgeable assets to access the entire unused amount of the borrowing capacity and that the pledgeable assets held by Members are conforming whole loans. The required haircuts on whole loans are estimated to be 20%[2]

continued ...

[1] As of 12/31/2002, total equity investment by Members was $35.2B and Advances paid to Members were $490B. FHLB Combined Annual Report, 2002, issued by Office of Finance

[2] Michael Wilson, FHLB Boston

b. Determine the amount of pledgeable assets Members would need to convert into Treasuries to change liquidity providers:

- To create a modest level of funding diversification, Members would need to lower their unused borrowing capacity at the System by, say, 20% or $43B. A $43B decrease in borrowing capacity would free up $54B of whole loans (based on an estimated average collateral haircut ratio of 20%)

- To obtain the same amount of liquidity Members could:
  - Reduce the portion of their equity investment in the Banks needed to provide $43B of borrowing capacity; this now unneeded equity capital is $2B[1]. Use redemptions to purchase 5-year Treasuries
  - Convert $41B of whole loans into 5-year Treasuries
  - Keep the remaining $11B in whole loans undisturbed on balance sheet

Note: In this and other analyses FMCG assumes that Members will change their liquidity profile while leaving their interest rate risk exposure undisturbed. Thus, none of the cost estimates are increased or decreased by earning changes associated with asset-liability risks that would otherwise occur if whole loans were converted into liquid securities. This is done by assuming Members convert whole loans into Treasuries with approximately the same duration as the loans. These Treasuries would then be pledged at the Fed Discount window to obtain liquidity

continued ...

[1] Calculated as 43B divided by 21 (i.e., capital ratio). Note: presumes either that Members will want to reduce their equity investments or that Banks will want the excess capital levels to be reduced under these circumstances

c. *Calculate lost income on FHLB pledgeable collateral vs. Fed Discount window-pledgeable investments (e.g., Treasuries):*

- Member's equity holding in FHLBs
  - Amount converted: $2B — this is excess equity vs. needed amounts to draw down Advances for liquidity purposes
  - Spread between System-wide dividend yield (4.5%)[1,2] and yield on 5-year Treasuries (3.11%)[3]: 140 bp
  - Lost income = $2B × 140 bp = $28mm
- Whole loans
  - Amount converted: $41B
  - Option-adjusted spread in lost income: 114 bp
    - OAS is used instead of the simple bond yield differential between whole loans and Treasuries to incorporate prepayment optionality inherent in whole loans but not Treasuries
    - The 15-year Fannie Mae MBS priced closest to par has a yield of 4.51% and an OAS[4] of 94 bp
    - Given that the OAS in whole mortgages are typically 20bp higher than the OAS in MBS, the OAS of 114 bp (94 bp + 20 bp) represents the yield spread between approximately 5-year[5] Treasury and mortgage whole loans
  - Lost income = $41B × 114 bp = $467mm
- The total cost to Members would be about $500mm. This is composed of $28mm (for redeemed equity used to purchase Treasuries) + $467mm (for lower amounts of whole loans used to purchase Treasuries).

[1] Using the System average dividend rate per FHLB Combined Annual Report, 2002, issued by Office of Finance

[2] To be conservative we assumed that FHLBank dividends are fully taxable. According to Michael Wilson, FHLB Boston, it is, however, possible for Members to defer their tax liability — if dividends are paid in stock, the tax liability can be deferred indefinitely as long as the Member does not redeem such stock

[3] 5-year Treasury rate, Federal Reserve, as of 9/19/2003

[4] The assumptions in the OAS computation are Bloomberg prepayment model, 20% volatility and 3% mean reversion in interest rates

[5] The weighted average life (WAL) of the MBS is 4.4 years

Appendix B: The Methodology For Calculating The Potential Increase In Funding Costs Related To SEC Registration Of FHLBs' Stock

The methodology used to estimate the potential effects of the SEC registration on the FHLB's cost of funds consists of the following four steps:

1. *Evaluate the factors determining how the FHLB debt is likely to trade upon SEC registration:*

   - As some traditional investors in FHLB debt use the absence of a need to register with the SEC as a definition of GSE status, they may, therefore, for a time, be prevented from buying new issues and may have to sell current holdings

   - At a minimum, there could be little or no effect on spreads

   - Barring changes in credit quality of FHLBs, a potential *worst-case* effect could be that, upon SEC registration, FHLB debt *for a time* trades more like AAA-rated Bank/Finance bonds[1]

   - After the FHLB System is able to adjust its indicia, FHLB debt would return back to normal GSE yields

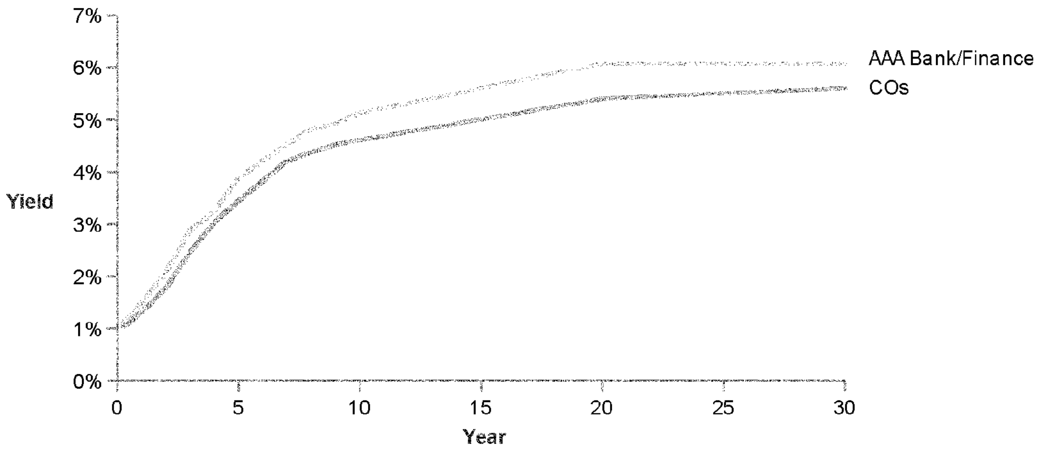
continued ...

[1] Currently COs carry a credit rating of AAA from major rating agencies based on the GSE status of the FHLB System

2. *Estimate the potential increase in the cost of funds:*

— Compare the term structure of FHLB and AAA Bank/Finance issues. As Exhibit 1 below shows, the spread increases vary from about 10bp to 70bp, depending on the maturity date of the debt

Exhibit 1: Yield Curves Of FHLB Issues And AAA Bank/Finance Debt[1]



continued ...

[1] Bloomberg Yield Curve Analytics, data as of 9/19/2003

3. *Determine the run-off schedule for Consolidated Obligations:*

– Determine the term structure of outstanding balances and assume that new issuances follow the same maturity/call schedule

- The term structure of outstanding balances for consolidated bonds is provided below by term to maturity or next call date[1]

Years	***1***	***2***	***3***	***4***	***5***	***8***
Balance distribution by term to maturity or call date	60%	18%	9%	4%	3%	6%

- The term structure of outstanding balances for discount notes is provided below by term to maturity[2]

Months	***1***	***2***	***3***	***4***	***5***	***6***	***6+***
Balance distribution by term to maturity	57%	22%	10%	4%	3%	3%	1%

continued ...

[1] FHLB Combined Annual Report, 2002, issued by Office of Finance, FMCG analytics

[2] FHLB System Discount Note maturity summary prepared by the Office of Finance as of 7/31/03, FMCG analytics

- Estimate the average *monthly* issuance of COs:
  - For consolidated bonds, average issuance per month = (Annual consolidated bond issuance[1])÷12 = $435B÷12 = $36B
  - For discount notes, average issuance per month = (Outstanding DNs[2] × %DNs maturing within 1-month[3]) = $147B × 57% = $83B
- Apply the term structure of DNs and consolidated bonds to average monthly issuance to estimate the run-off schedule:
  - Consolidated bonds:

Years	***1***	***2***	***3***	***4***	***5***	***8***
Balance distribution by maturity or call date	60%	18%	9%	4%	3%	6%
Balance distribution × monthly issuance ($B)	21.8	6.5	3.2	1.5	1.1	2.2

  - Discount notes:

Months	***1***	***2***	***3***	***4***	***5***	***6***	***6+***
Balance distribution by maturity	57%	22%	10%	4%	3%	3%	1%
Balance distribution × monthly issuance ($B)	47.4	18.5	8.5	3.1	2.5	2.4	1.1

[1] Annual consolidated bond issuance in 2002. Source: Debt issuance statistics, Office of Finance

[2] Outstanding DN balances as of Dec 31, 2002. Source: Annual Report

[3] FHLB System Discount Notes maturity summary prepared by the Office of Finance

4. *Calculate the lifetime cost[1] of worst-case increase in spreads for one month worth of CO issuances:*

- The lifetime cost increase for each term to maturity (or term to call when callable) schedule is calculated as

  (Balance maturing at maturity M from run-off schedule) × (Spread between GSE AAA and Bank/Finance AAA for maturity M) × (Maturity in years, M)

- Estimate the total cost for one month worth of issuances by summing up lifetime costs of increase in spreads for all term to maturity (or term to next call) schedules:

Month	***Average yield***		***Interest costs***		
	Bonds	***DNs***	***Bonds***	***DNs***	***Total***
AAA-rated GSE	182 bp	105 bp	$1.9B	$143mm	$2.0B
AAA-rated Bank/finance	206 bp	115 bp	$2.1 B	$157mm	$2.3B
Funding cost increase	24 bp	10 bp	$235mm	$15mm	$250mm

continued ...

[1] The lifetime cost is defined as the total increase in funding cost over the contractual term to maturity or to earliest call date

This estimate of $250mm is, however, somewhat of an understatement because interest costs are based on the term structure that reflects the term to next call date rather than the term to maturity for callable debt. If forward curve is an unbiased estimator of future rates, callable debt will be called only half of the time (i.e., when rates rise to the forward curve or less), thus our estimate is based on shorter terms for callables than are really appropriate

Adjusting investment policies of those with “no SEC registration” indicia for GSE status takes time — likely to be many months. Advanced warning of the change in exemption from SEC registration will cushion this effect. Using a conservative 3-month adjustment period at $250mm per month yields $750mm.

The annual yield increase on System debt issued under this scenario is 24 bp at $250mm in added lifetime cost. Spreading $250mm across the $674B in System debt outstanding as of 12/21/02 results in 3.7 bp of average extra funding costs. At $750mm cost (a three-month GSE indicia change estimate), the 3.7 bp incremental cost would be a bit higher and persist longer. (Rollovers of short-term debt would prevent the incremental yield from rising all the way to 3.7 bp × 3 or 11.1 bp.)

PROPOSALS FOR IMPROVING THE REGULATION OF THE HOUSING GOVERNMENT SPONSORED ENTERPRISES

THURSDAY, OCTOBER 23, 2003

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:06 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

This morning the Committee meets to hold our second hearing on proposals to improve the regulation of Government Sponsored Enterprises. During our hearing last week, we heard from the Administration and the Government Sponsored Enterprises. Today, we will hear from a variety of viewpoints, including the current regulators.

These hearings will provide the Committee with a thorough debate of the critical issues that must be resolved in order to establish a strong and credible regulator for the Government Sponsored Enterprises. It is my view that any new regulator must oversee the Federal Home Loan Bank System as well as Fannie Mae and Freddie Mac. Comprehensive regulatory reform of this nature deserves careful consideration, and this Committee will work diligently to craft an appropriate reform package. Whether we can do so this fall is not clear, but I will certainly make this a continued priority as the Chairman.

For our first panel today, we welcome three witnesses: Mr. John Korsmo, Chairman of the Federal Housing Finance Board; Mr. Armando Falcon, Director of the Office of Federal Housing Enterprise Oversight; and Mr. Douglas Holtz-Eakin, Director of the Congressional Budget Office.

Our second panel will include five witnesses: Mr. John D. Koch, Executive Vice President and Chief Lending Officer, Charter One Bank of Cleveland, Ohio, testifying on behalf of America's Community Bankers; Mr. Dale Torpey, President and CEO of Federation Bank of Washington, Iowa, testifying on behalf of the Independent Community Bankers of America; Mr. Allen Fishbein, Director of Housing and Credit Policy for the Consumer Federation of America; and Mr. Robert Couch, Chairman of the Mortgage Bankers Association; and Ms. Iona Harrison, Chairman of the Public Policy Committee of the National Association of REALTORS®.

I want to thank all of the witnesses for appearing before the Committee today.

Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman, for convening this important hearing. As you said, this is the second opportunity for the Committee to consider the question of how to effectively regulate the GSE's—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

Understanding and improving the supervision of the GSE's involves many complex and challenging issues. I think our hearing last week made that clear. Testimony from two Cabinet Secretaries and representatives of the regulated entities I think made valuable contributions to our deliberations. But I believe it is fair to say that there are a number of questions still to be examined. I look forward to further consideration of those issues today.

Of course, the GSE's do not make the mortgage market function by themselves. They work in partnership with a network of lenders and realtors who are integral to the smooth running of our housing finance system. We will hear today from several representatives of these industries who interact daily with the GSE's. I look forward to hearing their perspectives, indeed the perspectives of all of our witnesses today, as we examine this question of effective supervision of these entities.

Mr. Chairman, I want to commend you for putting together hearings with a variety of interested parties on this important issue so that we really get the benefit of a wide range of points of view.

Finally, as I did last week, I want to underscore the importance of acceding to the Administration's request for an additional $7.5 million for OFHEO to conduct reviews of accounting practices at the enterprises it regulates. I very much hope that will be included in the funding for fiscal year 2004. It is an Administration request, and I very much hope that Congress will deliver on it.

While we deliberate on creating a new, more effective regulatory structure, we obviously need to be sure that the current regulator is adequately funded.

Thank you very much.

Chairman SHELBY. Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman, for holding this very important meeting and hearing. I would like to thank all of our witnesses that are going to testify for their testimony.

Last week, we heard from two Cabinet Secretaries as well as representatives from Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Now we will hear from the Federal Housing Finance Board, the CEO of OFHEO, and the representatives from the banking industry, the realtors, and the consumer groups. I applaud the Chairman for bringing so many who could be affected by the GSE legislation before the Committee.

We all agree that Fannie and Freddie need a new regulator. Even Fannie and Freddie agree to that. But that was the easy part. Now we have to figure out how to do it. If we do not do it right, we are simply rearranging the deck chairs on the Titanic. It will sink. We all agree that we must not do anything in this bill that could harm our housing markets, and I warn those that are in positions of authority in the Treasury to watch what they say. As of yesterday, one of them popped his mouth off, and the market went completely haywire in the interest rates.

We all agree we must worry about unintended consequences. I do want to reiterate a concern I voiced last week at the hearing we had. I had a number of small community banks in Kentucky, contact me about their concerns about this effort. We only have small banks in Kentucky, and they are scared to death. My small banks are worried that they will not be able to use the same GSE products they use today. They are worried about the products they use to stay in compliance with their CRA obligations, and they will not have them available if we do something to change the regulator.

I would like to make sure my little banks are not harmed. I would like to hear from all of our witnesses on if they feel this concern is a valid concern.

I would also like to hear from our witnesses on whether or not they feel the Federal Home Loan Bank should stay with their existing regulator or should be moved to a new regulator and why, because I do not agree with the Chairman on this, and I would like to hear from our witnesses. I will look forward to broaching this with our witnesses and in the question and answer period.

Once again, I thank all of our witnesses for testifying, and we thank the Chairman for holding the hearing.

Chairman SHELBY. Senator Johnson.

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Thank you, Mr. Chairman, for calling today's hearing to discuss the regulatory framework for housing GSE's, and I welcome the members of our panels today.

It is critical that we move forward with regulatory restructuring, and today will give us an opportunity to get the current GSE regulators' take on what tools will be useful in strengthening oversight. But even more important, we will hear from those who work together with the GSE's to make affordable housing a reality for millions of Americans.

Mr. Chairman, I have to admit that my patience has worn thin with Treasury at the moment. A statement yesterday from our Assistant Secretary of Financial Institutions, Mr. Abernathy, making veiled threats about what might happen to the GSE $2.5 billion line of credit with the Treasury if they do not get their way relative to a proposed safety and soundness regulator under the Treasury having the authority to approve new products and very low firewalls between the Agency and the Treasury Secretary and the politics of the Treasury Department are very distressing to me and should be distressing to anyone concerned about affordable housing for American families.

I am disappointed at what appears to be a decreasing momentum for regulatory reform. Clearly, there is a significant agreement about the need for strengthened regulatory oversight, and yet at last week's hearing, Secretary Snow put forward a proposal that I think raised as many questions as it answered.

It is essential, I believe, that any new GSE regulator, if housed in Treasury, be independent in the same way or in similar ways as the OCC and the OTS. I have signed a letter with some of my Committee colleagues supporting the idea that the GSE regulator may well be moved to Treasury, and yet I am disappointed that the Administration seems to want to retreat from the conventional wisdom that it is good policy to remove the financial regulators from political forces.

The whole point of this exercise is to create a credible regulator. Why would we want to do it in a way that increases its vulnerability to political whims, regardless of which party is in the White House?

We need to look at safety and soundness implications for allowing a regulator to set minimum capital requirements as well as the effects such a change in capital would have on the affordable housing mission of the GSE's. In addition, thoughtful deliberations must take place on how new products and activities should be addressed in any legislation to alter the regulation of GSE's. I share the concern that my colleague from Kentucky has expressed about the regulatory oversight structure of the Federal Home Loan Banks, and I think we need to approach that with great care as we progress on this issue.

And yet, at the same time that we look at changes in the regulatory structure, we have to take great care not to upset a system of housing finance that has allowed successfully millions of middle-income Americans to realize the dream of homeownership. There is a "First, do no harm" criteria here, I believe, that we need to address. In so many ways, the housing GSE's have helped to create a system that has strengthened our communities and broadened the reach of homeownership. That should continue to be our top priority, and I look forward to working with my colleagues in a bipartisan fashion on this Committee to that end.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Hagel.

STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you. I want to add my welcome to our guests this morning, and I appreciate very much their testimony and an opportunity to exchange thoughts about a rather vital issue for the future of our housing market. Really, it is attached to and part of a significant dynamic of our economy, which you all understand, and we appreciate that.

Mr. Chairman, I also appreciate your continued focus on this issue, with this a hearing coming back to back with last week's hearing. And I would hope that this Committee will be in a position to actually finalize something soon, and I know the Chairman's commitment to that. There is little question, as my colleague from Kentucky noted, as to a requirement to reform what you are doing every day so that there is a new sense of confidence in the market as we move forward into this new century.

Thank you.

I might, as a matter of personal privilege, Mr. Chairman, acknowledge that our distinguished colleague from Kentucky's birthday is today.

[Laughter.]

It is worthy of note because there is a new serenity about him, a new peacefulness.

[Laughter.]

He is more docile than I have ever seen him, and I attribute it all to a wiser, more mature U.S. Senator on his birthday. Happy birthday, Senator Bunning.

Mr. Chairman, thank you.

Chairman SHELBY. Thank you, Senator Hagel. You noticed something we have not noticed about the Senator.

[Laughter.]

Chairman SHELBY. Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman. And Happy Birthday. I cannot say anything else to begin.

Let me also say, Mr. Chairman, how much I appreciate these hearings. You have assembled an array of witnesses that will provide valuable insights to the Committee as we go forward, and thank you for that. I think it is good that we have the regulators here who can offer very specific recommendations based upon real experience over several years, and I think that is very valuable.

There are several issues, obviously, that I think we should touch upon: Whether the Housing Finance Board and OFHEO should be merged together in some new constellation of regulators; whether the GSE's' regulator should have the ability to set minimum capital standards—that is an issue that repeatedly comes up before us and amongst us; how we can best ensure that Fannie Mae and Freddie Mac and the 12 Federal Home Loan Banks are expanding affordable housing opportunities for low-income families. We talk a lot about the housing sector here. It is a very vital part of our economy, but, frankly, we are not doing enough to produce low-income homes in this country, and that is something that these Government enterprises should be at the forefront of trying to do. I know they have a mission and they are doing it, but I think we can do more.

Then, of course, the overarching question, the impact of any changes we make on the housing finance industry, as alluded to by Senator Bunning and others, that has to be foremost in our considerations.

Again, thank you, Mr. Chairman, for scheduling these hearings, and I appreciate your interest in this very important topic.

Thank you.

Chairman SHELBY. Thank you, Senator Reed.

Senator Bennett.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman. I simply join in thanking you for holding these hearings. They are very useful and informative. We are learning a great deal, and I am willing to get on with it.

Thank you.

Chairman SHELBY. Gentlemen, your written testimony will be made part of the record in its entirety. We will start with Mr. Korsmo, and you proceed as you wish.

STATEMENT OF JOHN T. KORSMO CHAIRMAN, FEDERAL HOUSING FINANCE BOARD

Mr. KORSMO. Good morning, and thank you, Mr. Chairman, Ranking Member Sarbanes, and distinguished Members of the Committee.

In December 2001, this Committee and the Senate honored me with confirmation to membership on the Federal Housing Finance Board, and President Bush entrusted me with the Board's chairmanship. During my confirmation hearing, both Senator Sarbanes and former Senator Gramm impressed on me—indelibly—their concern over the Finance Board's inadequate performance.

In response, I committed myself to leading the Agency to fulfill the intent of Congress in FIRREA in 1989 and the Gramm-Leach-Bliley a decade later, that is, to create a credible arm's-length regulator for the Federal Home Loan Banks. I testify today not as an apologist for the Federal Home Loan Banks and certainly not as a partisan for the Finance Board but, rather, as a safety and soundness regulator who takes his oath of office and his promise to this Committee very seriously.

In that spirit, I offer my experience at the Finance Board as you seek to establish policy for the supervision of the Nation's 14 housing-related Government Sponsored Enterprises.

The Federal Home Loan Bank Act grants the Finance Board the authority, the independence, and the executive branch voice that I believe are needed for robust supervision of Government sponsored public trusts.

Of course, not only are regulatory tools necessary, but also the willingness to use those tools. At this Committee's oversight hearing on September 9, I discussed the aggressive and disciplined agenda of improvement my colleagues and I have undertaken at the Finance Board. Today, in the interest of time, let me cite my earlier testimony and give you just a brief update on activities since that oversight hearing.

Our Office of Supervision is continuing its enhancement of bank supervision and oversight and its expansion of critical staff. The Finance Board now has more than double the number of examiners on staff when I took the oath of office in December 2001. This core of 18 staff examiners will expand to 30 by this time next year, and it is supplemented by additional financial analysts, accountants, and risk management and mortgage specialists. My prepared testimony includes a chart that summarizes the examiners' accreditations and experience, and I think you will find them impressive.

Effective oversight of GSE's also requires full transparency of the regulated entities. The day following this Committee's oversight hearing, the Finance Board unanimously adopted a proposed rule to require each of the Federal Home Loan Banks to comply with the periodic financial reporting provisions of the Securities Exchange Act of 1934. I regard SEC registration as critical to improving corporate and financial transparency, a factor of significant value to both Federal Home Loan Bank members and investors in Federal Home Loan Bank debt.

I believe the Finance Board has dramatically improved the job it does of ensuring the safety and soundness and housing mission compliance of the Federal Home Loan Banks. As I come before you today, I know of no immediate or imminent safety and soundness or liquidity imperative forcing us to do the job of recasting supervision of the housing GSE's any way but the right way—with a strong, independent regulator. We are all aware the stakes are high if gains made are diluted or lost in the course of attaining the worthy goals of GSE reform. These high stakes suggest to me the value of undertaking a complete review of all housing GSE's, their charters and missions, and their role in the capital and mortgage markets, not just for today but also for the future. Development by policymakers of a coherent national agenda clearly outlining Government and private housing finance roles and informed policy to ensure another seven decades of stability, growth, and innovation in housing finance will guarantee all parties to the debate are fully equipped to design a world-class supervisor able to evolve along with the housing GSE's and the markets of tomorrow.

A review of housing GSE charters and principles would not preclude, of course, immediate action with respect to OFHEO. OFHEO's mission could well benefit from budget independence and the granting of the full powers in use by other banking supervisors, including the Finance Board, under the Federal Home Loan Bank Act. I understand as well that Congress may decide to establish an enhanced regulatory structure for Fannie Mae and Freddie Mac that includes the Federal Home Loan Banks. If so, I would urge this Committee, of course, to equip the new regulator with the principles of strength and independence proven by the Federal Reserve, FDIC, OCC, and OTS, augmented by the proven housing GSE supervision features already in practice at the Finance Board.

But your effort must also focus on the very real differences—differences of charter, differences of ownership, differences of capital structure—that exist between the Federal Home Loan Banks on the one hand and Fannie Mae and Freddie Mac on the other and anticipate adoption of reasonable methods to accommodate those differences. This is no small task, and I respectfully ask you to proceed carefully.

As a matter of housing GSE policy, Congress and the Administration may also wish to safeguard in a consolidated regulator the potential for Federal Home Loan Banks to offer to their members products and services in competition with other housing GSE's to lower costs and increase choices for homebuyers.

Thank you, Mr. Chairman and Members of the Committee, for the opportunity to appear before you this morning. I am pleased to respond to any questions.

Chairman SHELBY. Mr. Falcon.

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

Mr. FALCON. Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for inviting me to appear before you today. I am pleased to provide my views on improvements that can and should be made to the regulatory oversight of Fannie Mae and Freddie Mac. My views are my own and are not necessarily those of the President or the Secretary of Housing and Urban Development.

When I took office as Director of OFHEO in October 1999, I quickly realized that the Agency's long-term success was jeopardized by inadequate resources, a constraining funding mechanism, and a lack of powers equal to those of other regulators. And so over the past 4 years, I have been a consistent advocate of legislation designed to address those shortcomings, and so I was encouraged by the Administration's comprehensive proposal. I am in general agreement with it, but I do have a few concerns that I hope can be properly addressed.

I would like to outline my views in the context of five guiding principles. They are: First, the regulator should remain independent; second, the regulator should be permanently funded, outside the appropriations process; three, the regulator should have powers equal to those of other safety and soundness regulators; four, the regulator should have full discretion in setting capital standards; and, five, legislation should build on progress made.

Adherence to each of these principles will strengthen supervision and the safe and sound operation of the Enterprises. Our ultimate goal and benchmark should be to establish a new regulator that is on an equal plane with the OCC and the OTS, both of which operate as independent safety and soundness regulators within the Treasury Department. I would like to elaborate on the five principles.

First, the regulator should remain independent. The concept of an independent Federal agency to oversee Fannie Mae and Freddie Mac was established in the legislative history of the 1992 Act that created OFHEO. The need for regulatory independence was born out of Congress' experience with the savings and loan crisis. I had the privilege of serving as counsel to the House Banking Committee for 8 years during that difficult period. One of the clear lessons learned was that all safety and soundness regulators should be objective, nonpartisan, and protected from political interference. This is especially critical at times when regulators must make difficult and sometimes politically unpopular decisions. In addition, independent regulation protects Congress' ability to receive the regulator's best judgment on regulatory matters unfiltered and without delay. With billions of dollars of potential taxpayer liability at stake, it is in everyone's interest that this important safeguard not be weakened.

Second, the regulator should be permanently funded, outside the appropriations process. Currently, OFHEO is funded annually through the Federal budget and appropriations process, even though the Agency does not utilize any taxpayer funds. OFHEO is funded through assessments on the Enterprises, but those assessments cannot occur until approved by an appropriations bill and at a level set by the appropriations act. OFHEO is the only safety and soundness regulator funded in this limited manner. At a minimum, this serious anomaly should be fixed.

Third, the regulator should have powers equal to those of other regulators. While OFHEO's regulatory powers are fairly comparable to those of other financial safety and soundness regulators, certain authorities need to be provided and others clarified. For example, a safety and soundness regulator should have independent litigation authority, enhanced hiring authority, and a full range of enforcement powers provided to financial regulators. Also, the laws should be revised to provide clearly that the regulator is empowered to address misconduct by institution-affiliated parties and to exercise general supervisory authorities.

Fourth, the regulator should have full discretion in setting capital standards. Capital is one of the fundamental bulwarks of effective safety and soundness regulation. The regulator should have broad discretion to exercise his or her best judgment, using all the information available through the examination process and otherwise, to determine if capital adjustments are necessary. All other safety and soundness regulators have this discretion.

Going forward, the Agency needs to have the authority to modify both minimum and risk-based capital standards. This authority would help meet the changing mix of enterprise business, the market environment in which they operate, and the changing nature of risk measurements themselves.

Fifth, legislation should build on progress we have made over the last 10 years. Regulating Fannie Mae and Freddie Mac requires a specialized skill set. The capacity to model the cashflows of all the mortgages, debt, and other financial instrument of the Enterprises needed for the stress test is unique among financial institution regulators.

Over the past 10 years, OFHEO has developed the specialized expertise, from our examiners and financial analysts, to our researchers and capital analysts, and that is necessary to supervise those two unique companies. The cost in terms of lost regulatory capacity spent while trying to rebuild that infrastructure would be substantial. That is why I recommend that, if a new regulator is established, OFHEO's personnel, regulations, and administrative infrastructure should be transferred intact to the new agency. I believe it would be highly counterproductive to do otherwise.

There are a couple of other matters I would like to briefly discuss. First, I agree with Secretary Snow that the Presidentially appointed board members should be discontinued. This is not a reflection of current or former Presidentially appointed directors. Rather, I think corporate governance would be enhanced if the shareholders were allowed to select all members of the board.

Also, I support the granting of authority to the safety and soundness regulator to determine whether the activities of the Enterprises are consistent with their charters. This would mean that a single regulator would have the ability to review all of the Enterprises' activities—new and existing. This change will consolidate the supervision of the enterprises in a manner consistent with the authorities of other regulators.

In conclusion, let me raise two other points. I would be remiss in not noting my appreciation for the interest and support of the Members of the Committee, as expressed by Senator Sarbanes, with respect to the Administration's request for an additional $7.5

million for the Agency to conduct its business. I would urge the Committee to help us get those additional funds, and they would be much needed.

Second, with regard to our ongoing investigation of Freddie Mac, I would like to inform the Committee of a recent development. Last night, OFHEO entered into a consent order with Mr. David Glenn, the former Vice Chairman, President, and Chief Operating Officer of Freddie Mac. Mr. Glenn now loses some $13 million in benefits, and under the order Mr. Glenn will cooperate fully with OFHEO, pay a civil money penalty of $125,000, and be barred from working for the Enterprises, even on a consultant basis. This is a significant development, and as you would expect, we will proceed deliberately and carefully in building a complete record of what has transpired. In addition, we will continue to take any appropriate regulatory action necessary to hold individuals accountable and bring this event to a proper resolution.

I look forward to working with the Committee on the legislative developments, and I would be happy to answer any questions you may have.

Senator BENNETT. [Presiding.] Thank you.

Dr. Holtz-Eakins.

STATEMENT OF DOUGLAS HOLTZ-EAKIN
DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. HOLTZ-EAKIN. Thank you very much, Senator Bennett, Senator Sarbanes, Members of the Committee. Thank you for the chance to be here today.

Over nearly two decades and in what amounts to nearly 15 studies and testimonies, under the direction of Congress the Congressional Budget Office has looked closely at the housing GSE's and GSE's more generally. And as Congress contemplates a restructuring of the oversight and regulation of those GSE's, I thought it would be useful to frame the discussion in the context of the broad findings of that body of research. What emerges from those studies are really three major points.

First, the sponsored status of the GSE's provides an implied guarantee which bestows upon them substantial benefits; second, these substantial benefits at the same time expose taxpayers to a risk that they will be forced to pick up the losses from the failure of a GSE in excess of those that can be accommated by private capital and, finally, an effective regulator can help to manage these risks, but not entirely eliminate them. These findings may be helpful to the Congress in thinking about the design of a new regulator.

Let me talk about each of these points in turn.

The benefit bestowed upon GSE's is that, compared to a fully private sector enterprise that has equivalent capital and takes equivalent risks, a GSE can both borrow more and borrow at a lower rate than this comparison firm. How can it do this? Well, the implied guarantee stems from the existence of several features of its setup: the line of credit at the Treasury, the exemption from SEC registration and disclosure requirements, the exemption from State and local taxes, the fact that some members of the board of directors are appointed by the President, and that Federally insured banks can hold larger amounts of GSE's' securities than private securities. These are sufficient in the eyes of market participants to overwhelm the explicit denial of such a guarantee by the GSE's.

In 2001, the Congressional Budget Office estimated that the implied subsidy to the housing GSE's during the period 1998 to 2000 was on the order of $10 to $15 billion per year, and if we were to update that today, we would guess that the current subsidy would be at the higher end of that range.

This subsidy exists despite the fact that with the evolution of private capital markets and the maturation of mortgage finance in general, it no longer appears necessary for GSE's to be present in the market in order to generate a reliable flow of money to the housing sector.

Nevertheless, the presence of this subsidy does place the taxpayer at risk. The implied guarantee means that taxpayers may be forced to assume risks for losses above the GSE's capital holdings. These risks emerge from various sources. The GSE's face credit risk from the default on mortgages, interest rate risks from changes in long-term rates, prepayment risks from the decisions of private borrowers, and operations risks in the conduct of any hedges against the previous risks, including the possibility of counterparty default in their derivative operations.

The fact that a small credit risk may be present in GSE operations should not change the overall focus on the risk faced from the composite of these different sources, and indeed the ability to assess the overall risk facing a GSE is one of the paramount features of thinking about a new regulator.

It is true that the presence of private capital in the GSE's provides some inherent incentives for monitoring and risk management, and the GSE's undertake great efforts, in fact, to manage their risks from prepayment and interest rate. However, this risk cannot be eliminated due to the private market incentives alone. As a result, it is useful to keep it within bounds so that the taxpayer does not face risks that are undesirable, and that there be a transparent statement of risks so that regulators, taxpayers, and Congress may be able to assess the risks that they face.

Importantly, there is an extent to which shareholders will want to undertake more risk. If one looks at the record from 1990 to 2000, the GSE's' average return on their equity of about 23 percent compared to 14 percent for similar private-sector financial entities. The source of this increased rate of return is the fact that they held lower capital, less than half of the capital held by comparable private sector entities. This ability to get a higher return stems directly from the ability to exploit higher risk with that lower capital. The low capital, of course, places the taxpayer in the position of dealing with the consequences should there be some financial distress at a GSE, and in turn would place Congress in the very difficult position of deciding either to walk away from a GSE or to face the consequences of a financial shock of unknown magnitude.

With that background, the design of any enhanced regulatory agency should have many objectives, and these should include the ability to limit taxpayer risk and the overall subsidy to GSE's. GSE's, Fannie and Freddie, in particular, have the ability to either hold directly mortgages which they purchase or to sell off mortgage-based securities. In holding mortgages, they undertake to incur the entire interest, prepayment, and operations risks. In selling off the mortgage-backed securities, they retain only the credit risk.

In this way, their business model allows them to determine the degree to which the taxpayer is exposed to risk, and for that reason, the regulator should have the power to limit the risk that the GSE's undertake in order to protect the taxpayer's interest.

Given the complex activities used to hedge against prepayment and interest rate risk, the regulator must have the ability to assess the quality of those hedges and the overall exposure to risk. The regulator must be able to prevent, in the worst case, a failed GSE from continuing to exploit such a subsidy by taking on more risk in an effort to return to solvency.

In addition, it would be useful for the new regulator to be able to leverage the Public Company Accounting Oversight Board and the most obvious way to do that would be to give the regulator the ability to adjust the capital requirements of the GSE's in order to place the broad oversight of private capital markets on the side of the regulator. And to make that easier for the private sector, it would be useful to increase the public disclosure of oversight findings and the transparency of the GSE's in general.

In closing, I would point out that Congress can support such a regulator in a variety of ways, not the least of which would be by setting boundaries for capital requirements that support the regulator's need to provide some insurance against the taxpayers facing unwanted risks and by forcing greater disclosure and registration requirements as a part of the ongoing oversight of the operations of the GSE's.

I thank you for the opportunity to be here today and look forward to answering your questions.

Senator BENNETT. Thank you very much.

Senator Bunning, you were the first Member of the majority here, let's start with you.

Senator BUNNING. A question for Chairman Korsmo. What issue would arise if all three GSE's were consolidated under one regulator? I know in your testimony you gave some examples, but do you foresee any others?

Mr. KORSMO. I do not think it is possible, Senator, really to overstate the importance of recognizing the differences in the way that Fannie Mae and Freddie Mac and the Federal Home Loan Banks are structured and what constitutes their membership, their capital structure, and how they do business. The cooperative nature of the 12 Federal Home Loan Banks I think is significant. It was you, Senator Bunning, who cited the small banks in your State. I am from North Dakota. The 70 members of the Federal Home Loan Bank of Des Moines from my State are extremely dependent on the liquidity options that membership in the Federal Home Loan Banks affords them.

I think that important mission, as I say, has to be recognized and protected. I also think it is incumbent upon policymakers as they look at the possibility of combining regulation to recognize the importance of the competition that exists on a minimal level, but potentially at a larger level, between the Federal Home Loan Banks and Fannie and Freddie. I think the fact that the acquired member assets programs, which are really another methodology of providing housing finance liquidity to member banks, the growth of those programs is indicative of the need for another outlet, another service, if you will, to be provided, particularly to community lenders, but lenders of all sizes who are members of the system, another outlet for liquidity sources for mortgage financing that is afforded by their membership in the banks.

I think also we want to take a very careful look at the affordable housing programs and measure the affordable housing programs at the Federal Home Loan Banks against the affordable housing goals that are now relevant for Fannie and Freddie. There are arguments in favor of both, but I think the success of the affordable housing programs, the importance that any number of Members of Congress have cited, the importance that those programs play in providing another source of affordable housing funding I think are significant. And so any review, I would hope, that would look at consolidation would take that into play.

And, finally, of course, the whole question of the operation of the Office of Finance. The Office of Finance, of course, is the vehicle through which the Federal Home Loan Banks issue debt in the debt markets. It is an odd creature. It is not incorporated. It does not have a balance sheet. It has no management responsibilities. It is, if you will, a joint venture of the 12 Federal Home Loan Banks, and I think how that would function under a combined regulator needs to be looked at carefully.

Senator BUNNING. You almost took up my entire 5 minutes with one answer.

Mr. KORSMO. Sorry, Senator.

Senator BUNNING. The last hearing that we had with Secretary Snow and Secretary Martinez, the need for financial experts to staff a new regulator for Freddie and Fannie, with the recent discoveries of losses at the banks in New York and Atlanta, there is a concern that the Finance Board may not have the resources to effectively regulate the Federal Home Loan Bank System.

How do you respond to those concerns?

Mr. KORSMO. I think certainly 18 months ago those concerns were legitimate, and I do not want to downplay what has occurred at both New York and Atlanta, although I will say that the Atlanta loss is an accounting loss, reflective of the vagaries of FAS 133. That is not to say that it is not significant.

I will say that it has been an important process for us to set up a process to attract the kind of talent that is necessary, and I would suggest that we have made dramatic improvement in that regard over the last 18 months. And I think it goes beyond the question of adding examiners, for example.

We have nine Ph.D.s in economics and finance on our staff who——

Senator BUNNING. And all of them have a different opinion.

Mr. KORSMO. Who are involved in the process of establishing risk-monitoring procedures and risk-modeling procedures. They are the ones that—supervision, I should say, is more than just examination. Part of what we have accomplished is we have actually built a supervision function at the Federal Housing Finance Board that really did not exist until 2 years ago.

And so I think we are making significant progress. Do we have a long way to go? I think the answer to that is yes, but I would hate to see any change in structure at this point lose the progress that we have made to this point.

Senator BUNNING. Thank you.

Thank you, Mr. Chairman.

Senator BENNETT. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Let me follow up Senator Bunning's last question. The OCC has an average of 20 or so on-site examiners at each of the largest banks under its supervision. How many examiners does the Finance Board have on-site at each of the Federal Home Loan Banks?

Mr. KORSMO. Today there are no examiners on-site, sir.

Senator SARBANES. How many examiners do you have all together?

Mr. KORSMO. Today we have 18 staff examiners, three examiners who are also mortgage analyst specialists, and, of course, the supervisor of our supervision function.

Senator SARBANES. And I understand you have plans to go up to 30—is that right?—by the end of next year.

Mr. KORSMO. That is correct.

Senator SARBANES. Now, that is 30 total to examine the whole system?

Mr. KORSMO. That is correct.

Senator SARBANES. So we should compare that with the OCC having—well, I do not know the full number they have, but they have, on average, 20 resident examiners at each of the largest banks. Is that correct?

Mr. KORSMO. I cannot speak to the situation at OCC. I do not know. Or OTS, I do not know.

Senator SARBANES. Well, what is your view of that situation?

Mr. KORSMO. Needless to say, I am concerned about it, and that is why we have made, as I was mentioning to Senator Bunning in response to his question, fairly dramatic improvements from where we were when I arrived. And I have to thank my board colleagues for their support in this effort.

When I got there, we had eight bank examiners on staff, eight very good examiners, but eight who had an impossible task of overseeing, as you so correctly point out, 12 very large financial institutions with, at the time, assets in excess of $700 billion, capital of $30 billion, debt in excess of $650 billion.

What we have put in place starting with the process of hiring a professional director of our Office of Supervision and a professional, experienced assistant director of our Office of Supervision is a very deliberate, a very disciplined, and a very orderly process to upgrade not only our examination function but also really to create an off-site supervisory function.

Is the progress enough? Have we moved fast enough? That is a question, you know, I have to leave to others to decide. But I can tell you that the progress is dramatic. It is not where we want to be by any stretch of the imagination, but the movement is in the right direction.

Senator SARBANES. Where do you want to be? What is your goal?

Mr. KORSMO. Our goal is—and part of the difficulty of moving any faster, sir, is the simple process of bringing qualified people on board and, frankly, attracting them. We are now at the point where we now have as many as 250 applicants for qualified exam positions. But we can only move so fast.

Senator SARBANES. How many examiners do you think you need? First of all, I take it it is your view that you do not know have enough examiners to do the job.

Mr. KORSMO. Let me answer that question this way: I think we are doing a very effective job of oversight of the banks. Am I saying that we have enough? Clearly not. We have already budgeted, for 2004, to have more.

Senator SARBANES. All right. Well, how many do you think you need in order to do the job?

Mr. KORSMO. Again, I think that is a question I cannot answer. Certainly our Director of Supervision——

Senator SARBANES. Well, you are the head of——

Mr. KORSMO. —has suggested that 30 is what we can reasonably expect to have on board and coordinate a new supervisory function between now and the end of next year.

Senator SARBANES. Well, now, if you get the 30——

Mr. KORSMO. Will we be done? No.

Senator SARBANES. —is that where you want to be? I mean, how many—you are the Chairman of this Board.

Senator BENNETT. If there were no budgetary constrictions and you could have whatever you want, what number would you give us?

Senator SARBANES. Yes, how many do you need to do the job?

Mr. KORSMO. I appreciate the question, but understand, budgetary restrictions are not the only constraint. One of the constraints is doing this in a disciplined and orderly fashion. Moving from a supervisory program that was nonexistent to one that exists today has been serious progress. I do not know the answer to how many. I would suggest 50 or 60 is probably appropriate, and that is the goal that we have set long term.

The problem is, of course, we cannot——

Senator SARBANES. So you have set a long-term goal?

Mr. KORSMO. That is correct, sir, yes.

Senator SARBANES. Well, I wish we had gotten to that sooner. [Laughter.]

What is that long-term goal?

Mr. KORSMO. Fifty or 60.

Senator SARBANES. Well, my time is about up. I do want to ask a couple of questions to Mr. Falcon before the red light goes on.

Senator BENNETT. Proceed.

Senator SARBANES. In light of OFHEO's consent order with David Glenn, which you announced this morning, when do you expect a report on Freddie Mac to be completed?

Mr. FALCON. We are going to take at least a couple of weeks, Senator, to assess the information that he will provide to us and determine how much additional investigation will be warranted by the information he gives us.

At the end of the 2-week period, I would like to come back to you, if I may, and tell you based on what we have learned how much additional time we think it will take based on the additional investigative work.

Senator SARBANES. Do you have adequate resources to complete the report as you would like?

Mr. FALCON. Not currently, however, once we get the supplemental funds, I hope that will suffice. But if it does not, I will certainly let you know as soon as we understand that.

Senator SARBANES. So your target date now for doing the report is when? Because, earlier, it was by now, as I recall.

Mr. FALCON. Yes, and we were planning to release the report by the end of the month, but given the fact that we will have new information available to us from the second ranking individual in the company, I would not want to produce an incomplete report. I would rather, if you would allow us additional time, take that new information into consideration.

Senator SARBANES. All right. Thank you.

Senator BENNETT. Thank you.

Senator Hagel.

Senator HAGEL. Thank you.

Mr. Falcon, in your testimony, you said, "I also support the granting of authority to the safety and soundness regulator to determine whether the activities of an enterprise are consistent with its charter authority." Would you develop that a little more fully? I note that you do talk further about it in your testimony, but why do you think that is so important?

Mr. FALCON. I think it is important to establish as a benchmark that any new safety and soundness regulator should have, if one is established, the same authorities as every other safety and soundness regulator. And every other regulator does have the authority to opine on what activities are permissible under the terms of the charter. And certainly as the regulator with the enforcement powers over the two enterprises, I think consistent with that standard, we should have the authority to opine on what is and is not permissible under the terms of the charter.

Senator HAGEL. Obviously, to keep them within the mission, the charter of that mission.

Mr. FALCON. Yes, Senator.

Senator HAGEL. Do you think the two GSE's that you regulate have drifted from that charter, that mission?

Mr. FALCON. What I think has happened is increasingly there is a gray area. The terms of the charters are very ambiguous, and there is not a black and white line in the charters as to what they can and cannot do. But certainly as the marketplace evolves and changes and technology advances, certainly the gray area expands and the Enterprises will continue to test the gray area.

Senator HAGEL. So that is one of the reasons that you think this should be clearly defined, at least in the regulator's eyes, and within the empowerment of that regulator so it all connects?

Mr. FALCON. I think it is to everyone's benefit that there not be uncertainty as to what is or is not permissible, including for the two companies. And if there was a regulator with the authority to clearly state that this is or is not permissible, you would not have any cloud hanging over the activities of the companies.

Senator HAGEL. There would be no question.

Mr. FALCON. Right.

Senator HAGEL. Do you think, as we rewrite a new regulatory reform document, that we should be clear and more definitive?

Mr. FALCON. I think that would be preferable.

Senator HAGEL. But still give the new regulator the enforcement powers over both—safety and soundness, and mission?

Mr. FALCON. Yes.

Senator HAGEL. And more clearly define the mission.

Mr. FALCON. Yes.

Senator HAGEL. Thank you.

Mr. Holtz-Eakin, thank you for your contributions. I was interested in some comments you made about the housing market, and it leads me to this question: Do you think there is a continued need for GSE's?

Mr. HOLTZ-EAKIN. I think that if one looks at the various objectives of GSE's, one is to ensure a reliable flow of financial funds to the housing sector. There is a good reason to believe that in large integrated capital markets these flows would occur in the absence of GSE's, and indeed, there is some evidence in that private sector firms that have undertaken to provide capital market financing for those mortgages not covered by the GSE's and other firms that have securitized different kinds of loans, such as credit cards or commercial mortgages. So there is a considerable amount of evidence that these activities—the provision of funds and the disbursement of risk among capital market participants—can be undertaken by other entities as well.

Senator HAGEL. Do you think then that the markets have or are going to outgrow GSE's?

Mr. HOLTZ-EAKIN. I think there is every reason to believe the private capital markets can funnel these funds to the housing sector, and there is also some evidence in the research community that the private market is equal or in some cases ahead of the GSE's in providing funds to low-income borrowers. On those two fronts, there has been a maturation of private-sector capital markets that has in many ways caught up to the GSE's.

Senator HAGEL. Thank you.

My light is about ready to turn red, and I wanted to ask you a question, Mr. Korsmo. You, in your testimony, suggested to some extent that you look at Federal Home Loan Banks as maybe a competitor, some competition to the other two GSE's, more choice, lower rates, and so on. Could you define that a little bit more clearly, what you meant by that?

Mr. KORSMO. As I alluded to, the acquired member asset programs, MPF and MPP, do provide albeit a small competitor at this point to Fannie and Freddie, they do provide competition, competition that I think has become recognized in some of the comments you probably heard Fannie and Freddie make about the desirability of banks being in that line of business, although I would argue it is the same line of business as advances.

I think having another outlet, another vehicle for providing mortgage funding to lenders, particularly small lenders, particularly rural lenders, but also members of the Federal Home Loan Banks in general does provide a competitive edge that leads to lower costs, presumably over time, at the very least, for homebuyers.

Senator HAGEL. Thank you.

Mr. Chairman, thank you.

Senator BENNETT. Thank you.

Senator Reed.

Senator REED. Thank you, Mr. Chairman.

Mr. Falcon, the current minimum capital standard is 2.5 percent for these GSE's. Is that too high or too low?

Mr. FALCON. I believe it is adequate for the time being.

Senator REED. And the proposal is to allow the regulator set both the minimum capital and the risk-based capital. What are the advantages that you see for that, or disadvantages?

Mr. FALCON. I think it would be an advantage to give the regulator the discretion to adjust both capital levels, if the regulator determined in its best judgment it was appropriate. There are two different types of standards. The risk-based capital standard is one that tries to quantify measurable risk through the use of models, through the use of historical analysis of performance of assets and liabilities. And that is all fed into a stress test which produces cashflows and determines what is the appropriate capital level.

But nothing is ever fail-safe. That is why you also need a minimum capital standard to ensure that, at a minimum, they will always maintain a certain amount of capital. And so the two capital standards interact in that manner.

If given the changes in the marketplace, the changes in the companies' risk profile, it is in the regulator's judgment that either standard needs to be adjusted upward, I believe it would be important for the regulator to have that discretion and to be able to exercise that discretion in a timely manner.

Senator REED. Why wouldn't it be sufficient simply to have the discretion to adjust risk-based capital since the most critical change is a result of business practices of the firm that drives the risk-based capital? That is something I think you alluded to in your response.

Mr. FALCON. Right. Well, as I said, I think since risk-based tries to capture quantifiable risk, I do not think it is ever possible to capture them perfectly, and so you always have to rely on at least a flat leverage type ratio as a fail-safe in the event that anything was not fully captured in a stress test.

Senator REED. Typically, risk-based capital is higher than minimum capital.

Mr. FALCON. Not currently, sir.

Senator REED. Not currently?

Mr. FALCON. Yes, Senator.

Senator REED. So, you are saying risk-based capital is lower than minimum capital?

Mr. FALCON. Yes, sir.

Senator REED. And, again, I guess if you adjusted risk-based capital up, you would effectively in this case compensate for the perceived lack of capital. You would just raise it above the minimum level, which you could do. Is that correct?

Mr. FALCON. Yes.

Senator REED. While you have been Director of OFHEO, has HUD ever approved or declined to approve a new program or product that you believed would undermine the safety and soundness of one of your regulated entities?

Mr. FALCON. Not that I am aware of, sir.

Senator REED. Do you see the difficulty there, where there could be a possibility of programmatic approval of something that would be unsafe or unsound? Wouldn't you object and wouldn't your objections—even though you technically do not have the authority, but your objections would be heard?

Mr. FALCON. Well, I think they would be taken into account. Our role still would continue to be to make sure there was adequate capital held against the activity. So if we thought something was an extraordinary risk, even if it was consistent with the charters, we would make sure that there was adequate capital to set aside against the potential risk of loss of the activity.

Senator REED. Just a general question, and, Mr. Korsmo, you might respond to it also. There has been some discussion of having one regulator for both Fannie and Freddie and for the Federal Home Loan Banks. I know you have alluded to this and commented on it. Once again your thoughts, and then, Mr. Falcon, if you could comment.

Mr. KORSMO. I certainly think there is the potential for advantages, and I will leave to the policymakers the decision as to whether or not those advantages outweigh the disadvantages. My only admonition along those lines is the one I made in my opening statement, and that is to remain cognizant of the very real differences that exist between the Federal Home Loan Banks and Fannie and Freddie in terms of charter and capital structure and membership structure. So long as those are recognized, the decision may be easier.

Senator REED. Mr. Falcon.

Mr. FALCON. I think as the Federal Home Loan Banks develop into more of a competitor of the enterprises, I think it would be a benefit to the regulator of each entity to be able to fully understand the operations and activities of each. The real question is to what extent you have any uniformity of regulatory policies as expressed in the regulations or guidances, and whether or not you require— or have an uniformity as those policies apply to each entity. I think that is the more difficult question.

Senator REED. Thank you.

Senator BENNETT. Thank you.

I would like to follow along on the comments that were made in response to Senator Hagel. Mr. Holtz-Eakin, you are suggesting the market would fill in for the GSE's if the GSE's were to disappear.

Mr. HOLTZ-EAKIN. I believe that there is a lot of evidence that the private markets can manage the finance of the U.S. housing sector, and at present the presence of an uneven playing field with taxpayers assuming a credit enhancement for the GSE's makes it impossible to observe them filling in, but in the absence of that there is good reason to believe they would.

Senator BENNETT. What would be the effect on cost? Would the price of mortgages go up if the GSE's were to disappear? You outline in your testimony or the GAO that the GSE's can borrow at lower rates of interest, and presumably that would go away. Would that not reflect in the higher cost in the housing market?

Mr. HOLTZ-EAKIN. The research we have done to date suggests that of the subsidy provided by taxpayers, about 25 basis points shows up in the form of lower rates to borrowers, the remainder is retained by the GSE's. Given our most recent estimates, there would be about a 25-basis-point impact on mortgage interest rates.

Senator BENNETT. Let me be sure I understand what you are saying. Would the mortgage rates go up by 25 basis points if the GSE's were to disappear?

Mr. HOLTZ-EAKIN. With no other changes in the market, the elimination of the implicit guarantee would raise mortgage interest rates by 25 basis points.

Senator BENNETT. Is that not a social good that the Congress decides is worth the implied guarantee, to have lower-cost housing, particularly for the low-income Americans?

Mr. HOLTZ-EAKIN. It is clearly only one element of the overall benefit cost test: Whether the cost of having taxpayers assume more risk is outweighed by the benefits of this, particularly for low-income individuals. The research suggests that 25 basis points alone would not move substantial numbers of low-income borrowers into homes, that a larger movement in interest rates, of around 2 percentage points, is needed to really have a substantial impact on homeownership rates among lower-income individuals.

Senator BENNETT. So you are saying 25 basis points is basically trivial.

Mr. HOLTZ-EAKIN. Trivial is in the eye of the beholder, but those are the magnitudes that we estimate would happen and the magnitudes the research community suggests are important.

Senator BENNETT. Thank you.

Now, following along the lines that Senator Reed raised, in our previous hearing and in post mortems of the previous hearing, it strikes me that one of the sticking points here is the question of the role of the regulator, assuming a new regulator is established within the Treasury, the role of the regulator and the role of HUD. I think that was the issue that Senator Reed's comments were getting toward.

Mr. Falcon, you have said you as the existing regulator have never seen HUD do anything that would in fact affect safety and soundness. The GSE's prefer to deal with HUD because they prefer the devil they know to the devil they do not know. They worked out an accommodation with HUD whereby new products are approved relatively rapidly, and their fear, as I understand it, is that a new regulator would ultimately end up approving the same new products, but do so in a manner that would take enough time, create some bureaucratic arterial sclerosis, that it never moves, and ultimately therefore there would be a delay in getting new products to the market.

Could you comment on that whole thing? I imagine you have given it some thought, and you are the only one who has had some practical experience with the dichotomy between HUD's role and a regulator's role.

Mr. FALCON. The way things are set up now, Senator, is with HUD as the mission regulator, and us as the safety and soundness regulator, we are also tasked for enforcing, as the enforcement arm for the Enterprises, even in most matters related to mission regulation. If HUD thought there was an issue, an activity that the Enterprises could not engage in and an enforcement action was necessary, it would be up to OFHEO to take the enforcement action.

As the safety and soundness regulator and responsibility for assuring that the Enterprises are in compliance with all of the laws and regulations that apply to them, we have to make sure that we understand what is going on in the area of their activities, and if we saw that there was a clear violation of a law, including their charters, we would step in and advise the company that it was not permissible. We have done that before.

But where they operate in the vast gray area, we defer to HUD on what is permissible and what is not. What I am suggesting is that we just take it a step further and give the safety and soundness regulator the authority to also opine in this gray area. There are different ways to do this to make sure that HUD continues to have a role when the activity involves some affordable housing or low-income housing program. I think something could definitely be structured there. But I think it is just a matter of making sure that the regulator—we do not prefer that the agency is operating under a cloud and leave themselves open to a potential legal challenge, that it be clear what they can and cannot do.

That is why I think it is the interest of the safety and soundness regulator to have this type of authority as all the others do.

Senator BENNETT. Senator Corzine.

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Chairman Bennett, and welcome to the panel. I apologize for not being here. I had another obligation.

Just a quick question to Director Holtz-Eakin. This 25 basis points has to be an average, cannot possibly be every single element. I think that is what Senator Bennett was talking about. It is a range of benefits to different mortgage takers. I would presume that since there are credit spreads in the mortgage market, in the mortgage lending market, that some people, while they may be spending a lot more than they would otherwise be, it is still going to be a lower spread than otherwise. I presume it is an average.

Mr. HOLTZ-EAKIN. There is certainly a spread, and this is an average result from our study.

Senator CORZINE. So that different elements of the market may benefit more than 25 basis points. Folks accessing with less quality credit or at least credit histories than other people, and therefore some of that might be more important for certain segments of the market than it would be others. It would not just be a standard 25 basis points.

Mr. HOLTZ-EAKIN. There will certainly be a spread, and what we will look at is those mortgages that qualify under Fannie's and Freddie's requirements.

Senator CORZINE. As you probably can recognize that sometimes the spread gets so much that supply and demand would actually allocate out some money at the long end of the widening of the spread, 200 basis points or 400 basis points for some element. It gets to a point where it is prohibitive or the market rate just gets to a marginal rate somebody cannot afford. I presume that at some level that occurs because of this.

Mr. HOLTZ-EAKIN. As an economist, I would never dispute the fact that some people get priced out of markets. I take that point. The degree to which that is an empirical phenomenon is not something we investigated.

Senator CORZINE. I think that when we are talking a about 25 basis point, I think I do not know what the outstanding mortgage lending money is, but on an average basis, on an annual basis, time discounted value over a period of time, that is actually a pretty substantial benefit to consumers, and since it would be different for different segments I still think it is a quite substantial benefit for mortgage production and homeownership which I think is one of the core cases of what we would be arguing, why GSE's have a reason to exist.

Mr. HOLTZ-EAKIN. In terms of the magnitudes, our estimate at the time was $10 to $15 billion a year in subsidy, of which something on the order of half to two-thirds shows up in the form of lower mortgage interest rates. So that is a way to divide up the degree to which the subsidy benefits consumers.

Senator CORZINE. It goes to the core of whether policymakers think that is an appropriate way to generate these kinds of issues enough.

Mr. HOLTZ-EAKIN. Absolutely.

Senator CORZINE. I have a question, Mr. Korsmo. I know these things could take months. What is the capital standards that the Federal Home Loan Banks have? We talked about minimum standards and there are risk-based standards, but what do they look like at the Federal Home Loan Banks? Maybe you answered that in your testimony.

Mr. KORSMO. Let me answer that question a couple of ways. Obviously, there is a statutory minimum of 4 percent that is included in the statute, a minimum leverage requirement that is based on the definition of capital that Congress has provided that goes to 5 percent. There is also a risk-based capital element that is established by regulation, as Mr. Falcon alluded to earlier with the case with Fannie and Freddie. The risk-based capital level that is provided by the regulatory definitions is below the statutory minimum, and so all the banks are operating under that 4 percent statutory minimum.

There is a variety of course among the 12 institutions—I should say there is a variety of levels of capital among the variety of—among the 12 institutions I think they range from a low of about 4.2 percent maybe to a high in excess of 5.5. I know the Chicago Bank just announced their new level is approximately 5.15 percent. I can talk a little bit about what is included in the risk-based capital reg if that is——

Senator CORZINE. But it has not really bitten.

Mr. KORSMO. No, it has not really bitten, that is correct.

Senator CORZINE. Have you looked at the nature of your risk-based capital standards relative to what OFHEO has developed with regard to the GSE's?

Mr. KORSMO. I have not. There is a comparison of course. The standards are different and the factors that go into the standard are different. For example, our scenarios are substantially different than the scenarios under which OFHEO develops their risk-based capital standard. It is much more——

Senator CORZINE. I see the red light is on. Are those differences a function of a different mission, different purpose, or are they a function of different intellectual framework?

Mr. KORSMO. I think they are different intellectual framework, different methodology.

Senator CORZINE. If there was a consolidation, then we would want to think about how——

Mr. KORSMO. They would have to be reconciled, yes, sir.

Senator BENNETT. Thank you, Senator.

Senator Allard.

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, I would like to inquire about the Federal Housing Finance Board in its role as a nonappropriated agency, as you enact your own budget and assess the Banks on the cost of the operation. How important is this authority in your ability to carry out your mission?

Mr. KORSMO. I think it is significant, and I would certainly urge the policymakers to take a look at any new regulatory body or any change in the current regulatory structure to reflect the ability to generate a budget.

Senator ALLARD. So you think OFHEO or any new agency that we set up should have that capability?

Mr. KORSMO. Yes, sir, I do indeed. Obviously, there have to be some constraints. I think that the process at the Finance Board, whereby the budget is adopted by a majority vote at an open meeting provides the balance that is necessary to make sure that we are not penalizing the entities we regulate by the budget process.

Senator ALLARD. Dr. Holtz-Eakin, how do we apply accountability to a regulatory agency like this? I think back, for example, of the FDA. Before they approve drugs they go back to the industry and say, well, we are not going to approve any more applications for new drugs and we are going to slow down the process unless you work with us to increase fees on services. Is there a way that we can bring accountability into the budget process on that type of a proposal or do we already have it?

Mr. HOLTZ-EAKIN. I think accountability follows transparency on the part of both those being regulated and the regulator. So the degree to which the regulatory oversight process is transparent and made as clear as possible to all parties—the regulators, those regulated, and the Congress—will help accountability more probably than any other single factor, the observability of the actions of both parties. If I had to pick one thing, I would point to that.

Comparability across regulatory agencies is useful as well, so that in the same way that competition in private markets allows comparison shopping, having the same accounting standards and disclosure standards and being able to observe differences across——

Senator ALLARD. I would like to have both of you respond to this question. How do we know you, the regulator or regulators, have established a reasonable budget? If it does not go through the appropriation process? Any of you who would like to respond to that.

Mr. FALCON. I think what would weigh heavily on my mind is the fact that what powers you give us can also be taken away. If we abuse the authority that you would give us at OFHEO to set our own budget outside the appropriations process, and we abuse that authority by not being responsible with how we set our budgets, then you would have every opportunity to put us back in the appropriations process. But our budget process would be very transparent, and our assessments would be based on a regulation that would be set in formula, would be predictable to the companies that we regulate, and they would not be set without their input through the regulatory process.

Senator ALLARD. You imply in your comments that somehow it is always easy to get legislation through the Senate. It is not.

[Laughter.]

How is it that we have, again, I come back to accountability, and Mr. Korsmo, maybe you want to speak on that.

Mr. KORSMO. I think Dr. Holtz-Eakin is right. It is the transparency of the process that is significant, and that is why one of the things we have done in the last 2 years at the Finance Board is to adopt the budget in an open meeting. Previously, it was done by notational vote. One year it was adopted by fiat of the chairman. I think the assurance of accountability that lies at least in the structure of the current Federal Housing Finance Board, besides the obvious element of transparency is the fact that the 8,008 financial institutions who are members of one or another of the 12 Federal Home Loan Banks and who pay those assessments ultimately, I suspect you would hear from them if they thought our level of assessment was inappropriate.

Senator ALLARD. I am going to move on—my time is about ready to expire. Mr. Chairman, if I may just briefly——

Senator BENNETT. Does anyone else have an additional question they would like to ask?

Senator SARBANES. Yes, but why do you not——

Senator BENNETT. Why don't you go a little bit over time. And I have one additional question.

Senator ALLARD. Then I do not have any questions. That will take care of it for me.

So we have divided responsibility. How do we get communication channels open so regulators can communicate back and forth, and maybe if you all, Mr. Falcon and Mr. Korsmo, would talk about that a little bit.

Mr. FALCON. It does occur through regulatory agencies. Our examiners are part of an interagency examination council, where they meet regularly to discuss evolving benchmarks, evolving regulatory practices, and best practices at the different entities that we all regulate. That occurs I think at different type of program levels within the agencies. It certainly, as issues come up that are of mutual interest to myself and the chairman, we certainly discuss those with each other.

Mr. KORSMO. I think that is one limitation under which we operate that could be corrected. Our examiners do not belong to FFIEC, Federal Financial Institutions Examination Council. I think that is a shortcoming. The ability for us to participate in that process would be very important, particularly the opportunity to interact with other examiners of large financial institutions.

Senator ALLARD. So this would be to your advantage then in that respect, to be brought in with Fannie Mae and Freddie Mac with a Treasury regulator. That would give you an——

Mr. KORSMO. I think that is a larger issue, Senator. A simpler approach to it would just be to make the Federal Housing Finance Board a member of FFIEC, which it is not today.

Senator ALLARD. I see.

Thank you, Mr. Chairman.

Senator BENNETT. Thank you.

Senator Sarbanes.

Senator SARBANES. Mr. Korsmo, you have been increasing the budget, but you could set the budget at the figure that you thought was necessary in order to adequately regulate, could you not?

Mr. KORSMO. We could. Again, I will mention that in the 20 months I have been there, what we have tried to do is proceed in a deliberate, disciplined, and orderly fashion. One of the things——

Senator SARBANES. I understand that. I was prompted to ask you that question by your response to Senator Allard, saying that your member banks, you would presume, would protest if you were taking the budget up. But there is a conflict there, is there not? You are the regulator. If you do not think the budget is adequate you need to make it adequate whether they protest or not, do you not?

Mr. KORSMO. That is absolutely correct, sir, which I think you will see reflected in the budget for fiscal year 2004 where we have made a fairly dramatic increase.

Senator SARBANES. All right. I wanted to ask both you and Mr. Falcon this question. If an independent regulator were to be set up, perhaps not in the Treasury, or even in the Treasury, I mean wherever, should it be a single person regulator or a multiperson regulator, and why, or does it make any difference?

Mr. FALCON. My preference would be for a single head of the agency as opposed to a board or commission structure. I have not had experience being the chairman of the board, regulatory agency run by a board, but I can tell you from my experiences as a single head of an agency that it provides me the ability to take quick and decisive action as necessary without the need to consult with a board. It provides me to clearly set the mission of the agency. It allows me to make sure that all the policies are consistent with those as in my best judgment I think are appropriate.

Now, granted, you can have some of that with a board structure as well, but I think just as far as the ease in running the agency, the administrative functions, as well as setting policy, I much prefer a single head of an agency.

Mr. KORSMO. As Director Falcon has only had the experience of the single member or single director institution, I have only functioned with a board. There are certainly limitations inherent, and he has outlined them, in functioning with a board. The flip side of that of course is there are certain advantages I think that are inherent in having five individuals who come from different backgrounds, different perspectives, the opportunity to participate in the decisionmaking process.

If I were to construct an administrative process for the Finance Board, would I structure it precisely the way it is now? I am not sure that I would. But again, it is the only paradigm I have experienced. So, I would say it certainly works.

Senator SARBANES. Thank you.

Chairman SHELBY. [Presiding.] Thank you.

Dr. Holtz-Eakin, your testimony indicates that when the GSE's hold more mortgages in portfolio the risk faced by the GSE's may be increased. You also indicate in your written testimony that this activity has increased over time. What are some of the possible explanations for the shift in activity by the GSE's, and what can you tell us about how the GSE's have managed the risk.

Mr. HOLTZ-EAKIN. I can only speculate on the ultimate motivation for shifts in portfolios. The result is that by holding more risk there is a greater rate of return to these activities, and one would expect that to be reflected in return on equity, for example.

The degree to which that risk is managed is very hard to quantify. Net positions on hedges and derivatives are very difficult for even the best examiners to keep up with on a day-to-day basis. It is one of the challenges that would face any regulator, and for that reason, quantifying the management of that risk is hard. The bottom line is, however, they have earned higher rates of return on equity than have comparable private-sector financial institutions, and that typically is associated with greater risk.

Chairman SHELBY. To what extent is it necessary to achieve liquidity in the housing finance markets, to have the GSE's hold mortgage or MBS's in portfolio?

Mr. HOLTZ-EAKIN. I do not think that is a central part of achieving liquidity. Financial markets will price the attributes of securities, not the names on them, and the risk characteristics—the interest rate risk, the prepayment risk—have little to do with who has actually got its name on the securities.

For the Nation as a whole, there will be an outstanding stock of mortgages at any point in time, and the bearing of that risk is typically a voluntary action in private markets. The GSE's shift some to the taxpayer in a slightly different fashion.

Chairman SHELBY. Mr. Falcon, you have indicated that you believe the new safety and soundness regulator should have program approval authority. Do you believe this would inhibit the GSEs' ability to meet their mission of expanding homeownership?

Mr. FALCON. I do not think it would. The authority would not be used in a manner to inhibit their ability to fulfill this affordable housing mission. In fact, as we have performed our regulatory duties, because we have some role in charter compliance presently, where we see a clear violation we will step in and tell the Enterprise that is not permissible. And as we put our risk-based capital standard in place, we did that in a way that did not provide any disruption to the company, it was a smooth implementation. And they are meeting the standard now. I think it is more a necessity for the risk for the safety and soundness regulator to be able to ensure that the companies are in compliance with the charters and that none of their activities are under a cloud.

Chairman SHELBY. You also suggest a mechanism to ensure that the new regulator solicit and consider all views. How would such a process work in practice, just briefly?

Mr. FALCON. I think what would be beneficial is that when the agency decided that there was an activity that needed to be reviewed for purposes of charter compliance, that it should put out a notice to all interested parties that the agency is considering that activity, and ask for comment from anyone who is interested about whether or not in their view the activity is or is not permissible, and the benefits and the downsides of the activity.

Chairman SHELBY. Doctor, as you know, the minimum capital threshold of 2.5 percent that Fannie and Freddie are subject to is often compared to the 4 percent minimum capital standard that banks and thrifts must meet. Fannie and Freddie—and they have done it here—that they do not need to hold as much capital as banks and thrifts because they pursue lower-risk activities, which there is some truth to. How would you respond to this assertion? If a 2.5 percent threshold was appropriate in 1992 how should the Congress evaluate whether it remains the appropriate threshold today?

Mr. HOLTZ-EAKIN. I think there are two types of responses to that. The first is that I think the record is quite clear that the overall credit risk pursued by the GSE's is, in fact, relatively modest. However, that is only a narrow component of the overall types of risks that I outlined in my testimony. Judging the adequacy of capital standards against those other risks, which are, in fact, shared by the private sector, is probably a more fruitful way to go.

In revisiting the minimum capital requirements, it is useful to keep in mind that one part of the purpose of those capital requirements would be to ensure not just the institutions but the overall impact of those institutions on financial markets against large disruption. That is a role that regulators should have a keen eye toward and may affect the decision on capital requirements.

Chairman SHELBY. Mr. Korsmo, the Finance Board supports requiring each Federal Home Loan Bank to register with the Securities and Exchange Commission. I agree with enhancing disclosure, but I am not sure that all the appropriate issues have been addressed here. My question to you is: How does the Finance Board propose to address certain unique structural factors in the Federal Home Loan Bank System, such as joint and several liability of the system?

Mr. KORSMO. That is an excellent question, Mr. Chairman. And our view on that has been that the best way to address those questions is to have the questions resolved between the 12 potential registrants and the SEC themselves. At least 5 of the Banks have been actively engaged in those discussions. There were certainly any number of threshold issues that we recognized that the Finance Board is having to have some successful resolution in terms of their accounting practice prior to moving ahead. I think we have made sufficient progress, that the final progress needs to be made between the staff of the SEC and the staffs of the 12 potential registrants.

Chairman SHELBY. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

Let me just follow on on this joint and several concept. Do you have joint oversight of the consolidated balance sheet? Do you look at balance sheet and the risk-based capital standards? Are they applied on a consolidated basis?

Mr. KORSMO. I understand that joint and several liability only applies to consolidated obligations. I guess the short answer to your question is yes.

Senator CORZINE. So you look at the minimum capital standards and the risk-based capital standards for the overall balance sheet even though the joint and several only relates to the——

Mr. KORSMO. No, no. I am sorry.

Senator CORZINE. You look at the individual unit banks.

Mr. KORSMO. That is correct.

Senator CORZINE. I just have a question then. The main financing technique for the Banks is through the consolidated borrowing debentures. One last question that I had. Mr. Falcon, I think I used the term "mind boggling" last time when I talked about a $1.5 to $3 billion estimate, under reported earnings, and that seemingly has grown from that $1.5 to $3 to $4.5. Are there any obvious explanations on the size of what moved us out of that range, and when do we feel that a full accounting for the difference in Freddie Mac can actually be explained?

Mr. FALCON. The process is on track to be concluded sometime in mid-November, and so they will then be issuing statements, assuming everything goes as planned. That is just the magnitude of which earnings were moved into future time periods, rather than being recognized in the earlier time periods if the proper accounting rules were utilized. It is just a reflection of the cumulative impact of all the different transactions that we are engaged in to try to smooth out these earnings over time.

Senator CORZINE. Was there a standard procedure that was used that was used to move forward earnings?

Mr. FALCON. There was a wide variety of different types of transactions.

Senator CORZINE. Pardon?

Mr. FALCON. There was a wide variety of different types of transactions.

Senator CORZINE. It was not just one kind.

Mr. FALCON. Right, right.

Senator CORZINE. It was not a generic methodology.

Mr. FALCON. No.

Senator CORZINE. Thank you.

Chairman SHELBY. Senator Bennett.

Senator BENNETT. Thank you, Mr. Chairman.

Two quick questions. Simply the terminology that has been used around here. There has been reference to the taxpayer subsidy. Subsidy usually means that if it is not done, money ends up in the Treasury. Is there a suggestion that if the GSE's were eliminated there would be an extra $10 billion in the Treasury?

Mr. HOLTZ-EAKIN. The nature of the subsidy is the lower borrowing costs to the GSE's and the budgetary reflection of that is the low probability, over long periods of time, that there would be an event which would place the taxpayer at the risk of actually providing funds directly was done with the Federal Farm Credit System in the 1980's.

Senator BENNETT. But there is not a subsidy like a farm subsidy that we can quantify every year. If we were to eliminate the GSE's, presumably there would be an elimination of risk, but there would not be an immediate amount of money showing up in the Treasury if we eliminated the GSE's.

Mr. HOLTZ-EAKIN. There would not be a cashflow to the Treasury, but the situation is similar to credit reform, where we could reflect on the budget the implicit cost of that risk and take account of it in budgetary deliberations.

Senator BENNETT. Is there a budget figure for implied risk?

Mr. HOLTZ-EAKIN. Not in this area, but in other areas where guarantees are provided by the Federal Government credit reform does allow for an explicit entry in the budget for the value of that guarantee.

Senator SARBANES. Yes, but the more you talk that way, the more explicit the guarantee becomes and everyone runs around saying this is not an explicit guarantee and they are required to state it absolutely. Then everyone comes along here, it is—I mean you are sitting there at the table taking an implicit guarantee and making it explicit, are you not?

Mr. HOLTZ-EAKIN. I am not. I am not in any way advocating a particular budgetary treatment. I am trying to explain that to the extent that it is perceived to be a guarantee, it has consequences for the real provision of resources and perhaps for the Government.

Senator BENNETT. There is no cashflow subsidy.

Mr. HOLTZ-EAKIN. Not at present.

Senator BENNETT. The only other question. We talk about taxpayer risk, and I admit there is an implication of some taxpayer risk, but isn't the first line of risk the shareholders? They stand to lose everything if the GSE's fail, do they not?

Mr. HOLTZ-EAKIN. Absolutely. And the empirical question is the degree to which that line of defense is adequate. As was mentioned, I think in Mr. Falcon's opening remarks, capital is the bulwark against which you would place these risks, and the question is whether the capital is adequate.

Senator BENNETT. And if the capital is attracted to the GSE by the noncash subsidy and the risk is borne by the capital, maybe this is a good idea.

Mr. HOLTZ-EAKIN. The outcome is that the GSE's, as compared to simliarly rated private sector entities, have less capital. There is less there, and there is a higher rate of return because of this lower capital.

Senator BENNETT. Now we get into the Chairman's question about the reason there is less capital is that there is less risk because they do not issue credit cards, they stay with mortgages. And that is another philosophical argument. I simply wanted to be sure I understood the terms we are using here and when we are talking about subsidy we are not talking about a cash subsidy, we are talking about an implied subsidy, and when we are talking about risk, it is true that the risk is all held by the shareholders, and there is an implied risk for tax holders, but again, we cannot truly quantify it until we see how much of a disaster the shareholders have to absorb.

Mr. HOLTZ-EAKIN. The degree to which it can be quantified, we have taken one approach in our past studies which is to compare borrowing costs of comparable private sector entities with the GSE's. There is another approach basically called an options value approach—where by you could, in the same way, try to quantify the magnitudes involved, and if that was something of interest, we would be happy to work with you on that.

Senator BENNETT. Thank you, Mr. Chairman.

Chairman SHELBY. When we are talking about risk, the 2.5 versus the 4, have there been any studies that any of you know done showing the real risk in the marketplace there? In other words, what is the percentage of losses of Freddie and Fannie compared to an ordinary bank that is into all kinds of other risk? See, they, by statute, are limited to what they can invest in. Is that not right, Mr. Falcon?

Mr. FALCON. Yes, sir.

Chairman SHELBY. Go ahead. Do you know if there are any studies showing this, if there are risks, and then their risks?

Mr. HOLTZ-EAKIN. I think the spirit of the question is what are the outcomes that you can look at. You can look at the default rates and outcomes for comparable private-sector entities. In my testimony, I reference this. Over a 15-year period for comparably rated private sector entities, that rate is nearly 2 percent.

Chairman SHELBY. Gentlemen, we thank you for your testimony here today and participating. I apologize for having to leave and come back, but I am Chairman of a Subcommittee on Appropriations that has opened up on the floor, so I will be on the floor a lot today. Thank you.

Chairman SHELBY. We will now move to our second panel. All of your written testimony will be made part of the hearing record in its entirety, and if you would take 5 minutes apiece—I know that is compressing your time—to sum up your remarks, we would be very appreciative, and then we will get into the others.

Mr. Koch, we will start with you. First, I want to yield to Senator Sarbanes for a statement.

Senator SARBANES. Mr. Chairman, I join with you in welcoming the witnesses, but I particularly want to welcome Iona Harrison, who is here on behalf of the National Association of REALTORS®. Ms. Harrison is from Upper Marlboro, Maryland in nearby Prince George's County. She has long been active in her community there. She has played an important leadership role with the realtors, both in the Maryland chapter and nationally, and we are very pleased she is here today, and I am looking forward to her testimony. Thank you.

Chairman SHELBY. Thank you.

Mr. Koch.

STATEMENT OF JOHN D. KOCH
EXECUTIVE VICE PRESIDENT AND CHIEF LENDING OFFICER
CHARTER ONE BANK, NA, CLEVELAND, OHIO
ON BEHALF OF
AMERICA'S COMMUNITY BANKERS

Mr. KOCH. Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, I am John Koch, Executive Vice President and Chief Credit and Lending Officer for Charter One Bank in Cleveland, Ohio. I am also Chairman of America's Community Bankers GSE Policy Committee and a member of ACB's board.

Many of our members are specialists in mortgage lending and actively involved in the secondary market. Therefore, we appreciate this opportunity to provide our comments to the Committee.

ACB has intense interest in GSE regulatory reform for several reasons. We strongly support efforts to improve regulation of all the housing GSE's including the Federal Home Loan Banks to better ensure safety and soundness. We strongly support the secondary market role of Fannie Mae and Freddie Mac and their important housing mission. We particularly note their contribution to our underserved communities, which has been most substantial, but we further note that significant disparities still sadly exist in homeownership rates for low- and moderate-income households in this country.

Our members are also substantial stockholders and borrowers in the Federal Home Loan Bank System. For example, my own institution has active relationships with all these entities. Charter One Bank services over $15 billion in home mortgages for Fannie Mae and Freddie Mac. Our Federal Home Loan Bank advances total nearly $10 billion. Our investment in the Federal Home Loan Bank System totals $700 million, which is our largest investment by far. So the safety and soundness of the Federal Home Loan Bank System is of paramount interest to us and to the members and to our bankers members across the United States.

ACB recognizes that the legislative situation we face is very fluid. During the House Committee's consideration of this issue, we supported shifting regulation of Fannie Mae and Freddie Mac to a fully funded independent regulator within the Treasury. We also support an amendment to include the Federal Home Loan Banks in that agency. We continue to support both of these concepts and strongly urge you to consider including them in your legislation. It is essential that this new agency be independent. My written testimony details the key elements of independence that are currently provided to other financial regulators at this point in time. If the Treasury can not accept an independent agency within the Department, ACB would consider and support a stand-alone agency.

Regardless of location, however, the new agency must also be able to fund itself without going through the annual appropriations process. It must have sufficient resources to get its job done. ACB strongly endorses the Administration's position that the new agency have the authority to review both current and future programs of Fannie Mae and Freddie Mac.

For over a decade, HUD has not exercised its current program approval authority. As a result, Fannie Mae and Freddie Mac have engaged in or attempted to engage in activities inconsistent with their secondary market responsibilities. Most importantly, these activities further raise the risk profile of these institutions. New initiatives such as acquisition and development lending underscore this point, that the review process and the authority needs to be shifted into one regulator. This process after all is good enough for all the banks of this country throughout the entire banking system.

ACB strongly agrees with the Administration's position that there should be no limit to the new agency's ability to adjust capital requirements for Fannie Mae and Freddie Mac. Let me be clear that we are not proposing that capital requirements be increased at this time, but capital is the foundation for the safety and soundness of our financial system, and must remain a flexible regulatory tool. Without capital authority the new regulator's power is gutted.

While supporting the regulator for the housing GSE's, the new agency should administer the unique statutory arrangements that apply to each. The Federal Home Loan Banks are cooperatives, not public companies, and pose different regulatory issues. While acknowledging key differences, we note that the Federal Home Loan Banks, Fannie Mae, and Freddie Mac are all engaged in extensive interest rate management. A combined agency would be better able to supervise these risks. Concentrating all the expertise in one agency would provide good regulatory leverage for analysis of hedging risks, for example, investment concentrations, et cetera. This would be more efficient Government.

I wish to again express ACB's appreciation for the invitation to testify to these important issues. We certainly support the Committee's efforts to strengthen the regulation of Fannie Mae, Freddie Mac, and Federal Home Loan Banks. We look forward to working with you as you craft legislation to accomplish this goal.

Chairman SHELBY. Thank you.

Mr. Torpey.

STATEMENT OF DALE J. TORPEY
PRESIDENT AND CEO
FEDERATION BANK, WASHINGTON, IOWA
ON BEHALF OF
INDEPENDENT COMMUNITY BANKERS OF AMERICA

Mr. TORPEY. Chairman Shelby, Ranking Member Sarbanes and Senate Banking Committee Members, I appreciate this opportunity to present ICBA's views on proposals for improving housing GSE regulation. This is a matter of critical importance to community banking.

I am Dale Torpey, President and CEO of Federation Bank in Washington, Iowa. I serve as Chairman of the ICBA's Lending Committee. I also chair the board of directors of the Federal Home Loan Bank of Des Moines. But my testimony today is delivered exclusively on ICBA's behalf.

As a general principle, we do not believe the Treasury should direct the housing policy, just as it should not run the monetary policy of our Nation. In our view should Treasury be granted oversight of either Fannie Mae, Freddie Mac, or all three of the housing GSE's, its tax and fiscal policy responsibilities would likely present clear conflicts of interest with housing policy.

We also share concerns expressed by others regarding the historical absence of housing policy expertise at Treasury. Since the Gramm-Leach-Bliley Act of 1999 widened membership in the Federal Home Loan Bank System and expanded the categories of eligible collateral for Federal Home Loan Banks' advances, thousands of community banks use advances as a competitive and flexible funding tool. Our ability to continue to use this increasingly important funding source is crucial to safe and sound asset liability management and to provide lendable funds for our communities. Similarly, the fact that Federal Deposit Insurance coverage levels have not increased since 1980 has given communities banks further incentive to turn to FHLB advances as a stable alternative funding source.

ICBA continues to believe that Federal Home Loan Banks should be regulated by a separate and independent agency, a status the existing Federal Housing Finance Board already enjoys. Under FHFB's regulatory's guidance, the FHLB's have a near impeccable record of providing well collateralized advances to thousands of institutions. The FHFB has and continues to take important steps to upgrade its examination and supervision capacities. ICBA has long supported independent financial regulatory agencies such as the Federal Reserve, FDIC, and the SEC.

Earlier this month the ICBA Board of Directors discussed FHLB regulation at length. Our board voted unanimously to oppose, including the FHLB's, in any new proposed new Fannie/Freddie regulatory structure in Treasury. Our board did not discuss the concept of a new independent regulatory structure outside Treasury for Fannie/Freddie and the FHLB's, a concept voiced by some in recent days.

While not our first preference, ICBA may not oppose the concept of a new independent regulator for all three housing GSE's outside Treasury depending on how the details flesh out. First, the specific regulatory powers of such an agency would have to be determined. We note that the FHFB and OFHEO do not currently have the same powers. Second, the unique ownership, operational, and capital structure and mission of the FHLB's would have to be recognized and preserved. Community banks are significant direct and indirect users of Fannie/Freddie conduits into the secondary mortgage market, and the sale of mortgages originated by community banks into the secondary market increases our liquidity and in turn allows us to make more loans in our communities.

The current system has enabled us to reach record homeownership levels and to accommodate consumer refinancing needs in the recent low interest rate environment. We must be careful not to jeopardize this success.

Regarding proposals to bring Fannie/Freddie regulation under Treasury, the ICBA reiterates its staunchly held view that any such entity must be politically independent in order to be a world class financial regulator.

We strongly urge Congress to ensure that any potential legislation contain appropriate firewalls and independence between Fannie, Freddie, and Treasury's politically appointed policymakers.

In closing, the ICBA urges the Committee to carefully and fully consider the issues associated with housing GSE regulation before rushing to action. There is no shortage of opinions and strongly held viewpoints on these issues. We concur with the sentiments expressed by a number of Committee Members that it is imperative that any regulatory structuring be done right, given its potential impact on our crucial housing sector and on community banks' continued ability to meet the lending needs of Main Street America.

I thank you for the opportunity today to testify, and I would be pleased to answer any questions.

Chairman SHELBY. Thank you.

Mr. Fishbein.

STATEMENT OF ALLEN J. FISHBEIN DIRECTOR FOR HOUSING AND CREDIT POLICY CONSUMER FEDERATION OF AMERICA ON BEHALF OF CONSUMER FEDERATION OF AMERICA, NATIONAL ASSOCIATION OF CONSUMER ADVOCATES, NATIONAL COMMUNITY REINVESTMENT COALITION, NATIONAL CONGRESS FOR COMMUNITY ECONOMIC DEVELOPMENT AND NATIONAL FAIR HOUSING ALLIANCE

Mr. FISHBEIN. Thank you, Mr. Chairman, Senator Sarbanes, and Members of the Committee. My name is Allen Fishbein, and I am Director of Housing and Credit Policy for the Consumer Federation of America, and we appreciate the opportunity to testify on proposals for improving the regulation of housing Government Sponsored Enterprises.

My opening statement today is also on behalf of the following organizations: The National Association of Consumer Advocates, the National Community Reinvestment Coalition, National Congress for Community Economic Development, and the National Fair Housing Alliance.

As national consumer community and civil rights organizations committed to the promotion of fair and affordable housing for all of America's citizens, we watch with considerable interest the ongoing debate about possible changes to the regulatory structure for Fannie Mae and Freddie Mac, and wanted to share a few of our observations.

We appreciate those in Congress who desire to assure the adequacy of safety and soundness and mission-related requirements for the GSE's. We also urge that Congress be very careful in tinkering with the GSE's' basic overall regulatory structure. At a minimum such changes to the regulatory structure should do no harm to the GSE's' housing mission. However, we also believe that the current debate provides an opportunity to clarify those areas of the GSE's' affordable housing mission that should be expanded. Fannie Mae and Freddie Mac have fulfilled an important part of their mission by providing affordable housing capital for low- and moderate-income and minority households, yet much remains for the GSE's to accomplish in expanding fair and affordable housing opportunities for the residents of our Nation's underserved communities, such as providing greater assistance to first-time minority and low-income homeowners, securitizing multifamily rental mortgage products. Similarly, while the GSE's have been industry leaders in adopting policies to combat a number of predatory lending practices such as their repudiation of the purchase of single-premium credit life insurance products, they have yet to address certain other egregious lending practices.

More specifically, we believe important improvements to present affordable housing goals requirement are desirable. Clearly, the establishment of these goals has served an important function, encouraging the GSE's to better serve the needs of underserved areas and low- and moderate-income households, and in fact, both Enterprises have consistently met or exceeded the goal level set for them. Nonetheless, the three statutory goals in place do not permit HUD to focus sufficient GSE attention to addressing some of the neediest segments of the mortgage market. Establishing an additional GSE home purchase goal and providing HUD with supplemental authority to set sub goals for GSE activity for particularly needs within the overall statutory goals, while not diminishing the ability of the GSE's to serve the needs of all consumers refinancing loans would enhance the overall effectiveness of this important mandate. Also, reform of the GSE's' housing goals should include provisions to expand opportunities for public input into this important area of regulation.

Our strong interest in affordable housing extends to other aspects of regulatory restructuring as well. We are particularly concerned that proposals to shift general charter oversight and new program approval authority away from HUD to the Treasury Department will detract from the regulatory focus on the GSE's' performance of their housing mission. At the same time, funding the reasonable cost of this regulation through direct assessments of the GSE's and not through the appropriations process would go a long way in strengthening oversight capacity.

We are also concerned with deliberations around two regulatory areas, capital requirements and the program approval process. First, the GSE's' capital requirement is one of the most critical and sensitive issues. We recognize that the establishment of appropriate capital requirements may at times involve tradeoffs, but we fear that unnecessary increases in capital requirements, particularly the minimum requirement, could result in a higher cost to homebuyers.

Second, in evaluating any changes to the current program or approval process, a delicate balance is required between a careful examination of whether a new GSE product serves its important public mission and the need to not overburden these organizations' innovative efforts to provide new lending opportunities in the most difficult to serve communities. While there may be a need to improve the current approval process, we urge you to proceed cautiously and resist efforts to over encumber this process.

While my testimony mainly focuses on regulatory oversight of Fannie Mae and Freddie Mac, we also offer the following comments on the regulation of the other GSE's, the Federal Home Loan Bank System. We believe the Federal Home Loan Bank system has evolved and must also have clear and specific housing goals that challenge lenders to better server underserved populations. Should Congress decide to abolish the Federal Housing Finance Board, the System's regulator, and transfer authority to another agency, we strongly prefer that mission oversight be transferred to HUD and that the Department also be provided with authority to establish new affordable housing requirements to ensure that activities undertaken by the Federal Home Loan Banks are targeted to low- and moderate-income housing and other underserved community needs.

In closing, we thank you, Mr. Chairman, and Senator Sarbanes for your work and attempting to strengthen the effectiveness of the GSE's, to serve the housing needs of America's underserved populations. We urge that you support provisions to strengthen the housing goals requirement, but also proceed with caution and resist the urge to make changes to their status or their charter that might result in fewer affordable housing opportunities.

Thank you for this opportunity to testify and I would be glad to answer any questions you have.

Chairman SHELBY. Thank you.

Mr. Couch.

STATEMENT OF ROBERT M. COUCH CHAIRMAN, MORTGAGE BANKERS ASSOCIATION

Mr. COUCH. Thank you. Chairman Shelby, Ranking Member Sarbanes, and distinguished Committee Members, thank you for inviting the Mortgage Bankers Association to speak at this important hearing.

MBA members originate loans in the primary mortgage market and then sell those loans to Fannie Mae and Freddie Mac. MBA therefore has a keen interest in maintaining the safety and soundness of our country's real estate finance system.

Fannie Mae and Freddie Mac play two important roles in the American home finance system. First, they provide market liquidity. Second, the buy affordable housing loans from lenders so that lower-income Americans and those living in underserved areas can get access to housing credit. Obviously, it is imperative to have effective oversight of the GSE's.

The Mortgage Bankers Association endorses the principles for GSE regulation laid out by Secretary Snow and Secretary Martinez before the Committee earlier this month. Further, the Mortgage Bankers support certain core principles for effective regulation of Fannie Mae and Freddie Mac. First, effective safety and soundness oversight is vital. The Treasury Department successfully regulates both national banks and Federal thrifts and has successfully demonstrated its ability to fulfill the role of a financial safety and soundness regulator. The Mortgage Bankers support establishing Treasury as the safety and soundness regulator for Fannie Mae and Freddie Mac.

Second, the GSE regulators, both within the Treasury and HUD, need to have adequate funding if they are going to live up to their important duties. The Mortgage Bankers Association urges this Committee to look at the Office of Thrift Supervision funding mechanism in drafting its legislation.

Third, the safety and soundness regulator needs flexibility in setting capital standards. MBA does not mean to imply that today's capital requirements are inappropriate or inadequate in any way. Rather, MBA believes that the regulator needs the tools to respond to changing marketplace conditions. Capital standards are a fundamental tool in this regard. A statute should not unduly tie a regulator's hands.

Fourth, a regulator needs adequate enforcement authority to correct any problems that may arise and more importantly, to deter problems in the first place. MBA believes that the banking enforcement tools have proven their effectiveness over the years and supports including such tools for the GSE regulator.

Within these four core principles, one issue stands out to MBA as fundamentally important for the mortgage industry, the safety and soundness of GSE programs and activities. The activities of Fannie Mae and Freddie Mac have ramifications throughout the American mortgage market, and indeed throughout domestic and international economies.

For these reasons all of their activities must be safe and sound, not just some. We believe that the approval of new programs and activities is fundamentally linked to financial safety and soundness. The safety and soundness regulator is in the best position to evaluate the appropriateness of new or proposed GSE programs. Congress should draw a clear line between the primary and secondary mortgage markets. In no event should the GSE's be permitted to encroach upon the mortgage origination process of use their Government-sponsored benefits to distort the competitive landscape of the primary mortgage market.

MBA also believes that it is important that the regulator not micro-manage the GSE's, and that it not unduly constrain the GSE's' ability to innovate in a timely manner to meet marketplace needs. Fannie Mae and Freddie Mac have Government sponsorship so they can assist Americans with their housing needs. Effective safety and soundness oversight ensures that the GSE's are able to meet these needs. MBA strongly supports the affordable housing goals for Fannie Mae and Freddie Mac and endorses HUD's role in setting and enforcing those goals.

MBA strongly urges Congress to reform the oversight of Fannie Mae and Freddie Mac in this manner so that they can continue their role in supporting housing, especially affordable housing.

Thank you, and I am happy to answer any questions the Committee may have.

Chairman SHELBY. Thank you.

Ms. Harrison.

STATEMENT OF IONA C. HARRISON
REALTY EXECUTIVES-MAIN STREET, U.S.A.
ON BEHALF OF
THE NATIONAL ASSOCIATION OF REALTORS®

Ms. HARRISON. Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, good afternoon. I am Iona Harrison with Realty Executives Main Street USA, a real estate brokerage firm in Upper Marlboro, Maryland. As incoming chair of the National Association of REALTORS® Public Policy Coordinating Committee, thank you for the opportunity to give NAR's views on proposals to enhance regulation of the housing GSE's.

Before I begin my statement, let me first thank you, Mr. Chairman, and Senator Allard, if he were here, for efforts on the American Dream Downpayment Act. The Senate Banking Committee unanimously approved this bill with two important amendments that increased the FHA multifamily loan limits in high cost areas and improved the FHA hybrid ARM program.

NAR leads a coalition of supporters who are hopeful that the bill will come to the Senate floor shortly. By adopting this legislation, Congress will send a strong message supporting the Administration on increasing homeownership opportunities. This bill is evidence of the importance this Congress and Administration place on homeownership opportunities. Your GSE reforms can ensure that this commitment remains a high priority in future years. To do so, NAR believes that a new safety and soundness GSE regulator must be truly independent and that program approval and housing mission must remain at HUD.

The National Association of REALTORS® supports a credible and vigorous GSE regulator. REALTORS® agree that Fannie Mae and Freddie Mac should have an independent regulator for safety and soundness. We recommend that a new regulatory agency in the Treasury Department should have necessary and sufficient firewalls to ensure its political and operating independence similar to those that currently exist for the OCC and OTS.

The Administration proposal to place GSE regulatory oversight and new program approval under the Treasury Department is a major change. REALTORS® expressed opposition to moving GSE housing mission and program approval from HUD when the Administration's plan was first released. Our concern is that housing policy has not been the purview or expertise of the Treasury Department. This has been the purview of HUD. Housing and real estate industries naturally look to HUD to address housing mission, programs and affordable housing goals. HUD should maintain its primacy in these areas.

REALTORS® recognize that new programs could have an impact on safety and soundness. Therefore, the new regulator should have a consulting role to HUD on any safety and soundness implications. Program approval must continue at HUD under current standards. Congress deemed the Government Sponsored Enterprise model as an appropriate vehicle to advance homeownership and housing policy as recently as 1992 when it adopted the Federal Housing Enterprises Financial Safety and Soundness Act. Since that time, Congress, homeowners, the housing finance system, and the Nation's economy have all benefited tremendously. The unprecedented expansion of homeownership rates is undeniable testament to the efficiency and liquidity of the secondary mortgage market and the housing sector.

Although realtors support a strong regulator, we insist that regulatory reform does not imply and should not result in any weakening of the current housing finance system. Targeted reform for GSE regulation should strengthen our housing finance system.

Mr. Chairman, in conclusion, realtors support your deliberate, thoughtful consideration of what measures should be taken to improve GSE oversight. We look forward to working with you and I will be happy to answer any questions you may have.

Chairman SHELBY. Thank you. We have a vote on the floor but I thought I would start a few questions. Senator Sarbanes and I will have to go vote, recess the Committee, and come back, because you are too important to let loose yet.

Mr. KOCH AND MR. Torpey, the minimum capital threshold that we keep talking about at 2.5 percent that Fannie and Freddie are subject to is often compared, as we know, to the 4 percent minimum capital standard that banks and thrifts must meet. Do you believe that this is a fair comparison given the riskier set of assets held by banks and thrifts?

Mr. TORPEY. I can start with that. I think given the limited assets that the GSE's have that it is probably adequate. I always say within the banks that we always want to have at least 10 percent of any entity coming in, and many times 20 to 30 percent. But on the other hand we are dealing in our area with agriculture, with small businesses, with that thing. So the risks are completely different as far as I am concerned.

Chairman SHELBY. Mr. Koch.

Mr. KOCH. I think the real issue here is what activities are they getting involved in and the need to have the minimum capital reviewed by their primary regulator. For example, Fannie Mae and Freddie Mac have secured approval to get involved in A&D lending. A&D lending is land development activity, which is highly risky, involving expertise significantly different than simply investing in one to four family owner-occupied properties, or even owner-occupied apartments. There are zoning issues, there are guarantor issues. These are high-risk investment types.

So the 2.5 percent minimum really needs to be weighed in terms of what kinds of new activities are they getting involved in. That is the real issue here. As new activities expand, and they have expanded dramatically without significant regulatory oversight, that is where the capital really becomes critical.

Chairman SHELBY. Senator Sarbanes is not going to be able to come back. He has other commitments and we have to vote, so I am going to yield to him now.

Senator SARBANES. Thank you very much, Mr. Chairman. First, I want to thank the panel. We certainly appreciate not only your oral testimony but also the careful work which has obviously gone into your written testimony. I just want to ask one question. I apologize I will not be able to return because we did not expect this vote to happen.

The Assistant Secretary of the Treasury spoke at the Heritage Foundation yesterday, which was reported—which actually affected the bond markets as I think you are aware. One of the fellow panelists, in fact the resident fellow at the American Enterprise Institute said, the only realistic answer, talking about the GSE's, is to provide more competition in the secondary market. I think the only answer is privatization.

I would just very quickly like to get a response of the members of this panel to that proposal, and the concern on the part of some that that objective is floating behind a lot of the discussion on this issue. If I could just quickly get a response.

Mr. KOCH. Very quickly, housing in the United States is the best in the world. We are the global envy on housing. Substantially changing the process in terms of privatization, we would not support at this time. We would support additional, however, efforts to assist low-income and moderate-income individuals in this country for enhanced housing opportunities.

Senator SARBANES. Mr. Torpey.

Mr. TORPEY. We would oppose that. I think Senator Bunning asked the question about the harm to small banks. If you privatize the system, you would have large banks that may have access to that, but I think the real harm here would be the harm to small community banks where we are not going to have access to the same funding that a large national bank would. And quite frankly, these small community banks are so important to these small communities that to privatize that I think would do great harm to the system.

Senator SARBANES. Mr. Fishbein.

Mr. FISHBEIN. The GSE's were established to perform a very important public mission, not the least of which is to direct increased financing to improve opportunities for affordable housing for low- and moderate-income households and underserved communities, and we think that public mission and need continues and therefore, so should the GSE's.

Senator SARBANES. Mr. Couch.

Mr. COUCH. First to your issue of competition, the Mortgage Bankers Association has a long-standing policy that more competition is good and that is why we are in support of the Federal Home Loan Banks activities in the mortgage markets. With respect to privatization, we would be opposed to privatization because, as several of the panelists, said the system right now is working well and we would like to keep it doing what it is doing so well right now.

Senator SARBANES. Ms. Harrison.

Ms. HARRISON. Again, NAR's position is to promote homeownership at every level and to continue to provide mortgage vehicles to effect that goal. The GSE's have this unique homeownership mission that we would continue to support. Quite frankly, I personally feel that private sector would not necessarily have this goal in mind since I would think making a profit would be their primary goal and underserved people would continue to be underserved.

Senator SARBANES. Thank you very much.

Thank you, Mr. Chairman.

Chairman SHELBY. We do have a vote, and because I have about four or five complicated questions, I would like, if I could, to submit those for the record, give you time, all of you, this panel, time to answer these for the Committee. Would that be agreeable to you?

With that, we are going to go vote. We do not know what is going to happen behind that. We thank you for your testimony and we look forward to the answers to these other questions. You help us immensely. Thank you a lot.

We are adjourned.

[Whereupon, at 12:16 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF JOHN T. KORSMO

CHAIRMAN, FEDERAL HOUSING FINANCE BOARD

OCTOBER 23, 2003

Good morning and thank you, Mr. Chairman, Ranking Member Sarbanes, and distinguished Members of the Committee.

In December 2001, this Committee and the Senate honored me with confirmation to membership on the Federal Housing Finance Board (Finance Board) and President Bush entrusted me with the Finance Board's chairmanship. During my confirmation hearing, both Senator Sarbanes and former Senator Gramm impressed on me—indelibly—their concern over the Finance Board's inadequate performance.

In response, I committed myself to leading the Agency to fulfill the intent of Congress in FIRREA and the Gramm-Leach-Bliley Act—that is, to create a credible arm's-length regulator for the Federal Home Loan Banks (FHLBanks). So, I testify today not as an apologist for the Banks and certainly not as a partisan for the Finance Board, but rather as a safety and soundness regulator who takes seriously his oath of office and his promise to this Committee.

In that spirit, I offer today my experience as you seek to develop policy for the supervision of the Nation's housing Government Sponsored Enterprises (GSE's).

Congress and the Administration are engaged in a worthy effort to ensure proper regulation of the GSE's, and this effort, I believe, would be well-served by seeking a broader context. That is, to craft an appropriate housing GSE regulator, policymakers should thoroughly consider what is to be regulated, both today and in the future. The first question to ask is what today's capital and mortgage markets look like, 70 years after the charters for housing GSE's were cast? What will these markets look like 10, 20, 30 years in the future? And what role or roles should Government Sponsored Enterprises play in those markets?

Answering these questions I believe will require a thorough review, necessary to set the stage for a comprehensive reform debate in Congress, with participation by the executive branch, by the housing GSE's themselves and their competitors, and by the public.

This review, of course, does not preclude immediate action with respect to the Office of Federal Housing Enterprise Oversight (OFHEO). OFHEO's mission could well benefit from budget independence and the granting of the same full powers in use by other banking supervisors, including the Finance Board under the Federal Home Loan Bank Act.

The Federal Home Loan Bank Act grants the Finance Board the authority, the independence, and the executive branch voice needed for robust supervision of Government sponsored public trusts.

Through FIRREA in 1989 and Gramm-Leach-Bliley a decade later, Congress drew on the lessons of the thrift crisis and the poorly conceived Federal Home Loan Bank Board to shape the Finance Board into a safety and soundness and mission watchdog for the Federal Home Loan Banks, granting the Finance Board all the authority and independence needed to be a world-class regulator.

The Federal Home Loan Bank Act provides:

- Enforcement authority on a par with other Federal bank regulators;
- Flexibility to tighten capital standards and risk monitoring, if needed;
- Authority to review and approve new business activities in advance;
- Authority to define and monitor affordable housing programs conducted by Federal Home Loan Banks;
- Full authority to liquidate a Bank, to establish a replacement, or to merge weakened Banks;
- The freedom to garner budget resources from the Banks and to deploy them as most needed; and
- A direct voice on the Board for the executive branch in overseeing the Federal Home Loan Banks' role in capital markets and mortgage markets.

None of these tools is found in OFHEO's statute. These tools should be considered for inclusion if Congress decides, after determining the appropriate future roles of housing GSE's, that a new regulator for some or all of the Enterprises is required.

Overview

To properly consider the effective oversight of housing GSE's, as now constituted, Congress should proceed on the basis of proposals from the Administration and several Members that seek to increase the tools available to supervise Freddie Mac and Fannie Mae.

As mentioned, the Federal Home Loan Bank Act, as amended by FIRREA and Gramm-Leach-Bliley, equips the Federal Housing Finance Board with the full set of supervisory tools required for world-class oversight. Increasingly, these powers are aggressively and ably employed by the Finance Board.

Because markets are sophisticated and place a premium on actual performance and verifiable information, I do not believe simply changing the name or status of the agency responsible for the Federal Home Loan Bank Act will result in more favorable treatment of FHLBanks by investors. I know of no study concerning Federal thrifts and national banks, for example, substantiating the premise that distinct but effective regulators affect the price of borrowing by Federal thrifts and national banks.

As this debate refocuses on substantive and difficult questions, it will be necessary to distinguish the risks inherent in the housing GSE's banking functions, the unique risks associated with housing GSE status, and the nature of possible future problems.

It is also important to recognize that remedying the known shortcomings in the 1992 GSE Act regulating Freddie Mac and Fannie Mae and/or transferring Federal Home Loan Bank Act authority to a new body will not, in and of themselves, reduce or dilute the potential risks posed by the housing GSE's to the taxpayers and the economy. The housing GSE's are banking enterprises, and banking is an inherently risky business. In the housing GSE sector, these risks and market share are highly concentrated in the two largest enterprises.

The housing GSE's have grown exponentially in size, sophistication, and inherent risk as capital and mortgage markets have revolutionized. All 14 housing GSE's now play critical roles in domestic and global capital markets and in U.S. housing markets. That growth, together with the reality of a perceived taxpayer guarantee, make it imperative that the Freddie Mac and Fannie Mae oversight statute be brought up to world-class and that Finance Board administration of the FHLBank Act complete its rapid evolution to world-class.

Unique Housing GSE Risks

For holding companies, commercial banks, thrifts, and credit unions supervised by Federal banking agencies, the institutions' boards of directors determine the markets to be served, the products to be offered, and the pace of growth or retraction.

For housing GSE's, the broad parameters of markets served, products offered, and growth are driven by Congressional charters.

These charters were framed in the 1930's and charged the FHLBanks, Fannie Mae, and later Freddie Mac with providing liquidity for lenders making long-term amortizing home mortgages. The housing GSE's were part of a set of New Deal policy innovations, including Federal Housing Administration mortgage insurance and the activities now conducted under the aegis of Ginnie Mae, which have succeeded beyond all reasonable expectations in establishing the long-term amortizing mortgage as the industry standard, creating a secondary market in these loans, and creating a securitization market based on these products.

The monopolies granted by both the FHLBank charter and the Freddie Mac and Fannie Mae charters also bear the seeds of systemic risk. Protection from broadly effective competition from other GSE's or fully private firms assists the housing GSE's in accomplishing their missions. But this benefit may also partially shield them from the harsher realities of the marketplace that tend to reward the best capitalized, best managed corporations in a given sector.

Closely associated with monopoly privileges is the taxpayer guarantee that appears to flow from the bare fact of Government sponsorship and from the tax exemptions, securities law exemptions, Treasury "line of credit," and other benefits of that sponsorship. Anecdotal but consistent and long-standing evidence indicates that the "implied guarantee" and "agency debt" status are extremely valuable attributes. This distraction from assessing the credit-worthiness of housing GSE's on wholly tangible grounds is another systemic source of risk unique to these 14 Enterprises.

Moreover, because the GSE's are expected to serve all markets through all parts of the business cycle, and more importantly, because the fundamental missions and roles have not been recalibrated as fully private firms have successfully followed the GSE's into most mortgage finance products and services, housing GSE's tend to grow without meaningful restrictions.

As housing GSE's acquire greater exposure to inherent banking risks through growth, they also are exposed to increased risk as a result of their participation in derivatives, securities, and debt markets which have become more global, more sophisticated, more innovative, and more rapidly-evolving.

These factors, weighed with the systemic risks of GSE status, argue that housing GSE risk in the future can only be significantly reduced by curtailing inefficient protections from competition and/or by recalibrating the charters so that housing GSE's actually shrink as fully private firms successfully take over some of the mortgage finance products and services now dominated by GSE's.

The safety and soundness regulators of the housing GSE's are not the appropriate bodies for designing or effecting these charter reforms. The Government Sponsored Enterprises, by definition, are charged with accomplishing public objectives through private ownership. Only the public's representatives, the Congress and the Administration, can validly assess the need for future GSE participation in housing finance and capital markets and assign the benefits and obligations consistent with that need. The Congress and Administration are also the only valid bodies for determining the amount of risk to taxpayers and the national economy appropriate to the contributions of housing GSE's.

Once the future roles of housing GSE's are assigned and the appropriate risk level is determined, it should be, as it is now, the duty of the Finance Board, OFHEO, and the Department of Housing and Urban Development (HUD), or whatever successor agencies Congress and the Administration may create, to police their governance and operations in managing inherent risks and their fidelity to housing GSE charters.

The Future of Housing GSE Supervision

Mapping the future of housing GSE oversight, properly calibrated to match the future roles and risks of the Enterprises, begins with an honest assessment of the authorities governing the operation of OFHEO and the Finance Board.

When Congress established a regulator for Freddie Mac and Fannie Mae in 1992, it did not provide OFHEO with all the tools and independence of the Office of the Comptroller of the Currency (OCC), Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), or Federal Reserve.

Even taking into account the new product and affordable housing portfolios assigned to HUD, these two housing GSE's are not supervised on fully comparable terms to Federal credit unions, national banks, Federal thrifts, bank holding companies, or, for that matter, the Federal Home Loan Banks.

The 1992 GSE Act's deficiencies in funding and in supervision and enforcement tools and flexibility should be addressed.

The Administration's proposals and some Congressional proposals largely bring to bear on Freddie Mac and Fannie Mae budget resources and supervisory tools fully comparable to those available to other Federal supervisors of financial institutions. The Administration also makes a common sense and plainly necessary proposal to give the public a role in shaping and overseeing Freddie Mac and Fannie Mae, which is similar to the executive branch participation on the Finance Board.

As outlined above, the Finance Board already is endowed with the resources, strength, independence, and supervisory scope that mark world-class safety and soundness regulators.

But until recently, the Finance Board was not fully discharging the mandates of the FHLBank Act or making full use of its independence and resources. Fortunately, these shortcomings are being rapidly and thoroughly rectified.

Today, the Finance Board has more than double the number of examiners on staff when I took the oath of office in December 2001 and my Board colleagues and I began the process of rebuilding the examination and supervision functions at the Finance Board. This corps of 18 examiners will expand to 30 by this time next year and has been supplemented by additional financial analysts, accountants, and risk management specialists.

The Finance Board is recruiting and hiring the best and brightest from other Federal banking agencies. The average Finance Board examiner has over 17 years of examination experience, and every examiner is a commissioned examiner, has a professional accreditation, or both.

Finance Board oversight has improved in every way and the opportunity to work with the members of the Federal Home Loan Bank oversight team is now becoming a prestige career move.

Attached to this prepared testimony is an appendix providing more detail on the new FHLBank supervision program being put in place and the progress made to date. The numbers provided in the appendix are impressive, but more important is the explanation of how the Finance Board has entirely revamped its approach to FHLBank supervision over the past 18 months.

Certainly, the Federal Home Loan Bank Act already provides the Finance Board with power to meet any eventuality, and we are fast approaching world-class status in the size and skills, the capacity and sophistication, of our staff and their oversight of the 12 Banks.

Mr. Chairman, you asked me to address other specific issues in my prepared testimony. Allow me to do so at this point.

Funding Process

Independent boards have advantages and disadvantages compared to both the OCC/OTS model and to a less autonomous bureau within Treasury. One strength of an independent board is that budgets set by action of the Finance Board, for example, in public meetings provide a suitable degree of accountability in resource allocation without compromising independence through Congressional or OMB review.

Capital Regime

The minimum leverage requirements and risk-based capital requirements now in force for FHLBanks appear to be appropriate. Importantly, the Federal Home Loan Bank Act permits the Finance Board to increase or tailor these standards if experience demonstrates a need.

SEC Registration

Only through conservative management and superior transparency and governance will all 14 housing GSE's maintain the highest measure of market confidence. I believe superior transparency requires that each FHLBank commit to voluntarily meet the quarterly and annual financial reporting requirements of Section 12(g) of the Securities Exchange Act of 1934, as administered and enforced by the Securities and Exchange Commission (SEC). SEC registration and disclosure will enable markets to place greater reliance on and maintain greater confidence in the balance sheets, business prospects, and corporate governance of the FHLBanks. That is why, at its September 10, 2003, meeting, the Finance Board unanimously adopted and subsequently published for comment a proposed regulation requiring FHLBank 1934 Act registration.

Office of Finance

Before closing this discussion of the possible or feared effects of housing GSE regulator reform on the funding of FHLBanks, I must alert the Committee to a question requiring considerable study before attempting any transfer of responsibility for administration of the FHLBank Act. The Act ratified the Federal Home Loan Bank Board's establishment of the Office of Finance (OF) to issue consolidated obligations (bonds and notes) on behalf of the FHLBanks. Several years ago, the Finance Board devolved authority over management of the OF to a board of directors appointed by the Finance Board. The OF has also been assigned the task of compiling and issuing combined financial reports for the 12 FHLBanks.

But OF is an unusual corporate posture. It is not incorporated and has no balance sheet and no executive control of any FHLBank. OF instead acts as an agent for the FHLBanks and is the "name and face" shown to capital markets—which are not offered obligations in the name of any specific FHLBank, but rather "System" obligations issued through OF and backed by the joint and several liability of all 12 FHLBanks.

Understanding Treasury's apparent wish to avoid providing any reenforcement of the perception of an implied taxpayer guarantee behind housing GSE debt, Treasury's views should be included in determining whether and how to shift authority over OF to Treasury.

Conclusion

Legislating the best set of tools and best structure for housing GSE supervision is an area of economic and housing policy that must be addressed.

Before again locking into statute a system of supervision for some or all housing GSE's that is not world-class, policymakers from Congress, Treasury, HUD, and all 14 housing GSE's should begin the more comprehensive charter reform debate outlined above.

That comprehensive reform debate should sort out—70 years after creation of GSE's and long-term amortizing mortgages—the most constructive role for housing GSE's in the mortgage finance marketplace of the 21st century. The questions policymakers should consider asking include:

- What is the right level of competition between housing GSE's and other mortgage financiers?
- What is the right level of competition among the housing GSE's themselves?
- What is the right level of risk to the taxpayers in proportion to the benefits the housing GSE's confer on the Nation's housing finance system?

Once a coherent national policy clearly outlining Government and private roles in the future is in place, all parties to the debate will be fully equipped to design a world-class supervisor able to evolve along with housing GSE's appropriately sized and appropriately directed to best support but not interfere with the markets of tomorrow.

I know of no immediate or imminent safety and soundness or liquidity imperative forcing us to do the job any way but the right way, and I think everyone is aware the stakes are high if the result is muddled.

I suggest, therefore, that the housing GSE reform effort move in a logical, deliberate manner to define the roles Freddie Mac, Fannie Mae, and the Federal Home Loan Banks should play in a continually innovating mortgage finance market, to define the appropriate risks to assume in the institutions fulfilling those roles, and then to determine how best to regulate the roles and risks and innovations that result.

Again, thank you for the asking me to speak to you today and for the attention this Committee gives to homeownership, housing affordability, and housing GSE issues.

APPENDIX

Testimony of John T. Korsmo,
Chairman, Federal Housing Finance Board,
Before the Senate Committee on Banking, Housing, and Urban Affairs
Washington, D.C.
October 23, 2003

Initiatives at the Federal Housing Finance Board to improve oversight of the Federal Home Loan Banks

For most of their history, the Federal Home Loan Banks were overseen by the Federal Home Loan Bank Board. That agency had a mixed mandate to help operate the Banks, to regulate the Banks' owners – federally insured thrifts – and to promote the Federal Home Loan Banks and thrifts.

Congress sorted out this puzzle with the passage of the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) in 1989. Nevertheless, in a 1998 report, the General Accounting Office (GAO) found that the Federal Housing Finance Board – nine years after its creation – remained inadequately focused on safety and soundness supervision and too closely involved in operating the Banks, and at times appeared to be a cheerleader for the Banks, rather than an arm's length regulator.

Upon becoming chairman in December 2001, Chairman Korsmo determined these problems still existed and had to be corrected for the Finance Board to effectively oversee the Federal Home Loan Banks and Office of Finance for safety and soundness and achievement of their housing finance mission. Just one example demonstrates this point: At the time of the Chairman's appointment, the Finance Board had only eight bank examiners on staff to review and supervise a dozen financial institutions with, at the time, more than $700 billion in assets, more than $30 billion in capital, and some $650 billion in outstanding debt. Yet, at the same time, the agency also had eight people in its Office of Public Affairs. The relative allocation of resources simply did not meet the agency's statutory mandates.

In addition to being understaffed, the examination function insufficiently focused on the Banks' risk assessment processes and the Banks' internal control systems. Such shortcomings had been identified in the 1998 GAO report on the Finance Board's examination program.

These circumstances called for an immediate and vigorous response, beginning with the recruitment of new leadership for the agency's Office of Supervision. Following a national search, the Finance Board brought on a new director and a new deputy director of supervision, who between them have 40 years of regulatory experience with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (FDIC).

The agency also hired an Associate Director for Examinations who oversees all our safety and soundness examiners. She has more than 15 years of bank regulatory experience with the FDIC. In addition, a newly hired Senior Advisor to the Director of Supervision to provide support to the Risk Modeling and Risk Monitoring Divisions. That Senior Advisor possesses some 30 years of bank supervision, capital markets, and capital regulation experience with the Board of Governors of the Federal Reserve System and the Office of Thrift Supervision.

Examiners represent the foundation of the Federal Housing Finance Board's oversight function. The Finance Board has increased the resources available to fortify that foundation, expanding the agency's examination staff to 18 full-time bank examiners as of October. The goal is to have 30 in place by the end of this fiscal year.

The examination staff, including the Deputy Director of the Office of Supervision, averages more than 17 years of professional experience in banking, mortgage finance, and bank examinations. All examiners are commissioned examiners or have a professional accreditation, and many have both. (See chart.)

Position	**Highest Level Education**	**Years of Experience**	**Accreditations**
Deputy Director	BS, Finance/Econ.	28	Commissioned Bank Examiner (CBE), Graduate School of Banking
Examiner/Associate Director	BS, Finance	19	CBE, Graduate School of Banking
Examiner/Portfolio Manager	MS, Finance	13	CBE, Chartered Financial Analyst (CFA)
Examiner/Portfolio Manager (Acting)	BS, Economics	9	Certified Public Account (CPA); CFA
Examiner	MBA	17	Certified Financial Institutions Examiner
Examiner	BS, Mgmt./ BA	25	Chartered Bank Auditor; ABA National Graduate Compliance School
Examiner	BA, Accounting	23	CBE; Certified Regulatory Compliance Manager
Examiner	MBA, Finance	16	CBE; Certified Risk Professional
Examiner	MBA, Accounting	17	Certified Investment and Derivative Auditor (CIDA)
Examiner	MBA, Finance	26	Federal Thrift Regulator (FTR)
Examiner	BBA, Finance	11	CBE; Graduate School of Banking; CFA Level II
Examiner	MBA	18	FTR; Certified Information Systems Auditor (CISA)
Examiner	BA	13	CBE
Examiner	BS, Finance	17	CBE; CISA
Examiner	BA, Economics	19	FTR; CFA Level I
Examiner	BS, Finance	10	CBE; CFA; Certified Financial Risk Manger; CIDA
Examiner	BA, Economics	16	Certified Financial Institutions Examiner
Examiner	BBA, Finance	13	CBE; CFA Level II

Position	Highest Level Education	Years of Experience	Accreditations
Examiner[1]	BA, Accounting and Economics	18	CPA, CFA Level II, Registered Securities Representative Series 7, 63
Examiner[2]	BA, Business	24	Commissioned National Bank Examiner (NBE), Graduate School of Banking.
Mortgage Analyst	BS, Business	6	CFA
Mortgage Analyst	MBA, Finance	25	Registered Securities Representative Series 7, 63

In addition to adding highly qualified and experienced examiners to the staff of the Federal Housing Finance Board, the agency has also made a fundamental – and necessary – change in approach in the examination function. The Finance Board is now conducting more thorough, risk-focused examinations, and communicating the results of those examinations more effectively to the Banks.

Examinations now recognize that banking – including AAA-rated, GSE banking – is a business of managing risks, and the responsibility of bank supervisors is to ensure that the institutions they regulate understand those risks and monitor and control them through prudent risk management practices.

To enhance analysis and oversight in the risk management area, two risk units have been established – a Risk Modeling Division and a Risk Monitoring Division. The Risk Modeling Division is responsible for the development of our asset/liability modeling and for monitoring the Bank's internal interest rate risk models. The Risk Monitoring Division pulls together agency data and the Banks' own financial reporting into a risk-monitoring framework.

While on-site examinations remain the primary tool of supervisors, the agency now complements exams with off-site monitoring and regular communication with the Banks. The new "Bank Analyst Program" charges a member of the Office of Supervision with following an individual Bank and reviewing monthly and quarterly financial reports for trends and changes, while also keeping abreast of issues in the financial and housing industries to determine their effect on each Bank.

The Office of General Counsel has also assigned attorneys who serve as points of contact for the examiners on issues concerning particular Banks.

In short, the Finance Board's safety and soundness oversight of the Federal Home Loan Banks has improved dramatically. More work remains to be done, but the Finance Board is a much stronger and more capable regulatory agency than it was as recently as 12 months ago.

[1] Accepted position. Starts at Finance Board in October.

[2] Accepted position. Starts at Finance Board in November.

PREPARED STATEMENT OF ARMANDO FALCON, JR.

DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

OCTOBER 23, 2003

Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee, thank you for inviting me to appear before you today. I am pleased to provide my views on improvements that can and should be made to the regulatory oversight of Fannie Mae and Freddie Mac. My views are my own and are not necessarily those of the President or the Secretary of Housing and Urban Development.

When I took office as Director of the Office of Federal Housing Enterprise Oversight (OFHEO) in October 1999, I quickly realized that the Agency's long-term success was jeopardized by inadequate resources, a constraining funding mechanism, and a lack of powers equal to those of other regulators. Over the past 4 years, I have been a consistent advocate of legislation designed to address those shortcomings, and so I was encouraged by the Administration's comprehensive proposal.

I am in general agreement with it, but I do have a few concerns that I hope can be properly addressed.

Guiding Principles

I would like to outline my views in the context of five guiding principles. They are:

- The regulator should remain independent;
- The regulator should be permanently funded, outside the appropriations process;
- The regulator should have powers equal to those of other safety and soundness regulators;
- The regulator should have full discretion in setting capital standards; and
- Legislation should build on progress made.

Adherence to each of these principles will strengthen supervision and the safe and sound operation of the Enterprises. Our ultimate goal and benchmark should be to establish a new regulator that is on an equal plane with the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS), both of which operate as independent safety and soundness regulators within the Treasury Department. I would like to elaborate on the five principles.

Regulatory Independence

First, the regulator should remain independent. The concept of an independent Federal agency to oversee Fannie Mae and Freddie Mac was established in the legislative history of the 1992 Act that created OFHEO. The need for regulatory independence was borne out of Congress' experience with the savings and loan crisis. I had the privilege of serving as Counsel to the House Banking Committee during that difficult period. One of the clear lessons learned was that all safety and soundness regulators should be objective, nonpartisan, and protected from political interference. This is especially critical at times when regulators must make difficult and sometimes politically unpopular decisions. In addition, independent regulation protects Congress' ability to receive the regulator's best judgment on regulatory matters unfiltered and without delay. With billions of dollars of potential taxpayer liability at stake, it is in everyone's interest that this important safeguard not be weakened.

Like OFHEO, the Office of Thrift Supervision is another useful example of how a new independent regulator should be established as part of a Departmental organization. In 1989, Congress transferred responsibility for thrift regulation from the Federal Home Loan Bank Board to a newly created OTS within the Treasury Department. The OTS was established as a fully independent regulator. It has the same powers and unfettered ability to use those powers as the OCC.

Congress should ensure that the new regulator has full statutory independence.

Permanent Funding

Second, the regulator should be permanently funded, outside the appropriations process. Currently, OFHEO is funded annually through the Federal budget and appropriations process, even though the Agency does not utilize any taxpayer funds. OFHEO is funded through assessments on the Enterprises, but those assessments cannot occur until approved by an appropriations bill and at a level set by the bill. OFHEO is the only safety and soundness regulator funded in this limited manner. At a minimum, this serious anomaly should be fixed. Permanent funding will enable the regulator to fulfill its budgetary needs on a more reasonable basis without the timing constraint associated with the annual appropriations process. There should also be clear language that the Agency has the authority to levy special assessments or to establish a reserve fund as needed, to meet emergencies. Currently, any additional funds required to meet urgent, unexpected needs can be obtained only after a supplemental appropriation is enacted. This can delay action by the Agency to resolve problems early, before they threaten the safety and soundness of an Enterprise. Permanent funding will contribute to operational independence and will allow the Agency to respond quickly to any crisis at the Enterprises.

Enhanced Supervisory Authority

Third, the regulator should have powers equal to those of other regulators. While OFHEO's regulatory powers are fairly comparable to those of other financial safety and soundness regulators, certain authorities need to be provided and others clarified. For example, a safety and soundness regulator should have independent litigation authority, enhanced hiring authority and a full range of enforcement powers provided to financial regulators. Also, the laws should be revised to provide clearly that the regulator is empowered to address misconduct by institution-affiliated parties and to exercise general supervisory authorities.

Flexible Capital Regulation

Fourth, the regulator should have full discretion in setting capital standards. Capital is one of the fundamental bulwarks of effective safety and soundness regulation. The regulator should have broad discretion to exercise his or her best judgment, using all the information available through the examination process and otherwise, to determine if capital adjustments are necessary. All other safety and soundness regulators have this discretion.

Going forward, the Agency needs to have the authority to modify both minimum and risk-based standards. This authority would help meet the changing mix of Enterprise business, the market environment in which they operate, and the changing nature of risk measurements themselves. As Secretary Snow has said in testimony before Congress, "Broad authority over capital standards and the ability to change them as appropriate are of vital importance to a credible, world-class regulator." I agree.

Build on Progress

Fifth, legislation should build on the progress we have made over the last 10 years. Regulating Fannie Mae and Freddie Mac requires a specialized skill set. The capacity to model the cashflows of all the mortgages, debt, and other financial instruments owned, issued, or guaranteed by the Enterprises, needed for the stress test, is unique among financial institution regulators. Expertise in how these two secondary mortgage market companies manage mortgage risk, including the broad use of sophisticated derivatives and collectible debt is vital for effective regulation. In addition, an understanding of how the Enterprises are affected by the markets in which they operate is extremely important.

Over the past 10 years, OFHEO has developed the specialized expertise, from our examiners and financial analysts, to our researchers and capital analysts, that is necessary to supervise these two unique companies. The cost in terms of lost regulatory capacity spent while trying to rebuild that infrastructure would be substantial. That is why I recommend that, if a new regulator is established in the Treasury Department, OFHEO's personnel, regulations, and administrative infrastructure should be transferred intact to the new agency. It would be highly counterproductive to do otherwise.

Additional Issues

There are a couple of other matters I would like to briefly discuss. First, I agree with Secretary Snow that the Presidentially appointed board positions should be discontinued. This is not a reflection of current or former Presidentially appointed directors. Rather, I think corporate governance would be enhanced if the shareholders were allowed to select all members of the board. It is difficult for even the most conscientious director to fully contribute when their terms are limited to one year, unless reappointed, and last on average for only 15 months. Shareholder elected directors usually are reappointed for up to 10 years.

I also support the granting of authority to the safety and soundness regulator to determine whether the activities of an Enterprise are consistent with its charter authority. This would mean that a single regulator would have the ability to review all of the Enterprises' activities—new and existing. This change will consolidate the supervision of the Enterprises in a manner consistent with authorities of other regulators. I appreciate the concern expressed about the primacy of the Enterprises' housing mission if and when the charter compliance responsibility is shifted. The goal, in fact, of enforcing charter compliance is to ensure that the Enterprises remain properly focused on their housing mission and not stray into extraneous ventures. Consistent with that goal, I think a mechanism can be instituted to ensure that a new regulator actively solicits and considers all views, including housing advocates, when exercising its authority. The importance of their housing mission is actually why the Enterprises exist. Strengthening their safety and soundness regulation supports that mission by ensuring that they are strong enough to provide the financial services that make that mission a reality.

Conclusion

Mr. Chairman, before concluding my testimony, I would be remiss in not noting my appreciation for the interest and support of Members of this Committee during last week's hearing with respect to the Administration's request of $7.5 million in additional appropriations for OFHEO in fiscal year 2004. I look forward to working with the Committee on this request, as well as legislation to strengthen regulation of the Enterprises. I will be happy to answer questions that you and the Committee may have.

PREPARED STATEMENT OF DOUGLAS HOLTZ-EAKIN

DIRECTOR, CONGRESSIONAL BUDGET OFFICE

OCTOBER 23, 2003

Mr. Chairman, Senator Sarbanes, and Members of the Committee, thank you for this opportunity to discuss the Congressional Budget Office's (CBO's) work on the economics, costs, and regulation of the Government Sponsored Enterprises (GSE's) for housing—namely, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Broadly speaking, that work leads to three main points:

- The Federal Government confers substantial benefits on GSE's through an implied guarantee of their debt and other financial obligations;
- In doing so, the Government necessarily exposes taxpayers to risks; and
- Effective regulation can reduce but not eliminate the risks to taxpayers from the GSE's.

The Benefits of GSE Status

The principal benefit of having the status of Government Sponsored Enterprise is the ability to borrow at lower rates of interest than any fully private firm holding the same amount of private equity capital and taking the same risks is able to do. Sponsored status also enables the GSE's to borrow far larger sums than would be available to private borrowers. Low-cost capital and easy access to the market is the direct result of an implied Federal guarantee of the GSEs' obligations.

The implicit guarantee is communicated to investors in capital markets through a number of provisions of law that create a perception of enhanced credit quality for the Enterprises as a result of their affiliation with the Government. Those provisions include a line of credit at the U.S. Treasury; exemption from the Securities and Exchange Commission's (SEC's) registration and disclosure requirements; exemption from State and local income taxes; and the appointment of some directors by the President of the United States. In addition, although Federally chartered and Federally insured banks face a limit on the amounts that they can invest in other types of securities, that limit does not apply to the GSEs' securities. Taken together, those statutory privileges have been sufficient to overcome an explicit denial of Federal backing that the GSE's include in their prospectuses.

GSE status and the benefits it conveys are no longer necessary to the functions that Fannie Mae, Freddie Mac, and the Federal Home Loan Banks perform. Those purposes include ensuring a reliable source of funds to housing and increasing access to mortgage credit by low- and moderate-income borrowers so that more families can own their homes. Private financial institutions that lack GSE status, such as Washington Mutual and Bank of America, currently maintain a reliable link between the wholesale capital markets and retail lenders who originate home mortgages not eligible for financing from the GSE's. Moreover, the Government has numerous more-direct policies to assist low-income homebuyers, including mortgage insurance offered by the Federal Housing Administration and other more-targeted programs administered by Federal agencies.

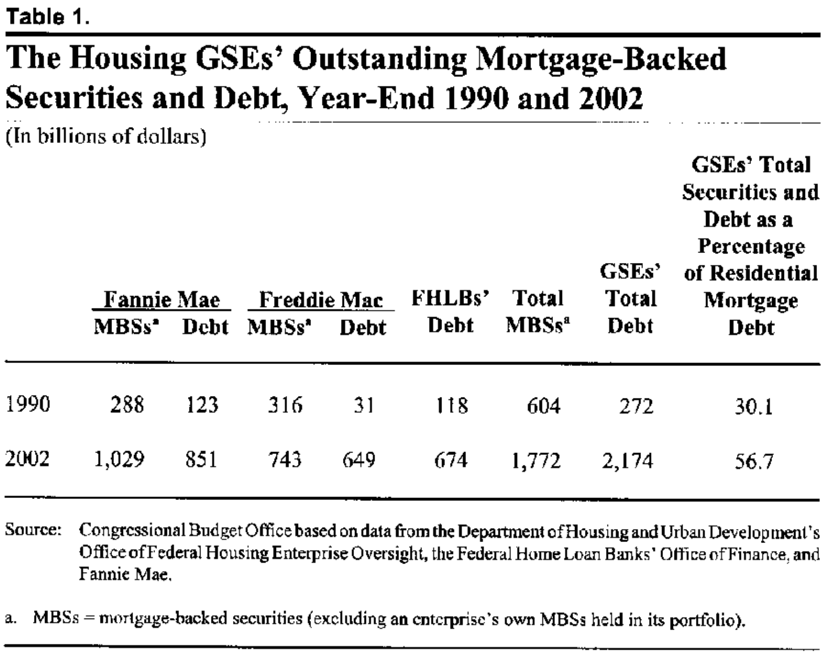


Table 1.

The Housing GSEs' Outstanding Mortgage-Backed Securities and Debt, Year-End 1990 and 2002

(In billions of dollars)

	Fannie Mae		Freddie Mac		FHLBs'	Total	GSEs' Total	GSEs' Total Securities and Debt as a Percentage of Residential Mortgage
	MBSs[a]	Dcbt	MBSs[a]	Debt	Debt	MBSs[a]	Debt	Debt
1990	288	123	316	31	118	604	272	30.1
2002	1,029	851	743	649	674	1,772	2,174	56.7

Source: Congressional Budget Office based on data from the Department of Housing and Urban Development's Office of Federal Housing Enterprise Oversight, the Federal Home Loan Banks' Office of Finance, and Fannie Mae.

a. MBSs = mortgage-backed securities (excluding an enterprise's own MBSs held in its portfolio).

Private financial intermediaries, however, cannot match the low funding costs of the GSE's. To approach the GSEs' borrowing rates, they would have to raise more private equity capital and other private credit enhancements than do the housing GSE's. In short, they would need to convince lenders that they could replicate the Federal guarantee through private means. However, private providers of risk-bearing or credit-enhancement services require compensation commensurate with the assumed risk. The requisite backing from private sources, therefore, is costly. By contrast, the Government, provides the benefits of low-cost funding without charge.

Assisted by the implied Federal guarantee, the housing GSE's have grown into some of the largest financial institutions in the world. Their outstanding securities now exceed $4 trillion—or more than the entire U.S. public debt. In the process, Fannie Mae and Freddie Mac have come to dominate the U.S. residential mortgage market, accounting for almost 57 percent of residential mortgage debt (see Table 1).

The value of the Federal subsidy to the GSE's can be approximated by comparing the Enterprises' actual funding costs with those they would face as private intermediaries. In May 2001, CBO estimated that difference—on the basis of a credit rating of AA–2 for the housing GSE's—to be $10 billion to $15 billion per year from 1998 to 2000. Adjusted for the growth of the Enterprises (but with any increases in risk ignored), the current annual subsidy is, at a minimum, above the upper end of that range.

The Exposure of Taxpayers to Risks from the GSE's

By supporting the activities of the housing GSE's through an implied guarantee, the Government has assumed, on behalf of taxpayers, the risk of losses that might exceed the Enterprises' holdings of private equity capital. The housing GSE's offer public assurances that their assumed risks, especially for credit or default losses, are low in relation to their private capital. As a result, taxpayers may conclude that their own risk exposure is also low.

The housing GSE's appear to be principally exposed to interest rate, prepayment, and operations risks. Interest rate risk refers to the different effect that changes in interest rates can have on the value of a firm's assets and liabilities and thus on its net worth. For example, an increase in interest rates will reduce the value of both fixed-rate assets and fixed-rate liabilities, but the value of assets will be hit harder if the assets have a longer maturity than the liabilities do. A rise in interest rates, therefore, can wipe out a financial intermediary's equity capital.

Entities that hold portfolios of fixed-rate mortgages are also subject to prepayment risk. Specifically, the value of a portfolio of fixed-rate mortgages declines when borrowers exercise their option to refinance and prepay their existing mortgages in response to a decline in market rates. In combination, interest rate and prepayment risks mean that the housing GSE's are potentially vulnerable to losses from both increases and decreases in interest rates.

Even those firms that appear to be well-managed are subject to operations risk, or the adverse effects of errors in judgment by management in protecting the value of a firm. That threat can manifest itself in lapses in the integrity and performance of existing controls, systems, and practices.

Private equity holders and other stakeholders in the housing GSE's have some incentive to manage and control risk, but overall those incentives are weaker than those for investors in other entities. Market discipline is weakened by the Federal guarantee, which reduces the need for bondholders to monitor and restrict the Enterprises' risks. Further, equity holders have diminished incentives to resist risk taking to the extent that they believe that the Government would intervene to sustain the GSE's. Member institutions holding equity in the Federal Home Loan Banks may undervalue the Enterprises' risks because they can withdraw some of their equity from a financially troubled bank to reduce their potential losses. Following severe losses, equity holders who cannot withdraw their capital can have an incentive to accept increased risks by the Enterprises because that approach may be their only means of recovering those losses. In sum, the Federal Government cannot count exclusively on non-Federal stakeholders to limit the risks to taxpayers from the housing GSE's.

Nonetheless, the housing GSE's are managing prepayment risk and interest rate risk through such means as issuing debt securities that can be redeemed at par before maturity and using derivatives, including interest rate swaps. Also, the GSEs' internal monitoring and safeguards reduce operations risk. Finally, the housing GSE's are limiting their exposure to credit risk by requiring private mortgage insurance on loans with less than a 20 percent downpayment and by leaving some of that risk with the loan originators.

As a practical matter, however, the Enterprises' risks cannot be eliminated, nor would doing so be in the interests of equity investors. The risks of financing and holding a portfolio of mortgages are simply too varied and complex to permit management to identify them all and to find another party willing to accept them at a reasonable cost. The more feasible objective of holding interest rate and prepayment risks within acceptable bounds is among the most complex and difficult tasks facing the managers of mortgage portfolios. At the housing GSE's, risk management is assigned a high priority and is reported to be vigorously pursued with state of the art systems and analytical procedures. Even so, best practices intended to achieve vital objectives occasionally fail and produce unpleasant surprises.

Matters are complicated further by shareholders' desire to retain some risks. The return on riskless financial activity is close to the return on U.S. Treasury securities. In competitive markets, investors can obtain high rates of return only by assuming risks. Fannie Mae and Freddie Mac have consistently earned high rates of return on equity. For example, the average annual return on their equity from 1990 to 2002 was over 23 percent. A comparison group of large financial services firms averaged returns of less than 14 percent during that period. One essential operating difference between those two GSE's and private firms is that the GSE's hold less than half as much private equity capital per dollar of assets as the comparison firms do (3.70 percent versus 9.14 percent). If Fannie Mae and Freddie Mac retained about the same risks as private financial services firms, then their higher rates of return on capital could be explained by their lower levels of capital.

Future losses from risks retained by the housing enterprises would be borne by the Enterprises' equity investors up to the limit of the GSEs' equity and reserves. Creditors could then look to the Federal Government to cover losses above those amounts. Some observers claim that the Government's commitment is only conjectural and therefore potentially illusory. However, when another GSE, the Farm Credit System, suffered threatening losses in the 1980's, the Congress authorized up to $4 billion in Federal financial assistance to avoid a default on bonds that carried a similar guarantee. In that case, at least, the implied Federal guarantee became real. In the event of future losses by the housing GSE's in excess of their private capital, the Government would face a choice between ignoring a financial shock of unknown magnitude or confirming that its guarantee would be honored. The significant difference in the expected short-term costs of those alternatives suggests that the capital markets are likely to be correct in supposing that the Government will not walk away from its implied guarantee when the need for Federal support arises.

A rough indication of the likelihood of such an event is provided by the cumulative average historical default rate for corporate debt with a credit rating comparable to that of Fannie Mae and Freddie Mac. Standard & Poor's reports that for debt rated AA-, the cumulative average default rate over 15 years is 1.92 percent. By that indication, a default by Fannie Mae or Freddie Mac is highly unlikely over the next 15 years. But it is not an impossibility.

The Role of Regulation in Limiting Taxpayers' Risks

By enhancing the housing GSEs' credit quality, the Federal Government gives the Enterprises substantial control over the risks faced by taxpayers and over the amount of the Federal subsidy. The Enterprises can increase that subsidy by expanding their volume of guaranteed debt, by engaging in riskier activities, by reducing their efforts to hedge existing risks, and by diverting income to activities outside their missions or distributing it to shareholders.

Fannie Mae and Freddie Mac have two means of channeling funds from the capital markets to retail lenders: Investing in mortgages and guaranteeing mortgage-backed securities (MBS's). To invest in mortgages, the Enterprises issue debt obligations and purchase mortgages. Alternatively, they pool individual mortgages, insure the pools against credit risk, and sell undivided interests in the pools directly to

investors in the form of mortgage-backed securities. Purchasing and holding mortgages as investments entails greater risks and returns for the GSE's than guaranteeing MBS's does. Fannie Mae and Freddie Mac have dramatically increased the size of their investment portfolios relative to their guarantees of MBS's since 1990 (see Table 2). In fact, Fannie Mae and Freddie Mac now hold in portfolio about one-third of their guaranteed MBS's. Similarly, the Federal Home Loan Banks have increased their portfolio holdings of mortgages from less than $1 billion in 1998 to more than $60 billion in 2002 and to $90 billion by the middle of 2003.

When the Enterprises buy and hold mortgage assets in portfolio, they are retaining interest rate, prepayment, and credit risks on those loans. But when the GSE's sell mortgages to investors through guaranteed MBS's, they transfer interest rate and prepayment risks, retaining only the more transparent, manageable credit risk. As the GSE's move mortgages into their portfolios, they increase both the expected returns and risks to shareholders; for taxpayers, only the risks increase. The increase in risk is reflected in the statutory minimum for private capital to be held by Fannie Mae and Freddie Mac of 2.5 percent for mortgages in portfolio and 0.45 percent for MBS's. Whether those differences in capital requirements accurately reflect true differences in the level of risk, however, is impossible to know because the Enterprises can vary the extent to which they hedge portfolio risks. Determining the adequacy of the Federal Home Loan Banks' capital is further complicated by the ability of members to redeem some capital at par. Redeemable capital is unlikely to be available to absorb the Banks' losses or to protect taxpayers.

Table 2.

The Housing GSEs' Mortgage Portfolios Expressed as a Share of Their Outstanding Debt and Mortgage-Backed Securities, Year-End 1990 and 2002

(In percent)

	Fannie Mae	Freddie Mac	Federal Home Loan Banks	
	Retained Mortgage Portfolio as a Share of Debt and MBSs[a]	Retained Mortgage Portfolio as a Share of Debt and MBSs[a]	Net Mortgage Loans as a Share of Debt	GSEs' Total Assets (Billions of dollars)
1990	27.7	6.3	0	340
2002	42.4	41.9	9.1	2,374

Source: Congressional Budget Office based on data from the Department of Housing and Urban Development's Office of Federal Housing Enterprise Oversight and the Federal Home Loan Banks' Office of Finance.

a. MBSs = mortgage-backed securities (excluding an enterprise's own MBSs held in its portfolio).

An important purpose of the regulation of GSE's is to limit taxpayers' risks and the size of the subsidy. To do so, regulators must understand, monitor, and assess the risks of the Enterprises virtually to the same extent that their management does. But some dimensions of risk are not easily transparent. Even world-class regulators—well-funded, well staffed, and politically independent—are unlikely to be able to maintain a complete understanding of the extent to which taxpayers are exposed to risks.

Nonetheless, regulators can limit the GSEs' ability to leverage the value of the Federal guarantee. To do that, they need a range of capabilities to address the varied means by which the GSE's can increase the risk exposure of taxpayers. Those capabilities include being able to adjust capital requirements, to assess the extent to which the GSE's have retained interest rate and prepayment risks and the effectiveness of hedges against those risks, to hold management responsible for the adequacy of internal systems and controls, and to prevent a failed GSE from continuing to use the Federal guarantee.

The regulators also need enough public support to enable them to exercise their authority to compel changes in risky behavior by the housing GSE's. Toward that end, increased public disclosure of the findings of regulatory oversight of the Enterprises could be useful. Freddie Mac has agreed to publicly report its fair-value, or mark-to-market, net worth quarterly. That practice increases transparency and might be usefully adopted by all of the GSE's.

The Congress could facilitate the regulators' difficult task by setting statutory boundaries on the GSEs' ability to increase the value of the Federal subsidy. For example, the Congress could legislate a higher margin of safety in the minimum capital standards. It could also act to limit the growth (or profitability) of GSEs' portfolio investments and move toward more-equal treatment of the Enterprises and their potential competitors. Some Members of Congress have proposed requiring SEC registration of GSE securities, for example. A May 2003 CBO report on that topic found that such a requirement would be unlikely to have a significant adverse effect on the GSE's or on the mortgage markets. Similarly, in the absence of evidence that Presidentially appointed directors have a unique advantage in defending taxpayers' interests, the selection of directors might be left entirely to private shareholders.

Action by the Congress to bolster regulators' ability to ensure safe operation by the GSE's would better protect taxpayers. Furthermore, the GSEs' public mission does not appear to require them to sacrifice safety and soundness. Certainly, from the taxpayers' perspective, having the GSE's pursue a low-risk strategy is strongly preferable to tolerating a risky one.

PREPARED STATEMENT OF JOHN D. KOCH

EXECUTIVE VICE PRESIDENT AND CHIEF LENDING OFFICER
CHARTER ONE BANK, NA, CLEVELAND, OHIO
ON BEHALF OF AMERICA'S COMMUNITY BANKERS, WASHINGTON, DC

OCTOBER 23, 2003

Mr. Chairman and Members of the Committee, my name is John D. Koch, Executive Vice President and Chief Credit and Lending Officer of Charter One Bank, NA in Cleveland, Ohio. I am also a member of the board of America's Community Bankers and chairman of its GSE Policy Committee. ACB appreciates this opportunity to testify on proposals to improve the regulation of the housing-related Government Sponsored Enterprises, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. ACB members include State and Federally chartered savings institutions and commercial banks. Our members are both stock- and mutually owned. As community bankers, many are specialists in mortgage lending. They are actively involved in the secondary market through Fannie Mae and Freddie Mac and other secondary market participants. Charter One services over $15 billion in home mortgages for Fannie Mae and Freddie Mac. ACB members are also substantial stockholders in and borrowers from the FHLBanks.

ACB has long supported the traditional role Fannie Mae and Freddie Mac serve in the secondary mortgage market. They have provided great benefits to homebuyers and mortgage originators. In fact, they have significantly increased their commitment to community banks over the last several years. ACB helped initiate these changes by entering into business relationships with both companies that enable community banks to be more competitive in the marketplace.

Similarly, ACB members depend tremendously on the advances provided by the FHLBanks. Our bank's FHLBank advances total nearly $10 billion. These advances make it possible for community banks to make sound home loans that may not conform to the strict criteria of the secondary market. FHLBank advances also provide an alternative funding source for community banks that choose to keep loans they originate—whether conforming or not—in their own portfolios.

In addition, ACB members own more than half of the stock issued by FHLBanks and hold significant amounts of mortgage backed securities and other debt issued by Fannie Mae, Freddie Mac, and the FHLBanks. Charter One's investment in FHLBank stock totals $700 million, by far our largest single investment.

Clearly, the continued financial health of all of these entities is critical to Charter One and other ACB members and their communities. Therefore, ACB strongly supports this Committee's effort to improve the regulatory system for the GSE's.

Scope of the Agency

The Administration has recommended that Congress establish a new agency that would regulate all of the housing GSE's. ACB agrees with the Administration that the regulatory structure for these entities should be substantially improved and supports proposals to create a new independent regulator for FHLBanks that is housed inside Treasury. However, ACB recognizes that we are involved in a fluid and dynamic legislative situation. For example, the Treasury Department has raised concerns about the establishment of a new independent agency within the Department. ACB differs with Treasury on this issue. As we emphasize later in our testimony, it is essential that the new regulator be independent. Therefore, as an alternative way to address Treasury's concerns, ACB would support formation of a new, independent regulator as a stand-alone agency.

ACB continues to prefer a separate regulator for the FHLBanks. Nevertheless, ACB strongly supports an amendment drafted by Representatives Royce, Maloney, and Leach that would merge the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board into a new, independent, and fully funded Treasury agency. We recommend that you strongly consider taking a similar approach in your legislation.

The Royce Amendment recognizes the differences between the FHLBanks and Fannie Mae and Freddie Mac by establishing two deputy directors and maintaining separate funding for the costs of regulation. Under the amendment, the new agency would administer the unique statutory arrangements that apply to the FHLBanks and Fannie Mae/Freddie Mac.

If the new agency does become the regulator for the FHLBanks, it should maintain the Banks' access to the capital markets and their current well-defined mission to support the mortgage finance, affordable housing, and community development activities of member banks. The advance programs of the FHLBanks ensure home-buyers have ready access to home mortgage financing through FHLBank members.

ACB recognizes that the Finance Board has increased its commitment to safety and soundness regulation. However, we believe there is substantial room for improvement and change in the regulation of the FHLBank System. A merged agency would avoid a perception that any of these Government Sponsored Entities are subject to more effective regulation than any of the others. We also note that the FHLBanks, Fannie Mae, and Freddie Mac are all engaged in extensive interest rate risk management and believe a combined agency would be better able to supervise these risks.

While dealing with concerns common to all of the entities, the legislation would have to ensure that the new regulatory structure recognizes the unique and successful business model of the FHLBank System. Unlike Freddie Mac and Fannie Mae, the System is a cooperative owned by its member institutions. The FHLBanks' stock is not publicly traded and does not fluctuate in value. In addition, each of the FHLBanks is jointly and severally liable to all the others. Each of these GSE business models has their strengths. Any revised regulatory system should continue to respect those differences, while advancing the common goal—to maintain their financial safety and soundness.

Agency Structure, Funding, and Independence

The Administration recommends that Congress eliminate OFHEO and the Finance Board and move their functions into an independent agency housed in the Department of the Treasury. This structure works for two key regulators, the Comptroller of the Currency and the Office of Thrift Supervision. A key element behind each agency's success is their high degree of independence from the Treasury, which insulates them from concerns about political influence.

Additionally, both the OCC and OTS enjoy—and OFHEO does not have—the ability to fund its operations without resort to the annual Congressional appropriations process. ACB strongly endorses the repeated recommendation of OFHEO Director Falcon to eliminate this anomaly and allow the regulator of Fannie Mae and Freddie Mac to assess those companies without the cumbersome appropriations process. It is important that the final bill provide the new agency with a complete exemption from the appropriations process, similar to that provided to other financial regulators.

Independence is the other characteristic of the various financial regulators that ACB strongly believes must also be in the regulator for Fannie Mae, Freddie Mac, and the FHLBanks. Again, this has served our financial system and consumers very well. If a new agency is created within Treasury, it should have autonomy in the following key areas:

- Appointment of Director. The director should be appointed by the President and confirmed by the Senate for a fixed term and be removable by the President only for good cause.
- Testimony. Congress should be able to count on receiving the agency's unvarnished views on all issues it faces.
- Rulemaking. There should be no opening for politically appointed officials to delay or prevent the agency from issuing rules it believes necessary.
- Supervision and Examination. All parties involved will benefit from a strict separation between political appointees and supervisory and examination staff.
- Enforcement. The agency's enforcement actions must be independent from any outside interference.
- Litigation Authority. The director should be able to act in his own name and through his own attorneys rather than have the Attorney General represent the agency.
- Employment Authority. The director should have the ability to employ officers and employees under authority comparable to that of other financial regulators.

Authority over Mission and Programs

The Finance Board has authority over all aspects of the FHLBanks: Ensuring safety and soundness and that they carry out their statutory housing finance mission. The Royce Amendment would continue this approach under the new agency.

ACB strongly endorses the Administration's position that the new agency should have similar authority to ensure that Fannie Mae and Freddie Mac are also carrying out their secondary market mission. This agency must have the authority to review both current and future programs of Freddie Mac and Fannie Mae. In particular, new activities should be subject to an application and approval process similar to what is in place for bank holding companies today. For over a decade, the Department of Housing and Urban Development has not exercised its current program approval authority. As a result, Fannie Mae and Freddie Mac have engaged in or attempted to engage in activities inconsistent with their secondary market responsibilities.

For example, both entities have issued retail debt instruments in denominations of as little as $1,000. These are being marketed by third parties to consumers with considerable emphasis on their implied Federal Government backing, when there is no such guarantee. Fannie Mae and Freddie Mac have responded to this problem by significantly improving disclosures. However, we doubt the public is adequately informed and protected. In addition to principal risk, these notes carry interest rate and call risk that relatively unsophisticated investors do not understand. Of course, these risks do not exist for traditional deposit products, such as certificates of deposit. Nevertheless, these small-denomination notes unfairly compete with CD's, weakening community banks' ability to meet housing finance and other community credit needs.

ACB is concerned that these debt programs may be part of an attempt to create a "name brand" image for Fannie Mae and Freddie Mac in the mind of average consumers. Their extensive retail advertising is further strong evidence that this is a major goal for these entities.

This branding effort could help Fannie Mae and Freddie Mac's efforts to move into the primary mortgage market. In one example of this, Freddie Mac entered into an agreement with an online mortgage company that attempted to reduce primary mortgage originators to, at best, a nominal role in the process. An effective mission regulator is needed to prevent Freddie Mac and Fannie Mae from using their Government-provided advantages to supplant private firms that compete in the primary mortgage market.

The Administration's proposal makes clear that HUD would retain its mission authority to set affordable housing goals for Fannie Mae and Freddie Mac. As Secretary Mel Martinez testified, HUD would actually gain new regulatory clout to enforce those goals. However, ACB does not support the Administration recommendation that HUD be authorized to set new sub goals. Sub goals, while perhaps assuring a certain result, may lead to GSE purchase behaviors with unexpected and potentially undesirable consequences.

Some housing advocates have expressed concern that, if HUD does not retain all mission and program oversight over Fannie Mae and Freddie Mac, their commitment to housing, particularly low- and moderate-income housing will suffer. However, Secretary Martinez testified in strong support of the Administration's proposal to shift these responsibilities, other than affordable housing goals, to the Treasury. If Congress provides for a substantial degree of independence for the new agency and affirms the companies' housing mission, there should be no decrease in their support for housing. In fact, we believe Fannie Mae and Freddie Mac must continue to be challenged to increase homeownership by minority families. And, as mentioned, under the Administration's proposal HUD's role would be enhanced in the area of affordable housing.

Capital Requirements

ACB strongly agrees with the Administration position that, while the existing capital regulation adopted by OFHEO should be the new agency's starting point for Fannie Mae and Freddie Mac, there should be no limit on its ability to adjust capital requirements for Fannie Mae and Freddie Mac if it finds that necessary. Capital is the foundation for the safety and soundness of our financial system. Therefore, the new agency must have complete authority to adjust all capital requirements as necessary, subject to rulemaking.

The Finance Board already has this authority with respect to the FHLBanks. The Royce Amendment would maintain the new agency's authority to adjust the FHLBanks' capital requirements. The new regulator should respect genuine differences between the FHLBanks and Fannie Mae/Freddie Mac—including their very different capital structures. However, a regulator's ability to adjust capital levels is fundamental and must apply to all of the regulated entities.

As Congress has recognized, the taxpayers are ultimately at risk when a major part of the financial system is undercapitalized. While there is no explicit Federal guarantee for Fannie Mae and Freddie Mac, it is impossible to believe the Government would stand aside if either of these companies faced serious difficulty. Requiring them to maintain adequate capital will provide vital insulation for the taxpayers.

Community bankers are particularly sensitive to this issue. We are already concerned that the proposed Basel II Accords could result in lower or disparate capital standards for the large banks that will adopt the new system. We would be equally troubled if regulatory reform for Fannie Mae and Freddie Mac had a similar result. The capital requirements for Freddie Mac and Fannie Mae should reflect the specific financial risks facing each, including realistic treatment of counterparty risk and direct investment in mortgages.

Enforcement Authority

The Administration recommends that the new agency be given enforcement authority comparable to that of the banking agencies. ACB supports this point of view. However, we recommend that Congress carefully examine the current enforcement authority for OFHEO and the Finance Board to determine exactly which additional powers are needed and which banking agency provisions are not appropriate to deal with the unique features of the housing GSE's.

Conclusion

I wish to again express ACB's appreciation for this opportunity to testify on these important issues. We strongly support the Committee's effort to strengthen the regulation of Freddie Mac, Fannie Mae, and the Federal Home Loan Banks. We look forward to working with you as you craft legislation to accomplish this goal.

PREPARED STATEMENT OF DALE J. TORPEY

PRESIDENT AND CEO, FEDERATION BANK, WASHINGTON, IOWA
ON BEHALF OF THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

OCTOBER 23, 2003

Introduction

Chairman Shelby, Ranking Member Sarbanes, and Senate Banking Committee Members, the Independent Community Bankers of America (ICBA) appreciates this opportunity to present our views on proposals for improving the regulation of the housing Government Sponsored Enterprises (GSE's).

I am Dale J. Torpey, President and CEO of Federation Bank, a $115 million asset bank located in Washington, Iowa. I currently serve as Chairman of the Lending Committee of the ICBA. I am also currently Chairman of the Board of Directors of the Federal Home Loan Bank of Des Moines. My testimony today is delivered exclusively on behalf of the ICBA.

Potential regulatory restructuring of the housing GSE's is a matter of critical importance to the community banking industry.

As a general principle, we do not believe that the Treasury Department should direct the housing policy of our Nation just as it should not run the monetary policy of our Nation. In our view, should the Treasury Department be granted supervisory and regulatory oversight of either Fannie Mae/Freddie Mac or all three of the housing GSE's, its tax policy and fiscal policy responsibilities would likely present clear conflicts of interest with housing policy. ICBA also shares the concerns that have been expressed by others regarding the historical absence of expertise in housing policy at Treasury.

Regulation of the Federal Home Loan Banks

Since the passage of the Federal Home Loan Bank System Modernization Title of the Gramm-Leach-Bliley Act (Title VI of P.L. 106–102) in 1999, which liberalized membership in the Federal Home Loan Banks (FHLBanks) and expanded the categories of eligible collateral for FHLBank advances, thousands of community banks are using FHLBank advances as a competitive and flexible funding source. The ability of community banks to continue to utilize this increasingly important funding source is crucial to safe and sound asset-liability management, as well as their ability to meet the lending needs of their communities. Similarly, the fact that Federal deposit insurance coverage levels have not increased since 1980 has given community banks further incentive to turn to FHLBank advances as a stable, alternative source of funding to meet Main Street's lending needs.

ICBA continues to hold the view that the FHLBanks should be regulated by a separate and independent agency—a status that the existing Federal Housing Finance Board (FHFB) already enjoys. Under the regulatory guidance of the FHFB, the FHLBanks have a near-impeccable record of providing well-collateralized advances to thousands of institutions. The FHFB also has taken important steps, and continues to take steps, to upgrade its examination and supervision capacities focusing on safety and soundness.

At its Fall meeting earlier this month, the 110-member ICBA Board of Directors, with representation from nearly every State, discussed the issue of FHLBank regulation at length. The ICBA board voted unanimously to oppose including the FHLBanks in any proposed new supervisory and regulatory structure for Fannie Mae and Freddie Mac in the U.S. Treasury Department.

The ICBA Board did not discuss the concept of a new, independent regulatory structure outside the Treasury Department for Fannie Mae, Freddie Mac, and the FHLBanks—a concept which has been voiced by some in recent days.

The ICBA has long supported independent financial regulatory agencies—for example, agencies such as the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC) and the Securities and Exchange Commission (SEC).

While not our first preference, the ICBA may not oppose the concept of a new independent regulator for all three housing GSE's outside the Treasury Department, depending on how key details are fleshed out. The Federal Home Loan Bank Act could potentially serve as the legislative foundation for such a structure. However, two key issues would have to be worked out for such a structure to gain widespread support. First, the specific regulatory powers of such an agency would have to be determined. We note that the FHFB and the Office of Federal Housing Enterprise Oversight (OFHEO) do not currently have the same powers. Second, the unique ownership, operational and capital structure, and mission of the FHLBanks, which is distinct from that of Fannie/Freddie, would have to be recognized and preserved in constructing the new agency.

Regulation of Fannie Mae and Freddie Mac

Community banks are significant direct or indirect users of the Fannie Mae and Freddie Mac conduits into the secondary mortgage market. The sale of mortgages originated by community banks into the secondary market increases the liquidity of these locally owned- and operated-financial institutions, allowing them to better serve the lending needs of Main Street America. Our system of homeownership is the envy of the world and it has been the stalwart of the American economy during economically challenging times in recent years. The current system has enabled us to reach record homeownership levels and to accommodate consumer refinancing needs in the recent low interest rate environment. This must not be overlooked as part of the process when considering GSE regulatory restructuring.

Regarding proposals to bring the regulation of Fannie Mae and Freddie Mac under the Treasury Department, ICBA reiterates its staunchly held view that any such entity must be politically independent in order to be regarded as a world-class financial regulatory agency. We firmly believe that the traditional political independence of our Federal financial agencies has immeasurably strengthened the U.S. economic and financial system. Currently, the Office of the Comptroller of the Currency (OCC)and the Office of Thrift Supervision (OTS) are protected from the Treasury's political influence.

We strongly urge Congress to make certain that any potential legislation contain appropriate firewalls and independence between Fannie and Freddie and the Treasury's politically-appointed policymakers. Politicizing regulation is an ever-present danger, and we believe it is paramount to maintain the independence of any new regulator overseeing safety and soundness and Fannie and Freddie's Congressionally mandated missions to support home ownership.

Other Key Issues

In the letter of invitation for today's hearing, ICBA was also asked for its views on several other issues in the debate over housing GSE regulation.

First, what is the appropriate capital regime for the housing GSE's? We support the continuing authority of each GSE regulator to establish, and modify, as necessary, the level of risk-based capital that the GSE's are required to hold. As market and risk factors change, the regulators must be able to adjust to these changes in a timely manner. However, ICBA does not support granting the GSE regulators the authority to modify statutory or minimum capital. Such new authority could confer on the regulators the authority to de facto adjust program levels by raising minimum capital, reducing the amount of resources available for program activities.

Second, what should the funding mechanism be for the new regulator? To insulate the housing GSE regulators from undue political influence and enhance independence, ICBA supports removing funding of the GSE regulators from the appropriations process and funding them solely through a self-generated fee structure.

Third, where should authority for new program approvals be placed? We believe that in order for the housing GSE's to continue to be innovative in the development and implementation of new products to meet the demands of the marketplace, there should be a smooth and seamless process for getting these products online. Clearly, if a FHLBank, Fannie Mae or Freddie Mac develops a program that is inconsistent with safety and soundness or with their Congressionally mandated missions, there must be a review process to make that determination. But there should not be disincentives for the GSE's to be innovative and adaptive to new market conditions. Our housing finance system has evolved rapidly over the recent past due to changing technology and changes in the demands of consumers. The FHLBanks, Fannie Mae, and Freddie Mac must have the flexibility to develop the housing finance products needed by consumers in a timely manner and not have new products, programs and activities be bogged down by bureaucracy.

Fourth, what is the appropriateness of HUD's continuing role in the oversight of Fannie Mae and Freddie Mac? Because of its responsibilities and expertise, our preference is that HUD should continue to establish our Nation's housing goals and control the mission activities of Fannie/Freddie to achieve those goals.

Conclusion

In closing, ICBA would urge the Committee to carefully and fully consider the issues associated with regulation of the housing GSE's before rushing to action. The ICBA has long supported world-class, independent regulatory agencies such as the FDIC and the Federal Reserve, both of which are governed by boards that are independent of the U.S. Treasury.

There is no shortage of opinions and strongly held viewpoints on these issues. We concur with the sentiments expressed by a number of Members of this Committee that it is imperative that any regulatory restructuring be done right given its potential impact on the crucial housing sector of our economy and on community banks' continued ability to meet the lending needs of Main Street America.

Thank you for the opportunity to testify. I would be pleased to answer any questions.

PREPARED STATEMENT OF ALLEN J. FISHBEIN

Director for Housing and Credit Policy
Consumer Federation of America
on behalf of
National Association of Consumer Advocates,
National Community Reinvestment Coalition,
National Congress for Community Economic Development,
National Fair Housing Alliance, and Consumer Federation of America

October 23, 2003

Good morning Chairman Shelby, Senator Sarbanes, and Members of the Committee. My name is Allen J. Fishbein, and I am the Director of Housing and Credit Policy for the Consumer Federation of America. I appreciate the opportunity to testify on proposals for improving the regulation of the Government Sponsored Housing Enterprises (GSE's). My written testimony today is also on behalf of the National Association of Consumer Advocates, National Community Reinvestment Coalition, National Congress for Community Economic Development, and the National Fair Housing Alliance.

CFA is a nonprofit association of 300 proconsumer organizations, with a combined membership of 50 million, founded in 1968 to advance the consumer interest through education and advocacy. My own background in the area of GSE regulation includes my tenure at HUD, where I served as Senior Advisor for GSE Oversight. My responsibilities at HUD included assisting with the supervision of the rulemaking that resulted in establishment of the present affordable housing goals for Fannie Mae and Freddie Mae, along with the management of other areas of the Department's GSE regulatory oversight.

As national consumer, community, and civil rights organizations committed to the promotion of fair and affordable housing for all of America's citizens, we watch with considerable interest the ongoing debate about possible changes to the regulatory structure for Fannie Mae and Freddie Mac and wanted to share a few of our observations.

We appreciate those in Congress who desire to assure the adequacy of safety and soundness and mission-related requirements for the Government Sponsored Housing Enterprises—Fannie Mae and Freddie Mac (GSE's). We also urge that Congress be very careful in tinkering with the GSEs' basic overall regulatory structure. At a minimum, such changes to the regulatory structure should do no harm to the GSEs' housing mission. However, we also believe that the current debate provides an important opportunity to clarify those areas of the GSEs' affordable housing mission that should be expanded. Fannie Mae and Freddie Mac have fulfilled an important part of their mission by providing affordable housing capital for low- and moderate-income and minority households. Yet much remains for the GSE's to accomplish in expanding fair and affordable housing opportunities for the residents of our Nation's underserved communities, such as providing greater assistance to first-time minority, and low-income homeowners and securitizing multifamily rental mortgage products. Similarly, while the GSE's have been industry leaders in adopting policies to combat a number of predatory lending practices, such as their repudiation of the purchase of loans that included single premium credit insurance (SPCI), they have yet to address certain other egregious lending practices.

More specifically, we believe that important improvements to the present affordable housing goals requirement are desirable. Clearly the establishment of these goals has served an important function, encouraging the GSE's to better serve the needs of underserved areas and low- and moderate-income housing households. In fact, both enterprises have consistently met or exceeded the goal levels set for them. Nonetheless, the three broad statutory goals in place do not permit HUD to focus sufficient GSE attention to addressing some of the neediest segments of the mortgage market, such as low-income, minority, and other underserved homebuyers, or certain rental and rural housing finance needs. Establishing an additional GSE home purchase goal, and providing HUD with supplemental authority to set subgoals for GSE activity for particularly pressing needs within the overall statutory goals, while not diminishing the ability of the GSE's to serve the needs of all consumers refinancing loans, would enhance the overall effectiveness of this important mandate.

Also, reform of the GSE housing goals should include provisions to expand opportunities for public input into this important area of regulation. We favor improvements to the GSE public use database presently maintained by HUD to make the information available fully comparable with data reported by mortgage lenders under the Home Mortgage Disclosure Act. Opportunities for public comment should also be provided in the event that a GSE did not meet its annual performance requirement and HUD as a result required the GSE to submit a remedial plan.

Our strong interest in affordable housing extends to other aspects of regulatory restructuring as well. We are particularly concerned that proposals to shift general charter oversight and new program approval authority away from HUD to the Treasury Department will detract from the regulatory focus on GSE performance of their housing mission. At the same time, funding the reasonable costs of this regulation through direct assessments of the GSE's, and not through the appropriations process, would go a long way to strengthening oversight capacity.

We are also concerned with the deliberations around two regulatory areas, capital requirements and the program approval process. First, the GSEs' capital requirement is one of the most critical and sensitive issues. We recognize that the establishment of appropriate capital requirements may at time involve tradeoffs, but we fear that unnecessary increases in capital requirements, particularly the minimum requirement, could result in higher costs to homebuyers. Simply, we should not make it harder for minority and low-wealth families to be able to afford to become homeowners.

Second, in evaluating any changes to the current program approval process, a delicate balance is required between a careful examination of whether a new GSE product serves its important public mission and the need to not over-burden these organizations' innovative efforts to provide new lending opportunities in the most difficult to serve communities. While there may be a need to improve the current approval process, we urge you to proceed cautiously, and resist efforts to over-encumber this process.

While this testimony focuses mainly on regulatory oversight of Fannie Mae and Freddie Mac, we also offer the following comments on regulation of the other housing GSE, the Federal Home Loan Bank System (FHLB System). We believe the FHLB System as it has evolved must also have clear and specific housing goals that challenge the lenders to better serve underserved populations. Should Congress decide to abolish the Federal Housing Finance Board, the system's regulator, and transfer authority to another agency, we strongly prefer that mission oversight be transferred to HUD, and that the Department also be provided with authority to establish new affordable housing requirements to ensure that activities undertaken by the FHLBanks are targeted to low- and moderate-income housing and other underserved community needs. These new requirements should build on the existing Affordable Housing and Community Investment Programs (AHP and CIP) and also work to increase FHLB member support for these and other affordable housing and economic development initiatives.

In closing, we thank you for your work in attempting to strengthen the effectiveness of the GSE's to serve the housing needs of America's underserved populations. We urge that you support provisions to strengthen the housing goals requirement, but also proceed with caution and resist the urge to make changes to their status or their charter that might result in fewer affordable housing opportunities.

Thank you again, Mr. Chairman, for the opportunity to offer our views on this important topic. I am happy to answer any questions that either you or other Members of the Committee may have.

PREPARED STATEMENT OF ROBERT M. COUCH

CHAIRMAN, MORTGAGE BANKERS ASSOCIATION

OCTOBER 23, 2003

Mr. Chairman and Members of the Senate Banking Committee, the Mortgage Bankers Association appreciates this opportunity to express our views on the important issues surrounding improving the regulation of the housing Government Sponsored Enterprises (GSE's). The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry. We have approximately 2,700 member companies engaged in every aspect of real estate finance. MBA members originate loans in the primary mortgage market that Fannie Mae and Freddie Mac purchase. MBA, therefore, has a keen interest in maintaining the safety and soundness of our country's real estate finance system.

Fannie Mae and Freddie Mac are the biggest participants in our country's secondary mortgage market. Their regulation has come under scrutiny lately, with many calls for improvement.

Treasury Secretary John Snow and Housing and Urban Development (HUD) Secretary Mel Martinez presented the Administration's proposal for GSE regulatory reform in testimony before the House Financial Services Committee on September 10, 2003, and before the Senate Banking, Housing, and Urban Affairs Committee on October 16, 2003. The two Secretaries proposed to move safety and soundness regulation of Fannie Mae and Freddie Mac to a new agency within the Treasury Department. They further proposed to task the safety and soundness regulator with approving new and ongoing programs and activities, in consultation with HUD. And they proposed to strengthen the regulators' authority and funding.

MBA reiterates its support of the Administration's proposals. MBA has long advocated strong and effective oversight of the GSE's. We believe effective safety and soundness regulation is critical because of Fannie Mae's and Freddie Mac's size and because of their importance to the housing finance system. MBA is pleased to see that the Administration and Members of Congress support strengthening the regulation of Fannie Mae and Freddie Mac.

MBA supports the Administration's proposal to improve and strengthen the general regulatory, supervisory, and enforcement powers with respect to the GSE's. Further, MBA endorses giving the safety and soundness regulator appropriate flexibility in setting capital standards, instead of relying on a rigid, statutory stress test that does not allow the regulator to react adequately to changes in the financial marketplace. MBA also supports the Administration's proposal to fund GSE regulation independently, through assessments on Fannie Mae and Freddie Mac outside of the Congressional appropriations process.

MBA also endorses the Administration's proposal on one of the most important aspects of safety and soundness, that is, program oversight. The GSEs' programs are a key determinant of their safety and soundness, and it is imperative that the programs be conducted safely and soundly. Only financially healthy, safe and sound GSE's can contribute to their housing mission. If, for example, a GSE were to embark on a program of purchasing especially risky loans, the GSE's safety and soundness would likewise be at risk. Or, if a GSE were to engage in a high-volume program that entails liquidity risks or systemic risks, the safety and soundness of such a program would be of critical concern to our housing and financial markets, and to a safety and soundness regulator. GSE programs and activities are intrinsically linked to safety and soundness.

The safety and soundness regulator, for these reasons, is in the best position to evaluate the appropriateness of GSE programs. The regulatory approval system should be robust, and should have a clear definition of what requires regulatory review. Congress should draw a clear line between the primary and secondary mortgage markets. In no event should the GSE's be permitted to encroach upon the mortgage origination process. In no event should the GSE's be permitted to use their Government sponsored benefits to distort the competitive landscape of the primary mortgage market.

MBA also believes that it is important that the regulator not micro-manage the GSE's, and that it not unduly constrain the GSEs' ability to innovate in a timely manner in response to marketplace needs. Regulatory approval for new programs must come in a timely manner, and should be based on clear and well-defined criteria.

In exchange for the benefits of Government sponsorship, Fannie Mae and Freddie Mac have an affirmative obligation to meet certain housing goals. MBA very strongly supports the affordable housing goals for Fannie Mae and Freddie Mac because the goals require the GSE's to focus some of their activities on lower-income Americans and those living in underserved areas. MBA agrees that HUD is the appropriate agency to set and enforce the housing goals for Fannie Mae and Freddie Mac.

The Mortgage Bankers Association strongly urges Congress to reform the oversight of Fannie Mae and Freddie Mac in this manner so that they can continue their role in supporting housing, especially affordable housing, in this country.

The Mortgage Bankers Association appreciates the opportunity to present its views on these important issues. We would be happy to answer any questions the Committee may have.

PREPARED STATEMENT OF IONA C. HARRISON

REALTY EXECUTIVES-MAIN STREET, U.S.A.

ON BEHALF OF THE NATIONAL ASSOCIATION OF REALTORS®

OCTOBER 23, 2003

Introduction

Chairman Shelby, Senator Sarbanes, and Members of the Committee, I am Iona C. Harrison, a broker with Realty Executives-Main Street, U.S.A. in Upper Marlboro, Maryland. I am here on behalf of over 950,000 members of the National Association of REALTORS® to share our views on the important issue of GSE regulation and the housing finance system.

For the record, REALTORS® want to thank Senator Shelby, Senator Allard and Members of the Committee for reporting the "American Dream Downpayment Act." The Senate Banking Committee unanimously approved this bill with two important amendments. First, the bill increases the FHA multifamily loan limits in high cost areas. Second, the bill provides a technical correction to improve the FHA hybrid ARM program. NAR is a strong advocate for this program. In fact, NAR lead a coalition of supporters who are hopeful that the bill will come to the Senate floor shortly. By adopting the American Dream Downpayment legislation Congress will send a strong message supporting the Administration on increasing homeownership opportunities in the United States. This legislation is evidence of the importance this Congress and Administration place on homeownership opportunity in the United States. NAR believes that a new independent safety and soundness GSE regulator combined with continued HUD authority over housing programs and mission will ensure that this commitment remains a high priority in future years.

GSE Regulatory Reform

REALTORS® applaud Congress and the Administration for what we believe could become a measured, well-considered refinement to regulating the Government Sponsored Enterprises, Fannie Mae and Freddie Mac. The Bush Administration has outlined principles that will underscore the importance of the GSEs' mission, status, and safety and soundness oversight that make our housing finance system unique and so effective. Safety and soundness regulation would be lodged at the Treasury Department because of its financial expertise. REALTORS® support this move because it sends a clear message to housing finance and investor markets. But while safety and soundness regulation may move to the Treasury, REALTORS® strongly believe that the current housing mission should continue to be housed at the Cabinet-level Department of Housing and Urban Development. We strongly believe that

HUD should continue to speak for housing, new GSE program oversight, and the GSEs' critical mission supporting homeownership.

Over the past decade the housing sector and American homeowners have benefited significantly from the strength of the Nation's housing finance system. At the core of our housing finance system are the secondary mortgage market and the Government sponsored mission of Fannie Mae and Freddie Mac. The National Association of REALTORS® supports a credible and vigorous GSE regulator. A strong regulator reinforces President Bush's and Congress commitment to housing and homeownership, promotes confidence in Fannie Mae, Freddie Mac, and the real estate and housing finance industries, and protects U.S. citizens against systemic risk. Although realtors support a strong regulator, we insist that regulatory reform does not imply and should not result in any weakening of the current housing finance system.

Congress deemed the Government Sponsored Enterprise model as an appropriate vehicle to advance housing and housing policy as recently as 1992. Fannie Mae and Freddie Mac were chartered as private corporations with publicly traded stock with the mission to bring new mortgage products to the market, and to use innovation and technology to continue simplifying the mortgage process. In exchange for the Federal charter to facilitate the residential secondary mortgage market, certain advantages were provided to Fannie Mae and Freddie Mac. Since enactment of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title XIII of Public Law 102–550), Congress, homeowners, the housing finance system, and the Nation's economy have all benefited tremendously. The unprecedented expansion of homeownership rates is undeniable testament to the efficiency and liquidity of the secondary mortgage market and the housing sector.

Administration Regulatory Recommendations

In recent testimony to the Senate Banking Committee, Treasury Secretary John Snow and HUD Secretary Mel Martinez outlined the powers, duties, and authorities a new GSE safety and soundness regulator should have in a new agency within the Treasury Department and the relationship that HUD would have going forward. The proposed new supervisory agency would focus on safety and soundness, together with program and product approval, in consultation with HUD. Secretary Snow urged consideration of an agency that would be independent of the Congressional appropriations process, and that Treasury would have, at a minimum, clearance of new regulations and Congressional testimony.

Secretary Martinez supported the Administration view that authority over new program approval be transferred from HUD to the new regulator in his testimony. Secretary Martinez advocated HUD retaining authority over the GSE affordable housing goals, and called for expanded authority to enforce the housing goals, impose civil penalties for failure to meet the housing goals, explicitly provide that the GSE's act to increase homeownership, and expand authority to set housing goals and sub goals.

NAR would like to comment on key elements of the Administration's plan that are most relevant for the real estate industry.

Independent Regulator

REALTORS® would agree that Fannie Mae and Freddie Mac should have an independent regulator for safety and soundness. We would recommend that the new regulatory agency in the Treasury Department should have necessary and sufficient firewalls to ensure its political and operating independence similar to those that currently exist for the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) regulatory models.

GSE Capital

In outlining the authority for the new regulator regarding GSE capital, Secretary Snow highlighted in his testimony a need for stability in capital standards. "Capital," he said, "is the fundamental element of the financial condition of an enterprise, and the capital standards should not become the subject of frequent change." REALTORS® agree with Secretary Snow on this general point regarding capital. These capital standards should be allowed to remain in place for a period of time sufficient to evaluate their effectiveness.

GSE Mission, Program and Product Review

The Administration proposal to place GSE regulatory oversight and new program approval under the Treasury Department is a major change in regulatory oversight of the housing GSE's. REALTORS® expressed opposition to moving GSE housing mission oversight from HUD when the Administration's plan was first released. Our concern is that housing policy has not been the purview or expertise of the Treasury

Department; this has been the purview of HUD. The housing and real estate industries naturally look to HUD to address the housing mission, programs and products, and affordable housing goals that are central to the GSEs' existence. In the new GSE regulatory regime we strongly believe that HUD should maintain its primacy in these areas.

Secretary Martinez proposed that HUD continue to consult with the Treasury Department on new activities requested by the GSE's. REALTORS® recognize that new programs and products could have an impact on safety and soundness considerations. But REALTORS® believe that new program approval should remain at HUD with the same approval standards in current law. There is "substantial expertise," as stated by Secretary Martinez in his testimony on September 10 before the House Financial Services Committee regarding mortgage and housing markets programs. While REALTORS® have considerable respect for the financial expertise at Treasury, HUD expertise as our Nation's primary housing agency should not be relegated to a consultative role on matters of new programs approval or lines of business.

Secretary Snow and Secretary Martinez outlined the Administration's principles in subtle terms. Consequently, REALTORS® are guarded about the direction of draft legislation that we understand will be the starting point for GSE regulatory reform. Significant revisions in the GSEs' role in the housing finance system could introduce uncertainties and unintended consequences that will have ill effects for the GSE's and the housing sector.

Federal Home Loan Banks

Secretary Snow's recent testimony to this Committee reiterated a call to create a credible, single regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. REALTORS® do not have position on regulating the Federal Home Loan Banks.

Targeted, Not Sweeping Reform

REALTORS® firmly believe that targeted reform for the GSE regulatory system strengthens our housing finance system. We support a narrow bill that institutes safety and soundness regulatory reforms, and does no harm to the GSE housing mission, charter, or status. Given the fragility of the economy with mixed, weak signals about recovery, REALTORS® want to impress on lawmakers that safety and soundness concerns should not undermine the housing mission, programs and product innovations, or charter status of Fannie Mae and Freddie Mac. Targeted reform for the GSE regulatory system strengthens our housing finance system. REALTORS® expect that Congress will act judiciously to assure a critical role for HUD in GSE mission, program development and review. Congress should assure that under new regulatory oversight Fannie Mae and Freddie Mac would thrive and continue their critical roles in supporting American homeownership. In short order, these companies should have the best opportunities to help our citizens achieve homeownership.

Conclusion

We applaud the Committee's efforts to build a more robust GSE regulatory structure. The National Association of REALTORS® believes that an overarching principle guiding any consideration of regulatory reform proposals should assure that reform not become a reason or justification for rewriting the GSEs' housing mission or weakening the housing finance system.

Congressional intent and the Nation's homeowners have been well-served since 1992 when the GSEs' charter, mission, and status were reaffirmed. What is needed is a strong, rigorous safety and soundness regulator, while HUD retains mission and new program oversight.

The National Association of REALTORS® looks forward to reviewing the proposed legislation to reinvigorate GSE regulation. REALTORS® want to work with Congress to continue addressing housing and homeownership issues and supporting the mission and charter objectives of the housing GSE's.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM ARMANDO FALCON, JR.

Q.1. In your written statement, you proposed that any new regulator be given "full discretion in setting capital standards." For the record, what is the value of having both a minimum capital standard and a risk-based capital standard? That is, what purpose does each standard serve?

A.1. Capital standards are designed to ensure that regulated institutions can survive periods of significant misfortune involving sizeable financial losses. In theory, a single standard that encompassed all relevant considerations would suffice to determine capital adequacy. In practice, that would be very difficult, and Congress has wisely required OFHEO and all depository institution regulators to implement both a leverage-based standard and a more finely tuned risk-based standard.

Evaluation of capital adequacy entails a broad range of considerations including not only an institution's current book of business; but also the current and prospective risk environment, its business strategies and potential changes in those strategies, the strength of its customer and supplier relationships, the strength of its internal controls, potential fragility if the markets in which it buys and sells, the structure of those markets and potential changes in the way those markets function, the vulnerability of the institution's reputation, the systemic importance of the institution, and many other factors.

Issues of practicality constrain the determinants of capital requirements to a small subset of these factors. Thus, for example, OFHEO's risk-based standard focuses on each Enterprise's, current book of business and two possible future risk environments. It requires sufficient capital to cover losses or current positions in extended, specific adverse' circumstances. This is a highly detailed rule that examines this aspect of capital adequacy in depth. It is important that the Enterprises be able to meet this requirement, but does not necessarily imply that capital is adequate. A high degree of protection against interest rate and credit risk can reduce the risk-based requirement to very low or zero levels, without addressing other risks.

The minimum capital (leverage-based) standard is a fail-safe mechanism that ensures a substantial amount of capital regardless of measured interest rate and credit risks. Incorporating all other risks into the risk-based standard would be problematic. They generally do not fit well into the scenario format because the range of possibilities is essentially infinite. Also, the magnitudes of other risks generally are not easily quantifiable, but rather are more a matter of judgment.

A separate standard that encompasses these judgments makes sense. While it would be possible to add the two requirements to make a single rule that would produce an overall requirement that would be considerably more volatile than the current combination, and might usually be higher than necessary. So far, the judgment exercised by Congress in setting the ratios used to determine the minimum capital requirements has worked satisfactorily. However, institutions and their business environments change over time. An expert safety and soundness regulator is best able to judge, if and when changes, to a leverage-based ratio should be made. Accordingly, Congress should give the regulator of Fannie Mae and Freddie Mac the same authority it has given depository institution regulators to adjust all capital requirements if necessary.

Q.2. The Administration has suggested that the new regulatory agency should have more than the powers associated with conservatorship. Should one of the GSE's under your watch encounter serious financial difficulties, do you believe that the existing authority of your agency would be sufficient to manage the crisis?

A.2. OFHEO has strong conservatorship authority that it may bring to bear should an Enterprise under its jurisdiction encounter problems that merit appointment of a conservator. This authority, while sufficient to manage a crisis, does not provide all the tools a safety and soundness regulator should have. OFHEO has supported legislative clarification of its authority to support its interpretation of the law. Additionally, OFHEO has called for legislative action to provide receivership authority that is available to other Federal financial regulators. It should be noted that existing statutory law permits the charters of the Enterprises only to be revoked by Congress, thus receivership would enhance the ability to oversee the Enterprises, and assure the markets of a full range of remedies available to the safety and soundness regulator while preserving Congressional control over charter termination.

Q.3. OFHEO and the Finance Board clearly do not have the complete arsenal of Prompt Corrective Action tools that the OCC and other bank regulators have. In fact, the Finance Board has no statutory Prompt Corrective Action authority. Do you believe that a new regulator must have the same Prompt Corrective Action tools as the bank regulators?

A.3. Yes, and OFHEO has an array of Prompt Corrective Action tools. Modeled on bank regulations, the Prompt Corrective Action regulations are broad and tied to capital levels. However, OFHEO has proposed legislative enhancements that would conform OFHEO's statutory authorities even more closely to the bank regulators; that is, express authority to act on safety and soundness matters.

It also should be noted that OFHEO has added to its Prompt Corrective Action rules a section on prompt supervisory response. This section provides an orderly procedure for OFHEO to act in cases where capital may not be impaired and provides both a description of key situations as well as an order for OFHEO actions. Thus, OFHEO has a regulatory structure that provides for action before capital levels are reached that trigger Prompt Corrective Actions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM ARMANDO FALCON, JR.

Q.1. In your testimony, you suggested that the current minimum capital standard of 2.5 percent is sufficient to ensure the safety and soundness of the GSE's. However, you argued the new proposed safety and soundness regulator should have absolute discretion to change both the risk-based and minimum capital requirements, since, as you characterized it, the minimum capital standards acts as a “fail-safe mechanism” to capture risks that allegedly cannot be addressed in the risk-based role.

Please explain in detail why the risk-based capital rule cannot address these alleged risks to the safety and soundness to the GSE’s. If these risks cannot be quantified, on what basis would the regulator change the minimum capital requirements in order to act as a “fail-safe mechanism?” How would this basis for changing the minimum capital standard be different from the basis for determining the risk-based capital rule? Do you believe that it would harm the ability of Fannie and Freddie’s regulator to perform its oversight functions if Congress placed restrictions on its ability to adjust the minimum capital standards? Why or why not?

A.1. Capital standards are designed to ensure that regulated institutions can survive periods of significant misfortune involving sizeable financial losses. In theory, a single standard that encompassed all relevant considerations would suffice to determine capital adequacy. In practice, that would be very difficult and Congress has wisely required OFHEO and all depository institution regulators to implement both a leverage-based standard and a more finely risk-based standard.

Evaluation of capital adequacy entails a broad range of considerations including not only an institution’s current book of business; but also the current and prospective risk environment, its business strategies and potential changes in those strategies, the strength of its customer and supplier relationships, the strength of its internal controls, potential fragility if the markets in which it buys and sells, the structure of those markets and potential changes in the way those markets function, the vulnerability of the institution’s reputation, the systemic importance of the institution, and many other factors.

Issues of practicality constrain the determinants of capital requirements to a small subset of these factors. Thus, for example, OFHEO’s risk-based standard focuses on each Enterprise’s current book of business and two possible future risk environments. It requires sufficient capital to cover losses or current positions in extended, specific adverse circumstances. This is a highly detailed rule that examines this aspect of capital adequacy in depth. It is important that the Enterprises be able to meet this requirement, but does not necessarily imply that capital is adequate. A high degree of protection against interest rate and credit risk can reduce the risk-based requirement to very low or zero levels without addressing other risks.

The minimum capital (leverage-based) standard is a fail-safe mechanism that ensures a substantial amount of capital regardless of measured interest rate and credit risks. Incorporating all other risks into the risk-based standard would be problematic. They generally do not fit well into the scenario format because the range of possibilities is essentially infinite. Also, the magnitudes of other risks generally are not easily quantifiable, but rather are more a matter of judgment.

A separate standard that encompasses these judgments makes sense. While it would be possible to add the two requirements to make a single rule that would produce an overall requirement that would be considerably more volatile than the current combination, and might usually be higher than necessary. So far the judgment exercised by Congress in setting the ratios used to determine the minimum capital requirements has worked satisfactorily. However, institutions and their business environments change over time. An expert safety and soundness regulator is best able to judge if and when changes to a leverage-based ratio should be made. Accordingly, Congress should give the regulator of Fannie Mae and Freddie Mac the same authority it has given depository institution regulators to adjust all capital requirements if necessary.

Q.2. Do you believe the current separation of regulatory authority that gives the power to oversee new GSE programs and activities to HUD, and safety and soundness to OFHEO, has undermined your ability to oversee the safety and soundness of Fannie and Freddie? Why or why not?

A.2. The separate regulatory authority for new program review by HUD doesn't undermine OFHEO's safety and soundness authority.

OFHEO has endorsed bringing new program authority into the safety and soundness regulator as this is the case with other financial regulators. This will also permit the examination and on-site expertise of OFHEO to be brought to bear in making decisions on new programs and potentially produce fuller and quicker review of new programs.

All of these benefits may occur without any adverse impact on housing mission or safety and soundness. Congressional goals on Enterprise housing mission are in statute and must be followed by the safety and soundness regulator and indeed today in applying safety and soundness rules under its jurisdiction. OFHEO abides by Congressional housing policy in such areas as low- and moderate-income programs undertaken by the Enterprises.

Q.3. You testified that while you have been OFHEO Director, HUD has never approved (or declined to withhold approval) a new GSE program or product that you believed would have undermined Fannie and/or Freddie's safety and soundness. In light of this history, why do you believe that the authority to approve any new GSE programs or products must be included in the oversight authority of the GSE safety and soundness regulator? What is wrong with the current GSE program and product review system, which includes OFHEO in a consultative role?

A.3. HUD has addressed few new program proposals over the years since passage of the 1992 Act that required OFHEO to review the matters for safety and soundness consideration. Thus, our experience is not one of problems with the current situation insofar as safety and soundness is concerned, as noted in my response to Question #2 above.

However, OFHEO's "consultative" role may create a potential conflict should a situation arise where HUD and OFHEO have differing views on a particular program. For the reasons stated in my response to Question #2, it is my belief that the benefits of a new structure are more than sufficient to review the existing separation of functions. It would be beneficial, as is the case with other financial regulators, to have independent authority to review new programs for charter compliance.

Q.4. At the July 17, 2003, GSE oversight hearing, you testified that OFHEO would conduct a special investigation of the accounting practices of Freddie Mac. The report of the investigation is now expected to be completed in November. Has the investigation provided you with any insights or further recommendations about how Congress might improve the oversight of the GSE's?

A.4. Yes, the investigation gave the Agency insights into additional authority OFHEO needs to be better able to accomplish its regulatory goals. These are included in the report of our special examination of Freddie Mac.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM DOUGLAS HOLTZ-EAKIN

Conservatorship/Receivership Authority

The Administration has proposed that the new regulator have all the receivership authority necessary to direct the orderly liquidation of assets.

Q.1.a. What difficulties would you see in moving to receivership powers akin to those held by the FDIC?

A.1.a. One purpose of receivership is to prevent a failing institution from continuing to incur losses after its equity capital has been exhausted. In the case of Federally insured banks and Government Sponsored Enterprises, the Government has a direct interest in preventing failed institutions from taking on additional risks in an attempt to win back their losses. Another purpose is to transfer the function of the failed entity to a new service provider. For the most part, the FDIC seems to have adequate authority to ensure an orderly winding down of the affairs of a troubled bank without exposing the Government to excessive additional risks. I would note, however, that the housing GSE's are far larger than the typical failed bank and that their greater size may present special challenges to a receiver's attempts to limit risk and transfer operations to another firm or other firms. But with that caveat, the receivership powers of the FDIC would seem to be a reasonable starting point.

Q.1.b. What impact would receivership authority have on the ability of the GSE's to access the debt markets?

A.1.b. Providing receivership authority to a regulator might cause investors in debt securities to consider how they might be affected by the exercise of such authority and then to monitor the financial condition of the Enterprises more carefully. While that increased attention to financial fundamentals could reduce the price that investors pay for GSE debt, it would not be expected to interfere with access to the debt markets by financially sound GSE's.

For a failed GSE, appropriate receivership authority would preclude access to the debt markets, except as necessary to ensure an orderly transfer of functions to another financial institution.

Office of Finance in the FHLBank System

Q.2. If the regulator for the Federal Home Loan Bank System were to be moved into the Treasury Department, should the Finance

Board's Office of Finance also be moved, or how would you suggest handling the Office of Finance?

A.2. The Office of Finance, even though a part of the Federal Housing Finance Board, has no regulatory duty or authority. Rather, its role is to fund the lending operations of the Banks by issuing and servicing their debt securities as efficiently as possible. Given its purpose and function, it would be appropriate for the Office of Finance to continue to operate privately, outside of Treasury.

RESPONSE TO A WRITTEN QUESTION OF SENATOR REED FROM DOUGLAS HOLTZ-EAKIN

Capital Standards

Q.1. In your testimony, you mention that regulators can limit GSEs' risk exposure to taxpayers by having the capabilities to adjust capital requirements and other tools. Currently, the GSE safety and soundness regulator can adjust the risk-based capital standard. Why does the minimum capital standard need to be changed in addition to the regulator being able to change the risk-based capital standard? Please explain in detail.

A.1. The risk-based capital standard is based on a complex computer-based effort to model the risk assumed by the GSE's. The minimum capital standard, by contrast, is intended to provide a margin of safety against unquantifiable risks, including systemic risks, and against errors and failures in the risk-based capital stress test. Indeed, the regulator who is responsible for setting the risk-based capital standard may be uniquely positioned to appreciate the limitations of that standard.

Both standards could be useful in providing a measure of protection for taxpayers against the adverse consequences of assumed risk. Thus, I see no reason to restrict the authority of the safety and soundness regulator to setting capital standards based solely on quantified risks.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM DALE J. TORPEY

Oversight of the FHLB Housing Programs

Q.1.a. Your testimony addressed HUD's mission control for Fannie Mae and Freddie Mac. HUD, however, does not oversee the housing mission or affordable housing programs of the Federal Home Loan Banks. Do you believe that the Federal Home Loan Banks' affordable housing mission needs to be changed?

A.1.a. ICBA believes that the Federal Home Loan Banks have performed extremely well in accomplishing their affordable housing mission. According to the FHLBanks' Office of Finance, during 2002, the FHLBanks contributed some $286 million to the Affordable Housing Program. Since the program's inception in 1990, the FHLBanks have awarded over $1.7 billion in AHP subsidies helping to create nearly 359,000 housing units for low-income families. ICBA does not see any need to make changes to this program.

Q.1.b. If a single regulator for the GSE's is created, should the FHLBanks' housing mission be treated differently than that of Freddie Mac and Fannie Mae?

A.1.b. Congress established different ways for the FHLBanks to fulfill their housing mission compared to those established for Fannie Mae and Freddie Mac. Congress gave Fannie Mae and Freddie Mac goals for the purchase of mortgage loans for certain geographic areas and for certain consumers based on income levels. These goals are consistent with the secondary market function of Fannie Mae and Freddie Mac. Congress, however, created a very different program, the Affordable Housing Program, for the FHLBanks. This program funnels a specified portion of the FHLBs' net income to their members so they in turn can help their customers qualify for affordable housing loans. ICBA sees the difference in these programs as complementing the differences in the function, operation and structure of the FHLBanks that serve primarily as a source of funding to their members, versus the secondary market function of Fannie Mae and Freddie Mac.

Prompt Corrective Action

Q.2. OFHEO and the Finance Board clearly do not have the complete arsenal of Prompt Corrective Action tools that the OCC and other bank regulators have. In fact, the Finance Board has no statutory Prompt Corrective Action authority. Do you believe that a new regulator must have the same Prompt Corrective Action tools as the bank regulators?

A.2. We believe that the GSE's should have strong regulatory oversight. ICBA has not yet concluded its analysis of the differences in regulatory powers of OFHEO and the Finance Board as compared to those of the bank regulators, and we have not yet determined if the GSE regulators should have the exact same powers as those of the bank regulators.

Program Approval Authority

Q.3. Do you believe that moving prior program approval from HUD to a new safety and soundness regulator would have any adverse impacts on the GSEs' housing mission?

A.3. ICBA testified that for the housing GSE's to continue to be innovative in the development and implementation of new products to meet the demands of the marketplace, there should be a smooth and seamless process for getting these products online. As we stated, if a FHLBank, Fannie Mae, or Freddie Mac develops a program that is inconsistent with safety and soundness or with their Congressionally mandated mission, there must be a review process to make that determination. We continue to believe that there should not be disincentives for the GSE's to be innovative and adaptive to new market conditions. Our housing finance system has evolved rapidly over the recent past due to changing technology and changes in the demands of consumers. The housing GSE's must have the flexibility to develop the housing finance products needed by consumers in a timely manner and not have new products, programs, and activities be bogged down by bureaucracy. Because of its responsibilities and expertise, we prefer that prior program review for Fannie Mae and Freddie Mac remain in the hands of HUD. We would also reiterate our strong concern that given the Treasury Department's existing tax and fiscal policy responsibilities, moving authority for housing policy to Treasury would likely present clear conflicts of interest. Also, as we testified, we share the concerns expressed by others regarding the historical absence of housing expertise at Treasury.

Capital Standards

Q.4. Could giving the GSE regulator, be it the current regulator or a new regulator, greater discretion over minimum capital standards have any adverse consequences on the mortgage market?

A.4. Congress has established the minimum capital standards for Fannie Mae and Freddie Mac, and the equivalent for the FHLBanks, while giving their regulators the responsibility to set risk-based capital standards. As ICBA testified, this should continue to be the case. Market factors and potential risks can change rapidly and it is appropriate for a regulator to have the ability to adjust risk-based capital standards and risk factors through the regulatory process. Congress should retain the authority to modify statutory or minimum capital or leverage standards as these standards can affect the amount of capital flowing to the housing sector.

RESPONSE TO A WRITTEN QUESTION OF SENATOR HAGEL FROM DALE J. TORPEY

Minimum Capital

Q.1. In your written testimony, you state that ICBA supports a "politically independent," "world-class" regulator like the OCC and the OTS. However, you object to that new regulator having authority to adjust minimum capital, a power which is granted to the OCC and the OTS. Shouldn't a truly world-class regulator, like our Nation's bank regulators, have the authority to adjust minimum capital?

A.1. When Congress wrote legislation governing the housing GSE's, it set the minimum capital standards for Fannie Mae and Freddie Mac and the minimum leverage ratio for the FHLB's, and also gave guidance for their regulators to establish risk-based capital ratios. We believe this has worked well so far and see no reason for change. ICBA has been concerned that a politically influenced regulator would use the minimum capital or leverage standards as a way to increase or decrease the capital flowing to the housing sector for political reasons rather than to control risk. If regulators see that the risks facing the GSE's warrant increases in capital, they have the ability to require higher levels based on a methodical, risk-measurement process. If warranted, regulators are able to set risk-based capital standards so that the entities hold more capital than would be required by minimum capital or leverage standards.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM DALE J. TORPEY

Regulatory Restructuring

Q.1. In your testimony, you argue that "the FHLB's should continue to be regulated by a separate and independent agency" and that the "ICBA Board (has) voted unanimously to oppose including the FHLB's in any proposed new supervisory and regulatory structure for Fannie Mae and Freddie Mac in the U.S. Treasury Department." However, you also state that "the ICBA may not oppose the concept of a new independent regulator for all . . . housing GSE's outside the Treasury Department." How could GSE regulatory reform legislation be drafted to address the differences between Fannie and Freddie and the FHLB's but remain consistent enough so as to establish a level playing field between the housing GSE's? Do you have any specific recommendations?

A.1. ICBA has only started to look at this very complex issue. We see many differences between the FHLB's and the other two housing GSE's and we have begun to identify them. For example, ICBA members place a great value on the regional structure of the FHLB System and would not want to see legislation that pushes the System toward consolidation so that its structure looks more like Fannie Mae's and Freddie Mac's for the ease of regulation and oversight. The FHLB System is a cooperative and its member users should continue to be eligible to hold seats on FHLB boards of directors. Yet, it is probably not appropriate for Congress to set aside a number of seats on the boards of public companies Fannie Mae and Freddie Mac for their seller/servicers. One idea that has already received some level of public discourse is the creation of a single, independent regulator for all three housing GSE's—but which would have two separate divisions, one for Fannie Mae and Freddie Mac, and the other for the FHLBanks. ICBA continues to study this and other ideas.

Cost of Funds

Q.2. Do you believe that if the FHLB System were not regulated by the proposed new regulating entity the cost of capital for the banks, relative to Fannie and Freddie, would eventually increase? Why or why not?

A.2. We do not believe that cost of funds will be materially impacted by who the regulator is. Fannie/Freddie and the FHLB's have long had different regulators and this has not been an issue. More important to the capital markets is whether or not GSE status remains intact, and other factors that might affect the bond ratings of the individual GSE's.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM ROBERT M. COUCH

Program Approval Authority

Q.1. Do you believe that moving prior program approval from HUD to a new safety and soundness regulator would have any adverse impacts on the GSEs' housing mission?

A.1. Moving prior program approval from HUD to a new safety and soundness regulator would strengthen the GSEs' housing mission. The GSE's are committed to their housing mission. Moving regulatory oversight of their programs will not change their commitment at all. It would merely ensure that they carry out their mission safely and soundly, something everyone supports.

There is no question that the GSE's must operate their programs safely and soundly—they would fail in their housing mission otherwise, and that would be unacceptable to all. Safety and soundness is the core foundation upon which the entire GSE housing mission rests. GSE programs must be safe and sound for the very purpose of maintaining that core foundation.

Some parties have expressed concern that safety and soundness review or oversight of GSE programs would interfere with the GSEs' housing mission. These parties are concerned that a safety and soundness regulator, such as an agency under the Treasury Department, would not be sufficiently concerned about the GSEs' housing mission. MBA does not share this view.

In fact, we believe that Treasury has demonstrated repeatedly an ability to oversee program approval reviews without any adverse impact on housing. Treasury oversees all national banks and Federal thrifts in the country. The thrift industry, in particular, is a major participant in the housing industry, and the Treasury has successfully regulated thrifts since 1989. Treasury oversees new activities for thrifts, without any adverse affects on the housing industry, and with no interference with thrifts' ability to innovate and stay competitive. Further, Treasury's responsibilities include administering the Community Redevelopment Act for both banks and thrifts, ensuring that lending resources are available in communities.

Capital Standards

Q.2. Could giving the GSE regulator, be it the current regulator or a new regulator, greater discretion over minimum capital standards have any adverse consequences on the mortgage market?

A.2. A financial regulator needs appropriate discretion to carry out its duties—ensuring adequate capital standards is typically a core component of that role.

Today, OFHEO has no discretion in setting minimum capital standards. The minimum capital requirement is set entirely by a statute enacted in 1992, and cannot change as the marketplace changes or as the GSE's change. Even in the case of a financially distressed GSE or of a market crisis, OFHEO has no authority to alter the minimum capital requirement.

MBA believes that the GSE regulator should have the necessary discretion to determine appropriate capital requirements, commensurate with the goal of ensuring financial safety and soundness and prudent risk management. Fannie Mae and Freddie Mac today appear to be well-capitalized, so no imminent change is foreseeable. Ultimately, the mortgage market benefits if the regulator is empowered to act to prevent a crisis, rather than just respond to one.

RESPONSE TO A WRITTEN QUESTION OF SENATOR HAGEL FROM ROBERT M. COUCH

Q.1. MBA has published an issue paper in which you suggest standards for determining when a GSE activity is outside the boundaries of the secondary mortgage market. Can you summarize this document for us, and do you think we should use it as a guideline for the regulator in evaluating Fannie and Freddie's programs, products, and activities?

A.1. MBA published an issue paper in 2001 entitled *Defining the Boundaries of GSE Activity,* available on our website at (control-click this link): *http://www.mortgagebankers.org/library/isp/*

2003_4/03–03.pdf. Below is a summary of the issue paper, followed by an answer to your question about it.

This issue paper arose out of concern on the part of many MBA member mortgage lenders that Fannie Mae and Freddie Mac have begun to insert themselves into the primary mortgage market. The issue paper describes the important role the GSE's play in the secondary mortgage market, and compares and contrasts that to the role of the originating mortgage lenders in the primary mortgage market. Congress created Fannie Mae and Freddie Mac to provide liquidity in the secondary mortgage market. The GSE's work together with primary mortgage market lenders to provide the American public with our highly successful residential mortgage market.

The GSE's enjoy legal and financial benefits of Government sponsorship, designed to ensure the GSE's provide secondary market stability and liquidity. If the GSE's were to use their Government sponsored competitive benefits to expand their activities into the primary market, their competitive advantage could permit them to dominate the primary market. Consumers would be the ultimate losers. Primary market domination backed by competitive advantages would stifle competition, raise mortgage prices, and limit consumers' financing options.

Many believe that the GSE's have been moving into the primary mortgage market. They have, for example, acquired interests in a range of nonlender primary market participants, begun advertising heavily directly to consumers (who do not participate in the secondary market), and they have worked to increase their market share by enforcing loan delivery standards that favor their proprietary technologies for primary market activities, to the detriment and demise of private market technology providers.

Current law is vague, leaving the GSE's vulnerable to criticism that the existing regulatory system is unable to provide adequate oversight of the GSEs' mission and programs. Current law prohibits both GSE's from mortgage loan origination, but does not define loan origination. The issue paper provides a detailed description of the differences between the primary and secondary markets. In brief, primary market participants work directly with consumers. The secondary market is investment-related, involving a mortgage loan after it has been originated, and there is no consumer contact in the secondary market.

The GSE charters were established decades ago. More recently, in 1992, Congress required the GSE's to meet affordable housing goals. Congress did not thereby alter the scope of the GSEs' mission and did not intend a wholesale rewrite of their charters. A link between meeting a housing goal and an otherwise-impermissible GSE activity does not justify GSE entry into the primary market. Every GSE initiative must promote liquidity in the secondary mortgage market.

The issue paper further sets out standards and criteria for distinguishing between the primary and secondary markets. Generally, if an activity involves contact with borrowers or potential borrowers, or their agents or representatives, it is a primary market activity and is impermissible to the GSE's.

MBA believes this issue paper would provide very useful guidance to Congress in considering Fannie Mae's and Freddie Mac's activities. MBA members are the lenders who originate the loans that Fannie Mae and Freddie Mac buy and guarantee. Our members have direct, hands-on experience working with the GSE's—that is what our members do every day. Further, MBA established this issue paper by convening a blue ribbon panel of industry leaders from among our members. The panel extensively analyzed and reviewed the spectrum of GSE activities and the primary mortgage market. The panel solicited and received extensive comment from both Fannie Mae and Freddie Mac in preparing this issue paper. The resulting issue paper is an expert, detailed, analysis of the distinctions between the primary and secondary markets, and an approach for determining whether particular activities are beyond the boundaries of the secondary market.

It is important for Congress to address the boundaries of the secondary market. Currently, there are no clear boundaries, and the GSE's have been taking advantage of that lack of clarity to the detriment of the primary market. No regulator currently has the authority or capacity to address the problem, so it persists. MBA very strongly urges Congress to draw, and equip a regulator to enforce, very clear boundaries of GSE activity in the secondary mortgage market.

PROPOSALS FOR IMPROVING THE REGULATORY REGIME OF GOVERNMENT SPONSORED ENTERPRISES

TUESDAY, FEBRUARY 10, 2004

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:01 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

This morning, the Committee meets to hold our third hearing on proposals to improve the regulation of Government Sponsored Enterprises. The intention of these hearings is to build a solid record as the Committee continues to pursue legislation to establish a strong and credible regulator for the GSE's.

I would like to welcome Comptroller General David Walker from the General Accounting Office as our first witness this morning. Mr. Walker became the seventh Comptroller General of the United States and began his 15-year term when he took his oath of office on November 9, 1998. During Mr. Walker's tenure, the GAO has completed a number of important studies on the topic of GSE's. We are fortunate to have this body of work to draw from as we consider regulatory reform, and we look forward to discussing the broad array of issues with you today, Mr. Walker.

Our second panel includes three witnesses: Mr. Alan Beller, Director of the Division of Corporate Finance and Senior Counselor to the Securities and Exchange Commission; Professor Richard Carnell, Associate Professor of Law at Fordham Law School; and Mr. James R. Rayburn, President of the National Association of Home Builders. These witnesses have distinguished professional backgrounds which will enable them to provide this Committee with sound insights on particular aspects of GSE regulation. Mr. Beller, the Committee will benefit from your expertise in the area of corporate financial disclosure as we consider how to improve transparency and ensure meaningful GSE financial disclosures.

Mr. Carnell is a former Assistant Secretary for Financial Institutions at the Department of the Treasury and also a former Senior Counsel to this Committee. We will be particularly interested in your insights as to how to give a new GSE regulator the same stature and credibility as our bank regulators. Finally, Mr. Rayburn will provide us with some insights on any impact that GSE regulatory reform will have on our Nation's housing markets.

Comprehensive regulatory reform deserves careful consideration, and this Committee will work very diligently to craft an appropriate reform package. The GSE's play a vital role in expanding homeownership, and I strongly support their mission. However, the Congress cannot sit idly by after the events of last year. It is our duty to maintain the continued strength of the U.S. home mortgage market. But we must also put in place, I believe, a GSE regulator that has the necessary independence, strength, and credibility to carry out its mandate. That mandate is to ensure that all the housing GSE's fulfill their public mission in a safe and sound manner. In order to create an improved regulatory structure, I believe we must have a full and open debate on a variety of issues, such as the structure of the regulator, authority for the program review, and capital requirements. These are not easy questions to resolve, but I am confident that this Committee can reach a consensus on these issues.

I want to thank all the witnesses for appearing before the Committee today. We look forward to hearing your testimony and the discussion to follow.

Mr. Walker, your written statement will be made part of the record—Jack, do you have an opening statement?

COMMENT OF SENATOR JACK REED

Senator REED. No, sir, I do not. I would just like to thank you for holding this important hearing and the witnesses for being here today.

Chairman SHELBY. Senator Sununu.

COMMENT OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. No, Mr. Chairman. I just want to echo the remarks of my collegue.

Chairman SHELBY. Okay. Your written statement will be made part of the record in its entirety. You proceed as you wish.

STATEMENT OF DAVID M. WALKER COMPTROLLER GENERAL, ACCOMPANIED BY TOM McCOOL, MANAGING DIRECTOR FINANCIAL MARKETS AND COMMUNITY INVESTMENTS U.S. GENERAL ACCOUNTING OFFICE

Mr. WALKER. Thank you, Mr. Chairman and Senators. It is a pleasure to be here to talk to you today about oversight of Government Sponsored Enterprises. As you know, Government Sponsored Enterprises had combined obligations, including mortgage-backed securities and other debt obligations, of $4.4 trillion as of September 30, 2003. In my view, our past experience in the savings and loan industry, the recent accountability breakdowns in the private sector, and the importance of gaining public trust and confidence in regulatory agencies that oversee our financial institutions and capital markets, these factors are directly relevant to the ongoing debate and appropriate regulatory oversight of GSE's.

In our view, in order to ensure that GSE's operate in a safe and sound manner, it is essential that effective governance, reasonable transparency, and effective oversight systems are established and maintained. In particular, we believe the GSE's should lead by example in the area of corporate governance. The GSE regulators must be strong, independent, and have the necessary expertise in order to do their jobs, and GSE mission definitions and benefit measures need to be clearly established.

However, our work has also found that GSE governance does not always reflect best practices, and some of these other areas require attention at this time as well. Furthermore, the regulatory structure for housing GSE's is fragmented, and serious questions exist as to the capacity of GSE regulators to effectively fulfill their responsibilities.

To prevent the need for the Federal Government to ever have to provide financial support to a GSE and to minimize the financial risk of instability, it is critical to ensure that proper corporate governance, reasonable transparency, and effective oversight mechanisms are in place. Not only should GSE's be sensitive to good governance, but it is also all the more important that they lead by example in connection with accountability, integrity, and public trust issues.

A regulatory system of GSE oversight must have the necessary strength, independence, and capability to protect against the significant risk and potential cost to taxpayers posed by the GSE's. We have consistently supported, and continue to believe in, the need for the creation of a single regulator to oversee both safety and soundness and mission issues associated with the housing GSE's. A single regulator could be more independent and objective than separate regulatory bodies and could be more prominent than any one alone. Further, a single regulator would be better positioned to consider potential trade-offs between mission requirements and safety and soundness considerations because such a regulator would develop a fuller understanding of the operations of these large and complex financial institutions.

To be effective, the single regulator must have all the regulatory powers, enforcement authorities, technical expertise, and technological capabilities necessary to oversee GSE operations and compliance with their missions. In this regard, we believe that a hybrid executive director and coordinating board model, possibly similar to the one applicable to the Pension Benefit Guaranty Corporation, should be considered by the Congress.

Irrespective of the regulatory model, without clearly defined measures of the GSE's benefits, it is not possible for Congress, accountability organizations, and the public to determine whether the Federal Government should be potentially subject to the financial risk associated with GSE activity. In some cases, there is a lack of measurable mission-oriented criteria that would allow for meaningful assessment of GSEs' mission achievement or whether the GSEs' activities are consistent with their public interest charters. In some cases, it is clear GSE's have contributed to their public missions for which they were initially created. In this regard, it is generally agreed that Fannie Mae and Freddie Mac's mortgage purchase activities have lowered the interest rates on qualifying mortgages below what they otherwise would have been.

At the same time, additional studies may be necessary to more precisely estimate the extent to which GSE activities have benefited certain homebuyers, especially those who can least afford a home.

In this and other areas, there is substantially greater uncertainty regarding the benefits of GSE activities, both individually, collectively, and as compared to private non-GSE lenders. As a result, more research is needed to clarify these issues.

Additionally, the lines that initially existed between Fannie Mae and Freddie Mac, on the one hand, and the Federal Home Loan Bank System, on the other hand, have blurred over the years. This can lead to legitimate questions regarding how many GSE's do we need to get the job done. In some cases, the absence of specific criteria and guidance complicates the efforts to assess the need for and the benefits of GSE's.

Finally, I would like to also point out that there are other limitations in the evidence and research on benefits provided by GSE activities. There is limited information as to the extent to which the Federal Home Loan Bank System's more than $500 billion in outstanding advances as of mid-2003 have facilitated mortgage activity. There is limited information available on the extent to which Fannie Mae and Freddie Mac's investments in nonmortgage assets, such as long-term corporate bonds, serve their public missions. And there is virtually no evidence available as to whether Farmer Mac's activities have benefited agricultural real estate markets.

Without quantifiable measures and reliable data, Congress and the public cannot judge the effectiveness of GSE's in meeting their missions or whether the benefits provided by these entities are in the public interest and outweigh the potential financial risk.

To improve the quality of information about GSE activities, we believe that the GSE's should have a single regulator dealing with safety and soundness and mission activities, and that additional research is necessary with regard to some of the items that I have noted in my statement.

Mr. Chairman, that would conclude my opening statement. I would be more than happy to answer any questions that you and the other Senators may have.

Chairman SHELBY. Mr. Walker, the discussion, among other things, on the structure of a new GSE regulator has focused on two models: an independent bureau of the Treasury, like the OCC, for example, or a stand-alone independent agency, like the SEC or the FDIC or others.

If the Congress chose to adopt the independent agency structure, how do we ensure that this regulator has sufficient stature and credibility to provide strong oversight of the GSE's?

Mr. WALKER. Well, obviously, the structure can be important. One has to ascertain what are the proper qualifications for a person who would end up leading and overseeing this entity whether or not they should be Presidential appointee with Senate confirmation, what type of authorities they should have, including from a regulatory standpoint and an enforcement standpoint. So, I think those are the substantive issues that one would have to look at.

Mr. Chairman, I know there has been some controversy regarding the issue of whether or not to combine the safety and soundness mission issues. I think whether you go with an independent agency or whether you go with an entity within an existing department or agency, like the Treasury Department, it might merit considering having an executive director model with a coordinating board.

Chairman SHELBY. A board with prestige, right?

Mr. WALKER. Yes, a board with prestige. For example, you could have the Secretary of the Treasury, the Secretary of HUD, and other appropriate parties——

Chairman SHELBY. The Fed, the Chairman of the Fed.

Mr. WALKER. Potentially.

Chairman SHELBY. SEC Chairman, maybe.

Mr. WALKER. Potentially. But the idea is that, to the extent that you want to make sure that there are responsible authorities, knowledgeable parties who are concerned with and interested in safety, soundness, and mission, and who could help to make sure that all those issues were considered.

Chairman SHELBY. Could you describe some of the problems of Fannie Mae and the Farm Credit System during the 1980's, their underlying causes and the nature of the Government's assistance?

Mr. WALKER. I might get a little bit of help on that since that is before my time, Mr. Chairman, if you do not mind. This is Tom McCool, who is the Managing Director of our Financial Markets and Community Investment, with your indulgence.

Mr. MCCOOL. Mr. Chairman, yes, well, Fannie Mae was given forbearance. Fannie Mae was not actually given direct assistance, but they were in trouble and they were given forbearance from a capital and tax perspective. My understanding or my recollection is—it was actually before my time as well—that the Farm Credit System was actually given assistance as part of a bailout, and then it was also reengineered to hopefully be a more independent—the Farm Credit Administration was reengineered to be a more effective agency and a more stand-alone, arm's-length regulator.

Chairman SHELBY. Mr. Walker, your written testimony notes that OFHEO cannot place Fannie Mae or Freddie Mac into receivership. They can go in as a conservator, as I understand, which is different.

Based on your analysis, do you believe that the existing statute authorizing the appointment of a conservator gives the regulator sufficient authority to resolve a troubled GSE?

Mr. WALKER. Based upon the past experience with the savings and loan industry, et cetera, we believe that consideration should be given to expand that beyond just a conservator, and in some usual circumstances to allow for receivership. That is not something that one would expect to happen. I would hope that it would not happen. But, on the other hand, we believe it is something that needs to be in the toolbox of the regulator.

Obviously, that is something where it would be necessary to prescribe some type of guidance as to when and under what circumstances receivership would be used.

Chairman SHELBY. But you have to be ready for it.

Mr. WALKER. Correct. It should be in the toolbox, in our view, Mr. Chairman.

Chairman SHELBY. Would resolution procedures along the lines of those held by FDIC to form bridge banks or to deal with systemic risk issues also be advisable for a GSE regulator?

Mr. WALKER. We believe it is important for you to look at what types of authorities and tools other entities have, such as this, and really the question in our view would be: Why shouldn't they have it? In other words, the presumption would be that they should have these tools——

Chairman SHELBY. If you are going to have a regulator, you need a regulator. Is that correct?

Mr. WALKER. Right.

Chairman SHELBY. The last question I am going to touch on—we have a lot of other people here—is the impact of earnings per share as a corporate goal. Doesn't every public company focus on earnings per share?

Mr. WALKER. They clearly do, Mr. Chairman.

Chairman SHELBY. Does this attention to earnings per share measurements impact the holdings in the GSE portfolios, in your judgment?

Mr. WALKER. It can. As you know, there are certain holdings that can enhance value and potentially moderate risk, and such investments have the potential to do that. And I believe, Mr. Chairman, that one of the challenges that we have, not just with GSE's but in corporate America, is too much focus on short-term earnings rather than earnings over the longer-term, along with sustainable earnings, and quality earnings.

Chairman SHELBY. Senator Reed.

Senator REED. Thank you very much, Mr. Chairman.

Thank you, Mr. Walker, for your testimony.

Back in 1997, the GAO issued a report, "Advantages and Disadvantages of Creating a Single Housing GSE Regulator." It rolls right off the tongue, a very good title. "Our analysis of different regulatory structures indicate that an independent, arm's-length, stand-alone regulatory body headed by a board would best fit our criteria for effective regulatory agencies." Is that still your position today?

Mr. WALKER. We do believe there needs to be a single regulator to address safety, soundness, and mission considerations. I have now offered a possible hybrid model that we did not put forward in 1997 that I think the Congress should consider, an executive director but possibly a coordinating board involved with appropriate individuals to be able to help make sure that there is effective coordination of mission, safety, and soundness considerations.

Senator REED. What has changed since 1997 that would prompt this hybrid proposal?

Mr. WALKER. David M. Walker has become Comptroller General of the United States and has prior experience in dealing with entities that had these types of structures. It has worked pretty well. For example—and, by the way, the financial condition of the entity that I am going to talk about is not a model that we want to follow, but the Pension Benefit Guaranty Corporation has an executive director and has a board of directors comprised of the Secretary of Labor, the Secretary of Treasury, and the Secretary of Commerce. One of the reasons that that model was chosen was to be able to provide the executive director with the responsibility and authority to run this independent agency in a way to protect the public interest and to serve the mission purpose of the agency, at the same point in time recognizing that each of those three Cabinet-level Departments had an interest in the activities of the PBGC and the board served as a mechanism for them to periodically be able to convene and discuss issues of major public significance.

It is not an activist board, but it is a mechanism that worked fairly well during my tenure and helped to deal with major public policy concerns.

Senator REED. Well, I must confess, one of the concerns I have is the notion of independence, and when you have Cabinet Secretaries who are effectively the board of directors, they are subject—and regardless of the Administration—to the current winds that are blowing through this town. And that to me is not something that is going to reassure the investing public and the markets that the decisions are being made on an independent basis based upon the financial conditions of the housing market in this case.

You know, I think with that model you run the risk—and I will not even get into the financial condition of the Pension Benefit Guaranty Corporation—of conditions which, if not realistically problems, appear to be problems to people.

Mr. WALKER. Senator, I would respectfully suggest that one might want to look at who would be the appropriate members of the board. In my personal opinion, clearly you would want to have the Secretary of the Treasury and the Secretary of Housing and Urban Development. But you may want other individuals, such as the ones the Chairman suggested, to be involved who tend to be somewhat more independent and/or have term appointments that could help provide that check and balance.

Chairman SHELBY. It also would bring prestige to this board, would they not?

Mr. WALKER. Yes, Mr. Chairman, depending upon what positions and who the parties are, it could.

Senator REED. Well, again, a contrary view might be that some of our boards work very well because they have a term, they are removed from the day-to-day politics, the individuals have been in several administrations. Again, I think we should be very, very sensitive to the notion of independence because of the signals it will send to the marketplace.

Let me ask something else, too. There is the notion with these GSE's that there is an implicit subsidy to their activities because of their perceived benefit of not failing, we will step in. What is your view on that?

Mr. WALKER. Well, various studies have been conducted over time that speak of this implicit subsidy, one recently conducted by the staff of the Federal Reserve Board. I think there is a general view that some people presume that if there was a failure at one of these institutions, the Federal Government would step in.

As you know, the Federal Government is not obligated to step in. There are no appropriated funds involved at the present point in time. But quite frankly the Federal Government is not obligated to step in for the Pension Benefit Guaranty Corporation either. Nonetheless, perceptions of this——

Chairman SHELBY. Or large banks.

Senator REED. Or large banks.

Mr. WALKER. Or large banks. Nonetheless, there is a broad-based market perception that the Federal Government stands behind this entity, and that clearly has an impact.

Senator REED. I think your comments are useful because this perception is not exclusive to Fannie Mae and Freddie Mac. As the Chairman points out, I think most people in the market would assume we would not let our largest or second largest bank fail because of the consequences.

Mr. WALKER. That is correct. There are other important entities where the Government would be presumed to step in. Whether or not that will occur one can debate.

Senator REED. Thank you, Mr. Walker.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman.

Mr. Walker, if we were to proceed with legislation that would establish a new independent regulator for both Fannie and Freddie and the Federal Home Loan Banks, it seems to me that one area of obvious difference is the statutory capital structure for the GSE's. Do you have any insight that you could share with us with regard to how we might contend with that difference in the legislation that would be developed?

Mr. WALKER. Tom, I would ask if you have any thoughts on that based on our past work.

Mr. MCCOOL. I think that, again, it is different to have a capital framework written in statute. If you look at OFHEO's capital statute versus the Finance Board or the bank regulators, OFHEO has the one that is written in statute. I think that our view would be that Congress can write a capital standard and put it in the statute, but it would be useful to give the regulator some ability to have the flexibility to go above that minimum in cases where either new risks arise or new situations arise that were not foreseen by the legislation.

Senator CRAPO. So are you saying that we would have the same structure for all entities, or would the new regulator have the ability to have different structures?

Mr. MCCOOL. I believe that, again, the point would be that you want a risk-based capital approach that dealt with the risks that the entities were undertaking, and whether they are Home Loan Banks or Fannie and Freddie, for example, if you combine their reuglation, they would all have the same risks although not in the same combinations. But you would want the same capital to be applied to the same risk.

Mr. WALKER. Senator, I think you may want to have a statutory structure or framework. At the same time, I think it is important for the regulator, as we note in our testimony, to have reasonable flexibility to be able to make judgments about what the appropriate capital requirements should be given the risk involved. And one would have to assess that issue in connection with each of the various entities that they are being regulated. So it would be based on the substance or the nature of what the relative risk is. If the facts were the same, you would get the same answer. But the facts may not be the same between these different entities.

Senator CRAPO. So how would we have a statutory capital structure but then have the regulatory flexibility? Are you saying we would define the capital risk by statute and then have the regulator determine how to apply that risk?

Mr. MCCOOL. Well, actually, let me back up. It may be that the best thing to do would be not to have a statutory capital structure and to give the regulator criteria for applying capital to risk, which, again, is more or less the way it works for bank regulators. The bank regulators do not have a statutory capital structure, but they are supposed to provide a capital structure that is consistent with the risks that the institutions undertake. So rather than define broad criteria, it might be best to give the regulator flexibility within the context of particular activities to define capital in accordance with the risk undertaken.

Senator CRAPO. Mr. Walker, do you agree with that?

Mr. WALKER. I do. We are saying the same thing in a different way.

Senator CRAPO. All right. Thank you very much.

Chairman SHELBY. Senator Corzine.

STATEMENT OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Mr. Chairman.

Let me just pursue that question. I want to make sure I understand this correctly. You are talking about flexibility with regard to the definition of the risk-based capital rules that the regulator would provide. Are you distinguished between absolute minimum capital requirements and risk-based capital? Or are you underscoring the need for flexibility with one or both?

Mr. MCCOOL. Again, currently there is a statutory minimum for Fannie and Freddie in terms of their leverage ratios or effectively their minimum capital standards. I think that one could put in place, again, minimum capital standards in legislation that were not necessarily risk based, but the point would be you would want to give the regulator the flexibility to set risk-based capital standards that were, again, consistent with the level of risk undertaken by the entities. So that if different entities did similar things, they would face similar capital charges. And if they did different things, the differences would be reflected in the capital charges.

Mr. WALKER. Senator, a different way of saying it you may want to establish the floor, but you may not want to establish the ceiling, and make sure that you have criteria such that the regulator can apply the facts and circumstances to determine what the appropriate capital requirement would be given applicable those facts and circumstances.

Senator CORZINE. I think that is actually one of the difficult judgments that we are going to have to make, and, you know, how do you then figure out what is the appropriate minimum capital standard. It is true, though, that banks operate off of a risk-based system than these more modern regulatory structures that people are trying to appropriate.

Let me ask, are there any clear or are there any objective standards on why one might think that a regulatory agency should be in a group of regulatory elements? I heard you talk about structure and authorities, but you left out synergies. When one would consider the model of it being within the Treasury, one might say that having a stand-alone entity does not allow for the synergies of staying current with the latest financial knowledge base in the same way that you would if you were in a broader organization that had a culture of dealing with regulation or the common use of software and other elements that may be appropriate. You are going to have to build a whole bureaucracy that would not otherwise exist.

Are there objective standards or objective metrics that you would use to justify one versus the stand-alone agency that might be outside of just the structural issues and authorities that you spoke to?

Mr. WALKER. I think there are certain issues, Senator, that have to be addressed irrespective of whether you are within a particular department or agency like the Treasury or whether you are independent. I mean, do you have a critical mass? Do you have the right type of skills and knowledge? Do you have the right type of authorities? Do you have enough credibility, if you will, and capability to get the job done?

I do, however, believe there is a difference between coordination and integration, and if you are an entity that is an independent entity within a larger entity, then the odds are you are going to end up having more ongoing interaction and more questions being asked as to there are opportunities to do things in the same way or in a synergistic manner, and there could be some incremental benefit that could be achieved.

But I think the more important issues are the critical mass, the capabilities, the credibility, and the authorities. Those are the more important issues, I believe.

Senator CORZINE. Did you feel when you looked at OFHEO whether it failed in matching up against or at least was weaker than it would have otherwise been against those criteria, whether structure, critical mass, authorities, and maybe even synergies where there might be checks and balances within the system?

Mr. WALKER. We believe that there would be a significant plus to combine the regulators, to have a single regulator for safety, soundness, and mission, and that that regulator needs additional authorities above and beyond what authorities that OFHEO does not have right now.

Tom, do you have anything to add?

Mr. MCCOOL. Again, that part of the issue is that I think we believe that having the Federal Home Loan Banks and Fannie and Freddie in the same entity, being regulated by this entity would create synergies. It would allow you to provide more of a career track for examiners. It could grow from more simple home loan banks, up through more complicated home loan banks, up to Fannie and Freddie, and would allow more cross-matching across various types of expertise within, again, a regulator with more critical mass.

Senator CORZINE. But coming back to that, you get that critical mass by combining the different regulators. Then it is a separate issue as to whether or not you get any additional synergy—you get synergy that way. You get critical mass and synergy that way. Then there is a debate as to whether or not you are going to get that much more synergy because it happens to be within a department or agency. So the most synergy you are going to get is going to be through combining the potential regulators into one. You could get some more by having it within a department or agency.

Thank you.

Chairman SHELBY. Senator Sununu.

Senator SUNUNU. Thank you, Mr. Chairman.

Mr. Walker, as I understand it, the GAO has studied this issue and issued reports in 1991, 1993, and 1997. I might have missed one in there. In each of those cases, aside from the proposal that you spoke to Senator Reed about regarding the board structure and the directors that you have included this time, in each of those studies is it correct that the GAO, whoever the Comptroller happened to be, has recommended an independent regulator that has responsibility for overseeing safety and soundness, capital standards, the various business activities that these GSE's are involved in and regulating the mission? Have all of those things been consistent in all of these studies?

Mr. WALKER. Yes, Senator. Those are consistent recommendations throughout.

Senator SUNUNU. And your recommendation is consistent with all of those other studies? It is not just because you are afraid to be different, is it?

Mr. WALKER. No. It is consistent, and in fact, we have had a number of serious subsequent events that have occurred since those reports, both within the public sector and the private sector that would lead me to believe it is even more important.

Senator SUNUNU. I appreciate that. I am being a little facetious given your statements recently about other budgetary matters. I do not think anyone can claim you are not someone who is unwilling to speak their mind. And I appreciate that. I think that is extremely helpful for this Committee to have someone that is willing to at least step up on a somewhat political issue like this and speak their mind.

You mentioned receivership and your feeling that some provision addressing receivership might be helpful or valuable. It is my understanding that this model was used in the S&L bailout and restructuring. Did it work reasonably well as a mechanism for the S&L crisis?

Mr. WALKER. Based on my experience—and I want to ask for Tom to comment because he was at GAO at the time—I believe it had mixed results with regard to what happened with the S&L situation.

Mr. MCCOOL. Right. But I think a lot of it had to do with when receivership was imposed as much as whether it was receivership versus conservatorship. I think what part of the issue has been, and to some extent still is, is the question of when you close down an institution. I think once you decide to close down an institution, receivership has a lot of advantages compared with conservatorship, but the question about when you make that call has always been an issue, and as I said, we have seen instances recently where it still is an issue.

Senator SUNUNU. I mentioned the consistency in these evaluations by the GAO going back now more than 12 years, uniform recommendations that all the capital standards, all the business activities, all the mission-related activity as well, be included under an independent regulator.

What about the issue of the type and the amount of nonmortgage-related assets held by the GSE's; should that fall within the scope of the independent regulator, and does your report include specific recommendations?

Mr. WALKER. We do reference the fact that that is an area that would be subject to oversight by these new independent entity. How does it relate to the related risk and the public purpose for these entities? Not a per se preclusion by any means, but it is something that I think the regulator has to be able to consider.

Senator SUNUNU. Something that they should be able to consider.

Senator Reed talked about or raised the concern of politics, and I think that is important, in the board structure, cabinet secretaries, Treasury, HUD, which you mentioned would naturally have an interest and an expertise here. But there are natural concerns because those are cabinet positions. In previous reports the GAO has recommended that the Chairman of the Federal Reserve be part of the board. Having the Chairman of the Fed as part of the board would seemingly address many of the concerns raised by Senator Reed. Is that a recommendation that you would stand by or support?

Mr. WALKER. I believe that is something the Chairman of the Federal Reserve may or may not want to do, but that would clearly be a positive step.

I think the other thing, Senator, that one might want to consider—because I am on another board with the Chairman of the Federal Reserve right now dealing with the airline industry—the other thing you may want to consider is there are other board models out there that are hybrids. In addition to the one that I mentioned, I was a trustee of Social Security and Medicare for 5 years, and on that you have three cabinet secretaries and you have two people from the private sector who meet certain experience requirements. So in addition to the Chairman of the Federal Reserve and potentially others, you may want to think about whether or not you have some public members who are not Government employees.

Senator SUNUNU. One final question about the mission. GAO, I think in the 1997 report, highlighted or discussed that when mission and safety and soundness regulations are performed by different regulators, even with some coordination there is the potential for the GSE's to try to pit the regulators against one another. Could you talk a little bit about examples, the specific examples where this had occurred, and whether that was behind your recommendation that it all be included in the new regulator?

Mr. WALKER. I will make a comment, then ask Tom for some specific examples. There is no question that to the extent that you have different regulators and they have different rules and different authorities, that there is going to be some human tendency to try to do that. That is just human nature. Our view is that for critical mass, for credibility, for capability, potentially for synergy and other purposes, that it makes sense to have one regulator for these types of entities.

Tom.

Mr. MCCOOL. Again, I think that our experience with having a mission regulator without—under a different entity than the safety and soundness regulator, it was not so much that there were clashes, as that the mission regulator in the case of Fannie and Freddie, when it first set its goals in the mid-1990's, did not have much financial experience and did not have much ability to understand what pushing the goals a little higher would lead to in terms of potential risk or potential loss in profit, and I think that is what we think a regulator that understands the whole thing can do and do a better job of.

So our view, for example, is the first set of goals that HUD set were fairly conservative because they were operating without the full knowledge of everything that one regulator could have. Since then HUD has ratcheted up the goals and one could argue that the goals are maybe getting to where they should be, but without seeing the whole picture it is very hard to make that judgment. And we think a single regulator could do that.

Mr. WALKER. If I can come back real quickly, Senator. To me this is an issue like so many issues: It is a combination of value and risk. How can we try to maximize value and manage risk? In doing that I think you need to integrate the mission issues with the safety and soundness issues because there are tradeoffs. We are trying to achieve certain public purposes through these entities, and those need to be considered. But to the extent that you push the envelope too far one way, it can have an adverse effect on the other. So by integrating these issues I think you have a better chance of being able to make more informed judgments on the value/risk tradeoff.

Senator SUNUNU. Thank you.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman. I am sorry I was not here at the outset, and I want to join with others in welcoming the Comptroller General again. We always very much appreciate his appearances and his testimony. And Mr. McCool, it is good to see you again.

Mr. Chairman, I do want to commend you for the very thorough and thoughtful way you are approaching this matter. This is the fourth hearing we have held on this issue. It is a very important issue, and I think we need obviously to build as strong and as thorough a record as we can as we consider moving ahead.

Fannie Mae and Freddie Mac, along with the FHA, have been key players in making the mortgage market in this country the deepest and most liquid in the world, and actually it is the accumulation of housing wealth and the ability of homeowners to tap into that wealth because of the efficiency of our mortgage markets that have been a strong support for our economy.

Most recently it is clear that the economy has been held up by people being able to draw on their housing wealth. So we have to be very careful, as we move ahead, that we do not impinge negatively on the secondary mortgage market to which Fannie and Freddie have contributed so much.

One way to exercise that responsibility is to make sure these institutions are subject to strong, effective supervision and regulation, that they are within a framework that can assure their safety and soundness. I would apply the same thinking to the Federal Home Loan Banks. Of course, there is concern now about the adequacy of the supervision drawn to our attention by Freddie Mac's recent problems.

I do, in fairness to OFHEO, want to say I do think they have responded appropriately, as I see it, to the Freddie Mac problems. They have moved ahead, and I am going to ask the Comptroller General whether they have a view on that particular current issue.

But we do have these important questions as to whether the regulators have sufficient resources, expertise, and authority to provide the effective supervision. We are trying to balance two important goals: Increase scrutiny and more effective regulation, and commitment to the housing mission.

I want to first ask the Comptroller General, what is your view about the adequacy of the housing mission of these institutions? How well is that being addressed? How important is it, and how do we ensure that if it is important that we are adequately addressing it?

Mr. WALKER. Senator, as you know, one of the primary reasons why these are GSE's is to promote homeownership in general, and also among those who can least afford to own a home. As Director McCool mentioned earlier, Housing and Urban Development has had the responsibility to set those mission goals, and they significantly increased what those goals were, I think in 1998, if I am not mistaken.

I believe, as my testimony notes, that additional guidance might be necessary by this Congress on mission and what is trying to be accomplished. And I think that we have to keep in mind that in the case of Fannie Mae and Freddie Mac, they are public companies, and that therefore those who are on the board of directors of those entities have a fiduciary obligation to the shareholders.

At the same point in time at least the statutory appointees who are being put on the board to protect the public interest, need to pay special attention to the public purpose of these entities, and that more needs to be done in order for them to be able to demonstrate, other than lowering the average mortgage by 25 to 40 basis points, what else is being done and to what extent are these GSE's are adding value above and beyond value that other GSE's are adding, and to what extent these GSE's are doing a better job than non-Government Sponsored Enterprises with regard to mortgage lending. I think there are some very serious issues that need to be explored further.

Senator SARBANES. How would you ensure that the housing mission was being adequately addressed in any structure that is developed here?

Mr. WALKER. That is why I think that you should consider this hybrid model. I really believe that it is important to consider some type of a hybrid model with regard to overseeing the regulator that provides the capability, the credibility, and the ability to look at both the public mission and also the safety and soundness issues. I believe that could help tremendously, in addition to other items that we laid out in the testimony.

Senator SARBANES. Mr. Chairman, I see my time is up. I have a couple more questions after the others finish.

Chairman SHELBY. Thank you.

Senator Hagel.

STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you.

Mr. McCool, Mr. Walker, thank you for coming before us this morning.

I want to begin, Mr. Walker, with part of the exchange you had with Senator Reed regarding the concept of too big to fail. In your view, have the housing GSE's and their relevance to the housing market approached the "too big to fail" position?

Mr. WALKER. Well, first let me say I do not think any entity is too big to fail, but I do think that we have to be careful to make sure that they do not fail because if one of these entities did fail, it would have a significant adverse ripple effect throughout the entire financial markets.

But, Tom, would you agree?

Mr. MCCOOL. I agree. I mean that the question of whether something is too big to fail is fundamentally, ultimately a political call I guess is part of it. But to the extent you can keep it from becoming—reduce the prospects of failure by having effective oversight and regulation, that is where we need to focus our attention.

Again, we have not had to deal with a "too big to fail" situation, at least in the financial sector in a while, and we do not know, for example, in the banking sector whether the new rules and procedures put in place by FDICIA will work. We hope they will or hope they will allow a large institution to be at least unwound in an effective way, if not protecting it from failure.

But it is a concern because obviously when entities perceive themselves as too big to fail or are perceived as too big to fail, that has consequences for market discipline.

Senator HAGEL. Following up on your comments, your point about we need to do everything we can to assure that we do not get into a position like that. Would, for example, restricting the types and amounts of assets, be a useful regulatory tool, as we are thinking through possibilities as we start to develop a framework for a new regulator?

Mr. WALKER. I think that comes back to one of the questions that Senator Sununu and others mentioned, and that is, should the regulator have the ability to provide some type of restrictions on the amount or type of assets that they can hold including whether and to what extent derivatives are used to mitigate risk and to reduce risk, rather than to enhance earnings. I think these are things that should be within the portfolio of the regulator within reason.

Chairman SHELBY. Could you elaborate on that just a little bit? I know it is his time, but would you?

Mr. MCCOOL. Well, as we know, derivatives can be——

Senator SARBANES. The Chairman just gave him additional time. [Laughter.]

Senator HAGEL. My time is your time, Mr. Chairman. That is fine.

Chairman SHELBY. Senator Hagel and Senator Sununu both have taken a big interest in showing a lot of leadership in this are, so I think this is important to what you are touching on.

Mr. WALKER. I mean the fact of the matter is, derivatives can be used to mitigate or moderate risk through matching concepts and a variety of other things, or they can, if not properly used, serve to increase risk and volatility. We have seen examples of this in some of the recent failures in the private sector, where activities were being engaged in in order to increase earnings, but at substantial risk. It is important when you are dealing with an entity that is Government sponsored, of which there is a public purpose, that they be allowed reasonable flexibility to engage in certain types of investments and investment strategies, but hopefully, those are designed to moderate and mitigate risk rather than to enhance short-term earnings.

Senator HAGEL. Thank you. With regard to financial transparency—and we have dealt with that this morning in some detail, and there will be more of that exchange—what are your views as to mandatory compliance with prevailing SEC regulations?

Mr. WALKER. My understanding is at least some of the entities—I think it is Fannie Mae, if I am not mistaken—are voluntarily complying with—Fannie is voluntarily complying with some of the SEC requirements, and Freddie Mac is considering it, if I am not mistaken. These are public companies with significant shareholders with important public purposes, and I clearly believe that the concepts behind increased transparency are ones that these entities need to follow. Whether or not that means that they have to be subject to the same requirements under the 1933 and 1934 Act, there could be some issues with the 1933 Act, which I think the SEC representative can talk about, I think in substance they need to conform with the requirements. Whether or not it is by statute, that is up to the Congress.

Senator HAGEL. So you would say that they really should be mandatory?

Mr. WALKER. I would say they need to enhance their transparency, and one of the ways to do that is to subject them to these Acts.

We have not taken a formal position on this in the past time? I think they need enhanced transparency, and I will not go as far as saying that they should be subject to the Act. That is for Congress to decide.

Senator HAGEL. Would then fair value disclosure be useful?

Mr. WALKER. Yes.

Senator HAGEL. Thank you.

Chairman SHELBY. Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman.

Welcome, General Walker. Good morning. Let me see if I understand what you said with respect to how you think the regulatory structure should be organized. Do I understand you believe that there should be an independent regulator, single independent regulator?

Mr. WALKER. That is correct, Senator.

Senator CARPER. Do you believe that a regulator should be housed within Treasury?

Mr. WALKER. It can either be within Treasury. There is some incremental synergy that could be attained that way, or independently, but we are not taking a position on that.

Senator CARPER. How would you recommend that we go about making that decision? What should we keep in mind as we try to decide?

Mr. WALKER. My personal view is the issues that are the most important are pulling together one single regulator that has responsibility for mission and safety and soundness, making sure that they have the appropriate amount of authorities, the appropriate capabilities in order to get the job done, and I think you can look to other models that are out there as to ones that have been totally independent in how they have worked, versus ones that have been within departments and agencies, and make a judgment based upon that.

My view is, is that the issue that I think most people have talked about is how do you deal with balancing the mission and the safety and soundness issues. The reason that I threw out the idea of the possibility of a board structure is I think that is a good way to do that, and that could be accomplished whether it is within the Treasury Department or not. For example, the Pension Benefit Guaranty Corporation has a board of directors that I think could be built upon, and technically the Pension Benefit Guaranty Corporation is deemed to be within the Labor Department. It has separate facilities. It is within their budget, but in many ways it operates very independently. So look at past experience is what I would say, and what has worked and what has not worked.

Senator CARPER. I want you to talk with us—and you may have already done this, and if you have, I am going to beg your indulgence—but I would like to just pick your brain a little bit if I could with respect to who should be setting minimum capital levels? Should it be a regulator? Should it be something that Congress does through legislation? Talk to us about the pros and cons of doing either.

Mr. WALKER. One of the things we talked about earlier, Senator, is that the regulator needs to have the flexibility to be able to—

Senator CARPER. Wait a minute. Before you do that, just preface your response to my question by talking about the importance of the minimum capital levels. Why is it important?

Mr. WALKER. Minimum capital requirements are obviously very important in order to assure safety and soundness. It is one of the most fundamental elements to try to assure safety and soundness. In that regard, one of the things that we had talked about a little bit earlier was the possibility of Congress considering providing minimum requirements. In other words, setting the floor but not the ceiling, providing some guidance that the regulator would use, but allowing the regulator some flexibility to be able to employ risk-based concepts dealing with different entities to determine what the appropriate capital requirement should be, given the risk involved.

Senator CARPER. Do you see that as a compromise between one or the other? Is that a reasonable compromise?

Mr. WALKER. I see it as a reasonable and prudent course because the fact of the matter is, Congress may want to provide minimums. Congress may want to provide criteria or standards that the regulator must consider. Congress may want to assure that there is a regulatory process with appropriate transparency that the regulator must follow in setting these capital requirements. But I believe that the regulator is in the best position to make informed judgments, including exercising tradeoff considerations between mission goals and safety and soundness considerations.

Senator CARPER. Obviously, the Fannie Mae and Freddie Mac are a different breed of animal than the Federal Home Loan Banks, and with that in mind, how should we and how should this independent regulator approach the regulation of the Federal Home Loan Banks?

Mr. WALKER. Presumably, this single regulator would be responsible for overseeing all of these entities. It would be Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. Presumably they would all be subject to a minimum capital requirement, but that the regulator would, based on facts and circumstances basis, be able to decide what the appropriate capital requirement would be for each type of entity.

Tom, I would ask if you want to comment.

Mr. MCCOOL. Again, the point would be that you would set capital requirements that were based on different types of risks and we know that the Federal Home Loan Banks have different types of risk than Fannie and Freddie, but they also have similar types of risks; it depends on the activity. Some of the banks do different things than other banks, and so even within this system, the Federal Home Loan Bank System, there are different types of activities that would require different capital depending on the risk level. The same principles would apply across the Federal Home Loan Banks and Fannie and Freddie.

Senator CARPER. Thank you very much.

Chairman SHELBY. Thank you, Senator Carper.

Senator Chafee.

STATEMENT OF SENATOR LINCOLN D. CHAFFEE

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Walker, you have testified that there should be some kind of hybrid oversight, and in the second panel, Mr. Rayburn is going to testify that he believes that the Department of Housing and Urban Development is the appropriate agency to regulate the mission of Fannie Mae and Freddie Mac.

What is the best argument you could use to convince Mr. Rayburn that it is better to have a hybrid?

Mr. WALKER. My view is that the Department of Housing and Urban Development clearly has a stake, and they clearly need to be involved.

I believe that the hybrid option is one way to help assure that they will be involved, that they will have a seat at the table, and at the same point in time, recognizing that one has to balance the mission with the safety and soundness issues, and that is the way to get it done. That is my personal view.

Senator CHAFEE. Thank you.

My other questions have been asked already, and that is the only one I had, Mr. Chairman.

Thank you.

Chairman SHELBY. Thank you, Senator Chafee.

Senator Bennett.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman.

As we go through these hearings, the issues become clearer, and I congratulate you for your usual job of being very thorough in this but moving toward a goal. And I think it is pretty well summarized, General Walker, by your comment that we have the mission issue, and we have the safety and soundness issue. We want to be sure that the regulator keeps everything safe and sound, but not in such a way as gets in the way of the mission. Senator Sarbanes talked about how successful we have been—the most successful of any nation on Earth in stimulating homeownership by virtue of this structure we have built—and we do not want to damage that.

Senator Sununu made reference to the savings and loan crisis. I came to the Senate in the midst of that crisis and had some period of time outside the Senate where I watched the regulators close down sound S&L's as well as failed S&L's in their zeal to make sure that everything was safe. And there were shareholders who lost their life savings and viable businesses that were shut down in the zeal of the Federal regulators to make sure there were not anymore loan losses. And we saw an example of that at the back end, which I saw when I came to the Senate in two ways—number one, when they started liquidating all of the things that they took over, they found that a lot of them were worth a whole lot more than they had thought, and therefore, the Government got a lot back—the shareholders were out and injured, but the Government seized these things—"seized" is not the proper legal word, but it is in effect what happened—in an effort to get safety and soundness, shutting down, and then having good assets as they came around to liquidate them, and the S&L final bill was not as big as projected because the Government had all those assets.

And then, the other aspect of it was financial institutions in that period, when I was just coming on the Banking Committee, were reluctant to loan because they saw how badly beat up people were when they took any kind of risk—in the name of safety and soundness you cannot do that—and we had problems where we were saying you have to get some liquidity into the economy to get it going. And it took a year or more before banks began to raise their heads enough to say, "We will start to make some loans again, but we are fearful from the reaction of the regulators."

I give you that history because that is basically what you are talking about. If we decide that safety and soundness is the holy grail, we can tighten this thing down to the point that no more loans are made, and yes, your money is safe—it is all sitting there in Government securities rather than in loans—it is safe, but we are not fulfilling the mission.

So as we hold these multiple hearings, we come more and more to that point—how can we assure safety and soundness without being so paranoid on that subject that we shut down the mission and ultimately damage the benefit to society that these groups are doing.

There are a number of issues here, and you have talked about that one, but I want to introduce two more and just get your reaction. You say these are public companies, which in the case of Fannie and Freddie, they are. The Federal Home Loan Banks are not. So that becomes an additional wrinkle that a regulator has to deal with.

Furthermore, the Federal Home Loan Banks are so structured that there is a joint and several liability situation built in. All of the focus has been on the implied Government guarantee. I still do not understand what that is. It is either a guarantee or it is not, and if there is an implied guarantee, where do I go to collect the implied guarantee on an investment that I have that went bad. To which window do I show up and get cashed in if I have an implied guarantee that my investment is okay, but there is nothing in writing? But okay, are we talking about the implied guarantee for Fannie and Freddie, but you have joint and several liability, which is in stone for the Federal Home Loan Banks?

The SEC obviously has a role to play in a publicly traded company like Fannie and Freddie, but what does the SEC have to do here when you bunch in the Federal Home Loan Banks? Talk about that mix for a little while.

Mr. WALKER. First, the implied guarantee. Let me start with that, since you mention it. There are a lot of entities that the Federal Government is involved with that do not have express guarantees by the Federal Government. They are not backed by the full faith and credit of the U.S. Government. One example is the GSE's. Another example is the PBGC, the Pension Benefit Guaranty Corporation. Its insurance system is not backed by the full faith and credit of the U.S. Government.

Implied guarantees I think presume something that Senator Hagel talked about, this "too big to fail" concept, that whether there is a legal commitment or not, from a practical standpoint, many people speculate, maybe rightly, maybe wrongly, they speculate that if something really bad happens, that politically, there would be a move to step in and that therefore, that is the "implied guarantee." It is not expressed, it is not a legal commitment.

Senator BENNETT. The mix of the GSE's, Freddie, Federal Home Loan Bank, joint and several liability, SEC, public company, nonpublic. How does that all work out?

Mr. WALKER. Thank you, Senator, for refreshing my memory.

I think we have to look at each based on the facts and circumstances. You are right that the Federal Home Loan Banks are cooperatives. They are not public companies. So therefore, I think having them subject to SEC regulation is obviously not the issue.

On the other hand, as it deals with mission, safety, and soundness, it seems that there are a lot of common denominators that a single, integrated regulator would be able to consider and apply as appropriate involved with the Federal Home Loan Banks versus Fannie Mae versus Freddie Mac.

So there are certain elements that would apply. There are other elements that would not. But from the regulator's standpoint when you are dealing with mission, safety, and soundness, it seems to me there are a lot of common denominators, and there are synergies.

Senator BENNETT. I agree with that, and my time is up, but it just occurs to me that it may well be that if you put the Federal Home Loan Bank boards into this pot, you have to eliminate the joint and several liability arrangement that they currently have and thereby change the structure of them so they become more like the other entities that are in the pot.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you, Senator Bennett.

Mr. Walker, I have a couple of questions following up on Senator Bennett's questions for the record. One has to do with the organizational structure of the new GSE regulator, keeping in mind the differences among Fannie Mae, Freddie Mac, and as he has pointed out, the Federal Home Loan Banks and so forth.

The other question would relate to corporate governance and the Finance Board. We would like that answered for the record, and we will get this to you in a few minutes.

We have been talking about risk here and mission, safety and soundness. What we are trying to do as I understand it—and I have been on this Committee for 18 years; Senator Sarbanes dates me here—but we both sat through the debacle of the thrifts. Senator Bennett came in the middle of it, I believe, on the Committee.

Senator SARBANES. And helped us to straighten it out.

Chairman SHELBY. Absolutely.

But at the same time, what we are trying to do is balance the mission of the GSE's, which we mostly agree is sound—that is, the housing policy for the United States of America and the people, and homeownership—and the safety and soundness of the GSE's as financial institutions.

Is that what we are trying to do?

Mr. WALKER. I agree, to balance those interests.

Chairman SHELBY. Absolutely.

And we have been talking a lot about failures here, but what we are really trying to get at if we create a powerful regulator is to preclude failure, to stay away from failure, in other words, to make sure that these institutions are going to be there for the future.

Is that a fair statement?

Mr. WALKER. That is correct, Senator. We want to prevent a failure, and we want to learn from the lessons of the past.

Chairman SHELBY. How important, Mr. Walker, is it for the regulator, whoever the regulator would be in the future, to know what the models are at Fannie Mae, Freddie Mac, or the Federal Home Loan Bank board—in other words, wouldn't they have to know what is going on there? It is a very complicated situation. They would have to have the personnel to know, and they would have to be hands-on, to know what was going on, so to speak.

One of the problems that I have gathered here is that it was PricewaterhouseCoopers, inside accountants, that brought the Freddie Mac situation to a head and not OFHEO. I agree with Senator Sarbanes that the leadership at OFHEO since the revelations at Freddie Mac and Fannie Mae have been very diligent.

Go ahead.

Mr. WALKER. OFHEO has not historically had many people with expertise in accounting and reporting issues. They recognize the need to beef up in this area. They are taking steps to do that, and I think that that is appropriate that they do. In addition, in fairness to OFHEO, I will also note that one of the things I mentioned was about the need to have model corporate governance practices. OFHEO has taken steps to try to make sure that at least in the case of Freddie Mac, the CEO is separated from chairman of the board, which is a best practice in that regard, and they are trying to become more active there.

Senator SARBANES. May I——

Chairman SHELBY. If I can finish up, Senator Sarbanes, of the securities that Freddie Mac, Fannie Mae, and the Federal Home Loan Bank Board, create—and this is the securitization of the whole organization—who owns or buys most of those securities? Isn't it the banks? Don't a lot of the banks, as investors, invest in the GSE securities?

Mr. WALKER. That is my understanding, Senator.

Chairman SHELBY. Is that correct?

Mr. MCCOOL. Yes. They are purchased by mutual funds, they are purchased by banks, but a lot of other entities purchase them.

Chairman SHELBY. Thank you.

Senator Sarbanes.

Senator SARBANES. Mr. Chairman, I just wanted to follow up on the other point.

An independent, assured source of funding for the regulator is a very important aspect of this, is it not? You were mentioning OFHEO's difficulties, but is not that one of them and something that needs to be addressed in any effort to strengthen the regulatory structure?

Mr. WALKER. It is important to assure that they have an adequate amount of resources in order to effectively do their job, and that is one consideration that I think you are going to have to give as to how should they be funded and the means by which they should be funded.

Senator SARBANES. Now, in your report, you point out that the FHFB just had 10 examiners as of about 18 months ago to examine the 12 Federal Home Loan Banks, and they have initiated a program to increase it up to 30. Of course, I think the Comptroller has 20 or 30 people at one or another of the major institutions that they are involved in as I understand it.

So it is really falling way short of what is needed, is it not?

Mr. WALKER. They are clearly going to have to take a look at what they need to get the job done versus the current resources they have, and they are likely to need additional resources.

Senator SARBANES. Do you have any perception that the Federal Housing Finance Board has actually been acting more as an advocate for increasing the powers of the bank system rather than its safety and soundness regulator?

Mr. WALKER. I do not.

Tom.

Mr. McCool. We have not taken a position on that, Senator.

Senator Sarbanes. Some have argued—and actually, it has come up here today—that you cannot put the Federal Home Loan Banks into the same regulatory structure as Freddie and Fannie because there are important differences. I take it your position is that the similarities more than outweigh the differences, and therefore it is sensible to put them all under the same regulatory structure. Is that correct?

Mr. Walker. That is correct, Senator. There would be some differences, but there are more commonalities than differences, and with regard to mission, safety, security, soundness, there are more similarities than differences.

Senator Sarbanes. Thank you.

Thank you, Mr. Chairman.

Chairman Shelby. Senator Sununu, anymore questions?

Senator Sununu. No, Mr. Chairman.

Chairman Shelby. Senator Hagel.

Senator Hagel. No questions.

Chairman Shelby. Senator Chafee.

Senator Chafee. No questions.

Chairman Shelby. Mr. Walker, we thank you, and we look forward to your answers to those last questions and any others for the record. We appreciate your appearance before the Committee and your insights into what we are trying to do.

Mr. Walker. Thank you, Mr. Chairman.

Senator Sarbanes. Mr. Chairman, could I note that the GAO has built up quite a body of expertise on this issue, and I would hope we could be able to draw on the Comptroller General for his counsel and advice as we move forward.

Mr. Walker. We have great staff, and we are happy to help.

Thank you.

Senator Sarbanes. You have a good head of a great staff, too.

Mr. Walker. Thank you.

Chairman Shelby. Our next panel will be Mr. Alan Beller, Director, Division of Corporate Finance and Senior Counselor to the Commission on Securities and Exchange; Mr. Richard Carnell, Professor of Law, Fordham University Law School; and Mr. James R. Rayburn, President, National Association of Home Builders.

Gentlemen, we appreciate your patience dealing with the first panel. Your written statements, we have for the record, and we have reviewed them. We would appreciate it if you would sum up as soon as your can your top points here today.

We will start with Mr. Beller.

STATEMENT OF ALAN L. BELLER
DIRECTOR, DIVISION OF CORPORATION FINANCE
U.S. SECURITIES AND EXCHANGE COMMISSION

Mr. Beller. Thank you, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee.

I am pleased to have this opportunity to testify before you on behalf of the Securities and Exchange Commission regarding the application of disclosure and reporting requirements of the Federal securities laws to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. These Government Sponsored Enterprises, or GSE's, issue marketable debt to the public. In addition, Fannie Mae and Freddie Mac have publicly held common stock and also issue guaranteed mortgage-backed securities. All of these entities and their securities are exempt from the registration and disclosure provisions of the Federal securities laws. None of the debt securities issued by any of these GSE's is backed by the full faith and credit of the United States.

As to the Commission's historical views on GSE disclosure, since at least 1992, the Commission has expressed the view that because the GSE's sell securities to the public, including debt securities, and have public investors and do not have the full faith and credit backing of Government securities, their disclosure should comply with the disclosure requirements of the Federal securities laws. Mandatory compliance by the GSE's is the objective. Further, the disclosure quality that we seek for the GSE's can only result from becoming subject to the SEC's reporting system. The disclosure quality results not only from the Commission's rules, but also the Commission's and the staff's administration of these rules, including our review and comment processes and our enforcement program.

A 1992 joint report of the Department of the Treasury, the Board of Governors of the Federal Reserve System, and the Commission on the Government securities market addressed attaining that objective through registration. However the means, mandatory registration or voluntary registration, for example, would appear to be less significant than the objective—mandatory compliance with SEC disclosure and other requirements.

I would like to turn to a preliminary discussion of our registration requirements. For purposes of today's subject, two of the Federal securities laws are relevant—the Securities Act of 1933 and the Securities Exchange Act of 1934. Registration under the Exchange Act results in reporting companies providing for disclosure of detailed information relating principally to the company itself. Registration under the Exchange Act also subjects companies to the provisions of the Sarbanes-Oxley Act applicable to issuers.

The Securities Act, by contrast, requires registration by issuers of transactions, namely public offerings of their securities. One result of registration under the Securities Act is required disclosure of essentially the same information regarding corporations as is required for reporting companies under the Exchange Act. Another result of registration under the Securities Act is disclosure regarding the securities being offered. Finally, because Securities Act registration statements are subject to review by the Commission staff, registration can affect the timing of offering transactions.

With that summary, let me turn to Fannie Mae and Freddie Mac. On July 12, 2002, Fannie Mae and Freddie Mac announced that each would voluntarily register its common stock under the Exchange Act and thus become mandatorily subject to Commission reporting requirements. Fannie Mae's registration statement under the Exchange Act was declared effective on March 31, 2003. Freddie Mac has stated that it intends to conclude the Exchange Act registration process after it completes its restatement and audit of the financial statements. I think Freddie Mac's latest information is that they intend to become subject to registration in 2005.

The Office of Federal Housing Enterprise Oversight has also adopted rules requiring the officers and directors of Fannie Mae and Freddie Mac to file with the Commission the insider transaction reports required by the Exchange Act and requires the companies to file with the Commission all proxy documents that are also required pursuant to the Exchange Act.

It has been our focus to date that investors who purchase and sell stock or debt of the GSE's are entitled to the corporate information required under the Exchange Act. Registration under the Securities Act would not result in disclosure of additional corporate information.

Registration of securities transactions by Fannie Mae and Freddie Mac under the Securities Act, especially offerings of their mortgage-backed and other mortgage-related securities, does require consideration of factors not implicated by registration under the Exchange Act. The Commission did not recommend in 1992 removing the exemption from the Federal securities laws for the offer and sale of mortgage-backed and mortgage-related securities of Fannie Mae and Freddie Mac. We seek the achievement of the benefits for investors of registration under the securities laws, but we also recognize that these other factors need to be examined in connection with considering registration.

First, as noted earlier, the review process of the Division of Corporation Finance of registration statements under the Securities Act means that the timing of offerings can be affected.

Second, Fannie Mae's and Freddie Mac's mortgage-backed and other mortgage-related securities are backed by their respective guarantees. Exchange Act filings already would contain important corporate information necessary to analyze those securities as a credit matter.

And finally, registration of offerings of the GSEs' mortgage-backed and related securities under the Securities Act may raise another significant and complex factor—the impact on the U.S. mortgage market—that we believe should be considered. In particular, a substantial portion, and recently a majority of the GSEs' mortgage-backed securities have been sold into the so-called "To Be Announced" or TBA, market. These transactions involve forward sales of mortgage-backed securities made up of pools of mortgages not yet identified and in many cases not yet even in existence. Therefore, in a TBA transaction, actual mortgage pool characteristics cannot be disclosed at the time of registration or offering. The TBA standards that those mortgage pools must meet, which have been established by market participants, are already available to the market independent of registration.

In addition, we understand that the TBA market is used to set or "lock in" mortgage rates in the U.S. housing market. A decision to require registration under the Securities Act of offers and sales of mortgage-backed securities should therefore take into account whether and if so, how such registration might impact the mortgage market and especially the operation of the TBA market.

I would now like to turn to the Federal Home Loan Banks. The Federal Home Loan Bank System was created in 1932 and is comprised of the 12 banks. The Federal Home Loan Bank System through the Office of Finance is one of the largest issuers of debt securities in the world into the public markets. Approximately $716.9 billion was outstanding as of September 30, 2003.

The Federal Home Loan Banks are exempt from the Federal securities laws because they are GSE's. In the absence of their GSE status, they would be required to register, and the fact that they issue only public debt and do not have public equity would not change their status as required to register as issues of public debt securities. The Banks, because they are exempt, are also not subject currently to the provisions of the Sarbanes-Oxley Act. In September 2003, the Federal Housing Finance Board proposed for comment a rule to require registration with the Commission by the Banks under the Exchange Act. The comment period for that rule ended on January 15, 2004.

The Federal Home Loan Banks have many of the same disclosure issues as any financial institution whose debt securities are issued to, and held by, the public. As discussed earlier, we believe investors in the Banks' debt securities are entitled to the same type of information as that provided by other issuers of public debt. As also discussed earlier, we further believe that the Commission's detailed disclosure rules and filing requirements, review and comment process, and enforcement mechanisms provide the best framework for disclosing information to which investors are entitled.

As is the case with Fannie Mae and Freddie Mac, the focus to date for mandatory disclosure has been the corporate disclosure required under the Exchange Act. Registration of offers and sales of securities by the Federal Home Loan Banks under the Securities Act has not been the focus to date and is not the subject of the proposed Finance Board rule. In particular, as with Fannie Mae and Freddie Mac, disclosure of corporate information following Exchange Act registration is the same as would be required under the Securities Act.

Because of the structure of the Federal Home Loan Bank System, including the Office of Finance, however, there are some issues that may be unique to the Banks that should be taken into account in considering registration. The staff of the Commission has met with members and staff of the Finance Board, representatives of the Banks, and a group of directors of certain Banks, in each case at their request, to discuss the issues that registration under the Exchange Act may raise.

In addition, insofar as registration under the Exchange Act is being considered, we believe there would be no impact on the timing or other aspects of offering transactions as a result of registration.

We have also indicated to the Banks that we would work with them to determine if there were certain requirements, such as the proxy rules, from which it should be clear the Banks are exempted because the publicly held securities that implicate registration and disclosure issues are their debt securities. This would produce the same results as would be the case for corporate issuers whose only public securities are debt securities. And there is a very significant number of very large corporate issuers who fall into that category.

In addition to these items, there have been certain accounting-related issues that have been identified as significant for the Banks in terms of ascertaining our staff's view prior to any registration process. We have met with representatives and advisers of the Banks to resolve those issues, and the resolution is discussed in detail in the written testimony that I have submitted; I do not intend to go into those right now.

In conclusion, the individual and institutional investors who hold debt securities of the banks depend for repayment on the Banks under their joint and several liability, and not a Government guarantee. We therefore believe that applying the Commission's disclosure requirements and processes is the preferred method of helping to ensure that these investors receive the materially accurate and complete disclosures they deserve. If registration by the Banks is pursued, we are committed to achieving that result with maximum protection for investors and maximum efficiency for registrants, consistent with our mission to protect investors.

Thank you again for inviting me to speak here today on behalf of the Commission. I would be pleased to answer any questions that you may have.

Chairman SHELBY. Thank you, Mr. Beller.

Mr. Carnell, welcome back to the Committee.

STATEMENT OF RICHARD S. CARNELL ASSOCIATE PROFESSOR OF LAW, FORDHAM UNIVERSITY SCHOOL OF LAW, NEW YORK, NEW YORK

Mr. CARNELL. Thank you, Mr. Chairman.

Mr. Chairman, Senator Sarbanes, Members of the Committee, I am pleased to have this opportunity to discuss how to improve the regulation of the housing GSE's and particularly how to structure a new GSE regulator.

I commend you, Mr. Chairman, for your leadership in focusing attention on these issues, on the weaknesses of current law and the weaknesses of the current structure of OFHEO, and for your resolve to move legislation to correct these problems.

A new GSE regulatory agency should regulate all three housing GSE's. It should be responsible for keeping GSE's safe and sound and for making sure that GSE's carry out their housing mission. It should have permanent funding. It should have the same safety and soundness authority as the Federal bank regulators, including authority to raise capital standards and take enforcement action. It should also be able to appoint a receiver for an insolvent GSE.

I want to focus now on three specific issues—first, the governance of the new agency; second, the need to have an adequate mechanism for handling an insolvent GSE; and third, the double game that GSE's play in talking about their relationship to the Federal Government.

First, governance of a new agency. In structuring the agency, the paramount goal should be to assure the agency's independence from the GSE's and thus to maintain the new agency's integrity, objectivity, and effectiveness. One approach would be to make the agency an autonomous bureau of the Treasury Department, like the OCC and OTS. The Treasury has an institutional commitment to safety and soundness and has the will and institutional credibility to stand up to the GSE's. The GSE's would find the Treasury harder to bully than any of the alternatives, including a new, independent agency.

The GAO has suggested a hybrid approach with an executive director and a coordinating board. I would like to think more about that but also to offer some initial impressions.

I like the idea that the coordinating board would consist of people with other major Government responsibilities. That will help you get capable people. If you want to find somebody for a board position that does not have other responsibilities—that is, where you are not the chair of the agency, and you do not have any other position in Government—you are going to have trouble getting really qualified people to take those jobs and stay there. There is just not enough challenge.

So if the coordinating board does consist of people like the Secretary of Treasury, the Secretary of HUD, the Chair of the SEC, and the Chair of the Fed, I think that is a composition that makes sense.

I would caution, though, about trying to have the coordinating board actually run the agency. Big boards may sound good on paper, but they often work badly. Without a strong executive director, I do not think a five-member board, no matter who was on it, would be up to the job over time. I think it would be vulnerable to manipulation by the GSE's. I think that having so many members blurs accountability and impedes decisionmaking. So I think the executive director, if you went that route, should have considerable power to make policy.

The second topic I want to address is receivership. Current law provides no adequate mechanism for dealing with Fannie and Freddie if they become insolvent, that is, if their liabilities exceed their assets. We have mechanisms like this for the Federal Home Loan Banks, we have it for business corporations. We do not have it for Fannie and Freddie. The Bankruptcy Code does not apply. OFHEO could appoint a conservator, but the conservator would have no power to resolve the shortfall between the liabilities and the assets.

So this lack of an orderly receivership mechanism is a serious gap in current law, with potentially serious consequences for financial markets. Congress could fill the gap by authorizing the GSE regulator to commence a bankruptcy proceeding against an insolvent GSE, or it could take a different approach, like the banking law, and authorize the regulator to appoint a receiver to deal with it under a specialized body of law. That is what we do with the FDIC.

I want to point out, by the way, that receivership is not something special to the thrift debacle. Bank regulators have done probably a thousand bank failures and a thousand receiverships in the last two decades, and that has worked well in that context.

A receivership mechanism, by providing an orderly means for dealing with a failed GSE's debts, would help limit and contain the harm resulting from a GSE's failure.

Third, I want to talk about what I call the GSEs' double game, about their relationship to the Government. Fannie and Freddie play an extraordinarily successful double game in dealing with this relationship. They deny that they have any legally enforceable Government backing. They leave the impression that they have no Government backing at all, yet at the same time, they also work to reinforce the market perception that the Government implicitly backs them.

Critics of GSE's did not make up the idea of an implied guarantee. Fannie and Freddie themselves have propagated that idea for decades. For example, in my written statement, I give several examples. One of them is where Fannie Mae said in an official comment letter to the OCC, it emphasized the "implied Government backing of Fannie Mae," and it goes on to say that this backing makes Fannie's securities "mere proxies for Treasury securities."

Think about that. Fannie says its implied Government backing is so strong that its securities are almost as good as U.S. Treasury securities. So this double game lets the GSE's have it both ways. It is like telling Congress and the press, "Don't worry, the Government is not on the hook," and then turning around and telling Wall Street, "Don't worry, the Government really is on the hook."

The GSE's play this game unchallenged, year after year. No reporter exposes it. No committee investigates it. No executive branch official criticizes it. So in a world of global information, the GSE's still get away with saying one thing to Washington policymakers and saying something fundamentally different to New York bond traders and financial analysts.

Last week, Fannie Mae's CEO seemed to question the existence of any implied guarantee. I urge the Committee to follow up on this point, an important point, by having Fannie and Freddie answer three simple questions which I list in my written statement.

For example, if Fannie and Freddie were to default on their debts, would the Federal Government have any moral obligation to ensure that Fannie and Freddie's creditors get paid? I think it would really move the process along to get some clarify here.

Finally, I want to say a word about affordable housing.

Chairman SHELBY. Mr. Carnell, what were the other questions?

Mr. CARNELL. Oh, they are in my prepared testimony.

Chairman SHELBY. Share them with the audience.

Mr. CARNELL. Oh, certainly. I appreciate your interest, Mr. Chairman.

Chairman SHELBY. Absolutely.

Mr. CARNELL. The other questions are: Do capital market participants err in perceiving the Federal Government as implicitly backing Fannie and Freddie?

And, do you believe that the Government in any way implicitly backs Fannie and Freddie?

So they are related questions, but I think to get clear, unequivocal answers from the GSE's would be very beneficial.

Finally, I would like to say a word about affordable housing. Fannie and Freddie receive very valuable benefits from the Government, but they do very little considering their size and special privileges that would otherwise get done.

Studies have indicated that they do less, proportionately, than banks and thrifts. The basic problem is that the current affordable housing requirements are not targeted. Fannie and Freddie can satisfy these requirements by doing lots of middle class and lower middle class housing that they have a profit motive to do anyway.

So as long as Fannie and Freddie retain their Government sponsorship, they should be required to do much more for affordable housing.

Thank you, Mr. Chairman, and I will be glad to answer questions at the appropriate time.

Chairman SHELBY. Thank you.

Mr. Rayburn.

STATEMENT OF JAMES R. RAYBURN PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS

Mr. RAYBURN. Good morning, Chairman Shelby, Ranking Member Sarbanes, and distinguished Members of the Committee.

My name is Bobby Rayburn, and I am a builder of affordable housing in Mississippi, Louisiana, and Alabama. I am also the President of the 215,000-member National Association of Home Builders, which I represent today.

Thank you for holding this hearing on the regulatory framework of the housing GSE's.

NAHB believes that the focus of the GSE regulatory reform must remain, to use your words, Mr. Chairman, on their vital role of providing liquidity and stability for the Nation's housing finance system. This has been clearly demonstrated by housing's critical job-producing role as an economic engine in an otherwise faltering economy.

It is safe to say that the record one million-plus new home sales last year would not have occurred without the liquid and vibrant secondary market that is supported by the housing GSE's. I want to emphasize that no one believes there is an imminent crisis within the GSE system. There is time to take a careful and thoughtful approach to these issues. An ill-conceived change could seriously damage housing and the economy.

Regulation of the GSE's involves two key aspects—one, enforcing compliance with safety and soundness principles, and two, ensuring unwavering mission orientation. The purpose of the safety and soundness regulation is to ensure that the housing GSE's are adequately capitalized and to ensure appropriate governance structures and procedures.

NAHB would support transferring the safety and soundness oversight of the GSE's to a strong and credible regulator that possesses adequate authority and resources, such as the Treasury Department.

The purpose of mission regulation is to ensure that the GSE's fulfill their Congressional mandate and operate within their charters. Safety and soundness is a very relevant element but should not dominate program oversight. That would severely retard the development of programs needed to fulfill the GSEs' housing mission.

NAHB maintains the program approval activities that are currently conducted by HUD should not be transferred to the Treasury Department.

Innovative solutions to increase homeownership will continue only if mission oversight is regulated by an agency which has a housing mission, housing expertise, and housing experience. We believe that HUD should also continue to set and enforce Fannie Mae's and Freddie Mac's affordable housing goals.

We agree that more needs to be done to encourage the GSE's to increase their activities in some market segments and believe that the best way to do this is through the bonus point incentives within the existing goals. We have laid out some specific recommendations within my written statement, Mr. Chairman.

Mr. Chairman, you also asked me to touch on the capital requirements of the GSE's. NAHB supports a strong capital system for GSE's. We also believe that there is a need for stability in capital standards. NAHB therefore cautions against any immediate changes in either the GSEs' risk-based or minimum capital standards.

Over the longer-term, we believe that the safety and soundness regulator should have the flexibility to adjust capital standards as necessary. However, a significant increase in the GSEs' minimum capital standard requirements would not be justified unless there is a measurable change in their risk profile. Overcapitalization of the GSE's beyond a level of reasonable risk would have unintended consequences for the housing markets by reducing the level of capital for housing and increasing mortgage rates.

You also asked for feedback on the idea of a stand-alone independent regulator. While not our first preference, NAHB would be open to exploring the concept depending on how the details are implemented. NAHB's primary concern in any regulatory scenario is that the mission regulator must have a housing focus and expertise. The safety and soundness regulator must have sufficient respect and authority to satisfy Congress and the capital markets. NAHB recommends such an agency should be governed by a board of directors rather than by a single agency head. In order to ensure a housing focus, the board must have a HUD representative among others with housing expertise.

It is also imperative to recognize the differences between Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. This can be done by establishing two divisions and maintaining separate funding for the cost of regulation.

In conclusion, NAHB appreciates the opportunity to share our views on the regulatory framework for the housing GSE's. We look forward to working with the Committee on fashioning a solution to the oversight of these important housing institutions.

Thank you.

Chairman SHELBY. I will start with Mr. Beller. Thank your appearance and for your detailed statement a few minutes ago.

Some people contend, Mr. Beller, that requiring the GSE's to register their debt under the Securities Act of 1933 would be impractical given the frequency with which the GSE's go to market.

The concern has been raised that registration of securities under the Securities Act of 1933 would be disruptive to funding practices because they would have to wait for the SEC to approve their filings.

Can you please comment on these concerns regarding the registration of GSE debt, and how has the SEC accommodated other large financial institutions that go to market on a regular basis?

In other words, is that a real concern, or is that just something that people are putting out there?

Mr. BELLER. There are certainly issues that are implicated by Securities Act registration that are not implicated by Exchange Act registration, and that is I think one of the reasons the focus of attention to date has been on the Exchange Act regulation, because from our point of view, it is essentially issue-free with respect to the things you are talking about.

Having said that, if the question is restricted to the straight debt, that is, the nonmortgage-backed debt of Fannie and Freddie, and to the debt of the Federal Home Loan Banks, their issuance would raise issues of timing. We do sometimes review registration statements. It is a fact of life that large, frequent corporate issuers face and live with on a frequent basis.

I will say to you, I guess, one that our self-registration process has made it much easier for large, frequent issuers to access the markets on what they consider to be a timely basis, and there are many, many large issuers, including financial institutions who, if they are not in the market every day, are certainly in the market very frequently.

We have in process some thoughts about modernizing our self system further that would accommodate large corporate issuers and the GSE's if they were to become registrants under the 1933 Securities Act.

But the timing issue is the principal question that I think one has to get comfortable with. My own view is that if you are talking about straight debt, it is manageable. The other side of that equation is you really do not get much more information, and as to the corporations themselves, you get no more information with Securities Act registration than you already get with Exchange Act registration given our integrated disclosure system.

The final point I would make is that—and my testimony reflects this—we are in no way opposed to Securities Act registration. We believe in the benefits that the securities laws and our processes provide for investors. But we do believe when it comes to the mortgage-backed securities and the mortgage-related securities of Fannie Mae and Freddie Mac that we would note that the Commission recommendation in 1992 in the joint report did not extend to the mortgage-backed securities, and we believe that this Committee and the Congress in considering whether to extend Securities Act registration to those securities should properly take into account what the impact would be on the mortgage market and particularly on the TBA market. We are not experts in being able to determine that impact, but we do believe it is one of the subjects that should be on the table because of the importance of the TBA market particularly in setting mortgage rates.

Chairman SHELBY. Thank you.

Professor Carnell, your statement earlier of having a strong executive regulator that would be able to run the regulatory structure, I totally, totally agree with you on. You reference maybe a three-person board. While we are doing these hearings thoroughly and measured, because this is important legislation, as you well know, I had thrown out the idea—and this is just an idea—of maybe having an independent board, having the Secretary of the Treasury on that board, having the HUD Secretary on that board because of the housing issue, having perhaps the Federal Reserve Chairman on that board and the SEC Chairman on that board. I believe that would be four. I did not think about it until we had the GAO Comptroller General here; he serves on some boards, and of course, we will discuss this ourselves.

But I think it is very important, as you pointed out, to have a strong executive, to have, as Senator Sarbanes mentioned, and he is absolutely right on this, independent funding and maybe a five-person board.

Do you want to elaborate a little?

Mr. CARNELL. Well, if you were going to go the route of a five-member board, I like your composition—that is, to have the Treasury and HUD on there, I think is fundamental. And of course, there would be an appointed chair, I presume, a chair appointed by the President an confirmed by the Senate, who would be the executive head of the agency.

Chairman SHELBY. Sure.

Mr. CARNELL. That would be my approach with a three-member board.

If you were going to go to a five-member board, having the two additional people be from the SEC and the Fed I think is excellent, because these are people who have existing Government responsibilities.

Chairman SHELBY. Knowledge base, too.

Mr. CARNELL. Knowledge base, and those are prestigious agencies. Those are good jobs. So you are going to be able to get capable people to come and do that, as opposed to having somebody come to essentially be a drone, an extra couple of wheels on an agency, and if they try to do anything, they will be doing back door diplomacy with the GSE's or trying to micromanage the agency staff. It is just not a good idea.

Chairman SHELBY. We have talked all morning and in other hearings, and we will have some more hearings here before we move on proposed legislation, on the ambiguity in the Government, our relationship with the GSE. It is there, as you pointed out so aptly. I do not know how we resolve that ambiguity, but clear language is important.

Mr. CARNELL. One suggestion, Mr. Chairman, would be that in my testimony I point out how the existing disclaimers of Government liability that, for example, the GSE's have to put in their securities, and there are also disclaimers in law—all three of them are fundamentally flawed because they do not speak to the real question here. In other words, they look like they are answering the question, but they are answering a different question.

So, I do not think they do what Congress meant for them to do.

Chairman SHELBY. Okay.

Mr. Rayburn, in your testimony, you suggest that removing any of the GSEs' legal exemptions would diminish their ability to meet their mission. How would greater transparency of their financial activities impede the mission? It looks to me like it would strengthen their mission—if they have nothing to hide.

Mr. RAYBURN. Mr. Chairman, we are for transparency in this whole issue. I think the central focus here is an issue that this

Congress decided already some 50, 60, 70 years ago when the Congress decided that housing should have a special preference, housing should have the utmost and have the ability of the American people to be able to get into homeownership and the creation of wealth.

We are for a strong regulator. We are looking for a regulator also separately, as my testimony points out, that adheres to the mission of housing and housing affordability as well as additional affordable housing goals.

Chairman SHELBY. Well, a lot of us are committed to the housing goal, but we are also committed to safety and soundness, and I think that with balance, we can have both.

Mr. RAYBURN. One reason, Mr. Chairman, that we believe there should be a division or something outside of Treasury as far as mission and the affordable housing goals is because we believe that Treasury has a bias against housing, as has been proven over the years.

Chairman SHELBY. Well, my suggestion was an independent regulator outside of Treasury.

Mr. RAYBURN. But you put the Secretary of Treasury on there.

Chairman SHELBY. And also I would put some others on there with a lot of expertise. You would also create a strong executive.

Mr. RAYBURN. I think we could agree with that, and I have a concept paper here that I would like to leave with you——

Chairman SHELBY. We will take that.

Mr. RAYBURN. —but as long as the central mission of this whole process dealt with housing and affordable housing.

Chairman SHELBY. Okay.

Mr. Beller, should Congress be wary—those of us up here—of applying to the banks a disclosure scheme that was intended for public companies—in other words, the Federal Home Loan Banks?

Mr. BELLER. I think very strongly that you should not be wary or words.

Chairman SHELBY. Not be; okay.

Mr. BELLER. As I said before, we have very significant numbers of companies who are registered and report with us solely because they issue public debt securities—over 100.

Senator SARBANES. Mr. Chairman, could I pipe in right here——

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. —because I think that is a very important question. There have been these activities going on under certain rules, and it seems to me that the transition over is important.

I have information here that says that, “In the first 6 months of 2003, the Federal Home Loan Banks went to the market 7,000 times and raised $349 billion.”

Chairman SHELBY. Seven thousand times.

Senator SARBANES. “A large market debt issuer and SEC registrant, GE, raised $42 billion in 249 bond issues. Ford Motor Company raised $8.5 billion in 236 bond issues. Total debt issuance in 2003—the U.S. Treasury, $625 billion, Federal Home Loan Banks, $550 billion, in 11,500 separate deals.”

I am concerned about these figures with respect to the Federal Home Loan Banks. It is one of the things we are wrestling with. But it does seem to me that this order of magnitude of difference gives me some pause or concern with respect to your assurance that there is not a problem, that it is not something we need to think through and worry about.

Mr. BELLER. With respect to Exchange Act registration which would get investors the information about the Banks that we believe they deserve to have, the number of offerings and issuance is really not a relevant consideration. They would file annual reports, they would file quarterly reports, they would file current reports, as any other registrant. But the actual offering of securities would not trigger a registration requirement, and that is why I said earlier the Exchange Act registration issue is really issue-free as to straight debt.

As Chairman Shelby pointed out, and as you are both very correctly focusing on, the issue of timing of offering transactions by the Federal Home Loan Banks, while I believe we could use our existing processes to make it manageable, does raise issues with respect to timing and filings the Exchange Act registration proposal does not raise, and at the same time, with Exchange Act registration, you are getting basically all the corporate information that you would get under Securities Act registration anyway.

Senator SARBANES. But you are drawing a distinction, then, or a line between—you would not apply, or at least have concern about just applying full-scale, what applies to a private corporation; is that right?

Mr. BELLER. We would have no issues applying Exchange Act registration and all the requirements of the Exchange Act to a debt-only issuer to the Federal Home Loan Banks.

Senator SARBANES. What would you have a problem with?

Mr. BELLER. We believe, as my testimony indicates, that this Committee and the Congress should consider, and we are happy to consider with you, the timing issues that would be raised by extending the registration requirement to Securities Act registration as well as Exchange Act registration.

Senator SARBANES. I see. Okay.

Thank you, Mr. Chairman. Sorry.

Chairman SHELBY. These are very important questions, and I know Senator Sununu has been very patient, and I have a couple of other things I want to touch on.

Financial statements of the Federal Home Loan Banks—could you touch on how the SEC would treat, if you thought this out, the combined financial statements of the Federal Home Loan Banks and what authority would the SEC have to address material misstatements in the combined financial statements?

Mr. BELLER. That is an issue that we have been thinking hard about and talking to the Finance Board about, because there is no registrant, there is no issuer with respect to the combined financial statements. They roll up the financial statements of the 12 Federal Home Loan Banks.

What we have proposed to the Finance Board—the Finance Board has the right to review and approve the combined financial statements under its current regulations is a mechanism whereby they would—and I think this would be workable with any regulator who had that authority—in connection with their approval provide us with an opportunity to review and give comments on the combined financial statements and raise issues with them before they were approved based in large part, presumably, on our familiarity with the individual statements of the banks.

I suppose the last thing I would say to that is that while there is no issuer with respect to the combined financial statements, they would nonetheless be subject to our antifraud jurisdiction and enforcement processes.

Chairman SHELBY. Thank you.

Mr. Rayburn, one last question for you, if I could, on program approval versus regulation approval. In regard to the independence of any new regulator, your testimony argues for a high level of independence, which I support. You specifically suggest in relation to rulemaking—and these are your words—"The agency's policy justifications for issuing regulations should be devoid of interference from politically appointed officials." You also argue that program approval should remain at HUD.

I am curious as to why you believe the issues of safety and soundness should be insulated from political pressures, but program approval should not be. Why the difference—just for the record.

Mr. RAYBURN. Well, for example, the program approval left at HUD would do some of the good things that HUD has done in the new programs that have been approved with both Fannie and Freddie. The regulatory side is one that, while we certainly do not like interference with the political environment in anything—we would hope not to have that there; we would hope that those programs in regulation would be based on a just and fair system.

But in addition to that, I think one of the most important things that still has to be said here—and I really want to take just a moment, Mr. Chairman——

Chairman SHELBY. Yes, sir.

Mr. RAYBURN. —and thank you for having me here today representing the Home Builders' Association, because I think thus far in your panelists, I am the only person who is a home builder who sees the face of America out there, and I appreciate that.

Chairman SHELBY. Your appearance here today on this panel is very important.

Mr. RAYBURN. Thank you.

I want to share also with you that while we in the Home Builders try very hard to produce those 1.8 million units that we did last year, we are fulfilling a need not only in the environment of our country, but we are also fulfilling a need with the demand that is out there today. Today in our country, we have some one million immigrants coming in, we have 1.3 million household formations, we have between 400,000 and 500,000 units that get burned down, blown away, or torn down in this country every year. So the need and demand is going to be there for the next 10 years.

If you create a regulator to regulate housing that the Congress has said is very important, and you have said the same thing, Mr. Chairman, and others here today, if you create a regulator that messes up the system, that as some would have it moves capital away from housing to other places, then you have really injured a key part of this economy as we know it today. Housing has propped up the economy for over 3 years now, and hopefully, the economics of what is taking place right now will kick in gear and take off. But I can assure you that we will continue to try to help, but we need your help. We need the help of those strong, vibrant GSE's, Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System, and we need it done outside of politics as far as the regulation is concerned, but with help on the affordable housing goals and the allowance of new programs to take place in a very clean and unfettered environment.

Chairman SHELBY. I think we share the same goals.

Senator Sununu.

Senator SUNUNU. Thank you, Mr. Chairman.

Thank you, Mr. Rayburn, and to your point, which is an important one, we are not in the business, or our goal should not be to move capital toward housing or away from housing. What we want to focus on here is establishing a regulatory structure that makes sense, a regulatory structure that is focused, that has the powers it needs in order to ensure safety and soundness within this area of business, of finance, that affects the housing industry.

I also appreciate your perspective in the real world. I do not know if you use those terms, but I like that term. You are out there in a business, taking risks, making decisions every day, and I think we should all appreciate that.

How many members are there in the Home Builders?

Mr. RAYBURN. Two hundred fifteen thousand member firms and over 800-plus local and State associations, employing some 8 million people in this country.

Senator SUNUNU. You mentioned that you deal with affordable housing. I assume some of those members, deal let us say exclusively in single-family or higher-end stuff?

Mr. RAYBURN. Certainly.

Senator SUNUNU. And you even build on spec?

Mr. RAYBURN. Certainly.

Senator SUNUNU. And you even build million-dollar houses on spec?

Mr. RAYBURN. Certainly.

Senator SUNUNU. Some of them refuse to build on spec?

Mr. RAYBURN. Yes, sir.

Senator SUNUNU. I know I have dealt with some that have refused to build on spec.

Do any of them provide financing for their customers in any particular way?

Mr. RAYBURN. Some of our large production, high production builders do.

Senator SUNUNU. Or, I suppose in a more personal or informal way, you can stretch out the payables and payment schedules; they set their own payment schedules with the people they are doing business with, don't they?

Mr. RAYBURN. I would say that a few do, not a lot—not with the housing finance system in this country the way it is today.

Senator SUNUNU. Do all the members in your association have the same risk profile, or do these choices they make affect their business risk?

Mr. RAYBURN. I think choices affect everybody's business risk. I touched on moving capital away from housing and some of the programs that have come out in the last 10 years to positively affect the production of affordable housing. For example, Fannie Mae recently got approval from HUD after a 10-year pilot program at HUD to do AD&C lending. AD&C is acquisition, development and construction lending. I know that I was around in the early 1980's and the early 1990's when construction financing dried up for one reason or another in this country.

Senator SUNUNU. An interesting point. Naturally, the point I am making is in part that the business activities, the business lines that you are involved in, your business practices, all affect the risk and the safety and the soundness of an institution. You mentioned development and construction. There again is a good point. I assume getting involved in the financing of a commercial development on spec in Houston probably looks a lot different than getting involved in a commercial development in San Diego, Seattle, or Manchester, New Hampshire. Again, the business or program activity has a big impact on the safety and the soundness of whatever institution might be involved, whether it is a GSE or the Federal Home Loan Bank or an independent home builder like yourself.

So it would seem to me that we would want the regulator responsible for the safety and soundness of these very important institutions to have some ability, not just some ability but the ability, to make good decisions about these new lines of business or program activities, but this is something that the Home Builders have opposed. Why is that?

Let me be more pointed. It seems inconsistent to me that you would oppose putting this type of regulatory authority into the regulator responsible for soundness when you have the direct business experience that reinforces this perception that business activity, program activity, really does affect risk profile.

Mr. RAYBURN. Senator, we would always separate the two because of the fact that we want to keep housing as a central focus and mission. If you give veto power over the safety and soundness regulator, then all of a sudden, the safety and soundness regulator is controlling the production of housing in this country. If we are going to have a referendum on housing, then that is what we should do. But some of the GSE detractors have thrown up other issues.

That is why we believe that the central focus on any regulator should not be tied to safety and soundness being inclusive of mission, programs, as well as the affordable housing goals.

Senator SUNUNU. Even if those programs have a direct effect on risk profile and the safety and soundness of the institution?

Mr. RAYBURN. They should be considered by the safety and soundness regulator, but it should not have veto power over it, no, sir.

Senator SUNUNU. But you do not want to give them any power to limit or regulate the areas of business or programs or lines of activity that these institutions can be involved in?

Mr. RAYBURN. I believe if Congress in its wisdom sets up this regulator in the right way that it can be done in a manner that it can be handled effectively and still keep housing's central focus and mission out there so the American public can continue to access the American Dream of homeownership.

Senator SUNUNU. In your written testimony, you suggest that most of the proposals that you have seen "often make no reference to the responsibility of the regulator to ensure that the GSE's fulfill their Congressionally mandated purpose."

Which of the proposals that are out there make no reference to the responsibility of the regulator to ensure that GSE's fulfill their mandated purpose?

Mr. RAYBURN. The proposal by the White House, as an example, that Treasury be the regulator. Everything would be inside Treasury, totally controlled by Treasury.

Senator SUNUNU. I think you mentioned this earlier. How has Treasury proven its bias against housing?

Mr. RAYBURN. In the mortgage revenue bond program, there has been no increase in the single-family limit since 1994, even though we have repeatedly asked the Treasury to take a look at that and move it upward. It is causing a problem in so many areas in so many States.

The Low-Income Housing Tax Credit Program on the multifamily production side, with what is called the TAM's, the Technical Advice Memorandums, we have repeatedly asked Treasury to take a look at those and solve some of the problems that are created by their going in and giving these private rulings and not letting it happen. Those are the examples, Senator.

Senator SUNUNU. So you are citing the proposals in this case to put the regulator in Treasury, not necessarily the proposals to put it somewhere outside Treasury, as Senator Shelby has described in many of this proposals and remarks.

Mr. RAYBURN. That is correct.

Chairman SHELBY. Senator Sununu, your time is up. We will give you another round.

Senator SUNUNU. I am sorry, Mr. Chairman. I am over time.

Thank you very much, Mr. Rayburn.

Chairman SHELBY. Senator Sarbanes, thank you for your patience.

Senator SARBANES. Thank you, Mr. Chairman.

Mr. Rayburn, perception of your testimony today is that if you could be assured that an independent regulator would be balanced in terms of harmonizing safety and soundness in the housing mission, that would address a lot of your concerns, would it not?

Mr. RAYBURN. Yes, sir, it would. How would you do that?

Senator SARBANES. Well, I am going to try to follow along with you here now.

Let me put some permutations to you. If you had the HUD Secretary on there, presumably as a champion for housing—although that presumption is not always borne out, I regret to say, which is another problem—but if you had the HUD Secretary, the Treasury Secretary, and then had an independent chairman appointed by the President and confirmed by the Senate, which would create a dynamic to try to get somebody of stature, presumably, who would be able to balance these things out, and also wrote in some pretty strong housing mission goals or requirements, that might do it—I do not know. What is your reaction to that?

Mr. RAYBURN. It might.

Senator SARBANES. I think the thing that Rick Carnell wanted is a loaded deck for you all——

Mr. RAYBURN. I concur whole-heartedly, Senator.

Senator SARBANES. —a little bit for the housing mission, but we are struggling here to find some way to make sure we get safety and soundness and also get appropriate attention to the housing mission.

First of all, would you regard the HUD Secretary and the Treasury Secretary as an even-Steven arrangement, a counterbalance one with the other?

Mr. RAYBURN. I do not know whom you give veto power to over what, but I would be interested to see on paper how you would structure this thing. But I would also point out something you said a while ago, Senator. You know, whether the HUD Secretary and what is taking place at HUD right now is really focused where it should be, I certainly cannot speak to, but I know that the Department of Housing and Urban Development is the only Cabinet-level agency that talks about housing at all, that is focused on housing.

Even as late as yesterday, I was at HUD visiting with Under Secretary Bernardi on a number of different housing issues. I as President of NAHB this year, am appointing inside of our own trade association a housing task force that is going to look at the operations of HUD. Under Secretary Bernardi told me he would be glad to help us and participate, as Secretary Weicher did also, in our efforts, because we are on the front line, using the housing programs at HUD on an everyday basis. Whether it be the FHA insure mortgages, whether it be on the multifamily side or through the home grant programs of the CDBG, we are out there front-lining every day, working to find better ways to work with HUD as the central focus of housing in this country, as well as the GSE's, in order to be able to produce more and better affordable housing.

Senator SARBANES. Yes. Well, I have to say to you in all candor that my perception of HUD in recent times is that it has not been a very forceful advocate for housing, and in fact I think there are people within the HUD hierarchy who are really not carrying out the housing mission, they are constraining it.

Mr. RAYBURN. We hope to work to change that.

Senator SARBANES. In fact, the former Secretary Martinez came here with John Snow and in effect abdicated, I thought, the HUD Secretary's role as far as being a clear spokesman or advocate for housing. So, I think there is a problem, but that is a bigger question and must reflect where the Administration is placing its priorities. It still leaves us wrestling with the question of how do we get a regulator who adequately addresses the safety and soundness, but at the same time, we ensure that the housing mission receives appropriate attention and is not simply submerged in the process.

Mr. RAYBURN. We are looking for the same thing, Senator.

Senator SARBANES. That is why the Chairman is holding these hearings.

Mr. RAYBURN. But also I would like to point out in the entire process that in this country, we still have so many families and so many individuals who are left out of affordable housing and housing ownership in this country. This year, the theme of NAHB is going to be "housing America's working families." Working families are defined as the teachers, the firemen, the policemen, the public service providers in the communities that you and I live in that teach our children, protect our streets, keep our homes safe, and provide the necessary services that we have to have in those communities that we depend on—but yet at night, they go to another community to live, 50, 60, 70 miles away a lot of the time, or they live in underhoused conditions, housing that does not meet their needs, is not something that most families would want to live in.

Working with the Congress and working with HUD and our friends at the GSE's, we hope to continue to try to find more and better ways to help those working families in this country to become homeowners and move toward the wealth creation scenario that we would all like to see continued.

So, Senator, we would like to see your continued help and support, sir.

Senator SARBANES. Mr. Chairman, let me just say in closing first that I welcome the Home Builders' initiative that you have just outlined for us about housing the working families. The Home Builders over the years have made a very important contribution, I think, to the economic and social strength in this country. First of all, you do it directly in helping to provide housing for our families. I think homeownership contributes to strong communities. Every study has shown that once people are invested in homeownership, their investment in their community, their concern for maintaining the community, strengthening the schools, and so forth and so on takes a significant leap forward. Of course, there is the broader macroeconomic impact of housing in this country and the strength that that brings overall to the economy.

We are mindful of that mission. We are also, of course, as Chairman Shelby pointed out, having sat here through the savings and loan—well, I cannot find an adjective——

Chairman SHELBY. Debacle.

Mr. RAYBURN. I was on the business side of that, too, and it was not fun.

Senator SARBANES. —it was rough, it was rough, no question about it—so we want to make sure that——

Chairman SHELBY. Senator Sarbanes and I have a little institutional history here.

Senator SARBANES. Yes, we have some memory on that.

Thank you very much for your testimony.

Mr. RAYBURN. Thank you.

Chairman SHELBY. I would just like to make a point. I did not read in Professor Carnell's statement that he is antihousing but he is sound housing.

If we are committed—and we are—to a housing program for all Americans, we want to make sure that that has the financial footings underneath it. Otherwise, it will be a crisis, and we will have real problems, more so than we have ever seen. What we are trying to do is balance that, as I see it, to avoid that, to make sure that the institutions that finance our housing for the most part are sound and safe and mission-oriented. That is my goal, anyway.

Professor Carnell, do you want to touch on that?

Mr. CARNELL. It is certainly mine as well, Mr. Chairman.

I might add that in 6 years as Assistant Secretary of the Treasury, I head no words spoken against housing. And if you think more broadly about what are the incentives for policymakers, housing has a special place in American policy, American values, and American politics. We have a large, well-organized prohousing lobby. We have no antihousing lobby. There is no incentive for elected officials to be antihousing.

And this notion that the Department of the Treasury is populated by these venomous gnomes who want people to be ill-housed is simply untrue, and I would note that it is a way of talking that we saw from the savings and loan lobby 20 years ago when they were basically resisting being brought into modern regulation.

So, I agree with you, Mr. Chairman, that we need to strike a balance here, and I just want to point out that I do not see the incentives for elected officials or major political appointees to be antihousing.

Mr. RAYBURN. As a follow-up——

Senator SARBANES. Do you think there is a place in the scale, short of being a venomous gnome who wants the population to be ill-housed, where someone might be perceived as not being a forceful advocate for housing?

Mr. CARNELL. Certainly that is possible. Mr. Rayburn pointed to some tax issues, and there are disagreements about how tax benefits should be adjusted. But I never saw these people.

Senator SARBANES. Yes. I do not have to see the Treasury people as venomous gnomes in order to maybe have a little concern about how sympathetic they are to an active housing program, do I?

Mr. CARNELL. I do not see them as unsympathetic. I understand your point about wanting balance. So in that sense, the answer to your question is yes. But you talked about, for example, if you had a multimember agency. If you have Treasury and HUD on there, I think you are going to have balance. It may be from one Administration to another, we may disagree with policies. In a democratic government, that is just something we have to deal with, that sometimes people with power are people who are not going to share our values. But I think that structurally, it makes sense and that there is balance there.

Chairman SHELBY. Mr. Carnell, what if we created a regulator whose term would be longer than, say, a 4-year term?

Mr. CARNELL. I think more than 4 years would be——

Chairman SHELBY. Give some independence, maybe.

Mr. CARNELL. —yes—and I would say, too, that something that has been done with some agencies is you just appoint somebody to fill the unexpired term of their predecessor. I would not suggest doing that here.

Chairman SHELBY. No, that is not a good situation.

Mr. CARNELL. You want more continuity. You want this to be a good job.

Chairman SHELBY. You have a temporary deal there, and it just does not bode well.

Mr. CARNELL. Exactly.

Chairman SHELBY. Mr. Rayburn.

Mr. RAYBURN. Senator, if I might follow up on that, I would share that we would welcome Mr. Carnell as well as all of the

Treasury Department over on the prohousing side, but we would like a little proof——

Chairman SHELBY. Mr. Carnell is a Professor at Fordham Law School now.

Mr. RAYBURN. —I know, but his track record was over there, though—but we would like a little proof that that would take place, and it certainly has not based on their track record.

Chairman SHELBY. Well, gentlemen, we thank you for a spirited discussion and your insights into all of this.

The hearing is adjourned.

Thank you.

[Whereupon, at 12:25 p.m., the hearing was adjourned.]

[Prepared statements and response to written questions supplied for the record follow:]

PREPARED STATEMENT OF SENATOR ELIZABETH DOLE

As everyone knows, Fannie Mae and Freddie Mac were created to help more Americans own their own homes. Their mission—as set forth by Congress—is to promote home mortgage financing by bringing liquidity to the secondary mortgage market and making more funds available for Americans to buy homes. Today, their outstanding securities now exceed $4 trillion—or more than the entire U.S. public debt.

In order to carry out this mission, Congress granted Fannie and Freddie privileges that have not been extended to other participants in mortgage financing. Among these privileges is a line of credit with the U.S. Treasury to which the GSE's could turn for short-term capital needs. This line of credit demonstrates this Nation's commitment to the mission of the institutions, and also the special relationship between these institutions and the Treasury.

This relationship allows Fannie Mae and Freddie Mac to borrow money at a rate as much as 40 basis points below other well-capitalized financial institutions. In addition, the GSE's are exempted from State and local taxes and from registering with the SEC or paying the fees associated with such registration, exemptions not enjoyed by other privately held businesses and financial institutions. As a result of enjoying these advantages, Fannie and Freddie now have virtually unlimited market power in any activity they choose to enter.

A growing consensus has recently emerged that Congress should establish a regulator over Fannie Mae and Freddie Mac with adequate resources, staff, and authority to monitor new and ongoing activities of the GSE's.

A prime example demonstrating the need for such a regulator is the announcement by Fannie Mae last fall that an accounting error had resulted in a $1.1 billion understatement of shareholder equity. Upon reviewing reports, it appears this was an honest mistake made while complying with the Federal Accounting Standards Board's new rule number 149. As a result of this announcement, and the subsequent reaction in the markets, over $4 billion of market capitalization disappeared overnight.

Our financial markets also have additional concerns about Fannie Mae and Freddie Mac. For example, the ability of Fannie Mae and Freddie Mac to aggressively hedge against interest rate risks. While no one is questioning their ability to provide effective hedges—they successfully managed over $1 trillion dollars of interest rate swaps in 2002—I would note that a great deal rests upon their ability to properly manage such risks and we need only to look at the last few months to see that both Fannie Mae and Freddie Mac make mistakes.

Such concerns intensify market sensitivity, which will continue until Congress establishes a new regulator over these entities and its powers are implemented.

As Fannie Mae and Freddie Mac continue to grow in order to carryout their missions, I believe we must have a regulator empowered with sufficient authority to prevent fraud and mistakes that can easily add up to the loss of billions of dollars, and thereby protect the American tax payers.

Any new regulator must be able to determine whether or not new programs and products contemplated by the GSE's help them fulfill their mission or whether those areas cannot be filled by private industry. Further, such authority cannot be limited solely to safety and soundness concerns—it is certain that actions exist that are safe and sound, but which nonetheless are inappropriate for Fannie and Freddie to take.

Last summer, Senators Hagel, Sununu, and I introduced S. 1508, the Federal Enterprise Regulatory Reform Act of 2003. Our legislation gives the regulator authority to approve new products and thereby ensure Fannie Mae and Freddie Mac remain focused on their core mission of promoting affordable home mortgage financing, especially for those Americans who have never owned their home before. I hope my colleagues will join us in support of this important initiative.

Mr. Chairman, your dedication to this issue is greatly appreciated and I look forward to our continuing work on this important issue. The need for proper regulatory oversight of the GSE's is a high priority and I am committed to working through these issues with you.

United States General Accounting Office

GAO

Testimony

Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

For Release on Delivery
Expected at 10:00 a.m. EST
Tuesday, February 10, 2004

GOVERNMENT-SPONSORED ENTERPRISES

A Framework for Strengthening GSE Governance and Oversight

Statement of David M. Walker
Comptroller General of the United States

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Highlights

Highlights of GAO-04-269T, a testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate

Why GAO Did This Study

Congress established government sponsored enterprises (GSE)—such as Fannie Mae, Freddie Mac, the FHLBank System, and the Farm Credit System—to facilitate the development of mortgage and agricultural lending in the United States. Although the federal government does not explicitly guarantee the GSEs' approximately $4.4 trillion in financial obligations, the potential exists that the government would provide financial assistance in an emergency as it has done in the past. Recent financial reporting problems at Freddie Mac have raised concerns about the quality of the GSEs' corporate governance and regulatory oversight.

To assist Congress in reviewing the adequacy of GSE oversight, this testimony provides information on GSE corporate governance, regulatory oversight, and mission compliance measures.

What GAO Recommends

GAO recommends several steps that GSEs, regulators, and Congress can take to strengthen GSE oversight. These steps include strengthening GSE corporate governance, creating a single housing GSE regulator, and establishing standards to measure GSE mission compliance.

www.gao.gov/cgi-bin/getrpt?GAO-04-269T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Thomas J. McCool at (202) 512-8678 or mccoolt@gao.gov.

Tuesday, February 10, 2004

GOVERNMENT-SPONSORED ENTERPRISES

A Framework for Strengthening GSE Governance and Oversight

What GAO Found

GSEs should lead by example in connection with governance, accountability, integrity, and public trust issues. GSEs should strive to achieve model corporate governance structure, provide reasonable transparency of financial and performance activities, and adopt compensation arrangements that focus on both long-term and short-term results. However, GSE corporate governance has not always reflected best practices. For example, currently, the Chief Executive Officers (CEO) of Freddie Mac and Fannie Mae also serve as the chairmen of their respective GSE boards, which is not consistent with model governance standards that call for officers to work for an independent board. GAO notes that as part of its regulatory agreement, Freddie Mac has agreed to separate the position of CEO and the position of chairman within a reasonable period of time. However, Fannie Mae has yet to take this step. With respect to compensation arrangements, Freddie Mac's focus on short-term financial results as performance targets appears to have contributed to the GSE's recent financial reporting problems.

GSE regulators must be capable, credible, strong, and independent. However, the regulatory structure for the housing GSEs—Fannie Mae, Freddie Mac, and the FHLBank System—is fragmented with safety and soundness and mission oversight responsibilities divided among three regulators. A single housing GSE regulator offers many advantages over this fragmented structure including prominence in government, the sharing of technical expertise, and the ability to assess trade-offs between safety and soundness considerations and certain mission compliance activities, such as affordable housing initiatives. Although there are advantages of a single director model for the new housing GSE regulator, GAO believes on balance that a board or a hybrid board and director might make the most sense to oversee the GSEs' safety and soundness and mission oversight. To be effective, the single GSE regulator must also have all the regulatory oversight and enforcement powers necessary to carry out its critical responsibilities.

Because of a lack of clear measures, it is difficult for Congress, accountability organizations, and the public to determine whether the benefits provided by the GSEs' activities are in the public interest and outweigh their financial risks. Available evidence and data indicate that the housing GSEs have made, in some cases, progress in benefiting homebuyers. For example, it is generally agreed that Fannie Mae and Freddie Mac's activities have lowered mortgage interest rates, although there is debate over the degree of these benefits. However, it is not clear that the housing GSEs' large holdings of mortgage-backed securities benefit borrowers. There is also limited information as to the extent to which the FHLBank System's more than $500 billion in outstanding loans to financial institutions have facilitated mortgage lending.

Mr. Chairman, Mr. Ranking Member, and Members of the Committee:

I appreciate the opportunity to participate in today's hearing to discuss oversight of the government-sponsored enterprises (GSE), namely Fannie Mae, Freddie Mac, the Federal Home Loan Banks (FHLBanks), the Farm Credit System (FCS), and the Federal Agricultural Mortgage Corporation (Farmer Mac). I note that the GSEs had combined obligations, including mortgage-backed securities (MBS) and other debt obligations, of $4.4 trillion as of September 30, 2003, and, as I will explain in detail later, the potential exists that the federal government may choose to provide financial assistance to the GSEs in an emergency. Accounting and financial reporting problems related to earnings disclosed by Freddie Mac last year have raised several concerns about the company's management and board of directors as well as the effectiveness of regulatory oversight that is designed to protect taxpayers from the risks associated with the GSEs. Recently reported investment losses at the FHLBanks have also served to raise public concerns regarding the well-being of GSEs. These events prompted Congress to consider the need for meaningful reforms to help strengthen the oversight of GSEs. In my view, our past experience in the savings and loan industry, the recent accountability breakdowns in the private sector, and the importance of gaining public trust for regulatory agencies that oversee our financial institutions and our capital markets is directly relevant to the ongoing debate on appropriate regulatory oversight of GSEs.

It is clear that many parties have different views on what needs to be fixed and how to do it. My comments today are intended to frame GSE oversight issues broadly and provide our views on some of the questions and options that must be addressed to better oversee the GSEs going forward. Although my comments will largely focus on the housing GSEs—Fannie Mae, Freddie Mac, and the FHLBank System—given the themes of our discussion today, I will also use examples from the other GSEs to illustrate my points. We look forward to working with Congress to provide assistance in defining these issues, exploring various options, and identifying their implications in order to address any weaknesses that could serve to threaten confidence in our financial markets and that inhibit improvements in the current regulatory structure.

My testimony today is divided into two sections. In the first part, I will provide an overview of the GSEs and their missions, discuss the risks they pose to taxpayers and financial markets, and then I will lay out principles to help ensure effective governance and oversight of the GSEs. Second, I will provide our views regarding the extent to which GSE governance and oversight structures are consistent with these important principles.

In summary, to ensure that the GSEs operate in a safe and sound manner, it is essential that effective governance, reasonable transparency, and effective oversight systems are established and maintained. In particular, the GSEs should lead by example in the area of corporate governance; GSE regulators must be strong, independent, and have necessary expertise; and GSE mission definitions and benefit measures need to be established. However, our work found that GSE corporate governance does not always reflect best practices; for example, Fannie Mae's Chief Executive Officer (CEO) serves as chairman and its Chief Operating Officer (COO) and Chief Financial Officer (CFO) both serve as vice chairmen of the board, which is not consistent with model governance theory that calls for an independent board and chair. I note that Freddie Mac's CEO is also the chairman of that company's board but Freddie Mac has agreed to split these functions in the future. Furthermore, the regulatory structure for the housing GSEs is fragmented and serious questions exist as to the capacity of GSE regulators to fulfill their responsibilities. In each of these areas, I will summarize steps that Congress, GSEs, and regulators can take to improve GSE governance and oversight. In particular, I believe that Congress should establish a single housing GSE regulator that would be governed by a board or a hybrid board and director and provided with the authorities necessary to carry out its mission.

To prepare for this testimony, we relied heavily on a substantial amount of work that we had done on GSEs and their regulatory oversight in the past, but we also reviewed our historical positions in light of the current regulatory structure and GSE activities. The attachment lists reports representing this body of work. In addition to reviewing our past work, we solicited views of officials from the Office of Federal Housing Enterprises Oversight (OFHEO), the Department of Housing and Urban Development (HUD), and the Federal Housing Finance Board (FHFB). We also reviewed financial data on the GSEs, best practices standards for corporate governance, and regulatory reports on such issues as the GSEs' effects on financial market stability. We conducted our work in Washington, D.C., between November 2003 and January 2004 in accordance with generally accepted government auditing standards.

Overview of GSEs, Their Risks, and Principles for Effective Governance and Oversight

I would like to begin by summarizing the roles and responsibilities of the GSEs, describing their potential risks to taxpayers and the financial markets, and offering certain principles on governance and oversight to help ensure that the GSEs' activities are safe, sound, and consistent with their public missions.

What are the GSEs and How Do They Carry Out Their Missions?

Over the past century, Congress established GSEs to address concerns that private financial institutions were not adequately meeting the credit needs of homebuyers and agricultural interests (see table 1). The GSEs are government-sponsored, privately owned and operated corporations whose public missions are to enhance the availability of mortgage and agricultural credit across the United States. It is also generally understood that the housing GSEs' public missions include the obligation to meet the needs of targeted groups of borrowers.[2] The GSEs generally carry out their missions by (1) borrowing funds in the capital markets and purchasing assets from financial institutions or making loans to the institutions or (2) securitizing assets and providing a credit guarantee to security holders. These activities may provide mortgage or real estate credit to homebuyers, businesses, or farmers at rates or conditions more favorable than those that would be available in the absence of these GSEs. It is important to note that the GSEs' debt and security offerings are not explicitly guaranteed or insured by the U.S. government.

[2] Through legislation, Congress has required the housing GSEs to serve the credit needs of targeted borrowers, such as low-income, urban, and rural homeowners. For example, Fannie Mae and Freddie Mac are required to meet housing goals established by HUD for the purchase of mortgages serving targeted groups. The FHLBanks are also required to provide grants or below market price advances for mortgages serving targeted groups through the Affordable Housing Program.

Table 1: Overview Information on the GSEs as of September 30, 2003

Dollars in billions

GSE and year created	Financial obligations	Structure	Regulator
Fannie Mae (1938)	$2,187[a]	For profit publicly traded	OFHEO - safety & soundness HUD - mission
Freddie Mac (1970)	$1,388[a]	For profit publicly traded	OFHEO - safety & soundness HUD - mission
FHLBank System (1932)	$716.9[b]	12 District Banks Member-owned cooperatives	FHFB
FCS (1916)	$97.1[c]	5 banks and 99 Associations Member-owned cooperatives	Farm Credit Administration
Farmer Mac (1987)	$7.2[d]	For profit publicly traded	Farm Credit Administration – Office of Secondary Market Oversight

Sources: OFHEO, FHLBank System Office of Finance, Federal Farm Credit Banks Funding Corporation, and Farm Credit Administration (FCA).

[a] Includes short- and long-term debt and MBS held by investors. Freddie Mac data are as of December 31, 2002, and are subject to change as Freddie Mac is currently restating its 2002, 2001, and possibly 2000 financial statements.

[b] FHLBank System consolidated obligations.

[c] Total liabilities, including securities, bonds, and other liabilities.

[d] On-balance sheet liabilities and off-balance sheet liabilities, including agricultural mortgage-backed securities (AMBS) held by investors.

Let me now briefly discuss the missions and activities of each of the GSEs:

- Fannie Mae and Freddie Mac's mission is to enhance the availability of mortgage credit across the nation during both good and bad economic times by purchasing mortgages from lenders (banks, thrifts, and mortgage lenders) that use the proceeds to make additional mortgages available to homebuyers. Most mortgages purchased by Fannie Mae and Freddie Mac are conventional mortgages, which have no federal insurance or guarantee. The companies' mortgage purchases are subject to a conforming loan limit that currently stands at $333,700 for a single-family home in most states. Although Fannie Mae and Freddie Mac hold some mortgages in their portfolios that they purchased, most mortgages are placed in mortgage pools to support MBS. Fannie Mae and Freddie Mac issued MBS are either sold to investors (off-balance sheet obligations) or held in their retained portfolios (on-balance sheet obligations). Fannie Mae and Freddie Mac guarantee the timely payment of interest and principal on MBS that they issue.

- The 12 FHLBanks traditionally made loans also known as advances to their members (typically banks or thrifts) to facilitate housing finance and community economic development. FHLBank members are required to collateralize advances with high quality assets such as single-family mortgages. More recently, the FHLBanks initiated programs to purchase mortgages directly from their members and hold them in their retained portfolios. This process is similar to Fannie Mae and Freddie Mac's traditional business activities, although the FHLBanks do not currently have the authority to securitize mortgages.

- FCS, of which Farmer Mac is an independent institution, is a nationwide network of borrower-owned financial institutions and specialized service organizations. FCS consists of six Farm Credit Banks and one Agricultural Credit Bank, which provide funding and affiliated services to locally owned Farm Credit associations and numerous cooperatives nationwide. Among other activities, FCS provides credit and related services to farmers, ranchers, producers, and rural homeowners.

- Farmer Mac's mission is to provide for a secondary marketing arrangement for agricultural real estate and rural housing loans subject to its underwriting standards. Farmer Mac purchases mortgages directly from lenders for cash and purchases bonds from agricultural lenders. Farmer Mac securitizes mortgages and issues AMBS and, like Fannie Mae and Freddie Mac, guarantees the timely payment of interest and principal on these securities. Farmer Mac holds most of the AMBS that it issues in its retained portfolio.

What are the Risks of the GSEs?

As a result of their activities, the GSEs' outstanding debt and off-balance sheet financial obligations are large. The GSEs' financial obligations were $4.4 trillion as of September 30, 2003. By comparison, the U.S. Treasury had $6.8 trillion in total obligations for the same date. The GSEs face the risk of losses primarily from credit risk, interest rate risk, and operational risks.[2] Although the federal government explicitly does not guarantee the obligations of the GSEs, it is generally assumed on Wall Street that assistance would be provided in a financial emergency. In fact, during the 1980s the federal government provided financial assistance to both Fannie Mae and FCS when they experienced difficulties due to sharply rising interest rates and declining agricultural land values, respectively. The potential exists that Congress and the Executive Branch would determine that such assistance was again necessary in the event that one or more of the GSEs experienced severe financial difficulties. Because the markets perceive that there is an implied federal guarantee on the GSEs' obligations, the GSEs are able to borrow at interest rates below that of private corporations, which as I discussed earlier allows them to extend credit to financial institutions at favorable rates.

The GSEs also pose potential risks to the stability of the U.S. financial system. In particular, if Fannie Mae, Freddie Mac, or the FHLBank System were unable to meet their financial obligations, other financial market participants depending on payments from these GSEs, may in turn become unable to meet their financial obligations. This risk, called systemic risk, is often associated with the housing GSEs because of the sheer size of their financial obligations. For example, as discussed in OFHEO's 2003 report on systemic risk, if either Fannie Mae or Freddie Mac were to become insolvent, financial institutions holding the enterprise's MBS could be put into a situation where they could no longer rely on those securities as a ready source of liquidity.[3] Depending on the response of the federal government, the financial health of the banking segment of the financial services industry could decline rapidly, possibly leading to a decline in economic activity. As another example, derivatives counterparties holding contracts with a financially troubled GSE could realize large losses if the GSE were no longer able to meet its obligations. If such a hypothetical event were to occur, widespread defaults could occur in derivatives markets.

[2] Credit risk is the possibility of financial loss resulting from default by homeowners on housing assets that have lost value; interest rate risk is the risk of loss due to fluctuations in interest rates; and operational risk includes the possibility of financial loss resulting from inadequate or failed internal processes, people and systems, or from external events.

[3] Office of Federal Housing Enterprises Oversight. *Systemic Risk: Fannie Mae, Freddie Mac, and the Role of OFHEO.* Washington, D.C: February 4, 2003.

How Can GSE Risks Be Mitigated?

To prevent the need for the federal government ever to have to provide financial support to a GSE and to minimize the risks of financial instability, it is critical to ensure that proper corporate governance, reasonable transparency, and effective oversight systems are in place. There are several lines of defense to ensure that GSEs' activities are conducted in a safe and sound manner including management, boards of directors, auditors, and regulators. As we have seen in recent private sector instances such as Enron and Worldcom, these critical lines of defense can and do fail. Consequently, the private sector, Congress, and regulators have initiated actions—such as the passage and implementation of the Sarbanes-Oxley Act—to ensure that the risk of such failures of governance and oversight are minimized. In my view, it is all the more important that strong safeguards are established for the GSEs because such institutions are not subject to the same degree of market discipline as other privately run businesses. As a result of the perception of an implied guarantee of GSE obligations, customers and creditors may be less willing to monitor the companies' risk-taking, which could encourage managers to take on excessive risks.

I would now like to offer, on the basis of both my own experience and past GAO work, several specific and pragmatic principles to ensure effective GSE governance and oversight:

The GSEs Should Lead by Example in Terms of Corporate Governance and Accountability

Not only should GSEs be sensitive to good governance but it is all the more important they lead by example in connection with accountability, integrity, and public trust. In particular, GSEs should strive to have a truly independent board, compensation arrangements consistent with their public mission and private shareholder obligations, and appropriate transparency of their financial activities. Under model governance theory, the board of directors works in the best interest of the shareholders and the CEO works for the board. Board members should be independent and be able to provide strategic advice to management in order to help maximize shareholder value. The board should also help manage risk to shareholders and have a clear responsibility to hold management accountable for results both currently and over time. I note that in the context of the GSEs, boards could also have a responsibility to ensure that the GSEs' activities fulfill their public missions. In some cases, there can be a tension between maximizing shareholder value and fulfilling public missions. GSE boards and executives must have the requisite commitment and talent to respond to this challenge.

To adhere to model governance theory, it is also important for the board to ensure that overall executive compensation is aligned with achievements related to the company's long-term strategic objectives and less on short-term accomplishments such as quarterly or annual earnings. Further, it is not just the total amount of compensation but the form and structure of executive compensation arrangements that is important as well. Finally, transparency through timely and reliable financial and performance information and reasonable disclosures is necessary to enable capital markets and investors to understand related values and risks associated with the GSEs. Market discipline works best when firms fully and publicly disclose their financial obligations and activities.

The GSEs Require a Strong, Independent, and Capable Regulatory System

A regulatory system of GSE oversight must have the necessary strength, independence, and capability to protect against the significant risks and potential costs to taxpayers posed by the GSEs. We have consistently supported and continue to believe in the need for the creation of a single regulator to oversee both safety and soundness and mission of the housing GSEs, which, as I will describe later, are currently divided among OFHEO, HUD, and FHFB.[4] A single regulator could be more independent and objective than separate regulatory bodies and could be more prominent than either one alone. Although the housing GSEs operate differently, the risks they manage and their missions are similar. We believe that valuable synergies could be achieved and expertise in evaluating GSE risk management could be shared more easily within one agency. In addition, we believe that a single regulator would be better positioned to oversee the GSEs' compliance with mission activities, such as special housing goals and any new programs or initiatives any of the GSEs might undertake. This single regulator should be better able to assess these activities' competitive effects on all three housing GSEs and better able to ensure consistency of regulation for GSEs that operate in similar markets.

Further, a single regulator would be better positioned to consider potential trade-offs between mission requirements and safety and soundness considerations, because such a regulator would develop a fuller understanding of the operations of these large and complex financial institutions. Some critics of combining safety and soundness and mission have voiced concerns that doing so could create regulatory conflict for the regulator. However, we believe that a healthy tension would be created that could lead to improved oversight. The trade-offs between safety and

[4] See U.S. General Accounting Office, ***Government-Sponsored Enterprises: Advantages and Disadvantages of Creating a Single Housing GSE Regulator***, GAO/GGD-97-139 (Washington, D.C.: July 9, 1997).

soundness and compliance with mission requirements could be best understood and accounted for by having a single regulator that has complete knowledge of the GSEs' financial condition, regulates the mission goals Congress sets, and assesses efforts to fulfill them.

To be effective, the single regulator must have all the powers, authorities, and technical expertise necessary to oversee the GSEs' operations and compliance with their missions.

Measures Must Be Established to Help Ensure That the GSEs' Benefits Outweigh the Financial Risks That Their Activities Pose to Taxpayers

Without clearly defined measures of the GSEs' benefits, it is not possible for Congress, accountability organizations, and the public to determine whether the federal government should be subject to the financial risks associated with the GSEs' activities. I acknowledge that developing such measures may prove challenging for several reasons. First, isolating the GSEs' effects on mortgage and agricultural credit markets is a complex and technical undertaking. Second, the GSEs' financial activities have evolved over the years and become increasingly sophisticated, which further complicates any analysis of the GSEs' benefits and costs. Third, in some cases, there is a lack of measurable mission-related criteria that would allow for a meaningful assessment of the GSEs' mission achievement or whether the GSEs' activities are consistent with their charters. Nevertheless, past actions by Congress and regulators demonstrate that developing such quantifiable measures is possible. For example, in 1992, Congress required HUD to set numeric housing goals for Fannie Mae and Freddie Mac to help ensure that their mortgage purchases served the needs of low-income households as well as other targeted groups.

The GSEs' Corporate Governance, Regulatory Oversight, and Mission Compliance Reporting Can Be Strengthened

Now that I have laid out the risks associated with the GSEs and principles for effective governance and oversight, I would like to turn my attention to how the current system compares with those principles. While there is some positive information to report about the GSEs, there are also weaknesses in the areas of corporate governance, regulatory oversight, and mission compliance reporting. In each of these areas, there are steps we believe Congress, the regulators, or GSEs can take to address weaknesses in GSE governance and oversight that we have identified.

GSE Corporate Governance Practices Can Be Improved

The GSEs' corporate governance practices are not fully consistent with the principles that I previously mentioned. The first principle I discussed is independence of the board and the role of the board of directors. There are instances where the GSEs can further their efforts in ensuring board independence. To illustrate:

- Like CEOs at many other publicly traded companies, the CEO of Fannie Mae and the CEO of Freddie Mac currently serve as chairman of their respective boards of directors. In addition, Fannie Mae's COO and CFO both serve as vice chairmen of the board. All too frequently, such individuals will have significant influence over who is asked to join the board and who is asked to leave it. OFHEO, in its special examination of Freddie Mac (OFHEO report), recommended that Freddie Mac should separate the functions of the CEO and the board chairman to improve the effectiveness of the board of directors and Freddie Mac has agreed to do so.[5] I also note that OFHEO recently submitted proposed corporate governance reforms to the Office of Management and Budget that would require the GSEs to separate the CEO and chair positions; and

- A recent FHFB study on board governance of the FHLBanks found that the selection process for board and committee chairpersons and assignment of committee memberships at some FHLBanks lacked transparency or inclusiveness.[6] The study concluded that committee selection processes relying on only one person or the recommendations of senior management may diminish the independence of directors. FHFB recommended the FHLBanks strengthen their boards of directors by using a transparent and inclusive selection process.

In practice, GSE boards may face difficulties in complying with modern governance standards because of statutory and regulatory requirements regarding the structure, selection, and composition of such boards. For example,

- Fannie Mae and Freddie Mac's boards include five seats that are appointed annually by the President, serve one-year terms, and

[5] Office of Federal Housing Enterprises Oversight. *Report of the Special Examination of Freddie Mac.* December 2003.

[6] Federal Housing Finance Board. *Report of the Horizontal Review of Board Governance of the Federal Home Loan Banks.* June 2003.

represent various interests including the real estate industry, the mortgage lending industry, and consumer interests.[7] Treasury has proposed eliminating the presidentially appointed directors at Fannie Mae and Freddie Mac because the perceived roles of these directors contradict best practices of corporate governance.[8] OFHEO agrees with Treasury's position because it has found that the appointed members do not play meaningful roles on the GSEs' boards. While there may be reasons to eliminate these positions, should Congress decide to retain them, it should consider (1) lengthening the terms of the appointed directors so that they have sufficient time to understand the GSEs' complex activities, (2) establishing criteria to ensure that qualified individuals serve on the boards who have expertise in financial activities and understand the GSEs' mission responsibilities, and (3) establishing fiduciary responsibilities to serve the special public purpose of the GSE.

- I would also like to point out that FHFB appoints at least 6 directors, known as public interest directors, to serve on the board of the FHLBanks, whose boards each consist of at least 14 members. We believe that a selection process that uses a regulator to select the directors of the regulated entities could jeopardize the independence of those directors as well as FHFB.
- As another example, our recent study of Farmer Mac provides an illustration of how congressionally established board structure can complicate a GSE's compliance with board independence requirements. We noted that the statutory structure of the Farmer Mac board requires a majority of the directors to come from institutions that utilize Farmer Mac's services.[9] This raises questions as to the independence of that board.

[7] As specified in their charters, Fannie Mae and Freddie Mac each have 18-member boards of directors. The President appoints 5 of the directors at each company, while shareholders elect the other 13. Board members are elected or appointed to 1-year terms.

[8] *Testimony of Secretary John W. Snow Before the U.S. Senate Committee on Banking, Housing and Urban Affairs*. Washington, D.C.: October 16, 2003. He stated that "…The Administration is committed to make sure that corporate governance … remain strong and effective. That requires that there be great clarity that the people running large companies are there to serve the interests of the shareholders and that their incentives and loyalties be clearly aligned in this way."

[9] U.S. General Accounting Office, ***Farmer Mac: Some Progress Made, but Greater Attention to Risk Management, Mission, and Corporate Governance Is Needed***. GAO-04-116 (Washington, D.C.: Oct 16, 2003).

In the area of compensation, there are indications that the structure of executive compensation arrangements and the process of determining compensation levels at the GSEs are not in line with best practices for corporate governance. As examples,

- According to the OFHEO report, approximately 54 percent of the total cash compensation (salaries, bonuses, and other compensation) paid by Freddie Mac to executive officers for performance in 2001 was based on corporate performance for that year. The study found that the compensation of senior executives, in particular, the size of the bonus pool, was tied, in part, to meeting or exceeding annual specified earnings per share targets. OFHEO concluded that the importance of achieving such targets contributed, in part, to the improper accounting and management practices of the GSE. As such, OFHEO recommended that Freddie Mac should develop financial incentives for executives and employees based on long-term goals.
- Our study at Farmer Mac also identified an aggressive stock option vesting plan whereby stock options for employees and directors were fully vested within 2 years. By comparison, companies have average vesting periods of 4 to 5 years. Farmer Mac has since changed its vesting program to be more aligned with those of other companies.

Finally, in my view, adequate transparency is important because the housing GSEs engage in complex transactions, such as securitizations, guarantees, and hedging of risk which introduce many financial reporting complexities. With the exception of Farmer Mac, GSEs are exempt from the securities laws, and are not required to file disclosure documents with the Securities Exchange Commission (SEC) with respect to their securities issuances. Nevertheless, in October 2000, Fannie Mae and Freddie Mac adopted six voluntary commitments aimed at increasing their financial disclosures. More recently, Fannie Mae has registered its stock with SEC on a voluntary basis and Freddie Mac has stated its intention to do the same. Although financial disclosure may improve transparency, its impact on the GSEs and their customers or funding parties may be limited if the GSEs are perceived to have implicit government backing. For this reason, while market discipline can play a role in curbing risky behavior by GSEs, it also has its limitations. Effective oversight thus takes on more importance as a means for limiting inappropriate risk-taking behavior by the GSEs. Now let me move on to the last line of defense, that is, oversight by regulators.

Housing GSE Regulatory Structure Does Not Ensure Effective Oversight

Unfortunately, the current housing GSE regulatory structure is fragmented, which limits the federal government's ability to oversee the GSE's activities. Congress now has the opportunity to rationalize the current GSE regulatory structure through the creation of a single regulator that would oversee the housing GSEs' safety and soundness and mission activities. Congress should also ensure that the new GSE regulator has the authorities necessary to carry out its critical responsibilities.

GSE Regulatory Structure Can Be Consolidated

Although the housing GSEs share similar risks and missions, there are three regulators overseeing either their safety and soundness, their missions, or both. Currently, OFHEO regulates Fannie Mae and Freddie Mac on matters of safety and soundness, while HUD is the mission regulator. FHFB serves as the safety and soundness and mission regulator of the FHLBanks. Available evidence raises questions about the capacity of the current regulatory structure to effectively monitor the GSEs' safety and soundness and mission compliance. To illustrate:

- OFHEO did not identify the substantial financial accounting problems at Freddie Mac at an early stage. In fact, OFHEO's 2001 and 2002 examinations of Freddie Mac gave high marks to the GSE in such relevant areas as corporate governance and internal controls, despite the widespread deficiencies later identified in these areas. OFHEO's current director has stated that the agency plans to strengthen its examination program, create an office of the chief accountant, and elevate the important area of corporate accounting into its oversight process.

- As of July 2002, FHFB employed just 10 examiners to review the increased risks and complexity of the 12 FHLBanks and the agency's reviews of key activities—such as internal controls—were limited.[10] Although FHFB has initiated a program to triple the number of examiners to 30 by the end of FY 2004 and has revised its examination program, it is too soon to judge the effectiveness of FHFB's initiatives.[11] For example, as FHFB continues the process of developing a sufficient and capable force of examiners, it must cope with the fact that several FHLBanks reported losses or weak financial results in late FY 2003 and

[10] The FHLBanks direct mortgage purchase programs expose the banks to interest rate risk and increasingly sophisticated strategies—such as the use of derivatives and hedging techniques—are necessary to manage these risks.

[11] By late 2003, FHFB had a staff of 22 examination professionals, according to FHFB officials.

some FHLBanks continue to expand their mortgage purchase programs.

- HUD officials we contacted said that the department lacks sufficient staff and resources necessary to carry out its GSE mission oversight responsibilities. HUD officials said that although the GSEs' assets have increased nearly six-fold since 1992, HUD's staffing has declined by 4,200 positions and GSE oversight—which now consists of about 13 full-time positions—must compete with other department priorities for the limited resources available. The President's 2005 budget includes a proposal that would allow HUD to assess Fannie Mae and Freddie Mac for the cost of its mission oversight.[12] I also note that HUD (1) has not proposed a rule to ensure that the GSEs' nonmortgage investments (such as long-term corporate debt) are consistent with their housing mission as the department committed to do in response to a 1998 GAO report and (2) it is not clear that HUD has the expertise necessary to review sophisticated financial products and issues, which are associated with nonmortgage investments and new program applications.[13]

As I stated previously, a single GSE regulator offers many advantages over the fragmented structure that exists today including prominence in government, the sharing of technical expertise, and the ability to assess trade-offs between safety and soundness considerations and certain mission compliance activities.

In determining the appropriate structure for a new GSE regulator, we note that Congress has authorized two different structures for governing financial regulatory agencies: a single director and board. Among financial regulators, single directors head the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) and OFHEO while boards or commissions run FHFB, SEC, and the Board of Governors of the Federal Reserve System, among others. The single director model has advantages over a board or commission; for example, the director can make decisions without the potential hindrance of having to consult with or obtain the approval of other board members.

[12] HUD's GSE mission oversight expenses are funded through the appropriations process.

[13] U.S. General Accounting Office, *Government Sponsored Enterprises: Federal Oversight Needed for Nonmortgage Investments*, GAO/GGD-98-48 (Washington, D.C.: March 11, 1998).

In our previous work, however, we have stated that a "stand-alone" agency with a board of directors would better ensure the independence and prominence of the regulator and allow it to act independently of the influence of the housing GSEs, which are large and politically influential. A governing board may offer the advantage of allowing different perspectives, providing stability, and bringing prestige to the regulator. Moreover, if the board included the secretaries of Treasury and HUD or their designees, the potential exists that safety and soundness and housing mission compliance concerns would both be represented. We are mindful, though, based on recently completed work, of some of the disadvantages of a stand-alone agency with a board of directors that is divided along party lines.[14] Tensions and conflicts between board members potentially diminish some of these benefits.

I would note that in other regulatory sectors—besides financial regulation—Congress has established alternative board structures that could be considered as potential models for the new GSE regulator. One such alternative structure would be to have a presidentially appointed and Senate confirmed director, and a board of directors comprised of the secretaries from relevant executive branch agencies, such as Treasury and HUD. Board members being from the same political party could lessen some of the tensions and conflicts observed at boards purposefully structured to have a split in membership along party lines. A board comprised of members all from the same political party may, though, not benefit from different perspectives to the same extent as a board with members from different political parties. Therefore, an advisory committee to the regulator could be formed, to include representatives of financial markets, housing, and the general public. This advisory committee could also be required to have some reasonable representation from different political parties.

I would now like to comment on issues surrounding the potential funding arrangements for a new housing GSE regulator. Similar to FHFB, OCC, and OTS, OFHEO funds its operations through assessments on its regulated entities, Fannie Mae and Freddie Mac. However, unlike these agencies that are exempt from the appropriations process, OFHEO can only collect the assessments when approved by an appropriations bill and

[14] See U.S. General Accounting Office, ***Financial Regulation: Review of Selected Operations of the Federal Housing Finance Board***, GAO-03-364 (Washington, D.C.: Feb. 28, 2003).

at a level set by its appropriators. While testifying on GSE regulatory reform, the director of OFHEO noted that the appropriations process has placed severe constraint on OFHEO's operations and has hindered its ability to hire additional resources it needs to strengthen its oversight.[15]

Exempting the new GSE regulator from the appropriations process would provide the agency the financial independence necessary to carry out its responsibilities. More importantly, without the timing constraints of the appropriations process, the regulator could more quickly respond to budgetary needs created by any crisis at the GSEs. However, being outside the appropriations process can create trade-offs. First, while the regulator will have more control over its own budget and funding level, it will lose the checks and balances provided by the federal budget and appropriations processes or the potential reliance on increased appropriations during revenue shortfalls. As a result, the regulator would need to establish a system of budgetary controls to ensure fiscal restraint. Second, removing the regulator from the appropriations process could diminish congressional oversight of the agency's operations. This trade-off could be mitigated through increased oversight by the regulator's congressional authorizing committees, such as a process of regular congressional hearings on the new GSE regulator's operations and activities.

Congress Should Ensure That the New Housing GSE Regulator Has Adequate Enforcement Authorities

The new GSE regulator must have adequate powers and authorities to address unsafe and unsound practices, respond to financial emergencies, and ensure that the GSEs comply with their public missions. In our previous work, we have stated that each GSE housing regulator administers its own statutory scheme and these schemes contain various types of powers and authorities, which although similar, are not identical.[16] Further, the GSE housing regulators' powers and authorities differ from that of banking regulators in key areas. The following describes some of

[15] *Statement of the Honorable Armando Falcon, Jr., Director of OFHEO before the House Financial Services Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises Hearing on The Office of Federal Housing Enterprise Oversight's December Report of the Special Examination of Freddie Mac.* Washington, D.C.: January 21, 2004.

[16] See U.S. General Accounting Office, *Comparison of Financial Institution Regulators' Enforcement and Prompt Corrective Action Authorities*, GAO-01-322R (Washington, D.C.: Jan. 31, 2001).

these differences, which Congress may wish to consider in determining the appropriate authorities for a new GSE housing regulator:

- Unlike bank regulators and FHFB, OFHEO's (1) authority to issue Cease and Desist Orders does not specifically list an unsafe and unsound practice as grounds for issuance and (2) powers do not include the same direct removal and prohibition authorities applicable to officers and directors;

- Bank regulators have prompt corrective authorities that are arguably more robust and proactive than those of OFHEO and FHFB. These authorities require that bank regulators take specific supervisory actions when bank capital levels fall to specific levels or provide the regulators with the option of taking other actions when other specified unsafe and unsound actions occur.[17] Although OFHEO has statutory authority to take certain actions when Fannie Mae or Freddie Mac capital falls to predetermined levels, the authorities are not as proactive or broad as those of the bank regulators.[18] OFHEO has also established regulations requiring specified supervisory actions when unsafe developments are identified that do not include capital, but OFHEO's statute does not specifically mention these actions. FHFB's statute does not establish prompt corrective action scheme, but FHFB officials believe they have all the authority necessary to carry out their safety and soundness responsibilities; and

- Unlike bank regulators—which can place insolvent banks into receivership—and FHFB, which can take actions to liquidate an FHLBank, OFHEO is limited to placing Fannie Mae or Freddie Mac into a conservatorship.[19] I note that should Congress decide to grant the

[17] Capital can be a lagging indicator of unsafe and unsound conditions at financial institutions. Declining asset quality is an unsafe and unsound condition that may be identified months or years before capital declines.

[18] For example, bank regulators are required to take specified regulatory actions at earlier stages of capital depletion than is OFHEO. Bank regulators are also required to initiate four supervisory actions if an institution is undercapitalized—including restricting asset growth—while OFHEO is mandated to take only two actions (not including restricting asset growth).

[19] According to OFHEO officials, a receivership is empowered to take over the assets and operate an entity, assuming all of its powers and conducting all of its business as well as removing officers and directors. A receiver may place the failed institution into liquidation and sell its assets. While a conservator may also remove officers and directors of an entity, a conservator is typically appointed to conserve rather than dispose of assets.

new GSE regulator receivership authority, it should task the regulator to develop rules and procedures that would reduce the adverse impacts that a GSE liquidation could have on housing finance and the stability of financial markets.

In summary, I believe Congress can review the regulatory authorities at OFHEO, FHFB, and bank regulators and, where appropriate, ensure that the new regulator has sufficient authorities to carry out its critical responsibilities.

Measures Have Not Been Established to Determine Whether the GSEs' Benefits Outweigh Their Risks

In important cases, it is clear that the GSEs have fulfilled the public missions for which they were initially created. Since the establishment of Fannie Mae and the FHLBank System in the 1930s, for example, the nation's mortgage finance market has progressed from a regionally based system characterized by periodic credit shortages to a nationwide and liquid system. Furthermore, it is generally agreed that Fannie Mae and Freddie Mac's mortgage purchase activities have lowered the interest rates on qualifying mortgages below what they otherwise would be. In a 1996 report, we estimated that Fannie Mae and Freddie Mac's activities lowered the rate on qualifying mortgages by about 15 to 35 basis points or a monthly savings of between $10 and $25 on a typical mortgage of $100,000.[20] Subsequently, federal agencies and researchers, academics, and the GSEs have initiated studies that have estimated the extent of the benefits provided by the GSEs' activities and the recipients of such benefits (i.e., homebuyers vs. investors and management), which have reached differing conclusions. Additional studies may be needed to more precisely estimate the extent to which the GSEs' activities benefit homebuyers.

In other areas, however, there is substantially greater uncertainty regarding the benefits of the GSEs' activities and more research is needed to clarify these issues. Although the GSEs have expanded rapidly and become more complex in recent years, for example, it is not always clear how the GSEs' growth and complexity have enhanced their public missions. For instance, at year-end 2002, Fannie Mae and Freddie Mac held a combined $1.4 trillion of mortgage assets in their retained portfolios, including MBS, while the FHLBanks hold about a combined $100 billion of

[20] U.S. General Accounting Office, *Housing Enterprises: Potential Impacts of Severing Government Sponsorship*, GAO/GGD-96-120 (Washington, D.C.: May 13, 1996).

MBS. Although holding mortgage assets in their portfolios may enhance the profitability of the GSEs, it also exposes them to interest rate risk, which requires the use of sophisticated financial strategies—such as the use of hedging which includes the use of derivatives to manage effectively. In addition, derivatives may also be used by financial institutions to take positions on interest rate movements, which can enhance their profitability but which is also inherently risky. Over the years, questions have been raised as to whether the GSEs' portfolio investments in MBS generate benefits to borrowers.

Additionally, the lines that initially existed between Fannie Mae and Freddie Mac on the one hand and the FHLBank System on the other have blurred. In addition to making advances to their members, for example, FHLBanks have now purchased about $108 billion in mortgages directly from their members, which is essentially Fannie Mae and Freddie Mac's traditional business. Although the FHLBanks' mortgage purchases may enhance competition in the market for secondary mortgage purchases, they can just as easily raise questions as to whether there is a need for an additional GSE performing essentially the same mission and incurring similar risks.

In some cases, the absence of specific criteria and guidance complicates efforts to assess the benefits of the GSEs' activities. Our recent work concluded that Farmer Mac's statute contains broad mission purpose statements and lacks specific or measurable criteria that would help determine whether the GSE is meeting its policy goals. Farmer Mac's nonmission-related assets—such as long-term corporate bonds—declined from 66 percent of assets in 1997 to 37 percent in 2002. However, the composition and criteria for nonmission investments could potentially lead to investments that are excessive in relation to Farmer Mac's financial operating needs or otherwise would be inappropriate to the statutory purpose of Farmer Mac. We suggested that Congress should consider establishing clearer mission goals for Farmer Mac with respect to the agricultural and real estate market to allow a determination as to whether Farmer Mac had achieved its public policy goals.

Finally, I would also like to point out that there are other limitations in the evidence and research on the benefits provided by the GSEs' activities. The following are some examples that we have identified:

- There is limited information as to the extent to which the FHLBank System's more than $500 billion in outstanding advances, as of mid-year 2003, have facilitated mortgage availability. Although anecdotal information is available on the benefits of FHLBank advances, studies using quantitative analysis to assess the impacts of FHLBank advances on housing and community development have not been produced.

- There is limited information available on the extent to which Fannie Mae and Freddie Mac's investments in nonmortgage assets—such as long-term corporate bonds—serve their public missions. As I described earlier, HUD has not acted on its general regulatory authority to review the appropriateness of the GSEs' nonmortgage investments as it committed to do in response to a 1998 GAO report. Given that HUD has not acted in this area for the past 6 years, we again recommend that Congress legislate nonmortgage investment criteria for HUD or any new GSE regulator that may be established through legislation.

- There is virtually no information available as to whether Farmer Mac's activities have benefited agricultural real estate markets. For example, the depth and liquidity of the demand for AMBS in the current market is unknown.

Without quantifiable measures and reliable data, Congress and the public cannot judge the effectiveness of the GSEs in meeting their missions or whether the benefits provided by the GSEs' various activities are in the public interest and outweigh their financial risks. To improve the quality of information about the GSEs' activities, I believe that the GSEs, the new housing GSE regulator, and FCA—the regulator of Farmer Mac and FCS—should research the areas that we have identified as well as others and periodically report their findings to the public.

Mr. Chairman, this concludes my statement. In summary, I believe that the following steps can be taken to strengthen GSE governance and oversight:

- Fannie Mae and Freddie Mac should ensure that their executives report to independent boards; FHLBank directors should be chosen through transparent and inclusive processes; and GSE compensation packages should include short and long-term performance measures;

- Congress should create a single housing GSE regulator that is governed by a board or a hybrid board and director and has adequate authorities to fulfill its safety and soundness and mission compliance oversight responsibilities; and

- Congress should provide clearer direction to the GSEs in fulfilling their missions—such as in the case of the GSEs' nonmortgage investments—and the GSEs, the new GSE regulator, and FCA should research certain aspects of the GSEs' financial activities and periodically report to the public as to how these activities are consistent with mission requirements.

I would now be happy to respond to any questions that you or other members of the Committee may have.

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GAO Government-Sponsored Enterprise Related Reports

Farmer Mac: Some Progress Made, but Greater Attention to Risk Management, Mission, and Corporate Governance Is Needed. GAO-04-116. Washington, D.C.: October 16, 2003

Federal Home Loan Bank System: Key Loan Pricing Terms Can Differ Significantly. GAO-03-973. Washington, D.C.: September 8, 2003.

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PREPARED STATEMENT OF ALAN L. BELLER

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U.S. SECURITIES AND EXCHANGE COMMISSION

FEBRUARY 10, 2004

Introduction

I am pleased to have this opportunity to testify before you on behalf of the Securities and Exchange Commission regarding the application of disclosure and reporting requirements of the Federal securities laws to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. These Government Sponsored Enterprises (GSE's) issue marketable debt to the public. In addition Fannie Mae and Freddie Mac have publicly held common stock and also issue guaranteed mortgage-backed securities to the public. All of these entities and their securities are exempt from the registration and disclosure provisions of the Federal securities laws. None of the debt securities issued by any of these GSE's is backed by the full faith and credit of the United States.

Commission's Historical Views on GSE Disclosure

Since at least 1992, the Commission has expressed the view that, because the GSE's, most prominently Fannie Mae and Freddie Mac, but also including the Federal Home Loan Banks, sell securities to the public and have public investors, and do not have the "full faith and credit" Government backing of Government securities, their disclosures should comply with the disclosure requirements of the Federal securities laws. The Commission participated with the Department of the Treasury and the Board of Governors of the Federal Reserve System in a 1992 Joint Report on the Government Securities Market (1992 Report) that addressed these issues, among other things.[1] Mandatory compliance by the GSE's with these disclosure requirements and the Federal securities laws is the objective. While the 1992 Report addressed registration, the manner by which mandatory compliance is achieved—including through voluntary registration with the Commission—may be less significant. Further, the disclosure quality that we seek for the GSE's can only result from becoming subject to the SEC's reporting system. The disclosure quality results not only from our disclosure rules but also the Commission's and the staff's administration of these rules, including our review and comment processes and our enforcement program.

Preliminary Discussion of Registration

For purposes of today's subject, two of the Federal securities laws are relevant—the Securities Act of 1933 (Securities Act)[2] and the Securities Exchange Act of 1934 (Exchange Act).[3] The Exchange Act requires, or allows for, registration by issuers of classes of their public securities. Registration under the Exchange Act results in reporting requirements providing for disclosure of detailed information relating principally to the issuer. Under the Exchange Act and the Commission's rules, required information includes financial statements, management's discussion and analysis, description of business, information regarding directors and management and compensation, information regarding related party transactions and other information.[4] This corporate information is the information on which the Commission and staff have focused in urging disclosure by GSE's. Registration under the Exchange Act also subjects reporting companies to the provisions of the Sarbanes-Oxley Act applicable to issuers.[5] These provisions include CEO and CFO certification requirements, internal control requirements, prohibition on loans to insiders, restrictions on the use of proforma or non-GAAP measures and enhanced disclosure requirements, for example regarding off-balance sheet transactions.

The Securities Act, by contrast to the Exchange Act, requires registration by issuers of transactions, namely public offerings by issuers of their securities. One result of registration under the Securities Act is required disclosure of essentially the same corporate information as is required for reporting companies under the Exchange Act. Another result of registration under the Securities Act is required dis-

[1] Department of the Treasury, Securities and Exchange Commission, Board of Governors of the Federal Reserve System, *Joint Report on the Government Securities Market,* January 1992.

[2] 15 U.S.C. § 77a *et. seq.*

[3] 15 U.S.C. § 78a *et. seq.*

[4] See generally Regulation S–X, 17 CFR 210 and Regulation S–K 17 CFR 229.

[5] Pub. L. 107–204 (2002) 116 Stat. 745 (2002).

closure regarding the securities being offered.[6] Finally, because the Securities Act registers securities offerings, review by the Commission staff of Securities Act registration statements can directly affect the timing of those transactions.

Fannie Mae and Freddie Mac

On July 12, 2002, Fannie Mae and Freddie Mac announced that each would voluntarily register its common stock under the Exchange Act and thus become subject to Commission reporting requirements. This decision took the form of a public announcement, along with press releases issued by each company. Fannie Mae's registration statement under the Exchange Act was declared effective on March 31, 2003. Freddie Mac has stated it intends to complete the Exchange Act registration process when it completes its restatement and audit of its financial statements. As noted above, registration and reporting also trigger applicability of the provisions of the Sarbanes-Oxley Act that apply to reporting companies.

The proxy and insider transaction reporting requirements of the Exchange Act (Sections 14(a) and 16(a)) by their terms specifically apply only to nonexempt equity securities. The classes of common stock of Fannie Mae and Freddie Mac remain exempt securities even if registered under the Exchange Act and thus not subject to either section. In order to obtain the disclosure that would be required by officers and directors of the companies under the insider transaction reporting requirements of the Exchange Act and compliance by the companies with the Commission's proxy rules, the Office of Federal Housing Enterprise Oversight adopted rules effective April 30, 2003 requiring the officers and directors of Fannie Mae and Freddie Mac to file with the Commission all reports and forms that would be required by Section 16(a) and the companies to file with the Commission all reports required pursuant to Section 14(a).

As I noted, Fannie Mae has registered its common stock under the Exchange Act. Fannie Mae is now fully subject to the Commission's disclosure rules and the requirements of the Sarbanes-Oxley Act. Freddie Mac has not completed the process. Fannie Mae has filed with the Commission its 2002 annual report on Form 10–K including audited financial statements, quarterly reports on Form 10–Q containing unaudited financial statements, its proxy statement relating to its annual meeting of shareholders and numerous current reports on Form 8–K. In addition, officers and directors of Fannie Mae have filed dozens of Statements of Changes in Beneficial Ownership on Form 4.

Our attention to date in seeking disclosure by the GSE's that meets our requirements has focused on corporate information. It has been our priority that investors who purchase and sell stock or "straight" debt (that is nonmortgage-backed debt) of the GSE's are entitled to the corporate information required to be disclosed under the Exchange Act. While Fannie Mae and Freddie Mac continue to be exempt from the requirements to register the offer and sale of securities under the Securities Act of 1933, the information about the corporation that would be required to be disclosed in a prospectus contained in a registration statement under the Securities Act is the same as Fannie Mae is, and Freddie Mac will be, required to provide as a result of their voluntary registration under the Exchange Act.

Registration of securities transactions by Fannie Mae and Freddie Mac under the Securities Act, especially offerings of their mortgage-backed and other mortgage-related securities, requires consideration of factors not present with the more easily accomplished registration under the Exchange Act. The Commission did not recommend in the 1992 Report removing the exemption from the Federal securities laws for the offer and sale of mortgage-backed and mortgage-related securities of Fannie Mae and Freddie Mac. While we seek the achievement of the benefits for investors of registration under the securities laws, we recognize that these other factors need to be examined.

First, as noted above, the review process of the Division of Corporation Finance of registration statements of transactions under the Securities Act means that the timing of transactions could be affected. This is not the case as a result of Exchange Act registration, which requires the filing of periodic and current reports with company information rather than filings tied to the timing of offerings.

Second, because Fannie Mae's and Freddie Mac's mortgage-backed and other mortgage-related securities are backed by their respective guarantees, important information in analyzing these securities as a credit matter includes their financial and other corporate information. Exchange Act filings would contain this information without regard to Securities Act registration.

[6] Registration of sales under the Securities Act also results in an automatic requirement to file Exchange Act reports for at least some period of time.

As to other information regarding mortgage-backed and related securities, in late 2002, staff of the Commission, Department of the Treasury, and OFHEO conducted a joint study of disclosure regarding mortgage-backed securities with a view to ensure that investors in mortgage-backed securities are provided with the information that they should have. The task force issued a report in January 2003.[7] The report notes that market participants found the mortgage-backed securities market extremely efficient. The report concluded that some additional disclosures would be both useful and feasible in the mortgage-backed securities market. These include:

- Loan purpose (that is, whether a purchase or refinance)
- Original loan-to-value (LTV) ratios
- Standardized credit scores of borrowers
- Servicer for the pool (this may not always be the seller or originator)
- Occupancy status (owner-occupied or investor)
- Property type (for example, detached, condo)

Both Fannie Mae and Freddie Mac have implemented these new disclosures.

Finally, registration of offerings of the GSE's mortgage-backed and related securities under the Securities Act may raise another significant and uniquely complex factor—the impact on the mortgage market—that should be considered. In particular, a substantial portion, and recently a majority, of the GSE's mortgage-backed securities have been sold into the so-called "To Be Announced," or TBA, market. These transactions involve forward sales of mortgage-backed securities comprised of pools of mortgages not yet identified and in many, if not most, cases not yet in existence. The parameters which the securities and the mortgages in the pools must meet are set forth in standards established for the TBA market by market participants and discussed in the January 2003 report. Because actual mortgage pools are not established at the time of the forward sale transactions, there can be no disclosure of mortgage pool characteristics at the time of registration of the offerings. The TBA standards the mortgage pools must meet are already available to the market.

In addition, we understand that the TBA market is used to set or "lock in" mortgage rates in the U.S. housing market. A decision to require registration under the Securities Act of offers and sale of mortgage-backed securities should properly take into account whether, and if so, how such registration might impact the mortgage market and the operation of the TBA market. I believe that similar considerations formed at least a portion of the background for the conclusion expressed in the 1992 Report.

Federal Home Loan Banks

The Federal Home Loan Bank System was created prior to enactment of the Securities Act and the Exchange Act and the creation of the Securities and Exchange Commission in 1934. The System was created in 1932 to restore confidence to the Nation's financial institutions and improve the supply of funds to local lenders.[8] The System is comprised of 12 banks. The Federal Home Loan Bank System through the Office of Finance is one of the largest issuers of debt securities in the world with $673.7 billion outstanding as of December 31, 2002. We believe that the holders of debt issued by the Office of Finance, for which the 12 Banks are jointly and severally liable, are entitled to the same type of information that is provided to investors in other public debt securities. Our interest is in assuring that public investors in this debt are provided with sufficient information when they are making their investment decisions.

The Federal Home Loan Banks are also exempt from the Federal securities laws. The Banks prepare financial statements based on regulations of the Federal Housing Finance Board, which refer to Commission disclosure regulations. However, the staff of the Commission does not review these financial statements or any other disclosure documents of the Banks. The Banks are also not subject to the provisions of Sarbanes-Oxley Act of 2002 applicable to issuers, as discussed above. However, the Banks are subject to general antifraud restrictions prohibiting false or misleading statements of material facts or the omission of material facts necessary to make the statements made, in light of the circumstances under which they are made, not misleading. In September 2003, the Finance Board proposed for comment a rule to require registration under the Exchange Act by the Banks with the Commission. The comment period for that rule ended January 15, 2004.

[7] Department of the Treasury, Office of Federal Housing Enterprise Oversight, Securities and Exchange Commission, *Staff Report: Enhancing Disclosure in the Mortgage-Backed Securities Market,* January 2003.

[8] Federal Home Loan Bank Act, Pub. L. No. 72–304, 47 Stat. 725 (1932)

The Banks, although Federally chartered entities, have many of the same disclosure issues as any financial institution whose securities are issued to, and held by, the public. Consolidated obligations for which each Bank is either primarily or secondarily obligated are sold to the public in underwritten offerings. As discussed above, we believe investors in those debt securities are entitled to the same type of information as that provided by other issuers of public debt. As also discussed above, we further believe that the Commission's detailed disclosure rules and filing requirements and the staff review and comment process provide the best framework for disclosing information to which investors are entitled.

Because the debt of the Banks does not carry the full faith and credit backing of the United States and investors in the Banks' debt must therefore look only to the Banks for repayment of the debt, disclosures by the Banks should give the holders of its debt a materially complete and accurate picture of the Banks' financial and operational situation to evaluate an investment. As is the case with Fannie Mae and Freddie Mac, the focus for disclosure has been the corporate disclosure required for a reporting company that registers under the Exchange Act. Registration of offers and sales of securities under the Securities Act has not been the focus and is not the subject of the proposed Finance Board rule. In particular, as with Fannie Mae and Freddie Mac, corporate disclosure resulting from Exchange Act registration is the same as would be required as a result of Securities Act registration.

Because of the structure of the Federal Home Loan Bank System, including the Office of Finance, however, there are some issues that may be unique to the Banks. Staff of the Commission has met with members and staff of the Federal Housing Finance Board, representatives of the Banks and a group of directors of certain Banks, in each case at their request, to discuss the issues that registration under the Exchange Act may raise.

Very early in our discussions with all of these parties, we sought to clearly and carefully address concerns raised by the Banks about whether registration would require the structure of the System to change. The Commission has no regulatory interest in changing the structure of the System. Registration under the Exchange Act of each of the 12 Banks would not alter the structure of the Federal Home Loan Bank System. In addition, insofar as registration of a class of each Bank's securities under the Exchange Act is being considered, there would be no impact on the timing or other aspects of offering transactions as a result of registration.

Because our focus on disclosure relates to the debt issued by the Banks and not to their common stock, Commission staff had initially considered with the Finance Board and the Banks the possibility of the Banks registering a class of debt securities. Under the Exchange Act the corporate disclosure required of a company is the same whether the security registered is debt or common stock. However, registration of equity could implicate additional requirements for the Banks, such as the proxy rules. Therefore Commission staff suggested the Banks register a class of debt securities. In our discussions with the Banks, each Bank expressed a preference for registering a class of its stock, if any security was to be registered under the Exchange Act. Because the corporate disclosure is the same, this is acceptable to us. Staff have also indicated to the Banks that we would work with them to determine if there were certain requirements, such as the proxy rules, from which it should be clear the Banks are exempted because the publicly held securities that implicate registration and disclosure issues are their debt securities. This would produce the same result as would be the case for corporate issuers whose only public securities are debt securities.

In addition to these items, there have been four accounting related issues that have been identified as significant for the Banks in terms of ascertaining our staff's view prior to any registration process. We have met with representatives and advisers of some of the Banks to resolve these issues. Those issues include: The accounting treatment of the payment to REFCORP, the role of the combined financial statements of the 12 Banks, the accounting classification of redeemable capital stock, and the accounting treatment related to the joint and several nature of the Banks' obligations:

- The Financial Institutions Reform, Recovery, and Enforcement Act of 1989[9] obligated the Banks to make an annual $300 million payment to the U.S. Treasury until 2030 for the partial payment of interest on bonds issued by the Resolution Funding Corporation, or REFCORP. The Gramm-Leach-Bliley Act[10] in 1999 changed how REFCORP payments are calculated and due. Each Bank is now obligated to pay 20 percent of earnings annually until these amounts for the whole

[9] Pub. L. No. 103–73 (1989).
[10] Pub. L. No. 106–102 (1999).

system are equivalent to a $300 million annual annuity with a final maturity date of April 15, 2030. The Banks view the REFCORP payments as similar to a tax and accordingly, no obligation for future payments is recorded on their balance sheets. The Commission staff has indicated to the Banks that we would not object to this current presentation of the treatment of REFCORP payments.

- Each Bank is a separate corporation with its own management, employees, and board of directors. The Office of Finance, which is an agent for the Banks, prepares combined financial statements of the 12 Banks for public distribution. The financial statements are not consolidated because there are separate and distinct stockholder groups for each Bank with no common management or ownership at the system level. The Commission staff believes that the correct way to proceed is to have individual Banks register. Because of the structure of the System, there is no issuer tied to the combined statements to register under the Exchange Act. Commission staff believes, however, there are policy reasons for us to have an opportunity to review and comment on the combined financial statements which are distributed to investors. Under Finance Board regulations the Board determines whether the combined financials statements comply with their requirements.[11] Staff have proposed that we would have arrangements with the Finance Board so that their reviews would give the Commission staff the opportunity to review the combined financial statements and provide the Finance Board comments, if any. None of the Banks would have additional responsibility for the combined financial statements as a result of registration under the Exchange Act or the staff's proposed arrangements with the Finance Board regarding the combined statements.
- The Gramm-Leach-Bliley Act required each of the Banks to create a new capital structure. That Act allows each Bank to create two classes of stock, one with a redemption period of 6 months and the other with a redemption period of 5 years. The Banks are in the process of implementing their new capital plans. Because the stock will be redeemable, the issue arose as to whether the stock could be included as permanent equity on the financial statements of the Banks. Because all of the stock of each of the banks is "puttable," the Commission staff will not object if it is not separated from the equity section of the balance sheet. This would be similar to the treatment of the equity for co-ops currently registered under the Exchange Act. The face of the financial statements would need to indicate the stock is "puttable" and the notes to the financial statements would include disclosure on how the puts work and on how much of the stock is in excess of the amount required to be held by member banks which is generally based on the member bank's activity. We have indicated to the Banks that we will continue to have dialogue with them on the proper accounting treatment in the event a stockholder puts the stock to a Bank.
- The Commission staff has also had discussions with the Banks regarding the appropriate treatment of the joint and several nature of the Consolidated Obligations. Staff has indicated to the Banks that it would not object to each Bank reflecting on the face of its balance sheet as long-term indebtedness only the amount of Consolidated Obligations for which that Bank has received proceeds and is therefore viewed by the Banks as primarily liable. The Banks would also disclose the total amount of outstanding obligations. The Commission staff has also indicated to the Banks that it would not object to their accounting treatment for the contingent liability related to each Bank's guarantee of the remainder of the outstanding Consolidated Obligations for which it is not primarily liable.

Conclusion

The individual and institutional investors who hold debt securities of the Banks depend for repayment on the Banks and not a Government guarantee. We believe that applying the Commission's disclosure requirements and processes is the preferred method of helping to ensure that these investors receive the materially accurate and complete disclosure they deserve. We believe that the Commission's detailed disclosure rules and filing requirements, and our staff review and comment process, provide the best framework for disclosing that information. We have a long history of reviewing the disclosure of companies in many diverse industries and we regularly review the complex debt and equity structures of these companies. We have not initiated any process to seek voluntary registration by the Federal Home Loan Banks of their securities, but we do believe that our rules and registration would provide the desired result. If registration by the Banks is pursued, we are committed to achieving that result with maximum protection for investors and maximum efficiency for all registrants consistent with our mission to protect investors.

[11] 12 CFR 985.6(b).

PREPARED STATEMENT OF RICHARD S. CARNELL

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FEBRUARY 10, 2004

Mr. Chairman, Senator Sarbanes, and Members of the Committee, I am pleased to have this opportunity to discuss ways to improve the regulation of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System.

As Government Sponsored Enterprises, these entities are privately owned, profit-oriented corporations that have Congressional charters and receive an array of Federal benefits not available to businesses generally. More importantly, capital market participants believe that the Government implicitly backs each GSE—and would not let the GSE's creditors go unpaid. This perceived implicit guarantee is the GSEs' most important and most distinctive characteristic. It enables the three housing GSE's to borrow $2.2 trillion at rates below those available to even the most creditworthy fully private borrowers.

For years the GSE's assured us that they met the highest standards of corporate governance, fully complied with generally accepted accounting principles, provided disclosure at least as good as what the Federal securities laws required, faced tough and effective safety-and-soundness regulation, and were so well run that no one had any business requiring them to do anything they did not want to do. Recent scandals and other developments cast doubt on these claims and on the adequacy of GSE regulation. The Administration has proposed major reforms of such regulation, including the creation of a new GSE regulatory agency. Treasury Secretary Snow has rightly called for "a strong, credible, and well-resourced regulator" with "powers . . . comparable in scope and force to those of other world-class financial regulators, fully sufficient to carry out the agency's mandate, with accountability to avoid dominance by the entities it regulates."

In my testimony today, I will:

- identify six fundamental questions Congress faces in structuring a GSE regulator;
- offer suggested answers to those questions;
- describe the double game by which the GSE's deny that they have "full faith and credit" Government backing—in ways that leave the impression that they have no Government backing at all—even as they work to reinforce the market perception of implicit Government backing;
- refute the GSEs' attempt to liken FDIC-insured banks to GSE's and to argue that we should not concern ourselves with GSE subsidies because the Government gives banks greater subsidies; and
- examine "systemic risk"—particularly the argument that if a GSE got into financial trouble, the Government would have no choice but to rescue it, lest its failure unacceptably damage the financial system.

Structuring the Regulator

In designing (or redesigning) a regulatory agency, Congress faces six fundamental questions:

- *Jurisdiction:* Who will the agency regulate?
- *Mission:* What objectives should the agency seek to achieve?
- *Governance:* Who will run the agency, and under what ground rules?
- *Resources:* How will the agency pay its expenses?
- *Legal Authority:* What legal tools will the agency have to do its job?
- *Incentives:* What incentives will the agency's officers and employees have?

I will first briefly analyze OFHEO's structural weaknesses in light of these questions. I will then discuss how to structure a new GSE regulatory agency, considering the first five questions in turn and (in so doing) noting how the answers given to those questions will affect the agency's incentives. For the new agency's incentives will be crucial to the agency's success or failure.

OFHEO'S STRUCTURAL WEAKNESSES

Congress created OFHEO with significant structural weaknesses. Specifically, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (1992 Act) created a small, hyper-specialized agency—with uncertain funding and overly narrow powers—to regulate two huge, relatively homogeneous firms with great political clout. The Act housed that agency in a department with no institutional commitment to safety and soundness, little credibility to spare, and little ability to protect OFHEO against pressure from Fannie and Freddie. I summarize some of these structural weaknesses and their consequences in the table following this page.

Building these weaknesses into OFHEO was a bit like keeping a watchdog hobbled, muzzled, and underfed.

JURISDICTION

The new agency should regulate Fannie, Freddie, and the Federal Home Loan Bank System, taking over the functions currently performed by OFHEO and the Federal Housing Finance Board.[1]

Having a single agency regulate all three housing GSE's would have several advantages over the current system. The General Accounting Office identified and aptly summarized these advantages in its excellent report, *Government Sponsored Enterprises: Advantages and Disadvantages of Creating a Single Housing GSE Regulator* (1997), on which I will draw extensively in this part of my testimony.

[1] I will argue below that the new agency should, ideally, also become responsible for overseeing Fannie and Freddie's housing mission, taking over functions currently performed by HUD.

STRUCTURAL WEAKNESSES OF OFHEO		
Issue	**Weakness**	**Result**
Jurisdiction	OFHEO regulates only two firms, which are large, powerful, and relatively homogeneous	Fannie and Freddie have very similar interests, and can easily unite to pressure OFHEO
Mission	OFHEO has responsibility for safety and soundness, while HUD has responsibility for housing mission	Divided responsibility creates the potential for the GSEs to try to pit OFHEO and HUD against each other, or to tell each agency that a given matter falls only within the authority of the other agency
Governance	OFHEO is an autonomous bureau of HUD, a department with no institutional commitment to safety and soundness, little credibility to spare, and little ability to protect OFHEO against pressure from Fannie and Freddie	OFHEO can expect little useful support and protection from HUD. White House may treat the directorship of OFHEO as a housing (rather than safety-and-soundness) appointment
Resources	OFHEO must depend on annual appropriations, even though it receives no tax money	Fannie and Freddie use the appropriations process both to pressure OFHEO and to limit OFHEO's capacity to scrutinize the GSEs more rigorously
Legal Authority	OFHEO has much more limited authority than federal bank regulators to set capital standards, take prompt corrective action, and take enforcement action. OFHEO has no authority to appoint a receiver for an insolvent GSE	OFHEO is needlessly constrained from taking substantively appropriate action to keep the GSEs safe and sound. The GSEs can quibble about the statutory legitimacy of other substantively appropriate action. Neither OFHEO nor anyone else has adequate tools for dealing with an insolvent GSE

First, and most importantly, a single regulator would have more independence from the firms it regulates. The Federal Home Loan Bank System has a different business model and different interests than Fannie and Freddie. These differences should create what the GAO called "a healthy tension in the oversight of the [GSE's] that could help prevent the regulator from being 'captured' by the GSEs" (that is, from identifying with and primarily serving the GSEs' interests).

A similar "healthy tension" in State thrift regulation yielded major benefits during the thrift debacle of the 1980's. The most severe losses among State-chartered, Federally insured thrifts occurred in States (for example, Texas and California) with hyper-specialized regulators that supervised only thrifts. States whose banking commissioners also regulated thrifts had a much better record of keeping thrifts healthy and avoiding costly failures. This difference in outcomes reflected a difference in regulators' incentives. Hyper-specialized thrift-only regulators proved overly reluctant to rein in risky practices, close insolvent thrifts, and require sick thrifts to recapitalize. Such strong measures would have risked alienating thrifts (the regulators' main constituency) and putting the regulators out of business. By contrast, State officials who regulated both banks and thrifts had greater liberty to take tough but necessary action against troubled thrifts. State-chartered banks demanded such action. Moreover, these officials knew that their agencies could, if necessary, survive without a thrift clientele. So regulating both banks and thrifts gave these officials more freedom to do their jobs well. Similarly, regulating all three housing GSE's would give the new GSE regulator more freedom to do its job well than if it regulated only Fannie and Freddie or only the Federal Home Loan Banks.

Second, an agency regulating all three housing GSE's would be larger and (in the GAO's phrase) "more prominent in Government" than OFHEO and the Finance Board. This increased stature "could help attract and retain staff with the special mix of expertise and experience needed to examine and monitor these sophisticated GSE's."

Third, a single housing GSE regulator could achieve "some economies and efficiencies" by having staff "share expertise in such areas as examinations, credit and interest rate risk monitoring, financial analysis, and economic research" and by combining "[a]dministrative support functions."

Fourth, such an agency could achieve greater consistency in regulating the three housing GSE's.

The main disadvantage of creating a single regulator would be quite modest: What the GAO called "the short-term disruption that would come with any type of change."

Mission

OFHEO and HUD currently divide regulation of Fannie and Freddie, with OFHEO responsible for safety and soundness and HUD responsible for housing mission. The Finance Board, by contrast, has both types of responsibility for the Federal Home Loan Bank System.

Giving the new GSE regulator both safety and soundness and mission responsibilities would have three advantages. First, it would promote accountability by both the regulator and the GSE's. Divided responsibility creates "the potential for the GSE's to try to pit the regulators against each other" (as the GAO's 1997 report noted) or to tell each regulator that a given matter—which may raise both mission and safety and soundness issues—falls only within the authority of the other regulator. Second, giving a single agency both responsibilities would simplify compliance by the GSE's. Third, insofar as GSE policy must take account of both mission and safety and soundness, giving one agency both responsibilities would promote better-informed decisionmaking.

Accordingly, I would support combining both responsibilities in one agency if that can be done under sound governance (discussed below). But sound governance is so critical that it should not be compromised to obtain the more modest benefits of combining the two responsibilities. In any event, the GSE's should have to limit their activities to the secondary market and obtain the new agency's approval before commencing new activities.

Governance

General Approach

The paramount goal in structuring a new GSE regulatory agency should be to assure the agency's independence from the firms it regulates. The housing GSE's are powerful, aggressive, and politically effective. They are adept at capturing or cowing regulators. But a sound governance structure—combined with other reforms (such as having one agency, with permanent funding and adequate legal authority, regulate all three housing GSE's)—can help the agency avoid such capture or intimidation.

Two possible governance structures offer the best prospects for maintaining the agency's integrity, objectivity, and effectiveness.

The first approach would make the agency an autonomous bureau of the Treasury Department.[2] The Treasury has an institutional commitment to safety and soundness, and has the will and the institutional credibility to stand up to the GSE's. The GSE's would find the Treasury harder to bully than HUD, OFHEO, the Finance Board, or a new independent agency. I believe that a Treasury-based GSE regulator would also diligently carry out its responsibilities for the GSEs' housing mission. The myth of the Treasury as hostile to housing and eager to choke off housing finance is just that: A myth, popularized decades ago by thrift lobbyists intent on keeping thrift regulation a lax, cozy backwater. The Treasury's Office of Thrift Supervision (OTS) has performed both safety-and-soundness and housing-mission responsibilities for over 14 years, without antihousing bias (and with greater competence than the independent agency it replaced).

The second approach would place the new agency under a three- or five-member board. The board would include one representative each from the Treasury and HUD. It would also include either one or three appointed members nominated by the President and confirmed by the Senate. An appointed member would serve as chair of the board and executive head of the agency. The Treasury, HUD, and the appointed member(s) would each bring their own perspectives and expertise to bear.

I view a three-member board[3] as preferable to a five-member board. A larger board would (other things being equal) have more difficulty making decisions and be more vulnerable to capture or manipulation by the GSE's. Moreover, the two additional appointed positions on a five-member board would probably offer too little challenge to attract and retain the most talented, energetic people. The chair would head the agency, and the Treasury and HUD members would have their own responsibilities. But how would the two extra appointed members occupy themselves? Would they end up half-idle, hobnobbing with the GSE's, intriguing against other board members, or attempting to micromanage the agency's staff? The prospect of such high-level underemployment would hinder the recruitment and retention of able, independent individuals.

Regulatory Autonomy

The Administration has opposed making the new agency a bureau of the Treasury unless the agency must clear its regulations and Congressional testimony through the Treasury. The Administration gives two reasons for requiring such clearance—and thus treating the new agency differently than the Treasury's Office of the Comptroller of the Currency (OCC) and Office of Thrift Supervision.[4] First, because the new agency would regulate only a few firms, all very large, it would be particularly vulnerable to "capture" by those firms. This vulnerability (in Secretary Snow's words) "makes the oversight of overall policy development by the Treasury Department vital." Second, "it is vitally important that the Treasury Department be able to monitor the new regulator's policies to ensure that such policies are not reinforcing any such market misperception of an implied guarantee."

I concur in both arguments: A specialized GSE regulatory agency would be acutely vulnerable to capture; and the Treasury should be able to monitor a Treasury bureau's policies to ensure that they do not reinforce market misperception of an implied guarantee. But these arguments do not necessarily show that Treasury clearance of regulations and testimony is essential—or that autonomy of the general type enjoyed by the OCC and OTS would not work. Both the OCC and OTS are (in the words of the OTS statute) "subject to the general oversight of the Secretary of the Treasury." 12 U.S.C. §§1, 1462a(b)(1). This oversight offers some protection against capture and should help ensure the agency's policies do not reinforce the market misperception. Insofar as the Treasury remains concerned about the misperception, the Treasury itself can speak out any time, which would correct the misperception far more effectively than vetting regulations and testimony. Moreover, the GSEs' aggressiveness and political clout—and the new agency's consequent

[2] My confidence in the Treasury may reflect my own association with that department from 1993 through 1999. Yet I had concluded years before—at the time of the thrift debacle—that the Treasury was the best place to house GSE regulation.

[3] The Pension Benefit Guaranty Corporation provides a precedent for a three-member board that draws a majority of its members from executive departments. The PBGC board consists of the Secretaries of Labor, Treasury, and Commerce. 29 U.S.C. §1302(d).

[4] The Treasury cannot "delay or prevent the issuance of any rule or the promulgation of any regulation" by the OCC or OTS. No one can require clearance of those agencies' Congressional testimony. 12 U.S.C. §§1, 250, 1462a(b)(4).

need for support—would give the agency reason to consult and cooperate with the Treasury even if the agency did not need formal Treasury clearance of regulations and testimony.

Requiring Treasury clearance of the new agency's Congressional testimony could cause delay, as Treasury officials who might otherwise have little interest in the Agency's work scrutinized the testimony to make sure it would not embarrass the Treasury Secretary or the Administration. One persistently tardy participant in a clearance process can make testimony persistently late despite the other participants' best efforts. Note, moreover, that if the Secretary cannot control the agency's testimony, then it is harder (although not impossible) to blame the Secretary for that testimony.

A stronger case exists for Treasury clearance of the new agency's regulations (although I do not regard such clearance as essential). Such clearance would help guard against capture. It need not cause delay, as regulation-writing takes time and rarely has the short deadlines typical in preparing Congressional testimony.

In any event, Treasury clearance of regulations should not derail GSE reform legislation. Congress can develop middle-ground options, such as (1) setting a time limit on Treasury review, or (2) permitting the new agency to proceed with a proposed regulation unless the Treasury expressly disapproves the regulation within a specified time period and publishes specific written reasons for its disapproval. Such an intermediate option would make Treasury review of the Agency's regulations more than merely advisory, while providing safeguards against delay or unreasoned disapproval.

RESOURCES

Like the OCC and OTS, OFHEO pays its expenses using fees collected from the firms it regulates; it receives no general tax money. But unlike the OCC and OTS, OFHEO needs an annual appropriation to set and collect such fees. Fannie and Freddie have used the appropriations process both to pressure OFHEO (just as thrifts used the process to pressure the old Federal Home Loan Bank Board) and to limit OFHEO's capacity to undertake more rigorous scrutiny of the GSE's. To reinforce the new agency's independence from the firms it regulates, Congress should end this reliance on appropriations.

LEGAL AUTHORITY

Capital, Enforcement, and Prompt Corrective Action

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 drew on banking law to strengthen the safety and soundness regulation of Fannie and Freddie. The 1992 Act required new capital standards. It included Prompt Corrective Action provisions to encourage the GSE's to correct capital deficiencies. It authorized OFHEO to take administrative enforcement action against unsafe practices. But at the insistence of Fannie and Freddie, the 1992 Act unwisely tended to deny OFHEO authority possessed by bank regulators. As a result, OFHEO has (in Tom Stanton's phrase) "a parody of the authority of the Federal bank regulators." The limits on OFHEO's authority contrast sharply with the goal of creating "a strong, world-class regulatory agency" with powers "comparable in scope and force to those of other world-class financial regulators."

Bank regulators have broad authority to prescribe capital standards, including authority to impose new standards or toughen existing standards. 12 U.S.C. §§ 1831o(c)(1), 3907(a). OFHEO, by contrast, faces major constraints on the form and content of capital standards, including an extraordinarily complex Congressionally dictated stress test. §§ 4611–4612. The new regulator needs authority to raise capital standards in light of experience.

OFHEO has much weaker enforcement authority (§§ 4631–4636) than Federal bank regulators (§ 1818), as shown in the table following this page. For example, bank regulators can issue a cease-and-desist order against any "unsafe and unsound practice." OFHEO can issue such an order only if the conduct jeopardizes a GSE's capital. Bank regulators can bar any officer, director, or employee of an FDIC-insured institution from working at that or any other Federally insured institution if the individual committed misconduct (for example, breaking the law) that (1) enriched the individual or caused loss to the institution, and (2) involved personal dishonesty or demonstrated willful or continuing disregard for institution's safety and soundness. OFHEO has no such authority. Bank regulators can impose civil money penalties of up to $25,000 per day for lawbreaking that enriches the violator or breaches the violator's fiduciary duties. OFHEO cannot impose civil money penalties on these grounds. Bank regulators can impose civil money penalties of up to $1 million per day for (1) knowingly breaking the law or breaching fiduciary duty, and thereby (2) substantially enriching the violator or causing the institution substantial loss. OFHEO cannot impose civil money penalties on these grounds.

DIFFERENCES IN ENFORCEMENT AUTHORITY

Enforcement Action		Current Authority	
Type	**Explanation**	**Federal Bank Regulators**	**OFHEO**
Cease-and-Desist Order	Requiring institution or individual to stop improper conduct	Can issue order against any "unsafe or unsound practice"	Can issue order only against conduct that jeopardizes GSE's capital. If GSE is adequately capitalized, conduct must "threaten to cause a significant depletion" of capital. If GSE is not adequately capitalized, conduct must be "likely to result in a material depletion" of capital
Removal; Prohibition	Barring officer, director, or employee from working at institution	Can bar any individual guilty of certain misconduct (e.g., violating law) if the misconduct (1) had certain consequences (e.g., enriched the individual or caused loss to the institution), and (2) involved personal dishonesty or demonstrated willful or continuing disregard for institution's safety and soundness	Has no such authority
Civil Money Penalties	Civil fine of up to $25,000 per day	Can impose if violation of statute or regulation also breaches fiduciary duty or enriches violator	Cannot impose for these reasons
	Civil fine of up to $1 million per day	Can impose for (1) knowingly violating law or breaching fiduciary duty and thereby (2) causing institution substantial loss or giving violator substantial pecuniary gain	Cannot impose for these reasons

Fannie and Freddie face Prompt Corrective Action rules (§§ 4614–4619, 4622) conspicuously weaker than those governing FDIC-insured depository institutions (§ 1831o). For example, an undercapitalized bank cannot increase its total assets unless (1) the bank has an acceptable capital restoration plan, (2) the asset growth comports with the plan, and (3) the bank's capital ratio increases at a rate sufficient to enable the bank to become adequately capitalized within a reasonable time. § 1831o(e)(3). Yet no statute bars Fannie and Freddie from continuing to grow while undercapitalized, even if they have no capital restoration plan or if the growth conflicts with such a plan (§ 4615). The Prompt Corrective Action statute authorizes growth restrictions only against a significantly or critically undercapitalized GSE, and makes such sanctions purely discretionary. §§ 4616(b)(2), 4617(b), (c)(2). Similarly, a bank cannot pay dividends if the bank is or would become undercapitalized, whereas even an undercapitalized GSE may be able to pay dividends as long as the dividends are not so large as to render the GSE significantly undercapitalized. §§ 1831o(d)(1)(A), 4515(a)(2).

The GSE enforcement and Prompt Corrective Action rules should be strengthened in line with their banking counterparts.

Receivership

There are two basic ways to deal with a firm if its liabilities exceed its assets and it cannot pay its debts as they become due: Liquidation and reorganization. Liquidation involves selling the firm's assets and using the proceeds to pay creditors. Reorganization involves scaling back the firm's liabilities, such as by turning some of the firm's debt into equity.

Liquidation or reorganization mechanisms exist for most firms. A court can liquidate a business corporation under Chapter 7 of the Bankruptcy Code or (with enough creditors' approval) reorganize the corporation under Chapter 11. The FDIC can liquidate or reorganize an insolvent FDIC-insured bank or thrift. The Federal Housing Finance Board can liquidate or reorganize a Federal Home Loan Bank.

But in the case of Fannie and Freddie, no adequate legal mechanism exists for dealing with a GSE if its liabilities exceed its assets. The Bankruptcy Code does not apply.[5] Although OFHEO can appoint a "conservator" to take control of the GSE, the conservator cannot require creditors to exchange debt for equity or to accept less than full payment of their claims.[6] Thus if the GSE's assets fall short of its liabilities, the conservator has no power to resolve the shortfall.[7] The insolvent GSE would remain adrift in legal uncertainty until Congress enacted special legislation.

This lack of an orderly "receivership" mechanism—that is, mechanism for using the insolvent GSE's assets to satisfy the GSE's creditors—is a serious gap in current law, with potentially serious consequences for financial markets. So long as the gap remains, the GSE regulator will not truly have powers "comparable in scope and force to those of other world-class financial supervisors, fully sufficient to carry out the agency's mandate."

Congress can fill the gap in at least two ways: (1) by authorizing the GSE regulator to commence a bankruptcy proceeding against an insolvent GSE; or (2) by authorizing the regulator to appoint a receiver to deal with the GSE under a specialized set of rules such as those applicable to failed banks. Either approach can do the job.

Regulating GSE's but having no receivership mechanism is like investing in an elaborate fireprotection system—complete with firewalls, smoke detectors, heat sensors, alarm bells, and sprinklers—but failing to mount a crucial fire door on its

[5] Specifically, the Bankruptcy Code does not permit Fannie or Freddie to become a debtor in a bankruptcy proceeding, whether voluntarily or involuntarily. As Federal instrumentalities, Fannie and Freddie are "governmental units" under § 101(27) of the Bankruptcy Code and thus under § 101(41) are not a "person." Under § 109(a) only a "person" can become a "debtor" in a bankruptcy proceeding. See 11 U.S.C. §§ 101(27), (41), 109(a).

[6] Under 12 U.S.C. § 4620(a), a conservator generally "shall have all the powers of the shareholders, directors, and officers of the Enterprise under conservatorship and may operate the Enterprise in the name of the Enterprise." But a firm's shareholders and managers have no power to require creditors to exchange debt for equity or to accept only partial payment of their claims.

Nor does § 4620(f) authorize OFHEO to write down creditors' claims. Under § 4620(f) OFHEO "may require a conservator to set aside and make available for payment to creditors any amounts that the Director determines may safely be used for such purpose." Using this authority, OFHEO could require a conservator to make larger or earlier payments to creditors than the conservator might otherwise make. But the statute in no way suggests that by accepting such payments creditors would waive their right to eventual payment in full.

[7] A conservator might, in theory, attempt to get all of the GSE's creditors to agree to scale back their claims. But obtaining the creditors' unanimous consent would be impracticable given the large number of creditors and the incentive for some creditors to threaten to veto the deal unless they received favored treatment.

hinges. Like firesafety measures, GSE safety and soundness regulation serves dual purposes. Firesafety measures protect a building by preventing and extinguishing fires there; they also protect other buildings by inhibiting the spread of fire. Similarly, GSE regulation seeks not only to keep the GSE's themselves safe but also to protect the financial and housing sectors from damage that might result from a GSE's failure. Bank regulation serves similar purposes and did so even before Federal deposit insurance: Seeking both to protect banks' depositors and other creditors and to prevent bank failures from causing broader economic harm. A receivership mechanism, by providing an orderly means for dealing with a failed GSE's obligations, would help limit and contain the harm resulting from a GSE's failure.

The GSEs' Double Game

In General

In managing their relationship to the Federal Government, the GSE's play an extraordinarily successful double game: They deny that they have any formal, legally enforceable Government backing, even as they work to reinforce the market perception of *implicit* Government backing. Let us look more closely at the two parts of the double game.

First, the GSE's emphatically deny that they have any formal, legally enforceable Government backing—in itself, a valid point. But the GSE's make this point in ways designed to convince the uninitiated that the GSE's enjoy *no Government backing at all* (an implication directly conflicting with the second part of the double game). The GSE's stress that "Every one of our debt securities clearly states, in plain English, it is not backed by the full faith and credit of the Government."[8] They argue that they operate "with entirely private capital" and that their activities "are entirely supported by [their] revenue . . . and the capital of private investors and are *not in any way guaranteed by the Federal Government.*"[9]

Second, the GSE's work to reinforce the perception of implicit Government backing. Consider three examples involving Fannie. In the first example, Fannie sought legislative history stating that Fannie and Freddie "are *implicitly backed by the full faith and credit of the U.S. Government.*"[10] In the second example, Fannie attacked Treasury Under Secretary Gensler as "irresponsible" and "unprofessional" when he testified before a House Subcommittee on March 22, 2000, that "the Government does not guarantee [GSEs'] securities."[11]

In the third example, Fannie argued in a 1998 letter to the Office of the Comptroller of the Currency that "all GSE issued securities merit" more favorable treatment under the Federal banking agencies' risk-based capital standards than all "AAA-rated [non-GSE] asset-backed securities." Thus the mere fact that a GSE issues a security makes that security more creditworthy than any non-GSE security. An IOU issued by a financially troubled GSE (such as the Farm Credit System before its 1987 bailout) would, under Fannie's reasoning, still be more creditworthy than a top-tier asset-backed security guaranteed by the Nation's healthiest fully private corporation. Fannie based this argument squarely on what it calls "the implied Government backing of Fannie Mae":

> GSE issues generically, and Fannie Mae-guaranteed MBS in particular, are viewed by the capital markets as *near proxies for Treasury securities* in terms of credit worthiness.
>
> . . .
>
> Fannie Mae standard domestic obligations, like Treasuries, typically receive no rating on an issue-by-issue basis, because investors and the rating agencies view the implied government backing of Fannie Mae as a sufficient indication of the investment quality of Fannie Mae obligations. . . .[12]

Thus Fannie contended that in assessing credit quality, investors and rating agencies do not (and presumably need not) look beyond "the implied Government backing of Fannie Mae," which in Fannie's view renders Fannie's securities "near proxies for Treasuries." These assertions are all the more remarkable in that Fannie made

[8] Franklin D. Raines, Remarks at Conference on Money Markets and the News: Press Coverage of the Modern Revolution in Financial Services, March 19, 1999.

[9] Fannie Mae, FM Watch Observer: Glossary of Terms, *www.fmwatch-observer.com/glossary.html* (emphasis added).

[10] When I worked for this Committee on a Glass-Steagall repeal bill in 1987–88, Fannie asked that I include such language (emphasis added) in a draft section-by-section analysis, which I declined to do.

[11] K. Day, Remarks Put Pressure on Fannie, Freddie Bonds, *Washington Post,* Mar. 24, 2000, at E1; J. Kosterlitz, Siblings Fat and Sassy, 32 *National Journal* 1498 (2000).

[12] Letter from Anthony F. Marra to OCC, Feb. 3, 1998 (emphasis added).

them in a formal comment letter to a bureau of the Treasury. We may reasonably infer that when Fannie meets with rating agencies and securities analysts—out of earshot of Government officials—it makes arguments at least as strong as those quoted above.

This double game lets the GSE's have it both ways. In effect, the GSE's tell Congress and the news media, "Don't worry, the Government is *not* on the hook"—and then turn around and tell Wall Street, "Don't worry, the Government really *is* on the hook." The GSE's play this game unchallenged, year after year.

Fannie's CEO, Franklin D. Raines, recently seemed to question the "theory . . . that there is an 'implied guarantee' that the Government would repay our creditors if we failed." In a February 6 speech at the American Enterprise Institute, Mr. Raines declared:

> [S]ome assert that we have an "implied guarantee" that the market relies on. Yet it is not clear what an implied guarantee means. We do not know who is making the implication or exactly what is being guaranteed. Indeed, Treasury Secretary Snow has testified that there is no implied guarantee.
>
> I believe that *the true value of our charter does not rest on a Government guarantee of our obligations—implied or otherwise.*
>
> Instead, our charter signifies that the Government places such a high value on our mission of expanding homeownership and affordable housing, that it goes to extraordinary lengths to ensure that the private management of our operations is closely supervised, and that our private capital is matched to our risks, even under extraordinary circumstances—all to ensure our continued success.
>
> This is the pact that the Federal Government has with investors. It does not cost taxpayers anything. And so far, it has worked very well. *This pact ensures that it is private capital that is at risk, not the taxpayer.* [Emphasis added.]

I urge the Committee to follow up on this statement by having Fannie and Freddie answer three simple questions:

- Do capital market participants err in perceiving the Federal Government as implicitly backing Fannie and Freddie?
- Do you believe that the Government in any way implicitly backs Fannie and Freddie?
- If Fannie and Freddie were to default on their obligations, would the Government have any moral obligation to assure that Fannie and Freddie's creditors got paid?

IMPLIED GUARANTEE: FANNIE MAE'S OWN WORDS

Franklin D. Raines ***AEI Speech*** ***Feb. 4, 2004***	**Anthony F. Marra** ***Formal Comment Letter to OCC*** ***Feb. 3, 1998***	**Timothy Howard** ***Statement for Reporters*** ***March 22, 2000***
"[S]ome assert that we have an 'implied guarantee' that the market relies on. Yet it is not clear what an implied guarantee means. We do not know who is making the implication or exactly what is being guaranteed"	"[I]nvestors and the rating agencies view the implied government backing of Fannie Mae as a sufficient indication of the investment quality of Fannie Mae obligations"	Called Treasury Under Secretary Gensler "irresponsible" and "unprofessional" for testifying that "the government does not guarantee [GSEs'] securities"

INEFFECTIVE STATUTORY DISCLAIMERS

In seeking to limit the taxpayers' exposure to the GSE's, Congress has enacted three disclaimers of liability. But the phrasing of these disclaimers, far from hindering the GSEs' double game, fits it neatly.

First, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 declares "neither the Enterprises [that is, Fannie and Freddie] . . . nor any securities or obligations issued by the Enterprises . . . are backed by the full faith and credit of the United States." 12 U.S.C. § 4501(4). But this disclaimer merely restates the obvious: That the Government has no formal, legally enforceable liability for the GSEs' securities. It does not disclaim implicit backing, nor does it signal that market participants err in perceiving such backing. It thus avoids the real issue.

Second, a statutory section entitled "Protection of taxpayers against liability" declares that the 1992 Act "may not be construed as obligating the Federal Government, either directly or indirectly, to provide any funds" to Fannie or Freddie "or to honor, reimburse, or otherwise guarantee any obligation or liability" of Fannie or Freddie. § 4503. This disclaimer also avoids the real issue. No one argues that the 1992 Act *created* implicit backing where it did not already exist. Market participants had long believed such backing to exist under the GSEs' charters. Congress did not act to correct that perception.[13]

Third, each firm's securities must include "appropriate language . . . clearly indicating" that the securities "are not guaranteed by the United States and do not constitute a debt or obligation of the United States or of any agency or instrumentality thereof" other than the GSE in question. §§ 1455(h)(1), 1719(b), (d)–(e). This requirement repeats the fundamental weakness of the first disclaimer: It disclaims formal, legally enforceable liability, even as it fails to disclaim implicit backing. "Indeed, the disclaimer itself hints at a special Federal relationship; completely private firms do not need to disclaim Federal backing because no one believes such backing exists."[14]

No one argues that the Government has any formal, legally enforceable liability for the GSEs' securities. Thus the disclaimers ignore the real issue: Whether the Government, although not legally bound to rescue the GSE's, would nonetheless do so (for example, because it felt a moral obligation for their debts or feared that a GSE default might damage the Nation's financial system).

SUBSIDY DENIAL

The GSEs' double game helps the GSE's argue that they get little or no Government subsidy. Yet no one can honestly dispute that Fannie and Freddie receive valuable benefits not available to businesses generally. These benefits include exemption from most State and local taxes and exemption from the registration and reporting requirements of the securities laws. The benefits also include a conditional line of credit at the U.S. Treasury and special rules relating to the GSEs' securities—for example, rules that: Equate those securities with U.S. Treasury securities for some purposes; permit issuance and transfer of those securities over the system used for issuing and transferring U.S. Treasury securities; and fail to limit FDIC-insured banks' investments in those securities. This special treatment strongly abets the market perception of implicit Federal backing. The Congressional Budget Office's reports and testimony demonstrate the great value of these special benefits.

Yet Fannie, in particular, insists that it receives no subsidy. Relying on a narrow dictionary definition to the effect that a "subsidy" is "monetary assistance granted by a Government to a person or private commercial enterprise," Fannie asserts: "Fannie Mae does not receive a penny of public funds. To the contrary, last year our Federal tax liability was $1.6 billion. True subsidies also are tangible. Fannie Mae's Government benefits are not."[15] Fannie's reasoning—that a subsidy involves only a tangible payment of money by the Government—produces absurd results. If Congress were to exempt Fannie from ever again having to pay any corporate income tax, that would supposedly not be a subsidy because it involves no cash payment to Fannie. Similarly, if a foreign government gave an energy-intensive, capital-intensive export industry unlimited access to free electricity and no-interest

[13] The second disclaimer also replicates the weakness of the first disclaimer in declaring that the 1992 Act "may not be construed as implying that any such enterprise . . ., or any obligations or securities of such an enterprise . . . are backed by the full faith and credit of the United States." § 4503.

[14] Ronald C. Moe and Thomas H. Stanton, *Government Sponsored Enterprises as Federal Instrumentalities: Reconciling Private Management with Public Accountability,* 49 PUB. ADMIN. REV. 321, 323 (1989).

[15] Timothy Howard, *Fannie Mae's Benefits to Home Buyers: The Business Perspective,* 37 FED. RESERVE BANK CHI. ANN. CONF. BANK STRUCTURE & COMPETITION 68, 69 (2001).

loans, that would supposedly not be a subsidy, either. These examples highlight the unreality of Fannie's arguments.

CURBING THE DOUBLE GAME

I suggest that any GSE legislation:

(1) correct the faulty statutory disclaimers of Federal liability for Fannie and Freddie (discussed above);

(2) correct sloppy language in the Secondary Mortgage Market Enhancement Act of 1984 stating that for some purposes Fannie and Freddie securities "shall be considered to be obligations issued by the United States," 15 U.S.C. § 77r–1(a)(1)–(2);

(3) prohibit any GSE from representing that the U.S. Government directly or indirectly backs the GSE (except in discussing formal, legally enforceable obligations of the Government) with the intent to induce anyone to rely on that representation in connection with the purchase or sale of any security; and

(4) prohibit any Government agency or official from characterizing GSE securities as Government securities.

Properly Comparing Banks and GSE's

Fannie and Freddie often argue that the Federal Government gives FDIC-insured banks[16] benefits comparable to, or even greater than, those it gives Fannie and Freddie; that concern about subsidies to Fannie and Freddie is accordingly unwarranted and even hypocritical; and that any greater financial success shown by Fannie and Freddie simply reflects their greater efficiency.

Let us start with the issue of efficiency. Fannie and Freddie have lower overhead than banks because they do a different business than banks. Most banks do a predominantly retail business. To deal directly with large numbers of small customers, they have more offices and larger staffs than they otherwise would. By contrast, Fannie and Freddie do a wholesale business, which enables them to have lower overhead.

Now let us turn to the issue of relative subsidy. FDIC insurance has a different set of costs and benefits than the Government's sponsorship of Fannie and Freddie. You might expect FDIC insurance to provide a greater net subsidy.[17] After all, FDIC insurance is established by law and carries the Government's full faith and credit. Yet the Government's perceived implicit backing of Fannie and Freddie actually tends to provide a greater net subsidy than FDIC insurance, for six structural reasons.[18]

1. Unlimited Coverage. Federal deposit insurance applies only to deposits and then only up to a $100,000 limit. The FDIC can protect a failed bank's uninsured deposits and nondeposit creditors (such as bondholders) only under very narrow circumstances. By contrast, the Government's perceived implicit backing of GSE's has no limits: It applies to all of a GSE's obligations, with no dollar ceiling.

2. No Receivership Mechanism. When an FDIC-insured bank fails, the FDIC becomes receiver for the bank: It takes control of the bank, gathers the bank's assets, and pays the bank's creditors in a specified order of priority. The bank's depositors must get paid in full before the bank's other creditors can get paid at all. If the bank's liabilities exceed its assets, its shareholders lose their ownership interest, its nondeposit creditors normally incur a partial or total loss, and its uninsured depositors often incur some loss. Similarly, when an ordinary nonfinancial company fails, it is liquidated under Chapter 7 of the Bankruptcy Code. The bankruptcy court appoints a trustee, who takes control of the company, gathers its assets, and pays creditors in a specified order of priority. The lack of any receivership mechanism for Fannie and Freddie reinforces the market perception that the Government would assure full payment of each firm's creditors.

[16] For simplicity I use "banks" to refer to all FDIC-insured depository institutions, including thrift institutions.

[17] The gross subsidy represents the total value of the special benefits provided by the Federal Government—benefits not available to businesses generally or even financial institutions generally. The net subsidy represents the difference between the gross subsidy and the offsetting costs that the entity must incur as a bank or GSE—costs not imposed on financial institutions generally.

[18] I have set forth these arguments more fully in *The Structure of Subsidy: Federal Deposit Insurance Versus Federal Sponsorship of Fannie Mae and Freddie Mac,* in SERVING TWO MASTERS, YET OUT OF CONTROL: FANNIE MAE AND FREDDIE MAC 56–83 (2001).

Most of these structural reasons hold true for the Federal Home Loan Banks, which also enjoy exemption from the Federal income tax. But the Federal Home Loan Banks do face the possibility of receivership, and must pay 10 percent of their net income to an affordable housing program and another 20 percent toward interest payments on debt securities issued to help finance the thrift clean-up. 12 U.S.C. §§ 1430(j), 1433, 1441b(f)(2)(C), 1446.

3. No Cross-Guarantees to Protect Taxpayers. Federal deposit insurance involves strong safeguards designed to ensure that banks—rather than the taxpayers—bear any losses incurred in protecting insured depositors. Banks must normally pay premiums large enough to ensure that the FDIC's insurance funds have at least $1.25 in reserves for each $100 of insured deposits. This obligation to pay premiums gives each insurance fund a claim on the capital and earnings of all banks insured by that fund—and in effect creates a network of indirect cross-guarantees among FDIC-insured banks. Thus each member of the Bank Insurance Fund is liable for ensuring that the FDIC can protect insured depositors at every other BIF member bank. As long as the fund can replenish its reserves, its existence precludes any loss to the taxpayers.

No similar cross-guarantees reduce the Government's risk-exposure to Fannie and Freddie. The two GSE's pay no insurance premiums and have no insurance fund. The two GSE's do not even cross-guarantee each other. If one GSE failed, the survivor would have no responsibility to pay the failed GSE's creditors.

4. Special Deals Instead of General Rules. To a much larger degree than banks, Fannie and Freddie reap the benefits of special, company-specific laws and avoid the discipline of generic law. Instead of operating under laws applicable to thousands of businesses, the two GSE's often get to operate under statutes designed for them alone.

5. Protection from Effective Competition Subsidizes GSE Shareholders. Federal and State regulators routinely issue bank charters to qualified applicants. Once chartered, a bank can typically engage in a wide range of activities statewide and even nationwide. No longer does each bank charter require special legislation. No longer do regulators grant charters sparingly so as to limit competition with existing banks. Entry into banking is relatively easy, and banking law affords banks little protection against competition. Thus, if banks receive a net Federal subsidy, they should generally face enough competition to force them to pass the subsidy through to their customers.

Fannie and Freddie, by contrast, enjoy significant protection against competition. Their Government sponsorship reduces their borrowing costs and increases the value of their guarantees to such an extent that no fully private firm can compete against them effectively. And only Congress can charter a competing GSE. By impeding competition with Fannie and Freddie, these constraints on entry increase the potential for the two GSEs' Government benefits to end up in the hands of their shareholders rather than their customers.

6. Free Ride. Banks must normally pay for deposit insurance. They must also comply with an array of restrictions and requirements not applicable to businesses generally. But Fannie and Freddie pay no fee for their Government sponsorship. They make no payments to an insurance fund or affordable housing fund. They need not provide public benefits that impose significant costs on their shareholders. HUD's affordable housing goals are so weak that Fannie and Freddie can meet them without doing more for affordable housing than banks do. I believe that the two GSE's would have a profit motive to do their affordable housing business in any event, even without a Government subsidy.

Considering the great value of the benefits Fannie and Freddie receive from the Government, they should be doing *far* more to increase homeownership at the margin (for example, by the lower-middle class, the working poor, and members of certain historically disadvantaged minority groups).

Systemic Risk

GSE's are often characterized as "too big to fail"—meaning that if they neared default on their debts, the Government would have to rescue them lest their failure unleash "systemic risk" that would gravely damage the Nation's financial system and economy.

Discussions of systemic risk (whether in the GSE or the bank context) often have a tone of inevitability. But systemic risk is not a force of nature like earthquakes, hurricanes, and tornados. It results from human decisions: For example, decisions by market participants and Government officials about how to structure the financial system, what risks to take, and how to respond to problems. If investors expect the Government to protect them from the full pain of downside scenarios, they will tend to take greater risks than they otherwise would have taken. Thus "too big to fail" and "systemic risk" are to a large extent *circular:* They have their roots in prevailing expectations, and they easily become self-fulfilling prophecies. Insofar as investors expect the Government to rescue troubled GSE's, market discipline on GSE's will weaken, which will tend to increase the risk that the GSE's ultimately will get into financial trouble.

If a GSE's troubles coincide with a broader financial crisis, Government officials will face additional pressures to rescue the GSE. For if during the crisis those officials seriously upset established expectations, they may create contagious uncertainty about the Government's willingness to meet other expectations. A crisis is thus a particularly inopportune time for attempting to reeducate market participants about the scope of the Government's undertakings. So if the Government tacitly accepts "too big to fail" expectations during good times, it may find itself constrained during a crisis to rescue a GSE against its better judgment.

But the circularity of systemic risk also has a positive side: If the Government acts in a timely way, it can correct "too big to fail" expectations. Congress did just that in the FDIC Improvement Act of 1991 (FDICIA) by curtailing the practice of treating FDIC-insured banks as "too big to fail."[19] FDICIA's "least-cost resolution" rule allows the FDIC to protect a failed bank's uninsured depositors and nondeposit creditors only if doing so is the "least costly to the deposit insurance fund of all possible methods" for meeting the FDIC's obligation to insured depositors. 12 U.S.C. § 1823(c)(4). The rule has a narrow systemic-risk exception, which has never been used.[20] Before FDICIA, the FDIC was spending extra money from the deposit insurance fund to protect uninsured depositors at banks as small as $500 million in total assets. But less than 1 year later, when an $8.8 billion bank group in a swing State failed just a few days before the 1992 Presidential election, the FDIC did not protect uninsured depositors and financial markets took that action in stride. By giving clear and timely notice of the new policy, Congress had succeeded in changing market participants' expectations. Proper and timely Government action can thus reduce the potential for systemic risk.[21]

Effective safety and soundness regulation of the GSE's can further reduce that risk. Yet we should beware of relying excessively on regulation. Regulation did not prevent the U.S. banking system from collapsing in 1933. Regulation did not prevent the 1980's thrift debacle, with its $125 billion cost to the taxpayers. Regulation did not prevent the bank failures of the 1980's and early 1990's, which depleted the FDIC's Bank Insurance Fund. Nor, more recently, did OFHEO detect Fannie and Freddie's accounting problems, even though it had examiners scrutinizing each GSE year-round. The failings of regulation underscore the need to maintain market discipline on the GSE's and other large financial institutions.

Miscellaneous

ENDING THE GOVERNMENT'S ROLE IN APPOINTING GSE DIRECTORS

Under current law, Federal officials appoint some members of each housing GSE's board of directors. For both Fannie and Freddie, the President appoints 5 of each GSE's 18 directors. 12 U.S.C. §§ 1452(a)(2)(A), 1723(b). The Federal Housing Finance Board appoints 6 of each Federal Home Loan Bank's 14 directors. § 1427(a).

The Administration rightly proposes to end governmental appointment of GSE directors (and, as an initial step in that direction, has indicated that it will no longer appoint directors of Freddie). Government-appointed directors face a conflict of interest. They presumably have some duty to serve the public. Yet under corporate law they presumably also have fiduciary duties to their corporation's shareholders. These duties conflict whenever the shareholders' interests run counter to some broader public interest: For example, when the shareholders' interest in maximizing profits conflicts with the public interest in protecting the taxpayers or promoting affordable housing. In 1988, Freddie's directors concluded that their fiduciary duties

[19] In context of a failed FDIC-insured bank, "too big to fail" treatment involves spending extra money from the deposit insurance fund to protect deposits above the $100,000 limit on deposit insurance coverage. It may also involve extra spending to protect nondeposit creditors.

[20] The systemic-risk exception becomes an option only if recommended to the Secretary of the Treasury by two-thirds majorities of both the Federal Reserve Board and the FDIC's Board of Directors. The Secretary can make the exception only if the Secretary determines, "in consultation with the President," that least-cost resolution of a given institution "would have serious adverse effects on economic conditions or financial stability." The Secretary must document the determination. The General Accounting Office must review and report on the exception, including the potential for it to diminish market discipline and encourage unsound risk-taking. To recoup the additional cost of deviating from least-cost resolution, the FDIC must levy a special assessment on insured depository institutions. § 1823(c)(4)(G). Congress designed these rules to promote accountability and make the process sufficiently unpleasant that systemic-risk exceptions would be made rarely (if at all) and never lightly.

[21] By engineering a bailout of Long Term Capital Management in 1998, the Federal Reserve Bank of New York squandered some of FDICIA's hard-won gains. Yet the dramatic change in how the FDIC dealt with failed banks during the early 1990's shows that progress can be made in curtailing too big to fail treatment.

compelled them to side with the shareholders against the taxpayers.[22] In any event, government appointments to GSEs' boards of directors have served more as political plums than as vehicles for upholding the public interest.

Ending such appointments—so that GSE shareholders would elect all GSE directors—would remove the conflict of interest. By strengthening shareholders' control over each GSE, ending such appointments could also help shareholders hold management more accountable and thus promote better corporate governance.

Complying with Securities Laws

The GSEs' statutory exemption from the registration and reporting requirements of the Federal securities laws is an anachronism and deserves to be repealed. The exemption sends the wrong signal: That GSE's are so "special," so close to the Government, that investors in their securities have no need for the protections afforded by those requirements.

Opportunities for Immediate Administrative Action

Regulators can and should act now to improve the regulation of Fannie and Freddie.

First, to help avoid unhealthy concentrations of credit risk among FDIC-insured banks, the Federal banking agencies should prescribe guidelines for banks' credit exposure to individual GSE's and to GSE's generally.[23]

Second, the Securities and Exchange Commission should prohibit mutual funds whose portfolios consist largely of GSE securities from mislabeling themselves as "Government" or "U.S. Government" funds.[24]

Third, the Federal Reserve Board should proceed with its proposal to curtail so-called "daylight overdrafts" by GSE's.

Fourth, HUD should tighten its scrutiny of the GSEs' mission, using its authority to review activity-expansion, prescribe affordable-housing goals, and interpret relevant statutes.

Conclusion

The GSE's argue as though the present is always the wrong time to enact any reform that they do not want, such as reform that benefits taxpayers or homebuyers rather than the GSEs' managers and shareholders. In the GSEs' view, either (1) there is no acute problem warranting reform, or (2) reform now would crimp housing markets and risk destabilizing the financial system. But now is the right time to act—to correct the deficiencies in GSE regulation before a crisis hits or another scandal breaks.

PREPARED STATEMENT OF JAMES R. RAYBURN

President, National Association of Home Builders

February 10, 2004

Introduction

The 215,000 members of the National Association of Home Builders (NAHB) appreciate the opportunity to present their views to the Senate Committee on Banking, Housing, and Urban Affairs on the regulatory framework for Fannie Mae, Freddie Mac, and the Federal Home Loan Bank (FHLBank) System, including safe-

[22] The three members of the old Federal Home Loan Bank Board—appointed by the President and confirmed by the Senate—served ex officio as Freddie's board of directors. Freddie's preferred share price had more than doubled in response to a proposal to allow anyone to own Freddie shares. (By severing Freddie's historic link to the thrift industry, the proposal would free Freddie to increase its profits by amassing a large portfolio of mortgage-backed securities.) Senate Banking Committee Chairman William Proxmire developed a plan to grant the relief desired upon payment of a fee to reduce the taxpayers' bill for the thrift clean-up. But Freddie's management convinced Freddie's directors that their fiduciary duties compelled them to oppose the Proxmire plan.

[23] Regulators could, for example, prescribe rules or guidelines under Section 305(b)(1)(A)(ii) of FDICIA, which requires risk-based capital standards to "take adequate account of . . . concentration of credit risk." Regulators could also issue more specific examination standards.

[24] The SEC prohibits a mutual fund from having "name suggesting that the Fund . . . [is] guaranteed . . . by the United States Government." 17 CFR § 270.35d–1. But many mutual funds that invest predominantly in GSE securities nonetheless call themselves "U.S. Government Securities Funds." To take what is probably an extreme example, the Pacific Capital U.S. Government Securities Cash Assets Trust had 98.8 percent of its assets in GSE securities as of September 30, 2003; it evidently held no U.S. Government securities at all. See *http://www.aquilafunds.com/ourcompany/moneyfunds.htm* (semi-annual report), at 9.

ty and soundness oversight, new program approval, and the establishment and enforcement of affordable housing goals. These housing-related Government sponsored Enterprises (GSE's) are critical components of the Nation's housing finance system and are largely responsible for the efficiency and resiliency of that system, as reflected in the tremendous advances recorded in the availability and affordability of mortgage products for homebuyers and providers of rental housing. The success and value of our housing finance system has been clearly evident in recent years, as the housing sector sustained economic performance while other areas of the economy faltered.

Considering the complexity of the housing finance marketplace and the risks at stake, the task of restructuring the regulatory framework of the housing-related GSE's is a daunting one. However, NAHB believes that two governing principles should guide the debate. First, the regulatory framework for the GSE's must be credible and effective to ensure these organizations fulfill their mission in a safe and sound manner. Second, the public/private partnership of the housing finance system is sacrosanct; any other changes to the current system should not disrupt the efficient operation of the mortgage markets and the impediments to the development of effective programs to address the Nation's housing needs. With these concepts as a foundation, NAHB offers the following recommendations.

NAHB maintains its previously asserted position that the Department of Housing and Urban Development (HUD) is the appropriate agency to regulate the mission of Fannie Mae and Freddie Mac, including approving new programs and establishing and enforcing affordable housing goals. However, if Congress chooses to explore the option of creating an independent regulator with oversight for all the housing-related GSE's, we implore Congress to ensure that the regulator has a thorough understanding of and extensive involvement in housing-related issues. We do not believe that the Department of the Treasury, which is well-suited as a safety and soundness regulator, has sufficient expertise and involvement in housing issues to serve as a housing-related GSE program regulator.

Background

Housing and the Economy

The housing market has been an engine of growth in recent years, sustaining the economy during a difficult stretch. That performance continued in 2003, with new home sales reaching a record performance of more than a million closings. Single-family home construction has been robust and totaled 1.5 million units in 2003. Multifamily activity has been more subdued, but still posted a respectable showing, pushing total housing starts above the lofty 1.8 million units threshold.

While low interest rates and favorable demographics have spurred demand, these results would not have been possible without the support of the finance system for housing. The bedrock of that system is a liquid and vibrant secondary market that is the product of the activities of Fannie Mae, Freddie Mac, and the FHLBank System. These enterprises have not only contributed to the affordability of housing credit, but also have taken the lead in expanding the menu of affordable housing programs and products.

GSE's and Housing Finance

The housing-related GSE's are American success stories. As mentioned above, they have brought enormous benefits to homebuyers, renters, and the housing finance system. These include:

Reduction of mortgage interest rates—The impact of the housing-related GSE's on mortgage borrowing costs is well documented. Homebuyers with conforming loans—mortgages eligible for purchase by Fannie Mae and Freddie Mac, those up to $333,700 for one-unit properties—pay mortgage rates that are approximately 25 to 50 basis points lower than rates paid by other conventional mortgage borrowers. The FHLBanks have done their share by passing through their advantageous borrowing rates for use in member loan programs. Further rate reductions are provided through the subsidies of the FHLBank System's Affordable Housing Program (AHP) and the Community Investment Program (CIP).

Reliable and stable flow of mortgage credit—The linkage that the GSE's provide to the national and international capital markets sustains the flow of capital to housing, even under changing economic conditions. While the economy has undergone major shocks over the past decade, homebuyers have experienced no interruption in the availability of mortgage credit.

Elimination of regional disparities in interest rates—The GSE's provide a nationwide market for mortgage funds, a key factor in the elimination of regional disparities in the availability and cost of mortgage credit, which occurred regularly before the housing-related GSE's came on the scene. Today, interest rates in mortgage markets around the country vary by no more than 10 basis points.

Cushion against local economic downturns—When regional economies begin to slow, some participants in the mortgage industry have restricted credit or abandoned markets in search of opportunities elsewhere. This is not the practice of the GSE's. They maintain a presence in all markets under all economic conditions, cushioning the impact of local or regional declines in economic activity.

Market standardization and innovation—The GSE's have brought innovation to the mortgage markets to address a broad range of borrower and investor preferences. For example, Fannie Mae and Freddie Mac have established reduced downpayment programs to help cash-strapped first-time homebuyers. Recently developed mortgage products to assist borrowers with tarnished credit histories further exemplify the extent to which Fannie Mae and Freddie Mac employ novel approaches to respond to consumer credit needs. The FHLBanks also stand out in this area by virtue of the programs that are stimulated and supported by the AHP and the CIP.

Expansion of homeownership and rental housing opportunities—The housing GSE's have made very significant strides in expanding homeownership opportunities and increasing the supply of affordable rental housing in underserved areas. The housing goals enacted by the 1992 GSE Act have successfully encouraged both Fannie Mae and Freddie Mac to significantly increase their service to the market sectors targeted by the housing goals. The supply of affordable housing is further augmented by the 12 FHLBanks; each contributes at least 10 percent of its annual net earnings to its statutorily prescribed Affordable Housing Program to subsidize the cost of housing for very low-income and low- or moderate-income households.

Context for GSE Oversight Evaluation

NAHB believes that debate and discussion on the future of GSE regulation should begin by reflecting on how and why these entities came to exist. The genesis of all three housing-related GSE's can be traced to Congress' recognition of the strong public policy benefits of housing and homeownership opportunities. Fannie Mae, Freddie Mac, and the FHLBank System were chartered to provide liquidity and stability for the Nation's housing finance system. The decision by Congress to confer the sponsorship of the U.S. Government on these entities was not a superficial one. Undoubtedly, Congress realized that no private corporation would assume the risks or expend the resources to undertake an objective of this magnitude. Moreover, it would be unlikely that any particular entity would have the credibility to attract the appropriate blend of borrowers and investors. Rather, Congress was keenly aware that in order for an enterprise to overcome such obstacles it would need the imprimatur of the U.S. Government. It is this well-forged public/private alliance that makes this Nation's housing finance system the model, if not the envy, of the world.

As mentioned above, housing is a significant financial element in today's economy, not just in a macroeconomic sense, but also in terms of every homeowner's portfolio. The remarkable growth of Fannie Mae, Freddie Mac, and the FHLBank System has been raised by others as a point of discussion and concern. NAHB suggests that the performance of these entities should be evaluated within the context of the growth of the housing finance sector and its impact on consumers, investors, and the economy at large. From this perspective their growth can be viewed in a positive light.

NAHB believes it would be a tremendous mistake to turn discussion on GSE regulation into a referendum of our highly successful housing finance system. Attempts to alter the Government's sponsorship of Fannie Mae, Freddie Mac, or the FHLBanks arguably contradicts Congress' intent, and most definitely would destroy the foundation upon which the system rests.

The key to the GSEs' success is their steadfast focus on their mission. They are in one business, housing finance—a relatively low-risk endeavor. This narrow focus should be recognized in the discussion of any future regulatory framework. The GSE's are not banks operating in far-flung and highly risky product lines and markets and should not be regulated as such.

Even the staunchest advocates of GSE regulatory reform would agree that there is no imminent crisis in the GSE system. Therefore, NAHB urges a careful and thoughtful approach on GSE regulation. NAHB is certain that such a course will produce tremendous rewards to those with most at stake in the process—America's homeowners and renters.

Guiding Principles for GSE Oversight

Since the GSE regulatory reform debate began in earnest last year, there has been no shortage of recommendations on a wide range of elements that many policymakers believe would enhance the stature of the regulatory system for Fannie Mae, Freddie Mac, and the FHLBank System. NAHB notes that most of the recommendations focus primarily on enhancing the *power* of the regulator to impose restrictions on the GSE's. Such proposals often make no reference to the *responsibility* of the regulator to ensure that the GSE's fulfill their Congressionally mandated purpose. Furthermore, others have recommended simply transferring the oversight from one agency to another without establishing a logical nexus between the expertise of the regulator and the mission of the entities to be regulated. NAHB urges this Committee to take a more rational approach by first establishing a foundation of core principles on which to build a solid regulatory framework. As direct participants in the production of housing and related activities, NAHB offers the committee the following set of core principles:

1. The GSE status of these institutions must be maintained. Efforts to privatize, withdraw any of the Federal privileges and legal exemptions, or otherwise diminish the ability of the GSE's to provide housing financing at the lowest possible cost should be opposed.
2. The GSE's should fulfill their public mission by conducting activities authorized by their charters in a safe and sound manner and by promoting access to mortgage credit to address the needs of affordable housing throughout the Nation.
3. The regulatory framework of the GSE's should be strong and credible, possess adequate authority and resources and reflect the differences inherent in the charters and operating structures of the GSE's. Further, the regulatory framework should foster competition among the GSE's to develop and implement innovative, low-cost funding and other programs to meet the nation's housing credit needs.
4. The mission oversight of Fannie Mae and Freddie Mac (including approval of new programs and enforcement of affordable housing goals) should be conducted by the Department of Housing and Urban Development or another entity with a thorough understanding of and extensive involvement in housing-related issues.
5. The safety and soundness oversight of Fannie Mae and Freddie Mac should be conducted by an independent regulatory agency through rigorous examinations, enforcement of regulations (including capital standards) and transparency, without unnecessarily impairing the ability of these GSE's to accomplish their mission.
6. The recently implemented risk-based capital standards for Fannie Mae and Freddie Mac should be allowed to remain in place for a period of time sufficient to evaluate the effectiveness of the new standards.
7. The regulation of the mission and safety and soundness of the Federal Home Loan Bank System should reflect the uniqueness of the System's mission, cooperative operating structure, charter type, and other characteristics. This is best accomplished by having a regulator dedicated solely to FHLBank System oversight or by having a separate FHLBank System oversight division if a single agency regulates all of the housing GSE's.

Current GSE Regulatory Framework

Fannie Mae and Freddie Mac

The 1992 GSE Act established a dual regulatory oversight structure for Fannie Mae and Freddie Mac. HUD is the programmatic (or mission) regulator and the Office of Federal Housing Enterprise Oversight (OFHEO) is the safety and soundness regulator.

The 1992 GSE Act requires Fannie Mae and Freddie Mac to obtain prior approval by HUD of any new mortgage programs. The Act defines new programs as any programs that are significantly different from programs previously approved or engaged in prior to 1992. HUD is required to review new programs to ensure that they are consistent with the GSEs' charters and are in the public interest. In addition, Fannie Mae and Freddie Mac are required by law to meet annual housing goals established by HUD.

Finally, the 1992 GSE Act established OFHEO as an independent office within HUD to oversee the safety and soundness of Fannie Mae and Freddie Mac. OFHEO's primary responsibilities are to establish and enforce capital standards for Fannie Mae and Freddie Mac and to conduct annual on-site examinations of the firms to ensure that they are operating in a safe and sound manner. Fannie Mae and Freddie Mac are required to meet two capital standards, a minimum leverage ratio and a risk-based capital (RBC) standard.

FEDERAL HOME LOAN BANK SYSTEM

The FHLBank System was created by Congress in 1932 by the Federal Home Loan Bank Act. The Federal Housing Finance Board (Finance Board) is the FHLBank System's regulator. An independent agency, the Finance Board regulates both mission and financial safety and soundness. The FHLBanks are required to comply with both a leverage and a RBC capital requirement. The FHLBanks are also required by law to contribute a percentage of their net earnings each year to fund affordable housing programs.

Administration's Proposal

The Bush Administration proposes to create a new Federal agency within the Department of the Treasury (Treasury) to regulate and supervise the financial activities of Fannie Mae, Freddie Mac, and the FHLBank System. The new agency would have general regulatory, supervisory, and enforcement powers for GSE oversight, including the authority to establish, enforce, and revise capital standards. Oversight of Fannie Mae's and Freddie Mac's existing activities and approval of new activities would be shifted from HUD to the new Treasury agency. HUD would be left with minimal regulatory authority, limited to oversight of the annual affordable housing goals and a consultative role in program oversight. The Administration's proposal makes no specific recommendations for how the new regulatory agency would accommodate the inherent differences between Fannie Mae, Freddie Mac, and the FHLBank System. The Secretary of the Treasury would enforce policy accountability through review of the new agency's regulations, budget, and policy statements to the Congress. Importantly, the Administration does not recommend any changes in the GSEs' agency status.

NAHB POSITION ON KEY ELEMENTS

Several elements of the Administration's proposal are antithetical to the core principles of GSE oversight. At the very least, the Administration's proposal would raise the costs of housing and stifle innovation. At worst, the proposal has the potential to undermine the entire housing finance system.

Much of the debate surrounding the GSE regulatory restructuring has focused on the treatment of Fannie Mae and Freddie Mac. Indeed, most of the key elements of the Administration's proposal relate exclusively to these two GSE's. Other reform proposals have proposed including the Federal Home Loan Banks under the new GSE regulatory framework, either within the Treasury safety and soundness regulator or through the establishment of an independent regulator for all the housing GSE's. NAHB's comments and recommendations on key elements of these various proposals are discussed below.

PROPOSED FANNIE MAE AND FREDDIE MAC REGULATORY FRAMEWORK

Location of Program Oversight

Under the Administration's proposal, Treasury would assume not only safety and soundness duties but also most mission-related oversight duties. For example, HUD's current authority to approve new programs would be transferred to Treasury under the premise that new program approval is a safety and soundness issue rather than a mission-oversight issue. HUD would have a consulting role.

NAHB maintains that the program approval activities that are currently conducted by HUD should not be transferred to the Treasury Department. HUD is the preeminent regulatory authority on housing-related issues. Treasury has virtually no experience or expertise in evaluating the effectiveness and appropriateness of housing policies, especially those pertaining to housing for working families. Treasury presently has oversight for two important housing tax programs, low-income housing tax credits and mortgage revenue bonds. Operation of these programs is left to the States and HUD to set program specifics. Outside of these tax programs, Treasury has little experience or expertise in evaluating the effectiveness and appropriateness of housing policies.

The ability of Fannie Mae and Freddie Mac to spur innovative solutions and to develop new products that increase homeownership and rental housing opportunities will be jeopardized if the mission of these corporations is regulated by Treasury. This stifling of innovation would reduce the capacity of Fannie Mae and Freddie Mac to provide the liquidity and stability needed to keep mortgage credit available at the lowest possible cost to homeowners and rental housing providers.

NAHB believes that Fannie Mae's and Freddie Mac's ability to spur innovative solutions and to develop new products that increase homeownership will continue only if the mission of these corporations is regulated by an agency which also has a housing mission, that would, as a consequence, contain a thorough understanding of and extensive involvement in housing-related issues. The only Federal agency in existence now with sufficient housing mission orientation, experience, knowledge and focus is the Department of Housing and Urban Development. For this reason, NAHB recommends that HUD should retain its current status as the mission regulator for Fannie Mae and Freddie Mac, including approving new programs and establishing annual affordable housing goals.

The legislative history of program oversight provisions clearly indicates that the objective and focus of program oversight is not safety and soundness, it is mission compliance. The 1968 Fannie Mae Charter Act, which reconstituted Fannie Mae as a Government sponsored private corporation, granted HUD general regulatory power to ensure Fannie Mae's compliance with its housing mission as specified in the charter. In 1970, HUD was vested with prior approval of all new Fannie Mae programs through the Emergency Home Finance Act, which also created Freddie Mac. HUD was granted regulatory oversight of Freddie Mac in 1989 through the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), which transferred this authority to HUD from the Federal Home Loan Bank Board. Finally, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the GSE Act) reaffirmed HUD as the program regulator of Fannie Mae and Freddie Mac and gave HUD the authority to establish, monitor and enforce affordable housing goals.

The legislative history reflects the recognition by Congress that program oversight is a function of mission regulation that must be conducted by an agency with a thorough understanding of and extensive involvement in housing-related issues. Indeed, during consideration of the 1992 GSE Act, Senate Banking Committee Chairman Riegle stated that "in order to properly coordinate national housing policy . . . regulations relating to the housing missions of Fannie Mae and Freddie Mac should be issued only with the review of the HUD Secretary."

HUD has proven itself to possess the capacity to adequately evaluate the potential benefits to housing from the GSEs' innovation and advancement in products and to ensure that the GSE's do not stray from their statutory mission. However, NAHB believes that HUD's program oversight could be strengthened through the establishment of an independently funded office within HUD. Having an office within HUD dedicated to mission oversight of Fannie and Freddie would be preferable to the current situation where GSE oversight is conducted through the Office of Housing with few dedicated staff and staff from other HUD offices are detailed on an ad hoc basis for GSE oversight duties. NAHB would support assessing Fannie Mae and Freddie Mac to fund the new HUD office.

Process of Program Approval

Under current law, Fannie Mae and Freddie Mac must submit a new program approval request to HUD if the initiative is "significantly different" from a program previously approved; is an activity in which the GSE had not engaged prior to passage of the 1992 GSE Act; or, represents an expansion in terms of dollar volume, number of mortgages or securities involved above limits expressly contained in any prior program approval. Further, if HUD believes an activity should be subject to prior approval, HUD may also request additional information or require a GSE to submit a program request. (Prior to 1 year after the effective date of the risk-based capital regulations, the GSE's were required to simultaneously submit new program requests to the Director of OFHEO. With the implementation of the RBC rule in September 2002, OFHEO now has a consulting role, at HUD's discretion, in the evaluation of new programs.) HUD is required to approve any new program request unless it is not authorized by the GSEs' Charter Acts or is not in the public interest.

The Administration proposes to significantly expand what would have to be approved, to include any activity or product that differs significantly from current activities. Fannie Mae and Freddie Mac introduce a myriad of new activities and products each year. Submitting each of these to the approval process envisioned by the Administration would severely inhibit or delay the development and implementation of valuable new mortgage products and technological innovations. The housing-related GSE's require a program approval process that provides adequate flexibility to respond promptly to market needs, while empowering their regulator to ensure ongoing charter compliance and to assess safety and soundness.

The existing program approval requirements and process have served the housing market well by ensuring effective regulatory oversight and encouraging product innovation to fulfill the GSEs' housing mission. This is particularly true in the affordable housing area where both GSE's have introduced products and services to expand homeownership opportunities for low- and moderate- (low/mod) income borrowers, renters and residents of areas underserved by the broader housing finance system. Technological innovations by the GSE's, such as their automated underwriting systems (AUS), also have contributed to their efforts to expand homeownership opportunities. In the affordable multifamily market, both GSE's have established forward commitment programs that support much-needed production of new units. Further, each has developed partnerships and alliances at the national and local levels to expand affordable housing opportunities.

While NAHB strongly supports the current process, we believe that the process could be improved in three areas: (1) the scope of review; (2) safety and soundness considerations, and (3) the mechanics of the review process.

Scope of review should facilitate innovation. A delicate balance is required between a careful examination of whether a new GSE program serves its important public mission and the need to not over-burden these organizations' innovative efforts to provide new lending opportunities in the most difficult to serve communities. There may be a need to improve the current approval process, NAHB urges Congress to proceed cautiously, and resist efforts to over-encumber this process.

The current process rightfully limits prior approval to new programs, which are defined as very broad undertakings unlike what is currently being done. The Administration proposes to significantly broaden what would have to be approved to include any new business activities. Submitting each new activity to the approval process envisioned by the Administration would result in such micromanagement of the GSEs' innovations that they would be unable to respond to changing market conditions in a timely fashion. The result would be to stifle or severely inhibit development and implementation of valuable new mortgage products and technological innovations that have helped to dramatically expand homeownership in the country.

The Administration asserts that their proposed new activity review would be the same model under which banks operate. A review of activity approval for banks and their financial subsidiaries indicates that this is not the case. Banks are not subject to an activity by activity review as envisioned by the Administration. They have wide latitude to engage in any activity enumerated in the National Bank Act. Banks also are permitted to conduct activities that are incidental to those enumerated.

There are no specific statutory or regulatory requirements for national banks to notify or seek OCC approval prior to engaging in a new business activity. However, banks often seek preliminary determinations from the OCC if an activity does not have a readily apparent nexus to an activity listed in the National Bank Act. Issues relating to new and ongoing activities are also addressed during the bank examination process.

Similarly, financial subsidiaries of national banks also have expansive latitude to engage in a wide range of statutorily enumerated activities without prior approval. Under the Gramm-Leach-Bliley (GLB) Act financial subsidiaries may engage in activities that are "financial in nature". The act provides a preliminary list of such activities and authorizes the list to be expanded by the Treasury Department in coordination with the Federal Reserve. If a bank wishes to engage in one of the enumerated new activities through a financial subsidiary, it must provide a notice to the OCC within 5 days before engaging in a new activity. The only prior approval notice added in the GLB Act is for activities not listed in the statute when the company is seeking the Treasury and Fed to authorize such activities.

Safety and soundness considerations should accompany, not dominate program approval decisions. The present program approval structure strikes an appropriate balance between mission and safety and soundness oversight. Safety and soundness are not criteria for new program approval. Indeed, the Treasury Department reached the same conclusion in its 1990 study on the GSE's. Treasury stated,

> "*the regulatory authority which monitors a GSE's fulfillment of its Congressional mandate should be different from the entity implementing financial safety and soundness standards. Separating these two regulatory functions will remove risks to the taxpayers by removing a perceived conflict of interest* [emphasis added]. . . . The Treasury recommends that the current program regulator continue to be responsible for ensuring that the GSE meets its Congressional mandate by effectively serving its intended beneficiaries." *Report of the Secretary of the Treasury on Government Sponsored Enterprises,* May 31, 1990.

It is interesting that the Administration now views program approval as a function of safety and soundness oversight to be overseen by the Treasury. As discussed above, NAHB believes Treasury is the wrong place to put program approval. Treasury lacks experience in and knowledge of housing.

This is not to say that safety and soundness should not be a consideration in new program review. NAHB believes that safety and soundness is one of the many elements that should be evaluated during the new program approval process, but maintains it should not be the paramount consideration as the administration has proposed.

Reviewing new programs solely on the basis of safety and soundness would severely retard the development of programs needed by Fannie Mae and Freddie Mac to fulfill their housing mission. It will stifle innovation necessary to provide liquidity to the housing credit markets, particularly in areas that otherwise would not be adequately served. Such activities, by definition, involve higher risk and would be greatly constrained if program approval is solely a component and function of safety and soundness regulation.

The safety and soundness regulator should have a consultative role in program review, not the final decision. Some criteria that the safety and soundness regulator should consider are:

- Risk assessment: Does the new program pose undue risks to the Enterprise or the housing finance system generally?
- Risk management: Does the Enterprise have the expertise, resources, and programs in place to effectively manage the interest rate, credit, or other risks associated with the new program?
- Capital adequacy: Does the Enterprise have present or reasonably anticipated reserves to compensate for the risks involved?

Further, we note that the risks of new activities are accounted for in the risk-based capital model, which ensures that the GSE's have adequate reserves to cover the risks of new programs.

Program review process should be clarified with specific criteria. Presently, HUD has 45 days to review a new program request, with one 15 day extension. As noted, HUD is required to approve a new program request unless it is not in compliance with the GSEs' Charter Acts or is not in the public interest. The present process is vague on the content of the application request and the criteria for approval. NAHB supports retention of the current timeframes for approval of new program requests and offers the following suggestions for application content and review criteria.

New Program Request Application Content:

- Citation to the statutory, regulatory, or other legal authority;
- Estimate of the anticipated dollar volume of the program (short- and long-term);
- Full description of proposed program, including: Purpose and operation; target market; delivery system; and effect of the activity on the housing market, broadly, and/or ability to meet affordable housing goals; and,
- Assessment of the risks associated with the activity, and a demonstration of the Enterprise's ability to manage those risks.

Review Criteria:

- Charter compliance: Is the program consistent with the Enterprise's charter and other relevant statutory and regulatory authority, and does the new program support the mission of the Enterprise?
- Public interest: Is the new program in the public interest? Does it support or help to fulfill an important housing-related objective?
- Innovation: Does the new program foster innovation in the availability or delivery of housing-related financial services?
- Risk Assessment: Must consult with and consider risk assessment by safety and soundness regulator.

Extent and Control of Fannie Mae and Freddie Mac Affordable Housing Goals

The current statute contains three specific goals that are intended to push Fannie Mae and Freddie Mac further into housing finance products and markets than they may otherwise go. HUD sets the specific levels of business they must achieve. HUD has steadily increased the levels and the GSE's have achieved them.

NAHB has always been a strong supporter of the affordable housing goals for Fannie Mae and Freddie Mac since HUD was granted this authority by the 1992 GSE Act. The housing goals establish percent of business purchase goals for three categories: Low- and moderate-income, underserved areas, and special affordable. The first set of goals was established by regulation in 1995, and was updated in 2000 to cover the years 2001–2003. Current goals levels, as a percent of annual purchases, are: 50 percent for low-mod; 31 percent for underserved areas; and, 20 percent for special affordable.

Both GSE's have consistently exceeded all of the housing goals since the initial goals were established in 1995. The goals have encouraged Fannie Mae and Freddie Mac to reach deeper into the affordable housing market with tangible benefits. The

GSE's financing of housing for low- and moderate-income families has increased from under 30 percent of their purchases in 1992 (prior to passage of the GSE Act) to over 51 percent in 2002.

The Administration is proposing to strengthen HUD's housing goals authority over Fannie Mae and Freddie Mac. As the HUD Secretary outlined in his October 16, 2003 testimony before this Committee, this will include the creation of a new GSE office within HUD, independently funded by the GSE's, to establish, maintain, and enforce housing goals. HUD would be granted new administrative authority to enforce housing goals, enhanced civil penalties for failure to meet the goals, and expanded authority to set housing goals and sub-goals beyond the three currently established. The President's proposed budget for fiscal year 2005 also calls for adding a new goal to promote affordable housing homeownership.

For the same reason that NAHB supports HUD as Fannie Mae's and Freddie Mac's mission regulator, NAHB supports HUD as the regulator for the GSEs' housing goals. We agree with the HUD Secretary that "HUD is the appropriate agency to develop and enforce housing goals. Institutionally, [HUD's] mission is devoted to furthering the goal of affordable housing and homeownership and HUD has the most expertise in this area." Indeed, NAHB believes housing goals authority is one of HUD's key functions as mission regulator for Fannie Mae and Freddie Mac.

NAHB also agrees that more needs to be done to encourage the GSE's to increase their activities in some market segments. However, we do not believe that adding additional goals or sub-goals, as the Administration has proposed, is the best way this could be accomplished. Fannie Mae and Freddie Mac were created to serve a broad range of housing needs and we would not want overly stringent or complex goals to impede that mission. Continual increases in the percentage targets will have diminishing returns and run the risk of adversely impacting other housing programs, such as FHA's single family program.

NAHB believes that a better way to encourage increased GSE activity in underserved markets is through bonus point incentives within the existing goals system. HUD's 2000 goals rule, which established goals for 2001–2003, also provided for bonus points during this period for units financed for GSE mortgage purchases in small (5–50 unit) multifamily properties and for units in 2- to 4-unit owner-occupied units. These units are key sources of affordable housing for large numbers of low- and moderate-income households, first-time homebuyers, and minorities. One-third of the rented homes are in buildings with 5 to 50 units and minority renters are more likely to be the occupant than are white residents. The bonus point system ended on December 31, 2003, when HUD chose not to extend it beyond the effective termination date.

NAHB is a strong supporter of the bonus points system as a flexible means to provide incentives for the GSE's to increase activity in targeted markets and we adamantly oppose HUD's decision to terminate the bonus points. The bonus points were an integral component of the current goals structure and they served their intended purpose as both Fannie Mae and Freddie Mac increased their purchases of bonus-related mortgages. For example, Fannie Mae's purchases of small multifamily (5–50) properties as a percentage of their total multifamily purchases more than doubled from 1.7 percent in 1997 to 4 percent in 2002. Similarly, Freddie Mac's purchases increased from 3 percent in 1997 to 6.5 percent in 2002.

NAHB is concerned that the elimination of the bonus points incentive will disrupt the progress that has been made in these markets as the GSE's focus on larger multifamily properties which are more "goals-rich" in order to meet their overall housing goals. More work remains to be done in the small multifamily market, especially in rural areas and urban infill locations that are part of community revitalization efforts.

As we have stated above, NAHB believes bonus points are a very effective tool for focusing GSE affordable housing efforts on areas of greatest need. NAHB urges this Committee to instruct HUD to reinstate the bonus points for small multifamily properties. We also recommend that bonus points for loans on small multifamily projects, rural homes and newly built homes be included in statutory provisions for affordable housing goals under any new GSE regulatory regime.

Finally, NAHB suggests that consideration should be given to the statutory factors HUD must consider in setting the housing goals. The 1992 GSE Act requires HUD to consider the following six factors in establishing the goals:

- national housing needs;
- economic, housing, and demographic conditions;
- performance and effort of the GSE's toward achieving the goal in previous years;
- size of the conventional mortgage market serving the targeted population or areas, relative to the size of the overall conventional market;

- ability of the GSE's to lead the industry in making mortgage credit available for the targeted population or areas; and,
- the need to maintain the sound financial condition of the GSE's.

Of particular concern, is the requirement that the GSE's "lead the market" in reaching underserved populations. In evaluating this criterion, HUD includes markets in which the GSE's are unable to fully participate, such as manufactured housing loans and subprime loans. While NAHB does not dispute that the GSE's should be held accountable for their performance in these areas, NAHB believes that some allowances should be made for the fact that these markets are not readily available to them.

Safety and Soundness Regulator

NAHB supports strong and credible safety and soundness oversight for Fannie Mae and Freddie Mac. The purpose of safety and soundness regulation is to ensure that Fannie Mae and Freddie Mac are adequately capitalized for the mission-related programs they are operating, and appropriate governance structures and procedures are in place to operate those programs in a safe and sound manner. The safety and soundness of Fannie Mae and Freddie Mac should be ensured through rigorous examination, enforcement of capital standards and transparency, without unnecessarily impairing the ability of the GSE's to perform their housing mission. It is imperative that the safety and soundness functions be separate from mission regulation, specifically program oversight and housing goals. Safety and soundness regulation should not be a vehicle for disapproving programs so the enterprises undertake little or no risk.

As stated earlier, NAHB strongly disagrees with the position that the GSE safety and soundness regulator must have the primary role in approving new programs in order to adequately perform safety and soundness oversight. This argument is based on the assumption that the mission regulator would increase the riskiness of Fannie Mae's and Freddie Mac's operations by allowing them to expand into activities beyond the scope of their charters. As outlined above, charter compliance is a prerequisite for new program approval. NAHB supports a requirement that the mission regulator consult with the safety and soundness regulator during new program reviews. We also feel that the safety and soundness regulator should be empowered to prevent the GSE's from undertaking any new activity representing a threat to their ongoing viable operation. However, the focus of safety and soundness regulation and supervision should be on ensuring that Fannie Mae and Freddie Mac hold adequate capital in relation to the risk of the activities they are undertaking and that these enterprises have the appropriate staff, systems, and management controls in place to operate the programs in a safe and sound manner.

Safety and soundness oversight of Fannie Mae and Freddie Mac presently resides with OFHEO, an independent office within HUD. Recent events with respect to Freddie Mac's and Fannie Mae's accounting practices have led a number of observers to raise serious questions about OFHEO's ability to perform these regulatory functions. In light of these concerns, NAHB would support the transfer of safety and soundness oversight of Fannie Mae and Freddie Mac from OFHEO to another entity with greater capacity and resources, such as the Treasury Department. We recognize Treasury as the premier financial institution regulator because of its expertise and experience with financial issues. However, as explained above, the authority of the office must be limited primarily to safety and soundness functions only because Treasury is not equipped to handle mission oversight of the GSE's.

Capital

NAHB has consistently supported the establishment and enforcement of appropriate capital standards for Fannie Mae and Freddie Mac. Pursuant to the 1992 GSE Act, Fannie Mae and Freddie Mac are required to meet two capital standards, a minimum leverage ratio and a risk-based capital (RBC) standard. The minimum leverage ratio is 2.5 percent of assets plus 0.45 percent of adjusted off-balance sheet obligations. By law, the RBC standard, is based on a stress test which calculates the amount of capital that Fannie Mae and Freddie Mac must hold to maintain positive capital over a 10-year period of adverse credit and interest rate conditions, plus an additional 30 percent of this capital level to cover management and operations risk. The firms must meet both the RBC and minimum capital standards to be classified as adequately capitalized. Failure to meet the capital standards would trigger enforcement actions ranging from limits on growth and activities to conservatorship.

Fannie Mae and Freddie Mac have consistently met their capital standards and thus have been classified as adequately capitalized. Prior to the implementation of the RBC standard, the firms were required to meet the minimum leverage ratio.

The RBC standard became enforceable on September 13, 2002, after nearly 10 years of development. The RBC test is the first regulatory capital standard to be based on a stress test and has been hailed as the most dynamic and stringent capital standard for any financial institution.

The Administration proposes to provide the Treasury regulator greater flexibility in establishing the leverage and RBC requirements. However, in testimony before this Committee last year, Treasury Secretary Snow mentioned the need for stability in capital standards and suggested that capital standards should not be subject to frequent change. NAHB agrees with this perspective and applauds Secretary Snow's decision not to recommend any changes in the statute dictating the GSEs' minimum and RBC requirements. Given that the current RBC standards took 10 years to develop and have been in effect for only 1 year, we are pleased that the Treasury is willing to give the requirements a chance to work. NAHB recommends against any immediate changes in the GSEs' minimum capital standard as well. Longer-term, NAHB agrees the safety and soundness regulator should have the flexibility to adjust capital standards as necessary. However, NAHB cautions against significant changes in the GSE's RBC standard or any significant increase in the GSE's minimum capital standard. Overcapitalization of the GSE's, beyond the level of risk, is not economically efficient and could have unintended consequences for the housing markets, by reducing the level of capital for housing and increasing mortgage rates.

NAHB would also oppose the imposition of bank-like capital standards for the GSE's as some have proposed. Congress rejected this notion and intentionally drafted a separate capital regime for Fannie Mae and Freddie Mac under the 1992 GSE Act. The present capital framework takes into account the unique nature of the GSE's business, that there are only two firms (as compared to thousands of banks) and they engage in a monoline business, focused on low-risk residential mortgages (unlike banks which engage in a wide range of activities). During the lengthy development process of the current RBC standard, OFHEO took great pains to ensure that the standard appropriately ties capital to risk. Bank regulators have recognized that bank capital standards do not tie capital to risk and are now engaged in a process to revise bank capital standards through the Basel II Accord.

Independence of Regulator

OFHEO currently operates independently of the cabinet agency where it resides (HUD). Other banking regulators within Treasury also operate with independence. For example, regulations, agency guidance and testimony emanating from the Office of Thrift Supervision (OTS) or the Office of the Comptroller of the Currency (OCC) are not subject to a mandatory approval requirement by Treasury. The Federal Housing Finance Board is an independent, stand-alone regulatory agency.

The Administration proposal requires Treasury approval of testimony and regulations from the regulator within Treasury. NAHB strongly believes that safety and soundness regulators should be objective, nonpartisan, and protected from political interference. This is especially critical at times when regulators must make difficult and sometimes politically unpopular decisions. The primary responsibility of the regulator is to implement policy made by the Congress, and to do so in a safe and sound manner. NAHB strongly believes that a regulator lacking true independence may eventually find itself pursuing other agendas, not the will of Congress, nor what is demanded to assure safety and soundness.

Independent regulation also protects Congress' ability to receive the regulator's best judgment on regulatory matters unfiltered and without delay. With billions of dollars of potential taxpayer liability at stake, it is in everyone's interest that this important safeguard not be weakened. Therefore, NAHB believes if a new agency is created within Treasury, it should have autonomy in the following key areas:

- Testimony. Congress should be able to count on receiving the agency's unadulterated views on all issues it faces.
- Rulemaking. The agency's policy justification for issuing regulations should be devoid of interference from politically appointed officials.
- Supervision and Examination. True safety and soundness cannot be attained without a strict separation between political appointees and supervisory and examination staff.
- Enforcement. The agency's enforcement actions must be unblemished by any extraneous influence.

Inclusion of the FHLBank System

The Administration has called for placing Fannie Mae, Freddie Mac, and the FHLBanks under a single regulator. In fact, the President's proposed budget for fiscal year 2005 includes provisions for transferring oversight of the Federal Home Loan Banks from the Federal Housing Finance Board to the same new office at

Treasury that would regulate Fannie Mae and Freddie Mac. NAHB believes that it is Congress' responsibility to scrutinize the regulatory oversight of the housing GSE's, and to ensure that they provide the Nation's network of community-based financial institutions with the safest, soundest source of residential mortgage and community development credit possible. While all three GSE's have much in common, NAHB believes it is important to both recognize and preserve the unique nature of the FHLBanks. For example, unlike Fannie Mae and Freddie Mac, the FHLBank System is a cooperative owned by its member institutions. The FHLBanks' stock is not publicly traded and does not fluctuate in value. In addition, each of the FHLBanks is jointly and severally liable to all the others.

Each of the three GSE business models has their strengths. Any revised regulatory system should continue to respect those differences, while advancing the common goal—to maintain their financial safety and soundness.

Funding of Regulator

President Bush's fiscal year 2005 budget proposes to increase the amount of resources allocated to regulating the housing-related GSE's. The proposed budget earmarks $83 million to establish a new office within Treasury. The budget also anticipates that HUD will incur approximately $6.25 million in the establishment and enforcement of affordable housing goals, ensuring GSE compliance with fair housing laws, and providing consultation to the safety and soundness regulator on new activities. The activities of the safety and soundness regulator would be funded through mandatory assessments on all of the GSE's; the mission oversight costs at HUD would be assessed on Fannie Mae and Freddie Mac.

NAHB believes that those who supervise and regulate the GSE's should possess adequate authority and resources. The housing-related GSE's are engaged in a myriad of complex financial transactions. It is crucial for the regulator to possess a high degree of experience, knowledge, and familiarity with current accounting, risk-management and housing-related issues so that they are credible, confident, and capable. Furthermore, NAHB believes that it is entirely reasonable for the GSE's to fund the responsibilities of their regulator.

Independent Regulatory Body

The idea of a stand-alone independent regulator has been floated as a compromise to break the current impasse among policymakers on the key issues of program oversight and political independence of the regulator. It is argued that a stand-alone agency would resolve concerns about independence of the regulator from Treasury, as well as Treasury's oversight of new programs. It might also ease concerns about including the FHLBanks in the new system since a merged agency would avoid a perception that any of these Government Sponsored Enterprises are subject to more effective regulation than any of the others.

While not our first preference, NAHB would be open to exploring the concept of a new independent regulator for all three housing GSE's outside the Treasury Department, depending on how key details are implemented. NAHB's primary concern in either regulatory scenario is that the mission regulator must have a housing focus and expertise and the safety and soundness regulator must have sufficient respect and authority to satisfy Congress and the capital markets.

In addition to the funding and political independence issues addressed in other sections of this testimony, NAHB notes that other preliminary characteristics to consider are the corporate structure of the agency, and how its managers will be selected. Given the diversity and complexity of supervisory issues the agency will address, NAHB initially recommends the agency be structured as a board of directors rather than a single agency head. In this scenario, NAHB suggests that a HUD representative should serve on the board in order to ensure that it possesses a housing-oriented focus and experience. NAHB also suggests that the board comprise stakeholders from various industry sectors. As mentioned above, it is imperative to recognize the differences between Fannie Mae, Freddie Mac, and the FHLBanks. This could be effectuated by establishing two divisions and maintaining separate funding for the costs of regulation.

Conclusion

NAHB appreciates the opportunity to share our views on the regulatory framework for Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. The critical supports provided by these housing Government Sponsored Enterprises (GSE's) were an essential component to the recent success of the housing market in sustaining the Nation's economy. NAHB appreciates the Committee's efforts to assess and seek improvements to the regulatory framework of these GSE's. We look forward to working with the Committee as you progress toward fashioning a narrow regulatory solution to the oversight of these important housing institutions.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM ALAN L. BELLER

At our October 23, 2003 hearing, Federal House Finance Board (FHFB) Chairman Korsmo testified that he recommended to Congress that all 12 Federal Home Loan Banks (FHLB's) comply with the Securities Exchange Act of 1934. However, some of the 12 FHLB's have argued that, due to the unique nature of the System, disclosure registrations as required under the Securities Exchange Act of 1934 are difficult to implement, and would prevent the FHLB's from efficiently offering securities to the market. Only the Cincinnati FHLB has voted to implement the disclosure registrations of the Securities Exchange Act of 1934.

Q.1.a. What is your reaction to that argument? Do you foresee any major impediments to Securities Exchange Act of 1934 compliance for the FHLB's? Why or why not?

A.1.a. We do not foresee any major impediments. We have met with representatives of many of the Banks and with staff of the Federal Housing Finance Board to discuss a number of aspects of the requirements and timing of registration under the Securities Exchange Act of 1934. In particular, we have addressed what have been identified as four threshold accounting issues. As noted in my testimony, we have resolved those issues.

In addition, Commission staff members have worked with representatives of a number of the Banks to discuss accommodations the staff will make to address concerns the Banks have raised. The Commission staff has clearly indicated that it will provide "no-action," interpretive or other relief, to accommodate each Bank's preference to register a class of its capital stock rather than a class of debt. We believe that the investors in the publicly issued debt of the Banks are entitled to the same level of information as that provided to investors in debt securities of other public companies. However, if the Banks register a class of their capital stock with the SEC, they would be subject to certain disclosure and other requirements beyond those to which companies that have registered only their debt securities with us, and not their common stock or other equity securities, are subject. In our discussions with the representatives of the Banks and the Finance Board, the Commission staff has agreed to provide relief from provisions of the securities laws that would make the requirements to which they are subject consistent with those of companies who have registered only their debt securities with us.

The Federal Home Loan Banks, although federally chartered entities, have many of the same disclosure issues faced by any financial institutions whose securities are issued to, and held by, the public. The Federal Home Loan Bank System is one of the largest issuers of debt securities in the world. The debt of the Banks does not carry the full faith and credit backing of the United States and investors in the Banks' debt must, therefore, look only to the Banks for repayment of the debt. Therefore, disclosures by the Banks should give the holders of their debt a materially complete and accurate picture of the Banks' financial and operational situation to provide investors in their debt with sufficient information on which to evaluate an investment. As noted above, we believe that the holders of debt issued by the Office of Finance, for which the 12

Banks are jointly and severally liable, are entitled to the same type of information that is provided to investors in other public debt securities. We believe that the Commission's detailed disclosure rules and filing requirements and the staff review and comment process provide the best framework for disclosing information to which investors are entitled. In addition, we have a long history of reviewing complex entities that comply with the disclosure requirements of the Exchange Act and other Federal securities laws.

Q.1.b. Would registration prevent the FHLB's from efficiently offering securities to the market?

A.1.b. No. Under the Securities Exchange Act of 1934, publicly reporting companies are required to file periodic and current reports. Registration under the Securities Exchange Act of 1934 is not tied to the timing of offerings as it is under the Securities Act of 1933. There would, therefore, be no impact on a Bank's timing or other aspects of offering securities as a result of Exchange Act registration. Some Banks have expressed concern that staff review of a Bank's Exchange Act reports might require a Bank to cease selling its securities. However, the staff does not advise or instruct a publicly reporting company to stop selling securities based on its comments on the company's Exchange Act filings. As is the case now, if a Bank uncovers a disclosure issue the Bank itself must determine whether or not it should continue to sell securities in the public markets. While registration under the Exchange Act may cause the Commission staff to raise a comment which could alert a Bank to a particular issue, it would, as now, be up to the Bank to determine whether the issue was significant enough to temporarily curtail securities offerings until the appropriate disclosure was provided to the public. This would be the case whether the issue was identified by the Bank itself or by the Commission staff in a comment letter.

Fannie and Freddie have argued that due to the nature of the mortgage-backed securities market structure, the fees associated with the Securities Act of 1933 disclosure would be onerous, seriously slowing the offering of mortgage-backed securities to the "To Be Announced" (TBA) market, as well as being unfairly costly. They also claim the volume of the securities they offer also makes such registrations difficult for the SEC to handle expeditiously.

Q.2.a. What is your reaction to that argument? In your opinion, can the SEC handle such registrations? Would it be too difficult to implement or too costly?

A.2.a. We have a long history of overseeing the disclosure and offerings of companies in many diverse industries including financial companies that perpetually offer securities to the market. The current registration fee is $126.70 for each $1,000,000 of securities offered. Since Fannie and Freddie issue a large volume of securities, the fees they would pay for registering the offer and sale of securities under the Securities Act of 1933 could be large. We have no reason to believe that subjecting Fannie and Freddie to the same fees, disclosure, and review as other companies that offer mortgage-backed securities to the market would be unfairly costly to Fannie or Freddie or present any difficulties for the SEC. However, as noted below, we do not know whether or how requiring registration of the mortgage-backed securities would impact the mortgage market, and we have consistently stated that an evaluation of this impact should be part of any consideration of whether their mortgage-backed securities should be registered under the Act.

Q.2.b. What would be the effect of implementing SEC registration on the liquidity of the Nation's housing finance system and on the end mortgage interest rates available to the homebuyer?

A.2.b. It has been our priority that investors who purchase and sell stock or "straight" debt (that is, non-mortgage-backed debt) of the GSE's are entitled to the corporate information publicly registered companies must disclosure under the Securities Exchange Act of 1934. Fannie Mae has registered its common stock under the Exchange Act and is now fully subject to the Commission's disclosure rules and the requirements of the Sarbanes-Oxley Act. Freddie Mac has not yet completed the process of registering under the Exchange Act but has stated it intends to complete the registration process when it completes its restatement and audit of its financial statements. Both of the GSE's continue to be exempt from the requirements to register the offer and sale of securities under the Securities Act of 1933 and as such the timing of their offerings and therefore, as noted above, their liquidity will not be impacted by Exchange Act registration.

Registration of offerings of the GSE's mortgage-backed and related securities under the Securities Act may raise issues regarding the impact on the mortgage market, especially the TBA market. A decision to require registration under the Securities Act of offers and sale of mortgage-backed securities should properly take into account consideration of whether, and if so, how such registration might impact the mortgage market and the operation of the TBA market. The staff of the Commission does not have expertise to determine whether or how this might impact the mortgage market. As noted above, we have consistently stated that an evaluation of this impact should be part of any consideration of whether Fannie's and Freddie's mortgage-backed securities should be registered under the Securities Act.

Q.3. It is my understanding that Freddie's compliance with the 1934 Act is being delayed due to its ongoing revisions of its financial statements. Freddie is expected to release its revised earnings sometime this month. Has Freddie communicated with the SEC regarding when they expect to come into compliance with the 1934 Act? When specifically do you believe they will be able to do so?

A.3. Freddie Mac has indicated it intends to complete the Exchange Act registration process when it completes its restatement and audit of its financial statements and is current in its financial statements. Most recently, Freddie Mac has indicated it believes it will complete registration under the Exchange Act by mid-2005.

PROPOSALS FOR IMPROVING THE REGULATION OF HOUSING GOVERNMENT SPONSORED ENTERPRISES

TUESDAY, FEBRUARY 24, 2004

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:01 a.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The Committee will come to order.

Today, the Committee continues its consideration of needed reforms to the regulatory regime for the housing GSE's. This is the fourth hearing on this matter. The time and the resources that the Committee have dedicated to this matter underscore its importance.

Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System provide liquidity to a vital sector of our national economy—the housing markets. Because of their crucial roles in our economy, the financial condition, and safe and sound operations of these institutions must be diligently monitored.

Given their size, and their sophisticated risk management strategies, this monitoring is no simple task. It is one of my top priorities to report legislation from this Committee that will create a new housing GSE regulator that will have the stature, sophistication, and necessary regulatory tools to ensure that these institutions continue to carry out their public policy mission in a safe and sound manner.

Today, the Committee will hear from Alan Greenspan, the Chairman of the Board of Governors of the Federal Reserve System. Chairman Greenspan will share his insights with this Committee on the role that the housing GSE's play in the housing sector, the impact of their operations on our financial markets, and the need to establish a strong, credible regulator.

Senator Allard, do you have an opening statement?

STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Mr. Chairman, I do have just a very brief statement.

First of all, I would like to thank you for your diligence in following this issue. It is very important, I think, and I would also like to thank Chairman Greenspan for taking time from his busy schedule to show up before this Committee to testify. I have always valued his testimony before this Committee. And as Chairman of the Housing Subcommittee, reforming the GSE's is a topic in which I am keenly interested.

The housing market is no doubt a critical aspect of the U.S. economy. We have seen the housing market sustain itself during this last economic downturn that we had. It was actually a persistent bright spot that we had in our economy when everything else was not doing well. The financing of mortgages I think in recent years has helped to power the economy through the recent recession.

Now, the GSE's have been an active part of helping the American Dream come true for millions of families. The GSE's, though, are large, complex financial institutions that merit the highest levels of scrutiny. I believe alternative regulatory proposals to ensure the protection of the U.S. housing markets are necessary. This regulatory authority needs to rest on a strong, financially sound foundation, and I look forward to discussing the necessary elements a regulator must have to do its job effectively.

Though many items still need to be worked out as part of a new regulatory regime, I believe we are making progress, and I hope that we can all agree that we must have a strong regulator. We owe nothing less to the taxpayers and homeowners of the Nation.

I look forward to hearing from Chairman Greenspan and his thoughts on how we can reform and improve the regulatory structure for GSE's.

Chairman SHELBY. Senator Dole.

STATEMENT OF SENATOR ELIZABETH DOLE

Senator DOLE. Thank you, Mr. Chairman. I would like to express my appreciation for your continued leadership on this very important issue.

Last summer, Senators Hagel, Sununu, and I introduced S. 1508, the Federal Enterprise Regulatory Reform Act. I think my colleagues would agree that approximately 95 percent of this bill enjoys broad, bipartisan support. As for that remaining 5 percent, I am confident you will find agreement, Chairman Shelby, as you are working this issue.

The question of the proper powers and resources available to a regulator of the Government Sponsored Enterprises has proven to be a vexing issue. Chairman Shelby, you have been carefully crafting solutions to some of the more controversial proposals contained in the GSE reform package, and this Committee is very close, I believe, to achieving a consensus. After so much work, it is my hope that the consensus will earn all of our support.

I understand, Chairman Greenspan, that you have devoted a considerable amount of your time, in addition to that of your staff, on the risks and benefits of our GSE bill. I appreciate your willingness to weigh in on these important issues.

One issue of particular importance is the need to ensure that the regulator has the ability to control nonmortgage investments of the GSE's. In his testimony 2 weeks ago, the Comptroller General stated, "We again recommend that Congress legislate nonmortgage investment criteria for HUD or any new GSE regulator that may be established through legislation." The General Accounting Office has warned us that the incentives to use the benefits of Government sponsorship to increase shareholder value could, over time, erode the public mission. I believe every Member of this Committee is committed to ensuring that the mission to create greater opportunities for homeownership, especially for minority populations, is the number one priority for the GSE's. We must make sure that our effort gives this mission the focus and attention it deserves by all GSE's, and that there is no chance of erosion over time.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman.

Chairman Greenspan, welcome. It seems like you were just here. In fact, I think you were. Welcome back.

I read in some of the briefing material for today's hearing an explanation—I think it showed up in the *American Banker*—about different kinds of capital from minimum to risk-based accords, or a whole lot of others. And so the question that I am going to be asking you, just to telegraph my pitch, is to explain all those capital standards in ways that even former Governors can understand. And if you could do that today, you will get an A-plus from me, and maybe make those relevant to our discussion.

When I was Governor of Delaware, we used to have a slogan in our administration. You have all heard probably somewhere in your life the axiom, somebody who did a job, did not do it necessarily very well, you say, "That is good enough for Government work." I never liked that.

Later on, I used to hear people say often, "If it ain't broke, do not fix it." And that applies, I guess, to things inside as well outside of Government. And I have never been real crazy about that one either.

The slogan that we adopted for 8 years was, "If it is not perfect, make it better." And I think when we look at the way that we regulate our GSE's, it is not perfect. We can make it better. But as we approach the job of doing that, I think it is important for us to keep in mind that today in this country, almost 70 percent of the people live in a home that they own. And it is a remarkable success story.

In my little State, our homeownership rate is actually approaching 75 percent. And as we try to make what is not perfect more perfect, I think it is important that we do so in a way that does not undermine the remarkable success that we have had in fostering homeownership.

Welcome back. We look forward to your testimony.

Chairman SHELBY. Senator Bunning.

STATEMENT OF SENATOR JIM BUNNING

Senator BUNNING. Thank you, Mr. Chairman.

Just less than 2 weeks ago, Chairman Greenspan, you testified before this Committee about monetary policy, and at the time I criticized you for allowing yourself and the Fed to be drawn into things that have nothing to do with monetary policy. I do not think that studies on home interest rates and whether GSE's help or hurt homeownership have much to do with monetary policy. However, your monetary policy decisions, comments, and studies can have a great influence on home interest rates and whether or not someone can purchase a home.

I was very surprised to hear about the recent Fed GSE study. I was surprised it stated that Fannie and Freddie are responsible for an average of 7-basis-point decrease on home mortgages.

I have two Kentucky papers in front of me. Both have mortgage surveys. Both of them show a 25- to 50-basis-point difference between 30-year fixed-rate mortgages that GSE's can buy and 30-year jumbo mortgages which GSE's cannot buy. I would like to know your opinion on why there is such a difference between the rates of the jumbo and the fixed-rate loans and if these differences are consistent with the recent Fed study.

I was also struck by a comment in your speech yesterday to the credit unions. You stated, "Recent research within the Federal Reserve suggests that many homeowners might have saved tens of thousands of dollars had they held adjustable rate mortgages rather than fixed-rate mortgages during the past decade, though this would not have been the case, of course, had interest rates trended sharply upward."

Of course, if homeowners knew that rates would be lower, they would have used adjustable rate mortgages. But most homeowners do not know what rates are going to be for the next 30 years. That is why they buy fixed-rate mortgages. Not very many homeowners have the resources that the Fed has in being able to predict long-term interest rates. So they buy fixed-rates despite the fact that they are more expensive to hedge against risk.

For the average American, losing your home is not worth the risk of possibly saving some money on a 30-year adjustable mortgage. Rates were low in the last decade, historically low. But most of us here remember the 1970's and early 1980's and how high rates were then. If rates started to rise to Carter-level rates, I am fairly certain that no one would want an adjustable rate mortgage.

You are always warning economic institutions, public and private, that they must hedge against risk. I agree with you and think it is very prudent advice. But I also think the average American should hedge against risk for their most important investment—their home.

Once again, thank you for coming today. I look forward to your testimony.

Chairman SHELBY. Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Thank you very much, Mr. Chairman, for scheduling these hearings on this very important topic of Government Sponsored Enterprises, and thank you, Chairman Greenspan, for attending.

There are a host of technical issues that we have to consider, things such as the merger of the various regulatory agencies, whether or not there should be a statutory standard for capital, the potential impact on all of these things. But what most concerns me is how we can harness these organizations, both Fannie Mae and

Freddie Mac and the Federal Home Loan Banks, to provide affordable housing opportunities for our citizens. Because as I go about this country, that is one of the great sources of concern and difficulty for families all across this country. Housing prices are soaring. The housing markets are doing extremely well. As a result, rental markets are appreciating dramatically. It is impossible for anyone making a minimum wage job to afford even a decent rental unit in most places, probably every place in the country.

We have to do something. And, to date, we have been unable to harness in a proactive way the Federal policy for a housing trust fund or anything that will stimulate production and try to generate more opportunities. And if not by design, then by default, we have to rely upon some of these private entities.

I frankly think we have to challenge all of these entities to do more, not just rhetorically but practically, to provide opportunity for affordable housing, not simply to provide mortgage support for people who can afford to buy expensive homes or even mid-priced homes, but to look out and make sure that we have a place so that all of our families can find a place. I hope in the context of these discussions that you can give us your advice on that point also.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman.

Mr. Greenspan, again, we thank you for sharing your wisdom and being with us here today.

I think my focus today is going to be, as I think is indicated by Senator Carper, on the capital standards issue. Obviously, there are a lot of issues that we need to deal with as we address the relationship in the home mortgage industry between Fannie and Freddie, the Federal Home Loan Banks, and the private sector lending institutions.

To me, one of the questions that is clearly in the forefront is the question of capital standards, the questions like: Should the statute, if we pass one, set a floor? Or should the statute establish any type of capital standard as opposed to letting it be set regulatorily by any new regulator that might be established? Questions like: Should the capital requirements be different for different types of institutions depending on the nature of risk which they incur? Should capital standards be imposed that extend beyond the level of risk? And is establishment of a capital standard that exceeds risk economically inefficient?

It is questions like this which I believe we must address as we address the question of establishing a new regulator and setting the parameters and the scope of authority of such a new regulator.

I know that you have looked at this very closely, and I look forward to your testimony today. And, Mr. Chairman, I also look forward to working with you as we put this together. Thank you.

Chairman SHELBY. Absolutely.

Senator Enzi.

STATEMENT OF SENATOR MICHAEL B. ENZI

Senator ENZI. Thank you, Mr. Chairman. I appreciate your holding this hearing. I would ask that my full statement be a part of the record.

Chairman SHELBY. Without objection, it is so ordered.

Senator ENZI. I would mention something a little more basic on getting homes, and that is having jobs. I passed the Workforce Investment Act, and I am going to be pressing both sides to come up with conferees for that so that people can upgrade their skills, make a little bit more money, and be able to afford houses.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Sarbanes.

STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Mr. Chairman, first of all, I want to express my appreciation to you once again for continuing the Committee's thorough and careful examination of the issue of the regulation of the housing GSE's. This is an important series of hearings, and obviously, I hope at the end of it we will be able to develop a consensus with respect to a world-class regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

I think it is always important, of course, to remind ourselves that the primary purpose of Fannie Mae and Freddie Mac is to maintain a strong, liquid, stable secondary market for residential mortgages, including multifamily mortgages. I think most people feel they have done this well over the years and it is reflected in the rates of homeownership that exist in this country when compared with what exists elsewhere in the world.

The other primary purpose of these Enterprises is to expand access to affordable housing for low-income families and for those who live in underserved areas. We have sought to accomplish this by setting certain affordable housing goals, and while those targets have been met, there is some considerable sentiment that more could be done to expand housing opportunities.

Housing has a special place in American society. A home of one's own is part of the American Dream. Both the current and previous Administrations have made expanded homeownership, particularly for minorities, an important goal. And, indeed, I think it should be. Homeownership is associated with a whole set of social and civic virtues, from better school performance to lower levels of juvenile delinquency, to higher levels of voting and civic participation. And I think we need to keep that in mind as we consider the framework within which these institutions will operate.

The considerable question has been raised as to the adequacy of existing regulations, with considerable concern about the Federal Housing Finance Board, whose examination and supervisory capacity is being far short of what is required. OFHEO, which has been working quite hard recently to catch up on its responsibilities, seems not to have been aware of the depth of the problems at Freddie Mac. And because the housing GSE's are so important to our economy and our financial system, obviously we have an important responsibility to ensure that they are properly supervised and regulated.

Mr. Chairman, I am pleased that we have Chairman Greenspan here with us today. I understand, I think, that tomorrow afternoon we will be hearing from the representatives of the——

Chairman SHELBY. That is right, the GSE's.

Senator SARBANES. The three GSE's, and I look forward to that hearing as well.

Thank you very much.

Chairman SHELBY. Chairman Greenspan, welcome again to the Committee. You spend a lot of time with us, but we think that is quality time. You proceed as you wish.

Senator SARBANES. They tell us you look forward to it with unanticipated joy. Is that correct?

[Laughter.]

Chairman GREENSPAN. It is always a joy, Senator.

Senator SARBANES. Thank you.

Chairman SHELBY. The Chairman can handle his own, I am sure.

STATEMENT OF ALAN GREENSPAN, CHAIRMAN BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Chairman GREENSPAN. Mr. Chairman, Senator Sarbanes, and Members of the Committee, thank you very much for inviting me to discuss the role of the housing-related Government Sponsored Enterprises in our economy this morning.

As you know, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks collectively dominate the financing of residential housing in the United States. Indeed, these entities have grown to be among the largest financial institutions in the United States.

During the 1980's and 1990's, Fannie and Freddie contributed importantly to the development of the secondary mortgage markets for home loans and to the diversification of funding sources for depository institutions and other mortgage originators, as I explain in somewhat greater detail in my written remarks.

Yet given their history of innovation in mortgage-based securities, why do Fannie and Freddie now generate such substantial concern? The unease relates mainly to the scale and growth of the mortgage-related asset portfolios held on their balance sheets. That growth has been facilitated, at least in part, by a perceived special advantage of these institutions that keeps normal market restraints from being fully effective.

The GSEs' special advantage arises because, despite the explicit statement on the prospectus of GSE debentures that they are not backed by the full faith and credit of the U.S. Government, most investors have apparently concluded that during a crisis the Federal Government will prevent the GSE's from defaulting on their debt. An implicit guarantee is thus created not by the Congress but by the willingness of investors to accept a lower rate of interest on GSE debt than they would otherwise require in the absence of Federal sponsorship.

Because Fannie and Freddie can borrow at a subsidized rate, they have been able to pay higher prices to originators for their mortgages than can potential competitors and to gradually but inexorably take over the market for conforming mortgages. This process has provided Fannie and Freddie with a powerful vehicle and incentive for achieving extremely rapid growth of their balance sheets. The resultant scale gives Fannie and Freddie additional advantages that potential private sector competitors cannot overcome. Importantly, the scale itself has reinforced investors' perceptions that, in the event of a crisis involving Fannie and Freddie, policymakers would have little alternative than to have the taxpayers explicitly stand behind GSE debt. This view is widespread in the marketplace despite the privatization of Fannie and Freddie and their control by private shareholders, because these institutions continue to have Government missions, a line of credit with the Treasury, and other Government benefits, which confer upon them a special status in the eyes of many investors.

A recent study by a Federal Reserve economist, Wayne Passmore, attempts to quantify the value of that implicit subsidy to the private shareholders of Fannie and Freddie. His research indicates that it may account for more than half of the stock market capitalization of these institutions.

Passmore's analysis suggests that Fannie and Freddie likely lower mortgage rates less than 16 basis points, with a best estimate centering on about 7 basis points. If the estimate of 7 basis points is correct, the associated present value of homeowner savings is only about one-half the after-tax subsidy that shareholders of these GSE's are estimated to receive. Congressional Budget Office and other estimates differ, but they come to essentially the same conclusion. A substantial portion of these GSEs' implicit subsidy accrues to GSE shareholders in the form of increased dividends and stock market values.

As noted by the General Accounting Office, the task of assessing the costs and benefits associated with the GSE's is difficult. One possible way to advance the technical discussion would be for the Congress to request disinterested parties to convene groups of technical experts in an effort to better understand and measure these costs and benefits.

The Federal Reserve is concerned about the growth and the scale of the GSEs' mortgage-related portfolios, which concentrate interest rate and prepayment risks at these two institutions. Unlike many well-capitalized savings and loans and commercial banks, Fannie and Freddie have chosen not to manage that risk by holding greater capital. Instead, they have chosen heightened leverage, which raises interest rate risk but enables them to multiply the profitability of subsidized debt in direct proportion to their degree of leverage. Without the expectation of Government support in a crisis, such leverage would not be possible without a significantly higher cost of debt.

In general, interest rate risk is readily handled by adjusting maturities of assets and liabilities. But hedging prepayment risk is more complex. To manage this risk with little capital requires a conceptually sophisticated hedging framework. In essence, the current system depends on the risk managers at Fannie and Freddie, as good as they are, to do everything just right, rather than depending on a market-based system supported by the risk assessments and management capabilities of many participants with different views and different strategies for hedging risks. Our financial system would be more robust if we relied on a market-based system that spreads interest rate risks, rather than on the current system, which concentrates such risk with these two GSE's.

As always, concerns about systemic risk are appropriately focused on large, highly leveraged financial institutions such as the GSE's that play substantial roles in the functioning of financial markets. I should emphasize that Fannie and Freddie, to date, appear to have managed these risks well and that we see nothing on the immediate horizon that is likely to create a systemic problem. But to fend off possible future system difficulties, which we assess as likely if GSE expansion continues unabated, preventive actions are required sooner rather than later.

As a general matter, we rely in a market economy upon market discipline to constrain the leverage of firms, including financial institutions. However, the existence, or even the perception, of Government backing undermines the effectiveness of market discipline. A market system relies on the vigilance of lenders and investors in market transactions to assure themselves of their counterparties' strength. Many counterparties in GSE transactions, when assessing their risk, clearly rely instead on the GSEs' perceived special relationship to the Government. Thus, with housing-related GSE's, regulators cannot rely significantly on market discipline.

Determining the suitable amount of capital for Fannie and Freddie is both a difficult and technical process, and in the Federal Reserve's judgment, a regulator should have a free hand in determining the minimum and risk-based capital standards for these institutions.

The size of Fannie and Freddie and the complexity of their financial operations and the general indifference of many investors to the financial condition of the GSE's because of their perceived special relationship to the Government suggest that the GSE regulator must have authority similar to that of the banking regulators. In addressing the role of a new GSE regulator, the Congress needs to clarify the circumstances under which a GSE can become insolvent and, in particular, the resultant position—both during and after insolvency—of the investors that hold GSE debt. This process must be clear before it is needed; otherwise, should these institutions experience significant financial difficulty, the hands of any regulator, and of public authorities generally, would be constrained by uncertainties about the process. Left unresolved, such uncertainties would only heighten the prospect that a crisis would result in an explicit guaranteeing of GSE debt.

World-class regulation, by itself, may not be sufficient and, indeed, as suggested by Treasury Secretary Snow, may even worsen the situation if market participants infer from such regulation that the Government is all the more likely to back GSE debt. This is the heart of a dilemma in designing regulation for the GSE's. On the one hand, if the regulation of the GSE's is strengthened, the market may view them even more as extensions of the Government and view their debt as Government debt. The result, short of a marked increase in capital, would be to expand the implicit subsidy and allow the GSE's to play an even larger unconstrained role in the financial markets. On the other hand, if we fail to strengthen GSE regulation, the possibility of an actual crisis or insolvency is increased.

Most of the concerns associated with systemic risks flow from the size of the balance sheets that these GSE's maintain. One way the Congress could constrain the size of these balance sheets is to alter the composition of Fannie's and Freddie's mortgage financing by limiting the dollar amount of their debt relative to the dollar amount of mortgages securitized and held by other investors. Although it is difficult to know how best to set such a rule, this approach would continue to expand the depth and liquidity of mortgage markets through mortgage securitization but would remove most of the potential systemic risks associated with these GSE's. Ideally, such a ratio would focus the business operations of Fannie and Freddie on the enhancement of secondary markets and not on the capture of the implicit subsidy.

Limiting the debt of Fannie and Freddie and expanding their role in mortgage securitization would be consistent with the original Congressional intent that these institutions provide stability in the market for residential mortgages and provide liquidity for mortgage investors. Deep and liquid markets for mortgages are made possible using mortgage-based securities that are held by non-GSE private investors. Fannie's and Freddie's purchases of their own or each other's securities with their debt do not appear needed to supply mortgage market liquidity or to enhance capital markets in the United States.

The expansion of homeownership is a widely supported goal in this country. A sense of ownership and commitment to our communities imparts a degree of stability that is particularly valuable to society, as Senator Sarbanes pointed out. But there are many ways to enhance the attractiveness of homeownership at significantly less potential cost to taxpayers than through the opaque and circuitous GSE paradigm currently in place.

In sum, Mr. Chairman, the Congress needs to create a GSE regulator with authority on a par with that of banking regulators, with a free hand to set appropriate capital standards, and with a clear process sanctioned by the Congress for placing a GSE into receivership. However, if the Congress takes only these actions, it runs the risk of solidifying investors' perceptions that the GSE's are instruments of the Government and that their debt is equivalent to Government debt. The GSE's will have increased incentives to continue to grow faster than the overall home mortgage market. Because they already purchase most conforming mortgages, they, like all effective profit-maximizing organizations, will be seeking new avenues to expand the scope of their operations, assisted by a subsidy that their existing or potential competitors do not enjoy.

Thus, GSE's need to be limited in the issuance of GSE debt and in the purchase of assets, both mortgages and nonmortgages, that they hold. Fannie and Freddie should be encouraged to continue to expand mortgage securitization, keeping mortgage markets deep and liquid while limiting the size of their portfolios. This action will allow the mortgage markets to support homeownership and homebuilding in a manner consistent with preserving the safe and sound financial markets of the United States.

Thank you very much, Mr. Chairman, and I would appreciate it if my complete remarks are included for the record, and I look forward to your questions.

Chairman SHELBY. Without objection, your written statement will be made a part of the record in its entirety.

Mr. Chairman, to go back over this again, you state that possible future systemic difficulties are likely if GSE expansion continues unabated. Why do you feel that such systemic problems are likely—your word—and what can be done to prevent such problems? I think this is important here.

Chairman GREENSPAN. Senator, this is the most crucial issue. As I have stated in my written remarks, Fannie Mae and Freddie Mac are extraordinarily effective institutions, and they have done a great deal for this country in developing the secondary mortgage market, which has been a very important issue in the whole structure of the developed asset-backed securities markets in which they originally took the lead.

The problem that exists is that because of the fact that they have a subsidy, granted, as I indicated before, not by the Congress, but by the expectation that Government will bail them out in the event of a crisis, they have been able to take a highly competitive position and, indeed, essentially are elbowing out a number of competitors who did not have such a subsidy, and as a result, they have been growing at an exceptionally rapid rate, increasing their share of the market. And if you project into the future, you effectively get a system in which they will be increasingly pressing to move beyond the mortgage markets because they need a continuous growth rate in their profitability to maintain the level of their stock price.

Chairman SHELBY. What do you mean “move beyond the mortgage”—into other products?

Chairman GREENSPAN. Yes, into other products and into nonmortgage areas. And to the extent that they are a profit-making organization, they are very properly concerned about the value of their stock, and the value of their stock has been largely a function of the extraordinarily stable gain in earnings, although I must admit that has come into question with respect to the accounting at Freddie Mac, but nonetheless they have been very effective increasing balance sheets, increasing earnings, and increasing stock prices.

I must say to you these are very effectively run organizations, and I wish they would be running without their subsidy because I think they would still be doing very well.

Chairman SHELBY. Mr. Chairman, you stated that the GSE’s receive a funding advantage from the market’s perception that they are too big to fail. What about large banking institutions like Citigroup or Bank of America, does the market perceive them too big to fail in perhaps a different vein? Do they receive a similar funding advantage?

Chairman GREENSPAN. I think they receive some, Senator.

Chairman SHELBY. Have you ever quantified that? Has anybody at the Federal Reserve?

Chairman GREENSPAN. Yes, it is very substantially less than the types of numbers we are looking at. Remember that there are significant differences. Remember that these large banking organizations are fairly well-capitalized, far better, of course, than Fannie or Freddie, and they are supervised with respect to all of their actions and activities in a way which we are hopeful that the Congress will move on shortly on the GSE's.

So the answer is, yes, there are similarities here, but the degree of difference is very large. And I would say one of the reasons why the issue of Fannie and Freddie did not arise earlier is they were not large enough, and they did not create a potential significant problem for the overall financial system—not that they do today, as I point out, but they will almost surely do in years ahead unless some changes are made in the structure of how these organizations function.

Chairman SHELBY. If these huge banking institutions, Citigroup, Bank of America and so forth, if they are perceived as too big to fail, do we need—

Chairman GREENSPAN. Let me just say that I did not mean to imply that. I think there are some who do believe that. I do not think that is the general market.

Chairman SHELBY. There is a perception by some people that some of the largest banks are too big to fail.

Chairman GREENSPAN. Yes, the reason I say "not quite" is that if you look at the prices of their securities in the marketplace, it is fairly evident that there is very considerable question as to whether in the event of failure they will in fact be bailed out. That is far less the case on the part of the securities of Fannie and Freddie, which very significantly indicate a generalized expectation of support by the Government in the event of crisis.

Chairman SHELBY. In that context, do we need to give the new proposed GSE regulator the same type of systemic risk powers that FDIC has?

Chairman GREENSPAN. I would certainly think so, sir.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Chairman Greenspan, do you favor, as a goal, privatizing the GSE's?

Chairman GREENSPAN. As a goal, I would, and, in fact, I have stated so on many occasions—but the main problem is to reduce the subsidy and to make these particular institutions far more balanced in the way they function in the market. I think privatizing them would do that, but I think, short of that, the types of recommendations that I have made will also do that.

And since I fully recognize that my view about privatization is a highly minority point of view, I think it is sometimes important to go to the really important issue, which is eliminating the subsidy, and that could be substantially done and taken out of the marketplace as a crucial disturbing factor without privatization.

Senator SARBANES. Why do you think your view on privatization is a highly minority view?

Chairman GREENSPAN. Because I have taken surveys amongst a lot of people.

[Laughter.]

Senator SARBANES. Well, that explains the quantity of it, but it does not explain the quality of it. What is the rationale that prevents it or that keeps it as a highly minority point of view?

Chairman GREENSPAN. I suspect it is an issue of experience and education. I believe my concern is that we do not get educated in a way which will make us all recognize that privatization is a potential goal.

I do think that if Fannie and Freddie were to function mainly by securitizing mortgage-backed securities, which is a profitable business, I think that the extent of the subsidy which is involved in that is really quite small. And considering the advantages that would carry with it, I think it could be well within the realm of the types of subsidies which the Congress has created over the years, and certainly would not, in any way, from my point of view, induce concerns about systemic risk.

The systemic risk issue is wholly related to the question of issuing debentures and investing the proceeds of those debentures in other assets, whether they be mortgages, mortgage-backed securities or, as a significant part of the portfolio of the GSE's indicate, nonmortgage assets.

Senator SARBANES. In a letter to Representative Baker back in 2000, you said that "lower mortgage costs that may result from the implicit subsidy would result in housing expanding relative to nonhousing investment, including private-sector initiatives such as investment in productivity-enhancing plant and equipment."

Do you think, as a society, we channel too much capital into housing?

Chairman GREENSPAN. I do not. I think that, from an economic point of view, there is no question that doing that, in a technical sense, is less efficient than moving capital into productivity-enhancing assets.

I made a speech on Friday in which I indicated how important the issue of the sense of property rights and ownership is to the basis of a free market capitalist system in this country. And while I certainly recognize the inefficiencies that might technically be involved with respect to moving capital from so-called productivity-producing assets to homeownership, I think the value that homeownership has is far superior as an important value in maintaining our economic and social system than the question of efficiency.

There is no doubt that it is, from a technical point of view, less efficient in the creation of wealth. But from the overall view of what is important for a market capitalist system, to have broad acceptance of property rights and a broad ownership of property in this country far exceeds, in my judgment, the values of the efficiency questions which I raised.

Senator SARBANES. Let me address this Passmore study. There are two CBO studies which find a greater reduction in mortgage rates for borrowers than the Fed study. You found a reduction of 7 basis points in the mortgage rates. The two CBO studies found 25 basis points in one, 35 basis points in the other.

Now, in your testimony, you seem to dismiss this difference by saying that the Fed and CBO come essentially to the same conclusions, that shareholders were paying a portion of the subsidy. But the degree might be quite significant from a policy point of view. The CBO studies indicate the benefit to the public of the GSE's is considerably greater than one would conclude from the Fed study.

Chairman GREENSPAN. But they are both very small in the sense that all of the analysis that we have done, and others, have indicated that 25 or 35 or 45 basis points has very little effect on the rate of homeownership or on housing starts. We have examined, over the years, the sensitivity of home construction and homeownership to interest rates.

Senator SARBANES. Let me be clear on this point. So you are shifting your argument now away from how much of the benefit goes to the borrower to the argument that even if all of the benefit went to the borrower, it would still not affect the rate of homeownership; is that correct?

Chairman GREENSPAN. No. "All of the benefits" is a very large number.

Senator SARBANES. The CBO study has about two-thirds of the benefits going to the borrower.

Chairman GREENSPAN. Let me put it this way, very specifically. There are two questions here. One is there is a gross subsidy and how much of it passes through directly to the homeowner, that number is a fraction of the total by everyone's calculation. And the question essentially is, is this an efficient way of creating homeownership, when we know, statistically, that the major contributors to homeownership are issues of downpayment and income? I am not saying that interest rates do not have an effect. What I am largely saying is that where the numbers are concentrated with respect to estimates, the notion that significantly enhances homeownership is something we find statistically difficult to sustain.

One of the reasons why I am suggesting that this issue be examined in far greater detail is that we are dealing with a very major public policy question, and how one concludes on this issue and how one decides what to do I think requires the best analysis.

Obviously, Wayne Passmore and his staff had full access to the previous studies, and I think it is a question of people sitting down who are technically expert in this field and making judgments of which sets of data are accurate. I will just say this: One, all of the estimates imply that a very significant amount of the subsidy goes to the profits of these institutions and, two, the major estimates indicate levels which do not historically suggest to us that they have a major impact on homeownership. I would suggest, finally, that issues of downpayment be looked at far more carefully. FHA, for example, does it quite efficiently in that regard.

Senator SARBANES. Mr. Chairman, I am still not getting an answer. If all of the benefits pass through, I take it, it would still be your position against because you do not think it affects homeownership rates; is that right?

Chairman GREENSPAN. First of all, let us remember this is not a legal subsidy. This is a subsidy granted by the private sector. If all of the subsidies went through, and it was sanctioned by the Congress, I would say that was an appropriate procedure by which the Congress endeavored to lower mortgage interest rates, which have value.

I am not saying it has no value. I am just saying its impact on homeownership and on housing starts is not great, but it is obviously a very important financial advantage to a homeowner to get a lower interest rate, and if the whole subsidy were passed through to homeowners, it would make a significant difference. I am saying that it is not a substantial proportion and that, in my judgment, is not the way a subsidy should function.

Senator SARBANES. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

I am going to base my question on what you think the impact of the debt that both of the GSE's have on our economy potentially. I have been looking at some of the figures too. The figures I have is on the CBO. I think they said about 50 percent of the value of the subsidy goes to homeowners and about 50 percent goes to administration, which is mainly executive salaries and then also the shareholder profits.

And then I also look at the total debt that you have in the GSE's. It is around $2.2 trillion I think in 2002, and the public debt for the Federal Government was at $3.2 trillion, and the trend, as expressed by Dr. Gregory Mankiw, who is Chairman of the President's Council of Economic Advisers, said if that trend continues, it could exceed the privately held debt of the Federal Government.

So my question to you, Mr. Chairman, and I would appreciate hearing your thoughts on the future of the GSE's, as it relates to debt and systemic risk, and do you believe that this debt poses any threat to the U.S. economy?

Chairman GREENSPAN. I believe the process, in the long-run, would, in the sense that we have now in place a very ambiguous structure which I do not think should be allowed to continue. Either the Congress should agree that, in the event of default, it will guarantee GSE debt or not. If the former is the case, then it should be stipulated explicitly, and the Congress obviously can do that, and that would clarify a good deal of the issue.

The problem is that, unless that is done, we are confronted with a situation in which, on the one hand, there is a general belief in the marketplace that these securities are backed by the full faith and credit of the U.S. Government, even though they are explicitly not so stated, and the law says they are not, and the question is, the larger that debt becomes, the more this is an issue.

What we have is an ambiguity which, in the event of a crisis migth require explicit guaranteeing of the debt, and a crisis could occur not because Fannie and Freddie are doing anything wrong, and indeed, as I said in my opening remarks, they are very skillful operators. I think they do risk management exceptionally well, and I think they are very well-run organizations in general.

The problem is that it is not in their control to really comprehend all of the type of crises that can arise, and because they have concentrated interest risk, what that basically means is that their ability to hedge that risk is limited; that is, it is theoretically possible to fully hedge interest rate risk. As a practical matter, it is extremely costly and never quite fully the case, for reasons I could get into, but I do not think it is really necessary at this point.

My major concern is that if you just project this debt into the future without resolving either the subsidy question that is implicit there or what will happen in the event of a crisis, it may be many years hence before you can address the issue again. I find that an issue which can be addressed now or in the immediate future in a manner which would fend off that concern which I think will grow as the years go on.

Senator ALLARD. Mr. Chairman, I even worry about the Federal Government. If the Federal Government guarantees this debt of $2.2 trillion, that would add into the public debt. That is going to have an impact, would it not?

Chairman GREENSPAN. It becomes equivalent to public debt, certainly.

Senator ALLARD. Yes, and then all of a sudden your public debt has really a marked increase, and I wonder what that would do, as far as instilling confidence in the economy when that figure would come out? It seems to me that even that would have an adverse impact on the economy.

Chairman GREENSPAN. Well, I think the main issue here is to get this issue resolved sooner rather than later. I am not sure exactly what the impact would be now, but I would certainly agree with you if the issue were left to fester for a number of years, and we tried to address it at a later time.

Senator SARBANES. Is the Senator referring the U.S. Government debt?

Senator ALLARD. Yes, I am referring to the debt that we have with the GSE's. He is assuming, in his response to me, he said, well, one way that we could assure that the debt would not be a problem, as far as the economy is concerned, is if there was a guarantee from the Federal Government.

My point is, if there is a guarantee from the Federal Government, then that $2.2 trillion gets added into the $3.2 trillion, and if people all of a sudden see that jump to $5.4 trillion, that could have an impact on people's thinking, and consequently an impact on the economy.

Senator SARBANES. Oh, I see.

Is the $3.2 trillion, that is the Government debt?

Senator ALLARD. That is the public debt.

Senator SARBANES. And is that what we were told 3 years ago we were paying down too quickly?

[Laughter.]

Chairman GREENSPAN. I just want to point one thing out; that when the Government guarantees debt, it is handled in a somewhat different way. But from an economic point of view, there is no question that what you are stating is correct, Senator.

Senator ALLARD. Mr. Chairman, may I proceed with a second question?

Chairman SHELBY. Go ahead. One more question.

Senator ALLARD. I am interested in OFHEO. It has a lot of regulatory responsibilities, and the question I have is do you believe that funding for the regulator should be guaranteed in the President's budget or should it be subjected to the annual appropriations process? And also do you believe that the need for resources would differ greatly if the regulator resided independently rather than within the Treasury?

Chairman GREENSPAN. With respect to the latter question, I am not sure, and I am not sure it should be an issue one way or the other.

I do think that you want the funding of the resources of the new regulator to be outside the appropriations process, if that is at all feasible.

Senator ALLARD. Mr. Chairman, my time has expired, and I appreciate your generosity on that.

Thank you.

Chairman SHELBY. Senator Carper.

Senator CARPER. Thanks.

Chairman Greenspan, I have a couple of questions I am going to ask, and I am going to ask you just to limit your responses. So just be as direct with me as you can, and I know you will.

Let us just back up just for a moment, and just share, at least with me, and maybe with some of my colleagues, what is the wrong that we are trying to right here? What is the potential harm that we are trying to avert?

Chairman GREENSPAN. I believe that is a very good question, Senator.

What we are trying to avert is we have, in our financial system right now, two very large and growing financial institutions which are very effective and are essentially capable of gaining market shares in a very major market, to a large extent as a consequence of a subsidy that prevents the markets from adjusting appropriately. It prevents competition and the normal adjustment processes that we see on a day-by-day basis from functioning in a way that creates stability.

It is basically creating an abnormality which the system cannot close around, and the potential of that is a systemic risk sometime in the future if they continue to increase at the rate at which they are.

Senator CARPER. You spoke of your own minority view as to the course that we should take with respect to privatizing the GSE's. You also shared with us a different approach, and I believe that it dealt with limiting GSE issuance of debt. Would you go back to that and just explain that again for us, please.

Chairman GREENSPAN. Yes, Senator. There are two businesses here in the GSE's. First of all, the GSE's purchase mortgages from mortgage originators: Commercial banks, savings and loans, mortgage bankers, and the like.

Part of their business is to securitize those mortgages, guarantee them, charge a fee for servicing and the guarantee and then selling the mortgage-backed security on to other investors like pension funds, commercial banks or a number of other institutions. That is a profitable business, and that is indeed the secondary mortgage market.

There is another business which relates to the issue of taking part of the mortgages which are purchased and holding them on the balance sheets of the GSE's. These mortgages are selling at market interest rates. But if you have a subsidy in issuing debt, the GSE's are picking up an abnormal profit, which is the normal profit in the spreads plus the size of the subsidies, so that there is the incentive to put assets on the balance sheet, whether or not they are mortgages, corporate bonds, or other things which are on the GSE balance sheets, that, in effect, harvests the subsidy, which, remember, because it is not restricted by the Congress, can be expanded at will by the GSE's.

And so what we have is a structure in which a very rapidly growing organization, holding assets and financing them by subsidized debt, is growing in a manner which really does not, in and of itself, contribute to either homeownership or necessarily liquidity or other aspects of the financial markets.

There are disputes, I must tell you, and there are some people who do believe that has some effect on securities markets. I think the evidence here is very murky and clearly, in any event, more of a secondary issue than anything else.

The crucial question there is these are two businesses. They are both subsidized. They both have a high rate of return on equity. Indeed, the rate of return on equity on the part of the GSE's is significantly above that of, say, large commercial banks, which is an indication that they have a special advantage. And I am saying that there is one part of this business which we should be endeavoring to get them to expand because that is the base in which the secondary mortgage market functions.

The ownership of assets on the balance sheet is a very seriously lesser force. My own judgment is it has very little to do with either homeownership, home construction, or even having a very significant impact at all on interest rates. The real issue is the securitization, which is what Fannie and Freddie originated. They do an exceptionally good job of that technically.

And my own view—and why I think privatization would be the thing for them to want to do—is I basically believe that if they were to fully privatize, they would be smaller organizations, their profit levels would be somewhat less, their price earnings ratios would be much higher, and in all likelihood they may even have greater market value largely because they do things so well.

Senator CARPER. My time has expired.

Mr. Chairman, I had indicated earlier that I wanted to raise some questions relating to capital and different kinds of capital, but I am going to yield to Senator Crapo over there because my suspicion is he or Senator Enzi will probably get into that.

Thank you.

Chairman SHELBY. Thank you.

Senator Dole.

Senator DOLE. Chairman Greenspan, 2 weeks ago, the Comptroller General testified before this Committee and recommended that the legislation we consider contain clear criteria for nonmortgage investments.

Your testimony clearly states that you support a limitation of nonmortgage investments. Would you elaborate on why this limitation is so important?

Chairman GREENSPAN. Well, Senator, from the point of view of profitability of the GSE's, whether you hold mortgage assets, corporate bonds, or any form of securities not related to housing at all—indeed, any asset at all—will create a profit, because remember, since the issuance of debt, which has this implicit guarantee on it, is unrestrained—in fact, the initiation is wholly up to the GSE itself—it means that if you can find assets in which to invest the proceeds that are at market values, you will automatically generate a profit and in effect pick up an additional above-market profit to the extent that there is a lowered cost of your borrowed funds.

I find very little in the way of this process which helps homebuilding—or, I should say, homeownership—and if the purpose of the structure of the GSE's is to enhance the secondary mortgage market, which was its original purpose, it is not clear to me that that does anything whatever except increase the profitability of the GSE's.

Senator DOLE. I appreciate how clear you are in your prepared testimony when you state that "In the Federal Reserve's judgment, a regulator should have a free hand in determining the minimum and risk-based capital standards."

Should we have the regulator consider any factors other than safety and soundness when deciding what the proper level of minimal capital should be?

Chairman GREENSPAN. Senator, I think it is very difficult to have mixed goals. It is tough enough as it is to have safety and soundness as your purpose in regulating an institution. And I would hope that to the extent that there are changes, enlargement, or anything with respect to the GSEs' mission that those things be kept separate from the issue of how capital is determined, because the purpose of capital in this particular context is to insulate the problems of a GSE from creating overall financial problems for the system as a whole.

I would hope that the new regulator of the GSE's would have very much the same sorts of authority that the Federal Reserve, the Office of the Comptroller, and the FDIC have in order to manage the risks that we all are exposed to. To constrain that, I think, creates overall risks to the financial system which I do not think are desirable.

Senator DOLE. Now, it is my understanding that the GSE's consider families with incomes at or below 80 percent of area median income to be low income, while the Community Reinvestment Act defines families with incomes at or below 50 percent of area median income to be low income.

Chairman Greenspan, do you believe that we should create a uniform standard for what should be considered a low-income loan toward affordable housing goals?

Chairman GREENSPAN. I think that is a determination for those who are directly related to housing policy in this country, because as I indicated before, homeownership is something which is strongly supported by this Nation and, as I said before, for good reason, and how one gets there is not necessarily through secondary mortgage market, which I certainly acknowledge does help, but there are lots of other things which relate to this policy, and I think that the integration of the homeownership goal and housing goal generally of the GSE's has to be consistent with the other goals of our policies in this area. But I could not give you any judgment as to how that should be reconciled.

Senator DOLE. When Fannie and Freddie established their automated underwriting standards, they established a standard in which no lender can compare its underwriting standards to those established by the GSE's. A loan is either accepted or rejected by the GSE's, with no idea as to how risk factors are weighted or why the borrower failed to qualify.

How can this black-box underwriting be considered to support liquidity? Doesn't a liquid market need a significant degree of transparency?

Chairman GREENSPAN. Senator, there is a problem here in the fact that these are private organizations, and that is private property, and they have developed it in a manner which they perceive to be of value, and I think one has to argue that it is clearly a significant value for these institutions.

I think the issue that comes up is with respect to the question of transparency, largely because of this very ambiguous relationship with the GSE's, but in my judgment, so long as it is private property, it belongs to the GSE's and should not be made available except under extraordinary circumstances, and I think that is one of the issues which I think is on the table.

Senator DOLE. Thank you, Mr. Chairman. I think my time has expired.

Chairman SHELBY. Thank you, Senator Dole.

Senator Reed.

Senator REED. Thank you very much.

Thank you, Chairman Greenspan. Mr. Chairman, is there anything that we should do to make it clearer that the full faith and credit of the United States is not behind the operations of these GSE's, because much of our discussion this morning rests upon this subsidy of some kind, and yet—and I hope you can enlighten me—it appears that we have taken steps, at least legally, to try to make it clear that these agencies will not be supported by us. I mean, there is always the hypothetical, but what more can we do I guess is the question.

Chairman GREENSPAN. I think that there are innumerable ways to do that. A basic problem that we all have is that when somebody—a Government official or even groups of people in the Congress—may stipulate that that will not happen, they do not believe you, because they believe that in the event of a crisis, in effect, the Federal Government will not allow the institution to go into receivership.

I presume there are ways in which the Congress can pass a law that prohibits it or does something, but you have to be a little careful because what you do not want to do is inhibit any forms of activity which are required in the event of a crisis.

For example, we are the lender of last resort. In the event of a crisis of a major institution which we think were it to liquidate very quickly could create systemic instability, we will endeavor to find a way to liquidate it gradually, unwind the whole operation, obviously eliminate all shareholders value and perhaps even create some haircuts to the debt itself. But that process is necessary in order to prevent a shock to the system and a destabilization.

So it is not an easy issue to resolve, but I do think that in the wisdom of the Congress, you will find a way, if that is your desire, to make that clear and in effect, perhaps, in the way in which the receivership issue gets handled in the new regulator, convey that implicit in that are potential haircuts to debt.

Senator REED. As an aside, perhaps, but is your policy that you have just announced with respect to institutions that you govern reflected in their equity prices and their ability to go to the market and receive the more preferential rates?

Chairman GREENSPAN. Do you mean is our general policy—

Senator REED. For a large money center bank, do you think it is reflect there as you suggest it is reflected in the ability of Freddie and Fannie to go to the equity markets and the debt markets?

Chairman GREENSPAN. For Fannie and Freddie, it is very clear that it is reflected. If you look at the prices of debt of some major commercial banks, you see some of it, but far less. In other words, senior debt on the part of the major banks has higher yields than senior debt on the part of Fannie and Freddie. And the reason for that is largely there is a different view. While there is a Federal safety net for our depository institutions, the market does not view that debt as risk-free, essentially, and as a consequence requires a higher yield than the market requires of Fannie and Freddie.

Senator REED. Let me turn to a question that I raised in my opening statement. This goes to how we can support policies for better, more affordable housing—not just homeownership but multifamily housing that provides for citizens who cannot yet afford a house.

What I think you have been saying is that there is an implicit subsidy because the market reads what we do or thinks that we will step in at the last minute. This implicit subsidy is not fully passed through to achieve the goals that we have outlined—homeownership, expansion of those opportunities. Do you think as a matter of policy it would be appropriate for us to somehow recapture some of that undistributed benefit for housing programs?

Chairman GREENSPAN. I think that is an issue for Congress to make a judgment on. In other words, I am not against private institutions making a profit. I feel uncomfortable when their profit is made by subsidies. And I am not in a position to make a judgment as to where the Congress draws the line, but in this case, I will say, and I have said many times in the past, I do not think it is wise for this very odd situation to continue indefinitely, namely, that the markets believe that the Government will do one thing, the Government says it will not, and down the road eventually from that point of view is a very serious financial problem.

So clarification of this question I think is very important. If the Congress decides that it is perfectly all right for a significant part of the subsidy to go to shareholders, that is a judgment for the Congress to make.

Senator REED. And on the contrary, some of that subsidy should be returned in some way into the marketplace for homeownership—is that a legitimate judgment also?

Chairman GREENSPAN. Sure.

Senator REED. Thank you.

Chairman SHELBY. Senator Crapo.

Senator CRAPO. Thank you very much, Mr. Chairman.

Chairman Greenspan, I have a number of issues I want to try to get into, so I will try to move as quickly as I can through them. But first, before I get into the capital requirement issue, I noted in your testimony that you have stated that the Federal Home Loan Banks are not the focus of your testimony today but that much of what you have to say today applies to them as well. In fact, you say that because the Federal Home Loan Banks can design their advances to encompass almost any type of risk, they are even more complex to analyze than the GSE's.

As you know, we are looking at establishing a new regulator. If such a new regulator were established, do you believe that the Federal Home Loan Banks as well as the GSE's should all be under the same regulator?

Chairman GREENSPAN. I do, Senator.

Senator CRAPO. With regard to the capital standards, in your testimony you state that "Determining the suitable amount of capital for Fannie and Freddie is a difficult and technical process, and in the Federal Reserve's judgment, a regulator should have a free hand in determining the minimum and risk-based capital standards for these institutions."

Do you believe that in any legislation we establish, we should stay away from establishing a capital standard but instead set the risk-based factors or at least get some kind of policy analysis so that the regulator is involved in setting both the minimum and the other risk-based capital requirements?

Chairman GREENSPAN. Senator, I think that the way it is handled for depository institutions is the model that I think should be followed, which is there is a generic authority given to the regulator. For example, we have as you know under FIDICA a set of catgories which the Congress put in legislation not in numbers but in the nature of where we should be putting various different sorts of numbers. I believe the 2 percent is statutory. But there is very considerable discretion on the part of regulators as to where we then essentially translate the notions expressed by the Congress in legislation into numbers, and those numbers will change from time to time, as indeed they should.

So, I would say you could do worse than just take a look at the statutes which you enable us to function under.

Senator CRAPO. Thank you.

With regard to your testimony, you also indicated that the leverage which Fannie and Freddie now are able to utilize would not be possible without the expectation of a Federal guarantee. Do you believe that the current capital standards that Fannie and Freddie operate under are too low given the risk that is being incurred?

Chairman GREENSPAN. Senator, it is difficult to make a judgment, and let me express why. There is a tradeoff in interest rate risk or management. It is, as I indicated before, theoretically possible to so create a hedge structure that you fully eliminate all interest rate risk, and then, all you are dealing with is credit risk. And there is no question that mortgages per se are fairly safe instruments.

My own suspicion is that there is likely to be some increase in capital requirements if you have a regulator, largely because it is very difficult to get what we call "convexity hedging" as the result of a tendency in a big refinance boom for problems to arise.

The general issue is that you can create a very significant hedge but not without very significant cost. So that there is a tradeoff here between the cost that the GSE's are willing to expend, effectively, to get zero duration gap, and appropriate convexity hedging, and the issue of capital. There are tradeoffs.

So it is conceivable to me that Fannie and Freddie could set up a set of hedges which would require very little capital to be supported. But remember, crucial here is the fundamental question which comes first—is the Federal Government going to stand behind those instruments?

If indeed the Federal Government is going to guarantee the debentures of Fannie and Freddie, the required capital is called "zero"—you do not need any capital under those conditions.

Senator CRAPO. Thank you. That leads to the last question I wanted to ask. I would like to into a lot more on the capital, but I just have one last question to ask, and that is, assuming that it would be the policy of the Congress to make it clear that the Federal Government was not providing a guarantee and that we were to do something in any legislation to try to clarify that, I am struggling with exactly how we would effectively do so.

For example, we could put language in the statute that said the Federal Government will not guarantee the insolvency of Fannie and Freddie, but there would still, it seems to me, be a perception——

Chairman GREENSPAN. They will not believe you.

Senator CRAPO. Yes. That is the point. I mean, we can say it in the statute, and we could even put "and we really mean it," but the question is how do we actually make it clear that this Congress will not back?

Chairman GREENSPAN. I think the only way to do it—and I am not necessarily recommending this, because I think it is a very sensitive issue in the marketplace would be if you were to clarify how one would actually create a receivership and what would happen to the various holders of debt and equity and various other instruments, how they would be handled in advance, it might actually create a greater reality than I think merely a firm stipulation that you will not do anything would carry.

Senator CRAPO. Thank you. I look forward to working that out in a little more detail with your thoughts on that, and perhaps we might even find some procedural mechanisms to put into place that would require a super-majority vote in Congress. But I am not even sure we could pull that off. So, I thank you for those thoughts.

Chairman SHELBY. Senator Stabenow.

STATEMENT OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you, Mr. Chairman, and welcome, Chairman Greenspan.

First, I would just indicate to you, Mr. Chairman, that given the comments about the importance of downpayments in terms of helping in homeownership, I would just point out that Senator Gordon Smith and I have for some time introduced a first-time homebuyers' tax credit that we believe is substantial and would help homebuyers, and we would welcome the opportunity to bring it up before the Committee and have the opportunity to debate and pass that legislation.

Before questions, I do have an observation, though, Mr. Chairman. I have watched as a member of the Budget Committee and had the honor of hearing you on a number of occasions on the Budget Committee as well as before this Committee debating the importance of paying down debt and the relationship to interest rates and the fact that we know, even during difficult economic times that it has been the housing market that has in large part sustained us because of low interest rates.

So, I find it interesting and surprising that now we would be saying today that interest rates do not matter that much for people, when I truly believe that in the situation that we have been in, and the challenging times economically, in fact the actions of your agency and the low interest rates and the housing market, the refinancing, the purchasing of new homes, has been a substantial part of driving the economy and helping people into homeownership.

I am surprised to hear you say somehow that interest rates do not matter, or that somehow the ability for Freddie Mac and Fannie Mae to make a difference on interest rates would not make a difference. Certainly it makes a difference in the monthly payment I know that I make, and I look very closely, as my constituents do, at the interest rate and how it relates to the payments that they have to make in order to buy a home.

Chairman GREENSPAN. I think you are raising an important issue which probably should have been discussed earlier.

All the evidence that we have suggests that the types of interest rate changes that really matter are not basis points but percentage points. In other words, you really need 1 or 2 percentage points' change to really change the overall outlook.

There is no question, though, that any small change in interest rates does affect the monthly payment that people make on their mortgages. But I want to point out that to the extent that that decline is the result of a contingent liability that might be arising because of a subsidy, the homeowner as taxpayer is actually taking on a commitment which is probably as large in some cases and under certain assumptions larger than the benefits that they would get from the lowered monthly payments.

There is no question that lowering interest rates—for example, all the refinancing that we went through—had a very important impact on consumer purchasing and on the basic economic well-being of the average American household. But all of our analysis—and we have done this for years, and so has everybody else—suggests that you really need far greater decreases in interest rates than 25 basis points, for example, to have a significant impact on either homeownership or on home construction.

Senator STABENOW. I appreciate you clarifying that, because I do believe that in fact what you are saying is true in terms of interest rates and the importance of interest rates.

I do have a question regarding the Passmore analysis in looking at this more closely and the really startling assertion that the GSE's do not contribute a significant rate difference between conforming and jumbo mortgages.

I notice that in the study—which admittedly is very complicated, as you have said; it is a complex economic exercise—Mr. Passmore's study concedes, though, that "These data are not up to the tax of measuring the GSEs' effect on mortgage rates precisely."

My question is given the fact that he is admitting the complexity and that they have not been up to the task of measuring the effect precisely, this would suggest that the information is possibly incomplete or possibly inaccurate.

The question I would have is why would we assume, then, that his conclusions are absolutely accurate and complete.

Chairman GREENSPAN. The answer, Senator, is we do not. And we do something different. You are dealing in this particular area with very complex sets of relationships, and we have a number of very sophisticated statistical techniques which enabled us to get a model of how these markets function and, if we have data that is appropriate and accurate, interrelationships amongst various variables.

By the very nature of the way we do it, we cannot precisely estimate anything, but we get ranges. I mean, for example, one of the criticisms on this came from Dr. Greene at NYU the other day, and I read his piece, and it is a very interesting piece. It demonstrates that certain of the relationships create errors in the way the calculations are made. And I could add four or five myself as to what assumptions are made.

But what we do know is that in the very broadest sense, that even with all the errors, of which there are many, we can get a judgment of what is accurate.

For example, when everybody says about the Passmore study that, oh, it is incorrect here or incorrect there, or it does not do this or it does not do that, I am waiting for somebody to come up with an alternate model. It is one thing to say, well, this is not necessarily the case—and I would say, absolutely. But I would argue, for example, there is this very serious question as to what proportion of the subsidy flows through to the homeowner. And the argument is—is it, say, 7 basis points, 10 basis points, 12—the point at issue is what is the probability that all of the subsidy goes through to the homeowner. And I will tell you that approaches zero.

In other words, we do not know exactly what the pass-through is—or, as Dr. Greene focuses on in his paper, the so-called "omega parameter" in Passmore's study—but we know with a high degree of probability that it is within a reasonable range, and that range essentially says that the proportion of the subsidy that flows through to the homeowner is far less than I suspect is conventional wisdom as to what happens in the world.

So while it is certainly the case that all of these models are weak, in one form or another, they are very robust with respect to answering the question, in what range do these numbers tend to fall, as distinct from what the specific number is.

I would suggest—and indeed, we are very thankful that people are trying to address this issue; I find that I am quite pleased that everybody is trying to help us—I ask, in addition to them helping us, instead of just saying this could be wrong, this could be wrong, this is likely to be in error, to come up with a system which is an alternative way of looking at the same problem and demonstrating that the conclusion, the generic conclusion that is made in the Passmore piece, is wrong.

And I will tell you if they do that, we will be the first to say, "Congratulations. That is a remarkable piece of analytical work." I am waiting.

Senator STABENOW. Mr. Chairman, if I might just quickly ask one other issue, because I think there is another important piece of all that. That is, as we are talking about the benefits of the GSE's, we also give them responsibility, we also give them affordable housing goals, we also set up certain criteria for them—and, as you are suggesting privatizing on the one side, of course, then the question is will in fact those goals be able to be met on the other side, and wouldn't eliminating the Government sponsorship and eliminating the affordable housing goals redirect capital in the second market toward loans that are easier to make. Often, these are difficult goals to achieve, and there are public purposes for it, which is why we have the GSE's in the first place, and I would have a real concern about whether or not capital would be redirected in the secondary market without this relationship.

Chairman GREENSPAN. I understand your concern, but we have the Federal Housing Administration, they come directly at the issue of homeownership by effectively getting downpayments down. I am not sure that there are not a whole series of alternate means to enhance homeownership.

I think that the GSE's, whether private or not private, are exceptionally well-structured to maintain a viable secondary mortgage market, which is an extraordinarily valuable asset in this country.

The issue of the impact on homeownership is far more directly done by other means. If, for example, these institutions were privatized, I think that you are quite right, they would not and should have as a private organization any requirement of homeownership responsibility. But I do believe there are innumerable other vehicles to do that. They are not the only ones to do it, and actually, I am not sure that that is an efficient way of doing it.

What they do is a very efficient way of maintaining a viable, deep, and liquid mortgage market which has great importance beyond housing. But I would never consider that that particular economic structure is well-suited or best-suited for the purpose of enhancing homeownership.

Senator STABENOW. Thank you.

Chairman SHELBY. Senator Sununu.

STATEMENT OF SENATOR JOHN E. SUNUNU

Senator SUNUNU. Thank you, Mr. Chairman.

Mr. Greenspan, oftentimes going last means we get a choice to either ask you strange questions that have not yet been asked or just to make you repeat the good stuff, so bear with me here as I try to add something to this discussion. And I know that you want to talk more about "convexity" and "omega," but I do not understand any of that.

I do understand a little bit about risk, though, and you spent some time talking about an ideal world where these GSE's could hedge all of their interest rate risk. It would be expensive, but they could do it.

Now, even if that were accomplished, is it still the case, however, that they would maintain credit risk, and they would maintain prepayment risk and therefore need to have some minimum capital that is regulated by the regulator that we have been talking about?

Chairman GREENSPAN. Well, they can with difficulty hedge prepayment risk. It is expensive, and it is a little tricky, because it sometimes requires that you get in what is called "delta hedging" and complex types of hedging instruments, and they do not always work, as indeed we have found out in the last year. A number of organizations tried to hedge their interest rate risk and largely failed.

But it is possible to take out numbers of different types of hedges. There are difficulties in the event of a crisis where you could get both Fannie and Freddie trying to get the same type of hedge in the same market, and it may be difficult to do. But that is a technical question.

All I was trying to stipulate was that capital is not the sole criterion to essentially cover interest rate risk and that credit risk as such is indeed rather small in the holding of mortgage assets, and the amount of capital required for that is clearly lower than C&I loans or credit card debt or something of that nature.

I was merely raising the issue of these without talking about what degree of hedging you have succeeded in doing, the determination of what is the appropriate amount of capital for interest rate risk is not determinative.

Senator SUNUNU. It is my understanding that roughly 60 percent of the country's banking institutions hold at least half of their equity capital in GSE debt. Is that a number that you agree with, and to what extent does that contribute to some of the concerns of systemic risk that you discussed in your testimony?

Chairman GREENSPAN. It is a large number. I do not know whether it is the explicit number. My concerns are not related to that per se. In other words, my concerns are that if we stabilize the system and create an overall model which can go forward over the longer-term, there is no reason to believe that those particular instruments are in any way open to question.

But I think the major issue is to focus on where the current relationships will lead us if we do not change direction.

Senator SUNUNU. Doesn't the degree to which our financial institutions depend on these securities as a part of their equity capital make getting this regulatory structure more important?

Chairman GREENSPAN. I think that here is where supervision really matters. That is, every one of the banks are scrutinized with respect to what they have and where their concentrations are, and I think there are lots of discussions that go on between bank supervisors and the officers of the commercial banks. My judgment is that there is a considerable amount of effort on the part, I know, of our supervisors to be fairly vocal on the question of concentration of risk within particular institutions. And I suspect, but I do not know in detail, that that issue is up front, discussed, and evaluated and the risks understood, I believe, by both the regulators and the banks.

Senator SUNUNU. You described a second business, two businesses, that the GSE's are engaged in. The second business you described as one where the GSE's hold mortgages or mortgage-backed securities on their books that are paid interest at market rates, and they finance the purchase of that portfolio with their own debt, which is discounted because of the implied subsidy that we have been talking about. That is a good business. What would you call that business? Is it fair to call that a form of arbitrage?

Chairman GREENSPAN. It is a perfectly sound business, and a lot of organizations engage in it. My only concern is that there is a subsidy in the liability side of the balance sheet.

Senator SUNUNU. Is it fair to describe that business as arbitrating their implied subsidy?

Chairman GREENSPAN. No.

Senator SUNUNU. Or, their implied guarantee.

Chairman GREENSPAN. Well, I do not know if the word "arbitrage" is the right term there. What they are doing is very simple. They are borrowing money, and they are investing it, and that is a financial intermediation activity. Arbitrage is usually related to differences between prices, but here, it is just a big, fat gap which they can use.

Senator SUNUNU. There is a subtlety there that escaped me, but I think the point was made.

You suggested that that business, that second business, does not contribute to homeownership rates. Is that a fair characterization?

Chairman GREENSPAN. I would be surprised if anybody could demonstrate that it had a significant impact on homeownership. I am waiting to see the evidence. I have seen none.

Senator SUNUNU. Would you recommend by extension any absolute limits, limitations, on the size of the portfolio that the GSE's could then hold?

Chairman GREENSPAN. At this stage, I have not given very much thought to that. All I know is where I believe the problem is is right here, and the question is that first a judgment has to be made as to whether in fact the regulator or the Congress or people who are going to be making these judgments believe that that is indeed the case. If that is the conclusion, then, that is a secondary question as to where the appropriate numbers would be.

My own judgment is that the extent of the subsidy increasing should not be at anywhere near the pace that it has been in recent years.

Senator SUNUNU. There is a resolution introduced by Senator Schumer—I am sorry he is not here today—and I think it is cosponsored by half a dozen or so Members of this Committee, and in part the language of the resolution states: "Whereas, Chairman Greenspan has provided a steadying hand on policy during periods of great financial risk for America; and whereas, Chairman Greenspan has carefully upheld the responsibility of the Federal Reserve to be unbalanced and impartial in its decisionmaking; and whereas, Chairman Greenspan possesses wisdom and experience and competence in the public"—now, I am sorry to say that I am not a cosponsor of the resolution, but it would seem to me that someone who was to unbiased and impartial and has these great qualities would be an excellent nominee to sit on the advisory board that has been contemplated and discussed in previous hearings for overseeing a new regulator.

Wouldn't those be good qualities to have as a board member exercising fiduciary responsibility and oversight of such an important part of our financial system?

Chairman GREENSPAN. Senator, it would if it were not for the fact that we have a potential large conflict of interest. On the one hand, we are involved in being the lender of last resort and the institution which has been required by the Congress to try to maintain systemic stability. If we were involved, I am fearful that we would have on the one hand the desire to make sure that the GSE's were whole the way all regulators do and we do for commercial banks, but we would clearly be concerned if we thought there were systemic risks involved in the process.

So, I would say we would probably be uncomfortable in that particular role and hope that we are not asked to do so.

Senator SUNUNU. Thank you, Mr. Chairman.

Chairman SHELBY. Thank you.

Chairman Greenspan, you have touched on a number of things here today, and I might go over a few that you have already talked about a little bit.

We do have that ambiguous relationship—that is, the Federal Government—with the GSE's. How do we actually get rid of that ambiguity is a complicated, tricky thing. I do not know how we do it. You have alluded to it a little bit, but how do we define the relationship is important, is it not?

Chairman GREENSPAN. Yes. Of all the issues that have been discussed today, I think that is the most difficult one, because you cannot have in a rational government or a rational society two fundamentally different views as to what will happen under a certain event, because that invites crisis and it invites instability, and invites a conclusion that the Congress will not be able to control unless it moves in advance and defines exactly how this issue will be resolved.

One possibility—and as I said, it is difficult to know exactly how to construct this—is to define what would happen in the event of some form of crisis where you can define the nature of a receivership and who gets what under certain conditions. That would be a difficult thing to do. It would clarify the issue and perhaps clarify enough to remove the ambiguity going forward.

Chairman SHELBY. But there is a heck of a lot of difference between a conservatorship and a receivership. The banking system that we deal with up here every day, they are subject, at least technically, to a receivership. Is that correct?

Chairman GREENSPAN. Correct.

Chairman SHELBY. Now, if we were to create some type of receivership in legislation, you could not just unwind overnight——

Chairman GREENSPAN. No. The problem here——

Chairman SHELBY. It is very complicated.

Chairman GREENSPAN. It is very complicated, and you have to be very careful not to undermine the GSE's in the process.

Chairman SHELBY. Because if you did, you could undermine some of the banking system——

Chairman GREENSPAN. Absolutely.

Chairman SHELBY. —because the banking system are big investors here; is that right?

Chairman GREENSPAN. This is the reason why I think this is a very sensitive question and the reason why it is an issue that I perceive to be necessary to be resolved in the longer-run.

As I indicated early on, Senator, I think at the moment there is no evidence that there is any imminent systemic risk here, and that is precisely the reason why I think this is the time that you start to think about making certain it does not occur in the future.

In the process of defining how this is done, remember, as you point out, that under existing statute, there is a conservatorship, not a receivership, which essentially says for all practical reasons that the Congress will bail out the GSE's in the event of a crisis.

Chairman SHELBY. It is another implied guarantee; is that right?

Chairman GREENSPAN. Under existing rules, if there is a crisis, it is going to be very difficult for the Federal Government not to guarantee these assets. If that is not the decision of the Congress, something different has got to be done, and all I will say to you, as you very well understand, Mr. Chairman, this is a very difficult situation because we have extraordinarily viable GSE's.

Chairman SHELBY. That is right.

Chairman GREENSPAN. Fannie and Freddie—I may criticize the issue of the subsidy, and that is basically because it is so starkly different for me in the sense that without the subsidy, as I have told my friends in both of these institutions, I think they would be far better off privatized, and one of the reasons is I think they are very well run.

But if in the process of resolving this issue, we undercut these institutions, I think we will be doing the Nation a great disservice. So it is not a simple process as I see it.

Chairman SHELBY. Mr. Chairman, could we have a statement of public policy that we are very interested in—and we know why, for economic reasons, social reasons, and so forth—on private housing ownership in this country and at the same time state we are interested in sound financial institutions to help bring this about? Couldn't we do both, or can we?

Chairman GREENSPAN. Mr. Chairman, I think we have to do both.

Chairman SHELBY. We have to do both. Okay.

Fannie and Freddie are subject, as I understand it, to a 30 percent risk-based capital add-on for operational risk. Is this sufficient to guard against operational risk?

Chairman GREENSPAN. I do not know the answer to that.

Chairman SHELBY. Okay. Would you get back with us on that, maybe?

Chairman GREENSPAN. I will get back to you, but I have a suspicion that it is a difficult question to answer unless you get involved——

Chairman SHELBY. Very complicated.

Chairman GREENSPAN. —into the detail of what their potential operational risks could be.

Chairman SHELBY. Okay.

Chairman GREENSPAN. But I will check and see if I can find somebody to address that.

Chairman SHELBY. Okay. Mr. Chairman, do you believe, or could you say that the GSE's now hold sufficiently diverse assets to protect against liquidity risk? You said you believe they are pretty well-managed.

Chairman GREENSPAN. I would say generally they have quite adequate liquidity.

Chairman SHELBY. Mr. Chairman, we have had one hearing on Basel II here, and there has been some skepticism, as you know, from some of your regulator contemporaries expressed on some of the models that Basel II's framework would come about.

You note in your testimony, "In order to manage risk with little capital requires a conceptually sophisticated hedging framework" and that—these are your words—"in essence, the current system depends on the risk managers at Fannie and Freddie to do everything just right."

If this is the case for Freddie and Fannie, who tout their risk management practices, shouldn't we have similar concerns with the reliance that Basel II would similarly place on such models, because they would change the whole capital structure as we know it, at least from up here?

Chairman GREENSPAN. Yes. Fannie and Freddie are special cases which are quite different from the institutions that Basel II is directed at.

In other words, this is a special case of highly leveraged, low credit risk, high interest rate institutions. I do not want to say they are unique, but they are close to that. The type of risk-based capital procedures that are involved in Basel II are far less complex types of issues than arise here, and also, it is a different type of risk management.

Chairman SHELBY. Okay. Mr. Chairman, one last question. You assert in your testimony that "Fannie and Freddie's purchases of their own or each other's securities or their debt do not appear needed to supply mortgage market liquidity or to enhance capital markets in the United States." Those are your words.

You suggest—and these are your words again—"deep and liquid markets that are provided by MBS's held by private investors."

What effect if any would we see on liquidity in the mortgage market where the GSE is prevented from holding these securities in their own portfolio?

Chairman GREENSPAN. I do not think there should be a prohibition. I just think the size is what the issue is all about. In other words, to the extent that you need to hold securities for various different operations which facilitate the securitization operations of the GSE's, that is perfectly sensible.

Chairman SHELBY. Is that generally temporary, though?

Chairman GREENSPAN. Well, the issue is not the temporary; it is a question that is a very small part of the portfolio they hold.

Chairman SHELBY. Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

Let me just follow up on the question that the Chairman just put, because I think it is interesting. Some have argued that the GSE's provide important stability in the mortgage markets during periods of economic instability, and they cite, for example, the Asian debt crisis in 1998 or the business and bank recession of 1990–1992, and argue that the mortgage rates would have increased dramatically at that time—as in fact they did in the jumbo mortgage market and in other credit markets—but that the GSEs' ability to continue buying mortgages and mortgage-backed securities made a difference so that they helped play an important stabilizing role.

What is your response to that?

Chairman GREENSPAN. First of all, the reason that there were fairly significant purchases at that time is that during that crisis you had a flight to quality which pushed long-term Treasury rates down, and because the presumption was that the GSE debt was comparable to Treasury, its rates went down, and as a consequence of that, the margins opened up, and it became quite profitable to go in and purchase mortgages and mortgage-backed securities. So that the issue was not an endeavor to do something for the markets per se; it was a very sensible business decision.

Senator SARBANES. But did that endeavor contribute to stability?

Chairman GREENSPAN. I think it did in part, yes; I said I think it did in part.

Senator SARBANES. Okay. Now, I was struck by your response to Senator Stabenow earlier on the effect of GSE's on mortgage rates in which you said, well, if it is 7 basis points, citing the Passmore study, and then you said, well, maybe it is 10 or maybe it is 12, and that was the range of your example. But are you familiar with the CBO study in 2001 that said the effect of GSE's on mortgage rates was 25 basis points?

Chairman GREENSPAN. I am, Senator.

Senator SARBANES. And are you familiar with the CBO study in 1996 that said the effect of GSE's on mortgage rates was 35 basis points?

Chairman GREENSPAN. I am, Senator.

Senator SARBANES. I am interested why your range of example seemed to fall so significantly short of these other studies—excepting, at least in part, the argument that we have all these different studies, and we do not really know, which I think was the thrust of your argument, but then the range you gave really fell well short of these CBO studies.

Chairman GREENSPAN. Well, I think you have to remember that as these studies progress, we are learning things, and each analyst has the ability to learn from previous estimates. The early estimates, as best I can judge, were much simpler in structure and in evaluation than those that have occurred more recently.

Remember that Wayne Passmore and his colleagues who worked on this study were fully familiar with those previous studies and clearly, they had the choice of saying, well, they are right, or we can improve on them; and in the process, as best I can judge looking at the different techniques that are employed, the most recent study by Passmore and his colleagues is by far the most sophisticated and the one most likely to be accurate.

Senator SARBANES. There is considerable controversy over that.

Chairman GREENSPAN. Oh, indeed, there is.

Senator SARBANES. Yes.

Chairman GREENSPAN. And I might say that the one thing that I am quite pleased about, Senator, is that we are finally coming to grips with this issue, and I hope that a good deal of resources, private and otherwise, are applied in this direction. And as we said when we released the draft of the Passmore study, we hope that people will criticize it.

Senator SARBANES. Am I right in thinking that the rates offered by mortgage lenders are such that the rates on conforming mortgages are 25 to 30 basis points less than the jumbo loan rate?

Chairman GREENSPAN. Let me say this issue that has been raised about—you can look in the newspaper, and you can find all these rates, and differ the jumbos look significantly different from the conforming—what Passmore and his colleagues did was basically to look at the actual transactions that occurred. Remember that these things that you read in the newspaper are list prices, and list prices have never, in any market, been a good reflection of what transactions were. And while there are questions about the quality of the transactions data—there is an issue there of whether or not there are sub-prime loans in those data——

Senator SARBANES. That is right.

Chairman GREENSPAN. —but there is no question that you do not use posted prices or offers or listed prices when you have transaction prices, which is essentially the market, and it is the market which determines what the spread is between jumbos and conforming mortgages.

Senator SARBANES. What do you think that spread is?

Chairman GREENSPAN. I think the numbers that came out of the Passmore studies look—since I did not do the actual numbers—they look to me like they did a fairly sophisticated job.

Senator SARBANES. What are those numbers?

Chairman GREENSPAN. What is the actual number used in that? [Conferring.] Dr. Passmore says it is 16 to 19 basis points.

Senator SARBANES. That is Dr. Passmore there?

Chairman GREENSPAN. That is Dr. Passmore.

[Laughter.]

And if you have questions for him, by all means go ahead.

Senator SARBANES. He actually exists.

[Laughter.]

He is not just a pseudonym in the Federal Reserve System.

Chairman SHELBY. He is real. Senator Sarbanes, he is real and breathing. We just saw him in action.

Senator SARBANES. I see that, I see that. Okay.

Chairman GREENSPAN. Sorry I outed you, my friend.

[Laughter.]

Senator SARBANES. Chairman Greenspan, Comptroller General Walker testified to this Committee that the Federal Housing Finance Board, FHFB, had just 10 examiners in July 2002 to examine the 12 Home Loan Banks—10 examiners—and the Board is planning to expand that to only 30 examiners by the end of this year.

Now, most observers feel that the Federal Home Loan Banks are engaging in riskier activities than they used to be. This point of concern was raised by former Assistant Secretary of the Treasury Sheila Baer at a hearing held here last year.

I understand, actually, that the OCC has as many as 20 or more examiners resident in each of the large national banks. What is your view of the capacity of the Federal Housing Finance Board to meet its supervisory responsibilities?

Chairman GREENSPAN. The number seems quite low in the context of what the banking regulators' general relationship is between examiners and examined institutions. I do not know what the actual numbers are, but our number is very substantially greater, and I assume the Comptroller's is as well, than the numbers you cite.

Senator SARBANES. You said earlier that you thought the Federal Home Loan Banks should be brought under the umbrella of this supervisor of the GSE's, but I think it might be helpful to us if you gave us some of your rationale and reasons for thinking that.

Chairman GREENSPAN. The reason basically is first that they too have a subsidy very similar to that of Fannie and Freddie. Indeed, the GSE subsidies are generally fairly consistent with one another.

Then, of course, the major asset that is involved in the Federal Home Loan Bank System is mortgages. So both the assets and the liabilities are quite similar and have the same economic effects. And as a consequence, it would strike me that many of the principles that would be involved in supervising and regulating Fannie and Freddie would also be applicable, with some changes, to the Federal Home Loan Bank System.

Senator SARBANES. Well, the Chairman had to leave, and I am going to wrap it up. It is a great temptation, obviously, at this point, but I am going to forego that temptation and thank you, Chairman Greenspan, for coming before the Committee. We appreciate, as always, your testimony.

The hearing stands adjourned.

[Whereupon, at 12:13 p.m., the hearing was adjourned.]

[Prepared statements and response to written questions supplied for the record follow:]

PREPARED STATEMENT OF SENATOR MICHAEL B. ENZI

As we are coming to the close of hearings on the regulatory oversight of the housing Government Sponsored Enterprises, we should take a step back to where we began. At that time, the focus of the hearings were on the accounting errors of Freddie Mac and whether the Office of Federal Housing Enterprise Oversight was sufficient in catching those errors in a timely and effective manner. Today, it is clear that the issues as well as our national housing agenda have become much broader than that.

Not only are we discussing a new regulator for Freddie Mac and Fannie Mae but there has also been much discussion of whether to include the Federal Home Loan Banks into the system.

Back in August, I sent a letter with a few of my colleagues to Treasury Secretary Snow that a new regulator for Fannie Mae and Freddie Mac should be established and that the new regulatory entity have sufficient resources and tools to oversee the complex financial instruments used by those two entities. In addition, I stated that the regulator must be independently financed. Today, I still believe that those issues are valid and necessary.

Our housing market is still one of the most important driving sectors of our economy. That is due in large part to the Federal Reserve Board's ability to maintain low interest rates and from homebuyers being able to tap into the equity of their homes built upon the tremendous growth of the housing market. The housing industry bears little resemblance to what it looked like 15 years ago. However, from a rural State perspective, there are still improvements that can be made.

As we debate the new regulatory structure of the Government Sponsored Enterprises, I believe that it is essential that we maintain the individual characteristics of Fannie Mae and Freddie Mac and the Federal Home Loan Banks. Wyoming, as a rural State, has benefitted from the unique nature of both systems. We must be cautious not to make any legislative changes that may limit the distinctions or cause those distinctions to disappear in the future. In addition, if the new regulator is to be entrusted with complete oversight of the Enterprises, the regulator must be structured as not to impede rural or Native American housing needs or the Enterprises ability to solve those difficult housing problems. I look forward to working with you, Mr. Chairman, and my colleagues as we will be considering legislation in the near future.

Another vital component of the housing market is the need for reform of the real estate settlement process. The settlement process has helped us achieve the growth in the housing market. The Department of Housing and Urban Development has pending a regulatory proposal to amend the regulations implementing the Real Estate Settlement Procedures Act. This proposal has been very controversial both from a small and a large business perspective.

Recently, I had the opportunity to meet with Acting Secretary Jackson. I told him that reform of the settlement process is essential, however, I strongly believe that it would be in the best interest of everyone involved that the rule be reproposed. This will allow everyone a fair opportunity to comment on whatever changes the Department intends to make. In addition, it will give the Department a chance to fix its flawed small business economic analysis. It is important this rule proposal be done properly otherwise it could significantly affect our strong housing market.

Turning for a moment to topic unrelated to the housing industry, Chairman Greenspan, you recently stated before this Committee on the skills of our workforce, "what will ultimately determine the standard of living of this country is the skill of the people." You went on to state, "[w]e need a level of skills of our working population which is continuously becoming more conceptual to match the types of goods and services that consumers want."

The Workforce Investment Act Amendments is designed to accomplish the goal that you describe—preparing the 21st century workforce for 21st century jobs. The well-being of our workers, their families, and our country depends on meeting this goal.

This legislation has passed both the House and the Senate. In light of your comments, I am urging the leadership of both parties to appoint conferees on this vital legislation for the growth of our economy and for the jobs of our people.

Thank you Mr. Chairman for holding this important hearing. And thank you Chairman Greenspan for being with us today.

PREPARED STATEMENT OF ALAN GREENSPAN

CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

FEBRUARY 24, 2004

Mr. Chairman, Senator Sarbanes, and Members of the Committee, thank you for inviting me to discuss the role of housing-related Government Sponsored Enterprises (GSE's) in our economy. These GSE's—the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), and the Federal Home Loan Banks (FHLB's)—collectively dominate the financing of residential housing in the United States. Indeed, these entities have grown to be among the largest financial institutions in the United States, and they now stand behind more than $4 trillion of mortgages—or more than three-quarters of the single-family mortgages in the United States—either by holding the mortgage-related assets directly or assuming their credit risk.[1] Given their ties to the Government and the consequent private market subsidized debt that they issue, it is little wonder that these GSE's have come under increased scrutiny as their competitive presence in the marketplace has increased.

In my remarks, I will not focus on the Federal Home Loan Banks, although much of this analysis applies to them as well. In fact, because the Federal Home Loan Banks can design their advances to encompass almost any type of risk, they are more complex to analyze than other GSE's and, hence, raise additional issues.

During the 1980's and early 1990's, Fannie Mae and Freddie Mac (hereafter Fannie and Freddie) contributed importantly to the development of the secondary mortgage markets for home loans and to the diversification of funding sources for depository institutions and other mortgage originators. Although the risk that a home mortgage borrower may default is small for any individual mortgage, risks can be substantial for a financial institution holding a large volume of mortgages for homes concentrated in one area or a few areas of the country. The possible consequences of such concentration of risk were vividly illustrated by the events of the 1980's, when oil prices fell and the subsequent economic distress led to numerous mortgage defaults in Texas and surrounding states. The secondary markets pioneered by Fannie and Freddie permit mortgage lenders to diversify these risks geographically and thus to extend more safely a greater amount of residential mortgage credit than might otherwise be prudent.

The key to developing secondary markets was securitization, and Fannie and Freddie played a critical role in developing and promoting mortgage securitization, the process whereby mortgages are bundled together into pools and then turned into securities that can be bought and sold alongside other debt securities. Securitization by Fannie and Freddie allows mortgage originators to separate themselves from almost all aspects of risk associated with mortgage lending: Once the originator sells the loan into the secondary market, he or she may play no further role in the contract. This development was particularly important before the emergence of truly nationwide banking institutions because it provided a dramatically improved method for diversifying mortgage credit risk. Fannie and Freddie demonstrated that, by facilitating the diversification of mortgage portfolios and insisting on the application of sound loan underwriting standards, the credit risk associated with holding con-

[1] Fannie Mae and Freddie Mac stand behind mortgages in two ways: The first method is to purchase mortgages, bundle them together, and then sell claims on the cashflows to be generated by these bundles. These claims are known as mortgage-backed securities (MBS). The second method involves Fannie's and Freddie's purchasing mortgages or their own mortgage-backed securities outright and financing those purchases by selling debt directly in the name of the GSE. Both methods create publicly traded securities and thus permit a wide variety and large number of purely private investors to fund mortgages. Using the first method, Fannie and Freddie are relieved of interest-rate risk but are still exposed to credit risk because they guarantee MBS investors against the risk that some homeowners will default on the underlying mortgages. The second method of funding mortgages increases Fannie's and Freddie's debt outstanding and expands their balance sheets. In this case, Fannie Mae and Freddie Mac must manage the interest rate, prepayment, and credit risks associated with the mortgages they purchase.

In the conforming mortgage market, Fannie Mae and Freddie Mac, using these two methods, play dominant roles in funding and managing the credit risk of the mortgages, but they do not participate directly in the origination of mortgage credit. Depository institutions, mortgage bankers, and their affiliates originate most mortgages. However, the underwriting standards of Fannie Mae and Freddie Mac substantially influence which borrowers receive mortgage credit. As discussed below, because of Fannie Mae's and Freddie Mac's Government sponsored advantages, there currently is no secondary market for conforming mortgages other than that provided by Fannie Mae and Freddie Mac. If a bank chooses not to sell the mortgage that it originates, it must fund that mortgage and manage the associated credit and interest rate risks itself.

forming mortgages could be reduced to very low levels and could be distributed across a wide variety and large number of investors. This innovation in the mortgage market led to the securitization of many other assets and to the creation of many other types of securities. During the 1980's, the GSE's led the private sector in this innovation, and their contribution enhanced the stability of our financial markets.

Mortgage securitization continues to perform this crucial function, and its techniques have now been applied by the private sector in many markets, including markets for automobile loans, credit card loans, nonconforming mortgages, and commercial mortgages. Asset-backed securities and the secondary markets in which they trade generally provide both households and businesses with excellent access to credit at an appropriate risk-adjusted interest rate. Moreover, credit supply is far more stable today than it was because it is now founded on a much broader base of potential sources of funds. The aspiring homeowner no longer depends on the willingness of the local commercial bank or savings and loan association to hold his or her mortgage. Similarly, the sources of credit available to purchasers of cars and users of credit cards have expanded widely beyond local credit institutions. Unbeknownst to such borrowers, their loans may ultimately be held by a pension fund, an insurance company, a university endowment, or another investor far removed from the local area. This development has facilitated the substantial growth of nonmortgage consumer credit. Indeed, in the United States, more than $2 trillion of securitized assets currently exists with no Government guarantee, either explicit or implicit.

Given their history of innovation in mortgage-backed securities, why do Fannie and Freddie now generate such substantial concern? The unease relates mainly to the scale and growth of the mortgage-related asset portfolios held on their balance sheets. That growth has been facilitated, as least in part, by a perceived special advantage of these institutions that keeps normal market restraints from being fully effective.

The GSE's' special advantage arises because, despite the explicit statement on the prospectus to GSE debentures that they are not backed by the full faith and credit of the U.S. Government, most investors have apparently concluded that during a crisis the Federal Government will prevent the GSE's from defaulting on their debt. An implicit guarantee is thus created not by the Congress but by the willingness of investors to accept a lower rate of interest on GSE debt than they would otherwise require in the absence of Federal sponsorship.

Because Fannie and Freddie can borrow at a subsidized rate, they have been able to pay higher prices to originators for their mortgages than potential competitors and to gradually but inexorably take over the market for conforming mortgages.[2] This process has provided Fannie and Freddie with a powerful vehicle and incentive for achieving extremely rapid growth of their balance sheets. The resultant scale gives Fannie and Freddie additional advantages that potential private-sector competitors cannot overcome. Importantly, the scale itself has reinforced investors' perceptions that, in the event of a crisis involving Fannie and Freddie, policymakers would have little alternative than to have the taxpayers explicitly stand behind the GSE debt. This view is widespread in the marketplace despite the privatization of Fannie and Freddie and their control by private shareholders, because these institutions continue to have Government missions, a line of credit with the Treasury, and other Government benefits, which confer upon them a special status in the eyes of many investors.

The part of Fannie's and Freddie's purchases from mortgage originators that they do not fund themselves, but instead securitize, guarantee, and sell into the market, is a somewhat different business. The value of the guarantee is a function of the expectation that Fannie and Freddie will not be allowed to fail. While the rate of return reflects the implicit subsidy, a smaller amount of Fannie's and Freddie's overall profit comes from securitizing and selling mortgage-backed securities (MBS).

Fannie's and Freddie's persistently higher rates of return for bearing the relatively low credit risks associated with conforming mortgages is evidence of a significant implicit subsidy. A recent study by a Federal Reserve economist, Wayne Passmore, attempts to quantify the value of that implicit subsidy to the private

[2] Conforming mortgages are mortgages that are eligible for purchase by Fannie and Freddie. Fannie and Freddie can purchase mortgages only below the conforming loan limit (currently $333,700) and will purchase only those mortgages that meet their underwriting standards, including, for many mortgages, the standard that the mortgage is equivalent in risk to a mortgage with an 80 percent loan-to-value ratio. This latter requirement makes it difficult to know the extent of the market, but market participants generally believe that Fannie and Freddie purchase a large share of the truly conforming mortgages.

shareholders of Fannie and Freddie. His research indicates that it may account for more than half of the stock market capitalization of these institutions. The study also suggests that these institutions pass little of the benefit of their Government sponsored status to homeowners in the form of lower mortgage rates.

Passmore's analysis suggests that Fannie and Freddie likely lower mortgage rates less than 16 basis points, with a best estimate centering on about 7 basis points. If the estimated 7 basis points is correct, the associated present value of homeowner savings is only about half the after-tax subsidy that shareholders of these GSE's are estimated to receive. Congressional Budget Office and other estimates differ, but they come to the essentially same conclusion: A substantial portion of these GSEs' implicit subsidy accrues to GSE shareholders in the form of increased dividends and stock market value. Fannie and Freddie, as you know, have disputed the conclusions of many of these studies.

As noted by the General Accounting Office, the task of assessing the costs and benefits associated with the GSE's is difficult. One possible way to advance the technical discussion would be for the Congress to request disinterested parties to convene groups of technical experts in an effort to better understand and measure these costs and benefits.

The Federal Reserve is concerned about the growth and the scale of the GSEs' mortgage portfolios, which concentrate interest rate and prepayment risks at these two institutions. Unlike many well-capitalized savings and loans and commercial banks, Fannie and Freddie have chosen not to manage that risk by holding greater capital. Instead, they have chosen heightened leverage, which raises interest rate risk but enables them to multiply the profitability of subsidized debt in direct proportion to their degree of leverage. Without the expectation of Government support in a crisis, such leverage would not be possible without a significantly higher cost of debt.

Interest rate risk associated with fixed-rate mortgages, unless supported by substantial capital, however, can be of even greater concern than the credit risk. Interest rate volatility combined with the ability of homeowners to prepay their mortgages without penalty means that the cashflows associated with the holding of mortgage debt directly or through mortgage-backed securities are highly uncertain, even if the probability of default is low.

In general, interest rate risk is readily handled by adjusting maturities of assets and liabilities. But hedging prepayment risk is more complex. To manage this risk with little capital requires a conceptually sophisticated hedging framework. In essence, the current system depends on the risk managers at Fannie and Freddie to do everything just right, rather than depending on a market-based system supported by the risk assessments and management capabilities of many participants with different views and different strategies for hedging risks. Our financial system would be more robust if we relied on a market-based system that spreads interest rate risks, rather than on the current system, which concentrates such risk with the GSE's.

As always, concerns about systemic risk are appropriately focused on large, highly leveraged financial institutions such as the GSE's that play substantial roles in the functioning of financial markets. I should emphasize that Fannie and Freddie, to date, appear to have managed these risks well and that we see nothing on the immediate horizon that is likely to create a systemic problem. But to fend off possible future systemic difficulties, which we assess as likely if GSE expansion continues unabated, preventive actions are required sooner rather than later.

As a general matter, we rely in a market economy upon market discipline to constrain the leverage of firms, including financial institutions. However, the existence, or even the perception, of Government backing undermines the effectiveness of market discipline. A market system relies on the vigilance of lenders and investors in market transactions to assure themselves of their counterparties' strength. However, many counterparties in GSE transactions, when assessing their risk, clearly rely instead on the GSEs' perceived special relationship to the Government. Thus, with housing-related GSE's, regulators cannot rely significantly on market discipline. Indeed, they must assess whether these institutions hold appropriate amounts of capital relative to the risks that they assume and the costs that they might impose on others, including taxpayers, in the event of a financial-market meltdown. The issues are similar to those that arise in the context of commercial banking and deposit insurance—indeed, they are the reason that commercial banks are regulated and subject to stringent regulatory capital standards.

Traditionally, questions of capital adequacy for financial institutions have been evaluated with regard to credit and interest rate risks. However, in the case of the GSE's and other large regulated financial institutions with significant roles in market functioning, liquidity, and operation risks also need to be considered. Determining the suitable amount of capital for Fannie and Freddie is a difficult and technical process, and in the Federal Reserve's judgment, a regulator should have a free hand in determining the minimum and risk-based capital standards for these institutions.

The size of Fannie and Freddie, the complexity of their financial operations, and the general indifference of many investors to the financial condition of the GSE's because of their perceived special relationship to the Government suggest that the GSE regulator must have authority similar to that of the banking regulators. In addressing the role of a new GSE regulator, the Congress needs to clarify the circumstances under which a GSE can become insolvent and, in particular, the resultant position—both during and after insolvency—of the investors that hold GSE debt. This process must be clear before it is needed; otherwise, should these institutions experience significant financial difficulty, the hands of any regulator, and of public authorities generally, would be constrained by uncertainties about the process. Left unresolved, such uncertainties would only heighten the prospect that a crisis would result in an explicit guaranteeing of GSE debt.

World-class regulation, by itself, may not be sufficient and indeed, as suggested by Treasury Secretary Snow, may even worsen the situation if market participants infer from such regulation that the Government is all the more likely to back GSE debt. This is the heart of a dilemma in designing regulation for the GSE's. On the one hand, if the regulation of the GSE's is strengthened, the market may view them even more as extensions of the Government and view their debt as Government debt. The result, short of a marked increase in capital, would be to expand the implicit subsidy and allow the GSE's to play an even larger unconstrained role in the financial markets. On the other hand, if we fail to strengthen GSE regulation, the possibility of an actual crisis or insolvency is increased.

Some observers have argued that Fannie and Freddie are simple institutions with a function that is clear to all. The evidence suggests that this is far from the case. The difficulties of creating transparent accounting standards to reflect the gains and losses associated with hedging mortgage-prepayment risk highlight that the business of taking on interest rate and prepayment risk is far from simple and is difficult to communicate to outside investors.

Most of the concerns associated with systemic risks flow from the size of the balance sheets that these GSE's maintain. One way the Congress could constrain the size of these balance sheets is to alter the composition of Fannie's and Freddie's mortgage financing by limiting the dollar amount of their debt relative to the dollar amount of mortgages securitized and held by other investors. Although it is difficult to know how best to set such a rule, this approach would continue to expand the depth and liquidity of mortgage markets through mortgage securitization but would remove most of the potential systemic risks associated with these GSE's. Ideally, such a ratio would focus the business operations of Fannie and Freddie on the enhancement of secondary markets and not on the capture of the implicit subsidy.[3]

Limiting the debt of Fannie and Freddie and expanding their role in mortgage securitization would be consistent with the original Congressional intent that these institutions provide stability in the market for residential mortgages and provide liquidity for mortgage investors. Deep and liquid markets for mortgages are made using mortgage-backed securities that are held by non-GSE private investors. Fannie's and Freddie's purchases of their own or each other's securities with their debt do not appear needed to supply mortgage market liquidity or to enhance capital markets in the United States.

The expansion of homeownership is a widely supported goal in this country. A sense of ownership and commitment to our communities imparts a degree of stability that is particularly valuable to society. But there are many ways to enhance the attractiveness of homeownership at significantly less potential cost to taxpayers than through the opaque and circuitous GSE paradigm currently in place.

Even with a constraint on debt issuance, Fannie and Freddie would remain among the largest financial institutions in the United States and would be able to grow with the size of the mortgage markets. These are important organizations that, because of their implicit subsidy, are expanding at a pace beyond that consistent with systematic safety. They have made, and should—with less reliance on subsidies—continue to make, major contributions to the financial system of the United States.

In sum, the Congress needs to create a GSE regulator with authority on a par with that of banking regulators, with a free hand to set appropriate capital stand-

[3] Likewise, the ability of Federal Home Loan Banks to hold mortgages and mortgage-backed securities directly could also be limited, so that mortgage-related interest rate risks are managed by a variety of purely private investors.

ards, and with a clear process sanctioned by the Congress for placing a GSE in receivership. However, if the Congress takes only these actions, it runs the risk of solidifying investors' perceptions that the GSE's are instruments of the Government and that their debt is equivalent to government debt. The GSE's will have increased incentives to continue to grow faster than the overall home mortgage market. Because they already purchase most conforming mortgages, they, like all effective profit-maximizing organizations, will be seeking new avenues to expand the scope of their operations, assisted by a subsidy that their existing or potential competitors do not enjoy.

Thus, GSE's need to be limited in the issuance of GSE debt and in the purchase of assets, both mortgages and nonmortgages, that they hold. Fannie and Freddie should be encouraged to continue to expand mortgage securitization, keeping mortgage markets deep and liquid while limiting the size of their portfolios. This action will allow the mortgage markets to support homeownership and homebuilding in a manner consistent with preserving the safe and sound financial markets of the United States.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM ALAN GREENSPAN

Q.1 In recent years, Fannie Mae and Freddie Mac have tended to hold more loans and mortgage-backed securities in portfolio. Based on your review of available data and research, how would you respond to the assertion that these portfolio activities produce a greater reduction in interest rates than securitization activities?

A.1. While it is possible that the GSEs' portfolio holdings might lower mortgage rates slightly more than their securitization activities, to date there is no credible evidence of this effect. Although one study claims to have found such an effect (Naranjo and Toevs, 2002), this study actually seems to compare overall GSE purchase activity (mortgages purchased to securitize and hold as well as mortgages purchased to securitize and sell), not the GSEs' portfolio holdings, to mortgage securitization. The study has other methodological problems as well. Wayne Passmore and Shane Sherlund, two economists at the Federal Reserve Board, have undertaken a similar study that improves the methodology and uses more recent data. Their results suggest that GSE portfolio purchases follow from higher mortgage rates, as the GSE's pursue profit maximization, but the resultant growth in GSE portfolios does not influence mortgage rates either up or down. I have included an appendix (see Appendix 1) that summarizes their method and results. As I suggested in my testimony, the Congress should consider asking a disinterested party to organize a series of conferences or papers for studying these important issues.

In theory, there are two reasons why the GSEs' portfolio holdings might possibly yield lower mortgage rates relative to securitization. First, the GSE's might create some net new demand for mortgage assets through the debt issued to finance their portfolio. Second, the portfolio might transmit more of the GSEs' implied subsidy to homeowners than does mortgage securitization.

With regard to net new demand, it is possible some investors might strongly prefer to hold GSE debt rather than mortgage-backed securities (MBS). Most likely, these investors have this preference because they wish to avoid prepayment risks associated with MBS or because they believe that GSE debt is implicitly backed by the U.S. Government and are looking for a higher-yielding alternative with the safety of Treasury securities. In the former case, the secondary market has established that it is capable of repackaging MBS and creating securities with minimal prepayment risk, and thus GSE securities are unlikely to create any net new demand because it does not tap a unique investor base for mortgage-related debt. In the latter case, the net new demand for mortgage assets comes from investors who are either confused about the status of GSE debt or who are sophisticated market participants who believe that regardless of what the Government says, it will bailout the GSE's should they encounter financial difficulties. This demand for GSE debt is the source of the systemic risks posed by the GSE's, as well as the source of large GSE profits, because these investors do not demand that the yields on GSE debt reflect the risks associated with GSE balance sheet expansion. Whether it is the source of lower mortgage rates for conforming mortgages is difficult to determine, but the potential costs associated with possible systemic problems from the GSEs' portfolios greatly exceed the costs of slightly higher mortgage rates that might result from making it clear to investors that the Government does not back GSE debt.

The second way the GSE portfolio might lower mortgage rates is that the GSE's might pass through more of their portfolio subsidy to mortgage originators than they would pass through had they only securitized mortgages. The portfolio does indeed seem to account for a disproportionate share of the GSEs' subsidy. However, the GSEs' pricing advantage with regard to securitization alone seems to be adequate for enticing mortgage originators to sell conforming mortgages to Fannie Mae and Freddie Mac, suggesting that the higher subsidy associated with the mortgage portfolio (relative to mortgage securitization) is captured by the GSE shareholders.

Q.2. The GSE's argue that the full benefit of their funding advantage is passed along to homeowners through reduced interest rates on conforming loans. When compared to the interest rates charged for jumbo loans, the reduction in interest rates is greater than the funding advantage, producing a greater than 100 percent pass-through of the subsidy. How would you respond to this characterization of the funding advantage and to the existence of a subsidy greater than 100 percent?

A.2. The definition of subsidy implied in this question seems to sum the GSEs' funding advantage (their implicit subsidy) and the value that GSE's add to the mortgage financing process. The GSE's do add value, which is one reason why I believe that if their implicit subsidy were eliminated, they would continue to be viable and important companies that could earn a normal economic rate of return. However, their value added is not part of the implicit Government subsidy.

As for the assertion that 100 percent of the implied subsidy is passed through to mortgage borrowers, this appears to be false. As I noted in my testimony, Fannie Mae's and Freddie Mac's persistently higher rates of return for bearing the relatively low credit risks associated with conforming mortgages are evidence of a significant implicit subsidy. A study by Federal Reserve economist Wayne Passmore attempts to quantify the value of that implicit subsidy to the private shareholders of Fannie Mae and Freddie Mac. Consistent with studies conducted by the CBO, his study suggests that these institutions do not pass on much of the benefit of their Government sponsored status to homeowners in the form of lower mortgage rates.

Indeed, Passmore's analysis suggests the amount that Fannie Mae's and Freddie Mac's implied subsidy lowers mortgage rates is likely less than 16 basis points, with a best estimate centering on about 7 basis points. Earlier studies yielded slightly higher figures. For example, analysis conducted by CBO (2001) estimated the effect to be between 18 basis points and 25 basis points. Passmore's lower estimate is a result of newer data and a different technique that builds on earlier studies of this difference. Passmore's studies have been critiqued by several prominent economists. However, these critiques do not seem to change the results. I have attached an appendix (see Appendix 2) that responds to some of these critiques. As I mentioned above, the Congress may want to engage a disinterested party to examine these issues. We welcome comments on studies by Federal Reserve staff.

Q.3.a. Fannie Mae's and Freddie Mac's outstanding debt and mortgage-backed securities are held by banks, pension funds, and foreign governments. In addition, their hedging activities link them to many other large financial institutions. How do bank supervisors currently monitor the GSE debt and MBS's holdings of insured institutions and how do they measure the potential risk of these holdings?

A.3.a. Mortgage-backed securities of all types account for about 10 percent of the banking industry's assets, while agency securities (including direct obligations of GSE's) account for about 3 percent. Because these securities carry relatively little credit risk, they generally do not figure significantly in supervisory assessments of credit quality.

Supervisors thus monitor a bank's mortgage-backed securities and, to a lesser extent, holdings of GSE debt as part of assessing the institution's interest rate risk exposure, These instruments can contribute significantly to a bank's interest rate risk position because of their multiyear maturities and, in the case of mortgage-backed securities, the embedded options they carry associated with prepayments on the underlying mortgage loans.

As is discussed more fully in the response to question 5, supervisory efforts focus on assessing the adequacy of internal processes and risk measures relative to the institution's holdings and, more broadly, identifying "outlier" institutions with potentially excessive levels of risk. All banking organizations are required to have management processes, controls and measurement systems that are commensurate with the risk characteristics of the instruments they hold. Banks with significant mortgage-related holdings are expected to have risk processes and measures that take account of the complexities present in such instruments, including the risks associated with prepayments.

To assist supervisors (and the public) in monitoring these positions and the risks they may entail, commercial banks are required to provide information on GSE- and MBS-related holdings in their quarterly regulatory call reports. Banks provide information on the mortgage pass-through and other mortgage-backed securities they own, as well as direct obligations of GSE's and other Government agencies. Banks also report the contractual maturity of, and the presence of unrealized gains or losses on, their mortgage-backed securities, as well as the extent to which they are issued or guaranteed by Fannie Mae or Freddie Mac. Supervisors use these data in conjunction with a variety of screening tools to identify those institutions with the most significant risk profiles and devote greater attention to them in the examination process.

Q.3.b. How do bank supervisors review the activities of the bank counterparties to Freddie and Fannie?

A.3.b. Large banks that operate a dealer book in interest rate derivatives sell interest rate protection to their customers, including Fannie Mae and Freddie Mac, often as part of a broader business relationship that may include the provision of investment banking and other services to the GSE's.

The ongoing supervisory process at these large institutions includes targeted examinations and continuous monitoring by resident examiners, much of which is directed at their dealer activities. Supervisors expect these banks to maintain the proper risk management processes and controls in their dealer operations including customer due diligence, ongoing measurement of counterparty credit risk exposures, clearly defined counterparty limits and thresholds, and appropriate use of credit mitigation techniques such as margin and collateral requirements. A significant portion of the supervisory process is devoted to the review of risk management processes, controls, and measurement tools, including measurement systems that estimate value-at-risk and the potential future credit exposure associated with derivative positions. Supervisory personnel routinely review internal reports from these institutions describing their exposures and positions, including listings of the bank's largest derivative counterparties and credit exposure to these counterparties.

Q.4.a. Subordinated debt is valued as a tool in enhancing market discipline by proving a measure of the perceived risk profile of the issuer. How does GSE subordinated debt compare to GSE senior debt? Is the difference comparable to that of bank holding company subordinated debt versus BHC senior debt?

A.4.a. The available evidence suggests that GSE debt spreads are sensitive to financial and political risks. GSE senior debt spreads over comparable maturity Treasury securities rose following the September 2002 Fannie Mae duration gap disclosure, the June 2003 Freddie Mac management shake-up, and the July 2003 announcement by the European Central Bank that it would eliminate its holdings of debt issued by Fannie Mae and Freddie Mac and that it would advise its national central banks to do the same (see figure entitled GSE Debt Spreads, top panel). Subordinated debt spreads over comparable maturity Treasury securities also rose in response to these events (see GSE Debt Spreads, middle panel).

During the January 2002–December 2003 period, the average difference between subordinated debt spreads and senior debt spreads for the two GSE's were virtually identical, equaling about 46 basis points each for Fannie Mae and for Freddie Mac. Moreover, such differences did not increase after the events listed above, even though some of the events were specific to only one of these GSE's. Over the same period, the average differences between subordinated debt spreads and senior debt spreads for highly rated bank holding companies were considerably smaller. For example, Wells Fargo & Company and Citigroup (which had the same Moody's subordinated debt rating (Aa2) as did the two GSE's) had average differences between subordinated debt spreads and senior debt spreads of 16 and 30 basis points, respectively.

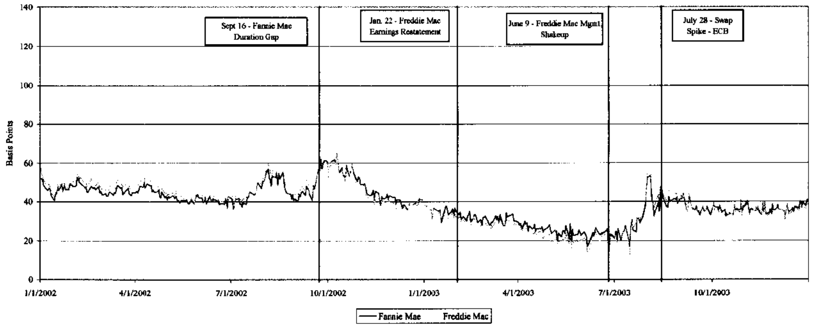
The differences between subordinated debt spreads and senior debt spreads are not directly comparable across GSE's and bank holding companies because GSE subordinated securities contain an interest deferral provision that is not a feature of *bank holding* *company* subordinated securities.[1] It is the case that subordinated debt instruments issued by banks contain an interest deferral provision.[2] When *bank* level differences between subordinated and senior debt spreads are compared with GSE differences between subordinated and senior debt spreads, they are more comparable and of similar magnitude (see GSE Debt Spreads, bottom panel). For example, the difference between subordinated and senior spreads for Wells Fargo Bank, N.A., averaged 52 basis points during January 2003–December 2003, which is of similar magnitude to the difference between subordinated and senior spreads for Fannie Mae and for Freddie Mac, which averaged 47 and 48 basis points, respectively, over the same period.

[1] Under terms of the voluntary commitment, the payment of interest on all outstanding GSE securities must be deferred if: (1) core capital falls below 125 percent of its "critical capital" requirement, or (2) core capital falls below minimum capital levels, and pursuant to the company's request, the Secretary of the Treasury exercises his or her discretionary authority to purchase the company's debt obligations under Section 304(c) of the Company's Charter Act.

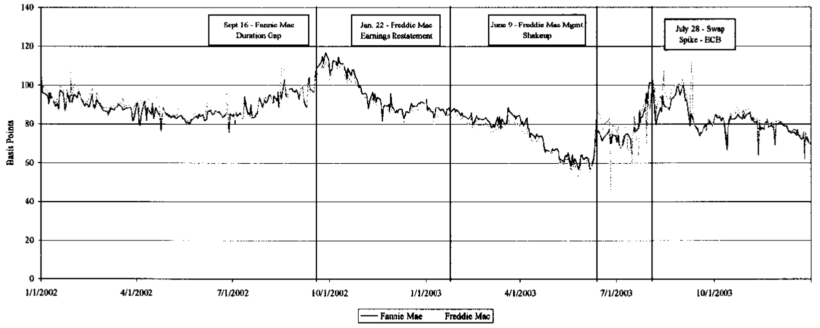
[2] Under the system of Prompt Corrective Action, 60 days after a bank is determined to be critically undercapitalized, it cannot make payments on subordinated debt without regulatory approval.

GSE Debt Spreads

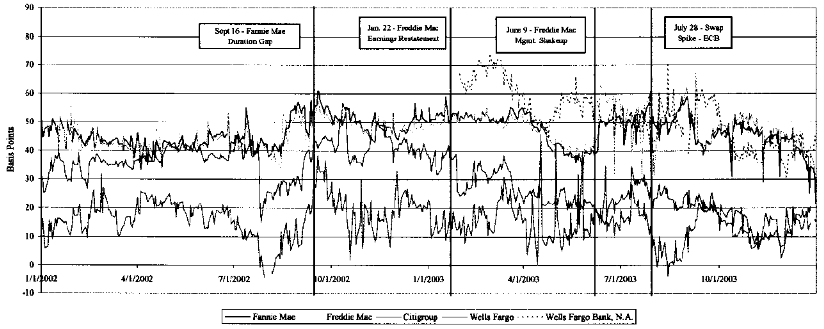
GSE Senior Debt Spreads over Comparable Maturity Treasury Securities
(Daily Data, January 2002 - December 2003)



GSE Subordinated Debt Spreads over Comparable Maturity Treasury Securities
(Daily Data, January 2002 - December 2003)



Differences Between Subordinated Debt Spreads and Senior Debt Spreads, Selected Entities
(Daily Data, January 2002 - December 2003)



NOTE: Debt spreads are calculated using Bloomberg generic prices using a 3-step procedure. First, yields on each bond are derived from prices using the Newton-Raphson iterative method. Second, the term structure of Treasury interest rates are identified for each date using a smoothing spline of the forward rate curve. Third, spreads are calculated as the difference between the derived bond yield and the interpolated Treasury yield of the same maturity. And, floating rate yields are converted to fixed rate yields using SWAPS market data.

Q.4.b. Should the Congress consider permitting the new regulator to include sub debt as a component of capital? Is there a reason to treat GSE's differently than banks?

A.4.b. As I stated in my testimony, the Congress should give the new GSE regulator clear authority to establish and modify the capital standards for the housing finance GSE's, which would include the ability to define what constitutes capital for purposes of these capital measures. Accordingly, the inclusion of subordinated debt as a component of capital should not be explicitly allowed or disallowed by statute. Rather, the decision of whether, how, or to what extent, subordinated debt should be treated as capital of a housing finance GSE should be delegated to the regulator, which can review and analyze these issues with a full understanding of the capital structure, operations, and risks of the GSE's.

The Federal Reserve has found that the ability to establish and amend all relevant capital requirements and the definition of what constitutes capital is crucial to carrying out the mission of maintaining the safety and soundness of supervised institutions. Having the ability to establish capital adequacy requirements and amend them over time provides supervisors with the flexibility to update the requirements as needed to ensure that they adequately capture banking risks, which tend to change relatively rapidly given the fast pace of change in the industry and in the environment in which these institutions operate. In light of market innovations in capital instruments, revisions in accounting rules, advances in techniques for measuring exposure to risk, and the natural tendency of institutions to arbitrage capital rules, if the banking regulators did not have the ability to revise the capital adequacy rules, the standards over time would become increasingly disconnected from the supervised entities' actual risk profiles and their usefulness would diminish.

Q.5. The current risk-based capital standard for Fannie Mae and Freddie Mac includes an interest rate component. The existing risk-based capital standard for commercial banks does not include such a component and is more focused on credit risks. How do bank supervisors evaluate the interest rate risk of banks? How does this assessment factor into a calculation of capital adequacy for each institution?

A.5. Regardless of their size or complexity, banking organizations are required to have interest rate risk management and measurement systems commensurate with the level and complexity of their risk profiles. The adequacy of these systems is evaluated within the ongoing supervisory process. Beginning in 1997, a new component was added to the interagency CAMEL bank rating system, now called CAMELS with the "S" standing for sensitivity. This new component evaluates an institution's ability to monitor and manage market risk, which in most cases is related to interest rate risk.

Supervisors monitor interest rate risk positions of banks through the supervisory process, which is oriented to identifying those banks with relatively large risk positions—so-called "outlier" institutions. This approach reflects the experience that interest rate risk has historically not been a significant cause of failures in the commercial banking industry. This is due to the diversification of bank assets, the presence of significant core deposits as a funding source, and the strong capital positions typically maintained by banks.

For smaller institutions, supervisors apply a variety of screening tools using data provided on regulatory reports to identify those banks with the most significant risk profiles. Given the prepayment options associated with mortgage-backed securities, holdings of these instruments factor into many of these screens. Examiners devote greater attention to interest rate risk issues in the supervision of "outlier" institutions.

At larger institutions, where positions are more difficult to assess using standard regulatory reports, supervisors rely more heavily on monitoring internal risk management reports through continuous supervision. This includes ongoing monitoring of internal risk measures, results of internal interest rate stress tests, limit reports and other tools routinely used in the management of the business. In particular, examiners consider in their assessments the internal estimates of the potential effect of stressful interest rate environments on the profitability and capital adequacy of the bank.

It is important to add that the risk-based capital requirements include not only the specific quantitative standards but also a series of factors cited in regulation that are to be considered in assessing a bank's capital adequacy, including interest rate risk. A bank with an outsized interest rate risk position could thus be required by its supervisor to hold additional capital beyond the regulatory minimum in light of that position, or alternatively to reduce its risk exposures.

Q.6.a. Your written testimony asserts that "Fannie Mae's and Freddie Mac's purchases of their own or each other securities with their debt do not appear needed to supply mortgage market liquidity or to enhance capital markets in the United States." You suggest "deep and liquid markets" that are provided by MBS's held by private investors. However, what effect, if any, would we see on liquidity in the mortgage market were the GSE's prevented from holding these securities in their portfolio?

A.6.a. I am not aware of any evidence that convincingly shows we would see an effect on liquidity if the Congress channeled GSE activity toward mortgage securitization and away from holding mortgage-backed securities in portfolio. It is securitization itself, not the GSEs' purchases of their own securities, that provides the liquidity benefits and there are many purchasers of GSE mortgage-backed securities in the markets. Thus, it is not clear why there would be any effect during periods of normal market functioning because capital markets in the United States are deep and liquid. When financial markets are in trouble, such as in 1998, investors often flee to the safety of Treasury securities—a so-called "flight to quality" that I noted during my testimony. Prices for corporate bonds, for State and local government bonds, for mortgage-backed securities, and for other asset-backed securities fall and their yields rise relative to yields on Treasury debt as the markets attempt to reassess the extent and depth of the crisis. At the same time, the prices of Treasury securities rise and their yields fall, as investors pay more for the safety and soundness provided by Federal Government debt.

Because Fannie Mae, Freddie Mac, and the Federal Home Loan Banks have ties to the Government, investors treat GSE debt as a near-substitute for Treasury debt. Thus, during market crises, the prices of implicitly insured GSE debt rise and their yields fall because some market participants flee toward GSE debt. Fannie Mae and Freddie Mac do what any profit-making financial entity would do when their funding costs fall and the yields on the assets they purchase rise—they issue more debt and they buy more assets. They undertake these activities not because of a concern for financial stabilization but because they maximize profits for their shareholders. This response may contribute to stability, but there is nothing unique about it with regard to Fannie Mae and Freddie Mac being GSE's. Other profit-maximizing entities in the financial markets behave in a similar manner.

As I noted in my testimony, for those who continue to have a concern about the GSEs' portfolio holdings, directing Fannie Mae's and Freddie Mac's activities toward mortgage securitization would still leave the GSE's with substantial portfolios and would allow them to grow with the mortgage markets. Whatever liquidity benefits they bring to the markets, if any, likely can be supported by GSE's with a greater emphasis on mortgage securitization and with less emphasis on enhancing their subsidy by holding their own MBS.

Q.6.b. Would this be true in both good and bad economic times?

A.6.b. As I stated above, I am not aware of a convincing argument that suggests that GSE's are a necessary part of market liquidity in either good or bad times. The Federal Reserve has, in the past, acted to stabilize markets and once we have acted, profit-maximizing entities reenter financial markets. The GSE's may sometimes tend to enter more quickly than other entities after the Federal Reserve has stabilized markets because their access to implicitly insured Government debt may yield greater profits during these times, but this aspect of the subsidy is not needed for financial stabilization.

Appendix 1

Naranjo and Toevs (2002) Revisited

Wayne Passmore and Shane Sherlund

3/22/2004

In a study commissioned by Fannie Mae, Naranjo and Toevs (2002) find that GSE securitization activity and mortgage purchases raise the jumbo-conforming spread and lower the conforming-constant maturity Treasury (CMT) and jumbo-CMT mortgage rate spreads. Further, they conclude that total mortgage purchases are 30 percent more productive than securitization activity at lowering the conforming-CMT spread. Their results are based on cointegration analysis procedures, which are commonly used to identify long-run relationships between variables.

We update the Naranjo and Toevs (N&T) study to coincide with the more recent sample period used in the Passmore, Sherlund, and Burgess (PSB) study – April 1997 through May 2003 (N&T use data from 1986 through 1998). Further, we modify the N&T approach in four important ways. First, we use portfolio purchases, defined as whole loans and retained MBS, as a measure of Fannie Mae's portfolio activity, instead of Fannie Mae's total mortgage purchases. Second, we divide both securitization *and* portfolio purchases by total originations (N&T normalize only their measure of securitization). Third, we estimate the marginal effects of portfolio purchases and securitization on mortgage rate spreads jointly (N&T estimate these effects separately and therefore confound the effects of purchases and securitization). Finally, we recognize that the long-run cointegrating relationship does not specify a causal relationship (N&T did not recognize this in their analysis). We therefore use hypothesis tests on the speed of adjustment parameters and Granger causality tests to ascertain the direction of causality.

Does the Data Exhibit Stationarity?

To begin, we verify the stationarity properties of our data. Regressing one nonstationary variable on another generally leads to spurious results, i.e., an apparent relationship when indeed there is none. But cointegration analysis avoids the problems associated with spurious results by formulating a linear combination of nonstationary variables that is itself stationary. This linear combination can be interpreted as a long-run relationship between variables. Any deviation from the long-run equilibrium eventually is self-correcting over time.

We use augmented Dickey-Fuller test statistics for each of the variables in our analysis to test for stationarity (table 1). As shown, each of the variables is nonstationary in levels, but stationary in first differences. Thus, each variable is integrated of order one, and we can proceed to estimating a long-run cointegrating relationship. The long-run cointegrating relationship, should one exist, specifies the linear combination of the nonstationary variables that itself is stationary.

Table 1: Unit root tests

ADF Test Statistics	Levels	First Differences
Jumbo-Conforming Spread	-2.57	-4.53
Conforming-CMT Spread	-3.31	-4.90
Jumbo-CMT Spread	-3.35	-4.86
log(Securitization/Originations)	-3.31	-4.98
log(Portfolio Purchases/Originations)	-2.66	-5.80

Reject the hypothesis of a unit root (nonstationarity) if test statistic less than -3.46 (95% confidence level).

Examining Data Cointegration

Do long-run cointegrating relationships exist between particular mortgage rate spreads (conditional on measures of credit and prepayment risk), Fannie Mae's portfolio purchases, and Fannie Mae's securitization activity? The estimated cointegrating vectors (shown in the top panel of table 2) imply long-run relationships of the form:

J-C Spread = 0.217*Securitization + 0.588*Portfolio Purchases,
C-CMT Spread = 0.934*Securitization + 0.332*Portfolio Purchases, or
J-CMT Spread = 1.136*Securitization + 0.302*Portfolio Purchases.

Note the positive relationships between the mortgage rate spreads and securitization and between the mortgage rate spreads and portfolio purchases. This result is strikingly different from the results of N&T and suggests that higher securitization and portfolio purchases actually increase mortgage rate spreads.[1] However, estimated cointegrating relationships are not unique and we suggest a different and equivalent set of long-run relationships, which are normalized by portfolio purchases rather than mortgage spreads. Our proposed system takes the form:

Portfolio Purchases = 1.701*J-C Spread - 0.369*Securitization,
Portfolio Purchases = 3.012*C-CMT Spread - 2.813*Securitization, or
Portfolio Purchases = 3.311*J-CMT Spread - 3.762*Securitization.

In these relationships, portfolio purchases increase with mortgage rate spreads but decrease as securitization increases. Under this interpretation, Fannie Mae purchases when it finds it most profitable – while spreads are high – and this effect is offset to some extent by securitization activity.[2]

For completeness, we present additional results comparable to those of N&T (the second and third panels of table 2). A ten percent increase in securitization activity increases the conforming-CMT spread by about 9 basis points, whereas as ten percent increase in portfolio purchases increases the conforming-CMT spread by about 3 basis points. But as noted above, we do not necessarily accept N&T proposed relationships, which for our data suggest that GSE activities increase mortgage rates. Instead, we reverse the causality and suggest that if the conforming-CMT spread increased by 10 basis points then some combination of changes in securitization and portfolio purchases must result that offsets the change in the confroming-CMT spread (as shown in the bottom panel of table 2).[3]

[1] One explanation of this difference is that the long-run relationship does not imply any directional causality (we examine this below). While it certainly could be the case that spreads move to reflect changes in securitization and purchases in N&T's earlier sample, this does not appear to be the case in a more recent time period.

[2] Note that these results are *extremely* sensitive to lag-length selection, choice of exogenous variables, and functional form. This could be due to the small sample size (only 74 months) or because of a very tenuous long-run relationship. It should also be noted that Johansen's full-information approach (used here and in N&T) does not have good small-sample properties.

[3] Without such a return to the long-run equilibrium, the series could not be cointegrated and such an estimated long-run relationship could be spurious.

Table 2: Mortgage Rate Spread Cointegration Analysis

	J-C Spread	C-CMT Spread	J-CMT Spread
Normalized Cointegrating Vector			
Mortgage Rate Spread	1.000	1.000	1.000
log(Securitization/Originations)	0.217	0.934	1.136
log(Portfolio Purchases/Originations)	0.588	0.332	0.302
Effect of 10% Increase in Fannie Mae Activity on Mortgage Rate Spreads (bps)			
log(Securitization/Originations)	2.2	9.3	11.4
log(Portfolio Purchases/Originations)	5.9	3.3	3.0
Effect of $1 Billion Increase in Fannie Mae Activity on Mortgage Rate Spreads (bps)			
log(Securitization/Originations)	0.6	2.4	3.0
log(Portfolio Purchases/Originations)	3.0	1.7	1.5
Effect of 10 bp Increase in Mortgage Rate Spreads on Fannie Mae Activity (percent)			
log(Securitization/Originations)	46.0	10.7	8.8
log(Portfolio Purchases/Originations)	17.0	30.1	33.1

Investigating the Causal Relationships between Spreads and GSE Activity

Do changes in mortgage rate spreads bring about changes in Fannie Mae securitization and portfolio purchases, or vice-versa? The speed of adjustment parameters that coincide with the estimated cointegrating vector provide some insight on the direction of causality. These parameters tell us how quickly each variable responds to deviations from the long-run relationship or, in other words, whether each variable is "weakly exogenous" to the system. Variables that respond quickly to shocks at least have the possibility of being "caused" by variables that respond slowly to disequilibria. However, we do not find statistical evidence of differences in the speed of adjustment parameters for the three variables in the analysis: mortgage spreads, portfolio purchases, and securitization, suggesting that none of the variables clearly cause movements in the other variables.

In order to better pin down the causal relationship(s), we conduct Granger causality tests. The results of these tests are reported in Table 3.[4] As shown, we conclude that causality generally seems to run from mortgage rate spreads to Fannie Mae's activities. That is, Fannie Mae's activities appear to react to changes in mortgage rate spreads, not vice-versa. Note that we cannot reject the hypothesis that portfolio purchases do not Granger cause mortgage rate spreads, while more often than not we can conclude that mortgage rate spreads do Granger cause portfolio purchases. We therefore conclude that the N&T normalization and the resulting implication that changes in Fannie Mae's activities bring about changes in mortgage rate spreads seem ill-founded.

Table 3: Granger Causality Tests

	J-C Spread	C-CMT Spread	J-CMT-Spread
Securitization → Spread	No	No	Yes
Portfolio Purchases → Spread	No	No	No
Spread → Securitization	Yes	Yes	Yes
Spread → Portfolio Purchases	No	Yes	Yes

$x \rightarrow y$: Reject the null hypothesis that x does not Granger cause y (causation flows from x to y).

Conclusion

To recap, the Naranjo and Toevs (2002) study suggests that Fannie Mae's purchases are 30 percent more effective than securitization activities in lowering mortgage rates. We update the Naranjo and Toevs study using more recent data and implementing some important modifications (namely, we use (1) portfolio purchases instead of mortgage purchases, (2) a consistent measure of Fannie Mae's

[4] Granger causality tests test the null hypothesis that past values of the explanatory variable (x) have no effect on the dependent variable (y). If a lagged value of x does have a statistically significant effect on y then we reject the null hypothesis that x does not Granger cause y, so that $x \rightarrow y$.

activities, (3) joint estimation of the marginal effects, and (4) proper interpretation of the long-run cointegrating relationship). In contrast to Naranjo and Toevs, we find a positive relationship between the volume of Fannie Mae's activities and mortgage rate spreads. Further, we conclude that the nature of causality appears to flow from mortgage rate spreads to Fannie Mae's activities, contrary to the assumption of Naranjo and Toevs.

Appendix 2

Response to Comments by Professor William Greene and Professor Alan Blinder on Passmore (2003) and Passmore, Sherlund and Burgess (2003)

Wayne Passmore and Shane Sherlund
3/22/2004

Professor William Greene's Comments

Dr. Greene raises several concerns about econometric specification and techniques. First, he cites an ambiguity in measuring the jumbo-conforming spread. The Passmore, Sherlund and Burgess (PSB) regression analysis includes indicator variables for both jumbo loans and for smaller loans (those with principal balances less than $100,000). The estimated coefficients on these two indicator variables therefore reflect the premium (or discount) in pricing these types of loans relative to moderately-sized (neither small nor jumbo) loans. PSB's average estimate of the coefficient on the jumbo loan indicator variable is about 16 basis points – which we call the jumbo-conforming spread, since it measures the pricing difference between moderately-sized and jumbo loans.

As pointed out by Dr. Greene, however, an ambiguity arises because of the inclusion of the small loan indicator variable. If we want to compare small loans with jumbo loans, we need to take into account not only the estimated effect of jumbo status, but the effect of small-loan status as well. PSB's average estimate of the coefficient on the small loan indicator variable is 14 basis points, indicating that small loans cost, on average, 14 basis points more than comparable moderately-sized loans, implying that the jumbo-conforming spread for small loans is only 2 basis points. Thus, for a generic conforming loan (either small or moderately-sized) the jumbo-conforming spread lies between 2 and 16 basis points (a weighted average gives an estimate of about 12 basis points), suggesting that the subsidy retained by GSE shareholders may be greater than that presented in Passmore (2003). We believe that comparing moderately-priced loans to jumbo loans gives a better comparison for the purpose of understanding the affect of GSEs, mainly because the generally higher small loan rates might reflect diseconomies of scale.

Second, Dr. Greene questions the two-step procedure used in the PSB study because the estimates might be inefficient. Efficiency is not an argument about whether or not our coefficients are accurate, but instead about the effective use of the information provided by the sample. We argue that our estimates are *not* necessarily inefficient given the underlying data structure. PSB conduct what is called multilevel data analysis – analysis on some data that are micro-level (individual loans) and other data that are macro-level (monthly macro variables). In this context, all that is needed in terms of efficiency is large group sizes (number of loans per month) and a relatively small number of groups (total number of months), both of which are satisfied with the MIRS data.[1] Dr. Greene seems to believe that the econometric specification focuses on the first-step equation and therefore falls within a random coefficients framework. Under the random coefficients framework, estimates are best obtained through a one-step approach in which the second-stage equation is substituted into the first-stage equation prior to estimation. But PSB's analysis (the estimate of ω) actually focuses on the second-step equation, in which the estimates of the jumbo-conforming spread are regressed against the GSE debt advantage and other variables reflecting risk and economic conditions. This equation requires *some* estimate of the jumbo-conforming spread, which, in this paper, is derived from the first-step estimation. Using a different way to derive the jumbo-conforming spread--the monthly difference between average jumbo and conforming rates--produces similar, albeit smaller, estimates of ω.[2] We believe that PSB's monthly first-step regressions more accurately pin down the jumbo-conforming spread than does using monthly averages.

Overall, incorporating Dr. Greene's remarks seems to generally lower our estimate of mortgage rate reduction produced by GSEs and thus raises our estimate of the GSE subsidy retained by shareholders.

Professor Alan Blinder's Comments

Dr. Blinder raises several concerns with the Passmore (2003) study. His main concern lies within the realms of sensitivity analysis – how sensitive are the results to changes in underlying assumptions? For example, Dr. Blinder cites the apparent sensitivity of the retained subsidy to the mortgage rate savings to homeowners, noting that Passmore's estimate of the mortgage rate savings is smaller than in previous studies. If we were to use these other studies' larger estimates of the mortgage rate savings, the retained subsidy would be smaller. This is certainly the case and Passmore himself explores the sensitivity of the retained subsidy to different estimates of the mortgage rate reduction (see the lower-right panel of exhibit 6 in Passmore's paper). But the question is whether these other studies provide an accurate estimate of the mortgage rate reduction for homeowners or whether the technique used in PSB is better. We prefer our estimate because it uses better data and because it attempts to parse the jumbo-conforming spread into components that are a result of the GSEs' ambiguous relationship to the government and those that are a result of characteristics of the conforming mortgage markets that likely would persist regardless of the GSEs' relation to the government.

[1] Note that we already adjust our standard errors to reflect the effects of heteroskedasticity, first-order autocorrelation, and clustering by month.

[2] Naranjo and Toevs (2002) also recognize the problem of grouping micro- and macro-level data (see footnote 12). However, they consider monthly averages because they use jumbo and conforming spreads to Treasuries in addition to the jumbo-conforming spread estimated in the first-step regression.

Dr. Blinder also discusses the random component to estimation, i.e., the range of parameter estimates implied by standard errors. In talking about Passmore's pass-through estimate, Blinder states that "the point, once again, is that the range of uncertainty is large." However, the estimate of the pass-through coefficient (ω) is 16.4 percent, with a standard error of 9.2 percentage points. We therefore reject the hypothesis that the implied subsidy is passed through in its entirety to homeowners via reduced mortgage rates. (We cannot, however, reject the hypothesis that none of the subsidy is passed through to homeowners at conventional confidence levels.)

Dr. Blinder writes that the GSE funding advantage is not a product of the implicit subsidy alone, the jumbo-conforming spread is not due to the GSE funding advantage alone, and homeownership rates are not only affected through mortgage rates. We acknowledge, and indeed argue in favor of, these points. In fact, our estimation attempts to control for economies of scale and efficiency found in the conforming MBS market (to remove this effect from the GSE funding advantage), and models the jumbo-conforming spread as not only a function of the GSE debt advantage but of other variables as well – to account for the GSEs' business operations and overall economic conditions. *We agree with Dr. Blinder that one must try to distinguish between the mortgage rate reductions generated by the business operations of an effective and efficient mortgage securitizer from those generated by the GSE subsidy.*

Finally, as noted in Passmore's paper, we also agree that reducing mortgage rates is an inefficient way to increase homeownership relative to providing downpayment assistance, credit enhancements, and tax benefits. However, the GSEs, by the nature of their charters, play only a limited role in these initiatives.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR ALLARD FROM ALAN GREENSPAN

Q.1. As you know, as a conservator OFHEO currently has no legal authority to reorganize or liquidize if their liabilities exceed their assets. In our last hearing on GSE's, Comptroller Walker of the General Accounting Office asserted that the authority of receivership should be in the "toolbox for extreme cases." Would you please share your thoughts on whether or not the new regulator should have receivership authority in order to be able to resolve a potential shortfall in assets?

A.1. Financial markets do not behave well with ambiguous law and hence it is highly desirable that the process for resolving an insolvent GSE be clarified by the Congress before such a process is needed. Current law permits the Director of OFHEO to act as conservator of a financially troubled GSE and, in this role, continue to operate the Enterprise. However, in order to continue to operate the Enterprise as a going concern, OFHEO would need funds to pay the insolvent Enterprise's obligations as they became due and, to avoid disruptions in the mortgage market, fulfill the Enterprise's commitments to purchase mortgages. Because the Enterprise in conservatorship would, by definition, be experiencing significant financial difficulties, it likely would not be able to borrow against the Enterprise's own creditworthiness. Current law does not answer the question of how OFHEO quickly would obtain the billions of dollars needed to continue the Enterprise's operations and meet its existing obligations.

The financial markets have interpreted the ambiguous nature of current law, and the lack of a clear and credible process for ensuring that the creditors of an insolvent Enterprise bear some risk of loss, as equivalent to a de facto guarantee that the U.S. Government would step in to provide funding to an Enterprise experiencing financial difficulties. If the Congress believes the financial markets are correct in this assumption, then it should consider making this guarantee explicit and removing the disclaimer from GSE debt that currently states that GSE debt is not guaranteed by the U.S. Government.

On the other hand, if GSE debt is not in fact supported by an implicit or explicit guarantee, then the Congress should establish a clear and credible framework for the resolution of an insolvent Enterprise that includes the authority and processes for ensuring that the creditors of the Enterprise bear some risk of loss. There are several ways that the Congress may choose to establish such a framework. For example, one option would be to provide a mechanism for the reorganization of an insolvent Enterprise under the Bankruptcy Code. The Bankruptcy Code provides the framework for the resolution and reorganization of other private entities that are not backed by Government guarantees or creditor protection schemes and its rules, procedures, and consequences are both well-developed and well-understood by market professionals. Alternatively, the Congress could seek to develop another framework for the resolution of an insolvent Enterprise that explicitly provides for the "haircutting" of creditors. If the Congress decides to follow this route, however, it should be careful to ensure that the framework established is clear and comprehensive and does not create or perpetuate a perception that the debt of Fannie Mae or Freddie Mac—both of which are private companies—bears implicit or explicit Government backing.

Q.2. I understand that you believe a housing regulator should, like other major bank regulators, have the authority to prescribe minimum and risk-based capital standards. If the regulator is given the statutory authority to determine capital standards, is there an existing model that you believe would work well to carry out this duty? Or rather, would an entirely new model need to be created, given the magnitude of the GSE's?

A.2. In my view, the broad statutory authority the banking agencies have to establish capital standards and safety and soundness regulations for their supervised institutions provides an appropriate model for the statutory authority that should be granted to the housing finance GSE regulator. Under existing law, the Federal banking supervisors have explicit statutory authority and broad flexibility to define capital and establish capital standards for banks. For example, the banking agencies have the ability to set the leverage and risk-based capital thresholds at which an institution becomes undercapitalized, significantly undercapitalized, or critically undercapitalized, and have the ability to establish additional capital standards for banking institutions other than the existing leverage and risk-based standards. Moreover, while banks are subject to one statutory capital requirement (a tangible equity to total assets ratio of 2 percent), the banking agencies have the ability to *raise* this threshold if they deem it appropriate. In addition and importantly, the Federal banking agencies have broad statutory authority to adopt regulations or take other actions that are necessary or appropriate to ensure the safety and soundness of banking institutions. This authority, which is an important complement to the capital authority, allows the banking agencies to address financial and operational weaknesses at an institution before these weaknesses undermine the institution's capital.

Q.3. In nature, Fannie Mae and Freddie Mac differ from the Federal Home Loan Banks. For example, Fannie and Freddie differ from the Federal Home Loan Banks in terms of ownership—Fannie and Freddie are owned by their private shareholders while the Federal Home Loan Banks are owned by their members, who are, for the most part, private financial institutions. Some have proposed that having one regulator for all three entities is the way to go. As this may end up being the case, what do you believe would be an appropriate structure to address the differences between Fannie and Freddie and the Federal Home Loan Banks within the regulating body?

A.3. As I have said previously, I believe it would be appropriate for the new regulator of Fannie Mae and Freddie Mac to also be responsible for the Federal Home Loan Banks (FHLB's). Traditionally, the FHLB's have been portfolios lenders who acted mainly as intermediaries between capital markets and mortgage lenders. They essentially pass-through capital market funding to the mortgage lenders, taking a passive role in the process. Over the past decade, however, the FHLB's have evolved into active portfolio managers who offer financial options to their members. With their large portfolios, the risks involved in hedging these options can be large and, as with Fannie Mae and Freddie Mac, difficult to evaluate and worrisome given the size and scope of the portfolio.

One check on growth in the FHLB System has been its cooperative ownership structure and its need not to compete directly with its owners. The force of these traditional checks, however, appears to have diminished over time and the FHLB System seems to be functioning more like a profit-seeking enterprise, looking for new investment opportunities and products. I believe this is a development that the Congress should monitor closely and that a new GSE regulator should have full authority to review and approve these activities.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM ALAN GREENSPAN

Q.1.a. In your written testimony on February 24, 2004, you conclude that various studies indicate that a "substantial portion of these GSEs' implicit subsidy accrues to GSE shareholders in the form of increased dividends and stock market value" instead of homebuyers. In light of their stellar recent financial performance and the implied Federal benefits that are not passed on to homebuyers, what more do you believe the GSE's could be doing to increase homeownership?

A.1.a. As I stated in my testimony, Fannie Mae's and Freddie Mac's persistently higher rates of return for bearing the relatively low credit risks associated with conforming mortgages are evidence of a significant implicit subsidy. Forcing the GSE's to pass through to homeowners more of the implicit subsidies generated by their large portfolios and associated debt issuance could involve potential systemic problems for the GSE's that would, in my view, greatly exceed possible benefits from the lower mortgage rates that might result from creating such a system. This is particularly true since these benefits could be realized by actions that focus the GSE on mortgage securization and not on portfolio holdings.

Homeownership is not well-served if the methods used to finance mortgage debt also create the possibility of systemic financial difficulties that potentially could adversely affect many households, as the current system does. If the Congress desires to efficiently pass through the Government's credit advantages through GSE's to homeowners and also to avoid systemic risk problems, it should consider explicitly insuring GSE debt and limiting GSE profits. If the Congress does not wish to explicitly insure GSE debt, it could pursue on-budget homeownership initiatives that deal directly with households' downpayment and credit history difficulties, which research suggests are significant barriers to homeownership.

Q.1.b. In your testimony, you suggest that the Affordable Housing Goals set by HUD for Fannie and Freddie are an "inefficient method" of passing the Fannie's and Freddie's implied Federal benefits to homeowners. Furthermore, in Mr. Rice's written testimony for the February 25, 2004 hearing, he suggests that the FHLB's Affordable Housing Program is a more effective method of achieving housing mission goals than Affordable Housing Goals: "Though we appreciate the goals the other housing GSE's maintain, we believe that in addition to greater consumer access to credit, one of the best ways of passing along our subsidy is through our Affordable Housing Program and the direct 10 percent contribution made by each of the 12 Home Loan Banks annually." How might the GSEs' implied Federal benefits be passed more efficiently on to homeowners? Please elaborate.

A.1.b. As I urged in my testimony, one way for the Congress to achieve this goal would be to refocus Fannie Mae's and Freddie Mac's activities toward mortgage securitization and away from holding their own mortgage-backed securities in their portfolios. If the estimates of Wayne Passmore and others are correct, the GSE's are inefficient mechanisms for the transfer of a subsidy to homeowners because the shareholders of the GSE's effectively extract a large portion of the benefits from their implied subsidy. On the other hand, mortgage securitization by itself appears to be sufficient for transmitting the benefits of the secondary mortgage markets to homeowners.

If the same mortgage rate reduction can be achieved through mortgage securitization as through the GSE mortgage portfolios—as it seems likely—then focusing the GSE's on securitization would be a more efficient method of using the GSE's to influence mortgage rates. Under this scenario, the GSE shareholders would not absorb as much of the benefits from the Government's ambiguity about GSE status.

As I mentioned above, another way for the Congress to more efficiently pass through the advantages of the Government's credit worthiness to homeowners would be to explicitly insure GSE debt and limit GSE profits. I would also note that encouraging GSE's to subsidize affordable housing through contributions from income can lead to unintended consequences. In the case of the FHLB's, such a requirement (along with requirements to make REFCORP payments) led to a ballooning of the FHLBs' nonadvance portfolio, leading to even greater issuance of GSE debt and increasing concerns about systemic risks. The GSE's can apparently borrow at subsidized rates without any realistic limit and invest the proceeds in any asset whose price is market determined. It can thus automatically profit from the investment. Taxing their income to support affordable housing will encourage them to expand their portfolios all the more.

Q.1.c. You mention in your testimony that "there are many ways to enhance the attractiveness of homeownership at significantly less potential cost to taxpayers than through the opaque and circuitous GSE paradigm currently in place." Please elaborate on these other potential less costly ways to promote homeownership.

A.1.c. As I stated above, one possible method would be for the Government to adopt on-budget homeownership initiatives that deal directly with downpayment and credit history difficulties of potential homebuyers, factors that research suggests are significant barriers to homeownership. While such programs would contain some funding costs, they would not present the potential for systemic risk embedded in the current GSE system.

Q.1.d. Similarly, do you believe that the GSE's should be doing more to promote affordable multifamily housing? If so, what specifically would you suggest the GSE's should do to promote affordable multifamily housing? Please elaborate.

A.1.d. The Congress should evaluate the GSEs' effectiveness in promoting multifamily housing and other affordable housing initiatives. The Federal Reserve's primary interest is that GSE activities are conducted in a safe and sound manner that does not increase or promote systemic risk in the financial system.

Q.1.e. In the context of GSE regulatory reform, the Administration has suggested creating new affordable housing goals and subgoals. Do you believe that these proposed goals and subgoals are as rigorous as should be, in light of recent GSE financial performance and the implied GSE benefits? Why or why not?

A.1.e. If the Congress desires the GSE's to pursue affordable housing goals and to lower mortgage rates, it should put in place rigorous systems to measure and evaluate the extent that these goals are being accomplished. As I stated in my testimony, a more efficient approach, and one that greatly reduces the potential for systemic risk, would be to encourage the GSE's to pursue mortgage securitization without the accumulation of enormous GSE mortgage portfolios and for the Congress to pursue affordable housing goals through on-budget programs targeted toward homeownership.

Q.2.a. In GAO's 1997 Report, "Advantages and Disadvantages of Creating a Single Housing GSE Regulator (GAO/GGD–97–139)," GAO argues, "Having an independent board would allow it to be structured to provide equal links to HUD, due to its role in housing policy and Treasury, due to its roles in finance and financial institution oversight. Having a single director, rather than a board, as head of the regulatory agency might provide for management efficiencies and clearer accountability. However, such an arrangement would sacrifice the advantages of having the different perspectives, expertise, prestige, and stability a board could provide." Do you concur with this preference for a board over a director agency structure? Why or why not?

A.2.a. As I stated in my testimony, world-class regulation, by itself, may not be sufficient and indeed, may even worsen the situation if market participants infer from such regulation that the Government is all the more likely to back GSE debt during a financial crisis. This is the heart of a dilemma in designing regulation for the GSE's. On the one hand, if the regulation of the GSE's is strengthened, the market may view them even more as extensions of the Government and view their debt as Government-backed. The result, short of a marked increase in capital, would be to expand the implicit subsidy and allow the GSE's to play an even larger unconstrained role in the financial markets. On the other hand, if we fail to strengthen GSE regulation, the possibility of an actual crisis or insolvency is increased. Regardless of whether the Congress creates an independent board or an agency director, the key issue is whether the Congress intends to bailout a GSE in the event of default. Any structure created by the Congress should incorporate clear and detailed provisions that spell out how the regulator is to deal with a GSE that has failed.

Q.2.b. In your testimony, you argued that the Chairman of the Board of Governors of the Federal Reserve System would have a substantial conflict of interest if placed on a board having oversight over the housing GSE's, as proposed by Chairman Shelby in a question to Comptroller-General Walker on February 10, 2004. You recommended against including the Chairman of the Board of Governors of the Federal Reserve System on the proposed board. Chairman Shelby also suggested that the proposed board also include the Chairman of the Securities and Exchange Commission. Do you think there is a similar conflict of interest with placing the Chairman of the Securities and Exchange Commission on the proposed board?

A.2.b. Other financial market regulators may or may not have conflicts of interest that might lead them to not want to be involved directly in the affairs of the GSE's. In general, the Congress may decide that it is best not to place regulators on a GSE board who, in the course of their primary duty, may be involved in situations that require judging the actions of a GSE and, perhaps, coming into conflict with its regulator. The Congress should assess whether or not such a conflict would exist with the Chairman of the Securities and Exchange Commission.

Q.3.a. In the same report, GAO argues that, "Our ongoing work has strengthened our belief that the housing GSE regulators would be more effective if combined and authorized to oversee both safety and soundness and mission compliance. Nothing we have observed has caused us to modify our criteria for an appropriate regulatory structure." For the record, do you support having a single regulator over all housing GSE's, Fannie, Freddie, and the Federal Home Loan Banks? Please elaborate.

A.3.a. Yes. These GSE's play essentially a similar role in the mortgage finance system and should be governed by the same regulatory framework.

Q.3.b.1. In your testimony, you appear to concur with this position. You said, "In my remarks, I will not focus on the Federal Home Loan Banks, although much of this analysis applies to them. In fact, because the Home Loan Banks can design their advances to encompass almost any type of risk, they are more complex to analyze than other GSE's and, hence, raise additional issues." Please elaborate on what you believe are the complexities involved with the risk profiles of the Federal Home Loan Banks.

A.3.b.1. The Federal Home Loan Banks (FHLB's), until recently, did not buy mortgage loans but instead provided loans (advances) to mortgage lenders who used their mortgage loans as collateral for the FHLB advances. In the past, advances simply passed on to mortgage lenders the borrowings of the FHLB's. Nowadays, however, FHLB advances can be custom designed for lenders, can include many financial options, and thus can pose complicated risks. Moreover, the mortgage loan portfolio of the FHLB's has increased significantly in recent years. The Congress should evaluate the growth in both the size and complexity of the FHLBs' portfolios and evaluate whether this growth is consistent with Congressional goals for the FHLB System and the safety and soundness of the financial system.

Q.3.b.2. Similarly, please elaborate on what you believe are the additional issues raised by such complexities.

A.3.b.2. As I stated above, traditionally the FHLB's have been portfolio lenders who acted mainly as intermediaries between capital markets and mortgage lenders. The FHLB's essentially passed-through subsidized capital market funding to mortgage lenders, taking a passive role in the process. Over the past decade, however, the FHLB's have evolved into active portfolio managers who offer financial options to their members. With their large portfolios, the risks involved in hedging these options can be large and, as with Fannie Mae and Freddie Mac, difficult to evaluate and worrisome given the size and scope of the portfolio.

Q.3.b.3. What important concepts do you recommend that Congress consider if and when designing legislation to create a single regulator for all housing GSE's? Please elaborate.

A.3.b.3. As I explained in my testimony, the regulator must be structured in a way that does not reinforce investors' perceptions that the Government implicitly backs GSE debt.

Q.4. In his testimony to the Committee on February 25, 2004, Chairman Raines submitted a chart detailing the differences between 30-year conforming and jumbo mortgage rates in 2003 to demonstrate a 21 basis point difference in Fannie's mortgage-backed securities yields. In addition, after including guaranty fees, servicing costs, "carry" costs, and other miscellaneous mortgage rate expenses, he argued that there was a 26 basis point difference between the conforming and jumbo rates that are offered to homebuyers. How do you respond to such evidence? Don't these data demonstrate the difference in mortgage transaction costs, as well as the mortgage transaction prices? Why or why not?

A.4. There is clearly a difference between GSE and non-GSE yields in the MBS market, as well as a difference between conforming and jumbo mortgage rates. As shown in Wayne Passmore's study, jumbo mortgage rates are usually 15 to 18 basis points higher than conforming mortgage rates. The question is, how much of the difference can be attributed to the GSE status of Fannie Mae and Freddie Mac? Passmore's study indicates that most of these differences are due to the economies of scale and other pricing efficiencies of the conforming loan and MBS markets. These market attributes would likely continue to exist even if Fannie Mae and Freddie Mac were not GSE's. The implicit subsidy is the element of the difference that would disappear should investors become convinced the GSE's were not Government-backed. According to Passmore's work, about 2 to 4 basis points of the conforming guarantee fee (embedded in the total guarantee fee, which is shown as 18 basis points in the chart you mention) is due to the subsidy. Indeed, if Fannie Mae and Freddie Mac were passing through some of their implied Government subsidies, one might generally expect the guarantee fee for conforming MBS to be less than the equivalent fee in the jumbo market, both because conforming mortgages are generally very safe assets and because Fannie Mae and Freddie Mac do not need to provide the same degree of credit enhancements for their MBS because of their implicit Government backing. In the Fannie Mae example, the guarantee fees are assumed equal.

Q.5. In the context of reviewing the regulation of the housing GSE's, do you believe that the current minimum capital standard of 2.5 percent for Fannie and Freddie is too low or too high?

A.5. Determining the appropriate minimum level of capital for the housing finance GSE's is a difficult and technical process that is best accomplished by the housing finance GSE regulator, which should have full access to information concerning the GSEs' activities, risks, risk management, and controls. The Federal Reserve generally does not have access to nonpublic information concerning the housing finance GSE's and has not conducted the analysis that would be required to express an opinion on the adequacy of the current minimum capital standard for the housing finance GSE's.

Q.5.a. On what basis do you believe the minimum capital standard should be set?

A.5.a. The housing finance GSE regulator should be encouraged to consider the three pillars of the proposed Basel Capital Accord in setting a minimum capital standard—the minimum capital requirements, the supervisory review process, and the market discipline or disclosure pillars.

Minimum capital standards should be established by the housing finance GSE regulator at a level that ensures that the major risks to which the housing finance GSE's are exposed—credit, interest rate, liquidity, and operational risks—are adequately covered, taking into account their ability to manage these risks. Ideally, one could rely primarily on a risk-based capital standard, but risk-based capital standards are not perfect and are still under development. Indeed, it likely will be many years before regulatory capital measures will be able to fully quantify and appropriately reflect all of the risks to which an entity may be subject over time. A leverage ratio places an overall constraint on the degree to which an institution can leverage its capital with debt that is implicitly or explicitly subsidized by the Government and works to limit the extent to which an institution can arbitrage the capital standard. It has been the Federal Reserve's experience that it is difficult for a banking organization to arbitrage simultaneously both the risk-based and leverage capital standards, which helps to ensure that the overall level of capital in the institution remains adequate in relation to its risk exposure.

In addition and importantly, the housing finance GSE regulator should have broad statutory authority to adopt regulations or take other actions that are necessary or appropriate to ensure the safety and soundness of the institutions it supervises. This authority, which is an important complement to the capital authority, would allow the housing finance GSE regulator to address financial and operational weaknesses at an institution.

Q.5.b. Do you believe that allowing Fannie and Freddie's regulator to have discretion only over risk-based capital is insufficient to maintain the safety and soundness of the GSE's? Why or why not?

A.5.b. As noted in my response to the prior question, a leverage ratio provides an important complement to a risk-based capital standard because risk-based standards are still relatively new and require significant ongoing development to encompass the many risks and arbitrage possibilities that exist in today's financial markets. Both types of standards are needed and, in my view, it is important for the Congress to provide the housing finance GSE regulator with clear authority to adjust standards for the entities under its jurisdiction.

History indicates that supervisors need the ability to revise and modify both the risk-based and leverage capital standards to ensure that these capital measures appropriately reflect changes in the financial markets, capital instruments, and the structure, operations, and risks of supervised institutions. In the banking area, the Federal banking supervisors have modified the leverage capital requirement in several significant ways since it was first adopted in the early 1980's. Most of these revisions altered the definition of capital as used under the leverage ratio requirement in response to accounting changes, financial product innovations, and market developments. The Congress should provide the housing finance GSE regulator with similar flexibility to update the minimum capital requirements for the GSE's as needed to ensure that they adequately capture risks and reflect the rapidly changing housing finance industry.

Q.5.c. Do you believe that it would harm the ability of Fannie and Freddie's regulator to perform its oversight functions if Congress placed restrictions on its ability to adjust the minimum capital standards? Why or why not?

A.5.c. Statutory restrictions on the ability of the housing finance GSE regulator to adjust the minimum capital standards would impede the ability of the regulator to modify those standards to respond in a timely way to market innovations in capital instruments, revisions in accounting rules, advances in techniques for measuring exposure to risk, and the natural tendency of institutions to arbitrage capital rules. Accordingly, such restrictions have the potential, over time, to cause the minimum capital standards to become increasingly disconnected from the supervised entities' risk profiles, and to significantly diminish their usefulness in ensuring their safety and soundness.

Q.5.d. At a staff briefing given by Fannie Mae on the issue of minimum capital, a Fannie representative said that raising minimum capital would require the GSE's to raise mortgage rates in order to keep earnings per share at current levels. In the context of capital standards, is there a way to ensure that more of the implied GSE benefits go toward the GSEs' housing mission, and less to the shareholders?

A.5.d. In my view, capital standards should be used solely as a mechanism to ensure the safety and soundness of supervised entities, rather than as a mechanism to promote the GSEs' housing mission. As I mentioned in my testimony, channeling the activities of the housing finance GSE's toward mortgage securitization could help to ensure that more of the implied GSE benefits accrue to the housing mission rather than investors. Refocusing the housing finance GSE's in this manner also would be consistent with the original Congressional intent that the GSE's provide stability in the market for residential mortgages and provide liquidity for mortgage investors.

Q.6. Do you believe the fact that current law gives authority to oversee new GSE programs and activities to HUD, and safety and soundness oversight to the Office of Federal Housing Enterprise Oversight (OFHEO), have undermined OFHEO's ability to oversee the safety and soundness of Fannie and Freddie? Why or why not?

A.6. Under current law, the Federal Reserve Board serves as the safety and soundness supervisor for bank holding companies and also has primary responsibility for reviewing and approving (or disapproving) proposals by bank holding companies to engage in new activities. (In some instances, the Board must coordinate its review of new activities with the Treasury Department.) Importantly, this authority permits the Board to review the potential risks involved with a proposed new activity, and the systems and procedures a bank holding company will use to monitor and control these risks, before the activity is commenced by a bank holding company. This authority also provides the Board with the ability to prevent bank holding companies from commencing any new activity that would present unacceptable risks to the safety and soundness of the banking organization or that is not authorized by applicable law.

As I mentioned in my testimony, I believe the GSE regulator should have authority similar to that of the banking regulators. This would include the authority to review and approve (or deny) proposals by a GSE to engage in new business activities, to place conditions on any such approvals to ensure that any new business activity commenced by a GSE is conducted in a safe and sound manner and is consistent with applicable law, and to enforce these prior approval requirements and any decisions made by the GSE regulator under this authority.

Q.7. In your testimony, you reiterated your support for privatization of the housing GSE's. However, in response to a question from Senator Sarbanes, you also appeared to disavow one of your previous recommendations advocating for redirecting capital away from housing and toward other, more "productive" uses. In a May 19, 2000 letter to Representative Baker, you said, ". . . these organizations alter the housing finance markets only to the degree that they pass through to homebuyers part of their Government subsidy. They accomplish this by diverting real resources from other market-determined uses." Later in that letter, you stated, "Subsidies accorded to the GSE's are, of necessity, at the expense of other Federal or private sector initiatives." In a subsequent August 25, 2000 letter to Representative Baker, you said, "If the lower costs associated with these implicitly subsidized funds are passed through to the mortgage market in the form of lower mortgage rates, then housing will expand relative to nonhousing investment, including private sector initiatives such as investment in productivity-enhancing plant and equipment." If the GSE's were privatized, wouldn't it result in capital being redirected away from housing toward other sectors of the economy, reducing liquidity in the secondary market, and thus resulting in higher mortgage rates for homebuyers? Why or why not?

A.7. In recent years, I have become impressed with how important wide homeownership has been to a general acceptance of property rights as a pillar of our society. This is not an issue I had given adequate thought to previously. Hence, although subsidizing of homeownership does divert capital from more "productive" uses, it is, in my judgment, a small price to pay for the benefits.

Subsidizing homeownership, as I indicated earlier, is far more efficiently implemented by on-budget programs. Too large a part of subsidies granted implicitly to GSE's is diverted to shareholders. None is diverted from on-budget subsidies.

Whether or not privatization of the GSE would raise mortgage rates or reduce liquidity in the secondary market depends on how much the GSEs' status as Government Sponsored Enterprises, and the implied subsidy that flows from this status, actually influences mortgage rates or provides liquidity. The evidence to date is that their influence on mortgage rates is small. The consequences of privatization do not seem to be significant except to the extent that it may cause Fannie Mae's and Freddie Mac's portfolio growth rates to lessen, thus reducing the systemic risk associated with such portfolios. As I indicated during my testimony, even after any privatization, it is likely Fannie Mae and Freddie Mac would continue to play important roles in the housing and mortgage markets.

RESPONSSE TO WRITTEN QUESTIONS OF SENATOR DOLE FROM ALAN GREENSPAN

Q.1. In your testimony you state "GSE's need to be limited in the issuance of GSE debt and in the purchase of assets, both mortgages and nonmortgages." You explain earlier in your testimony that these mortgage investments ". . . concentrate interest rate and prepayment risks at these two institutions." Some have argued that these mortgage investments help Fannie and Freddie to fulfill their mission. What are your thoughts on that?

A.1. Federal Reserve staff is not aware of any evidence that convincingly shows that channeling GSE activity toward mortgage securitization and away from holding mortgage-backed securities in portfolio would negatively impact liquidity in mortgage markets. Whatever liquidity or other benefits the GSE's bring to the markets, if any, likely can be supported by GSE's with a greater emphasis on mortgage securitization and with less emphasis on enhancing their subsidy by holding their own MBS. Moreover, as I noted in my testimony, any proposal to direct the flow of Fannie Mae's and Freddie Mac's activities toward mortgage securitization would still leave the GSE's among the largest financial institutions in the United States and would allow them to grow with the mortgage markets.

Q.2. Chairman Greenspan, the General Accounting Office has warned us that the incentives to use the benefits of Government sponsorship to increase shareholder value could, over time, erode the public mission. Do you agree with that warning?

A.2. Given the large nonmortgage portfolios held by the GSE's, I can understand GAO's concern.

Q.3. In your testimony you state: ". . . if the regulation of the GSE's is strengthened, the market may view them even more as extensions of the Government and view their debt as Government debt." Do you believe there is any practical way of strengthening their regulation without expanding the misperception of an implicit subsidy?

A.3. The practical way is to create GSE receivership provisions and make the method by which creditors of the GSE's can take losses clear and credible to the investing community.

PROPOSALS FOR IMPROVING THE REGULATION OF THE HOUSING GOVERNMENT SPONSORED ENTERPRISES

WEDNESDAY, FEBRUARY 25, 2004

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 2:34 p.m., in room SD–538, Dirksen Senate Office Building, Senator Richard C. Shelby (Chairman of the Committee) presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The hearing will come to order.

This afternoon, the Committee holds its fifth hearing on needed improvements to the regulation of Government Sponsored Enterprises. The Committee will hear from Mr. Franklin D. Raines, Chairman and Chief Executive Officer, Fannie Mae; Mr. Richard F. Syron, Chairman and Chief Executive Officer, Freddie Mac; and Mr. Norman B. Rice, President and Chief Executive Officer of the Federal Home Loan Bank of Seattle.

It is my intention that today's hearing will be the final session in our series of hearings. After today's hearing, we will have heard from a wide variety of witnesses, and we will have an extensive record to review in our deliberations. Several Members of this Committee introduced their own proposals to reform GSE regulation, and I want to commend Senators Hagel, Dole, Sununu, and Corzine for their hard work in this regard and their ideas and their approach, and also for their participation in the hearing process. They have been very involved.

It is time for the process to move forward. The Committee will be working over the next several weeks to assemble a legislative package. I know that all of the Members of this Committee share a goal of putting in place a strong, credible regulator that will ultimately benefit the GSE's, protect taxpayers, and preserve the prominent role of housing in our economy, which we all support.

I want to thank all the witnesses for appearing here today, and we look forward to your testimony and also the question period.

Senator Johnson, do you have an opening statement?

STATEMENT OF SENATOR TIM JOHNSON

Senator JOHNSON. Yes, a brief statement. Thank you, Mr. Chairman, for calling today's hearing, another in a series to determine the best way to improve the regulatory framework for the housing

GSE's. I look forward to hearing this distinguished panel. Following Chairman Greenspan's testimony yesterday, I think it is timely and important that we carefully consider the testimony of today's witnesses on the important mission our housing GSE's carry out every day to help advance the dream of homeownership for millions of low- and middle-income American families.

I simply do not agree with Chairman Greenspan's view that housing GSE's should be privatized. I am also growing increasingly concerned that officials of the Bush Administration, most recently Gregory Mankiw, Chairman of the Council of Economic Advisers, have called into question the real and perceived benefits Fannie and Freddie receive because of their Congressional charter. These benefits the Administration continues to attack come with critically important public policy responsibilities and mandates from Congress, including requiring Fannie and Freddie to meet affordable housing goals and targeted minority homeownership goals.

Congress provided these tools to the GSE's to help low- and middle-income Americans realize the dream of homeownership, and they are also restricted from participating in the marketplace for higher-end homes. There are important policy reasons that we need to address in considering regulatory reform, including whether to include the Federal Home Loan Bank in a new regulatory entity, appropriate minimum capital standards, receivership, and program approval authority.

I intend to work with my colleagues to reach a consensus on these and other issues, and I continue to believe that changes are needed to ensure the integrity of the system. However, I have to caution that continued statements by the Administration questioning the need for a Federal-private partnership through the Government Sponsored Enterprises makes reaching agreement on reforming the regulatory structure of these entities all the more difficult. The goalposts keep shifting, and I find this troubling.

In my home State of South Dakota, many community financial institutions rely heavily on products offered by Fannie Mae, Freddie Mac, and the Federal Home Loan Bank of Des Moines to help finance quality, affordable housing in small rural communities. Without the important private-public partnership demonstrated by our housing GSE's, I have to wonder how many of my low- and middle-income constituents in rural South Dakota would be significantly hindered in becoming homeowners.

The Administration, in the name of economic efficiency, has tried to convince us that exporting jobs is good, and now we are urged to leave our housing needs to the marketplace and hope for the best. As we move forward on regulatory reform of the housing GSE's, we have got to keep in mind the fundamental role that these institutions play and ensure that whatever changes we make to the regulatory structure, whether in the areas of minimum capital, receivership, or other issues, we do not inadvertently harm the housing mission of the GSE's.

As the creator of these important institutions, we in Congress have a special obligation to ensure that the GSE's are meeting their unique role while at the same time ensuring that the regulatory structure for the GSE's is strong, independent, and credible.

Mr. Chairman, while finding a consensus on these issues may be difficult, I am committed to working with you and my colleagues on this Committee to find solutions that balance the ability of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks to meet their critical missions with the need for world-class regulation of the GSE's.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Hagel.

STATEMENT OF SENATOR CHUCK HAGEL

Senator HAGEL. Mr. Chairman, thank you.

Mr. Chairman, I add my welcome to our distinguished panel. Chairman Raines, Chairman Syron, President Rice, thank you for appearing.

As we know, the secondary market plays a critical role in housing finance. Congress should not diminish this role. However, as Government Sponsored Enterprises like Fannie Mae and Freddie Mac dominate this landscape, Congress has a greater responsibility for strict oversight and comprehensive supervision. The stakes are profound, particularly when questions are raised about the implicit U.S. Government guarantee and the GSE's' growing relevance to our financial system.

Have these institutions become too big to fail, as some would argue. Will a financial crisis ensue if they are left inadequately supervised, as I believe Chairman Greenspan asked yesterday in his testimony.

Clearly, the existing regulatory framework requires strengthening to ensure that prevailing risks are mitigated. This is in the interest of the housing industry, the private capital markets, investors, and the American taxpayer. Few would argue the importance of housing to the national economy and the increasing role of the GSE's.

There are currently over $7.2 trillion in mortgage loans in the United States; 45 percent of all those loans are owned or guaranteed by Fannie Mae and Freddie Mac. This Committee should bear in mind that other companies also engage in the primary and secondary markets as well. These private companies face extensive regulatory oversight from multiple supervisors, including Federal and State banking agencies and the Securities and Exchange Commission. This comprehensive oversight can require, if certain conditions exist, prior product approval, limitations on growth, minimum capital standards, and even receivership.

Clearly, a gap exists in the regulatory framework of financial institutions and the Government Sponsored Enterprises. In introducing the Federal Enterprise Regulatory Reform Act, S. 1508, the intent sought by Senators Sununu, Dole, and I is to create a fundamentally strong regulatory framework, an agency with the capacity to establish capital guidelines, and, when necessary, have the discretion and authority to limit its activities.

These are integral regulatory rules that have been successfully applied by the U.S. Federal banking agencies. They are principles founded on the premise of curtailing risk when conditions are necessary. I am confident these measures will serve to enhance the confidence in the mortgage industry as well.

I might add, Mr. Chairman, also the intent of our bill was not to undo GSE's, nor to put GSE's out of business. That may come in a different era at a different time, but that has not been the intent of our legislation.

I again thank you, Mr. Chairman, for your leadership on this issue and look forward to our distinguished witnesses. And I might add I will probably not be able to engage the entire time since I am due to chair a hearing here shortly. But I wanted to be here to at least give the witnesses an opportunity to make their statements so I could benefit from what they have to say, and I will stay longer if I can. But, again, thank you for coming, gentlemen.

Chairman SHELBY. Thank you, Senator Hagel.

Senator Crapo.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you very much, Mr. Chairman, and also to Chairman Raines, Chairman Syron, and President Rice, we appreciate your coming before us today and look forward to your discussion with us. These are very critical issues.

As this Committee considers creating a new independent regulator for Fannie, Freddie, and the Federal Home Loan Banks, it is important that we recognize that although these GSE's have much in common, these entities are structurally different. And as we approach this issue, the first question that we must address is whether all three should be included under the same regulator, where the regulator will be located, and the level of independence of that regulator. And if they are all included, I am interested in learning today how you believe this regulator should be structured so that it can maximize the value and benefit of each GSE.

Would you support creating divisions within the regulatory structure? Should there be an advisory body in addition to or as a part of this regulator? If so, who should be included, and what value would this advisory body provide?

Additionally, there has been a lot of discussion about capital standards, and I have asked questions on it in, I believe, every hearing that we have held. Can each of you explain your capital standards and how they work and how each of your capital requirements compares to the commercial banks or the circumstances that you might face under such an independent regulator as we are talking about?

There are questions as to whether capital standards should be addressed statutorily, as a floor of some sort with broad discretion in the regulator, or whether the legislation that is established should instead not worry about setting any particular levels, but setting the standards by which capital should be evaluated by the regulator.

In yesterday's testimony, Chairman Greenspan said, “World-class regulation, by itself, may not be sufficient and, indeed, as suggested by Treasury Secretary Snow, may even worsen the situation if market participants infer from such regulation that the Government is all the more likely to back GSE debt.” I wonder what your responses are to the issues raised by Chairman Greenspan with regard to this implied guarantee that the marketplace seems to place on GSE debt.

I do have to take issue to some extent with those who would say that the Administration is critical of Government's role in and support of making sure we have strong, affordable housing in the United States. I certainly do not believe that any of the efforts that are undertaken by any of those who have introduced legislation or by those who have supported the idea of an independent regulator is intended to diminish the value of our Government's commitment to developing the best approach to affordable housing that this Nation can put together. The question instead is: How do we protect the U.S. taxpayer? How do we make certain that the housing industry and the mortgage industry are operating as efficiently and as safely as possible so that we do not face some of the very terrible circumstances that we have faced in other arenas? And how do we make certain ultimately that we achieve our objective of solid, affordable housing available to the maximum extent possible in our society?

I look forward to working with you on these issues and welcome your expertise and advice today. I should also say, Mr. Chairman, that like Mr. Hagel, I have not only another hearing but also I think half of my constituents from the State of Idaho are in Washington, DC, today.

[Laughter.]

And so I may have to slip out. But I can assure you, I will listen to as much as I can, and I will read every word of your testimony and listen to the points that you have made.

Thank you very much.

Chairman SHELBY. Senator Stabenow, do you have an opening statement?

STATEMENT OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you, Mr. Chairman. I do have a few comments. I would say to Senator Crapo, though, that I think the other half of the people here in town are from Michigan today, so I apologize in advance. Many of us are trying to be in many places at once today. But welcome to those who are here. We appreciate very much your leadership and your testimony today, and I think this is such an important topic, and I hope we will be focused on what is in the best interest of the American people and the important role that GSE's have played in helping to create a housing market that is affordable and available to people and to help keep the economy moving forward by the fact that we have had the housing market continue to be strong even in the face of other very challenging times in the economy. And I know that each of you have played a role in that.

Yesterday, we were able to hear from Federal Reserve Chairman Greenspan, and I must say that the views he offered I did not agree with, and some of the comments. And I hope that there is, in fact, not going to be support for privatizing GSE's. I do not believe that is in the best interest of the families that I represent in Michigan or people across the country.

I think the relationship between GSE's is unique. There is no doubt about it. But there is immense value to the public in the relationship that we have together. In return for a limited amount of Government benefits, the American public sees great rewards, in my judgment.

We task the GSE's with important projects like meeting affordable housing goals, and this allows these private sector companies to do good work simply by doing the business that you were set up to do. In addition, we are able to see great rewards to the public through the mortgage cost savings that the GSE's create.

I do think there are important questions for the Committee, Mr. Chairman, and I appreciate your ongoing efforts. I would hope that we would ask questions such as: How can we ensure we have a strong, respected, independent regulator, with adequate and reliable funding? How can we create a regulatory environment where Fannie and Freddie can innovate and create new products without burdensome and bureaucratic approval processes by Federal regulators? How do we make sure that accounting problems like those at Freddie Mac never happen again? And how can we raise the bar and ensure that Fannie Mae and Freddie Mac do as much as possible to expand homeownership opportunities to first-time homebuyers and minority homebuyers and working-class families who are good credit risks but lack the funding for a downpayment or closing costs?

I think we have important work in front of us, Mr. Chairman, and I appreciate your ongoing efforts in the hearings that we have had. Thank you.

Chairman SHELBY. Your written testimony will be made part of the record in its entirety. Mr. Raines, we will start with you, if you will sum up your testimony.

STATEMENT OF FRANKLIN D. RAINES CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FANNIE MAE

Mr. RAINES. Thank you very much, Mr. Chairman, and thank you, Members of the Committee, for an opportunity to testify before you once again on this important legislation concerning strengthening the safety and soundness of Fannie Mae.

On behalf of Fannie Mae, let me express all of our appreciation for the hard work this Committee has put in over the years and particularly in the last several months on this very important topic.

I would just like to make four points in my summary statement.

First, as I have testified before Congress previously, Fannie Mae supports legislation to establish a strong, well-funded, and respected safety and soundness regulator for the housing GSE's, and we do so because it is good for housing, the financial system, and our company. Private investors provide the capital that we use to purchase mortgages and to capitalize our business. They believe Fannie Mae is a good investment, but not because of any implied Government guarantee of our obligations. Instead, they count on the Government to apply rigorous oversight to the company because our mission is so critical to the national housing policy. Investor trust and confidence, combined with our low-risk and highly efficient business that focuses exclusively on mortgages, lowers our borrowing costs and that allows us to purchase and guarantee lower-cost mortgages for homebuyers.

The second point I would like to make is about our capital. Fannie Mae believes our regulator should have flexibility over our capital regime, which Congress established in 1992 with two parts. We have a minimum capital standard. It is bolstered by a risk-based capital requirement with a stress test which requires us to hold enough capital to survive sustained depression-like economic conditions. Our capital requirement is still ahead of its time. Nevertheless, we support legislation that would provide our regulator with full flexibility over our risk-based capital requirement since it is the regulator's premier tool to ensure that we are well-capitalized.

We also understand the interest in being prepared for unanticipated events, so we believe that if any unanticipated safety and soundness risk should arise, a risk not covered by our risk-based capital requirement, then our regulator should have the ability to temporarily increase our minimum capital to protect against that specific risk. Then when the risk goes away, the capital surcharge would go away as well. But we would urge Congress to ensure our minimum capital standard does not become a tool to alter National housing policy by restricting the flow of capital into housing.

And, finally, to fully match our capital against our risk, we recommend that our regulator should take into account our total capital as bank regulators do for banks. Specifically, banks can earn the rating of "well-capitalized" if they boost their total capital level beyond their regulatory requirement. Four years ago, Fannie Mae volunteered to issue subordinated debt to boost our capital, bringing our total capital today, including loan loss reserves and subordinated debt, to 4 percent of our balance sheet assets. Offering the regulatory designation of "well-capitalized" for our total capital would encourage future management to maintain this high standard. All told, we have $35 billion in total capital, plus $14 billion in subordinated debt. A recent Federal budget document suggested that a small mistake could harm our company. The opposite, of course, is true. It would have to be a colossal blunder to deplete $49 billion in capital and subordinated debt.

My third point is in the unlikely event of a large catastrophe that would threaten our company, our financial regulator would need the authority to step in and take over the business. The question has been whether our regulator should have the authority to impose a receiver or a conservator. Receivership makes sense for Federally insured banks. The deposit insurance fund must be reimbursed from the assets of the bank when it makes depositors of failing banks whole. So the Government has to ensure that it has the first claim to assets before other creditors are paid. For Fannie Mae, conservatorship makes more sense.

Here the task in the unlikely event of failure would be to conserve the assets of the corporation for debt holders since that is their only source of repayment. Because the Government has no investment in the company, there is no need for a receiver to protect the Government's investment. There is certainly no reason to complicate matters for debt holders who have invested in our securities based on the current arrangement.

My fourth point is about mortgage innovation, which created the best housing finance system in the world and is critical to meeting this growing Nation's growing housing needs in the future.

A few weeks ago, Fannie Mae launched a major expansion of our American Dream Commitment, a pledge we made 4 years ago to provide $2 trillion for 18 million minority and underserved families to own or rent a home before the decade was over. Because the housing market has been so strong, we met our top-line goals after only 4 years. So we launched an expanded plan focused on three goals: First, to create 6 million new homeowners, 1.8 million of them minorities, over the next decade; second, to help families at risk of losing their homes to stay in their homes; and, third, to expand the stock of affordable housing.

To carry out this plan, which will advance the President's goal to narrow the minority homeownership gap in America, we plan to launch immediately about 60 different mortgage initiatives with a range of lending and community partners, and ultimately the initiatives could exceed 100.

We believe that our financial regulator should have the authority to review at any time any activity by our company from a safety and soundness standpoint. We also support current requirements for prior approval of new programs.

But we oppose expanding the reach of prior approval to include mortgage activities and processes because such micromanagement would harm our ability to achieve these goals and respond to market needs, which is exactly what Congress intended us to do.

We would have to ask what public policy purpose would be achieved by slowing or stopping our ability to fight predatory lending, to expand low downpayment lending to teachers, police officers, and fire fighters, to help families with slightly imperfect credit get a low-cost loan, or to help minority families become first-time homebuyers.

In conclusion, Mr. Chairman, Congress has helped to create the best housing finance system in the world, a system other countries envy and want to emulate. By strengthening our financial regulator, Congress can further strengthen this system to ensure all Americans have the best housing opportunities in the world.

With that goal in mind, I have tried to make four points today: Fannie Mae supports having a strong, credible, well-funded financial regulator; we support having a strong capital regime matched to our risk; we believe that conservatorship is the best way to protect our creditors in the remote chance of failure; and we urge Congress to support mortgage innovation.

These are not esoteric issues. This is important. There is a lot at stake. On the front page of *The Washington Post* last week, there was an interesting article about the economy. It opened with a story of Greg and Mary Beardmore of Green Bay, Wisconsin, who were struggling on a reduced income in a tough job market. Yet they were unusually sunny about their future.

As the article stated, the Beardmores have kept their heads above water by refinancing their mortgage, lowering monthly payments, and taking heart in the swelling equity in a home that has gained $100,000 in value since they moved in 8 years ago. Mary Beardmore said, "I do not feel like I am losing ground because I have the security of my home. If we had to sell our house to stay afloat, we would do it very quickly. So, you know, I think it is okay."

I mention the Beardmores because families like them are depending on us to get reform right and to do no harm to housing. And Fannie Mae stands ready to work with this Committee and the Congress to achieve this goal that we share. And thank you very much for the opportunity to testify.

Chairman SHELBY. Thank you, Chairman Raines.

Chairman Syron.

STATEMENT OF RICHARD F. SYRON CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FREDDIE MAC

Mr. SYRON. Thank you, Chairman Shelby and Members of the Committee. I must say it is an honor to be here today. I am the new kid on the block, but I could aspire to no greater legacy than to restore public trust to an institution chartered by Congress to ensure the stability, liquidity, and accessibility of the Nation's mortgage markets.

I must say I approach the issues before the Committee today largely from the perspective of a regulator, having been President and CEO of the Federal Reserve Bank of Boston. But like most Americans, I am also a homeowner. I grew up in Boston in a two-family home financed by a VA loan that my father was able to get when he came home from World War II.

I have only been on the job 2 months, but I am convinced that legislation is essential to enhance the GSE regulatory oversight structure. I think it may even be overdue. World-class regulatory oversight is critical to the achievement of Freddie Mac's mission and to maintaining the confidence of the Congress, the public, and financial markets.

Today, I want to talk about two things: Why we exist and why regulatory reform is needed, and our position on some of those issues.

Homeownership, as we all know, is at a record high. Families build wealth. Kids do better in school. Neighborhoods are safer. And in recent years, housing has been referred to as the backbone of our Nation's economy, actually accounting for more than a third of the growth in nominal GDP in the last couple of years.

These are real benefits. They are real outcomes of a bipartisan decision to support homeownership by creating two institutions with the singular job of making mortgage markets stable and liquid. Unfortunately, sometimes we tend to take the GSE model of housing finance for granted.

In a vain search for greener pastures, this important debate today is at risk of wandering from a focus on real things to philosophical debates on issues such as privatization.

Freddie Mac strongly supports enactment of legislation to strengthen the GSE regulatory structure. Thus, we would respectfully encourage the Committee to focus on specific ways, as you have, to improve the GSE regulatory structure and avoid becoming sidetracked by side issues. To put it bluntly, let's get a top-notch regulatory structure in place and then get back to the job of putting more people, particularly minorities, in homes.

Now, just very quickly, a little background. GSE privatization may sound attractive in theory. But while the real benefits are there, the potential benefits of privatization are highly speculative.

Specifically, are we willing to risk the widespread availability of America's mortgage product of choice: 30 year, fixed-rate, prepayable mortgages without penalty?

Other countries are not able to offer their citizens the double benefit of this type of loan. For example, just across the border in Canada, the typical fixed-rate mortgage has a term of 7 years, a downpayment requirement of 25 percent, and punitive penalties for refinancing. And I would like to submit for the record, Mr. Chairman, just a sheet that——

Chairman SHELBY. Without objection, it will be made part of the record.

Mr. SYRON. Thank you, sir.

Perhaps I am a conservative at heart, but when the stakes are high and the risks of failure are substantial, I will stick with known benefits. This is not the time to begin dismantling the world's finest housing finance system or to place limits on its growth. The 20-percentage-point gap between white and minority homeownership rates indicates there is more work for us to do.

Now let me turn to the imperative for regulatory reform. Regulatory oversight of the GSE's is essential. Given the known benefits of the Nation's housing finance system, it is crucial to proceed with an abundance of care, however, as we do this. Borrowing a phrase from our friends at the Homebuilders, I urge the Committee to "measure twice and cut once."

Any one of the key provisions under consideration, if done inappropriately, could have negative effects similar to privatization.

Given my time constraints today, my comments will be limited to three issues that go to the heart of the regulatory debate. The first is capital.

Capital adequacy is absolutely key to the continued confidence of the Congress, the public, and investors. Compared to institutions I have personally regulated, the GSE's have the most sophisticated risk-based capital standard. Although our present regulator has significant discretion in adjusting the risk-based capital requirements, I would support providing the new regulator additional discretion.

My strong preference for risk-based capital standards can be traced to my tenure at the Federal Reserve Bank of Boston during the infamous credit crunch of the early 1990's. While many financial institutions in the Northeast were well-capitalized on a risk-adjusted basis, the cautionary raising of pure simple leverage ratios required them to liquidate a substantial portion of their assets. This resulted in a drying up of commercial credit that turned a 2-year mild recession into a 5- to 6-year severe slump, causing a lot of lost businesses, lost jobs, and lost homes.

Notwithstanding my philosophical differences, I would support regulator discretion to increase the GSE leverage ratio in the event of a finding of an unsafe and unsound practice. However, in my mind, parameters should be put in place that define the circumstances under which such an increase could be undertaken, as well as the parameters for returning to the statutory minimum once the problems had been addressed.

The second issue I would like to mention is conservatorship.

Now, while it may be appropriate to draw on certain banking provisions to improve the GSE regulatory oversight structure, we strongly believe that liquidation is not one of them.

Receivership is an appropriate disposition mechanism when you are dealing with thousands of Federally insured depository institutions whose failure could have an impact on depositors and on deposit insurance funds.

However, receivership is widely perceived in the market to have little practical application to large financial institutions, whether they be commercial banks or the GSE's. As a result, in my mind, it is not appropriate for dealing with the two GSE's, whose funding comes from world capital markets increasingly and not depositors and whose closure would have substantial economic, market, and public policy consequences for the Nation.

While receivership might provide theoretical benefits, it would introduce substantial uncertainties into the global debt markets as well as the MBS markets. This would have significant implications on our ability to finance 30-year, prepayable mortgages.

For these reasons, we believe retaining conservatorship is the right approach, in the unlikely event that a GSE were to experience extreme financial distress. Receivership would serve little practical purposes and would be interpreted by global capital markets as a first step toward privatizing the GSE's.

Finally, the benefits of debt financing or the issue of the retained portfolio.

The availability and cost of mortgages for America's homeowners would be negatively affected by efforts to constrain our retained portfolio. The fact is buying mortgages and mortgage-backed securities for our retained portfolio is essential to fulfilling our housing mission.

First, our purchases create price competition and reduced mortgage rates for consumers.

Second, our retained portfolio ensures we can continue providing liquidity during periods of market stress. For example, during the 1998 Asian debt crisis, lending in many sectors of the economy was disrupted as investors fled to the safety of Treasury securities. To boost falling demand for mortgages, Freddie Mac and its colleague Fannie Mae remained steadfast in the market. As a result, America's homebuyers were able to obtain low-cost mortgages during that period of stress. This would not have been possible if we had to rely solely on securitization.

Our issuance of debt securities likewise benefits the housing market by allowing us to tap the global financial markets to the benefit of U.S. homebuyers. Many investors prefer the predictability of GSE debt over mortgage-backed securities, which are sensitive to prepayment risk. Restricting the use of this important funding mechanism likely would result in a reduced supply of funds and higher costs for homeownership.

In closing, I would like to say a few words about Freddie Mac.

I am sadly aware that Freddie Mac's accounting issues are the source of much of the current controversy regarding the role of the GSE's, and I apologize to this Committee and the rest of the Nation for that. However, as with any episode such as this, it is critical to get the ship back on course without overreacting at the tiller.

One of my top priorities is to work with you to enact legislation that enhances our safety and soundness regulation. Regulatory reform is critical in light of the key role the GSE's play in our economy and in the achievement of the fondest hopes and dreams of Americans.

Equally important, I am focused on expanding Freddie Mac's commitment to mission. Freddie Mac is an institution with special privileges, and special responsibilities come with that. I am very concerned specifically about meeting the housing needs of minority families. We have to do that better, and we will.

Senators in today's *New York Times* on the front page, there is a picture of a family who is the third generation in that family to be living in a cellar. I am not talking about a basement apartment. I am talking about living in a cellar with no windows, next to a boiler and a sanitation system, because they can find no place else to live. We, as the GSE's, are not fully doing our jobs as long as that remains a widespread practice in this country, and we are committed to do better.

Thank you very much for the opportunity to appear before the Committee today, and I look forward to answering whatever questions you may have.

Chairman SHELBY. Thank you.

Mr. Rice.

STATEMENT OF NORMAN B. RICE PRESIDENT AND CHIEF EXECUTIVE OFFICER FEDERAL HOME LOAN BANK OF SEATTLE

Mr. RICE. Good afternoon, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. I am Norman B. Rice, Chief Executive Officer of the Federal Home Loan Bank of Seattle.

I would like to start today by underscoring the critical importance of this Committee's work—and that of Congress and the Administration—in supporting a world-class regulatory structure that ensures and enhances the safety soundness, and economic viability of the housing Government Sponsored Enterprises.

In my role representing the Council of Federal Home Loan Banks, I wanted to very clearly state our support for this effort.

The Federal Home Loan Banks are acutely aware of how much is at stake in this process for American taxpayers and our member shareholders. We understand that this Committee is considering the creation of a new agency. If so, it is imperative that the agency you create improves the oversight, the mission delivery, and the effectiveness of the business activities of the housing GSE's, and not hinder them.

When I testified before this Committee in October 2003, I outlined a set of four principles that framed the Bank System's bottom-line needs regarding a new regulatory structure. They include: Number one, preserving and reaffirming the Bank System's mission; number two, maintaining a strong, independent regulator; number three, preserving the Bank System funding through the Office of Finance; and, number four, preserving the unique cooperative and regional nature of the Bank System.

More specifically this afternoon, I would like to speak to the proposed regulatory structure we understand is currently under discussion, that of an independent agency that operates outside of a Cabinet-level department.

There are three key aspects of this proposed structure that I would like to address with the Committee today.

Number one, ensuring regulatory independence. A regulator lacking true independence is often subject to a wide range of demands and influences that we believe would be detrimental to the supervision, business activities, and the mission fulfillment of the GSE's. It is critically important that this new world-class regulator not be hampered by a cumbersome board structure and not be dominated by any single agency represented on the board. This new regulatory body must have the authority to govern in a truly independent manner.

Number two, agency oversight responsibilities. The Bank System believes this independent regulator should have the following authorities:

Ensuring the safety and soundness of the housing GSE's.

Overseeing all mission-based goals and programs. There are obvious differences in the mission-based goals and programs of the two housing GSE's and the Federal Home Loan Banks. However, we believe a proposed new regulator should have the authority to review, approve, and monitor all mission-based goals and programs. Our current regulator has that authority, and we believe it should be preserved.

Setting capital standards. Along with independence, any world-class regulator must have the authority to set both leverage- and risk-based capital standards. As you know, Congress conducted an extensive review and revision of our capital structure in the Gramm-Leach-Bliley legislation, and the Finance Board was given this broad authority in the Act. We believe any new regulatory agency should have the authority to raise and lower capital requirements as deemed appropriate and necessary. And anything less, in our opinion, would be a significant step backward.

Approving new business activities and programs. We believe a world-class regulator should preserve the Bank System's ability to innovate around existing products and services. In turn, the regulator should be diligent in examining and approving these innovations and exploring areas that represent new risks to the GSE's.

Speaking on behalf of the Seattle Bank, I believe our mortgage purchase program is a good example of where our regulator insisted on close oversight and examination prior to approving a new business line.

Number three, creating separate divisions for the Federal Home Loan Banks and the publicly traded housing GSE's.

While Fannie Mae and Freddie Mac and the Federal Home Loan Banks all share GSE status, we are fundamentally very different.

The Federal Home Loan Banks are cooperatively owned and capitalized by our members, most of whom are community banks occupying and delivering benefits to Main Street, while the other two housing GSE's must meet the quarterly earnings expectations of Wall Street investors.

To that end, the Bank System believes that creating separate divisions within a regulatory structure would add efficiencies in the provision of oversight and supervision.

In conclusion, I want to emphasis to the Committee that the onus of strengthen our system lies not only with Congress and the regulators, but also with the housing GSE's themselves.

We must be willing to take the steps necessary to efficiently manage our financial institutions in a safe and sound manner and provide world-class financial transparency and disclosure regarding our business operations. On that point there is no debate.

Where there is a difference of opinion among the Banks, and where there has been much discussion with our regulator and others, is concerning who should have authority over the financial disclosures and transparency—the SEC or the housing GSE regulator.

From the Bank System's perspective, we believe that a world-class regulator would potentially be better able to set the framework and supervision for the level of financial disclosure now being demanded of our system.

However, if Congress were to choose the SEC to regulate these financial disclosures, the Bank System believes some very specific accommodation are necessary.

As you move forward in this legislative process, I would ask that you keep in mind that we are a cooperative system, owned by more than 8,000 banks, thrifts, credit unions, and insurance companies. That means every dollar of value we create is passed through to our members and their communities. That is why Congress created the Bank System, and that is why we exist today.

So, I thank you for your time this afternoon, and I will be happy to answer your questions regarding my testimony.

Chairman SHELBY. Thank you, Mr. Rice.

Yesterday, as everyone knows, Chairman Greenspan recommended, among other things, that the GSE's be limited in their issuance of debt and in their purchases of assets. At the same time, he spoke favorably regarding the securitization process and its value to the housing market and to homeowners.

Would you agree that there is greater risk in holding mortgages and MBS's in portfolio?

Mr. Raines.

Mr. RAINES. I think, Mr. Chairman, the answer is it depends on how you have hedged your portfolio and that you can, in fact, reduce the risk of a mortgage portfolio——

Chairman SHELBY. And the quality of the portfolio?

Mr. RAINES. It depends on the quality of the portfolio, but as well how you would hedge the portfolio in order to demonstrate the amount of risk that is actually there. And there is a simple way to illustrate that, Mr. Chairman, that I think would be useful as we discuss these issues, if I can find it.

Chairman SHELBY. Do you want to come back to that?

Mr. RAINES. It is illustrated by our risk-based capital standard because it is a very important concept that Dick Syron was pointing out and that I also think is vital in understanding this whole discussion.

Under our risk-based capital standard, how much capital we have to hold depends on how much risk we have in our portfolio, and this chart illustrates in a simple way how the amount of capital that you should have depends on the level of risk.

Chairman SHELBY. Can you speak into the mike just a little more?

Mr. RAINES. Yes, sir. So, for example, on the far left it indicates that if you match your holdings of mortgages with 80 percent callable debt, you can reduce the capital requirement down to about 1 percent, which gets you down at the same level as credit risk.

On the other hand, if you finance your mortgage assets, as most banks do, by short-funding, using primarily deposits, you need 10-percent capital.

So how much capital you need to have depends on how much risk you have. Typically, Fannie Mae has a duration match and 50-percent callable debt, which requires us to have about 3-percent capital. However, if we change the risk, the capital requirement would go up.

Chairman SHELBY. But a world-class regulator, if we create one through legislation, would hopefully know all this, would they not, when they are assessing the risk that you are taking?

Mr. RAINES. They would hopefully know it.

Chairman SHELBY. Otherwise, if they were not up to the job, they would not know, but the kind we are trying to create or hopefully would create would understand these risks. And if they understood these risks, it would help them understand who they are supervising better, would it not?

Mr. RAINES. Yes, sir, I think it would help. But we have the example that the banking system to this day does not have a capital standard that takes into account interest rate risk. There is no interest rate risk included in the Basel standard that we have. Nor is there interest rate risk included in the proposed Basel standard.

So this capital standard that we have is actually quite unique as being the only one that captures credit risk and interest rate risk and operations risk.

Chairman SHELBY. So why do the GSE's—I will just speak to Fannie Mae first and then call on the others—hold mortgages in the portfolio? Is it because you have a better return? There is a reason why you hold them rather than securitize them.

Mr. RAINES. Well, actually, Mr. Chairman, the reason that Fannie Mae holds them is the first thing we did as a company was hold mortgages.

Chairman SHELBY. I know that.

Mr. RAINES. When we were founded in 1938, until the 1980's, that is all we did. But our research shows that for the incremental billion dollars of securitization versus a billion dollars of purchases by our portfolio, purchases by the portfolio have a 30-percent greater impact on lowering interest rates. And it is simple to understand. It introduces new demand into the market that otherwise would not be there. People who invest in our debt have chosen that they do not want to invest in mortgage-backed securities. So we actually attract more investors into mortgages than would otherwise be there.

So it is pretty clear from our research that the portfolio has a bigger impact on reducing interest rates than our securitization program.

Chairman SHELBY. But the holding of the debt in your portfolio causes great concern to Chairman Greenspan, for whom we all have a lot of respect.

Mr. RAINES. As do I.

Chairman SHELBY. As far as risk.

Mr. RAINES. As do I, although I found it curious that although banks are the largest holders of mortgages in portfolio, and although banks have the highest ratio of mortgages on their books today that they have ever had and have been growing at the fastest rate that they ever have, that was not mentioned, even though banks do not hedge interest rate risk and Fannie Mae and Freddie Mac do.

So, I found that a curious point that the companies who, in fact, hedge the risk were viewed by the Chairman as being more risky as compared to banks who do not.

Chairman SHELBY. I am sure we will get into that when the Chairman comes back. He spends a lot of time up here.

[Laughter.]

Mr. Raines, back in the early 1980's, it is my understanding that Fannie Mae experienced some problems with mortgages it had bought in portfolio. Didn't they encounter some difficulties during the early 1980's? And wasn't securitization viewed as a positive means to ensure that interest rate risk was not entirely concentrated with the GSE holding a mortgage portfolio? I think in your own organization you had some problems.

Mr. RAINES. Two things happened, Mr. Chairman. In the early 1980's, Fannie Mae operated like a big S&L. It borrowed short and lent long. And, fortunately, unlike the S&L's, it learned the lesson in time and was able to convert. And it did two things. One, it created the mortgage-backed securities program that gave it the ability to have an alternative execution. But the second and most important thing it did was create callable debt that allowed Fannie Mae to have liabilities that matched up with its assets.

And so it was those two innovations, not just the securitization but the creation of a large, liquid, viable, callable debt market that matched up with the mortgages that allowed us to move forward with an on-balance-sheet portfolio.

Chairman SHELBY. Mr. Syron, I will ask you this question, and then see whether the others have any comments. Chairman Greenspan also said yesterday most investors have apparently concluded that during a crisis the Federal Government will prevent the GSE's from defaulting on their debt, the so-called implicit guarantee.

Do you believe there is an implied guarantee backing the creditworthiness of GSE debt? Are you aware of Wall Street analysts making such claims? And if Fannie Mae or Freddie Mac were to become insolvent—which we pray they won't—would the Government have any moral obligation to make the creditors whole?

Now, I am familiar with your background as head of the Fed in Boston, so you bring that experience here. The Fed is the lender of last resort, is it not?

Mr. SYRON. First, sir, to answer your last question first, I am not sure that the Federal Government would have any moral obligation. I think in reality, to answer your question honestly, that financial markets, both domestically and internationally, tend to look at financial institutions, and some of this is reflected specifically in some of the treatment in some of the FDIC laws.

Chairman SHELBY. They would treat it as a national problem, would they not? And if it is treated as a national problem——

Mr. SYRON. I think that is correct.

Chairman SHELBY. —they wouldn't have a problem.

Mr. SYRON. I think that is correct, sir. You know, whether I believe that there are moral obligations or not is not what matters. What matters, as you imply, is what investors believe. I would argue that there is a whole family of these things, that if you were to go to the average purchaser of commercial paper for the very largest commercial banks in New York, that there are a lot of people that would believe that the Government wouldn't allow those institutions to go, and we have had experiences in that regard.

Chairman SHELBY. The "too big to fail" syndrome?

Mr. SYRON. Yes, sir. And I think it would be naïve for me to say that Freddie and Fannie and perhaps the Federal Home Loan Banks are not considered as part of that.

Chairman SHELBY. Do you agree with that, Mr. Raines?

Mr. RAINES. I believe that there is a perception that these institutions are so important that the Government will ensure, as best it can, that they are run well enough that they will not get into trouble; and if they are not run that way, that they will replace the leadership and make sure that the companies are run well. And that is the biggest guarantee. It is not that the Government is going to write a check. It is that the Government is not going to be indifferent. And the fact that the Government is not indifferent to the fate of these institutions, in the same way it is not indifferent to the fate of other large institutions, is the extra boost that is provided to them in the market.

Chairman SHELBY. Mr. Rice.

Mr. RICE. The underpinning of the Federal Home Loan Banks is the joint and several liability, and that is a case where all the banks will have to stand behind any failure in the system, and that has been the hallmark and underpinning of how we operate. And I really do believe that that is what we step up to, and I think that is an important ingredient in where we have to go. But I do believe that should the crisis be exacerbated beyond any of the other banks to back up a problem in the system, then it will be of a nature that all of us would want to solve it.

Chairman SHELBY. It was also mentioned more than just in passing yesterday about how do we curb the growth of the GSE's. I do not know that we would want to curb the growth, as long as they were adequately capitalized. Most financial institutions, if they are adequately capitalized or well-capitalized and well-regulated, nobody tries to curb their growth. Is that right, Mr. Syron?

Mr. SYRON. I think that is absolutely right, Mr. Chairman. And if I could, just touching back on your question to Chairman Raines, in looking at the capitalization of commercial banks versus the GSE's, actually, you know, in the proposed Basel II standards, risk-based standards for what banks across the world—and some of this is already reflected in practice—would be required to hold against mortgage-backed types of assets. I believe that is actually slightly lower than the 2.5 percent that we statutorily are required to hold now.

Chairman SHELBY. That is what is causing some of the regulators some heartburn, is not it?

Mr. SYRON. It is causing them a lot of heartburn.

Chairman SHELBY. Lowering the capital standards.

Mr. SYRON. But I think if you look at what Chairman Greenspan said yesterday, you know, that these institutions—and I am new to this, so I am not going to brag on the management of my own organization—have extraordinarily sophisticated hedging systems, extraordinarily sophisticated risk control systems, I mean to the extent where I every day at 5 o'clock, get a whole family of measures on my rim on exactly how we finished the day with respect to our exposure to interest rate risk. We have lots of measures of tests that we are within and whether we are meeting up to what is required.

Chairman SHELBY. Senator Dodd, I believe you are next.

COMMENTS OF SENATOR CHRISTOPHER J. DODD

Senator DODD. Thank you, Mr. Chairman, and I apologize for stepping in and out of the room here.

First of all, let me thank you, Mr. Chairman. You have done a very fine job—both you and Senator Sarbanes in having this series of hearings on this issue. And I think it has been tremendously worthwhile, so let me express my gratitude to you.

Let me thank all three of you as witnesses. I had a chance to listen to a couple of you talk and express yourselves, as well as read your testimony. And we thank you for it and for your ideas and suggestions.

I would just briefly say, Mr. Chairman, obviously like most of us here this is one of the great success stories of all time, and we do not want to lose sight of that. And as has been pointed by all, by our witnesses here, obviously the 70 percent of Americans who own their own homes today in no small measure due to the work that has been done here, and that should not be lost in this debate and discussion. And I think the points that have been raised by our witnesses emphasize that, and I certainly want to associate my own thoughts and feelings with those comments. And looking at how we can regulate these institutions in a way that will complement their jobs and the goals desired here is something we should embrace with a sense of caution, and I emphasize that word, that we do not do it in a way with a sledgehammer when a scalpel may be the appropriate tool so that we get maximum benefits out of these institutions rather than doing great damage to what has been one of the great engines of economic success in the last 30 or 40 years. So I thank them.

I do not know if you have raised this question while I stepped out of the room. If you have, then I will just step back. I heard Mr. Syron talking about it, and I know Frank Raines raised it as well, and that is the issue of receivership versus conservatorship. And I do not know if the question has been raised or not.

Chairman SHELBY. That is a good question, and timely, too.

Senator DODD. Why do not you just walk us through your concerns again? I heard briefly what you had to say, and I do not know if you disagreed with what each other had to say about this. I know you agreed mostly. And, Mr. Rice, as well, if you have some thoughts on this, I would like to hear them. But if you might give us your concerns with this recommended change that has been raised. And from your perspective what are the problems with providing a future regulator with the ability to place a GSE in receivership? And what are the potential market impacts of such a change?

Mr. SYRON. Senator, if I might just start on this, I think one of the great geniuses that Congress resulted with in creating these GSE's was an ability to transfer interest rate risk, particularly interest rate risk on 30-year, fixed-rate mortgages, from the homeowner to the capital markets.

Now, with the retained portfolio, given international investors' preferences not for mortgage-backed securities but preferences for the actual debt of these institutions, the GSE's, particularly Fannie and Freddie, we have found a way to sell more and more of our debt overseas, thereby shifting the interest rate risk, if you will, from homeowners in the United States to investors in foreign capital markets. And I think that is a substantial gain to the United States at a time when we have a lot of international trade issues, and it is not something that we very lightly want to give up.

I am not implying that there are not issues that have to be faced with this, but I think the best way to facing the issues of the size of our portfolio and the growth of our portfolio is the same way that you deal with the institutions as a whole, and that is, as my colleague said, making sure that you have good capital standards, that you have a very strong regulator, the regulator is able to change the capital standards on a frequent basis if it deems necessary because of change of risk, rather than specifically coming in and saying we are going to bless certain types of obligations and we are going to prohibit other types of obligations.

Thank you.

COMMENTS OF SENATOR PAUL S. SARBANES

Senator SARBANES. Did you indicate how much of your debt went overseas in your testimony?

Mr. SYRON. Yes, I think—now, Senator, I will apologize for being relatively new in this, but my understanding—and I only know our recent offerings. But in our recent offerings, I think somewhere on the order of about 34 percent has gone overseas.

Senator SARBANES. Of that offering, but how about your total debt, how much of it is overseas?

Mr. SYRON. I would have to get back to you on that.

Mr. RAINES. For Fannie Mae, of our benchmark debt securities, 32 percent are purchased by investors outside the United States. It is a very large part of our funding.

But, Senator Dodd, directly to your question, I think there is a lot of misunderstanding on this issue, and I think there has been a lot of back and forth on the names receiver and conservator. The key things are the powers. Typically, a receiver's major power that is different than other powers is the ability to take a contract and say it is no longer effective. That is the big power. It is able to take one position and put somebody else ahead of you and say they get paid before you do.

If you are the Government and have a bank insurance fund, you want to make sure you have paid the depositors and you are first in line to get repaid. And you need a receiver's power because, otherwise, everybody else will say you just showed up. We get paid first, you get paid last. So the job of the receiver is essentially to push everybody else out of the way, and pay the Government first. And then from whatever is left, the receiver can pay the others.

In our case, the Government is not involved, so there is nobody to be pushed out of the way. Our bond holders are simply saying, "Whatever there is left, pay me, but do not let someone else come in ahead of me." And when you say "receiver" in that kind of a case, they have a right to say, "Well, exactly who is this receiver supposed to shove out of the way? Is it me? And for whom? Who is putting money in? I am the only one putting money in. The shareholders are behind me, so that is fine. But who is it who wants to come ahead of me, the senior debt holder?" If you are a senior debt holder, you have to ask that question: "Why do they want this? Who do they want to have ahead of me? What is the point?"

I think it is far better to make it very clear—and I think Chairman Greenspan even suggested this yesterday—to make it very clear that the investors in the Enterprises have only access to the assets of the Enterprises and they get only what their contracts say they will get. And that is how we read the statute now. If others do not read it that way, we are perfectly happy to have it clarified that that is what is meant. But we think it would be a huge mistake for enterprises that have trillions of dollars of outstanding obligations for someone to come in and say, "Well, you know, we are not so sure about what those contracts mean. We are not so sure of how they will be enforced in the future."

I think that would be a terrible mistake to no advantage. So that is why it is so important to get this right. We shouldn't get hung up on the names. You can call the person "Bob" as far as I am concerned, as long as they do not have the power to push aside our debt holders and say they do not have access to the assets to pay off the debt holders, even if you do not get paid 100 percent. But they do not want someone else coming in and saying, someone else has the first access to those assets.

Mr. RICE. In the case of the Federal Home Loan Banks the case is already laid out. It is called joint and several liability, and should one bank falter, then the other banks are required to step up to the plate to cover the debt. So the Federal Home Loan Bank structure in my mind is resilient where each Federal Home Loan Bank is individually capitalized, but they are backed up by the other banks due to the joint and several aspects of that nature.

I think that one of the things that we really understood in this whole process of capital and looking, with Gramm-Leach-Bliley we review the capital of the Federal Home Loan Banks and raise the standard is what we needed to have as far as where we need to be. So, I think we were clearly under the magnifying glass for how we manage risk-based capital and leverage, and I think that will serve us well.

Senator DODD. Mr. Chairman, could I ask one more question?

Chairman SHELBY. Go ahead.

Senator DODD. One of the biggest concerns raised by Chairman Greenspan yesterday, one of the largest questions raised by him yesterday is that the Fannie Mae and Freddie Mac pose a systemic risk as a result of unsustainable growth, was I think the quote, almost a direct quote. Challenge that statement if you will.

Mr. SYRON. Senator, first of all I would say these organizations have undeniably grown very fast in the last number of years, but let us face it, we have had the best mortgage market, not just in the history of the United States, in the history of the world probably. Just given the changes that are happening in the economy, it is inevitable that the retained portfolios of these institutions are not going to grow as fast in the future and may even decline, and particularly in relationship to the public debt, I think as someone said, Greg Mankiw said, to the publicly held debt of the United States, given our own reasons of what is happening with the deficit, that is going to increase greatly.

Chairman SHELBY. I know it is Senator Dodd's time, but could you address specifically the concern of Chairman Greenspan to holding the debt in portfolio, because he spent some time on that yesterday.

Mr. SYRON. He spent a lot of time on it.

Chairman SHELBY. Obviously, it is a great concern to him.

Mr. SYRON. But I think now—I do not want to get into quibbling about, debating about exactly each of his words—I happened to watch his testimony again last night, and he focused a lot on the rate of growth of the debt from the current base, and he said that, paraphrasing, that he saw nothing in these institutions that gave him any current concern from a safety and soundness systemic perspective.

The issue he raised I think was that if you looked at the recent rate of growth of these portfolios, that he would have substantial concerns. What I am saying, quite honestly, is I do not think because of the expectation they have on what is going to happen on the mortgage market, that these portfolios are going to begin to have that rate of growth in the next few years as they have had in the last several years. That is a factual issue.

Beyond that, I think the way to deal with this—and I may be repeating myself here—but is to have a strong safety and soundness regulator, and as I have already said, in terms of their ability to look at us, we are going to be holding more capital. It may be unpopular. Then the maybe unpopular Basel II ratio would have some of the largest financial institutions in the world hold against similar securities.

Senator SARBANES. But that is just a proposal in Basel II and a lot of people are complaining very strongly about that.

Chairman SHELBY. All over the world.

Senator SARBANES. I do not think you can take a proposal about which considerable question is being raised and use that as the benchmark to make your argument.

Mr. SYRON. But I would come back then and I would say what we should look at is what has been the historical risk exposure of these types of assets. Both of these GSE's, exclusively housing

GSE's, have a requirement to meet quite strict stress tests on the different types of scenarios, and my understanding of it is, having gone through the exercise a couple of times, is that they meet those stress tests quite well. Your point is well taken, Senator, that it is a proposal and not a fully endorsed proposal by lots of people.

Mr. RAINES. Let me take a crack at this from another perspective. Clearly we are big, and we have grown as the market has grown. There are a couple of points that I would make, and that is that not only have we gotten big, but also everyone in the mortgage market has gotten big. Remember, the size of the mortgage market doubled in the last decade. It went from $3 trillion to $6 trillion, and we think it is going to double in this decade if we are going to meet the housing demand.

But look at this chart at what has happened since 1999 when we had $5 trillion of mortgage debt outstanding and in 2003 we went over $7 trillion. Freddie Mac's share of that went from 6 percent to 8 percent, Fannie Mae's went from 10 percent to 12 percent. The largest commercial banks went from 16 percent to 20 percent of the market. It is not simply the case that only these two institutions have gotten big.

There was a time when we thought Fannie Mae was about to be the largest company in America. Right now we are going backward. Why? Because banks are growing faster than we are. It is simply not enough to say these institutions have gotten big, because if that is the problem, you are going to have a problem across the board. You are going to have big banks, and we are in a country that is not used to having big financial institutions. We are a country where in many States it was illegal to be big. You could only have one branch. But we are now in a world in which we are going to have larger financial institutions. That is the first thing.

The second thing is: What are these institutions doing with these mortgages? Where is the risk?

Senator SARBANES. Who are the others before you leave that chart?

Mr. RAINES. The other largest holders?

Senator SARBANES. No. You have others, 52 percent in one and 47 percent in the other. Who is that?

Mr. RAINES. Primarily that is the holders of our mortgage-backed securities.

Senator SARBANES. Your mortgage-backed securities?

Mr. RAINES. Ours and Freddie Mac's, as well as the private label mortgage-backed securities that have been issued by banking institutions. So that is mutual funds and insurance companies——

Senator SARBANES. Of those mortgages, what percentage of them are yours and Freddie's?

Mr. RAINES. Of the total there is about 44 percent are a combination of Fannie Mae and Freddie Mac, where we have the credit risk. This is a measurement of who has the interest rate risk because we were talking about the concern about interest rate risks in portfolios. For about 44 percent of mortgage debt, Fannie Mae and Freddie Mac have the credit risk.

Chairman SHELBY. What do you mean by that? What is your guarantee on that, because there is a risk there.

Mr. RAINES. We guarantee the timely payment of principal and interest on the obligations. This is looking at who has the interest rate risk, and contrary to opinion, Fannie Mae and Freddie Mac do not own the interest rate risk on all the mortgages in America. We have a combination of about 20 percent on our portfolio. The other 80 percent is in other institutions, many of them quite large.

The second point is: How much risk do they have and what do they do with that risk? Because that is where you have to determine what is happening. This is a complicated chart, but I will make it quite simple. It is just simply a measure of what is the growth risk you have, that 12 and 8 percent I said before. What is the net? What is left after you have hedged? Fannie and Freddie do a pretty good job of taking the risk that they got in the beginning and passing on about half of that risk to others. Look what happens when you get to depository institutions. They pass on almost none of the risk that they take on when they buy mortgages. They keep it. So again, if I am worried about risk in financial institutions, I would be a lot more worried about those who take it and keep it than those who pass it on.

Senator SARBANES. What percent of their assets in the financial institutions are reflected by mortgages?

Mr. RAINES. Today about 34 percent.

Senator SARBANES. I thought the figure was about 21 percent.

Mr. RAINES. If you look at the financial assets of banks and thrifts, about 34 percent are made up of mortgage assets.

Senator SARBANES. What percent of your assets are made up of those items?

Mr. RAINES. Ninety-six. I mean we are specialists. This is what we do. In between banks and us would be thrifts, who have a large share as well.

Senator SARBANES. Would that not lead to the conclusion, if there is some concern about the risk here, and you are an institution in which 96 percent of your assets are in that category, that there is reason for heightened concern there as opposed to an institution in which 32 percent of its assets are in that category? Would that not simply follow, before you get to the hedging issue?

Mr. RAINES. You cannot ignore the hedging because we would not buy the asset if we did not do the hedging. It is not optional to us as to whether or not we are going to——

Chairman SHELBY. Mr. Raines, just for the record, and I know it is Senator Sarbanes—Senator Dodd's time.

[Laughter.]

On the other hand, I think Senator Bennett's time is coming up. But, Chairman Raines, what is the source of your data, and would you furnish that for the record?

Mr. RAINES. I would be delighted to do that.

Chairman SHELBY. Because our Committee would like to see that.

Mr. RAINES. I would be delighted to share it. This is an issue that obviously we spend a lot of time on. But it is a question I think the Committee can rightly ask: Are you better off having people who specialize in an asset, and this is all they do, or are you better off to have someone who has assets all over the board? Banks do 20 different things. They do junk bonds. They do Third

World debt. In whose hands would you rather have these assets? Someone is going to have this risk, unless of course we tell consumers, you cannot have a fixed rate mortgage. We can solve this problem. It is solved all over the world by telling people, you have the risk, you the homeowner. We are not going to have the banks take the risk. You have it.

In this country we have done something different, and in fact, that is why Fannie Mae was created in 1938, was to buy this newfangled mortgage that someone came up with, which was the FHA 30-year, fixed-rate, refinanceable mortgage. Today, over 60 years later, we are still doing the same thing.

Senator SARBANES. Of course, Chairman Greenspan was critical yesterday of that concept. I mean he is in here in a sense pushing adjustable rate mortgages yesterday, and throwing this risk back on the consumer, and in fact made the argument that the consumer would come out ahead. Of course, that is going to, it seems to me, require a fairly smart consumer who is going to have to know when to jump in and jump out and so forth. But he, in effect, is downing the 30-year fixed rate mortgage and pushing up the adjustable rate mortgage.

Mr. RAINES. Absolutely, Senator. You said it as plainly as I think it can be said, and the choice is really Congress's choice. It is a choice of whether or not you think consumers should have access to long-term fixed rate mortgages or they should not. And one can disagree on that. It is not as though that there is only one answer, but if you want them to have that choice, this is the only country who has figured out how to do it, and we figured out how to do it with a housing finance system that works.

Senator DODD. Particularly, if you are talking about serving underserved constituency. Adjustable rate mortgages, for a low income constituency, is a nightmare.

Mr. SYRON. If I may just inject something. Adjustable rate mortgages would have been a terrific instrument to have in the last 8 years or so when we have had one of great bull markets in bonds in the history of the republic. They would not have been such a great instrument to have had you taken out an adjustable rate mortgage in 1974, 1978, or any other points in the business cycle.

The plain fact is, as a matter of national policy—it happens to be national policy I agree with, but as Frank says, it is your choice—we have decided that as Americans that we would prefer to shift the risk, the interest rate risk from homeowners to a sector that is better able to bear it. Other nations have not tried to do that. Many are exploring doing it now. The EU, as you know, is looking at setting up a GSE, but that is a decision we have made.

Chairman SHELBY. Senator Bennett, you have been very patient.

STATEMENT OF SENATOR ROBERT F. BENNETT

Senator BENNETT. Thank you, Mr. Chairman. I have had all my questions already asked.

[Laughter.]

There is an advantage of waiting.

I have not had this conversation with Chairman Greenspan, and I would like to because I would like to understand his thinking a little better. All I have done is read about it in the newspaper, and I have long since learned that is not always a reliable source.

I think Chairman Greenspan shares my devotion to the market, and allowing the person who is getting the mortgage to make the choice whether he wants an ARM or a fixed rate. I have never had an ARM in my lifetime. I have always had a fixed rate. I have had various terms, 15 years as opposed to 30 years for a variety of reasons. No. As a matter of fact, I just signed up for an ARM. I lied. I am sorry.

[Laughter.]

Forgot that. That was just last week.

Chairman SHELBY. We will correct the record.

[Laughter.]

Senator BENNETT. Yes, correct the record on that.

As I listen though I think you are saying that if we decide as a matter of national policy we are going to limit the ability of the GSE's to grow, that means once we reach the ceiling, however or whatever we choose as the way and place to set it, that means that you have to wait till somebody pays off his 30-year mortgage before somebody else can get one. Is that an oversimplification if the pot is full? Some of the people behind you are shaking their heads.

Mr. SYRON. It is not totally the case because we still could secure it, take and securitize the 30-year mortgage.

Senator BENNETT. I see. The limit would come only from that which is supported by debt?

Mr. SYRON. Yes, that is right. Before I give up totally, do not forget that if we were to do that, we would be giving up the ability to tap foreign capital markets.

Senator BENNETT. I understand that. So there would still be some growth.

Mr. SYRON. Yes, sir.

Senator BENNETT. But it would limit the amount.

Mr. SYRON. It would have some limit on the amount.

Senator BENNETT. Back to my philosophical point. I do not like any form of governmental wage and price or product control. I like to let the marketplace decide what people get paid and what they can buy, and I think you are saying that the consumer is choosing this; even though the ARM is available, the consumers are making a choice.

The question is: Is that choice subsidized by virtue of the implied guarantee? In business I have never been able to cash in on an implied guarantee. I always prefer it in black and white, and I still do not understand where the implied guarantee—I guess it is the too-big-to-fail argument that we have heard here. Answer that question.

Mr. RAINES. There is no difference. We buy adjustable rate mortgages. We buy fixed rate mortgages. It is the consumer who is deciding, and consistently the consumer decides 80 percent of the time they would like a fixed rate mortgage. But in the market we are not in, in the jumbo market is only 50 percent fixed rate mortgages, and that is because the market we are not in cannot support the same level of fixed rate mortgages. In fact, right at the line where the loan limit exists, as soon as a loan falls into an area that we can buy, all of a sudden the market shifts over to fixed rate mortgages. So this is the consumer's choice. Fannie Mae, today I believe, has 1,000 different adjustable rate mortgages that we are willing to buy. There is no lack of choice. You name an index. You name a feature. Somewhere in there we have in our system that mortgage and the ability to buy that mortgage.

Consumer choice is vital here, and every occasion I have seen where consumers have had the choice to fix their largest single expenditure, particularly in the lowest interest rate environment we have had in 30 years, they take that choice. Some people, because of the cost, have to take on more risk because they can get a lower initial rate. So they get that rate and take on that risk because they want to get in the home so badly, but as soon as they can, our experience is, they flip out of that adjustable rate mortgage into a fixed mortgage.

Senator BENNETT. Except for the jumbo market.

Mr. RAINES. Except in the jumbo market where it is simply so much more expensive that it just does not make as much sense for them to be in——

Senator BENNETT. What is the line of the jumbo market these days?

Mr. RAINES. $333,700.

Senator BENNETT. You can see where I am going. My concern I have expressed to Mr. Rice when we had this hearing before, obviously safety and soundness has to be our primary goal here, but at the same time the way to be sure we have absolute safety and soundness is to require you to keep gold and make no loans whatsoever. That is pretty safe and sound, although with the commodity price maybe not even that is very good. We had to perform the mission. The question before the Committee, I believe, Mr. Chairman and Senator Shelby, is how do we construct a regulatory framework that gives us the ability to sleep at night on the safety and soundness issue and does not constrain the mission which the three of you and the organizations you represent have taken on and performed so admirably, that we do indeed lead the world by a very wide margin—this is not a close horse race—a very wide margin of homeownership, and that is a very difficult balancing act, and into it comes the new element that I had not thought of before this recent controversy raised by Chairman Greenspan of how do we do it in such a way that does not distort the market choices of the consumers that are taking out the mortgages, which is part, in my view, of fulfilling your mission. But it is a part which I had not addressed before. We have to make sure that the Government does not start picking winners and losers in product that is made available to the individual who takes out his mortgage, that he or she remains free to make, unimpeded by Government regulatory pressure, the right choice for him, and to switch if he decides he starts with an ARM and wants to go, we have to make sure that product is available for him to go. Is that a fair summary of the dilemma that we are facing here?

Mr. RAINES. It is, Senator, and it is going to get harder for you because the demand for mortgage credit in this decade, as I mentioned before, is going to double, and so we not only have to figure out how we continue to raise the $7 trillion that we are raising now, but we are also going to have to figure out how we get to $11 to $13 trillion while maintaining consumer choice and holding risk down.

If we had a static world where all we were doing was having to move around the current problem, it would be a lot easier, but we do not have a static world. These companies are going to have to figure out what investor have we not tapped? What part of the world has not invested enough in the United States? Who are we going to get to invest more than they have ever invested before in our housing market as opposed to their housing market? Our challenge is huge. This is what I worry about all the time. I do not worry about whether or not we know how to manage the mortgages we have on our books today. I worry about where we are going to find the money that is going to house this 30 million people who are going to be here in 2010, because if we do not, it is going to be a very simple result. We are going to have a shortage of housing capital. There will be higher prices to clear the market. Fewer people will qualify. So we will have a lower homeownership rate in the future than we have today, fewer people becoming homeowners, because we failed to come up with that additional $6 trillion of capital. So this is a huge, huge problem.

One of the reasons that I am so anxious for this Committee and this Congress to resolve these regulatory issues is so we can get about the work of doing this. We need a stable structure in order to take on this job. If it is up in the air, I cannot tell you that as we have in these prior decades, that we will be able to meet the task in the coming years.

Chairman SHELBY. Stable structure including a stable regulator.

Mr. RAINES. Exactly.

Senator BENNETT. If I can just ask one question, to which I do not want an answer, but to get it on the record so that we might look at it, I wonder if some study could be made of how much that increased demand is being driven by our present tax laws that say you cannot deduct credit card debt but you can deduct home debt, and how much demand for mortgages is being driven by an effort to get their debt into a situation where the interest can be deductible, as it used to be? I remember filling out my 1040 and used to be able to deduct interest in any place, and now the only place it is deductible—and you see all of the ads on the television saying: Consolidate all your bills and get yourself into our home mortgage situation and then all the interest is deductible. At some point we should have a study done to see whether or not the tax laws are driving an artificial amount of people going into their home loans that might be changed. As I say, it is a question to which I do not want an answer here. Thank you for your indulgence.

Chairman SHELBY. Before I call on Senator Carper I just want to respond to something you said, Chairman Raines. You were talking about specialization earlier. Banks have asked for expanded authority over the years for activities, as they say, to reduce risk through diversification. Fannie, as I understood it now, is engaging in one less risky activity. Does that not contradict the standard investment theory to spread your risk? You see what I am getting at?

Mr. RAINES. Actually, Mr. Chairman, there is a lot of debate and there has been some good work on this question of how much you can diversify away certain risk. It is not clear to me, and I think our experience is not such, that looking at banks, that this diversification across businesses has been successful. The counter argument is if you are in many businesses, how many of them can you be good at? And how many management teams can you bring together to manage all of these businesses? The experience I think in the banking sector has been if one of those businesses goes down, the diversification does not seem to have any effect whatsoever. I am much more a believer in putting your eggs in the basket; and watching the basket.

Chairman SHELBY. Senator Carper.

STATEMENT OF SENATOR THOMAS R. CARPER

Senator CARPER. Thanks, Mr. Chairman. To our witnesses, welcome and thank you for being with us today.

Mr. Raines, I walked in after you had given your testimony and Mr. Syron was just beginning his and I heard his testimony and that of Mr. Rice. I did not hear your testimony, and I am not going to ask you to give your testimony, but I what I would like for you to do is take just maybe a minute and just recap a couple of key nuggets that you would have us take out of here.

Mr. RAINES. I just tried to make four points in the testimony, that primarily we need to focus on the important goal of maintaining the best housing finance system in the world. Getting capital right is a very important part of that. Getting the receivership question resolved appropriately so it does not introduce new uncertainty into the marketplace is a very important part of that as well. And we have to make it possible to have innovation and not have it tied up in bureaucratic process.

Senator CARPER. Thank you. Yesterday, when Chairman Greenspan was here I asked him a question. I am going to ask you the same question. I asked him: What wrong are we trying to make right in this process, and what risk or what harm are we seeking to avert? Let me just ask each of you the same question. Mr. Rice, if we could just start with you.

Mr. RICE. I ask that question often, but I think what I really believe is at issue is a strong independent regulatory structure in order to manage the risk that is inherent with our business, and that by giving that regulator the powers to manage capital, to have independence, have the oversight responsibilities that are necessary, can restore a lot more confidence in this whole process.

I think that as you begin to pile on, so to speak, or look at other ancillary issues beyond, then it becomes a little more complex. I really do think that we are going to have to figure out and create a structure that allows an independent regulator to be accountable to the Banking Committee and Congress and engage in that dialogue of change rather than trying to statutorily try to make all those changes, because I think this is not just a turn of the screw and things are all right. I think it is a long-term discussion with trust and support for an independent regulator.

Senator CARPER. Mr. Syron, let me ask the same question. Again, the question is: What wrong are we seeking to make right and what harm are we seeking to avert?

Mr. SYRON. I think that is a very good question, Senator, because I think there is a confusion on it. First, in terms of what is right, I think we have the most effective housing finance system in the world and the people in the rest of the world will tell us that. The wrong, in my mind, that we need to make right is I do not think we have an adequate regulatory structure for the GSE's, an adequately funded regulatory structure, and I do not know if it is an adequately structured regulatory structure. I think that is the issue that we need to make right.

The issue that I do not think is broken and that we do not need to make right is to reexamine the entire housing finance system of the United States to explore the issue of whether we want to privatize these organizations and radically change the way we provide housing finance in the United States.

Senator CARPER. Mr. Raines.

Mr. RAINES. I think the legitimate issue that we would encourage the Congress to look at is whether the regulatory regime for these important institutions is appropriate given the need in the future. The last time Congress did this was 1992, and in 1992 it made big changes. We did not have a safety and soundness regulator before 1992. We did not have real capital standards before 1992. We did not have housing goals before 1992. All of that happened in the 1992 Act. I think it made the system better. I think it made Fannie Mae better. I hope that through this process you prepare these companies for the task that we have going forward, which is to carry out the national policy of making homeownership and affordable rental housing more available, and to meet the needs of a growing country.

In crafting a better arrangement from a regulatory standpoint, do not harm the underlying mission of the companies.

Senator CARPER. I am sure you heard from the critics of GSE's, particularly private sector competitors of the GSE's who really believe that you have an unfair advantage here, and it is something they would like to change. What do you say to those people?

Mr. SYRON. Unfair advantage, I have found is always very much in the eyes of the different competitors. Our different competitors have advantages of their own. They have, in many cases, depository insurance. They have an ability, which we are not looking for, to come in and out of markets. They will come in and out of these markets at the—excuse the expression—drop of a dime, depending on where things are most advantageous from their perspective. At least speaking for the two housing GSE's, our responsibility is to be focused on the housing industry. Business in the United States is the reason we are as effective as a Nation as we are is a very, very competitive situation. But everyone will look at their own situation and say someone else has an unfair advantage. When was the last time you heard a CEO come to you and say, "My company has an unfair advantage?"

Mr. RAINES. Senator, I think there is a lot of myth and legend about who has what unfair advantage. When you look at in terms of unfair advantages and you say, who has the best deal? I would love to have the deal the banks have. Why? We have to fund our balance sheet by issuing long-term debt in the capital markets. They fund most of their balance sheet with deposits, and those deposits are backed up by insurance and they are also backed up by the Fed window that allows them to borrow. This has a huge impact, and this goes to what I think is the biggest myth, that is, that Fannie Mae has the lowest cost of funds out there.

What I have plotted on this chart is since 1994 the cost of funds for commercial banks and for Fannie Mae. If you look at the cost of funds for the commercial banks, they are the low end, but it is cheating a little bit because they actually have to run branches and things to collect these funds, so it is not free. We have adjusted for that cost. As you see, throughout this entire period banks have had a lower cost of funds than Fannie Mae, and as my CFO likes to say, the real proof of this is that banks buy Fannie Mae debt. We do not buy deposits. We cannot make money buying deposits, but they make money buying Fannie Mae debt. Indeed, some people say they buy too much Fannie Mae debt, but there is no doubt that they buy Fannie Mae debt. How could they buy our debt, which is our cost of funds, if their cost of funds was higher than ours?

The great myth here is that Fannie Mae is sitting with a much lower cost of funds. Banks, if they want to grow their mortgage portfolio, do it, and we step aside. When they stop wanting to grow their mortgage portfolio, we step up. They may say, "Ah, but you can go into the agency market." I showed you before they do not use long-term debt very much in their funding, but they can go in the agency market too through the Federal Home Loan Banks. Their primary job is to fund banks out of the agency market. So they borrow at essentially the same cost that we do and pass it on to banks. So they have lower cost deposits and the same long term funding cost as we have. So that is a pretty good deal.

The tears that are shed on behalf of the banks that somehow we have an unfair advantage against them, I do not see it. I see them able to grow whenever they want to grow, to move from business to business whenever they want to, to merge into very large institutions without anyone being concerned that somehow there is systemic risk being created or the system is at risk. I think they do a great job as diversified financial institutions. We do a pretty good job as institutions who are focused on the housing market.

Chairman SHELBY. Senator Carper, could I just interject?

Senator CARPER. Sure.

Chairman SHELBY. A lot of the banks say you have, the GSE's the unfair advantage and so forth. What is your answer to that? Is that your answer?

Mr. RAINES. I say on the cost side it is pretty clear that we do not. They have never been able to explain to me why they buy our debt if our debt is lower than their cost of funds. But even on the capital side we do not have an advantage. In fact, I would be willing to trade with them. If they are willing to take our capital standard and be subject to the OFHEO risk-based capital standard where they have to have sufficient capital to withstand huge movements in interest rates and depression level credit losses——

Chairman SHELBY. They are into a lot of things that you are not into in the whole panoply of financial services. You are in a specialty.

Mr. RAINES. That is one reason why they need to hold a lot more capital because most of the things they are in outside of housing are far more risky.

But our capital standard is so rigorous that we had a firm a couple of years ago look at it and see what would happen to a thrift, which was the closest comparison to us without all these other businesses. If OFHEO capital standard were applied, the thrift would have to have 50 percent more capital.

Again, there is a lot of myth and legend that has been repeated over and over again that Fannie Mae has an easier capital standard, that we have cheaper cost of funds. The fact of the matter is that we do not.

Senator CARPER. I would like to yield back the balance of my time to Senator Dodd.

Chairman SHELBY. That was kind of you.

Senator Sarbanes.

Senator SARBANES. Thank you, Mr. Chairman.

I want to ask first what your position is on whether approval from the regulator should be required with respect to new product lines or product activity?

Mr. SYRON. Senator, I think it depends on how one defines those terms.

Senator SARBANES. Let me stop you right there. Do you agree with that?

Mr. RAINES. With what he just said so far?

Senator SARBANES. Yes.

Mr. RAINES. Yes, it does.

Senator SARBANES. Do you also agree with that, Mr. Rice?

Mr. RICE. We operate under a situation today that they approve any new business activity, the Finance Board.

Senator SARBANES. And do you think the regulator should have that power?

Mr. RICE. I have no problem with it.

Senator SARBANES. Even under a new structure here, okay. Do you agree with that statement?

Mr. SYRON. As I understand the statement, I agree with it.

[Laughter.]

I will not claim that I understand it, Senator.

Senator SARBANES. Rather than giving me all the qualifications, each of you tell me what power you think the regulator should have in this area?

Mr. SYRON. Can I try to answer that? Let me give you a case in which I think they should not be required to approve it and a case in which I think they should be required to approve it. Should we decide—we are not about to do this—but should we decide that we wanted to offer something like mortgage insurance or to go further toward the retail end, toward the origination end, I totally agree that the regulator——

Senator SARBANES. No, no. I have to get you down into the ball game. I have to get you onto the ball field. It does not help me to get these examples that are outside of the ball park because if we are going to have a regulator, the first question is are they going to have power in this area. Everyone, as I understand it, has said, yes, but it has to be properly defined, and I am trying to get a definition out of you. I want to know where you see the line, how do you define that line?

Mr. RAINES. Let me take a crack at that. I believe that the line should be exactly where it is today, at the program level. If we are doing something brand new, then the regulator should have the ability to preapprove that.

Chairman SHELBY. Or reject it.

Mr. RAINES. Or reject it. But, for example, one of the first things I did when I came in as Chairman of Fannie Mae is we had never been in the business of helping people with impaired credit. It was within our loan limit. It was a conventional loan. It was a mortgage. We had simply set our standards at a level that made them not qualify. I do not think I should have had to go to a regulator and say: Well, what do you think? Do you think that we should be able to do that? We cut down payments. I do not think we should have had to go to the regulator with that. I announced 3 or 4 weeks ago our expansion of our American Dream Commitment, 60 different initiatives. I do not think that the regulator should have been telling me whether or not I should set a goal of increasing the minority homeownership rate to 55 percent. I do not think they should be in the business of telling me that we should or should not be able to tighten up our predatory lending standards. I think that should be left to private management.

But for example, we had never been in the business of doing acquisition, development, and construction financing, which is different. We took that to HUD and HUD looked at it and they approved it. They could have said no. But that was a wholly different thing. It was not a mortgage where we were changing around the criteria. It is a wholly different business that we had been encouraged to get into, and we experimented with in cooperation with HUD. They approved that. So that is the distinction.

If every time I have a new product or a new activity, and I have to get approval, do you have any idea how long it would take me to get the 60 initiatives approved, even just to put together the request and to have all of the evidence that a regulator would want to look at? That is not a business. That is running a bureaucracy, and I do not think that the Congress should want to turn these companies that have been innovative companies with private management, into simply an extension of a bureaucracy.

Chairman SHELBY. Excuse me. I know it is Senator Sarbanes' time. How would you compare that to a bank regulator for a bank to get into various things, do they have to deal with a regulator?

Mr. RAINES. Banks do not have prior approval as long as they are within banking. Only if they are going into one of these new powers do they have to go and get approval. So it is quite similar. The term "new activity" is probably the most pernicious aspect of this because every time we change a process, we would have to go and get approval from a regulator. I think it would stifle not only these businesses but also any business. I cannot see how any entrepreneurial enterprise, public or private, could operate having to ask permission every time they wanted to have an innovation.

Senator SARBANES. Mr. Raines and Mr. Syron, everyone asserts that you get a subsidy flowing off of the implicit guarantee, and then there are various figures as to what portion of that subsidy gets passed through in order to benefit the consumer. What do you think the figure is that passes through to benefit the consumer?

Mr. RAINES. I think I can illustrate it for you pretty easily because we see it every day, and we can calculate it for you, and this may be a little bit different way than you have seen it before, but it is pretty clear as to what happens. This chart compares our market, the conforming market, below the $333,700 in the jumbo market. What I am comparing at the top is the yield on a mortgage-backed security issued by Fannie Mae versus a mortgage-backed security issued by a bank or someone else in the jumbo market. You can see that the difference in the yield between the two is about 21 basis points. That is what we bring to the party. The way we reduce rates is to bring down the yield on our mortgage-backed securities. We do that by increasing liquidity and by buying them ourselves through our portfolio. That is our contribution.

Everything after that is our cost of a guarantee fee and lender costs. When you get down to the primary rate, the rate that you find out in the market, the consumer is paying 5.93 percent versus 6.19, actually it expanded. Our 21 basis points became 26 basis points. This is why we say we pass on more than all of the benefit. If you give the "implied guarantee" all the credit for that 21 basis points at the top—which we do not, we think we actually do some things here; our liquidity actually is a big piece of that. But if the Government got 100 percent of the credit for that 21 basis points, by the time it gets to the consumer it turned into 26 because our system is more efficient than the jumbo system. Ours has more liquidity. Lenders have to compete more because we have more small lenders who are competing in our market than in the jumbo market.

This is not based on some fancy equation. This is simply going into the market and looking at every element between the issuance of that mortgage-backed security, which is the cost of funds for that mortgage, and the rate the consumer gets. I offer that up to you as far better proof than econometric models that try to calculate the same thing, not by observing what happened in the market, but by running mathematical equations to simulate what happens in the market.

Senator SARBANES. Is it your position that whatever subsidy you get is entirely passed through and that none of it stays within the confines to benefit the shareholders of the company?

Mr. RAINES. That is indeed our position. The shareholders in the company are——

Senator SARBANES. No one else has come here and taken that position.

Mr. RAINES. I have taken that position for years, and Fannie Mae has taken that position for years, and there are a number of studies that have been taken on, that have been conducted by conservatives, by liberals and others, who have come to exactly the same conclusion. We can provide the Committee with those studies that have examined that issue.

Chairman SHELBY. Could you do that?

Senator SARBANES. If we were to look at all these studies, your and others, and conclude that the subsidy was not being entirely passed through, what do you think should be done about that if anything?

Mr. RAINES. You have to ask the question, what is it that we do? If you believe that some of the "subsidy" was not being passed on, let us look and see where all the money that we make goes, and we can figure out where we think there is an excess. This chart shows for last year our total pretax earnings. This goes to the question, where does it go? Twenty-five percent of it the Federal Government gets in income taxes. We are a full Federal income taxpayer, probably one of the largest in the country. Twenty-five percent goes there. Fifty-seven percent goes to capital, to bolster that capital which is the safety that we have been talking about. Our shareholders only get 18 percent of it now. So if there is a dollar of subsidy that we get, this is a pretty good idea of where it goes now. The question is: Who should it be taken from if it is going to go some other place? Are we going to take it out of capital? Are we going to take it out of the taxes or are the shareholders supposed to give up of the 18 percent they get of the funding? There is no magical——

Senator SARBANES. How is it your shareholders do so well on a comparative basis, double figure payoffs and——

COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. Would the Senator yield?

Senator SARBANES. Certainly.

Senator CORZINE. I do think that the build-up in capital has something to do with shareholder value. If I am not mistaken, it does increase the book, and therefore somebody has some perspective on what value is created.

Mr. RAINES. Except the only problem here is that they can never liquidate the firm. So the only way they can——

Senator CORZINE. They can liquidate the stock. The marketplace has decided the value.

Mr. RAINES. Because they cannot liquidate the firm the capital is stuck inside the firm.

Senator CORZINE. That is true.

Mr. RAINES. But also with regard to the returns, let us be brutally honest here. Fannie Mae has a price-to-earnings ratio of about 9, which is half of the P/E ratio of the S&P 500 average. So we are half of the average companies' P/E. This is not a sign that shareholders think they are getting a fabulous deal. If they thought they were getting a fabulous deal, our P/E ratio would at least be equal to the average company.

I am not poor-mouthing, saying that somehow you need to help us. I am just simply saying the idea that somehow that our shareholders are getting a bonanza, when in fact, our stock has not performed even at the same level as other financials have over the last 5 years, says something about our relative position. It may be a good thing to be a financial, although all the financials have relatively low P/E's, but this is not the market indicia of a company that is collecting what economists would call rent, ordinarily having a return higher than the market, not lower.

Senator SARBANES. Is it your position that you cannot assume any greater burdens of responsibilities with respect to affordable housing because you are really stretched right out to the limit; is that right?

Mr. RAINES. No, just the opposite. I just announced the largest commitment to affordable housing any company in the world has ever made, and since I have been Chairman of this company we have committed $2 trillion. We have just committed to help create another 6 million new homeowners. I do not think there is any company who has done as much as Fannie Mae or promised to do as much as Fannie Mae, and we are not done. We believe we can do more, but we do not think it is a question of subsidies. We think it is a question of making the system work better, and if we make the system work better we can make more homeowners. I guess the proof is in the pudding, and if you would bear with me for one last chart, and I promise I will try not to do another one.

This is a comparison with our friends at the FHA, who have for years been leaders in providing service. It shows you the difference that can be made over time. I can show you this in a variety of ways. This is just looking at minority borrowers. I could show it looking at low-income borrowers or in poor areas.

Back in 2000, the FHA did substantially more service to minority borrowers than Fannie Mae, significantly more. We made a commitment that we were going to be the leaders in service to minority households. In 2001, we did 50 percent more than the FHA. In 2002, we did 2.5 times as much as the FHA. We do not where they are in 2003, but given that we increased our service by 70 percent, I daresay I do not think that they are going to be close to us there. This is real service to real people. The FHA is a Government owned, Government guaranteed, Government subsidized entity that can make loans in the same markets we make loans in, and we are able to provide dramatically more service through a private sector, private capital entity. This is a success story. This is not something for us to go and be sad about. We are serving more people than we ever were serving before. This is because we have reached out, we have tried to do more, and we keep pushing the envelope. I can pledge to you as long as I am Chairman of Fannie Mae, that we will continue to push the envelope of what we can do in the confines of private capital.

What we cannot do is be a subsidy source, where we are simply taking money and not investing in a business but giving it out as a subsidy. That will be the death of these companies and will prevent us from this type of service.

Senator SARBANES. I have one question for Mayor Rice. I want to get him into the—and I say Mayor. You know, Averell Harriman——

Mr. RICE. I accept the title.

Senator SARBANES. —insisted on being called Governor, even though he had been Secretary and Ambassador and everything else.

Mayor Rice, I am going to ask you a very simple question. What do you see in the current context as the purpose of the Federal Home Loan Bank System?

Mr. RICE. First of all, we are a cooperatively owned system, 8,000 members, and we serve our members to provide housing, financing, and liquidity for those members. One of the things you said earlier, what do we do with our subsidy? I think the CBO report that was laid out in 2001, the banks are cooperatively owned by retail financial institutions, they have elected to become members of the System, and they are eligible to borrow from the Federal Home Loan Bank for financing and advances.

Because the members are both owners and customers of the Federal Home Loan Banks, it is more likely that almost all the benefit of the GSE status is passed through to them either in the form of concessions on the advances or our dividends, because actually retail lending is highly competitive, and members may be forced, and often do, pass most of the benefit on to their customers in order to be competitive.

Senator SARBANES. Why do we have this facility? Why do we provide this facility to which the member banks can go and get advances at a reduced rate? Why do we do that?

Mr. RICE. Well, I think when you look at several of our members, they do not all have access to the capital markets in the same way. I think this is a way to give them liquidity. This is a way in which they can still be competitive in those smaller areas and those rural communities all throughout America where they are not large in scale, they are actually small and need that ally and that assistance. They also come to us periodically for new ideas and new opportunities such as to sell their mortgages, which we are undertaking and reviewing, and we try to respond to their needs.

Senator SARBANES. That sounds good, but then you start looking at the statistics beneath the surface. According to a report cited by the May 2001 CBO study of the housing GSE's, 52 percent of the mortgages held by FHLBank System members which are used as collateral for system advances, are jumbo loans. In fact, according to the CBO study, only 300 million out of 3 billion in total Federal subsidies received by the System benefits conforming mortgage borrowers. What is the public policy rationale for providing a Federal subsidy for jumbo borrowers?

Mr. RICE. I do not have those statistics. I do not agree with them totally, but I will say this. Remember though, you have to look at the whole range of what we are responding to do. Ten percent of our net income goes for affordable housing direct. Twenty percent of our net income goes for reducing the REFCORP debt. The sum of what we do is still intricately important in I think financing housing, financing and mortgage lending in our districts.

Senator SARBANES. If these statistics are correct, would they give you concern? Let us assume they are correct for the moment. Does that give you concern?

Mr. RICE. The jumbo loans and the 52 percent of what is held?

Senator SARBANES. Yes. Why are we providing this.

Mr. RICE. I think what I would like to see with the figures is by which members of our bank, because I think there are large members and there are small members, and they may very well be held by a class of members that are not representative of all 8,000 member institutions.

Senator SARBANES. I understand the 10 top members out of the 8,000 have 25 percent of the advances in the Federal Home Loan Bank System. Is that right?

Mr. RICE. I think that if you are part of a cooperative and members can join, I do not see anything wrong with that. I think really the idea is——

Senator SARBANES. Why are we providing this special status? Why do we have it if the advances are going to a concentrated number of large institutions, and if it is supporting jumbo loans, why are we doing this? What is the purpose of this?

Mr. RICE. I think the financial industry has changed drastically from when we started, and there is a barbell effect. There are large members on one side and there are small members on the other end of that barbell. I think that when you have a cooperative you cannot start discriminating between large and small. You have to afford the members of the cooperative access to the services that you have, and that is part of how we operate. I think if you start to begin to differentiate and begin to try to draw those lines, I think it become harder to manager.

Senator SARBANES. If it becomes highly concentrated, is it not reasonable for policymakers to start asking the question why do we have this system in any event? What is the purpose of it?

Mr. RICE. I still think that the purpose is to provide liquidity to financial institutions in need that do not have choice. I think it is also to offer those financial institutions choice in the marketplace, and whether size or not, that is the choice that we should offer our members.

Chairman SHELBY. Senator Corzine, you have been very patient. We should have given you most of the afternoon, given your background. Anyway, go ahead.

Senator CORZINE. I would only make one comment, that I suspect those P/E ratios would go up a lot faster if we were not debating how they were going to be structured for the next, whatever, but I think it is also a worthwhile discussion. I thank you, Mr. Chairman, for what I think is a very thoughtful discussion that we are having about these overall issues.

It seems to me that the systemic risk question that Chairman Greenspan raised yesterday continues to linger. I am not sure that I agree with it, but it lingers in the sense that diversification of risk, by some people' views, as I think the Chairman mentioned, is one of the principles at least some of us learned in Finance 101, and that there is a concentration of risk here, and therefore does that create another type of risk, beyond interest rate and credit, such as operational risk, which maybe we have seen displayed by the current circumstances of restatements of earnings and other issues, that unintended consequences tend to get bigger in a world where you do not have——

So, I guess I would like to hear whether you think the concentration of risk deserves some greater attention in the risk-based modeling than now is the case. As I see it, maybe it is what stimulated Chairman Greenspan to worry about systemic risk, if we are going to have grow $6 trillion over the next decade and mortgage debt outstanding being held. I guess not held, but creation.

I think it is a fair question. You know, is there some reductio ad absurdum number that these institutions should not grow beyond? Maybe it is not where we are today, but maybe it is some incredible number as you go on with the trillions here. I think that is the question that really is on the table, and particularly I was struck, Mr. Raines, by your comment that securities held are 30-percent more powerful in driving that 26-basis-point subsidy.

I would actually like to see the, I mean, it sounds like supply and demand being applied to the market, but I think on all of these issues, I would like to see some objective support for the arguments that one is talking about, and I accept that the 26 basis points looks like it is rational from this analysis, but we hear other people talking about maybe 10, maybe 15. Some of the studies that we have seen, I think we need to compare, and contrast and understand why there is such a broad difference and why there has—it is great that we are taking steps to help minority homeowners, those numbers look great, but what is the history and is it broad-based within the GSE's?

So all of those questions seem to me fair game in this overall discussion, but I think still the most important is the systemic risk by what is too big for any institution in the system. And I think we have gotten into "too big to fail" concepts in our financial system, whether it is GSE's or private-sector institutions. Therefore, we need, since the Government is sponsoring these institutions, the standard maybe is higher than it would be for private institutions.

And so I think that is why we are having this debate about minimum capital standards or whether we have risk-based standards and are the risk-based standards appropriate for the circumstances, particularly in the concentration of risk that is ahead.

I throw this out mainly because I do think that there becomes some diminishing return in concentration at some point, being an old believer in diversification. And so I think that is the burden you all have to talk to us about with regard to the standards.

Mr. RAINES. Well, Senator, I think you posed the question very well, and it is a central issue as to does our current regime encourage the right kind of behaviors given this focus in one asset class in one company. I would argue that it does, and let me just state a couple parts of that argument.

Because we have a risk-based capital standard that punishes keeping risk and rewards dispersing risk, we, unlike banks, have a very strong incentive to disperse risk to other holders. Because banks get no credit if they use mortgage insurance, they do not use mortgage insurance, and so they take all of the credit risk. Because banks do not get any credit if they use callable debt, they do not use callable debt. They take all of the interest rate risk. Their capital is fixed, essentially, regardless of their posture from a risk standpoint, and this distinguishes American banks from European banks, for example, and Canadian banks, where American banks on a dollar-for-dollar basis have more risk than European banks and Canadian banks because only in the United States do we have a fixed leverage requirement and because it is fixed, banks want to have the risk that would give them the return on that capital.

Our risk-based capital standard, on the other hand, rewards us if we get rid of risk. So if we use mortgage insurance, our capital requirement goes down. If we use more callable debt, our capital requirement goes down. So we had a very strong incentive to disperse risk.

I do not view Fannie Mae and Freddie Mac as being repositories of risk. I view us as being intermediaries, where we take risk from the consumer, and we transform that risk into forms that the capital markets are most likely to want to value highly. They will not value that loan. But if we can take that loan, put it into a mortgage-backed security and have that mortgage-backed security sold, or we can take that loan, issue our debt, and own it on our balance sheet, the market values that consumer risk more highly. And so our goal is not to stock up on risk. Our goal is to be a risk dispersal mechanism and to get a reasonable return for our shareholders, but not by increasing our risk profile.

Indeed, last July, we completed a year-long study in which we set a mandatory parameter of our risk appetite, and we set a very high standard. We wanted to be, on a stand-alone basis, without any GSE trappings, a AA, AA-minus company. We wanted to have, from both interest rate risk and credit risk, a lower volatility of earnings than your typical AA company.

As you know, we do not have a lot of AA-rated financial institutions. That is a very high standard to aspire to. We did not say, "Well, we are a GSE we get away with being an A, and could not we rock-and-roll then if we took on more risk." We instead said we think it is better for us to have a low tolerance for risk because that will facilitate our long-term access to the market through all conditions and maximize our mission and our shareholder value.

Senator CORZINE. How about the concept of operational risk?

Mr. RAINES. Operational risk is I think a vital piece of it. Unlike other capital standards——

Senator CORZINE. Do you think the capital standards that OFHEO now has in place actually take that into consideration?

Mr. SYRON. Excuse me. There is a 30-percent weight in our capital standards for operational risk, and it is appropriately so because I think the issue that you raised, as you become larger, I am not convinced that your operational risk on a proportional basis does diminish. So that is a reasonable question, but we do have a 30-percent, if you will, surcharge for operational risk in our capital ratios.

Mr. RAINES. Which is being debated in the bank context, as you know, and the banks have fiercely resisted having any capital set aside for operational risk. We are big operations.

Senator CORZINE. But should that be tied to the size of the balance sheet, ultimately, the size of the book of risk that you have played into the market?

Mr. RAINES. It probably does not correlate very well with the size of the balance sheet. It may well correlate better with the capital requirement or it may correlate better with number of loans or number of debt issuances because our operational risk comes in moving $12 trillion through the company every year, and that is more a function of the number of loans than it is of the size of the balance sheet because if the 18 million loans I think that we have are pooled into 1 million mortgage-backed securities, you do not have 18 million transactions, instead you have 1 million transactions that you are paying out on.

Senator CORZINE. As you also well know, that the hedging risk that you speak about, it is not just callable securities. There is a whole book of derivatives and other kinds of elements that are extraordinarily volatile in and of their own context, and so I think that we all need to do a lot of scrubbing on that operational risk.

And the bigger the book, the greater the danger. I am not sure it is a straight-lined element that needs to be examined.

Mr. RAINES. As well, our regulator's version of our risk-based capital standard has in it a counterparty risk element, and so it matters as to who your counterparties are, and it matters as to what your exposure is to them. So we have a big incentive, for example, to have collateral behind these obligations. So if they do not perform, we do not absorb all of the risk. There is still some residual risk, but it is mitigated by having cash collateral available.

Senator CORZINE. Those two issues are the ones that I am most interested in. I would like to see a real scrubbing. I hear a lot of complaints about the Federal Reserve study, that it is assertive, not empirical. We need to have open debate about where the subsidy or the amount of benefit that exists in the marketplace, and I think we all would be debating from a much clearer view if we actually had objective evidence about how we worked on this. I think it would be worthwhile. I would suggest that it would be worthwhile for all of us to see that all at one time, with different people having different points of view, to bring challenge to that.

But it is really a remarkable thing that I have heard many of my colleagues say about where our marketplace is, and by the way we do have adjustable rates, even in the fixed rate. I guess that is called the refinancing market people.

[Laughter.]

Chairman SHELBY. What is the market capitalization? What is the value today roughly of Fannie Mae?

Mr. RAINES. You want to know what the stock price is?

Chairman SHELBY. The market.

Mr. RAINES. I can tell you when I left the office, it was about $75 billion, but I am not so sure where it is now.

[Laughter.]

Chairman SHELBY. Mr. Syron, what was Freddie Mac's capitalization?

Mr. SYRON. Forty-two billion dollars, sir.

Chairman SHELBY. Twenty-two billion dollars.

Mr. SYRON. Forty-two.

Chairman SHELBY. What?

Mr. SYRON. Forty-two.

Chairman SHELBY. Oh, so over $100 billion, $120 billion.

What role would Congress play if we had a conservatorship? Would Congress be deciding whether to provide financial assistance once the GSE was in a conservatorship? In other words, taxpayers' money would be needed to keep it going possibly?

Mr. SYRON. Excuse me, Senator, may I try answering that? Because I think the point is absolutely correct about the difference between receivership and conservatorship between the GSE's and an ordinary depository institution, where you have the deposit insurance funds.

I mean, actually, if we think that there is this implied guarantee, leaving that aside, but if we were to assume arguendo, as they say, and we thought that there was this implied guarantee——

Chairman SHELBY. Do you think there is? I mean, do you think there is a benefit of subsidy that comes to Freddie Mac because people think there is an implied guarantee?

Senator SARBANES. I believe that the marketplace, to some degree—not 100-percent—but to some degree thinks that these institutions are so large, just as they would think with Citicorp, just as they would with JP Morgan, just as they would with a variety of other investment banks in the United States, thinks that special steps would be taken if they were to get into difficulty, to answer your question directly.

Chairman SHELBY. You think that is factored in, in the marketplace, don't you.

Mr. SYRON. I do, sir. But having said that, it comes back to this issue of conservatorship versus receivership. Because if that was the case, and the Congress at some point—and I am not saying it would. It might well decide not to—if the Congress were to decide in this one, and actually it is a Nobel Laureate that estimated that the chance of a cataclysmic meltdown in these institutions was less than 1 in 500,000. I can get you the exact citation, but it was about the same as an asteroid hitting the United States.

Chairman SHELBY. I hope they do not hit at the same time.

[Laughter.]

Mr. SYRON. Well, I do not know. It might not be all bad if you owe us.

[Laughter.]

Chairman SHELBY. You might not distinguish one from the other.

Mr. SYRON. Yes, that is right.

If you were to think in that 1 in 500,000 case or whatever probability you were to assign on it, that the Congress would have to do something, then, in that regard, it would be, you know it really would not make a difference if you were in receivership. There would be no advantage to being in receivership because the assets of the Enterprises would have to go to the debtholders. There would be no insurance fund or anything else. The question would be then, after the assets of the Enterprise were fully liquidated were they sufficient to address all of the claims of the debtholders.

Chairman SHELBY. Would there be anything left?

Mr. SYRON. Exactly.

Mr. RAINES. Senator, I think, with regard to the conservator, what would happen is that what a conservator would do is we would all be fired. A conservator would be running the company, and the goal of the conservator would be to pay off the liabilities of the company, and the conservator would wind down the company and pay off as many of the liabilities as the conservator could. At the end of the day if there were fewer assets than there were liabilities, he would announce simply that there was not enough money to pay everybody and that the company is no longer functioning.

Undoubtedly, our regulator would report to the Congress that the Enterprise had failed or was in the course of having failed. Now, would Congress at that point say this is so important that we need to do something? I have no idea. I think it depends entirely on what the circumstances are.

Chairman SHELBY. Senator Sarbanes and I sat on this Committee during the thrift debacle. We understand.

Mr. RAINES. There has been the thrift debacle, there has been the airline debacle, there has been Chrysler. There have been many occasions where the Congress, no one had ever uttered the word that there might be some implied guarantee, where Congress, for public policy reasons, decided it wanted to intervene but there is no obligation on the Congress of the United States to appropriate any funds to any conservator. The conservator only has the assets of the company to work with.

Chairman SHELBY. But if you had a receivership, and if you had language in there to what the receiver could do or not do or the steps within certain things, wouldn't that work? Because all receiverships, they do not go straight to liquidation in all receiverships, do they?

Mr. RAINES. No, but if the receiver has the authority to displace the senior debtholders, then that will be a huge problem because our debtholders would wonder for what reason do they have their authority?

In the bank's situation, it has been made clear that the receivers there cannot avoid certain contracts in order to protect those obligations. But in the discussions that I have heard, I have seen no such protection being suggested for the debtholders of Fannie Mae, and I think it just adds an element of confusion, particularly since it is not clear to me that you could apply a new receiver provision to the outstanding debt because those debtholders put their money forward under an entirely different regime. They have a contract, and it is not clear to me that that contract can be abrogated after the fact without having given them notice before they bought the securities.

Chairman SHELBY. I know in a private company, if a company goes bankrupt, the bondholders stand in a high-priority relationship. Stockholders' equity——

Mr. RAINES. Right, gone.

Chairman SHELBY. —they are really at risk.

Mr. SYRON. Senator, I think the question is what is the advantage of receivership versus conservatorship, and as far as I can see, from the public FISC point of view, there is no advantage of receivership over conservatorship, but it comes with this cost of casting a shadow, particularly in international capital markets, over the claims about debtholders. So that is the way I would be inclined to look at it.

Senator SARBANES. When you say your "debtholders," who are you referring to?

Mr. SYRON. I am referring, sir, to the debtholders not of mortgage—I am not referring to the holders of mortgage-backed securities. I am referring to the people that hold the debentures of the corporation, both domestically and overseas.

Senator SARBANES. Well, what would happen to the holders of the mortgage-backed securities?

Mr. SYRON. The holders of the mortgage-backed securities would have, I mean, we are responsible for the payment of the faith and credit, but the holders of the mortgage-backed securities would have ultimately to fall back on the assets, the mortgages that secure them and ultimately, if necessary, on the properties that were held. And given the history of these things, they would be in a quite favorable position.

Senator SARBANES. Who would get paid first?

Mr. SYRON. Who would get paid first? Boy, this is speculative, to some extent on my part, you would have two sets of creditors, if you will—the debtholders and the holders of the mortgage-backed securities, and I would assume that they would go on a pari passu basis, but I am not an attorney, and we should get back to—

Chairman SHELBY. The priorities are debtholders, in the scheme of things, in the corporate world, is it not?

Mr. RAINES. It depends on what the contracts say.

Chairman SHELBY. Absolutely.

Mr. RAINES. It depends on what the contracts say, and so you really have to go back to each contract, and the contracts that Freddie Mac have may be different than contracts we have. I do not want to answer as an absolute, but overall they stand pari passu. They stand in line together. The mortgage-backed securities holders have an advantage in that they also have the collateral of the mortgages which the debtholders do not. Our debtholders have no security interest in the mortgages in our portfolio, whereas, our mortgage-backed securities holders do have a security interest in the mortgage-backed security.

Chairman SHELBY. In the package that they buy.

Mr. RAINES. In the packages that they finance. But on the whole, they stand pari passu. The issue is that for some 60, 70 years we have been successfully selling debt on this basis. What I am concerned with is someone is going to put a provision in a statute that raises the question: Have you changed something? And, if so, what?

And I do not look forward to going around the world, as I am about to leave on Saturday for a week in Europe to go visit investors, and I am sure I am going to be asked a lot of questions about the last couple of days, I do not look forward to going out and explaining—

Senator SARBANES. You are going off to Europe for a week while the Congress is in session?

[Laughter.]

Mr. RAINES. Senator, I have such undying faith in the U.S. Congress that I would even dare to go off and visit investors and raise a little money for homeowners while Congress is in session.

Chairman SHELBY. Mr. Raines, let me pose this question to you. If the receiver had FDIC-like protections for debtholders, would that be acceptable?

Mr. RAINES. I would have to look at——

Chairman SHELBY. You want to look at it.

Mr. RAINES. We have to look at what is meant by——

Chairman SHELBY. Mr. Syron, you come out of the Federal Reserve, go ahead.

Mr. SYRON. Yes, excuse me, sir. I think that is a very good question. But, then, to be honest with you, we start to change the whole character of the receiver.

Chairman SHELBY. I know.

Mr. SYRON. But it does reduce——

Chairman SHELBY. Let us assume that we change the whole character of the receiver.

Mr. SYRON. I do not know the right or the exact answer, but it does remove some of the problem that you would have with debtholders.

Mr. RAINES. As I said, I can agree with the suggestion made by Chairman Greenspan——

Chairman SHELBY. It could alleviate some of the problems, possibly.

Senator SARBANES. Or you could call it "Bob." Did you not suggest earlier just calling it Bob?

[Laughter.]

You take these categories and try to press something into it, but these are special institutions or enterprises, and you may have to work out special arrangements to deal with them, and you need a different name.

Mr. RAINES. I agree with you totally, Senator, and that is why I agreed earlier with the suggestion by Chairman Greenspan. I am not adverse to spelling out in statute what happens. I just don't want to leave it ambiguous, and that is my concern. And I think putting the word "receiver" in makes it ambiguous. But if there is a concern that the statute is not clear, I am in favor of making it clear.

Chairman SHELBY. Now, the word "receiver" could be very definite and unambiguous. It depends on what you set out, could it not? A conservatorship could be ambiguous.

Mr. RAINES. It could be. And if there is a doubt as to what is meant in the statute today, even though we do not believe there is a doubt, but if there is a doubt, we have no problem with making it clear. But what I fear is that we will not be clear. It will be ambiguous, and what we will have is lawyers all over the world trying to figure out, what did Congress mean when they did that? They must have meant something. They could not have meant just to leave it the way it was.

Chairman SHELBY. That would not be the first time lawyers tried to find out what Congress meant—ambiguities.

[Laughter.]

Mr. RAINES. But trying to sell trillions of dollars of securities in that environment is not always the best.

Senator SARBANES. It is hard to persuade them that we did not mean anything, even though that may be the case.

[Laughter.]

Chairman SHELBY. I hope it means something, but you never know.

Mr. Raines, you note in your testimony that, "Enacting a receivership provision unfairly imposes new risk on holders of existing obligations that they could not have anticipated at the time they purchased the obligation."

What is the new risk you are referring to?

Mr. RAINES. It is the risk that there is a meaning in the receiver that is contrary to their interests.

Chairman SHELBY. Supersede the risk.

Mr. RAINES. They now have 60 years of history as to what this means. If the language changes, everyone is going to want to know what is the import of the change. That is why lawyers are so reluctant to change documents that have existed for many years.

Chairman SHELBY. That is why we have so many lawyers in Washington.

Mr. RICE. Mr. Chairman, one of the things I will say, as you look at the structure, that is one of the reasons why we think that it is necessary to have two divisions under them because we are not the same in the way we are laid out.

Chairman SHELBY. I know you are not, and I also know you are not publicly traded.

Mr. RICE. Right.

Chairman SHELBY. I want to follow up on this. I know that the evening is moving on. Wouldn't the GSE investors—I will pose it to these two—and debtholders be better served by a clearer specification of the resolution process; in other words, remove some ambiguity, Mr. Rice? In other words, if the GSE investors and debtholders knew what was in the resolution process.

Mr. RICE. Mr. Chairman, we have successfully sold trillions of dollars the way it is. Any change will be viewed introducing risk.

Chairman SHELBY. But a lot people are questioning the way it is now.

Mr. RICE. Not our investors.

Chairman SHELBY. I know that.

Mr. RICE. Our investors are not questioning it, and it is their money that is at risk.

Chairman SHELBY. But there is taxpayers' money possibly at risk, too, and that is what concerns a lot of people.

Mr. RICE. That is the problem.

Chairman SHELBY. That is right.

Mr. RICE. If the Congress is saying that there is no guarantee, but just in case we are going to do one, we are going to put in provisions that push you to the back of the line, there are a lot of people that are going to say that is not the deal I signed up for, that if you are going to guarantee it, guarantee it. If you are not going to guarantee it, do not guarantee it. But do not say I might change my mind later on and want to step to the front of the line.

Chairman SHELBY. I believe, in your words, you want to remove any ambiguity that we can. In other words, make the language clear. Clarity is important. I think that is what we are going to try to do. I do not know.

Mr. Syron, you note, and these are your words, that "many market participants might view a change to receivership as a first step to privatization of the GSE's." Given that GSE equity and debt is held by private investors, should these investors not bear the full risk? In other words, they bear the rewards.

Mr. SYRON. Well, I think that the situation is, I mean, Congress has before it, and Congress has the ability to totally privatize these entities. I think with that, you would take away some of the special responsibilities we have, for example, in the low-income housing area, where I think that we do have responsibilities. It is not clear to me what all of the gains to that would be.

What my real concern comes down to is that in this country, and we do not have anyplace in the world—I sound like Johnny One Note—we have this 30-year prepayable instrument, and I think if you were to totally privatize these institutions, that would go away because it does not exist anyplace else, even with the same set of players, and the more that we move in the direction of someone saying, well, we are moving closer to privatization, that the advantages that exist now in rates, differentials would diminish.

Chairman SHELBY. Your definition of privatization here, where there would be clear and unmistakable language that there would be no implied guarantee.

Mr. SYRON. No.

Chairman SHELBY. Is that what you are saying?

Mr. SYRON. No, I am going even beyond that. I am going beyond that and saying that these things are not creatures of Congress, that they have no tie to Government policy, in a sense.

Chairman SHELBY. They are creatures of the marketplace.

Mr. SYRON. Exactly.

Chairman SHELBY. And they are subject to the marketplace and the rules.

Mr. SYRON. And subject only to the marketplace.

Chairman SHELBY. Only.

Mr. Raines, in your opening statement I believe you indicated that the GSE funding advantage was not a result of an implied guarantee, but because of business focus and expertise. If this were the case, does it not follow logically that receivership authority will not impact GSE's funding advantage, if you accept that premise?

Mr. RAINES. No, it does not imply that.

Chairman SHELBY. It does not?

Mr. RAINES. It implies the Government is going to step into what had been previously a private enterprise and make decisions, and that is the issue. It is that somebody who is a stranger to the transaction is going to step in at some point and start saying here is the way it is going to go from now on. That is the danger. That is a risk. And I have been in the financial services business, now for 25 years. I have had to deal with this situation when I represented State and local Governments. I have had to deal with it in representing companies. I have had to deal with it even when I was in OMB, when we were privatizing the Government's ownership of the production of uranium.

As much as those of us who have been in public service like to believe that we can be helpful——

Chairman SHELBY. Sure.

Mr. RAINES. —when people are investing their money, they would just as soon rely on the deal they cut with the business entity and not think someone else is going to come in to be helpful at a later date.

Chairman SHELBY. Mr. Rice, Mayor, I am going to leave this last question to you. Currently, the Federal Home Loan Bank System issues its debt, as I understand it, by way of the Finance Board's Office of Finance. You are very aware that this is an entity that is legally under your System's current regulator, yet issues debt on behalf of the System. In other words, a regulator is issuing the debt.

Do you believe this authority should be transferred to the bank themselves to issue the debt, you know, as we create a future regulator? And, if so, do you have any thoughts on how a new Office of Finance owned by the banks would be organized. You see my question here.

Mr. RICE. No, I do. I think, in my opening remarks, I said I felt that the Office of Finance should move to the independent regulatory structure.

I do not think you can make that quantum leap in this legislation. So, I would elect or offer the suggestion that it stay with the regulator, and I think it operates well then.

Chairman SHELBY. To be the regulator and the issuer of debt.

Senator Carper, you have been very patient.

Senator CARPER. Just one question in closing, and again our thanks to each of you for joining us for this extended period of time and for your very thoughtful answers hopefully to our thoughtful questions.

I have a question really for you, Mr. Syron, and this is more I suppose of a personal nature than anything else.

I understand, in an earlier part of your life, you served the Boston Fed.

Mr. SYRON. Yes, sir.

Senator CARPER. And as I recall, you ran the show there for a while.

Mr. SYRON. Yes, sir.

Chairman SHELBY. I might add he ran it well.

Mr. SYRON. Thank you.

Senator CARPER. Yes, it got good reviews from as far away as Alabama.

[Laughter.]

Chairman SHELBY. You know, money travels, and so does a good reputation.

Mr. SYRON. Thank you, sir.

Senator CARPER. I would like for you just to take a moment in closing here and reflect, if you will, on your earlier service in that capacity some of the lessons that you learned and really some of the values that you brought from that service to your new responsibilities.

Mr. SYRON. Thank you for the question, Senator.

I would say, if there is one thing I learned, that it is be wary of unintended consequences; that often in solving the problems of today, we create the problems of tomorrow. You will remember that 8 or 9 years ago, everyone said that management in the United States was not sufficiently aligned with shareholders. So what we are going to do is load them up with options, and we have seen some of the undesirable outcomes that came from that.

I, also, think if my service had any searing impact on me, it was that you have to look at the system as a whole rather than just the parts, and particularly when we got into this credit crunch in New England in the 1990's, that there was a problem of looking at just, on an institution-by-institution basis or a piece-by-piece basis and not seeing what we were doing to the economy as a whole.

Sir, I would respectfully say that that is something I hope I can bring to this because it is like everything else in life. It is a balloon. You press in here, and it pops out someplace else. I will finish on this. What this is all about is none of us can eliminate risk. We are all about trying to repackage and reduce risk and have it go to the part of the system where we——

Chairman SHELBY. Minimize it.

Mr. SYRON. Yes, sir.

Mr. RICE. I just wanted to make a clarification, Mr. Chairman. I really believe the new regulator, when I was speaking about OFHEO's oversight, the bank still would be responsible for issuing the debt, but the oversight would still go with the new regulatory body.

Chairman SHELBY. Mr. Syron, you mentioned options in the times a few years back. A lot of people believe it was not the issuance of options, it is the way the options were treated, and that is of course still subject to debate, on the balance sheets, because options do have a place, I believe, in corporate America.

Mr. SYRON. Senator, I totally agree with you. My concern was that the way they were treated, from a tax perspective as compared to the way that——

Chairman SHELBY. That is right.

Mr. SYRON. —and restricted stock was treated created unfortunate incentives.

Chairman SHELBY. Absolutely. I totally agree.

Gentlemen, thank you for your insights today. We appreciate it. The hearing is adjourned.

[Whereupon, at 5:08 p.m., the hearing was adjourned.]

[Prepared statements, response to written questions, and additional material supplied for the record follow:]

Statement of Franklin D. Raines
Chairman and CEO, Fannie Mae
Before the Senate Committee on Banking, Housing, and Urban Affairs
February 25, 2004

Chairman Shelby, Senator Sarbanes, members of the committee, thank you for inviting me today to testify on GSE regulatory reform. The last time I came before you to discuss this subject was last October. Since that time, this committee has worked diligently to give shape to a new GSE regulatory regime that ensures strong oversight of Fannie Mae and Freddie Mac.

On behalf of Fannie Mae, let me express how much I appreciate the hard work and serious thought the Committee has invested in this issue over many years and in particular over the past several months.

I believe at the end of the day we share the same goals. We all want to protect, advance and strengthen the best housing finance system in the world. We all want to ensure that the government-sponsored housing enterprises, which fuel this remarkable system, continue to achieve their mission to expand homeownership in America. And we want to strengthen GSE oversight because effective oversight is in the best interest of the company, our mission, and the U.S. housing finance system. Let me repeat something I said last October: Fannie Mae supports a strong, credible safety and soundness regulator.

In fact, strong, effective oversight is the backbone of our unique GSE status.

Congress created Fannie Mae in 1938 as an instrument of national policy -- a policy to expand homeownership because it is good for families, communities, the economy, and the country. In 1968, Congress privatized Fannie Mae, but imposed a restrictive charter to ensure we continued to be an instrument of national policy promoting homeownership. And in 1992, Congress further focused us as an instrument of national policy, creating explicit affordable housing goals for the company and establishing a safety and soundness regulator to ensure the company's ongoing financial viability so that it could continue to serve homeowners. Strong oversight is the means by which the federal government displays its commitment to a national policy favoring homeownership.

That national policy is working. Fannie Mae and Freddie Mac have helped to create a market-based, consumer-focused housing finance system that draws capital from all over the world, making long-term, fixed-rate, refinanceable mortgages more widely available at lower costs. All of this is accomplished at no cost to the government. The highly efficient mortgage market touches millions of homeowners, as well as an entire housing industry. Last year, over $3.7 trillion of single-family mortgages were originated, as an estimated 22 million households either financed a new home purchase or refinanced an existing mortgage. In each of the last two years homeowners were able to take advantage of strong home price appreciation and low interest rates by taking out over $125 billion of home equity through "cash-out" refinancing, using the proceeds both to retire other, more expensive debt and to finance home improvement or other consumer expenditures. Other homeowners who refinanced were able to lower dramatically their mortgage payments, increasing their purchasing power. For example, a homeowner with a $150,000 mortgage was able to lower his monthly payment from $948 to $852 as mortgage rates dropped from 6.5 to 5.5 percent. And low interest rates and strong demographic demand led to record home sales and a record high homeownership rate of 68.6 percent last year.

We have consistently said that there should be a straightforward test for examining policy proposals that will affect our housing finance system:

- Does it improve the safety and soundness of the housing finance system?
- Does it reduce costs for consumers?
- Does it expand opportunities for homeownership?
- Does it support innovation necessary to better serve consumers and address the nation's toughest housing problems?

There are three issues that I would like to examine in the context of these four questions today: the GSE capital regime, conservatorship versus receivership and the necessary balance between private management and public oversight.

CAPITAL

There has been much discussion of capital in the debate over reform of our regulatory structure. It is critical that our capital regime be considered as one integrated whole, and that when it is compared to bank capital regimes, the comparison be made on the basis of relative risk.

The structure of our capital regime is different from the bank capital regime because it applies to only two companies and we essentially invest in only one asset, residential mortgages. As a result, our risks are more easily specified by a regulator and are lower than those of other financial institutions that invest in higher-risk assets such as commercial loans, credit card debt and foreign debt.

Development of Our Capital Regulation

In the early 1980s, faced with declining capital levels among banks, deregulation of the industry and problems caused by stagflation and crises with less-developed-country debt, U.S. bank regulators instituted numerical capital standards for the first time in the form of a leverage requirement. It was recognized that such a requirement was blunt in that it did not tie capital to risk and, in 1988, U.S. regulators joined their colleagues from other industrialized countries in instituting a risk-based capital standard in what was known as the Basel Accord.

The new bank risk-based standard only covered credit risk. It divided a bank's assets into four "buckets," depending on the obligor. Government securities required no capital support. The capital requirement for agency securities was 1.6 percent, for prime residential mortgages 4 percent and for assets such as commercial and consumer loans 8 percent. Regardless of whether a commercial loan was to a blue-chip or startup company, the capital requirement was the same 8%. The rules also required that banks hold capital against off-balance-sheet exposures.

Because the Basel Accord did not cover interest rate risk but, instead, was narrowly tailored to credit risk, U.S. regulators, unlike their foreign counterparts, uniquely continued to impose a leverage requirement as well as the new risk-based requirement on banks. However, they intended that this dual set of capital requirements would only be temporary until an interest-rate risk component could be developed for the risk-based standard. As Federal Reserve Chairman, Alan Greenspan, testified before this committee in 1992:

> "[W]e are looking very closely at the leverage ratio which was imposed as a necessary concomitant to the risk-based capital requirements which are being imposed worldwide to substitute for interest-rate risk.
>
> "But now that we are in the process of getting interest-rate risk embodied into the overall risk-based capital policy, I believe that we will fairly quickly be able to dispense with the leverage ratio."[1]

The following day he elaborated before a House committee:

> "And, as I've indicated elsewhere, one of the things that we are endeavoring to get changed, which we think might have some effect, is to try to eliminate the so-called leverage ratio in bank supervision by essentially getting the detailed means of evaluation of the interest rate risk, which is what the leverage ratio is supposed to measure, embodied in another way in our risk-based capital system, and eliminate what in my judgment at least is a much too Draconian tool to achieve what is endeavoring to be achieved by that."[2]

At the time Chairman Greenspan made these statements, the financial regulatory community anticipated that an interest-rate risk component of the risk-based capital requirements would be in place by early 1993.[3] It is still not in place.

The U.S. federal banking regulators put a lot of effort into developing an interest-rate risk capital requirement. The Federal Reserve, OCC and FDIC issued joint proposals for an interest-rate risk component in 1992, 1993 and 1995.[4]

[1] Testimony of Alan Greenspan, Senate Banking Committee, July 21, 1992

[2] Testimony of Alan Greenspan, House Subcommittee on Domestic Policy, July 22, 1992.

[3] "The agencies are expected to adopt final rules on interest rate risk by early next year," *Boston Chief Slams Regulators*, Claudia Cummins, *American Banker*, July 6, 1992 at 2.

Their efforts foundered. In June 1996, they finally abandoned attempts to promulgate an explicit interest-rate risk standard,[5] in part because of the great difficulty in fashioning an interest-rate risk requirement for an industry comprised, at the time, of 9,500 heterogeneous banks.

Where bank regulators failed, OFHEO succeeded. Based on legislation adopted by Congress in 1992, OFHEO, over a 10-year period, developed a comprehensive set of capital requirements that covered all of the risks faced by the two companies it regulates: credit risk, interest-rate risk and operations and management risk. For OFHEO the task was made easier by the fact that the new standard was designed to cover just two relatively homogeneous companies that invest in assets with broad and deeply liquid markets and finance these assets with wholesale funds.[6]

That is the crux of the difference between developing capital standards for GSEs and banks. Because there are just two low-risk, transparent enterprises supervised by a focused regulator, it is possible to develop capital standards tailored to the risks they face. In contrast, bank regulators must rely on the leverage requirement to compensate for the fact that the risk-based capital standards at their disposal are not sophisticated enough to capture all the risks a bank faces and not flexible enough to adequately cover the varied circumstances that the thousands of banks encounter. Faced with these conditions, bank regulators must have the flexibility to adjust the leverage ratio when they see a bank taking on increased risk.

OFHEO's Risk-Based Capital Rule

Fannie Mae's exposure to a severe economic scenario is more than adequately captured by the risk-based capital test that is now in force. The risk-based capital rule is rigorous and closely aligns required capital with the risks that the company takes. Under our risk-based capital standard, we must hold enough capital to survive a ten-year period of severe economic and financial stress characterized by simultaneous movements in interest rates of up to 600 basis points and nationwide mortgage defaults equal to those experienced in the oil patch region during the early 1980s. Risk-based capital is defined as the amount necessary to maintain positive capital over this 10-year period plus an additional 30 percent surcharge to cover unspecified management and operations risk.

A recent study by Joseph Stiglitz, winner of the 2001 Nobel Prize in economics, confirms the rigorous nature of this test, and the comfort policymakers should take regarding the inherent financial strength of any institution that can pass such a test. The paper

[4] *See* 57 FR 35507 (August 10, 1992), 58 FR 48206 (September 14, 1993) and 60 FR 39495 (August 2, 1995).

[5] *See* 61 FR 33166 (June 26, 1996).

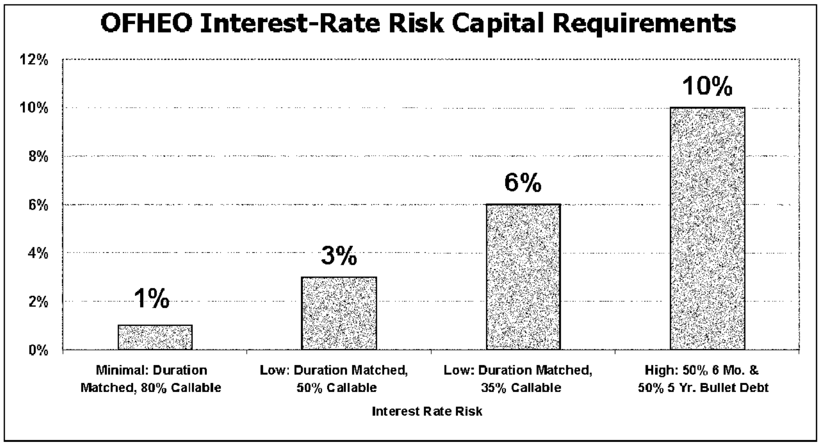
[6] One of the difficulties faced by bank regulators in developing an interest-rate risk capital requirement was determining the duration of bank core deposits such as checking and savings accounts. Although these are nominally short-term, or even overnight, funds, they are often left on deposit for extended periods of time even in the face of rising interest rates. In contrast, the duration of wholesale funds is more explicit.

concluded that the risk of default by Fannie Mae, if it holds sufficient capital to meet the risk-based capital rule's stress test, is "effectively zero."[7]

Several authorities have concluded that this test is far more rigorous than the risk-based capital test applied by bank regulators. A 1999 study by IPS-Sendero found that the thrift industry would run out of capital between the fifth and the seventh year of the ten-year stress test and that it would need to increase its capital by at least 60 percent if it was to meet a regulatory risk-based standard similar to that applied to Fannie Mae and Freddie Mac.[8] In addition, after reviewing the test, former FDIC chairman William Seidman concluded that: "The risk based capital standard set forth in the 1992 GSE Act creates a very stringent capital standard, one that could be devastatingly stringent if applied to most other financial institutions."[9]

Interest-rate risk is recognized as the biggest risk in mortgage investment, particularly, as in the case of Fannie Mae, where credit risk is geographically dispersed and is shared with counterparties. As shown in Exhibit 1, our capital requirement is closely tied to interest-rate risk. If we increased the amount of interest rate risk we take, our capital requirement would rise sharply and appropriately.

Exhibit 1



[7] *Implications of the New Fannie Mae and Freddie Mac Risk-Based Capital Standard*, Joseph E. Stiglitz, Jonathan M. Orszag, and Peter R. Orszag, Fannie Mae Papers, Volume I, Issue 2, May 7 2002 at 5.

[8] *Risk-Based Capital and the Thrift Industry: Implications of Risk-Based Capital Stress-Test Requirement,* Dave Dufresne, IPS Sendero (February 1999)

[9] Memorandum of L. William Seidman, Jacqueline Pace and David S. Chung to Freddie Mac (March 29, 2000)

This risk-based capital requirement is the premier tool of our regulator. And unlike a bank standard, it is structured to encourage us to reduce our risk. The more we hedge against interest rate risk, the lower our risk-based capital requirement.

But clearly, even if we hedge extensively and reduce our risk-based requirement, we must still hold some capital against unquantifiable risk. That is the role of our minimum capital requirement. Our minimum capital requirement is 2.5 percent of on-balance sheet assets and 45 basis points of off-balance sheet assets. It is a true backstop to our risk-based capital standard.

Because the bank risk-based standard does not align capital with risk to the extent that ours does, bank regulators rely to a greater extent on the leverage ratio to ensure banks hold adequate capital. Our risk-based capital standard is the primary tool for our regulator for providing this assurance. The incentives that stem from these two choices are very different. Under our risk-based capital standard, the more we hedge our risks, the less capital we have to hold. That is an incentive to reduce risk.

On the other hand, the higher the leverage ratio imposed on a bank, the greater risks those institutions must take in order to cover their cost of capital and provide a market rate of return for their investors. As Exhibit 2 shows, a higher leverage requirement does not necessarily reduce risk. In Europe, where there is no leverage requirement for banks but only a risk-based capital requirement, large banks hold lower risk assets than their U.S. counterparts.[10]

[10] One of the reasons why regulators in other countries may feel a comfort in the absence of a leverage requirement, not shared by U.S. authorities, is that foreign banks tend to be larger, on average, than U.S. banks and therefore relatively few in number. Citigroup, the largest banking company in the world, is a U.S. bank. Otherwise, however, large European banks tend to be much larger than U.S. ones, reflecting the fact that the banking industry in the U.S. is much more atomistic than in other countries. Of the 50 largest banks in the world at the end of 2002, 32 were European, and only 8 were headquartered in the U.S. As a result, the median size of the 25 largest European banks at the end of 2002 was $526 billion, the median size of the 25 largest U.S. banks was only one sixth the size, at $81 billion. Since U.S. authorities have to oversee a vastly greater number of banks than their counterparts abroad, they may feel the need for blunter tools such as a minimum leverage requirement.

Exhibit 2

The Median Capital Ratio of the 25 Largest Banking Companies
In the U.S. and Europe

	U.S.	Europ
Median Size of Bank (Total	$81B.	$526B.
Tier 1 Risk-Based Capital	8.2%	8.0%
Risk-Weighted Assets to Total	80.8%	41.6%
Leverage	6.7%	3.1%
Memo		
Fannie Mae Leverage Ratio (Core Capital to Total Assets,		3.2%

* European banks are not required to meet a leverage capital standard. The for all banks is defined here as Tier 1 or core capital (as defined by the divided by total

Sources: U.S. bank holding company call reports, annual reports. Data as of 12-31-02

If Fannie Mae were to stop guaranteeing and investing in mortgages, the credit and interest rate risks inherent in mortgages would not go away. Instead these risks would have to be borne by other institutions, primarily commercial banks and thrifts. These institutions take insured deposits that have an explicit guarantee from the government. Our debt securities have an explicit disavowal of any government support.

Fannie Mae raises funding in the world's capital markets where we are able to sell debt with characteristics that closely match the cash flow from our mortgages. The S&L experience in the 1980s shows the short maturity of the typical deposit makes it an unsuitable funding source for the long-term fixed-rate mortgage that is the norm in this country. If risk migrated from Fannie Mae to the banking system, taxpayers would be exposed to higher risk.

In order to fulfill our mission of attracting low-cost funding to the mortgage market, we must maintain our position as a low-risk, very high credit quality company. That is, our mission requires us to be one of the top-rated financial institutions in America and the world.

We have committed to maintain a stand-alone "risk-to-the-government" rating from Standard & Poor's of at least AA-, and a stand-alone "bank financial strength" rating from Moody's of at least A-, where A is the highest rating. We have also committed publicly to capitalize and hedge our mortgage portfolio and credit guaranty business so that each is able to withstand internal or external "stress tests" set to at least a AA standard, and meeting that commitment is an important corporate goal in 2004. Finally, we have as a goal to keep our mortgage prepayment and credit risk low enough that over time our core business earnings are less variable than the median of all AA and AAA companies in the S&P 500.

To put just one of these goals into further context, an A- rating on Moody's bank financial strength scale is the second highest after an A rating. A financial strength rating is a judgment as to the underlying health of a bank or other financial institution without any reliance on government support.[11] Only four banks *worldwide* have earned the A rating and eight, including Fannie Mae, the A- grade.[12]

Proposed Changes to Our Capital Regulation

From the perspective of how best to reduce risk to the financial system, it is clear that our regulatory structure, with a strict risk-based capital regime, is preferable. And while our risk-based capital test is the most rigorous faced by any financial institution, we recognize that a strong regulator should have the flexibility to regularly update the standard to ensure it remains consistent with best practices in financial regulation. We believe that giving the regulator complete flexibility to adjust the risk-based capital standard is the best way to ensure we hold capital commensurate with the risks we face.

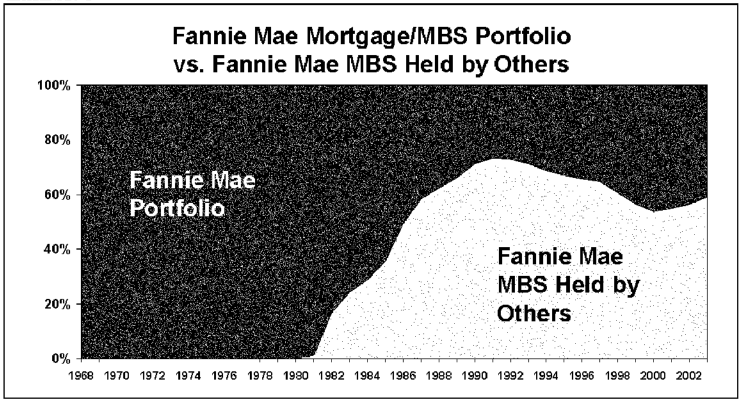
Some have suggested that our new regulator should have the same authority a bank regulator has to raise our minimum capital requirement. Given the far greater sophistication of our risk-based capital standard, it is unclear why that would be necessary. In the event we take on additional interest-rate, credit or operational risk, our risk-based capital standard would capture that risk and require us to hold more capital.

A decision to require us to hold more minimum capital with no change in the risk we face is not a safety and soundness decision, but rather a policy decision to reduce the amount of capital we provide to the mortgage market. We would buy fewer mortgages, reducing the demand for mortgages in the marketplace, which leads to lower prices and therefore higher mortgage rates. Our mortgage purchase activity has been our primary means of carrying out our mission since we were created in 1938. Until 1981, the company held all of the mortgages we bought in our own portfolio (Exhibit 3). It was only in that year that the company started guaranteeing MBS that were held by other investors.

[11] "Moody's Bank Financial Strength Ratings (BFSRs) represent Moody's opinion of a bank's intrinsic safety and soundness and, as such, exclude certain external credit risks and credit support. In addition to commercial banks, Moody's BFSRs may also be assigned to other types of financial institutions such as multilateral development banks, government-sponsored financial institutions and national development financial institutions. Bank Financial Strength Ratings do not address the probability of timely payment. Instead, Bank Financial Strength Ratings are a measure of the likelihood that a bank will require assistance from third parties such as its owners, its industry group, or official institutions." *Rating Action: Federal National Mortgage Association, Moody's Assigns Bank Financial Strength Rating of A- to Fannie Mae; Affirms Debt and Preferred Stock Ratings (Long-Term Senior Debt at Aaa).* Moody's Investor Service, New York, February 27, 2002.

[12] "At this time, four financial institutions (including one in the United States) have BFSRs of A, Moody's highest rating. Eight institutions (including three in the United States, among them Fannie Mae) have BFSRs of A-." Moody's, *id.*

Exhibit 3



Fannie Mae's purchase of mortgages or MBS are more effective in reducing mortgage rates than is the guaranty alone. An econometric study in 2002 found that "Fannie Mae purchases are over 30 percent more influential than GSE securitizations on mortgage yields."[13]

Hence, a decision to reduce the flow of mortgage capital to homeowners by raising our minimum capital requirement irrespective of risk amounts to a policy decision to reduce our impact on the market – a decision that is properly made by the legislative branch, not by a financial regulator. That is why we strongly urge that our minimum capital standard remain written into the law.

At the same time, we understand the interest in giving the regulator some flexibility to respond to unanticipated events. So we believe that if any unanticipated safety and soundness risk should arise – a risk not covered by our risk-based capital requirement – then our regulator should have the ability to temporarily increase our minimum capital to protect against that specific risk. Then, when the risk goes away, the capital surcharge would go away as well.

Subordinated Debt

Finally, there is another difference between bank capital regimes and ours. When we meet our minimum and risk-based capital standards, we are classified as "adequately capitalized" by our regulator. Banks, however, have an additional option – to hold added capital and achieve the category of "well-capitalized." This category provides a bank

[13] *The Effects of Purchases of Mortgages and Securitization by Government Sponsored Enterprises on Mortgage Yield Spreads and Volatility.* Andy Naranjo and Alden Toevs, *The Journal of Real Estate Finance and Economics*, 2002, Volume 25, Issue 2 at 173-195.

with the incentive to issue subordinated debt and achieve a higher rating from its regulator.

Both regulators and academics recognize that subordinated debt can play a valuable role in financial institution capital requirements in addition to equity:

- Federal Reserve Chairman Alan Greenspan has said, "The great advantage of having vehicles on the balance sheet such as subordinated debentures is that it is something in the nature...of a canary in a mine, that if...some of the credit capacity of these institutions seems to be eroding at the edges, it is very much more likely to show up in the prices of liabilities which are not insured and have no collateral behind them."[14]

- Former Fed Governor Lawrence Meyer has said "If the train crashes, then the subordinated debt holders sit not in the caboose but in the cab of the engine. They are thus quite sensitive to the speed of the train and the quality of the tracks."[15]

- According to a Federal Reserve Bank of Cleveland report, "Because sub-debt holders put their money on the line, they have an incentive to monitor the bank. If the bank's behavior should become riskier, investors will demand a higher premium for bearing that risk, and the interest rate will increase. Not only would potential investors be alerted by such information, but regulators too would find it useful as a signal that a bank needs more attention."[16]

- And the Shadow Financial Regulatory Committee has written "[I]t is desirable to go beyond a permissive approach toward subordinated debt as a component of bank capital by requiring that a minimum proportion of capital take the form of subordinated debt."[17]

Fannie Mae has made a voluntary commitment to issue subordinated debt, and has met that commitment, but it is not recognized in our capital regime. The use of incentives in bank regulation could easily be replicated in our regulation by creating a designation called "well-capitalized" when we hold capital, including loan loss reserves and subordinated debt, equal to 4 percent of our on balance sheet assets.

CONSERVATORSHIP

Just as GSE and bank capital regimes are appropriately different, GSE and bank regulation are appropriately different in the tools available to the regulator if an institution gets into serious financial trouble.

[14] Alan Greenspan, Senate Banking Committee, January 26, 2000

[15] Former Federal Reserve Governor Lawrence Meyer, quoted by Bloomberg, October 31, 2000

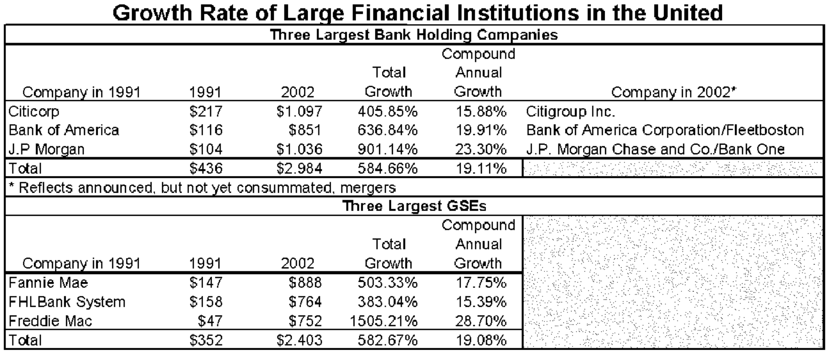
[16] *Subordinated Debt: Tough Love for Banks*, Joseph Haubrich, Staff economist, Federal Reserve Bank of Cleveland, December 1998 at http://www.clevelandfed.org/research/com98/1201.pdf

[17] Shadow Financial Regulatory Committee, Statement No. 160, March 2, 2000 at http://www.aei.org/publications/pubID.16542/pub_detail.asp

This issue has received attention lately, in part because a recent critique in the Administration's Budget proposal said that, "even a small mistake by a GSE could have consequences throughout the economy."

The budget document made this point in reference to the growth of the housing GSEs throughout the 1990s, observing that they grew in the aggregate by over 500 percent in the period. As it happens, such growth over that extended period of time is not exceptional in the United States.

Exhibit 4



Growth Rate of Large Financial Institutions in the United

Three Largest Bank Holding Companies					
Company in 1991	1991	2002	Total Growth	Compound Annual Growth	Company in 2002*
Citicorp	$217	$1.097	405.85%	15.88%	Citigroup Inc.
Bank of America	$116	$851	636.84%	19.91%	Bank of America Corporation/Fleetboston
J.P Morgan	$104	$1.036	901.14%	23.30%	J.P. Morgan Chase and Co./Bank One
Total	$436	$2.984	584.66%	19.11%	
* Reflects announced, but not yet consummated, mergers					
Three Largest GSEs					
Company in 1991	1991	2002	Total Growth	Compound Annual Growth	
Fannie Mae	$147	$888	503.33%	17.75%	
FHLBank System	$158	$764	383.04%	15.39%	
Freddie Mac	$47	$752	1505.21%	28.70%	
Total	$352	$2.403	582.67%	19.08%	

As shown in Exhibit 4, large banking companies have grown at a similar rate in a combination of mergers and internal organic growth.[18] Taking into account recent merger announcements, the three largest bank holding companies in the country will have grown by 585% since the early 1990s, almost exactly the same as the three housing GSEs.

The suggestion that a small mistake by a GSE could cause a major economic problem is simply not true. We have effective controls in place to protect against mistakes, and we have effective protections in place in the rare chance that something dramatic does happen.

[18] There may be those who object to this comparison on the ground that growth through merger is different from organic internal growth. This is not a tenable objection for at least two reasons: (1) Suppose two $100 billion banks merge to form a $200 billion bank. If the new bank should fail, the authorities have a $200 billion problem on their hands, which would not be the case without the merger except in the unlikely case where an extraordinary systemic shock forced the correlation of failure of the two $100 billion banks and (2) Numerous examples exist of mergers, *per se*, being the cause of problems in the banking industry, particularly as far as operations risk is concerned. Such problems arise from the forced conjunction of different systems, different credit philosophies, different cultures, etc.

Our financial regulator and a Nobel laureate in economics have both looked closely at our risk and found that our capital model is designed to prevent not just a small problem—but huge, devastating problems—from harming Fannie Mae or the economy. OFHEO examined the issue of systemic risk in early 2003[19], and found that we are a "very strong" financial institution, that the possibility of our "failing or contributing to a financial crisis is remote" and that the risk of our "causing a systemic disruption is highly unlikely." And Nobel laureate economist Joseph Stiglitz examined the stress test supporting our risk-based capital standard and found that the probability of this scenario occurring is exceedingly small -- less than 1 in 500,000. Given that result, he concluded that as long as Fannie Mae meets the risk-based capital standard, the likelihood of a default is "effectively zero." Those are the same odds that the asteroid 1999 AN10, discovered in January 1999, could crash into the earth.

In fact, it is virtually impossible for a small mistake to fell Fannie Mae. We have $35 billion in total capital, which includes nearly $6 billion in core earnings from last year. In addition, we have $14 billion of subordinated debt outstanding. It would take a very large mistake to cause us to run through the $49 billion in capital, subordinated debt and earnings we have today.

Even given how unlikely such an event could be, we have safeguards in place to protect us if such an unforeseeable event occurs.

First, we meet the very highest standards of liquidity management. We maintain a liquid investment portfolio of high-credit quality investments that we can draw on for liquidity purposes. We committed in 2000 to maintain enough liquidity to survive a three-month period without access to new-issue debt markets and to maintain at least 5 percent of our on-balance sheet assets in high-quality liquid investments. Over the last 6 years, the ratio of Fannie Mae's liquid non-mortgage assets to total assets has ranged from 6 percent to 17 percent. Second, we have mortgages and MBS to draw on. In the event of a liquidity crunch, we could borrow against this unencumbered portfolio.

In addition, in 2003, Glenn Hubbard, former Chairman of President Bush's Council of Economic Advisers, reviewed our liquidity management and concluded that "a 'liquidity crisis' for Fannie Mae is an extremely remote possibility."[20]

Altogether, for every $2 we have in debt and liabilities on our balance sheet, we have access to about $3 in capital, credit enhancements, and collateral. That collateral includes $1.5 trillion in property value   the homes and land behind our mortgages   some of the safest collateral in the world.

[19] *Systemic Risk: Fannie Mae Freddie Mac and the Role of OFHEO,* Office of Federal Housing Enterprise Oversight, February 4, 2003 available at http://www.ofheo.gov/Media/Archive/docs/reports/sysrisk.pdf.

[20] *Evaluating Liquidity Risk Management at Fannie Mae,* R. Glenn Hubbard, *Fannie Mae Papers* (Volume II, Issue 2), November 6, 2003 at 2, available at http://www.fanniemae.com/commentary/pdf/fmpv2i5.pdf.

Given our stringent capital requirements and our resilient asset base, Fannie Mae is one of the last financial institutions in the world that could cause a problem in the economy. To the contrary, during stressful times—including the global credit crunch of 1998 and post-September 11, 2001—we served to stabilize the financial system by keeping housing capital flowing smoothly.

Still, in the highly unlikely event of financial trouble, the regulator needs the authority to step in. Bank regulators and our regulator have these authorities. Bank regulators have the option to appoint a receiver or a conservator. When a bank gets into serious financial trouble, the regulator can install a receiver to close and sell the bank. The receiver has all the powers of the directors, officers and shareholders of the institution, and can repudiate certain contracts in the wind down process. This authority is critical in the banking system, as a means of protecting the taxpayer from the exposure created by federal deposit insurance. After the secured creditors, insured depositors have the first call on the failed bank's assets. The FDIC pays the depositors, and then is reimbursed from the assets of the bank. The receiver is necessary in order to put the FDIC – and thereby the taxpayers – first in line among the creditors of a failed bank. The other creditors collect only after the deposit insurance fund is repaid.

In the case of the GSEs, if one of the companies faces serious capital shortfalls, the regulator can install a conservator. In fact, the regulator can install a conservator at a GSE far earlier in the onset of a capital problem than a bank regulator can put a bank in receivership. The conservator has all the powers of the officers, directors and shareholders of the company and can take the steps necessary to rebuild the capital of the institution. What the conservator does not have is the ability to close down the company and the ability to repudiate contracts.

Conservatorship, rather than receivership, is the right model for the GSEs. Even in the banking world, the law provides the regulators with several ways of avoiding receivership for the largest banks if winding them down would create serious adverse effects on economic conditions or financial stability. In the case of Superior Bank, the last large bank failure, a conservatorship was established. And the law also provides special protections to "qualified financial contracts" to insulate them from the consequences of the exercise of the receiver's power to repudiate such contracts. This area of the law and the regulation has been long subject to interpretation, and the FDIC has issued numerous clarifying regulations to protect certain contracts.

It is unclear how a wholesale implementation of FDIC receivership powers, designed to protect insured depositors, would apply to Fannie Mae's obligations – our debt, our MBS, and our guaranty. For example, enacting a receivership provision unfairly imposes new risks on holders of existing obligations that they could not have anticipated at the time they purchased these obligations. The imposition of these risks, therefore, could undermine the pricing of existing obligations and cast uncertainty on how new obligations should be priced. The uncertainty would have a greater price impact on longer-term securities, and poses risks to the 30-year fixed-rate mortgage. The resulting higher debt prices would translate into higher mortgage rates for consumers. These issues must be carefully studied to avoid serious unintended market consequences. The risks inherent in moving to a receivership structure seem to far outweigh any benefit such a structure brings in the remote case in which one of the enterprises faces serious financial distress.

While government has a financial stake in a financial institution with guaranteed deposits, the government's stake in the GSE's success is not financial. The government's interest in these two institutions is their ability to serve as instruments of national policy, making homeownership more affordable and more available. That is why a conservator is the appropriate tool to deal with a capital inadequacy problem at a GSE. The conservator's role is to rebuild the capital of the GSE and ensure it remains an ongoing concern. Only Congress should decide if there is no longer a need for this instrument of national policy to support homeownership.

PRIVATE MANAGEMENT

Fannie Mae and Freddie Mac have been an incredible public policy success, driving private capital to accomplish the public mission of expanding homeownership. The model works because our incentives are properly aligned – we earn a return for our shareholders by fulfilling our mission.

Given our mission and charter, we agree that we should be subject to rigorous oversight of our safety and soundness and of our mission. In fact, rigorous oversight is an integral component of our charter. Our charter gives us benefits and restrictions designed to marshal private capital toward the public policy goal of expanding homeownership. In granting us this charter to expand homeownership, policymakers are expected to conduct effective oversight to ensure we are achieving our mission and operating safely and soundly so that we will continue as an ongoing business delivering on our mission.

It is critical to be clear on the balance between supervision and oversight and private management. This distinction between supervision and management is the foundation of commercial regulation throughout the marketplace. In the financial services sector, public policy has found the right balance between private management and public supervision. Companies thrive when management is allowed to take risks, innovate, and experiment, and even to see a new innovation fail, as long as that failure does not put the entire enterprise at risk. Companies that take no risks and do not innovate cannot evolve to meet the demands of consumers and improve living standards for all Americans. For us, we must have the freedom to innovate and experiment in order to accomplish our mission and reward our shareholders. As long as the company is well-capitalized, operating safely, complying with the charter and meeting its mission requirements, regulators can be confident in the day-to-day business operations and routine management decisions.

Continuing our success in expanding homeownership opportunities in the coming decade will require continued entrepreneurship. It requires a regulatory regime that effectively oversees the companies, without dictating the private management of the companies. This is true with regard both to risk management and to our pursuit of our mission.

Banking regulation recognizes the importance of private management in running a successful financial institution. While banking law gives bank regulators authority to set operational and managerial standards as the agency determines to be appropriate, bank regulators have interpreted this authority to mean that banks must have in place appropriate standards for operations and management. In risk management, bank regulators recognize that their role is not to dictate how an institution manages risk but to ensure that every bank has the necessary standards and meets them. The interagency rule implementing banking law states that the "standards established the objectives that proper operations and management oversight should achieve, while leaving the methods for achieving those objectives to each institution." It is private management of risk, with rigorous public oversight, that best serves the financial system, ensuring continued innovation to meet the needs of the ever-evolving marketplace.

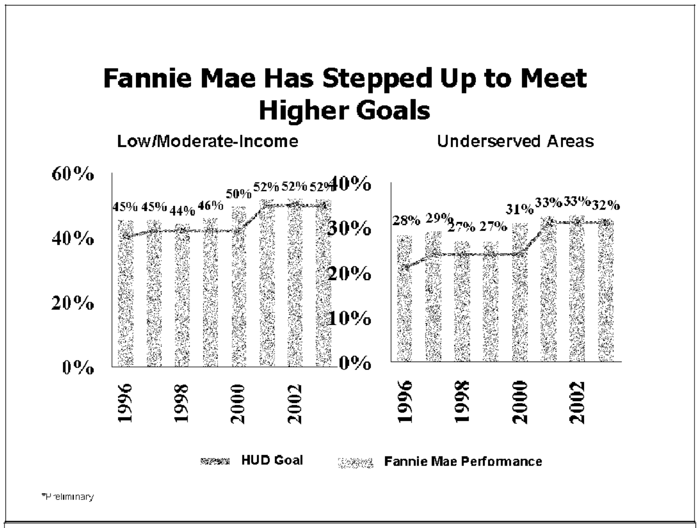
This bank model makes sense for Fannie Mae and Freddie Mac as well. Our regulator must ensure that we have standards in place to achieve best practices in risk management, without dictating the internal process at the company. Rigorous on-site examination ensures that our regulator validates the appropriateness of our risk management strategies and ensures that we live up to them. It is up to the company to devise those strategies and to disclose publicly the measures used by management to assess risk. We are a transparent company, disclosing risk measures on a monthly and quarterly basis. As an SEC-registrant, we make all the disclosures required of every publicly traded company. Our corporate governance and transparency were reviewed by Standard & Poor's in a report published in January 2003. The S&P report assigned Fannie Mae a corporate governance score of 9.0 on a 10-point scale -- a score it said reflected "governance practices that are consistently strong or very strong across each of [the] areas of analysis." With regard to transparency, S&P found that Fannie Mae's regulatory oversight and voluntary initiatives provide "disclosure about Fannie Mae's financial health that is unavailable from other, similar financial institutions" and that Fannie Mae provides "strong disclosure of its special purpose vehicles and risk management techniques."

With our charter, Fannie Mae has a special responsibility to focus on some of the nation's toughest housing problems. We do that every day in furtherance of our mission to expand homeownership. In 1994, Fannie Mae launched a *Trillion Dollar Commitment* dedicated to expanding markets and increasing access to mortgage credit. Upon completion of the *Trillion Dollar Commitment* in 2000, we announced our S2 trillion *American Dream Commitment,* a decade-long effort to close homeownership gaps and strengthen communities. Since 1994, Fannie Mae has served more than 16.5 million low- and moderate-income families and more than 5.5 million minority families. And last month we announced a third iteration of our American Dream Commitment, with a goal of financing mortgages for 6 million first-time homebuyers, including 1.8 million first-time minority homebuyers, in 10 years. We set a goal of increasing the minority homeownership rate to 55 percent in the next 10 years, a goal we cannot meet alone, to push ourselves to work with the industry to find mortgage solutions that work for minority families and minority communities.

HUD Housing Goals

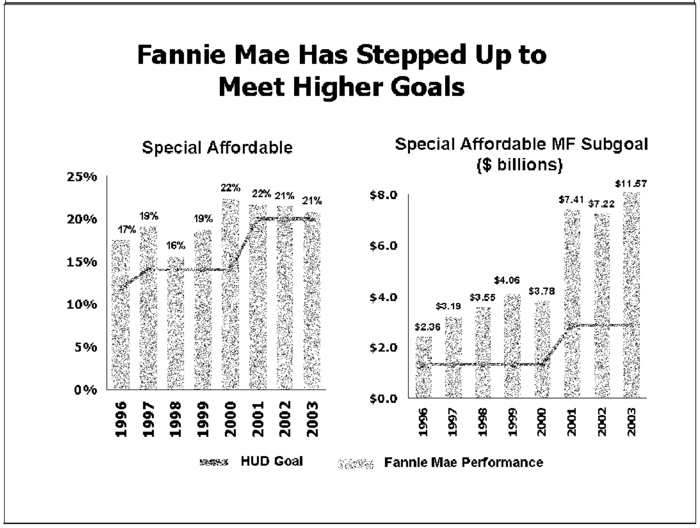
The 1992 Act created housing goals for Fannie Mae and Freddie Mac, to ensure that we remain focused on our affordable housing mission and to ensure that our business continues to promote homeownership as a national public policy priority. Under this authority, HUD sets specific share of business goals for purchasing loans to low- and moderate-income families, purchasing loans made to families living in underserved communities, and purchasing loans made to very low-income families and low-income families living in low-income areas.

Exhibit 5



Fannie Mae Has Stepped Up to Meet Higher Goals

*Preliminary



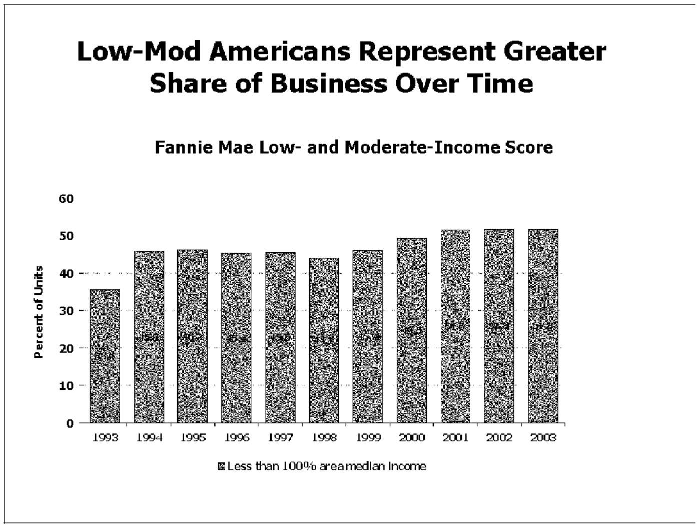
Fannie Mae Has Stepped Up to Meet Higher Goals

Those goals have increased substantially over the past 10 years, and we have consistently met those goals, even as they have become more demanding. In 2003, 59 percent of the mortgages we financed satisfied a HUD goal.

While we consistently meet the HUD affordable housing goals, we carry out a mission that is broader than specific governmental mandates. We are dramatically increasing our impact in underserved communities and we are responding to President Bush's challenge to expand minority homeownership. Since January 2000, we have financed $188 billion in purchase money loans to minorities, serving 1.4 million families. We work every day to innovate and develop creative ways to bring homeownership opportunities to all corners of the nation.

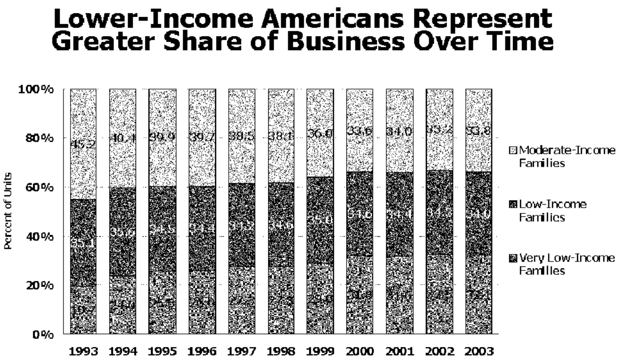
In fact, since Congress enacted the 1992 Act, we have steadily increased the share of our mortgage purchases that are loans to low- and moderate-income families. Over the past decade, the percentage of low-and moderate-income Americans we serve has grown substantially, from 35 percent to over 50 percent.

Exhibit 6



And within that population of borrowers, we have steadily increased the share of mortgage purchases that are loans to families earning between 60 percent and 80 percent of area median income, and the share of families earning less than 60 percent of area median income.

Exhibit 7

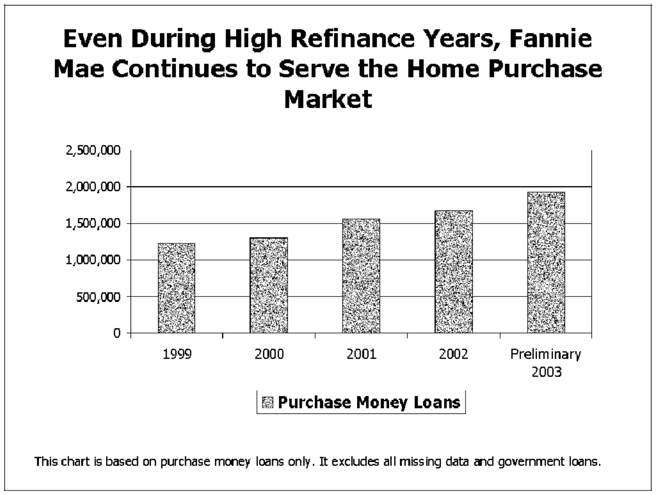


Lower-Income Americans Represent Greater Share of Business Over Time

We share the President's goal of creating an ownership society, and we understand the interest policymakers have in seeing us do more to make homeownership a reality for more Americans.

Last fall, the Administration proposed legislation that would create a purchase money mortgage goal for Fannie Mae and Freddie Mac. We are not opposed to the idea that we focus more specifically on home purchase mortgages as a means to increase the homeownership rate. As a company, we have increased the number of home purchase mortgages we buy every year and made a public commitment just last month to fund mortgages for 6 million first-time homebuyers in the coming decade. As this figure shows, even in years of record refinance volumes, such as 2002 and 2003, the number of home purchase mortgages we finance continues to grow.

Exhibit 8



This chart is based on purchase money loans only. It excludes all missing data and government loans.

Our strong commitment to homeownership is coupled with our responsibility to provide low-cost financing to the entire market. In fact, purchasing refinance mortgages is a critical part of our charter responsibility to ensure liquidity in the mortgage market. At the same time, the unpredictable nature of refinance volumes make forecasting extremely difficult as HUD establishes housing goals for future years. For example, in 2000, when HUD established the housing goals for 2003, economists at the Department, like economists elsewhere, predicted that the range of possible refinance volumes would not exceed 60 percent of total conventional conforming originations. In fact, last year refinance mortgages composed almost 80 percent of the total conventional conforming originations market.

Refinance volumes above predicted levels can put the housing goals out of reach. In 2002 and 2003, with refinance volumes far above anything anyone had predicted, Fannie Mae had to take extraordinary measures to meet the goals. In future years, if such a scenario occurs again, it is possible that we will have to limit our mortgage purchases to only those loans that meet one or more goals. Such a step is clearly not what is intended by our charter, which plainly states that the purposes of the company are to "promote stability in the secondary market for residential mortgages" and to "promote access to mortgage credit throughout the nation by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing."

A goals structure that creates incentives for us to focus on financing home purchase mortgages for low- and moderate-income Americans and underserved communities is appropriate. The Administration has various options to achieve this goal in a way that would ensure that in a high refinance year we are not forced to turn away from the refinance market in order to meet the housing goals.

Innovation

We embrace our mission, but the flexibility to pursue it is essential. In order for Fannie Mae to achieve our mission of making homeownership available to underserved families, we must be able to work directly with our partners to develop new products and new business processes. Intrusive regulation that seeks to replace business judgment with the government's judgment would prevent us from bringing these initiatives to market in a timely way.

Under current law, we work with our lender and community partners to create new products and new approaches to bring homeownership opportunities to underserved areas of the nation. We are required to seek approval from HUD when we want to engage in a new program – something significantly different from the business we were engaged in before the 1992 Act. The standard Congress created in 1992 has fostered an environment of unprecedented innovation in the mortgage industry over the last 10 years. Despite the constantly changing interest rate environment, and unprecedented volumes of business, Fannie Mae and the mortgage finance industry have created a revolution in underwriting, product innovation, and streamlined technology processes, to produce significant gains in lending to low- and moderate-income and other traditionally underserved borrowers. For example, Fannie Mae annual financing for low down payment loans (5 percent or less) has grown from $109 million in 1993 to $31 billion in 2003.

Under the current program approval standard, we can act in a timely manner to respond to the needs and ideas presented by our partners, such as low down payment loans through Flexible 97 and 100, My Community Mortgage products to meet Community Reinvestment Act needs, and Expanded Approval to reach out to underserved borrowers with blemished credit. These mortgage features have been crucial tools in reaching into communities that were previously underserved. The mortgage market today has a wider variety of products available than ever before, and therefore is better poised to meet the individual financing needs of a broader range of homebuyers. This has been possible because the program approval requirements in the 1992 law respect the need for innovation and strike an appropriate balance between charter enforcement and management discretion.

The current standard has allowed us the flexibility to work with lenders to meet the needs of the marketplace, while ensuring proper oversight of our mission. Just last year, we sought program approval for a new initiative to provide Acquisition, Development and Construction lending to help our lender partners finance the development of affordable housing.

We urge that any legislation reiterate the congressional view that Fannie Mae should support innovation in the market as it carries out its mission. Congress needs to make clear again that the companies are encouraged to innovate and be responsive to market needs. In addition, we believe that any change in this area must take into account the very strong concerns that have been raised from many within the housing industry, to ensure that innovation can remain strong.

Some have proposed an intrusive process that would require us to seek approval from HUD or from our new regulator every time we undertake a new “activity” or create a new “product.” Such micromanagement would put a halt to the innovation that has made the mortgage industry efficient enough to handle the volumes of mortgage originations last year and creative enough to bring homeownership opportunities to underserved communities around the nation.

Such micromanagement would also be far more constraining than anything imposed by bank regulators. Under the OCC and OTS regimes, banks are not required to seek pre-approval of new activities. Gramm-Leach-Bliley allows banks to go into broad new lines of business, like securities or insurance, without any pre-approval. They can engage in activities listed in their charters and incident thereto; they seek regulatory “cold-comfort” when they are pushing the envelope with respect to legal authority or suspect the regulator might have concerns. Regulators and courts have interpreted banks’ freedom very broadly.

Today, when a lender identifies a new mortgage product designed to meet the needs of a particular underserved community, we can examine the product and its risk profile and give the lender a timely response as to whether or not we will buy the loan. When we can respond quickly, lenders can bring the new mortgage product to market in a timely fashion. Under a “new product” standard, every time a lender approached us about a new mortgage feature, we would have to go to our regulator to get permission to purchase these loans. Small lenders could not put these targeted products into the market without knowing that we will buy them once originated. Innovation to meet the needs of underserved communities could come to a halt.

These innovations are critical to our ability to continue to serve our mission. And they could come to a halt under a “new activity” or “new product” standard.

THE ROLE OF OUR PORTFOLIO

The portfolio business has been and continues to be an important tool for achieving Fannie Mae’s housing mission. By purchasing mortgages and MBS for our portfolio, Fannie Mae expands the universe of mortgage market investors, bringing more capital into the mortgage market and bringing down mortgage rates. Investors who do not want the prepayment risk inherent in MBS can instead invest in Fannie Mae debt securities, which have more predictable cash flows over time. In this manner, Fannie Mae acts as an intermediary for the prepayment risk in mortgages, transforming risk, and providing value to homeowners and investors alike.

Fannie Mae follows a conservative and comprehensive strategy with respect to managing the interest rate risk of its portfolio business. Fannie Mae’s approach to managing this risk involves investing in assets and issuing liabilities that perform similarly in different interest rate environments in the context of a reliable, diversified, and disciplined approach to interest rate risk management.

Fannie Mae's mortgage portfolio business aims to achieve stable net interest income, regardless of changes in interest rates. In order to meet this objective, the risk management approach encompasses a set of well-defined strategies.

First, Fannie Mae funds new mortgage investments using a blend of debt securities, to achieve an approximate match between asset and liability cash flows. Second, in addition to matched funding, Fannie Mae uses options to reduce risk. Over the life of a mortgage, interest rates will change in ways that cannot be anticipated. Recognizing this, Fannie Mae purchases insurance against moves in rates by issuing extensive amounts of callable debt, which better matches the characteristics of the mortgage assets. Third, Fannie Mae uses derivatives, economic substitutes for noncallable and callable debt, to reduce risk and lower hedging costs. Finally, rebalancing, or active asset-liability management, is an additional, and important, element of portfolio interest rate risk management. We rebalance regularly, modifying the portfolio's composition and characteristics in order to adjust its exposure to changes in interest rates.

The effectiveness of Fannie Mae's interest rate risk management strategies can be seen in the fact that the company has continually produced remarkable stability in earnings growth and net interest margin. In spite of significant swings in interest rates over the past 15 years, the company has increased earnings every year. In fact, there have been significant interest rate movements within the last year. Mortgage rates increased by a full percentage point in just one month in July 2003. Fannie Mae has been a steady presence through these volatile times.

Our portfolio purchases reduce mortgage rates for homeowners. A recent study by Andy Naranjo and Alden Toevs of the First Manhattan Consulting Group showed that increases in securitizations or portfolio purchases each led to declines in mortgage rates for consumers. Further, they found that increased portfolio purchases led to larger declines in mortgage rates than did increased securitizations, and these purchases also reduced the volatility in mortgage rates.

By purchasing mortgages for its portfolio, Fannie Mae has been able to move independently to stabilize the mortgage market during a crisis. In so doing, it has provided an important source of stability to the market. This was clearly evident during the global financial market turmoil in the fall of 1998. Markets for many other securities dried up, while the market for conforming mortgages was relatively stable due to the extensive purchase activity by Fannie Mae and Freddie Mac. In their study, Naranjo and Toevs found that conforming rates would have been 66 basis points higher during this crisis without the stepped up purchasing activity of Fannie Mae and Freddie Mac.

Fannie Mae repeated this role of market stabilizer following the events of September 11. Unlike many other financial markets that week, the market for conforming mortgages remained open, and Fannie Mae was buying mortgages.

Our portfolio enables us to support our mission of providing liquidity to the secondary mortgage market, thereby making possible the availability of long-term, fixed-rate mortgages for homeowners, a product that is not generally available outside of the United States. An additional benefit of the portfolio is that if fosters innovation at Fannie Mae and in the broader mortgage market. New or unusual products are often difficult to securitize, at least initially. The ability to buy loans directly improves the company's flexibility when working with lenders to design new products. Although these new products cumulatively make up a small portion of the portfolio, the ability to design new products is greatly enhanced when lenders know that Fannie Mae can directly purchase the product in the secondary market.

Through the securitization of mortgages and through the transformation of risk in the portfolio, Fannie Mae attracts investors from around the world into the U.S. mortgage market, and lowers mortgage costs for homeowners. As a result, the average difference in 2002 between the conforming mortgages we can purchase and the jumbo mortgages we cannot purchase was 29 basis points, which translates into $19,300 in savings to consumers over the life of a 30-year fixed-rate loan.

Lowering the cost of a mortgage is critical to the bipartisan public policy goal of making homeownership available to Americans for whom the American Dream has long been out of reach. For every 25 basis points (one-quarter of a percentage point) decrease in mortgage rates, nearly 400,000 additional families can qualify to become first-time homebuyers.

Fannie Mae's portfolio competes with other investors for mortgage product

Fannie Mae competes with literally thousands of other institutions in the secondary market for the purchase of mortgage assets. In fact, commercial banks taken as a group, and particularly large banks (those with greater than $10 billion in assets) are the largest investors in mortgage assets, bigger than Fannie Mae and Freddie Mac combined. Some might be surprised to learn that market competition has seriously impeded growth in Fannie Mae's portfolio in recent months. As we regularly remind investors, we do not increase the size of our portfolio for its own sake. We employ our shareholders capital only when there is an acceptable rate of return available. In seven of the last 12 months, Fannie Mae's portfolio has declined because these returns were not available, largely due to the fact that banks were aggressively bidding for mortgage assets.

Exhibit 9

Banks Have Grown Their Market Share More Quickly Than Fannie Mae

	Share of MDO		
	12/31/1999	9/30/2003	Growth in Share
Largest Commercial Banks	16%	20%	4%
Fannie Mae	10%	12%	2%
Mortgage Debt Outstanding	$5.2 trillion	$7.6 trillion	

As shown in the table above, the largest banks have increased their investment in mortgage assets at a rate more than twice as fast as the growth in the underlying mortgage market, and have rapidly increased their share of total mortgage debt outstanding. Their share has increased by four percentage points from 2000 through the third quarter of 2003. Fannie Mae has grown in line with the market, increasing our share by only two percentage points over this time frame.

Impact of Portfolio Limits

There are some who would argue that the government through regulation or legislation should place an artificial limit on the growth of Fannie Mae's portfolio. We do not believe that such an approach is in the interest of homeowners. The question for policymakers is to ascertain where mortgage interest rate risk is best managed. The alternatives are institutions that are not focused exclusively on the mortgage market, banks which can go in and out of the mortgage market based upon prevailing returns, and homeowners themselves.

If Fannie Mae were limited in our ability to invest in mortgages, the interest rate risks inherent in mortgages would not go away, they would be borne by other institutions, primarily commercial banks and thrifts, or by homeowners. If risk migrated from Fannie Mae to the banking system, there is no doubt that taxpayers would be at higher risk. Commercial banks and thrifts take insured deposits that have an explicit guarantee from the government. Our debt securities have an explicit disavowal of any government support.

Because banks can use deposits as their primary funding for mortgages, their mortgage asset cash flows may not match up well against their deposit liabilities when interest rates change. In general, to maintain an overall asset-liability match, banks fund mortgages with short-term deposits and adjust the relative weighting of mortgages within their portfolios. In particular, banks do not use callable debt to fund or hedge mortgage investments.

Because they hedge to a lesser extent, banks investing in mortgages retain a good portion of the prepayment risk. But when interest rates move up significantly, they may have to sell mortgages into the market.

The market will ultimately adapt in one of two ways. Either banks will face higher risks, because they continue to hold fixed-rate mortgage assets without a liquid secondary market or any other market outlet, or banks will reduce the availability of 30-year, fixed-rate loans. Consumers would be left with only adjustable-rate products that expose them to uncertainty and interest rate volatility. If interest rate risk is not managed in the financial system, it has to be managed by individual mortgage borrowers, forced to take adjustable-rate mortgages. In fact, this is what the IMF explicitly advocated in its Global Financial Stability report, saying, "A more fundamental way for mortgage lenders to reduce their hedging needs would be to price adjustable-rate mortgage more aggressively to limit the creation of new fixed-rate mortgages with prepayment rights, although persuading borrowers to accept adjustable-rate mortgages when fixed rates are still at historically low levels would undoubtedly be difficult."

As Dr. Todd Buchholz has noted, "One of the most beneficial financial revolutions in recent memory has been in the housing sector, namely, the creation of secondary mortgage markets…the secondary mortgage market has been a vital technological and financial innovation that has helped spread risk, dampen economic crises, and attract more investors into the housing market…Without the secondary market, banks would have less liquidity available and would make fewer loans and charge higher interest rates."

A limit on our portfolio growth would eliminate our function as an outlet for banks in this situation. With Fannie Mae in place as backstop, ready and able to purchases mortgage assets should banks wish to unload them from their portfolios, the system works. When mortgages present a profitable opportunity for banks, banks invest, and Fannie Mae's portfolio is stable or declines. When mortgages are no longer profitable for banks relative to the many other assets they are able to invest in, banks can offload their mortgages to Fannie Mae and Freddie Mac. That is a benefit to the system, to banks, and to consumers.

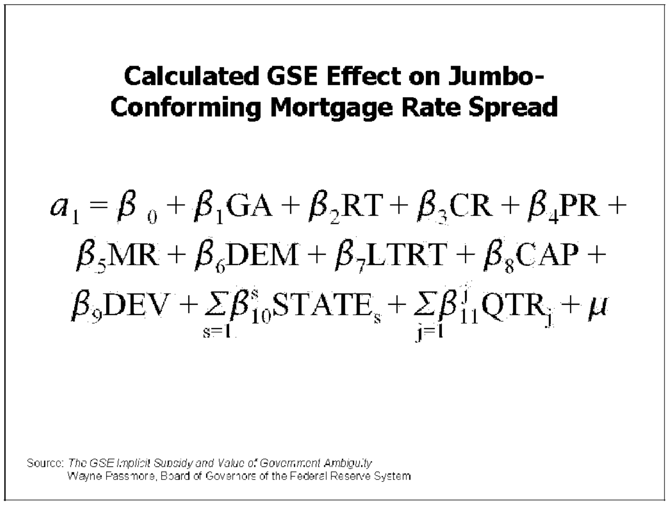
Any arbitrary constraint on our portfolio would remove an important bid for mortgages from the market, which would lead to higher and more volatile mortgage rates for homeowners. It would also increase risk to the taxpayer, as mortgage interest rate risk migrates from Fannie Mae and Freddie Mac to commercial banks, which fund themselves with government-insured deposits. Finally, it would increase risk to the financial system, removing Fannie Mae and Freddie Mac's ability to act as stabilizer during financial crises.

CONCLUSION

I applaud every member of this committee for the time and effort you have put into examining the options for strengthening our regulatory regime and carefully considering the implications of the different choices you may make. Our mortgage finance system today is the envy of the world – the only system in the world that has made long-term, refinanceable fixed-rate mortgages the standard consumer product. And the efficiency of our system has created an enormously liquid mortgage market that reduces mortgage rates for millions of homebuyers.

A recent paper by a Federal Reserve Board economist has questioned the benefits our current system brings to consumers, estimating that the GSEs only reduce mortgage rates by seven basis points.[21] To measure the extent to which Fannie Mae and Freddie Mac reduce conforming mortgage rates, the author constructs a complex equation (Exhibit 6) that does not reflect the way the mortgage market works. He also uses data that he himself characterizes as "not up to the task." Not surprisingly, his resulting estimate that Fannie Mae and Freddie Mac reduce conforming mortgage rates by only 7 basis points has little statistical significance and is at odds with everyday experience in the mortgage markets.

Exhibit 10



Calculated GSE Effect on Jumbo-Conforming Mortgage Rate Spread

$$a_1 = \beta_0 + \beta_1\mathrm{GA} + \beta_2\mathrm{RT} + \beta_3\mathrm{CR} + \beta_4\mathrm{PR} + \beta_5\mathrm{MR} + \beta_6\mathrm{DEM} + \beta_7\mathrm{LTRT} + \beta_8\mathrm{CAP} + \beta_9\mathrm{DEV} + \Sigma_{s=1}\beta^{s}_{10}\mathrm{STATE}_s + \Sigma_{j=1}\beta^{j}_{11}\mathrm{QTR}_j + \mu$$

Source: *The GSE Implicit Subsidy and Value of Government Ambiguity*
Wayne Passmore, Board of Governors of the Federal Reserve System

The Fed study, like a study in 2001 by the Congressional Budget Office, is based on the presumption that Fannie Mae and Freddie Mac receive a "subsidy" from the government, which is the sole determinant of the enterprises' ability to attract low cost funding. We asked David Gross of Lexecon to examine this premise. He noted that "By ignoring the fact that debt issued by banking organizations differs from debt issued by Fannie Mae and Freddie Mac for reasons other than the presence of a guarantee, the CBO overestimates the expected cost of government guarantees. In particular, to the extent that part of the reason that GSE debt has low interest rates is because of high levels of liquidity, the CBO methodology will overestimate the expected cost of government guarantees."[22]

[21] *The GSE Implicit Subsidy and Value of Government Ambiguity*, Wayne Passmore, Board of Governors of the Federal Reserve System, December 2003, available at http://www.federalreserve.gov/pubs/feds/2003/200364/200364pap.pdf.

[22] *The Government Role in Promoting Financial Sector Stability*, David Gross, *Fannie Mae Papers* (Volume II, Issue 3) July 2003, available at http://www.fanniemae.com/commentary/pdf/fmpv2i3.pdf

Fannie Mae's economists and econometricians reviewed the methodology of the Fed study, and found reason to be concerned that the analysis did not support the stated findings. The findings are attached. Specifically, they noted that both the data and techniques used caused a serious downward bias in trying to measure our effect on mortgage rates.

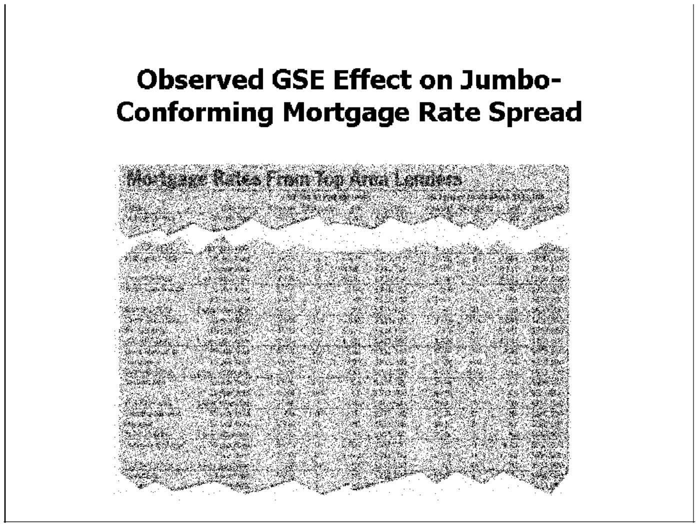
We also asked several eminent economists outside of Fannie Mae to take a look at the Fed study. Dr. William Greene, a prominent econometrician, examined the methodology employed in the Fed study and concluded, "Based on my review of the model specification, I conclude that the results in the Passmore study may well be seriously flawed...I believe the study should be subjected to extensive scrutiny before being used as a guide to the magnitude of Fannie Mae and Freddie Mac's impact on conforming mortgage rates." I've attached his comments for the record.

Last year, we commissioned a study from Professor R. Glenn Hubbard, former Chairman of the Council of Economic Advisers and a Professor at Columbia University, on Fannie Mae's management of liquidity risk. We recently asked for his views on the Fed study. In a letter, which I would like to enter into the record, he noted, "In the study I conducted last year, I found that Fannie Mae's return on assets and net interest margin have been less volatile historically than those of large commercial banks. This finding is consistent with the possibility that Fannie Mae's overall business risk is lower as well. This possibility and its implications for differences in funding costs between Fannie Mae and other financial institutions have not been fully explored in recent studies, including a recent Federal Reserve working paper."

We have also asked Professor Alan Blinder of Princeton, a former Vice Chairman of the Board of Governors of the Federal Reserve System for his reaction to the study. In a letter which is attached for the record, he states that there are a number of questions that could be asked with respect to such an analysis. "Passmore's conclusions depend sensitively on both his assumptions and the details of his estimation methods, many of which can be legitimately questioned," Blinder wrote.

Real world observations also differ from the econometric estimates in the Fed study. Many local newspapers publish mortgage rate charts every weekend, like the example from the Washington Post (Exhibit 7), listing the rates offered by many lenders.

Exhibit 11



Observed GSE Effect on Jumbo-Conforming Mortgage Rate Spread

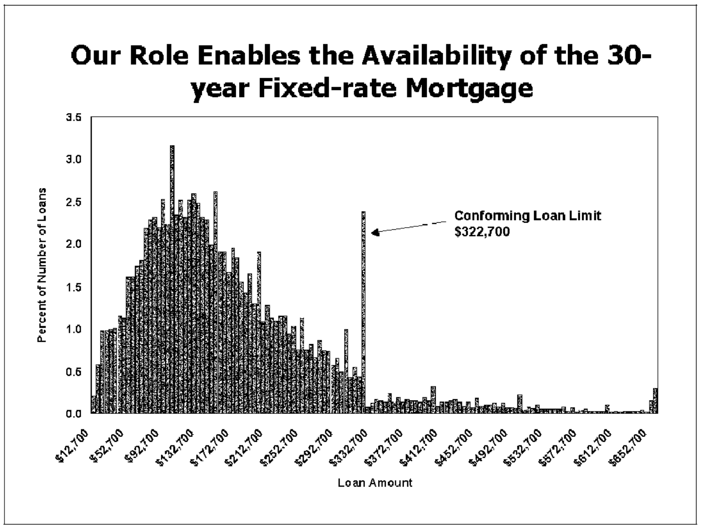
Mortgage Rates From Top Area Lenders

[illegible]

There is a substantial interest rate difference between the mortgages we finance, on the left, and those we don't finance on the right. The loans we finance typically cost between 20 and 50 basis points less than jumbo loans.

Not only do we lower rates, but we also make fixed-rate mortgages more available.

Exhibit 12



Our Role Enables the Availability of the 30-year Fixed-rate Mortgage

As you can see in Exhibit 8, there is a dramatic increase in share of adjustable-rate mortgages that begins just above our conforming loan limit. This difference is even more pronounced when you compare our market to the bank-based systems common throughout the world. Only in the United States are long-term, fixed-rate mortgages readily available, and here they account for nearly four of every five single-family first mortgages taken out by consumers.

In many bank-based systems in other countries, consumers only have access to the adjustable-rate mortgage loans that are a match for the banks' deposit base. But long-term, refinanceable fixed-rate mortgages are better for both consumers and the economy. With a fixed-rate mortgage consumers don't have to worry that rising interest rates will jeopardize their ability to make the payments on their home loan. And because the cost of existing mortgages is not affected when interest rates go up, and consumers can refinance their mortgages when rates go down, the fixed-rate mortgage contributes greatly to economic stability.

By making the long-term, fixed-rate mortgage more affordable and more available to American families, Fannie Mae fulfills its role as an instrument of national policy to expand homeownership. We believe in that mission, and work every day to achieve it. It is in the best interest of our mission – and of national policy to support homeownership – to ensure oversight by a world-class financial regulator. Millions of American families are counting on our mortgage finance system to continue to provide opportunities to reach the American Dream of homeownership. A great deal is at stake here. The 1992 Act has led to a transformation in mortgage finance unleashing innovation to make homeownership more affordable and more available in communities around the nation. I believe that Congress can build on that success, strengthening our regulatory regime to enhance our ability to achieve our mission and benefit millions of families in the future.

PREPARED STATEMENT OF RICHARD F. SYRON

CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FREDDIE MAC

FEBRUARY 25, 2004

Thank you, Chairman Shelby, Ranking Member Sarbanes, and Members of the Committee. Good afternoon. I appreciate the opportunity to appear before you today. My name is Richard F. Syron. I am the Chairman and Chief Executive Officer of Freddie Mac, a position I took at the end of December 2003.

Prior to joining Freddie Mac, I was Executive Chairman of Thermo Electron Corporation, an S&P 500 firm with 11,000 employees. Prior to that, I held a number of positions, including the Chairman and Executive Officer of the American Stock Exchange, President and Chief Executive Officer of the Federal Reserve Bank of Boston, and President and Chief Executive Officer of the Federal Home Loan Bank of Boston. I also served as assistant to then-Federal Reserve Chairman Paul Volcker, and earlier as Deputy Assistant Secretary for Economic Policy of the U.S. Department of the Treasury.

It is a great privilege to lead Freddie Mac, which plays such a critical role in financing homes for America's families—and providing strength and resiliency to America's economy. I could aspire to no greater legacy than to restore public trust in an institution chartered by Congress to ensure the stability and liquidity and accessibility of the Nation's mortgage markets.

The issue of regulatory oversight reform of the housing Government Sponsored Enterprises (GSE's) is vitally important to our Nation's economy and to homeowners. My views on this important topic have been profoundly shaped by my experiences as a former regulator. My firm belief that capital should be tied to risk stems directly from my tenure at the Boston Federal Reserve, where I was deeply involved in restructuring New England's banking system following the credit strains of the late 1980's and early 1990's. My views on homeownership, however, have more personal roots. I grew up in Boston in a two-family home financed by a VA loan that my father was able to obtain when he returned from World War II.

Today, in my comments to this Committee, I will focus on three areas:

- Why GSE's exist—and what they have accomplished;
- The imperative of regulatory oversight reform; and
- My top priorities for Freddie Mac, particularly how we are remedying our past accounting errors.

Why GSE's Exist and What They Have Accomplished

One advantage of being a newcomer is the ability to ask provocative questions—and there is no more provocative issue in the housing world than the role of the GSE's and the benefits they bring. Since arriving at Freddie Mac just 8 weeks ago, this question has been vigorously discussed in the halls of Government, by national think tanks, in newspapers—and just yesterday in this chamber by Alan Greenspan.

I approach this question from the perspective from what we know—that is, the current system of housing finance and its known benefits—and weigh it against what we do not know, that is, what housing finance would look like without the GSE's.

What we know is based on 70 years of mortgage history. In the aftermath of the Great Depression, Congress chose to provide explicit Government insurance to both the housing and banking industries to entice investors back to housing. While the plan worked, it also put the government directly on the hook for the risks associated with loaning individual homebuyers large sums of money for long periods of time. Mortgages carried significant credit risk because of the differences in the ability of borrowers to repay their loans. However, interest-rate risk was more vexing. Even if a borrower did not default over the course of 30 years, money would be tied up in a fixed-rate asset whose value was subject to the vagaries of interest-rate movements over prolonged periods.[1]

To address this issue, Congress found an ingenious way to stimulate long-term investment in housing without exposing the public fisc to the risk of substantial loss: Create financial institutions with a limited nexus to the Government and give them the singular job of making markets stable and liquid, at all points along the business cycle.

The GSE model of housing finance has been a Congressional success story. By providing attractive returns on capital, the GSE's have proven to be effective man-

[1] These risks are real: Recall the huge credit losses that resulted from the "oil-bust" in the early 1980's, and the taxpayer bailout of the S&L's, which were in the untenable position of holding 6 percent mortgages in an 18 percent interest-rate environment.

agers of the credit risk of the mortgages they buy. Further, by maintaining exclusive focus on the residential mortgage markets, as required by law, the GSE's have developed extraordinary expertise in understanding the credit characteristics of borrowers. This has resulted in a steady lowering of downpayment requirements within the conventional market to the point at which the GSE's, with no explicit subsidy, are able to provide nearly the same benefit to borrowers as the Government provides through its on-budget FHA and VA mortgage programs.

Management of interest-rate risk also has been a notable success. Through the creation of mortgage-backed securities, the issuance of callable debt and the use of derivatives, the GSE's routinely and efficiently transfer interest-rate risk from individual households to global capital markets. Not only do the GSE's make it possible for originators to lend money to individual homeowners for long periods of time at better rates than many corporations can borrow, but they also permit borrowers to "put" the mortgages back whenever they desire to do so and at no penalty. This extremely valuable option makes the 30-year, fixed-rate mortgage the product of choice among U.S. homeowners; in 2003, 82 percent of all conforming purchase-money originations were fixed-rate mortgages. Homeowners were able to profit from falling interest rates by refinancing into lower-cost loans, adding billions of dollars to our economy. Prepayable mortgages also help diminish friction in our economy by facilitating the mobility of the Nation's labor markets.

These innovations in mortgage financing made possible by the GSE's produce valuable benefits. Low-cost mortgage money is readily available. Families can get their loans approved in minutes. (In fact, during this hearing, Freddie Mac likely will have financed mortgages for about 2,000 families.) Today, more people own homes—and higher quality homes—than at any time in our Nation's history and than in virtually any other part of the world.[2] And wealth created through homeownership will help bear us into old age, taking some of the burden off Social Security and allowing us to pass something along to the next generation. Not a bad track record for Congressional inspired institutions that need no budget authority, pay significant Federal taxes, and employ thousands of people.

In United States, we tend to take these benefits for granted. However, very few countries can boast of such an efficient and effective mortgage delivery system.[3] Despite the integration of world capital markets, the United States is still the only place where a long-term callable mortgage product is broadly available. Countries that want to provide long-term prepayable mortgages to their own citizens are considering creating GSE's. The European Union is currently considering the creation of a GSE-type agency to "enable lenders to provide their existing mortgage products at better prices and introduce long-term, fixed-rate mortgages without redemption penalties."[4]

Let us now consider U.S. housing finance without the GSE's. There are three key arguments I would like to address.

First is the view that Government sponsorship is no longer needed to attract capital to housing or to provide an abundant supply of 30-year, fixed-rate mortgages. This optimistic view contradicts the experience in other developed countries. That is, if homeowners in Northern New York or Washington State lived a few miles to the north in Canada, they would typically be restricted to a 7-year, fixed-rate mortgages, they would be locked into higher interest rates or have to pay heavy penalties if they wanted to prepay, and they would have to put 25 percent down.

This sanguine view of markets also reflects our collective amnesia about where we are in the credit cycle. History reveals that certain industries will slump, that certain regions will experience economic downturn, which, in turn, causes house values to fall and defaults to rise. We also know that with interest-rates at historic lows, the mortgages put on the books today, in all likelihood, will require financing for decades to come. In short, it is easy to dismiss the risks of mortgage lending when times are good.

GSE's were created precisely for those times when things are not going so well, however. GSE's absorbed significant losses during the oil bust in the 1980's and during the weakening of the economy in Northeast in the early 1990's. They also stabilized residential mortgage rates during the international financial crisis of 1998—and again after-September 11—by continuing to provide liquidity to the secondary

[2] "As a result of the very favorable conditions in the housing sector, the U.S. homeownership rate climbed to 68.2 percent in the third quarter of 2003—equal to its highest level on record," 2004 Economic Report of the President, p. 89.

[3] Marsha J. Courchane and Judith A. Giles, "A Comparison of U.S. and Canadian Residential Mortgage Markets," March 2002.

[4] Richard Adams, "Banks Back Cheaper Mortgage Plan," *The Guardian,* November 17, 2003.

market for conforming home loans. Their actions ensured that mortgage credit remained available and affordable.

A second argument concerns the allocation of capital to housing. The housing market has an enormous impact on the economy, directly accounting for more than one-third of the nominal growth in GDP over the past 3 years.[5] And this does not begin to account for all the indirect support for consumption generated by record levels of refinancing in the past few years. Housing played an important counter-cyclical role in supporting the recent weak economy, as noted in the President's 2004 Economic Report:

> *Despite the similarities between the recent business cycle and previous ones, this most recent cycle was distinctive in important and instructive ways. One noteworthy difference is that real GDP fell much less in this recession than has been typical . . . This relatively mild decline in output can be attributed to unusually resilient household spending. Consumer spending on goods and services held up well throughout the slowdown, and investment in housing increased at a fairly steady pace rather than declining as has been typical in past recessions.*[6]

Finally, there are arguments about size and systemic risk. Residential mortgage debt outstanding grew at an annualized rate of 8.6 percent over the past decade. Not surprisingly, the GSE's also have experienced significant growth. But GSE size is not an accurate proxy for risk. On average, there is approximately 40 percent collateral in homeowner equity behind the loans Freddie Mac has guaranteed. Interest-rate risk also is well-managed. Freddie Mac strives to maintain an extremely closely match between the duration of our assets and liabilities. Throughout 2003, for example, a period of extreme turbulence in financial markets, Freddie Mac's duration gap never exceeded 1 month.

Finally, there is no way that mortgage debt and the risks of investing in it would disappear by downsizing the GSE's or making other changes to the GSE charter. Rather, the burden of managing mortgage credit risk would shift from these institutions to those with explicit Government support, while interest-rate risk would shift onto individual households. Another likely outcome is that higher costs of conventional mortgage financing could cause borrowers to shift into the FHA market, thereby actually increasing Government subsidization of housing. For homeowners, restrictions on GSE growth likely would result in reduced availability of 30-year, fixed-year, prepayable mortgages and higher costs.

These uncertain benefits must be coupled with the potential risks of dismantling a highly efficient and successful housing finance system. We can get a glimpse of a world without GSE's by looking at the jumbo market. On any given day, it is possible to look in a newspaper and find that mortgage rates on conforming loans are regularly one-quarter of a percentage point lower than those in the higher-balance jumbo market. Borrowers in the jumbo market not only pay higher rates, but they are also more likely to have to settle for an adjustable-rate mortgage (ARM's).

ARM's have the obvious advantage of lowering monthly mortgage payments in the first few years of homeowning, but they require borrowers to bear the interest-rate risk on the loan—rather than the capital markets bearing this risk. This results in higher borrower defaults over the long-term. Jumbo borrowers also typically make larger average downpayments than conforming borrowers. Higher mortgage-interest rates and larger downpayments make it significantly harder for low- and moderate-income families to become homeowners.[7]

In summary, we are a Nation of homeowners—and from all I can tell, we want to keep it that way. While discussions of the optimal allocation of the Nation's capital have their place, I believe this Nation made the right decision 70 years ago to lend housing a helping hand. (You will have to excuse my passion on this subject, but homeownership was part of my Ph.D. dissertation 30 years ago.) Bi-partisan support for Federal housing policy has paid enormous dividends. Families build wealth. Kids do better in school. Neighborhoods are safer. And, in recent years, housing has been the backbone of our Nation's economy. Support for homeownership—whether explicit or implicit—clearly has been good for this country.

But the task is not finished. There are millions of families still waiting to participate in the American Dream, and the homeownership gap between white families

[5] These percentages are based on data published by the Bureau of Economic Analysis, U.S. Department of Commerce for 1996 through 2003 and data for the same years available upon request from Freddie Mac.

[6] 2004 Economic Report of the President, pages 30, 32.

[7] Roberto Quercia, George McCarthy, and Susan Wachter, "The Impacts of Affordable Lending Efforts on Homeownership Rates," *Journal of Housing Economics* (Vol. 12, 2003), pp. 29–59.

and families of color is unacceptable. This is not the time to begin dismantling the world's finest housing finance system, or placing artificial limits on the GSE growth. The potential benefits of doing so are uncertain, and the risks are great.

Imperative for Regulatory Reform

Continued support for the GSE model of housing finance does not imply that improvements to the GSE regulatory oversight structure are not needed. They are. As a former regulator, I will be the first to say that world-class regulatory oversight is absolutely critical to the achievement of Freddie Mac's mission and to maintaining the confidence of the Congress, the public and financial markets. Freddie Mac strongly supports the enactment of legislation that provides strong, credible regulatory oversight. These enhancements are needed—even overdue.

I am sadly aware that Freddie Mac's accounting issues are the source of much of the current controversy regarding the role of the GSE's. However, as with any episode such as this, it is critical to get the ship back on course without overreacting at the wheel. Given the enormous benefits of the conforming mortgage market, which has proven its resiliency in all interest-rate and credit environments, zeal to improve this system must be tempered with an abundance of care. Borrowing a phrase from our friends at the Homebuilders, I urge the Committee to "measure twice and cut once."

To guard against potential negative unintended consequences, I would like to offer a set of principles, based on my experience as a former regulator. The new GSE regulatory structure must:

- Engender public confidence through world-class supervision and independence;
- Ensure continued safety and soundness of the GSE's;
- Respond flexibly to mortgage market innovation; and
- Strengthen GSE market discipline through robust and timely disclosure.

With these principles in mind, today, I will comment briefly on key aspects of the regulatory structure under consideration in this Committee.

Structure and Independence

Freddie Mac would strongly support an independent board regulatory structure modeled on independent Federal agencies such as the Securities and Exchange Commission. Our preference would be for a three-member board, comprised of a Chair and two additional members. The President would appoint Board members, by and with the advice and consent of the Senate, subject to statutory criteria relating to qualifications of the nominees. For instance, we believe that at least one member of the Board should have significant housing industry experience. It would also be important to ensure that members have significant experience with complex financial transactions. As is typical with independent boards, we would suggest that not more than two of the Board members be members of the same political party.

Notwithstanding the importance of housing and financial expertise, we would have some concern if the Board were to include representatives of cabinet departments such as the Department of Housing and Urban Development, the Department of the Treasury or other executive branch departments. The purpose of establishing an independent board is just that, independence. Inclusion of executive branch representatives on the GSE regulatory board could compromise this important component of world-class regulation.

Freddie Mac would have similar concerns should the Congress decide to locate the new regulatory office within the Department of the Treasury. To ensure independence, we would support applying the same operational controls as apply to the relationships between the Secretary of the Treasury and the Office of the Comptroller of the Currency and the Office of Thrift Supervision.[8] Adequate firewalls are needed to avoid the politicization of the GSE mission and the critical role we play in the Nation's economy and global financial markets.

Funding of New Oversight Offices

Freddie Mac supports providing both the new regulator and the Secretary of HUD authority to assess Freddie Mac outside the annual appropriations process to pay for the costs and expenses of carrying out their respective responsibilities vis-á-vis the GSE's. However, we would suggest that the General Accounting Office regularly report to the Congress on the efficacy of the new regulatory structure and the reasonableness of the costs relative to other world-class financial regulators so that neither unnecessarily raise the cost of meeting our mission.

[8] See 12 U.S.C. §§ 1, 250, 1462a(b)(2), (3), and (4) and 1464(d)(1)(A).

GSE Capital Requirements

Second to questions of GSE role and benefits, I have quickly learned that questions about GSE capital adequacy are highly contentious and can serve as "stalking horses" for other issues. There is no question these issues are of paramount importance. Capital adequacy is the touchstone of investor confidence and is key to our ability to attract low-cost mortgage funds. On that score, Freddie Mac consistently has exceeded both its minimum capital and risk-based capital standards.

However, from the perspective of a former regulator, I believe there are many difficult and sometimes confusing aspects about the direction of the debate on GSE regulatory oversight. The first is the view that the GSE's should be held to the same capital standard as for banks. Let me begin by stating the obvious: GSE's are not banks.

- There are nearly 10,000 banks and savings institutions in this country. There are two GSE's focused exclusively on housing.
- Banks are largely funded by deposits. GSE's must rely exclusively on the capital markets for their funding.
- Banks can (and do) invest in a wide range of higher-risk assets, ranging from unsecured loans, to commercial loans and loans to foreign countries. In contrast, GSE's are restricted to one line of business: Residential mortgages finance. We invest almost exclusively in conventional conforming mortgages, among the safest investment vehicles around.

Given these important distinctions, it is entirely appropriate that the GSE capital regime be distinct from the bank capital model. GSE capital requirements reflect the confinements of its GSE charter, such as the conforming loan limit and credit enhancement requirements for high loan-to-value mortgages. These charter limitations necessarily result in a lower GSE risk profile.

Since 1994, charge-off losses at the five largest banks have been, on average, 17 times larger each year than charge-offs at Freddie Mac. Even in these banks' *best* year, charge-offs were more than five times higher than Freddie Mac's *worst* year.[9] Limiting the comparison to mortgage assets, the residential mortgages found in bank portfolios typically entail greater risk than those in Freddie Mac's portfolio. In 2002, FDIC-insured institutions had an average charge-off rate of 11 basis points on their mortgage portfolios, compared to 1 basis point for Freddie Mac.[10] Given this lower risk exposure relative to banks, we believe that the GSE minimum capital requirement is adequate and need not be changed.

The second troubling aspect of the current debate is the fixation on the GSE minimum capital ratio, when the risk-based capital standard is a far more effective regulatory tool. Leverage ratios are last year's capital "model." They have significant limitations—and, depending on how they are enforced, can do more harm than good.

I observed first-hand the problems with overzealous enforcement of simple leverage ratios during my tenure at the Federal Reserve Bank of Boston in the early 1990's. While many financial institutions in the Northeast were adequately capitalized on a risk-adjusted basis, the strict enforcement of simple leverage ratios required them to liquidate a substantial portion of their assets. This resulted in a drying up of commercial credit that greatly exacerbated the economic downturn. The infamous "credit crunch" had profound effects on small and mid-size businesses and employment in the Northeast. It turned a 2-year recession into a 5- to 6-year slump.[11] I discuss these issues in two articles I wrote on this subject.[12]

My experiences are consistent with leading international trends in capital management. Drawing from recent statements by the Basel Committee on Banking Supervision, risk-based capital regimes are preferable to the use of simple ratios to set capital standards. In its 1999 Basel Consultative Paper and the 2001 New Basel

[9] Federal Financial Institutions Examination Council, *Consolidated Reports of Condition and Income* and Freddie Mac annual reports for 1994 to 2001. For 2002 Freddie Mac credit information, see *http://www.freddiemac.com/news/archives/investors/2003/4qer02.html.*

[10] Federal Financial Institutions Examination Council, *Consolidated Reports of Condition and Income* and Freddie Mac. See *http://www.freddiemac.com/news/archives/investors/2003/4qer02.html.*

[11] History of the Eighties, Lessons for the Future: An Examination of the Banking Crises of the 1980's and Early 1990's, vol. 1, part 2, Sectors and Regional Crises, Ch. 10, Banking Problems in the Northeast, Federal Deposit Insurance Corporation, 1997.

[12] See Richard F. Syron, statement before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance, and Urban Affairs, U.S. House of Representatives, May 8, 1991, reprinted in "Are We Experiencing a Credit Crunch?," *New England Economic Review* (July/August 1991), pp. 3–10; and Richard F. Syron, "The New England Credit Crunch," *Credit Markets in Transition: Proceedings of the 28th Annual Conference on Bank Structure and Competition,* Federal Reserve Bank of Chicago (1992), pp.483–9.

Capital Accord, the Committee proposed a capital adequacy framework to replace the 1988 Capital Accord for U.S. bank capital standards, which relied heavily on simple ratios to set capital standards. The new framework, which is currently under consideration in this country, more accurately aligns capital requirements to the actual risks incurred by regulated institutions.[13]

Notwithstanding my philosophic differences regarding the efficacy of leverage ratios, I can understand the need for regulator discretion to increase the leverage ratio in the event of a finding of an unsafe and unsound practice. We believe parameters should be put in place in statute that define the circumstances under which such an increase could be undertaken, as well as parameters for resetting the ratio to the statutory minimum once the unsafe and unsound practice has been satisfactorily addressed.

Discretion on Risk-Based Capital

In my view, greater discretion with regard to the GSE risk-based capital rule is the best way to avoid potential negative unintended consequences associated with strict enforcement of leverage ratios. Ten years in the making, the GSE risk-based standard is unique among financial services regulation. It requires Freddie Mac to hold capital sufficient to survive 10 years of *severe* economic conditions; under the risk-based test, both the credit and interest-rate risk of the GSE's mortgage holdings are stressed to historic proportions. Without a doubt, this rule is at the cutting edge of financial services regulation.[14] It ties capital to the specific risks of an institution—ensuring safety and soundness without raising costs unnecessarily or crippling the smooth flow of mortgage capital. It is the standard-bearer in capital regulation.

To ensure that the GSE capital standard remains at the forefront of capital regulation, the new regulator must have adequate discretion to keep pace with developments. Although the basic parameters of the risk-based capital stress test are set in law, our present regulator has significant discretion in adjusting the risk-based capital requirements. Additional discretion, such as provided to Federal banking agencies, could help ensure the GSE risk-based capital standard remains at the forefront of financial sophistication, while continuing to tie capital to risk.

Discretion must be balanced with continuity, however. Unnecessarily changing the risk-based capital standard harms those who made investment decisions based on a particular set of rules, only to find later that the rules were changed. This "regulatory risk" increases costs that are ultimately borne by mortgage borrowers. Therefore, until such time as an overhaul of the risk-based capital stress test appears warranted, the regulator should be encouraged to continue to apply the existing risk-based capital rule. The rule has been in effect for only 1 year and has yet to show signs of need for reform.

We also believe the new regulator should be encouraged to gather information over the entire business cycle before making changes. This could be accomplished by requiring that the current rule remain in place for a period of time and expressing Congressional intent to this effect. When a new rule appears warranted, policymakers should ensure that certain fundamental principles remain firmly intact. It would be our strong suggestion that any future capital standard must continue to tie capital levels to risk; be based on an analysis of historical mortgage market data; remain operationally workable and as transparent as possible; and accommodate innovation so the GSE's can carry out their missions.

Further, we would expect that any changes to the rule be accomplished through notice-and-comment rulemaking, with an adequate comment period for all interested parties to express their views, followed by an adequate transition period for the GSE's to make any necessary adjustments to comply with new requirements.

In summary, Freddie Mac supports improvements to the GSE capital regime that reflect the unique role of the GSE's, while ensuring public trust in our financial strength. Based on my experience as a regulator, I fully support granting the regulator greater discretion to set risk-based capital levels that accurately reflect the risks we undertake. Discretion on risk-based capital greatly mitigates the need to

[13] *The New Basel Capital Accord,* Consultative Document, Basel Committee on Banking Supervision (January 2001) (the 2001 Basel Accord).

[14] According to an analysis prepared by L. William Seidman, former Chairman of the FDIC, the stringent risk-based capital standard applicable to Freddie Mac could be extremely challenging if applied to most other financial institutions. L. William Seidman, *et al., Memorandum to Freddie Mac,* March 29, 2000. More recently, the CapAnalysis Group, LLC, concluded that the risk-based capital stress test is "a much more stringent test for judging the safety and soundness of a financial institution than is a traditional capital-requirements test." The CapAnalysis Group, LLC, *OFHEO Risk-Based Capital Stress Test Applied to U.S. Thrift Industry* (March 17, 2003), p.1.

provide unfettered regulator discretion on minimum capital. Changing capital standards unnecessarily, capriciously or frequently will reduce the amount of mortgage business the GSE's can do, resulting in higher costs for homeowners and renters.

Supervisory and Enforcement Parity

The current legislative structure provides our safety and soundness regulator an array of supervisory and enforcement authorities to ensure that Freddie Mac is adequately capitalized and operating safely.[15] If Congress were to deem it appropriate, we would support providing the GSE safety and soundness regulator authorities similar to those accorded to the Federal banking agencies. These enhanced powers would include broadening the individuals against whom the regulator could initiate cease-and-desist proceedings, new authority to initiate administrative enforcement proceedings for engaging in unsafe and unsound practices, new removal and suspension authority and authority to impose industry-wide prohibitions, and new authority to assess civil money and criminal penalties.

Conservatorship v. Receivership

While it may be appropriate to draw on certain banking provisions to improve the GSE regulatory oversight structure, we strongly believe the mechanism for dealing with extreme financial distress is not one of them. Receivership is an efficient disposition mechanism for thousands of Federally insured depository institutions, whose failure would not threaten the stability of and public confidence in the financial system, particularly in the Federal deposit insurance system. However, it is not a credible option for dealing with two GSE's. In contrast to the situation for most insured institutions, the decision to liquidate a GSE would have substantial economic, market, and public policy consequences. It would threaten the public policy mission of the GSE's and could potentially disrupt the legal obligations and expectations of market participants.

Recognizing the unique role of the GSE's, and our mission to expand homeownership, Congress chose a different disposition mechanism when it established the current GSE regulatory oversight structure. To address the unlikely event of extreme financial distress, Congress gave the safety and soundness regulator the right to appoint a conservator, which would rehabilitate an ailing GSE. However, Congress reserved to itself the right to appoint a receiver.

Although Freddie Mac believes that current law provides ample convervatorship powers, we would be willing to consider whether additional authorities could enhance Congress' and the public's confidence in our safe and sound operation. Such enhancements to existing GSE conservatorship powers would achieve the important policy objective of strengthening the GSE regulatory oversight structure without the potential unintended consequences that could result from receivership. Many market participants might view a change to receivership as a first step to privatization of the GSE's. This could have significant implications on our ability to support the market for 30-year, fixed-rate mortgages.

Mission Oversight and New Program Approval

We believe that the HUD Secretary should retain all existing GSE mission-related authority consistent with HUD's mission to expand homeownership and increase access to affordable housing. Specifically, HUD should retain authority to ensure that the purposes of the GSEs' charters are accomplished and continue to have regulatory, reporting, and enforcement responsibility for the affordable housing goals, just as under current law. Additionally, HUD should retain existing fair housing authority.

We also believe that, in keeping with its housing mission, HUD should retain its authority to approve any new programs of Freddie Mac and Fannie Mac. HUD alone has the expertise to determine whether new mortgage programs are in keeping with our charter and statutory purposes. In this vein, we also urge the Committee to maintain a new *program* standard—not a new *activity* standard. Requiring the regulator to provide advance approval of each and every new activity significantly exceeds the standard required of banks and would chill innovation in mortgage lending. Our ability to lower housing costs for homeowners and renters is directly linked to our expertise in managing mortgage credit risk and our distinguished record of bringing innovative products and services to market.

Affordable Housing Goals

Meeting the annual affordable housing goals is a key aspect of our meeting our mission. Established in 1993 and increased in 1995 and 2000, the affordable housing

[15] "Comparison of Financial Institution Regulators' Enforcement and Prompt Corrective Action Authorities," GAO–01–322R, January 31, 2001.

goals specify that significant shares of Freddie Mac's business finance homes for low- and moderate-income families and families living in underserved areas. In 2000, HUD specified that 50 percent of Freddie Mac's mortgage purchases must qualify for the low- and moderate-income goal,[16] 31 percent must be of mortgages to borrowers in underserved areas,[17] and 20 percent must be of mortgages to very-low income borrowers or low-income borrowers living in low-income areas.[18] Freddie Mac has successfully met all the permanent housing goals, which are the highest and toughest of any financial institution.

The existing statutory and regulatory structure provides great discretion to our mission regulator to determine the goals—and creates strong incentives for us to achieve them. The HUD Secretary currently has the regulatory authority to establish and adjust the housing goals. In the event a GSE fails to meet one or more of the goals—or there is a substantial probability that a GSE will fail one or more of the goals—the Secretary is authorized to require the submission of a housing plan. Further, the Secretary may initiate a cease-and-desist proceeding and impose civil money penalties for failing to fulfill the housing plan. By contrast, bank regulators do not have authority to bring enforcement proceedings against an institution that is not meeting its CRA obligations. These are strong incentives for the GSE's to strive to meet the goals year after year—to say nothing of the reputational "penalty" for failing to meet a goal.

Considering that we have consistently met the permanent affordable housing goals, and that existing powers already are the industry's toughest, additional enforcement authority seems completely unnecessary. Additional enforcement authority would add little to the legislative and regulatory incentives that Congress and HUD have put in place. Therefore, we respectfully suggest that no additional authority is needed.

Market Discipline Commitments

In October 2000, Freddie Mac and Fannie Mae announced a set of six public commitments to ensure the GSE's adhere to a high standard of financial risk management. These commitments continue to represent a very high "bar" among financial institutions. Excluding the commitment to adhere to an interim risk-based capital standard (which was rendered obsolete with the completion of the current risk-based capital stress test) the commitments are as follows:

- Periodic issuance of publicly traded and externally rated subordinated debt on a semiannual basis and in an amount such that the sum of core capital and outstanding subordinated debt will equal or exceed approximately 4 percent of on-balance-sheet assets. Because subordinated debt is unsecured and paid to the holders only after all other debt instruments are paid, the yield at which our subordinated debt trades provides a direct and quantitative market-based indication of our financial strength.
- Maintenance of at least 5 percent of on-balance sheet assets in liquid, marketable, nonmortgage securities and compliance with the Basel Committee on Banking Supervision Principles of Sound Liquidity Management, which requires at least 3 months' worth of liquidity, assuming no access to new issue public debt markets.
- Public disclosure of interest-rate risk sensitivity results on a monthly basis. The test assumes both a 50 basis-point shift in interest rates and a 25 basis-point shift in the slope of the yield curve—representing an abrupt change in our exposure to interest-rate risk.
- Public disclosure of credit risk sensitivity results on a quarterly basis. The disclosure shows the expected loss in the net fair value of Freddie Mac's assets and liabilities from an immediate nationwide decline in property values of 5 percent.
- Public disclosure of an annual independent rating from a nationally recognized statistical rating organization.

[16] Low- and moderate-income families have incomes at or below 100 percent of the area median income.

[17] Underserved areas are defined as (1) for OMB-defined metropolitan areas, census tracts having a median income at or below 120 percent of the median income of the metropolitan areas and a minority population of 30 percent or greater; or a median income at or below 90 percent of median income of the metropolitan area; and (2) for nonmetropolitan areas, counties having a median income at or below 120 percent of the state nonmetropolitan median income and minority population of 30 percent or greater; or a median income at or below 95 percent of the greater of the state nonmetropolitan median income or the nationwide nonmetropolitan median income.

[18] Low-income areas refer to census tracts in which the median income is at or below 80 percent of the area median income. Low-income families have incomes at or below 80 percent of area median income, while very-low income families have incomes at or below 60 percent of the area median income.

In July 2002, the GSE's made an additional commitment to voluntarily register their common stock with the Securities and Exchange Commission under the Securities Exchange Act of 1934 so that both companies will become reporting companies under that law. Freddie Mac remains irrevocably committed to completing this process as soon as possible after the company's return to timely reporting.

Freddie Mac would support giving the regulator authority to ensure we carry out these important public commitments. Taken together, they significantly enhance the degree of market discipline under which the GSE's operate. Robust and frequent credit and interest-rate risk disclosures, combined with the release of annual independent ratings and the issuance of subordinated debt, constitute an important "early warning system" for investors.

Top Priorities for Freddie Mac

Finally, I would like to say a few words about Freddie Mac—and my top priorities for strengthening this vital company and restoring the trust of the Congress, the public, and investors.

Commitment to Exemplary Accounting

Clearly, my most pressing priority is to get Freddie Mac's financials done—and done right. On November 21, 2003, the Freddie Mac Board of Directors and our management team announced the release of the company's restated and revised financial results for the years 2000 through 2002. The restatement was a significant step in Freddie Mac's progress toward achieving accurate and timely financial reporting. The company will issue its annual report for 2002 on Friday, February 27, 2004 and hold the related annual stockholders' meeting on March 31, 2004.

As for 2003 and beyond, we are currently working around the clock with the objective of releasing quarterly and full-year 2003 results by June 30, 2004 and to provide the 2003 annual report and hold the related stockholders' meeting as soon as possible thereafter.

I am also focused on ensuring that these problems do not happen again. I am pleased to report that, under the guidance of our Board of Directors, Freddie Mac is building an environment that will allow us to provide comprehensive and understandable information about our company, incorporating the highest level of financial transparency, accounting controls, compliance, and professional standards. Our aim is not simply to meet what is required but to become a model of financial excellence.

We have added over 100 professionals in the accounting, reporting, and control areas, including a significant number of new officers and senior managers. We have also retained leading experts in the areas of public disclosures and corporate governance to assist the company in designing and implementing processes and practices in these areas. In October 2003, we hired a Senior Vice President—Chief Compliance Officer who is responsible for overseeing Freddie Mac's compliance with policies, procedures and practices, including compliance with laws and regulations. Additionally, in October 2003, we created the position of Chief Enterprise Risk Officer. Both of these positions currently report directly to me.

We are also working to create and implement new infrastructure and systems to ensure the quality, integrity, transparency, and timeliness of our financial reporting.

Finally, we have taken steps to ensure that Freddie Mac's corporate culture promotes integrity, high ethical standards, and the importance of compliance. Virtually all of our employees have completed a corporate-wide training program on the company's Code of Conduct and the provisions of the Act sponsored by Senator Sarbanes and Chairman Oxley.

The scope of these activities is wide and deep. I was deeply involved in the transformation of a Fortune 500 company before, and I am committed to doing it again. Freddie Mac is on the path to becoming a new and better company.

Enhanced Commitment to Mission

My second priority is to renew and expand the company's commitment to mission. It is a great honor to be the leader of a company that has an explicit mission to do good things for society. There are very few publicly owned companies that have such a "higher calling"—and, as a Nation, we should work to make them better, as is the Committee's intent.

The special privileges that flow from the GSE charter entail special responsibility. While the annual affordable housing goals are an important component of our mission to expand mortgage market accessibility, I view the goals more as a threshold than a ceiling. I am particularly focused on the housing finance needs of minority consumers. The homeownership rate for African-Americans is 48 percent and 47 percent for Hispanics. We must do better—and we will.

When I was at the Federal Reserve Bank of Boston, I oversaw one of the first major research projects looking at discrimination in mortgage lending. That research led to calls for greater objectivity in mortgage underwriting—and eventually to the birth of automated underwriting. Automated underwriting systems, such as Freddie Mac's Loan Prospector®, have played a critical role in expanding minority borrower access to mortgage markets. Now Freddie Mac is looking at ways to integrate nontraditional credit variables into automated underwriting. It won't be easy—but neither was creating the first mortgage-backed security, which is now widely traded around the world.

We are also studying the best way to extend the efficiencies of the conforming mortgage market to the subprime market. This market serves a needed function, but many borrowers—particularly minority borrowers—could qualify for lower-cost conforming mortgages if they had the chance. Further, abusive lending practices make this market ripe for the standardization and accountability that the GSE's provide. It is time to transform that market so that is serves borrowers better.

These and other initiatives to enhance Freddie Mac's commitment to mission are currently under active consideration. I would be happy to return to the Committee at some future point to describe specific new commitments Freddie Mac will make to further expand access to low-cost mortgage money for more families.

Maintaining Safety and Soundness

A final priority is to maintain Freddie Mac's rock-solid commitment to safety and soundness. Despite last year's accounting travails, Freddie Mac's franchise was safe and strong. Our safety and soundness regulator, the Office of Housing Enterprises Oversight (OFHEO), continually assessed us as "adequately capitalized," the highest rating. And we are in full agreement with OFHEO's directive of [date] to hold excess capital until our financials are complete.

I have been particularly impressed by the company's assiduous management of interest-rate risk. Each day at 5 p.m., I receive a set of measures of Freddie Mac's exposure to interest-rate risk *for that day*. And each month, investors around the world see what I see when the company discloses our average monthly duration gap and other statistics. Only the housing GSE's provide such frequent and transparent measures of risk exposure. Freddie Mac is clearly a company that is serious about managing risk—and good at it, too. This will not change. If anything, I will see that our risk management practices and disclosures are strengthened.

Conclusion

Freddie Mac strongly supports the enactment of legislation that provides strong, credible regulatory oversight. These enhancements are needed—even overdue. They are critical to the achievement of our mission and to maintaining the confidence of the Congress and the public.

As a former regulator, I strongly support significant enhancements that will make our regulatory structure stronger, in many cases, than the bank regulatory model. Building these new enhancements into existing law would give the new GSE regulator comparable supervisory and enforcement powers as bank regulators. In addition, these enhancements would impose tougher regulatory requirements in many areas. Our mission regulator would continue to oversee the most challenging, quantitative affordable housing goals in the industry—with tremendous powers to enforce them.

These enhancements will ensure that we improve on the greatest housing finance system in the world—without damaging it. A measured approach to reform is critical to keeping the door of homeownership to a new generation of homebuyers.

Thank you for the opportunity to appear today. I look forward to working with Chairman Shelby, Ranking Member Sarbanes, and the Members of this Committee to secure the future of our housing finance system and, with it, the dreams of millions of families.

PREPARED STATEMENT OF NORMAN B. RICE

PRESIDENT AND CHIEF EXECUTIVE OFFICER
FEDERAL HOME LOAN BANK OF SEATTLE

FEBRUARY 25, 2004

Good afternoon Chairman Shelby, Ranking Member Sarbanes, and Members of the committee. I am Norman B. Rice, President and Chief Executive Officer of the Federal Home Loan Bank of Seattle.

I would like to start today by underscoring the critical importance of this Committee's work—and that of Congress and the Administration—in supporting a world-class regulatory structure that ensures and enhances the safety, soundness and economic viability of the housing Government Sponsored Enterprises (GSE's).

In my role representing the Council of Federal Home Loan Banks before this Committee, I wanted to very clearly state our support of this effort. The Bank System should—and must—at all times lead by example in terms of pursuing the highest levels of oversight and public accountability.

This Committee is to be commended for the thoroughness of the process and efforts regarding the creation of a new regulatory structure for the housing GSE's. We believe the strong, independent structure being discussed can serve the Bank System—and the more than 8,000 community financial institutions we serve—appropriately, and we stand committed to working with you in this effort.

The Federal Home Loan Banks are also acutely aware of how much is at stake in this process for those who struggle to make ends meet and find safe, affordable housing in communities across our country every day, for American residents and taxpayers, and for our member shareholders.

We understand that this Committee is considering the creation of a new agency. If so, it is imperative that the agency you create improves the oversight, the mission delivery, and the effectiveness of the business activities of the housing GSE's—not hinder them.

When I testified before this Committee in October 2003, I outlined a set of four principles that framed the Bank System's bottom-line needs regarding a new regulatory structure for the housing GSE's. These continue to be the key elements we believe must be included in legislation in order to create a world-class regulator.

What I put forth, in essence, were the pillars on which the Bank System cooperative rests—the elements that allow our 12 Banks to provide more than a half trillion dollars each year in advances to our member shareholders; that allow us to issue more than $150 million in Affordable Housing Program grants to communities across America; that allow us to provide more than $9 billion annually in reduced-rate loans for the purpose of community and economic development that benefit low- to moderate-income families and neighborhoods.

Critical to what must be contained in a regulatory structure? Yes.

Critical to the economic health of the communities our member shareholders serve? Yes.

Those Bank System principles include the following:

Preserve and Reaffirm the Bank System's Mission

Mission is everything to us. We strongly believe that any legislation should accomplish the following:

- Provide cost-effective funding to members for use in housing finance and community development.
- Preserve our regional affordable housing programs, which create housing opportunities for low- and moderate-income families. Since the inception of our Affordable Housing Programs in 1991, the Bank System has contributed more than $1.7 billion in grants to communities across America.
- Support housing finance through advances and mortgage programs.
- Preserve the Bank System's ability to bring to market innovative new business activities that advance our mission without creating a cumbersome process that prevents us from responding in a timely way to the needs of our member financial institutions.

A Strong and Independent Regulator

Safety and soundness of the Bank System is our No. 1 concern. This is absolutely consistent with the role of other bank regulatory agencies, in which the regulator responsible for safety and soundness has free and unfettered authority to determine policy, rulemaking, application, adjudicative, and budget matters. It is essential that this regulator have the independent authority to promulgate rules and perform its safety and soundness role without undue outside agency interference.

Preserve Bank System Funding

It is critical that we ensure that nothing is done that increases the Bank System's cost of funds and, correspondingly, increases costs for consumers and financial institutions.

Therefore, any legislation must:

- Preserve the role and function of the Office of Finance and clearly establish it as an entity of the Federal Home Loan Bank System, regulated and examined by the System's regulator.

- Ensure that neither the U.S. Treasury, nor the independent GSE regulatory unit, has the ability to impede or limit our access to the capital markets without cause.
- Not limit the financial management tools available to prudently manage the financial risks inherent in our funding and business activities.

Preserve the Unique Nature of the Bank System

While all three GSE's have much in common, we believe it is important to both recognize and preserve the unique nature of the FHLBanks.

Therefore, any legislation must:

- Preserve the cooperative ownership of the Bank System and the joint and several liability that is the underpinning of the Bank System.
- Preserve the unique regional structure of the 12 Banks that assures we are locally controlled and responsive to the financial and economic development needs of our communities.

I also would like to speak more specifically to the regulatory structure we understand is under discussion—that of an independent agency that operates outside of a cabinet-level department.

I will present to you this afternoon the Bank System's view on the following aspects of this proposed structure:

- Ensuring regulatory independence.
- Agency oversight responsibilities.
- Creating separate divisions for the Federal Home Loan Banks and the publicly traded housing GSE's.

Ensuring Regulatory Independence

A regulator lacking true independence is often subject to a wide range of demands and influences that we believe would be detrimental to the supervision, business activities, and mission fulfillment of the housing GSE's. The regulator of this new, proposed agency must have a laser focus on following the will of Congress in assuring fulfillment of the mission and the safety and soundness of the housing GSE's, not the agendas of outside agencies and other political influences.

We know that some have discussed the possibility of an advisory body in addition to or as a part of this regulator. The Bank System understands the potential value of a board or advisory committee, and the regulatory role other cabinet-level departments have played in the past. However, it is important that the new "world class" regulator not be hamstrung by a cumbersome board structure, and not be dominated or controlled by any single agency represented on the board. This new regulatory body must have the authority to govern—promulgate rules and perform its safety and soundness role.

Agency Oversight Responsibilities

The Bank System believes this independent regulator should have the following authorities:

- Ensuring the safety and soundness of the housing GSE's.
- Overseeing all mission-based goals and programs.

  There are obvious differences in the mission-based goals and programs for the two housing GSE's and the Federal Home Loan Banks.

  We are required to annually contribute 10 percent of our net income for affordable housing grants, while Fannie Mae and Freddie Mac have affordable housing goals. However, we believe a proposed new regulator should have the authority to review, approve, and monitor all mission-based goals and programs.

  Though we appreciate the goals the other housing GSE's maintain, we believe that in addition to greater consumer access to credit, one of the best ways of passing along our subsidy is through our Affordable Housing Program and the direct 10 percent contribution made by each of the 12 Federal Home Loan Banks annually.

  In addition, our current regulator has that mission-oversight authority, and we believe it has served the Bank System, its members and their communities very well.

- Setting capital standards.

  Along with independence, any world-class regulator must have the authority to set both leverage- and risk-based capital standards. As you know, Congress conducted an extensive review and revision of our capital structure in the Gramm-Leach-Bliley legislation, and the Federal Housing Finance Board was given this broad authority in the Act. We believe any new regulatory agency should have the authority to raise and lower capital requirements as deemed appropriate and necessary. Anything less, in our opinion, would be a significant step backward.

- Approving new business activities and programs.

  Having the capacity to innovate and keep pace with an evolving financial services industry is critical to all 12 Federal Home Loan Banks. We believe a world-class regulator should preserve the Bank System's ability to innovate around existing products and services. In turn, the regulator should be diligent in examining and approving these innovations and exploring areas that represent new risk to the GSE.

  Speaking on behalf of the Seattle Bank, I believe our Mortgage Purchase Program (MPP) is a good example of where a regulator insisted on close oversight and then approved a new business line. This new activity was and remains fully consistent with our mission and the statutory authority Congress conferred, but prior review was appropriate because it entailed substantial new risks.

  Likewise, going forward, the new regulator should enjoy and exercise the same authority to approve innovation. In turn, a Federal Home Loan Bank should be expected to demonstrate, first, that it has the capacity to manage the business before it is allowed to incur substantial new risk. Since nothing is static in financial services generally—and housing finance in particular—it is incumbent upon the regulator and regulated alike to remain vigilant. To that end, we continue to strengthen our internal infrastructure in an effort to better manage the risks of this new business, which has proven to drive significant value back to our member shareholders and lower housing costs for consumers.

Creating Separate Divisions for the Bank System and the Publicly Traded Housing GSE's

While Fannie Mae, Freddie Mac, and the Federal Home Loan Banks all share GSE status, we are, fundamentally, very different entities.

The Federal Home Loan Banks are cooperatively owned and capitalized by our members, most of whom are community banks occupying and delivering benefits to Main Streets across the country, while the other two housing GSE's must meet the quarterly earnings expectations of Wall Street investors.

To that end, the Bank System believes that creating separate divisions within a regulatory structure would add efficiencies in the provision of appropriate oversight and supervision. Our assumption is that staffing from previous regulatory agencies—such as the Finance Board and OFHEO—could be retained to provide a baseline of expertise for the two divisions.

In concluding this afternoon, I want to emphasize to the Committee that the onus for strengthening our system lies not only with Congress and regulators, but also with the housing GSE's themselves.

We must be willing to take the steps necessary to efficiently manage our financial institutions in a safe and sound manner, and provide world-class financial transparency and disclosure regarding our business operations. The Federal Home Loan Banks unanimously support providing enhanced, comprehensive, and fully transparent securities disclosure. On that point, there is no debate.

Where there is a difference of opinion among the Banks—and where there has been much discussion with our regulator, the Federal Housing Finance Board, and others—is concerning who should have authority over financial disclosures and transparency: The Securities Exchange Commission (SEC) or the housing GSE regulator. From the Bank System's perspective, we believe that a world-class regulator with the experience and expertise to oversee the housing GSE's would, potentially, be better able to set the framework and supervision for the level of financial disclosure now being demanded of our system.

If Congress' intent is to create a new, independent regulatory structure for the housing GSE's, why not invest the agency with the authority to oversee financial disclosure? Why not accommodate in this new framework the resources and expertise to supervise financial disclosure that conforms to SEC standards, yet fits appropriately within the Congressionally mandated scope of the housing GSE charter and mission?

We would respectfully request that this Committee consider this as an option as you continue your regulatory restructuring discussions for the housing GSE's.

However, if Congress were to choose the SEC to regulate these financial disclosures, the Bank System believes some very specific accommodations would be necessary.

The Banks have identified financial, operational, and legal considerations that could lead to uncertainties and risks to the system and adversely affect their ability to carry out their Congressionally mandated housing finance mission.

As just one example—issuer stock-repurchase requirements.

The purpose of this requirement is to provide adequate information to the SEC, the holder of an issuer's equity securities, and the marketplace of a potential change in control when an issuer repurchases its own shares.

The Federal Home Loan Banks routinely repurchase the excess stock of their members. All repurchases must be made at par value. Repurchase transactions often occur on a monthly basis, although they may occur more frequently than that, at the initiation of the FHLBank or at the request of a member shareholder.

The ability to repurchase excess stock of members enables our banks to manage their capital position in view of prevailing market and business conditions, consistent with Federal Housing Finance Board requirements.

Repurchases of excess stock cannot result in the change of control of a Federal Home Loan Bank, nor can they benefit one member at the expense of another, because all transactions must occur at par value.

Accordingly, no investor protection purpose would be served by requiring the Bank System to comply with the issuer-repurchase requirements of the Federal securities laws. Moreover, the application of such requirements would result in costly and unnecessary filings, in view of the volume and frequency of bank repurchase transactions.

Again, this is just one example—of several—illustrating the unique nature of the Bank System and the significant financial, operational, and legal challenges created when considering SEC registration for our 12 Banks.

However, it is important to note that the Bank System's ongoing questions and discussions have not prevented our institutions from working with SEC staff over the last year on the process of registering under the 1934 Act—a process driven, in large part, by proposed rulemaking through the Federal Housing Finance Board.

A Task Force of the Bank Presidents' Conference, as well as some individual Banks, have had a number of meetings with SEC officials to discuss the resolution of outstanding accounting and reporting issues.

In addition, the Seattle Bank Board of Directors, at our September 2003 meeting, adopted a resolution calling for SEC registration, pending resolution of all reporting and accounting issues. Our individual banks are also investing significantly in staff and resources in order to conform to SEC and Sarbanes-Oxley disclosure requirements.

If it is the will of Congress for the Federal Home Loan Banks to complete SEC registration, we believe we are moving in the right direction to make that happen in an appropriate timeframe—and in a way that maintains our ability to carry out the Bank System's Congressionally mandated housing finance mission.

After all, that is why the Federal Home Loan Banks exist—to provide flexible, long-term financing that helps our member shareholders fund the hopes, dreams, and critical needs of their communities.

As you move quickly forward in this legislative process, I would ask that you keep top of mind that we are a cooperative system owned by more than 8,000 banks, thrifts, credit unions, and insurance companies. That means every dollar of value we create is passed through to our members and their communities. That is why the Bank System exists.

We look forward to working with you in strengthening our cooperative and the oversight and supervision of the housing GSE's—for the good of the American public, our communities, and our members.

Thank you for your time this afternoon. I would be happy to answer any questions you may have regarding my testimony.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR HAGEL FROM RICHARD F. SYRON

Q.1. In a June 25, 2003 press release, Freddie Mac stated it would start to provide disclosure on its fair value balance sheet on a quarterly basis. Does Freddie Mac still plan to disclose this information? If so, then when?

A.1. Yes, Freddie Mac's objective continues to be to provide quarterly estimates of fair value balance sheet net assets for quarterly 2004 financial results subject to meeting our objective to return to timely financial reporting. We intend to return to timely financial reporting as soon as possible. However, we currently are not able to predict when we will do so.

Q.2. How would fair value balance sheets enhance transparency?

A.2. Our fair value of net assets represents management's estimation of the fair value of our existing net assets. Although it does not represent the value of the company as an ongoing concern, we believe it (along with our GAAP results and the interest rate risk sensitivity and other disclosures we publish) provides a useful perspective on our financial condition. This is because fair value of net assets takes a consistent approach to the measurement of all financial assets and liabilities, rather than an approach mixing historical cost and fair value techniques, as is the case with Freddie Mac's GAAP-based consolidated financial statements.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM RICHARD F. SYRON

Q.1. In Chairman Greenspan's testimony before this Committee on February 24, 2004, in response to a question I posed about whether it is appropriate for Congress to recapture some of the implicit Federal benefits that are not passed onto homeowners in the form of lowered mortgage interest rates, Chairman Greenspan agreed that it was a "legitimate judgment for Congress" to recapture some of these "lost" benefits. Why shouldn't Congress demand more of Fannie, Freddie, and the FHLB's in light of the implied Federal benefits that have been documented by several studies?

A.1. As we said in our testimony on February 25, Freddie Mac can and will do more to support homeownership and affordable housing. That said, we respectfully disagree with the premises of the question. Although Freddie Mac undeniably lowers interest rates—by an average of 25–30 basis points—this is not why Congress created Freddie Mac. More important, lowering interest rates is only one of the many indispensable benefits that Freddie Mac brings to America's families and the mortgage markets generally.

Congress created Freddie Mac to provide liquidity, support, and stability to the residential housing finance market and to support affordable housing. By fulfilling our mission purposes, we create value for homeowners, the housing finance system, and the overall economy that substantially exceeds the value of the benefits we receive from our charter:

- We have created a national mortgage market where funds are available at virtually the same rate throughout the country, regardless of economic or market conditions. We achieved this by attracting capital from a broad base of investors worldwide, which enables us to purchase mortgages at all times.

- We make 30-year, fixed-rate, prepayable mortgages widely available because we are much better able to manage the risk of such mortgages than other financial institutions. Only in the United States are these mortgages widely available.
- Our ability to buy mortgages at all times made the refinance boom of the past few years possible. Homeowners took advantage of low rates to reduce their mortgage interest costs by some $200 billion dollars in 2001–2002 alone. And as Chairman Greenspan has observed, the ability of homeowners to reduce their mortgage costs and liquefy their home equity has provided crucial support to the economy during the past several years.
- We provide critical stability in the mortgage market during periods of economic instability, such as during the Asian debt crisis of 1998 and the business and bank recession of 1990–1992. At these times, conforming mortgage rates would have increased dramatically except for our ability to continue buying mortgages and mortgage-backed securities. It is precisely during such periods of stress that the stabilizing role of the GSE's is most apparent.
- We pioneered innovations such as automated underwriting that have substantially lowered downpayment requirements, lowered costs, and reduced time in originating and closing mortgages. Equally important, through automated underwriting, we have helped make mortgage underwriting fairer and more objective.
- We have led the Nation in protecting consumers against predatory mortgage lending practices, and we are bringing the benefits of standardization to the subprime market. This leadership has especially benefited elderly, low-income, and minority families.

Many of these benefits are difficult to quantify specifically, but they have led to a housing finance system that is envied throughout the world. We believe the evidence clearly demonstrates that we fulfill the mission purposes for which we are created and create substantial benefits for homeowners, the housing finance system, and the economy. These benefits far outweigh any benefits we receive from our charter.

Q.2. Do you think that your Affordable Housing Goals are an "inefficient" way of passing your implied Federal benefits to homeowners? How might your implied Federal benefits be passed more efficiently on to homebuyers? Please elaborate.

A.2. As we stated in our answer to question 1, we create value for homeowners, the housing finance system, and the economy that substantially exceeds the value of the benefits we receive from our charter. The Affordable Housing Goals, though extremely important, are only one measure of the benefits we create.

Nonetheless, Freddie Mac provides a tremendous amount of support to affordable housing. We have met each of the three affordable housing goals for eight consecutive years—every year since HUD established permanent goals in 1995. Since the establishment of the goals in the 1992 Act, we have substantially increased our level of service to low- and moderate-income families and families in underserved areas. In 2003, we financed homes for almost 2.5

million low- and moderate-income families, a fourfold increase over our purchases of such mortgages in 1993. In fact, we financed more homes for low- and moderate-income families in 2003 than we did *for all borrowers* in 1993. In 2003, we bought more than $106 billion of mortgages made to minority families—again, an all-time record for us. By any standard, the goals should be considered a major public policy success.

In light of the GSEs' stellar financial performance and in the context of GSE regulatory reform, the Administration has suggested creating new affordable housing goals and subgoals.

Q.3.a. Do you believe that these more rigorous goals and subgoals are obtainable and appropriate, in light of your recent financial performance and the implicit Federal benefits you receive? Why or why not?

A.3.a. We do not know exactly what the Department of Housing and Urban Development (HUD) will propose when it publishes revised affordable housing goal rules for comment later this spring. Until HUD issues its proposal, it is difficult to evaluate whether any revisions to the current goals will be obtainable or appropriate. Our own discussions with HUD suggest that the revised regulations will seek to promote the Administration's overall goal—which we enthusiastically support—of increasing homeownership rates, particularly among minority families.

We believe that the goals, which have risen dramatically over the last decade, are already quite rigorous. Since 1993, the first year that HUD set the goal levels, the low- and moderate-income goal has risen from 28 to 50 percent, a 79 percent increase. In that same time, the underserved area goal has risen from 26 to 31 percent, a 19 percent increase. The special affordable goal has risen from 14 to 20 percent, a 43 percent increase, since HUD shifted the goal from a dollar amount to a percentage of purchases in 1996. As we said in our answer to question 2, we have responded by dramatically increasing our purchases of mortgages supporting affordable housing, and we have met all of the goals for eight consecutive years.

Moreover, we believe that HUD should be very cautious in considering new subgoals. For example, some have suggested creating a home purchase goal. This could reduce liquidity in the housing finance market by creating a disincentive for the GSE's to purchase refinance loans. The low mortgage rates of the last few years have allowed millions of American families to lower their housing costs and thus helped sustain the economy through a difficult period. A goal that discourages us from fully supporting the entire conforming market would not be in the best interests of homeowners or the national economy, and would be inconsistent with our mission. Moreover, Freddie Mac already provides strong support to home purchase needs. In each of the past 4 years (2000–2003), we have purchased more than $100 billion of home purchase mortgages each year. In 2003, we purchased nearly $150 billion of home purchase mortgages.

This is not to suggest that we can rest on our laurels. To the contrary, we can build on this record of success and continue working hard toward providing an even higher level of service to affordable housing needs. The homeownership rates for African-American and Hispanic-American families are unacceptably low. Freddie Mac and its employees are committed to doing more. We are reexamining our business practices and policies top-to-bottom to come up with ways we can expand homeownership opportunities further and make mortgage finance as affordable as possible for all of America's families.

Q.3.b. What more can Freddie Mac do to promote affordable multifamily housing? Please elaborate.

A.3.b. Apartment homes constitute a major share of the Nation's affordable housing. Last year, we purchased a record $22 billion in multifamily mortgages, representing nearly 600,000 apartments, more than 90 percent of which were affordable to low- and-moderate income families under the HUD goals. We will continue to be extremely active in the multifamily mortgage market.

We agree, however, that there is more that Freddie Mac can and must do. According to the Joint Center for Housing Studies at Harvard University, households with one full-time minimum wage earner cannot afford to rent even a modest one-bedroom apartment anywhere in the country. The Joint Center also reports that as of 2001 there was a shortage of affordable market-rate apartments (the type we typically finance) of about 2 million units; We are also entering a critical period in which properties originally financed through low-income housing tax credits will need rehabilitation if they are to be maintained as decent housing for low-income families. Even conventionally financed multifamily properties built in the 1970's and 1980's will soon need funding if they are to remain viable sources of housing for renters. There needs to be greater and more diversified support for rural multifamily properties.

One of the most important ways to meet these needs are "targeted" affordable multifamily mortgages, in which public/private partnerships create apartments that the owner commits to maintain as affordable to specific income groups on a long-term basis. Most private primary market lenders, however, lack the specialized staff to process these loans and thus find them uneconomic to originate. In the short-term, Freddie Mac is working hard to find lenders who are willing to make the effort to originate these mortgages. To this end, we recently designated four companies as nationwide targeted affordable lenders. We chose these particular companies because they have invested in personnel dedicated to this type of lending and they are affiliated with construction lenders and tax credit equity investors, which enables them to provide a full range of funding options to affordable housing developers.

To aid us in the pursuit of more enduring solutions, we have created a Targeted Affordable Advisory Council. The Council, which met for the first time in January, consists of a variety of prestigious affordable housing market participants who have agreed to help us streamline our internal processes for this type of product, enhance our existing targeted affordable products and develop new ones. During March, Freddie Mac held a Tax Credit Symposium in which we called on industry experts to help us better understand tax credit investment risk so that we can increase both our debt and equity investments in tax-credited properties.

We are also increasing our presence in the rural multifamily market. This area of the multifamily market has traditionally been the province of Federally sponsored programs, because most primary market lenders find it unprofitable to originate conventional mortgages on small, rural multifamily properties, but Federal budget cuts have diminished the amount of credit available to these properties. We have recently committed that this year we will buy loans to fund preservation and rehabilitation of properties financed in the past with loans made by the Rural Housing Services, while leaving the low-cost RHS loans in place. We are working with RHS to expand our activities in this underserved sector.

Another area in which we have been increasingly active is the market for small (5–50 unit) apartment loans, an area of the multifamily market that is important source of affordable housing and which HUD has previously identified as underserved by the secondary market. Last year alone, we financed about 180,000 units in about 12,500 small multifamily properties. Like other small properties, 5–50 unit mortgages are expensive to underwrite, and as a result most of our purchases came through portfolio transactions with large lenders specializing in these properties. We are using the knowledge gained from these purchases to help us better understand their special characteristics, with the aim of bringing efficiencies and liquidity to this sector and increasing sources of credit for these properties.

As many witnesses have stated before this Committee during the last several months, Mr. Greenspan testified on February 24, 2004 that it is crucial to have an appropriate and thoughtful process for GSE liquidation in the case that a GSE fails. He not only argued that it was important on safety and soundness grounds, but also that it was one of the few credible ways that Congress could combat the impression in the investment community that the Federal Government will bail out the GSE's in the event of a crisis. Chairman Greenspan emphasized the current conservatorship authority of OFHEO as evidence that Congress will bail out the GSE's with taxpayer funds if one of them fails.

Q.4.a. Do you believe that the current OFHEO conservatorship authority helps reinforce the impression that the Federal Government will bail out the GSE's in a crisis? Why or why not?

A.4.a. We believe that the conservatorship provisions of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the 1992 Act) help reinforce the impression that the Congress has reserved for itself the full range of resolution options in the event a GSE were to experience significant financial difficulties.

The conservatorship provisions of the 1992 Act are designed to allow the conservator to operate a GSE that is experiencing extreme financial distress as a going concern. These provisions contain no mechanism for the use of taxpayer funds to resolve an insolvent GSE; rather, the conservator must use funds generated by such a GSE's business operations to pay the GSEs' creditors.

The Congress carefully constructed the conservatorship provisions of the 1992 Act in recognition of the unique role of the GSE's in expanding, and lowering the cost of, homeownership. In passing the legislation that created the current regulatory oversight structure for the GSE's, the Senate Banking Committee stated,

> *This judgment takes account of the important role that the Enterprises play in our Nation's economy and their central role in the functioning of the residential housing finance sector of the economy. The Enterprises are clearly distinguishable from even the largest insured depository institutions, each of which may cease to be able to compete as a provider of financial services with varying degrees of economic impact. If the appointment of a conservator for an Enterprise were ever to become imminent, the Congress would have the opportunity to consider the reasons for the Enterprise's condition and the options then available to address that condition.* S. Rep. No. 282, 102d Cong., 2d Sess. 26 (1992).

While we cannot represent what an individual investor or investors as a group might think, the current conservatorship provisions together with the legislative history contemplate that the Congress would decide how best to resolve an insolvent GSE in the unlikely event of extreme financial distress.

In addition, as required by law, all of the Freddie Mac's obligations and securities state clearly and conspicuously in bold type that they are obligations of Freddie Mac only, and are not guaranteed by, or debts or obligations of, the United States or any agency or instrumentality of the United States.

Q.4.b. If it does, how can the liquidation authority for the housing GSE's be clarified in order to combat the investor impression that the GSE's will be bailed out with taxpayer funds in a crisis, while at the same time, ensuring that the housing mission of the GSE's is not unduly harmed in the process of liquidation? If it does not, do you think it is appropriate for Congress to make any changes to the current OFHEO conservatorship authority? Why or why not?

A.4.b. We believe that current law provides ample conservatorship powers for restoring an insolvent GSE to sound financial condition. A conservator appointed for such a GSE has all the powers the shareholders, directors, and officers of the GSE have to operate the GSE as a going concern. For example, a conservator may pay a GSE's creditors to the extent that funds may safely be made available for this purpose.

It is imperative that the GSEs' regulatory structure provides rigorous oversight and ensures the continued safety and soundness of the GSE's. Strong, credible regulatory oversight is key to preventing financial difficulties that could lead to the need to appoint a conservator.

Although we believe that current law contains sufficient conservatorship powers, we would be willing to consider whether these powers could be enhanced to make sure the Congress, the public, and investors are confident in our safe and sound operation.

Q.5. In his testimony, Chairman Greenspan reiterated his opinion, albeit admittedly minority opinion, that Fannie and Freddie should be privatized. Do you think that the GSE's should be privatized? Why or why not? How do you think it would affect the housing market and the Nation's housing finance system if Fannie and Freddie were privatized. Please elaborate.

A.5. We do not support privatizing the housing GSE's. To do so would effectively dismantle a proven housing finance system in exchange for uncertain benefits. Advocates of privatization set forth several arguments, none of which make a convincing case.

First, privatization advocates believe Government sponsorship is no longer needed to attract capital to housing or to provide an abundant supply of 30-year, fixed-rate, prepayable mortgages. This optimistic view contradicts the experience in other developed countries. In Canada, for example, homebuyers typically are restricted to a 7-year fixed-rate mortgage, must make a 25 percent downpayment, and are locked into higher interest rates or have to pay heavy penalties if they wanted to prepay.

This view also ignores our own jumbo market, which is not served by the GSE's. On any given day, it is possible to look in a newspaper and find that mortgage rates on conforming loans are regularly one-quarter of a percentage point lower than those in the higher-balance jumbo market. Borrowers in the jumbo market not only pay higher rates, but they are also more likely to have to settle for an adjustable-rate mortgage (ARM). ARM's have the obvious advantage of lowering monthly mortgage payments in the first few years of homeowning, but they require borrowers to bear the interest-rate risk on the loan—rather than the capital markets bearing this risk. This results in higher borrower defaults over the long-term. Jumbo borrowers also typically make larger average downpayments than conforming borrowers. Higher mortgage-interest rates and larger downpayments make it significantly harder for low- and moderate-income families to become homeowners.

This sanguine view of markets also ignores where we are in the credit cycle. History reveals that certain industries will slump, that certain regions will experience economic downturn, which, in turn, causes house values to fall and defaults to rise. We also know that with interest rates at historic lows, the mortgages put on the books today, in all likelihood, will require financing for decades to come. In short, it is easy to dismiss the risks of mortgage lending when times are good. GSE's were created precisely for those times when things are not going so well, however. GSE's absorbed significant losses during the oil bust in the 1980's and during the weakening of the economy in Northeast in the early 1990's. They also stabilized residential mortgage rates during the international financial crisis of 1998—and again after September 11—by continuing to provide liquidity to the secondary market for conforming home loans. Their actions ensured that mortgage credit remained available *and* affordable.

A second argument concerns the allocation of capital to housing. The housing market has an enormous impact on the economy, directly accounting for more than one-third of the nominal growth in GDP over the past 3 years. And this does not begin to account for all the indirect support for consumption generated by record levels of refinancing in the past few years. Housing played an important countercyclical role in supporting the recent weak economy, as noted in the' President's 2004 Economic Report:

> *Despite the similarities between the recent business cycle and previous ones, this most recent cycle was distinctive in important and instructive ways. One noteworthy difference is that real GDP fell much less in this recession than has been typical . . . This relatively mild decline in output can be attributed to unusually resilient household spending. Consumer spending on goods and services held up well throughout the slowdown, and investment in housing increased at a fairly steady pace rather than declining as has been typical in past recessions.*

The ability of the GSE's to purchase record amounts of mortgages during the past several years is a principal reason why the housing market remained strong in an otherwise weak economy. Privatization advocates have yet to demonstrate who other than the GSE's would be able to provide such high amounts of liquidity regardless of economic or market conditions.

Third, privatization advocates raise concerns about size and systemic risk. Residential mortgage debt outstanding grew at an annualized rate of 8.6 percent over the past decade. Not surprisingly, the GSE's also have experienced significant growth. But GSE size is not an accurate proxy for risk. For every mortgage Freddie Mac guarantees, whether it is securitized or held in the retained portfolio, there is approximately 40 percent collateral behind the loan in the form of homeowner equity. We actively manage interest-rate risk and other related market risks and take a disciplined approach to risk management. Freddie Mac strives to substantially match the duration of our assets and liabilities. Throughout 2003, for example, a period of extreme turbulence in financial markets, Freddie Mac's duration gap remained low. Moreover, mortgage debt and the risks of investing in it would not disappear by downsizing the GSE's or making other changes to the GSE charter. Rather, the burden of managing mortgage credit risk would shift from these institutions to those with explicit Government support (such as Federally insured depositories), while interest-rate risk would shift onto individual households. Another likely outcome is that higher costs of conventional mortgage financing could cause borrowers to shift into the FHA market, thereby actually increasing Government subsidization of housing.

In other words, we believe that those who call for privatization have not begun to demonstrate how this would be better for homeowners, the housing finance system, or the economy.

Q.6. It is my understanding that Freddie's compliance with the Securities and Exchange Act of 1934 is being delayed due to its ongoing revisions of its financial statements. Freddie is expected to release its revised earnings sometime soon. Have you communicated with the SEC regarding when you expect to come into compliance with the Securities and Exchange Act of 1934? When specifically do you believe that you will be able to do so?

A.6. Our most pressing priority is to bring Freddie Mac's financial statements current. On November 21, 2003, the Freddie Mac Board of Directors and management team announced the release of the company's restated and revised financial results for the years 2000 through 2002. The restatement was a significant step in Freddie

Mac's progress toward achieving accurate and timely reporting. In addition, we issued our annual report for 2002 on February 27, 2004 and will hold the related annual stockholders' meeting on March 31, 2004.

We intend to return to timely financial reporting as soon as possible. However, we currently are not able to predict when we will do so. Significant revisions to our accounting systems are necessary to implement the revised accounting policies adopted in connection with the restatement, as well as new accounting guidance applicable for 2003, so that those accounting systems can fully support the preparation of consolidated financial statements in accordance with GAAP. As a result, the public release of our 2003 financial results has been delayed. Our objective is to release combined quarterly and full-year 2003 results by June 30, 2004 and to provide our 2003 annual report and hold our related stockholders' meeting as soon as practicable thereafter. However, there can be no assurance that we will meet this objective.

We have been in ongoing discussions with the Securities and Exchange Commission (SEC) on various issues since our initial announcement that we would register our common stock with the SEC under the Securities Exchange Act of 1934. SEC rules require us to bring our financial statements "current" before we can finish the process of becoming an SEC registrant. We will complete our voluntary registration with the SEC after we return to timely financial reporting.

Q.7. Some witnesses before the Banking Committee have recommended placing your new regulator in the Department of the Treasury and letting it have oversight over the GSEs' housing mission, as well as their safety and soundness. However, are you aware that in an October 1, 2003 letter, Treasury gave notice to the National Cooperative Bank, a private nonprofit corporation originally created by Congress that has been and still is extensively involved in financing affordable housing that it was intending to increase the interest rates of its long-term loan by 700 basis points? If enacted, that interest rate would have been devastating to the affordable housing mission of the National Cooperative Bank. Doesn't this letter, at a minimum, demonstrate a desire by Treasury to promote safety and soundness to the determent of the National Cooperative Bank's housing mission? Why or why not?

A.7. We have not seen the letter you cite and are not familiar with the issue involving the National Cooperative Bank, so we cannot knowledgeably comment on it. However, to address the general concern you are raising, we would like to reiterate points we made in our testimony on establishing an effective regulatory oversight structure for the GSE's.

World-class regulatory oversight is critical to the achievement of Freddie Mac's mission and to maintaining the confidence of the Congress, the public, and financial markets. Freddie Mac strongly supports the enactment of legislation that provides strong, credible regulatory oversight. Accordingly, the new GSE regulatory structure must:

- Engender public confidence through world-class supervision and independence;

- Ensure the continued safety and soundness of the GSE's;
- Respond flexibly to mortgage market innovation; and
- Strengthen GSE market discipline through robust and timely disclosure.

We believe these principles will be realized most completely under an independent regulatory board modeled on independent Federal agencies such as the Securities and Exchange Commission. We believe such a board should not include representatives of HUD, Treasury, or other executive branch departments. The purpose of establishing an independent board is just that, independence. Inclusion of executive branch representatives on the GSE regulatory board could compromise this important component of world-class regulation.

Freddie Mac would have similar concerns should the Congress decide to locate the new regulatory office within the Department of the Treasury. To ensure independence, we would support applying the same operational controls as apply to the relationships between the Secretary of the Treasury and the Office of the Comptroller of the Currency and the Office of Thrift Supervision. Adequate firewalls are needed to avoid the politicization of the GSE mission and the critical role we play in the Nation's economy and global financial markets.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR REED FROM NORMAN B. RICE

Q.1. Your question raises the issue of whether Congress needs to "level the playing field" among the GSE's. Given the fundamental differences in the nature and composition of the Federal Home Loan Bank System and Fannie Mae and Freddie Mac, I doubt that it is desirable or even possible to establish a truly level playing field without a wholesale restructuring of the present GSE's.

A.1. Although the FHLBanks are exempt from all Federal, State, and local taxation except for real property taxes, they are obligated to make payments to the Resolution Funding Corporation (REFCORP) in the amount of 20 percent of net earnings after operating expenses and Affordable Housing Program (AHP) expense. In addition, annually the FHLBanks must set aside for the AHP the greater of an aggregate of $100 million or 10 percent of their current year's net income before charges for AHP (but after expenses for REFCORP). Assessments for REFCORP and AHP are the equivalent of a 26.5 percent effective income tax rate for the FHLBanks. In addition, all FHLBank cash dividends received by members are taxable; dividends received by members do not benefit from the corporate dividends received exclusion.

Q.2. Congress has established two very different housing obligations for the housing GSE's—the Affordable Housing Program (AHP) for the Federal Home Loan Banks, and Affordable Housing Goals (AHG's) for Fannie Mae and Freddie Mac. These differences make it difficult to attempt a direct comparison of the performance of the three GSE's in serving specific affordable housing needs. At the present time, the Federal Housing Finance Board and the Department of Housing and Urban Development are conducting a joint study to determine how the Chicago FHLBank's Mortgage

Partnership Finance program would score under the AHG's for Fannie Mae and Freddie Mac. Once this study is complete, it should provide a better understanding of the potential application of AHG's to the FHLBanks.

A.2. Although the AHP and AHG's are intended to achieve similar objectives, they operate in very different ways. For Fannie Mae and Freddie Mac, Congress has imposed certain requirements on their purchases of mortgages to target their efforts to specified affordable housing goals. In the case of the FHLBanks, Congress has required them to set aside 10 percent of their net profits for distribution as grants or below-cost loans in support of affordable housing. The AHP program also targets incomes lower than those established by the AHG's. AHP subsidies must be used to fund the purchase, construction, or rehabilitation of owner-occupied housing for very low-income, or low- or moderate-income (no greater than 80 percent of area median income) households; or rental housing in which at least 20 percent of the units will be occupied by and affordable for very low-income (no greater than 50 percent of area median income) households.