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H.R. 2575—THE SECONDARY MORTGAGE MARKET ENTERPRISES REGULATORY IMPROVEMENT ACT

HEARING

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

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H.R. 2575—THE SECONDARY MORTGAGE MARKET ENTERPRISES REGULATORY IMPROVEMENT ACT

Thursday, September 25, 2003

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to call, at 10:10 a.m., in Room 2128, Rayburn House Office Building, Hon. Michael Oxley [chairman of the committee] presiding.

Present: Representatives Oxley, Leach, Baker, Bachus, Castle, Royce, Lucas of Oklahoma, Ney, Kelly, Paul, Gillmor, Ryun, Ose, Green, Shays, Shadegg, Hart, Tiberi, Kennedy, Feeney, Hensarling, Garrett, Murphy, Brown-Waite, Barrett, Harris, Renzi, Frank, Kanjorski, Waters, Maloney, Carson, Sherman, Meeks, Lee, Inslee, Moore, Gonzalez, Lucas of Kentucky, Clay, Israel, Baca, Matheson, Miller of North Carolina, Scott, and Davis.

The CHAIRMAN. [Presiding.] The committee will come to order. Today the Financial Services Committee will hear from the regulators, the regulated, and outside parties interested in the oversight of the housing government-sponsored enterprises.

Two weeks ago, Secretaries Snow and Martinez came to the committee with the Administration's proposal to improve regulatory oversight for the GSEs. They proposed developing a world-class regulator with the tools to rigorously supervise the activities of these highly complex financial institutions. The Secretaries called for the regulator to be housed in the Department of the Treasury as an individual office, similar to that of the Office of the Comptroller of the Currency.

Additionally the proposal called for the Department of Housing and Urban Development to retain its role as regulator of the GSEs' mission and to ensure that the agencies meet their affordable housing goals.

HUD's expertise in this area is critical. Under the Administration's proposal the Department would receive additional powers to enforce compliance with the housing goals.

There is a broad agreement that the current regulatory structure for the GSEs is not operating as effectively as it should. The Office of Federal Housing Enterprise Oversight is underfunded, understaffed and unable to fully oversee the operations of these sophisticated enterprises.

This was reflected in the surprise management reorganization by Freddie Mac and by Wall Street reports stating that GSE oversight

is viewed with skepticism because OFHEO is largely seen as a weak regulator.

A strengthened regulator will send a signal to the markets that these entities have solid management and are engaging in safe and sound activities. Confidence will be restored in the GSEs and they will be able to get back to their important work of expanding home ownership opportunities without the distractions that have been plaguing them over the past several months.

Fannie Mae and Freddie Mac have done a good job of promoting home ownership and providing liquidity to the secondary mortgage market. These GSEs have quickly grown into large financial institutions that have a major impact on the housing market and the domestic economy. We must ensure that they have competent and thorough oversight, while making certain that any action we take does not have a negative impact on access to housing.

I am encouraged by the letters and statements of support the committee received following the last hearing on GSE regulatory reform and I hope today serves as an opportunity for members to learn more about the need for changes to the GSE regulatory structure and how that can be accomplished.

I would like to thank our Capital Markets Subcommittee Chairman Richard Baker for his years of work to strengthen the regulatory structure of the GSEs. His expertise on this issue serves our committee well. His numerous hearings, studies and bills provide our committee with an informed background on which to move forward.

I welcome the witnesses and I look forward to their testimony.

And I now recognize the gentleman from Massachusetts, the ranking member, Mr. Frank.

[The prepared statement of Hon. Michael G. Oxley can be found on page 106 in the appendix.]

Mr. FRANK. I think this is a very important hearing. And I appreciate the Chairman's willingness to have it under the auspices of the full committee.

I joined this committee in 1981 because I am interested in housing. And I guess I wouldn't want to boast about my accomplishments, because the situation regarding housing, particularly people who are of moderate and low income, has gotten worse during my tenure. I won't accept the blame, but I clearly haven't done a great deal of good.

And it makes it all the more important that we use every tool that we do have to try improve the housing stock. And Fannie Mae and Freddie Mac are two of the very important tools that we have.

And there are people I know who are critical of the arrangements that we have. I, frankly, welcome the fact that we have in Fannie Mae and Freddie Mac a means of bringing down housing costs that doesn't put a hit on the federal budget.

Essentially, there are people in the country who are prepared to lend money to Fannie Mae and Freddie Mac at less interest rates than they might get elsewhere. I thank those people for doing that. I must tell them that I hope they are not doing that on the assumption that if things go bad, I or my colleagues will bail them out. We will not.

On the other hand, I think it is clear that Fannie Mae and Freddie Mac are sufficiently secure so they are in no great danger. And I was glad to have Secretary Snow say when he testified that this is not something we are doing in response to a crisis. For once, Congress is getting out ahead of a problem. This is not the situation where, like the editorial writers, we come down from the hills after the battle is over and shoot the wounded. In this case, we are taking some anticipatory steps.

I don't think we face a crisis; I don't think that we have an impending disaster. We have a chance to improve regulation of two entities that I think are on the whole working well.

I have a particular concern. I know the ranking member of the Capital Markets Subcommittee has another concern about the independence and how well it will be able to function, and I share his views and will be working with him on that.

My primary interest—and I know I share this with others on this committee who care a lot about housing—is to make sure that nothing is done in this reorganization that weakens the ability, indeed the obligation of Fannie Mae and Freddie Mac to help us with our housing problem.

Now, housing is an interesting part of our economy. The argument that prosperity in general deals favorably with a lot of social problems has a lot of truth to it. By the end of the 1990s, the wages of low-income people had gone up. A number of things that we want to see happen happened from prosperity in general, but not in housing.

Paradoxically, because of the nature of the supply-demand relationship with housing, because of the kinks in the pipeline that negatively affect the supply of housing, the very prosperity of the 1990s that was so welcome for most of us exacerbated the housing problem for many people, in particular geographic areas and for people in particular economic situations.

So it is all the more important that we muster the maximum resources to protect those people and to maximize the leverage.

So when you move the regulation to Treasury, if that is done, and you leave housing with HUD, I am skeptical that, absent anything else, that is going to sufficiently protect housing.

Now, of course there are differences, I would agree. In the current Administration it might make not much difference whether it is in HUD or Treasury or if it were at the Nuclear Regulatory Commission, for all the attention we have gotten to housing from HUD. But we are not legislating only for the next year and a half, we are legislating for the future.

So I intend to be pressing to make sure that if a transfer goes through—and there are other questions to be addressed, and the ranking member on Capital Markets will be addressing some of them—that the housing function is not only protected, but strengthened. I want to increase the leverage we have.

Fannie Mae and Freddie Mac do very good work, and they are not endangering the fiscal health of this country. But they do derive benefits from the current set of legal arrangements.

I am fully supportive of maintaining that set of legal arrangements as long as in return we get not just help for the housing market in general, which is important, and lowering housing costs

in general, as they do, is a good thing, but also a particular use of the great resources that they have and the profits that they make to help us with affordable housing which the market in and of itself will not do.

So that is what we, many of us on our side, will be trying to do as we proceed, to make sure that whatever the final arrangements are, the housing function is not only protected, but enhanced, and that both the ability and the obligation of these two entities to help us with affordable housing is strengthened.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Louisiana, Mr. Baker.

Mr. BAKER. Thank you, Mr. Chairman. I want to again commend you for your continuing leadership role in addressing this issue, which is really very vital not only to taxpayers, but homeowners alike, and prospective homeowners.

This is not an issue which has really convenient answers, but it is essential for this committee, and I appreciate the full committee providing the leadership to get us to resolution.

Over the years the committee has made various inquiries in this effort, from probing the enterprises to determine the adequacy of their efforts in meeting important housing goals, as the ranking member has indicated his interest, to express concerns relative to their overall regulatory oversight.

The questions have not been limited just to a couple of obvious issues. Over the years, questions concerning mortgage-backed securities, leverage ratios, duration gap, bank investment concentration of GSE securities and a lot of other unique issues have been before the committee.

I am, frankly, quite ready, in fact anxious to turn over the examination of many of these questions to a fully funded, properly constructed, independent regulator, full of professionals able to give analytical examination and appropriate answers to these myriad questions.

It is, frankly, not business that members of Congress should routinely find themselves engaged, and I am sure many of my colleagues will enthusiastically agree with that perspective.

I also look forward to eliminating, frankly, the political risk that now exists with regard to threatening changes to the GSE charter, almost as much as I look forward to making absolutely sure that the taxpayers will never be called on to pick up the tab for the failure of the system.

Others may suggest radical new capital regimes, perhaps unreasonable constraints on new product approval, or attacks on the basic structure of the charter. I do not intend and will not go there.

Responsible regulatory oversight is the goal, and the closure that results from this effort will be beneficial, in my judgment, to all concerned.

I do think it appropriate to make a clarifying statement today concerning my opinion of the work of Mr. Falcon and his regulatory agency.

I have certainly expressed frustration at times with the pace with which action has been taken, and on some occasions I have had disagreements with recommended actions.

But there is one clear observation I want to put on the record, on behalf of all those employees who have given their best effort over the years, and that is, you have made considerable effort, with limited resources and your constrained authority which you have been given to discharge your responsibilities in a professional manner.

In fact, Mr. Falcon, your testimony today is one of the best statements by anyone as to the direction that this Congress should take in providing adequacy of regulatory oversight. It is evidence of your leadership and your willingness to take a difficult stand and give professional counsel to the best of your ability. I commend you.

As to the current task, I am very pleased to have received excellent recommendations for the modification of H.R. 2575 from the Secretary of the Treasury. All of those recommendations are suggestions which we have previously considered, have previously agreed, and do now fully support.

In fact, there are few modifications required to H.R. 2575 to make the provisions wholly consistent with Treasury recommendations.

As the Secretary has stated, Fannie and Freddie are world class financial organizations, and they require a world class regulatory structure, which is independently funded, with all appropriate authority, and the ability to make professional decisions absent political interference.

That has been, and remains, my legislative goal. It is also evident that protracted discussion of these concerns really has had no adverse effect on home ownership opportunities.

For those who continue to object to any structural change in regulatory oversight, I suggest just taking a deep breath. What we have enjoyed and continue to enjoy, the lowest mortgage interest rates in our country's history. I suggest that Alan Greenspan and his effect is more powerful than any action this Congress or this committee might consider.

In fact, this effort is only to ensure that the secondary mortgage market has stability, not to place constraints that will in any way adversely affect any individual's ability to achieve the dream of home ownership.

Further, it is certainly appropriate to afford opportunity to all stakeholders in this process to give their perspective on this important decision, but it should be clear to all concerned that if we are to construct an independent regulatory structure, the Congress should make the final policy decision in a manner which is independent from any single business perspective.

The enterprises, after all, are creations of the Congress, created to meet the needs of all who seek the opportunity of home ownership. We must balance that requirement with the responsibility of limiting risk to the taxpayer. That is, and should remain, the policy decision that only the Congress should make.

Regardless of the final determinations, Mr. Chairman, of the committee with regard to the construction of H.R. 2575, I will respect the consensus opinion reached on the myriad of issues and fully support the Chairman's effort to achieve this reform.

But is it now time for decisions. We don't need more inquiries, any more hearings. We have asked all the questions, and frankly heard all the various answers. It is now simply time for decisions.

I look forward to the completion of this work, and, Mr. Chairman, with your continuing strong leadership, consideration by the full House of this measure before the year is concluded.

I thank the chair.

The CHAIRMAN. The gentleman's time is expired.

The gentleman from Pennsylvania, Mr. Kanjorski?

Mr. KANJORSKI. Mr. Chairman, we will hear today from numerous witnesses about their views on the need to alter the current regulatory system for government-sponsored enterprises. I believe it is once again very important to highlight some of my current thoughts on these matters.

As my colleagues already know, I support strong and independent GSE regulation. A strong regulator, in my view, will protect the continued viability of our capital markets and promote confidence in Fannie Mae and Freddie Mac. It will also ensure taxpayers against systemic risk and expand housing opportunities for all Americans.

We must, however, tread carefully in developing any legislation to modify the GSE regulatory system. The housing marketplace is one of the most vibrant sectors in our struggling economy and we must ensure that our actions in Washington will not lead to unintended consequences in places like Scranton, Baton Rouge, Findlay or Fall River.

In our last hearing on GSE issues, senior officials within the Bush Administration indicated that there was no crisis that demanded immediate attention of the Congress. Consequently, instead of rushing to judgment, we ought to move judiciously and objectively in these matters to make sure that we properly construct an appropriate regulatory system.

In other words, the obligation to create an effective regulatory system should guide the timing of our deliberations instead of meeting some arbitrary deadline for taking action.

In developing any enhanced GSE regulatory system, I further believe that we should perform deliberate surgery. We should therefore abstain from considering radical proposals that would fundamentally change the ways in which the GSEs operate and the charters of the GSEs.

We must also ensure that the GSEs continue to achieve their statutory obligation of advancing affordable housing opportunities for low-and middle-income families.

As you know, Mr. Chairman, at the start of our two most recent hearings on GSEs, I have outlined five principles to guide our consideration of GSE regulatory reform legislation. Today I feel it is very important to expand my previous comments on one of these principles, regulatory autonomy.

In recent weeks, I have participated in numerous meetings with many experts on GSE matters.

The majority of these individuals have counseled me that in order to maintain credibility and be effective, a strong GSE regulator must have genuine independence from the political system.

In their prepared statements, many of today's witnesses also recognize the importance of and need for regulatory autonomy. Accordingly, they will call upon us to adopt a system in which the GSE regulatory reform bill can proceed in a proper and orderly manner.

Additionally, several others who will not testify at this hearing have noted the importance of statutorily protecting any new GSE regulator from improper political influence.

For example, the Independent Community Bankers Association has strongly urged us to construct legislation containing appropriate firewalls and independence between any new safety and soundness regulator for Fannie Mae and Freddie Mac and the Treasury Department's politically appointed policymakers. We should heed their sensible advice.

The National Association of Realtors has also recommended that any GSE regulator within the Treasury Department should have necessary and sufficient firewalls to ensure its political and operating independence, comparable to those that presently exist for the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

I wholeheartedly agree. The OCC and the OTS models provide us with an effective framework for constructing a new GSE safety and soundness regulator.

Specifically, this new agency should have the authority to submit testimony, recommendations and reports to the Congress without the prior review or approval of the Treasury Secretary.

It should further have the ability to issue rules and regulations without the review and approval of the Secretary.

Additionally, it should have the power to initiate and complete supervisory and enforcement actions without intervention by the Secretary. It should also have independent litigation authority.

Finally, we should prohibit the Secretary from merging the responsibilities of this office with any other regulator.

In closing, Mr. Chairman, I commend you for your leadership in these matters. I look forward to continuing to work with you to develop a balanced and bipartisan plan of action for reforming GSE safety and soundness regulation, ensuring the independence of the new regulator and preserving the affordable housing mission of Fannie Mae and Freddie Mac.

I yield back.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 117 in the appendix.]

The CHAIRMAN. The gentleman yields back.

The gentleman from California, Mr. Royce?

Mr. ROYCE. Thank you, Mr. Chairman, and thank you for holding this hearing. And I want to commend you, I want to commend Chairman Baker certainly, as well, for your leadership.

And I look forward to hearing the testimony of our witnesses today. Especially I look forward to welcoming a fellow Californian, Mr. Dean Schultz, who is with us, and he is the President of the Home Loan Bank of San Francisco.

This committee, in my view, must include the Federal Home Loan Bank system in any legislation that would create a new regulatory body for housing government-sponsored enterprises.

I think that today I would like to once again raise my own concerns with the Office of Federal Housing Enterprise Oversight and with the Federal Housing Finance Board.

The arguments to include the Federal Home Loan Banks in a better, stronger regulatory framework are consistent with the same arguments to include Fannie Mae and Freddie Mac. The Federal Home Loan Banks have debt outstanding and a derivatives portfolio comparable in size to both that of Fannie Mae and Freddie Mac.

Additionally, the Federal Home Loan Banks are changing the risk profile of the system through their rapidly growing mortgage assets.

The Finance Board has neither the depth nor the experience to oversee this risk. All three GSEs need to hedge their portfolios against movement of interest rates. And for this reason, Chairman Greenspan and Secretary Snow both make a compelling public-policy case to create one regulator for all three GSEs.

I believe that there is a political consensus building to act on the Federal Home Loan Banks. However, at the end of the day, if this committee must choose between sound public policy on one hand and a unanimous political consensus on the other, the committee here should pick good public policy.

In my view, the benefits of better regulation would accrue not only to the taxpayer and to the financial system at large, but it is also going to accrue to Fannie Mae and Freddie Mac and to the Federal Home Loan Banks. And the reason that is the case is because, not only is there going to be better regulation, but there is going to be a lower cost of capital for those institutions.

The regulator must see the whole scope of risks in GSE housing finance to perform its duties well, including, if we go forward and we include the Federal Home Loan Banks, this is going to allow Congress to construct the proper foundation for this oversight.

So I look forward to working with my colleagues from both sides of the aisle to create legislation that includes all three GSEs. And that legislation should adhere to a few basic principles.

The regulator should be independent, like the OCC and the OTS. The regulator should be independently funded, outside of the congressional appropriations process. The regulator should recognize distinctions in the business models between Fannie Mae and Freddie Mac and the Federal Home Loan Banks. And with the exception of affordable housing goals, with that exception, mission regulation should move to the new regulator.

And I thank you again for your leadership, Mr. Chairman.

[The prepared statement of Hon. Edward R. Royce can be found on page 122 in the appendix.]

The CHAIRMAN. Gentleman yields back.

Are there further opening statements?

Gentlelady from California?

Ms. WATERS. Thank you very much, Mr. Chairman. I am pleased that we are here today. And I do think this is a very important meeting.

The last time I heard testimony from Fannie Mae and Freddie Mac was May 16, 2000. As you know, I was a member of this distinguished committee when we enhanced the structure of these

GSEs in 1992 to assure safety and soundness in particularly their housing mission.

However, I have sat through nearly a dozen hearings where, frankly, we were trying to fix something that wasn't broke. Housing is the economic engine of our economy, and in no community does this engine need to work more than in mine. With last week's hurricane and the drain on the economy from the war in Iraq, we should do no harm to these GSEs. We should be enhancing regulation, not making fundamental change.

Mr. Chairman, we do not have a crisis at Freddie Mac, and in particular at Fannie Mae, under the outstanding leadership of Mr. Frank Raines. Everything in the 1992 act has worked just fine. In fact, the GSEs have exceeded their housing goals.

What we need to do today is to focus on the regulator, and this must be done in a manner so as not to impede their affordable housing mission, a mission that has seen innovation flourish from desktop underwriting to 100 percent loans.

We must be mindful that capital allows these GSEs to perform their mission. Nothing in the concerns at Freddie Mae had to do with their capital.

In this regard, I am pleased that Secretary Snow has communicated that Treasury has no intent to change the GSE's minimum capital or risk-based capital. Their risk-based capital requirements are subject to a decade-long, and I quote, "nuclear winter or deeply adverse credit and interest rate environment."

These GSEs have more than adequate capital for the business they are in: providing affordable housing. As I mentioned, we should not be making radical or fundamental change.

I also have several concerns, which I raised at last week's hearing, and I need to further set the record straight.

First, these GSEs lead, not lag the primary market in funding mortgage loans for low-income and minority home buyers. The goals we put in place in 1992 work.

In 2002 alone, Fannie Mae provided $279 billion in credit serving low-and moderate-income households.

Fannie Mae's $136.2 billion investment in mortgages to minority families exceed that of any private financial services institution—and may I say particularly Wells Fargo and their other competitors, who thrive in subprime and predatory lending—and even greatly exceeded the FHA's $46.4 billion in minority loan originations.

Moreover, since the inception of goals from 1993 to 2002, loans to African-Americans increased 219 percent and loans to Hispanics increased 244 percent, while loans to non-minorities increased 62 percent.

Additionally, in 2001, 43.1 percent of Fannie Mae's single-family business served low-and moderate-income borrowers compared to 42 percent for the conventional conforming market as described by the HMDA data. A total of 23 percent of Fannie Mae's business served minority home buyers, compared to 21.3 percent for the conventional conforming market.

Mr. Chairman and members, the GSEs are working. That is why I oppose the transfer of program approval to Treasury and expansions into new activities by either Treasury or HUD. I am opposed

to a new bureaucracy at HUD to track sub-goals. We should focus on those banks, many of them competitors of these GSEs, who avoid CRA and practice predatory lending.

In addition, less than 17 percent of OPO's budget was used for examinations. Reallocations of funds, not a new and expensive bureaucracy, is what is needed.

I also oppose the tinkering with the GSEs' status and indicia of GSEs' status. Leave the Presidential appointment of directors alone. Don't rattle the domestic and international markets with this tinkering.

Mr. Chairman, let me just close by saying, it is almost unfair to the regulatory agency at this point to simply criticize them for not exercising the kind of oversight that is now being concluded that they should be exercising without a real examination of their resources and their power and all that should go along with any regulatory agency.

If there is anything to fix or improve, it is the regulatory agency.

And again, I suppose I take a position that is somewhat different from some of my colleagues. I am absolutely, unequivocally opposed to the transfer to Treasury and the expansion into new activities by either Treasury or HUD.

I yield back the balance of my time.

The CHAIRMAN. Gentlelady yields back.

Are there further opening statements?

The gentleman from Ohio, Mr. Ney?

Mr. NEY. Thank you, Mr. Chairman. I think we all can say that we appreciate your holding this hearing. It is important we proceed cautiously, but expeditiously and carefully on the issues of providing a new regulator for GSEs, and you have done that.

I want to thank our many witnesses who will be here today, the current panel and also upcoming panel. David Hehman, who is President and CEO of the Cincinnati Federal Home Loan Bank will be here today.

As I mentioned, the hearing we held a couple weeks ago, as Chairman of the Housing Opportunities Subcommittee, I have a keen interest in the strength of our nation's housing market.

GSE regulation is an incredibly important issue for all Americans. One of the only things that held this economy together as we all know in the last two years was housing and automobiles. Right now, it is housing as an important part of the recovery.

The United States mortgage and credit markets are the envy of the world. The mortgage market has singlehandedly kept the economy afloat during the recent difficult economic times, and housing has proven to be the greatest single generator of wealth in our nation.

As our last hearing demonstrated, a consensus has begun to emerge that it is time to create a new safety and soundness regulator for Fannie Mae and Freddie Mac at the Treasury Department. With the important role the GSEs play in the capital markets and the possible risks they could pose to the financial system, reconstituting their safety and soundness regulator at Treasury is a prudent step at this time.

Such a move would send an important signal that we understand the importance of the GSEs and the secondary mortgage markets

in maintaining a stable economy and providing affordable housing for all Americans.

While there is a consensus regarding the safety and soundness regulator, I am anxious to hear from our many witnesses today on what they believe should be done with the HUD's oversight responsibility for the housing missions and enterprises, including approval authority for any new program and enforcement compliance with affordable housing goals.

These issues have received a significant amount of attention since the hearing a few weeks ago, and I look forward to asking some specific questions about them.

I would also like to make one personal observation on the regulation of GSEs. I believe it is important in any legislation we may consider to allow the housing GSEs to have sufficient flexibility to adapt to a changing mortgage market.

The liquidity that Fannie and Freddie provide to the market should not be compromised by unnecessary government regulation.

As I said before, I believe there are several important components that have been integral to providing enhanced regulation for GSEs while not impeding their ability to support affordable housing in America.

For example, I think it is imperative for HUD to continue to have an important role as it relates to the mission, charter and affordable housing goals of Fannie Mae and Freddie Mac. I have no doubt that the Treasury Department is unparalleled in its ability to manage safety and soundness for these corporations. However, Congress has charged HUD with the job of supervising affordable and minority housing in our country.

I am interested to hear what our witnesses think should be done regarding the capital requirements for Freddie Mac and Fannie Mae, if anything at all. Personally, I believe that the requirements Congress had mandated for GSEs have done a good job of setting a strong safety and soundness standard.

Likewise, I believe that while we must give the regulators the authority they need to keep the risk-based capital regulation relevant to the changing marketplace, we have to also allow the newly required risk-based capital requirements to take hold before we begin questioning it.

I know that there are critics of OFHEO risk-based capital regulation. However, it has been in place for less than a year, and we should allow a decent amount of time to evaluate its effects before we begin to dismantle it.

Finally, I want to make it clear that I believe the Department of Housing and Urban Development must maintain its role in leadership in promoting housing. This agency has an important role in ensuring our nation is focused on providing decent and affordable housing for all Americans. We have to respect that mission.

I also want to say hello and welcome to Mr. Falcon today for the job he has been undertaking here.

Again, Mr. Chairman, I thank you for holding this hearing and our witnesses for taking the time to be here. I look forward to the hearing. Thank you.

The CHAIRMAN. The gentleman yields back.

Are there further opening statements?

The gentleman from California, Mr. Baca seeks recognition?

Mr. BACA. Thank you very much, Mr. Chairman.

First of all, I would like to commend you for having this important hearing this morning.

Mr. Chairman, as we move forward on deliberation actions on the issues of GSE regulations I want to underscore what I heard many of my colleagues say that at the last hearing that is that we would oppose any changes in mission, charter or status of governmental-sponsored enterprises.

As our ranking member said at the last hearing, there is no crisis regarding the GSEs. We have two companies that are remarkably effective in the mission of providing affordable mortgage financing, to move more low-income families into home owning.

Fannie Mae plays an essential role in helping to finance affordable housing throughout the United States. One reason Fannie Mae has been successful is because the current status encourages them to be innovative, I state, be innovative, to introduce new products and to partner with other institutions to be proactive in reaching out to low-income families, I state, low-income families unembedded with corporate culture.

When you change this mission, the status or charter, you risk losing the focus, intensity and drive that bring on the challenge of providing, and I state, on providing the challenge of home ownership opportunities to low-income families.

Regarding the GSEs, safety and soundness is important, but whatever this committee does, we should not interfere with GSEs ability to innovate, to meet the needs of low-income families in underserved areas, and I state, underserved areas throughout the United States, such as my area, where the majority of the growth is in the Inland Empire.

GSE must have the flexibility and the products to develop and fulfill the responsibility of their congressional charter and housing mission.

Thank you again, Mr. Chairman, for having this hearing. I look forward to hearing the witnesses.

The CHAIRMAN. The gentleman yields back.

Are there further opening statements?

Having none, we now turn to our first distinguished panel, the Honorable Armando Falcon, Jr., Director of Federal Housing Enterprise Oversight; the Honorable John T. Korsmo, Chairman, Federal Housing Finance Board.

Gentlemen, welcome to the committee.

And, Mr. Falcon, we will begin with you.

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

Mr. FALCON. Thank you, Mr. Chairman.

Chairman Oxley, Ranking Member Frank 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.

I would like to begin by stating up front that I support legislation to strengthen the supervision of Fannie Mae and Freddie Mac. Upon taking office as Director of OFHEO in October of 1999, I quickly realized that the agency's long-term success was jeopardized by inadequate resources, a constraining funding mechanism and the lack of powers equal to those of other regulators.

Over the past four 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 and your efforts, Mr. Chairman, to move forward.

While I am in general agreement with the well-considered proposal that Secretaries Snow and Martinez have presented to the committee, 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, one, the regulator should remain independent; two, 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 would strengthen supervision and the safe and sound operation of the enterprises. Our ultimate goal and benchmark should be to establish a regulator that is on an equal plane with the Office of the Comptroller of the Currency and the Office of Thrift Supervision, 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 regulator 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 the Congress' experience with the savings and loan crisis.

I had the privilege, Mr. Chairman, of serving as counsel to this committee for eight years, this committee's predecessor, 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 regulators' 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 the newly created Of-

fice of Thrift Supervision within the Treasury Department. The Office of Thrift Supervision was established as a fully independent regulator. It has the same powers and unfettered ability to use those powers as the OCC.

So I believe Congress should ensure that the new regulator has full independence.

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 constraints associated with the annual appropriations process.

There should be clear authority for the agency to levy special assessments or establish a reserve fund as needed to meet emergencies. Currently, any additional funds required to meet urgent, unexpected needs can be attained 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.

At this point let me state, Mr. Chairman, that I appreciate that the Administration has sent up a supplemental budget request for the agency of $7.5 million, and I ask for the committee's support in getting that supplemental appropriation enacted.

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 receivership authority, independent litigation authority, enhanced hiring authority and the full range of enforcement powers provided to financial regulators.

Also, the law should be revised to provide clearly that the regulator is empowered to address misconduct by institution-affiliated parties and to exercise general supervisory powers.

I would be happy to provide the committee with a more comprehensive package if you so desire.

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 available information through the examinations process and otherwise to determine if capital adjustments are necessary. 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 the enterprises business, the

market environment in which they operate and the changing nature of risk measurements themselves.

As Secretary Snow said in his testimony before this committee, 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.

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 cash flows of all the mortgages, debt and other financial instruments of the enterprises, a necessity 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 derivative and callable 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.

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.

Also, I support granting authority to the safety and soundness regulator to determine whether activities of an enterprise are consistent with its charter. This would mean that a single regulator would have the ability to review all of the enterprises' activities, new and existing.

This would consolidate the supervision of the enterprises in a manner consistent with the authorities of other regulators once again.

I appreciate the concern expressed about the primacy of the enterprises' housing mission, if and when 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 mechanisms could be instituted to ensure that the new regulator actively solicits and considers all views, including housing advocates, when exercising this authority.

The importance of their housing mission is actually why the enterprises exist. Strengthening their safety and soundness regulations supports that mission by ensuring that they are strong

enough to provide the financial services that make that mission a reality.

Mr. Chairman, that concludes my testimony. I look forward to working with the committee as this important legislation moves forward. I look forward to answering any questions that you may have.

[The prepared statement of Hon. Armando Falcon Jr. can be found on page 145 in the appendix.]

The CHAIRMAN. Thank you, Mr. Falcon,

Mr. Korsmo?

STATEMENT OF JOHN T. KORSMO, CHAIRMAN, FEDERAL HOUSING FINANCE BOARD

Mr. KORSMO. Thank you, Mr. Chairman.

Chairman Oxley, Ranking Member Frank and distinguished members of the committee, thank you for inviting me to be part of this discussion today.

I have submitted more extensive written testimony to the committee and ask that it be included in the record.

The CHAIRMAN. Without objection, all of the statements will be made part of the record, including the members'.

Mr. KORSMO. Thank you, Mr. Chairman,.

Over the past year and a half, my colleagues and I at the Federal Housing Finance Board have undertaken a disciplined, continuing and I believe successful effort to improve the Finance Board's supervision and regulation of the Federal Home Loan Banks.

A 1998 GAO study found that nine years after its creation, the Federal Housing Finance Board remained inadequately focused on safety and soundness and too closely involved in operating the Federal Home Loan Banks.

When I became chairman in December 2001, my colleagues and I determined these problems persisted and required correction for the Finance Board to effectively oversee the banks for safety and soundness and achievement of their housing finance mission.

I think one quick example demonstrates my point. At the time of my appointment, the Finance Board had only eight bank examiners on staff to 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.

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.

Addressing these problems began with the recruitment of new leadership for the agency's Office of Supervision. After a national search, a new Director and a new Deputy Director of Supervision were hired who between them have 40 years of Federal Bank regulatory experience.

My Finance Board colleagues and I increased the resources available for supervision, expanding the examination staff to 17 full-time examiners today. Our goal is to have 24 in place by the end of this calendar year and 30 by October 2004.

We are now conducting more thorough examination, focusing on the bank's risk assessment processes, internal control systems and

systems of corporate governance, and we are communicating the results of those examinations more effectively to the banks.

Our 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 the institutions they regulate understand those risks and monitor and control them through prudent risk-management practices and effective board governance.

Board governance was recently the subject of the first of a series of system-wide supervisory reviews. This increased emphasis on bank board governance emerges from the Gramm-Leach-Bliley mandate that the Finance Board's appropriate role is not to operate the Federal Home Loan Banks, not to cheerlead for them, but rather to function as a true, arms-length regulator.

These staffing and policy improvements, as well as an ongoing initiative to enhance the bank's quarterly and annual financial disclosures and a renewed emphasis on building the retained earnings of the banks, have been guided by core principles of effective supervision.

Fortunately, the prerogatives and authority afforded the Finance Board by the Federal Home Loan Bank Act have permitted us to put these principles into practice.

They include, first, a GSE safety and soundness and mission regulator should have adequate resources, beginning with financial resources, to carry out its responsibilities.

Second, a GSE regulator should have the flexibility to allocate resources appropriately and efficiently to ensure the regulated entities operate in a financially safe and sound manner.

Third, a regulator must be able to attract experienced and knowledgeable staff, with specialized knowledge of the enterprises they supervise who are capable of keeping pace with changes in the mortgage, finance and capital markets.

Fourth, a regulator's authority to carry out its responsibilities should be clearly articulated in law and regulation. And, finally, a GSE regulator should be clearly independent of both undue political influence and the entities it regulates.

Finance Board adherence to these principles has produced stronger, more comprehensive oversight of the Federal Home Loan Banks. I believe the fast progress my Finance Board colleagues and I have made in increasing the capacity and sophistication of the agency's supervision staff demonstrates the effectiveness of the Finance Board's regulatory model.

Before I close, let me briefly comment on questions raised recently concerning cost of funds. I feel obliged to put this concern in some context.

Despite different charters, different ownership and capital structures, different business models and different regulators, all three housing GSEs raise funds in the agency debt market and benefit from the shared advantage of what the market perceives is an implied taxpayer guarantee.

The pricing of agency debt reflects a variety of factors that may affect the relative desirability of particular issuers at any given moment.

One factor that will never vary, however, is the Federal Housing Finance Board's commitment to the strongest possible safety and soundness supervision of the 12 Federal Home Loan Banks. On that commitment, the capital markets and this committee can rely.

Mr. Chairman, distinguished members of the committee, thank you for allowing me to discuss with you today the Federal Housing Finance Board and its efforts to strengthen oversight of the Federal Home Loan Banks. I believe the success of these efforts demonstrates that the Finance Board is achieving the goal of providing effective, efficient and independent regulation of the banks.

I hope our experience can be of value to you as you consider H.R. 2575. I am pleased to respond to any questions.

Thank you, Mr. Chairman.

[The prepared statement of Hon. John T. Korsmo can be found on page 182 in the appendix.]

The CHAIRMAN. Thank you, Mr. Korsmo, for your appearance today.

And let me begin some questions.

The Administration has argued that the Treasury Department should have the final say on regulations issued in testimony presented by the new regulator. And some claim that this will subject the regulator to the political process and possibly suppress statements or regulations that could be embarrassing to the Treasury.

On the other hand, others argue that without input from Treasury, the new regulator will not be able to utilize the depth and breadth of the Department's expertise.

I would like to hear both of you as regulators, your take on both sides of that issue.

Mr. Falcon?

Mr. FALCON. Thank you, Mr. Chairman.

I do believe it is important that the agency, with all the expertise that it has, the examination program and all of our analysts, be able to promulgate regulations based on what we believe is the best public policy for the agency.

I am not saying necessarily that there would be political interference guaranteed with every regulation that we try to promulgate, but just the additional delay and the possibility for the political interference, I think, makes it better public policy that we be allowed to promulgate the regulations without the reviewing approval of the Department.

We do that currently. Our regulations do go through OMB review. There is an opportunity of OMB review for any department, including the Treasury Department, to have some input into the regulations that we do promulgate, and I think that provides an adequate means for other input.

The CHAIRMAN. Mr. Korsmo?

Mr. KORSMO. Mr. Chairman, obviously my experience is a little different and limited to what experience I have had at the Finance Board. Our statute makes clear that the Finance Board acts as a body, and so as chairman I have to be very careful to make clear that my comments are only my own.

But I do have to feel that the independence our statute affords us in making comments is significant. Obviously, our regulatory process anticipates public comment when we make new regula-

tions. The departments of the Administration have not been shy, as neither have others in commenting on our activities, but I think there is a significant strength to any regulator in the independence that we appreciate at the Finance Board.

The CHAIRMAN. Let me ask both of you, is there a difference between what you mentioned, Mr. Falcon, in terms of promulgating regulations, and the Treasury having to sign off, for example, on testimony given here on Capitol Hill?

Mr. FALCON. Let me use today's testimony as an example, Mr. Chairman. I disagree with the Secretary of the Treasury's testimony that he gave you recently.

Whether or not I would be able to say that in the choice of words that I wanted to use might not be guaranteed if I had to get my testimony cleared by the Treasury Department. But I am able to come here today and give you my best judgment about what should be done and the status of anything with regards to companies that we regulate. That wouldn't be absolutely guaranteed if it had to be reviewed and approved by the Secretary of the Treasury.

The CHAIRMAN. Mr. Korsmo?

Mr. KORSMO. Again, Mr. Chairman, my experience is limited to that at the Finance Board, and I would say again that independence is a paramount feature of our experience, and I think the latitude, the flexibility it affords can't be overstated.

The CHAIRMAN. Mr. Falcon, as you know, Freddie Mac announced this morning that they will be unable to meet the deadline on their restatement. Could you share with us the OFHEO's involvement with the restatement process and what impact do you expect that this delay will have on Freddie's ability to comply with this voluntary agreement to register with the SEC?

Mr. FALCON. Yes, Mr. Chairman. We have been very involved in the restatement process ever since it began when they hired the new accountant. That is when Arthur Andersen was relieved of their duties by the company.

The recent development is that there has been a very recently uncovered glitch with one of the computer systems that produces data pursuant to FAS 140. The company has been keeping us informed. We are watching it very closely. It is going to result, though, in a delay until November of this year.

With regards to the registration with the SEC, that will not begin to happen until the company is able to produce timely quarterly financial statements. The restatement, when it comes out in November, will be for quarters leading up to the end of 2002. They still have work to do to produce financial statements for quarters for 2003. We hope that will be done by the end of this calendar year.

Then it will take maybe a quarter or two, into 2004, before the quarterly statements for each quarter can be produced in a timely manner. It is slowly getting all on track. But until they are able to produce a quarter's financial statements in a timely manner, they will not be able to register with the SEC. So it probably looks like maybe summer or fall of 2004 before that can actually take place, Mr. Chairman.

The CHAIRMAN. The chair's time has expired. The gentleman from Pennsylvania?

Mr. KANJORSKI. Thank you, Mr. Chairman.

I appreciate both of your initial testimony. I think you were frank, and I want to be very clear, particularly you, Mr. Falcon, and Mr. Korsmo, any vetting of testimony by an independent regulator by Treasury would have an effect on what you would initially suggest that you would want to say in testimony or potentially could be subject to correction.

And as I take your testimony, you are indicating you think that would be counterproductive. Is that correct?

Mr. FALCON. Yes, sir.

Mr. KORSMO. Yes, sir.

Mr. KANJORSKI. And when we use terms, the Secretary used them, "strong," "independent," "world class," clearly vetting testimony would interfere with the adjective "independent." Is that correct? I mean, can you be independent and have your testimony affected or vetted by a department such as Treasury?

Mr. FALCON. I think "independence," by definition, means you have the individual ability to take action and make statements without the necessity for review and approval by another individual or entity. And for the new regulator to be established as a world class regulator that would mean it will need all of those powers and independence that are comparable to the other financial safety and soundness regulators. This is just a vitally important part of it.

Mr. KANJORSKI. Is there anything that you see peculiar with the entities that you regulate that are significantly different than the banks or the thrifts that are regulated by the two other independent regulators that we have evidence of how they operate? Is there something unique with Freddie and Fannie that you really need the special resources of Treasury before you are capable of making judgments as a regulator?

Mr. FALCON. I think the agency has more expertise than exist in any other agency or department in the Federal Government with respect to the knowledge of these two companies and how they operate, the risks they face and how they manage those risks.

I think having the independence in exercising our best judgment with all of that expertise is very important.

Now, the independence plays another vitally important role because another unique aspect of what we do is we regulate only two companies, and they are two companies that are of course very politically active and very politically savvy. So it is important that the regulator be able to take its actions based on what it sees as using its best judgment without the potential for the companies to exercise their political acumen in a way that could undermine safety and soundness regulation.

Mr. KANJORSKI. Mr. Korsmo, do you have the same situation, some uniqueness or a lack of uniqueness on what you regulate that you need the support and depthful knowledge of Treasury before you are capable of performing your functions as a regulator?

Mr. KORSMO. Well, Congressman, as with the instance with Mr. Falcon's response, I think the expertise that resides at the Finance Board is unparalleled. I think the increased capacity and sophistication that we have brought over the last two years to our Office of Supervision leaves no doubt that we are more capable than any

other institution in taking a look at and providing oversight to the Federal Home Loan Banks.

Mr. KANJORSKI. Is there any reason, and either of you, that over this last several years that you have a need for support in creating policy decisions at your respective agencies that again you need a grandfather symbol out there or position of Treasury to help you out with these very difficult policy considerations you are called upon to make?

Mr. FALCON. I think we have in house all of the expertise necessary to make judgments on regulations we might promulgate. It is very helpful to have comments through the notice and comment process, and we appreciate that and take them under consideration. But the expertise necessary to take supervisory actions and promulgate regulations, I think does reside within the agency.

The CHAIRMAN. Gentleman's time has expired.

The Chair would indicate to the members that there is a vote on the floor, but it would be the Chair's intention to keep going. And Ms. Kelly is dutifully going over to vote and to come back and Chair while the Chair has a chance to vote. So we will continue to go through the questioning.

And the Chair now recognizes the gentleman from Louisiana, Mr. Baker.

Mr. BAKER. Thank the Chairman.

Mr. Falcon, in your itemization of those issues that are important to the new regulatory capacity, number four is full discretion of the regulator in setting capital standards. There has been some controversy surrounding the provisions in H.R. 2575, specifically section 114, which gives the regulator discretionary authority with regard to minimum capital standards.

The Secretary of the Treasury indicted in his testimony that he did not foresee the necessity for nor immediate action to increase either the risk-based, nor the minimum capital standards.

Is that a view with which you would concur, based on your information today?

Mr. FALCON. Yes. We have no plans currently and see no need currently to raise the capital standards.

Mr. BAKER. And that is a view with which I concur. But that is a distinctly different matter from whether the regulator should have the authority to adjust capital standards based on your review of risk and capital adequacy.

Have you had an opportunity or are you familiar with 2575 and that provision of 114 which gives the discretion to the new regulatory structure to adjust capital? Have you see that provision?

Mr. FALCON. Yes, I have.

Mr. BAKER. In your view, does that provision require an upward adjustment of the minimum capital standard?

Mr. FALCON. As I read it, I think it simply gives the agency the discretion to set capital as it thinks is appropriate.

Mr. BAKER. And I concur with that view. I just wanted to have your perspective as the regulator with regard to the effect of that provision. And I have no intent to pursue a provision which would arbitrarily require the upward adjustment of capital, but do fully intend to give the regulatory structure the authority to adjust min-

imum and risk-based capital as the regulator may deem appropriate, exercising your independent authority.

Secondly, I corresponded with you some time ago relative to the severance packages of former officials of Freddie Mac, only with regard to the question of the appropriateness of having those compensation packages finalized prior to a final determination of fact and a finding of accountability with regard to the conduct of those officials, making no comment as to what should or should not be done, only as to the agency's ability to intercede in the finalization of those compensation packages.

I have subsequently received correspondence from one of the employee's counsel indicating that the agency did not have the authority over the enterprise to either approve or disapprove those severance packages.

As I understand it, you have now corresponded with the board of Freddie Mac and indicated that you would like to see those employees terminated for cause, which the consequence of it would be to effectively terminate those packages.

Is that a correct summation of where we are?

Mr. FALCON. Yes.

Mr. BAKER. Is there, therefore, no actual authority for your agency today to review compensation packages or severance packages prior to their finalization with an employee?

Mr. FALCON. Well, I think we do have the authority to take appropriate action and determine what is the appropriate severance package or compensation for the individuals. I thought it was important as a matter of good corporate governance to set a clear principle that if you engage in wrongdoing you will be terminated and won't be allowed to resign and keep a large, substantial amount of money.

With respect to the letter you may have received from one individual's counsel, I understand they are representing their client's interests, but I am trying to protect the public's interest. I believe I have the authority and we will take action as we see is necessary.

Mr. BAKER. I only wanted to clarify for the record going forward, is there any need in your view while this committee is constructing the regulatory authority to make clear that the regulator that will be created has clear statutory authority and further a responsibility to review these matters.

And I say it in light of not only the Freddie Mac issue, but the unfortunate developments with the New York Exchange in the broad context of corporate governance. Particularly where it is an enterprise created by the Congress, we have a full responsibility, I believe, to assure the taxpayer that we are looking at the appropriateness of and have reviewed via the regulator the compensation arrangements.

Am I understanding that you do not believe we need to take any further action in regard to that matter to have this assurance?

Mr. FALCON. We do have the authority. However, if you think it advisable, it might be appropriate to remove any doubt, so you don't have to receive letters such as you did. You may want to say something specific in the statute.

Mr. BAKER. Let me suggest, if I may, and I would be happy to receive any recommendations you choose to forward, but specifi-

cally with regard to that item, should you have language you would suggest that we might consider I would be appreciative to receive it.

And, Mr. Korsmo, I am sorry to move so quickly, but the time on the vote on the floor is moving quickly and I will need to step out.

Not to do this quite so inappropriately, but is there a position, affirmatively or negatively, with regard to the bank system's participation in the new regulatory structure? I know there is division among individual bank districts as to the advisability. Has the board or have you reached some determination as to what this committee should do?

Mr. KORSMO. The board has not taken a formal position. I think it is safe to say, however, after consultation with my colleagues that we are unanimous in our feeling that given the progress we have made, and particularly the very different charters that exist between Fannie Mae and Freddie Mac and the Federal Home Loan Banks, the different ownership structures, the different business models, that we believe the progress we have made demonstrates that the Finance Board's independence should be preserved.

Mr. BAKER. So that is an independently arrived at "not sure, but probably not"?

Mr. KORSMO. Correct.

Mr. BAKER. I understand.

Mr. Falcon, there is one other question that has also been raised in press reports relative to new product approval processes. To my knowledge, in the history of HUD, who has to act after the product is in the marketplace, there has not been, to my knowledge, a product offering which has been revoked by HUD in its capacity as a new products regulator.

In your testimony, I believe I understood you to say that new product authority ought to be more appropriately housed in the regulatory structure that also reviews safety and soundness. Just to confirm, that is your recommendation to the committee?

Mr. FALCON. I think it would be appropriate to consolidate charter compliance authority with the safety and soundness regulator. All other safety and soundness regulators have the authority to interpret the charters of the entities that they regulate.

Now, as I see it, it is a matter of, as I put it, charter compliance. It is not a matter of, for us, new product approval authority. Charter compliance would go to every activity of the company.

Because OFHEO as a safety and soundness regulator has examiners in the companies every day, because we learn of new activities in order to incorporate them into our stress test, we could exercise that charter compliance authority without the necessity for any formal new product approval process. But I think it would be appropriate to consolidate and follow the model of the OCC and the OTS.

Mr. BAKER. I really regret my time has expired. After all these years, I have got to run. Thank you.

Mrs. KELLY. I guess it is my turn to ask a few questions.

So, two weeks ago, the Administration proposal called for the increased powers, and we have heard a lot of testimony from the Ad-

ministration about the need for a powerful regulator over at Treasury.

And at our hearing Secretary Martinez testified before the committee, and I am quoting him, "As the President's budget noted in February, numerous HUD studies and independent analyses have shown that the GSEs have historically lagged the primary market instead of leading it with respect to funding mortgage loans for low-income and minority home buyers."

This question, Mr. Falcon, is for you, because as a regulator for Fannie Mae and Freddie Mac, do you believe that they could increase their efforts to fund loans for low-income and minority home buyers if HUD was given greater authority to set the goals and the powers to enforce them?

Mr. FALCON. Let me say, Congresswoman, that I am fully supportive of the enterprise's affordable housing goals and their housing mission. I don't have the ability to comment as to whether those goals could be higher or not. I will leave that to HUD.

However, I do think, if you support goals, probably you would also support some teeth behind those goals. So I think the committee should consider whether or not some enforcement powers for HUD are appropriate to make sure that, if there was any need for some type of action to make sure the goals are met, that the authority is there.

Mrs. KELLY. So tell me how we would do that.

Mr. FALCON. If you use something comparable to a safety and soundness regulator's authority, you might require some type of corrective action plan where they would outline exactly how they would go about meeting the goals and addressing the shortcomings if the goals weren't met.

Mrs. KELLY. And where would that corrective action be, at Treasury or——

Mr. FALCON. With the housing goals being at HUD, I think it would be at HUD.

Mrs. KELLY. Do you think that this would harm the safety and soundness of Fannie Mae and Freddie Mac?

Mr. FALCON. We do communicate with HUD frequently about the housing goals when they go through the process of promulgating new goals, and we do offer them input as to whether or not we think there would be any safety and soundness concerns raised by any increased affordable housing goals. So we do provide input to the Department on the safety and soundness implications of new goals.

Mrs. KELLY. I want to go back to the low-income and minority home buyers statement by Secretary Martinez. I think there is a certain amount of concern on the part of a number of members of this committee, including myself, that this mission that is a part of what we are trying to do with housing, with Freddie Mac and Fannie Mae, I think there is a certain amount of concern that there be that mission continued. And I want you to address that, if you would.

Mr. FALCON. Thank you. I absolutely share that view that we don't want to do any harm to their ability to fulfill their housing mission. I am confident that if the committee decided to give the

new regulatory agency the authorities that it seeks that that wouldn't be inconsistent with their housing mission.

In fact, a stronger and healthier government-sponsored enterprise is more likely to be able to get deeper into affordable housing.

And so I think, rather than it being inconsistent or at odds with the housing mission, a strong and fully empowered safety and soundness regulator actually helps them further their housing goals.

Mrs. KELLY. I would like both of you to answer what your thoughts are on the relationship between balancing strong regulation and oversight and encouraging housing goals. Will you both answer that?

Mr. KORSMO. Representative Kelly, obviously the Congress has created a quite different model for the Federal Home Loan Bank System and how it meets its obligations to promoting affordable housing. The banks, of course, set aside 10 percent of their net—the greater of 10 percent of their net revenue or each bank's pro rata share of $100 million annually for funds that go into grants and subsidies for affordable housing projects.

Since 1994, every year that dollar figure has exceeded the $100 million minimum. In fact, last year it was in the neighborhood of $199 million.

And I think over the course, since the set-aside program was established, the banks have provided something like $1.7 billion in grants and subsidies for affordable housing projects.

I think that is a reasonable method, frankly, and I can't really speak to the housing goals, I am not as familiar with how they have been constructed and how they operate. But I think the banks should—well, frankly, the banks represent the largest single source of affordable housing dollars in the country, and I think that all too often that fact isn't recognized and the banks should be applauded for the great contribution they make to affordable housing.

Mrs. KELLY. Mr. Falcon, what I am getting at is that there are two different entities that are responsible for the tasks, and I am trying to figure out how we should appropriately coordinate the job that has to be done here to ensure that people have the necessary safety and soundness regulations in place, but also the mission of HUD is not lost. And if you have, either one of you have any suggestion for how you think we should do that, I would like to hear that.

Mr. FALCON. I think what I have suggested in terms of consolidating what you call mission, I think more of as charter compliance. Someone needs to be responsible for assuring that the enterprises always operate within the boundaries of their charters.

Congress gave them a charter with specific responsibilities, with specific powers. It is the same for any other federally chartered institution. Every other safety and soundness regulator has the responsibility of ensuring that the entities they regulate operate within the boundaries of the power Congress has granted to them.

And what I am suggesting is more of an issue of charter compliance, not prior approval, nothing else.

If a company wanted to invest in electronic commerce, that raises an entirely different issue, I think, than whether or not there is an impact on their housing mission. In fact, I think the responsibility

of charter compliance is to make sure that there is no deviation from the housing mission of the companies.

Mrs. KELLY. I want to ask another question. You requested $7 million to investigate the management reorganization at Freddie Mac. Is this just a question of a lack of funds or are there other tools that the OFHEO really needs to fully investigate and oversee the GSEs, and what percentage of your current budget is actually set aside right now for your examination staff?

Mr. FALCON. On average the percentage of dollars that we spend on supervision, examination and supervision, is comparable to that of every other regulator.

We do spend money that is comparable to every other regulator when it comes to allocation of dollars to the examination program versus the other responsibilities of the agency.

I have heard another comment about a misallocation, that we are not spending the right amount of money on exams. I don't think that data is accurate. We have looked at this question. When we compare the allocation of our agency budget to supervision, the examination program, it is comparable to the other regulatory agencies.

So I would want to assure you that we do allocate our budget in the proper manner.

Mrs. KELLY. Thank you very much.

Mr. Davis?

Mr. DAVIS. Thank you, Madam Chairman. One of the few times when someone on this row gets to go this early in the proceedings.

Let me try to focus my questions, if I can, on two particular areas. The first one relates to the nature of prior approval for new activities, which is one of the major parts of Mr. Baker's bill, as both of you know.

Let me ask you—and let me broadly associate myself with the comments of the Ranking Member and then Ms. Waters earlier to some extent, that in our desire for reform we don't want to necessarily over reform; we don't want to necessarily generate new problems in the effort to fix problems that we are already well aware of.

Can either of you comment, but particularly, you, Mr. Falcon, on whether or not there has been any historical or even any anecdotal evidence for that matter that either one of the GSEs has ever abused the current scope of activities? Is there any historical or anecdotal evidence that under the current structure that either Freddie Mac or Fannie have been engaged in doing anything that doesn't fit within their charter? How are we doing right now under the new activity section?

Mr. FALCON. I can give you one instance, involving one of the companies, several years ago. The companies when they purchase high LTV mortgages are required to use one of three forms of credit enhancements: one of them is mortgage insurance; another is participation insurance; and another I believe is repurchase arrangements.

One of the companies wanted to use a fourth that was inconsistent with what the law required, so we stopped the company from doing that.

But on this more general matter, to your question, OFHEO as a safety and soundness regulator is in the enterprises day in and day out through our examination program.

Through the examination program and through the need to incorporate new activities on a real-time basis into our stress test, we learn about new activities in a timely manner. And I think if charter compliance was given to the new agency, we could exercise that responsibility without the need for any formal prior approval, so that there wouldn't be any impact on their ability to innovate.

So it is different from HUD, which doesn't have an examination team in the enterprises and doesn't have a risk-based capital standard. But it is something that the safety and soundness regulator could do without the need for a formal prior approval mechanism.

Mr. DAVIS. Let me raise a question that a number of people on this side of the aisle and perhaps on the other side have raised, that if we give HUD under this new regime that Mr. Baker contemplates, if we give HUD a greater authority to oversee or to examine new activities, what is the level of transparency behind the decision-making at HUD?

One of the criticisms is that HUD could potentially, depending on a change in regime or a change in the whim of the people running the Department, could make the decision that a particular kind of program, for whatever reason, was not one that HUD wanted to embrace.

But obviously, given the fact that there are no public hearings required around that kind of analysis, given the fact that HUD could potentially do what it wanted for whatever reason, why would we want to expand their authority to regulate new programs unless we at the same time create more transparency around the decision-making process.

Mr. FALCON. I think transparency would be important. I am not sure what level of transparency is required right now. But the decisions it makes and the basis for those decisions, I am not sure that there is a requirement that they be disclosed right now.

But I would encourage transparency. We try to operate as fully transparent as possible.

Mr. DAVIS. Would you contemplate that there would be any circumstance when HUD could reject a new activity, provided the activity fit within the charter? The previous example you gave me was something that strikes me doesn't fit within the charter.

Let us say that HUD were to make an analysis that an activity fits within the GSE charter. Just as a public policymaker can you think of any circumstance when they should be able to nix an activity at that point or should the charter essentially be the standard?

Mr. FALCON. Well, I think the current standard that HUD applies under the statute is not just compliance with the charter, but there is also a public interest carve out as well. If HUD found that it wasn't in the public interest, even if it was permitted by the charter, I think the statute allows them to disallow the activity.

Mr. DAVIS. So your position would be that if Mr. Baker's bill were to be successful and we were to give HUD greater authority to regulate new activities, number one there should be a high-level

of transparency, that would certainly be ideal. And number two, that you think that the public interest standard should also be incorporated into whatever rationale would guide the decision-making process.

Mr. FALCON. It is another basis by which the regulator could disallow a new activity. I am not sure whether or not it is advisable to keep it or do away with it, but I am simply stating as a matter of fact it is there. It is a question that you would need to decide as to whether it is appropriate to keep it or not.

Mr. DAVIS. Okay. I think that my time has expired, Madam Chairman.

Mrs. KELLY. Thank you, Mr. Davis.

Mr. Leach?

Mr. LEACH. I want to talk about independence for a second from a little different perspective. I am one that strongly favors moving regulation to the Treasury. I also believe that it should include the Federal Home Loan Banks and that it should be independent from the politics of the Executive Branch, but it also should be independent from the politics of the United States Congress.

And let me explain what is current law and what is following current law and what I believe should be changed. But I do not give high hopes that that will occur.

In current law the regulation of Fannie Mae and Freddie Mac are the only institutions in the history of the United States of America where Congress says there will be a maximum capital ratio. This is a statute written by the regulated and pressed through the Congress.

Now, you indicated in earlier questions, Mr. Falcon, that you didn't have any current intent to raise capital standards. But do you believe that there should be a maximum capital ratio or do you think that that should be an independent judgment of the regulator, independent of the executive—that is, of Treasury—and of the Congress?

Mr. FALCON. I absolutely believe that that question should be left to the best judgment of the regulators to exercise, based on their knowledge of the companies. Yes.

Mr. LEACH. And that we should not have a maximum capital ratio statutorily imposed?

Mr. FALCON. That is right.

Mr. LEACH. Well, I think this is a fundamental issue and something that this committee is going to have to think through. We want independence from the Treasury; I think we should also want independence from legislative directives.

And I think it should be understood that I mean in a bizarre circumstance, but not a trivial one, the International Monetary Fund has called for an increase in capital ratios for Freddie and Fannie, based on scenarios that are conceivable, having conceivable difficulties in the world economy. And I hope that Congress does not hamstring any new independent regulator.

Now, Mr. Falcon, and also the distinguished head of the Cincinnati bank, do you think the Federal Home Loan Bank System ought to be within Treasury? What do you think, Armando?

Mr. FALCON. I think if Congress decided that it was appropriate, we could make it work. However, if you would allow me, I would

defer to Chairman Korsmo to find out what he thinks, maybe in the best interest of his regulated entities.

Mr. LEACH. Well, I appreciate that, but I want to make it clear, Mr. Chairman, the issue isn't the best interest of the regulated entities, the issue is the public interest.

Mr. FALCON. Yes, I agree. I misspoke there.

Mr. LEACH. What is your judgment on this, sir?

Mr. Korsmo?

Mr. KORSMO. Oh, excuse me. Pardon me, sir.

I think, frankly, that the job we are doing at the Housing Finance Board meets the goals of providing effective and efficient and independent regulation.

I think the progress we have made, particularly in the last two years, coupled with the very different charters under which the Federal Home Loan Banks and Fannie and Freddie operate, the very different ownership structure, the very different capital structure, the very different business models, it makes sense to preserve some degree of separation to ensure that the level of expertise that exists for the oversight of the Federal Home Loan Banks is distinct from that of Fannie and Freddie.

I would leave it to the Congress to make the judgment as to how that would be organized, but my belief is that we are demonstrating that the Federal Housing Finance Board is an appropriate regulator for the Federal Home Loan Banks.

Mr. LEACH. Well, let me just tell you the irony that is appearing. I am told Fannie and Freddie desperately do not want the Federal Home Loan Bank System under the same regulator, because the Federal Home Loan Bank System has a 4 percent capital requirement; they have a maximum 2.

I am also told that the Federal Home Loan Bank System, despite having a higher regulatory capital leverage ratio, the capital isn't particularly permanent and the regulation is not particularly firm.

We have an episode today in Pittsburgh where we have a bank that has been allowed to give dividends, dipping into capital not based upon income, which no bank regulator would likely have allowed for a commercial bank. And this does not strike one as a particularly prudential circumstance. Can you tell us a little bit about the Pittsburgh problem?

Mr. KORSMO. First of all, let me correct. The Pittsburgh bank has not dipped into capital; it has dipped into retained earnings.

Obviously, like any safety and soundness bank regulator, I have to be very careful about the information that I make public that comes from examination and supervisory activity.

That having been said, I think we appreciate the very real concern that you express about the level of retained earnings at the Federal Home Loan Banks. In fact, our Office of Supervision recently issued an advisory to the banks to review their retained earnings policies with a view toward increasing retained earnings in the bank system. And I can assure you that part of our ongoing examination and supervision function is to review not only the retained earnings policy, but also the dividend policies of the various boards of the 12 banks.

Mr. LEACH. Well, I appreciate it. But all I can tell you is there has been an exponential growth in assets of these banks. This ex-

ponential growth has some analogies to the savings and loan issue of the 1970s.

Now, on the boards there are some smart people, but I am very concerned with the supervision of these banks.

And I would stress you have joint and several liability. And one bank gets in difficulty, all of you are accountable, and that implies, one has to be concerned for the capital of all the banks. And I just hope as a regulator currently you are on top of the capital issue.

And I also believe the case for putting both of you under Treasury is just profound, absolutely profound today. And the case for giving independence to an independent regulator is extraordinary. And I just have a sense that we have too much captive in a regulator, and I say that with great concern.

And I am very concerned you are going to see things happen that are going to stretch your treasuries and stretch the treasuries of potentially the public. And so I think this is a great opportunity for the committee to make a very responsible step, and I hope we do in a comprehensive way.

Thank you.

The CHAIRMAN. The gentleman's time has expired.

The gentlelady from California, Ms. Waters?

Ms. WATERS. Thank you very much.

Mr. Chairman and members, I have been sitting here pondering the different requirements for the Federal Home Loan Bank and Fannie and Freddie. And I guess I am going to raise the question, why shouldn't the Federal Home Loan Banks be under the same requirements and restrictions as Fannie and Freddie?

Mr. KORSMO. In what regard, Representative Waters? You mean——

Ms. WATERS. Well, maybe we should start—we should back up, and let me ask, because I guess I don't really understand, what is the fundamental mission of the bank system? Is it cooperative lender or secondary market participant?

Mr. KORSMO. It is to provide liquidity to its member institutions, presumably for the purpose of making housing finance.

Ms. WATERS. And do you have housing goals?

Mr. KORSMO. There is a very different—Congress has constructed a very different methodology by which the Federal Home Loan Banks, as opposed to Fannie Mae and Freddie Mac, meet their responsibility to provide—to supplement affordable housing. In the case of the Federal Home Loan Banks, the greater of 10 percent of their net revenues, or each bank's pro rata share of $100 million a year, is set aside to be used for grants and subsidies to affordable housing projects.

What that has meant is every year since 1994, the banks have exceeded that $100 million target. In fact, last year it was something like $199 million was their 10 percent share. I think the year before it was approximately $246 million.

Since 1990, when the Congress established this process, the banks have made available and distributed approximately $1.7 billion in grants and subsidies to affordable housing and low-income housing projects.

I am familiar, of course, with the program that the Federal Home Loan Banks have and that we oversee at the Federal Hous-

ing Finance Board. I am less familiar, of course, with the housing goal scenario that is appropriate to Fannie and Freddie. But it is certainly an issue that I think Congress should look at, whether or not a separate model is still appropriate. But again——

Ms. WATERS. What do you think?

Mr. KORSMO.——in my role as regulator, it is difficult for me to make an assessment because I am not that familiar with how the housing goals operate.

Ms. WATERS. So you would not have compared the $100 million so-called set-aside with the Fannie and Freddie goals?

Mr. KORSMO. Again, Representative, it is a very different model that Congress has established for the banks as opposed to Fannie and Freddie. I have not compared them. I think it is probably appropriate that somebody take a good look at it.

Ms. WATERS. All right. Thank you very much.

I yield back the balance of my time.

The CHAIRMAN. The gentlelady yields back.

The gentleman from California, Mr. Royce?

Mr. ROYCE. Thank you, Mr. Chairman.

Mr. Korsmo, you told Mr. Leach that retained earnings weren't part of capital. Well, it is capital.

Mr. KORSMO. No, no, no. I am sorry. I thought he was making reference to dipping into the capital. Obviously——

Mr. ROYCE. Right.

Mr. KORSMO.——retained earnings is part of the minimum capital requirement.

Mr. ROYCE. Well, I just want to associate myself with the points that he made.

In your testimony, you told us that the Finance Board basically has improved over the last couple of years. But this morning in The Wall Street Journal and in the Financial Times, as you know, and in The New York Times, we have stories about some of the issues with the Federal Home Loan Bank of New York. And this follows other news about disappointing results that Congressman Leach pointed out about the Pittsburgh bank.

Now, I believe that the New York Bank has taken positive steps to manage through its troubles, but I am concerned that the Finance Board did not perform well here. I am concerned that the Finance Board again failed to protect against systemic risk.

Home Loan Banks do not usually either suspend their dividend or dip into retained earnings to pay their dividend. And, Mr. Korsmo, you have seen this happen twice in this quarter.

I guess my question is, should Congress be concerned about this? And should Congress be concerned that our Treasury Secretary Snow and our Federal Chairman Greenspan and our GAO have called for combining regulation of all three GSEs at this time?

Mr. KORSMO. Congressman, let me preface my response again with the statement I made to, I believe it was Representative Leach, that I have to be very careful as a financial regulator, and I know you would expect nothing different from the head of any bank regulatory agency, to discuss in a public forum examination and supervisory actions that we may have taken with respect to any individual member.

I can say in the case of the New York bank that the deterioration of the credit quality of certain of their asset-backed securities is a concern. I will tell you that we have monitored the situation very carefully.

Our examiner in charge is in constant contact with the New York Bank. As a regulator, it is our role to ensure that the steps taken by the bank are consistent with Finance Board regulations and prudent operations, including appropriate accounting for any actions taken by the bank.

Beyond that, it is perhaps not appropriate for me to comment.

I can say that I did talk to our examiner in charge only this morning about the articles you cited in The Wall Street Journal. I should probably mention that he pointed out to me two very significant factual errors in the article, and let me quote The Wall Street Journal article.

It said, quote, the bank said it would suspend its dividend payments to the customer banks for the third quarter to conserve cash, unquote.

That is absolutely wrong. The bank has plenty of cash and plenty of access to cash. What it did was suspend the dividend to protect retained earnings, and I think that was a prudent action.

As I mentioned, the Finance Board's Office of Supervision recently issued an advisory to the banks about our concerns about the level of retained earnings, not just at the New York bank, which frankly has fairly substantial retained earnings, but at all the banks. And we are looking at whether or not we need to take further regulatory action to deal with the current level of retained earnings.

Mr. ROYCE. Let me ask you another question. Isn't it fair to say that the existing bank regulatory agencies under Treasury, the OTS and the OCC, benefit from their affiliation, benefit from their association with Treasury? Don't they attract numerous well-qualified people to work for them? Wouldn't you say that?

In 1989, Congress replaced the Bank Board, the regulator of thrifts at the time, with the OTS under Treasury. That was done to enhance regulatory capability and to, frankly, enhance the reputation of the regulator.

Why, when we have this unusual chance to do the same for the regulation of these banks, should we not do this?

Mr. KORSMO. Well I think the two points I have made on that issue are significant. One, I think we have made significant progress. This is not your father's Finance Board, to coin a phrase. And, frankly, I am concerned that some of the significant enhancements that are now under way might be lost or deferred in a transition process.

We have made significant institutional changes at the Federal Housing Finance Board. We have created a new management infrastructure that I think the banks have come to recognize the primacy of safety and soundness that this Finance Board has placed.

The team we have built, the enhancements we have made, I think are significant.

I won't tell you that we are where we want to be yet. Frankly, we will never be done. But the movement is in the right direction

and what exists today is a decided improvement over what existed two years ago. I would hate to see that progress lost.

Mr. ROYCE. Let me ask you this question: The GAO has three times done an objective analysis where they have come to the same conclusion as Treasury, the same conclusion as our Federal Reserve Chairman. So assuming that the inclusion of the banks could be accomplished to recognize their structure and operations, to recognize their difference in mission, such as creating a separate division within the new agency for supervision of the banks, would you oppose such a creation?

Mr. KORSMO. As a regulator, I suppose it would probably be inappropriate for me to make a judgment one way or another. I will leave the decisions in that regard, setting policy, to the policymakers.

Again, my concern is that there be appropriate recognition of the very different charters that exist, the very different ownership structures that exist between the Federal Home Loan Banks and Fannie and Freddie.

And I would ask also that acknowledgement be made of the very real progress that the Finance Board has made. The last GAO study that you cited was made I think six months into my tenure. We were in the process of making improvements that now I think virtually every impartial observer recognizes. And I would just caution that the Congress move very carefully in dealing with the oversight of these——

Mr. ROYCE. I understand that, but to go back to the point that Congressman Leach made, you do have the question of what happened on your watch at Pittsburgh and what happened with the New York Bank. And they are certainly credited with taking the right corrective steps now, but the question is, in terms of the regulators, I mean, I think our concern is should we expect any more negative news stories soon?

And I think that what brings us here today is whether we are willing to take a look at the arguments advanced by the Federal Reserve Board Chairman, by our own GAO, by Chairman Greenspan and Secretary Snow of the Treasury, to look if we can't come up with a better model in which we can better anticipate and regulate for the GSEs.

The CHAIRMAN. The gentleman's time has expired.

Mr. ROYCE. I thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Texas, Mr. Gonzalez.

Mr. GONZALEZ. Thank you very much, Mr. Chairman.

The question will go to Director Falcon. I guess kind of as a threshold question, but for whatever reason, we believe this action is necessary, and we are moving forward regardless.

But up to this point, based on the recent situation arising out of the practices by Freddie Mac, is there any evidence that you are aware of that those actions and practices in any way jeopardized the safety and soundness of Freddie Mac?

Mr. FALCON. No, Congressman, this has not been a safety and soundness issue for the company. We have concerns, it is a serious matter, about accounting practices and management practices as well, but the results here were that earnings were not in fact man-

ufactured, but there was an attempt to move earnings over a period.

So it wasn't a matter that caused us concern about the financial liability or the safety and soundness of the company.

Mr. GONZALEZ. And there is no evidence out there right now that Fannie Mae has engaged in any similar type practice or action, is that right?

Mr. FALCON. That's right.

Mr. GONZALEZ. So regardless of the situation with the two big GSEs on safety and soundness, which usually is a predicate for anything that we do around here, we still will move forward with some new regulatory scheme.

And I think there are members on this side of the aisle that question that, for good reason, because we are not real sure. We are like a team of doctors and we decide that the patient, regardless of symptoms, is going to require a heart transplant. And we are going to do it, because we know if it is successful we will come out with a stronger patient.

The problem with a heart transplant is that the patient can die. And that is our concern, is that the patient, in this case the two big GSEs that accomplish such great goals in our communities, anyway, would be in danger.

I know you have had a chance to review Secretary Snow's testimony. It was not clear to me that what he was describing really adheres to your recommendations. On independence, for instance, I did not hear that. It was so incredibly general and nebulous that I am left with no real idea that Treasury had some thought what it would look like, what shape it would take.

Surely on clearance of testimony, there is disagreement. And I will tell you right now that members of this committee know that the least responsive witnesses are always from the departments. I think they must have classes or something when they come in there on how not to answer questions. Really, they just need to view all the testimony by Chairman Greenspan, and that would be sufficient to get a Ph.D. But nevertheless, that is what happens.

I don't see where we really benefit by that.

When it comes to appropriations, again, that wasn't part of his recommendation.

Do you understand what the Treasury contemplates? I know what some members may have out there for consideration, but at this point do you have any firm understanding?

OFHEO is not going to be subsumed like in OTS or whatever, because I didn't hear that coming from Secretary Snow. As a matter of fact, I heard pretty much the opposite. That was my interpretation of his testimony.

So based on his testimony and your understanding of it, because I know you have been following it, do you have any idea of the structure contemplated by Treasury?

Mr. FALCON. We have the general construct, but much of this will decided in the details. I am not familiar with the details about how this gets fleshed out and how the construct was elaborated on in the testimony actually would take place.

I think how that is done will depend to a large extent whether or not. The principles that I have tried to lay out are met and

whether or not we are actually moving safety and soundness forward or actually taking a step backward.

So, yes, we absolutely need to look at the details about how this is actually done.

Mr. GONZALEZ. Well, we share your concerns and appreciate your recommendations and suggestions. And I am hoping that legislatively we can build something out there that will assure that, that we give people latitude but not the ability to refashion the GSEs, to de facto change the charter and definitely its mission.

Again, thank you very much for your all's testimony.

The CHAIRMAN. The gentleman yields back.

The gentleman from Florida, Mr. Feeney?

Mr. FEENEY. Thank you, Mr. Chairman.

Mr. Falcon, I was taking a look at some of your comments and comparing them to Secretary Snow's recommendations, and on at least one issue it seems like you have stepped well out in front of anything that the Administration has recommended—that would be with respect to setting minimum standards.

As I understand Secretary Snow's testimony, the Administration while, it suggests for some flexibility in the future toward capital requirements, it is suggesting there should be no statutory change at this point. But on page 5 of your testimony, you say that the agency needs to have the authority to modify both minimum and risk-based standards. That seems to contradict what Secretary Snow suggests we ought to be doing.

And additionally, I have some concerns that if we have an agency out there that is able to unilaterally raise minimum risk standards, what we are ultimately going to be doing is to raise the cost of credit, especially in the affordable housing area.

And I would like you to, number one, tell us why it took your agencies the better part of a decade to put together some of the standards for both the risk-based and the minimum capital standards, but also explain the differences as you see them between your position and the Administration's?

Mr. FALCON. You are right, Congressman, I do disagree with the Secretary on that point, if his point was that there should be no modification made to minimum capital. And the authority that I am seeking is no different from that of the other safety and soundness regulators.

So if there is a concern about constraints on credit, I think that concern would be placed with all of the regulatory agencies.

But, in fact, I think we all exercise a very reasonable judgment when we use that authority. Setting capital is a very important part of how a safety and soundness regulator accomplishes its mission, and it has to balance the capital requirements against the ability of the companies to operate.

I think we try to balance those considerations very reasonably, and we wouldn't on some unsound basis just decide to increase the capital requirements. We don't have any current plan to increase the capital requirements right now, but it is important for us to have the authority to do so if we thought it was appropriate.

The last thing I want to do is come before this committee and explain why the capital was insufficient. So if the regulator ever needed to increase capital, I think we should have that authority.

On the risk-based capital standard, it did take more time than it should have. When I got to the agency, we all rolled up our sleeves and we just got it done. Now it is done and it has been functioning for about a year now. It is a state-of-the-art, vital stress test that makes sure that the companies can withstand severe economic shocks.

I am proud of the work the agency has done, and while it took longer than it should have, we did get it done.

Mr. FEENEY. Well, going back to the minimum capital for a second, the inference I draw from what you just said is that current minimum capital requirements, in your opinion, are not insufficient. In other words, that they are sufficient, to take out the double negative.

And yet you are asking Congress to give you the unilateral authority to raise those standards, which personally I believe would have the impact of at least marginally, and maybe substantially driving up the cost of capital, which would seriously affect especially the affordable housing market.

What would be wrong with, when the time comes that you believe that minimum capital standards are insufficient, coming to Congress and saying that, A, they are insufficient, and, B, you would like the power, if Congress doesn't raise the standards, you would like at that point to have the power to do so? Why should we give it to you now when there is no problem?

Mr. FALCON. So that I can be sure that a problem never develops. I think by the time I came to Congress and asked for the authority to raise capital, that is too late.

It is my job to ensure that we are able to prevent problems before they develop and to ensure that the enterprises remain safe and sound. And I am asking for the authority that every other regulator has.

We exercise it in our best judgment, and while we have no plans currently to raise capital, if we consider that the condition of the companies, based on our knowledge of their activities through our examination process, ever required us proposing an increase in capital, we wouldn't just do it willy-nilly. We would do it through a notice and comment period and through full administrative procedures and follow a process whereby we take full comment, including comments from this committee, absolutely, as well as general public comments. So we would do it with all due process and exercising our best judgment.

Mr. FEENEY. I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman yields back.

The gentleman, Mr. Scott, from Georgia?

Mr. SCOTT. Yes, thank you very much, Mr. Chairman.

I want to ask a two-part question. I want to preface it with a couple of what I think are facts here.

I think that given the tremendous growth of the size of Fannie Mae and Freddie Mac over the past decade, and their importance to the housing market, we all agree that they must have strong, independent regulation.

A couple of weeks ago, this committee heard testimony from the Secretaries of Treasury and HUD about the Administration's plans to improve the oversight of Fannie Mae and Freddie Mac, safety

and soundness, as well as their housing mission. And I believe that we have got to keep oversight focused foremost on what is in the best interests of the consumer and the market.

And given that, Freddie Mac and Fannie Mae have brought stability to the housing market. When they focus on their congressional-mandated mission, they provide a very vital tool for bringing home ownership to more Americans.

Right now, we are at a very critical point and juncture. Is it best to keep oversight in HUD or do we move it to Treasury?

I want to ask two questions, or a two-part question to each of you. First of all, have you talked with the folks at Fannie Mae? Have you gleaned the benefit of getting their inputs, since they have the congressional mandate, in terms of what would best help them to pursue their mission on this issue?

Especially in light of the second part of my question, which is that affordable housing goals for both Freddie Mac and Fannie Mae require that 50 percent of units should be built for low-and moderate-income home buyers, and 20 percent for very low-income families.

Yet, from 1998 to 2002, African-American home ownership rates only rose from 45.6 percent to 47.3 percent, less than 2 percent compared with the white average increase from 72 percent to 74.5 percent, huge gap remains.

Clearly, the mission of Freddie Mac, and especially Fannie Mae, is to close that gap.

Do you believe that the current housing goals are adequate enough to help bring African-American home ownership rates to 50 percent, just 50 percent, in the near future?

And the bottom line to this is this: Would moving the affordable housing mission to the Treasury Department weaken the focus from increasing home ownership and assisting Freddie Mac and Fannie Mae in achieving their mission?

Mr. FALCON. I think under the proposal that is before the committee, it doesn't propose moving the affordable housing goals to the new safety and soundness regulator. Those would remain with HUD.

As far as, are the goals adequate, I share your concern, Congressman, about closing that gap. I am from San Antonio, Texas, and I see that whenever I go back home.

So I think definitely companies should do all they can to try to ensure that that gap, using innovative means, is closed. We work to make sure that the means they use are safe and sound. And we have found that they do meet the safety and soundness requirement when they use aggressive means of trying to meet higher affordable housing goals.

As far as whether or not and how much they can go up, I am afraid I don't quite have the expertise to answer that question. It is better put with the office at HUD.

Mr. SCOTT. The other part of my question: Have you had conversations with the folks at Fannie Mae, and specifically Mr. Raines?

Mr. FALCON. Yes. We discuss frequently any pending regulatory matters. We haven't spoken about the housing goals, but we do

speak about regulatory matters frequently as needed. They are not shy about communicating their views to the agency.

The CHAIRMAN. The gentleman's time expired.

Mr. SCOTT. One point. May I have a little follow-up.

I just wanted to know, if I could, what was the disposition in that conversation with Mr. Raines concerning the movement to the Treasury Department?

Mr. FALCON. In our conversation we did not discuss each other's views on that point.

The CHAIRMAN. The gentleman's time has expired.

Gentleman, Mr. Raines will be on the next panel, I would say to my friend from Georgia.

The gentleman from Alabama?

Mr. BACHUS. I thank the chairman.

And I want to follow up, Director Falcon, with what Mr. Scott asked you about, and that is moving authority from HUD to the newly approved safety and soundness regulator, Treasury's proposal, as it relates to new product approval.

Now, what is your current roll, OFHEO's current role, as it deals with new product approval?

Mr. FALCON. Our role with the bifurcated system is that we are the enforcement arm of the government in respect to Fannie Mae and Freddie Mac. Even in the mission area, if HUD thought there was a need to promulgate or take some enforcement action because of a mission issue, they would come to OFHEO to promulgate the cease and desist order.

Mr. BACHUS. But what I am talking about, if they want to offer new products, if Fannie or Freddie wants to offer a new product and HUD approves that, do you have any role in that? Do they consult with you? Do you consult with them?

Mr. FALCON. Oh, yes, they do consult with us on the safety and soundness implications. The risk management of the new management, we do consult with them on that.

Our other role is, because we are the enforcement arm, if there is a clear violation of the charter, we will step in and make sure that there is no violation.

Mr. BACHUS. But I am just saying, you know, on a run of the mill, they ask to do a new product. Do you get that proposal, too?

Mr. FALCON. No, HUD will receive the proposal. We will receive information about the activity or product because we have to——

Mr. BACHUS. Okay, let us say a new product—do you consult when you see that new product proposed? Do you consult with HUD on it?

Mr. FALCON. Yes.

Mr. BACHUS. Have you ever told HUD—have you ever had objections to any new products?

Mr. FALCON. Have we? No.

Mr. BACHUS. No? So you have never objected to any new product——

Mr. FALCON. We don't see every——

Mr. BACHUS. What?

Mr. FALCON. I think we have seen every one, but I am not certain.

Mr. BACHUS. You may not have even seen some of them?

Mr. FALCON. Right. Well, I think we have seen every one.

Mr. BACHUS. Okay. But you never objected to any of them.

Mr. FALCON. No. We have raised concerns about——

Mr. BACHUS. Okay, you have raised concerns about certain new products.

Mr. FALCON. Yes.

Mr. BACHUS. As a result of you raising those concerns, was it given appropriate weight by HUD?

Mr. FALCON. I believe so.

Mr. BACHUS. Do you know?

Mr. FALCON. An example is one of the companies' investments, or an extension of the credit really, LendingTree. We consulted extensively with HUD on that activity and the implications of it.

Mr. BACHUS. Chairman Korsmo, in Treasury Secretary Snow's testimony two weeks ago before this panel, he expressed the view that leaving the Federal Home Loan Bank out of the new regulatory regime that would apply to Fannie and Freddie would place the banks, and I quote, "at a terrible competitive disadvantage."

Are you aware of his remarks? And do you disagree with the Secretary's views?

Mr. KORSMO. As I mentioned in my opening statement, I think there are so many factors at work that go into contributing to the pricing for various products that government-sponsored enterprises bring to the debt market that it is difficult to single out any particular aspect.

Just as at the Finance Board, we don't go to the Secretary for his approval on our testimony, he didn't come to me for approval on his.

But I would suggest that——

Mr. BACHUS. Well, do you believe there is any basis for him to make that statement?

Mr. KORSMO. I think it is limited at best. I think there are very few players in the agency market who make their decision as to pricing relationships on agency debt based on who the supervisor—who the supervising institution is.

That having been said——

Mr. BACHUS. You mean pricing isn't based on who the supervisor is or the level of supervision?

Mr. KORSMO. I was just going to say, I think that having been said, I think it is certainly important, and the market probably recognizes the importance of having a strong, independent regulator overseeing the function and operations——

Mr. BACHUS. So the more——

Mr. KORSMO.——but I don't think that's the key element.

Mr. BACHUS. So the more resources that the regulatory agency has, the better supervision.

Mr. KORSMO. I think that's a fair statement.

Mr. BACHUS. I think you are asking for additional resources, and presently, I think you state in your testimony that you have—your present complement is 17 full-time examiners?

The CHAIRMAN. The gentleman's time has expired.

Mr. BACHUS. Is that right?

Mr. KORSMO. Yes, sir.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Massachusetts.

Mr. FRANK. Mr. Chairman, we have got a vote. I will pass on my questions and go to my other members there and maybe we can finish up.

The CHAIRMAN. The chair would indicate—I talked to a couple of the members on this side of the aisle—we would like to dismiss this panel and then come back with the next panel.

What I would suggest is that the members recognize the gentlelady from New York. If the other members—if we run out of time, we recognize those members first when the second panel appears, if that is okay.

The gentlelady from New York.

Mrs. MALONEY. I will be very brief so my other colleagues can ask questions.

But going back to Mr. Bachus's question on competitiveness, I would like you to address one issue, the question of cost of funds, and are you concerned that if Congress creates a new regulator for Fannie and Freddie that is independent and viewed in the same league as the OCC and OCS, that it would undermine the competitiveness in regards to the cost of funds of the Federal Home Loan Bank?

And would you address, you said that you feel that everything is being regulated well, Mr. Korsmo, but the possibility that market perceptions may give an advantage to the other GSEs if they have a new sort of world-class regulator.

And very briefly, Mr. Falcon, I want to follow up on some of the questions of Mr. Baker on capital. In your testimony, you endorse allowing a new regulator to have discretion over the level of minimum and risk-based capital that the GSEs may hold.

And do you believe this because you think that it is an important tool for the regulator or because you believe the GSEs are undercapitalized and therefore are a risk in the near future?

Mr. FALCON. I will give a quick answer. I believe it is just an important tool.

Mrs. MALONEY. Okay. And, Mr. Korsmo——

Mr. KORSMO. Quick answer as well. I certainly appreciate the concern that some have expressed about the implications for Fannie and Freddie having different regulators in the Federal Home Loan Banks and the agency market.

I think any contention that it will have a significant impact, particularly given the fact that both entities will be regulated by world class regulators, I think is highly speculative.

Mrs. MALONEY. Thank you.

And I want to work with Mr. Royce on this and place in the record a synopsis of various GAO reports.

And I yield to my colleagues, Mr. Meeks and Mr. Sherman.

Mr. SHERMAN. I will take the chairman up on his offer to be among the first on the next panel.

The CHAIRMAN. I thank the gentleman.

The gentleman from New York?

Mr. MEEKS. And since I have to go to another hearing, I will try to be just real quick. As well as the fact that I am just pissed off at OFHEO because if it wasn't for you I don't think that we would be here in the first place.

And Freddie Mac, who on its own, you know, came out front and indicated it is wrong, and now the problem that we have and that we are faced with is maybe some individuals who wanted to do away with GSEs in the first place, you have given them an excuse to try to have this forum so that we can talk about it and maybe change the direction and the mission of what the GSEs had, which they have done a tremendous job.

There has been nothing that was indicated is wrong, you know, with Fannie Mae. Freddie Mac has come up on its own.

The question that then presents is the competence that your agency has with reference to deciding and regulating these GSEs.

And so I wish I could sit here and say that I am not upset with you, but I am very upset because what you do is give, you know, maybe giving a reason to, as Mr. Gonzalez said, to give someone heart surgery when they really don't need it, they need something else.

So the question, I guess, if there is a question that I have—and we don't have the time, because I want to know, really, what completely went wrong. You may have testified, but what really what was wrong and what would be needed by you. You know, you said, I think I heard you, you were talking about that if he had the same kind of powers or supervisory control as some of the big guys that maybe you can change it. But you didn't come voluntarily and say that at any point prior to the Freddie Mac incident.

So why and what can you say now so that we don't destroy the mission of these GSEs that are creating home ownership? Why should I have confidence, why should anyone have confidence in you as a regulator at this point?

Mr. FALCON. Congressman, OFHEO did not improperly apply accounting rules; Freddie Mac did. OFHEO did not try to manage earnings improperly; Freddie Mac did. So this isn't about the agency's engagement in improper conduct, it is about Freddie Mac. Let me just correct the record on that.

We don't review the accounting practices of the two companies. That is the role of the independent outside auditor. But we are going to begin to look at that going forward.

Mr. MEEKS. And you are saying—and I will stop you, because I know we have got to go vote—and you believe that just that one, by looking at the accountants—I mean, because we just had this huge corporate fraud dealing with accounting scandals, et cetera.

You are saying that then we'll give you the ability to catch any problems that may be in accounting—or otherwise. I mean, we have got to look for—and any other kind regulatory or record-keeping at any GSEs so that the American people can have confidence that there is stability and soundness—and safety and soundness in the principles, in the practices of the GSEs.

You are saying that is the sole piece that you need?

Mr. FALCON. I have been asking for these additional authorities for four years now. I have been asking for additional resources, involving independent appropriations assessment powers.

This is not a matter of the agency engaging in any misconduct.

And, yes, I think it would be better if the agency had additional resources, so that we could hire the types of people that we need, given the different activities we are going to be doing now. It is not

the role of the safety and soundness regulator to look at the application of GAAP with the GSEs books. That is the role of the auditor.

And as we have more resources, we are going to hire the type of people so that we begin to do that. Hopefully, we will try to catch these types of activities. These activities, by their nature, are concealed.

It is not easy for anyone to try to catch them. But with the resources, we are going to try.

The CHAIRMAN. The gentleman's time has expired.

The Chair thanks both of the gentlemen for your testimony, and the committee now stands in recess until 1 p.m.

[Recess.]

The CHAIRMAN. The committee will reconvene. And the Chair would like to introduce our second distinguished panel: Mr. George D. Gould, the Director of Freddie Mac; Mr. Franklin D. Raines, Chairman and Chief Executive Officer of Fannie Mae; Mr. Dean Schultz, President and CEO of Federal Home Loan Bank of San Francisco; and Mr. David H. Hehman, President and CEO of Federal Home Loan Bank of Cincinnati.

Gentlemen, thank you, particularly for your patience on the length of the first panel. The only good news is you are not the third panel.

[Laughter.]

And so you take them where you can find them.

And so again welcome.

And Mr. Gould, we will begin with you.

STATEMENT OF GEORGE D. GOULD, DIRECTOR, FREDDIE MAC

Mr. GOULD. All right, sir.

Well, thank you, Chairman Oxley, Ranking Member Frank, and members of the committee.

Good afternoon. My name is George Gould. I have served on the Freddie Mac board since 1990 and am currently the Presiding Director and Chairman of the Governance and Finance Committee. From 1985 through 1988, I served as Under Secretary for Finance at the Department of the Treasury.

I welcome the opportunity to discuss GSE regulatory oversight. Freddie Mac plays a central role in financing home ownership and rental housing for the nation's families, and given the importance of housing to the economy it is critical that our regulatory structure provide world class supervision.

But before expressing our views about regulatory restructuring, I would like to say a few words about the resolution of Freddie Mac's accounting issues and our continued safety and soundness.

In January 2003 we announced the need to restate earnings for 2000, 2001 and 2002. In stark contrast to other recent corporate restatements, we expect Freddie Mac's restatements to show a large cumulative increase in earnings for the prior years.

Timing is an issue, however, and I am disappointed to report to the committee today that our restatement will not be completed during the third quarter, as we had previously stated.

We were nearing completion of the restatement and were in the process of verifying results when we discovered a systems error.

We have isolated the underlying problem and will fix it as expeditiously as possible.

As the company stated in our June 25 press release, getting our financials right is job number one.

We are targeting to have this setback addressed during October; we plan to restate earnings in November. Whether it takes two more days or two more months, Freddie Mac is focused on getting our restatement right and regaining the trust of the Congress and the public in our financial statements.

As frustrating as these accounting issues are, let me say a few encouraging words about safety and soundness.

Freddie Mac's franchise is rock solid. Our exposure to both credit risk and interest rate risk remains extremely low.

Just today we announced that our key measure of interest rate risk, duration gap, was zero for the month of August in spite of it being a turbulent period in the bond markets. This is an outstanding example of Freddie Mac's highly disciplined approach to risk management.

Now I would like to comment briefly on the various regulatory proposals.

Over the past few years, Chairman Baker, Congressman Kanjorski and the entire committee have worked diligently to study ways to enhance our regulatory structure. I want to thank you for your hard work and I hope you will find that we have much in common.

To begin with, we support giving our regulator the authority to ensure we continue to carry out the public commitments we made in conjunction with this committee in October of 2000.

In addition, we support codifying the commitment we made last summer to register our common stock with the SEC under the Securities Exchange Act of 1934.

Freddie Mac also would support the creation of a new regulatory office within Treasury. To ensure regulatory independence, we support applying the same operational controls as apply to the relationship between Treasury and the OCC and the OTS.

We also support providing both the regulator and HUD authority to assess the GSEs outside of the annual appropriation process.

Capital adequacy is key to our ability to attract low-cost funds to finance home ownership in America. Our capital standards were developed in keeping with our charter, which restricts us to lower risk assets than banks.

Given our lower risk exposure, we agree with Secretary Snow that the GSE minimum capital requirement is adequate and need not be changed.

With regard to risk-based capital, we agree that the regulator should have adequate discretion, such as provided to federal banking agencies, but discretion should be balanced with continuity.

The risk-based capital standard, which took some 10 years to develop with our present regulator, has been in effect less than one year, and it should not be changed unnecessarily or capriciously. Until an overhaul appears warranted, the regulator should continue to apply the existing rule.

We also support continuity in our mission oversight. We believe the HUD Secretary should retain all existing GSE mission-related

authority. HUD should retain its authority to approve new programs under the same standard as in current law. HUD alone has the experience and the history to determine whether new programs are consistent with our charter and our statutory purposes.

The existing structure also works well with regard to our affordable housing goals. As mission regulator, HUD has significant discretion to establish and adjust the goals and to require the submission of a housing plan if we ever fail to meet one of them.

These are strong incentives for the GSEs to meet the goals year after year, to say nothing of the reputational penalties of failing to meet a goal.

Considering that we have consistently met the permanent affordable housing goals, additional enforcement authority seems unnecessary. Therefore, we would respectfully suggest that no additional authority is needed.

In closing, thank you again for the opportunity to appear today. Freddie Mac is safe, sound and strong.

We are prepared to support many of the provisions put forth by this committee and the Administration. A strong, credible regulator is essential to maintaining the confidence of the Congress and the public.

We look forward to working with Chairman Oxley, Ranking Member Frank, Chairman Baker and Ranking Member Kanjorski and other members of this committee as you move forward to enhance our regulatory oversight structure.

I look forward to answering any questions the committee may have.

[The prepared statement of George D. Gould can be found on page 163 in the appendix.]

The CHAIRMAN. Thank you, Mr. Gould.

And, Mr. Raines?

STATEMENT OF FRANKLIN RAINES, CEO, FANNIE MAE

Mr. RAINES. Thank you, Mr. Chairman, and thank you for this opportunity to appear before the committee. And let me as well thank the members.

Mr. Chairman, I have submitted a longer statement for the record, and I would ask that that could be included, and I can just summarize it.

The CHAIRMAN. Without objection, all the statements will be made part of the record.

Mr. RAINES. Thank you.

I want to thank you for the crucial role that the United States Congress has played and is playing today in building and sustaining and constantly improving the best housing finance system in the world.

Fannie Mae is proud to be at the core of this remarkable system. And I am here today to ask Congress to take action to make this remarkable system even better by supporting the Administration's proposal to move our financial regulator to become a bureau within the U.S. Department of the Treasury.

The Administration's proposal would help ensure that Fannie Mae and Freddie Mac have a strong, well-funded, highly credible financial regulator.

We support the Administration's proposal for three reasons.

First, we support having a strong, well-funded, highly credible financial regulator. Having a strong regulator is in the best interest of housing and housing finance, the best interest of investors and the markets that supply private capital to housing through Fannie Mae, and in the best interests of Fannie Mae and our stakeholders.

Second, the Administration's proposal supports our charter, mission and status, including our freedom to continue to innovate with our lender customers and housing partners to expand affordable housing to new people and places.

And, third, the Administration's proposal supports the advanced capital structure Congress provided in 1992, which ensures that we remain safe and sound through even the worse economic conditions, while allowing us to direct the maximum amount of low-cost financing to home buyers.

Fannie Mae looks forward to working with Congress and the Administration to see the proposal enacted into law this year.

I believe that strengthening our financial regulator is the next natural step in a sequence of congressional actions to advance the success of Fannie Mae, a sequence that began 65 years ago.

In 1938, with the blessing of Congress, the Federal Government created Fannie Mae. The purpose was to ensure a nationwide flow of low-cost mortgage capital to all communities, at all times, under all economic conditions and to make the long-term fixed-rate refinanceable mortgage available nationwide.

At the time, local housing lending was limited primarily to local bank deposits and the long-term, fixed-rate mortgage was a novel idea.

Today Fannie Mae is one of only two companies in America to guarantee the nationwide flow of low-cost mortgage capital at all times, even when other suppliers of mortgage capital cannot or choose not to provide such capital.

And the long-term fixed-rate mortgage is the standard home loan in America, the financing choice for 80 percent of homeowners and the most consumer friendly loan available.

With this financing, home buyers can lock in a low mortgage rate for the life of the loan. And if rates go down, they can refinance their mortgage and lower their monthly payments.

Three decades after creating Fannie Mae to ensure this nationwide flow of consumer friendly mortgages, Congress took a bold step to vastly enhance Fannie Mae's worth.

In 1968, Congress privatized Fannie Mae, creating a private, shareholder-owned corporation with a charter and a public mission of expanding home ownership by raising private capital.

Privatizing government functions was a novel idea at the time, but privatizing Fannie Mae has proven to be a resounding success and a model of marshalling private capital to achieve a public purpose, in this case the goal of expanding home ownership.

In its 30 years as a government agency, Fannie Mae had built $185 million of retained earnings, and in 1968, financed $6.8 billion in mortgages.

But after 35 years as a shareholder-owned company, Fannie Mae has amassed over $30 billion of private equity capital to finance $2 trillion of mortgages today.

In the process, Fannie Mae has helped over 50 million American families become homeowners, saved homeowners an estimated $5 billion in mortgage costs annually, and helped to make a low down payment mortgage the industry standard.

In 1992, following the thrift crisis, Congress revisited our charter, reaffirmed its commitment to our mission and updated our regulatory structure.

This framework set specific affordable housing goals, created an independent financial regulator with constant on-site supervision and established a rigorous two-part capital framework that a decade later is still more advanced than that of other financial institutions.

Since then, Fannie Mae has met or exceeded every requirement of our updated regulatory framework. Every year, we have met or exceeded our affordable housing goals, even as they have increased. Last year, 62 percent of our total business served low-or moderate-income families or underserved communities or both.

In 1994, we launched our trillion-dollar commitment, a pledge to provide $1 trillion in financing for 10 million underserved families before the decade was over.

In 2000, after we met this pledge, we launched a redoubled new pledge, our American Dream Commitment, to provide $2 trillion for 18 million underserved families before this decade is over.

We also set a voluntary goal: to lead the market in serving minority families. We pledged to provide $420 billion to help serve 3 million minority families. And when President Bush challenged the private sector to help create 5.5 million new minority homeowners by the end of the decade, Fannie Mae boosted our pledge to $700 billion as part of a 10-point plan to support the Administration's initiative.

As we expanded home ownership and our service to the market, Fannie Mae also met or exceeded the safety and soundness requirements of the 1992 act. In 2000, we adopted six voluntary initiatives to enhance our liquidity, transparency and market discipline.

In March of this year, we became a permanent SEC registrant and are now subject to the same corporate disclosure requirements of other SEC registrants.

Today we meet every requirement of the Sarbanes-Oxley legislation. Both Standard & Poor's and the Corporate Library have named Fannie Mae among the best companies in the nation and the world for corporate governance.

And since 1992, Fannie Mae has met or exceeded our capital requirements in every year. Indeed, we are one of the best capitalized financial institutions in the world, when compared to the risk of our business.

Our senior debt of course is rated AAA. Standard & Poor's risk-to-the-government rating is AA minus. Moody's rates us A minus on a scale where A is the highest rating in their ratings of the financial strength of international financial institutions.

These letter ratings rate our stand-alone financial strength in the absence of government support. These ratings make us one of the highest rated financial companies in the world. We are financially strong, because for every $2 in debt and liabilities, we have $3 in capital, collateral and mortgage insurance to back it.

Finally, if you look at Fannie Mae's capital under extreme conditions, we compare even more favorably with other financial institutions of our size.

Thanks to the periodic improvements Congress has made to our regulatory mechanism, Fannie Mae serves to reduce systemic risk. If we don't hold mortgages, some other investor, one with greater credit losses, a weaker hedging strategy, a lower credit rating and perhaps taxpayer-backed deposits at risk will have to hold them.

Now Congress is reviewing our regulatory framework a little more than a decade after the 1992 act, and I am heartened to see that there is a general consensus that everything Congress did to advance our charter, mission and status in 1992 has worked very well, and in many ways better than anyone could have imagined.

Indeed, what has emerged is a consensus not to change our charter, mission or status, but to ensure that these world class companies have a world class financial regulator and to do no harm to the best housing finance system in the world.

The Administration's proposal would modernize our financial regulator while protecting the housing finance system. Thus it would continue to advance the success of Fannie Mae well into the new century.

We estimate there will be 30 million more people and 13 to 15 million new households in this country by 2010. Demand for housing credit will grow by $6 to $7 trillion by that time. We need to have in place a regulatory structure that helps us meet that demand.

Fannie Mae urges Congress to adopt this proposal.

Thank you very much, Mr. Chairman.

[The prepared statement of Franklin D. Raines can be found on page 197 in the appendix.]

The CHAIRMAN. Thank you, Mr. Raines.

Mr. Schultz?

STATEMENT OF DEAN SCHULTZ, PRESIDENT AND CEO, FEDERAL HOME LOAN BANK OF SAN FRANCISCO

Mr. SCHULTZ. Thank you, Mr. Chairman, members of the committee.

I appreciate very much the opportunity to speak to you today on what I consider to be a very important issue.

I would like to start by making the simple point that I truly believe in the function of the GSEs. Using private capital, achieving a public purpose through this structure has benefited millions of Americans in home ownership.

I refer you to David Hehman's testimony on the size, strength and characteristics of the system and its ever-increasing role in American housing finance. The contribution is simply too large to put at risk.

I am here to testify before you on a bill to move regulation of Fannie Mae and Freddie Mac and the other housing GSEs to a new regulator, an independent regulator, organized in the Treasury.

The idea of that legislation is to enhance and improve regulation; it is not to change GSE charters, but to enhance and improve regulation. I view this as an opportunity for you and for us to include the Federal Home Loan Banks.

If the banks are not included and the bill goes forward, I believe the banks are potentially put at risk and will have missed an opportunity to enhance our regulatory structure. The risk will come about because the market may—not will, but may perceive a difference, a lessening of our GSE status, and reflect that in our cost of funds.

That would place our mission accomplishment at risk.

The ability to raise agency funds is critical to our ability to relend those funds to our members.

I know there are arguments—people want to wait until there is a better market, a better set of market conditions, or there is less contention in the system about moving forward. There has always been contention in the system, and legislation has passed in the past notwithstanding that contention. And waiting for markets to change to an appropriate condition is nothing I have ever been successful at, but perhaps you have.

Thank you very much for your giving me this opportunity to make these brief remarks, and I look forward to your questions.

[The prepared statement of Dean Schultz can be found on page 229 in the appendix.

The CHAIRMAN. Thank you, Mr. Schultz.

Mr. Hehman?

STATEMENT OF DAVID HEHMAN, PRESIDENT AND CEO, FEDERAL HOME LOAN BANK OF CINCINNATI

Mr. HEHMAN. Mr. Chairman, Ranking Member Frank and members of the committee, I truly appreciate the opportunity to testify before you today.

My name is David Hehman. I am President and CEO of the Federal Home Bank of Cincinnati.

The Federal Home Bank System consists of 12 regional banks and over 8,000 member financial institutions that play a vital role in the nation's housing finance and community lending system.

The bank system is a unique GSE. While the system shares a congressional charter and housing mission with Fannie Mae and Freddie Mac, the Federal Home Banks are fundamentally different in both structure and perspective.

The 12 regional banks and their members form a cooperative that is driven by customer credit demand, not profit maximization.

And while the 12 banks are independently owned and operated, they share joint and several liability for the system's debts. This leads to low-risk, not risk-free operations that have been well supervised under the current independent regulatory regime designed by the Congress.

Two critical pieces of legislation shape today's home loan banks. The Financial Institutions Reform, Recovery and Enforcement Act of 1989, FIRREA, expanded membership to include commercial banks and credit unions with a demonstrated commitment to housing finance. FIRREA also created the system's Res. Corp. payment and mandated the affordable housing program through which each bank sets aside 10 percent of net earnings annually for the creation of affordable housing throughout the nation.

That commitment has resulted in $1.7 billion of private capital flowing into the housing market to create 380,000 units of affordable housing.

Title VI of the Gramm-Leach-Bliley Act of 1999, sponsored by Congressmen Baker and Kanjorski, established universal voluntary membership, provided for a more permanent capital structure, expanded the types of collateral the community institution can pledge to secure advances, and increased the independent corporate governance of each bank.

Six banks, including Cincinnati, have implemented newly required capital stock plans. This task has occurred well within the legislative time frame and is due in no part to the strength of the system's independent regulator and the commitment of the board of directors of each Federal Home Loan Bank.

A financial snapshot of the Cincinnati bank I hope would be instructive to understanding how and why the cooperative structure is successful.

The Cincinnati bank is comprised of 750 members, serving Ohio, Kentucky and Tennessee. As of June 30, 2003, Cincinnati reported $47 billion in advances outstanding to its members, $7 billion in acquired mortgage assets, and $144 million in affordable housing program grants invested in the creation of 25,000 units of housing.

These are not just numbers; these are telecommunications jobs in central Ohio, the thousandth Habitat for Humanity house in Kentucky, which we dedicated last weekend, a small home improvement loan in Memphis that combats predatory lending, and 25 community-based financial institutions that are now able to sell mortgages into the secondary market.

My job as President of the Cincinnati bank and the job of my board are to ensure the success of this cooperative partnership. Our role at linking Main Street to Wall Street demands the flexibility to access the capital markets we now enjoy.

Bank advances are a critical component of the asset liability management of our community-based financial institutions, as evidenced by the fact that approximately three of every four members have borrowings outstanding at any given time.

The combination of our congressionally determined financial requirement, an independent regulator, engaged boards of directors and extensive risk management tools have proven to be a successful model.

However, adherence to this model does not mean we are adverse to change. The Cincinnati bank wants to do what is best for the financial quality of our institution and by extension the public it serves.

At its regularly scheduled meeting last month, the Cincinnati board of directors concluded that it was in the best interest of shareholders and the public served to retain the present independent regulatory structure for the bank. The structure and performance of the Finance Board has resulted in 12 healthy, AAA rated regional Home Loan Banks that currently support $500 billion in credit activity serving virtually every neighborhood in America.

At the same time the Cincinnati board affirmed its support of our independent regulator, it also directed management to begin

immediately the process of registering its stock under the Securities Exchange Act of 1934. And that process has indeed begun.

The Cincinnati bank strongly believes that registration of its stock with the SEC is the best method to provide both bond and stock investors the necessary financial information they require to assess the condition of the Federal Home Loan Banks.

My board and I believe that these two decisions are consistent and complementary of one another. We are confident the financial markets will continue to recognize that the Federal Home Loan Bank System consists of financially sound, conservatively managed, well-capitalized institutions.

In conclusion, the Federal Home Loan Banks are strong, conservatively run enterprises who have never experienced a loss on a loan to their member institutions.

The bank system's current independent regulator is best positioned to provide safety and soundness, as well as mission oversight for our cooperative enterprise.

Mr. Chairman, thank you for the opportunity to address the committee on this matter and I would be happy to answer any questions when so desired.

[The prepared statement of David H. Hehman can be found on page 173 in the appendix.]

The CHAIRMAN. Thank you, Mr. Hehman, and thanks to all of the witnesses.

Let me begin with Mr. Raines.

There have been a lot of discussions prior to this hearing about new program approval. I wonder if you could take the committee through that process for us and explain how that works with the regulators working with Fannie?

Mr. RAINES. Well, thank you, Mr. Chairman, for the opportunity to do that, because I think there has been some confusion about how the process in fact worked.

This committee—and the chairman of this committee—and then the Congress defined very clearly in the 1992 Act what the standard was. And that was, we were expected to innovate.

However, if we had a new program, something that was substantially different from what we had done before, we had to get prior approval from the Secretary of HUD before we could do that.

But we were told specifically in the legislative history that that the approval process did not apply to products, it did not apply to new processes, and it didn't apply to new products under already approved programs.

And what has happened since then under multiple Secretaries of HUD is that we have in fact had interactions with HUD as to new things that we are doing and keeping them informed.

And on some occasions, they have indicated they thought something we might be doing was a program. In other cases we brought to them something we thought might be a new program.

An example would be energy efficient loans. Congress asked Fannie Mae to do energy efficient loans back in the early 1980s. It wasn't until the 1990s that we figured out how to do it. And we took that to HUD ourselves and said we think this is a new program, even though Congress has specifically authorized us to do it, and we believe that it requires your approval.

The CHAIRMAN. Was that in the energy bill in the 1980s?

Mr. RAINES. It was in the energy bill in the 1980s. One of the things that the Congress did was look to Fannie Mae to help produce energy efficiency in the residential housing sector.

And so what happens in that process is that when HUD either determines on their own that it is a program or we suggest it is a program, they then have to make a determination, based on the legislative history which is to encourage innovation, to see if it meets our charter and if it is in the public interest.

And over that time, HUD has made decisions in a number of cases either that something wasn't a program or that if it was a program, that they would approve it.

And so this has actually been a dynamic process. Some had defined this as somehow that HUD was not carrying out their role.

If anything, our concern is that the process has been more restrictive on innovation than we think it should be or that we think Congress thought it should be, and that from time to time HUD has used their role to limit the development of new products in ways that we think are not helpful to the expansion of affordable housing.

But certainly this has been a dynamic process and not one that is by any means an inactive provision of the charter.

The CHAIRMAN. So it has not been a rubber stamp? There have been cases where you have actually been turned down for a new program approval?

Mr. RAINES. Yes, HUD has in fact indicated that they would turn things down. And, quite frankly, if we thought in our interactions with them that they thought it was inappropriate, we wouldn't go ahead and propose it.

So you have had the normal back and forth between the regulatee and the regulator in the definition of this, and I stress, through multiple Administrations and multiple Secretaries of HUD.

The CHAIRMAN. Is it true to say that there are some new programs potentially that could cause a safety and soundness issue?

Mr. RAINES. Well, there certainly could—you can imagine our trying to get into some area that could cause a safety and soundness issue. And that is one of the things that HUD would have to determine at the time.

The current process by which that is done is that HUD would consult with OFHEO and get their advice as to whether it caused a safety and soundness issue.

Although, typically, in most of these, it comes to a question of capitalization. OFHEO would typically look at an activity and say because of its risk, you have to have more capital, as opposed to simply saying there is no way you could possibly undertake that activity.

The CHAIRMAN. Well, this committee may be faced with an issue as early as next week in terms of the markup and trying to determine how we deal with the program approval, at the same time deal with the safety and soundness, because, as you know, the Treasury proposal is very heavily tilted towards Treasury and that whole milieu of issues.

And at some point we are going to have to wrestle with how we balance that between Treasury in the safety and soundness issue, which I think that is the gut issue has been decided, I think, my sense is, but the other issue in terms of the programs is still kind of out there.

From your perspective, and having experience in that area, what would you suggest?

Mr. RAINES. Well, we have had extensive discussions with Treasury as to what their rationale is for a change. And I have to say that our focus in discussions with them and with others has been more on what the decision-making criteria are, as opposed to the location.

It is far more important, we believe, that wherever the authority lies, that Congress make it clear that the intention is for the company to innovate.

And within the context of the Treasury discussions, you know, they have indicated to us that in fact they believe that a prior approval regime isn't necessary at all, that they believe that that isn't a requirement. And that has some attractive features obviously from the point of view of innovation.

However, we have been also talking to a wide range of our friends in the housing industry who have a very substantial concern that putting together the approval of our new program activities with the safety and soundness regulator might have a detrimental impact on housing. And we share a lot of those concerns.

And so I would say to you, Mr. Chairman, that from our standpoint, wherever the committee decides to physically locate it, the most important issue is that there be a standard that encourages innovation and that we not ignore the fact that it has been through innovation that we have been able to serve more and more people.

It is not from just doing that same plain vanilla 30-year fixed-rate mortgage we started doing in 1938. It is by having new programs, with low down payments, and with the ability to deal with people with impaired credit and other innovations that have really allowed us to expand affordable housing.

The CHAIRMAN. Are you suggesting the innovation standards be in the statute?

Mr. RAINES. We believe that the regulator, whoever it is, should have a Congressionally determined standard as to on what basis could they turn down innovation. We have no question that on a safety and soundness basis if it were deemed not to be safe and sound, no question that the regulator, whoever it is, should be able to turn that down.

But that has rarely been the issue. The issue has been more likely that someone doesn't want innovation because sometimes innovation means cutting cost. Sometimes innovation means new products coming in, competing with old products. And sometimes those who support the old products don't see it as an innovation, they see it as an invasion of their turf.

But just as the antitrust laws aren't there to protect competitors; they are there to protect competition. And we believe that the new program approval authority should be there to protect consumers and not to protect competitors.

The CHAIRMAN. Mr. Gould, do you have any comments in that regard, from the Freddie standpoint?

Mr. GOULD. Well, we feel, as I think Mr. Raines has suggested, that HUD has had a long experience in determining mission and programs, whereas the Treasury has not had that background. The Treasury would be very satisfactory to us in terms of safety and soundness, that is something that is their focus and I am sure that they would do well. But the expertise that HUD has developed, the history that HUD has had, makes us inclined to have those powers remain with HUD.

Now, yes, I think it is important what the criteria are. That obviously is really a threshold question. Whether one can codify those criteria I think is another matter. There has been a long evolution of the method of financing in the housing market, which has benefited the homeowner and has benefited the consumer in that respect. A lot of that has been innovation that we would be anxious not to stultify people's imagination as to what products or programs could be created as long as they are safe and sound.

I am not convinced that when one writes laws, that one can anticipate the future to that degree, and I think there has to be discretion left to the regulator.

The CHAIRMAN. Well said.

The gentleman from Pennsylvania?

Mr. KANJORSKI. Thank you, Mr. Chairman.

Speaking of innovation, I suspect if there hadn't been innovation on accounting processes, we wouldn't be here today, Mr. Gould.

Just to take a second of your time, I talked to another member of Congress who is holding a hearing on the Freddie Mac problem, and it seems that monies were transferred for a very short period of time with investment bankers for the purposes of not showing the income in a particular time frame, but to spread the income over a period of time.

And in private corporations, I know they do that on a regular basis, but whether or not with your special feature, having at least in the marketplace the implication of full faith and credit of the government, whether we like the idea that there is so much attention being paid by the board or the corporate family as to what profits look like and for reasons that I am trying to determine in my mind, why is the board so worried whether or not there are spikes in income.

And only potentially suggesting—I won't ask you to answer it—as we get into corporate governance and since we know salaries sometimes are determined on options and benefits, the motivation could easily be questioned here as to why Freddie Mac got into this difficulty.

But all that being said, I can't wait until we are able to get your responses up here to tell us what really happened.

Mr. GOULD. Well, there are a number of ways to look at it, depending on where one is coming from in a sense. I think it is worth stepping back and saying what the issue is here. And its most fundamental characteristic is the timing of the recognition of income.

What our new auditors have disagreed with, to some extent with the old auditors and to some extent with Freddie Mac's own policies, was when to recognize income that wasn't created out of air,

but in fact existed—this is not an Enron, this is not a WorldCom. The question was whether that income should have been recognized in earlier years or whether it should be spread out in many cases over the life of an asset. And that is really where the issue has taken place.

Now, Generally Accepted Accounting Practice is a must. There is no doubt that Freddie Mac and any other company should adhere to the rules of GAAP. Some of the more recent ones that had to do with derivatives, so-called FASB 133, are relatively new, there is some difference in interpretation that has gone on, and there is not a lot of precedent in history.

Nonetheless, we must adhere to GAAP. But there was a feeling on the part of Freddie Mac's former management that GAAP alone did not reflect the underlying economics of Freddie Mac's business. Freddie Mac was a much steadier vehicle, and sometimes the way things had to be reported, marked to the market as influenced by interest rate fluctuations, made it appear that there was more volatility than was inherent in their basic business.

And as best I can determine, I think that was a driver here in some of the attempts that were made.

Now not adhering to GAAP simply cannot be allowed to happen. But there was I think on the part of former management, who did make their mistakes, but who also had a genuine concern as to how best to represent the company's underlying earning power and nature to the public market.

Mr. KANJORSKI. I am looking forward to those explanations.

I do want to get to Mr. Raines, though. I looked at your testimony, and you don't seem to use the same magic words as the Secretary of the Treasury: strong, independent, world class.

Is that for the particular reason that maybe you agree with the Treasury and how they use independent is not necessarily independent?

Or maybe I should frame it in a direct question: What would you have against your regulator being unfettered and coming to Congress and being able to speak without having prior vetting by the Secretary of Treasury?

And, two, why do you consider, with your large institutions, it is important that the Secretary of the Treasury work on the policy matters for the regulator and why we can't have a separate policy decision made by the regulator?

Mr. RAINES. Well, Mr. Kanjorski, as to the language, I thought you and the Secretary explored the language quite well when he was here with you last time, so I didn't think I could add anything to that.

But to your specific question——

Mr. KANJORSKI. Well, do you want an independent regulator that doesn't get vetted and that doesn't have his policy reviewed by the Secretary of Treasury or not?

Mr. RAINES. Well, I think there were three issues that you discussed with the Secretary, and let me just discuss each of those three that go to independence.

One of them had to do with the finances of the regulator. We believe we should have a well-funded regulator; but we don't believe that anyone should have unfettered ability to set their own budget

without anyone looking at it. Within the banking context, that is regulated by the fact that banks can change regulators and so there is a constraint on how large their budget can be.

We would be the only one who would have a regulator who could set an unlimited budget. So we do not favor independence if it means that there is no one looking at the budget.

As it goes to regulation and independence, my understanding is that currently our regulator's regulations are reviewed by OMB and so that would not be a change on that.

On the issue that you specifically raised about testimony and about policy, that to me is an issue solely between the Congress of the United States and the Treasury Department. We have no view as to the resolution of that. And I understand the views of Congress, that you want an unfettered approach, and I understand the views of the Department, but we have no views as to how to resolve that third issue.

But on the first issue, we do have a point of view; on the second issue we think it is the status quo; and on the third issue, I think it is simply up to whatever the will of the committee is as to how you want to resolve that.

Mr. KANJORSKI. Mr. Raines, you are certainly well familiar, as a former Director of OMB, do you have review rights over OCC? Did you at the time?

Mr. RAINES. You know, I don't remember. I don't remember whether—and it may depend on the nature of the regulation, but I just don't remember whether OCC had to go through the OMB process.

Mr. KANJORSKI. I appreciate that. We will have to examine it.

Can I just ask one more question of our Federal Home Loan?

Obviously we have a difference of opinion here. The question is always arising, Mr, Schlutz, you referred to it in your testimony, there may be a difference in the interest rate and the market may look at your credit instruments in the future with a different eye as opposed to Freddie and Fannie. And that obviously worries you. But you said "it may." You were very careful not to use "it will." And I appreciate that.

Do you have that same fear, that there may be some difference in how the credit markets look at your paper as compared to Fannie and Freddie and could it put you at a disadvantage, Mr. Hehman, or do you feel that the system will work that out without a problem?

Mr. HEHMAN. I think the financial markets will work that out. I am not as concerned as some other folks who have speculated that our funding costs will change.

I think what is most critical is that we have good, solid reporting, and in our case we think that is through the SEC. And we think the financial markets will look at the underlying risk of the institution, its capital levels, its interest rate risk and so forth, not necessarily to whomever the regulator may be. So I am not that concerned about it.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Oklahoma, Mr. Lucas?

Mr. FRANK LUCAS OF OKLAHOMA. Thank you, Mr. Chairman.

And like all of my colleagues, I share those concerns about safety and soundness.

Mr. Raines, in particular, one of the challenges of being from Oklahoma and having a state with a tremendous amount of cultural diversity, people from every continent, by historic and ethnic origin, as well as 39 recognized Native American tribes, is that we have particular challenges when it comes to housing issues. And your folks have been very aggressive, very successful in my tenure in Congress in doing things to help facilitate efforts to address those kind of issues.

Could you for a moment speak to the issue that probably I think gets to the core of what a lot of us are concerned about, and that is the questions as addressed earlier about how the proposed legislation would affect your ability to create those new opportunities? Thinking about my Native Americans in Oklahoma, how would this legislation, this proposal as you understand it, impact those efforts?

Mr. RAINES. Well, Congressman, depending on how the committee writes the bill, it can either accelerate our ability to innovate or it can basically turn us into another stultified bureaucracy.

And I say that advisedly. We have 54 partnership offices around the country that we established for the sole purpose of working closely with local communities to try to bend our national programs to fit local circumstances.

And we have been remarkably successful in doing this and able to innovate, whether it is on Indian tribes and now that we are one of the only people who will buy mortgages on Indian reservations that are governed solely by the Indian judicial system, or whether it is in New Orleans where we are one of the first people to try to help them to move housing from being very small, shotgun class, into housing that moderate income and working people could own, all over the country.

But we have been able to innovate because we as a private company could say "yes" within the time frame that people needed.

But if, on the other hand, every time we had a new idea, a new activity, a new product, we had to go and get prior approval, that would not only slow the process down, I think it would discourage us from even trying because by the time we got it done, all of our partners would have been frustrated by our lack of ability to respond.

So a lot hinges on how it is written. And I think if it is written as I am thinking Congress intended in 1992, to encourage innovation, under a broad set of programs that had been approved, then I think we can continue to make an enormous amount of progress.

On the other hand, if we go backward and change the standard and make it so that if every time we change a process or an activity then that has to be approved, then I think it will bring innovation within the housing finance industry to a screeching halt.

Mr. LUCAS OF OKLAHOMA. Well, I appreciate that. And certainly of my 39 tribes, 16 of which are in my congressional district, every one has a different tribal charter, a different governing system, a different perspective. Most have uniquely different courts, tribal courts to work within. I appreciate that.

I think, Mr. Chairman, I would like to yield back the rest of my time at this time.

The CHAIRMAN. Gentleman yields back.

The gentleman from California, Mr. Sherman?

Mr. SHERMAN. Thank you, Mr. Chairman.

I think we all agree we need the strongest possible regulator of the financial soundness of the housing GSEs. And I think that we all agree that Treasury would be the entity that the markets would respect the most. That is why I am glad we are having a hearing and hopefully a markup of H.R. 2575, which is the subject of this hearing.

I am concerned, and I will ask the panel to bear with me on this, but this is a special concern, I think, for many of you, but especially from anyone from California, that H.R. 2575 currently still contains section 110, which would lower the conforming loan limit on single family units from $332,000 to $275,000. And that would be an anathema to those of us from high cost areas, including Los Angeles.

Now, I am told that it is the plan of the authors to delete that provision and I hope very much that that occurs. However, if it does not occur, then I think it would be germane for me to offer an amendment to raise the conforming limit in those states that contain a standard statistical metropolitan area in which housing prices on median exceed $322,000, or whatever the conforming loan limit is.

I am going to be leading up to a question here. But I will be interested to focus on not who should be the financial soundness regulator, but which entity should give new program approval to the housing GSEs.

I fear that if we take that away from HUD, it would be like taking the "H" from HUD and we would have to rename it UD, because housing would no longer be its province.

I understand that new programs may raise safety and soundness issues. So if HUD approved the new program, Treasury could then step in and say well, that is a riskier program, here are the reserves that you need. That is the proper purpose of a safety and soundness regulator.

But if the mission of developing new types of mortgages that will help those, say with tarnished credit histories, get financing, if that is moved over to an organization whose mission and expertise has nothing to do with getting people, particularly first-time home buyers into housing, I think that would be a problem. So I hope that we can keep the "H" in HUD.

Now, currently HUD does have as its primary responsibility, Mr. Raines and others for a oversight mission and it is their responsibility, as I have said, of approving new programs.

You have indicated that you support the Administration proposal to bifurcate these mission oversight duties, which would, as I have stated, result in HUD retaining its goal of providing affordable housing and Treasury would be the primary regulator of financial soundness.

Perhaps, Mr. Raines, you could explain why would it make sense to split these two functions? And do you think that HUD has more expertise in your mission goals of providing housing to, and particularly home ownership to those who currently don't own their homes?

Mr. RAINES. Well, I certainly believe that HUD does have that expertise. And we have been a partner with HUD over many years in working together to try to expand the availability of affordable housing. So clearly HUD has the housing expertise within the Federal Government, no question about that.

And that is why we are very focused on the issue, from our standpoint, of what the standard is on deciding as opposed to the geography of who decides. For us, if the wrong standard is there, we wouldn't want it in HUD. If the right standard is there, then we are open to where it can be. And ultimately, obviously, this committee is going to have to make up its own mind about that location.

But we don't see any magic in it being in one place or the other. There is nothing that is going to make it better by moving it to Treasury ipso facto. The question is what the standard is and how will that authority be used and will it be used to encourage innovation or will it be used instead for other purposes?

Mr. SHERMAN. So HUD has as its mission a dedication to providing affordable housing and home ownership to those who otherwise wouldn't have it. It has the expertise to evaluate your new programs to see whether they achieve that goal. And yet you are an agnostic on whether the agency with the mission and the expertise would have that as its function. I, however, am a true believer that we should keep the "H" in HUD.

And I yield back the balance.

The CHAIRMAN. The gentleman yields back.

The chair recognizes the gentleman from Louisiana, the chairman of the Capital Markets Subcommittee.

Mr. BAKER. Thank you, Mr. Chairman.

Mr. Gould, in your testimony you have a statement that says, "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 the safety and soundness oversight."

Beginning with that, I assume that absent the issue of capital and new product approval, using the Treasury testimony as your point of reference, do you generally support the proposal as outlined in the hearing before the committee by Treasury? Or are there issues of concern beyond capital and new product approval that you would like to bring to our attention for the committee's consideration?

Mr. GOULD. Well, again, there has been great deal of conversation on the earlier panel of independence. I think if one used the model of OTS or OCC, we would find that certainly to be acceptable given the independent decision-making. It wasn't totally clear to me from Secretary Snow's testimony whether that model was being totally followed. But that is what we would think is the proper way to do it.

And we stick with HUD on the mission because they have had experience, they do have perspective. That is their job. The Treasury has had no background in that. And it certainly is necessary to make sure that it is not restrictive, as opposed to allowing innovation.

But nonetheless, there is an agency that is experienced. And I think it is fair to say that Freddie Mac's experience working with HUD in that regard has been quite satisfactory.

Mr. BAKER. Thank you.

Mr. Raines, you have a similar comment in your testimony about the advisability of an independent regulator being constructed. Are their other issues on your list beyond the capital question and the new product approval or perhaps the independence issue that you would want to bring as concerns with the Treasury recommendation?

Mr. RAINES. Yes. The other item that we have emphasized is that our experience with our Presidential directors has been a good one. And it would be our preference to keep them as members of our board. And so I think that is a difference with the Secretary's proposal.

But fundamentally, with regard to no change in our status, in our charter, in our mission, we are in agreement with the Secretary.

With regard to capital in terms of no statutory change in minimum capital but more flexibility for the regulator with regard to risk-based capital, we are in agreement with the Secretary.

And as we just discussed, where it comes to innovation in housing, the key has to be to make sure that innovation in housing can occur. And if a standard can be established on that, then I think that probably we could get broad agreement in terms of location.

Mr. BAKER. Well, my reason for the question is we have a platform from which we can begin to construct an effort, and identifying those areas where we have outstanding differences are, I think important because by and large there is broader agreement than one might first perceive on the necessity to move forward with a new regulatory structure.

Some members today have questioned the advisability of any change in current regulatory form. And I wanted to have both your perspectives that you do believe it advisable, assuming that Congress conducts business properly from your perspective, absent those identified issues on which there is some concern on your part.

With respect to the Secretary's position on minimum capital, I asked an initial question during the hearing to which Mr. Ney asked a follow-up question.

There was another person just before the hearing concluded. I would like to read my question and the Secretary's response.

"Just for point of clarification, Mr. Secretary, on the capital issue, I understand the position currently is that we do not seek nor do we expect to change any capital standard immediately on establishing whatever this regulatory body would look like."

But coupled with that is the statement, "We do not, however, wish to limit our authority to change capital standards as we see fit both with regard to minimum or risk-based, based on staff analysis of risk assessment of the institution's leverage, or whatever standards you may choose to use. You do not want to have a regulatory system that constrains your ability to act in the public interest."

Secretary Snow: "That is right. That ought to be the decision of the regulator."

Now subsequent to that, there was a request by somebody to clarify further, and there was another statement issued relative to the capital standard issue.

"The Administration is not proposing legislation itself change any capital standard"—that is a point I agree with.

"We also are not suggesting that the statutory minimum capital of 2.5 percent be changed"—I agree with that.

"We are recommending that the new agency have full, more flexible authority over setting risk-based capital standards"—I agree with that.

So I guess our only point is, if we are not going to change minimum, do we construct a new regulator like every other financial regulator of every other financial institution who has that tool in his resume, recognizing that we are not going to change the minimum capital standards, but if risk profiles change and there is a need to change it, why should we have to come back to the Congress in order to adopt a minimum capital modification?

And I am out of time, and he is ready to push a button, so let me throw one more thing.

If we were to——

The CHAIRMAN. Was that a rhetorical question?

Mr. BAKER. I am just still kind of continuing the same question, because I figured you might cut me off if I stop and said this is question two.

So continuing in defining that question: If we were to take the advice of Mr. Royce and others and roll the Home Loan Bank System into a new single regulator, what would be the Federal Home Loan Bank's view of adopting your capital standard, which some bright legislators a few years back came up with this class A, B stock, where if you are class A you have to have 5 percent, class B, 4 percent, if you are blended somewhere between that.

Would you, based on your operational experience and your ability to make credit available to your customers and your ability to move in the markets, have you found that capital standard to be an inhibition to your success—either one of the Home Loan Bank folks—and would you recommend to us that if we were all together, everybody would have the same capital standard?

Mr. SCHULTZ. Speaking for myself, we have not found operating under the capital standard in the Federal Home Loan Bank Act to be a problem. I think as capital plans diverge as a result of the changes after Gramm-Leach-Bliley we may see competitive differences emerge among the banks. But the capital standards remain the same for all the banks and they have not been a problem.

Mr. BAKER. Mr. Hehman, do you want to respond?

Mr. HEHMAN. I would agree with that.

We have implemented our capital plan, Congressman. It is working. It is working quite well. And we think it is an appropriate level of capitalization for our balance sheet.

Mr. BAKER. Mr. Raines, do you want to respond?

Mr. RAINES. I wanted to respond to the first part of the compound question——

Mr. BAKER. Briefly.

Mr. RAINES.——which went to the Treasury's position on capital.

And I think having inquired of them very carefully as to what their position is, I would like to be sure that we don't have a misunderstanding.

My understanding of the Treasury's position, as they have reiterated it, is that they do not support a change in the statutory level of minimum capital. They do favor additional flexibility for risk-based capital. Therefore, the regulator would not be able to change the minimum capital standard, but could change the risk-based capital standard.

And the reason they would change the risk-based capital standard is if risk changed. So if an event occurred, then you would change the risk-based capital standard. There would be no reason to change the minimum capital standard because of a risk reason.

So the only reason I can imagine to change the minimum capital standard is that if you want to reduce the level of activity that we can carry out. And right now, our minimum capital standard is about 400 times our losses. The bank minimum capital standard is more like 50 times their losses.

So I would be concerned about a provision that said that they could change the minimum capital standard without Congress's approval, because that is a question that goes to how much you want us to do. The risk-based capital standard goes to how we handle the risk.

So I believe that we and the Treasury are in absolute agreement on that, that in their proposal, there is not a proposal to allow the regulator at a later date to change the minimum capital standard.

Mr. BAKER. Mr. Chairman?

The CHAIRMAN. The gentleman's time has expired.

Mr. BAKER. Just one further caveat: There is just an honest dispute here. I have had lengthy discussions with Treasury over many months over capital adequacy. And my view is just different from the gentleman's. But I think it is something we should appropriately resolve and look forward to doing so.

Thank you.

The CHAIRMAN. The gentleman from Missouri.

Mr. CLAY. Thank you, Mr. Chairman, and thank the panel for their testimony today.

In 1992, after exhaustive study, this committee made improvements to the charter for Fannie Mae and Freddie Mac. One improvement was intended to help close the housing gap which still exists between minority and majority homeowners.

While the gap remains at over 30 percentage points, I do not fault the GSEs for lack of trying. They work on a daily basis to create innovative products and programs which meet the needs of those denied the American dream of home ownership. Fannie Mae and Freddie Mac help to bring the dream of home ownership to thousands of my constituents on a regular basis.

I have serious concerns that as we rectify the problems at one GSE that Congress does not give in to the business opponents of these GSEs who profit from predatory and subprime lending at the expense of affordable housing.

The minority home ownership achievements of these GSEs are on the right track.

And, Mr. Chairman, I ask unanimous consent to submit my statement in its entirety into the record.

[The prepared statement of Hon. Wm. Lacy Clay can be found on page 110 in the appendix.]

The CHAIRMAN. Without objection.

Mr. CLAY. Thank you.

And for Mr. Raines. Last week in Secretary Martinez's testimony, he pointedly stated that you, Fannie Mae, does not lead the market in providing financing for low-income and minority home ownership. Could you please explain that to me? I am very interested to see if that was accurate.

Mr. RAINES. Well, with all due respect to the Secretary, we do disagree with the statement that was made, and in some ways I think it was a result of his referring to somewhat outdated information.

Fannie Mae is the largest single provider of financing for low-and moderate-income households in the country. Last year we provided $279 billion. We provided $136 billion to support minority families' ability to own homes.

To give you some perspective, that is more than the top four direct lenders combined, that Fannie Mae has done.

So no one is even close to the level of what Fannie Mae has done. Indeed, we finance far more in the way of first-time home buyers and minority home buyers than the FHA, where that is their major endeavor.

So we do lead the market. If you look at 2002 and 2001, we led the market with regard to low and moderate income borrowers and with regard to minority lending we led the market. And in the subcategories, with regard to African-American lending and Hispanic lending, we led the market.

But we not only led the market, we led the market with the lowest-cost product so that people were not just getting a loan. They were able to get the lowest-cost loan that was in the market.

So whether it is our housing goals, which we have met every year, or whether it is low and moderate income borrowers, or it is borrowers in underserved areas, or whether it is minority goals, which we set ourselves—HUD does not have the authority to set a minority goal, we set that ourselves—in all those cases we lead the market, and we are quite proud of it. And it hasn't been easy. But it is a fundamental to who we are and what we do.

And the last thing I would say is, there are many ways of looking at leading the market. One of them is obviously provision of mortgages. But it is also leading the market to make sure that people have the information they need so they know how to get a loan. It is also leading the market to make sure that discriminatory practices are taken out of underwriting. And it is also leading the market to be the largest investor in low-income housing tax credits, which is the single largest vehicle for financing affordable rental housing. None of those are captured by the HUD goals.

So we lead the market by their terms, and we lead the market by the terms of the housing industry.

Mr. CLAY. I thank you for that explanation and clarification.

Also, Mr. Raines, I understand that you currently have to meet certain housing goals. And my understanding is that you have never failed to meet those goals. Is that correct?

Mr. RAINES. That is correct.

Mr. CLAY. Could you tell me then why HUD wants to create new categories of sub-goals in this area, or do you know?

Mr. RAINES. I don't understand that, because HUD has authority currently to provide incentives for us to pursue particular types of loans that they believe are important.

For example, the last time they changed our goal level—and they have been changing our goal level periodically and raising it—they showed an interest in expanding our activity with small multi-family projects, five to 50 units. And they provided an incentive in the goal in order to do that.

So they have the authority now to have incentives to encourage us to do more in areas that they think are important for housing purposes.

Mr. CLAY. I thank you for that.

Thank you.

The CHAIRMAN. The gentleman yields back——

Mr. GOULD. Would I have a chance, Mr. Chairman, just to make——

The CHAIRMAN. Of course.

Mr. GOULD. Fannie Mae has done a very fine job on doing these goals. But I wouldn't want it to sound as though Freddie Mac is not part of this process. We joined with Fannie Mae in committing between the two of us, and Fannie is larger than we, so they can afford a bit more, a trillion dollars, the initiative President Bush announced, by 2010.

We continue to meet the permanent housing goals of HUD. There is more we can do. We are currently, for example, talking to the manufactured housing industry in terms of how we could innovate and with safety and soundness standards provide a flow of funds to that industry where people could perhaps have housing at a lower cost.

There is much to be done in housing in the future to fulfill our mission. But we are very much part of that mission and doing our percentage share I think, for example, of the trillion dollars, our share is roughly $450 billion.

Mr. CLAY. Mr. Gould, I had no intentions of——

Mr. GOULD. No, sir, I know that. But I just thought for the record.

Mr. CLAY.——overlooking Freddie Mac, because you all do play an essential part in Missouri also.

Thank you.

The CHAIRMAN. The gentleman from California, Mr. Royce.

Mr. GOULD. I have never found Fannie Mae bashful about these things.

Mr. ROYCE. Thank you, Mr. Chairman.

And just for the record, Mr. Chairman—Mr. Gould, yesterday Freddie Mac sent a letter to Chairman Oxley and the committee members here outlining your position on this debate. And let me just say that I was surprised to see Freddie Mac fighting against sound regulatory policy.

Furthermore, I could not believe that Freddie Mac was offering advice about placement of regulation for the Federal Home Loan Banks.

It would be my concern that Freddie Mac wants the banks left out so that you will have a cost-of-funding advantage in this situation. And I think that Freddie Mac should be a little more concerned about trying to produce some financial statements with integrity and a little less about trying to disadvantage a competitor.

I would like to ask Mr. Schultz a question, and specifically, Mr. Schultz, there is a history of tension, or in some cases antagonism, between banks and Treasury. If a new agency under Treasury regulates the banks, will this situation change or will it continue? And if the latter, would that be a positive regulatory change?

Mr. SCHULTZ. Thank you for your question.

The aphorism of what you see is a function of where you sit is applicable here. We have been listening to—I have been listening and learning from discussion about where regulatory approval is vested with respect to mission.

We do not have that issue. The Federal Housing Finance Board is our mission regulator and our safety and soundness regulator.

Our understanding, our hope is that if the Federal Home Loan Banks are included in this bill—and, again, I would like to state that it is not simply the cost-of-funds of question, it is the decision to create a world class regulator for the GSEs that causes me to say that we should be included as well.

But if we are included, then I hope that the Congress, this committee, will include language that protects the mission of the banks and protects the independence of the regulator, similar to what our other colleague GSEs would like to see, or Freddie Mac, and that that language go a long way toward resolving the concerns about whether or not Treasury would be—a Treasury-independent regulator would be a problem, hostile to the mission of the bank system.

Mr. ROYCE. Well, let me ask a question then of your colleague, Mr. Hehman.

And that question would be—going to that same premise—if we ensure sufficient mission protection—let us say that was possible—and we ensure agency independence, and that independence is under Treasury, really, in that situation, how far apart would the 12 Federal Home Loan Banks be? And in that context, would you still object to moving regulatory authority? Or do you think that in theory that might be possible to get that type of concurrence?

Mr. HEHMAN. Clearly, if you had those written into the legislation, the 12 banks would come probably closer in our view of this.

Again, our view is that the Finance Board has been an adequate regulator, does not need to be a part of the Treasury, or our regulator needs to be a part of the Treasury.

We do have some concerns about that at the Cincinnati bank, clearly.

Obviously, whatever the Congress decides in their wisdom, the Home Loan Banks are going to live with that.

The position that our board took is that the independent regulator—and independent is critical—who is also our mission regu-

lator, ought to be left alone. That is the view that our board of directors took, Congressman.

Mr. ROYCE. I appreciate that.

If we go back to Mr. Schultz—again, Mr. Schultz, if we move the functions of the Finance Board to Treasury, how do you think that new agency could be structured? Would you give us your insights into how you think that would most effectively be done?

Mr. SCHULTZ. Thank you.

I believe that the differences between the Federal Home Loan Banks and Fannie Mae and Freddie Mac have been discussed in other people's testimony. But basically we are talking about a cooperative with par value stock, and that is the way we get private capital to use for public purpose.

And there are a host of issues that arise that make us different from Fannie Mae and Freddie Mac. And for that reason, we would suggest that a separate office be created in this regulator for the Federal Home Loan Banks, which would assess the banks and use those funds to for its operations, and that the mission language and independence language be included in the statute.

We do think it is important that the activities of the regulator be funded through the banks.

Mr. ROYCE. Thank you, Mr. Schultz.

Mr. BAKER. I yield back, Mr. Chairman.

The CHAIRMAN. The gentleman yields back. The gentleman from California, Mr. Baca.

Mr. BACA. Thank you very much, Mr. Chairman.

First of all, I would like to thank our distinguished guests for appearing before us. I particularly want to thank Frank Raines and George Gould.

The work you do in the Latino community is very important. Both companies have impressive track records of expanding minority home ownership. Hispanic home ownership rates have increased from 44.7 in 1998 to almost 50 percent today.

In the year 2000, Fannie Mae financed over $135 million in loans to almost 1 million minority families. In my district, Freddie Mac purchased almost $1 million in mortgages that financed home ownership for over 800,000 families in the year 2000.

My question is for Mr. Frank Raines. Factoring immigration and population growth over the next 10 years, isn't there a common concern where the mortgage money will come from—or where it will come from to meet the demands going forward? That is question number one.

And shouldn't this be carefully factored in any legislation that do not encumber a well-working housing finance system?

Mr. RAINES. Congressman, I think that is absolutely right. We are going to need to find an additional $6 to $7 trillion of financing for home mortgages over the next 10 years—an additional $6 to $7 trillion.

We got the first $6 to $7 trillion over the last 200 years. And we are going to need to come up with another $6 to $7 trillion over the next 10 years.

So this is a very important debate that this committee is having as to the structure of the regulation of these entities that are so crucial for reaching around the world to find that $6 to $7 trillion.

One-third of the funding that Fannie Mae brings to its portfolio comes from outside the United States.

So it is very important that we have a structure in place that gives confidence to investors that they will continue to invest in American homes. Because if they don't, we will end up with a capital shortage.

Already, the U.S. mortgage market is the fastest-growing capital market in the world.

And so it is not as though we just can assume that another $6 to $7 trillion would come automatically. It will come through a lot of hard work and through well-financed, well-capitalized intermediaries who will attract that capital into our system and then provide it to lenders so that they can lend it to individual families.

Mr. BACA. Good. And isn't it true that home ownership will increase amongst the Hispanic community, as we look at right now we represent approximately 14 percent of the population, 42 million people? That includes Puerto Rico. Is it true then that the majority of the future home ownerships could come from the Hispanic community?

Mr. RAINES. Well, we are going to see tremendous growth in the Hispanic community. By 2020, we are going to see the growth in the Hispanic community of about 75 percent growth, 28 percent growth in the African-American community, 80 percent growth in the Asian community, at the same time the non-Hispanic white community's going to grow by 9 percent.

So quite clearly, the future of home ownership, the future of housing in America is going to be around this growing population that is going to need not only access to capital in theory, but in fact.

And this has been the area where we have had to work the hardest to make sure that the capital system is working for these families. And again, if we fail, if we fail to come up with $6 to $7 trillion, the people who will be hurt will be that part of the population that is growing and that part of the population that has not heretofore benefited from home ownership.

Mr. BACA. Thank you, I know that the minority community both appreciates Freddie Mae and Freddie Mac and the services it is providing in minority communities. So thank you.

The CHAIRMAN. The gentleman yields back.

The gentleman from Connecticut, Mr. Shays.

Mr. SHAYS. Thank you, Mr. Chairman, and I thank the gentlemen who are before us. I have significant respect for all of them. But I do think that we need to be asking some tough questions, and I do want the answers to a few questions.

Mr. Gould, back in June 25, Freddie Mac indicated its earnings could be restated by as much as $4.5 billion and that its accounting lapses are more serious and more pervasive than previously announced. Today, the company announced the restatement would be a minimum of $4.5 billion.

In the company's statement, I quote, "the disclosure process and disclosure in connection with these transactions and policies did not meet standards that would have been required of Freddie Mac had it been an SEC registrant."

The company further stated, "Freddie Mac is committed to strict compliance with generally accepted accounting principles and meeting fully the spirit and intent of all rules and regulations surrounding financial reporting."

This is my question. Given everything that has happened at your company, and the fact that you have acknowledged not living up to the disclosure standards required by the SEC of all other public traded companies, and also the fact that Freddie Mac now claims to be committed to strict compliance with all financial reporting requirements, how can you still argue that Freddie Mac should be outside the jurisdiction of the SEC and the Securities Act of 1933?

Mr. GOULD. Well, as you know we are going to become a registrant under the 1934 Act. As you know Freddie Mac is a constant financier. Compared to the average American company, therefore, the average registrant, we finance many, many, many times a year more than they do. And we have looked at the absolute requirements of the 1933 Act as a drag on that financing, because an additional cost which could get passed along in our cost structure to mortgages, to a slowdown, to——

Mr. SHAYS. So it would be basically your argument that it would provide additional costs and requirements, correct?

Mr. GOULD. Well, yes, but let me try to be more specific and give you examples.

Mr. SHAYS. You know, I don't want too long an answer.

Mr. GOULD. Okay.

Mr. SHAYS. Only because I am given five minutes.

Mr. GOULD. All right, sir.

Mr. SHAYS. Thank you. Regarding your reinstatement, my understanding is that the minimum $4.5 billion by which you may have underreported income is after tax. Is that correct?

Mr. GOULD. That is correct.

Mr. SHAYS. So your before tax is going to be—the minimum is going to be much higher than $4.5 billion?

Mr. GOULD. That assumes a 35 percent tax rate.

Mr. SHAYS. Can you give me an estimate of how much money your accounting practices have cost the Federal Government?

Mr. GOULD. Have cost the Federal Government in what sense?

Mr. SHAYS. In taxes that haven't been paid that should have been.

Mr. GOULD. Oh, gosh, the amount of taxes, if any, additional taxes payable would be minuscule compared to that amount of money.

Mr. SHAYS. Why, you don't pay—I know you don't pay Federal, I know you don't pay local and state taxes. But do you mean you don't pay Federal taxes?

Mr. GOULD. No, sir. There is a confusion there. Much of that money in the restatement is a function of marking instruments to market, which is not a taxable event. It is not a matter of having sold something and not reported the income or profit on the sale. It is a matter, particularly in a time of declining interest rates, of marking assets to the market, which therefore are worth more and should have been marked to the market, but were not at the time. But that is not a taxable event.

Mr. SHAYS. A June 17th story in the Hill newspaper quotes a Freddie Mac lobbyist as saying, "We feel good about these hearings because this is a great story to tell. The restatement of earnings is going to be up, not down."

Do you agree with this assessment that, in my words, that accounting fraud is good news as long as it is up?

Mr. GOULD. No, sir, I do not agree with your statement that it is fraud.

Mr. SHAYS. You don't think this was fraud?

Mr. GOULD. No, sir, I do not, nor does Mr. Doty, who was the investigator that I hired to look into this in the first place, as he testified today in the Energy and Commerce Committee.

Mr. SHAYS. Does the Government think it is fraud?

Mr. GOULD. Sir?

Mr. SHAYS. Does the Government think it is fraud?

Mr. GOULD. I do not know who the Government is in that respect, sir.

Mr. SHAYS. So the fact that you haven't complied with general accounting practices and have understated your earnings by over $4.5 billion, if someone in the private sector did that, wouldn't that be fraud?

Mr. GOULD. Well, I do not have a legal background, and I don't want to get past territory with which I feel familiar, but my understanding, for what it is worth, in that regard is that fraud also implies intent.

Mr. SHAYS. When do you intend to come under the 1934 Act?

Mr. GOULD. We have no present intention of doing so.

Mr. SHAYS. 1934 Act.

Mr. GOULD. Oh, I am sorry, 1934. I am sorry, I thought you said 1933. The 1934 Act is as soon as we can. We cannot do that until our financials are current. And that will probably, as Director Falcon said this morning on the first panel, that will probably take into the middle of next year. As soon as our financials are current, we will do so.

The CHAIRMAN. The gentleman's time has expired.

Gentleman from Massachusetts.

Mr. FRANK. Let me ask Mr. Gould and Mr. Raines on behalf of Freddie Mac and Fannie Mae, do you feel that over the past years you have been substantially under-regulated?

Mr. Raines?

Mr. RAINES. No, sir.

Mr. FRANK. Mr. Gould?

Mr. GOULD. No, sir.

Mr. FRANK. And let me ask now the gentleman from the Federal Home Loan Bank, do you believe that the Federal Home Loan Bank System has been substantially under-regulated?

Mr. HEHMAN. No, sir.

Mr. FRANK. Mr. Schultz?

Mr. SCHULTZ. No, sir.

Mr. FRANK. Okay. Then I am not entirely sure why we are here, but we killed the afternoon anyway, so we might as well go forward.

I must say, I am inclined to agree with that. I don't see any financial crisis. You can always make things better, but I do think

we should dispel the notion that we are here because there is something rotten that has gone on.

And I am not one who has been impressed with the history of results improved by reorganizing boxes, so I don't know whether OFHEO goes to Treasury or not, whether it makes a big deal, I am not going to fight it.

I am concerned about the housing piece.

And, Mr. Raines, I would differ with one question you were asked about whether you should be given—whether HUD should be given the ability to do sub-goal. And you said: Well, they already have the ability to give you incentives to do that.

Yes, but maybe they ought to have the right to give you orders to do it. I mean, I understand, we all would rather only do things that we were incentivized to do, but sometimes maybe we should be told to do things to do. And that to me is kind of an open question.

I think the current arrangement is a good one; I think we have benefited. I think we have benefited with regard to Fannie and Freddie in reducing the cost of housing in general.

As I have said, apparently there are people in this country, investors, who knowing everything they should know, are prepared to lend you money at a little less than they would charge other people. I am glad they do. I think housing benefits. Nobody should be under any illusions that there is any guarantee, implicit, explicit, whatever-plicit. It just ain't there.

And I find it ironic, frankly, that some of those who are the most interested in trying to—who are worried about this—the only people who it seems to me to be creating the impressions that there is a guarantee are the people who are your opponents, who keep saying there is one. If they would stop saying there is one, then they wouldn't have to worry about people thinking there was one, because it is a self-fulfilling prophecy.

But I am interested in doing a better job on the housing area.

Now, let me ask Mr. Schultz and Mr. Hehman, because this is something that really originated right here in this room, the affordable housing fund that the Federal Home Loan Banks have, is that an obstacle, the existence of that, is that an obstacle to your being able officially to perform the market functions that you perform?

Mr. SCHULTZ. We don't find the affordable housing program to be an obstacle.

Mr. FRANK. Mr. Hehman?

Mr. HEHMAN. No, sir, it is an incredibly efficient way to disperse that subsidy into the private sector.

Mr. FRANK. Absolutely right. And it is one of the few production programs we have right now, other than the low income tax credit, it is one of the few direct production programs we have, I think many of us are very pleased with it. I should say it initiated here, in this room, under the chairmanship of the late Mr. Gonzalez of Texas.

We had a tough fight on the floor of the House. It only survived on the floor of the House by two votes, and now everybody is all for it. And it is a very impressive kind of program, and I salute the Federal Home Loan Banks for the flexibility with which they run it.

And so then the next question is, Mr. Raines, Mr. Gould, have you ever thought about something like that? You know, you do a good job in reducing the cost and passing along the lower cost of funds. Here is a more specific form of subsidy. Have either agency thought about that?

Mr. Raines?

Mr. RAINES. Well, in 1992, the last time this committee dealt with our charter, there was a debate as to whether or not we should have a grant program such as the Home Loan Banks had or whether we should have goals. And the committee, after quite a bit of debate, chose goals instead.

Mr. FRANK. Right. I didn't ask that. I asked what does Fannie Mae think about that. You would rather have goals than grants?

Mr. RAINES. No, I didn't say that. No, I think we would be delighted if we got the same treatment the Home Loan Banks have, which is that they essentially get them as a credit against the taxes that they otherwise would owe.

Mr. FRANK. No, we should look at that.

I would be careful. If I were you, Mr. Raines, and I am a great supporter in general of your mission, but once you start saying, "I would like to be treated like everybody else," there is a lot of people that would like to be treated like you. So I think if I were you, I would do kind of stand-alone discussions.

Mr. RAINES. I didn't say that.

Mr. FRANK. Well, I understand that. But I mean, you are saying that an affordable housing program, if there was some tax credit aspects to it, would be a reasonable thing.

Mr. RAINES. No, I am simply saying, we pay at the full Federal rate.

Mr. FRANK. No, I understand that. But you said you thought that that wouldn't be a bad program if you had favorable tax treatment over it.

Mr. RAINES. I am sorry. I did not hear——

Mr. FRANK. Didn't you say that if you were treated the same and the tax—that it was a credit against your taxes, that it would be a reasonable thing to do? I thought I heard that.

Mr. RAINES. Yes. You are right. But even without that, today, Fannie Mae alone invests about $2 billion a year in low-income housing.

Mr. FRANK. Okay, but I didn't ask you about that. You know, I only talk about what I was asking about, which was that it is different, the affordable housing subsidy is a little bit different.

One other question for both of you.

A little indulgence here.

And I do think we should be doing more.

I have been disappointed, maybe I am wrong, and I will ask you and I will make it clear that this is not conclusive, but the people who work for me have told me that in the rural area, the 515 housing program which is the assisted housing that, frankly, neither one of you has done as much there as it seems to me should be done, like almost nothing. And we are running into an increasing problem here in rural subsidized housing, we have got rural housing that was built under Federal loans, assisted housing, it is going to expire and we are going to lose a lot of housing.

So I would ask, you can respond in writing, because we are running out of time, what you are doing with regard to the 515 rural housing.

And with that, Mr. Chairman, could I just put into the record a letter from Michael Jessee, who is President and Chief Executive Officer of the Federal Home Loan Bank of Boston, expressing the board of directors of the Boston bank—of the Federal Home Loan Bank—opposes at this time inclusion of the Federal Home Loan Bank in legislation creating a new regulator for Fannie Mae and Freddie Mac, absent credible evidence the Federal Home Loan Banks would be otherwise disadvantaged from a cost of funds basis.

And I would like to put that in the record.

[The following information can be found on page 256 in the appendix.]

The CHAIRMAN. Without objection.

The gentleman from Delaware, Mr. Castle.

Mr. CASTLE. Thank you, Mr. Chairman.

I realize we have another panel and we are out of session, so I will try to be relatively brief, and I may not even have any questions.

And Barney mentioned he is not impressed by reorganizing boxes, but we are apparently in the process of reorganizing boxes, and that is what it is all about.

I mentioned to Mr. Baker earlier today the remarkable change in some of the testimony we have had from people from not just this panel, but all day long, compared to what they might have said a year ago.

But I don't think that is bad. I just ironically noted that there has been a changed circumstance here.

I just would like to say this. These are huge—of all the things this committee has jurisdiction over and Congress has jurisdiction over, from an economic point of view, with the direct jurisdiction that we have over these particular entities, this is probably about as big as it comes.

And I have no way of judging by the size of it how well we have really done with helping with minority housing or with low-income, middle-income housing, but my sense is that has actually gone well. I think you have carried out your mission well.

You couldn't prove it by me. When you start talking about, what, $3.3 trillion in debt and some of the assets which you have, it is just very hard for the average Member of Congress, frankly, to totally comprehend.

But I think there would be more criticism if you had not done well. And I have heard a lot of praise over the years, so I think that has gone well.

On the other hand, I, for one, do feel that we do need regulatory change. From what I have read about the Freddie Mac investments, while I am not suggesting there is anything illegal about that or anything the government should be interested beyond that, I do believe we do have the oversight interest of making sure that is being handled correctly. The security of these entities is of tremendous significance.

Understanding the role of the Federal Home Loan Banks is also very difficult, frankly, for me, and I think for some other members here, in terms of where they should be in this reorganization of the boxes which may go on.

And obviously your mission and your goals as opposed to the regulation is something else that we all have to pay attention to.

But my only hope is that everybody in this room, because I think there is a lot of people out in the audience as well as the members up here, will be very focused on what is the right way to get those boxes stacked to make absolutely sure that we are carrying out the basic missions of housing, which we all view to be perhaps the most important issue of what you are doing, making absolutely sure that we don't set up something that lacks sufficient regulation so that maybe unintentionally we could have financial mishaps which could be a tremendous problem and which in my judgment would affect our whole economy in the United States and frankly the worldwide economy.

And so I hope when you have your meetings and you come before us and you testify, and again, not just the four of you, but everybody who is doing this, that everybody has given a lot of thought not to just their own interest, but to the overall balance of what our responsibility is, I mean ours collectively, not just Congress, but all of us in terms of helping the housing market in this country.

Because while you are in the instances of Freddie Mac and Fannie Mae private entities, you also have a tremendous public purpose in what you do.

So it is my hope that the people who are really knowledgeable can work together and really make a difference and end up with something which everyone is going to look back on and say, those were positive changes.

And I yield back.

The CHAIRMAN. The gentleman yields back.

The gentlemen from Alabama, Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman.

Mr. Raines, you touched on something earlier that I want to talk about for a minute or two. And in the earlier hearing, I talked with Mr. Falcon about what I think is a very significant problem that may not have received as much attention.

If we are going to expand HUD's oversight authority to go not just from new programs to new activities, I am concerned—and I suspect from your comments earlier today that you are concerned about a very basic problem, and it is this: a lack of transparency in how HUD goes about making that evaluation or how Treasury would go about it. Whatever the regulator, I think the question is, What are the standards for making an evaluation of what is permissible new activity and what is not?

One concern that I would have is that, as we look at the vicissitudes of HUD or the changes from Administration to Administration, it doesn't seem that we are going to have a lot of practical guidance in how HUD is going to look at these questions.

So can you talk for a minute or elaborate on your earlier answer about the appropriate standards that should be employed? Mr. Falcon, I think, said that he would be comfortable taking the broad

public policy standard that exists now for evaluating the programs and importing that into a new activity standard.

And so, I suppose we would be left with that fairly amorphous public policy standard. We would be left with a—not as amorphous, but not a terribly meaningful standard around what is within the guideline of the charter.

I am not really comforted by either one of those. So can you talk about that a little bit?

And, Mr. Gould, you also.

Mr. RAINES. Well, thank you for the opportunity to elaborate. I think the standard I have in mind is quite a simple one, and that is that a new program is consistent with the charter and consistent with the mission. That strikes me as being a sufficient standard; the bias should be that it will be approved as the current statute says unless it is not consistent with the charter and consistent with the mission.

The concern that I have is—and I have spent time in the Government and I have spent time in the private sector—that if it depends on a Government agency approving everything and making up its own mind about each and every item, it will take forever to get approvals done simply by the normal process of Government. So the bias should be toward "it is approved" unless it is found not to be consistent with the charter and not consistent with the mission.

I will give you an example. If we had an innovation that was a new program, but it involved Fannie Mae originating loans, well, that is against our charter. There is a prohibition in our charter for originating loans, and HUD would properly turn that down.

On the other hand, if we came up with a product that was a conventional mortgage, but it simply had different underwriting standards or it had new features, well, then, that wouldn't even rise to a decision because it is not a program, it is not something that is large, it is simply a change in a product. And even if it were a program, it would be consistent with our charter and consistent with our mission. So it is not a very elaborate standard that I am talking about.

What concerns me with a broad public purpose standard is that, depending on who is making that judgment, some could come to the conclusion that the public purpose is to restrict the expansion of housing, because they believe that the American people are investing too much money in housing.

Now, some would say, "Who would do that?" And I could go and round up most of the economists who have opined on this issue. They believe that we have invested too much in housing in this country, and they would say it was in the public interest to stop it.

Now, I don't think that is what this committee or this Congress would intend, but a broad public purpose or public policy standard would allow someone to have that position and they could come to that conclusion.

Now, I do not think that is what Congress intended in 1992, and I would hope that we could make it clear that that is not what Congress intends today.

Mr. DAVIS. Well, let me add one follow-up since my time is running a little bit low.

One of the other things that does not appear to be terribly controversial but which still concerns me is this notion of bifurcating the safety and soundness analysis from the mission analysis.

In one sense it sounds like an easy enough thing to do, but, you know, a number of us here are lawyers and we write whole textbooks about the difference between substantive and procedural. We write whole textbooks about whether something is truly new law or not.

So given that backdrop, I am not terribly comfortable that we would be able to sort out frankly what fits in a safety soundness box and what fits in the mission box.

Closely related to that, I am not clear who would be empowered to really break a tie. I am not clear who would be empowered to make an analysis. In virtually every Administration, with all due respect to HUD, Treasury is going to be the weightier department.

So can either of you, either Mr. Raines or Mr. Gould, comment? While, I understand—if I could have just a little bit of indulgence, Mr. Chairman—while I understand that both of you, I think both of you endorsed the notion of splitting safety and soundness from mission, can you talk as a practical matter about how we are going to differentiate between the two in every instance and who would have the authority to make the call if there were ever a tension between safety and soundness of mission?

Mr. GOULD. Well, I think the system has basically been working now in a bifurcated way. I mean, you have HUD focusing on the mission and OFHEO looking at safety and soundness. So I perhaps do not see that as the major change that you might, Mr. Davis.

But the Treasury I think is uniquely qualified to determine things in a safety and soundness basis, particularly having had an operational precedent with OCC and OTS. So that doesn't bother me and I have in my testimony recommended it.

I felt, however, that the Treasury would be starting from scratch in terms of determining mission and would have to build up to it, whereas that is really part of HUD's mission, if you will. Their expertise was worth retaining in that regard and although it may not be perfect to have a bifurcation, in fact it is taking advantage of both organizations' expertise and experience, and it is worth trying and seeing how it goes.

Now, if they disagree, who is the judge? Perhaps that would have to be determined by the Congress.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Texas, Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman.

Mr. Raines, forgive me, I missed part of your testimony, but I would like to make sure I have a very firm understanding of one point.

In your testimony you speak of supporting the Administration's proposal, but specifically in transferring the new product approval from HUD to Treasury. I understand your concerns about innovation and efficiency, but with regards to transferring new product approval to Treasury, are you for it or against it?

Mr. RAINES. I am in favor of a proposal, as I understand the Treasury has proposed it, where there would be an automatic approval of new housing innovations by Fannie Mae if that authority were moved to the Treasury. That is why I say it is so important what the standard is.

What Treasury has said is that there would be an automatic approval, but that if it were determined that there were a safety and soundness issue, they would have the right to later come in and take action. If that were not the standard, then I would not be in favor of the movement.

But in any event, I believe that there ought to be a very clear standard, even if the authority stays at HUD.

Mr. HENSARLING. So would the standard be regulatory or statutory?

Mr. RAINES. There ought to be a statutory standard, in my view, because I think it is very hard for regulatory agencies to create the standards under which they are operating, because they are essentially making the political decision.

So whether it is our regulator or any regulator, I believe Congress ought to establish what it is the Congress is asking the regulator to do. In this case I urge and I believe it has been the history of this committee that it wants the regulator to encourage housing innovation. That ought to be the first thought, is does this encourage housing finance innovation?

If Congress doesn't establish that standard, you are leaving it then to a regulator to invent their own standard. And that standard could be that we believe that there is too much investment in housing and therefore we are going to stifle innovations.

So I do not think you want to leave that to be an open question. I think Congress ought to tell the regulator in what direction you want to go.

And clearly, I think everyone in the housing finance industry believes that we have an impending housing crisis in this country and that there is a need to invest more in housing, not invest less.

Mr. HENSARLING. A question for the gentleman from the Federal Home Loan Banks. Obviously we have a divergence of opinion here, but specifically I would be interested to know your thoughts on being included in the same regulator as your brethren to your right.

How do you view that with respect to competitiveness? What is it about having the same regulator that will make you more or less competitive with Fannie and Freddie?

We could start with you, Mr. Schultz.

Mr. SCHULTZ. Sir, as I mentioned earlier, the concern that leads to our wanting to be included with the same regulator is that the market's perceptions are critical in terms of our cost of funds and our ongoing ability to access the markets, both domestically and abroad. And if there is a perception that, well, with the other two housing GSEs, the world class regulator is appropriate but the federal home loan banks do not need that kind of supervision, people may begin to question is it really a GSE? Is it really the same thing as those entities?

Or if there is a reason to criticize the regulatory structure that we are involved in owing to something that happens in one of the

banks, will there be a permanent increase in our cost of funds, which would be reflected through our not being able to achieve our mission?

So those are the concerns about competitiveness. And if you ask me to delineate all of the things I can think of, I can't go very far beyond that because I can't see the future. But I would be concerned with being treated differently if you choose to move the other two entities to a different regulator.

Mr. HENSARLING. Well, once again I apologize for plowing over old ground, but I missed part of the testimony.

Mr. Hehman, would you comment please?

Mr. HEHMAN. Yes, sir. Our concern about being put together with the other two GSEs is very simple, that we are not like them. We are a banking system that lends money to community-based institutions. We are a different animal. We are a different GSE.

So our concern is really to be lumped in with two other GSEs who do something, who are very involved in housing, clearly, but have a totally different delivery system, in my judgment, than the core mission of the Federal Home Loan Banks.

So our position is that the Home Loan Banks are different enough that the current regulatory system has done the job and that, in a sense, leave well enough alone.

Mr. HENSARLING. Thank you.

I see my time has expired.

The CHAIRMAN. Gentleman yields back.

The gentleman from Georgia, Mr. Scott?

Mr. SCOTT. Yes, thank you very much, Mr. Chairman.

To Mr. Raines and to Mr. Gould, I want to make sure we are clear here because I am tending to get kind of a schizophrenic response from the two of you in terms of your two feelings about the proposed legislation, the President's proposal, Administration's proposal.

On the one hand, I am hearing you say you basically support the Administration's proposal. In your interchange with Mr. Baker, I think you have tended to say you support basically that. But there was—Mr. Baker came back and said there was one point of disagreement there that I did not get picked up, but I want to.

This is an extraordinarily important hearing in that the people of America, I think, are listening and watching to get a clear signal where we go because what you all do is so critically important in the mission.

But on the other hand, I hear you saying that you are very fearful of moving from where we are, from HUD, because it may lower the priority in terms of the housing goals that we reach. And I am very concerned about this. I represent a district in Georgia where we have four of the fastest growing counties, 11 counties around metro Atlanta.

And just to point out my concern, you were tacking off some figures about what you have done, and I commend you for that. But if you look at what happened between 2001 and 2002 in terms of home ownership rates among white, black, Hispanic, other races, central cities and the suburbs, in every single category there was a little bit of movement.

For example, among whites, from 74.3 percent to 74.5; from Hispanic, 47.3 percent to 48.2; central cities, 58 to 59, 74.6 to 74.7.

The only area which there was a decrease was in the home ownership of African Americans, one of the four most critical groups to be sustained.

So I would like to give me a little answer to that as to why that decrease? Why the African American community? Is there something going on in that community that they are faced with that no one else has? I think we want to know that.

And if you could give us some clarity on how, on one hand, you favor what the Administration is doing, but then on the other hand you are fearful of what it is doing.

Mr. RAINES. Well, if I might start, Congressman. I think you put your finger on the conundrum that we face. We are vitally committed to our housing mission. It is what we do. It is who we are. And it is our number one priority.

Our housing mission, however, does require us to raise capital around the world. Our investors invest in Fannie Mae not because they necessarily share our housing mission, but because they think that Fannie Mae will be a good steward of the capital.

And so we need to have a regulatory regime that both helps us raise the capital and helps us do our mission. And finding that right mix is the conundrum you point to. And what we are struggling with here is what is that right mix of things that helps us raise the capital and helps us do our mission.

As I understand the Treasury proposal—and we don't agree with every line of the proposal—but as I understand the Treasury proposal, it would help us raise the capital and if properly prepared would help us do our housing mission.

If it would not help us do our housing mission, then we would oppose the legislation. And that is why, for example, we were quite firm on the point, if the proposal is to increase our minimum capital standards, we will oppose the proposal. And there should be no question I think in anyone's mind about that. Why? Because it would undermine our housing mission. It would allow us to do less. If you double our minimum capital, you cut in half what we can do.

But this is why I think you are feeling this tension, is that we need both. We need the access to the capital markets in order to do our mission. And that is why I, in my testimony, tried to lay out the history of how the Congress has dealt with this. And each time, it has, I believe, reached the right balance in those things.

It has not said that safety and soundness is more important than our mission. If that were true, then they should shut us down. The most safe and sound course is to have no obligations outstanding. But instead, Congress has reached a different balance.

So today, do we have a lot of obligations? Absolutely. But for every $2 that we have in debt and obligations, we have got $3 in collateral in American homes. And that has been successful.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from North Carolina, Mr. Miller?

Mr. BRAD MILLER OF NORTH CAROLINA. Thank you, Mr. Chairman.

Mr. Raines, you just said the word balance. And that is the first time I think I have heard this, because I think most of the debate has been about either considering safety and soundness or considering how to make credit available for home ownership, particularly among underserved populations, racial and ethnic minorities and just low-wealth families in general.

But I have seen this as a balance, as trying to strike a balance between those competing concerns. And we strike balances all the time in every area of the law. Harry Truman said he wanted to meet a one-handed economist because he got tired of hearing on the one hand, on the other hand from his economists. But he really should have talked to a lawyer if he wanted to hear about on the one hand, on the other hand.

Most of the debate, I have thought about which box to put this product approval in had to do with whether in striking that balance the bias would be on the side of safety and soundness or the bias would be in favor of encouraging home ownership. Those who oppose putting it in Treasury thought the bias would be in favor of safety and soundness. Those who wanted it—opposed having it in HUD thought the bias would be in favor of encouraging home ownership at the expense of safety and soundness.

I understand that you have said earlier that you do not care where it is, which box it is in, but that you think that the standard by which it should be subject, new product approval should be subjected, should be judged, should not consider safety and soundness at all? At the initial stage it should not—that product approval should not—it should be about whether it is consistent with your charter, and that is the extent of the analysis.

Mr. RAINES. And then the safety and soundness regulator would determine what the capital would be to ensure safety and soundness.

So there is a separation between consistency with our charter and our mission and what the appropriate capital is for it.

The safety and soundness regulator will always establish what the capital is, whether it has gone through the approval process or not. Anything we come up with, they establish the capital requirement.

Mr. BRAD MILLER OF NORTH CAROLINA. But my understanding of what you said earlier—and I have had the same experience everybody else had of being in and out of this hearing, it is a great frustration of serving in the House and trying to be a conscientious member of a committee—but my understanding is that your proposal or what you favor, that would come later.

Mr. RAINES. No, I think in reality what has happened currently is it comes almost simultaneously because the two of them will consult. That is what happens today. Today, OFHEO has the ability to establish whether or not it meets safety and soundness standards and what the capital should be and HUD decides whether or not it is consistent with our charter and our mission.

So we have that bifurcation today. And I think that part of the process works reasonably well.

I think the greater difficulty is simply what the standard is. On what basis should I decide this is okay or not okay? And I always thought it was clear. But some of our experience says there seems

to be some ambiguity about it, and I am asking the committee to resolve the ambiguity in favor of housing.

Mr. BRAD MILLER OF NORTH CAROLINA. I yield back.

The CHAIRMAN. The gentleman yields back.

The gentlelady from Indiana?

Ms. CARSON. Thank you very much, Mr. Chairman.

I am probably the only one on the committee having some unreadiness about transferring all this oversight and stuff like that because it appears to me that if Treasury can indeed establish some safe and soundness in terms of your capital risk and your capital investment then it ought to expand that work out to the whole United States of America, since we are on the brink of economic disaster.

But I do not understand the part that is proposed in terms of the Treasury Department having oversight and decision-making in terms of new missions and how this new regulator discerns what is a legitimate or a necessary new mission, new goals, new modus operandus.

And I heard all of you wonderful gentleman talk about you agree with all of this. But how does the Treasury Department discern what is a viable mission, what is a viable new mission or a new investment or—am I making my question clear?

Mr. GOULD. Well, in my testimony——

Ms. CARSON. I apologize, I have been——

Mr. GOULD. That is perfectly all right.

The way Freddie Mac has looked at it is that the mission goals and the definition of the mission has been set by HUD for many years. We think that is still appropriate for them to do so. They have the experience and the background to do so.

At the same time, it helps us do our mission and serve affordable housing to have the lowest cost of funding that we can achieve. And that is best achieved by having the market perceive us to have a very credible regulator. Credible in the sense of saying that we are safe and sound. And there is no better entity in that regard than the U.S. Treasury.

So this bifurcation, we feel, serves both our purposes: a safety and soundness regulator with credibility and an experienced organization in terms of what our mission should be.

Now, I do agree very much with Mr. Raines that we must be very careful of dampening innovation, particularly because the point that Mr. Scott made, Mr. Davis made and others, is as we go forward here, a clear part of our mission is going to be to try to serve the underserved parts of America.

And that means in order to remain safe and sound in doing so that we are going to need some innovation. We are going to need some financial vehicles that can provide funds flow to those areas and still not engender something that would disturb the markets in being unsafe.

So there is work to be done here. But neither one of these decisions are going to be made in the abstract. The Treasury should not just sit there and make safety and soundness decisions without consultation with the person in charge, HUD in our view, of our mission. That is not the way things should work and not the way things really do work.

So there is going to be a constant interchange or so-called working together here in order to accomplish what we have to do, which is to get the percentage of housing for minority groups in this country higher so that it is matching the white population. And that is going to take some innovation and that is going to take some work and that is going to take some commitment.

And I know Fannie Mae has spoken out about this and we have too. This is something we are both dedicated to and we are trying to find the best way to do it.

Ms. CARSON. If I may ask one more quick question, Mr. Chairman? And maybe this is not the right group to pose the question to.

In Indianapolis, where I am from, we have the highest rates of home foreclosures in the country. A lot of that has been naivete on the part of the consumer and all that and we recognize all of that and that needs to be fixed, that is broken.

But more importantly, our economy, our jobs are dissipating. We just last week got word that our biggest foundry is closing, 1,000 employees. United was there, they left, 2,000 people. For the most part, those people are homeowners.

Now, do you get the blame for all of these foreclosures that come up when you have been out in the market with these innovative programs?

And I might hasten to add that at the foundry especially 80 percent of those are people of color. They are going to lose their homes.

Do you have in this risk, capital risk management apparatus some forecast that say, "Hey, you better not loan that guy that money because he is going to lose his job next year"?

Now, that sounds like a dumb question and perhaps this isn't the panel that should address that.

Mr. RAINES. No, it is not at all an inappropriate question because it is the heart of what we do. We always are trying to find how can we help more and more people and do that within safe and sound principles.

And our experience has been quite good actually. Our experience has been quite good. Indeed, even for people who get into trouble and get behind in their mortgages, we have found that we have been able to keep half of them in their homes and not go to foreclosure by working with them as they work through periods of unemployment or sickness or divorce or other issues. So it is exactly the right question.

And avoiding foreclosure is as important as making the original loan. It doesn't do anyone any good to put someone into a home and then as soon as they get into a little bit of trouble, foreclose on it. And it doesn't do any good to have a bunch of foreclosed houses sitting abandoned in a community. That is why Fannie Mae fixes up houses before we

sell them back so that people are getting a house that is in good shape. And we do that very quickly.

But it is absolutely a critical part of what we and our lenders do, is to ensure that people who get into homes can stay there and to take whatever steps we need.

But I can tell you, we have been expanding into low down payment lending and to credit-impaired lending and the results have

been very good. And what that says to me is giving more people a chance has been good business.

The CHAIRMAN. The gentlelady's time has expired.

Ms. CARSON. I think you have done a good job.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Let me thank all of you, particularly our traveling folks from San Francisco and Cincinnati. We worked you pretty hard today, but I think the committee learned an awful lot. And that is obviously the purpose of these hearings. We thank you very much.

And the second panel is dismissed. And the third panel, the lucky third panel can now come forward.

Produce our third panel, beginning with Mr. D. Russell Taylor, President and CEO of Rahway Savings Association on behalf of America's Community Bankers. Mr. C. Kent Conine, Conine Residential Group, Inc., on behalf of the National Association of Home Builders. Mr. Allen Fishbein, Director of Housing and Credit Policy, Consumer Federation of America. Ms. Terri Montague, President and Chief Operating Officer of the Enterprise Foundation. Dr. William E. Spriggs, Executive Director of the National Urban League, Institute for Opportunity and Equality. And Mr. John Courson, President and CEO of Pacific Mortgage Company on behalf of the Mortgage Bankers Association of America.

And our last witness of the day, if you can't go to hell, be the last witness on the third panel, the gentleman from Texas, our former colleague, the Honorable Steve Bartlett, President and CEO of the Financial Services Roundtable.

Mr. FRANK. Mr. Chairman, that is what he gets for letting his seniority lapse. If he hadn't done that, he would have been way up there.

[Laughter.]

The CHAIRMAN. We thank all of you for your patience in waiting through this weighty subject and two panels before you. Again, it could be worse. It could be a Friday afternoon.

So with that, Mr. Taylor, let me recognize you for your testimony.

STATEMENT OF D. RUSSELL TAYLOR, PRESIDENT AND CEO, RAHWAY SAVINGS INSTITUTION, REPRESENTING AMERICA'S COMMUNITY BANKERS

Mr. TAYLOR. Absolutely. Thank you, Chairman Oxley, and thank you, Ranking Member Frank and members of the committee.

I am Russ Taylor. I am the President and CEO of the Rahway Savings Institution, a small mutual institution located in central New Jersey. I am also this year's chairman of America's Community Bankers.

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 on GSE regulatory reform.

ACB has an intense interest for several reasons.

First, we strongly support the secondary market role of Fannie Mae and Freddie Mac and the important housing mission they fulfill.

Second, we strongly support efforts to improve regulation to better ensure safety and soundness and focus on mission.

And three, our members are business partners with Fannie Mae and Freddie Mac and investors in their securities.

In fact, my own institution has active relationships with all of these entities.

ACB commends Chairman Baker and Representative Royce in their efforts. Their years of background work will make it easier for Congress to craft sound legislation.

We strongly support many of the provisions of their bills that provide substantial independence for the new agency.

My written testimony details the key elements of independence that are currently provided to other financial regulators. This to us is an essential element of GSE regulatory reform.

The new agency must also be able to fund itself without going through the annual appropriation process. 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, and as a result Fannie Mae and Freddie Mac have engaged in, or at least attempted to engage in, activities inconsistent with their secondary market responsibilities.

The Administration, and pending bills, make it clear that HUD will still set affordable housing goals for Fannie Mae and Freddie Mac. HUD would actually gain authority to set goals and to enforce them. That, plus a new independent agency with a mandate to enforce the company's housing mission, should maintain their support for housing.

ACB strongly agrees with the Administration position that there should be no limit on the new agency's ability to increase capital requirements for Fannie Mae and Freddie Mac if necessary.

Let me be clear that we are not proposing the capital requirements be increased. But capital is the foundation for the safety and soundness of our financial system and must remain a flexible tool available to the regulator.

We recognize that any solution that Congress develops for Fannie Mae and Freddie Mac may have a direct impact on the Federal Home Loan Bank System. That is a system that we deeply care about. In fact, Secretary Snow testified that the Federal Home Loan Banks should also be regulated by the new agency.

ACB has traditionally supported separation between the regulation of Fannie Mae and Freddie Mac and that of the bank system. The Federal Home Loan Banks are cooperatives, not public companies, and pose different regulatory issues.

However, our members who do support a merged agency are concerned that Fannie Mae and Freddie Mac will enjoy a cost-to-funds advantage if the bank system is not included.

They also know that Federal Home Loan Banks, Fannie Mae and Freddie Mac, are all engaged in extensive interest rate risk management. A combined agency would, in their view, be better able to supervise these risks. ACB's board is weighing these arguments as we speak today.

I wish to again express ACB's appreciation for your invitation 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 and look forward to working with you as you craft legislation to accomplish that goal.

Thank you.

[The prepared statement of D. Russell Taylor can be found on page 240 in the appendix.]

The CHAIRMAN. Thank you, Mr. Taylor.

Mr. Conine?

STATEMENT OF KENT CONINE, CONINE RESIDENTIAL GROUP, REPRESENTING NATIONAL ASSOCIATION OF HOMEBUILDERS

Mr. CONINE. Thank you, Chairman Oxley and members of the committee. My name is Kent Conine and I am President of the National Association of Home Builders, representing 211,000 members of our association, which employ over 8 million employees. Also President of Conine Residential Group, which is based in Dallas, Texas, specializing in both single-family and multi-family development and building.

I am pleased to comment on the recent proposals to restructure the regulatory framework for the housing-related GSEs.

On September the 10th, Treasury Secretary Snow and HUD Secretary Martinez unveiled before this committee the Administration's proposal to restructure the regulatory framework for the government-sponsored enterprises.

This pronouncement focused almost exclusively on improving the safety and soundness of the regulation of Fannie Mae and Freddie Mac.

While the nation's home builders support most of what has been put forth by the Administration to ensure a strong and credible regulatory framework, we have grave concerns about a shift from the narrow regulatory focus to a larger referendum on the housing finance system in general.

Housing mission and the GSE's role were largely omitted from the discussion during the September 10th hearing. We are pleased that this committee, by virtue of conducting today's hearing, recognizes that some of the concepts outlines by the Administration deserve more rigorous review and discussion.

Specifically, the Administration's proposal to remove the mission oversight or new program approval from HUD and place it in Treasury marks a fundamental shift in perspective about the role of HUD as well as how the GSEs engage in their day-to-day business and undertake new programs.

We strongly oppose such a change and urge you to retain HUD's oversight of new programs as well as the annual affordable housing goals and enforcement of our nation's Fair Housing Act.

In focusing on the safety and soundness regulation, we urge the committee not to lose sight of the core missions, which is consistent with the congressional intent creating the housing GSEs; that is to provide liquidity, capital and stability to the housing market.

Program oversight is key to this core mission.

The Administration's proposal blurs the mission of Fannie and Freddie, and thereby rationalizes its proposal by treating new program authority as an exclusive function of safety and soundness.

This has never been the case and fundamentally ignores the legislative history in the 1990 Treasury studies creating the 1992 GSE Act.

The objective and focus of program oversight is not safety and soundness, as HUD Secretary Martinez testified, it is mission compliance. An example would be furthering the Administration's goal of increasing minority home ownership.

Applying safety and soundness criteria in conjunction with Treasury's longstanding bias against programs that facilitate the flow of capital to housing would severely retard the development of new programs continuously needed by Fannie Mae and Freddie Mac to fulfill their housing mission and to adjust to market conditions.

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 of safety and soundness regulation.

For example, the highly successful Mortgage Revenue Bond program is being held hostage today by Treasury because they have failed to adjust the home purchase price limits since 1993.

On the issue of capital requirements, NAHB agrees with Secretary Snow that there is a need for stability in capital standards and that capital standards should not be subject to frequent change. NAHB applauds Secretary Snow's decisions not to recommend any changes in the GSE's risk-based capital regulation at this time, given that the standard took 10 years to develop and has been in effect for only about a year.

We are pleased that Treasury has given risk-based capital standard a chance to work.

Due to the low-risk nature of home mortgages, NAHB recommends against any changes in the GSEs minimum capital standard requirement as well.

Finally, the Administration is proposing to strengthen HUD housing goals authority over Fannie Mae and Freddie Mac. NAHB has a longstanding history of supporting housing goals. We supported the increases in the goals implemented by HUD's 2000 rule.

This rule also provided for bonus points for the 2001 to 2003 period for units financed for GSE mortgage-backed purchases in small, 50 to 50 unit multi-family properties and for units in two to four unit owner-occupied units.

NAHB feels that more needs to be done to encourage the GSEs to increase their activities in some market segments, such as rural areas and multi-family production.

At the same time, NAHB believes that any proposed changes to the housing goals should undergo careful examination. Fannie Mae and Freddie Mac were created to serve a broad range of housing needs, and we would not want to overly stringent the goals to impede that particular mission.

Continual increases in the percentages targets will also have diminishing returns and run the risk of adversely impacting other housing programs like our FHA single family program.

In conclusion, I appreciate the opportunity today to express our position on restructuring the regulatory oversight on the housing GSEs, particularly our opposition on moving the mission oversight from HUD.

I hope to work with you in the coming days to have a chance to work with you to craft a bill that will accomplish this mission.

Thank you.

[The prepared statement of C. Kent Conine can be found on page 127 in the appendix.]

The CHAIRMAN. Thank you, Mr. Conine.

Mr. Fishbein?

STATEMENT OF ALLEN FISHBEIN, DIRECTOR, HOUSING AND CREDIT POLICY, CONSUMER FEDERATION OF AMERICA

Mr. FISHBEIN. Thank you, Mr. Chairman, and Mr. Frank and members of the committee.

My name is Allen Fishbein and I am the Director of Housing and Credit Policy for the Consumer Federation of America.

CFA is a nonprofit association of some 300 consumer organizations with a combined membership of 50 million that was founded in 1968 to advance consumer interests.

CFA and many of its members have a longstanding interest and involvement in housing finance matters, including advocating for expanding the role of the GSEs in serving important housing needs.

My own background, which I want to mention, is that I served a tour at HUD as Senior Adviser for GSE Oversight. My duties included helping to supervise the setting of the present affordable housing goals for Fannie Mae and Freddie Mac.

We thank you for affording us this opportunity.

CFA believes that the GSEs play an important, indeed essential role in promoting a sound housing market and by providing expanded home ownership and other housing opportunities. Through their statutory mandates, the GSEs are required to serve a dedicated percentage of their business to address the needs of low-and moderate-income households and underserved communities.

Changes to the GSEs regulatory structure, therefore, must be undertaken with great care and precision, so as not to work at cross-purposes with the GSEs ability to carry out these important mission activities.

In short, the charge should be do no harm to the GSEs' housing mission.

To summarize the key points from my written testimony, number one, we believe that it is in everyone's best interest to have a strong oversight regulatory structure. The tremendous growth in the size of the GSEs over the past decade has raised the stakes for regulatory oversight. Certainly, consumers, whether they are existing or future home buyers, renters or investors, along with other stakeholders have a strong interest in effective oversight of the enterprises.

Thus it would be hard to argue against the need for Congress to review the adequacy of a regulatory structure that was put into place a decade or more ago.

Second, there is recognition that OFHEO does not have all the powers it needs to perform this oversight. Listening to the testimony today, maybe that is an understatement.

Unlike banking regulators, OFHEO does not have authority to assess the financial institutions it supervises for the full cost of oversight, and the funds for its budget are provided through a congressional appropriations process which has limited the agency's funding in comparison to banking regulatory agencies.

In addition, OFHEO is not equipped with a full range of enforcement tools commonly afforded to financial regulators.

Third, we believe the simplest way to correct this problem would be upgrade OFHEO, but we know that some on this committee have concluded that a mere upgrade alone would not be sufficient and that further changes in the regulatory structure are also needed.

For example, Mr. Baker's bill would abolish OFHEO and switch the functions of safety and soundness and some mission oversight functions to the Office of Thrift Supervision.

Also the Administration in their testimony before the committee outlined proposals for making even more extensive changes to the existing regulatory structure.

It is our belief, however, that strengthened financial oversight could be achieved without making major sweeping changes to the existing regulatory structure.

CFA is supportive of steps to enhance GSE safety and soundness oversight. Along these lines, we believe that providing GSE regulators with the authority to assess the enterprises themselves for the reasonable cost of oversight and removing funding for these activities from the annual appropriations process would go an extremely long way in addressing many of the concerns that have been cited.

Improving the mechanism used to fund the cost of GSE oversight would enable these regulators to increase their capacity and bring on additional financial expertise needed to perform their important functions.

However, again, we are not convinced that OFHEO is inherently flawed in its capacity to serve as a safety and soundness regulator.

Moving the GSE regulator to Treasury, while it is viewed by some as providing certain benefits in stature, could also carry with it disadvantages, not the least of which are likely to be administrative disruptions, at least in the short term. And because Fannie and Freddie are major issuers of debt in the capital markets, along with the Treasury Departments questions about potential conflicts of interest could conceivably arise from the Department's exercise of its new oversight powers over the GSE activities.

We also are troubled by the suggestion that the new Treasury bill would not be established as a fully independent office, along the lines of OCC and the Office of Thrift Supervision.

However, whether or not a safety and soundness regulator is ultimately shifted to Treasury, CFA believes that the charter oversight and new program approval should remain at HUD. Switching

this authority to Treasury we fear would detract from maintaining important regulatory focus on the GSE's housing mission performance.

And fifth and finally, we would like to see steps taken to strengthen the GSEs' obligation to support its affordable housing related activities. We were pleased that Secretary Martinez in his testimony before the committee made a number of constructive proposals aimed at spurring additional improvements in the GSEs' affordable housing performance.

In particular, we were pleased that the Secretary asked for authority for HUD to impose enforceable sub-goals. Sub-goals are a logical tool to ensure that the GSEs adequately consider the most underserved segments of the mortgage market.

However, the Secretary's proposal is not sufficient unless HUD places greater emphasis than it has on performing these important responsibilities. For example, HUD let slip the establishment of new goals for 2004 and beyond. The existing goals were originally set to end at the end of this year, and HUD's failure to take action this year means that the current levels will roll over for at least another year.

In addition, we also believe that much more can be done to improve GSE performance in meeting their goals through expanded public focus on the GSEs' activities. And in my written testimony, I mention two of these areas.

One would be to improve the GSE public use data base which is administered by HUD to permit better local analysis of the GSEs' activities, and, two, to have better reporting to Congress on the GSEs' affordable housing activities and its departmental plans for establishing new goals or explanations for why a goal periods would need to be extended.

The CHAIRMAN. Can you sum up, Mr. Fishbein?

Mr. FISHBEIN. I am going to close by reiterating that we believe it is in everyone's interest to have strong regulatory oversight of the GSEs and in doing so we urge the committee to proceed with caution and resist the urge to make needless changes that detract from the GSEs' ability to perform their mission obligations.

Thank you, Mr. Chairman.

[The prepared statement of Allen Fishbein can be found on page 153 in the appendix.]

The CHAIRMAN. Ms. Montague?

STATEMENT OF TERRI MONTAGUE, PRESIDENT AND CEO, THE ENTERPRISE FOUNDATION

Ms. MONTAGUE. Thank you, Chairman Oxley and Ranking Member Frank and members of the committee, for this opportunity to testify. I am Terri Montague, President and Chief Operating Officer at the Enterprise Foundation.

Enterprise provides private capital to support affordable housing and economic development in low-income communities. To date, we have invested in excess of $4.4 billion to finance more than 144,000 affordable homes for low-income people, including more than 12,000 in 2002.

Fannie Mae and Freddie Mac are among Enterprise's most important partners. Without them much of our work simply would not be possible.

Congress is considering significant changes to the Federal Government's regulations of these GSEs. We encourage Congress to deal with these issues as expeditiously as possible to avoid any uncertainty in the mortgage markets.

As many have already testified, we too strongly support safety and soundness regulations. And we support strong affordable housing requirements.

We agree with the Administration that there is no reason to change the GSEs' mission, charter or status. We also agree with the Administration that HUD should remain responsible for ensuring the companies' compliance with their congressionally mandated affordable housing responsibilities.

Briefly, we have recommendations regarding three issues, the location of prior approval authority, the scope of approval authority, and the establishment and enforcement of the GSE affordable housing goals.

On the first point, the location of prior approval authority, the Administration has proposed transferring this authority from HUD to a new safety and soundness regulator. The new agency would consult with HUD on new programs.

We agree with Chairman Baker and other members of the committee that HUD should retain this responsibility. We are not aware of any evidence that HUD has failed to exercise approval authority appropriately. We see no advantage to shifting approval authority to a new safety and soundness regulator.

After all, HUD is the only federal agency with expertise in housing finance and a mission to advance affordable housing and only HUD has the benefit of more than a decade of experience evaluating new GSE housing programs.

Secondly, the scope of authority issue. Current law requires the GSEs to obtain HUD approval for any new program. H.R. 2575 would substantially broaden this authority. It would require the companies to obtain HUD approval before engaging in a wide range of activities, not just new programs.

Again, HUD has not used its approval authority inappropriately. HUD also has the authority under current law, which it has previously exercised, to itself initiate a request for information from the GSEs regarding what it considers possible new programs.

Requiring the companies to seek federal signoff on new activities could curtail their ability to respond effectively to changes in the mortgage markets, such as rising interest rates. It also almost certainly would impede the GSEs' ability and incentive to innovate.

Low-income consumers and communities which often benefit most from GSE innovations could lose out.

We wonder whether Fannie Mae would have been able to pioneer use of the low-income housing tax credit if the company had been subject to the approval requirements the bill would impose.

As you may recall, in the credits early days, hardly any corporations were willing to commit capital to the program, as it was seen as too risky. And few Federal officials understood the program in that it was too new.

Fannie Mae stepped up when others would not and helped convince other corporations to invest. Fannie Mae and Freddie Mac committed to this fledgling Federal incentive, and in doing so, sent a strong signal to the marketplace that the credit was a sound investment.

The housing credit is now perhaps the most important Federal incentive for the development of rental housing for low-income people. And it is truly impossible to imagine such success without Fannie Mae and Freddie Mac's early and sustained participation.

On the third issue: In 1992, the GSE legislation requires the GSEs to dedicate substantial portions of their business to serving low-income people and communities. The Administration has proposed expanding HUD's ability to establish and enforce the GSE affordable housing goals.

We see no reason to change the statutory framework for the affordable housing goals at this time. HUD has the authority already to increase the percentage of business targets in each statutory-goal category.

HUD also has the authority under current law to incent the GSEs to achieve more specific affordable housing objectives. HUD has utilized this authority effectively in the past, resulting in substantial increases in the GSE's affordable housing financing.

HUD's most recent regulatory revision of the affordable housing goals resulting in the GSE's increasing their mortgage financing for low-income and underserved people and communities by nearly half a billion dollars between 2001 and 2011.

Let me be very clear: Enterprise has long urged Fannie Mae and Freddie Mac to increase their affordable housing activity. The companies could and should do more. We welcome the opportunity to work with HUD, the GSEs and other housing organizations to explore strengthening the goal levels and objectives. But we urge Congress and HUD not to proceed with any affordable housing goal revisions without seeking the advice and assistance of a wide range of housing organizations, as it always has in the past.

I would be pleased to answer any questions that you have.

[The prepared statement of Terri Y. Montague can be found on page 191 in the appendix.]

The CHAIRMAN. Thank you for your testimony.

Dr. Spriggs?

STATEMENT OF WILLIAM SPRIGGS, EXECUTIVE DIRECTOR, INSTITUTE FOR OPPORTUNITY AND EQUALITY, NATIONAL URBAN LEAGUE

Mr. SPRIGGS. Thank you, Congressman, and thank you, Congressman Frank, for this opportunity.

My name is William Spriggs. I am the executive director for the National Urban League's Institute for Opportunity and Equality. I am joined today Marvin Owens, who is the head of our housing department out of our New York headquarters.

The Congress here has gathered because the size of the securities and mortgage-backed security instruments issued by GSEs is now almost as large, in fact, a little larger than the U.S. Treasury-note market. And so that means that all of us should be concerned about the safety and soundness of these enterprises, and that they

are very important to the security of the American economy, if not the world's capital markets.

However, it is equally important to remember why Congress created the GSEs, and that has to do with capital markets.

In the case of the housing GSEs, the purpose was to create an effective market for residential mortgages, and this was in response to the lessons taught by history.

The leverage given to the housing GSEs by Congress was to establish increasing access to home mortgages for underserved areas, and this mission must remain paramount in assessing different measures of safety and soundness.

For instance, the risk-based capital standards that were put in place last year are an example of how it is important to try and keep the minimum capital requirements low so that we can have a larger pool of funds available for mortgages.

The primary concern of the League in this issue is the maintenance of the housing GSE mission. Our housing office partners with both Fannie Mae and Freddie Mac to deliver a set of services that we integrate with programs from the banking industry, the Department of Housing and Urban Development and others to try to increase home ownership in the African-American community.

There is no simple answer to the disparity in home ownership rates between African-Americans and whites. Access to credit is one part of the answer. Credit counseling is another part of the answer.

As an example, our program with Fannie Mae began in November 2002 with the signing of a five-year memorandum of understanding that launched a demonstration project in six and then seven and now eight of our affiliates, including Houston, Dallas, Tucson, Rochester, Seattle, Atlanta, and Stamford.

Working with J.P. Morgan Chase, the project has put more than 500 families into homes and got an additional 200 families prepared for home ownership, and it has moved over $43 million in loans.

Several of those affiliates are now at various stages in creating community housing development organizations, the next step in solving housing problems for low-income and African-American households in their cities.

So the Fannie Mae relationship is a catalyst that those affiliates have leveraged. The League has a similar program with Freddie Mac.

The key lesson learned from the experience of the National Urban League's housing department is that increasing home ownership requires a comprehensive approach. It was with this foresight that the housing GSEs were put within HUD. The housing GSEs should be viewed as a tool among others that can address the complexity of causes of the disparity in home ownership rates in America.

And it is in that regard that the National Urban League would be very concerned if program oversight were moved from HUD, even if safety and soundness oversight was moved to Treasury as some have proposed.

Program oversight should ensure that the housing GSEs keep to their charter and mission, but should also ensure that the housing

GSE programs fit into a coherent set of programs at HUD to create the largest affordable housing stock available for America, and that huge disparities in home ownership faced by African-Americans and Hispanics can be closed.

We would be concerned if the programs of the housing GSEs are evaluated out of context, out of the context of a comprehensive housing program, and that faulty conclusions could be reached from the effectiveness or appropriateness of the programs of the housing GSEs, and that inappropriate safety and soundness standards might then cloud the mission of the housing GSEs.

Still, we believe that important improvements could be made in program oversight. Organizations like the National Urban League, and you heard from The Enterprise Foundation just a second ago, and other community-based and nongovernment organizations have worked to address the housing needs of underserved communities.

Beyond comments to proposed rules, we hope that Congress will create a new way of rule-setting to ensure a transparent mechanism, to ensure HUD incorporates the views of such organizations in setting rules and regulations toward goal-setting for the housing GSEs and in program oversight.

To us, the key is not just mission, but whether the program proposals from the housing GSEs would actually lead to the housing targets established by HUD. And as I just explained, we think this is the responsibility of HUD, not just of the housing GSEs, that is, reaching affordable housing targets.

We think that this would incorporate the lessons learned by these organizations—Enterprise, the National Urban League, and others—on the front lines of address the housing problem and into assessing the likely effectiveness of the proposed program enclosing the home ownership gaps experienced by underserved markets.

Thank you.

[The prepared statement of William E. Spriggs can be found on page 236 in the appendix.]

Mr. BAKER. Thank you, Doctor.

Mr. Courson?

STATEMENT OF JOHN COURSON, PRESIDENT AND CEO, PACIFIC MORTGAGE COMPANY, ON BEHALF OF THE MORTGAGE BANKERS' ASSOCIATION OF AMERICA

Mr. COURSON. Thank you, Mr. Baker, Ranking Member Frank, distinguished committee members, thank you inviting the Mortgage Bankers to speak at this important hearing.

MBA members originate loans in the primary 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 play two important roles in the American finance system. First, they provide market liquidity, and second, they 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 GSEs. The Mortgage Bankers endorse the principles for GSE regulation played out by Secretary Snow and Secretary Martinez before

the committee earlier this month. And 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's 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 Treasury and HUD need to have adequate funding if they are to live up to their important duties. The Mortgage Bankers urge this committee to look at the Office of Thrift Supervision funding arrangement in drafting 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 hand.

Fourth, a regulator needs adequate enforcement authority to correct any problems that may arise, and, more importantly, to deter problems in the first place.

The Mortgage Bankers believe that the banking enforcement tools have proven their effectiveness over the years, and support including such tools for a 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 the domestic and international economies.

For these reasons, all 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 GSEs be permitted to encroach upon the mortgage origination process, or use their Government-sponsored benefits to distort the competitive landscape of the primary mortgage market.

The Mortgage Bankers also believe that it is important that the regulator not micro-manage the GSE, and that it not unduly constrain the GSEs' ability to innovate in a timely manner to meet the 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 GSEs are able to meet these housing needs.

MBA strongly supports the affordable housing goals for Fannie Mae and Freddie Mac, and endorses HUD's role in setting and en-

forcing those goals. The Mortgage Bankers strongly urge Congress to reform the oversight of Fannie Mae and Freddie Mac in this manner, so that they can continue in their role of supporting housing, especially affordable housing.

Congressman Baker, thank you, and I am happy to answer any questions.

[The prepared statement of John Courson can be found on page 139 in the appendix.]

Mr. BAKER. Thank you, sir. And welcome back to our former colleague, Mr. Bartlett.

STATEMENT OF STEVE BARTLETT, PRESIDENT AND CEO, THE FINANCIAL SERVICES ROUNDTABLE

Mr. BARTLETT. Chairman Baker, Ranking Member Frank, and Congressman Scott, this is about as close to a special order as I have done in any time in the last 12 years.

I notice Congressman Scott is looking at the clock. If you have a flight or something, and you want to take my time to ask a question, I will gladly yield. If that is the issue, that would be fine.

Well, I will stay within my five minutes. My name is Steve Bartlett, I am President of the Financial Services Roundtable and our newly formed Housing Policy Council.

Collectively, Mr. Chairman, and members of the committee, our member-companies represent the strongest commitment to housing in America today, originating some 70 percent of the residential mortgages in the United States.

Our members strongly support the goal of home-ownership for all Americans, and we help to meet it every day. We understand the functions and operations of both the primary and secondary mortgage markets.

Toward that end, our council has adopted five principles that we believe should guide this committee. Those principles are consistent with the proposal that Secretaries Snow and Martinez offered to the committee.

They include: One, the regulatory agency should be independent and housed within Treasury, much as the OCC and OTS are structured an operate within Treasury.

Second, the agency should be funded by nonappropriated funds.

Third, all supervision and regulation should be in one agency, not divided.

Fourth, the agency should have an abundance of staff qualified to understand, analyze and supervise the quality and the quantity of assets and liabilities of Fannie and Freddie.

And fifth, its securities disclosure should be the same as applicable to all other publicly traded companies.

Now, last week, Mr. Chairman, the council met and considered and added a sixth principle. The new bureau within the Treasury should also have regulatory and supervisory responsibility over the Federal Home Loan Banks.

Thus, the council strongly supports the Administration's proposal that an independent regulator within Treasury, free from the appropriations process, the safety and soundness regulation including the authority to review and approve new GSE activities.

The regulator should establish capital standards and have enforcement capabilities, and those should be a strong as that of banking regulators.

Speaking of banking regulators, I want to cite as an example the OCC. The OCC has offered a clear road map to follow. It has the authority to supervise all aspects of a national bank's operations, including review of new activities.

There is no need to re-invent the wheel or create new procedures. Now, the council, and I personally I must say, intend in no way to criticize, and it hasn't happened here today, the dedicated personnel at OFHEO or the Federal Housing Finance Board.

I find them to be professional, ethical, dedicated, knowledgeable individuals. They have not had the statutory authority to do their jobs. The Housing Policy Council and the Roundtable believes that under these new proposals they will have an opportunity to do a world-class job.

So in conclusion, the members of the Housing Policy Council believe in our system of housing finance, and we want to strengthen it. We recognize that the housing GSEs have an important role to play, but there is no question that the system of housing finance would benefit from a strong, independent regulator.

Inn conclusion, one statistic which I looked up this morning, the OCC regulates national banks with approximately $3.9 trillion of assets. OFHEO regulates GSEs with approximately $3.3 trillion in assets, owned and guaranteed, almost the same.

The OCC does its job with 2,800 employees, and full statutory independent authority. OFHEO has been asked to regulate almost the same size of assets with 115 employees, and no independent statutory authority.

Therein lies the challenge of this committee, Mr. Chairman, to provide statutory authority for a strong and independent regulator for this critical segment of the nation's financial marketplace and the home-ownership opportunities for all Americans.

The time to act is now, this session. Thank you.

[The prepared statement of Hon. Steve Bartlett can be found on page 123 in the appendix.]

Mr. BAKER. Thank you, Mr. Bartlett.

Mr. Taylor, it is my understanding that Rahway Savings Institution, as a regulated entity under the Office of Risk Supervision, has to comply today with what is known as community re-investment standards.

Mr. TAYLOR. That is correct.

Mr. BAKER. At issue is whether another entity other than HUD can adequately supervise a social mission compliance in an effective manner. What is your experience with OTS in your responsibilities as an institution in meeting your CRA criteria?

What is the supervision like, and what are the consequences of your failure to meet those standards?

Mr. TAYLOR. If I could just make one correction. We are not OTS-supervised; we are a state chartered bank. So we are supervised by the Department of Banking of the State of New Jersey, as well as the FDIC, as a Federal regulator.

And with regard to that and its relationship to an independent regulator under the Treasury for these GSEs, it has been very simple for us to be able to met our CRA requirements.

We do utilize, I must say also, the GSEs in question to help us attain those goals, in terms of utilizing their services and their programs, which is one of the main reasons why they are so beneficial to us and to the industry.

With regard to a regulator having oversight and having those kind of mission-directed responsibilities, we believe that if an independent agency under Treasury, a truly independent agency, is given the mission statement and the mission of housing as its key measure for these GSEs, that there should be no reason why the housing needs are not fully met.

Mr. BAKER. Do you share the view of other witnesses that Fannie and Freddie perhaps could do a better job in meeting the needs of low-income minorities and inner-city individuals than they do today?

Mr. TAYLOR. Tough question to answer. I think they have tried, and I commend them for what they have done. I think they have made some great strides.

They do come out with some innovative programs. Our members have taken advantage of them, ACB has entered into relationships with both Fannie Mae and Freddie Mac that deliver mortgages to them, both of which are conventional mortgages as well as CRA-related mortgages.

So I know the endeavor and the attempt on their part has been sincere, as it has been for the industry at large.

Mr. BAKER. Thank you. Mr. Bartlett, a capital-related question. As you know, I have raised the issue with Mr. Raines and others today about the adequacy of maintaining authority for the new regulator to appropriately review risk and adjust minimum capital.

As the rules now stand, the risk-based capital standard only recently promulgated is not yet in effect in the sense that the minimum capital required by statute of 2.5 percent is the actual currently required amount by a GSE.

In order for a regulator, currently OFHEO, to act under the statute, you must be critically undercapitalized, that is a level of 1.25 percent.

By allowing a regulator in the future, not today, no one is suggesting the immediate or imminent adjustment to either risk based or minimum capital standards—what would be your view, from your organization's perspective, given your broad scope of mortgage finance activities, as to the effect of allowing the regulator to have that authority? Would that enhance confidence? Would it have any effect on the ability to make credit available? What is the consequences of following the path that I have suggested?

Mr. BARTLETT. Chairman Baker, that path should be followed, as Secretary Snow proposed in his testimony. He was quite clear. I read: "The regulator should also have authority with regard to capital for the GSEs."

So it is essential that this regulator be given authority over capital. This is the only regulator in the United States of America that does not have authority over—financial regulator—over capital and that should be an essential part.

Now that authority over capital would enhance the safety and soundness and also enhance the confidence in the system. But I think that's sort of a starting point, and it's a mistake that should be corrected.

Mr. BAKER. Thank you.

Dr. Spriggs, I just have one observation, and I would like to hear your comment with regard to it. I have been involved in the initiation of a Hope 6 grant in my community. And it is a good project but it is potentially flawed unless it involves a number of aspects of community investment.

For example, merely making a line of credit available to an individual to acquire a home may not turn out to be a good event if at the same time you are not providing services in the community, creating jobs in the community and turning a blighted area around to become an economic model for all those who live there.

When we talk about providing resources for affordable housing, should we be looking beyond just the ability of Fannie and Freddie to address the access to capital by low income and perhaps look at it as a community renewal effort? I have been impressed by the community investment programs, CIP program under the Federal Home Loan Bank. And it is a much broader in scope program than what is now required of the two other housing GSEs. Can you comment on the advisability or the nature of that enhancement for the mission compliance for the two GSEs?

Mr. SPRIGGS. That's exactly my point, I think we have to look at it in a comprehensive way. And I would hope that HUD, because they run Hope 6, would think of how do you piece together the whole pie to make a successful Hope 6 project.

And it does take many different elements. It takes a very strong community-based organization with good technical skills to come into the ground and do as you observed, piece together some of these other things.

Some of them are HUD programs, but sometimes it takes an organization that deals with other federal agencies and put together the whole package from an array of what needs to be in place to make a community work.

Congressman Scott had been concerned that African-American home ownership had been dropping. But you know, this is going to be a key reaction to the recession and the loss of people's job.

So it isn't, as you were just saying, jobs, the structure of the neighborhood are as important, getting credit counseling is as important.

So that's why I think it is important for HUD to think of the goals that they set for the programs they approve for Fannie Mae and Freddie Mac as within that array. And only, in my view, HUD has the ability to think comprehensively about what should the program be to meet our housing goals because they have the other programs. As you were just mentioning, they have the other programs to put into place so we can meet those goals.

And I do not think we should look at Fannie Mae and Freddie Mac and point fingers and say you are a silver bullet, you have not done it. They are not a silver bullet. They are a necessary tool and we need their partnership. But we need to have this viewed as you have just mentioned in a comprehensive way.

Mr. BAKER. Thank you, sir.

Mr. Frank?

Mr. FRANK. I would agree with that. I think basically the point that you just made in the conversation here is that we want to go beyond lower loans and maybe get into some deeper subsidies. But I have a couple of things here.

First of all, I have to disagree with the gentleman from Louisiana that there is some analogy between the low-income housing goals of Fannie Mae and Freddie Mac and CRA, Community Reinvestment Act. I have defended the Community Reinvestment Act, but it is not a very strong mandate. And I think it is really qualitatively different from the affordable housing goals, which go much more specific. The Community Reinvestment Act says you lend in your own area. And it is not just a comparable mandate.

And yes, I would like to see deeper subsidies. I think the analogy that I asked about before was the affordable housing program of the Federal home loan bank, which was created here under the chairmanship of the late Henry Gonzales. And that is an element of subsidy.

But here is my problem, and I ask you to address this. I worry about increasing the capital requirements and the inconsistency there with the subsidy program. I would like to get Fannie and Freddie more deeply into helping low-income housing and possibly moving into something that is more explicitly a subsidy.

My concern is that this would not be what would be a regulator at Treasury's idea of the best way to promote safety and soundness. And in fact, there is a tension between increasing the capital requirements and increasing the subsidy. I just think you cannot argue it at both ends.

Members of the panel, Mr. Fishbein, let me start with you, if you would comment on that.

Mr. FISHBEIN. Well, I agree with you, Mr. Frank. There was a lot of talk in the discussion today about bifurcation of function. But the reality is that safety and soundness regulation and capital requirements interrelate with public mission. There is always going to be a give and take and a certain tension between these various functions. Hopefully it is a creative one.

Therefore, the regulatory structure that is put into place and the way that communications occur and decisions are made are an extremely important detail that should be part of any restructuring legislation. One of our concerns about placing the vast part of both safety and soundness and mission oversight at Treasury is that we believe that Treasury's emphasis will tend to be on safety and soundness. This will make it hard, therefore, for some close calls about mission to prevail in that kind of environment.

So there has to be a balance. And the balance has to include equally strong regulatory structures that are in position to bring forth the counter balance and expertise in analysis to ultimately make sound judgments and make sure that one side of regulation does not automatically prevail.

Mr. FRANK. Anyone else wish to address that?

I believe there has been more alarm raised about potential unsafety and unsoundness than, in fact, exists. And it has been my experience that when that happens, people start worrying that

things are not secure. And the first thing that happens is the poor people get tossed over the side because, after all, they are the least good risk.

Mr. Bartlett?

Mr. BARTLETT. Ranking Member Frank, this is the same tension that occurs with the OTS and OCC. The point is that because of that tension, the capital standards should not be set by statute. It should be set by a transparent regulatory process, which is in place for all other regulators, and should be authorized by——

Mr. FRANK. Well, I agree. I think my colleague may be asking you whether you think the regulator here, in fact, should more resemble the OTS and the OCC than some of the proposed statutes do.

But I would say this, yes, there is that same tension. But it is not the mission of either the OTS or the OCC to promote low-income housing. And that's the difference.

I don't want to treat Fannie Mae and Freddie Mac the same as I treat a regular bank. If I wanted them to be just like a regular bank, then we wouldn't need a Fannie Mae and a Freddie Mac. We could have a regular bank.

The theory is that we have these separate government-sponsored enterprises that do have some statutory advantages in return for which they focus on housing, and, specifically, we give them goals. We have the Community Reinvestment Act. Maybe if I filed a bill that gave every bank the same kind of low-income housing goals as Fannie and Freddie and some ability to—maybe I could get it passed. I don't think so.

And they are very different. OCC and OTS have a safety and soundness mandate entirely, with a little bit of social consciousness with the CRA. But the CRA basically says, "Do not suck too much money out of the community and do not put any back in."

It should be qualitatively different than the mandates we have given to Fannie and Freddie.

So I guess that may sum up to me why some of us have some differences on this. I do not want Fannie and Freddie to be just another bank. If they were not going to do more than another bank would because they have so many advantages, then we do not need them.

And so therefore, I do think I do not want the same kind of focus on safety and soundness that we have in OCC and OTS. I want to roll the dice a little bit more in this situation towards subsidized housing.

My time has expired, Mr. Chairman.

Mr. BAKER. Mr. Kanjorski?

Mr. KANJORSKI. Thank you, Mr. Chairman.

Listening to that discussion, I tend to agree that this is a very delicate area on how we handle mission and how we deal with what really independent strong role plus regulation will be and to tailor those two situations to these particular entities, not counting the fact that we have some earlier testimony about throwing in the Federal home loan bank system, which creates an entirely different problem we would have to address.

First of all, is anyone on the panel aware of a crisis situation where we have to do this in the next two or three weeks?

Do you really believe that some of the issues that have been raised here in the discussion with this panel, that this can all be accomplished with deliberative speed in a short period of time, like two or three weeks?

Mr. BARTLETT. Mr. Kanjorski, our organization and our companies have been quite concerned about this from a safety and soundness as well as a mission for the last several years. We have communicated that concern. But recently, that concern seems to have been highlighted by a number of factors.

So, yes, sir, I believe there is an urgency that is to the tune of some $3.3 trillion that is either owned or guaranteed by these two agencies that all the testimony that you have heard today bring in some question as to whether they are being properly regulated. So we think they are not being properly regulated. And we believe that with $3.3 trillion, you do not want to wait too long. And now is the time to act.

Mr. KANJORSKI. I would not suggest that everyone has questioned whether or not we can construct a better regulatory authority than what we presently have. I do not know whether we want to put a qualitative standard on what has existed. But my question is, we have so many fundamental questions, particularly missions and what is a strong independent regulator.

It seems to be we are going to have to wrestle a lot of things. Somebody suggested we write the mission. I think it was Mr. Raines. I venture to say I could anticipate taking weeks and weeks and weeks hammering that around and just what that description in statute should be of what the mission is so that it can be more readily applied.

My problem is I think we have a lot of haste here. We are going to run down and, Steve, having served on this committee before, you know what happens in haste. We sometimes do not dot all of our i's and cross all of our t's. And we can leave some awfully large holes in this mission.

Example, we are just starting to get down to people using the same description of what—you use the term independent and strong independent regulator and gave the example of the OCC and the OTS.

The Secretary, last week, said independent, strong, world-class regulator and gave the example of the IRS. I see a world of difference in that. And he may be more correct than we are or vice versa. But it seems we have to work.

If we are not defining our terms in the same way, we are going to put out a news release that Congress has passed a world-class, strong, independent regulator who cannot come up and talk to Congress, who cannot decide policy questions, who has limitations on supervision, has limitations on prosecutions, et cetera, et cetera, and going right down the line.

Or else, if we all put our minds to it and things do crystallize, we can come up with it.

I am just worried about doing in the limited amount of time left in this session. And I, myself, would like to have the legislation float for a while, so a lot of people could give us critiques of some of the problems that they see every day.

I left this session three or four times and met with people who critiqued me on various things happening here. I find that very informative and helpful, because, obviously, I do not think any of us on the committee are real experts in this area.

We are trying to craft language that will reflect expertise beyond the committee, actually.

With that, I appreciate all of the testimony of the panel. I look forward to hearing from you. As one member of Congress, look, if you see something happening, our names, you just have to call the Capitol operator and get a hold of us, give us some insight and some input as to, you know, how that big truck isn't going to fit in that little garage before we construct the garage.

And other than that, let's hope we can do something really contributory here to this system instead of ending up with just a whitewash on the garage door because there has been some circumstances that have brought this along.

With that, thank you very much for your testimony.

Mr. Chairman, I yield back.

Mr. BAKER. Mr. Scott?

Mr. SCOTT. Thank you, Mr. Chairman. I appreciate it so much.

Needless to say, this is an extraordinarily important issue to my constituents. I represent four of the fastest growing counties in the United States—middle-class, moderate, and lower-income. There is no greater need than housing.

The fundamental question that I have, and I would like to get a response first from Mr. Bartlett and Mr. Spriggs, because I think between the two of your testimony rests one of the fundamental issues that must be resolved. And that is this: There are some special reasons that Freddie Mac and Fannie Mae were put together. They have a special mission.

And there is much concern that this shift away from HUD over to the Treasury Department is in effect, throwing the baby out with the bath. There are concerns, especially from the minority community, and of those minority communities, as I pointed out, from this home-ownership rates, there is not one group within the minority groups that are suffering more than the African-Americans.

It is the only group in this country in which home ownership rates have gone down in this past year.

The others have increased bit by bit, and in African-American communities, it has gone down.

The reason I point that out is because there are some special peculiarities, sensitivities, that obviously affect the African-American community in terms of home ownership than any other group.

We are concerned that in this move that, at least with HUD, in terms of its comprehensive dealing with housing, the history, all of that there, that something will get lost in the move of this oversight to the Treasury Department.

I have some great appreciation for the safeness and the soundness aspect of this measure, and I certainly commend Congressman Baker on that pursuit.

But I think he along with all of us here on this panel must be assured that we are not losing any priority, any understanding, and in fact will strengthen any effort to move, or we don't move

it, because I don't think that the American people would go along with that. The American people are fair people, and understanding people, and keep in mind there is a mission here that must not be compromised.

And I would like to hear from you, Mr. Spriggs, and you, Mr. Bartlett, because I think the two of you, again, represent a solution to this, coming from two different sides. You are supporting this move to the Treasury, and Mr. Spriggs is saying there must be caution on it.

But first, Mr. Spriggs, what safeguards, what assurances would you be looking for in this area?

Mr. SPRIGGS. Well, again, because I think the reality is that the housing problem is complex, and it can't be solved only pointing at mortgage bankers or only pointing at Fannie Mae. And if a regulator has the responsibility of soundness primarily and comes from an institution that looks that way, I fear it would be like CRA. And those of us in many organizations have big struggles over getting the Community Reinvestment Act meaningfully enforced.

It is very rare to see a bank get a bad grade on their CRA. And it is not as if they are doing fantastic things. But it is just simply not the primary responsibility in evaluating them, to get meaningful about what are their real CRA activities.

And we are asking Fannie Mae to participate in something key and fundamental. As you said, Congressman, Americans are fair. And there are certain common values we have. Home-ownership is just one of those mom-and-apple-pie things. We all think that part of the American dream is to be able to own a home. And all Americans think that we should figure out how to solve home-ownership.

So that is much more specific than the CRA requirement. And I think it affects people differently when they think about whether you are meeting that target. If I get on Fannie Mae or Freddie Mac for not meeting the home-ownership, I think people react differently than if I say a bank didn't do 30 percent of loans in some neighborhood, and I am amorphous about whether those are business loans or whatever. I mean it just doesn't sound—it sounds like I am forcing the bank to do something bad.

Home-ownership is something everybody agrees is something we want to take place. So if it is a specific goal, it is a goal that needs to be integrated into a whole program; you can't just do it with one program. And it needs a whole Department, like HUD, to think through what are all the components, what is the realistic goal, because HUD has to deal with this. They can't give an unrealistic goal. What is the realistic goal?

And then to look at a program and be able to say, "Well, we have these programs. We know what they can do." If you are coming up with a program that is not going to get to that goal, we have all the metrics to compare it and tell you, that is not really a meaningful program. It may sound good on paper, but it is not a meaningful program.

So the theory is that we want it with an agency that has the expertise, that will set and is used to setting these specific and reasonable goals, and is thinking in a comprehensive way about how does that goal and how do the programs that are in place to meet that goal, how do they all fit together.

And I would be afraid of giving this to someone else who didn't have all that in front of them and, I would fear, drop the ball and let it escape or approve a program in a way that might be not as critical or disapprove of a program because they were not getting or were not as concerned about the goal.

Mr. SCOTT. Mr. Bartlett?

Mr. BARTLETT. Congressman Scott, thank you for the question.

First, Congressman, setting the GSE affordable housing goals under the Secretary's proposal, the two Secretaries, would remain at HUD. We believe and they believe that the process would be strengthened because there would be a transparent regulatory process that would be open for comment for all, and that is not the case today.

Secondly, I do agree that there is a special mission of Fannie and Freddie and the GSEs. In fact, and you have no way of knowing this, I was one of the principal authors of the 1983 act that started this, when it was much smaller.

And we set that mission, in layman's terms, as providing liquidity in the residential secondary mortgage market. It has succeeded beyond the wildest imagination, because by 1992, that was changed and Fannie would contend that it was significantly expanded.

But nevertheless, the regulatory structure was not caught up to it. A regulator was created that took—without the authority to adopt capital standards that every other regulator has always had, and it took eight years for them to issue their first regulation because of the statutory hamstring, not bad people.

So it has gotten to a $3.3 trillion overhang over the nation's economy. And unless strong, independent regulation is provided, the housing goals for Fannie and Freddie will go in the tank because the system will ultimately be in jeopardy. The system would be in jeopardy.

And that is why we are here, is to achieve those housing goals and make sure that we have strong capital standards to achieve them.

So I think this is a hearing and will be legislation that is designed to strengthen the system so that it can continue to provide housing and not allow it to be weakened.

Mr. FISHBEIN. Mr. Scott, can I answer that question as well?

Mr. SCOTT. Yes.

Mr. FISHBEIN. I certainly agree. It is our position, too, that mission responsibility should remain in HUD. But, in saying that, I would like to make some additional points.

First, that HUD is underfunded to do its present mission responsibility; that there are no special appropriations to perform this regulation; that HUD pays for funding for the staff—who are very dedicated, by the way, and very experienced from the general HUD operating budget. This sometime means that HUD has to make difficult budget choices.

So providing full funding, whether it be through an assessment process or a special appropriation, is absolutely critical.

Second, if the public mission function does get transferred, to Treasury, it is necessary to ensure that the director of this new office accountable for both functions. They should be judged by their

ability to conduct safety and soundness oversight well, but also by their ability to discharge the function as public mission regulator.

Combining both functions into a single office is very difficult which is why we have some concerns about such a move.

Should the Congress in its wisdom decide to go ahead and do that, it is very important these two functions be viewed as equally important. Ultimately, the person who heads this office should have the responsibility for discharging both duties with equal seriousness.

Mr. BAKER. Mr. Scott, in H.R. 2575, we have an independent assessment formula not only for safety and soundness within the OTS, but we also have a separate assessment in HUD for HUD's functions. So that is a very strong new, additional authority to ensure that your concerns about mission compliance is in hand.

Mr. TAYLOR. Could I comment on that last point?

We have heard today and we have talked a lot today about a world-class regulator. And I think we have heard testimony from Fannie Mae Chair Raines on this issue, and that is that he has investors that are not just in the United States but international, and that we are looking to create something to bring credibility to the marketplace.

And I would ask the question, what makes a regulator world-class if we take away its independence? What if it does not have the ability to look at or set capital standards and has no oversight on product and services? So at the end of the day, if the idea behind this is to have a world-class regulator for the GSEs, and then we limit its ability to regulate, what have we really done?

Mr. BAKER. You done?

Okay, thank you, Mr. Scott.

Just for the record, I want to establish that the current bill pending, 2575, was actually introduced on June 24th. Since the 106th Congress, I have been a part of or participated in 15 hearings on the subject of GSE regulation. And with the conclusion of this panel, you will be pleased to know you are part of 81 witnesses who have come before the Capital Market Subcommittee or the full committee on this subject. I would hope that in view of that record one would come to the conclusion we are not particularly rushing to judgment here.

But with all that aside, I want to express my appreciation to each of you for your perspectives that you have brought to the table. I do believe it will be helpful to us in formulating whatever the final product will ultimately look like.

I think the combination, frankly, of safety and soundness with mission compliance are not mutually exclusive, that we can take actions that are not only good for the enterprises and their shareholders, but we can take action that is also beneficial to the taxpayer. There is a net win to this process and the mere examination of the subject has not caused the housing market nor interest rates to go anywhere but down.

Since 1991, when we first began the discussion of creation of OFHEO, and you look at all the hostilities back and forth from controversial matters that were introduced or hearings that were engaged in, I suggest to you the Alan Greenspan effect is much more powerful than all of this combined. And we are enjoying record-low

interest rates for an extraordinarily long period of time. And if we are ever to engage in reformation of regulatory function, this window is a rare one indeed.

So not that it is our intent to have any person denied access to home ownership, in fact, I think the GSEs can do a great deal more in that regard than the do today. And I will join with my friends in seeking out statutory provisions to ensure that compliance.

But at the end of the day, this is far too important. They have grown so fast for too long that this issue does need a world-class regulator with the appropriate skills.

I also want to introduce into the record a statement by Mr. Rick Lazio, former member who now is President of the Financial Services Forum who could not be here but wanted to have that in the official hearing record.

[The following information can be found on page 246 in the appendix.]

Unless there are further comments, I thank you for your long-suffering patience. Meeting adjourned.

[Whereupon, at 4:20 p.m., the subcommittee was adjourned.]

A P P E N D I X

September 25, 2003

House
Committee on Financial Services
Michael G. Oxley (OH), Chairman
News

Opening Statement

Chairman Michael G. Oxley

Financial Services Committee

Improvements to GSE Regulation
September 25, 2003

Today, the Financial Services Committee will hear from the regulators, the regulated, and outside parties interested in the oversight of the housing Government Sponsored Enterprises. Two weeks ago, Secretaries Snow and Martinez came to the Committee with the Administration's proposal to improve regulatory oversight of the GSEs. They proposed developing a "world-class" regulator with the tools to rigorously supervise the activities of these highly complex financial institutions.

The Secretaries called for the regulator to be housed in the Department of Treasury as an individual office, similar to that of the Office of the Comptroller of the Currency. Additionally, the proposal called for the Department of Housing and Urban Development to retain its role as regulator of the GSE's mission and to ensure that the agencies meet their affordable housing goals. HUD's expertise in this area is critical, and under the Administration's proposal, the Department would receive additional powers to enforce compliance with the housing goals.

There is broad agreement that the current regulatory structure for the GSEs is not operating as effectively as it should. The Office of Federal Housing Enterprise Oversight is under-funded, under-staffed, and unable to fully oversee the operations of these sophisticated enterprises. This was reflected in the surprise management reorganization by Freddie Mac, and by Wall Street reports stating that GSE oversight is viewed with skepticism because OFHEO is largely seen as a weak regulator.

A strengthened regulator will send the signal to the markets that these entities have solid management, and are engaging in safe and sound activities. Confidence will be restored in the GSEs, and they will be able to get back to their important work of expanding homeownership opportunities without the distractions that have been plaguing them over the past several months.

Fannie Mae and Freddie Mac have done a good job of promoting home ownership and providing liquidity to the secondary mortgage market. These GSEs have quickly grown into large financial institutions that have a major impact on the housing market and the domestic economy. We must ensure that they have competent and thorough oversight,

while making certain that any action we take does not have a negative impact on access to housing.

I am encouraged by the letters and statements of support the Committee received following the last hearing on GSE regulatory reform. I hope today serves as an opportunity for Members to learn more about the need for changes to the GSE regulatory structure and how that can be accomplished.

I'd like to thank our Capital Markets Subcommittee Chairman Richard Baker for his years of work to strengthen the regulatory structure of the GSEs. His expertise on this issue serves our Committee well. His numerous hearings, studies and bills, provide our Committee with an informed background on which to move forward.

I welcome the witnesses and I look forward to their testimony.

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EXCHANGE

Subcommittee on Capital Markets

Richard H. Baker, Chairman

The News from U.S. Rep. Richard H. Baker
Sixth District, Louisiana
FOR IMMEDIATE RELEASE: September 10, 2003
CONTACT: Michael DiResto, 225-929-7711

Opening Statement
The Honorable Richard H. Baker, Capital Markets Subcommittee Chairman
House Financial Services Committee
September 25, 2003
Hearing on Legislation to Reform Regulatory Structure of the Housing GSEs

Mr. Chairman, I want to commend you for your leadership role in addressing this vital issue to taxpayers and homeowners alike. This is not an issue that has convenient answers, but it is essential for this committee to provide leadership on this important matter.

Over the years, the committee has made various inquiries in this effort, from probing the enterprises to determine the adequacy of their efforts in meeting important housing goals, to the expressed concerns relative to regulatory oversight. But the questions have not been limited to just the obvious issues. Over the years questions concerning mortgage backed securities, leverage ratios, durations gap, bank investment concentration of GSE securities, and other unique issues have come before the committee. I am quite ready, in fact anxious, to turn the examination of these questions over to a fully funded, properly constructed, independent regulatory office to professionally respond to such questions. It is frankly not a business that members of Congress should routinely find themselves engaged. I am sure that many of my colleagues enthusiastically agree.

I also look forward to eliminating the political risk to the enterprises of threatening changes to their charter, almost as much as I look forward to absolute assurance that the taxpayers will never be called to pick up the tab for the failure of the system. Others may suggest a radical new capital regimen, comparable constraints on new products, or attacks on the basic structure of the charters—I will not go there. Responsible regulatory oversight is the goal and the closure that results from this effort will be beneficial to all concerned.

I do think it appropriate to make a clarifying statement concerning my opinion of the work of Mr. Falcon and the regulatory agency currently charged with the duty of regulatory oversight. I have certainly expressed frustration at times with the pace with which action has been taken by the agency. And on some occasions, I have disagreed with the recommended actions. But there is one clear observation I wish to make on behalf of all those who have given their best effort over the years, and that is you have made considerable effort with the limited resources and the constrained authority which you have been given, to discharge your responsibilities.

In fact, Mr. Falcon, your testimony today is one of the best statements by anyone as to the direction this Congress should take in providing adequacy of oversight. Your statement is concrete evidence of your leadership and your ability to give professional council. I highly commend you.

As to the current task, I am very pleased to have received excellent recommendations for the modification of HR 2575 from the Secretaries of the Treasury and HUD. All of the recommendations are suggestions with which I have previously agreed and do now fully support. In fact, there are few modifications required to HR 2575 to make the provisions wholly consistent with the Treasury testimony. As the Secretary has stated, Fannie and Freddie are world-class financial organizations that require a world-class regulator. Independently funded, with all appropriate authority, with the ability to make professional decisions absent political interference. That has been, and still remains my legislative goal. It is also evident that the protracted discussion of these concerns has had no adverse effect on home ownership opportunities. For those who continue to object to any structural change in regulatory oversight, just take a deep breath. We have enjoyed, and continue to enjoy the lowest mortgage interest rates in history. I suggest the Alan Greenspan effect is far more powerful than any action this committee might consider. In fact, this effort is only to insure secondary mortgage market stability, not to place constraints that will in any way adversely affect any individual's ability to own their own home.

Further, it is certainly appropriate to afford opportunity to all stakeholders in this process to give their perspective on this important decision. But it should be clear to all concerned, that if we are to construct an independent regulatory structure, the Congress should make the final policy decisions, in a manner which is independent from any single business perspective. The enterprises are creations of the Congress, created to meet the needs of all who seek the opportunity of home ownership. We must balance that responsibility with limiting risk to the taxpayer. That is and will remain a policy decision that only the Congress should make. Regardless of the final determinations of the committee as to the construction of HR 2575, I will respect the consensus opinion reached, and fully support the Chairman's effort to achieve this essential reform. But it is now time for decisions: no more inquiries, no more hearings, we have asked all the questions, and frankly heard all the various answers. It now is simply the time for decisions. I look forward to the completion of this work and consideration by the full House before the year is completed.

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STATEMENT OF THE HONORABLE WM. LACY CLAY
Before the
Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
"Regulatory Oversight of the Government Sponsored Enterprises
September 25, 2003

Good morning Chairman Oxley, Ranking Member Frank and Members of the committee and witnesses.

In 1992, after exhaustive study, this Committee made improvements to the charter for Fannie Mae and Freddie Mac. One improvement was intended to help close the housing gap, which still exists between minority and majority homeowners. While the gap remains at over 30 percentage points, I do not fault the GSEs for lack of trying.

They work on a daily basis to create innovative products and programs which meet the needs of those denied the American dream of homeownership. Fannie Mae and Freddie Mac help to bring the dream of homeownership to thousands of my constituents on a regular basis. I have serious concerns that as we ratify the problems at one GSE that Congress does not give in to the business opponents of these GSEs who profit from predatory and subprime lending at the expense of affordable housing. The minority homeownership achievements of these GSEs are on the right track.

I support the creation of a new bureau within Treasury with the resources necessary to oversee the safety and soundness of Fannie Mae and Freddie Mac. Establishing a world class regulator for the GSEs would be a landmark achievement for the Bush Administration and the 108th Congress. It would also be in the best interests of Fannie Mae and Freddie Mac investors, the housing finance sector and the housing mission that we are serving.

Fannie Mae and Freddie Mac play a critical role in a well functioning secondary market and I would be very concerned with any changes to their charter that would compromise their ability to deliver on their mission. I favor legislation that will strengthen the "safety and soundness" regulator for these GSEs without diminishing their mission emphasis or inhibiting their ability to expand homeownership.

I am in favor of a strong regulator for the companies and would support changes needed for stronger regulation, however, I will not support any wholesale change to their business model given the benefits they have yielded in promoting homeownership and affordable housing.

These companies are important to our economy and to St. Louis. Fannie Mae has been an active participant in our downtown renaissance. This is inclusive of innovative product and program offerings like the Downtown Employer Assisted Housing program that is administered by the Downtown St. Louis Partnership. Additionally, in February of this year, Saint Louis University held a press conference to introduce Hometown SLU, the University's new Employer Assisted Housing Initiative which includes a financial incentive for employees purchasing a home near the University campuses as well as a technology platform, the Home Buyer's Assistance Site, that is available to all University employees regardless of where they purchase a home.

Congress should act quickly, yet with care, so as to avoid harmful unintended consequences. Uncertainty about this issue creates negative volatility in the market. The legislation must recognize the importance of stability in the capital standards required of the GSEs. Fannie Mae's and Freddie Mac's capital structure does not need to be changed, as the Administration has made clear. Increasing the capital standards for the GSEs now could result in an increase in the cost of homeownership.

Fannie Mae and Freddie Mac have met their housing goals every year. It is critical that housing goals are not increased to the point that they threaten the safety and soundness and undermine the ability of the GSEs to serve a market that includes middle-class and low-income borrowers. Housing goals that segment their business could force the GSEs to stop expanding homeownership opportunities and focus primarily on allocation of their business among various populations. Numerous goals would fragment the market and lead to credit allocation.

Mr. Chairman, Franklin Raines must be applauded for the great job that he has done in leading Fannie Mae in its execution of the mission assigned to it by the Congress. The GSEs, of which Fannie Mae is the largest, have become the world leaders in the secondary mortgage markets. They were mandated by Congress to create a secondary trading market to improve the functioning of home mortgage markets. They exceeded expectations and have done so well that in excess of 60% of the growth in the US economy the past couple of years is attributed to housing. Where would the country be without that contribution? Franklin Raines is indeed one of the country's modern day "profiles in courage".

Mr. Chairman. I ask unanimous consent to submit my statement to the record.

Congressman Joseph Crowley
Committee on Financial Services
Opening Statement
September 25, 2003

- I would like to begin by thanking Chairman Oxley and Ranking Member Frank for conducting this important hearing this morning
- Our Housing Government Sponsored Enterprises have been a focal point of many hearings of this Committee over the past few years
- What have we learned?
- They are safe and sound financial institutions, as they have always met the tough 6 voluntary commitments mandated by this Committee
- They have contributed significantly to keeping this economy afloat over the past 3 years
- They continually meet the housing goals as established by HUD
- They have done a phenomenal job at providing lower costs loans for homeowners throughout the United States
- On that point, I cite a story from the Wall Street Journal that demonstrates in my home region of New York City that jumbo rates are much greater then conforming loan rates in large part because of the existence of the housing GSE's in the conforming market
- I do have a concern that the housing GSE's be granted more flexibility in adjusting the definition of conforming loan limits for high cost areas, like New York City
- I welcome the participation of all parties at this hearing today, especially the Chairman of Fannie Mae, Frank Raines who is a stable voice at Fannie, just as he was a stable voice at OMB when he was head there, a long time ago, when surpluses, prosperity and near zero unemployment were our nation's biggest economic concerns
- Additionally, I look forward to hearing from Freddie Mac. While the newspapers have been discussing their recent restatements, and I do not condone the accounting problems there, I would like to remind people that when they restated, they showed GREATER earnings, not less, like most of the corporate accounting scandals we have seen over the past 3 years
- In my Congressional District alone, Freddie's $403.9 million in mortgage purchases financed homeownership for 3,413 families

- Additionally, I greatly look forward to hearing the comments of Panel 3, in discussing the important mission of Freddie and Fannie

- Regardless of the fate of OFHEO, any reform legislation must mandate that the missions of the housing GSE's remain, and I believe they are best kept at HUD, the Federal department dedicated to housing

- Additionally, we need to ensure the independence of the GSE's with respect to their creativity in creating new products for market

- This Committee wrote Gramm-Leach-Bliley. It would be against our basic nature to now restrict the ability of private companies to limit their dynamicism and creativity in bringing products to market – products which benefit our consumers

- Additionally, I am interested in hearing the testimony of OFHEO. They have been a much-maligned agency; while they have had problems, let us remember that it was Congress that repeatedly refused to provide them the funding they needed to do their job

- I look back at the Hinchey Amendment to the FY 2001 VA-HUD bill; while Mr. Baker did support this amendment to increase the oversight budget of HUD, most of his colleagues did not, and it failed on a near party line vote

- If OFHEO is essentially dissolved and its work brought to Treasury, I would want to make sure that it is done in a way that will not upset our capital markets but also ensure that the creativity of the GSE's are preserved, the independence of OFHEO is kept and that the mission of the housing GSE's as well as their goals remain in place

- As we all know, housing has been a provider of jobs and benefits, incomes and tax revenues during the past three years of recession, supporting the rest of the economy. We cannot dismantle this

- That is why I salute Treasury Secretary Snow's comments on not wanting to change the capital standards of the housing GSE's

- While it is clear to me that Fannie Mae and Freddie Mac are financially strong and sound, I think the financial markets would benefit from Congressional action to show that we will ensure that the role played by the Housing GSE's is maintained, and that their charter and mission to engage in all communities on behalf of affordable housing remains a priority.

- I am prepared to work with you, Mr. Chairman and Mr. Frank, to develop legislation this year to establish a strong safety and soundness regulator for the Housing GSE's at the Treasury Department if that is the will of this Committee

- Again, thank you, Mr. Chairman and Mr. Frank for holding this hearing today

September 25, 2003

Opening Statement by Congressman Paul E. Gillmor
House Financial Services Committee
Full Committee Hearing on Regulatory Oversight of the Government Sponsored Enterprises

Thank you, Mr. Chairman, for holding this important hearing and for your continued leadership on this issue. I would like to take this opportunity to extend a special welcome to David H. Hehman, the President and CEO of the Federal Home Loan Bank of Cincinnati in the great State of Ohio, which provides a great service to many banks in my district, the Fifth Congressional District of Ohio.

I think we're all in agreement that the current system of regulatory oversight for our Government Sponsored Enterprises (GSEs) needs to be reformed. Today, I look forward to a full discussion of all the proposals before us with the benefit of Treasury Secretary John Snow and Housing and Urban Development (HUD) Secretary Mel Martinez' remarks from our last hearing on this issue.

Late last year, in the wake of the Enron scandal and subsequent revelations of widespread problems in the accounting industry, the Federal Home Loan Mortgage Company (Freddie Mac) announced that it would have to restate its earnings after it fired its former auditor, Arthur Anderson.

This reevaluation kept Freddie Mac from upholding their voluntary agreement to file with the Securities and Exchange Commission (SEC) as the Federal National Mortgage Association (Fannie Mae) did in April of 2003. Two months later the Office of Federal Housing Enterprise Oversight (OFHEO) released its annual report to Congress addressing the upcoming earnings restatement by Freddie Mac, while expressing satisfaction with the independence of their internal and external audits and confidence in the actions of Freddie Mac's Board of Directors.

It concerns me greatly that the responsible federal regulator, OFHEO, was clearly unaware of these problems inside the management of Freddie Mac and was previously unaware of their need for an earnings restatement. OFHEO simply was not doing its job.

I am pleased to be an original cosponsor of Chairman Baker's legislation, the Secondary Mortgage Market Enterprises Regulatory Improvement Act (H.R. 2575), moving Fannie Mae and Freddie Mac under the supervision of the Treasury Department. I think it is very important that Treasury maintain full regulatory authority over Fannie Mae and Freddie Mac to ensure their safety and soundness.

With regard to the mission of Fannie Mae and Freddie Mae, including approval of new programs and fulfillment of affordable housing goals, I feel both Secretary Snow and Martinez made clear that a consultation process could be established allowing the Treasury Department to benefit from HUD's knowledge in this area without giving up regulatory authority.

Thank you again, Mr. Chairman, for calling this important hearing and I look forward to an informative session.

Statement of Congressman Charles Gonzalez (D-TX)

House Financial Service Committee Hearing on H.R. 2575, the Secondary Mortgage Market Enterprises Regulatory Improvement Act and the Administration's proposals on GSE regulation

September 25, 2003

I would like to welcome our distinguished guests to today's hearing on proposals to restructure federal oversight of Government Sponsored Enterprises. Thank you for joining us to offer your views on this critical issue.

As we all know, recent serious allegations of accounting improprieties at one of the GSE's has lead this Committee to review the safety and soundness oversight of these critical institutions. The GSE's are a critical part of our nation's economy and I am glad that we are looking at improving federal oversight of their business practices. In my opinion though, most Members of this Committee will support a transfer of safety and soundness jurisdiction to the Department of Treasury, provided that any such transfer would in no way weaken the housing mission of these institutions. The housing mission is the fundamental reason why the GSE's were created in the first place, and any structural changes to GSE oversight must ultimately result in housing becoming more affordable in America and not less.

There have been suggestions from some quarters that any changes to the GSE structure should include more aggressive review of their product development. I do support efforts to fully ensure that the safety and soundness oversight of these institutions is world class. But, we should not overburden these critical institutions with so much regulatory review that they lose the flexibility to quickly introduce new and creative products to the market. I will be looking closely at any proposals in this area to ensure that they result in more choices for consumers and not less.

Fannie Mae and Freddie Mac have been critical to making home ownership more affordable for millions of American families. I am firmly convinced that but for Fannie Mae and Freddie Mac we would not have ever increasing rates of home ownership especially in the Hispanic and African American communities. Whatever changes we consider over the next couple of weeks must have the interests of American consumers and taxpayers foremost in mind. I hope that during this process we do not lose sight of the fundamental purpose of the GSE's–to make housing more affordable for average Americans. Thank you and I yield back my time.

OPENING STATEMENT OF CONGRESSMAN PAUL E. KANJORSKI

COMMITTEE ON FINANCIAL SERVICES

THIRD HEARING ON REGULATORY OVERSIGHT OF GOVERNMENT SPONSORED ENTERPRISES

THURSDAY, SEPTEMBER 25, 2003

Mr. Chairman, before we hear today from our numerous witnesses about their views on the need to alter the current regulatory system for government-sponsored enterprises or GSEs, I believe it once again very important to highlight some of my current thoughts on these matters.

As my colleagues already know, I support strong GSE regulation. A strong regulator, in my view, will protect the continued viability of our capital markets and promote confidence in Fannie Mae and Freddie Mac. It will also insure taxpayers against systemic risk and expand housing opportunities for all Americans.

We must, however, tread carefully in developing any legislation to modify the GSE regulatory system. The housing marketplace is one of the most vibrant sectors in our struggling economy, and we must ensure that our actions in Washington will not lead to unintended consequences in places like Scranton, Baton Rouge, Findlay, or Fall River.

At our last hearing on GSE issues, senior officials within the Bush Administration indicated that there was no "crisis" that demanded the immediate attention of the Congress. Consequently, instead of rushing to judgment, we ought to move in a judicious and objective manner in these matters to make sure that we properly construct an appropriate regulatory system. In other words, the obligation to create an effective regulatory system should guide the timing of our deliberations instead of meeting some arbitrary deadline for taking action.

In developing any enhanced GSE regulatory system, I further believe that we should perform deliberate surgery. We should therefore abstain from considering radical proposals that would fundamentally change the ways in which the GSEs operate and the charters of the GSEs. We must also ensure that the GSEs continue to achieve their statutory objective of advancing affordable housing opportunities for low- and middle-income families.

As you know, Mr. Chairman, at the start of our two most recent hearings on GSE matters, I have outlined five principles to guide our consideration of GSE regulatory reform legislation. Today, I feel it very important to expand my previous comments on one of these principles: regulatory autonomy.

In recent weeks, I have participated in numerous meetings with many experts on GSE matters. The majority of these individuals have counseled me that in order to maintain credibility and be effective, a strong GSE regulator must have genuine independence from the political system. In their prepared statements, many of today's witnesses also recognize the importance of and need for regulatory autonomy. Accordingly, they will call upon us to adopt such a system in any GSE regulatory reform bill.

Additionally, several others who will not testify before us at this hearing have noted the importance of statutorily protecting any new GSE regulator from improper political influence. For example, the Independent Community Bankers Association has strongly urged us to

"construct legislation containing appropriate firewalls and independence" between any new safety and soundness regulator for Fannie Mae and Freddie Mac and the Treasury Department's "politically appointed policy makers." We should heed their sensible advice.

The National Association of Realtors has also recommended that any new GSE regulator within the Treasury Department should have "necessary and sufficient firewalls to ensure its political and operating independence" comparable to those that presently exist for the Office of the Comptroller of the Currency and the Office of Thrift Supervision. I wholeheartedly agree. The OCC and OTS models provide us with an effective framework for constructing a new GSE safety and soundness regulator.

Specifically, if we ultimately decide to alter the safety and soundness regulation of Fannie Mae and Freddie Mac and to move the regulator to the Treasury Department, this new agency should have the authority to submit testimony, recommendations and reports to Congress without the prior review or approval of the Secretary. It should further have the ability to issue rules and regulations without the review and approval of the Secretary. Additionally, it should have the power to initiate and complete supervisory and enforcement actions without intervention by the Secretary. It should also have independent litigation authority. Finally, we should prohibit the Secretary from merging the responsibilities of this new office with any other regulator.

In closing, Mr. Chairman, I commend you for your leadership in these matters. I also look forward to continuing to work with you to develop a balanced, bipartisan plan of action for reforming GSE safety and soundness regulation, ensuring the independence of the new regulator, and preserving the affordable housing mission of Fannie Mae and Freddie Mac.

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CONSUMER CREDIT

COMMITTEE ON
STANDARDS OF OFFICIAL
CONDUCT

Steven C. LaTourette
Congress of the United States
14th District, Ohio

September 25, 2003

Opening Statement of Congressman Steven C. LaTourette

Mr. Chairman, I'd first like to commend you for keeping this process focused on the regulatory structure in place for our GSEs and not making dramatic changes to the companies themselves. Regardless of whatever flaws may exist in our current system, we have a housing finance industry that is the envy of the world.

As you and the members of this Committee are well aware, this system requires the GSEs to hold capital that is commensurate with the risks they take. I am pleased that the Administration is not supporting the complete overhaul of a capital regime that has worked well. I'm also pleased to see that our goal here is to perfect this system, and not do away with it entirely.

At the same time, however, keeping the minimum capital standards in statute and at their current levels – again, as the Administration has proposed – gives an assurance to the market that mortgage capital will continue to flow unimpeded into our housing markets.

Thank you, Mr. Chairman.

ROOM 2453
RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515
(202) 225-5731

1 VICTORIA PLACE
ROOM 320
PAINESVILLE, OH 44077
(440) 352-3939
TOLL FREE IN OHIO
1-800-447-0529

MORELAND HILLS VILLAGE HALL
4350 SOM CENTER ROAD
MORELAND HILLS, OH 44022
(440) 542-9300

CAROLYN B. MALONEY
14TH DISTRICT, NEW YORK

2331 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515–3214
(202) 225–7944

COMMITTEES:
FINANCIAL SERVICES

GOVERNMENT REFORM

JOINT ECONOMIC COMMITTEE

Congress of the United States
House of Representatives
Washington, DC 20515–3214

DISTRICT OFFICES:

☐ 1651 THIRD AVENUE
SUITE 311
NEW YORK, NY 10128
(212) 860-0606

☐ 28-11 ASTORIA BOULEVARD
ASTORIA, NY 11102
(718) 932-1804

WEBSITE: www.house.gov/maloney

Statement of Rep. Carolyn B. Maloney (D-NY)
Committee on Financial Services
Reform of GSE Regulation
September 25, 2003

This hearing is likely the last before the Committee moves to a mark up of legislation that will reform the GSE regulators. As we move forward in this process, our focus should be on strengthening areas where regulation has proven weak while treading carefully so as to not adversely affect our nation's incredibly successful, diverse housing markets.

I look forward to hearing the perspectives of today's witnesses: the current GSE regulators, the GSEs themselves, housing industry representatives and consumer groups. As I listen to the testimony, I come to today's hearing hoping they build on some of the themes that I believe were established at our last meeting.

No matter where it is located, to be successful the new GSE regulator must be fully independent and free of political interference and from yearly appropriations. Without the ability to take independent positions before Congress, its authority will constantly be in question and different parties will attempt to influence regulatory outcomes by appealing to higher levels in the Treasury Department. Capital Markets Subcommittee Ranking Member Kanjorski has highlighted this issue and I am in agreement with his position.

I also agree with Ranking Member Frank that we must maintain as the focus of the GSEs' mission providing liquidity for low and moderate income housing. The GSEs provide for lower mortgage rates for millions of our constituents and I am convinced that if such mission oriented entities did not exist today we would be working to create them.

I also have a special interest in the Federal Home Loan Bank System as we work on this legislation. If Congress is going to create a new first class GSE regulator the Committee should closely consider whether including the Bank System in this effort is appropriate. As the Committee is aware, in 1997 the GAO concluded that a single regulator would have several advantages over the current structure.

Whatever we produce, we must continue to step forward and not back in increasing homeownership. While overall homeownership levels are 68 percent nationally, minority levels track far behind – with African-Americans at 47 percent and Hispanics and Latinos at 46 percent. Homeownership in New York City lags far behind national levels. This is my focus as we work on this bill.

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Statement of Congressman Gary G. Miller
Hearing on Regulatory Oversight of the Government Sponsored Enterprises
Committee on Financial Services
September 25, 2003

The United States housing markets are the envy of the world. We enjoy the lowest interest rates and the highest homeownership rates of any developed nation in the world. When Americans are homeowners, it spurs economic and community development and provides residents with a sense of pride in their community. Homeownership is the single largest creator of wealth for most Americans. For these reasons, it is imperative that we work through this process to maintain a strong housing market.

The recent problems at Freddie Mac should prompt us to ensure that the two largest participants in the housing market – Fannie Mae and Freddie Mac – have appropriate oversight. Because the housing markets are such an integral part of the economy and they are such large participants, it is imperative they remain safe and sound. That's why I support moving regulatory oversight from the Office of Federal Housing Enterprise and Oversight to the Department of Treasury. I believe the Department of Treasury has the expertise necessary to appropriately regulate complex financial institutions such as Fannie Mae and Freddie Mac. They will reassure investors and the markets that these companies are sound and that their investments in America's housing markets are safe.

However, certain core housing mission-related oversight can be better handled at the Department of Housing and Urban Development. Only HUD has the expertise to ensure certain aspects of Fannie Mae and Freddie Mac's business are in line with their congressionally-chartered mission of providing liquidity to the housing markets and meeting the markets demands for new programs for consumers.

I strongly believe that HUD should have the ability to pre-approve new programs for the GSEs. Quick and expeditious pre-approval of new programs allows Fannie Mae and Freddie Mac to quickly adapt in a changing marketplace. However, this is not to say HUD should have the ability to micromanage new products, which could cause disruption for homebuyers and lenders. To the contrary, Fannie Mae and Freddie Mac should retain the ability to quickly adapt to the marketplace and provide new products that are within their charters and mission. Anything to prohibit the free-flow of products to the marketplace is contrary to the American ideal of innovation and growth.

I have seen in my district how the ability to respond to local needs is vital in addressing affordable housing priorities. For example, in the cities of Brea and Anaheim, Fannie Mae has bought millions of dollars in Redevelopment Administration (RDA) loans to assist these cities with their redevelopment needs. In Whittier, Fannie Mae has worked with the city, its police force and local lenders to create an employer-assisted housing program for police officers so they can live in the communities they serve. They have created down payment assistance programs with various cities to help those families most in need with the biggest hurdle to buying a home – the down payment. And they have worked with Orange County to create a teacher's housing program to help teachers afford homes near the schools where they teach. All of these programs should not and cannot be subject to a radical program approval process that stifles innovation and the ability of the housing GSEs to meet the mission Congress set for them-- serving low, moderate and middle-income families all across this nation at all times.

Mr. Chairman, I thank you for holding this hearing. The goals of these two companies is so critical to the economy that I look forward to working on a clean bill that we can move out of the committee in an expeditious manner. I look forward to working with you and the other members of the committee to resolve this issue as quickly as possible.

Opening Statement of Rep. Ed Royce (CA-40)
25 September 2003
"GSE Oversight"

Mr. Chairman, thank you for holding this hearing on GSE Oversight. I commend you and Chairman Baker for your leadership on this topic. I look forward to hearing the testimony from our witnesses today. And, I would especially like to welcome a fellow Californian Mr. Dean Schultz, the President of the Home Loan Bank of San Francisco.

This Committee must include the Federal Home Loan Bank System in any legislation that would create a new regulatory body for housing Government Sponsored Enterprises (GSEs). Today I would once again like to publicly raise my own concerns with the Office of Federal Housing Enterprise Oversight (OFHEO) and the Federal Housing Finance Board (Finance Board).

The arguments to include the FHLBanks in a better, stronger regulatory framework are consistent with the arguments to include Fannie Mae and Freddie Mac. The FHLBanks have debt outstanding and a derivatives portfolio comparable in size to both Fannie Mae and Freddie Mac. Additionally, the FHLBanks are changing the risk profile of the System through their rapidly growing mortgage assets. The Finance Board has neither the depth nor experience to oversee these risks.

All three GSEs need to hedge their portfolios against movement of interest rates. For this reason, Chairman Greenspan and Secretary Snow both make a compelling public policy case to create one regulator for all three GSEs. I believe that there is a political consensus building to act on the FHLBanks. However, at the end of the day if this Committee must choose between sound public policy and political consensus, the Committee should pick good public policy.

In my view, the benefits of better regulation would accrue not only to the taxpayer and financial system at-large but also to Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The regulator must see the whole scope of risks in GSE housing finance to perform its duties well. Including the FHLBanks will allow Congress to construct the proper foundation for oversight.

I look forward to working with my colleagues from both sides of the aisle to create legislation that includes all three GSEs. I believe that legislation should adhere to the following principles:

1) The regulator should be independent just like the OCC and OTS,

2) The regulator should be independently funded outside of the Congressional appropriations process,

3) The regulator should recognize distinctions in the business models between Fannie Mae and Freddie Mac and the FHLBanks, and

4) With the exception of affordable housing goals, mission regulation should move to the new regulator.

Mr. Chairman, I commend your steadfast leadership on these issues. I yield back the balance of my time.

Statement of Steve Bartlett
President & CEO
The Financial Services Roundtable

Before the
Committee on Financial Services
Of the U.S. House of Representatives
on
H.R. 2575, the Secondary Mortgage Market Regulatory Improvement
Act and the Administration's Proposal on GSE Regulation

September 25, 2003

Mr. Chairman, Ranking Member Frank, and members of the Committee on Financial Services, I am Steve Bartlett, President and CEO of The Financial Services Roundtable, and it is my pleasure to appear before the Committee on behalf of the Roundtable and its newly formed Housing Policy Council on the regulation of the housing GSEs.

The members of the Roundtable and the Housing Policy Council originate approximately 70 percent of the residential mortgages in the United States; our members strongly support the goal of homeownership for all Americans and help meet it everyday. Our members thoroughly understand the functions and operations of both the primary and secondary mortgage markets. The Housing Policy Council was formed to address the regulatory and legislative framework for housing finance.

Sound regulation of the housing GSEs is a priority issue for the Housing Policy Council. Toward that end, the Council has adopted five principles that we believe should guide the Committee as it considers a new regulatory structure for the housing GSEs. I am pleased to say that those principles are consistent with the proposal that Secretaries Snow and Martinez presented to this Committee in early September. The principles adopted by the Council are as follows:

- The regulatory agency should be independent and housed with Treasury, much as the OCC and OTS are structured and operate within Treasury.
- The agency should be funded by non-appropriated funds.
- All supervision and regulation should be in one agency, not divided among two or more Federal Government entities.
- The agency should have an abundance of staff qualified to understand, analyze and supervise the quality and quantity of assets and liabilities of Fannie Mae and Freddie Mac, the risks of the business in which the enterprises engage, and the level of capital appropriate for them.
- The enterprises should be required to provide disclosures and to participate in the registration requirements applicable to all other publicly traded companies.

Last week, the Council added a sixth principle to this list: the new bureau within the Treasury also should have regulatory and supervisory responsibility over the Federal Home Loan Banks.

The Council strongly supports the Administration's position. The Council members believe there should be an independent regulator in Treasury, the regulator should be free from the appropriation process, the President should not appoint board members to the boards of the GSEs, the safety and soundness regulation which includes the authority to review and approve new GSE activities should be transferred to the new bureau, existing restrictions on the authority of the bureau to establish capital standards should be lifted, and the enforcement capabilities of the agency should be as strong as that of the banking regulators. The Council, like Secretaries

Snow and Martinez, believes that the Treasury Department is the most appropriate cabinet agency to supervise and regulate the housing GSEs. Treasury has general authority over the state of the economy and our nation's financial markets, and the operations of the GSEs, including the Federal Home Loan Banks, have reached a level where their role and financial stability is of importance not only to housing and financial markets, but also to the economy as a whole. Moreover, Treasury has experience in managing two other safety and soundness regulators, the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

We believe that the new bureau within the Treasury should have responsibility for the safety and soundness of the housing GSEs and the Federal Home Loan Banks. Safety and soundness, of course, includes the authority to review and approve new activities contemplated by the supervised entities – they are not separate functions. With supervisory and regulatory responsibility for all aspects of the operations of these entities, the bureau would be properly suited to make decisions about the individual elements of their businesses. Divided supervisory authority seldom works efficiently, and no other major financial institutions are subject to divided supervision.

The OCC, for example, has the authority to supervise all aspects of a national bank's operations, including the review of new activities. It has fashioned over the years a system of product approval that both efficiently encourages innovation and effectively manages risk. New product approval procedures of the new regulator should be patterned after those procedures applicable to national banks and federal thrifts. There is no need to invent a new procedure.

Currently, the Office of Federal Housing Enterprise Oversight is subject to the annual federal appropriations process, even though its operating funds come from assessments imposed on the housing GSEs. Removing the new bureau from this process will free the bureau from the time-consuming appropriations process and will insulate it from undue political pressures. All other federal financial regulatory agencies, including the OCC and OTS, are exempt from the appropriations process.

The housing GSEs are also exempt from the requirements of the federal securities laws enacted in 1933 and 1934. As a result, they are not required to register under those laws or make the same types of disclosures imposed on all other public companies. Voluntary adherence to some or all of the parts of these laws is not the same as mandatory adherence. Thus, the exemptions for the housing GSEs should be removed.

Finally, the member companies of the Council have been in the forefront of providing affordable housing for low and moderate income citizens for years, and the Council heartily supports the intention of the Administration to continue to require the GSEs to expand their activities in this area. The mortgage originators throughout the country as well as the Home Loan Banks have been active participants and will continue to be under the new program outlined by the Administration. To that end, the Council supports the retention of the affordable housing goals by the Department of Housing and Urban Affairs, and we believe that if the transfer of mission authority from HUD to the new bureau is structured properly, there will be no diminution of those goals.

The Council in no way intends to criticize the dedicated personnel at OFHEO or FHFB. They have been trying to do their regulatory and supervisory jobs under very difficult conditions and without a statutory scheme that will permit them to be effective. The Council feels that under the new proposals, they will have an opportunity to do a first class job.

In conclusion, Mr. Chairman, the members of the Housing Policy Council of the Roundtable believe in our system of housing finance and want to strengthen it. We recognize that the housing GSEs have an important role to play, but there is no question that the system of housing finance would benefit from a strong, independent regulator to insure the continued health and strength of this system.

Thank you for the opportunity to testify, and I would be pleased to respond to any questions.

Testimony Of
President C. Kent Conine
On behalf of the
National Association of Home Builders
Before the
United States House of Representatives
Committee on Financial Services
On
Proposals to Restructure the Regulatory Framework for the Housing-Related Government Sponsored Enterprises

September 25, 2003

Introduction

The 211,000 members of the National Association of Home Builders (NAHB) appreciates the opportunity to present their views to the House of Representatives' Financial Services Committee on the regulatory framework for the housing-related government-sponsored enterprises (GSEs), including safety and soundness oversight, new program approval and the establishment and enforcement of affordable housing goals. The GSEs – Fannie Mae, Freddie Mac and the Federal Home Loan Bank System -- 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 home buyers and providers of rental housing. The housing finance system has also allowed the housing sector to sustain economic performance as other sectors have faltered.

NAHB believes it is important that the regulatory framework for the GSEs is credible and effective to ensure these organizations fulfill their mission in a safe and sound manner. However, any changes in the current system must be carefully considered to avoid disruptions to the efficient operation of the mortgage markets and the impediments to the development of effective programs to address the nation's housing needs.

As discussed in detail below, 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 affordable housing goals. We do not feel that the Department of Treasury, which is well suited to oversee the safety and soundness of Fannie Mae and Freddie Mac's financial operations, has sufficient expertise and involvement in housing issues to also serve as the program regulator. NAHB is opposed to changes to the current regulatory arrangement for the Federal Home Loan Bank System.

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 continues this year, with new home sales heading toward a record performance of more than a million closings. Single-family home construction has been robust and should total about 1.4 million units in 2003. Multifamily activity has been more subdued, but should still post a respectable showing, pushing total housing starts above 1.7 million units for the second consecutive year.

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 and Freddie Mac. 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. The Federal Home

Loan Banks also continue to play an important role both by providing liquidity to housing lenders and by developing innovative programs to address housing needs.

GSEs and Housing Finance

The housing-related GSEs are American success stories. As mentioned above, they have brought enormous benefits to home buyers, renters and the housing finance system. These include:

Reduction of mortgage interest rates -- Home buyers with conforming loans -- mortgages eligible for purchase by Fannie Mae and Freddie Mac, those up to $322,700 for one-unit properties -- pay mortgage rates that are approximately 25 to 50 basis points lower than rates paid by other conventional mortgage borrowers. This fact was substantiated in the 1996 studies by the General Accounting Office, the Congressional Budget Office, HUD and the Treasury Department.

Reliable and stable flow of mortgage credit -- The linkage that the GSEs 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, home buyers have experienced no interruption in the availability of mortgage credit.

Elimination of regional disparities in interest rates -- The GSEs 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 Fannie Mae and Freddie Mac came on the scene. Today, interest rates in conforming 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 GSEs. 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 GSEs have brought both standardization and innovation to the mortgage markets, involving a variety of mortgage instruments and securities structures. Standardization is key to obtaining and retaining investor confidence and supports the innovation that has addressed a broad range of borrower and investor preferences. In the primary market, the GSEs have supported the development of hybrid mortgages that combine the benefits of adjustable and fixed-rate mortgages. The GSEs also have established reduced downpayment programs to help cash-strapped first-time home buyers. Recently, both Fannie Mae and Freddie Mac have introduced mortgage products to assist borrowers with tarnished credit histories. In addition, Fannie Mae and Freddie Mac are at the forefront of technological innovations to

streamline the mortgage process in order to reduce the time and cost involved in obtaining a mortgage.

Expansion of homeownership and rental housing opportunities -- The housing GSEs have made 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. These accomplishments are the result of concerted efforts by both Enterprises in the affordable housing arena. Both GSEs 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.

Current GSE Regulatory Framework

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 also 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 also 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.

Context for GSE Oversight Evaluation

NAHB believes that debate and discussion on the future of GSE regulation should be grounded in the fact that the housing-related GSEs were created to provide liquidity and stability to the housing market. NAHB believes it would be a tremendous mistake to turn discussion on GSE regulation into a referendum of our highly successful housing finance system. It would be ironic for debate and action on regulatory changes to undermine the success that has been achieved in these areas.

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 GSEs are not

banks operating in far-flung and highly risky product lines and markets and should not be regulated as such.

No one has stated concern of an imminent crisis in the GSE system. There is no need to rush to judgment. Hasty action could have catastrophic consequences for housing. NAHB urges a careful and thoughtful approach on GSE regulation and believes 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

NAHB endorses continued federal government support of America's housing finance system through GSEs, including Fannie Mae, Freddie Mac and the Federal Home Loan Banks. NAHB believes that government oversight of these GSEs should be guided by the following 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 GSEs to provide housing financing at the lowest possible cost should be opposed.

2. The GSEs 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 GSEs should be strong and credible, possess adequate authority and resources and reflect the differences inherent in the charters and operating structures of the GSEs. Further, the regulatory framework should foster competition among the GSEs 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 (HUD), an 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 GSEs 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. There should be no alteration in the Federal Housing Finance Board's (FHFB) responsibilities for regulation of the mission and safety and soundness of the Federal Home Loan Bank System.

Administration's Proposal

In outlining the Administration's proposal during testimony before this Committee on September 10, Treasury Secretary John Snow stated that "we have two core objectives that should guide us: a sound and resilient financial system, and increased homeownership opportunities for less advantaged Americans." These objectives are consistent with NAHB's guiding principles, but we are concerned that the administration's proposal may not accomplish these objectives and could undermine the housing finance system.

The Bush Administration proposes to create a new federal agency within the Treasury Department to regulate and supervise the financial activities of the housing GSEs. 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 existing GSE 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.

Importantly, the Administration does not recommend any changes in the GSEs' agency status. This is consistent with NAHB's first principle of GSE regulation. Further, we believe that the regulatory framework outlined by Secretary Snow should be limited to only Fannie Mae and Freddie Mac. Secretary Snow indicated in his testimony that the Administration also would like to bring the Federal Home Loan Banks under this regulatory structure. NAHB would oppose such a move. The structure of the Federal Home Loan Bank System is unique and substantially different from that of Fannie Mae and Freddie Mac. The Federal Home Loan Banks should continue to have their own independent regulator, currently housed in the Federal Housing Finance Board.

Mission Regulation

It is imperative that HUD retains current status as mission regulator for Fannie Mae and Freddie Mac. NAHB has grave concerns with the Administration's proposal to transfer program authority from HUD to the new Treasury office. Stripping HUD of any mission oversight functions constitutes a devastating attack on the mission of HUD by removing the agency's ability to improve housing opportunities for America's working families. Such a move would gut HUD's role as our nation's primary housing advocate and threatens to jeopardize the success of the housing finance system and undermine the vibrant housing market that sustained the economy in recent years.

There are three main aspects to GSE mission oversight: general charter compliance; program approval and oversight; and, housing goals enforcement, monitoring and enforcement. These functions form the core of mission regulation and cannot be separated as the Administration recommends.

Program Oversight

The objective and focus of program oversight is not safety and soundness, it is mission compliance. The legislative history of program oversight provisions makes this clear.

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 HUD, the only cabinet 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."

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 one year after the effective date of the risk-based capital regulations, the GSEs were required to simultaneously submit new program requests to the Director of OFHEO. With the implementation of the RBC capital 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 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 GSEs 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 GSEs, such as their automated underwriting systems

(AUS), also have contributed to their efforts to expand homeownership opportunities. In the affordable multifamily market, both GSEs 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.

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 GSEs. 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 Treasury and HUD now view program approval as a function of safety and soundness oversight to be overseen by the Treasury. NAHB believes Treasury is the wrong place to put program approval. Treasury lacks experience in and knowledge of housing. 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 in evaluating the effectiveness and appropriateness of housing policies.

Applying safety and soundness criteria, in conjunction with Treasury's longstanding bias against programs that facilitate the flow of capital to housing, 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 were solely a component and function of safety and soundness regulation.

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 that appropriate governance structures and procedures are in place to operate those programs in a safe and sound manner. Safety and soundness regulation should not be a vehicle for disapproving programs so the enterprises undertake little or no risk. We don't need GSEs for such a purpose and they could not fulfill their mission if they were regulated in such a manner. Safety and soundness regulation should focus on ensuring that there is adequate capital and strong effective risk management.

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 only continue if the mission of these corporations is regulated by HUD.

Housing Goals

The Administration is proposing to strengthen HUD's housing goals authority over Fannie Mae and Freddie Mac. As HUD Secretary Martinez outlined in his September 10 testimony, this will include the creation of a new GSE office within HUD, independently funded by the GSEs, 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.

NAHB supports HUD as the regulator for the GSEs' housing goals. We agree with Secretary Martinez 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 that housing goals authority is one of HUD's key functions as mission regulator for Fannie Mae and Freddie Mac.

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% for low-mod; 31% for underserved areas; and, 20% for special affordable

The 2000 rule also provided for bonus points for the 2001-2003 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. In addition, there is a temporary adjustment factor for Freddie Mac multifamily purchases that counts each unit in a property with more than 50 units as 1.35 units.

Both GSEs 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 GSEs 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.

NAHB supported HUD's increase in the goals for the 2001 – 2003 period, from the original goals put in place in 1995. NAHB feels that more needs to be done to encourage the GSEs to increase their activities in some market segments, such as rural areas and multifamily production.

At the same time, NAHB believes that any proposed changes to the housing goals should undergo careful examination. 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.

Safety and Soundness Regulator

NAHB supports strong and credible safety and soundness oversight for Fannie Mae and Freddie Mac. As discussed above, NAHB believes that the focus of safety and soundness regulation is to ensure that the GSEs are adequately capitalized and have appropriate risk management practices to fulfill their housing mission 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 GSEs 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 oversight of Fannie Mae and Freddie Mac presently resides with OFHEO, an independent office within HUD. The events of the last few months with respect to Freddie Mac's accounting practices raises serious questions about OFHEO's ability to perform these regulatory functions. Thus, NAHB would support the transfer of safety and soundness oversight of Fannie Mae and Freddie Mac from OFHEO to an office within the Treasury Department. We recognize that Treasury is the premier financial institution regulator because of its expertise and experience with financial issues. However, the authority of the office must be limited to safety and soundness functions only, mission oversight must continue to reside with HUD.

Further, NAHB believes that the safety and soundness regulator must be completely independent and statutorily protected from the Treasury's political influences, the same as regulatory agencies within Treasury. To this end, NAHB is concerned about any proposal that would require that all new regulations and Congressional testimonies prepared by the new office to be cleared through the Treasury Department. We strongly urge Congress to construct legislation that appropriately protects the independence between any new Treasury regulator over Fannie Mae and Freddie Mac and the Treasury's politically appointed policy makers.

Capital

NAHB has consistently supported the establishment and enforcement of 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.

Given the importance of capital to the financial condition of the GSEs, we agree with Sec. Snow that there is a need for stability in capital standards and that capital standards should not be subject to frequent change. NAHB applauds Sec. Snow's decision not to recommend any changes in the GSEs' RBC regulation at this time, given that the standard took ten years to develop and has been in effect for only one year. We are pleased that the Treasury is giving the RBC standard a chance to work. NAHB recommends against any changes in the GSEs' minimum capital standard as well.

Longer-term, NAHB agrees that the safety and soundness regulator should have the flexibility to adjust capital standards as necessary. However, NAHB cautions against any significant changes in the GSEs RBC standard or any significant increase in the GSEs minimum capital standard. Overcapitalization of the GSEs, 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 GSEs 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 GSEs 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.

Conclusion

NAHB appreciates the opportunity to share our views on the regulatory framework for the nation's housing government-sponsored enterprises. The critical supports provided by the housing GSEs, Fannie Mae, Freddie Mac and the Federal Home Loan Bank System, 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 the housing GSEs. We look forward to working with the Committee as you progress towards fashioning a narrow regulatory solution to the oversight of these important housing institutions.

Statement of John A. Courson

President & CEO
Pacific Mortgage Company
Folsom, California

on behalf of the

Mortgage Bankers Association of America

before the

U.S. House of Representatives

Financial Services Committee

Hearing on

Secondary Mortgage Market Enterprises Regulatory Improvement Act
&
the Administration's Proposals on GSE Regulation

September 25, 2003

Chairman Oxley, Ranking Member Frank, distinguished Committee members, good morning. I am John Courson, President and CEO of Central Pacific Mortgage Company, and Chairman of the Mortgage Bankers Association of America (MBA or the Mortgage Bankers). MBA is the national association representing the real estate finance industry. We have approximately 2,600 members that are 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.

Thank you for inviting the Mortgage Bankers to speak at this very important hearing concerning the regulation of the Government-Sponsored Enterprises (GSEs), the biggest participants in our country's secondary mortgage market. Fannie Mae and Freddie Mac play two important roles in the American home finance system. First, they provide market liquidity, which is critical to enabling mortgage loans to be originated, and which allows the American housing market to grow as our country's population and housing needs grow. Second, they buy affordable housing loans from lenders so that lower-income Americans and those living in underserved areas can get access to housing credit. These two roles – supporting the mortgage market and supporting affordable housing – play an important part in this country's housing finance system. The American housing finance system is the envy of the world.

Today, just over 68 percent of all Americans own their own homes, the highest rate in history. More minorities own homes now than ever. Purchasing a home is the largest investment that most Americans will ever make and it likely will become their largest asset. Close to 75 percent of all American homeowners borrow money to purchase their homes. Members of the Mortgage Bankers originate about 70% of residential loans in this country.

Homeownership benefits our citizens and our economy. The real estate sector employs 1.37 million individuals, a record level in U.S. history. The mortgage banking and brokerage industry has added almost 150,000 jobs since January 2001, bringing our total share to over 400,000 employees. Home sales stimulate additional, downstream economic activity. Home sales will add an estimated $25 billion in housing-related expenditures to the economy in 2003. States and localities benefit from

homeownership also—property taxes contributed approximately $285 billion to state and local budgets in 2002.

To maintain the vitality and stability of our housing finance system and of our financial markets in general, it is imperative to have effective oversight of the GSEs. Recently, we have seen examples in other industries of what can happen without effective oversight, and the Mortgage Bankers applaud this Committee's efforts to prevent future problems from arising in our housing finance system.

The Mortgage Bankers endorse the principles for GSE regulation laid out by the Secretary of the Treasury John Snow and the Secretary of Housing and Urban Development (HUD) Mel Martinez before this 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, the reason all of us are here today, is necessary. 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 Treasury and HUD, need to have adequate funding if they are to live up to their important duties. That funding should not be subject to either annual or permanent Congressional appropriations, so the regulators will be equipped to fulfill their missions, even in cases like the current one, where a

major problem arises very suddenly. Such a funding arrangement has worked well for OTS. Changing the current annual appropriation to a permanent appropriation will not strengthen the regulators, that is, it will not meet Congress's current goal of strengthening GSE regulation. The Mortgage Bankers urge this Committee to look to the OTS funding arrangement in drafting 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 the 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. The Mortgage Bankers believe that the enforcement tools that the banking agencies share 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 the most fundamentally important for the mortgage industry – the safety and soundness of GSE programs and activities. The programs in which GSEs engage, that is, what the GSEs do every day, is the basic determinant of their safety and soundness. When they implement a new program, when they purchase mortgage-backed securities, when they try a new way to hedge their interest rate risk, when they find a new source of debt, when they do the things day in and day out as a normal part of their business

operations, they put their safety and soundness at issue.

Fannie Mae and Freddie Mac are so large that when they undertake some activity, it has ramifications throughout the American mortgage market and, indeed, throughout domestic and international economies. The GSEs' risks are more than a mere question of housing, their risks are of central concern to financial regulators around the world. Because the GSEs' actions sway our economy, it is imperative that their activities be conducted safely and soundly. We certainly do not believe that any GSE would intentionally risk harming their financial standing or the state of the economy. Yet, the fact is that the GSEs are so large that they do affect our economy. For these reasons, their activities must be safe and sound – all of their activities, not just some. Congress cannot give the GSEs or their safety and soundness regulator an exemption from their obligation to ensure that new programs are consistent with prudent financial management and sound business operations. We believe that the approval of new programs and activities is intrinsically linked to financial safety and soundness.

The safety and soundness regulator, for these reasons, is in the best position to evaluate the appropriateness of new or proposed GSE programs. The regulatory approval system should be robust, and should have a clear definition of what requires prior regulatory review. Congress should draw a clear line between the primary and secondary mortgage markets -- in no event should the GSEs be permitted to encroach upon the mortgage origination process. In no event should the GSEs be permitted to use their government-sponsored benefits to distort the competitive landscape of the primary mortgage market.

The Mortgage Bankers also believe that it is important that the regulator not micromanage the GSEs, and that it not unduly constrain the GSEs' ability to respond in a timely manner to marketplace needs. Regulatory approval for new programs must come in a timely manner, and should be based on a clear and well-defined criteria.

Fannie Mae and Freddie Mac enjoy the benefits of government sponsorship so they can assist Americans with their housing needs. MBA very strongly supports the affordable housing goals for Fannie Mae and Freddie Mac because the goals require the GSEs to focus their activities on lower income Americans and those living in underserved areas. MBA endorses HUD's role in setting and enforcing those goals because HUD has extensive experience in this area. The goals are set based on extensive and complex research and analysis. The Mortgage Bankers support giving HUD flexible authority to set and enforce appropriate affordable housing goals for Fannie Mae and Freddie Mac.

The Mortgage Bankers strongly urge 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.

Thank you for asking the Mortgage Bankers to testify today on these important issues. We would be happy to supply you with any additional information you wish. I am happy to answer any questions the distinguished members of this Committee may have.

Statement of The Honorable Armando Falcon, Jr.
Director, Office of Federal Housing Enterprise Oversight
Before the Committee on Financial Services
U.S. House of Representatives

September 25, 2003

Chairman Oxley, Ranking Member Frank, 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.

I would like to begin by stating upfront that I support legislation to strengthen the supervision of Fannie Mae and Freddie Mac. Upon taking office as Director of Office of Federal Housing Enterprise Oversight (OFHEO) in October of 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 four 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 and your efforts, Mr. Chairman, to move forward. While I am in general agreement with the well-considered proposal that Secretaries Snow and Martinez have presented to the Committee, but I do have a few concerns that I hope can be properly addressed.

Guiding Principles

Now, I would like to outline my views in the context of five guiding principles. They are:

1) The regulator should remain independent;
2) The regulator should be permanently funded, outside the appropriations process;
3) The regulator should have powers equal to those of other safety and soundness regulators;
4) The regulator should have full discretion in setting capital standards; and
5) 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 this Committee's predecessor 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 or to establish a reserve fund assessments 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 the 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. I would be happy to provide the Committee with a more comprehensive package of suggestions later if you so desire.

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 said in his testimony before this Committee, "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 ten years. Regulating Fannie Mae and Freddie Mac requires a specialized skill set. The capacity to model the cash flows 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 collectable 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 ten 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 and reappointments are often denied for political reasons. Shareholder elected directors usually are reappointed for up to ten 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, that concludes my testimony. I look forward to working with the Committee as this important legislation moves forward. I will be happy to answer questions that you and the Committee may have.

Consumer Federation of America

TESTIMONY OF

ALLEN J. FISHBEIN
DIRECTOR FOR HOUSING AND CREDIT POLICY
CONSUMER FEDERATION OF AMERICA

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

REGARDING

H.R. 2575, THE SECONDARY MORTGAGE MARKET ENTERPRISES REGULATORY IMPROVEMENT ACT AND OTHER PROPOSALS ON GSE REGULATION

SEPTEMBER 25, 2003

WASHINGTON, D.C.

1424 16th Street, N.W., Suite 604 • Washington, D.C. 20036 • (202) 387-6121 • www.consumerfed.org

Chairman Oxley, Representative Frank, members of the committee, my name is Allen Fishbein and I am the Director of Housing and Credit Policy for the Consumer Federation of America. I am testifying today on behalf of CFA, which is a non-profit association of some 300 consumer organizations, with a combined membership of 50 million that was founded in 1968 to advance the consumer interest through advocacy and education. CFA and many of our members have had long-standing interest and involvement on housing finance matters, including advocating for expanding the role of the GSEs in serving important housing needs. As for my own background, I have been an advocate for many years on GSE issues and have served at HUD as Senior Advisor for GSE Oversight, where my responsibilities included assisting with supervision that led to the establishment of the present affordable housing goals for Fannie Mae and Freddie Mac. Thank you for affording us with the opportunity to present our views on various proposals the committee is considering revising the regulatory structure governing these two government sponsored housing enterprises.

Consumers – whether existing or future homebuyers, renters, or investors – have a great stake in the outcome of these deliberations. Fannie Mae and Freddie Mac, along with the Federal Home Loan Bank System are government sponsored enterprises (GSEs) created by Congress to help ensure the smooth flow of housing credit throughout the nation. CFA believes that the GSEs' play an important, indeed essential role, in promoting a sound housing market and by providing expanded homeownership and other housing opportunities. The GSEs' public charters limit their activities to their housing mission and in return, they are afforded special competitive privileges not enjoyed by fully private financial institutions. The GSEs also have additional statutory mandates that require them to serve special housing finance needs, such as expanding mortgage credit opportunities to low and moderate income households and underserved communities. Changes to the GSEs' regulatory structure, therefore, must be undertaken with great care and precision so as not to work at cross purposes with the GSEs' ability to carry out these important mission activities.

Does the GSEs' regulatory structure require changing?

Fannie Mae and Freddie Mac are the nation's two largest home finance companies. Through their secondary market activities the two GSEs own or guarantee more than $3 trillion in mortgages --almost one-half of all outstanding mortgage debt -- and fund nearly 80 percent of the estimated total of all conforming, non-government insured mortgages made. Further, because of their market dominance, the underwriting standards of the GSEs also have much sway over who is eligible for mortgage credit and on what terms.

The 12 Federal Home Loan Banks (FHLBs) that make up the Federal Home Loan Bank System are a somewhat different form of government sponsored enterprise, but one that is also mandated to serve broad housing finance needs as well as particular affordable housing needs. The system also provides an important source of funding for lenders,

which in turn, use these funds to finance home loans and other residential mortgages. The System has over 8,000 financial institution members at the end of 2002 and assets of over $700 billion. My written testimony today focuses largely on issues of oversight structure pertaining to Fannie Mae and Freddie Mac and not the FHLBanks since this seems to be the most immediate focus of the committee's deliberations. However, we are prepared to supplement this testimony by providing additional views on the merits of combining FHLB oversight what that of Fannie Mae and Freddie Mac.

Freddie Mac's announcement of plans to make a substantial restatement of its earnings for prior years, coupled with more recent revelations about the departure of its three top executives and other reports of irregularities attracted considerable attention this summer and seemed to have unnerved the financial markets. The sheer size of the GSEs and their importance to the housing market mean that investors are sensitive to any hint of trouble. We are aware that members of this committee expressed concerns that these difficulties were not detected earlier by regulators and do not believe the current structure has the capabilities to provide adequate oversight in this area.

Still others had called for a regulatory overhaul even before these recent developments came to light. Unquestionably, the tremendous growth in the size of the GSEs over the past decade has raised the stakes for regulatory oversight. Indeed, Fannie Mae's and Freddie Mac's mortgage investments have increased by over 620 percent and the GSEs today are two of the largest private debt issuers in the world (CRS Report to Congress, September 8, 2003, 2). Similarly, the FHLB System's business has sextupled and its membership has more than tripled since 1992, with commercial banks instead of savings institutions now constituting a majority of the system's membership. Government, the GSEs, consumers, residents of underserved communities, lenders, the housing industry and taxpayers all have a strong interest in effective oversight of enterprises financial condition. Thus, it would be hard to argue against the need for Congress to review the adequacy of a regulatory structure that was put into place a decade or more ago.

The existing regulatory structure governing Fannie Mae and Freddie was established in 1992 as part of the Federal Housing Enterprises Safety and Soundness Act (or GSE Act). The GSE Act established OFHEO as an independent agency, within the U.S. Housing and Urban Development (HUD) to oversee the safety and soundness of the two enterprises and to help ensure that they are adequately capitalized. The GSE Act also reaffirmed HUD as the GSEs' mission regulator, with general regulatory responsibility for ensuring that Fannie Mae and Freddie Mac operate within their public charters and otherwise fulfill their statutory mandates, including authority to review the GSEs new mortgage programs, establish and monitor the GSEs' fulfillment of their annual affordable housing performance goals, and ensure that they abide by fair lending requirements.

Review of Proposed Changes

There appears to be some consensus for taking steps to enhance the safety and soundness oversight of the GSEs. There also is growing recognition that OFHEO does not have all

the powers it needs to perform this oversight. Unlike banking regulators, OFHEO does not have authority to assess the financial institutions it supervises for the full cost of oversight. Funds for its budget are provided through congressional appropriations although collected from Fannie Mae and Freddie Mac in the form of semi-annual assessments. This approach limits the agency's funding in comparison to the direct assessment approach used by federal banking regulators. For example, OFHEO's budget for FY 2002 was just over $27 million. Rep. Baker and others have estimated that Office of the Comptroller of the Currency assessment for banks of the size of the GSEs would be around $70 million.

In addition, OFHEO is not equipped with the full range of enforcement tools commonly afforded to financial regulators. It is my understanding, for example, that the agency's "cease and desist" authority is limited to capital related matters and does not encompass other areas of safety and soundness regulation. Enhancing the agency's authority in this area would appear to make sense.

Perhaps the simplest way to correct this problem, in our view, would be to upgrade OFHEO. But we know that some on this committee have concluded that a mere upgrade alone would not be sufficient and that further changes to the regulatory structure are also needed. For example, H.R. 2575 introduced by Capital Markets Subcommittee Chairman Baker would abolish OFHEO as an independent agency within HUD and transfer safety and soundness authority and general regulatory authority HUD now has to a revamped Office of Thrift Supervision, an independent unit within the Treasury Department that also regulates savings institutions. The bill would retain HUD as the supervisor of the affordable housing mandates, expanded enforcement authority for these mandates, and also provides the department with new authority to pre-approve any new activities the GSEs want to undertake. H.R. 2575 would provide both HUD and the new regulator with authority to assess the GSEs directly for the costs of their oversight activities.

H.R. 2803 introduced by Rep. Royce generally follows a similar approach, although the bill also abolishes the Federal Housing Finance Board, which supervises the FHLBanks and designates the new office to handle combined oversight for all three GSEs.

Secretary Snow and Secretary Martinez in their testimony before this committee earlier this month outlined their proposal for making even more extensive changes to the existing regulatory restructure. Their plan calls for a major shifting of regulatory functions to a new cabinet department. It would reconstitute the safety and soundness regulator, along with HUD's general mission oversight and what expanded authority to review "new lines of business, new types of investments, and acquisitions" into a single new bureau to be located at the Treasury Department. HUD still would retain authority to oversee the GSEs' affordable housing goals and fair lending enforcement, but not much else. The two Secretaries also proposed that supervision of the FHLBanks would eventually come under the purview of this new bureau as well.

Strengthened financial oversight can be achieved without making major changes to the existing regulatory structure

CFA is supportive of steps to enhance GSE safety and soundness oversight. Along these lines, we believe that providing GSE regulators with authority to assess the enterprises themselves for the reasonable costs of oversight and removing funding for these activities from the annual appropriations process would go a long way in addressing many of the concerns cited. Banking regulators fund their supervisory activities this way and so should the GSE regulators. Improving the mechanism used to fund the cost of GSE oversight would enable these regulators to increase their capacity and bring on additional financial expertise needed to perform their important functions.

However, we are not convinced that OFHEO is inherently flawed in its capacity to serve as the safety and soundness regulator. Accordingly, we question whether creating a new agency is the wisest and most efficient means for achieving the immediate impact that many say are needed. Those that favor the transfer to Treasury apparently believe, as Secretary Snow testified, that it would confer "additional benefits of stature and policy support." In other words, that the GSE regulator could benefit from Treasury's financial expertise and prominence as a cabinet agency. The connection could also reinforce the importance of safety and soundness oversight, which may help to calm down market jitters raised by the events at Freddie Mac.

Yet moving the GSE regulator to Treasury could also carry with it disadvantages. Because Fannie Mae, Freddie Mac, and Treasury are the major issuers of debt in the capital markets, questions about potential conflicts of interest could conceivably arise from the department's exercise of its new oversight powers over GSE activities. Also, it seems inevitable that the transition would create administrative disruptions that would work at cross purposes with the objective of enhanced oversight, at least in the short term. We also are troubled by the suggestion that the new Treasury bureau would not be fully independent along the lines of the OCC and OTS. Secretary Snow indicated that this would be case by stating that the new bureau would be "required to clear new regulations and congressional testimony through the department."

CFA also has great concerns with other aspects of the plan being proposed. We believe strongly that the general charter oversight and new program approval should remain at HUD. Switching this authority to Treasury we fear would detract from maintaining important regulatory focus on GSE housing mission performance. Treasury's primary focus on safety and soundness concerns must be balanced carefully with an equally strong regulator that is in a position to offer different policy perspectives on regulatory matters, particularly as they pertain to mission related concerns. Experience should teach us that there will be tensions from time to time between safety and soundness and mission considerations. Thus, both functions should be afforded a comparable seat at the decision-making table to resolve these differences, otherwise the safety and soundness perspective will tend to override other legitimate considerations . We believe it would be

more difficult for this proper balancing to be achieved should both functions be combined under one roof at Treasury.

In opposing this transfer, we are mindful that the two Secretaries sought to assure this committee that HUD would be consulted on mission matters. But consultation does not equate with decision-making authority. Moreover, downsizing HUD authority in these two areas is likely to undercut the department's ability to perform its remaining functions (i.e., affordable housing goals and fair lending oversight). In any event, this shift would clearly establish HUD as a second tier GSE regulator.

Further, we believe that Treasury is not necessarily in the best position make important determinations about whether the GSEs are acting within their charters and undertaking housing finance programs that serve the public interest. HUD as the principal federal department responsible for housing is uniquely suited to provide important housing policy perspective in deciding these matters. Whatever changes in oversight, if any, may occur we would anticipate that HUD would continue to work in conjunction with the safety and soundness regulator, as it presently does with OFHEO, whenever issues of financial condition arise. However, we believe maintaining the current arrangement is far less cumbersome than requiring a new bureau at Treasury to bulk up its capacity to undertake supervision of issues with broad housing impact.

Please do no harm to the housing mission

I also would like to comment on proposals that are being considered by this committee to make changes to other key aspects of GSE regulation: the program approval process and the capital requirements.

First, with respect to the program approval process. The 1992 GSE Act reaffirmed HUD's authority to approve new programs initiated by Fannie Mae and Freddie Mac. At the same time, the statute narrowly prescribed the scope and circumstances under which this review can be undertaken. The statute defines "new program" basically in the context of a mortgage related program that is either "significantly different from programs that have been previously approved, either under the GSE Act or engaged in before this 1992 legislation was enacted. The statute provides that new programs must be approved UNLESS HUD first determines that the program: 1) is not authorized by specific sections of the GSEs' Charter Acts; 2) is not in the public interest; and/or 3) OFHEO determines that the program would risk significant deterioration of the financial conditions of the enterprise. Thus, the burden is on HUD to determine whether there are sufficient reasons to keep the GSE from going ahead with its new initiative.

It has been my experience that the statutory prescriptions I described and the limited staffing that HUD traditionally has devoted to the performance of this function have combined to limit the occasions for these reviews. To my count, HUD has approved only three new programs from 1995-2000 and may have approved one other since then. At the same time, the department has elected not to review major new GSE initiatives, such as

GSE entry into the subprime market and implementation of automated underwriting systems.

H.R. 2575 proposes to expand authority with HUD, but expand the authority to all new "activities" rather than just "programs." "New Activity" is defined by the bill as meaning "any program, activity, business process, or investment" that directly or indirectly affects the financing and other services related to mortgages. While H.R. 2575 incorporates standards for approval comparable to existing HUD authority, the bill requires prior approval for these activities and eliminates the 45 day time frame for review that is part of the present requirement. In effect, this provision shifts the burden to the GSE to demonstrate how the program meets the statutory criteria and should therefore be approved.

Given the limited use of review authority up to now it appears that improvements in the process are needed. However, program review should remain centered around public purpose objectives. Unless carefully crafted revising the provisions governing program reviews could end up the regulators micromanaging each GSE's day-to-day business. This outcome would be counter-productive and hamstring the ability of the GSEs to bring new products to market and to otherwise perform their housing mission. Thus, we urge the committee to move with care in this area and avoid the establishment of an overly bureaucratic and unnecessarily complex approval regimen.

Similarly, making changes to the GSEs capital requirements as part of regulatory restructuring legislation is another area that could have far reaching ramifications for the GSEs housing mission and affordable housing activities. Inevitably there will be tensions and tradeoffs between steps aimed at addressing the GSEs' financial exposure and their ability to increase funding for important mortgage related activities. Moreover, the GSEs' charters provide safeguards to help ensure proper balance in oversight and explicitly recognize that "activities relating to mortgages on housing for low and moderate income families involving a reasonable economic return that may be less than they return earned on other activities. . ." (12 U.S.C. Section 1431 note, 1716) The existing capital rules in place were a long time in coming and are based on statutory guidelines and were fashioned after much deliberation. Congress should proceed cautiously in providing new authority to make frequent changes to capital rules, which may ultimately serve to detract from the GSEs' ability to carry out their mission.

Strengthening oversight of the affordable housing goals

Finally, let me also use this opportunity to comment on HUD's oversight of the GSEs affordable housing goals and on ways that this function can be strengthened. The 1992 GSE Act established a procedure for setting three percentage of business goals for Fannie Mae and Freddie Mac – a Low and Moderate Income Goal (with at least 50 percent of the dwelling units financed by a GSE's mortgage purchases must be for families with incomes no greater than the areas median income), a Special Affordable Goal (with at least 20 percent of dwelling units financed by a GSE's mortgage purchases must be for very low income families (below 60 percent of area median income) or for low income

families (below 80 percent of median income) living in low income areas) , and a Geographically Targeted Goal (with at least 31 percent of the dwellings units financed by each GSE's mortgage purchases must be for units in underserved areas (i.e., central cities, rural areas, and other underserved areas based on income and minority concentration) as defined by HUD rules).

Implementation of the housing goals has had a substantial impact on Fannie Mae's and Freddie Mac's activities, more than doubling their low and moderate income housing business since they were first established in 1993. Both GSEs almost always have met and usually exceeded the goals levels in place through the year 2000 (the last year for which data have been published by HUD). Yet despite these improvements, HUD noted last year that the " market share for each (GSE) of the affordable housing lending categories is less than their share of the overall market; and they account for a very small share of the market for important groups such as minority first-time homebuyers." (Bunce, 2002, 5). The GSEs' have pledged to do better and Fannie Mae, for example, has undertaken a major initiative to increase funding of minority home purchase loans. Yet the HUD data suggests that there is considerable room for improvement.

Thus, we were pleased that Secretary Martinez in his testimony before this committee made a number of constructive proposals aimed at spurring additional improvements in the GSEs' affordable housing performance. The GSE Act prohibits HUD from establishing enforceable subgoals for the low and moderate income housing goal and the geographic area goal. Subgoals are a logical tool to ensure that the GSEs adequately consider the most underserved sectors of the mortgage market. For example, targeting minority and other underserved geographies would be ideal candidates for subgoals and would help to boost minority homeownership levels.

However, the Secretary's proposal is not sufficient unless HUD places greater emphasis than it has on performing these important responsibilities. For example, HUD let slip the establishment of new goals for 2004. The existing goals were originally set to end at the end of this year. HUD's failure to take action this year means that the current levels rollover for at least another year.

Both Fannie Mae and Freddie Mac say they surpassed their goal levels in 2001 and 2002, yet HUD tallies have yet to be released for these years. But we know that both enterprises rely on regulatory bonus points that provide 2 for 1 weighting found in the current rules to achieve their goal levels. These bonus point provisions are intended to increase the GSEs activity in the small multi-family and single family rental housing finance market. They are set to expire in December necessitating a substantial increase in both GSEs' affordable housing activities next year in order to meet their goal levels. We believe that these bonus points should not be extended without a full rulemaking process that would include opportunities for public comment to help the department assess the impact of this feature and considering whether they are worth continuing.

Also, the 2000 affordable housing goal rule implemented an additional bonus point system that is exclusive to Freddie Mac. Called a "temporary adjustment factor" (TAF),

this additional bonus point system permits Freddie Mac to receive additional credit for each qualifying multifamily mortgage for properties with more than 50 units. Although HUD had originally established the TAF as 1.2 (i.e., 20 percent added weighting per eligible unit, Freddie Mac was able to obtain a legislative amendment which increased the TAF to 1.35 units of credit (or 35 percent additional weighting per unit). According to data provided by Freddie Mac, the TAF added almost 3 percentage points to Freddie Mac's low and moderate income housing goal performance, over 1 percent to its geographically targeted goal performance, and 1.4 percent to its special affordable goal performance. The TAF is due to expire this year and should not be extended.

Additionally, we are extremely disappointed that HUD has continued to resist disclosing the results of a major fair lending review the department has undertaken and completed of the GSEs automated underwriting systems (AUS). The vast majority of mortgages made by lenders today are run through these systems, which rely on credit scoring and other statistical measures to rate creditworthiness. In effect, these systems determine who qualifies for prime mortgages and at what price. Borrowers that do not meet GSE standards, therefore, often are relegated to the more expensive subprime market. Credit scoring models almost always have disparate impacts for minorities, but they have not been subject to a full-scale regulatory review to determine whether they are discriminatory. The purpose of the HUD fair lending review of the AUS is to determine an answer to this essential question. Chairman Baker and others in Congress have written to HUD asking for the results of this inquiry, but to my knowledge they have yet to be forthcoming with the requested information.

The 2000 HUD rule establishing the existing goals levels also recognized that the GSEs, "have a public responsibility to help eliminate predatory mortgage practices which are inimical to the home financing and homeownership objectives that the GSEs were established to serve." (Federal Register, October 31, 2000, 65044) The rule affirmed corporate policies adopted by the GSEs at the time indicating that they would not purchase predatory mortgages by disallowing them from receiving goals credit for predatory loan purchases. HUD should be building on these prior actions by continuing to challenge the GSEs to expand upon these prohibited features and act more aggressively to challenge predatory practices in the subprime market. Unfortunately, HUD has not taken these critical steps.

In addition to a number of the suggestions recommended by Secretary Martinez, we believe that GSE performance toward meeting their goals could be improved through expanded public disclosure of these GSEs mortgage activities and through better reporting to Congress by HUD. Specifically, we recommend the following actions be taken:

- ***Improving the GSE Public Use Data Base.***

The 1992 GSE Act required HUD to establish a public use data base and provide expanded public disclosure of GSE mortgage activity. Unfortunately, this data base does not provide sufficiently useful information for enabling housing consumers and local

community groups to determine for themselves how active the GSEs are in their own localities. While some data is provided on GSE activity at the census tract level is not as detailed as data provided by mortgage lenders under the Home Mortgage Disclosure Act (HMDA). In particular, local GSE data does not specify at the census level mortgage type as well as other important loan characteristics (e.g., whether the purchase was a home purchase loan or a refinancing, whether it was a prime or subprime loan, loan to value ratios, loan amount). Expanded reporting of these data elements would greatly improve the utility of this data base and assist with a more complete analysis of GSE activities in communities throughout the nation.

- ***Better reporting to Congress on GSE affordable housing activities and departmental plans for establishing new goals.***

The GSE Act requires each GSE to report annually on its affordable housing performance, but does not require their regulator to report in a comparable way. While HUD publishes reports on GSE activities, annual reporting detailing the goal levels the GSEs' achieved and the activities undertaken to reach these levels would help to circulate this information more widely. These reports should distinguish between home purchase and refinancing purchases, purchase levels by different household income levels, and detail the extent to which the levels were achieved through the purchase of subprime mortgages. The department should also be required to report to Congress to explain delays in undertaking new rulemaking to set new housing goals in situations where the original term for these goals has expired or due to expire.

In closing, let me reiterate that we believe it is in everyone's interest to have strong regulatory oversight of the GSEs. In so doing, we urge the committee to proceed with caution and resist the urge to make needless changes that detract from the GSEs' ability to perform their public mission.

Mr. Chairman, this concludes my written testimony. Thank you again for the opportunity to testify today and I will be glad to answer any questions that you and other committee members have for me.

STATEMENT OF GEORGE D. GOULD

PRESIDING DIRECTOR

FREDDIE MAC

BEFORE THE COMMITTEE ON FINANCIAL SERVICES

OF THE

U. S. HOUSE OF REPRESENTATIVES

September 25, 2003

Thank you, Chairman Oxley, Ranking Member Frank 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 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 applaud Chairman Oxley, Congressman Frank and the Administration for their thoughtful deliberations on these questions of global importance.

Freddie Mac supports much of the Administration's proposal on regulatory reform. Before expressing our views on key aspects of the proposal, I would like to say a few words about the resolution of Freddie Mac's accounting issues and our continued safety and soundness.

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. We also expect it to result in a large increase in our regulatory capital surplus.

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.

Because we have not yet completed the restatement, I am not in a position to comment further on Freddie Mac's accounting issues today. However, once the restatement is complete, I would be more than happy to answer whatever questions you may have.

Finally, I would like to say a few words about Freddie Mac's safety and soundness. Some have used the opportunity presented by Freddie Mac's accounting problems to suggest that the company is somehow too large, too complex and too risky. Nothing could be further from the truth. Freddie Mac's exposure to both credit risk and interest-rate risk remains extremely low, despite a weak economy and a turbulent market environment. While there is absolutely no excuse for the issues that led to the need to restate earnings, Freddie Mac's business fundamentals remain rock solid. We will get through this difficult period, and emerge a much better company. We are working diligently to ensure that Freddie Mac's accounting expertise and disclosure practices measure up in every way to our time-tested risk management capabilities.

Now, let me return to the focus of this hearing: proposed legislation to strengthen the regulation of the housing government sponsored enterprises, or GSEs.

Regulatory Oversight Structure

Freddie Mac has long supported strong regulatory oversight. In October 2000, Freddie Mac and Fannie Mae joined with Chairman Baker, Representative Kanjorski and other members of the Committee to announce a set of public commitments to ensure that the two GSEs 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 March 2001, we appeared before Chairman Baker's subcommittee and announced we had implemented five of the six commitments, with the sixth being implemented the following month. Several months later, in June 2001, we stated 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, it has 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 bi-partisan support. In this regard, I would like to commend Chairmen Oxley and Shelby for the joint statement they issued after last week's hearing. In the statement, they pledged to seek a timely bi-partisan resolution of questions relating to regulatory restructuring.

With these principles in mind, today I will comment briefly on key aspects of the regulatory proposal described by Secretary Snow and Secretary of the Department of Housing and Urban Development (HUD), Mel Martinez, on September 10 before this Committee.

Creation of New Regulatory Office Within Treasury

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 five-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]

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-à-vis the GSEs. 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.

Supervisory and Enforcement Parity with Federal Banking Agencies

The current legislative structure provides our safety and soundness regulator an array of supervisory and enforcement authorities to ensure that Freddie Mac is adequately

[1] *See* 12 U.S.C. §§ 1, 250, 1462a(b)(2), (3) and (4).

capitalized and operating safely.[2] 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 that 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 that steps beyond potential enhancements to conservatorship would appropriately be left to the Congress and not to the GSE regulator.

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.[3] 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

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[2] "Comparison of Financial Institution Regulators' Enforcement and Prompt Corrective Action Authorities," GAO-01-322R, January 31, 2001.

[3] 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.

average charge-off rate of 11 basis points on their mortgage portfolios, compared to 1 basis point for Freddie Mac.[4]

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 eight 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 that the GSE minimum capital requirement is adequate and need not be changed. The GSEs' minimum capital requirements are 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.[5] 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."[6]

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

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[4] 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.
[5] L. William Seidman, et al., Memorandum to Freddie Mac, March 29, 2000.
[6] The CapAnalysis Group, LLC, OFHEO Risk-Based Capital Stress Test Applied to U.S. Thrift Industry (March 17, 2003), p. 1.

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 GSEs 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 GSEs 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 capital standards unnecessarily, capriciously or frequently will reduce the amount of mortgage business the GSEs can do, resulting in higher costs for homeowners and renters.

Market Discipline Commitments

In October 2000, Freddie Mac and Fannie Mae announced a set of six public commitments to ensure the GSEs 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 three 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 GSEs' 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 GSEs 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 GSEs 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.

Mission Regulation

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.

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 Mae under the same approval standards as in current law. 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. As our mission regulator, HUD is the appropriate place for approving new programs. HUD alone has the expertise to determine whether new mortgage programs are in keeping with our charter and statutory purposes.

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 under-served 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.

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. These are strong incentives for the GSEs to strive to meet the goals year after year – to say nothing of the reputational "penalty" for failing to meet a goal.

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[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.

The facts speak for themselves: Freddie Mac and Fannie Mae have consistently met the permanent affordable housing goals. 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 support many of the specific provisions put forth by the Administration and the Congress. We believe that a strong, credible regulator is essential 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.

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Thank you for the opportunity to appear today. I look forward to working with Chairman Oxley, Congressman Frank and the members of this Committee to secure the future of our housing finance system and, with it, the dreams of millions of families.

Statement of

David Hehman
President and CEO
Federal Home Loan Bank of Cincinnati

Before the

House Financial Services Committee

September 25, 2003

Mr. Chairman, Ranking Member Frank, and Members of the Committee, I appreciate the opportunity to speak to you today about the Federal Home Loan Banks (FHLBanks) and legislative proposals to reform regulation of the housing government sponsored enterprises. My name is David Hehman and I am President and CEO of the Federal Home Loan Bank of Cincinnati (Cincinnati FHLBank).

I would like to provide an overview of the FHLBanks, address the impact of recent legislation and conclude with the topic of regulatory reform.

FHLBank Overview

The FHLBanks were created in 1932 to support America's housing finance system. It was largely the FHLBanks' ability to raise long term debt in the capital markets and pass that funding along to their member financial institutions that encouraged the development of the 30 year fixed-rate mortgage that is the predominant financing tool in the United States mortgage finance system today.

The FHLBanks continue to play a vital role in the nation's housing finance and community lending system. Member institutions, primarily community banks and thrifts, use the FHLBanks' advance programs to meet the mortgage and community lending needs of their local markets, and use our Affordable Housing Programs to help house thousands of low-income families in those communities.

The FHLBank System (System) is comprised of 12 regional FHLBanks, their 8,080 member financial institutions and the Office of Finance that issues debt on behalf of the 12 regional FHLBanks. The regional FHLBanks are overseen by an independent regulator, the Federal Housing Finance Board (Finance Board).

The System is a unique GSE. While the System shares a congressional charter and housing mission with Fannie Mae and Freddie Mac, the FHLBanks are fundamentally different in both structure and perspective. The 12 regional FHLBanks and their members form a cooperative that is driven by customer credit demand, not profit maximization. And while the 12

FHLBanks are independently owned and operated, they share joint and several liability for the System's debt. This leads to very conservatively run operations that have been effectively supervised under the current independent regulatory regime designed by Congress.

Legislation

Congress has historically taken an active role in defining the mission and structure of the System. Two critical pieces of legislation shaped today's FHLBanks. The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) expanded membership to include commercial banks and credit unions with a demonstrated commitment to housing finance. FIRREA also created the System's Resolution Funding Corporation assessment and mandated the Affordable Housing Program through which each FHLBank sets aside 10 percent of net earnings annually for the creation of affordable housing throughout the nation. That commitment has resulted in $1.7 billion of private capital flowing into the housing market to create 380,000 units of affordable housing.

Title six of the Gramm-Leach-Bliley Act of 1999, sponsored by Congressmen Baker and Kanjorski, established universal voluntary membership; provided for a permanent capital structure; expanded the types of collateral that community institutions can pledge to secure advances, and increased the independent corporate governance of each FHLBank.

Six FHLBanks, including Cincinnati, have implemented newly required capital stock plans. This monumental task has occurred well within the legislative time frame, and is due in no small part to the strength of the System's independent regulator and the commitment of the boards of directors at each FHLBank. The new capital structures have left the System with $38 billion of capital with an aggregate capital-to-assets ratio of 4.7 percent as of June 30, 2003.

Financial Profile

These two pieces of legislation combined with the performance of the FHLBanks in the marketplace and customer demand for FHLBank products, resulted in considerable growth over the last decade. As of June 30, 2003, the FHLBanks had combined total assets of $809 billion up

from $721 billion a year ago, and up from $166 billion a decade ago. Likewise, FHLBank membership saw a dramatic increase from 3,900 members at June 30, 1993 to just over 8,000 at June 30, 2003.

A financial snapshot of the Cincinnati FHLBank is also instructive to understanding how and why the cooperative structure is successful. The Cincinnati FHLBank is comprised of 750 members serving Ohio, Kentucky and Tennessee. As of June 30, 2003, Cincinnati reported $47 billion in advances, $7 billion in acquired mortgage assets (AMA) and $144 million in Affordable Housing Program grants invested into the creation of 25,000 units of housing. These are not just numbers. These are telecommunications jobs in Urbana, Ohio; the 1000th Habitat House in Kentucky dedicated last weekend; a small home-improvement loan program in Memphis that combats predatory lending; and 25 community based financial institutions that were able to sell mortgages in the secondary market for the first time.

My job as president of the Cincinnati FHLBank and the job of my Board are to ensure the success of this cooperative partnership. That is how we fulfill our housing finance mission. Our role of linking Main Street to Wall Street demands the flexibility to access the capital markets that we now enjoy. The Cincinnati FHLBank stands ready to fund the housing, economic development and liquidity needs of our members on a continuous basis. Cincinnati FHLBank advances are a critical component of the asset/liability management of our community based institutions as evidenced by the fact that approximately three of every four members have borrowings outstanding at any given time. This flow of funds from Wall Street to Main Street is clearly demonstrated by the financing activity of our FHLBank this past month. The Cincinnati FHLBank participated in 71 separate issues of fixed rate debt ranging in maturity from one to 15 years. The average size of the bonds issued was $34 million, a very small number by bond market standards. The funding raised was used to directly support member advance demand and mortgage note sales as well as provide the Cincinnati FHLBank with its pool of liquidity.

Independent Regulator

My Board and I believe that we can best support and build upon our successful record with a strong, independent regulator, engaged corporate governance, and effective risk

management. Under our current regulatory regime, the Finance Board's primary duty is "to ensure that the FHLBanks operate in a financially safe and sound manner." The Finance Board is not limited by funding constraints in carrying out its declared focus of ensuring the FHLBanks' safety and soundness. Its funding is provided by assessments on the FHLBanks that are not subject to review or challenge by the FHLBanks.

Finance Board regulations govern a broad range of FHLBanks' operations including advances pricing, risk management, capital plan approval, directors' responsibilities and new business activities. The Finance Board also collects and monitors financial and risk management data from the FHLBanks each month, performs ongoing reviews of all aspects of the FHLBanks' operations and conducts annual on-site examinations of all 12 FHLBanks. The Finance Board's 2004 budget would include a $4.3 million increase devoted to the supervision function. The FHLBanks all believe that it is essential to have a strong, independent regulator with the resources to ensure the FHLBanks' continued safety and soundness as well as to oversee the housing mission.

Corporate Governance

Finance Board regulations require that the FHLBanks' boards of directors fulfill the typical corporate director duties including, but not limited to, the responsibility to select and oversee management, the responsibility to ensure the establishment and maintenance of an adequate internal control system, the responsibility to adopt a risk management policy, a strategic business plan, and a member products policy that details the Bank's credit and pricing policies, and the responsibility to approve the FHLBanks' annual operating and capital budgets and quarterly dividends.

In carrying out their responsibilities, the boards of directors typically establish and act through committees. Finance Board regulations require each FHLBank's board of directors to have an audit committee with very specific regulatory responsibilities, including direct oversight of the FHLBank's internal and external audit functions. The boards of directors also typically establish other committees to facilitate their oversight of management. Committees vary from FHLBank to FHLBank, but typically include risk management, human resources and housing

oversight functions. The various elements of the FHLBanks' corporate governance structure combine to provide boards of directors that are active, knowledgeable, and engaged, and that are fully aware of their responsibilities and take them very seriously. The Finance Board recently completed a Systemwide study of corporate governance across all 12 FHLBanks. The results and recommendations of this study were presented to our Board for review and approval this past summer.

Risk Management

As 12 independent institutions, each of the FHLBanks is responsible for its own risk management activities. Each FHLBank has its own risk profile guided by a number of factors that are held in common across the FHLBanks. This approach enables each FHLBank individually, as well as the Consolidated Obligations (COs) issued by the 12 FHLBanks collectively in the capital markets, to be rated AAA.

The cooperative structure of the FHLBanks eliminates many of the incentives a publicly traded company might have to raise its risk profile in search of higher returns. In my opinion, this cooperative structure discourages FHLBanks from taking excess risk. The mission of the cooperative is to provide member institutions the funding and financial services they need to meet the credit needs of their underserved communities. At the same time, the FHLBank must generate an adequate return for member shareholders that meets their opportunity cost of investing capital in a AAA-rated cooperative enterprise. Rates of return on FHLBank stock will average in the neighborhood of four percent in 2003, far below the rate of return expected from publicly traded corporations.

FHLBanks are required by regulation to maintain a Risk Management Policy, reviewed at least annually and a Financial Management Policy, which governs permissible investment and derivative activities and overall risk management limitations. FHLBanks are subject to very conservative capital requirements with total capital equal to at least 4.0 percent of total assets and must have sufficient permanent capital to meet a risk-based capital requirement established by the Finance Board. The FHLBanks minimize credit risk by ensuring that advances are fully secured, that their investments are limited to issuers or securities that are highly rated at the time

the investments are made, and that their AMAs have appropriate risk-sharing features. No FHLBank has ever suffered a credit loss on an advance to a member in the FHLBanks' 71-year history. As of June 30, 98 percent of the FHLBanks' investment securities have long term ratings of AAA or the corresponding highest short term ratings. In addition, due to the risk sharing structure of the AMA programs, the FHLBanks' loss experience on AMA assets has been virtually nonexistent. Exposure to market risk is controlled by the Financial Management Policy's conservative limits. The incentive to maintain the conservative limits arises through the cooperative, non-publicly-traded-stock structure of the FHLBank.

Because history is not always an accurate predictor of future performance, each FHLBank uses sophisticated, high quality financial models to continually assess the magnitude of the risk to each FHLBank's estimated market value of equity and earnings from various changes in interest rates, mortgage prepayment speeds and other market variables. These models are provided primarily by market-tested third-party companies with expertise in measuring market risk of mortgage instruments, advances, corporate debt and derivatives. The FHLBanks monitor and manage market risk continuously throughout every month. The market risk position is reported and discussed with each FHLBanks' boards of directors at each board meeting. The integrity of the process is ensured through close board oversight, annual Finance Board examinations, internal and external audits, and separation of personnel responsibilities. Personnel responsible for assessing market risk are separate from personnel responsible for day-to-day risk management activities and are further separated from personnel preparing FHLBank monthly financial statements.

Legislative Reform of GSEs

The combination of congressionally determined financial requirements, an independent regulator, engaged boards of directors and extensive risk management tools have proven to be a successful model. However, adherence to this model is not mutually exclusive to aversion to change. The Cincinnati FHLBank wants to do what is best for the financial quality of our institution and, by extension, for the public it serves.

At its regularly scheduled meeting last month, the Cincinnati FHLBank Board of Directors concluded that it is in the best interest of its shareholders and the public they serve to retain the present independent regulatory structure for the FHLBanks. The structure and performance of the Finance Board has resulted in 12 healthy, AAA-rated regional FHLBanks that currently support $500 billion worth of credit activity, serving virtually every neighborhood in America.

The Finance Board's independence alleviates political and department-specific affiliations that may bias its oversight function. The current post-FIRREA Finance Board has presided over the most expansive and prosperous period of FHLBank history against a backdrop of extreme volatility in the market place. During this time, each FHLBank has maintained a AAA rating and continued the 71-year tradition of never having experienced a loan loss. The current Finance Board Chairman has more than doubled supervisory staff to 17 examiners and has budgeted for a total of 30. Further, the structure of the Finance Board allows for safety and soundness as well as mission oversight of the $1.7 billion Affordable Housing Program and multi-million dollar community investment programs to fall under one regulatory roof. This independent, comprehensive regulatory structure tailored for the System works, and works well.

At the same time the Cincinnati FHLBank Board of Directors affirmed its support of our independent regulator, it also directed management to begin immediately the process of registering its stock under Section 12 of the Securities and Exchange Act of 1934. This statement of direction came after preliminary meetings with SEC officials to discuss issues arising from the unique nature of the FHLBanks and the equity shares held by its members. The Cincinnati FHLBank strongly believes that registration of stock with the SEC is the best method to provide both bond and stock investors the necessary financial information they require to assess the condition of our FHLBank.

Some critics of the current regulatory structure have argued that the FHLBanks will be disadvantaged in their funding decisions if their regulator operates outside of the Treasury Department. While we appreciate that position, we do not share it. In fact, at the present time the debt issued by the FHLBanks trades at a premium relative to other GSEs. We are confident

the financial markets will continue to recognize that the FHLBank System consists of financially sound and conservatively managed, well capitalized institutions whose primary goal is to serve its housing finance mission through its members. This current position will be further strengthened with SEC registration.

Conclusion

The FHLBanks are strong, conservatively run enterprises without a single credit loss in their 71-year history. There is no problem in need of a solution. The System's current independent regulator is best positioned to provide both safety and soundness as well as mission oversight for our cooperative enterprise.

Mr. Chairman, thank you for the opportunity to address the Committee on this important matter. I will be happy to answer questions at the appropriate time.

Testimony of John T. Korsmo,
Chairman, Federal Housing Finance Board,
Before the House of Representatives' Committee on Financial Services
Washington, D.C.
September 25, 2003

Testimony of John T. Korsmo,
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Good morning, Chairman Oxley, Ranking Member Frank, and distinguished members of the Committee. Thank you for inviting me to be part of this panel today on H.R. 2575 and the Administration's proposals regarding government sponsored enterprises.

Over the past year and a half, my colleagues and I at the Federal Housing Finance Board have undertaken a disciplined, continuing, and, I believe, successful effort to improve the agency's supervision and regulation of the Federal Home Loan Banks.

This process has been instructive, providing many lessons that I believe may be of value to you as you consider the best ways to strengthen government sponsored enterprise (GSE) oversight. Allow me to highlight several of these lessons.

First, a GSE safety and soundness and mission regulator should today – and for the foreseeable future – concentrate on understanding and keeping pace with the rapidly evolving mortgage finance sector.

Second, a GSE safety and soundness and mission regulator should have specialized knowledge of the business and risks of the enterprises it supervises.

Third, a GSE safety and soundness and mission regulator must guard its independence in establishing standards and in conducting examinations so as not to revert to a failed model of mixing supervision duties with other mandates.

Fourth, a GSE safety and soundness and mission regulator should possess all the tools and enforcement authority granted to commercial bank and thrift regulators.

And, finally, a GSE safety and soundness and mission regulator's effectiveness is enhanced by exemption from the appropriation process, allowing it flexibility to determine and structure its budget based on the primacy of safety and soundness.

The Finance Board has learned these lessons as a result of its efforts to build a stronger, more capable regulator for the Federal Home Loan Banks. We have been fortunate in that the Federal Home Loan Bank Act affords the Finance Board the prerogatives and authority required to build a truly world-class, arm's length regulator for the Banks. I believe the fast progress my Finance Board colleagues and I have made in increasing the capacity and sophistication of the agency's supervision staff demonstrates the Finance Board is well on the way to becoming just such a regulator.

Mr. Chairman, members of the committee, I respect the responsibility of the Congress to take aggressive steps to foster strong, independent regulation of both Fannie Mae and Freddie Mac and the Federal Home Loan Banks, and it goes without saying I will support whatever policy Congress adopts in this regard. Given the progress we have made at the Finance Board and the very different charters, ownership and capital structures, and business models of the Banks as compared to the other housing GSEs, however, I believe the Finance Board is achieving the goal of providing effective, efficient, and independent regulation of the Federal Home Loan Banks. Moreover, I believe it is critical that significant enhancements now underway not be lost or deferred in transition to any new regulatory regime at a time when the 12 Banks are entering a far more demanding risk-management environment.

IMPROVEMENTS IN SAFETY AND SOUNDNESS OVERSIGHT

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, I quickly 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 my 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 has in place 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).

My Finance Board colleagues and I increased the resources available for supervision, expanding the agency's examination staff to 17 full-time bank examiners. Our goal is to have 24 in place by the end of this calendar year, and 30 by October 2004.

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, we have established two risk units – 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 our data and the Banks' own financial reporting into a risk-monitoring framework.

We have 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. We also have hired a 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.

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. Our new "Bank Analyst Program" charges a member of our 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.

Our 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. We have more work ahead of us, to be sure, but the Finance Board is a much stronger and more capable regulatory agency than it was as recently as 12 months ago.

GOVERNANCE

When Congress passed the Gramm-Leach-Bliley Act of 1999, it gave the board of directors at each Federal Home Loan Bank the clear responsibility for making business decisions concerning that Bank. Any business decisions previously made by the Federal Housing Finance Board were devolved to the Banks.

This new, post-Gramm-Leach-Bliley relationship makes it even more critical that the Federal Home Loan Banks meet the highest standards of corporate governance, and that the Federal Housing Finance Board pursue rigorous safety and soundness supervision of board governance at these Banks.

Therefore, the Finance Board recently completed a thorough assessment of corporate governance at each of the Banks. This effort included the first-ever horizontal review – that is, a systemwide supervisory review of a single issue at each of the 12 Banks – which addressed the Banks' effectiveness relative to eight indicators of effective board governance.

Those indicators are:

- Engaged Board of Directors
- Skilled Senior Management
- Thorough Strategic Planning
- Sound Risk Management
- Robust Internal Control
- Effective Audit Program
- Strong Ethical Culture
- Timely, Accurate, and Complete Communications

The Finance Board's final report on this review includes a variety of general recommendations for improving corporate governance. The agency also provided specific, confidential feedback to each of the 12 Banks.

The Board's next step is to solicit from the Banks, their member institutions, experts, and interested members of the public any ideas for reform in this important area. Input generated may be used in the design of proposals aimed at making the Federal Home Loan Banks role models in corporate governance.

Earlier this year, the Finance Board also undertook a second systemwide horizontal review, that of the Federal Home Loan Banks' implementation of the statutorily mandated Affordable Housing Program (AHP). The AHP is a highly successful program that warrants a separate discussion.

THE AFFORDABLE HOUSING PROGRAM (AHP)

The Federal Home Loan Bank Act requires each Bank to establish and fund an Affordable Housing Program. Under the AHP, each Bank must annually contribute the greater of 10 percent of its net earnings for the previous year, or such prorated sums as may be required to ensure that the aggregate contribution of the Banks is at least $100 million. Actual contributions to the program were $199 million for 2002, and the contributions have exceeded $100 million each year since 1994.

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.

In 2002, the Finance Board adopted a regulation enabling Banks to allocate annually the greater of $4.5 million or 35 percent of each Bank's AHP contribution to homeownership set-asides. Part of this increased funding authority helps Banks combine AHP subsidies with HUD initiatives benefiting minority, immigrant, and other first-time homebuyer families.

Since the inception of the AHP in 1990, the Federal Home Loan Banks have contributed $1.7 billion to the program, funding 236,596 rental units and 122,126 owner-occupied units. In 2002, the Banks committed $286 million to AHP projects.

The Finance Board appropriately devolved operation of the AHP program to the individual Banks in the late 1990s, a valuable development because the Banks are best equipped to assess local affordable housing needs and build partnerships with local community groups and housing agencies.

Correspondingly, the Finance Board's oversight responsibility has grown with respect to the AHP to ensure proper and effective program operation. As such, we are following up the horizontal review with a new practice of examining each Bank's AHP program once a year. These exams are performed by examiners and analysts whose specialized training has specifically equipped them for this task.

We are also preparing regulatory language intended to enhance the effectiveness of the AHP by permitting Banks more latitude in establishing the criteria to score applications. The goal is for Banks to be more responsive to local housing conditions. We also plan to streamline the application process to permit projects to proceed more quickly and with lower administrative costs for the Banks.

AHP is truly one of the Federal Home Loan Banks' great success stories, and with rigorous oversight at the Federal Housing Finance Board, I am confident it will be even more successful in the years ahead.

REGULATORY PHILOSOPHY AND APPROACH

The 1998 GAO report also faulted the Federal Housing Finance Board for failing to maintain an arm's length relationship from the Federal Home Loan Banks, and my Finance Board colleagues and I have undertaken a range of steps to rectify this inappropriate approach toward regulation.

Two unanimous votes by the Finance Board – one a year ago, one just this month – demonstrate the new, more professional relationship between the regulator, the Finance Board, and the regulated entities, the Federal Home Loan Banks.

The Finance Board's current practices now recognize that its proper role is not to operate the Federal Home Loan Banks, not to cheerlead for them, but rather to function as a true arm's length regulator.

In September of 2002, the Finance Board adopted standards of conduct that delineated the formal relationship it now maintains with respect to the Federal Home Loan Banks. The standards also reaffirmed rules prohibiting Federal Housing Finance Board directors or employees from accepting meals, travel, or gifts from Federal Home Loan Banks.

By adopting these standards the Finance Board drew what I call "the bright red line of separation" between the regulator and regulated entities, a separation Congress sought to establish with passage of the Gramm-Leach-Bliley Act. The relationship means the Finance Board will act, at times, in the face of disagreement with the Federal Home Loan Banks.

An example of this independence is the other, more recent unanimous vote I mentioned. On September 10, the Finance Board adopted a proposed rule to require each Federal Home Loan Bank to register a class of its securities with the Securities and Exchange Commission under the Securities Exchange Act of 1934. While not all Banks embrace voluntary registration with the SEC, the Finance Board determined enhanced Bank disclosure – with appropriate safeguards to ensure continued effective operations of the Banks – is in the best interest of, in this case, investors in the Bank System and, more broadly, the public who stand behind these GSEs.

ENHANCED DISCLOSURES

In July of 2002, the Administration called on all government sponsored enterprises to comply with the corporate disclosure requirements of the Securities Exchange Act of 1934, as interpreted and enforced by the SEC.

Fannie Mae and Freddie Mac, the other two housing-related GSEs, answered this call. Fannie Mae has already filed its first disclosures under the new SEC regime.

As Chairman of the Federal Housing Finance Board, I, too, am determined to hold the Federal Home Loan Banks to the highest standard of disclosure. Accordingly, I formed a working group from the Finance Board and the Federal Home Loan Banks to review the implications of acceding to the Administration's request that all GSEs register.

Early this year, I concluded that voluntary registration with the SEC was indeed the best approach to providing enhanced public disclosure of the governance and finances of the Federal Home Loan Banks. I reached this conclusion based on two premises.

First, the Banks' long-term access to global capital markets will be enhanced by providing investors in consolidated obligations with maximum reliable transparency into the finances and governance of each of the 12 Banks. Markets function best, especially in times of stress, when needed information is readily available and reliable.

Second, as public trusts, these 12 GSEs have a duty to contribute both to the smooth functioning of capital and mortgage finance markets and to public confidence that the benefits of GSE status are used wisely.

At my urging, Federal Home Loan Banks and the staff of the SEC have held numerous meetings to address the process for voluntary registration, including methods for resolving several key disclosure and accounting questions.

The Board of Directors of the Federal Home Loan Bank of Cincinnati actively embraced the disclosure initiative as in the best interest of its members, voting in February to pursue voluntary registration. Last month, the Cincinnati board resolved to "actively engage, effective immediately, in the process of voluntary registration with the SEC of its member-held stock."

This summer, too, the boards of the Federal Home Loan Bank of San Francisco and the Federal Home Loan Bank of Atlanta resolved that, if SEC registration was the determined course of action, it is their request that the Finance Board adopt a regulation requiring it.

In response to those requests, on September 10 the Finance Board unanimously adopted a proposed regulation requiring each Bank to register a class of securities with the SEC under section 12(g) of the Securities Exchange Act of 1934.

The proposed rule provides for a lengthy, 120-day comment period, during which, I hope, the Banks will each meet with the SEC to work out the necessary details to effectuate registration and begin meeting the periodic financial reporting requirements of the '34 Act.

Following the Finance Board's recent vote, two additional Banks – New York and Topeka – also adopted resolutions moving them toward voluntary registration.

The focus of the enhanced disclosure effort from the start has been to ensure that the Federal Home Loan Banks play their part, as government sponsored enterprises, in contributing to the smooth functioning of the capital and mortgage finance markets. In the end, consistent and full disclosures of these institutions' finances and corporate governance also serve the public, who stand behind their charters as government sponsored enterprises.

CONCLUSION

Mr. Chairman, distinguished members of the Committee, thank you for allowing me to discuss with you today the Federal Housing Finance Board and its efforts to strengthen the agency's ability to oversee the Federal Home Loan Banks for safety and soundness and accomplishment of their housing finance mission. Since 2002, the Finance Board has dramatically improved its ability to perform its statutorily mandated responsibilities. The agency's supervision function is stronger, more thorough, and more effective. Taken in conjunction with the initiative to enhance the financial disclosures provided by the Federal Home Loan Banks, I believe the Finance Board is capably representing the interests of the public and taxpayers who stand behind the Federal Home Loan Banks and who benefit from the successful performance of the Federal Home Loan Banks' important role in housing finance.

I hope the experience of the Finance Board during this process will be of value to this Committee as you consider H.R. 2575 and other issues relating to government sponsored enterprises.

I am pleased to respond to any questions.

Testimony of Terri Y. Montague
President and Chief Operating Officer
The Enterprise Foundation

On
"The Secondary Mortgage Market Enterprises Regulatory Improvement Act And the Administration's proposals on GSE regulation"

For the House Committee on Financial Services

September 25, 2003

Introduction

Thank you, Chairman Oxley, Ranking Member Frank and members of the Committee for this opportunity to share with you The Enterprise Foundation's views on government regulation of Fannie Mae and Freddie Mac.

I am Terri Montague, president and chief operating officer of The Enterprise Foundation. Enterprise is a national nonprofit organization that provides private capital to support affordable housing and economic development in low-income communities. Enterprise and its wholly owned subsidiary companies have invested $4.4 billion to finance 144,000 affordable homes for low-income families and individuals, including more than 12,000 in 2002. We are currently investing half-a-billion dollars a year to help connect low-income people and communities to the mainstream economy.

We have no more important partners in our work than Fannie Mae and Freddie Mac. The companies have been indispensable to Enterprise's efforts to expand housing opportunities for low-income homebuyers and renters. In many cases, Fannie Mae and Freddie Mac alone were willing and able to help Enterprise meet the needs of the people and places we serve. Without them, much of our work simply would not be possible.

In the interest of full disclosure, the Committee should know that Enterprise regularly seeks support from many major financial institutions, including Fannie Mae and Freddie Mac. The companies and their corporate foundations, along with other financial institutions, have been major contributors to The Enterprise Foundation.

In addition, we have sought out senior executives from financial institutions to lend their talent, energy and personal contributions to our cause. Franklin Raines, Fannie Mae's chairman and chief executive officer, and Barry Zigas, senior vice president and executive director of Fannie Mae's National Community Lending Center, are Trustees of The Enterprise Foundation. Mr. Zigas has served since his days as executive director of the National Low Income Housing Coalition. Our Board also includes executives from other financial institutions who are committed to affordable housing.

First, Do No Harm

Congress is considering significant changes to the federal government's regulation of Fannie Mae and Freddie Mac. The administration and members of Congress have proposed a new regulator and expanded regulatory authority for Fannie Mae and Freddie Mac's financial safety and soundness, as well as their new activities. In addition, the administration has proposed to increase regulation of Fannie Mae and Freddie Mac's congressionally mandated affordable housing responsibilities.

We encourage Congress to deal with these issues as expeditiously as possible to avoid any uncertainty in the mortgage markets. In acting, Congress should follow the "Hippocratic housing oath:" first, do no harm. It is imperative that any congressional action affecting Fannie Mae and Freddie Mac does not limit the companies' ability and incentive to address the housing needs of low-income people and communities. Any changes to their federal regulation should, in fact, enhance the companies' capacity to innovate in furtherance of their vital public purpose mission. This is our sole priority in Congress' review of Fannie Mae and Freddie Mac's regulation.

Certainly, the safety and soundness of Fannie Mae and Freddie Mac is critical for taxpayers and the economy. Vigorous regulation is essential. There is no reason, however, that strong safety and soundness oversight should chill or constrain Fannie Mae and Freddie Mac's vitally important affordable housing activities—and it must not be encouraged or enabled to do so. In fact, the interests of affordable housing and safety and soundness are very compatible, if carried out the right way. We are encouraged that the administration has not indicated a need to change the new risk-based capital standards for Fannie Mae and Freddie Mac at this time. Enterprise has worked hard to ensure that implementation of those standards does not undermine the companies' affordable housing activities.

We also agree with the administration that there is no reason to change Fannie Mae and Freddie Mac's mission, charter or status. And we agree with the administration that the Department of Housing and Urban Development (HUD) should remain responsible for ensuring Fannie Mae and Freddie Mac's compliance with their affordable housing responsibilities.

Issues of Concern in Pending Proposals

The balance of our testimony addresses three critical issues regarding federal regulation of Fannie Mae and Freddie Mac that the administration and members of Congress have raised recently: 1) the location of the regulator responsible for approving new Fannie Mae and Freddie Mac initiatives; 2) the scope of that approval authority; and 3) the establishment and enforcement of Fannie Mae and Freddie Mac's affordable housing responsibilities.

Location of approval authority. Under current law, HUD is responsible for approving new Fannie Mae and Freddie Mac programs. The administration has proposed transferring this authority to a new agency that also would regulate Fannie Mae and Freddie Mac's financial safety and soundness. The administration has said it would support establishing such an agency as a bureau of the Treasury Department. The new agency would "consult" with HUD on new programs. Subcommittee Chairman Baker's (R-LA) legislation (H.R. 2575) would leave HUD in charge of "prior approval authority."

We agree with Chairman Baker that HUD should retain this responsibility. We are not aware of any evidence that HUD has not exercised prior approval authority appropriately. HUD is the only federal agency with expertise in affordable housing and a mission to advance it. Only HUD has the benefit of more than a decade of experience working with Fannie Mae and Freddie Mac to evaluate new programs. Getting a new agency up a new learning curve for no apparent gain seems an ill-advised use of limited resources.

Scope of approval authority. Current law requires Fannie Mae and Freddie Mac to obtain HUD's approval for any "new program" before implementing the program. The law generally requires HUD to approve any new program unless HUD finds that the new program does not comply with the appropriate company's charter or is not in the public interest. H.R. 2575 would require Fannie Mae and Freddie Mac to obtain HUD approval before commencing any "new activity," including changes to existing (approved) "programs, activities, business processes and investments" or expansion of (approved) programs.

Again, we wonder what problem this provision purports to fix. As noted above, HUD has exercised its prior approval authority appropriately. In addition, HUD has the authority under current law, which it has exercised, to itself initiate a request for information from Fannie Mae and Freddie Mac regarding what it considers possible new programs.

Requiring Fannie Mae and Freddie Mac to seek federal government sign-off on changes to such a wide range of activities could curtail the companies' ability to respond effectively to changes in the mortgage markets, such as rising interest rates. The expanded approval authority in H.R. 2575 also almost certainly would inhibit the companies' incentive to innovate. Low-income consumers and communities, which often benefit most from Fannie Mae and Freddie Mac's innovative initiatives, could lose out.

We recall that a primary purpose of prior approval authority when it was enacted in 1992 was to encourage and enhance Fannie Mae and Freddie Mac innovation in support of their affordable housing mission. We worry that the prior approval provision in H.R. 2575 would have the opposite effect. We wonder, for example, whether Fannie Mae would have had the same ability and incentive to pioneer with Enterprise the Low Income Housing Tax Credit (LIHTC) if the company had been subject to the approval requirements H.R. 2575 would impose.

Hardly any corporations were willing to commit capital to support affordable housing for low-income people through the LIHTC when the program was new. Virtually no federal officials understood the program. Even many housing groups that had advocated for the credit were not sure how well it would work. Fannie Mae stepped up when others would not to commit $25 million in investment through Enterprise and worked with us convince other corporations to invest. Together, we helped create the corporate market in LIHTC investments. Freddie Mac joined Fannie Mae several years later in helping to expand the market of LIHTC investors by making matching pledges for state and local LIHTC investment.

Fannie Mae and Freddie Mac's commitment to this fledgling federal incentive sent a strong signal to the marketplace that the Credit was a sound investment. Their participation solidified the program at a critical juncture, when its future hung in the balance. The LIHTC is now the most important federal incentive for the development of rental housing for low-income people, accounting for more than 115,000 affordable apartments for working families, seniors, homeless individuals and people with special needs every year. It is impossible to imagine such success without Fannie Mae and Freddie Mac's early and sustained participation.

Establishment and enforcement of affordable housing responsibilities. As the Committee is aware, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires Fannie Mae and Freddie Mac to dedicate substantial portions of their business to serving low-income people and underserved communities. They must meet annual goals, established by HUD, and expressed as a percentage of all the housing units for which the institutions provide financing, in the following categories: loans to low- and moderate-income borrowers (minimum 50 percent of all units financed by each company for 2003); loans in central cities, rural communities and other underserved areas (31 percent); and "special affordable" loans to very low-income borrowers and low-income borrowers living in low-income areas (20 percent).

The administration has proposed expanding HUD's ability to establish, maintain and enforce Fannie Mae and Freddie Mac's "affordable housing goals." While we have not seen details of the administration's proposal, the proposal would appear to require significant statutory changes. We see no reason to change the statutory framework for the affordable housing goals at this time. Let us be very clear: Enterprise has long encouraged Fannie Mae and Freddie Mac to increase their affordable housing activities. The companies could and should do more to help meet pressing housing needs. But changing the statute is the wrong approach.

HUD has the authority already to increase the percentage-of-business targets in each statutory goal category. HUD also has the authority under current law to incentivize Fannie Mae and Freddie Mac to achieve more specific affordable housing objectives, such as through bonus points, and, on a more limited basis, through "subgoals" of the "special affordable" housing goal.

HUD has utilized both types of authority effectively in the past, resulting in substantial increases in Fannie Mae and Freddie Mac's affordable housing financing.

HUD's most recent regulatory revision of the affordable housing goals, in 2000, resulted in Fannie Mae and Freddie Mac increasing their mortgage financing for low-income and underserved people and communities by nearly half-a-billion dollars between 2001 and 2011. That increase will enable the companies to serve 7 million families beyond the 21 million they already had committed to assist during that period. HUD also established bonus points in 2000 to increase Fannie Mae and Freddie Mac financing for small multifamily properties and owner-occupied two-to-four unit properties that also contain rental units.

More can be done under the current regulatory authority. In fact, the current affordable housing goals are up for a regulatory revision this year. We are not aware whether HUD plans to update the goals. We are not aware of any effort by the Department to seek the advice and assistance of housing organizations in any goal revision. If HUD intends to review the goals, we urge it to work with a wide range of housing organizations, including Fannie Mae and Freddie Mac, as it always has in the past, before moving forward.

We would support strengthening aspects of the affordable housing goal regulations to require, encourage and enable Fannie Mae and Freddie Mac to serve lower income borrowers and underserved areas. For example, we would support tightening the definition of "low-income" for the purposes of the "underserved areas" goal. The current regulation generally defines "underserved areas" as census tracts having a median income at or below 120 percent of metro median income and a minority population of 30 percent or greater, or a median income at or below 90 percent of metro median income. In rural areas, 95 percent substitutes for 90 percent (among other differences). The 90 percent and 95 percent targets should be changed to 80 percent, to align the definition of "low income" with the other parts of the goals regulation and other HUD programs and to get more resources where they are more needed.

In addition, we would support providing additional incentives to encourage greater Fannie Mae and Freddie Mac activity in other underserved segments of the market. These areas could include manufactured housing loans; single family loans to underserved minorities; single and multifamily rehabilitation loans; single and multifamily loans in Native America areas; single and multifamily loans in Empowerment Zones and Renewal Communities; loans to low-income rural borrowers; and loans to properties with expiring Section 8 contracts.

We also would strongly support measures to enhance Fannie Mae and Freddie's Mac's ability to pioneer innovative programs and initiatives such as financial guarantees, risk-sharing and targeted loan programs with mission-oriented partners, such as state housing finance agencies and community development financial institutions.

Enterprise's experience with Fannie Mae is illustrative. For example, Fannie Mae and Enterprise created a lending program, Enterprise Mortgage Investments (EMI), that provides low-cost capital and credit enhancement for rental housing for low-income working families. EMI's portfolio today includes nearly $300 million in financing,

totaling more than 10,000 affordable apartments. Enterprise and Fannie Mae also launched a venture in the early 1990s, Cornerstone Housing Corporation, which acquired government-owned foreclosed properties from the Resolution Trust Corporation and preserved their affordability. Cornerstone helped save more than 5,000 apartments for low-income people in mixed-income communities.

Fannie Mae and Freddie Mac have developed similar initiatives with many other organizations that broke new ground in affordable housing. These innovations have often pointed the way for the mainstream market to follow—benefiting those institutions' bottom lines and millions of low-income people. The ability to "test market" new private-public partnerships at scale is a unique value only Fannie Mae and Freddie Mac can provide in affordable housing.

Interestingly, Fannie Mae and Freddie Mac receive no affordable housing goals credit for their investment and direct lending activities, which are often the ways in which they have supplied the most innovative and important forms of capital to a variety of partners that reach extremely low-income people. Certainly, there should be an effort to encourage Fannie and Freddie Mac to make more of this capital available and to reward them for doing so in a financially prudent way.

Finally, we would support constructive efforts to enable Fannie Mae and Freddie Mac to play a more active role in the subprime mortgage market. The companies' resources, capacity and clout could position them to increase alternatives to predatory lenders, which are still stripping wealth and assets from too many low-income families. We commend HUD for imposing tough standards to help ensure Fannie Mae and Freddie Mac do not receive affordable housing goal credit for purchasing certain high cost loans. And we commend the companies for the strong steps they have taken on their own to help fight the predators. Working with HUD, mortgage lenders and housing advocates, we believe the companies could find additional ways to serve subprime borrowers and create a strong, fair secondary market for subprime loans.

The last time Congress revised Fannie Mae and Freddie Mac's statutory framework, it expressly provided the companies the freedom and flexibility to respond to fast moving market conditions and help meet our nation's affordable housing needs. The companies have consistently met their affordable housing responsibilities, even as HUD steadily and substantially increased them over the past decade. It is our experience that Fannie Mae and Freddie Mac's current statutory and regulatory framework has enhanced their ability and willingness to forge partnerships with organizations like Enterprise to deliver housing resources to people and places that cannot take full advantage of our nation's generally well functioning housing system. Millions of low-income people have a decent, affordable home as a result. Any changes to federal regulation of the companies should not jeopardize or limit that progress.

Statement of Franklin D. Raines
Chairman and CEO of
Fannie Mae
Before the U.S. House Committee on Financial Services
September 25, 2003

Chairman Oxley, Congressman Frank, and members of the committee, thank you very much for inviting me here today. I am here to testify on legislation that would alter Fannie Mae's regulatory framework. To give some context to these proposals, I would like to begin by describing the fundamental health and dynamism of our mortgage finance system, the efficiencies Fannie Mae has helped to bring to the system, our impact on broadening homeownership, and our leadership in disclosure, risk management and corporate governance.

Let me start by saying, I am appearing today in support of legislation – the right legislation – to strengthen Fannie Mae's regulatory oversight. I am here today to ask Congress to take action to make our housing finance system even stronger by enacting the Administration's proposal to move our financial regulator to a bureau of the US Department of Treasury.

We support the Administration's proposal for three main reasons:

First, we support having a strong, well-funded, highly credible financial regulator, and this move would help ensure that.

Second, the proposal supports our charter and mission, including our freedom to continue to innovate with our lender customers and housing partners to expand affordable housing to new people and places.

And third, the proposal supports the advanced capital structure Congress provided in 1992, which ensures that we remain safe and sound through even the worst conditions while allowing us to direct the maximum amount of low-cost financing to homebuyers. The proposal also calls for giving the regulator full and more flexible authority to adjust risk-based capital standards over time, to incorporate evolving best practices. We support giving the regulator this additional flexibility.

Fannie Mae looks forward to working with Congress and the Administration to adopt the proposal into law this year.

I believe that strengthening our financial regulator is the natural next step in a sequence of Congressional actions that have made the GSE construct an enormous success. Over the last 65 years, Congress has created a remarkable and unique public policy model that today marshals private capital – at no cost to the government -- to carry out the public policy goal of making homeownership more affordable. Let me review the history that has brought us to this opportunity today.

I: THE SUCCESS OF THE AMERICAN SYSTEM

When Fannie Mae was first created in 1938, the 30-year fixed rate mortgage was little more than an idea. Most homes were financed nearly entirely with cash. The standard mortgage product available in the market was a 5-year loan with a balloon payment at the end. When the federal government decided to start making 30-year fixed rate loans, no one really knew if the product would work. Today, it is the standard mortgage in the United States.

Again in 1968, innovative policymakers took another bold step, creating the GSE model we know today. Fannie Mae was privatized. It became a private, shareholder-owned company with a public mission to expand homeownership. This was a novel idea at the time. And the GSE model has proven an overwhelming success, marshalling private capital for a public mission.

In 1992, Congress established Fannie Mae's modern regulatory framework. It included specific affordable housing goals, a rigorous capital framework, and a constant, on-site program of supervision. In the decade since that law was enacted, Fannie Mae has played a central role as our mortgage markets have become increasingly efficient and we have done so maintaining strong, safe, and sound financial performance.

Our mortgage finance system is the envy of the world. Nowhere else in the world are low-downpayment, long-term, fixed rate, prepayable mortgages the market standard. Other nations have noticed our success and are eager to imitate it. Many have figured out how to use government guarantees and government funds to expand homeownership, but none have yet accomplished the success of the GSE model, galvanizing private companies to attract low cost funding to the mortgage market, without spending a dime of the taxpayers' money.

According to the Federal Housing Finance Board, last year in the United States, 83 percent of residential mortgages had fixed rates, with the predominant product being a thirty-year fixed-rate mortgage. By contrast, in Canada borrowers can get a fixed rate for only the first one to five years, and face a prepayment penalty equal to 3 months interest. And in Spain only about 10 percent of the market is fixed rate. In Germany, the typical downpayment is 35 to 40 percent, and in Japan homebuyers have to put down 50 to 60 percent.

In the UK, Chancellor of the Exchequer Gordon Brown is convinced that variable rate mortgages have contributed to housing booms and busts, by exposing homeowners to interest rate swings that create sudden leaps in monthly mortgage payments. He has a team working on creating a market for long-term fixed rate mortgages, and has made the introduction of a fixed rate mortgage product a pre-condition of the UK's adoption of the euro. Brown believes that this will help to reduce the boom and bust cycle in the property market in the UK.

Why are low down payment fixed rate prepayable mortgages so common here and a rarity elsewhere? The difference is Congress' long-standing commitment to homeownership and its decision to foster a sophisticated secondary mortgage market that continues to meet the needs of both homebuyers and investors.

The GSE model has succeeded where other nations have failed because it taps deep pools of capital around the world and disperses mortgage risk across the capital markets. Fannie Mae offers lenders the ability to shed the credit and interest rate risk inherent in a long-term fixed rate mortgage, and to transform mortgage risk into the various forms that investors want to buy. We do that in two ways, both

of which have a positive impact on our housing mission by lowering costs to current and potential homeowners.

The Credit Guaranty Business

First, we manage credit risk when lenders come to us with a pool of mortgages and we create a mortgage-backed security (MBS), which the lender can then hold or sell in the market place. Because we guarantee the timely payment of principal and interest on that MBS, investors who do not want to take on the credit risk of a mortgage can purchase MBS. Through our credit guaranty business, we have created and sustained a deep and liquid market for conventional, conforming MBS, which are the bedrock of today's secondary mortgage market.

Mortgage-backed securities are sometimes referred to as pass-through certificates, because the security passes through to investors the principal and interest payments each month from the mortgages backing the security. An investor in an MBS owns an interest in a pool of mortgages and receives the cash flows from this pool. A nationwide network of lenders such as mortgage bankers, savings and loan associations, and commercial banks originates the loans backing the MBS. Securitization by Fannie Mae converts a pool of relatively illiquid mortgage loans into a very liquid security, carrying a guarantee to the investor of timely payment of principal and interest. Fannie Mae's obligation under this guarantee is solely Fannie Mae's and is not backed by the United States government.

The market for these mortgage-backed securities functions with such efficiency that it is able to provide an abundant supply of mortgage credit to American homeowners at low cost, and it is one of the most liquid markets in the world. According to the Bond Market Association, in 2002, Fannie Mae, Freddie Mac, and Ginnie Mae combined MBS issuances totaled $1.46 trillion. On a typical trading day in 2002, more than $154 billion of conforming MBS changed hands. The ultimate beneficiaries of this vast liquidity are homeowners, because they have access to mortgage credit constantly at a lower cost.

The Portfolio Business

Second, we purchase mortgages directly and hold them in portfolio. In fact, while Fannie Mae did not begin guaranteeing MBS until 1981, the company has purchased mortgages for its portfolio since 1938. Today, Fannie Mae's mortgage portfolio remains a vital tool that enables the company to fulfill its housing mission.

Because many investors are not comfortable with the payment uncertainty of mortgages and MBS, 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 to manage the unpredictability of mortgages, which can prepay before maturity, can instead invest in Fannie Mae debt securities, whose payments are far more predictable. In this manner, Fannie Mae can attract additional investors in support of housing, providing value to homeowners and investors alike.

When Congress chartered Fannie Mae as a shareholder-owned company in 1968, the company's only line of business -- its only way to provide the residential mortgage market with liquidity -- was to purchase mortgages for its portfolio. 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 fall of 1998, when 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 a recent study by Andy Naranjo and Alden Toevs of the First Manhattan Consulting Group, the authors 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.

An additional benefit of the portfolio is that it 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 who want to sell new mortgage products into the secondary market. 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 point (one-quarter of a percentage point) decrease in mortgage rates, nearly 400,000 additional families can qualify to become first-time homebuyers.

II: FULFILLING OUR MISSION

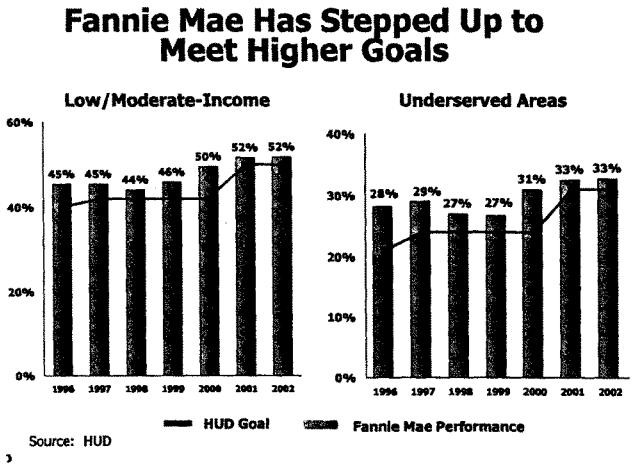
Serving Underserved Communities

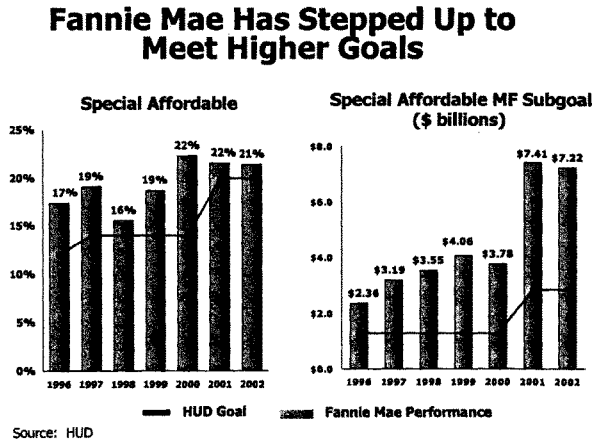
Fannie Mae has a special responsibility to focus on some of the nation's toughest housing problems. We do that every day in furtherance of our mission to expand homeownership. In 1994, Fannie Mae launched a *Trillion Dollar Commitment* dedicated to expanding markets and increasing access to mortgage credit. Upon completion of the *Trillion Dollar Commitment* in 2000, we announced our $2 trillion *American Dream Commitment*, a decade-long effort to close homeownership gaps and strengthen communities. Since 1994, Fannie Mae has served more than 12 million low- and moderate-income families and more than 4.8 million minority families.

As the 1992 Act established, HUD has responsibility for our housing mission. HUD has used this responsibility to ensure that we remain focused on our affordable housing mission and to ensure that our business continues to promote housing as a national public policy priority. In addition to operating under HUD's regulation, Fannie Mae also has worked with HUD on a variety of initiatives --including the President's Minority Homeownership Initiative, The Trillion Dollar Commitment, the American Dream Commitment, and important anti-predatory lending initiatives – that have furthered our affordable housing mission. We support a continued role for HUD as our mission regulator.

As the 1992 Act mandated, HUD has established affordable housing goals for the company, to quantify our mission responsibilities. HUD sets specific share of business goals for purchasing loans to low- and

moderate-income borrowers, purchasing loans to borrowers in underserved communities, and purchasing loans to very low-income families and low-income families living in low-income areas.





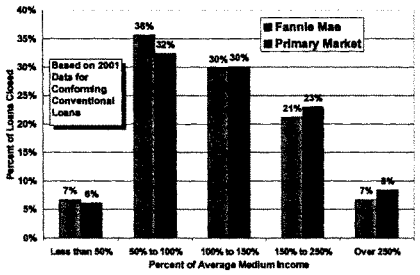
Those goals have increased substantially over the past ten years, and we have consistently met those goals, even as they have become more demanding.

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; we are responding to President Bush's challenge to expand minority homeownership; and we are providing leadership in the market in both qualitative and quantitative ways. We work every day to innovate and develop creative ways to bring homeownership opportunities to all corners of the nation.

Expanding Fannie Mae's Impact

Fannie Mae is 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. Further, as the chart below demonstrates, a greater share of Fannie Mae's business serves households with incomes below 100 percent of Area Median Income (AMI) than the conventional conforming market.

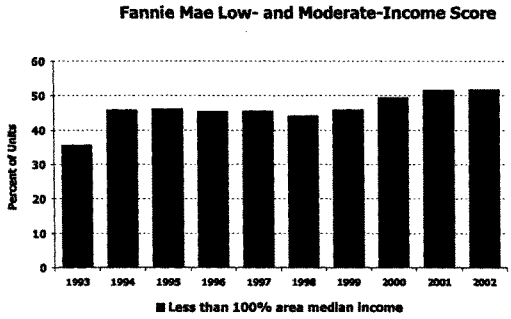
Fannie Mae Leads the Market in Serving Lower-Income Borrowers



Source: Fannie Mae

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.

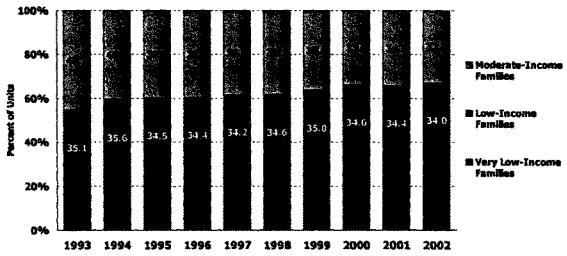
Low-Mod Borrowers Represent Greater Share of Business Over Time



Source: Fannie Mae

And within that population of borrowers, we have steadily increased the share of mortgage purchases that are loans to borrowers earning between 60 percent and 80 percent of area median income, and the share of borrowers earning less than 60 percent of area median income.

Lower-Income Borrowers Represent Greater Share of Business Over Time



Source: Fannie Mae

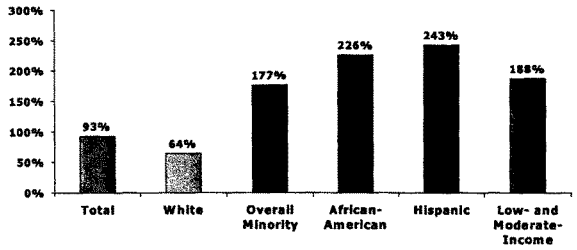
Expanding Minority Homeownership

Last year, President Bush challenged the housing industry to work with the Administration to create 5.5 million new minority homeowners by the end of the decade. Fannie Mae made a 10-point commitment to President Bush's Minority Homeownership Initiative, including a pledge to invest at least $700 billion to finance mortgages for minority families between 2000 and 2009. As of the end of June 2003, we had invested $381 billion toward that commitment, while we worked to solve difficult problems through innovative partnerships with lenders, faith-based institutions, counseling agencies, and state and local housing finance agencies.

In 2002 alone, Fannie Mae invested $136.2 billion in mortgages to minority families, exceeding that of any other private financial services institution and even greatly exceeding 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, purchases of loans to African Americans increased 226 percent and purchases of loans to Hispanics increased 243 percent, while our purchases of loans to non-minorities increased by only 64 percent.

Growth in Families Served

Fannie Mae: 1993 to 2002



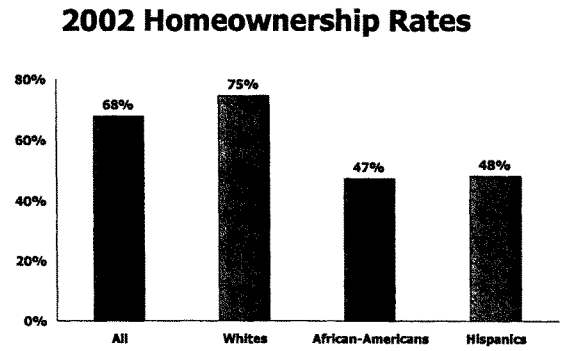
Source: Fannie Mae

We are determined to lead in minority lending, not just because it's the right thing to do, but also because it is what the market demands. We know that the biggest growth markets in the mortgage business are the same markets that have not been served very well in the past. By the year 2020, while the white population is projected to grow by about 5 percent, the African-American population will grow by 24 percent, the Hispanic American population by 70 percent, and the Asian American population by 75 percent.

In some places, Hispanic families are fast becoming a majority. By the end of this decade, Hispanics will contribute nearly half of the nation's population growth. We expect the US population, as a whole,

to grow by about 30 million during this decade alone, driven in large part by a healthy influx of new Americans. And that population growth will create 13-15 million new households.

Meanwhile, fewer than half of minorities own their homes, versus almost three-quarters of white families. That means there is an untapped market of millions of minority families right now waiting to be served.



Source: U.S. Census

In other words, the so-called emerging markets are the surging markets. If we are to grow as a company and continue to achieve our mission to expand affordable housing, we must find better ways to reach and serve these markets. Emerging markets are the future of Fannie Mae.

Innovation

Innovation has been critical in our efforts to reach new markets and underserved communities. Harnessing the powers of technology, Fannie Mae has made it possible for more people to access mortgage credit and to have more choices at better prices.

Since 1992, 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, minority, and other traditionally underserved borrowers.

For example, a downpayment is often the single largest obstacle preventing a family from purchasing a home. Fannie Mae was at the forefront of the mortgage industry expansion into low-downpayment lending and created the first standardized 3-percent-down mortgage. Fannie Mae financing for low down payment loans (5 percent or less) has grown from $109 million in 1993 to $17 billion in 2002.

We've also used technology to expand our underwriting criteria, so that we can reach underserved communities. For example, our Expanded Approval products make it possible for people with blemished credit to obtain a conforming mortgage loan. And we've added a Timely Payments Reward feature to those loans, enabling borrowers to lower their mortgage payment by making their payments on time. 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 home buyers.

Not only has innovation created a wider variety of mortgage products targeted to individual borrowers' needs, it has also streamlined the cost of processing a new mortgage loan. Our system has brilliantly harnessed the power of information technology to make the process of financing or refinancing a home faster, cheaper and easier for consumers, and more efficient for the industry.

The highly liquid and efficient mortgage market laid the foundation for the refinance boom of the last two years. This has enabled borrowers to take advantage of the lowest interest rates in decades and thereby save billions of dollars in interest costs. In a speech delivered on March 4, 2003 to the Independent Community Bankers of America, Federal Reserve Chairman Alan Greenspan reported that in 2002, close to 10 million mortgages were refinanced, and that households "cashed out" almost $200 billion of their accumulated home equity, likely using as much as half of that amount to modernize their homes and for personal consumption -- spending that directly affected GDP and jobs. He went on to say that approximately half of that cashed out equity went to consumption – consumption spending that provided much needed support to an otherwise flagging economy.

Greenspan acknowledged the significance of record low mortgage rates in the refinancing wave. He also pointed out that the relative ease in the process of refinancing, compared to ten years ago, played a significant role in prompting these additional household expenditures.

> *"Even as recently as the late 1980s, a family that wanted to use housing wealth to finance consumption would have faced an expensive and time-consuming process...Although substantial home equity wealth has existed for many years, only in the last decade or so has secured borrowing against home equity become a cost-effective source of credit in a wide variety of circumstances."*

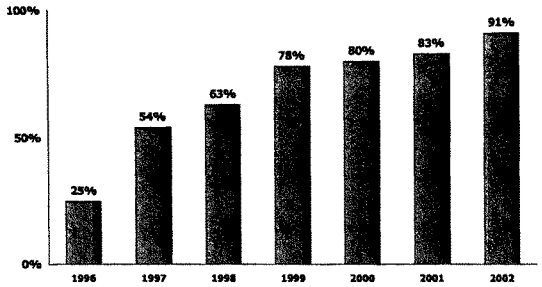
He concluded his remarks by noting, "Home equity extraction may be the household sector's realization of the benefit of a rapidly evolving financial intermediation system."

Fannie Mae has played an integral role in standardizing the mortgage process through technology, to make it faster and less expensive for lenders and for consumers to refinance into lower cost mortgages and to cash out some of the equity in their homes.

From the inception of our technology efforts, Fannie Mae's vision has always been to create technology that was scalable through economic ups and downs. Through our technology, our underwriting flexibilities and our access to capital, Fannie Mae has been able to work with lenders across the country to insure that, no matter the size of the market, lenders are able to service their borrowers effectively and efficiently. Without that technological progress, the industry may well have been overwhelmed and unable to accommodate the refinance wave of the last two years.

In a 2002 study, MORTECH, a company specializing in research on the mortgage industry and its use of technology, found that the use of automated underwriting systems (AUS) was nearly universal. That represents a complete transformation of the industry over the last ten years. Virtually all underwriting was manual in 1993. By 2002, 91.3 percent of lenders had implemented automated underwriting. An estimated 75 percent of loan applications were underwritten using automated underwriting in 2002.

Use of Automated Underwriting Has Increased Industry Efficiency



Percent of Industry Use of AU Since 1996

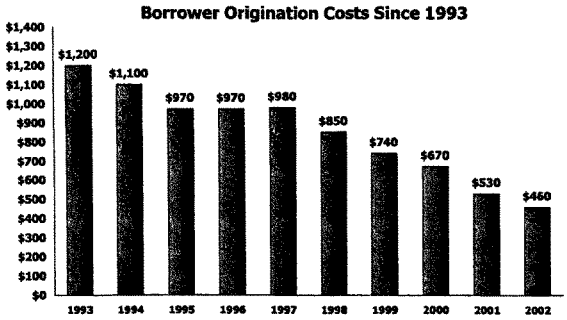
Source: MORTECH 2002/03

Technology has enabled lenders to handle volumes that have more than tripled in the last ten years. During the 1993 refinance boom, the mortgage industry originated $1.0 trillion in mortgage loans, of which 52 percent was comprised of refinance transactions. This year, we are projecting that the mortgage industry will originate over $3.3 trillion, with over 67 percent being refinance transactions.

Without today's technology, the 1993 mortgage market was both paper and people intensive. In 1993, refinancings were treated no differently from regular purchase mortgages. A homeowner seeking to refinance had to fill out a complete application, wait two weeks or longer for approval, order a full house inspection and wait an average of 45 days to close. The inefficient process added dollars and time to the homeowners' cost.

Today is quite different. The introduction of technology has dramatically improved lender efficiencies. With automated underwriting, a lender can provide a borrower with an approval in minutes. In fact, more than 75 percent of applicants are now approved in two to three minutes. And more importantly, lenders who have integrated technology into their business processes witnessed tremendous cost savings. Automated underwriting systems have cut origination costs for mortgage banks, commercial banks, and thrifts. And borrowers have reaped the rewards, in lower mortgage costs.

Automated Underwriting Has Lowered Borrower Costs



Source: MORTECH 2002/03 **Origination Costs on a $100,000 Loan**

Technology also impacted our ability to do business at lower costs. Fannie Mae had difficulty handling the volumes in 1993. In the peak month of the 1993 refinance boom, we had 631 people processing 320,000 loans. We hired a large number of temporary employees to handle the huge volume of paper. This year, at the peak of the refinance wave, 250 Fannie Mae employees processed one million loans a month

Providing Leadership in the Market

The 1992 Act focused Fannie Mae on our mission and gave us the flexibility to innovate to meet that mission. As a result, we now lead the market in funding mortgages for low-income and minority home buyers.

There have been many studies that have attempted to measure Fannie Mae's impact in the market. Last week, you heard that some of these studies showed that Fannie Mae lags the primary market in funding mortgage loans for low-income and minority homebuyers. Actually, the most recent data show that Fannie Mae leads the market, by measurements HUD uses and by more common measurements.

Fannie Mae is the nation's largest private investor in affordable housing and minority lending. 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 against the market in which we operate – Fannie Mae's performance on affordable housing lending has consistently surpassed the primary market's performance.

Two weeks ago, Secretary Martinez's testimony repeated analysis from the President's budget that Fannie Mae's affordable housing performance in our single-family business lagged the primary market

as measured by Home Mortgage Disclosure Act (HMDA) data. The Secretary's testimony cited data from 1999 that HUD believes showed that we lagged the market that year.

Over the years, Fannie Mae has disagreed with HUD's methodology for defining market leadership primarily because the Department has used a definition of the primary market that includes a large part of the subprime market, where Fannie Mae has traditionally not operated. If the subprime market is not included, a HMDA-based market leadership analysis shows that we have consistently led or matched the conventional market in the past.

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, non-subprime market. 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 and Fannie Mae data.

In recent years, Fannie Mae has sought to extend financing to those with imperfect credit, but those advances are not captured in the analysis cited by the Secretary, which focused on data from 1997 through 1999. As a result, since 2001 Fannie Mae has led the market even using the broader definition of the comparison market employed by HUD. Using HUD's definition of the primary market, the 2001 data reveals that Fannie Mae led the market in purchasing loans 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). This represents our own best efforts to replicate HUD's methodology, as HUD has not yet published any analysis using 2001 data.

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 were 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.

Finally, HUD data is focused entirely on single-family homes. None of this analysis includes any of the impacts from our investments in Low Income Housing Tax Credits, multifamily affordable rental housing, Mortgage Revenue Bonds or the other community development investments we make through our American Community Fund.

Market leadership is about qualitative as well as quantitative contributions. Fannie Mae has been an innovative leader in the affordable housing field. The company was at the forefront of the mortgage industry expansion into low-downpayment lending, initiating the purchase of the Fannie 97 mortgage in 1994 as the first widely available and standardized 3 percent down mortgage product and offering loans with as little as a $500 contribution from the borrower today.

We've also harnessed technology to break down the lending barriers minorities often face, mainly by making our automated underwriting system even more flexible so lenders could provide Fannie Mae financing to families with atypical financial profiles. For example, we provided more feedback in the

underwriting findings so that lenders could help consumers understand what went into the decision so they could try to fix any problems and get a "yes" decision from that lender.

Our investments in technology have expanded markets for our lender partners, and by reducing the cost of originations, enhanced affordability for the homebuyer. More recently, Fannie Mae has launched new efforts to serve borrowers with blemished credit histories. Our Expanded Approval and Timely Payment Rewards product lines are examples of how we help conventional mortgage lenders broaden their markets to serve borrowers previously left only to subprime lenders.

We've also used our role in the secondary market to change practices in the primary market to reduce the prevalence of predatory lending. We are working in local communities throughout the nation to help develop solutions to the problem of predatory lending. For example, in Essex County, NJ, Fannie Mae worked with New Jersey Citizen Action, the U.S. Department of Housing & Urban Development, Essex County, and interested lender partners to develop a workout solution was specifically crafted to help more than 100 families primarily in Essex County who were victims of a property flipping scheme that occurred from 1999 to 2001.

We work to support and increase public advocacy to protect mortgage consumer rights. We believe that all home-buying consumers should be treated equally and should have access to the lowest cost mortgage for which they qualify. We also want home-buying consumers to know the true cost of the mortgages they are being offered -- including all fees and charges.

We have established industry-leading anti-predatory lending policy guidelines to combat abusive lending practices in the marketplace. By setting tough standards and at the same time making conventional mortgage products more widely available, we are working to see that good practices chase bad practices out of the mortgage market.

III: SOUND BUSINESS

Best in Class Disclosure

Fannie Mae has worked with Congress and the last two Administrations to create best-in-class disclosure and corporate governance practices for the company.

In 2000, in consultation with the Treasury Department and members of this committee, Fannie Mae crafted a set of proposals designed to place it at the leading edge of safety and soundness practices. These voluntary initiatives include commitments to issue subordinated debt, obtain an annual "risk to the government" rating, enhance our liquidity planning, disclose more information about interest rate risk and credit risk sensitivity, and implement and disclose the results of an interim risk-based capital standard. In several cases, we created financial structures and disclosures that have little precedent among financial institutions. Taken together, these initiatives give investors and policymakers more information about Fannie Mae's risk exposure -- and confidence that Fannie Mae can manage that exposure -- than they can get from any other financial institution. We continue to meet every one of the voluntary initiatives.

These disclosures, combined with the regulatory mechanisms Congress enacted in 1992, place Fannie Mae at the vanguard of risk management and disclosure practices worldwide, with cutting-edge regulatory discipline bolstered by cutting-edge market discipline.

In the post-Enron environment, policymakers expressed some concern that some of our disclosures were voluntary rather than mandatory. Some were concerned that our financial statements were not on the SEC's EDGAR website. We responded by consulting with the Treasury Department and members of this committee about their concerns, and then committing to voluntarily register our common stock with the SEC under the 1934 Securities and Exchange Act. In March, we completed that registration, and we are now permanently subject to all SEC disclosure rules and fully subject to all provisions of the Sarbanes-Oxley Act of 2002 just like any other SEC registrant. We cannot ever back out of this registration.

And we took further disclosure steps earlier this year. While the SEC has detailed guidelines for disclosures for many types of securities and issuers, the SEC currently does not have such guidelines for issuers of asset-backed or mortgage backed securities. Instead it reviews the disclosures of each private-label issuer. In a comparable process, a joint Treasury-SEC-OFHEO task force undertook a similar review of our MBS disclosures. When the task force recommended that we add six new pool level disclosures to our MBS issuances, we agreed. As of April, those disclosures are in place. As a result of this process, there are no significant difference between our MBS disclosures and those of private-label issuers.

Fannie Mae has relied on multilayered, redundant risk management practices for the past decade. We now have added multilayered, redundant disclosure and transparency practices, with both a greater quantity and a greater quality of information and disclosure. We now put out more -- and more timely -- information to the public, investors and policymakers than any other financial institution in the world.

If policymakers or investors have a question or concern about how Fannie Mae is doing, there are several ways to find out. They can look at the results of our supervision exams, which are public, unlike those of other financial institutions. They can look at our capital levels, our stress test results, our external rating reports, our regular reports on how the economy is affecting our business, or changes in the value of our subordinated debt. No financial company in the world will give policymakers and investors more information about its financial condition than Fannie Mae does.

Our voluntary initiatives ensure that Fannie Mae will remain one of the safest, soundest financial institutions in the world. Our subordinated debt rating and our risk-to-the-government rating are among the strongest in the industry. We have more than adequate liquidity to survive for three months assuming no access to the capital markets. We could endure the worst economic shocks in history -- shocks that few other financial institutions could survive -- with significant capital left over.

As several financial regulators have noted, there is a world of difference between disclosure and transparency. It is easy to post reams of information on a web site or to include mountains of extraneous material in a financial report. It is a difficult, ongoing process to ensure that not only does the company disclose information, but that we do so in a way that investors, policymakers, and other stakeholders can truly understand the nature of our business. We believe we have achieved a market-leading level of transparency, and we have some external support for this belief.

In summarizing the value of the package of disclosures to which Fannie Mae and Freddie Mac committed themselves in 2000, Moody's stated:

> *These financial disclosure commitments by Fannie Mae and Freddie Mac set new standards not only for them, but also for the global financial market.*
>
> *The provision by Fannie Mae and Freddie Mac of periodic, detailed risk information to the broad market will permit better independent reviews and monitoring of their risk profiles and should substantially reduce the uncertainty about their actual financial health as well as dampen any systemic risks they present.*
>
> *The regular disclosure of their interest and credit risk exposure, combined with stress testing of their capital base, should significantly increase market comfort with their risk management disciplines and capital adequacy. The stress test, in particular, will show whether the two GSEs have sufficient capital to withstand very harsh market developments over a long period.*

In addition, Professor Benton E. Gup, testifying before your Subcommittee on Financial Institutions and Consumer Credit on July 19, said, "The *Fannie Mae 2002 Annual Report* does an outstanding job explaining how this [GSE] uses derivatives to hedge interest rate and credit risk....The annual report of Fannie Mae should be read by all real estate lenders to gain insights about how to mitigate the risks associated with such loans."

Excellence in Risk Management

This country is unique in that our financial system offers homeowners the option of a 30-year, fixed-rate mortgage with a prepayment option. It is the most consumer-friendly, consumer-favored mortgage option available because it allows the homeowner to lock in current rates for 30 years and refinance to lower rates during that time. But if you want to give homebuyers the prepayment option, someone is going to have to manage the prepayment risk. Fannie Mae was created to make long term, fixed-rate mortgages with a prepayment option available nationwide. When you compare various potential mortgage investors in this country, you have to ask, who will bear the risk, and to what extent will that investor hedge that risk?

In Fannie Mae's case, the answer is that we consistently, conservatively manage these risks. Fannie Mae's core competencies are the management of mortgage interest rate and credit risks. That is why we are the low-cost, low-risk provider of these risk management services.

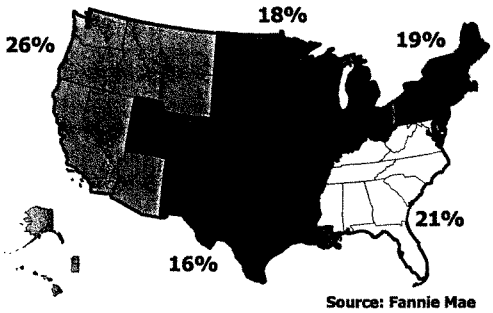
Credit Risk Management

Residential mortgages are relatively low-risk assets from a credit perspective. However, Fannie Mae's credit performance clearly shows that by specializing in managing mortgage credit risk, we have achieved significant gains in efficiency and performance. Homeowners and taxpayers alike are better off with Fannie Mae managing this risk.

Unlike other financial companies, Fannie Mae has one main business line, mortgages, which are among the safest products in the financial services sector. Most other financial institutions engage in a broad array of lending activities, ranging from mortgages, auto loans, credit cards, and commercial lending, to far riskier and more obscure activities.

Fannie Mae takes steps to further reduce the already low level of risk in mortgages. The company's first line of defense is the equity in the homes securing the mortgages. On average, owners have 38 percent equity in the homes financed by Fannie Mae mortgages. Furthermore, these homes are spread relatively evenly across the country so that the company is not overly exposed to a downturn in any one area.

Regional Distribution of Mortgages in Fannie Mae's Portfolio or MBS (Year-End 2002)

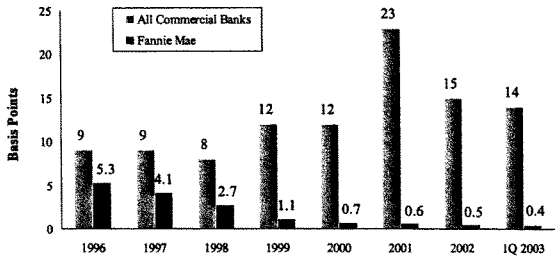


Source: Fannie Mae

Fannie Mae also disperses its risk by sharing credit exposure with various partners. Credit enhancements include primary loan-level mortgage insurance, pool mortgage insurance, recourse arrangements with lenders, and other customized contracts. As of the end of 2002, we shared with others the credit risk on $491 billion of single-family mortgages in Fannie Mae's portfolio or outstanding MBS. In 2002, credit enhancements absorbed $317 million, or 82 percent, of $386 million in gross single-family losses. As a result, while the company's book of business more than doubled between 1995 and 2002, its credit losses were cut by a factor of more than four—even while its total book of business grew.

Observers might attribute these stellar results to a strong housing market in recent years. Strong house prices have certainly helped keep credit losses low. But that is not the whole story. After all, credit losses in the mortgage portfolios of banks have not shown a similar decline. Thus, for instance, Fannie Mae's credit losses of 0.5 basis points in its single-family portfolio in 2002 compares with bank credit losses on mortgages of 15 basis points. Furthermore, while Fannie Mae's losses have trended sharply lower in the last five years, banks' losses have not followed a similar pattern.

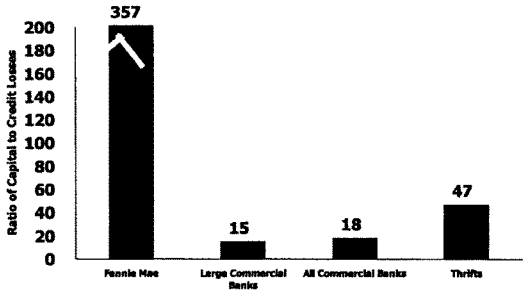
Single Family Net Charge Off Ratios



Bank amounts include home equity activity.
Fannie Mae amounts are net credit-related losses as a percent of average net portfolio and net MBS; Fannie Mae credit-related losses include net charge offs and foreclosed property expenses.
Source: Fannie Mae Annual Reports and Investor/Analyst Reports, and FDIC.

In summary, Fannie Mae's exceedingly strong credit risk performance is not simply the result of a robust economy. Instead, the company's credit management and loss mitigation techniques have borne increasing fruit over the last several years.

Ratio of Capital to Credit Losses



Note: As of Q3 02, there were 80 commercial banks with assets > $10 BN. These 80 are part of 59 larger banking companies (i.e., multiple commercial banking subsidiaries of Bank of America have assets >$10 BN, but are part of one banking company. Bank of America's subsidiaries with assets < $10 BN are not included).

Source: FDIC and OTS, from FDIC website, and Fannie Mae Q3 02 Investor/Analyst Report

Reflective of its low level of risk, Fannie Mae's ratio of capital to credit losses for the first three quarters of 2002 was 357 The thrift industry, which also specializes in mortgages, had a comparable ratio of 47, less than a quarter the capital coverage that Fannie Mae had. Large commercial banks, on the other hand, had a capital coverage ratio of only 15, with the entire banking industry at 18. The further one gets away from specialization in mortgages, the greater the level of losses relative to capital.

The question for policymakers is not how to eliminate credit risk from the system. That is not possible. The question is which institutions best manage this risk and are best able to withstand credit crises. In the event of a credit crisis, Fannie Mae is in a 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. Banks would not.

Interest-Rate Risk Management

With respect to interest-rate risk management, Fannie Mae's primary role is to manage, and largely disperse, the risk inherent in long-term, fixed-rate mortgages. The concept follows that outlined in a speech a year ago by Federal Reserve Chairman Alan Greenspan:

> "The development of our paradigms for containing risk has emphasized dispersion of risk to those willing, and presumably able, to bear it. If risk is properly dispersed, shocks to the overall economic system will be better absorbed and less likely to create cascading failures that could threaten financial stability."

Fannie Mae carries out this role by 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 the management of interest rate risk. . Fannie Mae's approach to the management of this risk is really quite different from approaches used by other mortgage investors.

Fannie Mae's mortgage portfolio consists mostly of long-term fixed-rate amortizing mortgages. If mortgages paid off according to their scheduled cash flows, match-funding them would be simple. One would simply raise liabilities with laddered maturities far into the future that matched the monthly return of principal of the amortizing mortgage portfolio. The resulting ladder would be a mixture of short, medium and long-term debt instruments.

However, most fixed-rate mortgages give borrowers the option to prepay, thereby clouding with uncertainty the future cash flows from a mortgage portfolio. The biggest determinant of their choice is the future course of interest rates. There will always be a certain level of loan prepayments because of life-circumstance changes. In a falling interest rate environment, this core will be swamped by the amount of prepayments that are part of the refinancing wave that takes place when interest rates decline significantly. A subsequent rise in interest rates would then see a scale-back in the amount of prepayments to somewhere close to the core level.

The future course of interest rates is unpredictable. Therefore, the future level of mortgage prepayments (and, hence, of mortgage cash flows) is also unpredictable. To hedge this prepayment risk, Fannie Mae relies on the broad issuance of callable debt. Callable debt gives the mortgage investor the ability to call debt in response to mortgage prepayments prompted by a fall in interest rates. This enables the investor to reissue debt at a lower rate and fund new mortgages that are now at a lower yield, maintaining a relatively stable net interest margin.

Callable debt is not always the most efficient or effective method of hedging interest rate and prepayment risk. Derivatives are used, by Fannie Mae as well as many others, to complement callable debt in achieving the optimal funding mix for mortgage portfolios. They add flexibility to Fannie Mae's portfolio rebalancing because their terms can be restructured in response to changing market conditions in ways that are difficult if not impossible to accomplish with debt issued in public markets.

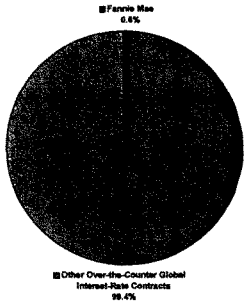
Fannie Mae uses only the most straightforward types of derivatives—such as interest rate swaps, swaptions, and interest rate caps—whose values are easy to model and predict. The company also acts only as an end user of derivatives. It does not trade, take positions or speculate in derivatives. Its counterparties are highly rated financial institutions, and it requires these institutions to post collateral to secure their obligations to Fannie Mae.

Derivatives have conferred substantial benefits on financial markets. Federal Reserve Chairman Greenspan has commented on the benefits of using derivatives to manage interest rate and other risks:

> "Financial derivatives ... have grown at a phenomenal pace over the past fifteen years...These increasingly complex financial instruments have especially contributed, particularly over the past couple of stressful years, to the development of a far more flexible, efficient, and resilient financial system than existed just a quarter-century ago."

Fannie Mae is a relatively small player in a huge global derivatives market. Data from the Bank for International Settlements show that the total notional principal balance of the over-the-counter (OTC) derivatives market as of December 2002 was $142 *trillion*. At that date, $102 trillion were interest rate contracts as opposed to those based on commodities, currencies, or equities. Fannie Mae's $657 billion in notional principal as of the same date was 0.64 percent of the total notional amount of interest-rate-based contracts and less than one-half of one percent of total contracts. By comparison, as of the end of 2002, U.S. commercial banks held $56 trillion in notional volumes. Holdings were quite concentrated. At the end of the second quarter of 2003, the three largest banks accounted for approximately 90 percent of notional value held by the banking sector.

Fannie Mae Share of the Over-the-Counter Interest Rate Contracts



However, these notional values are often a source of confusion. Notional values, as their name implies, do not represent exposures to loss. Neither of the parties to an interest-rate swap, for instance, owes the notional value or is ever going to have to pay it. The notional value is used as the basis for calculating the much, much smaller payments that actually change hands between the contracting parties.

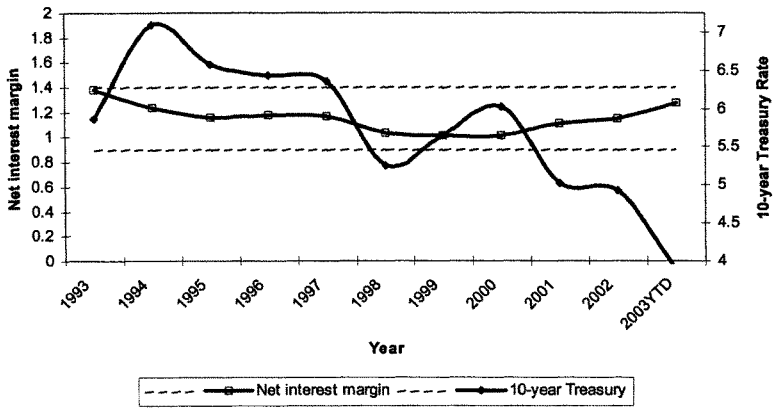
The actual exposure to a counterparty is also much lower. In Fannie Mae's case, its total derivatives exposure on December 31, 2002 was $3.3 billion. Against that exposure it held collateral valued at $3.1 billion, making the net exposure just $197 million. This means that even if every derivatives counterparty defaulted simultaneously and without warning, it still would cost Fannie Mae only $197 million to replace the economic value of those contracts. The replacement need not necessarily be in the form of derivatives. An alternative replacement could be an issuance of callable debt. By contrast, according to the OCC, top banks have on average credit exposure equal to 240 percent of their risk-based capital as of the second quarter of 2003.

It is worthwhile to put this total net exposure in perspective: net income for Fannie Mae in 2002 was $4.5 billion so that the $197 million credit exposure in derivatives could be covered by approximately two weeks of net income.

To limit the risk of a default on a derivatives contract, Fannie Mae engages in new derivatives contracts only with well-established, high credit quality counterparties that are experienced in managing derivative books. As of the end of 2002 all of its derivative contracts were with counterparties rated A or higher.

The effectiveness of Fannie Mae's interest rate risk management strategies can be seen in the fact that the company has never suffered a loss from a credit default by a counterparty and has continually produced remarkable stability in net interest margin in a variety of interest rate environments. Indeed, if the interest rate scenario of the early 1980's were repeated today, Fannie Mae would not only avoid losses—the company would continue to show strong earnings.

Net interest margin and 10-year Treasury Rate



Liquidity Risk Management

During the financial crises in the fall of 1998 and following the events of September 11, Fannie Mae provided liquidity to the financial markets. By dealing almost exclusively in easily-valued residential mortgages and MBS, as opposed to heterogeneous, illiquid, and hard-to-value assets found on the books of other institutions, Fannie Mae is largely protected against to any liquidity risk.

A vital part of risk management at a financial institution is the management of liquidity risk. Fannie Mae has pledged to meet the very highest standards of liquidity management. In this regard, it has several natural advantages in its favor. In the first place, much of the company's funding is long term. At the end of 2001, for instance, 55 percent of the company's debt had a remaining maturity of more than one year. These funds are not suddenly redeemable by creditors unlike most of the deposits in a commercial bank. A major part of the company is insulated, therefore, against a sudden "run."

Secondly, the company maintains a liquid investment portfolio (LIP) of liquid, high credit quality, non-mortgage securities that it could draw upon in the event of a market disruption for its debt.

Third, Fannie Mae has a huge pool of mortgages and mortgage-backed securities. The company could also borrow (using repurchase agreements) against this unencumbered portfolio. As part of its calculation of resources available to meet liquidity needs, the company assumes that securities in its portfolio would trade at a substantial discount during any liquidity crisis.

As part of its October 2000 Voluntary Initiatives Fannie Mae committed to maintain contingency plans for handling a liquidity crisis based on the assumption that it was unable to access the new-issue debt markets for a period exceeding three months. Under this commitment, the company pledged to maintain at least five percent of its on-balance sheet assets in a liquid, marketable portfolio of non-mortgage

securities and to maintain additional, highly liquid securities in unencumbered form in order to facilitate liquidity. The company also pledged to comply with the 14 principles for sound liquidity management established by the Basel Committee.

Moody's complimented the liquidity commitment of Fannie Mae and Freddie Mac: "The two GSEs' commitment to maintain in excess of three months of on-balance-sheet liquidity will reduce their already modest exposure to unforeseen liquidity crises. These commitments should provide a higher level of comfort to the market about Fannie Mae and Freddie Mac's strong liquidity position."

Fannie Mae included a liquidity component in its six initiatives based on discussions with policymakers who specifically recommended the formulation of a liquidity policy. Fannie Mae's liquidity needs are fairly straightforward, and the relevant provision of the voluntary initiatives responds to concerns about a significant disruption in the market.

Certainly, it is difficult to foresee how a future liquidity problem might unfold, but it is unlikely that such a problem would last beyond a certain number of days. The Basel Committee has set three months of liquidity as the outer limit of what a large financial institution should maintain. For Fannie Mae, it is a minimum. The company's actual liquidity significantly exceeds its three-month commitment.

Taxpayers are better off with Fannie Mae

Clearly, homeowners and our financial system are better off with Fannie Mae actively pursuing our housing mission. And while critics charge that taxpayers are at risk, that is not the case. The alternatives make that clear. If Fannie Mae were to stop guaranteeing and investing in mortgages, the credit and interest rate risks inherent in mortgages would not go away, they would 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. If risk migrated from Fannie Mae to the banking system, there is no doubt that taxpayers would be at 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" credit rating from Standard & Poor's of at least AA-, and a stand-alone "bank financial strength" credit rating from Moody's of at least A-, on a scale in which A is the highest. 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. 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.

Our public commitment to maintain very high credit ratings is intended to provide investors with external validation of our low-risk posture. Let me note that a AA-level rating is very strong. For the past 70 years the creditworthiness of the debt of AA-level companies has been indistinguishable from that of AAA-rated companies.

Of the more than 24,000 registered financial institutions in America, only about three dozen have AA or AAA ratings. Companies earn a AA rating by showing objective third parties they can weather virtually

any economic and financial environment - and by posting a consistent pattern of earnings growth that reflects a low-risk business strategy.

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 an institution takes. A recent study, written 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 Stiglitz paper, "Implications of the New Fannie Mae and Freddie Mac Risk-Based Capital Standard," examines the likelihood of the risk-based capital scenarios occurring. The Stiglitz econometric analysis finds that the probability of the stress test scenarios is conservatively one in five hundred thousand and may be smaller than one in three million. Stiglitz concludes 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". If the chances for a Fannie Mae default under the stress test are effectively zero, then the potential for Fannie Mae to pose any risk to taxpayers must also be effectively zero.

A comprehensive examination of our activities reveals that the possibility of any event that would cause Fannie Mae to default on its commitments, and hence pose a risk to other financial institutions or to the financial system is extremely low and approaches zero.

Corporate Governance

Fannie Mae's conservative risk management, and disclosure of our risk measures, give investors a solid understanding of our business. That openness is critical to our ability to raise private capital to pursue our mission. To raise low-cost funds for the U.S. mortgage market, it is also critical that we earn and ensure the trust of investors, shareholders, and other stakeholders every day.

Openness. Integrity. Responsibility. Accountability. Fannie Mae puts a premium on upholding these simple, core principles in our corporate mission, business, and culture for an important reason: Trust is uniquely crucial to our company. To fulfill our mission, Fannie Mae needs to be active in the capital markets every working day. Our job is to raise billions of dollars in private capital from investors all over the world, at the lowest cost possible, to finance homeownership. Before they entrust us with their money, investors need to trust Fannie Mae.

Last year, even before the passage of Sarbanes-Oxley legislation, I set in motion a 6-month corporate governance project, working with our board, to make Fannie Mae best in class in corporate governance. The Corporate Governance Committee of our board of directors -- under the leadership of Ann McLaughlin Korologos -- met for six months to put together a best-in-class model that works for Fannie Mae. They looked at the best practices in the market, including those offered by the New York Stock Exchange, The Business Roundtable, the Conference Board and others to see where we might make our governance even better.

This spring, our board voted to approve and adopt a series of corporate governance guidelines. In most ways, we already matched up to best in class, but the board's action will codify and strengthen our practices.

There are two key principles embedded in our policy. First, the roles of the board and management are clear and distinct. That is, the board picks the CEO -- the CEO does not pick the board. The board monitors the CEO -- the CEO does not manage the board. The CEO serves at the pleasure of the board.

The CEO is not a free agent or an independent player. He is an employee of Fannie Mae. He works for the shareholders. And he is personally responsible for making sure the company is operating ethically and effectively.

The second key principle is that, to hold the CEO accountable, the board must be independent and free from issues of conflict of interest. As The Business Roundtable and others recommend, a significant majority of our board members are independent from management. By independent, we mean these directors have no material relationships with the company that might impair their independent judgment.

Additionally, to further facilitate the ability of our directors to bring their independent judgment to the issues facing the company, Fannie Mae's non-management directors meet as a group on a regular basis in executive sessions without management present. Those sessions allow the nonmanagement directors to assess management's performance in as open and candid a setting as possible.

The board committees that watch over our audits, our compensation, the selection of board members and our corporate governance policies are comprised entirely of independent members. They meet whenever they want. They have meetings without management in the room. And they can hire whatever outside advisors and experts that they need to do their jobs.

We have established a corporate governance website for Fannie Mae, where we post background on our board, our Corporate Governance Guidelines, our bylaws, the charters of our committees and other key corporate governance materials. We also publish ways in which any shareholder, employee or other interested person can contact our nonmanagement directors or audit committee directly with any concerns or questions they might have.

Last fall, we asked S&P to examine our corporate governance and transparency, to let us know where we can improve, and let others know where we stand. In fact, Fannie Mae was the first U.S. company to receive and publish Standard & Poor's corporate governance score.

The Standard & Poor's announcement noted, "By being the first U.S. company to publish its governance score from Standard & Poor's, Fannie Mae is not only demonstrating its own strong governance practices, but is also showing leadership in the U.S. with regard to providing greater openness and disclosure about its corporate governance standards."

Let me describe some of the highlights of the report. First, the report made an interesting observation. More than most companies, Fannie Mae operates in a fishbowl thanks to our unique corporate status, our size and influence in the housing market, our public interest mission and the scope of our activity in the fixed-income markets.

These factors, the report notes, "increase [Fannie Mae's] public visibility and invite scrutiny from the private and public sectors and the media," which allows "more scope for external stakeholder influence at Fannie Mae than would be the case for companies with lower public profiles."

In addition, the report states, "Fannie Mae is among the most tightly regulated financial companies in the world." Our regulatory oversight and voluntary initiatives, it said, provide "disclosure about Fannie Mae's financial health that is unavailable from other, similar financial institutions."

Fannie Mae scored very highly on corporate governance. Standard & Poor's gave Fannie Mae a corporate governance score of 9.0 out of a possible 10, saying, "Fannie Mae's corporate governance

practices are judged . . . to be at a very strong level on a global basis of comparison." As the report states, our board "combines a good mix of new and longer-serving directors, directors of high caliber and with a diversity of skills and a strong voice of independence and engagement."

The report affirms that our board structure meets the latest rules on board composition proposed by the New York Stock Exchange for member companies, and has for some time. The report also concurs that our board has a substantial majority of independent, non-executive directors and independent board committees.

As the report says, "The [Fannie Mae] Board appears to be an effective leader of the company and monitor of management." And, "directors appear to be engaged and show a desire to demonstrate leadership in board effectiveness and governance." And, "Fannie Mae's audit committee demonstrates a commitment to the independence of the audit process. Its members are actively engaged with both the internal audit team and the outside auditors."

Fannie Mae's corporate governance has also been recognized by the Corporate Library, an independent ratings group. In June, The Corporate Library presented Fannie Mae's Board with a special citation as the best "stakeholder board" for its explicit commitment to setting the standard for outstanding corporate governance. In addition, Governance Metrics International, in its most recent rating from July of this year, commended Fannie Mae's stepped-up governance practices, giving the company a rating of 8.5 out of 10, well above the 6.2 average rating for the diversified financial industry.

Summing Up 10 Years of Progress

Since Congress enacted legislation in 1992, Fannie Mae has helped achieve dramatic changes in the mortgage market. We have fostered innovation and facilitated a remarkable increase in efficiency. We have expanded homeownership, especially among underserved communities, and the nation now enjoys the highest homeownership rate in our history. We have consistently met the affordable housing goals set by HUD. We have done this while constantly improving our disclosure, our corporate governance, and our financial strength.

In short, we believe Fannie Mae is achieving the mission given it by Congress. And, if my discussions with many of you on the committee are any indication, we believe Congress remains firmly committed to that mission of expanding homeownership. Therefore, as Congress considers legislation affecting our regulatory framework, we believe it should focus on addressing regulatory shortcomings, not on changing the features of our charter and mission that made the successes of the last decade possible.

IV: TODAY'S LEGISLATIVE CHALLENGE

Secretaries Snow and Martinez appeared before this committee last week, and I'd like to comment on the recommendations they laid out. First, I believe it is important to note that they focused on fixing the shortfalls in our safety and soundness supervisory regime, not on making changes to the companies or their charters. That is the right focus for this legislative process.

Supervision

We support the creation of a new bureau at the Treasury Department with the resources necessary to oversee the safety and soundness of Fannie Mae and Freddie Mac.

Given our mission and charter, we have no doubt that we should be subject to safety and soundness regulation. Safety and soundness are integral to the success of any private financial services institution. In fact, there are several large, complex financial institutions that are not subject to safety and soundness regulation today. Congress may want to examine that issue at another time. At Fannie Mae, we welcome strong, credible safety and soundness oversight.

It is critical to be clear on the singular mission of safety and soundness regulation of privately capitalized, privately managed companies. That mission is to focus on the survival of the companies in stressful economic conditions. In other words, the job of a safety and soundness regulator is to ensure the companies have the capital necessary to withstand severe economic stress. As long as the company is well-capitalized, safety and soundness regulation is not about questioning day-to-day business operations or routine management decisions.

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. In the private sector, companies thrive when management is allowed to take some risks, innovate, and experiment, and even to see a new innovation fail, as long as that failure doesn't 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.

The 1992 Act struck a good balance between private management of the companies and public supervision to ensure that management doesn't put the companies at risk of failure. The financial services industry has evolved dramatically in those 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. It is appropriate that, 11 years later, Congress look at our safety and soundness regime to see if that balance is still correct.

Over the last 11 years, our safety and soundness regulator, 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 on-site OCC exam team dedicated to any of the largest OCC-regulated banks. OFHEO's current budget includes a plan to expand to 66 examiners.

The creation of an independent bureau in the Treasury Department to regulate the safety and soundness of Fannie Mae and Freddie Mac – a bureau armed with the powers and resources needed to do the job – can mark a further significant improvement in the quality, consistency, and focus of the financial regulation of the two companies.

The bureaus within the Treasury that currently regulate the banking industry are highly regarded financial regulators that keep pace with evolving best practices and attract high quality staff. Establishing a new, world-class financial regulator for Fannie Mae and Freddie Mac within the Department of the Treasury, with a reliable funding base and the flexibility necessary to do its job effectively, would be a landmark achievement for the Bush Administration and the 108th Congress. It would also be in the best interests of Fannie Mae, our investors, the housing finance sector, and the housing mission we serve.

That bureau should not only have reliable funding but also a clear plan in how to employ its resources. The OCC and OTS devote over three-quarters of their budgets to examination and supervision. This apportionment of funding reflects the fact that these agencies' have a single, clear priority: examination and supervision to monitor continuously the safety and soundness of the regulated enterprises. A new regulator for the GSEs should have 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 all operations of the regulated companies.

We believe that effective regulation must also ensure that Fannie Mae can continue to carry out its mission. As I have shown, Fannie Mae has made dramatic strides in the past ten years, expanding access to capital, broadening homeownership among low- and moderate-income Americans, and supporting breathtaking innovation in the mortgage market.

In order to continue that success, Fannie Mae must continue to operate under a regulatory regime that does not damage our ability to support homeownership. That damage can be incurred by changing our mission, status, or charter, or through excessive and intrusive regulation of our business, through unwise changes in capital standards, or through unneeded regulation that undermines the efficiencies of the markets in which we operate.

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 new program approval requirements must ensure Fannie Mae's continued freedom to work with lenders, non-profits, community organizations and local governments to support innovation in the market. 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 without intrusive regulation that seeks to replace business judgment with the government's judgment. And we must be able to bring these initiatives to market in a timely way.

The standard Congress created in 1992 has fostered an environment of unprecedented innovation in the mortgage industry over the last ten 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 financing for low down payment loans (5 percent or less) has grown from $109 million in 1993 to $17 billion in 2002.

We have been able to respond quickly to market needs and to ideas presented by our partners, such as low down payment loans through Flexible 97 and 100, My Community Mortgage products to meet CRA 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 home buyers. 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 managerial discretion.

Many of our lenders partners and leaders in the housing industry, like the National Association of Home Builders, the National Association of Realtors, the Independent Community Bankers of America, Enterprise, and Self-Help, fear that moving program approval authority away from HUD could diminish housing as a public policy priority, and could create a barrier to innovation that hinders us from achieving our mission within our charter. We share those concerns. We urge the committee to carefully consider these issues and ensure that any program approval process does not in any way diminish the emphasis on our housing mission in our regulation.

In our conversations with leaders in the housing industry, we have focused on the importance of how program approval authority is exercised, wherever it is ultimately located. We believe any legislation must again 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.

The words of our partner Angelo Mozilo, chairman of Countrywide, summarize industry concerns, "I applaud your [Congress'] efforts to ensure that these companies are effectively and competently regulated. However, I urge you to avoid any proposal that seeks to micromanage these companies and to constrain their ability to innovate and respond to market demands. It is critical that the appropriate balance be struck between safety and soundness and the industry's ability to quickly and effectively provide new and innovative products to the housing market."

Capital

Capital requirements are a fundamental part of financial regulation. The approach announced by Treasury last week focuses on ways to give the regulator more flexibility in aligning capital requirements with the risks Fannie Mae takes on, while ensuring that Fannie Mae can continue to fulfill its mission. It is this balance that Congress struck in 1992, and it is a balance Congress must continue to maintain in this legislation.

As you know, Fannie Mae has two capital standards, the minimum capital, or leverage, requirement, and the risk-based capital requirement. The minimum capital requirement sets a floor and covers the indefinable and perhaps unknowable risk present with any institution.

Fannie Mae's minimum capital requirement should not be viewed in isolation. It is coupled with restrictions on our business: we invest only in residential mortgages, which are less risky than many bank investments like consumer debt, commercial real estate, or third-world debt. Furthermore, our book of business is more geographically diverse than most banks, and the company is required to have loss-sharing agreements on higher risk loans.

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. Increasing minimum capital when there is no increase in risk raises the cost of capital to housing and undercuts our ability to fulfill our mission. Quite simply, if you choose to double capital for the same level of risk, you will cut in half the impact Fannie Mae can have in fulfilling its mission.

It is entirely appropriate for a regulator to increase the capital requirement if an institution takes on added risk, and regulators achieve this 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. This standard, which took ten years to complete, has been in place for one year, and Fannie Mae has met the requirements of the test every quarter.

In setting risk-based capital requirements, a regulator must adjust to changes in the economy and in the assessment and measurement of risk. Under the current statute, our regulator has flexibility to adjust the standard, and Treasury has asked for additional flexibility in this area. We support giving the regulator fuller and 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.

As I noted earlier, in 2001, Fannie Mae began to issue subordinated date in significant amounts. Subordinated debt is counted as tier-two capital by bank regulators, and Fannie Mae now has $10 billion in such debt. This additional capital component supplements the $30.7 billion in core capital that Fannie Mae held on June 30, 2003, or 3.4 percent of the assets on our balance sheet. As we have pledged, we will continue to issue subordinated debt until equity capital plus subordinated debt equal 4 percent of on-balance sheet assets.

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 met or exceeded those goals. 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 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 two years, for instance, 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 created bonuses that incented Fannie Mae to pay special attention to financing small multi-family 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 pie – increasing the low-cost funding available for mortgages for middle class families as well as for underserved communities. Housing goals that segment our business could force us to stop expanding the pie and focus only on the allocation of our business among various populations. 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.

H.R. 2575

Fannie Mae supports a strong, credible, well-funded regulator, and we believe that the Department of Treasury has proposed a plan to strengthen our regulator while ensuring that no harm comes to housing or the contribution housing makes to a strong economy.

However, I must also be clear that we do not believe that H.R. 2575 in its current form is a basis for consensus legislation. We believe it would harm the functioning of the housing finance system and would not improve regulation, and it goes well beyond a plan to enhance the effectiveness of our safety and soundness regulator. I have many concerns with many provisions of the bill. Let me cite briefly just a few of the provisions in the bill that would most egregiously undermine our ability to carry out the mission Congress has given to us.

H.R 2575 would stifle innovation in the mortgage market by requiring prior approval for any new "program, activity, business process, or investment that directly or indirectly provides financing or other services to conventional mortgages." It would replace the current standard, which is to review any program that is "significantly different" from a program already in place in 1992, with a standard that sanctions a virtually limitless scope of review. This provision would also allow HUD to reject new programs even if they comply with our charter and are in the public interest.

This would affect not just Fannie Mae; its impact would be felt across the industry. Any lender who wanted to develop a new business process or mortgage product with Fannie Mae would have HUD as a silent partner, requiring approval on a wide range of innovations. The number of changes requiring government authorization could overwhelm the review process, including things as simple as changing the processes of acquiring mortgages. It would particularly disadvantage small and medium-sized lenders, who work with Fannie Mae to innovate in order to compete with large lenders.

In addition, the proposed legislation includes many provisions that go far beyond any initiative focused simply on strengthening our regulator. It would make unwise changes in our capital standards. It would impose on Fannie Mae an enforcement and prompt corrective action regime that is far more harsh than the provisions applicable to any other financial institution. It would take away from Congress the ultimate ability to dissolve the GSEs. It would change the formulation by which our loan limit is calculated, even though the GAO has said that the current process works well. It would force disclosure of proprietary information – information no other financial institution is required to divulge. It would micro-manage the assets we hold for liquidity purposes. And it requires a series of studies by an unwieldy panel that would simply revisit issues that have been reviewed closely in great detail by Congress and the Administration over the past several years.

For these reasons, we urge the committee to steer a different course and reject H.R. 2575 in its current form. We believe policymakers will find consensus around the approach outlined by Secretary Snow, which will enhance regulation while preserving our ability to carry out the mission Congress has given to us.

Conclusion

Homeownership is available today to more Americans than ever before. And homeownership continues to be a priority of this Administration and this Congress. You have before you an opportunity to reiterate your commitment to broadening access to the American Dream.

I look forward to working with the entire Congress to strengthen our safety and soundness regulator, to ensure that the new agency has the resources to do its job effectively and adopt best practices in financial regulation appropriate to the risk the company faces. A strong safety and soundness regulator is in the best interest of Fannie Mae and the mission we serve. By strengthening our safety and soundness regulator, and avoiding any change to the mission, status or charter of the company, you will set the stage for the continued expansion of homeownership in communities across America.

Federal Home Loan Bank of San Francisco

Housing GSE Regulatory Restructuring Proposals

House Committee on Financial Services

September 25, 2003

Testimony of Dean Schultz

President and CEO

Federal Home Loan Bank of San Francisco

Good morning. My name is Dean Schultz, and I am the President of the Federal Home Loan Bank of San Francisco. I am here today on behalf of the San Francisco Bank to support regulatory restructuring of the two housing GSE regulators: the Federal Housing Finance Board, the regulator of the 12 regional Federal Home Loan Banks; and OFHEO, the regulator of Fannie Mae and Freddie Mac. The board of the San Francisco Bank strongly believes that a new independent agency under Treasury, with one director regulating the Federal Home Loan Banks, Fannie Mae, and Freddie Mac, and with appropriate language recognizing the mission of the Banks, is the best way to ensure continued safe and sound operation of these institutions, a robust housing finance market, and in the words of Secretary Snow, "world-class regulation."

In 1932, Congress established the Federal Home Loan Bank System of 12 cooperatively-owned regional Banks to promote housing, and the Banks take that housing finance mission seriously. Since its inception, the System has developed a high level of expertise in providing housing finance to housing lenders, and has created a very effective and efficient delivery system. The Banks do so by providing liquidity for home mortgage loans that would otherwise be illiquid because such loans do not meet the underwriting criteria of the secondary market. The members in our Bank – California, Nevada, and Arizona banks, savings institutions, and credit unions — range in size from some of the nation's largest housing lenders to single office institutions. Our diverse membership base has a common interest: using the Bank to provide funds for housing loans. Access to the Bank's advances provides lenders the confidence that they will be

able to hold loans that they cannot sell easily in the secondary market and still meet either the seasonal or cyclical demands of the borrowing public. In effect, access to Bank advances takes the liquidity risk out of lending to families with the fewest financial options.

During the past 15 years, Congress has broadened the membership and mission of the Federal Home Loan Bank System, in addition to establishing a separate regulator, the Federal Housing Finance Board. In 1989, Congress established the Finance Board as a regulator that would focus on the unique cooperative structure and mission of the Federal Home Loan Banks. As such, the Finance Board has established rules and policies designed to ensure that the Banks provide liquidity for housing loans in a safe and sound manner. In 1992, Congress established OFHEO under HUD as the regulator of Fannie Mae and Freddie Mac. In doing so, Congress did not combine the Finance Board with OFHEO, and recognized that the GSEs each possessed different structures and missions. While the Federal Home Loan Banks principal business is making advances to member institutions, Fannie Mae and Freddie Mac are in the business of purchasing conventional loans and either holding them in portfolio, or securitizing them for sale in the secondary market. By their nature, Fannie Mae and Freddie Mac must have uniform national underwriting criteria, and deal with homogenous mortgage loans to permit the secondary market to function effectively. As national, publicly traded companies, Fannie Mae and Freddie Mac are structurally different from the regional, cooperatively owned Federal Home Loan Banks. So it made sense over ten years ago to create regulators that focused on their different missions and operations.

There has been some convergence of the activities of the Banks and Fannie Mae and Freddie Mac during the past several years, and therefore, in the risks posed by each of the entities. To serve the needs of their members and to assure the availability of reasonably priced funds for housing, the Banks have developed programs under which they purchase mortgages from members, but the selling members retain the credit risk. Over the past dozen years, the business strategies of Fannie Mae and Freddie Mac have evolved, and the enterprises have been holding more loans in their portfolios. These similarities make some of the operational distinctions between the Banks and the Fannie Mae and Freddie Mac less significant. In addition, both are in the business for one principal purpose — to provide funding and liquidity to ensure the continued stability and growth of affordable housing finance. Recognizing the increasing commonalities among these housing GSEs, we believe that any consideration of regulatory restructuring must include not only Fannie Mae and Freddie Mac, but also the Federal Home Loan Banks.

We understand that the Committee will consider legislation, based on Congressman Baker's bill, to replace OFHEO with a new agency under the Treasury Department in order to provide enhanced regulation of Fannie Mae and Freddie Mac. The Federal Home Loan Bank of San Francisco supports replacing the Finance Board, the regulator of the 12 regional Federal Home Loan Banks, with the same new independent agency under Treasury. This would provide consistent, enhanced and vigorous regulation for all housing GSEs, and would be a strong statement in the marketplace that regulation of housing GSEs is a priority of the Congress and the

Administration. An independent regulator also assures the marketplace that regulation, examination, and policy development will occur in an apolitical framework.

The San Francisco Bank believes that Congress has a unique opportunity to consolidate housing GSE regulation in one independent agency under Treasury. Like other financial regulators, the Finance Board and OFHEO were established at different times to deal with different GSE structures, and little consideration was given to the fact that each of the regulated entities involved housing finance. Today, there is no need for two separate housing GSE regulators when one could do the job more effectively.

To recognize and preserve the separate statutory structures and operations of the Federal Home Loan Banks and Fannie Mae and Freddie Mac, we recommend that Congress establish the new independent agency under Treasury with two deputy directors: one for the cooperatively-owned regional Federal Home Loan Banks; and one for the publicly-held Fannie Mae and Freddie Mac. The deputy director for the Federal Home Loan Banks would implement and enforce the Federal Home Loan Bank Act, and the deputy director for Fannie Mae and Freddie Mac would implement and enforce the Federal Housing Enterprise Financial Safety and Soundness Act. Alignment with Treasury, the principal advocate for the Administration's financial policies and its primary link to the financial markets, would deliver a strong message to the financial markets that the new agency will provide enhanced, vigorous regulation of the housing GSEs. Such legislation would also make the new agency a peer of other financial

institution regulators, especially the Office of Thrift Supervision and the Office of the Comptroller of the Currency, both independent agencies under Treasury.

Combining the Finance Board and OFHEO was mentioned by Chairman Oxley and Secretary Snow at this Committee's September 10th hearing. Both recognized the significance of housing finance to our economy and home buyers, and the need for a "strong world-class regulatory agency to oversee the potential operations of the GSEs and the safety and soundness of their financial activities." As Secretary Snow indicated, legislation should maintain healthy national markets for housing finance, and not merely be an exercise in moving existing agencies from one part of the government to another. He said that an agency under Treasury would be a "value added proposal" that would provide the agency with more significance, more expertise. We agree wholeheartedly.

The General Accounting Office has considered the issue of establishing a single housing GSE regulator. In its July 1997 report to Congress, it indicated that such a regulator would have several advantages. Affirming its 1991 and 1993 reports on these GSEs, the GAO indicated that a single regulatory agency would best fit its criteria of being: (1) independent and objective; (2) prominent in government; (3) economically efficient; and (4) consistent in its approach to regulation. GAO indicated in 1997 that it found no evidence that would cause it to alter its previous positions, and its ongoing work "has strengthened our belief that OFHEO and FHFB would be more effective if combined." It went on to say that a single regulator would create valuable synergies

among regulatory staff, even if as GAO suggested, the regulation of the two entities be separated within a single regulator.

We appreciate very much the opportunity to present these views today. We also appreciate the substantial work of both Congressman Baker and Congressman Royce in proposing legislation dealing with GSE regulatory restructuring. We urge the Committee to include a proposal to combine the Finance Board and OFHEO into a new independent agency under the Treasury Department in any legislation that the Committee adopts.

Thank you.

NATIONAL URBAN LEAGUE

Hearing on H.R. 2575,
the Secondary Mortgage Market Enterprises Regulatory Improvement Act
Before the
Committee on Financial Services
United States House of Representatives

TESTIMONY
Concerns about the Program Oversight of GSE Housing Programs

September 25, 2003

By

William E. Spriggs
Executive Director, National Urban League Institute for Opportunity and Equality

The Urban League is the nation's oldest and largest community-based movement devoted to empowering African Americans to enter the economic and social mainstream.

The Urban League movement was founded in 1910. The National Urban League, headquartered in New York City, spearheads our nonprofit, nonpartisan, community-based movement. The heart of the Urban League movement is our professionally staffed Urban League affiliates in over 100 cities in 34 states and the District of Columbia.

The mission of the Urban League movement is to enable African Americans to secure economic self-reliance, parity and power and civil rights. On behalf of the League, I thank Chairmen Oxley and ranking member Congressman Frank for this opportunity to share the thoughts of the League on this important topic.

The size of securities and mortgage backed security instruments issued by Government Sponsored Enterprises (GSE) is now larger than the market for U.S. Treasury notes. That makes the safety and soundness of these enterprises very important to the security of the American economy.

However, it is equally important to the reason Congress created GSE. In the case of the housing GSE the purpose was to create an effective market for residential mortgages, and this was in response to the lessons taught by history. The leverage given to the housing GSE by Congress was to accomplish increasing the access to the home mortgages to under served areas. This mission must remain paramount in assessing different measures of safety and soundness. For instance, the risk-based capital standards that were put in place last year are an example of this, since keeping minimum capital requirements creates a larger pool of funds available for mortgages.

The primary concern of the League in this issue is the maintenance of the housing GSE mission. Our housing office partners with both Fannie Mae and Freddie Mac to deliver a set of services that we integrate with programs from the banking industry, the Department of Housing and Urban Development (HUD) and others to try and increase home ownership in the African American community.

There is no simple answer to the disparity in homeownership rates between African Americans and whites. Access to credit is one part of the answer. Credit counseling is

another part of the answer. As an example, our program with Fannie Mae began in November 2000, with the signing of a five year Memorandum of Understanding that launched a demonstration project in six and then a seventh and eighth of our affiliates including Houston, Dallas, Seattle, Tucson, Rochester, Seattle, Atlanta and Stamford. Working with JP Morgan Chase, the project has put more than 500 families into homes, and got an additional 200 families prepared for homeownership. Several of those affiliates are at various stages in creating Community Housing Development Organizations, a next step in solving housing problems for low income and African American households in their cities. So, the Fannie Mae relationship is a catalyst that those affiliates have leveraged. The League has a similar program with Freddie Mac.

The key lesson learned from the experience of the National Urban League's housing office is that increasing homeownership requires a comprehensive approach. It was with foresight then that the housing GSE were put within HUD. The housing GSE should be viewed as a tool, among others, that can address the complexity of causes of the disparity in home ownership rates in America. And, it is in that regard that the National Urban League would be very concerned if program oversight were to be moved from HUD, even if safety and soundness oversight was moved to Treasury as some have proposed.

Program oversight should insure that the housing GSE keep to their charter and mission, but should also insure that the housing GSE programs fit into a coherent set of programs at HUD to create the largest affordable housing stock possible for America, and that huge disparities in home ownership faced by African Americans and Hispanics can be closed.

We would be concerned if the programs of the housing GSE are evaluated out of the context of a comprehensive housing program, that faulty conclusions could be reached on the effectiveness or appropriateness of the programs of the housing GSE, and that inappropriate safety and soundness standards might then cloud the mission of the housing GSE.

Still, improvements could be made in program oversight. Organizations like the National Urban League, and other community based and non-government organizations have worked to address the housing needs of underserved communities. Beyond comments to proposed rules, we hope that Congress will create a new way of rule setting to insure a transparent mechanism to insure HUD incorporates the views of such organizations in setting rules and regulations toward goal setting for the housing GSE, and in program oversight. This would incorporate the lessons learned by those organizations on the front lines of addressing the housing problem into assessing the likely effectiveness of a proposed program in closing the home ownership gaps experienced by underserved markets.

– REVISED –

Testimony of

America's Community Bankers

on

H.R. 2575
Secondary Mortgage Market Enterprises Regulatory Improvement Act and the Administration's Proposals on GSE Regulation

before the

Committee on Financial Services

of the

United States House of Representatives

on

September 25, 2003

D. Russell Taylor
President and CEO
Rahway Savings Institution
Rahway, New Jersey

and

Chairman
America's Community Bankers
Washington, DC

Mr. Chairman and Members of the Committee, my name is D. Russell Taylor, President and CEO of Rahway Savings Institution in Rahway, New Jersey and I am also Chairman of America's Community Bankers. 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 and actively involved in the secondary market.

Before outlining ACB's position on the pending legislation to reform the regulation of Fannie Mae and Freddie Mac, it is important for the committee to understand the relationships ACB and our members have with these firms. ACB has long supported the traditional role these entities 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. My own institution is an active participant in these programs.

In addition, ACB members hold substantial amounts of mortgage backed securities and other debt issued by Fannie Mae and Freddie Mac. Therefore, they have a great interest in the financial health of these firms.

While actively supporting the secondary market role for Fannie Mae and Freddie Mac, ACB has continued to oppose plans to use their government-granted advantages to extend their activities beyond their secondary market role. For example, we have opposed initiatives that would result in their competing directly with mortgage originators in the primary market and financing their operations in competition with the retail depository institutions.

As a result of our strong support for the secondary market role of Fannie Mae and Freddie Mac, our equally strong opposition to movement into the primary market, and our members' role as investors in their securities, ACB has an intense interest in proposals to reform the regulation of Freddie Mac and Fannie Mae. We also believe that any solution the Congress develops for Fannie Mae and Freddie Mac may have a direct impact on the Federal Home Loan Bank System, a system we care deeply about. Therefore, we appreciate this opportunity to provide our comments to the committee. Our testimony will focus on the various issues raised both by pending legislation and the Administration's proposals to reform the regulatory structure over Fannie Mae and Freddie Mac. ACB wishes to commend Chairman Baker and Representative Royce on their long-time interest and hard work on these issues. Their years of background work will make it easier for Congress to craft legislation to respond to the current difficulties facing Freddie Mac and the Office of Federal Housing Enterprise Oversight.

Agency Structure, Funding, and Independence

The Administration proposal and the pending legislation would eliminate OFHEO and move its functions into the Department of the Treasury. This structure works for two key regulators, the Comptroller of the Currency and the Office of Thrift Supervision that have the necessary independence from the Treasury.

Importantly, 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. We are concerned that, while H.R. 2575 creates a permanent appropriation, it does not remove assessments on Freddie Mac and Fannie Mae from the appropriations process. It is important that the committee's 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 Freddie Mac and Fannie Mae. 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 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

ACB strongly endorses the Administration's position that the new 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 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 CDs, 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 on-line 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 proposal and various legislative proposals make clear that HUD would retain its authority to set affordable housing goals for Fannie Mae and Freddie Mac. As Secretary Mel Martinez testified, HUD would actually gain authority – being authorized to set sub goals and to enforce those goals with new regulatory clout. ACB recommends that you include this proposal in your legislation.

Some have expressed concern that, if HUD does not retain mission and program oversight over Fannie Mae and Freddie Mac, their commitment to housing, particularly low- and moderate-income housing will suffer. However, 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. 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, there should be no limit on its ability to increase 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 increase capital requirements as necessary, subject to rulemaking. This must apply both to increases in the leverage ratio and the risk-based capital requirement. The Baker bill, H.R. 2575, includes language that appears to accomplish this purpose.

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 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 counter-party risk and massive direct investment in mortgages.

Enforcement Authority

The Administration proposal and various legislative proposals before the Congress would each provide the new agency with enforcement authority comparable to that of the banking agencies. Both the Baker bill (H.R. 2575) and the Royce bill (H.R. 2803) have substantial detail on what – in the words of Treasury Secretary John Snow – constitutes "world-class" regulatory authority. ACB recommends that the committee adopt these and similar proposals to improve the regulation of Fannie Mae and Freddie Mac.

Scope of the Agency

Secretary Snow suggested in his testimony before this committee that the FHLBanks should also be regulated by the new agency. Representative Royce's bill would eliminate the Federal Housing Finance Board and move its regulatory responsibility over the FHLBanks into the new agency. ACB has traditionally supported separation between the regulation of Fannie Mae and Freddie Mac and that of the FHLBanks. The FHLBanks are cooperatives, rather than public companies, and pose different regulatory issues from those of Fannie Mae and Freddie Mac. While the Finance Board has substantially increased its commitment to safety and soundness regulation recently, ACB also believes there is substantial room for improvement and change in the regulation of the FHLBank System.

Our members who support a merged agency are concerned that Freddie Mac and Fannie Mae will enjoy a cost-of-funds advantage if the market believes that those companies are subject to more effective regulation than are the FHLBanks. They 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.

ACB's policy bodies are weighing these and other arguments. Our members firmly believe that a new agency – whether it regulates just Freddie Mac and Fannie Mae or also covers the FHLBanks – must be as independent as the nation's other financial regulators.

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 support the mortgage finance, affordable housing, and community development activities of member banks. The advance programs of the FHLBanks ensure that homebuyers have ready access to home mortgage financing through FHLBank members.

In addition, 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 advance the goals of expanded mortgage finance and affordable housing shared by Fannie Mae, Freddie Mac, and the FHLBanks.

Conclusion

I wish to again express ACB's appreciation for your invitation 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.

Testimony of
Rick A. Lazio
President
The Financial Services Forum
before the
Committee on Financial Services
United States House of Representatives
Washington, D.C.
September 25, 2003

Chairman Oxley, Ranking Member Frank, Capital Markets subcommittee Chairman Baker and Ranking Member Kanjorski, Housing subcommittee Chairman Ney and Ranking Member Waters, I very much appreciate the opportunity to provide this testimony on the important issue of the future oversight of the housing-related government-sponsored enterprises ("GSEs").

The issue of housing – ensuring the availability of an adequate supply of sufficient quality, and promoting access to the capital necessary to acquire that supply – has been a topic of great interest to me for many years. As many of you will recall, I served as Chairman of this Committee's subcommittee on Housing and Community Opportunity from 1995 through 2001. Together, the members of that subcommittee accomplished a great deal on behalf of the American homeowner:

- Expanding homeownership and economic opportunities for all Americans by removing barriers to affordable housing, providing more local flexibility in existing federal programs to foster homeownership, reducing regulatory barriers, and empowering community-based non-profit groups dedicated to homeownership;

- Simplifying procedures for buying a first home;
- Promoting access to flood insurance in disaster-prone areas of the country;
- Reducing mortgage insurance premiums and other obstacles to expanded home ownership;
- Modernizing the affordable housing program for seniors, providing greater self-sufficiency through reverse equity mortgages and enhanced services to promote independent living; and,
- Introducing legislation to amend and modernize the Stewart B. McKinney Homeless Assistance Act to ensure that states and local communities are provided sufficient flexibility to use Federal assistance more effectively.

Owning one's own home is the American Dream and I was very proud of the work our Committee accomplished to expand access to that dream. I remain as committed as ever to that objective.

The Mission and Methods of the Housing-Related GSEs

The Federal National Mortgage Association ("Fannie Mae") and the Federal Home Loan Mortgage Corporation ("Freddie Mac") are mandated by their governing statutes to enhance the liquidity of the mortgage finance markets and to promote access to mortgage credit for households that historically have been underserved by the private markets. The GSEs carry out this important function by purchasing residential mortgages within the "conforming loan" limit – today $322,700. These loans are either held in portfolio or packaged into GSE-guaranteed mortgage-backed securities. Assets held in

portfolio are financed by the companies' debt issues, which are typically short-term. By buying the mortgages from banks and other originators of home loans, the GSEs free lenders to make new mortgage loans and help keep the U.S. housing market buoyant.

As of September 2000, Fannie and Freddie had purchased or securitized and guaranteed $2.2 trillion in outstanding mortgages. Of this, $936 billion was held in the GSEs' asset portfolios, while $1.3 trillion served as collateral for outstanding MBS.

Fannie and Freddie's role in financing affordable housing in the United States is unique and critical. By enhancing the liquidity of the mortgage market through purchasing and securitizing residential mortgages, Fannie and Freddie lower the cost and assure the availability of mortgage credit, expanding access to homeownership for Americans. Moreover, as the dominant firms in the secondary mortgage market, the GSEs set standards for the entire mortgage industry, and their activities have a significant impact on the primary market.

Reasons For Concern

In recent years, however, a growing number of economists, academics, industry participants, members of Congress, and other government officials, have raised questions regarding the role of the GSEs in the U.S. housing finance market, the preferential funding and regulatory treatment they enjoy, and the adequacy of their supervisory oversight.

In response to this expressed concern, in mid-2001, the Financial Services Forum, which I presently serve as president, formed a working group to study the housing-related GSEs, focusing on Fannie and Freddie. The Financial Services Forum is an organization comprised of the chief executive officers of 20 of the largest financial institutions in the United States, including commercial banks, securities firms and insurance companies. The purpose of the Forum is to promote policies that enhance savings and investment in the United States, and to promote an open, competitive and sound financial services marketplace.

In beginning its work, the Forum's working group was quite aware that the public policy debate concerning the proper role and regulation of the housing GSEs has at times been highly politicized. With this in mind, the group sought to conduct an impartial and balanced review of the GSEs. The group's members were asked to apply their own experience in the marketplace and to consider data and arguments provided by a balanced array of interested parties.

In addition to collecting and analyzing data from a wide range of sources, the working group also solicited the views and participation of both Fannie and Freddie. Participation by the GSEs was forthcoming, in the form of conference calls that included Fannie and Freddie staff, as well as meetings with Fannie CEO Franklin D. Raines and Freddie CEO Leland Brendsell to brief them on progress made and to solicit their feedback on the overall process.

The Forum's working group identified two principal areas for analysis:

- Systemic Risk: Do the GSEs pose systemic risk similar to that of other large financial institutions and, if so, what can be done to mitigate risk?

- Oversight and Regulation: Is the scope and quality of current oversight of the housing GSEs adequate?

Systemic Risk

Fannie and Freddie are very large financial institutions. As of year-end 2001, the two GSEs held total mortgage portfolios of $1.6 trillion and $1.1 trillion respectively – in both cases more than double the portfolio size reported at year-end 1997. To fund this growth, Fannie and Freddie have increased their outstanding debt – from $196 billion at year-end 1992 to $1.1 trillion at year-end 2000 – an average annual growth rate of nearly 24 percent. At these growth rates, Fannie and Freddie's outstanding debt could surpass the total outstanding debt of the U.S. Government in a few years.

Over time, the average credit quality of mortgages owned or guaranteed by Fannie and Freddie had remained rather steady. Recently, however, both GSEs have become increasingly active purchasers of sub-prime loans. Indeed, Fannie Mae, whose sub-prime purchases accounted for just 7 percent of the market in 2001, has indicated that it expects to eventually reach as much as half the market. In addition, starting in 2000,

Fannie and Freddie began purchasing mortgages with loan-to-value ratios greater than 97 percent.

In an analysis of the GSEs published at year-end 2001, Moody's highlighted Fannie's "exposure to significant asset-liability and credit risks," and noted that Freddie's "exposure to mortgage pre-payment and credit risk is significant and complex." Meanwhile, Fannie and Freddie operate with debt-to-equity capital ratios three to four times as high as large banks.

Given their remarkable size, the high rate of growth of their balance sheets and outstanding debt, the increasing complexity of their operations, and their expanding array of business activities, it is clear that should either Fannie or Freddie experience financial difficulty, the effects could be dramatic and widespread. As the Office of Management and Budget has observed: "Financial trouble of a large GSE could cause strong repercussions in financial markets, affecting Federally insured entities and economic activity."

Oversight and Regulation

The Federal Housing Enterprises Safety and Soundness Act of 1992 reformed Federal regulation of Fannie Mae and Freddie Mac and created the Office of Federal Housing Enterprise Oversight (OFHEO) to conduct safety and soundness examinations of the two GSEs and enforce minimum, risk-based capital requirements. However, many economists, industry participants, members of Congress, and other government officials

have expressed concern that OFHEO does not have the resources, statutorily defined powers, or independence necessary to provide oversight of the degree or rigor commensurate with the size and importance of Fannie and Freddie.

For example, OFHEO has only 120 employees and an annual budget of just $30 million – clearly inadequate to effectively supervise the activities of two institutions with balance sheets of over $1 trillion. The long struggle of OFHEO to promulgate its risk-based capital rule for the GSEs – mandated by Congress in 1992, yet taking nearly ten years to produce – illustrated OFHEO's difficulty in effectively carrying out its mission. Moreover, under the terms of its founding statute, OFHEO is subject to the annual appropriations process, which hampers its independence and limits its capacity.

Recently Revealed Problems at Freddie

Compounding the Forum's concern regarding these structural and policy issues were the recent revelations of accounting irregularities at Freddie Mac. As you will recall, last June Freddie's CEO, along with the company's president and its chief financial officer, were dismissed after it was revealed that Freddie had executed highly complex derivative transactions, the sole purpose of which was to "smooth" its earnings. These transactions, and the decisions that led to such tactics, are worrisome for two reasons: 1) smoothing of earnings violates established accounting practices; and, 2) the GSEs commonly use derivatives to hedge the value of their mortgage assets against the risk of interest rate changes on their enormous debt.

As a result of these acknowledged irregularities, it is expected that Freddie will issue a restatement of past earnings totaling as much as $4.5 billion. Perhaps more significantly, given Freddie's phenomenal rate of growth in recent years and the increasing complexity of it activities, these violations raise concerns regarding the adequacy of corporate governance and risk management practices at Freddie.

Forum Support for the President's Plan

With these legitimate concerns in mind, the Financial Services Forum supports the Administration's recommendation that Congress enact legislation to create a new Federal agency to regulate and supervise the financial activities of the housing-related GSEs. Access to affordable housing financing is of such importance to our economy – and our priorities as a nation – that a strong, well-finance, appropriately empowered supervisor is needed to oversee the prudential operations of the GSEs and the safety and soundness of their financial activities consistent with maintaining a healthy national housing markets.

The Forum also supports the recommendation that the new agency be independent and housed within the Treasury Department. Treasury is the department assigned general governmental authority over the nation's financial markets and the broader economy. Moreover, Treasury oversees two other supervisory agencies, the Office of the Comptroller of the Currency and the Office of Thrift Supervision.

It is the Forum's view that a supervisory agency possessing the authority and powers outlined by Treasury Secretary Snow before this Committee earlier this month – together with expanded HUD authority over the GSEs' affordable housing mission – would effectively achieve the dual policy imperatives of increasing home ownership opportunities while at the same time ensuring a sound and resilient financial system.

It should be emphasized that ensuring Fannie and Freddie's financial safety and soundness is essential to preserving the GSEs' ability to meet the housing finance needs of Americans. Progress in advancing home ownership throughout the nation depends on strong and efficient national housing finance markets – which in turn depend on the strength and well-being of the housing-related GSEs.

In the weeks following Freddie's June 9th announcement of its derivative and accounting improprieties, the company's stock price plummeted by more than 20 percent. Even more telling, the price of a *Fannie Mae* share also dropped by nearly 20 percent. There is even evidence that Fannie and Freddie's cost of borrowing increased after the announcement, and, as Business Week magazine concluded in a mid-June analysis: "...borrowing costs could go higher...In that case, Freddie wouldn't be able to provide as much mortgage money as cheaply as in the past. Mortgage rates would rise and nibble at home prices..."

This is what we all want to prevent. Fannie and Freddie are critically important institutions in the U.S. housing market. Every effort must be made to ensure that the GSEs will continue to effectively provide affordable access to housing finance to the largest number of Americans possible. Given Fannie and Freddie's enormous size, rapid rate of growth, expanding business activities, and increasingly complexity, it is altogether reasonable and appropriately prudent that their operations, capitalization, new activities, and management processes be subject to the oversight of a robust supervisor – just as all other financial institutions of similar size and complexity are.

I and the Financial Services Forum look forward to assisting and supporting the Committee as it continues its consideration of the Administration's recommendations for legislation.

FHLBBoston

MICHAEL A. JESSEE
President and Chief Executive Officer
michael.jessee@fhlbboston.com

September 24, 2003

The Honorable Barney Frank
House of Representatives
Washington, D.C. 20515

Dear Congressman Frank:

I wanted you to be aware that the Board of Directors of the Federal Home Loan Bank of Boston unanimously adopted the following position on the regulation of Federal Home Loan Banks at its September board meeting:

The Board of Directors of the Boston Bank opposes at this time inclusion of the Federal Home Loan Banks in legislation creating a new regulator for Fannie Mae and Freddie Mac under Treasury, absent credible evidence that the Federal Home Loan Banks would be otherwise disadvantaged from a cost of funds basis.

Thank you for your consideration.

Sincerely,

Federal Home Loan Bank of Boston | 111 Huntington Avenue | Boston, MA 02199 | 617-292-9610 | FAX: 617-375-2245

Statement for the Hearing Record

Of

Catherine B. Whatley, 2003 President
NATIONAL ASSOCIATION OF REALTORS®
For
The Committee on Financial Services
Hearing on H.R. 2575, the Secondary Mortgage Market Enterprises Regulatory Improvement Act and the Administration's proposals on GSE regulation.

United States House of Representatives
Washington, D.C.

September 25, 2003

The National Association of Realtors® and its more than 930,000 members 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 Financial Services 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 GSEs 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 GSEs. 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 GSEs. 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 to this 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.

Secretary Snow and Secretary Martinez outlined the Administration's principles in subtle terms. Consequently, Realtors® are guarded about the base 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 GSEs and the housing sector.

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 was 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 Fannie Mae and Freddie Mac.

Question from Congresswoman Brown-Waite to John Courson:

Could you explain the difference between the primary and secondary markets for mortgages and the respective roles of mortgage bankers, such as yourself, and Fannie and Freddie?

Mr. Courson: The primary mortgage market is the market in which lenders such as mortgage bankers make, or originate, loans to homebuyers and homeowners.

Mortgage bankers originate mortgage loans. We solicit borrowers, and borrowers who want mortgages solicit us. We have direct contact with borrowers. We educate consumers and counsel them about what types of loan might be appropriate for their needs. We take loan applications, process them, underwrite loans, arrange loan closing services, and we fund mortgage loans. That is the primary mortgage market.

A mortgage banker, after funding and closing a loan, often wants to sell it in order to get liquidity to fund another loan. Buying loans from mortgage bankers and thus supplying liquidity to make additional loans is the function of the secondary mortgage market. Fannie Mae and Freddie Mac are the dominant secondary mortgage market participants.

It is important to understand that the secondary mortgage market is a financial market rather than a consumer market. Fannie Mae and Freddie Mac buy loans that have already been made. They could sell the loans, but it is more practical to securitize them. To securitize loans, Fannie Mae and Freddie Mac pool a number of loans, use them as collateral for securities, then guarantee the securities. Guaranteed, mortgage-backed securities are more liquid that the mortgage loans themselves. Fannie Mae and Freddie Mac sometimes hold the mortgage-backed securities (MBS) they create, and sometimes they buy each other's MBS. They finance their activities by selling debt securities.

Congress has prohibited both Fannie Mae and Freddie Mac from originating loans, but has never defined the term "originate." We believe it is important for Congress to develop a regulatory system that ensures that the GSEs adhere to their secondary market purpose, and that they not use their size, wealth, and other benefits of their government-sponsored status to compete with mortgage bankers in the primary mortgage market.

Question

As we consider an independent regulatory structure within Treasury, I have looked at the examination budgets at OCC and OTS. I understand those bank regulatory agencies spend around 2/3rds of their budget on pure examination staffs. What percentage of your budget goes toward examination?

Answer

OFHEO 's allocation of resources to the direct supervision of Fannie Mae and Freddie Mac is comparable to the resources that the OCC and OTS allocate to supervising the financial institutions that they regulate. Information contained in each agency's FY 2003 Performance Plan facilitates a direct comparison.

OFHEO allocated 87% of its FY 2003 budget on the direct supervision of Fannie Mae and Freddie Mac. OFHEO's FY 2003 Performance Plan allocates resources to three Strategic goals: 1) Ensure the Enterprises comply with safety and soundness standards and are adequately capitalized, 2) Enhance public understanding of the nation's housing finance system, and 3) Contribute to Federal efforts to promote efficient and effective financial markets and homeownership. Strategic Goal 1 encompasses all of OFHEO's efforts in the direct supervision of the Enterprises.

The OCC's FY 2003 Performance Plan allocates the agency's resources to four program activities (Supervise, Charter, Regulate, and Analyze Risk). The Supervise program area includes all activities that relate to the ongoing supervision of individual national banks, including activities to ensure capital adequacy. The OCC allocated 84% of its FY 2003 budget for this activity.

The OTS's FY 2003 Performance Plan allocates the agency's resources to the accomplishment of four strategic goals: 1) A safe and sound thrift industry, 2) A flexible regulatory framework ...., 3) Fair access to financial services, and 4) A motivated and expert workforce. The strategic goal of ensuring a safe and sound thrift industry (Strategic Goal 1) includes all activities that relate to the ongoing supervision of individual thrifts, including activities to ensure capital adequacy. The OTS allocated 86% of its FY 2003 budget to achieve this goal.

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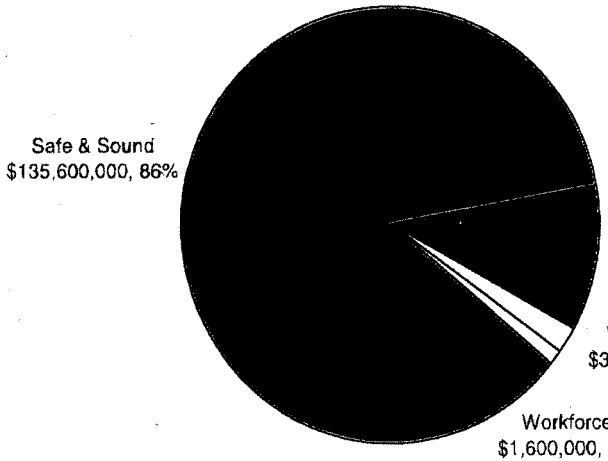
Allocation of OTS Resources for FY 2003



Source: OTS' FY 2003 Performance Plan
Total budget is $157,700,000

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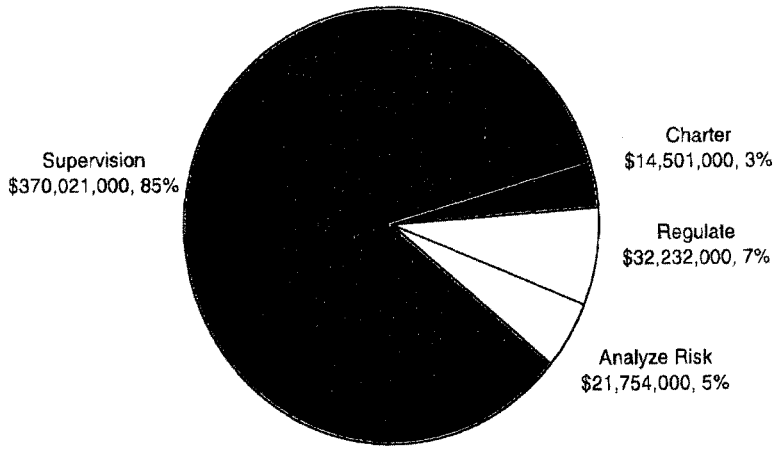
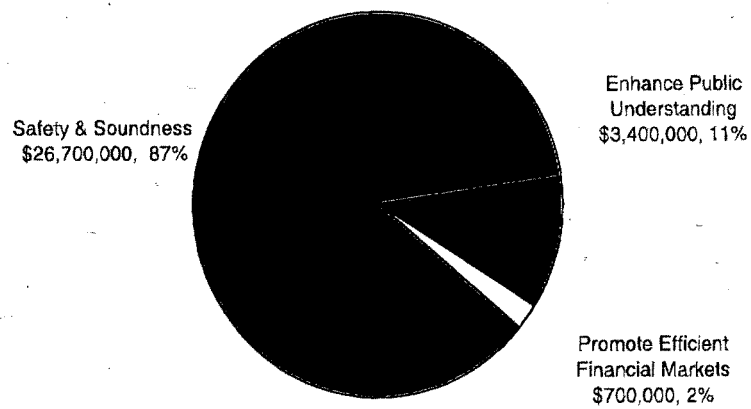
Allocation of OCC Resources for FY 2003



Source: OCC's FY 2003 Budget/Performance Plan
Total budget is $438,508,000

10/22/2003

Allocation of OFHEO Resources for FY 2003



Source: OFHEO's FY 2003 Performance Plan
Total budget is $30,800,000

10/22/2003

Responses to
Questions for the Record
From Congresswoman Brown-Waite
By Mr. George Gould
Presiding Director, Freddie Mac

Q. The news that your restatement of financials will again be delayed is considerably troubling. As I see it, you cannot comply with Bush Administration's request with the 1934 S.E.C. Act until you file audited financials. Is that correct?

A. . Freddie Mac will not be able to complete its voluntary agreement to register under the 1934 Act until it has resumed timely reporting. The company's objective is to release quarterly and full-year 2003 results by June 30, 2004 and to provide its 2003 annual report and hold its related stockholders' meeting as soon as practicable thereafter. The company's objective is to return to timely reporting as soon as practicable after its release of 2003 results. The company remains committed to completing voluntary 1934 Act common stock registration with the Securities and Exchange Commission ("SEC"), with the objective of completing the process as soon as possible after the company's return to timely reporting.

Q. Does that also mean that you are not currently bound by the terms of Sarbanes-Oxley?

A. Freddie Mac will be fully subject to the Sarbanes-Oxley Act when it completes its voluntary common stock registration with the SEC under the Securities and Exchange Act of 1934. However, Freddie Mac already is in the process of implementing policies and procedures to become fully compliant with the Sarbanes-Oxley Act. Freddie Mac also has implemented a corporate-wide employee-training program for its 4,300 employees on the provisions of Sarbanes-Oxley and the company's Code of Conduct, which has been completed by 98.5% of its employees

Q. When you submit audited financials, now in October, will that be for 2000, 2001, and 2002? Where do you stand with the first two quarters of 2003?

A. On November 21, 2003, the company announced the results of its restatement of previously issued consolidated financial statements for the years 2000 and 2001 and the first three quarters of 2002 and the revision of fourth quarter and full-year consolidated financial statements for 2002. The company expects to provide its 2002 annual report and hold its related annual stockholders' meeting in

first quarter 2004. The company's objective is to release quarterly and full-year results for 2003 by June 30, 2004 and to provide its 2003 annual report and hold its related stockholders' meeting as soon as practicable thereafter. The company's objective is to return to timely reporting as soon as practicable after its release of 2003 results.

Responses to a
Question for the Record
From Ranking Member, Congressman Frank
By Mr. George Gould
Presiding Director, Freddie Mac

When I testified before the House Committee on Financial Services on September 25 of this year, you asked me to respond in writing to your question regarding Freddie Mac's involvement with the USDA's Rural Housing Service's Program for Rural Rental Housing (commonly referred to as "Section 515 loans").

As you know, Section 515 loans were designed to help ensure the availability of rental apartments for very low-, low-, and moderate-income tenants, including the elderly, families and people with disabilities, who live in communities that have been identified by the Rural Development State Directors as greatly in need of affordable multifamily rental housing. Section 515 loans are made directly to the borrower by the Rural Housing Service (RHS). Borrowers seeking Section 515 financing must be unable to obtain credit elsewhere at rates that will allow them to maintain affordable rents.

Freddie Mac has held some preliminary discussions with RHS staff members regarding Section 515 mortgages and we are very interested in finding a way to support this program. Since 1994, the program has faced severe budget cuts. As a result, Section 515 loans financed fewer than 1,800 new apartment units nationwide last year. Exacerbating the budget cuts is the fact that most of the estimated 18,000 properties that have been financed through the 515 program over the years are now aging. The annual allocation of funds to the 515 program–$115 million for fiscal year 2003–is insufficient to cover both the necessary rehabilitation of existing properties and the development of new apartments.

In an effort to rejuvenate the program, the RHS recently hired Beekman Advisors, consultants with extensive experience in multifamily finance, to help evaluate the severity of the situation and find solutions to keep the program operating effectively. Freddie Mac's Multifamily staff met with Beekman Advisors in December to discuss the future of the program and explore ways in which Freddie Mac might work with the USDA to help ensure the survival of the 515 program.

One possible solution is for Freddie Mac to purchase participation interests in new Section 515 loans that the RHS would originate on recently renovated 515 properties. If the RHS is receptive to this idea,

the funds generated by our purchase of participations would provide a much-needed cash infusion to the 515 program, effectively subsidizing the annual funding allocation and allowing the program to grow.

Freddie Mac and the RHS have worked together successfully in the past. In 2001, we executed a "Memorandum of Understanding" with the USDA, which made us the first secondary market participant to agree to purchase Section 538 loans under the Guaranteed Rural Rental Housing Program. Prior to this agreement, the private lenders who make 538 loans were unable to replenish their funds in the secondary mortgage market. Freddie Mac has since purchased two 538 loans, totaling $3.28 million, on an individual basis. We continue to investigate more efficient methods of acquiring 538 loans, such as purchasing pools of these mortgages.

Freddie Mac looks forward to renewing our relationship with the RHS and hope to purchase loans under both the 515 and the 538 programs in 2004.

Question 1

Can you explain some of the internal measures Fannie Mae took, voluntarily, to ensure its safety and soundness, even before Sarbanes-Oxley?

Answer

Fannie Mae seeks to be a market leader in all aspects of our business. To ensure our safety and soundness, we use best-in-class risk management practices. We have also taken strong steps to establish world-class corporate governance and disclosure practices.

World-class risk management practices

Fannie Mae's state-of-the-art credit risk, interest rate risk, and liquidity risk management practices ensure the company's safety and soundness. We have consistently and conservatively managed these risks.

Credit risk management

Unlike other financial companies, Fannie Mae has one main business line, mortgages, which are among the safest products in the financial services sector. Most other financial institutions engage in a broad array of lending activities, ranging from mortgages, auto loans, credit cards, and commercial lending, to far riskier and more obscure activities. In contrast, Fannie Mae holds a geographically diversified book of business of low-risk mortgage loans.

Fannie Mae takes steps to further reduce the already low level of credit risk in mortgages. Fannie Mae disperses risk by sharing credit exposure with various partners. Credit enhancements include primary loan-level mortgage insurance, pool mortgage insurance, recourse arrangements with lenders, and other customized contracts. As a result, while the company's book of business more than doubled between 1995 and 2002, our credit losses were cut by a factor of more than four.

Interest rate risk management

With respect to interest-rate risk management, Fannie Mae's primary role is to manage, and largely disperse, the risk inherent in long-term, fixed-rate mortgages. Fannie Mae carries out this role by investing in assets and issuing liabilities that perform similarly across different interest rate environments in the context of a reliable, diversified, and disciplined approach to the management of interest rate risk.

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 in our net interest margin. In spite of significant swings in interest rates over the past 15 years, the company has increased core earnings every year.

Liquidity risk management

In 2000 Fannie Mae voluntarily committed to establish and maintain a liquidity plan to deal with any potential loss of market access. Under that plan, Fannie Mae maintains

sufficient liquidity to operate for three months at a minimum without any access to the debt markets.

By fulfilling our role of maintaining liquidity in the secondary mortgage market, Fannie Mae actually helps prevent systemic events. During the financial crisis in the fall of 1998, when demand for most other securities dried up, the market for conforming US mortgages was relatively stable due to large purchases by Fannie Mae and Freddie Mac.

Fannie Mae repeated this role following the events of September 11. Historically, Fannie Mae has provided the financial system with liquidity during crises, rather than posing a risk to the system. Far from contributing to any systemic threat, Fannie Mae is positioned to stabilize the financial system in times of crisis, not to transmit shocks to other institutions.

Strong corporate governance

Last year, before the passage of Sarbanes-Oxley legislation, Fannie Mae set in motion a 6-month corporate governance project, working with our Board, to make Fannie Mae best in class in corporate governance. The Corporate Governance Committee of our Board of Directors met for six months to put together a best-in-class model that works for Fannie Mae. They looked at the best practices in the market, including those offered by the New York Stock Exchange, The Business Roundtable, the Conference Board and others to see where we might make our governance even better.

This spring, our Board voted to approve and adopt a series of corporate governance guidelines. There are two key principles embedded in our policy. First, the roles of the Board and management are clear and distinct. The second key principle is that, to hold the CEO accountable, the Board must be independent and free from issues of conflict of interest. As The Business Roundtable and others recommend, a significant majority of our Board members are independent from management.

Last fall, we asked Standard & Poor's to examine our corporate governance and transparency, to let us know where we can improve and let others know where we stand. The S&P announcement noted that, "Fannie Mae is among the most tightly regulated financial companies in the world." Our regulatory oversight and voluntary initiatives, it said, provide "disclosure about Fannie Mae's financial health that is unavailable from other, similar financial institutions."

Market-leading financial disclosures and transparency

Voluntary Initiatives

In October 2000, after discussions with leadership in Congress and representatives from the federal regulatory agencies, Fannie Mae announced a commitment to implement measures to improve financial transparency and market discipline.

- Regular issuance of subordinated debt in an amount such that by the end of 2003, capital plus sub debt would equal 4 percent of on-balance sheet assets, after providing sufficient capital for off-balance sheet obligations
- Monthly disclosures of net interest income at risk, duration gap, and our liquidity position
- Quarterly disclosure of credit loss sensitivity
- Public disclosure of independent financial strength or "risk to the government" ratings
- Interim disclosure of an internal version of the risk-based capital stress test (superceded by OFHEO's quarterly capital classifications)

SEC Registration
On March 31, 2003 Fannie Mae filed our first 10-K with the SEC. This voluntary action was under Section 12(g) of the Securities Exchange Act of 1934, which allows an issuer that otherwise is not subject to the requirements of the Exchange Act to register our common stock with the SEC.

As a result of the 12(g) filing of our common stock, Fannie Mae is now subject to the disclosure requirements of Section 13 of the Exchange Act – requiring ongoing filing with the SEC of periodic and material-event disclosures under the SEC's own rules, regulations and procedures. We are also subject to all of the requirements of Sarbanes-Oxley. Although Fannie Mae's decision to become an SEC registrant was voluntary, we are now subject to the same periodic financial disclosure requirements as all other publicly held companies.

MBS Disclosures
In March 2003, a joint Treasury-SEC-OFHEO task force reviewed our MBS disclosures and recommended that we disclose six additional pool characteristics. We responded to their comments by fully implementing their recommendations. As of April 2003, these additional disclosures were in place.

Additional Disclosures
Furthermore, Fannie Mae and its regulators provide a broad array of information to the market on a regular basis. We provide additional financial disclosures on a monthly or quarterly basis. Through its Public Use Data Base, HUD publishes a great deal of information on our mortgage portfolio and its characteristics. Finally, OFHEO releases quarterly capital classifications, as well as periodic reports on the state of the mortgage market, and annual reports to Congress that reflect our examination results.

Fannie Mae has been and will remain committed to being a leader in terms of disclosure and transparency.

Question 2

It seems that Fannie Mae has made a commendable, voluntary effort to remain safe and sound, but the problems with Freddie Mac are often transferred to Fannie Mae in the eyes of the public. Are you concerned that this uncertainty could have an unfair impact on your company if nothing is done?

Answer

We have always striven to maintain world-class disclosure practices so that investors can judge our company on the merits. Our monthly and quarterly disclosures give investors clear information about Fannie Mae's risk management practices, so they can make independent judgments about our company without reference to anything happening at Freddie Mac When S&P reviewed our disclosures in January 2003, they reported that our regulatory oversight and voluntary initiatives provide "disclosure about Fannie Mae's financial health that is unavailable from other, similar financial institutions."

Question 3

I have some concerns with certain aspects of the Administration's proposal, specifically the new program approval requirements moving to Treasury. I, personally, am more comfortable with the housing experts managing this area. Would you object to HUD retaining this power, as long as they have the ability to be more effective than OFHEO?

Answer

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 ten 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. 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 lenders 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.

However, 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. A new regulator should 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 should be able to 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. 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.

Fannie Mae's Commitment to Rural Housing and the USDA 515 Rural Rental Housing Program

Fannie Mae's American Dream Commitment goal in rural housing is to do at least $100 billion in rural affordable housing business by the end of the decade. We are well on our way to exceeding this goal. In 2002, we exceeded all expectations by investing over $20 billion in rural affordable housing. This is a 37% increase over our investments in 2001.

Section 515 is a multifamily Rural Rental Housing program that is funded, serviced and administrated by the USDA Rural Housing Services (RHS). These loans are not sold to Fannie Mae or any other investor. Fannie Mae does help leverage the Section 515 program through various financial arrangements. For example, Fannie Mae, through its multifamily department, provides equity to Section 515 properties that qualify for Low Income Housing Tax Credits. To date, we have invested over $73 million of equity in 212 properties containing 6,854 units.

For example, a 40-unit, $600,000 rehab and preservation transaction in upstate New York was just approved. The financing includes a subordination of an existing Section 515 mortgage by RHS, and the issuance of a new first mortgage by a Fannie Mae multifamily lender, Capri Capital. RHS faces a big challenge in providing financial and other incentives to attract new capital to its aging stock of affordable housing and we have been working closely to help preserve it. We will continue to work with RHS and other lender partners to further develop this approach to revitalize and preserve rural rental housing.