Testimony of W. Michael House
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Before the
Senate Governmental Affairs Committee
Subcommittee on Financial Management, the Budget and International Security
Hearing
Oversight on Government Sponsored Enterprises:
The Risks and Benefits to Consumers
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2:00 p.m.

Chairman Fitzgerald, Sen. Akaka, and Members of the Subcommittee: my name is Mike House. I am the Executive Director of FM Policy Focus, a coalition of seven associations of financial services companies actively engaged in the mortgage industry. Our members include the American Financial Services Association; the Association of Financial Guaranty Insurers; the Consumer Bankers Association; the Consumer Mortgage Coalition; the Financial Services Roundtable; the Mortgage Insurance Companies of America; and the National Home Equity Mortgage Association.

Together, we are proud to be a vital part of an industry that helps millions of Americans realize the American Dream of homeownership each year. On behalf of our members, I want to thank you for the opportunity to participate in this important and timely hearing. I bring a special greeting on behalf of our Chairman, former Congressman J.C. Watts, who regrets that he could not be here today.

It is hard to believe, but Alan Greenspan was 12 years old, the average home cost less than $5,000 and America had just 48 states when Congress first decided to use taxpayer dollars in 1938 to subsidize an organization to support the secondary mortgage market. It was a genuine example of vision on the part of Congress, and our members strongly support the continuing secondary mortgage market mission of Fannie Mae and its sibling Freddie Mac.

The members of FM Policy Focus have some of the most enviable jobs in the industry: They get to sit across the table from new homeowners and see the looks on people's faces when they are handed the keys to their new homes for the first time. As it should be in a nation built on free enterprise, homeownership and affordable housing are driven overwhelmingly by the private sector. But while we sit on the front lines, it is a strength of our system that Fannie Mae and Freddie Mac buy the mortgages that our members originate and insure, freeing up even more capital to put more Americans in their own homes.

For that reason, Congress continues to subsidize Fannie Mae and Freddie Mac each year to the tune of about $10.6 billion, according to a 2002 Congressional Budget Office analysis.
FM Policy Focus strongly supports maintaining the special relationship and the special responsibilities of these government-sponsored enterprises (GSEs) in the nation's mortgage markets. When in full compliance with their charters, the GSEs *do* provide this vital function of sustaining a liquid secondary mortgage market, which is the healthiest in the world.

The problem is that for Fannie Mae and Freddie Mac to be in full compliance with their charters and fulfill their congressionally-mandated mission, they need effective government oversight – oversight founded on the same three principles that guide the oversight of the world's largest banks and make up the three pillars of the Basel Accord: namely, sound capital, effective supervision, and market discipline from enhanced disclosure.

From where we sit today, Fannie Mae and Freddie Mac are 0-for-3.

Together, they are weakly regulated by an under-staffed, under-funded agency. They hold 20-50 percent of the capital required by bank regulators for depository institutions holding mortgages. And they are the only two publicly traded companies in the Fortune 500 that are exempt from routine Securities and Exchange Commission (SEC) disclosures required to ensure transparency and standards of investor accountability.

If this combination were present at a private institution, its customers, debt-holders and stockholders would be at great risk in the event of failure. But since Fannie Mae and Freddie Mac are government-sponsored enterprises, which are perceived to be backed by the Federal Treasury, it is taxpayers that would be on the hook to bail out Fannie Mae and Freddie Mac in the event of failure. In one fell swoop, taxpayers could go from being in the dark about Fannie Mae and Freddie Mac's operations to being in the red trying to bail them out.

Given that Fannie Mae and Freddie Mac carry about $1.5 trillion in debt between them today, the failure of either one of them could potentially make the savings and loan crisis of a decade ago look minor.

All of our members are proud to be partners of Fannie Mae and Freddie Mac. But like any good partners – just like any good friends -- we tell our partners when we think they're wrong. FM Policy Focus makes it a priority to alert the public to actions of Fannie Mae and Freddie Mac that benefit the interests of their investors at the expense of homebuyers and taxpayers. We support market competition that results in increased access to affordable housing for consumers. We support federal policies that do not allow the GSEs to move beyond their unique charters to deal directly with homebuyers and consumers or into markets well served by the truly private sector. And we support Federal policies that prevent taxpayer exposure to unnecessary risks that could require a massive bailout.

FM Policy Focus believes Congress should enact legislation this year that will bring greater accountability and transparency to the GSEs and their operations, while reducing the risk to taxpayers. We believe that any reform bill should:

- Strengthen GSE regulation by moving this responsibility from the Department of Housing and Urban Development (HUD) to the Department of the Treasury;
- Make the new regulator a member of the Federal Financial Institutions Examination Council (FFEIC);
- Provide the new regulator with powers comparable to those available to bank regulators, including the approval of new products and activities;

- Require that GSEs hold bank-like capital;
- Fund the new regulator through assessments on the GSEs, comparable to those supervisory fees which fund bank regulators;
- Tighten the national affordable housing standard that now applies to the GSEs by making that standard apply within individual metropolitan statistical areas;
- Repeal Fannie Mae's and Freddie Mac's exemptions from the Securities Act of 1933 and the Securities Exchange Act of 1934;
- Repeal the GSEs' exemption from the privacy provisions which, under Gramm-Leach-Bliley, apply to all other financial institutions;
- In the context of maintaining a liquid secondary market and adequate capital, cap the amount of their own and each other's mortgage-backed securities (MBS) which the GSEs may hold in their own portfolios;
- Limit the GSEs' non-mission portfolio assets and investments;
- Cap the amount of debt the GSEs may issue without seeking Treasury approval; and
- Establish a clear limit on the GSEs' business activities to a strictly secondary market role that prohibits encroachment into primary market activity.

We recommend these changes together because none is adequate by itself.

A Single Strong Regulator

The GSEs are complicated financial giants: they have $1.6 trillion in combined assets; $1.4 trillion in retained mortgages in portfolio; $1.5 trillion in outstanding debt; and $1.5 trillion in notional derivatives. In addition, outstanding mortgage-backed securities guaranteed by the GSEs, but held by third parties, total $1.7 trillion.

Every day, Fannie Mae and Freddie Mac behave in the same way as other large financial institutions: they trade, borrow, and raise capital in the world's debt and equity markets. Unlike other large sophisticated financial institutions, the GSEs are subject to minimal regulatory oversight. This creates systemic risk if something goes wrong because the ordinary market disciplines – capital and disclosure among them – are not in place to create a buffer against GSE risk.

In the private market, bank regulators of large financial institutions have an array of weapons in their arsenal: minimum and core capital standards about twice as high as those imposed on the GSEs, which bank regulators can raise still further as risk warrants; a panoply of supervisory powers to stop any activity deemed unsafe or unsound, including executive compensation practices or relations with third parties; authority to review and approve all new activities of significance, with most proposed first for public comment to ensure the bank regulators know all they need before a new line of business is allowed; the ability to put an insured depository into receivership; and a variety of disclosures required by the bank regulators that are supplemented by SEC-mandated disclosures of parent publicly traded companies.

The GSEs' safety and soundness regulator, the Office of Federal Housing Enterprise Oversight (OFHEO) has been given supervisory and examination powers over Fannie Mae and Freddie Mac, but these are far less potent than those authorized for federal banking regulators. Congress

did ask OFHEO in 1992 to govern not only the new minimum capital standards – about half those imposed on banks for high-quality mortgages – but also to issue new risk-based capital standards. Congress wisely required OFHEO to produce a risk-based capital rule for the housing GSEs to establish how much capital they needed to survive a period of difficulty. Ofcourse, nine years later, OFHEO finally published a rule that ran nearly 700-plus dense and detailed pages, ultimately raising more questions than it answered. As we know from the last few runs of the OFHEO risk-based capital rules, it found acceptable for a GSE leverage ratios of 300:1 or even more – hugely higher capital ratios than those accepted by U. S. and international bank regulators for comparable mortgage-related risk.

Recent developments at Fannie Mae and Freddie Mac have further demonstrated the woeful inadequacy of the current regulatory structure. In recent weeks, any doubts about the inadequacy of GSE supervision must have been put to rest. Last year, Fannie Mae went far outside its own self-imposed interest-rate risk standards, but OFHEO did not know about this until Fannie had to tell the financial markets, and it only took action after House Capital Markets Subcommittee Chairman Richard Baker demanded that it do so. Freddie Mac, of course, is embroiled in a restatement for several years of its earnings. As OFHEO Director Armando Falcon made clear in testimony on July 17, 2003 before the Senate Banking Committee, the regulatory agency was woefully behind the firm's own lax internal auditor and even now seems unaware of many key issues affecting the long-term stability of Freddie Mac.

The remainder of GSE regulatory responsibilities, those related to setting affordable housing goals and making certain that Fannie Mae and Freddie Mac meet those goals and engage only in activities within their charter that are in the public interest and safe, was left to HUD.

The GSEs have a vital role to play in expanding access to mortgage finance. More than ten years ago, Congress directed them to lead the market in promoting affordable housing, a mission strongly endorsed by the members of FM Policy Focus.

Yet the GSEs lag the private sector in promoting affordable housing. Don't just take my word for it – there are 24 separate independent studies that prove that the full power and resources of Fannie Mae and Freddie Mac are not being applied to their affordable housing mission today. I have attached a list of these studies to this testimony.

Our members originate and insure the loans the GSEs buy, and we hope they will do more to promote our own affordable housing activities, especially with regard to minority homebuyers. Many members of FM Policy Focus are subject to the Community Reinvestment Act (CRA), which requires a special focus on low- and moderate-income home purchasers. The GSEs today do not buy many CRA loans, and we would like to work with them to do so, thereby enhancing their affordable housing responsibilities.

Congress did not give the GSEs' safety and soundness regulator power over new programs – in sharp contrast to the mandate for bank regulators ratified as recently as the Gramm-Leach-Bliley Act of 1999. Instead, HUD is currently required to provide prior approval for new GSE programs. However, HUD has never implemented a meaningful new program review process. Only once did it review a new program, and then only at the direct request of a Member of

Congress. This failure has taken on new urgency: Most of the programs that the GSEs are proposing today are new financial products, targeted directly to consumers, and more broadly used for general consumer lending, rather than focusing on home mortgage finance for under-served market segments. FM Policy Focus believes the GSEs' charter, though often vague, confines Fannie Mae and Freddie Mac to the secondary mortgage market. Yet increasingly, over the last ten years, Fannie Mae and Freddie Mac have engaged in a series of primary mortgage market activities. This must not be allowed to continue.

Every outreach into broader and more complex financial products holds the potential of undermining the safety and soundness of the GSEs. HUD is unfamiliar with the types of highly complex transactions in which the GSEs engage and does not or cannot stop a GSE from implementing risky ventures.

For example, Fannie Mae has launched itself into something it calls PaymentPower™, an entry into high-risk consumer lending. At other large financial institutions, such transactions – even if approved by a bank or insurance regulator – would require considerable capital and experienced effective risk management, and draw the attention of dozens of experienced regulators looking into every aspect of the new program.

But at present HUD has not more than seven people responsible for oversight, not just of the PaymentPower™ program itself, but overseeing *all* of Fannie Mae and Freddie Mac's activities. Little wonder that HUD has so far taken no action PaymentPower™. Moreover, since Fannie Mae and Freddie Mac are exempt from state insurance and consumer laws, even these reliable consumer-oriented regulators have no standing to question PaymentPower™ or any other GSE products.

It is clear from these examples and many more that Congress must enact legislation to reform the regulation of the GSEs. They are simply too big to ignore. The current regulatory scheme is bifurcated, weak, and subject to undue influence from the GSEs. FM Policy Focus recommends that Congress replace the existing, ineffective regulatory regime with a strong single regulator, which has all the attributes cited by Federal Reserve Chairman Alan Greenspan in his testimony before the Senate Banking Committee on July 16, 2003, namely: expertise, regulatory authority, and powers strong enough to keep the GSEs safe and sound.

We think it makes the most sense to move these functions to the place where this kind of regulatory expertise already resides: the Department of the Treasury. At FM Policy Focus, we support a plan to move the GSEs' regulator from HUD to an independent agency within Treasury comparable to, but separate from, the Office of Thrift Supervision and the Office of the Comptroller of the Currency -- with authority over safety and soundness, mission and affordable housing. The new regulator should also join other banking regulators as a member of the FFEIC.

We urge that these responsibilities be moved outside the appropriations process, relying instead as banking regulators do, on the assessment of fees on Fannie Mae and Freddie Mac.

We want to reiterate that we believe such a regulator should approve new activities for the GSEs only after determining that the new activity fulfills the GSEs' primary missions of providing a

liquid secondary market and promoting the availability of affordable mortgage finance. Any new program, activity or investment should be approved only after a process comparable to that used by the banking regulators: first, there should be a broad proposal about the activity to ensure that the regulator receives a full range of views on it; then, any GSE wishing to use the new power should give the regulator prior notice that provides ample information on its financial and managerial capability to engage in the new activity. In all cases, the new activity or investment should be allowed only if, as under current law, it is consistent with the GSE charter, in the public interest and found to be safe and sound.

Require Bank-Like Capital

Second, we believe that the GSEs should be required to have capital similar to that imposed by the Federal Reserve on large bank holdings of comparable mortgage risk – that is, bank-like capital.

It's no mystery why capital is important – when crises flare in the financial markets, a strong capital base makes any institution better able to weather a storm without running the risk of permanent injury to itself or to the taxpayer. Sufficient capital helps protect against mistakes and unpredictable circumstances.

Consider what happened with the savings and loan industry in the 1980s. S&Ls grew increasingly larger, entering new lines of business, while sitting atop an ever-shrinking capital base. When things went badly, taxpayers were left on the hook to the tune of $250 billion or more. In turn, Congress wisely instituted minimum capital standards for banks and saving associations, and further required that only well-capitalized firms could become financial holding companies.

But today, Fannie Mae and Freddie Mac are allowed to operate on a capital base that doesn't even measure up to the capital held by S&Ls in the 1980s before the crash, let alone after the reform.

As William Poole, President of the Federal Reserve Bank of St. Louis, pointed out in remarks at an OFHEO Symposium in March of this year, the low GSE capital base is especially dangerous because:

> Capital is especially important for the GSEs because their short-term obligations are large. Fannie Mae and Freddie Mac have debt obligations due within one year of about 45 percent of their debt liabilities. Any problem in the capital markets affecting these firms could become very large, very quickly. What might 'very quickly' mean? Because of the scale of the short-term obligations of the GSEs, the GSEs are rolling over many billions of dollars of obligations each week. For this reason, a market crisis could become acute in a matter of day, or even hours.

In other words, as Thomas Schatz, President of Citizens Against Government Waste, said in testimony before the House Capital Markets Subcommittee on June 25, 2003, "the risks posed by Fannie Mae and Freddie Mac are more dangerous than those posed by the Federal Home Loan

Banks because Fannie Mae and Freddie Mac are so large, so thinly capitalized, and so dominant in their field."

We concur with Federal Reserve Chairman Greenspan, who states in an April letter that:

> …the existence, or even the perception, of government financial support for financial institutions undermines the effectiveness of market discipline. Thus, in the case of the housing-related GSEs – Fannie Mae, Freddie Mac, and the Federal Home Loan Banks – to ensure that these institutions do not pose a systemic threat regulators cannot rely wholly on market discipline and must assess whether these institutions hold appropriate amounts of capital relative to the risks they assume and the costs they might impose on others, including taxpayers.

More Disclosure Should Be Required

As I mentioned earlier, with their special status, Fannie Mae and Freddie Mac are the only two publicly traded companies in the Fortune 500 that are exempt from regulation by the SEC.

A year ago, under pressure from Congress, Fannie Mae and Freddie Mac agreed to register their equities under the Securities Exchange Act of 1934 with the SEC and adhere to the agency's annual and quarterly financial reporting rules. Fannie Mae followed through and registered early this year; Freddie Mac still has not done so and recently said it did not expect to do so before the middle of next year, nearly two years after making its original promise.

This agreement, worked out by the GSEs with the Treasury, the SEC, and OFHEO, was touted by the GSEs as being a "voluntary" commitment, yet one which was arrived at after months of bitter resistance to making any such commitment. Moreover, we question the GSEs' good faith as they simultaneously asked for and received No-Action letters from the SEC, detailing all the provisions of the securities laws which still do not apply. Copies of those letters are also attached to this statement.

We have seen the folly of such "voluntary" agreements. Freddie Mac has volunteered to tell us very little of what got it – and potentially the taxpayers – in trouble.

The reason Fannie Mae and Freddie Mac enjoy this special treatment is because they remain exempt from the Securities Act of 1933, which would require Fannie Mae and Freddie Mac to register their mortgage-backed securities and debt offerings. They continue to remain exempt from key provisions of the Securities Exchange Act of 1934, including the rules governing tender offers and public reporting of trades by insiders. A chart comparing the application of these laws to other publicly traded companies and to the GSEs is attached to this testimony.

At a time when the rest of corporate America is subject to stringent review of its activities, the GSEs continue to operate as islands of their own.

We think this is a prime case where the government should lead by example: send the right message to investors and the rest of corporate America, and require full disclosure and full SEC

registration by the GSEs of all their securities. Fannie Mae and Freddie Mac protest that such compliance will have adverse affects. But we agree with the findings of a joint study by the Treasury Department, OFHEO, and the SEC this past February, which concluded:

> The Task Force finds more persuasive the argument of other investors and market participants who counter that any adverse affects from additional disclosure would be short-term, and ultimately be outweighed by the benefits of greater information flowing into, and therefore more informed analysis of, the MBS market.

This view has been supported in recent months by the Congressional Budget Office and Moody's Investor Service, both of which argued that disclosure would not disrupt the secondary mortgage market. It's time to let the sun shine in on Fannie Mae and Freddie Mac.

FM Policy Focus also supports disclosure to the GSE regulator through quarterly reports like bank "call reports." Such disclosure would be made even stronger if regulators demanded stand-alone ratings from the rating agencies to truly assess GSE risk. A stand-alone rating means the rating that would be given to Fannie Mae and Freddie Mac as if they were completely private enterprises, with no tie to the Federal government. Current ratings incorporate unlimited access to debt markets because of the GSEs' special status. For investors looking to compare apples to apples in this market, stand-alone ratings would be a valuable source of information.

Taken together, the appointment of a single strong regulator, the requirement of bank-like capital, and the requirement of full disclosure would dramatically improve oversight of Fannie Mae and Freddie Mac in a way that would more ably protect taxpayers from the possibility of potential systemic risk, and would bring the GSEs more in line with the standards that apply to every other large financial institution.

Benefits For Consumers and Taxpayers

It's been said that homeownership is the triple crown of social policy – helping people buy their own homes is great economic policy, with housing and housing-related activities contributing 20 percent to our GDP; it is good social policy, because homes frame families, which are the building blocks of our society; and it is great community policy, because nothing builds stronger neighborhoods where people care about what happens on their street and look after each other like homeownership – whether it's the South Bronx, South Alabama, or Southern California. That's why our members are so proud to play a vital role in this industry.

The changes I've outlined here today are a win-win for consumers and taxpayers as well. For consumers, effective regulation and oversight of the GSEs mean lower mortgage costs – because better regulation and more capital is good for purchasers of GSE debt and MBS who will be willing to accept lower interest rates on GSE debt and MBS, knowing that there is more real capital and protection behind each bond and GSE-guaranteed mortgage-backed security. Lower interest rates demanded by bond and mortgage-backed securities purchasers mean lower capital costs for the GSEs, which the GSEs can then pass through to borrowers.

Improved regulation can only usher in an expanded focus on affordable housing, because a unified regulator is in a better position to require the GSEs to address the mission they so proudly profess in their television commercials, rather than trying to boost earnings through artificial accounting or other high-risk ventures.

Finally, improved regulation offers the best deal for taxpayers. Higher capital and more careful regulation mean the taxpayer will less likely be asked to pick up the implicit federal guarantee of the GSEs. In turn, a stronger housing finance system -- with GSEs focusing on maintaining a liquid secondary market and not moving into other high-risk businesses currently well-served by the private market – will advance economic development across the country.

Closing

In closing, Mr. Chairman, the members of FM Policy Focus urge Congress to take an active role to ensure that an appropriate new regulatory structure is crafted, and that all views have a chance to be heard. We're grateful for your leadership on this point, and for your insistence that several points of view be included here today.

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Attachments

1. Bibliography, studies of GSE funding of affordable loans

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This is a link to the SEC No-Action letter to Fannie Mae:
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This is a link to the SEC No-Action letter to Freddie Mac:
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