



Federal Housing Finance Board
Office of the Board of Directors

STATEMENT FOR THE RECORD

OF

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GSE REGULATORY REFORM - A DIFFERENT POINT OF VIEW

We appreciate this opportunity to present our views regarding proposed reforms of the regulation of the federal housing GSEs.

We have served on the Federal Housing Finance Board (FHFB) for a combined total of almost nine years and have participated in developing FHFB policies and regulations of the Federal Home Loan Bank System. Participation in those decisions was instructive and helped shape our views on the importance of the FHFB and what is needed in the future.

Our primary long run objective is to continue the progress we are making in turning the FHFB into a "world class" regulator of the Federal Home Loan Bank System - a regulator responsible for the safety and soundness, as well as the mission, of the System. In his testimony, FHFB Chairman Ronald Rosenfeld briefed you on the extraordinary efforts of the Federal Home Loan Banks to mitigate the impact of the freezing up of financial markets, so we will not repeat those statistics. However, we do note that the FHFB's strong regulatory oversight of the Federal Home Loan Banks was an important factor in the ability of the Federal Home Loan Bank System to perform that critical role. As we have worked together on these challenging issues, we should note

that it has been a pleasure to work with the Chairman and our other colleagues on the Board. We each bring different experiences, expertise, and regulatory philosophies to our current responsibilities. However, it is because of those differences that we are able to do a more thoughtful and effective job of regulating the Federal Home Loan Banks. It is these experiences that make us optimistic about the future of the FHFB and the Federal Home Loan Bank regulatory system, particularly since the Federal Home Loan Banks have served as the primary federal agency responding to the current crisis in the financial markets. We have carefully and successfully balanced safety and soundness with our housing finance mandate in order to prevent the meltdown of credit markets in August of 2007 from turning into an even worse financial market crisis.

On the matter of GSE regulatory reform, each one of us on the FHFB holds his or her own views. No single member of the Board of Directors can speak for the agency. Hence, our views on GSE reform are our personal views.

Stated simply, we oppose folding the regulation of the Federal Home Loan Banks into a single GSE regulator. The central issues at hand relate to the statutory powers of OFHEO, the regulator of Fannie Mae and Freddie Mac. Little if anything in the debate has any relevance to the Federal Home Loan Banks or FHFB.

We see few if any potential benefits for the regulation of the Federal Home Loan Banks, from such a change, and we see significant downside risk. The regulatory regime and the activities of the Federal Home Loan Banks have little in common with the regulatory regime and activities of Fannie Mae and Freddie Mac, currently regulated by OFHEO. Because the regulatory issues and challenges are so different (and the issues surrounding Fannie Mae and Freddie Mac are so much more visible), we fear that the quality of the regulatory oversight of the Federal Home Loan Banks' safety and soundness would suffer and the System's mission could be substantially diminished.

We take as our starting point the following:

- We are firm believers in the mission of the Federal Home Loan Bank System – to provide needed liquidity and support housing finance;
- Since the 1930's, the Federal Home Loan Bank System has ably served as an essential element of the nation's housing finance system and as a key institution in implementing community and economic development goals;
- We do not agree with those who claim that because of changes in the private capital markets, the Federal Home Loan Bank System is now obsolete; and
- We believe the most effective way to assure the safety and soundness and robust mission of the FHLBank System is to maintain the FHFB as the independent regulator, led by a five-member Board of Directors.

THE ADMINISTRATION'S GSE REFORM PROPOSAL

Central to the Administration's proposal is the strengthening of the legal authorities of the regulator of Fannie Mae and Freddie Mac. Furthermore, the administration proposes to consolidate the supervision of Fannie Mae, Freddie Mac and Federal Home Loan Banks into a "new" regulatory body headed by a single administrator, rather than a multi-person financial regulatory board, such as the Securities Exchange Commission (SEC), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), the Federal Reserve Board (FRB) and the FHFB. Would this really be a more desirable regulatory structure for the financial institutions they regulate? Would a single regulator overseeing all of the housing GSEs be a preferable regulatory structure? We think not.

Having served on multi-person federal financial regulatory agencies, we believe that better policy decisions result from the interplay of regulators with different backgrounds and perspectives. The designers of FRB, the SEC, the NCUA, to mention only a few examples, understood the need for this diversity of power and thought.

In many presentations promoting the Administration's proposed GSE bill, OFHEO makes five basic arguments in support of their version of a GSE reform plan. We would like to comment on those five arguments and demonstrate that they are largely irrelevant when applied to the regulation of Federal Home Loan Banks.

1. Bank-Regulator-Like Powers

The first argument that has been made is that the new housing GSE regulator needs "bank-regulator-like powers." OFHEO, or its successor, claims to need independent litigation authority and receivership authority to effectively regulate Freddie Mac and Fannie Mae.

The FHFB already has independent litigation authority and expansive regulatory powers to reorganize and liquidate a Federal Home Loan Bank. No reform legislation is essential in order to arm the current Federal Home Loan Bank regulator with additional powers.

2. Independence

OFHEO contends that "regulatory independence for the GSE regulator must be strengthened". However, the FHFB is independent of the political control of any Administration.

OFHEO argues that OFHEO or its successor GSE regulator should be freed from the congressional budget process in order to assure independence. However, FHFB

already has independent budget authority and there is no need for legislation to assure the policy or budget independence of the FHFB.

Finally, with no evidence or discussion, OFHEO asserts that “greater regulatory muscle and independence will be provided by combining the agency with the FHFB, the regulator of the Federal Home Loan Banks.”

The FHFB already has the strength and the independence to perform its regulatory functions adequately and efficiently. The FHFB does not need new legislation to achieve these regulatory objectives. Furthermore, we do not see how eliminating the FHFB would provide OFHEO with independence and muscle that it cannot realize on its own.

3. Mission and New Product Authority

Third, OFHEO argues that since the current authority over the mission and products offered by Freddie Mac and Fannie Mae is vested in HUD, OFHEO is left in the difficult position “of considering only safety and soundness elements of activities that could be in violation of an Enterprise’s charter.” The FHFB already exercises authority over the Federal Home Loan Banks’ mission and new product offerings. Hence, no new authority is needed by the regulator of the Federal Home Loan Banks.

4. Flexible Capital Requirements

OFHEO argues that “flexible capital requirements are needed to strengthen regulation of the Enterprises” and concludes that OFHEO’s risk-based capital requirements have been constrained by requirements contained in the 1992 statute.

While OFEO may need legislation on this matter, the FHFB does not. The FHFB already has sufficient authority to adjust capital requirements for Federal Home Loan Banks to meet any new risk. In fact, the FHFB has had no difficulty in imposing additional capital requirements and dividend limits on the banks we regulate, something OFHEO says that it is unable to do. Hence, on this issue, there is again no reason to include the Federal Home Loan Bank System in what should be an OFHEO reform bill.

5. Limits on Fannie and Freddie Portfolio Growth and Federal Home Loan Bank Advances

Finally, OFHEO has argued that its successor should have explicit authority to set portfolio growth limits for Freddie Mac and Fannie Mae. We understand these concerns. But in the face of the current crisis in which the GSE segment of the housing finance market is the only part of the market that continues to function effectively, is this the

most important priority at this time? While this is an important policy issue for the Congress to resolve, it is not an issue for the Federal Home Loan Banks.

Placing arbitrary caps on Federal Home Loan Bank lending to member financial institutions makes no sense. The way such lending is capitalized (members must buy the Federal Home Loan Bank stock needed to support their borrowing) and the way in which risk is sharply limited (lending to members is on a fully secured basis) makes any arbitrary caps unnecessary. And, most importantly, if arbitrary caps were placed on the Federal Home Loan Banks advances, the System's critical role as an assured provider of liquidity would cease to be viable.

Again, we have a set of arguments being made for GSE reforms that are irrelevant with regard to the safe and sound operation of the Federal Home Loan Bank System, and potentially very deleterious to the mission of the Federal Home Loan Banks. We fear that policy initiatives of a new combined regulator could suffer from the dangers of false analogies. If portfolio limits were placed on Fannie Mae and Freddie Mac by a new combined regulator, we can see how arbitrary caps on Federal Home Loan Banks lending to their members could be easily adopted in order to assure that all the GSEs were treated equally.

HISTORY OF THE GSE DEBATE

The case to reform the regulation of Fannie Mae and Freddie Mac has gone through a torturous and long public policy debate. It started when these two GSEs were economically and politically very powerful. The critics of these entities came with an assortment of different motivations. They were successful in initiating a debate over the regulation of Fannie Mae and Freddie Mac which highlighted a number of important issues regarding the regulatory powers of OFHEO and potential risks associated with Fannie Mae and Freddie Mac. In doing so, they also set the terms of reference of the debate. As everyone in Washington knows, the side that frames the terms of reference of a public policy debate is ninety percent of the way toward winning the public policy battle.

The debate over the need to reform the regulation of Fannie Mae and Freddie Mac focused on the costs and benefits of these GSEs – as defined by their critics. The primary benefit was identified as one-quarter of a point off the cost of a prime conforming mortgage. This “benefit” was arrived at by comparing the cost of prime conforming mortgages with the cost of high credit quality jumbo mortgages. Twenty-five basis points was the spread between these two types of mortgages before the meltdown of the credit markets this past August. On the cost side, one major cost of the GSEs was defined as the contingent liability to the U.S. Treasury, which was estimated to be several hundred billion dollars. This estimate was repeatedly put forward by critics of the GSEs, notwithstanding the repeated statements by administration spokespersons that there was no such thing as an “implicit guarantee” for GSE debt or MBS. And,

hence, there could be no contingent liability. The second major cost put forth by GSE critics was the specter of “systemic risk.”

In all of the debate over the need to reform regulation of OFHEO, no one mentioned the most important benefit of the GSEs – assured liquidity for housing finance at appropriate levels. And, in all of the debate, no one bothered to consider that the private sector alternatives to the GSEs presented much greater systemic risk than the GSEs. The 2007 meltdown of U.S. credit markets was the result of the systemic risk posed by unregulated or lightly regulated private sector firms. The government is now faced with determining how to best fix the ensuing financial mess that is pushing the U.S. economy into recession.

DROP THE FHFB FROM ANY FANNIE MAE AND FREDDIE MAC REGULATORY REFORM BILL

By including the Federal Home Loan Bank System in this reform package, the Federal Home Loan Banks, in our view, are being held hostage by those who see the need to reform the regulation and business of the other two housing finance GSEs. There are good arguments for why OFHEO needs additional regulatory authorities. However, those arguments have no bearing on or relevance for the Federal Home Loan Banks and the Federal Housing Finance Board.

At this time of great difficulty in financial markets and housing finance, the Congress should move carefully to try to fix the current crisis, without disturbing those parts of the market and the regulatory structures that are working well. That is why we urge you to drop the Federal Housing Finance Board from any OFHEO /Freddie Mac and Fannie Mae reform bill. This is especially important because, no matter how valuable such a bill may be from the perspective of effective regulation of Freddie Mac and Fannie Mae, regulatory reform itself will make no contribution to repairing the current crisis in financial markets and housing finance. And, unnecessary changes hold the risk of making the situation worse.