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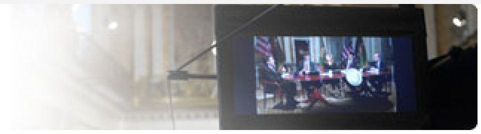

Assistant Secretary David G. Nason Testimony on Reforming GSE Regulation Before the Senate Committee on Banking, Housing and Urban Affairs

2/7/2008

Washington - Chairman Dodd, Ranking Member Shelby, and Members of the Committee, thank you for inviting me to appear before you today. I very much appreciate the opportunity to present the Treasury Department's perspective on regulatory reform for our nation's housing government sponsored enterprises (GSEs): Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (FHLBanks).

Overview of Housing and Mortgage Market Activity

The U.S. economy is diverse and resilient, and our long-term fundamentals are healthy. Yet, economic growth has slowed and the risks are clearly to the downside given current conditions in the housing, credit, and energy markets. Issues related to housing and credit markets bring us directly to the topic of today's hearing.

This Committee is very well aware that the housing and mortgage markets are going through a transition period that is exerting stress on homeowners. The current housing downturn comes after eight years of exceptional housing price appreciation and the housing market is likely to remain weak well into this year and potentially beyond 2008.

A vitally important aspect of working through the current transition in the housing market is ensuring that mortgage credit remains available for both home purchase and refinance transactions. On August 31, 2007, President Bush announced a series of efforts to help mitigate challenges in the housing market. Last week, Under Secretary Steel appeared before this Committee to outline our progress to date and to describe our ongoing efforts to help reduce the number of preventable foreclosures. We appreciate the work and cooperation of the Congress in this area and ask that the Congress pass Federal Housing Administration (FHA) modernization as soon as possible in order to increase opportunities for homeowners to refinance into more sustainable mortgage products.

The Administration also recognizes that the GSEs have played an important role in making credit available to current and prospective homeowners. Since year-end 2006, Fannie Mae and Freddie Mac have increased their outstanding mortgage-backed securities (MBS) by over $600 billion. In addition, outstanding advances of the FHLBank System increased by $184 billion in the third quarter alone, providing additional liquidity and a source of funding to support the lending activities of insured depository institutions and other FHLBank members.

The Time for Regulatory Reform of the Housing GSEs is Now

A key element of the housing GSEs' public purpose is to enhance liquidity in the mortgage market. If we expect the housing GSEs to perform that mission, we must demand that they have a regulatory structure that is appropriate for the importance of the mission and the risk that it entails. It is the Treasury Department's view, and it appears to be generally recognized, that the housing GSEs' regulators have neither the tools, nor the resources, to deal effectively with the current size, complexity, and overall importance of these enterprises.

We acknowledge and commend the housing GSEs for adding some degree of stability to the current mortgage market. Of course, they have had their own problems in recent years and are not immune to problems that are currently plaguing the mortgage market.

The well documented accounting and corporate governance problems that emerged first at Freddie Mac in 2003 then later at Fannie Mae in 2004 raised fundamental questions about the risk management practices at both companies. In response to these issues, the Office of Federal Housing Enterprise Oversight (OFHEO) has entered into supervisory consent agreements with the boards of directors at Fannie Mae and Freddie Mac. These supervisory agreements, which were consummated in December 2003 for Freddie Mac and in September 2004 for Fannie Mae, require the enterprises among other things to improve their internal controls and risk-management operations. While Fannie Mae and Freddie Mac have made substantial progress in addressing these issues, as of December 27, 2007, OFHEO still had supervisory concerns about the internal control and operational weaknesses at both enterprises.

In addition, the FHLBanks were not immune to similar risk management issues, as the regulatory actions associated with problems at the FHLBank of Chicago and the FHLBank of Seattle illustrated. The severity of the problems in the case of the FHLBank of Chicago is evident as discussions are underway regarding a potential merger with the FHLBank of Dallas. This would be the first merger within the FHLBank System since 1946, when the FHLBanks of Los Angeles and Portland were merged to create the FHLBank of San Francisco.

More recently, much like other financial institutions involved in mortgage finance, Fannie Mae and Freddie Mac have experienced various levels of stress in the current mortgage environment. For example, in the third quarter of 2007, Fannie Mae and Freddie Mac reported losses of $1.5 billion and $2.1 billion, respectively. Furthermore, in the fourth quarter of 2007, Fannie Mae and Freddie Mac raised preferred equity capital in the amount of $7.9 and $6.5 billion, respectively. These recent increases in equity capital help to keep the enterprises above their regulatory capital minimums in what has been, and what many expect will continue to be, a difficult operating environment in the near-term for entities in the mortgage market.

All of these factors point to a clear and urgent need for completing housing GSE regulatory reform, and we thank this Committee for taking this important step toward this goal. The Treasury Department's core objectives for housing GSE regulatory reform are: (1) the need for a sound and resilient financial system, and (2) increased homeownership opportunities for less-advantaged Americans. It is paramount that the housing GSEs properly manage and supervise the risks they undertake and that a strong regulator oversee their operations. Otherwise their solvency could be threatened and this could have a negative impact on the stability of other financial institutions and the overall strength of our economy.

Necessary Powers for Financial Regulation

Throughout the debate on housing GSE regulatory reform, the Treasury Department's focus has been on ensuring that the new regulator has all of the powers, authority, and stature required to perform its mandated function. In this regard, the new regulator's powers should be comparable in scope and force to those of our nation's other financial institution regulators.

In terms of comparable powers, we must ensure that the new housing GSE regulatory agency is not encumbered by the current restrictions that are placed on OFHEO. Many of the following key elements of housing GSE regulatory reform have been debated in recent years:

- *Capital Requirements – Under current law, the minimum capital requirements for the housing GSEs are fixed in statute, and the risk-based capital requirement for Fannie Mae and Freddie Mac is based on a highly-prescribed stress test that is set forth in statute. These limitations are inconsistent with the ability of other financial regulators to set both minimum and risk-based capital requirements. The new housing GSE regulatory agency must have the authority to set both minimum and risk-based capital requirements.*
- *Receivership/Conservatorship – Under current law, OFHEO has the authority to place Fannie Mae or Freddie Mac into conservatorship but not into receivership. Should such circumstances arise, the new housing GSE regulatory agency must have more than the powers associated with conservatorship. In particular, the new regulatory agency must have all the receivership authority that is necessary to direct the liquidation of assets and otherwise direct an orderly wind down of an enterprise. The new regulatory agency must also be required to take mandatory receivership actions under certain circumstances. Such receivership authority can be established in full recognition that the Congress has retained to itself, in the case of Fannie Mae and Freddie Mac, the power to revoke a charter. Providing the new regulatory agency the ability to complete an orderly wind down of a troubled regulated entity also encourages greater market discipline by clarifying that investors may suffer losses. Enhanced market discipline is essential to promoting safe and sound operations, which is consistent with maintaining the GSEs' role in our housing finance system and protecting our broader financial system from problems at a GSE.*
- *New Activity Approval and Mission Oversight – Under current law, the Department of Housing and Urban Development (HUD) is responsible for approving new programs, setting housing goals, and overall mission oversight of Fannie Mae and Freddie Mac. The authority for approving new activities of Fannie Mae and Freddie Mac and ensuring compliance with their mission must be transferred from HUD and combined with the other supervisory/enforcement powers of the new housing GSE regulatory agency. This authority is consistent with availability of one of the central tools that every effective financial regulator has – the ability to say "no" to new activities that are inconsistent with the charter of the regulated institutions, with their prudential operation, or with the public interest.*
- *Other Aspects of Enhanced Authority – Housing GSE reform legislation also should include additional measures in order to provide the new regulator with authorities comparable to other U.S. financial institution regulators. Such enhancements should ensure that the GSE regulatory agency has: (1) independent funding outside of the appropriations process; (2) independent litigating authority and other related powers; and (3) the full set of regulatory and enforcement tools.*
- *Government-Appointed Directors – The Federal government should not be involved in the appointment of directors to the boards of Fannie Mae, Freddie Mac, and the FHLBanks. Consistent with long-standing principles of corporate governance, directors of the housing GSEs have a fiduciary responsibility to shareholders. The government appointment of directors does not change this fiduciary responsibility, but does give the impression that the government may have a say or influence in the operation of the housing GSEs. That is not the case, and this should be corrected to improve corporate governance and to clarify further that the housing GSEs are not backed by the Federal government.*
- *Combining the Regulatory Authority of the Housing GSEs – The FHLBanks are regulated by the Federal Housing Finance Board. The FHLBanks should be placed under the same regulator with Fannie Mae and Freddie Mac, and this new regulatory regime should be structured to take into account certain special differences between the FHLBanks and the other GSEs. This would enhance the critical mass of financial expertise needed to oversee the GSEs. At the same time there are many common synergies, such as the FHLBanks' investments in mortgages and MBS, and the mortgage investments of the other housing GSEs. In addition, combining regulatory authority over all of the housing GSEs under one regulator has the potential to increase the stature of the new agency and better enable it to deal with these large and influential companies.*

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The housing GSE regulatory reform bill passed by the House of Representatives (H.R. 1427) addresses many of these aforementioned core reform issues in an adequate manner. However, additional elements of reform are necessary to address the GSEs' particular characteristics.

Additional Key Elements of Housing GSE Regulatory Reform

In addition to addressing the fundamental shortcomings in the current GSE regulatory structure, it is just as important that the new regulator have the appropriate authority to consider the unique characteristics of the GSEs and their housing missions. The housing GSEs were created to accomplish a mission, and they were provided a certain set of statutory benefits to help in carrying out that mission.

For example, in terms of specific benefits, the housing GSEs are not subject to state or local taxation and they have access to a line of credit with the Treasury Department. Fannie Mae and Freddie Mac each have a $2.25 billion line and the FHLBank System has $4 billion line, which pales in comparison to the size of their debt obligations –$770 billion each for Fannie Mae and Freddie Mac and $1.1 trillion for the FHLBank System as of September 30, 2007.

The GSEs also benefit from the market's misperception that the U.S. Government guarantees or stands behind GSE obligations. This misperception, unfortunately, results in preferential funding rates being provided to the GSEs. There are differing views on the precise amount of this benefit, but there is general agreement that the benefit exists. It is this benefit and a lack of effective market discipline that largely drove the rapid expansion of the retained mortgage portfolios of Fannie Mae and Freddie Mac throughout the 1990s.

Fannie Mae and Freddie Mac operate in the secondary mortgage market by providing credit guarantees on mortgage-backed securities (MBS) or by directly investing in mortgages and mortgage-related securities through their retained mortgage portfolios.

In the credit guarantee business, Fannie Mae and Freddie Mac generally enter into swap agreements with mortgage lenders under which individual mortgages are transformed into MBS guaranteed by the GSEs. Fannie Mae and Freddie Mac also have the ability to purchase mortgages and package them into MBS.

In the mortgage investment business, Fannie Mae and Freddie Mac issue debt securities to fund an investment portfolio of mortgage-related securities. In comparison to the credit guarantee business where credit risk is the main exposure, the mortgage investment business involves both credit and interest rate risk. As has been evident during the recent problems in the mortgage market, liquidity in the conforming mortgage market has remained relatively stable. This has occurred primarily through the GSEs' credit guarantee function and increased levels of mortgage securitization as the size of their retained mortgage portfolios essentially has remained unchanged since 2005. While credit risk has been increasing and should not be taken lightly, especially in the current mortgage market environment, the Treasury Department continues to believe that the mortgage investment businesses of Fannie Mae and Freddie Mac present the greatest potential risks over the long-run. At the same time, the mortgage investment business has a much more tenuous connection to the GSEs' housing mission.

As the Treasury Department has noted previously, the combination of three key features of Fannie Mae's and Freddie Mac's retained mortgage portfolios warrant the attention of policymakers: (1) the size of the retained mortgage portfolios of Fannie Mae and Freddie Mac – $1.4 trillion as of year-end 2007; (2) the lack of effective market discipline; and (3) the interconnectivity between the GSEs' mortgage investment activities and the other key players in our nation's financial system, both insured depository institutions and derivative counterparties. The combination of these three factors causes the GSEs to present the potential for systemic risk to our financial system and the global economy.

The idea that the GSEs have unique characteristics that could create tensions or potential problems is not an ideological or partisan view. Policymakers have been struggling with the inherent tension and the potential problems posed by the GSEs for decades. In fact, a Treasury Department official stated in testimony a few years ago, "[a]s the GSEs continue to grow and to play an increasingly central role in the capital markets, issues of potential systemic risk and market competition become more relevant." That statement was not from a member of the Bush Administration Treasury Department, but rather from testimony delivered in March of 2000 by the then Under Secretary Gensler of the Clinton Administration Treasury Department.

As we further consider authorities of the new GSE regulator, to address the long-run issues posed by their retained mortgage portfolios, the new housing GSE regulatory agency must be provided specific review authority over the retained mortgage portfolios of Fannie Mae and Freddie Mac. Such authority must establish a clear and transparent process based on guidance from the Congress on how the new regulatory agency will evaluate the retained mortgage portfolios in terms of risk and consistency with mission. While the broader risk issues related to the FHLBanks are less than those that are present with Fannie Mae and Freddie Mac, a review of the investment portfolios of the FHLBanks for mission consistency also would be appropriate.

Conclusion

In conclusion, we at the Treasury Department remain convinced that a new regulatory structure for the housing GSEs is essential if these entities are to continue to perform their public mission successfully. We look forward to continuing to work with you on this important issue. Thank you.

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