



**U.S. TREASURY DEPARTMENT
OFFICE OF PUBLIC AFFAIRS**

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TESTIMONY OF TREASURY UNDER SECRETARY ROBERT K. STEEL

**BEFORE THE U.S. HOUSE FINANCIAL SERVICES COMMITTEE
ON GOVERNMENT SPONSORED ENTERPRISE REFORM**

Washington, DC- Thank you Chairman Frank, Ranking Member Bachus, and Members of the Committee for inviting me to appear before you today.

The United States has one of the most successful housing finance systems in the world. Our nation's housing finance system provides consumers with a wide range of mortgage finance options that open the door for home ownership. In today's mortgage market, consumers can choose from mortgage products designed to match their desired payment characteristics. Consumers also have greater flexibility regarding down payment options, and reductions from the once standard 20 percent down payment have played a critical role in expanding home ownership opportunities. In addition, consumers have increasingly used the mortgage market to tap illiquid housing wealth that has accumulated over time with cash out refinancing or through the use of home equity lending products.

The underlying structure of our nation's housing finance system is supported by various types of financial institutions: federally insured depository institutions and mortgage banks that both originate, service, and invest in mortgages; private mortgage insurers that provide insurance on low down payment mortgage loans; mortgage brokers that assist consumers in obtaining mortgages; investment banking firms that arrange securitization transactions and invest in mortgages; and, of course, the housing government sponsored enterprises (GSEs) – Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBanks).

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. Treasury continues to believe that the credit guarantee function provides a useful mechanism in the operation of an effective secondary market for mortgages. 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. Treasury continues to believe that the mortgage investment businesses of Fannie Mae and Freddie Mac present the greatest potential risks, while at the same time having a much more tenuous connection to their housing mission than the credit guarantee business.

Recent accounting/corporate governance problems and regulatory restrictions have limited the growth of Fannie Mae and Freddie Mac over the last few years. Nonetheless, they are still a significant presence in our nation's housing finance system. As of year-end 2006, the retained mortgage portfolios of Fannie Mae and Freddie Mac totaled \$1.4 trillion, which is off slightly from the \$1.6 trillion outstanding as of year-end 2003. In addition, as of year-end 2006, Fannie Mae and Freddie Mac provided credit guarantees on \$2.9 trillion of MBS. Together, Fannie Mae and Freddie Mac have about \$4.3 trillion of mortgage credit exposure as of year-end 2006, which was about 40 percent of total outstanding mortgage debt. And while it is difficult to calculate precisely, given that fixed-rate mortgages make up the significant portion of the credit guarantees and mortgage assets of Fannie Mae and Freddie Mac, their share of the fixed-rate mortgage market would be even higher.

The FHLBanks also are significant participants in our nation's housing finance system, but they operate under a different business model than Fannie Mae and Freddie Mac. The FHLBanks' primary business is making advances – or secured loans – to member institutions that are involved in housing finance to various degrees. As of year-end 2006, FHLBank advances were \$641 billion. The FHLBanks are also active mortgage investors. As of year-end 2006, they directly held \$225 billion in mortgage assets – \$98 billion as individual mortgages and \$127 billion as MBS. At year-end, the FHLBanks also held \$144 billion in fed funds and other investments, and total assets were \$1 trillion.

Core Objectives of Housing GSE Regulatory Reform

It is Treasury's view, and it appears to be generally recognized, that the regulatory system for housing GSEs neither has the tools, nor the stature, to deal effectively with the current size, complexity, and importance of these enterprises. While some of these issues have been raised for years, it was the accounting/corporate governance problems that emerged first at Freddie Mac in 2003 then later at Fannie Mae in 2004 that brought these issues to the forefront. In addition, the FHLBanks were not immune to these problems as the

regulatory actions associated with problems at the FHLBank of Chicago and the FHLBank of Seattle illustrated.

Treasury has been an active participant in the housing GSE regulatory reform debate. We have continually stated that we have two core objectives: the need for a sound and resilient financial system, and increased homeownership opportunities for less advantaged Americans. In line with our core objectives, our reform proposals have been designed to minimize risks that the housing GSEs pose to the broader financial system and clearly focus the housing GSEs on their mission. More specifically, our reform proposals have included provisions to improve regulatory oversight, enhance market discipline, and allow for the establishment of appropriate capital requirements for the housing GSEs. If the housing GSEs are going to continue to accomplish their mission, it is paramount that the risks undertaken by the housing GSEs are properly managed and supervised; otherwise there may be a threat to their solvency, and importantly to the stability of other financial institutions and the strength of our economy.

It is widely recognized that there is a deficiency in the oversight of the housing GSEs and Congress has worked to improve the regulation of the housing GSEs. We at Treasury appreciate this effort and pledge to continue to work with you to establish a new regulator that has all the authorities necessary to oversee these complex and sophisticated institutions.

Key Elements of Housing GSE Regulatory Reform

Throughout the debate on housing GSE regulatory reform, Treasury's focus has been on ensuring the new regulator has all of the powers, authority, and stature needed to do its job. In this regard, a core tenet of our position is that the new regulator's powers should be comparable in scope and force to those of our nation's other financial institution regulators. As I have mentioned, the housing GSEs have grown into large and complex financial institutions that require strong and effective oversight. In addition, later in my testimony, I will describe what makes the housing GSEs different than a typical financial institution. 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.

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 the Office of Federal Housing Enterprise Oversight (OFHEO). Some key elements of housing GSE regulatory reform that have been debated in recent years include the following:

- 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 broadly set both minimum and risk-based capital requirements. The new housing GSE regulatory agency must have enhanced flexibility to set both minimum and risk-based capital requirements. Sections 111 and 112 of H.R. 1427 largely accomplish

this goal. We would be strongly opposed to changes that weaken the new regulatory agency's ability to effectively implement the capital provisions.

- 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 to 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 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. Section 144 of H.R. 1427 largely accomplishes this goal.
- 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. 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. Section 122 and other provisions of H.R. 1427 largely accomplish this goal.

Other important aspects of housing GSE regulatory reform that represent a significant improvement over current law and further provide comparability to other U.S. financial institution regulators include ensuring that the new housing GSE regulatory agency has: independent funding outside of the appropriations process; independent litigating authority and other related powers; and the full set of regulatory and enforcement tools. H.R. 1427 largely accomplishes these goals.

In addition to ensuring that the new housing GSE regulatory agency has powers and authority consistent with that of other U.S. financial institution regulators, the housing GSEs also have unique characteristics that must be addressed in regulatory reform legislation. The housing GSEs were created to accomplish a mission, and they were provided a certain set of statutory benefits to help in the accomplishment of 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

(\$2.25 billion each for Fannie Mae and Freddie Mac and \$4 billion for the FHLBank System, which pales in comparison to the size of their debt obligations). The GSEs also greatly benefit from the market's perception that the U.S. government guarantees or stands behind GSE obligations, which results in preferential funding rates being provided to the GSEs. On behalf of Treasury, I want to reiterate that the GSEs' debt and other financial obligations are not backed by the federal government. There are differing views on the precise amount of this benefit, but 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.

As Treasury 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 2006; (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. This view has not changed.

In addition, given that Fannie Mae and Freddie Mac have a specified housing mission, and that the potential for broader risks to our financial system is associated with their retained mortgage portfolios, a sensible approach is to ensure that the mortgage investment activities of these GSEs are necessary to accomplish their housing mission. To address these issues, 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 should establish a clear and transparent process based on direction from Congress on how the new regulatory agency will evaluate the retained mortgage portfolios in terms of risk and consistency with mission. Section 113 of H.R. 1427 largely accomplishes this goal for Fannie Mae and Freddie Mac. 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 would also be appropriate.

In terms of the new regulator's authority or other changes related to the unique characteristics of the housing GSEs, other appropriate elements of housing GSE regulatory reform should include:

- Government-Appointed Directors – Treasury supports clarification that the 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 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 further clarify that the housing GSEs are not backed by the Federal government.

- Combining the Regulatory Authority of the Housing GSEs – Treasury continues to believe that the FHLBanks should be placed under the same regulator with Fannie Mae and Freddie Mac, and that this new regulatory regime should be structured to take into account certain special differences between the Federal Home Loan Banks 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. In other words, the potential for regulatory capture should be reduced. Title II of H.R. 1427 largely accomplishes this goal.

Conclusion

In conclusion, we at Treasury appreciate the efforts of the Chairman and Members of the Committee in working toward achieving resolution of the housing GSE regulatory reform issue. H.R. 1427 will establish a new regulator with powers that are comparable to other financial institution regulators, which will greatly improve the oversight of the housing GSEs. We still have strong concerns with certain aspects of H.R. 1427. In particular, if an Affordable Housing Fund is going to part of this legislation, the Fund must be: controlled by the Federal government not by Fannie Mae and Freddie Mac; temporary; and capped. In addition, the provision increasing the conforming loan limit in high cost areas is inappropriate because there do not appear to be problems in the provision of mortgage credit in these areas, and it could detract from the affordable housing efforts of Fannie Mae and Freddie Mac. Nonetheless, Treasury is supportive of the regulatory enhancements contained in this legislation as they are a significant improvement over current law. Any efforts to limit these powers or weaken the new regulator will not be viewed favorably.

We look forward to continuing to work with you on this important issue. Thank you.