

Testimony of
America's Community Bankers
on
Regulation of Fannie Mae, Freddie Mac
and the
Federal Home Loan Bank System
before the
Committee on Banking, Housing & Urban Affairs
of the
U.S. Senate
on
October 23, 2003

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Mr. Chairman and Members of the Committee, my name is John D. Koch, Executive Vice President and Chief Credit and Lending Officer of Charter One Bank, NA in Cleveland, Ohio. I am also a member of the board of America's Community Bankers and chairman of its GSE Policy Committee. ACB appreciates this opportunity to testify on proposals to improve the regulation of the housing-related government sponsored enterprises, Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. 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. They are actively involved in the secondary market through Fannie Mae and Freddie Mac and other secondary market participants. Charter One services over \$15 billion in home mortgages for Fannie Mae and Freddie Mac. ACB members are also substantial stockholders in and borrowers from the FHLBanks.

ACB has long supported the traditional role Fannie Mae and Freddie Mac 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.

Similarly, ACB members depend tremendously on the advances provided by the FHLBanks. Our bank's FHLBank advances total nearly \$10 billion. These advances make it possible for community banks to make sound home loans that may not conform to the strict criteria of the secondary market. FHLBank advances also provide an alternative funding source for

community banks that choose to keep loans they originate – whether conforming or not – in their own portfolios.

In addition, ACB members own more than half of the stock issued by FHLBanks and hold significant amounts of mortgage backed securities and other debt issued by Fannie Mae, Freddie Mac, and the FHLBanks. Charter One's investment in FHLBank stock totals \$700 million, by far our largest single investment.

Clearly, the continued financial health of all of these entities is critical to Charter One and other ACB members and their communities. Therefore, ACB strongly supports this Committee's effort to improve the regulatory system for the GSEs.

Scope of the Agency

The Administration has recommended that Congress establish a new agency that would regulate all of the housing GSEs. ACB agrees with the Administration that the regulatory structure for these entities should be substantially improved and supports proposals to create a new independent regulator for FHLBanks that is housed inside Treasury. However, ACB recognizes that we are involved in a fluid and dynamic legislative situation. For example, the Treasury Department has raised concerns about the establishment of a new independent agency within the Department. ACB differs with Treasury on this issue. As we emphasize later in our testimony, it is essential that the new regulator be independent. Therefore, as an alternative way to address

Treasury's concerns, ACB would support formation of a new, independent regulator as a stand-alone agency.

ACB continues to prefer a separate regulator for the FHLBanks. Nevertheless, ACB strongly supports an amendment drafted by Representatives Royce, Maloney, and Leach that would merge the Office of Federal Housing Enterprise Oversight and the Federal Housing Finance Board into a new, independent, and fully funded Treasury agency. We recommend that you strongly consider taking a similar approach in your legislation.

The Royce amendment recognizes the differences between the FHLBanks and Fannie Mae and Freddie Mac by establishing two deputy directors and maintaining separate funding for the costs of regulation. Under the amendment, the new agency would administer the unique statutory arrangements that apply to the FHLBanks and Fannie Mae/Freddie Mac.

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 to 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.

ACB recognizes that the Finance Board has increased its commitment to safety and soundness regulation. However, we believe there is substantial room for improvement and change in the regulation of the FHLBank System. A merged agency would avoid a perception that any of

these government-sponsored entities are subject to more effective regulation than any of the others. We 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.

While dealing with concerns common to all of the entities, 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 continue to respect those differences, while advancing the common goal – to maintain their financial safety and soundness.

Agency Structure, Funding, and Independence

The Administration recommends that Congress eliminate OFHEO and the Finance Board and move their functions into an independent agency housed in the Department of the Treasury. This structure works for two key regulators, the Comptroller of the Currency and the Office of Thrift Supervision. A key element behind each agency's success is their high degree of independence from the Treasury, which insulates them from concerns about political influence.

Additionally, 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. It is important that the final 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 Fannie Mae, Freddie Mac, and the FHLBanks. 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 good 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

The Finance Board has authority over all aspects of the FHLBanks: ensuring safety and soundness and also that they carry out their statutory housing finance mission. The Royce amendment would continue this approach under the new agency.

ACB strongly endorses the Administration's position that the new agency should have similar authority to ensure that Fannie Mae and Freddie Mac are also carrying out their secondary market mission. This 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 informed and 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 makes clear that HUD would retain its mission authority to set affordable housing goals for Fannie Mae and Freddie Mac. As Secretary Mel Martinez testified,

HUD would actually gain new regulatory clout to enforce those goals. However, ACB does not support the Administration recommendation that HUD be authorized to set new sub goals. Sub-goals, while perhaps assuring a certain result, may lead to GSE purchase behaviors with unexpected and potentially undesirable consequences.

Some housing advocates have expressed concern that, if HUD does not retain all mission and program oversight over Fannie Mae and Freddie Mac, their commitment to housing, particularly low- and moderate-income housing will suffer. However, Secretary Martinez testified in strong support of the Administration's proposal to shift these responsibilities, other than affordable housing goals, to the Treasury. 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. In fact, we believe Fannie Mae and Freddie Mac must continue to be challenged to increase homeownership by minority families. 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 for Fannie Mae and Freddie Mac, there should be no limit on its ability to adjust 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 adjust all capital requirements as necessary, subject to rulemaking.

The Finance Board already has this authority with respect to the FHLBanks. The Royce amendment would maintain the new agency's authority to adjust the FHLBanks' capital requirements. The new regulator should respect genuine differences between the FHLBanks and Fannie Mae/Freddie Mac – including their very different capital structures. However, a regulator's ability to adjust capital levels is fundamental and must apply to all of the regulated entities.

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 or disparate 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 direct investment in mortgages.

Enforcement Authority

The Administration recommends that the new agency be given enforcement authority comparable to that of the banking agencies. ACB supports this point of view. However, we recommend that Congress carefully examine the current enforcement authority for OFHEO and the Finance Board to determine exactly which additional powers are needed and which banking agency provisions are not appropriate to deal with the unique features of the housing GSEs.

Conclusion

I wish to again express ACB's appreciation for this opportunity 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.