



Testimony Of
James R. Rayburn
On Behalf Of the
National Association of Home Builders
Before the
United States Senate Committee on Banking,
Housing and Urban Affairs
On
Government-Sponsored Enterprises
Regulatory Reform
February 10, 2004

Introduction

The 215,000 members of the National Association of Home Builders (NAHB) appreciate the opportunity to present their views to the Senate Committee on Banking, Housing and Urban Affairs on the regulatory framework for Fannie Mae, Freddie Mac and the Federal Home Loan Bank (FHLBank) System, including safety and soundness oversight, new program approval and the establishment and enforcement of affordable housing goals. These housing-related government-sponsored enterprises (GSEs) are critical components of the nation's housing finance system and are largely responsible for the efficiency and resiliency of that system, as reflected in the tremendous advances recorded in the availability and affordability of mortgage products for home buyers and providers of rental housing. The success and value of our housing finance system has been clearly evident in recent years, as the housing sector sustained economic performance while other areas of the economy faltered.

Considering the complexity of the housing finance marketplace and the risks at stake, the task of restructuring the regulatory framework of the housing-related GSEs is a daunting one. However, NAHB believes that two governing principles should guide the debate. First, the regulatory framework for the GSEs must be credible and effective to ensure these organizations fulfill their mission in a safe and sound manner. Second, the public/private partnership of the housing finance system is sacrosanct; any other changes to the current system should not disrupt the efficient operation of the mortgage markets and the impediments to the development of effective programs to address the nation's housing needs. With these concepts as a foundation, NAHB offers the following recommendations.

NAHB maintains its previously asserted position that the Department of Housing and Urban Development (HUD) is the appropriate agency to regulate the mission of Fannie Mae and Freddie Mac, including approving new programs and establishing and enforcing affordable housing goals. However, if Congress chooses to explore the option of creating an independent regulator with oversight for all the housing-related GSEs, we implore Congress to ensure that the regulator has a thorough understanding of and extensive involvement in housing-related issues. We do not believe that the Department of Treasury, which is well suited as a safety and soundness regulator, has sufficient expertise and involvement in housing issues to serve as a housing-related GSE program regulator.

Background

Housing and the Economy

The housing market has been an engine of growth in recent years, sustaining the economy during a difficult stretch. That performance continued in 2003, with new home sales reaching a record performance of more than a million closings. Single-family home construction has been robust and totaled 1.5 million units in 2003. Multifamily activity has been more subdued, but still posted a respectable showing, pushing total housing starts above the lofty 1.8 million units threshold.

While low interest rates and favorable demographics have spurred demand, these results would not have been possible without the support of the finance system for housing. The bedrock of that system is a liquid and vibrant secondary market that is the product of the activities of Fannie Mae, Freddie Mac and the FHLBank System. These enterprises have not

only contributed to the affordability of housing credit, but also have taken the lead in expanding the menu of affordable housing programs and products.

GSEs and Housing Finance

The housing-related GSEs are American success stories. As mentioned above, they have brought enormous benefits to home buyers, renters and the housing finance system. These include:

Reduction of mortgage interest rates -- The impact of the housing-related GSEs on mortgage borrowing costs is well documented. Home buyers with conforming loans -- mortgages eligible for purchase by Fannie Mae and Freddie Mac, those up to \$333,700 for one-unit properties -- pay mortgage rates that are approximately 25 to 50 basis points lower than rates paid by other conventional mortgage borrowers. The FHLBanks have done their share by passing through their advantageous borrowing rates for use in member loan programs. Further rate reductions are provided through the subsidies of the FHLBank System's Affordable Housing Program (AHP) and the Community Investment Program (CIP).

Reliable and stable flow of mortgage credit -- The linkage that the GSEs provide to the national and international capital markets sustains the flow of capital to housing, even under changing economic conditions. While the economy has undergone major shocks over the past decade, home buyers have experienced no interruption in the availability of mortgage credit.

Elimination of regional disparities in interest rates -- The GSEs provide a nationwide market for mortgage funds, a key factor in the elimination of regional disparities in the availability and cost of mortgage credit, which occurred regularly before the housing-related GSEs came on the scene. Today, interest rates in mortgage markets around the country vary by no more than 10 basis points.

Cushion against local economic downturns -- When regional economies begin to slow, some participants in the mortgage industry have restricted credit or abandoned markets in search of opportunities elsewhere. This is not the practice of the GSEs. They maintain a presence in all markets under all economic conditions, cushioning the impact of local or regional declines in economic activity.

Market standardization and innovation -- The GSEs have brought innovation to the mortgage markets to address a broad range of borrower and investor preferences. For example, Fannie Mae and Freddie Mac have established reduced downpayment programs to help cash-strapped first-time home buyers. Recently developed mortgage products to assist borrowers with tarnished credit histories further exemplify the extent to which Fannie Mae and Freddie Mac employ novel approaches to respond to consumer credit needs. The FHLBanks also stand out in this area by virtue of the programs that are stimulated and supported by the AHP and the CIP.

Expansion of homeownership and rental housing opportunities -- The housing GSEs have made significant strides in expanding homeownership opportunities and increasing the

supply of affordable rental housing in underserved areas. The housing goals enacted by the 1992 GSE Act have successfully encouraged both Fannie Mae and Freddie Mac to significantly increase their service to the market sectors targeted by the housing goals. The supply of affordable housing is further augmented by the 12 FHLBanks; each contributes at least 10 percent of its annual net earnings to its statutorily prescribed Affordable Housing Program to subsidize the cost of housing for very low-income and low- or moderate-income households.

Context for GSE Oversight Evaluation

NAHB believes that debate and discussion on the future of GSE regulation should begin by reflecting on how and why these entities came to exist. The genesis of all three housing-related GSEs can be traced to Congress' recognition of the strong public policy benefits of housing and homeownership opportunities. Fannie Mae, Freddie Mac and the FHLBank System were chartered to provide liquidity and stability for the nation's housing finance system. The decision by Congress to confer the sponsorship of the United States Government on these entities was not a superficial one. Undoubtedly, Congress realized that no private corporation would assume the risks or expend the resources to undertake an objective of this magnitude. Moreover, it would be unlikely that any particular entity would have the credibility to attract the appropriate blend of borrowers and investors. Rather, Congress was keenly aware that in order for an enterprise to overcome such obstacles it would need the imprimatur of the United States Government. It is this well-forged public/private alliance that makes this nation's housing finance system the model, if not the envy, of the world.

As mentioned above, housing is a significant financial element in today's economy, not just in a macroeconomic sense, but also in terms of every homeowner's portfolio. The remarkable growth of Fannie Mae, Freddie Mac and the FHLBank System has been raised by others as a point of discussion and concern. NAHB suggests that the performance of these entities should be evaluated within the context of the growth of the housing finance sector and its impact on consumers, investors and the economy at large. From this perspective their growth can be viewed in a positive light.

NAHB believes it would be a tremendous mistake to turn discussion on GSE regulation into a referendum of our highly successful housing finance system. Attempts to alter the government's sponsorship of Fannie Mae, Freddie Mac or the FHLBanks arguably contradicts Congress' intent, and most definitely would destroy the foundation upon which the system rests.

The key to the GSEs' success is their steadfast focus on their mission. They are in one business, housing finance – a relatively low-risk endeavor. This narrow focus should be recognized in the discussion of any future regulatory framework. The GSEs are not banks operating in far-flung and highly risky product lines and markets and should not be regulated as such.

Even the staunchest advocates of GSE regulatory reform would agree that there is no imminent crisis in the GSE system. Therefore, NAHB urges a careful and thoughtful approach on GSE regulation. NAHB is certain that such a course will produce tremendous rewards to those with most at stake in the process – America's homeowners and renters.

Guiding Principles for GSE Oversight

Since the GSE regulatory reform debate began in earnest last year, there has been no shortage of recommendations on a wide range of elements that many policymakers believe would enhance the stature of the regulatory system for Fannie Mae, Freddie Mac and the FHLBank System. NAHB notes that most of the recommendations focus primarily on enhancing the power of the regulator to impose restrictions on the GSEs. Such proposals often make no reference to the responsibility of the regulator to ensure that the GSEs fulfill their congressionally mandated purpose. Furthermore, others have recommended simply transferring the oversight from one agency to another without establishing a logical nexus between the expertise of the regulator and the mission of the entities to be regulated. NAHB urges this committee to take a more rational approach by first establishing a foundation of core principles on which to build a solid regulatory framework. As direct participants in the production of housing and related activities, NAHB offers the committee the following set of core principles:

1. The GSE status of these institutions must be maintained. Efforts to privatize, withdraw any of the federal privileges and legal exemptions, or otherwise diminish the ability of the GSEs to provide housing financing at the lowest possible cost should be opposed.
2. The GSEs should fulfill their public mission by conducting activities authorized by their charters in a safe and sound manner and by promoting access to mortgage credit to address the needs of affordable housing throughout the nation.

3. The regulatory framework of the GSEs should be strong and credible, possess adequate authority and resources and reflect the differences inherent in the charters and operating structures of the GSEs. Further, the regulatory framework should foster competition among the GSEs to develop and implement innovative, low-cost funding and other programs to meet the nation's housing credit needs.
4. The mission oversight of Fannie Mae and Freddie Mac (including approval of new programs and enforcement of affordable housing goals) should be conducted by the Department of Housing and Urban Development or another entity with a thorough understanding of and extensive involvement in housing-related issues.
5. The safety and soundness oversight of Fannie Mae and Freddie Mac should be conducted by an independent regulatory agency through rigorous examinations, enforcement of regulations (including capital standards) and transparency, without unnecessarily impairing the ability of these GSEs to accomplish their mission.
6. The recently implemented risk-based capital standards for Fannie Mae and Freddie Mac should be allowed to remain in place for a period of time sufficient to evaluate the effectiveness of the new standards.
7. The regulation of the mission and safety and soundness of the Federal Home Loan Bank System should reflect the uniqueness of the System's mission, cooperative operating structure, charter type, and other characteristics. This is best accomplished by having a

regulator dedicated solely to FHLBank System oversight or by having a separate FHLBank System oversight division if a single agency regulates all of the housing GSEs.

Current GSE Regulatory Framework

Fannie Mae and Freddie Mac

The 1992 GSE Act established a dual regulatory oversight structure for Fannie Mae and Freddie Mac. HUD is the programmatic (or mission) regulator and the Office of Federal Housing Enterprise Oversight (OFHEO) is the safety and soundness regulator.

The 1992 GSE Act requires Fannie Mae and Freddie Mac to obtain prior approval by HUD of any new mortgage programs. The Act defines new programs as any programs that are significantly different from programs previously approved or engaged in prior to 1992. HUD is required to review new programs to ensure that they are consistent with the GSEs' charters and are in the public interest. In addition, Fannie Mae and Freddie Mac are required by law to meet annual housing goals established by HUD.

Finally, the 1992 GSE Act established OFHEO as an independent office within HUD to oversee the safety and soundness of Fannie Mae and Freddie Mac. OFHEO's primary responsibilities are to establish and enforce capital standards for Fannie Mae and Freddie Mac and to conduct annual on-site examinations of the firms to ensure that they are operating in a safe and sound manner. Fannie Mae and Freddie Mac are required to meet two capital standards, a minimum leverage ratio and a risk-based capital (RBC) standard.

Federal Home Loan Bank System

The FHLBank System was created by Congress in 1932 by the Federal Home Loan Bank Act. The Federal Housing Finance Board (Finance Board) is the FHLBank System's regulator. An independent agency, the Finance Board regulates both mission and financial safety and soundness. The FHLBanks are required to comply with both a leverage and a RBC capital requirement. The FHLBanks are also required by law to contribute a percentage of their net earnings each year to fund affordable housing programs.

Administration's Proposal

The Bush Administration proposes to create a new federal agency within the Department of the Treasury (Treasury) to regulate and supervise the financial activities of Fannie Mae, Freddie Mac and the FHLBank System. The new agency would have general regulatory, supervisory and enforcement powers for GSE oversight, including the authority to establish, enforce and revise capital standards. Oversight of Fannie Mae's and Freddie Mac's existing activities and approval of new activities would be shifted from HUD to the new Treasury agency. HUD would be left with minimal regulatory authority, limited to oversight of the annual affordable housing goals and a consultative role in program oversight. The Administration's proposal makes no specific recommendations for how the new regulatory agency would accommodate the inherent differences between Fannie Mae, Freddie Mac and the FHLBank System. The Secretary of the Treasury would enforce policy accountability through review of the new agency's regulations, budget, and policy statements to the Congress. Importantly, the Administration does not recommend any changes in the GSEs' agency status.

NAHB Position on Key Elements

Several elements of the Administration's proposal are antithetical to the core principles of GSE oversight. At the very least, the Administration's proposal would raise the costs of housing and stifle innovation. At worst, the proposal has the potential to undermine the entire housing finance system.

Much of the debate surrounding the GSE regulatory restructuring has focused on the treatment of Fannie Mae and Freddie Mac. Indeed, most of the key elements of the Administration's proposal relate exclusively to these two GSEs. Other reform proposals have proposed including the Federal Home Loan Banks under the new GSE regulatory framework, either within the Treasury safety and soundness regulator or through the establishment of an independent regulator for all the housing GSEs. NAHB's comments and recommendations on key elements of these various proposals are discussed below.

Proposed Fannie Mae and Freddie Mac Regulatory Framework

Location of Program Oversight

Under the Administration's proposal, Treasury would assume not only safety and soundness duties but also most mission-related oversight duties. For example, HUD's current authority to approve new programs would be transferred to Treasury under the premise that new program approval is a safety and soundness issue rather than a mission-oversight issue. HUD would have a consulting role.

NAHB maintains that the program approval activities that are currently conducted by HUD should not be transferred to the Treasury Department. HUD is the preeminent regulatory authority on housing-related issues. Treasury has virtually no experience or expertise in evaluating the effectiveness and appropriateness of housing policies, especially those pertaining to housing for working families. Treasury presently has oversight for two important housing tax programs, low-income housing tax credits and mortgage revenue bonds. Operation of these programs is left to the states and HUD to set program specifics. Outside of these tax programs, Treasury has little experience or expertise in evaluating the effectiveness and appropriateness of housing policies.

The ability of Fannie Mae and Freddie Mac to spur innovative solutions and to develop new products that increase homeownership and rental housing opportunities will be jeopardized if the mission of these corporations is regulated by Treasury. This stifling of innovation would reduce the capacity of Fannie Mae and Freddie Mac to provide the liquidity and stability needed to keep mortgage credit available at the lowest possible cost to home owners and rental housing providers.

NAHB believes that Fannie Mae's and Freddie Mac's ability to spur innovative solutions and to develop new products that increase homeownership will continue only if the mission of these corporations is regulated by an agency which also has a housing mission, that would, as a consequence, contain a thorough understanding of and extensive involvement in housing-related issues. The only federal agency in existence now with sufficient housing mission orientation, experience, knowledge and focus is the Department of Housing and Urban Development. For

this reason, NAHB recommends that HUD should retain its current status as the mission regulator for Fannie Mae and Freddie Mac, including approving new programs and establishing annual affordable housing goals.

The legislative history of program oversight provisions clearly indicates that the objective and focus of program oversight is not safety and soundness, it is mission compliance. The 1968 Fannie Mae Charter Act, which reconstituted Fannie Mae as a government-sponsored private corporation, granted HUD general regulatory power to ensure Fannie Mae's compliance with its housing mission as specified in the charter. In 1970, HUD was vested with prior approval of all new Fannie Mae programs through the Emergency Home Finance Act, which also created Freddie Mac. HUD was granted regulatory oversight of Freddie Mac in 1989 through the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), which transferred this authority to HUD from the Federal Home Loan Bank Board. Finally, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the GSE Act) reaffirmed HUD as the program regulator of Fannie Mae and Freddie Mac and gave HUD the authority to establish, monitor and enforce affordable housing goals.

The legislative history reflects the recognition by Congress that program oversight is a function of mission regulation that must be conducted by an agency with a thorough understanding of and extensive involvement in housing-related issues. Indeed, during consideration of the 1992 GSE Act, Senate Banking Committee Chairman Riegle stated that "in order to properly coordinate national housing policy, ... regulations relating to the housing

missions of Fannie Mae and Freddie Mac should be issued only with the review of the HUD Secretary.”

HUD has proven itself to possess the capacity to adequately evaluate the potential benefits to housing from the GSEs’ innovation and advancement in products and to ensure that the GSEs do not stray from their statutory mission. However, NAHB believes that HUD’s program oversight could be strengthened through the establishment of an independently funded office within HUD. Having an office within HUD dedicated to mission oversight of Fannie and Freddie would be preferable to the current situation where GSE oversight is conducted through the Office of Housing with few dedicated staff and staff from other HUD offices are detailed on an ad hoc basis for GSE oversight duties. NAHB would support assessing Fannie Mae and Freddie Mac to fund the new HUD office.

Process of program approval

Under current law, Fannie Mae and Freddie Mac must submit a new program approval request to HUD if the initiative is “significantly different” from a program previously approved; is an activity in which the GSE had not engaged prior to passage of the 1992 GSE Act; or, represents an expansion in terms of dollar volume, number of mortgages or securities involved above limits expressly contained in any prior program approval. Further, if HUD believes an activity should be subject to prior approval, HUD may also request additional information or require a GSE to submit a program request. (Prior to one year after the effective date of the risk-based capital regulations, the GSEs were required to simultaneously submit new program requests to the Director of OFHEO. With the implementation of the RBC capital rule in

September 2002, OFHEO now has a consulting role, at HUD's discretion, in the evaluation of new programs.) HUD is required to approve any new program request unless it is not authorized by the GSEs' Charter Acts or is not in the public interest.

The Administration proposes to significantly expand what would have to be approved, to include any activity or product that differs significantly from current activities. Fannie Mae and Freddie Mac introduce a myriad of new activities and products each year. Submitting each of these to the approval process envisioned by the Administration would severely inhibit or delay the development and implementation of valuable new mortgage products and technological innovations. The housing-related GSEs require a program approval process that provides adequate flexibility to respond promptly to market needs, while empowering their regulator to ensure ongoing charter compliance and to assess safety and soundness.

The existing program approval requirements and process have served the housing market well by ensuring effective regulatory oversight and encouraging product innovation to fulfill the GSEs' housing mission. This is particularly true in the affordable housing area where both GSEs have introduced products and services to expand homeownership opportunities for low-and moderate- (low/mod) income borrowers, renters and residents of areas underserved by the broader housing finance system. Technological innovations by the GSEs, such as their automated underwriting systems (AUS), also have contributed to their efforts to expand homeownership opportunities. In the affordable multifamily market, both GSEs have established forward commitment programs that support much-needed production of new units. Further, each

has developed partnerships and alliances at the national and local levels to expand affordable housing opportunities.

While NAHB strongly supports the current process, we believe that the process could be improved in three areas: (1) the scope of review; (2) safety and soundness considerations, and (3) the mechanics of the review process.

Scope of review should facilitate innovation. A delicate balance is required between a careful examination of whether a new GSE program serves its important public mission and the need to not over-burden these organizations' innovative efforts to provide new lending opportunities in the most difficult to serve communities. While there may be a need to improve the current approval process, NAHB urges Congress to proceed cautiously, and resist efforts to over-encumber this process.

The current process rightfully limits prior approval to new programs, which are defined as very broad undertakings unlike what is currently being done. The Administration proposes to significantly broaden what would have to be approved to include any new business activities. Submitting each new activity to the approval process envisioned by the Administration would result in such micromanagement of the GSEs' innovations that they would be unable to respond to changing market conditions in a timely fashion. The result would be to stifle or severely inhibit development and implementation of valuable new mortgage products and technological innovations that have helped to dramatically expand homeownership in the country.

The Administration asserts that their proposed new activity review would be the same model under which banks operate. A review of activity approval for banks and their financial subsidiaries indicates that this is not the case. Banks are not subject to an activity by activity review as envisioned by the Administration. They have wide latitude to engage in any activity enumerated in the National Bank Act. Banks also are permitted to conduct activities that are incidental to those enumerated.

There are no specific statutory or regulatory requirements for national banks to notify or seek OCC approval prior to engaging in a new business activity. However, banks often seek preliminary determinations from the OCC if an activity does not have a readily apparent nexus to an activity listed in the National Bank Act. Issues relating to new and ongoing activities are also addressed during the bank examination process.

Similarly, financial subsidiaries of national banks also have expansive latitude to engage in a wide range of statutorily enumerated activities without prior approval. Under the Gramm-Leach-Bliley (GLB) Act financial subsidiaries may engage in activities that are “financial in nature”. The act provides a preliminary list of such activities and authorizes the list to be expanded by the Treasury Department in coordination with the Federal Reserve. If a bank wishes to engage in one of the enumerated new activities through a financial subsidiary, it must provide a notice to the OCC within five days before engaging in a new activity. The only prior approval notice added in the GLB Act is for activities not listed in the statute when the company is seeking the Treasury and Fed to authorize such activities.

Safety and soundness considerations should accompany, not dominate program approval decisions. The present program approval structure strikes an appropriate balance between mission and safety and soundness oversight. Safety and soundness are not criteria for new program approval. Indeed, the Treasury Department reached the same conclusion in its 1990 study on the GSEs. Treasury stated,

“the regulatory authority which monitors a GSE’s fulfillment of its Congressional mandate should be different from the entity implementing financial safety and soundness standards. Separating these two regulatory functions will remove risks to the taxpayers by removing a perceived conflict of interest [emphasis added]. ... The Treasury recommends that the current program regulator continue to be responsible for ensuring that the GSE meets its Congressional mandate by effectively serving its intended beneficiaries.” Report of the Secretary of the Treasury on Government-Sponsored Enterprises, May 31, 1990.

It is interesting that the Administration now views program approval as a function of safety and soundness oversight to be overseen by the Treasury. As discussed above, NAHB believes Treasury is the wrong place to put program approval. Treasury lacks experience in and knowledge of housing.

This is not to say that safety and soundness should not be a consideration in new program review. NAHB believes that safety and soundness is one of the many elements that should be

evaluated during the new program approval process, but maintains it should not be the paramount consideration as the Administration has proposed.

Reviewing new programs solely on the basis of safety and soundness would severely retard the development of programs needed by Fannie Mae and Freddie Mac to fulfill their housing mission. It will stifle innovation necessary to provide liquidity to the housing credit markets, particularly in areas that otherwise would not be adequately served. Such activities, by definition, involve higher risk and would be greatly constrained if program approval is solely a component and function of safety and soundness regulation.

The safety and soundness regulator should have a consultative role in program review, not the final decision. Some criteria that the safety and soundness regulator should consider are:

- Risk assessment: Does the new program pose undue risks to the enterprise or the housing finance system generally?
- Risk management: Does the enterprise have the expertise, resources and programs in place to effectively manage the interest rate, credit or other risks associated with the new program?
- Capital adequacy: Does the enterprise have present or reasonably anticipated reserves to compensate for the risks involved?

Further, we note that the risks of new activities are accounted for in the risk-based capital model, which ensures that the GSEs have adequate reserves to cover the risks of new programs.

Program review process should be clarified with specific criteria. Presently, HUD has 45 days to review a new program request, with one 15 day extension. As noted, HUD is required to approve a new program request unless it is not in compliance with the GSEs' Charter Acts or is not in the public interest. The present process is vague on the content of the application request and the criteria for approval. NAHB supports retention of the current timeframes for approval of new program requests and offers the following suggestions for application content and review criteria.

New Program Request Application Content:

- Citation to the statutory, regulatory or other legal authority;
- Estimate of the anticipated dollar volume of the program (short- and long-term);
- Full description of proposed program, including: purpose and operation; target market; delivery system; and effect of the activity on the housing market, broadly, and/or ability to meet affordable housing goals; and,
- Assessment of the risks associated with the activity, and a demonstration of the enterprise's ability to manage those risks.

Review Criteria:

- Charter compliance: Is the program consistent with the enterprise's charter and other relevant statutory and regulatory authority, and does the new program support the mission of the enterprise?
- Public interest: Is the new program in the public interest? Does it support or help to fulfill an important housing-related objective?
- Innovation: Does the new program foster innovation in the availability or delivery of housing-related financial services?
- Risk Assessment: Must consult with and consider risk assessment by safety and soundness regulator.

Extent and Control of Fannie Mae and Freddie Mac Affordable Housing Goals

The current statute contains three specific goals that are intended to push Fannie Mae and Freddie Mac further into housing finance products and markets than they may otherwise go. HUD sets the specific levels of business they must achieve. HUD has steadily increased the levels and the GSEs have achieved them.

NAHB has always been a strong supporter of the affordable housing goals for Fannie Mae and Freddie Mac since HUD was granted this authority by the 1992 GSE Act. The housing goals establish percent of business purchase goals for three categories: low- and moderate-income, underserved areas and special affordable. The first set of goals was established by regulation in 1995, and was updated in 2000 to cover the years 2001-2003. Current goals levels,

as a percent of annual purchases, are: 50% for low-mod; 31% for underserved areas; and, 20% for special affordable

Both GSEs have consistently exceeded all of the housing goals since the initial goals were established in 1995. The goals have encouraged Fannie Mae and Freddie Mac to reach deeper into the affordable housing market with tangible benefits. The GSEs financing of housing for low-and-moderate-income families has increased from under 30 percent of their purchases in 1992 (prior to passage of the GSE Act) to over 51 percent in 2002.

The Administration is proposing to strengthen HUD's housing goals authority over Fannie Mae and Freddie Mac. As the HUD Secretary outlined in his October 16, 2003 testimony before this Committee, this will include the creation of a new GSE office within HUD, independently funded by the GSEs, to establish, maintain and enforce housing goals. HUD would be granted new administrative authority to enforce housing goals, enhanced civil penalties for failure to meet the goals, and expanded authority to set housing goals and sub-goals beyond the three currently established. The President's proposed budget for Fiscal Year 2005 also calls for adding a new goal to promote affordable housing homeownership.

For the same reason that NAHB supports HUD as Fannie Mae's and Freddie Mac's mission regulator, NAHB supports HUD as the regulator for the GSEs' housing goals. We agree with the HUD Secretary that "HUD is the appropriate agency to develop and enforce housing goals. Institutionally, [HUD's] mission is devoted to furthering the goal of affordable housing and homeownership and HUD has the most expertise in this area." Indeed, NAHB believes that

housing goals authority is one of HUD's key functions as mission regulator for Fannie Mae and Freddie Mac.

NAHB also agrees that more needs to be done to encourage the GSEs to increase their activities in some market segments. However, we do not believe that adding additional goals or sub-goals, as the Administration has proposed, is the best way this could be accomplished. Fannie Mae and Freddie Mac were created to serve a broad range of housing needs and we would not want overly stringent or complex goals to impede that mission. Continual increases in the percentage targets will have diminishing returns and run the risk of adversely impacting other housing programs, such as FHA's single family program.

NAHB believes that a better way to encourage increased GSE activity in underserved markets is through bonus point incentives within the existing goals system. HUD's 2000 goals rule, which established goals for 2001-2003, also provided for bonus points during this period for units financed for GSE mortgage purchases in small (5-50 unit) multifamily properties and for units in 2- to 4-unit owner-occupied units. These units are key sources of affordable housing for large numbers of low- and moderate-income households, first-time homebuyers and minorities. One-third of the rented homes are in buildings with 5 to 50 units and minority renters are more likely to be the occupant than are white residents. The bonus point system ended on December 31, 2003, when HUD chose not to extend it beyond the effective termination date.

NAHB is a strong supporter of the bonus points system as a flexible means to provide incentives for the GSEs to increase activity in targeted markets and we adamantly oppose HUD's

decision to terminate the bonus points. The bonus points were an integral component of the current goals structure and they served their intended purpose as both Fannie Mae and Freddie Mac increased their purchases of bonus-related mortgages. For example, Fannie Mae's purchases of small multifamily (5-50) properties as a percentage of their total multifamily purchases more than doubled from 1.7 percent in 1997 to 4 percent in 2002. Similarly, Freddie Mac's purchases increased from 3 percent in 1997 to 6.5 percent in 2002.

NAHB is concerned that the elimination of the bonus points incentive will disrupt the progress that has been made in these markets as the GSEs focus on larger multifamily properties which are more "goals-rich" in order to meet their overall housing goals. More work remains to be done in the small multifamily market, especially in rural areas and urban infill locations that are part of community revitalization efforts.

As we have stated, NAHB believes bonus points are a very effective tool for focusing GSE affordable housing efforts on areas of greatest need. NAHB urges this Committee to instruct HUD to reinstate the bonus points for small multifamily properties. We also recommend that bonus points for loans on small multifamily projects, rural homes and newly built homes be included in statutory provisions for affordable housing goals under any new GSE regulatory regime.

Finally, NAHB suggests that consideration should be given to the statutory factors HUD must consider in setting the housing goals. The 1992 GSE Act requires HUD to consider the following six factors in establishing the goals:

1. national housing needs;
2. economic, housing and demographic conditions;
3. performance and effort of the GSEs toward achieving the goal in previous years;
4. size of the conventional mortgage market serving the targeted population or areas, relative to the size of the overall conventional market;
5. ability of the GSEs to lead the industry in making mortgage credit available for the targeted population or areas; and,
6. the need to maintain the sound financial condition of the GSEs.

Of particular concern, is the requirement that the GSEs “lead the market” in reaching underserved populations. In evaluating this criterion, HUD includes markets in which the GSEs are unable to fully participate, such as manufactured housing loans and subprime loans. While NAHB does not dispute that the GSEs should be held accountable for their performance in these areas, NAHB believes that some allowances should be made for the fact that these markets are not readily available to them.

Safety and Soundness Regulator

NAHB supports strong and credible safety and soundness oversight for Fannie Mae and Freddie Mac. The purpose of safety and soundness regulation is to ensure that Fannie Mae and Freddie Mac are adequately capitalized for the mission-related programs they are operating, and that appropriate governance structures and procedures are in place to operate those programs in a safe and sound manner. The safety and soundness of Fannie Mae and Freddie Mac should be

ensured through rigorous examination, enforcement of capital standards and transparency, without unnecessarily impairing the ability of the GSEs to perform their housing mission. It is imperative that the safety and soundness functions be separate from mission regulation, specifically program oversight and housing goals. Safety and soundness regulation should not be a vehicle for disapproving programs so the enterprises undertake little or no risk.

As stated earlier, NAHB strongly disagrees with the position that the GSE safety and soundness regulator must have the primary role in approving new programs in order to adequately perform safety and soundness oversight. This argument is based on the assumption that the mission regulator would increase the riskiness of Fannie Mae's and Freddie Mac's operations by allowing them to expand into activities beyond the scope of their charters. As outlined above, charter compliance is a prerequisite for new program approval. NAHB supports a requirement that the mission regulator consult with the safety and soundness regulator during new program reviews. We also feel that the safety and soundness regulator should be empowered to prevent the GSEs from undertaking any new activity representing a threat to their ongoing viable operation. However, the focus of safety and soundness regulation and supervision should be on ensuring that Fannie Mae and Freddie Mac hold adequate capital in relation to the risk of the activities they are undertaking and that these enterprises have the appropriate staff, systems and management controls in place to operate the programs in a safe and sound manner.

Safety and soundness oversight of Fannie Mae and Freddie Mac presently resides with OFHEO, an independent office within HUD. Recent events with respect to Freddie Mac's and

Fannie Mae's accounting practices have led a number of observers to raise serious questions about OFHEO's ability to perform these regulatory functions. In light of these concerns, NAHB would support the transfer of safety and soundness oversight of Fannie Mae and Freddie Mac from OFHEO to another entity with greater capacity and resources, such as the Treasury Department. We recognize that Treasury is the premier financial institution regulator because of its expertise and experience with financial issues. However, as explained above, the authority of the office must be limited primarily to safety and soundness functions only because Treasury is not equipped to handle mission oversight of the GSEs.

Capital

NAHB has consistently supported the establishment and enforcement of appropriate capital standards for Fannie Mae and Freddie Mac. Pursuant to the 1992 GSE Act, Fannie Mae and Freddie Mac are required to meet two capital standards, a minimum leverage ratio and a risk-based capital (RBC) standard. The minimum leverage ratio is 2.5 percent of assets plus 0.45 percent of adjusted off-balance sheet obligations. By law, the RBC standard, is based on a stress test which calculates the amount of capital that Fannie Mae and Freddie Mac must hold to maintain positive capital over a 10-year period of adverse credit and interest rate conditions, plus an additional 30 percent of this capital level to cover management and operations risk. The firms must meet both the RBC and minimum capital standards to be classified as adequately capitalized. Failure to meet the capital standards would trigger enforcement actions ranging from limits on growth and activities to conservatorship.

Fannie Mae and Freddie Mac have consistently met their capital standards and thus have been classified as adequately capitalized. Prior to the implementation of the RBC standard, the firms were required to meet the minimum leverage ratio. The RBC standard became enforceable on September 13, 2002 after nearly 10 years of development. The RBC test is the first regulatory capital standard to be based on a stress test and has been hailed as the most dynamic and stringent capital standard for any financial institution.

The Administration proposes to provide the Treasury regulator greater flexibility in establishing the leverage and RBC requirements. However, in testimony before this committee last year, Treasury Secretary Snow mentioned the need for stability in capital standards and suggested that capital standards should not be subject to frequent change. NAHB agrees with this perspective and applauds Secretary Snow's decision not to recommend any changes in the statute dictating the GSEs' minimum and RBC requirements. Given that the current RBC standards took ten years to develop and have been in effect for only one year, we are pleased that the Treasury is willing to give the requirements a chance to work. NAHB recommends against any immediate changes in the GSEs' minimum capital standard as well.

Longer-term, NAHB agrees that the safety and soundness regulator should have the flexibility to adjust capital standards as necessary. However, NAHB cautions against any significant changes in the GSEs RBC standard or any significant increase in the GSEs minimum capital standard. Overcapitalization of the GSEs, beyond the level of risk, is not economically efficient and could have unintended consequences for the housing markets, by reducing the level of capital for housing and increasing mortgage rates.

NAHB would also oppose the imposition of bank-like capital standards for the GSEs as some have proposed. Congress rejected this notion and intentionally drafted a separate capital regime for Fannie Mae and Freddie Mac under the 1992 GSE Act. The present capital framework takes into account the unique nature of the GSEs business, that there are only two firms (as compared to thousands of banks) and they engage in a monoline business, focused on low-risk residential mortgages (unlike banks which engage in a wide range of activities). During the lengthy development process of the current RBC standard, OFHEO took great pains to ensure that the standard appropriately ties capital to risk. Bank regulators have recognized that bank capital standards do not tie capital to risk and are now engaged in a process to revise bank capital standards through the Basel II Accord.

Independence of Regulator

OFHEO currently operates independently of the cabinet agency where it resides (HUD). Other banking regulators within Treasury also operate with independence. For example, regulations, agency guidance and testimony emanating from the Office of Thrift Supervision (OTS) or the Office of the Comptroller of the Currency (OCC) are not subject to a mandatory approval requirement by Treasury. The Federal Housing Finance Board is an independent, stand-alone regulatory agency.

The Administration proposal requires Treasury approval of testimony and regulations from the regulator within Treasury. NAHB strongly believes that safety and soundness regulators should be objective, nonpartisan, and protected from political interference. This is especially

critical at times when regulators must make difficult and sometimes politically unpopular decisions. The primary responsibility of the regulator is to implement policy made by the Congress, and to do so in a safe and sound manner. NAHB strongly believes that a regulator lacking true independence may eventually find itself pursuing other agendas, not the will of Congress, nor what is demanded to assure safety and soundness.

Independent regulation also protects Congress' ability to receive the regulator's best judgment on regulatory matters unfiltered and without delay. With billions of dollars of potential taxpayer liability at stake, it is in everyone's interest that this important safeguard not be weakened. Therefore, NAHB believes that if a new agency is created within Treasury, it should have autonomy in the following key areas:

- Testimony. Congress should be able to count on receiving the agency's unadulterated views on all issues it faces.
- Rulemaking. The agency's policy justification for issuing regulations should be devoid of interference from politically appointed officials.
- Supervision and Examination. True safety and soundness cannot be attained without a strict separation between political appointees and supervisory and examination staff.
- Enforcement. The agency's enforcement actions must be unblemished by any extraneous influence.

Inclusion of the FHLBank System

The Administration has called for placing Fannie Mae, Freddie Mac and the FHLBanks under a single regulator. In fact, the President's proposed budget for Fiscal Year 2005 (FY 2005) includes provisions for transferring oversight of the Federal Home Loan Banks from the Federal Housing Finance Board to the same new office at Treasury that would regulate Fannie Mae and Freddie Mac. NAHB believes that it is Congress' responsibility to scrutinize the regulatory oversight of the housing GSEs, and to ensure that they provide the nation's network of community-based financial institutions with the safest, soundest source of residential mortgage and community development credit possible. While all three GSEs have much in common, NAHB believes it is important to both recognize and preserve the unique nature of the FHLBanks. For example, unlike Fannie Mae and Freddie Mac, the FHLBank 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 the three 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.

Funding of Regulator

President Bush's FY 2005 budget proposes to increase the amount of resources allocated to regulating the housing-related GSEs. The proposed budget earmarks \$83 million to establish a new office within Treasury. The budget also anticipates that HUD will incur approximately

\$6.25 million in the establishment and enforcement of affordable housing goals, ensuring GSE compliance with fair housing laws, and providing consultation to the safety and soundness regulator on new activities. The activities of the safety and soundness regulator would be funded through mandatory assessments on all of the GSEs; the mission oversight costs at HUD would be assessed on Fannie Mae and Freddie Mac.

NAHB believes that those who supervise and regulate the GSEs should possess adequate authority and resources. The housing-related GSEs are engaged in a myriad of complex financial transactions. It is crucial for the regulator to possess a high degree of experience, knowledge and familiarity with current accounting, risk-management and housing-related issues so that they are credible, confident and capable. Furthermore, NAHB believes that it is entirely reasonable for the GSEs to fund the responsibilities of their regulator.

Independent Regulatory Body

The idea of a stand-alone independent regulator has been floated as a compromise to break the current impasse among policymakers on the key issues of program oversight and political independence of the regulator. It is argued that a stand-alone agency would resolve concerns about independence of the regulator from Treasury, as well as Treasury's oversight of new programs. It might also ease concerns about including the FHLBanks in the new system since 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.

While not our first preference, NAHB would be open to exploring the concept of a new independent regulator for all three housing GSEs outside the Treasury Department, depending on

how key details are implemented. NAHB's primary concern in either regulatory scenario is that the mission regulator must have a housing focus and expertise and the safety and soundness regulator must have sufficient respect and authority to satisfy Congress and the capital markets.

In addition to the funding and political independence issues addressed in other sections of this testimony, NAHB notes that other preliminary characteristics to consider are the corporate structure of the agency, and how its managers will be selected. Given the diversity and complexity of supervisory issues the agency will address, NAHB initially recommends the agency be structured as a board of directors rather than a single agency head. In this scenario, NAHB suggests that a HUD representative should serve on the board in order to ensure that it possesses a housing-oriented focus and experience. NAHB also suggests that the board comprise stakeholders from various industry sectors. As mentioned above, it is imperative to recognize the differences between Fannie Mae, Freddie Mac and the FHLBanks. This could be effectuated by establishing two divisions and maintaining separate funding for the costs of regulation.

Conclusion

NAHB appreciates the opportunity to share our views on the regulatory framework for Fannie Mae, Freddie Mac and the Federal Home Loan Bank System. The critical supports provided by these housing government-sponsored enterprises (GSEs) were an essential component to the recent success of the housing market in sustaining the nation's economy. NAHB appreciates the Committee's efforts to assess and seek improvements to the regulatory framework of these GSEs. We look forward to working with the Committee as you progress

towards fashioning a narrow regulatory solution to the oversight of these important housing institutions.