

# **DEPARTMENT OF THE TREASURY**

## **OFFICE OF PUBLIC AFFAIRS**

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### **Testimony of Secretary John W. Snow Before the U.S. Senate Committee on Banking, Housing and Urban Affairs Proposals for Housing GSE Reform**

Thank you Chairman Shelby, Ranking Member Sarbanes, and members of the Committee for inviting me to appear before you today.

The United States has the broadest, deepest, most successful housing markets in the world, supported by an interdependent financial services infrastructure. That financial services infrastructure includes institutions such as federally insured depositories, mortgage banks, private mortgage insurers, and Wall Street investment banking firms. And a unique and prominent role in that infrastructure is performed by the housing government-sponsored enterprises (GSEs) – Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System (FHLB).

With the aid of these financial institutions, Americans have ready access to a wide array of mortgage finance options. Our national system of housing finance plays an important role in promoting home ownership – a key priority of this Administration. We have seen tremendous progress in increasing home ownership in America, which now stands at 69 percent. Secretary Jackson and I share the commitment made by the President to expand home ownership to 5.5 million more minority homeowners by the end of the decade.

Our national system of housing finance needs to remain strong and healthy so that it can continue to make mortgage credit available and provide financing opportunities for new homeowners. Secretary Jackson and I are here today to discuss reforms for the GSEs that will achieve these objectives. These reforms are intended to ensure greater regulatory oversight, enhanced market discipline, and appropriate capital requirements for the GSEs. As we consider these reforms, we are guided by two core objectives: the need for a sound and resilient financial system and increased opportunities for home ownership, especially for less advantaged Americans.

Secretary Jackson will describe in greater detail the role that the GSEs were created to perform, and the home ownership goals we have set forth for them. Allow me to state succinctly why the Administration is so committed to bring about real reform. The risks undertaken by the GSEs, if not properly managed,

may pose a threat to their solvency, the stability of other financial institutions and the strength of our economy.

## **Essential Elements of GSE Regulatory Reform**

In 2003, the Administration set forth what we consider to be essential elements for creating a new, stronger, more credible regulatory system for the GSEs. The Administration's position is that without these essential reforms, any new regulatory system would be little improved from the inadequate system we have today. In light of the recent events at the GSEs, the need for meaningful reform has become even more clear. Half-measures will only exacerbate the risks to our financial system.

As we outlined in detail in 2003, the regulator for the GSEs should have powers comparable in scope and force to those of other world-class financial supervisors and fully sufficient to carry out the agency's mandate. The regulator must have clear general regulatory, supervisory, and enforcement powers with respect to the GSEs. These powers must include the authority to set both minimum capital standards and risk-based capital standards; the power to assess the entities for independent funding outside of the appropriations process; and the ability to place a failed GSE in receivership. An effective receivership mechanism, similar to that held by other safety-and-soundness regulators, should help bring about critical market discipline to ward off the prospect of a GSE falling into significant financial distress. In addition, I wish to note the interplay between an effective FDIC-like receivership mechanism and the so-called line of credit that exists between the Treasury and the GSEs. As members of this Committee are aware, the Treasury Secretary has discretion to issue debt in the amount of \$2.25 billion to each of Fannie Mae and Freddie Mac and \$4 billion to the FHLBs. Some commentators believe that this credit availability reinforces the perception that the Federal government backs the debt obligations of the Enterprises. This perception is false. In fact, I would exercise the line of credit (which pales in comparison to the size of the debt obligations of the GSEs today) only in the event that a GSE was in significant financial distress and needed the capital to emerge successfully through the receivership process. Congress may wish to consider reforms in this area as well.

As I said in my testimony of September 10, 2003 before the House Committee on Financial Services, in order to address the unique mission of these enterprises as chartered by Congress, an effective regulator must have an integrated package of authorities. The package must empower the regulator to address problems that may arise (like those which we have witnessed in the last two years) before they cause damage to the financial system.

Another key power for the new regulator is the ability to review the activities of a regulated entity, whether they be new activities or those in which the regulated entity already participates. We need to strengthen the activity review process, including greater public participation through notice and comment rulemaking. Meaningful reform will also give greater clarity to the types of activities that fall within the GSEs' mission, thus ensuring that new and existing activities focus the GSEs on promoting housing opportunities. These tools should be a meaningful part of the oversight of the housing GSEs.

Events that have transpired since I testified before this Committee in 2003 reinforce concerns over the systemic risks posed by the GSEs and further highlight the need for real GSE reform to ensure that our housing finance system remains a strong and vibrant source of funding for expanding homeownership opportunities in America. The Administration remains troubled that neither Fannie Mae nor Freddie Mac has financial statements filed with the SEC that can be relied upon. Freddie Mac has yet to file any financial statements in conformity with the securities laws, and Fannie Mae is not expected to be able to issue financial restatements for many months or even years. We recognize some of the unique characteristics of the GSEs, but believe strongly that they, as well as the Federal Home Loan Banks, should be held to public reporting requirements with the SEC comparable to other large, complex public companies.

We believe that reform legislation must provide the regulator with the authority, tools, and guidance from Congress as to what is expected of the GSEs going forward. Consistent with the Administration's vision for strong and effective regulatory and market discipline, I would like to expand on some other key elements that are needed in order to adequately protect the stability of our housing markets, our financial system, and our overall economy. Most notably, I would like to describe the need to control the size and scope of the GSEs' investment portfolios.

### **Financial and Accounting Problems at the Housing GSEs**

The Administration's proposal in 2003 was presented against the background of serious financial and accounting problems at the housing GSEs, including the June 2003 Freddie Mac announcement that it would restate its 2000-2001 financial statements and further delay the release of its 2002 financial statements. Since the last time I appeared before you, the following events have transpired:

- OFHEO released a report of initial findings on Fannie Mae in September 2004 citing improper accounting procedures and practices, internal control deficiencies and questionable management oversight.
- The SEC concurred in the findings of inappropriate accounting practices, and directed Fannie Mae to restate its earnings for 2001-2003. Fannie Mae, then, estimated that it would be forced to recognize \$9 billion in losses.
- OFHEO concluded in December 2004 that Fannie Mae was "significantly undercapitalized" in the third quarter of 2004, and demanded that the minimum capital requirement be increased by 30 percent to ensure that the Enterprise strengthened its financial position.
- And just three weeks ago, Fannie Mae disclosed to the SEC that it could be forced to recognize an additional \$2.4 billion of losses, stating that it is unable to reasonably estimate the effect of these issues on reported results of operations.
- In 2004 the FHLBanks of Chicago and Seattle entered into written agreements with their regulator, the Federal Housing Finance Board (Finance Board), to implement changes to enhance their risk management, capital structure, governance and other practices and procedures. In March of 2005, ten FHLBanks implemented new risk-based and leverage requirements. The others are expected to comply soon.

These events demonstrate that the GSEs do not have reliable financial controls to manage their operations risk. Such failures in controls, particularly in such highly leveraged institutions, jeopardizes not only the GSEs' safety and soundness, but also poses risks to the entire financial system.

### **Limitations on the GSEs' Debt-Financed Portfolio Investments**

As additional financial and accounting problems have surfaced with the GSEs, and as the Administration has continued to evaluate the overall structure of the GSEs' operations in relation to their mission, we believe that meaningful reform of the regulatory structure of the GSEs must include mechanisms to protect our broader financial markets from unnecessary risks. More than six out of ten institutions in the banking industry hold as assets GSE debt in excess of 50 percent of their capital. We share the view expressed by Chairman Greenspan and others that the sheer size of the mortgage-based investment portfolios of the GSEs has grown well beyond anything needed in carrying out their housing mission. As Chairman Greenspan has stated:

"... these institutions, if they continue to grow, continue to have the low capital that they have, continue to engage in the dynamic hedging of their portfolios, which they need to do for interest rate risk aversion, ... create ever growing potential risks down the road."

Fannie Mae and Freddie Mac operate two independent main business lines today: (1) a credit guarantee business associated with securitizing mortgages; and (2) a portfolio investment business that involves

purchasing mortgages and various mortgage-related securities (including their own mortgage-backed securities) and non-mission related assets. The first of these—the guarantee and securitization of mortgages—is integral to the operation of an effective secondary market for mortgages. The business of investing and holding an investment portfolio of mortgages and other higher-risk assets for its own proprietary trading account and inventory, however, has a much more tenuous connection to the housing mission of the GSEs.

Freddie Mac and Fannie Mae, as we know them, were largely a product of the turbulent financial period of the late 1960s and early 1970s. One of the primary goals of creating Fannie Mae and Freddie Mac was “... to provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing.” Initially, Fannie Mae provided this assistance primarily by buying mortgages while Freddie Mac concentrated on securitizing mortgages, a pattern that continued throughout the 1980s.

Since 1990, however, the mortgage portfolio business of both of the housing GSEs has grown rapidly, much to the financial benefit of the Enterprises' management and shareholders. From 1990 through 2003, Fannie Mae's mortgage investments increased from \$114 billion to \$902 billion, and the ratio of mortgage investments to outstanding guaranteed mortgage-backed securities increased from 40 percent to 69 percent. Freddie Mac's growth in mortgage investments was even more dramatic. From 1990 through 2003, Freddie Mac's mortgage investments increased from \$22 billion to \$660 billion, and the ratio of mortgage investments to outstanding guaranteed mortgage-backed securities increased from 7 percent to 88 percent.

In general, the risks of the mortgage investment business are more complex to manage than the risks of the credit guarantee business. For example, with the rising interest rates in the early 1980s, Fannie Mae's cost of funds rose above the interest rate it was earning on its long-term, fixed-rate mortgages. This interest rate mismatch was similar to that faced by the savings and loan industry, and Fannie Mae became insolvent on a mark-to-market basis. Only a combination of legislative tax relief, regulatory forbearance, and a decline in interest rates allowed Fannie Mae to grow out of its problem.

The mortgage investment portfolio of the housing GSEs has grown rapidly, beginning in the 1990s, motivated by high profit margins and made possible by a substantial debt funding advantage. This funding advantage arises because markets incorrectly assume that the Federal government provides some form of guarantee to GSE debt. This rapid growth has created a new dimension of risk, one that not only involves our national system of housing finance, but the potential for systemic risk to financial markets in general. The potential for systemic risk is associated with Fannie Mae's and Freddie Mac's large portfolios of mortgages and mortgage-backed securities and other non-related assets, funded at extremely high rates of leverage. The GSEs hold less than one-half the capital of similarly sized financial institutions. The value of these large portfolios can fall dramatically when interest rates change because individuals can prepay their mortgages.

Some of this risk can be hedged through the use of derivatives and other risk transfer mechanisms. Nevertheless, the risk does not disappear altogether, and in the event of an unforeseen problem, the GSEs might not have the funds to pay off their debtholders, which could lead to ripple effects throughout our entire financial system. For example, GSE debt is widely held by banks, so that if this debt declined in value, some banks could find their solvency endangered. Concerns about the GSEs' hedging strategies are reinforced by the regulatory enforcement actions of recent months. Neither Fannie Mae nor Freddie Mac has been able to put forth fair and accurate financial statements. Given this lack of accurate and reliable information, Congress and the Administration are correct in worrying whether the risks that have been undertaken by the GSEs are properly understood, measured, and made public.

These portfolio holdings thus raise fundamental concerns. Are there benefits that outweigh the potential costs? Neither the Treasury nor the Federal Reserve has found evidence that these portfolio holdings (above some minimum threshold) provide meaningful benefits to borrowers. We believe that Congress could usefully consider whether there are meaningful benefits to such holdings, and whether such benefits outweigh the costs.

In order to protect against the systemic risks posed by the GSEs' mortgage investment business, the Administration recommends that limitations be placed on the size of the GSEs' retained mortgage investment portfolios. An appropriate phase-in period for the reduction of the existing portfolios would be needed so as not to disrupt mortgage or financial markets. After the appropriate phase-in period, given the overall advances in securitization, the large amount of data available on mortgages, and the increased sophistication of mortgage investors, we believe that our capital markets could adjust to a significant reduction in the presence of the GSEs as mortgage investors.

In addition to protecting our financial system against potential systemic risk, it is also very important that our national housing finance system continues to function smoothly and that the GSEs are able to accomplish their missions – in particular their support for affordable housing. Our recommendation to limit the investment portfolios of Fannie Mae and Freddie Mac does not in any way limit their ability to guarantee mortgage-backed securities. In that regard, it is worth noting that Freddie Mac operated a successful credit guarantee business throughout the 1980s with a retained mortgage portfolio that was only a small fraction of its current size. Therefore, given that these core functions of the GSEs are preserved, we see no reason why limits on the GSEs' retained mortgage portfolios should impair their ability to provide support for affordable housing, including the ability of Fannie Mae and Freddie Mac to meet their affordable housing goals set by HUD.

### **Location of the New Regulatory Agency**

While the powers and authorities of the new regulator remain of paramount importance to the Administration, Congress should also continue to consider the location of the new regulator. In 2003, the Administration said it was open to making the new regulatory agency a part of the Treasury Department, provided that there were adequate elements of policy accountability to the Secretary of the Treasury. The advantages of placing the new regulator within the Treasury should not be overlooked. First, the start-up time and transition issues related to setting up the new agency would be lessened; housing another agency within Treasury, which is familiar with such relationships, is less time consuming than creating an entirely new agency, which would facilitate effectively transferring existing OFHEO and Federal Housing Finance Board operations to Treasury. Second, addressing issues associated with systemic risk is an important aspect of our proposal, and the Treasury Department is the Executive Branch agency with responsibility to adopt a holistic approach to systemic risk and oversee the proper functioning of financial markets. Third, improving market discipline is important, and the Treasury Department is in the best position to monitor the new regulator's activities while ensuring that investors have a proper understanding of GSE securities. Finally, we believe that there would be less opportunity for regulatory capture were the new regulator housed in Treasury, given the diversity and size of the interests which regularly appear before the Department.

However, as we described in detail last year, there are conditions that need to be met in order for the Administration to support establishing the new regulator as a part of Treasury. The new agency should be required to clear new regulations and policy statements to Congress through the Treasury Department. The Treasury Department and OMB should also have review authority over the new agency's budget to ensure that resources are being properly allocated. Nevertheless, in any such arrangement, the new regulatory agency should have independent responsibility over specific matters of supervision, enforcement, and access to the Federal courts. By housing the new regulator in Treasury with adequate oversight authority, we can achieve the best of both worlds: ensuring a strong, independent regulator while providing for accountability and expertise from the Executive Branch.

## **The Appropriate Role of the Federal Home Loan Banks**

Over the last decade the Federal Home Loan Bank System has undergone considerable change. Membership in the System was extended to commercial banks and they now make up the overwhelming number of members of the System. The Federal Home Loan Banks greatly expanded their investment portfolios and some Banks aggressively moved into the mortgage investment business, types of activities that moved the Banks away from their traditional wholesale funding activities for members. And while perhaps not particularly new, large financial institutions account for the bulk of borrowing from many of the Federal Home Loan Banks.

The Administration continues to believe that the Federal Home Loan Banks 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. Consistent with the primary goal of creating an effective regulatory regime for Fannie Mae and Freddie Mac, I believe constructive steps can be taken in this context toward also improving the regulation of the Federal Home Loan Banks. To reach that goal, the regulatory structure of the system should be examined with a careful eye to converging regulation of all of the GSEs to the same extent that their operations (and the risks they present) have likewise converged. In particular, the Administration believes regulation of the Federal Home Loan Banks would be enhanced if Congress were to delineate an explicit mission for them. In addition, we believe that Congress should consider reforming the appointment of directors to the boards of the banks to ensure that the best corporate governance practices are employed. And while progress is being made to ensure that the Federal Home Loan Banks file their financial statements with the SEC much like other large financial institutions with outstanding public debt, Congress should formalize such obligations by statute.

### **Conclusion**

In conclusion, our primary goals in developing our GSE reform proposal are to promote the strength and resilience of our housing finance markets, lessen the potential for systemic risk, and continue our progress in meeting the mortgage credit needs of all our Nation's homebuyers. To accomplish those purposes, the fundamental elements of reform that the Administration has proposed are essential.

In addition, events at the GSEs over the course of the last year reinforce the need for a strengthened regulatory regime. There are a range of other reforms which would also advance our common interest in ensuring the resiliency of the financial system and the robustness of the housing finance system. The Administration is open to consider additional ideas for reform.

I look forward to working with you on this important issue.