Statement of

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General Counsel
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Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs

"Housing Finance Reform: Powers and Structure of a Strong Regulator"

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Chairman Johnson, Ranking Member Crapo and members of the Committee, thank you for your invitation to testify on the powers and structure of a regulator for a revised housing finance system. My name is Alfred M. Pollard and I am General Counsel for the Federal Housing Finance Agency (FHFA), which is the safety and soundness regulator of the Federal Home Loan Bank System and Fannie Mae and Freddie Mac. The introduction of S. 1217 and the work of the cosponsors and of the Chairman and Ranking Member in moving forward with housing finance reform are important steps. I have addressed the questions you put to me in your letter and will be pleased to answer any questions you may have.

Supervisory Tools Available to FHFA

Following enactment of the Housing and Economic Recovery Act of 2008 (HERA), the new Federal Housing Finance Agency came into existence with an enhanced array of supervisory tools. These include explicit authority to impose and enforce prudential standards, including capital standards; obtain reports from parties on a regular and on an as-requested basis; conduct targeted and full scope examinations; oversee executive compensation, including incentive compensation and golden parachutes; require remedial actions; and authorities to undertake a full range of enforcement actions.

FHFA's predecessor as supervisor of Fannie Mae and Freddie Mac was the Office of Federal Housing Enterprise Oversight (OFHEO). In general, OFHEO did not have a full range of authorities, including authority to set capital requirements or to undertake supervisory actions that were comparable to those of other financial regulators; HERA corrected that. At OFHEO, congressional appropriations were required, subjecting the regulator to potential disruptions if a budget were not in place; HERA corrected that. At OFHEO, no receivership authority existed which symbolized a regulator without a full range of capacities; HERA corrected that. At OFHEO much had to be done with implied authorities; HERA corrected that, providing explicit authorities and language regarding "incidental authority." In addition, by merging OFHEO and the Federal Housing Finance Board, FHFA's predecessor as supervisor of the Federal Home Loan Bank System, HERA increased synergies over the regulation of the government-sponsored sector of the housing finance market. Overall, HERA made important changes to the regulatory authority over Fannie Mae and Freddie Mac, but by the time the law was passed it was too late to implement those authorities prior to the need for conservatorships.

More specifically, let me cover a few of the basic regulatory tools that FHFA has today:

Supervision and Examination. FHFA has a full array of supervisory tools, many of which were unavailable to OFHEO, but provided under HERA to FHFA. Since its creation in 2008, FHFA has implemented these tools through a comprehensive supervisory program described here.

FHFA supervision is carried out by two divisions—the Division of Enterprise Regulation with responsibility for Fannie Mae and Freddie Mac and the Division of Bank Regulation with responsibility for the twelve Federal Home Loan Banks and the Office of Finance. Both Divisions employ on-site examination and off-site analysis and carry forward prudential standards set forth in regulation to meet FHFA's responsibilities relating to safety and soundness and compliance with laws and regulations.

With respect to Fannie Mae and Freddie Mac, even in conservatorships, FHFA maintains a permanent on-site presence of examiners who conduct examinations and monitor business activities, key risks and compliance. With respect to the Federal Home Loan Banks, FHFA typically carries out three on-site examinations per quarter so that all twelve FHLBanks are examined on-site once per year. As with Fannie Mae and Freddie Mac, FHFA has an ongoing program of off-site monitoring of the FHLBanks.

FHFA has established comprehensive examination manuals that serve as guides for examination efforts and are available to the regulated entities and to the general public. FHFA continues to issue Advisory Bulletins on a timely basis regarding key matters such as credit risk management and model risk governance. Typically, these are based on best practices that have emerged in bank regulation, though appropriately adapted to the unique characteristics of our regulated entities, starting with the fact that they are not commercial banks. FHFA remains the only financial regulator tasked with providing an annual report to Congress on its examination results.

FHFA's two supervisory Divisions work closely with the Division of Housing Mission and Goals that has expertise in mortgage-related products and markets, to ensure the agency maintains a comprehensive view of risks and housing finance activities. Together these three divisions also conduct the mission oversight of the regulated entities.

With Fannie Mae and Freddie Mac each in conservatorship, FHFA's oversight of these companies goes beyond traditional supervisory activities. As the conservatorships have lasted far longer than originally anticipated, FHFA has responded by developing an Office of Conservatorship Operations and an Office of Strategic Initiatives that carry out FHFA's responsibilities regarding the current operations of the conservatorships. These Offices coordinate and collaborate with the other divisions to enable FHFA to meet its responsibilities and its mission of ensuring our regulated entities operate in a safe and sound manner so they may serve as a reliable source of liquidity and funding for housing finance and community investment.

Enforcement. FHFA may take a broad range of enforcement actions by statute and, by regulation and policy guidance, has elaborated on the conduct of such powers. Cease and desist orders, civil money penalties, debarment of officials, the ability to act against institution-affiliated parties all exist within the ambit of our statute; additionally, the Agency has created a process for suspending individual or corporate counterparties found guilty of criminal law violations. Overall, FHFA has broad administrative enforcement powers regarding the regulated entities and the ability to access judicial remedies if necessary to address third parties through its independent litigation authority.

Emergency Tools. HERA provided FHFA a broad range of regulatory tools for addressing emergency situations. The Agency does not possess a fund such as the Deposit Insurance Fund to cover specified losses, but it does maintain a working capital fund and has the ability to impose special assessments on the regulated entities to address any shortfalls in its resources in order to respond to emergency situations. Temporary emergency funding was provided in the form of a support agreement with the U.S. Treasury Department in 2008 and this remains the main source of funding to provide capital support to the conservatorships. Finally, FHFA has employed its authorities and they have been affirmed in a number of important court rulings.

As to those court decisions, several have aided in rounding out FHFA authorities. Significantly in a case in the Southern District of New York, the Court found not only that FHFA had examination privilege, but also shared similar authorities to banking regulators. This solidified the examination privilege that facilitates effective supervision, but as well made clear that FHFA supervisory actions find support in long-standing bank regulatory powers. For a new agency, these judicial decisions are important.

In sum, the agency is equipped to meet the mission Congress has set for it. What I will now address is the regulatory structure set forth in S. 1217, and, based on some of the lessons learned during this crisis, where areas exist for improvement in terms of regulatory structure and powers.

S. 1217, Housing Finance Reform and Taxpayer Protection Act of 2013

FHFA has endorsed the need for legislative action on housing finance reform. S. 1217 is an important effort in moving that process forward.

Proposed Regulatory Structure. S. 1217 would establish a new model for the secondary mortgage market and a new supervisory agency, the Federal Mortgage Insurance Corporation (FMIC). The range of FMIC's duties and responsibilities represents a movement away from traditional examination- and enforcement-based supervision to a multi-faceted construct that covers availability and transparency of information, standard-setting to enter and participate in the market, supervision of participants, access to credit and the secondary mortgage market, insurance of securities and establishment and operation of databases including a mortgage data repository. Implementation of the bill's varied elements will require careful thought and planning over the five-year transitional period and the undertaking of appropriate transitional steps. It must be noted, however, that beyond the regulatory structure and authorities, a key lesson learned during the financial crisis is that, even with adequate powers, regulators will not always get it right; therefore, if taxpayers are going to be exposed to risk of losses, sufficient private capital must be available in front of taxpayers, as contemplated in S. 1217.

Regulatory Tools That Should Be Added. The bill provides FMIC with limited explicit regulatory authority, though additional tools may be implied and, importantly, an "incidental powers" provision is set forth. Making regulatory authority clear and explicit, including where appropriate the ability to establish prudential standards, set capital requirements and take enforcement actions, would enhance market stability and provide a higher degree of confidence to all market participants. Further, the ability to address both the primary parties to be regulated and to have certain authorities in relation to their contractual counterparties would be in line with existing legal practice. Where the bill implies authority, but does not expressly confer it, action FMIC would determine to take could lead to litigation and result in different outcomes in different jurisdictions, undermining the operation of a national housing finance market.

Reliance on implied authority also makes it difficult to say what is missing. What is clear is that FMIC needs a full array of supervisory and enforcement authorities with regard to the market participants for which it must set standards and approve entry, including the authority to set capital standards, request reports from and examine these participants, establish enforceable prudential standards, require participants to undertake remedial actions where appropriate and impose penalties for bad behavior and bad actors. In the structure proposed in S. 1217, providing FMIC with these tools is not only important for market integrity, but also to protect taxpayers in light of the risks associated with FMIC insurance. These powers are familiar to current participants in the housing finance market—many of which are already subject to supervision by FHFA or by a state or federal regulatory authority—and to the extent they have not been provided to FMIC or are only implied in S. 1217, they should be made explicit.

FHFA has provided language to demonstrate how these powers, which could be implied and are incidental to other authorities already expressed in S. 1217, could be made clearer in the bill. For example, FMIC has authority to approve or suspend approval for participants and "suspending" implies requiring remedial action; this should be made explicit. Also, FMIC's authority to revoke approvals implies the ability to revoke participation and thus prohibit participation; such prohibition should be made explicit.

Finally, as re-affirmed by the crisis, greater sharing of supervisory information among regulators, greater cooperation among regulators, such as FHFA-CFPB efforts on a national mortgage data base, and greater transparency for markets, such as FHFA directing the publication by the Enterprises of historical loan data, are critical. These are core areas on which FHFA is working and will continue to build.

Improvements to S.1217 Regulatory Structure. Because S. 1217 sets a new direction for the housing finance market, two questions are critical—as the Committee has asked, does the legislation get the right structural pieces in place for the new market to function smoothly and efficiently and does it provide for an effective transition from the current system to the new market. FHFA has identified some areas where the bill could more fully answer these questions.

For example, S. 1217 acknowledges that many likely participants in the new market are already subject to prudential supervision by other safety and soundness state or federal regulators by authorizing consultation or directing FMIC to coordinate with another agency, but more could be done to ensure that other regulators share information with FMIC and that exams are coordinated, reducing burdens on participants and improving supervisory approaches and outcomes. FMIC and FHFA roles in the Financial Stability Oversight Council should be clarified to ensure that during market transition appropriate representation remains in place. FMIC should have an appropriate and explicit role in the Federal Financial Institutions Examination Council.

There may also be gaps to be filled. For instance, today all mortgage servicers are subject to certain compliance oversight with regard to consumer protections, but non-bank servicers may not be subject to prudential oversight. The bill does not address enhanced supervision of non-bank servicers, even though their safety and soundness and their conformance with required practices are critical to FMIC's mandate to protect taxpayers. Assigning regulatory oversight to FMIC with the ability to set and enforce prudential requirements could help fill this gap. Additionally, FHFA has seen certain state and local laws that may impair the efficient operation of a national secondary mortgage market.

The bill also provides for FMIC to be funded exclusively by insurance fees, which would be collected on mortgage-backed securities that FMIC insures. Relying exclusively on fees as a funding base, particularly as the new market is developing, may present certain challenges. Clearly, at its inception, FMIC should have sufficient resources to be fully operational and sound. Further, funding FMIC and growing the insurance reserve could require rather large insurance fees in FMIC's early years. In times of market distress, FMIC revenues could drop substantially. These challenges may be addressed by expanding FMIC's sources of funding to include other fees and assessments; for example, creating application fees, which are not explicit, and restoring assessments on the Home Loan Banks for their supervision.

Transition. Transition to the new agency involves a simultaneous wind-down of the Enterprises and the transfer of functions and employees from FHFA to FMIC and the hiring of additional employees as needed to fulfill the new agency's responsibilities. FHFA was created five years ago by merging the functions and employees of three agencies—OFHEO, the Finance Board and elements of the Department of Housing and Urban Development—into a single agency with all of the functions of its three parts. Here, the transition involves employees from one agency, but into a framework with multiple responsibilities. S. 1217 establishes a two-step transition that would have FHFA and FMIC co-exist for five years, which could be confusing and inefficient for both market participants and agency employees.

FHFA's experience in standing up a new agency would argue in favor of immediately transferring all FHFA personnel and responsibilities to FMIC, thus permitting a smooth integration, a focus on meeting the bill's five-year goal of full implementation and maintaining the congressional direction to wind down Fannie Mae and Freddie Mac. In particular, moving all employees to the new agency—or, possibly, renaming and empowering FHFA as FMIC—avoids issues of dispersion of resources and expertise that may prove beneficial to the various tasks assigned in the legislation. Guidance would be helpful on the legal authority of FMIC's Director to act before the Board is fully constituted. Funding in transition may be critical to assure that a smooth start for FMIC occurs with a solid capitalized reserve fund, systems and technology in place and providing resources to address challenges not anticipated at this time.

New Utilities. FHFA continues work on the Common Securitization Platform. As FHFA and, later, FMIC move to develop more fully the National Mortgage Database and an approach for a national mortgage market repository for notes and other documents, it may be beneficial to address these two items with additional legislative language. A national note repository can bring benefits to homeowners, lenders, the state foreclosure process and efforts of groups such as the Uniform Law Commission to make more uniform state foreclosure laws.

Conclusion

FHFA continues to support early congressional action to make clear for FHFA, for its regulated entities, for borrowers and for financial markets the directions you believe most appropriate to protect taxpayers, maintain access to housing finance products and services and the strongest regulatory structure that is credible, empowered, clearly defined and transparent to carry forward your directions. While all of this has complexities, that should not deter prudent actions.

In closing, FHFA appreciates the opportunity to work with you and your staffs and those of the cosponsors, as well as those of other committee members, to assist in any way we can as you move forward on this critical task of addressing a new housing finance structure. The certainty that can come from such efforts will benefit homeowners, investors and taxpayers.