Committee on Banking, Housing and Urban Affairs
U.S. Senate

Statement by
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Regulatory Reform of the Housing Government-Sponsored Enterprises

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Chairman Shelby, Ranking Member Sarbanes, it is an honor to appear before the Committee today. As you know, this will likely be my last appearance before a Congressional Committee as Director of OFHEO. It has been a pleasure to work with the Committee over the past six years as, together, we have sought to strengthen oversight of Fannie Mae and Freddie Mac.

More recently, we have demonstrated that the regulatory process can work. I appreciate the patience this Committee has shown as OFHEO has successfully tackled very serious problems, first at Freddie Mac and now at Fannie Mae. We have the cooperation of the board and senior management of both Enterprises currently. However, more work remains to be done, and the agency is devoting its full attention to identifying and fixing all the problems at Fannie Mae and Freddie Mac.

The views I will be expressing today are my own and do not necessarily represent those of the President or the Secretary of Housing and Urban Development.

While I believe we have placed the regulatory process on the right path, the need for comprehensive structural improvement remains. And in my view, we must address these structural issues, as soon as possible, through new legislation. Given the size of the housing Enterprises, their importance to our housing market, and the integral role they play in the broader financial markets, they must be placed under the oversight of a strong regulator. Such a regulator must possess a full array of supervisory and enforcement tools and gain adequate levels of funding.

Over time, the United States has developed a coherent national housing policy represented by a variety of federal programs designed to further homeownership and affordable housing. The success of our national policy is the envy of the world. Today, 69 percent of Americans own their own homes, and our country is the better for it. Yet I believe we should set our sights even higher, particularly for low- and moderate-income Americans. Homeownership, after all, strengthens our families and our communities. Homeownership also fosters broader economic benefits. Indeed, the strong housing market of recent years has been a principal reason why the U.S. economy has continued to grow in the face of significant obstacles. Clearly, Fannie Mae and Freddie Mac have

played a central role in achieving our national housing goals, and with proper regulatory oversight, they should continue to do so.

Absent a strong, fully-empowered regulator, however, the long-term success of our housing market, and of the broader financial markets, will be at risk. The recent problems at the housing GSEs highlight the need to ensure that our ambitious national housing policy goals are supported by an equally strong oversight regime.

I am proud to say that OFHEO has been able to identify and correct the problems at Fannie Mae before more serious damage occurred. But we might not be so fortunate the next time. OFHEO has accomplished its mission through the efforts of its world-class staff, despite the agency being hampered at times by its lack of world-class powers and, historically, it's under-funding. Unless new legislation removes these structural impediments, over the long-term, regulatory oversight will not be adequate to the task of ensuring that Fannie Mae and Freddie Mac meet their charter obligations in a safe and sound manner.

Legislative Principles

The legislation the Committee is now contemplating will play a critical role in the further development of our nation's housing finance system. As I look back over my tenure at OFHEO, I believe such legislation must be guided by six basic principles.

1) The regulator must remain independent;
2) The regulator must be permanently funded, outside the appropriations process;

3) The regulator must have powers equal to those of other safety and soundness regulators;

4) The regulator must have full discretion in setting capital standards;
5) The regulator's mandate must be enhanced; and
6) The legislation should build on progress already made.

Adherence to these principles will strengthen the supervision of the Enterprises, their safe and sound operation, and their ability to meet their charter obligations. Our ultimate goal should be to establish a new agency that stands on a plane with the other safety and soundness regulators, and that has the capacity to address the unique issues raised by the housing Enterprises.

1) The Regulator Must Remain Independent

An enhanced regulator must remain independent. The concept of an independent federal agency overseeing Fannie Mae and Freddie Mac was fundamental to the 1992 Act that created OFHEO. The need for regulatory independence was borne of Congress' experience with the savings and loan crisis. I had the privilege of serving as counsel to the House Banking Committee during that difficult period. One of the clear lessons

learned – and put into practice in the 1992 Act – was that all safety and soundness regulators should maintain objectivity and nonpartisanship, and be protected from political interference. I see no need to alter these precepts as they become especially critical at times when regulators must make difficult and sometimes politically unpopular decisions. In addition, independent regulation protects Congress' ability to receive the agency's best judgment on regulatory matters, unfiltered and without delay.

Regulatory independence should also encompass the agency's ability to issue regulations on the same basis as other independent agencies, without the need for Administration approval. Current rulemaking procedures, with opportunities for all interested parties to comment, provide the regulator and the public with an open process, one which results in informed rulemaking. With billions of dollars of potential taxpayer liability at stake, it is in everyone's interest that the safeguards provided by regulatory independence be maintained.

2) The Regulator Must Be Permanently Funded, Outside the Appropriations Process

The regulator must gain permanent funding, outside the appropriations process. Currently, OFHEO must go through a highly-politicized annual appropriations exercise, even though the agency does not use taxpayer funds. Assessments on the Enterprises fund OFHEO. We cannot receive those assessments, however, until approved by Congress – and at a level set by Congress. OFHEO is the only safety and soundness regulator that must go through the appropriations process. Permanent funding will enable the regulator to fulfill its budgetary needs on a reasonable basis, without the timing and political constraints or unpredictability associated with the appropriations process. Permanent funding will also contribute to operational independence and will allow the agency to respond more quickly to developments at the Enterprises. I appreciate this Committee's support for such independent funding.

New legislation should also include clear language stating that the agency has the authority to levy special assessments, or to establish a reserve fund if needed, to meet emergencies

3) The Regulator Must Have Powers Equal to Those of Other Safety and Soundness Regulators

The regulator must have regulatory, supervisory and enforcement powers equal to those of other safety and soundness regulators. It should have independent litigation authority, enhanced hiring authority and the full range of enforcement powers provided to other financial regulators. The legislation should clearly give the agency the power to address misconduct by institution-affiliated parties and to exercise general supervisory authority. It should provide the regulator with the power to place an Enterprise into receivership, if necessary. The regulator should be able to review both new and current activities of the Enterprises for both safety and soundness and charter compliance.

4) The Regulator Must Have Full Discretion in Setting Capital Standards

The regulator must have full discretion in setting capital standards. Capital constitutes a bulwark of effective safety and soundness regulation. The regulator should have broad discretion to exercise his or her best judgment, using all the information available through examinations and other oversight, to determine prudential capital adjustments. All other safety and soundness regulators have this discretion.

Indeed, the new agency should have the authority to modify both minimum and risk-based capital standards. Such authority would help ensure that the Enterprises best accommodate changes in the mix of their business, the market environment in which they operate, and in the ability to measure risk itself.

5) The Regulator's Mandate Must Be Enhanced

Safety and soundness regulation and charter compliance should be placed together, under one roof. Safety and soundness regulation supports the charter responsibilities of the housing Enterprises by ensuring that they are strong enough to fulfill their mission. Moreover, by placing both safety and soundness and charter compliance within a single agency, we can use and leverage the expertise and data that will reside in the regulator.

In addition, we should charge the regulator with the responsibility for monitoring and analyzing our nation's housing finance system. Ultimately, we should view the agency not just as a regulator of the Enterprises, but as a monitor of the health of our nation's housing finance system. I'm not suggesting that the agency have additional regulatory authority over any part of the mortgage industry beyond the housing Enterprises. But I do think it should have a responsibility and a mandate to research, assess, and observe this very critical segment of our economy. The agency should leverage its expertise by looking for ways to improve our housing finance system at all points in the process. Indeed, research already forms an important part of OFHEO's regulatory activities. We have access to the largest repositories of mortgage data in the country, including data from Fannie Mae, Freddie Mac, the Federal Housing Administration, and private firms. This research benefits both OFHEO's regulatory oversight and the public's understanding of the housing market, as exemplified by our quarterly release of the widely-followed House Price Index.

6) The Legislation Should Build on Progress Already Made

Legislation should build on the progress we have already made over the last twelve years. Regulating Fannie Mae and Freddie Mac requires a specialized set of skills. OFHEO's capacity to model the cash flows of all the mortgages, debt, and other financial instruments owned, issued, or guaranteed by the Enterprises – which we use in our risk-based stress test – remains unique among financial regulators. Expertise on how these two secondary mortgage market companies manage mortgage risk, including their

wide use of sophisticated derivatives and callable debt, is vital for effective regulation. So too is an understanding of how the Enterprises are affected by the broader financial markets in which they operate. OFHEO has developed the specialized expertise – from our examiners and financial analysts, to our researchers and capital analysts – necessary to supervise Fannie Mae and Freddie Mac. A new regulator should build on that expertise rather than seek to develop it from scratch.

Portfolio Limits

Regarding the issue of portfolio limits, I believe the most prudent course of action would be for Congress to give the regulator explicit authority to regulate the size of the housing Enterprises' portfolios, accompanied by specific statutory guidance on the exercise of such authority. Fixing specific limits in statute could prove counterproductive should market conditions dictate the need for flexibility.

I suggest that it would be best to rely on the regulator's judgment in carrying out Congress' intent on this issue. The guidance Congress provides the regulator thus becomes crucial. Guidance strictly limiting the portfolios to amounts necessary for adequate provisions of mortgage market liquidity, for example, would produce a far different result than guidance simply linking portfolio size to an Enterprise's ability to manage the associated risks. The latter standard, in fact, parallels the current state of regulation regarding the housing Enterprises' portfolios.

Once Congress has made the fundamental policy decisions on this matter, the regulator should conduct any necessary analysis, seek input from interested parties, determine appropriate levels corresponding to the guidance, and ensure orderly implementation of any changes in the size of the Enterprises' portfolio, should that be deemed necessary.

Conclusion

Chairman Shelby, Ranking Member Sarbanes, I am proud of what OFHEO has accomplished during my tenure. Despite the obstacles we have faced, despite the constraints under which we operate, OFHEO has kept two of the nation's five top financial institutions safe and sound.

As you move forward on legislation, I urge you to keep the principles I have outlined in mind. I hope they will assist you in forging a consensus, if not on the details of legislation, at least on the broad purposes that should guide Congress in its crucial work on the housing Enterprises.