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Before the Senate Committee on Banking, Housing and Urban Affairs
October 16, 2003

Chairman Shelby, Senator Sarbanes and members of the committee, thank you for inviting me here today to share my views on legislation to strengthen the safety and soundness regulation of Fannie Mae.

A strong safety and soundness regulator is in the best interest of Fannie Mae, homeowners, and the financial system. I am here to voice support for legislation that creates a new world-class safety and soundness regulator within the Department of the Treasury. There is a strong and growing community of support for legislation that focuses on strengthened financial regulation and does not directly or indirectly change our mission, status, or charter.

The impact of what you do here can be enormous, for the economy as a whole and for expanding affordable homeownership and affordable rental housing in particular. First, as you know, the home mortgage refinance wave of the last two years has allowed millions of families to increase their savings or raise their standard of living. Federal Reserve Chairman Alan Greenspan has noted that last year close to 10 million households "cashed out" almost $200 billion of their accumulated home equity, using as much as half of that amount for consumption. Home mortgage refinance provided the single largest stimulus to the economy last year, and it made difficult economic times more manageable for families across the nation. Our ability to use technology and to draw private capital into the home mortgage market was critical to ensuring that lenders were able to meet refinance demands effectively and efficiently.

Second, we as a society have a long-held commitment to homeownership. Congress has reflected that commitment by making homeownership a public policy priority, in tax policy, in policy affecting government-sponsored enterprises, and in the commitment to FHA and other government programs. Recent public policy commitments have reaffirmed the importance of homeownership. Just this month, the House of Representatives overwhelmingly passed legislation to provide downpayment assistance to cash-strapped families.

President Bush has made expanding homeownership a priority for his Administration. Last summer he called on the private sector to partner with government to create 5.5 million new minority homeowners this decade. Fannie Mae stepped up to the plate to meet that challenge. We committed $700 billion in financing for minority borrowers, and are forming partnerships in communities across the nation to bring mortgage financing to underserved minority communities.

Enacting legislation that will strengthen safety and soundness regulation of Fannie Mae and Freddie Mac can enhance our role in promoting a smooth functioning mortgage finance industry. Ultimately that leads to more homeownership opportunities for more Americans.

Since I testified before the House Financial Services Committee on this issue on September 25, the debate over changing our regulatory framework has moved on from general principles to specific issues. Rather than repeat my recent testimony, I would like to specifically address the questions posed by the Committee in its invitation requesting my appearance here today.

The Structure and Mission of the New Regulator

Safety and soundness regulation of privately capitalized, privately managed companies has a singular mission. That mission is to ensure that institutions have the ability to manage the risks they face. As long as a company is managing risk properly, safety and soundness regulation should not dictate day-to-day business operations or routine management decisions. Private companies thrive when management is allowed to innovate and experiment, and even to see a new innovation fail, as long as that failure does not put the enterprise at risk. Companies that take no risks and do not innovate cannot evolve to meet the demands of consumers and improve living standards for all Americans.

This distinction between supervision and management is the foundation of commercial regulation throughout the marketplace. In the financial services sector, our public policy has found the right balance between private management and public supervision. And the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 struck the right balance between private management of Fannie Mae and Freddie Mac and public supervision to ensure that management doesn't put the companies at risk of failure.

The financial services industry has evolved dramatically over the last 11 years, as financial institutions have merged and broadened their lines of business. The housing finance industry has evolved as well, developing products and technology that have given both homebuyers and mortgage investors more choices at lower costs. It is appropriate that, 11 years later, Congress reexamine the safety and soundness regime it built in 1992 to see if that balance is still correct.

Striking the right balance between appropriate and effective safety and soundness oversight and avoidance of micromanagement is important when considering the powers of the new regulator. The new Treasury bureau should be charged with the full authority to ensure that the enterprises are operating in a safe and sound manner, and that they remain adequately capitalized. World-class safety and soundness regulation is designed to help ensure that financial institutions do not mismanage the risks they face in a way that threaten the financial viability of the companies.

At the same time, Congress should not open the door for the regulator to prescribe, outside the necessities of safety and soundness oversight, how the enterprises conduct their businesses – whether it be the management of credit and counterparty risk, management of interest rate exposure, issuance of subordinated debt, or adequacy of liquidity and reserves, to name just some of the issues the enterprises must manage. The modern best-practices regulatory approach to these issues, as reflected in the practices of the OCC and OTS, for example, is for the regulator to issue guidelines ensuring that the regulated financial institutions have adequate policies and procedures addressing these prudential matters. The regulated entities are then examined against these standards. This approach not only avoids micromanagement, but also ensures necessary flexibility for examination staff. In fashioning the new regulator's duties and responsibilities, Congress should follow the evolving best practices used by regulators for the rest of the industry.

Funding

To ensure adequate resources, a new Treasury bureau should be funded independent of the appropriations process. Over the last 11 years, OFHEO has steadily increased its budget and grown its examination staff. Today, OFHEO has a staff of 40 examiners, or 20 per institution. This is comparable to the size of the typical on-site OCC exam team dedicated to any of the largest OCC-regulated banks. OFHEO's current budget includes a plan to expand to 66 examiners over the next year.

While independent funding will ensure that the new regulator has the necessary resources to do its job, there must be some review of that independent assessment, to ensure that the regulator does not assess the companies in an arbitrary way. In the banking system, the ability of any bank at any time to change charters engenders a regulatory competition that prevents excessive assessments. Fannie Mae and Freddie Mac will not have an option to move to a different charter, and therefore some other mechanism must be developed.

There are many different ways to achieve this objective. Fundamentally, it should involve some wider review within the Administration of the new agency's budget. Congress could mandate transparency for the new agency's funding by requiring it to release for notice and comment a proposed budget and resulting assessment. This would be similar to the approach used by the National Credit Union Administration. Or the increase from year to year could be based on an objective index. Of course, we would support the agency's ability to obtain additional funding mid-year if necessary.

Currently, OMB authority to apportion agency funds is an important check in ensuring the most effective and economical use of resources. Their authority covers agencies funded both through the appropriations process and outside of it, and we believe it would be an important level of review that should be adopted for the new safety and soundness regulator.

A new regulator must not only have necessary resources, but those resources must also be spent appropriately. Today, the OCC and the OTS devote more than three quarters of their budgets to examination and supervision. This emphasis in their budgets is evidence of these agencies' focus on examination and supervision to monitor continuously the safety and soundness of the regulated enterprises. A new regulator for the Fannie Mae and Freddie Mac should have a similarly clear focus on examination and supervision, with a similar division of resources to ensure the regulator's priority remains on on-site, daily oversight of the safety and soundness of the operations of the regulated companies.

<u>Independence</u>
The independence of the new regulator is also an issue of discussion in the current legislative debate. In particular, policymakers today differ over the independence of the new regulator with respect to funding, testimony and regulation. As I stated earlier, we do believe that there must be some review of the assessments the regulator levies on the company, to ensure the budget fully funds the regulatory mission of the agency but does not include arbitrary assessments. Because we cannot change regulators the way banks can, we favor outside review of the new regulator's budget.

With regard to the issuance of regulations, currently OFHEO's regulations are reviewed by OMB. That practice does afford broader policy input into any proposed regulation, and we believe that broader input has value. The third issue, review of testimony, raises important questions that Congress and the Administration will have to address directly and resolve.

The Powers of a New Regulator

The new regulator must have the powers necessary to carry out its role. The current debate over these powers has focused on capital, prompt corrective action and new program approval. Let me take up each of those issues separately.

<u>The Appropriate Capital Regime</u>
Capital requirements are a fundamental part of financial regulation. The approach Treasury put forward in testimony before the House Financial Services Committee focuses on ways to give the regulator more flexibility in aligning capital requirements with the risks Fannie Mae takes on, while ensuring that we can continue to fulfill our mission. It is this balance that Congress struck in 1992, and it is a balance Congress should maintain in any proposed legislation.

As you know, Fannie Mae has two capital standards, a minimum capital (or leverage) requirement, and a risk-based capital requirement. The minimum capital requirement sets a floor and also incorporates the indefinable, non-quantifiable risk present with any institution. Fannie Mae must hold the greater of the minimum capital requirement or the risk-based capital requirement.

Minimum capital is defined as the sum of 2.50 percent of on-balance sheet assets and 0.45 percent of mortgage-backed securities guaranteed by but not owned by Fannie Mae. Including capital for off-balance sheet obligations distinguishes Fannie Mae's minimum standard from the bank leverage ratio, which requires that banks hold capital only against on-balance sheet assets.

Calculated in the same manner as the bank leverage ratio, Fannie Mae's core capital was 3.3 percent of on-balance sheet assets, or $30.7 billion, as of June 30, 2003. Furthermore, beginning in 2001, Fannie Mae has issued subordinated debt as a supplement to our equity capital. Subordinated debt can act as a risk-absorbing layer on top of core capital and can serve as a market signal of a corporation's credit risk. Fannie Mae's subordinated debt outstanding totaled $11.5 billion at June 30, 2003, or 1.2 percent of on-balance sheet assets. Thus the sum of core capital and outstanding subordinated debt represented 4.5 percent of on-balance sheet assets at the end of the second quarter, or $42.2 billion.

Fannie Mae's minimum capital requirement should be viewed in the context of the limited business in which we operate. By law, we invest only in residential mortgages, which are less risky than many bank investments such as consumer debt, commercial real estate, or foreign debt. Furthermore, our book of business is more geographically diverse than most banks, and we are required to have loss-sharing agreements on higher-risk loans.

As a result, Fannie Mae has far lower losses than other lenders. For instance, Fannie Mae's credit losses in 2002 were 0.5 basis points of our total single-family mortgages. That compares with bank credit losses on mortgages of 15 basis points in 2002. Furthermore, while Fannie Mae's losses have trended sharply lower in the last five years, banks' losses on mortgages have not followed a similar pattern.

The further an institution moves away from specialization in mortgages, the greater the level of losses relative to capital. Reflective of our low level of risk, Fannie Mae's capital was 357 times its credit losses for the first two quarters of 2003. The thrift industry, which also specializes in mortgages, had a comparable ratio of 47:1, less than one-seventh the capital coverage that Fannie Mae had. Large commercial banks, on the other hand, had a capital coverage ratio of only 15:1, with the entire banking industry at 18:1.

The question for policymakers is not how to eliminate credit risk from the system. That is not possible. The question is how do institutions manage this risk, and what capital is necessary to cover the risk. In the event of a credit crisis, Fannie Mae is in a much stronger position to survive than are the other potential holders of mortgage credit risk. If credit losses were to increase by a factor of 20, Fannie Mae would have sufficient capital to cover the resulting losses. The average bank would not.

For these reasons, Fannie Mae's minimum capital requirement should remain set in statute at 2.5 percent for on-balance-sheet assets and 0.45 percent for off-balance-sheet assets. Doing so supports Fannie Mae's mission of bringing low-cost capital to housing. Increasing minimum capital absent any increase in risk raises the cost of capital to housing and undercuts our ability to fulfill our mission of constantly providing liquidity in all markets and through all economic conditions. Quite simply, if you raise capital requirements for the same level of risk, you will substantially reduce the impact Fannie Mae can have in fulfilling its mission.

Of course, a key responsibility of a safety and soundness regulator is to evaluate continuously the risks the company faces and adjust capital requirements accordingly. Financial regulators achieve this goal through a risk-based capital standard. In Fannie Mae's case, this requirement is determined by a statutory "stress test," computing the capital needed to survive a prolonged adverse economic environment, assuming no new business and adding a 30 percent capital cushion for operations risk. The regulation that implements this standard has been in place for one year, after ten years of development. Fannie Mae has met the requirements of that rule every quarter.

A world-class regulator must have the ability to adjust this risk-based capital requirement to reflect both changes in the economy and in the risks facing an institution. Under the current statute, our regulator has considerable flexibility to adjust the standard. The Administration has asked for additional flexibility in this area. We support giving the regulator more flexible authority in this area, while recognizing that there is a need for stability in capital standards, which should not be subject to frequent change. Additional flexibility in altering the risk-based capital standard will ensure that the regulator can require the companies to hold appropriate levels of capital consistent with the risks they take.

Location and Standard for New Program Approval

To carry out our mission effectively, Fannie Mae must be able to harness the innovation and efficiency of the private sector to promote affordable housing as a clearly articulated public policy goal. The standard Congress created in 1992 has fostered an environment of unprecedented innovation in the mortgage industry over the last ten years.

In a constantly changing interest rate environment and faced with unprecedented volumes of business, Fannie Mae and the mortgage finance industry have created a revolution in underwriting, product innovation, and streamlined technology processes, to produce significant gains in lending to low- and moderate-income and other traditionally underserved borrowers. We have automated our underwriting, reducing mortgage origination costs by an average of $800, and enabling applicants to get an answer from a mortgage lender in minutes rather than weeks. Our improved credit analysis has helped us to develop mortgage products for credit-impaired borrowers who previously had little access to conventional mortgages. We have worked with lenders to develop low-downpayment loans, bringing homeownership within reach of Americans who can afford a monthly mortgage payment but do not have savings for a 20 percent downpayment. Much of this innovation is driven by our lender customers, who routinely challenge us to add features to match their offerings, and to partner with them to increase access and efficiency.

Some of our competitors have decried innovation as somehow outside our charter. But the facts are these: In 1992, when our charter was last revised, mortgages made up 86 percent of Fannie Mae's total assets. Another 11 percent was devoted to maintaining necessary liquidity and the remaining 3 percent consisted of other assets. In 2002, mortgages made up 90 percent of Fannie Mae's total assets. Another 7 percent was devoted to our liquidity portfolio and – just as in 1992 – only 3 percent consisted of other assets. Clearly, our devotion to our mission has not changed. The innovations we have pioneered or adopted from others are not only within our charter; they are necessary to meet our charter obligations. We cannot serve our mission of making homeownership more affordable unless we can innovate continuously to create products and processes that better serve the industry and homebuyers.

The mortgage market today provides consumers with a wider variety of products than ever before, and therefore is better poised to meet the individual financing needs of a broader range of homebuyers. This has been possible because the program approval requirements in the 1992 law respect the need for innovation. Lenders have felt free to innovate and develop new products to reach underserved communities because we have been able to review the products and, whenever possible, assure them that we will purchase these loans in the secondary market. Without that secondary market outlet, lenders would have to assume more risk and expense in developing innovative mortgage products that are vital for reaching new markets.

There is a consensus in the housing industry that innovation is best protected by maintaining HUD's role as mission regulator for Fannie Mae and Freddie Mac. Many of our lender partners and leaders in the housing industry, such as the National Association of Home Builders, the National Association of Realtors, the Independent Community Bankers of America, the Enterprise Foundation, LISC, and Self-Help Credit Union, fear that moving program approval authority away from HUD could diminish housing as a public policy priority, and create a barrier to innovation that hinders us from achieving our mission within our charter. We share those concerns, and as a result we support maintaining HUD's authority to review new programs.

The current debate over whether program approval authority should be housed at HUD or at the new Treasury bureau misses a critical point. Maintaining HUD's role as mission regulator to review new programs does not diminish the power and authority of the safety and soundness regulator on matters of financial risk. In our view, a world-class financial regulator must have the ability to address any issues that pose a risk to safety and soundness. The new regulator will have on-site examination staffs continually reviewing and assessing programs, products and business processes at Fannie Mae. Just like a bank regulator, the new bureau could examine any activity in detail at any time, and address any activity it found to pose a safety and soundness risk, even if it has been approved by HUD for charter compliance.

Wherever Congress decides to locate the program approval authority, our greatest concern is that the process and standard allow Fannie Mae the freedom to work with lenders to create innovative mortgage products that meet consumers' needs. Lenders eager to reach underserved communities have developed mortgage features that make homeownership more affordable to these communities. Before they make these innovative mortgages available, they want to know that Fannie Mae will purchase them in the secondary market.

If new legislation creates a bureaucratic process in which every new mortgage "product" or "activity" must be formally approved before we can tell a lender we will buy it, or every process innovation to improve efficiency must first be vetted by some third party, then innovation to address tough housing problems will come to a screeching halt. Without a secondary market partner, lenders will be less able to pursue the creative partnerships that are critical to meeting Congress' public policy goal of bringing homeownership opportunities to underserved communities. Any new program approval regulatory regime must ensure Fannie Mae's continued freedom to work with lenders, non-profits, community organizations and local governments to develop new products and new business processes without intrusive regulation that seeks to replace business judgment with the government's judgment.

Prompt Corrective Action Authority

In determining the appropriate and necessary powers to ensure a world-class regulator for Fannie Mae, there has also been some debate over what prompt corrective action or PCA powers a new regulator should have.

Congress created a PCA regime for OFHEO one year after creating a PCA regime for bank regulators, purposely altering the bank regime to make it appropriate to Fannie Mae and Freddie Mac. Because Fannie Mae and Freddie Mac differ from banks, Congress crafted a prompt corrective action regime for OFHEO that focuses specifically on how Fannie Mae and Freddie Mac operate in the secondary market without importing those wholly inapplicable aspects of the bank-like PCA regime.

Interestingly, prompt corrective action is not the preferred method of supervisory enforcement by banking regulators. In fact, capital deterioration is seen as a lagging indicator of problems at banks. Thus, bank regulators often take action pursuant to their cease and desist, civil money penalty, and suspension and removal authority long before a bank would be subject to PCA. As reflected in its enforcement regulations and as we have seen by the recent actions it has taken, OFHEO has considerable enforcement authority. Fannie Mae supports the enhancement of these authorities by giving the new regulator cease and desist and civil money penalty authority consistent with the authority of bank regulators. Fannie Mae also supports the addition of express authority for the new regulator to suspend and remove personnel from the enterprise for violations of laws, regulations, final cease and desist orders and written agreements.

As part of our PCA regime, Congress specifically provided for the authority of our regulator to appoint a conservator should an enterprise become significantly or critically undercapitalized. By providing for a conservatorship process in the 1992 Act, Congress, and in particular this Committee, made clear its preference that an enterprise be privately recapitalized rather than liquidated in order for the important mission of the enterprise to be protected. Moreover, Congress reserved to itself, as Fannie Mae and Freddie Mac's chartering body, the right to extinguish those charters.

We welcome Congress' discussion of potential enhancement of the conservatorship powers enumerated in the 1992 Act. Certainly, we believe a conservator for an enterprise should be able to take such actions as may be necessary to put the enterprise in a sound and solvent condition as well as those that are appropriate to carry on the business of the enterprise and preserve and conserve the enterprise's assets and property.

HUD's Continuing Oversight Role

Finally, the Committee has asked for our thoughts on HUD's role in the oversight of the Fannie Mae and Freddie Mac. As I stated earlier, I support maintaining HUD's authority to review new programs for charter compliance, and I share the concerns of the housing industry that moving this authority from HUD to the Treasury Department could diminish the overall public policy commitment to homeownership as a national priority.

Let me comment on legislative proposals regarding HUD's authority with regard to housing goals. HUD sets housing goals as a regulatory requirement to ensure that Fannie Mae focuses particular attention on low- and moderate-income borrowers and underserved areas. We have consistently exceeded those goals every year since 1994. The agency is currently developing proposed goals for next year and beyond.

Over the years, HUD has sought to establish goals that require the company to stretch beyond levels we might otherwise achieve, without threatening our safety and soundness or jeopardizing the liquidity of the mortgage finance system. HUD relies on predictions of market size to establish these goals. This kind of forecasting is not easy and predictions are likely to be inexact. The record-breaking refinance boom of the last two years, for instance, has resulted in a dramatically different mortgage market from the one envisioned when the current goals were set in 2000, substantially increasing the difficulty we face in meeting them.

Setting goals in the midst of changing markets requires flexibility -- for HUD in setting the goals and for Fannie Mae in meeting them. HUD's recasting of the goals in 2000 is an example of the flexibility it has under current law. The Department increased all three housing goals. The goal for Fannie Mae's purchase of loans to low- and moderate-income borrowers, for instance, was increased from 42 percent in 1999 to 50 percent in 2001. In addition, the new goals created bonuses that gave Fannie Mae the incentive to pay special attention to financing small multi-family properties and owner-occupied 2-4 unit properties, which HUD identified as having particular value to underserved groups and which it believed would benefit from increased participation by Fannie Mae and Freddie Mac.

Fannie Mae also has flexibility under the current structure. We must meet three national goals through a combination of our single-family and multi-family businesses, including all types of business – both refinances and purchase money mortgages – that we engage in. And we must pursue this focus on affordable lending while serving the broader market. Under the current framework, Fannie Mae has been able to achieve both objectives, though it has been very difficult in some years.

Going forward, it is critical that Congress not change the structure of housing goals in a way that would fragment the market Fannie Mae serves. The mortgage market in the United States is a national market, with mortgage rates essentially the same in every community in America. Indeed, Fannie Mae and Freddie Mac were founded to, among other things, provide stability in the secondary market for residential mortgages and promote access to capital throughout the nation by increasing the liquidity of mortgage investment and improving the distribution of investment capital. A series of regional goals, as some have suggested, could disrupt the free flow of capital into certain areas in favor of others and place these founding principles at risk. In addition, the proliferation of national goals would similarly begin to fragment the market among a number of competing credit priorities and weaken our ability to bring efficiencies to the market.

Therefore, it is essential that our affordable housing requirements drive us to expand access to underserved communities without undermining our support for the broader market. The Administration's proposal, which appears to establish a series of home purchase goals and give the Secretary open-ended authority to set or amend additional national goals would, we believe, undermine our ability to support the broader market.

Conclusion

I have tried to respond to the specific issues that have been at the center of the legislative debate over the last few weeks. I am sure there are other issues I have not addressed, and I look forward to discussing these topics with you as well.

We as a society have long made homeownership a national policy priority. And the work of the Congress to address that priority has been an unprecedented success. We have the most effective and efficient home mortgage market in the world, continually working to make homeownership affordable to an ever larger number of Americans.

I have attached the testimony delivered to the House Financial Services Committee last month, which lays out the steps Congress has taken and the steps we have taken that together have expanded homeownership opportunities for millions of America's families. I believe Congress has an opportunity this year to build on this success, by creating a new financial regulator that will ensure the continued health of the mortgage finance market and enable us to continue bringing low-cost financing to millions of American homeowners.