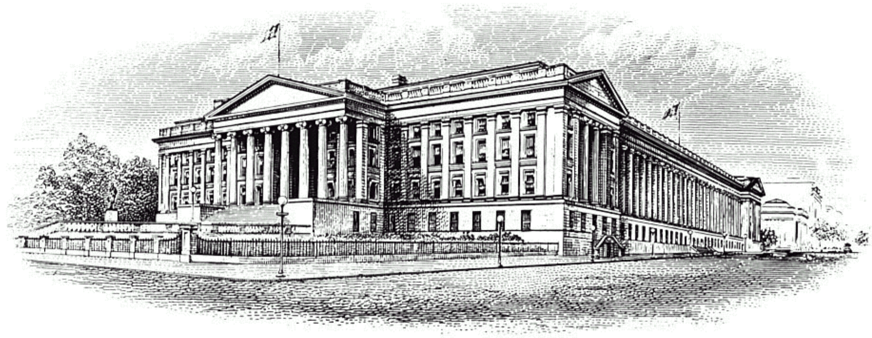

DEPARTMENT OF THE TREASURY
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Testimony of Secretary John W. Snow
Before the
U.S. Senate Committee on Banking, Housing and Urban Affairs
Washington, DC

Proposals for Improving the Regulation of the Housing GSEs

Testimony of
John W. Snow
Secretary of the Treasury
Before the Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C.
October 16, 2003

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

Homeownership is an important building block of individual financial security as well as strong communities. Our national system of housing finance plays a key role in promoting homeownership. We might call it one of the economic wonders of the world. Playing a prominent role in the vitality of our housing finance system are the government sponsored enterprises (GSEs): Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. They need to be strong and healthy so that they can play that important role today and be here to continue that important role in the future. That is why Secretary Martinez and I are here today.

As the President has made clear, one of the great strengths of America is that everyone has an opportunity to gain the independence and dignity that come from home ownership. And, Secretary Martinez 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.

There is a general recognition that the existing supervisory system for these enterprises does not have the tools, stature, authority, or resources to reach that goal. The regulatory structure is ill-equipped to deal effectively with the current size, complexity, and importance of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. As we attempt to remedy this situation, we must be mindful that we have two core objectives that should guide us: a sound and resilient financial system, and increased homeownership opportunities for less advantaged Americans.

To serve both of these objectives we need to devote careful attention to the resilience of our system of housing finance. These enterprises play such a major role in our housing finance system and housing finance is so important to our national economy that we need a strong, world-class regulatory agency to oversee their prudential operations, including safety and soundness, consistent with maintaining healthy national markets for housing finance.

On September 10, in testimony before the House Financial Services Committee, we called upon Congress to create a new and stronger regulatory system for Fannie Mae, Freddie Mac, and ideally the Federal Home Loan Banks. At that time, I outlined the Administration's recommendations for the essential, minimum requirements for a credible regulator for these enterprises. At that same hearing, Secretary Martinez outlined measures that the Administration would desire to increase homeownership opportunities. Today I renew that request, and I will highlight some of the key elements that the Administration believes are essential to reform of the supervision of these important housing government sponsored enterprises. Without these reforms, any new regulatory system would be little improved from the inadequate system we have today. In doing so, I must emphasize that we are not presenting a wish list of reforms that we would like to see enacted. We are presenting the minimum elements that are needed in a credible regulatory structure, a structure that can ensure that our housing finance system remains a strong and vibrant source of funding for expanding homeownership opportunities in America. There may be additional reforms worthy of consideration, and I look forward to discussing them, but the reforms that Secretary Martinez and I are presenting today are the foundation for an enduring program of housing finance to help provide an effective regulatory system for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

Essential Elements of Regulatory Reform

To begin with, we must make sure that we keep our eye on the crucial task of getting the regulatory structure right. In general, the legislative objective should be to create a strong, credible, and well-resourced regulator with all of the powers, authority, and stature needed to do its job. In this regard, the new agency's powers should be comparable in scope and force to those of other world-class financial regulators, fully sufficient to carry out the agency's mandate, with accountability to avoid dominance by the entities it regulates. This means that the new agency should have general regulatory, supervisory, and enforcement powers with respect to the enterprises. In my September 10 testimony, I outlined the broad parameters of the new agency's powers and presented a list of specific items that should be included.

Each of these reforms should be placed in context. The Administration wants Fannie Mae, Freddie Mac, and the Federal Home Loan Banks to be models of the highest corporate governance standards, rather than exceptions to the rule. The Administration is committed to make sure that corporate governance and oversight remain strong and effective. That requires that there be great clarity that the people running large companies are there to serve the interests of the shareholders and that their incentives and loyalties be clearly aligned in this way. One man cannot serve two masters. Fannie Mae and Freddie Mac are large, experienced, publicly-traded enterprises that have grown significantly and taken important places in our capital markets. The Administration is committed to make sure that the directors of publicly-traded corporations like Fannie Mae and Freddie Mac are elected by their shareholders, rather than selected by the President.

Location of the Agency

While in my statement on September 10 the Administration did not make a request that the new regulatory agency be made a bureau of the Treasury Department, I did say that such a recommendation could be contemplated and would be supportable if the new agency were established with adequate elements of policy accountability to the Secretary of the Treasury. The necessary arrangement would allow the agency to draw upon the resources of the department for depth of policy guidance, stature, and authority, assuring that the regulated enterprises remain focused on their important housing duties, operating within prudent bounds that will ensure sustained financial vigor to continue to fulfill their housing finance roles.

To allow the Treasury Department to provide real value to the new regulatory agency, at a minimum, the new agency should be required to clear new regulations through the department. The existing independent regulator for Fannie Mae and Freddie Mac currently clears its new regulations through the Office of Management and Budget (OMB), so it would not be novel for the new agency as a bureau of the Treasury to clear its new regulations with the Treasury Secretary as well as OMB. The Treasury Department should also have review authority over the new agency's budget to ensure that resources are being properly allocated. And to ensure policy consistency, a new Treasury bureau should clear its policy statements to the Congress through the department. Nevertheless, in any such arrangement, the new supervisory agency should have independent responsibility over specific matters of supervision, enforcement, and access to the Federal courts.

The direct involvement of the Treasury Department in providing policy guidance to the new regulatory agency is important for a number of reasons.

First, unlike the Treasury Department's other financial institution regulatory bureaus, the new regulatory agency would only be responsible for regulating a very limited number of very large financial institutions, ranging in size from more than $30 billion in assets to more than $700 billion in assets. This increases the possibility of regulatory capture, and makes the oversight of overall policy development by the Treasury Department vital.

Second, even though the obligations of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are not backed by the full faith and credit of the United States government, market participants have come to believe that some sort of implied guarantee exists, weakening market discipline of the enterprises. Market discipline is an essential element of any regulatory oversight regime, the first line of regulation of commercial banks and thrifts. A weakening of market discipline is inconsistent with our goal of a resilient housing finance system, particularly if it weakens the sensitivity of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks to the demands of the housing markets. Therefore, it is vitally important that the Treasury Department be able to monitor the new regulator's policies to ensure that such policies are not reinforcing any such market misperception of an implied guarantee.

The Administration's proposal strengthens the Department of Housing and Urban Development's oversight of the GSEs' housing goals. However, we need a credible, single regulator to do the important job of overall prudential supervision of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, one that will help ensure that the enterprises are healthy today and strong tomorrow. We need a regulator that has all of the tools and stature and resources to do the job, that is independent with regard to supervision and enforcement, but that has accountability in the formulation of policy.

New Activities Approval

The Administration has proposed that the authority for approving new activities of the housing enterprises be transferred from HUD to the new regulatory agency. This proposal is consistent with availability of one of the central tools that every effective financial regulator has—the ability to say "no" to new activities that are inconsistent with the charter of the regulated institutions, inconsistent with their prudential operation, or inconsistent with the public interest. The Federal Reserve has this kind of authority for bank holding companies, the Comptroller of the Currency has comparable authority for national banks, and the Office of Thrift Supervision has similar authority for savings associations. The current financial regulator for Fannie Mae and Freddie Mac lacks that authority, one of its most serious weaknesses. If we are serious about creating an effective, credible financial regulator, it must have the authority, in consultation with the Secretary of HUD, to review new activities as well as to review their ongoing activities.

Innovation has been fostered and encouraged under the review authorities that our nation's banking regulators have, and we see no reason why providing similar authority to the new regulatory agency would stifle innovation by Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

Capital Requirements

While we are not recommending a statutory change to the current capital requirements, we believe that the regulator should have broad authority with regard to setting the capital requirements of the enterprises, both with respect to risk-based capital and minimum capital. Authority for setting capital standards needs to be flexible enough to employ the best regulatory thinking, conscious of the enterprises' own measures of risk, so that the regulator can direct Fannie Mae, Freddie Mac, and the Federal Home Loan Banks to each maintain capital and reserves sufficient to support the risks that arise or exist in its business. We want the regulator to have the authority to increase minimum and risk-based capital requirements if warranted. Providing the new regulatory agency flexibility in regard to setting risk-based capital requirements would be an important and necessary improvement over the current awkward risk-based capital regime that applies to Fannie Mae and Freddie Mac.

Receivership/Conservatorship

Should sufficiently troubling circumstances require it, the new regulatory agency should have more than the powers associated with conservatorship. It should have all receivership authority necessary to direct the orderly liquidation of assets and otherwise to direct an orderly wind down of an enterprise, in full recognition that Congress has retained to itself, in the case of Fannie Mae and Freddie Mac, the power to revoke a charter. Providing the new regulatory agency the ability to complete an orderly wind down of a troubled regulated entity also encourages greater market discipline, which is consistent with our goal of a resilient housing finance system that responds to the needs of customers in the housing markets.

Federal Home Loan Bank System

The importance of our housing finance markets requires that all of the housing enterprises be included in a single program of world-class supervision. We see the need for this for the Federal Home Loan Banks just as we see it for Fannie Mae and Freddie Mac. While including the Federal Home Loan Banks in a program of world-class supervision presents some significant issues of policy and important details that must not be glossed over, that does not mean that their inclusion should be avoided at this time. This does not require that the supervisory structure of the housing GSEs be identical in all respects, but it does require that the new regulator have the same caliber of authorities, stature, powers, and resources for enforcement and supervision of all of its regulated entities.

Since September 10, when Secretary Martinez and I testified on this subject before the House Financial Services Committee, tremendous progress has occurred in developing a consensus. There now appears to be an emerging consensus for providing a new supervisory structure for the Federal Home Loan Banks. Today, we are very encouraged that this can be achieved, as part of a new regulatory system for Fannie Mae and Freddie Mac.

Conclusion

In conclusion, let us consider once again our purpose here this morning. It is to consider how best to promote the strength and resilience of our housing finance markets, in order to continue our progress in advancing home ownership throughout the nation. The housing-related government sponsored enterprises were created by Congress to assist in achieving that goal. Our aim must be to give them the first class quality of supervision that the importance of their charge requires. To accomplish that purpose, the fundamental elements that the Administration has proposed are essential.