

**LEGISLATIVE PROPOSALS ON GOVERNMENT-  
SPONSORED ENTERPRISE (GSE) REFORM**

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**HEARING**  
BEFORE THE  
**COMMITTEE ON FINANCIAL SERVICES**  
**U.S. HOUSE OF REPRESENTATIVES**  
ONE HUNDRED TENTH CONGRESS  
FIRST SESSION

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MARCH 15, 2007  
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## LEGISLATIVE PROPOSALS ON GOVERNMENT-SPONSORED ENTERPRISE (GSE) REFORM

Thursday, March 15, 2007

U.S. HOUSE OF REPRESENTATIVES,  
COMMITTEE ON FINANCIAL SERVICES,  
*Washington, D.C.*

The committee met, pursuant to notice, at 10:04 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Present: Representatives Frank, Waters, Maloney, Watt, Meeks, Moore of Kansas, Hinojosa, Clay, Miller of North Carolina, Scott, Cleaver, Bean, Davis, Sires, Hodes, Ellison, Perlmutter, Murphy, Donnelly; Bachus, Baker, Royce, Gillmor, Biggert, Shays, Miller of California, Hensarling, Garrett, Pearce, Neugebauer, Bachmann, and Roskam.

The CHAIRMAN. This hearing of the Committee on Financial Services will come to order. This is the second hearing we will be having before the committee on the question of the Government-Sponsored Enterprises (GSEs).

The chairman of the Subcommittee on Capital Markets, Mr. Kanjorski, had a very useful hearing on this on Monday.

We hope to be voting on this bill in committee before the break; I think we set it for March 28th. We then hope to be able to go to the Floor; that is where we are.

We have been working on this bill for some time. A version of this bill that is quite close to the bill that is before us passed this committee by a very large majority and in the House by a large majority in the previous Congress.

It was largely bipartisan. There were some points of difference. I will note that a couple of the points of difference have been specifically addressed, not in the existence of the housing fund, but in how it is administered and calculated.

There have been some other changes as well in conversation that I had with some consultation with the Minority, but I do not claim to date to have the full responsibility for this, but we did try to stay in touch with people.

This was in December, so it was still when Mr. Oxley was the outgoing chairman. We had conversations with the Treasury Department, with various people; Under Secretary Steel was very important in that.

We have the bill before us. The bill does several things that seemed to us important. First of all, it substantially enhances the

power of the regulator. I do want to say that I think there has been a somewhat excessive debate over exactly what the powers of the regulator are.

We currently have a regulatory structure that most of us agree gives the regulator less legal authority than he ought to have. Despite that, in the past few months, the regulator has ordered both Fannie Mae and Freddie Mac to do things that they did not want to do on their own because nobody ever has to order anybody to do what they want to do, except in circumstances which it would be inappropriate to discuss here.

The fact is that even with the acknowledged less than full authority, both Fannie Mae and Freddie Mac complied. I think we ought to recognize that if you have a regulator and he has powers and he is determined to do something, he is probably going to be able to do that.

We can set a framework and set some guidelines. Here are the guidelines that I want to set in the bill, and I think the bill does this.

There are people who believe as a matter of economic philosophy that it is a mistake to interfere with the allocative function of the capital market by giving a preference to housing and particularly homeownership. That is a legitimate philosophical debate.

By creating and continuing the GSEs, which get a certain advantage when they borrow in a marketplace because of arrangements that exist, and even more important, because of perceptions about those arrangements, including some misperceptions, I do not feel—I try not to promulgate misperceptions, but I have no objection to benefitting from other people's misperceptions, as long as their existence was not my fault.

I think that is where we are to some extent with Fannie Mae and Freddie Mac. I believe the misperceptions are deeply rooted but it will not shake them by so designating them.

That does give a preference in the capital market for housing—homeownership but also rental housing—as we will get into. I understand there are people who are philosophically opposed to it.

I believe some of the debate that happened last year and before came between people who shared the philosophical view that it was a mistake to have the allocative function in the capital market interfered with and those of us who said no, we like having this preference for housing.

Then the question becomes okay, if you agree that it is legitimate to maintain the preference for housing, two sets of questions come up. Is there sufficient power of the regulator to make sure that as you go forward with this system, you do not run into problems within these two entities that could cause broader problems, safety and soundness issues.

I believe in this bill, and I know the former chairman, Mr. Oxley, agreed with this. We believe strongly that the bill we had last year gave the regulator full power to deal with any safety and soundness issue, whether by raising the capital or reducing the portfolio or other means.

Subsequent to that bill being passed, when Mr. Oxley believed as I did that we had reached that level, we have somewhat enhanced the power of the regulator.

I do not think there was any room for doubt that the regulator has full powers under this bill to do what needs to be done for safety and soundness.

We did disagree that they should be empowered to deal with something defined as “systemic risk” over and above safety and soundness. I will confess to being very skeptical that you can have entities that cause risks to the system when they themselves had no problems.

I am trying to envision Samson in the Temple pulling down the walls and not getting hit in the head. I do not think you can destroy the entity and escape any damage yourself. We will discuss this.

I have to say that this is an atmosphere of some sensitivity, and I would hope that we would get agreement, not just on the language of this bill, but agreement frankly among us, including the people here, as to what that means and how it will be interpreted.

You can never write everything exactly. I think we need some common understanding of what we mean by this in the areas I am talking about.

Full powers over safety and soundness, but not reaching the philosophical debate, and I think the philosophical debate gets into the systemic risk issue.

Secondly, there is the question of housing. I will give myself an additional 2 minutes and then I will pass it onto the Minority.

One of the arguments that has been made for changes is that Fannie Mae and Freddie Mac get the benefits that I talked about from the perception or misperception by the financial community, and too many of those benefits remain with the stockholders of Fannie Mae and Freddie Mac, and in past times, with even the CEOs of Fannie Mae and Freddie Mac, although stay tuned for the executive compensation legislation where we may deal with that in a broader sense.

Under Fannie Mae and Freddie Mac’s past executives, not current ones, there was an abuse of compensation practices. There was also an argument that they shared too much of the money, that money was being held for Fannie Mae and Freddie Mac’s benefit, and not enough was being shared with the public purpose.

There are two things you can do if you feel that. You can reduce what Fannie Mae and Freddie Mac are able to accumulate by cutting back on the portfolio or other ways, or you can allow them to continue that level, depending on how they fare in the market, but require them to share more of it with the public purpose.

That is what we chose in the bill last year and we choose again in the bill that is now pending. That is the creation of the housing fund. Let me be clear.

Fannie Mae and Freddie Mac have goals, and those goals are to help affordable housing. Affordable housing, as people who cover housing know technically has several subcategories.

Affordable housing used to be for the goals housing aimed at people at 100 percent of the median. At the suggestion of people in the Financial Roundtable, and in particular, our former colleague here, Mr. Bartlett, we said no, that is not consistent. We generally say affordable housing has to be aimed at people at 85 percent of the median or below. We changed that in the bill to 80 percent.

You cannot get much below people who are at 80 percent of median simply by the secondary market by buying loans.

If you are going to reach people who are at low income, 50 percent, extremely low income, 30 percent of median and below, then there has to be an element of subsidy. You cannot do it just by loans. That is the distinction that some people fail to understand.

This bill does enhance the goals. It does try to push Fannie Mae and Freddie Mac—it will push Fannie Mae and Freddie Mac into doing more in the 80 percent range. Nothing you can do with loans and repurchase of loans and securitization of mortgages reaches that low level.

We then say yes, we agree that they are keeping more of the benefit than they should. We take a small part of that benefit and put it in the housing fund.

I have to say here that some of my friends on the conservative side seem to me to be inconsistent. On the one hand, they are advocating very tough regulation for Fannie Mae and Freddie Mac, unlike any other private entity, because they have this government-sponsored enterprise element.

When it comes to regulating them, telling them how much capital they can have, what they can hold in their portfolio, what, in fact, activities they can engage in, they are public entities to be regulated.

But when it then comes to how you deal with the profits they amass, all of a sudden they become private property, no trespassing, you will be electrocuted if you come on the land.

They cannot be both. They cannot be wholly government sponsored for the purposes of regulating them and setting their capital standards, etc., but then private enterprise, so that you cannot take the money. We think that they are a mix, and reasonable activity is permissible in both cases.

That is what this bill does.

The Chair now recognizes the gentleman from Alabama. The gentleman from Alabama has used the power under the rule here, which we agreed to, to take an additional 10 minutes, so he has 20 minutes. The gentleman is entitled to 20 minutes for an opening statement.

I realize this is a lot for you all to sit and listen to, but this is an important bill. I do think it is important that we air these things. I assume you are all smart enough to figure that the morning was killed anyway, so it should not be a problem that you have to sit and listen to us.

The gentleman is recognized for 5 minutes.

Mr. BACHUS. I thank the chairman. I do not know whether it is a bigger burden on you to listen to me or to listen to the chairman.

[Laughter]

Mr. BACHUS. I will not ask you.

Chairman Frank, let me start by thanking you for holding this hearing. This is a very important matter. It is important for the GSEs, Fannie Mae, Freddie Mac, and for our 12 Federal Home Loan Banks. It is also important for homeowners, for taxpayers, and for prospective homeowners.

This committee has been working to enact meaningful reform of the GSEs and their regulator for years. This is not an issue with

convenient answers. Actually, it is a subject where really every proposed solution raises some new difficult questions.

Having said that, I do believe that we are close to our goal of GSE reform legislation.

Promoting homeownership, especially homeownership for low and moderate income families, is a priority for the Republican members of this committee. Congress created the Housing GSEs to expand homeownership and meet the needs of any person who wants to live the American dream.

We must balance that requirement with the responsibility of limiting risk to the taxpayer and the burden to the market. Fortunately, a strong bipartisan consensus exists around the issue of GSE reform.

Events of recent years have led many to conclude that the current regulators are underfunded, understaffed, and unable to fully oversee the operations of these sophisticated entities.

Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are large, complex financial institutions requiring a world class regulatory structure which is independently funded with all appropriate authority and independence.

When the committee debated GSE legislation last Congress, I did join, as the chairman said, with a substantial number of my Republican colleagues in opposing the creation of a housing fund that would have been drawn from the GSEs after tax income and used to fund certain housing initiatives by outside parties, including nonprofit organizations and community development groups.

This year's bill includes a modified version of that proposal—one substituting a funding mechanism based upon the GSEs' total outstanding mortgages.

In the interest of fairness and accuracy, as Chairman Frank correctly stated, the language in this year's bill is an improvement over last year's version.

While I respect Chairman Frank's long-standing and sincere belief in the importance of creating this fund, I agree with the Congressional Budget Office that new assessments on GSEs would inevitably be passed along to their customers in the form of higher fees, therefore, raising the cost of purchasing a home or refinancing an existing mortgage.

Additionally, many on our side of the aisle have serious questions about the ability of State housing bureaucracies to competitively, and let me stress that word, competitively, and efficiently deliver and monitor upwards of \$500 million per year.

Further, the proposed fund is extraneous to the task at hand, creating a world class safety and soundness regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

Therefore, I must remain opposed to the inclusion of the proposed affordable housing fund in the GSE reform bill.

We still have in our power the ability to pass a strong, very much needed GSE reform bill with overwhelming bipartisan support. All that would be necessary to achieve this goal is to de-link GSE reform from the proposed housing fund, and to make the latter the focus of a separate legislative proposal.

Let me conclude by saying that I still believe we can address this honest philosophical disagreement in a manner consistent with the

House Financial Services Committee's long and unique history of bipartisan cooperation.

Hopefully, we can move forward swiftly on the issue of GSE reform, and then tackle the separate question of expanding our Nation's affordable housing supply in a manner beneficial to taxpayers, homeowners, and those who wish to rent in a manner consistent with free market principles.

Again, Mr. Chairman, I thank you for holding this hearing, I commend you for this legislation, and I thank our witnesses for taking the time to be here.

The CHAIRMAN. The gentlewoman from California is recognized for 5 minutes.

Ms. WATERS. Thank you very much, Mr. Chairman. I certainly appreciate the opportunity to hear from our witnesses today, and I appreciate the work that both you and Mr. Kanjorski have done in order to get us to this point.

I am very, very interested in GSE reform for a number of reasons. I must share with you, Mr. Chairman and members, that despite the fact that I agree that there is a need for some reform, I have never been comfortable with the politics that led to this reform, the formation of FM Watch, and what that means, and what appears to have been a fight about market share, and a lot of concern about whether or not the GSEs were entering into the retail portion of this business rather than being confined to their mission. I am not so sure that much of this had not been about that kind of competition.

I have paid some attention to this bill. It is a masterpiece of legislation that certainly I must spend a lot more time on. I have a lot of questions about OFHEO. I have had a lot of questions about OFHEO from the first time that I was introduced to exactly what they did and what they did not do. I am anxious to have the correct kind of oversight agency, but I still have questions.

We talk about the new make-up of the board of the GSEs and taking away the President's appointments, and I am not so sure that I agree with that. I want to raise the question about whether or not OFHEO has a board. Who oversees OFHEO?

I am also concerned about some of the functions of HUD that will be removed from HUD to OFHEO, and I think that this committee has never resolved whether or not the accepted accounting principles and practices are consistent and that we really do understand them.

I suspect that there will always be some questions about whether or not the accounting practices are the correct ones to be used because it seems to me that there are still things about the accounting practices that have never been resolved.

We are all interested in safety and soundness. I know the constant refrain about the fact that these GSEs are too big and that God forbid, they should collapse, but it has been a lot more of the kind of negative questioning and the anticipated problems rather than any real problems within these GSEs as it relates to their soundness.

I think they should have reasonable capital requirements, but I will be taking a strong look and discussing with you, my colleagues, not only that but other aspects of this legislation.

Let me commend you, Mr. Chairman, on the housing trust fund. I think that was brilliant. I like the idea that we are going to help the GSEs realize their mission of more affordable housing.

We have all constantly said to the GSEs that we want more done in low-income housing, and this certainly will help.

I think we still have a long way to go to talk about how it gets managed. I think there are a lot of ideas about how that housing trust fund gets managed and what is the best way to get the resources to the people who can really do something about creating housing opportunities for our Nation.

I look forward to that discussion and the information that will be shared with all of us by our colleagues about their experiences.

Also, all of these agencies need oversight on diversity. One of the good things about the GSEs is our ability to talk with them about diversity and their responsiveness to us, where they come in and they show us their charts. They let us know about movement. They let us know about their efforts to have diversity within these huge corporations.

The last time I talked with OFHEO, I do not think there were any African Americans in management, for example. I am not supportive of any oversight of any agency of government that is supposed to be doing the business of all the people that does not reflect the kind of diversity that will help me to understand that they know they are working for everybody.

I will be raising these questions. I will be pushing very hard to make sure that we do some corrections. I am not yet sold on quite the way this reform has taken place.

I yield back the balance of my time.

The CHAIRMAN. I will recognize the gentleman from Alabama. We agreed under our rules that we would have 10 minutes of opening statements for each side, with either the ranking member or the chairman of the subcommittee or committee at his request to do an additional 10 minutes.

The gentleman from Alabama now has time remaining. I am going to yield to the gentleman from Alabama and he can yield the time that is remaining to him as he wishes.

Mr. BACHUS. Thank you, Mr. Chairman. Mr. Chairman, I plan to yield 3 minutes to Mr. Baker, 3 minutes to Ms. Biggert, 3 minutes to Mr. Royce, 1 minute to Mr. Gillmor, 3 minutes to Mr. Miller, and 1 minute each to Mr. Garrett and Mr. Neugebauer.

The CHAIRMAN. The gentleman has permission to do that, and it is the timekeeper's problem now, not mine. The gentleman may proceed.

[Laughter]

Mr. BACHUS. At this time, I yield 3 minutes to Mr. Baker, Congressman Baker.

Mr. BAKER. Mr. Ranking Member, I know there are people asking for time. I do not need 3 minutes. I will take 30 seconds, if you would, in keeping your calculation, that will give you a couple of minutes to play with.

Mr. BACHUS. I will yield such time as you may consume.

Mr. BAKER. I will take 30 seconds. I want to thank you for the time. I want to thank the chairman for his good work on this im-

portant bill. We have come a long, long way over many, many years.

Now is the time to get this done. I think this is an excellent product from a safety and soundness standpoint. Certainly, there are improvements that can be made to any bill that is offered.

I look forward to improving it and more importantly, to hearing from our witnesses and learning more about the subject.

I yield back.

Mr. BACHUS. Thank you. That will free up time for one additional member. Ms. Biggert for 3 minutes.

Mrs. BIGGERT. Thank you, Mr. Chairman, and Ranking Member Bachus, for holding this hearing today.

I would like to welcome today's witnesses, Under Secretary Steel, Director Lockhart, and Assistant Secretary Cornick, our GSEs' representatives, and all of the housing professionals who are here today.

I look forward to hearing your views on the latest version of the bill.

This is not a new bill or a new issue for those of us who have served on the committee since at least the 106th Congress. We held about 23 hearings and heard from well over 100 witnesses. In May of 2005, this committee reported out Mr. Baker's bill, H.R. 1461, by a vote of 65–5. In October of 2005, the House passed the bill by a vote of 331–90.

I supported Mr. Baker's bill and commend him on his years of work on this issue. Our colleagues on the other side of the Capitol, however, failed to act on his bill during the last Congress, since we have returned for another round of GSE discussions.

I would also like to thank Chairman Frank and Mr. Baker for introducing a GSE bill to establish a new and stronger regulator for the GSEs and the Federal Home Loan Banks.

I hope that this legislation will give the new regulator crystal clear direction about its authority, available tools, and mission, so that it can guide the GSEs to be more effective for homeowners, market participants, financial institutions, and taxpayers. We also should aim to isolate this regulator from political influence.

At this time, I have two concerns with the most recent version of the GSE reform bill. First, I hope we can take a closer look at the section of H.R. 1427 on program review and approval.

I was active on this issue last Congress and I look forward to working with my colleagues to ensure that we strike the right balance, one that allows appropriate oversight, but does not impede the kind of innovation that ultimately is good for consumers and homeowners.

Today, we should examine if the language as drafted is too ambiguous or if it will accommodate this important balance.

Second, I am concerned about certain provisions in the affordable housing fund section of the bill—how this will establish a formula to allocate funds to States and Indian tribes, which would in turn determine which organizations receive the funds.

I am not convinced that this is the best delivery method. Should the language be more specific and outline organizations that are appropriate to receive these funds? Should HUD play a more expanded role in the fund than the bill envisions?

Should the affordable housing fund be modeled after the affordable housing program that is administered by the Federal Home Loan Banks?

I hope today's hearing will shed light on these specific issues as well as on other important provisions of the bill regarding mission, portfolio limits, and capital requirements.

Again, I welcome today's witnesses and thank Chairman Frank for holding this hearing. I yield back.

Mr. BACHUS. Thank you. At this time, I yield 3 minutes to the gentleman from California, Mr. Royce.

Mr. ROYCE. Thank you. Mr. Chairman, despite many of the improvements in this bill, and despite the improvements it would make on the regulatory structure of the GSEs, I am deeply troubled by two provisions.

First, the legislation fails to give the regulator authority to take into account the systemic risk to the financial markets and to the housing sector when reviewing the size and scale of the GSEs' retained mortgage portfolios.

I think that is the whole point of regulating them. We do not do here what the Fed has suggested, and as we have heard from various experts, including the Fed Board, a failure by the GSEs to properly manage their large concentration of interest rate risk could de-stabilize the global financial system.

In 2005, then-Fed Chairman Greenspan warned this committee—he warned us here—against passing legislation without giving the regulator appropriate authority to oversee systemic risk.

My second point is that I am adamantly opposed to the creation of an affordable housing fund. As I said last year, this fund is an experiment in socialism. We have a philosophical disagreement about this, and I will not belabor the point now, but this fund should not be included in legislation to improve the safety and soundness of the GSEs. This is essentially a poison pill provision.

Mr. Chairman, I believe that last week Fed Chairman Bernanke provided a road map for a solution to both the systemic risk and affordable housing issues.

As the Federal Reserve has not been asked to testify today, I would like to submit his March 6th speech entitled "GSE Portfolios, Systemic Risk and Affordable Housing" into the record.

The CBO estimated that Fannie Mae and Freddie Mac shareholders benefit in the amount of \$12.3 billion because of the enterprises' perceived relationship to the Federal Government.

The CHAIRMAN. Without objection, we will accept that document into the record.

Mr. ROYCE. Thank you, Mr. Chairman.

In light of this subsidy, Federal Reserve Chairman Bernanke's latest proposal makes a great deal of sense because it allows the GSEs to use the subsidy for affordable housing by enabling them to purchase and retain mortgages extended only to households with below median income.

This would do much more in addressing affordable housing than the fund contained in H.R. 1427. It would reduce the systemic risk posed by the retained portfolios, and I hope my colleagues will consider the approach advocated by the Federal Reserve Board, as I think it is most practical, and it is a very responsible solution.

I would also end by commending you, Mr. Chairman, because you did put several things in this bill like setting minimum and risk based capital standards. You placed a troubled entity into receivership. You set up a system to review product approval and mission and to be independently funded outside the appropriations process.

I agree with those changes that you put in the bill, but I raise these philosophical points because I think—

The CHAIRMAN. If the gentleman will yield briefly, I appreciate that. I appreciate both his praising some elements but also maintaining his opposition. I need both to get this bill through.

Mr. ROYCE. Thank you.

Mr. BACHUS. Thank you. Mr. Chairman, we have 8 minutes remaining on our side. I would like at this time to assign 1 minute to Mr. Gillmor and 3 minutes to Mr. Miller following him. I will have an additional 4½ minutes after that. Let's do those two.

Mr. GILLMOR. I thank the ranking member for yielding, and I commend the chairman for moving forward with this hearing.

The issue of GSE reform is an extremely important one for the safety and soundness of our financial system. It is one that this committee has worked on previously.

I think it is clear that we need a strong regulator. I think that regulator ought to have the authority to oversee the size and the types of activity. I think you can do that and let the GSEs preserve their very important mission of promoting housing.

I also wanted to mention that I am very happy to see that the bill includes a provision that I had introduced last year requiring that these companies disclose their charitable contributions to shareholders.

There is a lot of concern about corporate governance and a lot of management kind of forget that it is the shareholders' money, and we are talking about billions of dollars here.

I think it is very good that this principle is incorporated in this legislation; I would hope to see it extended in other legislation; I appreciate the opportunity; and I yield back.

Mr. MILLER OF CALIFORNIA. Thank you. I commend Barney Frank and Mr. Bachus for bringing this bill forward.

We have been dealing with this issue for quite a few years and dealing with safety and soundness on the part of GSEs and limiting risk. That is really, really important.

We need to be careful not to hinder the basic innovation we have available through GSEs in doing that. We need to guarantee that mortgages are also accessible in the future.

Increasing capital requirements when there is a risk is appropriate on a temporary basis, but there needs to be a very strong trigger that rolls back those increases once the issue has been resolved. We do not want to increase and yet leave it there without decreasing it when the issue has been taken care of.

Conforming loan limits in high cost areas is a really growing problem. We talk about affordable housing, and in many ways, affordable housing is a matter of perspective based on where you live.

OFHEO put out a chart that I think is very, very good. I am not talking about subprime loans. I am talking about jumbo loans in this country compared to conforming loans.

Only 18.1 percent of jumbo loans are at a fixed rate compared to 82 percent in conforming loans. Much of the problem that we are facing in this country with foreclosures and defaults has to do with, I think, the lack of conforming in high cost areas.

If you look at what the jumbo market is doing today, 34.9 percent of all the loans made are interest only ARMs, and 23.9 are negative amortization ARMs. If you look at the chart put out by Business Week in September of last year, you cannot see it, but the red you see on there is all California.

That is the amount of foreclosures, and the high amount of foreclosures we are facing in this country, and they happen to be in the marketplace where conforming is not available and GSEs cannot do an adequate job, and even FHA, because the limits are set so low that they just do not work for California.

This bill does something that is very, very good. It raises those limits in high cost areas. There has been quite a debate about subprime and the amount of risk associated with subprime and foreclosures today and defaults.

I think what you are doing throughout most of this country has proved to be very good. Yes, there are some defaults, but when you look at it compared to the defaults we are facing in California because of the exotic loans that the jumbo loan market has created, we have to be able to effectively deal with that.

I think we are at fault as Congress for not dealing with that. As with any legislation, there are parts of a bill that some of us do not like, but that is basically true of any piece of legislation we put forward in this country.

We need to be very, very creative in GSEs. We need to also be able to expand the availability of GSEs. People in my district and my State should not be discriminated against just because they are a high cost area. That basically is what we face today.

This bill resolves a lot of that. It goes a long way in creating basically fairness throughout this country on how we are going to provide government programs.

I just commend the ranking member and the chairman for pushing this bill forward. I look forward to supporting it, and I yield back.

Mr. BACHUS. Thank you. At this time, our last 4½ minutes will be distributed to Mr. Garrett for 90 seconds, Mr. Neugebauer for 90 seconds, and Mr. Shays for 90 seconds.

Mr. GARRETT. Thank you. I would first note that the chairman, who earlier pointed out the contradictory views that some members have of the GSEs should look to the GSEs themselves, if they have contradictory views. Sometimes playing up their government role when that serves their purpose and playing up their private role when that serves their purpose.

The chairman also pointed out some of the new actions by the regulator. I think that also shows the problem with this legislation, that without some specific benchmarks in place with regard to portfolio limitations, we may find ourselves in the same situation with another regulator down the road not implementing those

when we are merely giving direction and not specific benchmarks. That is the second problem.

The chairman also points out the reference to Samson and the Temple. I think that is also exactly a problem. When you disrupt a system, you do pull it down on your head. We must remember that Samson had his eyes gouged out. He was blind at the time. I think we are still blind in this situation, and when it falls on his head, it falls on the taxpayers' heads in this situation.

Finally, the chairman makes reference to the benefits to stockholders and the CEOs of the implicit government guarantee. He references only two solutions: reduce the portfolio; or share some of that public portion of the portfolio.

There are two other ones. We could end the implicit backstop of that guarantee of the government to these GSEs, and fourthly, we can use what Chairman Bernanke said, to put limitations on that portfolio and put it right to low-income and affordable housing, and that would be a second and third way to make sure those profits do not go to the stockholders but go to the people that Congress intended.

With that, I yield back.

The CHAIRMAN. There is a vote. We can finish the opening statements; go vote; and then come back.

Mr. NEUGEBAUER. Thank you, Mr. Chairman, and Ranking Member Bachus.

I think one of the concerns I have is that as I have sat in the early days of the 110th Congress and the latter days of the 109th Congress, we have moved from our regulatory role to a management role.

Congress is now not only trying to regulate companies, but now they are trying to manage those where we are trying to tell companies what they should pay their CEOs. Now we are saying to companies, and this particular entity, that we are going to put a tax on you. We are going to tax your portfolio based on the amount of business that you have on the books.

We have gone from leaving that money on your balance sheet and being able to bring innovative programs to giving it to States. That is just additional taxation.

I am very concerned about the direction that we are moving in with this bill in many areas. The fact is that we heard Secretary Jackson yesterday say to us, and it is a true statement, that today more people own a home today in America than any other time in the history of our market.

We have some of the most robust markets in the world. We are the envy of the world, and particularly our mortgage market. As I travel abroad and talk to other countries of developing markets, they do not have the tools for housing that Americans have.

I am very concerned about where we are moving in this direction. I am hoping we can, in the mark-up, make this bill get back to what it is intended to do, and that is to regulate rather than manage.

I am very concerned that today as the capital markets are watching C-Span, they are packing their bags for other places that are more friendly to investment than I think this Congress is heading as far as making a fertile investment market where we have a very

robust marketplace, but I think we are moving in a direction now that sends the wrong signal to these markets.

What this bill is going to do is raise the cost of housing for the American people by the fact that Fannie Mae is a big player in a lot of the mortgages, and Freddie Mac, they are a very big player in that.

I am very concerned about putting another tax on the American people in the form of a fee.

Mr. SHAYS. Thank you, Mr. Chairman, and Ranking Member Bachus.

First, Mr. Lockhart, thank you for your service to our country, as Executive Director of the Pension Benefit Guarantee Corporation, Deputy Commissioner of Social Security, and now Director of the Office of Federal Housing Enterprise Oversight, a constituent of mine. Had you chosen to be in the private sector, you could have had a much different return on your investment. Thank you for your service.

I just want to say that in my judgment, GSEs have been getting away with not real life murder, but practically. I think they have been operated in a very corrupt way. They were exempted from the 1934 and 1933 Acts. They were exempted from Sarbanes-Oxley. It was pressure by a number of people that finally got them to have to act like they were under the 1934 Act. When we did that, we learned how corrupt they had been operated.

I am looking forward to them being cleaned up. The bottom line is that they could keep any profit and pass any loss onto the government, and they basically were able to keep this unique status by catering to the needs of Members of Congress, and they got away with it for many years.

I am happy that reality has finally caught up with them and that we can protect the public and they can do the work they are supposed to do, and that is to help the low and middle income communities, as well as help the housing market in general.

I thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman. I will use my remaining time just to say I did want to acknowledge the gentleman from New Jersey reposed my accusation that some on the other side were being inconsistent by viewing Fannie Mae and Freddie Mac sometimes as purely private profit maximizing corporations and others as entities with a public interest, and he reposed by saying they were also inconsistent.

I am glad to lump them altogether. I am glad to say that sometimes Fannie Mae and Freddie Mac are as inconsistent as members of the Minority. I have tried to be consistent. I will not use either of them as my standard for logic in this regard.

Secondly, I did want to respond to the gentleman from Texas who said we were trying to set CEO salaries. No bill that I know of proposes to do that. We have talked about legislation that will let the shareholders vote on CEO salaries in an advisory capacity.

The gentleman from Texas demolishes a strawman, and while we are at the break, perhaps they can sweep up the debris that would have accumulated.

Also, I think we have seen—my last point is this, and the gentleman from New Jersey said, well, Federal Reserve Chairman

Bernanke suggested a way to resolve this by having them do more with their portfolio. That is a fundamental misunderstanding of the need for affordable housing.

You are talking about 80 percent of median and above when you talk about the portfolio. Those should be done by the sensible purchase of loans.

When you are talking about people at 50 percent below, as we define low income, 30 percent below median, extremely low income, there is no way short of subsidy that you can do that.

You may not want to have Fannie Mae and Freddie Mac contributing to alleviating the problem for people at that low end. Literally, no one who deals with housing thinks that by secondary market and securitization, you can get much below the 80 percent. We did lower it from 100 percent to 80 percent as the benchmark for the goals.

It is simply not the case that you can reach the level of subsidy we hope to, the lowest income people, by using the normal securitization methods.

Mr. SHAYS. Mr. Chairman, and Mr. Steel, I thank you for your service as well, another Connecticut resident. Obviously, I thank all. A great leader in our community.

The CHAIRMAN. I was going to say, what about Cornick? Only people in Connecticut?

[Laughter]

The CHAIRMAN. Thank you, Mr. Cornick. The hearing will recess and we will come back. You will have to move to Connecticut to be thanked.

[Recess]

The CHAIRMAN. The hearing will reconvene. Please take your seats.

We will begin the testimony. First, we have a panel of Administration officials. We will begin with Robert Steel, who is the Under Secretary for Domestic Finance in the Department of Treasury.

Mr. Steel?

**STATEMENT OF THE HONORABLE ROBERT K. STEEL, UNDER SECRETARY FOR DOMESTIC FINANCE, DEPARTMENT OF THE TREASURY**

Mr. STEEL. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee, for inviting me to appear today before you to discuss the very important issue of Housing Government-Sponsored Enterprise (GSE) regulatory reform.

H.R. 1427 will significantly improve the supervision of GSEs. This legislation creates a strong regulator with authorities that are commensurate with other financial regulators' powers, to ensure that the housing finance system remains vibrant.

H.R. 1427 is a well-crafted and balanced bill. It has been a privilege working with the committee on this important effort, and we look forward at Treasury to continuing to do so.

The United States has one of the most successful housing finance systems in the world. Our Nation's housing finance system provides consumers with a wide range of mortgage finance options that open up the door for homeownership and access to normally illiquid housing wealth accumulated over time.

The housing GSEs—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks—are important components of our Nation’s housing finance system, as are federally insured depository institutions, mortgage banks, private mortgage insurers, mortgage brokers, and investment banking firms.

Fannie Mae and Freddie Mac operate in the secondary mortgage market by providing credit guarantees on mortgage backed securities or by directly investing in mortgages and mortgage related securities through their retained mortgage portfolios.

Recent accounting and corporate governance problems and regulatory oversight have limited the growth of Fannie Mae and Freddie Mac over the last few years.

Nonetheless, they are still a significant presence in our Nation’s housing finance system. Together, Fannie Mae and Freddie Mac have about \$4.3 trillion of mortgage credit exposure as of year end 2006, which was about 40 percent of total outstanding mortgage debt in our country.

The Federal Home Loan Banks also are significant participants in our Nation’s housing finance system, but they operate under a different business model than Fannie Mae and Freddie Mac.

The Federal Home Loan Banks’ primary business is making advances or secured loans to member institutions that are involved in housing finance to various degrees.

As of year end 2006, Federal Home Loan Bank advances were \$641 billion, and they held total mortgage investments of \$225 billion, and total assets of approximately \$1 trillion.

Treasury has continually stated that we have two core objectives regarding GSE regulatory reform. First, the need for a sound and resilient financial system, and second, increased homeownership opportunities for less advantaged Americans.

In line with our core objectives, our reform proposals have been designed to minimize the risks that the housing GSEs pose to the financial system, and to focus the housing GSEs on that specific mission.

It is widely recognized that there is a deficiency in the oversight and regulation of the housing GSEs, and Congress has worked to improve this situation. We at Treasury appreciate this effort and pledge to continue to work with you to establish a new regulator that has all the authorities necessary to oversee these complex and sophisticated institutions.

Throughout the debate on housing GSE regulatory reform, Treasury’s focus has been on ensuring that the new regulator has all the powers, authority, and statute needed to do the job.

In this regard, a core tenet of our position is that the new regulator’s powers should be comparable in scope and force to those of our Nation’s other financial institution regulators.

In addition, the housing GSEs are different than a typical financial institution. It is just as essential that the new regulator have the appropriate authority to consider these unique characteristics of the GSEs and their housing mission.

In terms of comparable powers, we must ensure that the new housing GSE regulatory agency has the following authority: it must have the flexibility to set both minimum and risk based capital requirements; it must have all the receivership authority that is nec-

essary to direct liquidation of assets and otherwise to direct an orderly wind down in the event of the failure of an enterprise; it must be required to take mandatory receivership actions under certain circumstances; it must have the authority for approving new activities of Fannie Mae and Freddie Mac and ensuring compliance with their mission; and it must also have independent funding outside of the appropriations process, independent litigating authority, and other related powers. In other words, the full tool box of regulatory and enforcement skills characteristic of a financial regulator.

In addition to ensuring comparable regulatory authority, the housing GSEs must also have unique characteristics that must be addressed in regulatory reform legislation.

The housing GSEs were created to accomplish a mission and they were provided a certain set of statutory benefits to help in the accomplishment of this mission. The GSEs also greatly benefit from the market's perception that the U.S. Government guarantees or stands behind GSE obligations, which results in preferential funding rates being provided to the GSEs.

On behalf of the Treasury, I want to once again reiterate that the GSEs' debt and other financial obligations are not backed by the Federal Government.

As Treasury has previously noted, the combination of three factors of Fannie Mae and Freddie Mac's retained mortgage portfolios warrant the attention of policymakers: first, the size of the retained mortgage portfolios of Fannie Mae and Freddie Mac, \$1.4 trillion as of year end 2006; second, the lack of effective market discipline; and third, the interconnectivity between the GSEs' mortgage investment activities and the other key players in our Nation's financial system.

The combination of these three factors causes the GSEs to present the potential for systemic risk to our financial system and the global economy. This view has not changed. Thus, other appropriate measures are needed in this legislation to take into account these unique characteristics of the housing GSEs.

These essential components include that the new regulatory agency must be provided specific review authority over the retained mortgage portfolios of Fannie Mae and Freddie Mac. Such authority should establish a clear and transparent process based on direction from Congress on how the new regulatory agency will evaluate the retained mortgage portfolios in terms of risk and consistency with mission.

There must be clarification that the government should not be involved in the appointment of directors to the boards of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

The Federal Home Loan Banks must be placed under the same regulator with Fannie Mae and Freddie Mac and then this new regulatory regime should be structured to take into account certain special differences between the Federal Home Loan Banks and the other GSEs. This would enhance the critical mass of financial expertise needed to oversee the GSEs.

In conclusion, we at Treasury appreciate the efforts of the chairman and members of the committee in working towards achieving resolution of the housing GSE regulatory reform issue.

H.R. 1427 will establish a new regulator with powers that are comparable to other financial institution regulators, which will greatly improve the oversight of the housing GSEs.

We still have concerns with certain aspects of H.R. 1427. In particular, if an affordable housing fund is going to be part of this legislation, the fund must be controlled by the Federal Government, not by Fannie Mae and Freddie Mac. It must be temporary and capped.

In addition, the provision increasing the conforming loan limit in high cost areas is inappropriate because there do not appear to be any problems in the provision of mortgage credit in these areas, and it could detract from the affordable housing ambitions of Fannie Mae and Freddie Mac.

Nonetheless, the Treasury is supportive of the regulatory enhancements contained in this legislation as they are a significant improvement over the current law. Any efforts to limit these powers or weaken the new regulator would not be favorable.

Thank you, very much. We look forward to continuing to work with you.

[The prepared statement of Under Secretary Steel can be found on page 187 of the appendix.]

The CHAIRMAN. Next is Director James B. Lockhart III, of OFHEO, and I would like to point out that, like Mr. Steel, he is from Fairfield County, Connecticut.

[Laughter]

**STATEMENT OF THE HONORABLE JAMES B. LOCKHART III, DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT (OFHEO)**

Mr. LOCKHART. Chairman Frank, Ranking Member Bachus, members of the committee, and certainly Congressman Shays, thank you for inviting me here today to discuss the very important issue of GSE reform and H.R. 1427. I am grateful to you for your hard work in reaching what I believe is a balanced approach to needed reforms. It is time for action.

Housing and homeownership are critical components of the American dream and the American economy. Together, the 12 Federal Home Loan Banks, Fannie Mae, and Freddie Mac, are involved in 46 percent of the total mortgage debt outstanding in this country. Their total debt and guaranteed MBS of \$5.4 trillion is larger than the public debt of the United States.

Like all financial institutions, the housing GSEs face a full range of risk, including market, credit, and operational risk, only on a larger and more concentrated scale.

Fannie Mae, Freddie Mac, and several of the Federal Home Loan Banks have experienced serious difficulties handling those risks in the past.

Current remediation efforts will help reduce but not eliminate those risks. OFHEO will be making its annual report to Congress in early April. It will show that Fannie Mae and Freddie Mac are making progress but still have many problems to correct.

Their, and frankly OFHEO's, performance fell far short of what Congress expected. In my view, the most important lesson learned is the compelling need for legislation.

The new regulator must ensure that the GSEs operate in a safe and sound manner and support affordable housing and the liquidity and stability of the mortgage market.

The new regulator must also understand the GSEs' accountability to their shareholders to earn a fair return, and that the GSEs are not subject to the normal market disciplines.

I am very pleased that there is a general consensus that the new GSE regulator's authorities should be similar to those of bank regulators. Reform must be built on this bank regulator model.

The new regulator must have regulatory, supervisory, and enforcement powers equivalent to the bank regulators, including receivership powers. Receivership powers provide one way to prevent problems in one financial institution from spilling over to others, and might enhance market discipline.

As Controller General David Walker said, "A single housing GSE regulator will be more objective, efficient, effective, and prominent than the two separate bodies."

It is critical that the new regulator respect the differences and the similarities of the enterprises and the banks. Just like the bank regulators, the new GSE regulator needs to have both safety and soundness powers, as well as mission and new product authorities.

It also needs independent litigating and budgeting authority. OFHEO is the only safety and soundness regulator that must be congressionally appropriated. Without relief from the continuing resolution, planned resources and critical supervisory areas will have to be cut this year.

Minimum capital rules are lower than other financial institutions, and the risk based capital rule must be modernized. The regulator needs authority to adjust both the minimum and risk based capital requirements through an open rulemaking process, supplemented by the ability to respond quickly to changing conditions.

From 1990 to 2005, Fannie Mae's and Freddie Mac's portfolios grew out of control; they grew tenfold to over \$1.4 trillion. Over half of their portfolios are invested in their own MBS, and less than 30 percent meet HUD's affordable housing goals.

H.R. 1427 provides specific guidelines to the regulator of using an open rulemaking process to better focus the portfolios on their missions while considering the risk. This process needs to consider their ongoing support of the mortgage market.

Last year, in 2006, despite the growth restrictions we have on their portfolios and stiff competition, their total book of business, including their unrestricted guaranteed MBS, grew 8 percent.

It is time to move forward on legislation to create a new stronger GSE regulator, and assure the safety and soundness of the housing GSEs and their full dedication to their important mission of supporting the liquidity and stability of the mortgage market and affordable housing.

Thank you.

[The prepared statement of Director Lockhart can be found on page 174 of the appendix.]

The CHAIRMAN. Thank you, Mr. Lockhart.

The final witness from the Administration is L. Carter Cornick, the General Deputy Assistant Secretary from the Department of Housing and Urban Development.

Mr. Cornick?

**STATEMENT OF THE HONORABLE L. CARTER CORNICK, GENERAL DEPUTY ASSISTANT SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**

Mr. CORNICK. Thank you very much, Mr. Chairman. Chairman Frank, Ranking Member Bachus, and distinguished members, I ask that my written statement be accepted for the record.

The CHAIRMAN. Without objection. Let me say that any statements by any of the witnesses that they wish to insert will be inserted.

At this point, I would ask unanimous consent also to put into the record the statement of the Consumer Mortgage Coalition. In fact, I would ask unanimous consent that members have general leave to insert any material they wish to insert, assuming that no one would abuse the privilege.

Please go ahead, Mr. Cornick.

Mr. CORNICK. Yes, sir. Thank you for the opportunity to speak today about H.R. 1427. This important regulatory reform legislation is needed to strengthen the Federal Government's oversight of Housing Government-Sponsored Enterprises—Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

The legislation improves the oversight of the GSEs by creating a regulator on par with the existing financial regulators. HUD fully endorses establishing a new regulator for all three that would combine safety and soundness authority with oversight of their respective housing missions.

HUD is especially interested in ensuring that the new legislation continues to promote affordable housing, in part because of the Department's well-established role in ensuring that the Nation's affordable housing needs are addressed by both public and private initiatives, and in part because of a long held responsibility to regulate Fannie Mae and Freddie Mac.

The last 10 years have been years of increased affordable lending for low-income and minority families in the conventional mortgage market. The Home Mortgage Disclosure Act data shows substantial growth in conventional lending to low-income and minority borrowers, and suggests that new affordable lending initiatives have had a positive measurable impact.

Most agree that in addition to low interest rates, economic expansion, enhanced regulation of CRA obligations, and HUD's affordable housing goals, all have contributed to a renewed emphasis on low-income and minority lending in conventional markets.

Today is about how the GSEs will be regulated in the future, and so how the government will measure GSE performance in meeting the affordable housing objectives is important.

The affordable housing goals have been a key focus of HUD's regulatory oversight work. In 1992, Congress expressed concern about the GSEs' funding of affordable loans for low-income families, particularly those living in inner city neighborhoods that had been redlined by primary market lenders.

Congress called for HUD to establish their annual goals. In carrying out its responsibilities to set, monitor, and enforce these

goals, HUD established progressively higher goal levels by regulation in 1995, 2000, and again in 2004.

Since 1999, both GSEs have improved their performance significantly and in many cases, now exceed the conventional market for home purchase loans to very low and low and moderate income borrowers.

We believe it is important with respect to the affordable housing goals in H.R. 1427 that the proposal retains the housing goals' structure as a means of measuring GSE performance. In fact, there are some improvements over the current statute, including, as the chairman has pointed out, the establishment of an 80 percent income ceiling for defining under served census tracts, and providing monetary penalties for GSEs' failure to achieve a housing goal.

We think the structure of the housing goals as set out in the bill may not achieve the desired outcomes. I ask the committee to consider the following, starting with the single family goals.

The single family very low income goal is targeted to a market that is very small. Currently, very-low-income borrowers account for only 6 to 7 percent of the conventional conforming market. Small markets like this provide very modest incentive for GSEs to develop products. As of 2005, GSEs already exceeded the conventional market for loans at this income level.

Another thought. New goals exclude an important affordable housing market as we read it, the one to four unit single family rental properties. Even though these rental units are a very important source of affordable housing, in 2005, as many of you know, they accounted for 54 percent of all occupied rental units and just under half of those were affordable to very-low-income families.

We hope your bill will encourage the GSEs to grow their single family rental business.

Next, three separate multi-family goals will be difficult to establish because market data is not readily available. In the past, HUD has had to piece together estimates of the multi-family market from different sources.

I also want to point out that H.R. 1427, as we read it, does not include overall standards for evaluating GSE performance in serving lower income families and their neighborhoods.

Our experience shows there are effective tools for moving GSEs from sub-par to market performance across all their books of business, and we would like to see overall market based goals reinstated.

We hope you will clarify the duty to serve provisions and the written statement expands on this point.

HUD's written comments for the record include additional analysis and data. I would also like to draw your attention to our written comments on the conforming loan limits.

Before I close, I would like to comment on the affordable housing fund. With respect to the affordable housing fund, while HUD does not advocate for the creation of a fund, we share the view that any such fund should have a cap.

We do think there are important improvements that need to be noted: the fund managed by the director rather than the GSEs; providing greater clarity for the recipients; and crafting a more precise sunset provision.

Thank you for the opportunity to appear. I will be ready for questions.

[The prepared statement of Assistant Secretary Cornick can be found on page 97 of the appendix.]

The CHAIRMAN. Thank you. Let me begin with Mr. Steel and Mr. Lockhart. One of the debates we had was that I think it is generally agreed that there should be enhanced power on the part of whomever the regulator is to compel changes in the capital levels or in the portfolio from the standpoint of safety and soundness, affected also, of course, by mission.

There was a legitimate philosophical debate as to whether, per se, the entities were too big. The question is whether the legislation should or should not give that authority.

In the bill as introduced, at page 50, for later reference, authority to establish additional capital and reserve requirements, it says that the director can establish requirements with respect to any program or activity as he considers appropriate to ensure that the regulated entity operates in a safe and sound manner with sufficient capital and reserves to support the risks that arise in the operations and management of the regulated entity.

There is a further paragraph on that. I read the one on Federal Home Loan Banks, with the GSEs, similarly.

Standards by which the portfolio holdings are rated and growth of the portfolio holdings of the enterprises will be deemed to be consistent with the mission and safe and sound operations.

It lists a number of factors. Liquidity needs, potential risk by the nature of the holding, and here is where we get to some controversy because of the interpretation, and I want to see if we can arrive at some agreement on this.

Factor seven, number seven. Any additional factors the director determines appropriate except that the factor shall be consistent with the purpose of this Act and any authorizing sections.

My understanding when we were working on this was that those specific numbered provisions really relate back to "A" in general. In general, shall by regulation establish standards by which the portfolio holdings are rated and growth of the portfolio holdings will be deemed to be consistent with the mission and safe and sound operations of the enterprises.

In developing such standards, the director shall consider. The question was whether in referring to other factors, that would go beyond what was just in the opening paragraph.

My intention was that those factors would be enumerated with regard to that opening paragraph.

Mr. Steel, does that conform to your understanding?

Mr. STEEL. Mr. Chairman, thank you. I think in that same paragraph, the duality of one mission, and two, safety and soundness is declared.

The CHAIRMAN. Yes.

Mr. STEEL. Both. Then there is further articulation via points one through seven, which you summarized. In addition, there will be additionally up above referenced a transparent process for development of guidance and rules and things like that.

It is our view that these articulations are the right methodologies by which to empower the regulator.

The CHAIRMAN. I understand that. When we talk about additional factors, would that include a view that these are just too large and they were interfering with competitive—what bothers me is the interpretation by some that additional factors could take you beyond safety and soundness and mission.

Mr. STEEL. I think mission and safety and soundness capture everything.

The CHAIRMAN. These articulations are in pursuit of the mandate to do safety and soundness and mission?

Mr. STEEL. Yes.

The CHAIRMAN. That was our intention. I appreciate that. Let me ask Mr. Cornick, and I appreciate your comments on the goals. You talked about one exclusion from the goals, on four unit, did I hear that right? I am inclined to agree with what you said. Would you elaborate on that?

Mr. CORNICK. Yes, sir. What we have found as we looked through the legislation, and we are still going through it as much as we can, is that the goals are silent on the one to four unit rental property.

The CHAIRMAN. I think it is on page seven of the written testimony; is that correct? I think we are in agreement here and we would want to accommodate that proposal, particularly my colleagues from Summerville and south Boston, Massachusetts, are not here, and if we did not do three deckers, I could not go home.

Mr. CORNICK. I think one of the things that happens here is you have engaged in a deliberative process throughout. Obviously, the spirit and point is that we are in dialogue and working together and we just wanted to put that goal forward.

The CHAIRMAN. I appreciate that. We will be glad to work with you on the goal. Again, there is a duality here. There are goals which Fannie Mae and Freddie Mac can have to advance by the loans they purchase. We believe there is a segment that needs help that I was about to say no one is going to lend to that segment, but actually, it turns out some people were willing to lend to very poor people, and we are in big trouble because of it. We do not want to start them buying more subprime loans.

I appreciate those. We will be glad to work with you, Mr. Secretary.

Mr. CORNICK. Absolutely.

The CHAIRMAN. On making sure that we do the goals. I know we will hear later from some of the people from the various development communities, the affordable housing lenders, again about the goals. They are separate from although complimentary to the affordable housing fund.

Thank you. The gentleman from Alabama.

Mr. BACHUS. Thank you. I want to address one issue in my questioning because of limitation of time. Let me just read again what I said in my opening statement.

I said that many on our side of the aisle have serious questions about the ability of State housing bureaucracies to competitively and efficiently deliver and monitor upwards of \$500 million per year. We are talking about the housing fund and the State agencies distributing that.

I am going to ask Under Secretary Steel and Assistant Secretary Cornick, as drafted, the legislation says the States will be allowed to decide which of its agencies should administer the program and allocate the grants.

Do you believe this is an appropriate distribution mechanism for the fund if one is created, and are you confident that State housing agencies are capable of administering this new program in a way that ensures that funds are distributed competitively to deserving recipients?

If not, what changes would you make in the housing fund?

Mr. STEEL. I will begin, sir. I think that if we talk about first the housing fund at maybe a higher altitude and then come down to your specific question.

Mr. BACHUS. Sure. I guess my question could just be are you comfortable with the housing fund. If not, how would you change it?

One thing you said was you both would like to cap it, I understand.

Mr. STEEL. Yes, sir. I think that when the history is told, that the key issue for Treasury was to drive the regulatory reform so as to have a strong regulator for the housing GSEs.

As part of that, some people saw that the appropriate bridge in dealing with this issue for the GSEs should also deal with another part of the housing finance area, and there was birthed the affordable housing fund. That was as part of the process.

That was not the original ambition, but that has developed. If that is going to be part of this, then the key issues for the Administration and for Treasury are that it not be controlled by the GSEs, that it be temporary, that it be capped, and not be part of a political process.

If my memory is correct, it is Section 133, which lists about seven or eight specific attributes of the way in which the housing fund would be administered, and we are comfortable with that specificity so that we can be in favor of this.

Mr. BACHUS. Are there any that you would add to that 133?

Mr. STEEL. I think the ones articulated seem like the important ones to us.

Mr. BACHUS. Mr. Cornick?

Mr. CORNICK. Yes, sir. The first point is obviously the cap. From our perspective, certainty and stability go with such a feature for that fund.

The second point that you raised, and it actually gets at some of what Ms. Biggert also pointed to, we look at this fund—the first thing is there is no daylight between anyone in the Administration. We are all supportive of the overall goals and the work that is before you.

It is important to note that this fund is very distinct from safety and soundness and all of the regulatory concerns. It is a grant program. It is a grant program close to on the scale of a \$2 billion home program, which we do run, I think, with some distinction.

In the division of labor, we tend to believe at HUD that we do a very good job running these sorts of things. We understand that the proposal calls for the regulator and we are going to be cooperative in working with people to share the best of our knowledge.

I think that one of the issues that you all speak to in the work that you put forward is capacity and making sure there is capacity and making sure that these funds are properly distributed, and you properly pointed to competitively. It is a very significant point.

I think that is the best that I could offer at this juncture.

Mr. BACHUS. Just to clarify, you both said you would like it to be temporary and capped. Would you elaborate on that?

Mr. CORNICK. Sir, from my perspective, certainty and stability is what that introduces from our perspective. We think you do not want to inadvertently submit the GSEs or the fund to wild swings one way or another, depending on different conditions.

Mr. BACHUS. Do you have a number in mind or could you come up with one? While you are thinking about that, I will ask Under Secretary Steel.

Mr. STEEL. I think with regard to sunset, again, if my memory is correct, this expires as stipulated in 2012. The second is that the methodology—there was lots of discussion about the methodology of how to set the size of this housing fund.

After lots of back and forth and good discussion which was helpful and educational, we basically drove it off the size of the portfolios, which is a less volatile and more predictable measure or metric. This is tied to something that is comfortable to us from that perspective.

Mr. BACHUS. You said you would like a cap.

Mr. STEEL. I think it is capped by being tied to the size of the portfolio.

Mr. BACHUS. You are saying it is capped now?

Mr. STEEL. It is capped by the arithmetic of the size of the portfolio, which will be a function of risk based capital and all the other aspects of the regulator, which makes us comfortable that this is a good compromise by which to determine a size.

The CHAIRMAN. Before I recognize the gentleman, I am going to take just 30 seconds.

Mr. Cornick?

Mr. CORNICK. Yes, sir. The number that we had in mind that we have shared with the staff and talked with different folk is somewhere on the order of 525 to 550.

The CHAIRMAN. I thank you. When you said it would be comparable to \$2 billion, you got my hopes up wildly.

[Laughter]

Mr. CORNICK. I was adding.

The CHAIRMAN. Comparable in that it is one quarter as much. I suppose that is comparability.

Mr. CORNICK. I was just adding years.

The CHAIRMAN. Thank you. The only other thing I would say this, and briefly, we had cited that according to some of the critics, particularly of the GSEs, they receive an implicit subsidy, albeit once we say it, it is no longer implicit, but they receive a subsidy of \$12.8 billion per year from the taxpayers.

With \$500 million, we are asking for about 4 percent of that. I think they are still getting off pretty good, and those who worry that we are unduly impinging, it does not seem to me that you can complain that they are getting a \$12.8 billion subsidy from the taxpayers, and then begrudge \$500 million for low-income housing.

The gentlewoman from California.

Ms. WATERS. Thank you, very much. I think that was a good discussion of the housing trust fund and the goals that have been set.

While I had intended to talk a little bit more about that, I think it is just safe to say that many of us are extremely excited about the possibilities for this fund.

I do believe that whatever needs to be done to work out the management of the fund will be done, and this will go a long way toward helping us all meet our goals.

I wanted to take a minute, if I may, to ask a question or two of Mr. Lockhart. I see that in your testimony, you have indicated that the GSEs have made considerable progress and you are pleased with the progress they have made. I think it said you saw no reason why that should not continue. Is that true?

Mr. LOCKHART. Yes, that is true. We are just finishing our exams for year end 2006. We will be publishing that in the next 3 weeks or so.

It will show that they have made progress. I think the progress has been slower than we expected in the management team, but they are making progress.

Ms. WATERS. What did you do to contribute to that progress?

Mr. LOCKHART. Certainly, we have been very, very active in the remediation process with the management teams, and our examination teams have been in there pushing them forward, basically.

Ms. WATERS. Could you be specific about any remediation that you have been involved in that has helped to improve the performance of the GSEs?

Mr. LOCKHART. Both GSEs have put together plans about how to remediate their problems, and we have been very active in looking at those plans and working with them on the plans, and to the extent that they are not performing against the plans, we have certainly pointed that out to them.

Ms. WATERS. Could you be specific about one of the remediation means or one area of remediation that you have been involved with that has changed the way they operate in any appreciable way?

Mr. LOCKHART. We certainly have a whole series of different areas we have been involved with.

Ms. WATERS. Just give me one.

Mr. LOCKHART. Certainly the accounting, and the risk management. They have hired new risk management teams. We have been working with the risk management teams, market credit and especially operational risk management teams, and working with them to improve.

Ms. WATERS. Can you tell me why you think the way the board is constructed for the GSEs needs to be changed?

Mr. LOCKHART. At the moment, both Fannie Mae and Freddie Mac's boards do not have any presidentially appointed directors. To me, the boards are working very effectively at the moment.

The process is that they have head hunters who go out and really get very high quality people. We vet them to make sure that we think they are acceptable, and then they are voted in by the shareholders.

The boards are working extremely hard at these two companies, given the amount of remediation to do, and we think it is an effective governance structure.

Ms. WATERS. You think that for the future, the boards should have and keep the presidential appointees?

Mr. LOCKHART. I do not think it is necessary and there are some conflicts of interest with presidential appointees, and to me, the more reasonable structure is to have directors elected by the shareholders.

Ms. WATERS. Can you tell me why you believe that you need not to be reviewed and come under the appropriations process?

Mr. LOCKHART. The appropriations process is a very cumbersome process for an agency that has to respond quickly to problems. We have been in existence for about 15 years. In 13 of them, we have had a continuing resolution. That makes it very hard to plan.

At the moment, we are at last year's budgeted amount of \$60 million. We asked for \$67.5 million. Much of that is going to the litigation that we really have no control over, but we have to respond to the judges.

Ms. WATERS. Is that not true of all the agencies of government that have to go through the appropriations process?

Mr. LOCKHART. Many of them have similar issues, but I do not think the same. I think the better analogy is to all the bank and financial regulators, which do not have to go through the appropriations process.

One of the reasons they do not is that they are funded by the institutions that are regulated, and they do not have an impact on the budget, and neither do we.

Ms. WATERS. Do you think you should have a board of directors?

Mr. LOCKHART. Yes, I think we should have a board of directors.

Ms. WATERS. Have you recommended that?

Mr. LOCKHART. Yes, I have. As Congressman Shays mentioned, I ran the Pension Benefit Guarantee Corporation, and during that period, we had a board of directors composed of three Cabinet secretaries, including the Secretary of the Treasury.

Ms. WATERS. If I may, Mr. Chairman, I know my time is up, but what have you done about diversity at OFHEO?

Mr. LOCKHART. First of all, I think diversity is extremely important. I came from the most diverse government agency, Social Security. We are working in our recruiting efforts and our training efforts to promote a more diverse workforce.

Ms. WATERS. How long have you been working on it?

Mr. LOCKHART. I have been there for 9 months.

Ms. WATERS. You have not been able to find anybody in 9 months?

Mr. LOCKHART. We have been promoting people. In fact, I think you made a statement that we did not have an African American in management. We actually do.

Ms. WATERS. You found one?

Mr. LOCKHART. She is very, very talented, and came from Wall Street.

Ms. WATERS. I know, I just said you found one. You have one? O-n-e.

Mr. LOCKHART. One; yes.

Ms. WATERS. Thank you.

The CHAIRMAN. The gentlewoman from Illinois.

Mrs. BIGGERT. Thank you, Mr. Chairman. I would like to go back to the affordable housing fund section of the bill. As I said in my opening statement, HUD has the responsibility of establishing a formula to allocate funds to the States and to the tribes, and then they would determine which organizations receive the funds. The funds then go to the States. Mr. Cornick, what normally would the States do if that is the Administration that goes to—the funds would go to the States?

Mr. CORNICK. Right, but under the Home Program—well, we have a couple. The Home Program works off of participating jurisdictions. The CDBG program works off of States as well as off entitlement communities, etc. And so we have a couple of different methods that substantial sums of HUD money are funneled out to the communities of State and local governments. We also work very closely with State housing finance agencies.

As all of this relates though to the Affordable Housing Fund, one of the things that we are grappling with, we just had but a couple of days to go through the legislation ourselves, and what we wanted to do was just put forward some big picture points. I cannot speak exactly with precision about where and how this thing is working because our folks are still working hard to be sure that we understand all of the dynamics that are in play. But if you are willing, we would love—we are already working very closely with the chairman on a number of things that we discussed, we would just like to continue. We have some follow-up from yesterday with you as well.

The CHAIRMAN. Would the gentlewoman yield?

Mrs. BIGGERT. Yes.

The CHAIRMAN. We are marking up—well, we are not marking this up, I take it back. We are not marking this up until the 28th, so there is plenty of time.

Mr. CORNICK. Okay.

The CHAIRMAN. And we will be open to this. The 28th is the day of the markup for this and that gives us plenty of time.

Mr. CORNICK. That is very helpful.

The CHAIRMAN. And I think all of us on both sides will be very receptive to specifics between now and then.

Mrs. BIGGERT. Yes, I would appreciate that.

Mr. CORNICK. Yes, ma'am.

Mrs. BIGGERT. But just in general, do you think that this is the best delivery method so far?

Mr. CORNICK. Well, I have betrayed a certain prejudice in that we are very proud of the work that we do, and we think that we have a pretty good set of systems that work well. By the same token, we are very respectful of the fact that what is proposed has some substantial support, and what we want to do is be productive. I have betrayed the fact that we feel that we could responsibly and efficiently produce some division of labor gains by using a system in a network that is very successful. But it is just for consideration.

Mrs. BIGGERT. Well, do you think maybe then that you should have a more expanded role?

Mr. CORNICK. We certainly would not be shy about it were it something that the Congress felt comfortable with.

Mrs. BIGGERT. And what about modeling it after the Affordable Housing Program that the Federal Home Loan Banks administer; is that a possibility?

Mr. CORNICK. I would have to get back with you on that because the truth is I am not smart enough how they do their work.

Mrs. BIGGERT. Okay. I am concerned about the delivery just because we have seen what has happened in Louisiana particularly, that the money has gone down there and it has not been given out yet and has not started to be useful as it should be.

Mr. CORNICK. Yes, ma'am. It is something that we have been working—you and the Secretary have talked about this very—we have been working very hard with them, and we just have some substantial challenges and we are just getting through them.

Mrs. BIGGERT. Okay, then, Mr. Steel, would you have any comment on this from the point of view of the Treasury about using something like the Federal Home Loan Banks as administrators?

Mr. STEEL. Thank you very much for the question. I think that there are several different ways we could go about this and discuss it. We are not opposed to that idea but the way as promulgated in the bill as written today is fine, also. And the key issue was the caveats that I described, and we walked through earlier, and this delivery mechanism as described by the States is fine with us. But if others are to be considered, that is fine too.

Mrs. BIGGERT. Thank you. I yield back.

The CHAIRMAN. I thank the gentlewoman. The gentleman from North Carolina.

Mr. WATT. Thank you, Mr. Chairman, and thank you for—

The CHAIRMAN. Gentlemen, just for a second, this is a very important piece of legislation. We have a long day of hearings, this is a very big committee, and unfortunately too many of the members pay attention, so we have long hearings and there is nothing I can do about that. I just want to tell people, for the convenience of the members and witnesses, that I plan to stay here all day and finish this. There is no need to take a lunch break, because it is not a markup situation; members can come and go. I say that for the benefit of the later witnesses, if they want to feel free to come and go, but it is—we are going to finish this hearing today, and people can adjust their lives accordingly.

The gentleman from North Carolina.

Mr. WATT. Can I steal that part of my time back from you?

The CHAIRMAN. We just started now.

Mr. WATT. Thank you, sir. Let me thank the chairman for convening the hearing. It is an extremely important hearing and an extremely important piece of legislation. I am a very hardy supporter of a stronger and more independent regulator, and I want to ask some questions in two areas related to the independence and the strength because some responsibilities go with being a stronger regulator. I have some concerns about the level of independence that I want to get on to the record here if I can.

First of all, Mr. Lockhart, you are familiar with something called Operation Noriega, have you ever heard that term before?

Mr. LOCKHART. No, I am not sure I have.

Mr. WATT. Okay. There were reports circulated that somebody in the White House had more than a passing interest in how this new regulatory framework got formulated and may have had pretty aggressive interest in the reports that were done evaluating the GSEs performance. I also serve on Judiciary, and we have seen over the last couple of weeks revelations about the Administration being engaged in things, I mean the White House itself being engaged in things we thought were in many respects much, much more independent. Can each of the three witnesses give me assurances today that there are not e-mails, paper trails, interference from the White House, either in the reports that OFHEO has issued up to this point, the financial evaluations or reports, or in the shaping of reactions to the legislation here or legislation in general? Mr. Lockhart first.

Mr. LOCKHART. Certainly, I am an independent regulator. In fact, I have been an independent regulator in three jobs in the government—at the PBGC and Social Security, as well as OFHEO—so I understand independence, and I think it is very important.

Mr. WATT. You agree with me then that it would be inappropriate for somebody in the White House to be interfering in an independent regulator's evaluation of conduct?

Mr. LOCKHART. I agree with that and certainly in my 9 months there, there has not even been a hint of that.

Mr. WATT. I think this would go back prior to your 9 months there, so I am seeking your assurance that that kind of inappropriate activity has not taken place to your knowledge prior to your 9 months there. I want you to speak beyond your 9 months there, Mr. Lockhart.

Mr. LOCKHART. Well, again, I can tell you the most important report we put out since I have been there is the special examination of Fannie Mae.

Mr. WATT. I am talking about conduct that may have occurred prior to your being there, Mr. Lockhart. You are here on behalf of the agency. I am asking you about whether you have any knowledge of any e-mails, any correspondence whatsoever that may have even come close to the line about shaping the reports that OFHEO has issued?

Mr. LOCKHART. No, I do not.

Mr. WATT. Okay. And, Mr. Steel, Mr. Cornick, do you have any?

Mr. STEEL. No, sir.

Mr. CORNICK. Absolutely not.

Mr. WATT. Now the second part of this inquiry that I want to be clear on is that there are some responsibilities other than independence that go with a strong regulator and there is some concern that some people have raised that in the conduct of OFHEO's activities, it has released information, financial information, publicly and prematurely. I concede at some point all of this financial information must come out and be evaluated by the public since these are public corporations. My question to you, I assume you believe, Mr. Lockhart, that OFHEO is governed by those privacy provisions, non-disclosure provisions under 18 U.S.C., section 1905?

Mr. LOCKHART. I am not sure of the cite, but I do believe that we are covered by privacy, yes, and we do keep the information pri-

vate. A lot of our information is insider information and there are a whole series of rules around that as well.

Mr. WATT. And to your knowledge has OFHEO at any point prematurely and in violation of any of this statute, or any other statute that you are aware of, released any information that it should not have, either before you got there or within the 9 months that you have been there?

Mr. LOCKHART. I really unfortunately cannot speak before I got there on that kind of issue, but I can tell you what we have done while I have been there is that we protected the inside information. We do publish information about these two companies, we put out a quarterly capital report, which has information on them, and we are required by law to put this annual report to Congress that has information in it, which is somewhat different than the other regulators.

Mr. WATT. And can I get your commitment to go back and review those prior disclosures so that we can be assured that this independence and this stronger regulation is accompanied by responsibility that is transparent also?

Mr. LOCKHART. I certainly believe in that, and we will certainly look at that. I think it is very, very important for a regulator not to be political.

Mr. WATT. Can I just ask him to do one other thing, I want to ask him a question, to take a closer look at the provisions of 18 U.S.C., section 1905, and see whether there might need to be some clarification in this bill that we are considering that makes those responsibilities of OFHEO more concrete and transparent so the public has confidence not only in what the GSEs are doing but in what this stronger, more independent, more public and powerful regulator is doing?

Mr. LOCKHART. I certainly will look at that. I have just been told that is the Trade Secrets Act you are talking about, that cite there, and certainly we will look at it.

Mr. WATT. I think this goes well beyond trade secrets the way I read this.

Mr. LOCKHART. We will certainly look at it.

Mr. WATT. I thank the chairman for his generosity.

The CHAIRMAN. The gentleman from Connecticut.

Mr. SHAYS. Thank you, Mr. Chairman. Mr. Cornick, as you reviewed the law, is it your interpretation that the legislation would transfer fair housing enforcement away from HUD or are you concerned about it?

Mr. CORNICK. Our attorneys recognize that we are just going over this and continue to do it. But currently the way we are reading H.R. 1427, there is a transfer of HUD's fair lending, fair housing GSE oversight authority to a new regulator.

Mr. SHAYS. And you would be opposed to that?

Mr. CORNICK. Well, we would offer for consideration that we have a very established record in working that. We have been very successful enforcing the Nation's fair housing and fair lending laws.

Mr. SHAYS. So the answer is you would be concerned?

Mr. CORNICK. Yes.

Mr. SHAYS. Okay.

The CHAIRMAN. Would the gentleman yield? Could we get the cite to that because we share that concern? Do you have the textual cite to that?

Mr. CORNICK. Let me see, sir.

The CHAIRMAN. If you do not, we will try—

Mr. CORNICK. But I appreciate the question because it is important.

Mr. SHAYS. Right, I think the committee will be concerned about that as well. Mr. Steel, if you would, section 115 of the bill requires Fannie Mae and Freddie Mac to register one class of stock under the 1934 Act. Why only the 1934 Act and why only one class of securities?

Mr. STEEL. Thank you. The rules are specific that these institutions were exempt from the 1933 and 1934 Act, that is going back historically. They have chosen to voluntarily comply with the 1934 Act. This is the current situation. It is not—and it is not something that we feel is required but should it be something that develops in the course of the bill, we would not be against it.

Mr. SHAYS. Well, let me ask you a question, the 1933 and 1934 Act have very real purposes, correct?

Mr. STEEL. Yes.

Mr. SHAYS. Fannie Mae and Freddie Mac are publicly traded, correct?

Mr. STEEL. Yes.

Mr. SHAYS. So isn't there an argument that could strongly be made at the very least that they should comply like any other company that is traded publicly?

Mr. STEEL. Yes, that argument could be made.

Mr. SHAYS. But the Administration is remaining neutral on it?

Mr. STEEL. We are comfortable with the way it is described now.

Mr. SHAYS. Yes, unfortunately, before your time, folks were comfortable not having them under the law at all. And until we frankly forced them to have to disclose under the 1934 Act, and they said voluntarily they were doing it, like we did not have a right to make them, that is when we learned about all the problems. And it seems to me, and I will just publicly lobby you, I hope the Administration pro-actively engages in this and says, listen, let's treat them like any other company.

Mr. STEEL. Great.

Mr. SHAYS. Let's make sure they are under all the requirements that any other company would be. Mr. Lockhart, I would love to know about, GSEs are exempt from the privacy protection law enacted by Congress for other financial service firms in the Gramm-Leach-Bliley Act. Has OFHEO issued anything like the banking agency guidance or does this need to be addressed in our bill?

Mr. LOCKHART. I really don't know that and I will have to get back to you on that.

Mr. SHAYS. Okay.

Mr. LOCKHART. But if we need to get it in the bill, I know we put out guidances around privacy, whether they are exactly like the bank I am not sure.

Mr. SHAYS. But do you think this is an issue that should be addressed?

Mr. LOCKHART. Certainly, and we will look at it.

Mr. SHAYS. Mr. Steel, I am sorry.

Mr. STEEL. I think this is somewhat similar to the previous point that there has been exemption but it is certainly something to be considered, and we are glad to study and have conversations as things move ahead.

Mr. LOCKHART. Could I make one point on the registration?

Mr. SHAYS. Sure.

Mr. LOCKHART. Actually, Freddie Mac is not registered yet. By the time they were going to register with the SEC, their financials—

Mr. SHAYS. They could not comply.

Mr. LOCKHART. They could not comply.

Mr. SHAYS. Yes.

Mr. LOCKHART. So once they get their financials in good shape, they are going to register.

Mr. SHAYS. And that is a good qualification but it does not argue not for them to be—

Mr. LOCKHART. Right.

Mr. SHAYS. Okay. One last point, and it is to you Mr. Lockhart, OFHEO, everyone agrees that it is doing a much job under your management and significant changes, and I am not just saying that because you happen to be a constituent. I am not, that is the consensus. But what powers right now do you lack that you think you should have regardless of this bill that we are considering? What is the biggest area of weakness in your authority?

Mr. LOCKHART. Well, we really don't have the powers of a bank regulator and that is a whole series of powers, receivership, portfolio, capital.

Mr. SHAYS. So there is a whole host of issues?

Mr. LOCKHART. It is a very long list of issues and really has led to a weak regulator and so we have to sort of pick ourselves up by the bootstrap, if you will.

Mr. SHAYS. The thing that concerns me is, as hard as we may work on this committee to get the job done, we cannot be certain what the Senate will do, and I think we are going to get out a good bill. So I am just interested in that. My time is up. Thank you, very much.

The CHAIRMAN. I would just point out that by odd coincidence, the chairman of the Senate Committee is from, guess where? He is from Connecticut. Once again, maybe you can work with him.

Mr. SHAYS. You know sometimes, Mr. Chairman, your Massachusetts accent I do not always understand. That is my problem.

The CHAIRMAN. The gentleman from New York, which is where my accent is really from.

Mr. MEEKS. Thank you, Mr. Chairman, thank you for holding this important hearing. I have some interest, and let me address my first question to Mr. Steel. In dealing with the Federal Home Loan Banks and the appointment of these independent public interest directors, I am concerned about their independence. And I know that 2 years had gone by and these positions had not been, only 40 percent of the director positions were vacant. No one was appointed to them. And then after a rule, and I think the rule was this past January, they came out with criteria that in the case that

the candidate should include familiarity with financial and accounting matters.

Now these are supposed to be public interest directors, and it seems to me if in fact you just specify you must have that particular background, are not we eliminating some of the independence? Because it seems to me then that the individuals can hire for the directors their cronies, the individuals that they know, either from the member banks, etc. Should there be another criterion in which we could also utilize individuals who will be appointed because of the public interest on the Federal Home Loan directorships?

Mr. STEEL. Thank you. I think that the way I would answer your question is you would hope they are complementary skills, that in addition to the financial tools to be able to monitor the activities, that having people that have the public interest in their mind and things like that is an additional attribute that you would hope would be the case. But I think the idea that there should be people who do not have these other financial skills is a road that I would not want to go down.

Mr. MEEKS. Do you think that these directors should be confirmed by the Senate?

Mr. STEEL. Confirmed by the Senate?

Mr. MEEKS. By the Senate?

Mr. STEEL. I am sorry, by the?

Mr. MEEKS. By the Senate?

Mr. STEEL. I think that the best protocol is that they should come through the normal process and Senate confirmation is fine.

Mr. MEEKS. Let me further ask Mr. Steel on the other matter of which—

Mr. STEEL. I am sorry, I think I mis-spoke. They should not be confirmed by the Senate but instead come through and be approved by the board. And this gets into this issue, sir, that really Mr. Lockhart spoke about, which is complex, and that is these organizations, as the chairman said in his opening comments, are hybrids. They basically have private market and public policy ambitions too. But I think that the key issue here is that, as we have described, we need to continue to communicate that they are separate from the government and from a governance perspective so as to make clear that the financial tie, as described in the preferred cost of capital, is as clear as it can be, that is not the case.

Mr. MEEKS. My concern just is that there is some independence and that we just do not have individuals deciding to elect individuals to the board who are just from those same circles because that is what becomes—that is who you know and there is no outreach to have some real independence of individuals who will be there specifically for the public interest. And I just think that we have to make sure that there is independence there.

Let me just ask you, Mr. Steel, I know that last week Moody's upgraded the rating for the Nation's largest banks based upon the high potential of a government bail out. And the Treasury has justified limiting the portfolio of the GSEs due to a lack of market discipline based upon a perceived government bailout. My question, is should the same kind of restraints be placed upon the big banks?

Mr. STEEL. Well, I think that there is a distinct difference, and it is a question I look forward to answering. The reality is that the cost of capital for other institutions in the financial marketplace goes up and down and their costs of borrowing go up and down. They are set by the marketplace, and they are not linked in the same way to the interest rate of the government.

When you look at the cost of borrowing for the housing GSEs, it clearly does not represent the cost that it would be if there was not this determined link, this assigned link to the government. When you look at other large financial institutions, their costs go up and down depending on whether people perceive them as more risky, or less risky, and they really are subject to market type checks and balances.

Mr. MEEKS. They are both regulated, I heard what you said, the difference, they are both being regulated.

Mr. STEEL. Yes.

Mr. MEEKS. Different agencies, both the industries and it seems like large sums of money but one you are saying is regulated closer or restricted more than the other?

Mr. STEEL. The marketplace believes, and as I said in my opening comments and it was also referenced by others, the marketplace assigns a borrowing rate to the housing GSEs that is tied and infers a government backstop. I have declared that is not the case but that is the way it works so there is not the market check and balance that you would normally have when people tend to change their business model.

Mr. MEEKS. I see my time is up. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from California.

Mr. MILLER OF CALIFORNIA. Thank you, Mr. Chairman. I rather enjoy these hearings we have and the testimony from individuals from Washington, D.C. It reminds me of why I fly home every week because I do not want to develop a Washington mentality. Under Secretary Steel, what would you consider affordable housing?

Mr. STEEL. Well, I think that Chairman Frank gave some descriptions earlier.

Mr. MILLER OF CALIFORNIA. But what do you consider affordable housing? I know what he thinks. I heard your testimony, I want to know what you think. What do you think affordable housing is?

Mr. STEEL. I think that when you look at the median price, and we basically go through the arithmetic and conforming loan limits and things like that, we have basically seen how it works out.

Mr. MILLER OF CALIFORNIA. So you believe that median is some part of the definition of affordable housing, then why do you discriminate against areas like California in your comments? You do not have a problem with Guam. You do not have a problem with Alaska. You do not have a problem with Hawaii and these areas that are afforded a higher rate to fall under GSEs, you do not have a problem with that, but when I look at this chart that shows the States that are in trouble with foreclosure, California, but your comments actually discriminated against my State of California when we are trying to raise conforming loan rates in California.

And all you have to do look at OFHEO's chart to realize there is a huge need, and I think you need to read this chart before you testify and make these comments again. If you look at the under-

writing standards of the private sectors, they are not as rigorous as Freddie Mac and Fannie Mae are because Freddie and Fannie, 82 percent of their loans are fixed rate loans, 18.1 percent of the other marketplace is fixed rate loans, and because of these loans that are being made out there in the private sector, people are in real trouble today.

And yet in your testimony, you said, "There does not appear to be a problem in the provisions of mortgage credit in these areas and it could be a distraction from the affordable housing efforts of Freddie and Fannie." What do you consider affordable housing? I was born in Huntsville, Arkansas, Madison County. My district is Orange County, California. Are you trying to tell me that affordable housing in Madison County, Arkansas, is the same as affordable housing in Orange County, California? That is a question.

Mr. STEEL. No, sir.

Mr. MILLER OF CALIFORNIA. Then how can you make a generic statement, as you did, that there does not appear to be a need or there is no apparent reason to stop discriminating against high-cost parts of this country and affording them the same opportunity as Madison County, Arkansas and other places that they can get an affordable house and they can go through Freddie Mac and Fannie Mae at a better rate. And if you look at historically, your problem loans, they have never been as problematic as what I am facing in California today with the jumbo market, even at Freddie and Fannie's worst.

So your comments to me, as I see it, you have a program that I fully support, that I believe works, and you are telling me that I am not as good as Guam, as Alaska, as Hawaii? How can you say that? And that is what you said? How can you say that?

I want you to justify that on TV to the people I represent, and people in other high-costs parts of this country, that they are not as good as people in those areas and they should be discriminated against and not offered a loan that the Federal Government basically backs up and guarantees because we do, and the same taxpayers in my district are the same taxpayers in Alaska and Hawaii, why they are not qualified for the same kind?

I am really upset about this, because we make these stupid—excuse me, we make these unacceptable Washington statements with a Washington perspective, that is why I think local housing authorities need more control and more leeway in determining the needs of the local people. We make statements like this, that there does not appear to be a need and you look at the charts, and the need is absolutely beyond question and the crisis is beyond question. These are not the crises and the defaults today, these areas are the crisis. The only red on this entire map of the United States is California and most of this country has availability of GSE loans; we do not.

So you cannot tell me that an affordable house in Arkansas, or maybe some parts of Oregon where my family lives, are the same as an affordable home in California. I cannot buy a \$300,000 house in my district hardly. If you can, it is in such disrepair that it is illegal to move into. You would have to go revamp it. So we have been fighting for years, and I commend the chairman for this, his efforts in this, too, to try to create some type of a system that is

fair and equitable throughout this country but the concept that I have schoolteachers and firefighters and police officers driving 2 hours back and forth to work each day because they cannot afford to buy a house in the community within which they live, yet if they get FHA availability and some GSE availability, you would move more people into homes with a safer, less risky loan.

I apologize, I do not mean to offend you, but when you make statements like this, that somebody probably wrote and typed for you and you read in a meeting like this, and you tell me my people are not good enough, they are the same taxpayers as anybody else in this country because they happen to live in a high-cost area. You need to think about what we are trying to do in this country and that is provide liquidity in the housing market, and we are discriminating against most of the housing market in high-cost areas.

And I am a little fired up, I know, Mr. Chairman, I do not want you to get too much exercise with your gavel there, but I would like you to re-think that. That is just not fair and it is just not equitable, especially when you are not the problem.

The CHAIRMAN. Mr. Steel, I would not want to deprive you of a chance to respond if you are eager to do so.

Mr. MILLER OF CALIFORNIA. I would love you to, please.

Mr. STEEL. Well, I am happy to respond. First of all, I appreciate the perspective, and it will certainly be considered, and we will come back. I think, though, that the only thing I would challenge, sir, with all due respect, is it is not a question of being good. That is not the right way it was described. We are trying to develop a system for allocating and it is not a matter of assigning value to people or things like that.

Mr. MILLER OF CALIFORNIA. Mr. Chairman, 5 seconds, please? If you can allocate it to Hawaii and Alaska and Guam, it should also be allocated to my part of California and over all of California.

The CHAIRMAN. I would just say, if the gentleman would yield, I would just add to this and that allocation, I think, is not the right word. I do not see this as in any way zero sum, that is, it is not the case that doing the high-end loans in any way detracts, and indeed if we are looking at the goals, which are a percentage of overall loans, if we look at the Affordable Housing Fund, which is going to be fueled if we are successful by the portfolio, to some extent, the more loans they make in these high-cost areas, the more will be generated. So no one should see this as zero sum. The gentleman from Kansas?

Mr. MOORE OF KANSAS. Thank you, Mr. Chairman. And, Mr. Chairman, I want to commend you for this legislation, which I believe represents an important bipartisan compromise. H.R. 1427 creates a strong new regulator for government-sponsored enterprises that will ensure the safety and soundness of these entities in our housing marketplace while also helping them fulfill their role in providing affordable housing opportunities for families all across our country. I hope this committee will be able to move forward after this hearing in marking up this legislation and moving it on its way to becoming law.

The question I have for Mr. Lockhart is that the legislation we are considering today, sir, charges the new director with developing standards by which the enterprises' portfolio holdings "will be

deemed to be consistent with” their mission and safe and sound operations, as you read this language, do you believe it would permit the director to set quantitative standards, that is standards to prescribe a specific level or range for the portfolio holdings or does it contemplate standards that are more qualitative in nature? What sort of considerations should the director take into account in assuring the safety and soundness of the GSEs?

Mr. LOCKHART. I think the legislation could set quantitative, or at least ranges, as well as qualitative standards. Certainly, I think the legislation gives very good guidance to the regulator that it should be looking at the liquidity of the market and the entities, it should be looking at the stability of the marketplace, it should make sure that they are able to securitize mortgages, which is their biggest business, and also they should consider the risk and very importantly affordable housing. The legislation requires that the regulator has to put the regulation out in about 180 days. I would hope that it could even be done quicker, and that there could be a really good dialogue about the various factors going forward.

Mr. MOORE OF KANSAS. Thank you, sir. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from New Jersey.

Mr. GARRETT. Thank you, Mr. Chairman. Thank you again, panel. First, dealing with the issue of the so-called housing program or as some of us call it a mortgage tax increase because in essence it is a tax on the GSEs and hence down the line to the eventual consumers. Maybe Mr. Cornick or maybe other members of the panel can answer this question, I am not talking about the programs that you run with regard to housing, but we have heard other testimony already with regard to the GSEs and that the private market basically is doing a better job when it comes to providing affordable housing than what the GSEs have already done so isn't it implicit in this legislation that where it is saying that we are going to be adding on this housing program, isn't it implicit in the legislation that we are saying that the GSEs have failed and we are trying to come with another solution since they did not do their job in the first place?

Mr. CORNICK. Personally, I would not draw that conclusion. One of the things that we have found through our own goals—

Mr. GARRETT. Well, if they were doing the job and they were providing it, they would be doing better than in the private market and we would not be looking to add another—

Mr. CORNICK. That is where we are trying to get them and they are not currently there, that is true.

Mr. GARRETT. Again with regard to this program, Mr. Steel, you were saying I think, maybe Mr. Lockhart you said this as well, I am not sure, that with regard to this program, it should be a temporary program, is that correct?

Mr. STEEL. Yes.

Mr. GARRETT. I have only been here in Washington for 4 years, maybe you can give me some examples other than tax cuts, which are set to expire and there is always an argument that they should be temporary by some sides of the aisle, can you give me some examples of other government programs that we have set up that have been temporary programs that actually are temporary? I am

thinking of TRIO right now, which was supposed to be a temporary program, and we are seeing that going to continue on, but are there other programs that are truly established as temporary and then at the end they go away or do not they always just sort of stay around for good because once they leave, they begin a constituency for it?

Mr. LOCKHART. I am newer than you and I do not have examples.

Mr. GARRETT. Okay. Can anyone else give me examples so I can go home and say that yes—

Mr. CORNICK. Yes, sir, I can give you one.

Mr. GARRETT. Okay.

Mr. CORNICK. Moving to Work at HUD, that is a demonstration program that I believe has a 10-year history.

Mr. GARRETT. And then expired and did not morph into something else?

Mr. CORNICK. It continues to be reauthorized or authorized through the appropriations process.

Mr. GARRETT. Okay, so that is an example where we had a temporary program, it was supposed to be temporary—

Mr. CORNICK. Actually, it has always been a demonstration, it has never grown into a full-fledged authorized stand-alone program.

Mr. GARRETT. So maybe I should have some concern that even though both sides here believe that it should be temporary, it may not be.

Mr. LOCKHART. One example would be the Resolution Trust Corporation, which was winding up the S&Ls. I think if you look at the President's proposals, one of the proposals is actually to put forward a sunset commission to oversee these kinds of things to make sure that programs that are no longer necessary, are no longer working, are being shut down and that is happening in this Administration.

Mr. GARRETT. That is something that I would totally agree with and if we have the authority in this committee, I would encourage the chairman—I do not think we do—to try to look into sun-setting a number of programs. Going over to a second area and that is the portfolios. Back in 1990, the portfolio amounts for Fannie Mae and Freddie Mac was \$136 billion. By 2003, they were up to \$1.6 trillion.

And the reason I give 2003 data is because that is what I have in front of me because I understand that for both of those funds, we do not have total financials until 2004 and 2005.

So my two questions for you are this, will shrinking their portfolios reduce systemic risk, (a)? And (b), can you really answer any of these questions when it comes to systemic risks and the size of their portfolio since we still do not even have data that is less than 3 years old? And how do we move forward on any of this until we actually have that data?

Mr. LOCKHART. Well, as the regulator, we do have the data, some of it may be still estimates but we do have the data, and we are certainly using that from a regulatory standpoint. The portfolios have come down about \$200 billion since then and that is because the regulator took action and asked them to put up more capital and the response was to draw down their portfolios somewhat. Cer-

tainly, one has to consider the size of the portfolios as part of safety and soundness, and I think it is an important issue.

The other thing about the portfolios is that it is just one of their two businesses. I think it is important to remember that this is about only a third of their total book of business and how they help the mortgage market. The other two-thirds is their guaranteeing of MBS's and those guarantees have credit risks, just like their portfolio, but a lot less interest rate risk and operational risk.

Mr. GARRETT. And I think I have time for just more question. Mr. Steel, you have not suggested any limit on the amount of the GSE obligations that a bank may hold, that was an idea proposed by the Clinton Treasury Department, I believe, and included in some prior versions of this legislation. Do you support such?

Mr. STEEL. I think the key push for us has been, and will be, to have a strong regulator. And if we make the GSEs subject to good regulation with the right balance of both the size and the capital required, then that is the right anecdote for dealing with all the issues.

Mr. GARRETT. Okay, thank you.

The CHAIRMAN. The gentleman from Texas.

Mr. HINOJOSA. Thank you, Mr. Chairman. I want to thank you and Ranking Member Bachus for bringing this important issue for us to have this hearing on your bill. The outcome after this important hearing on reform of enterprises and Federal Home Loan Banks is very important to my congressional district, as well as to my State of Texas. I wish to ask my question to the Honorable Robert Steel, and also get input from The Honorable James Lockhart.

Gentlemen, as you know, Chairman Frank's legislation, H.R. 1427, proposes a product review process for Fannie Mae and Freddie Mac that goes far beyond the bank regulatory model. National banks are not required by OCC rules to obtain prior approval for every new product that they introduce. Do you support this section of the H.R. 1427 bill? And, in your view, what justifies imposing a stricter regime on Fannie Mae and Freddie Mac?

Mr. STEEL. Thank you. I think that the way I would think about this is really in the context of some of the earlier conversations. The housing GSEs are hybrid institutions and they have unusual characteristics. They are part private and part public in terms of the policy ambitions. And therefore we have said all along from the Treasury perspective that we think of the tools needed as in two parts.

The first part are tools that are consistent with a strong bank-like regulator. But, secondly, there are additional tools needed because of the special nature of GSEs and this product review is part of the special nature that we think is appropriate given this hybrid construct. Let me again reiterate that the development of rules in the open and transparent system will be a way for Congress to comment and have input on this and then the strong regulator will apply them over time. And that seems like the right prescription to go with this situation.

Mr. HINOJOSA. Well, I am concerned that if you go too far, the low-income families in regions like the one I represent, where over 40 percent are below the national poverty level, would never be able to own their dream home. And so I am concerned that you

folks just might go a little bit too far to the right. And I would ask Mr. Lockhart, would you give me your views?

Mr. LOCKHART. Well, first of all, I think regulatory review of new products is not unusual, either in banking or in the insurance industry. I am more familiar with the insurance industry. What is maybe a little different here is the more public nature of the reviews, but the regulator will put out a regulation, and certainly if there are private parts that should not be exposed to the public, that will not be exposed.

But my view, again, is innovation is critical for these companies, and I think we have to encourage that. At the moment, unfortunately because of their problems, they are not really capable of innovating and so what we need to do is help get them fixed. And then I think this would be a very good process going forward to look at major new products.

Mr. HINOJOSA. Well, I believe that to close that gap that has existed for far too long, we are going to have to be creative and innovative and be able to regulate them but, as I said earlier, not to go too far and not let them work and help us reach that goal.

I want to continue and say that it seems to me that a financially healthy national bank does not have to obtain the approval of the Comptroller of the Currency or formally notify the comptroller before offering a type of mortgage that it had not offered before nor would a healthy bank need permission to start offering auto loans even though it had not done so before. I am concerned about an overly-bureaucratic bill approval process that might stifle innovation or harm the very reason we created Fannie Mae and Freddie Mac. So why treat Fannie and Freddie differently, and I address that to Mr. Lockhart?

Mr. LOCKHART. Well, as Mr. Steel said, these are hybrid organizations, they have a very important public mission, and they have a very big role in the U.S. economy so we have to make sure, as part of regulatory review, that their new products are safe and sound. That is not meant to stifle innovation, it is just meant to make sure that they do not have safety and soundness problems. And I think, hopefully, a regulator can and has been able, will be able to work the balance between safety and soundness and innovation.

Mr. HINOJOSA. Thank you for your response. I have already gone beyond my limit, and I yield back.

The CHAIRMAN. I thank the gentleman. The gentleman from New Mexico.

Mr. PEARCE. I thank the chairman for the hearing. I think my question, Mr. Steel, would be how do you perceive the secondary market in the reform bill, the bill that we have due, are GSEs going to stay involved in the secondary market? What are the applications that we need to face there, I think would be my question?

Mr. STEEL. Well, I think that the clear issue here is that this proposal focuses on the issue of mission and the issue of safety and soundness. And the mission is clearly stipulated to be focused on extending credit for housing and so this does not limit their involvement in the secondary market. And that could continue but it will be up to the regulator to balance the business model with the

appropriate risk-based capital and give him guidance and provide the right perspective so as to protect those twin, dual aspects.

Mr. PEARCE. And you would see that flexibility to stay in or get out as being an appropriate flexibility, you think that flexibility is appropriately given?

Mr. STEEL. Yes.

Mr. PEARCE. Okay. Any other comments on the panel on this particular issue because I suspect we are going to hear more about this as we move forward because if see enough of it in the evening news, sometimes it percolates to a hearing, you never can tell?

Mr. LOCKHART. Well, I certainly think that they have an extremely important role in the secondary market and this legislation that is proposed will only strengthen that role. They not only have a portfolio but, as I said earlier, they also are the major providers of securitized MBS's that back up the mortgage market. So I think this bill will only strengthen them and strengthen their capability.

Mr. PEARCE. Mr. Cornick, any comments?

Mr. CORNICK. No, sir.

Mr. PEARCE. If we could go just a little bit further and assess the strength—not just the strength of the market but the activity that goes into the secondary market? I come from a very poor district, probably \$22,000 to \$25,000 is our average income, and so secondary markets frankly play a very large role in seeing that people in New Mexico get access, so what happens if we constrict the secondary markets unnecessarily? Are there elements of the business world that are going to pick up those loans?

I think that loan pool right now is about \$700 million—\$700 billion, excuse me, it is almost a trillion dollars to low-incomers and yet you can see it coming from the evening news, they think we ought to squeeze that down and shut it off, but it is going to affect people in the poor districts. And so what options do we have going into the future? What potential, what risks are out there in the market if we over-regulate and then what are the effects, if I could get some comment?

Mr. LOCKHART. I think you have a very reasonable concern, that we do not want to over-regulate and we have to be cautious about what is happening out in the marketplace today. Freddie Mac and Fannie Mae are big players in the secondary mortgage market, including the kinds of securities you are talking about which are private label securities issued by issuers including Wall Street banks and other firms. They have been reasonably big buyers in that and they have actually been only playing at the very top level, the triple A tranche, but they do have between them probably \$300 billion of private label securities and there is nothing in this bill that would not allow them to continue to do that. And then hopefully over time, they can develop capabilities to do even more.

Mr. PEARCE. Mr. Steel, any comment?

Mr. STEEL. I would agree.

Mr. PEARCE. Okay, thank you, Mr. Chairman. I see my time is about gone.

The CHAIRMAN. I thank the gentleman. The gentleman from Missouri.

Mr. CLAY. Thank you, Mr. Chairman. Thank you for holding this hearing. Mr. Lockhart, Chairman Frank's legislation, H.R. 1427,

would set the capital levels for Fannie Mae and Freddie Mac. Congress set the capital levels in the 1992 legislation as well. While I support giving you bank-like authority to increase the capital levels when there is a serious safety and soundness condition, I am very concerned that you might over-interpret this authority to be broader and more than we in the Congress intend.

What can you tell the committee today to give us assurances that we are all on the same page as to what authority we are giving to the new regulator and how you would use that authority if you were the new regulator?

Mr. LOCKHART. The legislation gives the regulator, through an open rulemaking process the ability to look at not only the minimum capital rules but also the risk-based capital rules. On the risk-based side, the present rules were in that 1992 legislation. The model that is built out of it is not very effective and we will definitely be looking to make it more effective.

On the minimum capital side, there is no doubt that there are limits in place. The minimum capital requirements are much lower than for any other financial institution but there is reason for that. And there are some other reasons that they potentially should be higher. As you probably know, at the present time, we have a 30 percent add-on to that given the regulatory risk, which makes instead of 2.5 percent, 3.25 percent. And certainly that is a number that we are more comfortable with at the moment considering the situation.

Mr. CLAY. Let me get some clarification from you, Mr. Lockhart. On January 19th, the "Wall Street Journal" Financial Services Brief read, "Fannie Mae OFHEO director reveals a net loss at Fannie Mae." Did you announce Fannie Mae's third quarter financial results in mid-January 2007 before Fannie Mae released them to the public and did Fannie Mae approve your release of this confidential information?

Mr. LOCKHART. We released that information when we put out the capital report, which is a public document containing information given to us from Fannie Mae that we are required to put out quarterly. So we released that in late December. And through those numbers, it showed that Fannie Mae had a loss for the third quarter. We will be putting capital numbers out again at the end of this month.

Mr. CLAY. And you are aware of 18 U.S.C., section 1905, as far as not being able to reveal statements of Fannie Mae?

Mr. LOCKHART. I think it was mentioned to me earlier.

Mr. CLAY. Okay, and your response earlier, I may not have been here?

Mr. LOCKHART. My response is that the information you are talking about was already out in the public sphere because of the capital report that we put out.

Mr. CLAY. Okay, thank you for that response. Mr. Steel, we are discussing GSE legislation that may lead to limits on GSE portfolios and activities. Fannie Mae and Freddie Mac may have used the wrong accounting treatment but they seem to be on the right path now. In a mortgage market downturn when many lenders will exit the market but the GSEs remain, why are considering pro-

posals to limit GSE growth? What do you think the effect of these limits will be on the mortgage market and on borrowers?

Mr. STEEL. I think the key issue that I would want to highlight is this is not an effort to limit the growth of participation. This is an effort to establish the right capital regimen and the right regulatory regimen and those twin things will make these GSEs stronger so that they can do their job better. And if you really are concerned for the longer term, intermediate to longer term, about their ability to be effective, step one is to have a strong regulator that applies the right capital regimen so people have confidence they can do their job.

Mr. CLAY. And that still enables them to accomplish their mission of providing affordable housing to Americans?

Mr. LOCKHART. Even more so to my mind.

Mr. CLAY. Even more so?

Mr. LOCKHART. Yes.

Mr. CLAY. Because of the strong regulation?

Mr. LOCKHART. Because of strong regulation and appropriate capital and the right presentation to the marketplace.

Mr. CLAY. Thank you for that response. I yield back, Mr. Chairman. Thank you.

The CHAIRMAN. The gentleman from Louisiana.

Mr. BAKER. I thank the Chair. Just to quickly summarize, and I apologize for my absence, believe me I do not miss GSE hearings. I was over in Transportation on some Katrina-related matters that required my attention. But to summarize, we have enterprises that were created by acts of Congress who were given a privileged place in the market and, as a result, the market views these enterprises as low risk because there is the prospect that the U.S. Government/taxpayer would step in, in the event of an adverse economic outcome and assume obligations of the enterprise, while at the same time, should the enterprises remain profitable, the shareholders of that enterprise enjoy those profits.

So we have a unique business model in which it is a joining of public resources which generate profit for shareholders. That type of entity, in my opinion, requires us to act carefully because we are the ones who by statute created these two or three particular activities. The Federal Home Loan Bank of course, for the record, is not a shareholder-driven institution, it is even more unique.

However, given that prospect and the changing nature of the business practice over the life of these enterprises has necessitated a change in the proper regulatory oversight. For example, in the years in which MBS did not exist and the enterprises did not buy their own, the risk profile of those entities in that day, in my view, was a great deal less volatile than it would be if considered today as enterprises buy more and more of their own MBS, bringing that risk on to the books, which they previously did not enjoy.

And the reason why they do so of course is to enhance profitability. That has nothing to do with the provision of housing to low-income people. In fact, when you go through a portfolio analysis and look at the numbers of mortgages held, which are 5 percent or less down payment, which I have drawn the conclusion that generally poor people do not have money, it is just me, that is where I wind up, and that means at the down payment level, they are

going to have less involved in the deal than the person who is selling a home, capturing a profit and rolling that into the next one. But when you analyze the portfolio, and I will ask, Director, if you have a number that you could share with us, you would find the typical home mortgage value in that portfolio to be about what?

Mr. LOCKHART. I think the average home mortgage values are between \$130,000 and \$150,000.

Mr. BAKER. In most cases that represents a LTV of 70 percent or less by my calculation?

Mr. LOCKHART. That is correct.

Mr. BAKER. Which means if it is \$150,000 and the person has \$50,000 equity, that is a \$200,000 house securing an \$150,000 loan kind of average. So it is not the customary first-time home buyer that one might assume that these enterprises are principally engaged in. They are funding middle America's homeownership opportunities. And when you look at their ability to meet the needs of low-income, minorities, first-time home buyers, however we choose to characterize it, in your view have they met or exceeded the traditional market performance or have they lagged behind the market?

Mr. LOCKHART. It is a tough issue to say whether they have met the market performance. One issue is that it is hard for them to reach some of the really low-income borrowers.

Mr. BAKER. And that goes to the risk requirement because when they buy subprimes, they only take Class A's, they do not take the higher risk/lower credit score stuff in order to minimize their risk so their shareholders know their profit is not at risk and there is the inherent conflict as to why we need this regulatory change. Taxpayers and the Congress gave them this authority but required them the obligation, because of this privilege, to meet certain credit extensions that otherwise might not be met.

But when we look at what they hold in their portfolio, it is not typically what we would expect if they were intending to meet only the low-income, first-time homebuyers' needs. In fact, 60 percent of the mortgages held in the country are held by folks other than Fannie Mae and Freddie Mac, so that credit needs are now being met in a variety of new ways that are alternatives that did not 10 years ago perhaps exist.

One last thing, Mr. Steel, with regard to the minimum capital suggestion, some have argued that we need to consider alternative assets being placed in the pot that counts toward your Tier I capital requirements, such as subordinated debt. Some people call that "funny money." What I want to know is what is the position, what is your view of the current construct of the Tier I capital requirement, minimum capital requirement as it is now envisioned in the legislation? And should we consider the addition of "funny money" to meet those goals?

Mr. STEEL. Well, I think that it is pretty clear in bank capital that subordinated debt would not be part of Tier I and so that should not be included as part of the Tier I capital.

Mr. BAKER. So you feel the current construct of the minimum capital requirement is sufficient?

Mr. STEEL. Yes.

Mr. BAKER. Thank you, very much. I yield back, Mr. Chairman. Let me also thank the chairman for his leadership.

The CHAIRMAN. I thank the gentleman as the first one who got us started in this area, and we appreciate the cooperation. The gentleman from Georgia.

Mr. SCOTT. Thank you, Mr. Chairman. I too want to commend you, Mr. Chairman, for your leadership on this issue. It is very important. Mr. Steel, let me ask you this, why must the Federal Home Loan Banks be under this new regulator? There is clearly a difference here; the Home Loan Banks operate under a totally different business model, and they are not as risk prone. It just seems to me that that is not the way to go. Why are you persistent in wanting them under this new regulator?

Mr. STEEL. Good, I will start, and maybe Mr. Lockhart will comment additionally, but I think that from my perspective this is the right umbrella regulator to get the housing GSEs and the Federal Home Loan Banks under this. I believe that enough of the same characteristics are existing between all three of these, and that this is the best tool for that task. There are differences, and several have commented, and that the two, Fannie Mae and Freddie Mac are more similar, but the Federal Home Loan Banks are sufficiently like this that we think this is the right way to approach it.

Mr. SCOTT. But do not the Federal Home Loan Banks basically just primarily make secured loans to their member institutions who are involved in this as opposed to Freddie Mac and Fannie Mae who are involved in a myriad of things that pertain to much greater risk? And do not we run the risk, in putting these two basically apples and oranges together, of this not operating in the best interest of our consumers?

Mr. STEEL. I think the real issue here, sir, is that the regulator will be able to adapt the rules and apply them to each of the entities so that they are in the right form.

Mr. SCOTT. Well, tell me this, Mr. Steel, what is wrong with their current regulator? I would think that they are doing the job; there are not the same complaints that we get with Freddie and Fannie?

Mr. STEEL. I think that the same rudiments of why we believe that we need a bank-like regulator with all the appropriate tools, and we have walked through the half a dozen characteristics, really apply here to the Federal Home Loan Banks also.

Mr. SCOTT. Well, tell me this then, what regulatory authority that they do not now have, will this legislation would provide?

Mr. LOCKHART. Well, I think the legislation really does make a lot of sense because they do have a lot of similarities. The FHLBs have portfolios. In fact, two of them got in very big trouble with the risk management around those portfolios. So they do have some very similar issues going forward. They are all housing GSEs, they are all in the marketplace, and it really makes a lot of sense to me to have one regulator, as Controller General Walker said, that oversees all the housing GSEs to try to bring more prominence to the issue and also to bring more efficiency and more effective regulating?

Mr. SCOTT. Well, how do you see this benefitting the marketplace?

Mr. LOCKHART. I think a more efficient regulator will benefit the marketplace. I think going forward that Federal Home Loan Banks understand that having a stronger regulator will help them retain their shareholders and their business.

Mr. SCOTT. But is not the current regulator doing the job now? Where are they failing? I do not see where this problem is that it is necessary to take the Federal Home Loan folks and put them into this. If there was a problem with the current regulator, then I could see that but nowhere has that been pointed out.

Mr. LOCKHART. Well, there are certainly issues at the moment around the capital and especially the risk related to the capital of the Federal Home Loan Banks. And, as I said, there were certainly several that had some significant problems.

Mr. SCOTT. All right, well, let me go to another question I wanted to ask Secretary Steel. We have been on this issue of GSE reform, and last year the reform legislation died in the final hours of the session. And my question is, is this Administration committed, really committed, to negotiating in good faith to quickly finish action on GSE reform?

Mr. STEEL. I am quite appreciative of that question. I pledge to you that Treasury, of which I am affiliated, is committed to that and would like—and is here today in support of the bill. And I believe, and you can—really in some ways the question might be better answered by Chairman Frank as to the commitment and seriousness of intent. And I pledge to you that is exactly why we are here and that we have worked hard to get to this place and look forward, as the expression was used, I think by the chairman, to getting the ball over the goal line.

Mr. SCOTT. Well, are there areas that this committee is considering in this legislation that the Administration will definitely oppose?

Mr. STEEL. I think that we have tried to talk—the things that are on the table today are things we have worked on. There are still some open issues but there is nothing that we see as being an issue that is discouraging to us to want to proceed full speed ahead.

Mr. SCOTT. Are there areas that the Administration can find that is not included now that you would desire to be included?

Mr. STEEL. Well, I think we specifically referred earlier to the Federal Home Loan Bank directors being appointed independently as opposed to from the government. And I think that would be one. And there are other nuances that we will discuss, but we have worked hard to get to this point and feel comfortable with where we are.

Mr. SCOTT. Thank you, sir. I yield back, Mr. Chairman.

The CHAIRMAN. Before recognizing the gentlewoman from Illinois, if I could respond. Yes, I would say to the gentleman there have been very good faith negotiations that have been very productive. I think the answer is that we are within reach in all these things. Let me summarize it this way, the experience I have had in a number of areas, but most importantly here in negotiating this, is one of the reasons why I am now convinced that having been involved in the financial services industry is better prepara-

tion for being Secretary of the Treasury than either aluminum or railroads.

[Laughter]

The CHAIRMAN. I would also, just if I could speak a little further, say that as far as the Home Loan Banks are concerned, several of us, the gentleman from Pennsylvania who chairs the subcommittee now and myself, originally took the position that the Home Loan Bank should not be included and some of the Home Loan Banks came to us and said, "But if you set up a new structure and we are excluded, it will look funny and people will wonder why we are excluded." And there were some, obviously not all, who feared that they would then be at a disadvantage in the raising of capital because they would not be under the same secure regulator.

By the way, regarding Sarbanes/Oxley, etc., an acknowledgment that being well-regulated is an advantage in trying to raise capital because of the confidence it instills in investors, so many of us wanted to keep the Home Loan Banks out. However, many of them came to us and said that they wanted to be in. Now, some of them say that they want to be out again, and there was a problem here, which is that legislating is different than playing with a yo-yo, and you have to accept that some things only go one way.

I would note, however, that there is one very important similarity between the Federal Home Loan Banks and the GSEs, or at least I hope there will be at the end of this year—the Federal Home Loan Banks have had, since the late 1980's or early 1990's, thanks to Henry B. Gonzalez's leadership, an Affordable Housing Program which comes from the profits of private sector entities. It has been very well run. Many people do not know about it because good news is not news and there have not been scandals. And a significant of units have been built. In my area, the Boston Home Loan Bank has been a superb supporter of affordable housing.

So when people talk about the Affordable Housing Fund to Fannie and Freddie, this is not some new idea; it is explicitly copied from the idea and the very good experience of the Federal Home Loan Banks.

The gentlewoman from Illinois.

Mr. BAKER. I just want to make one little quick observation regarding my experience on inclusion or not to include. I was lobbied very strenuously not to include, we do not like it, we do not want to be part of it, but if you are going to do it, put us in it.

The CHAIRMAN. The gentlewoman from Illinois.

Ms. BEAN. Thank you, Mr. Chairman, for the hearing and thank you to the panel for your testimony today. I have two questions that I wanted to address to both Director Lockhart and Secretary Steel.

If I can ask them both and then you can each give your response, that would be helpful. While it is understandable why an institution's capital requirements might be increased to address specific concerns, maybe they are not current, they need remediation, they lack appropriate controls, my question is, in those situations would you support returning to the statutory minimum levels once those conditions have passed?

That is the first question. And the second is are there any circumstances where you would by regulation permanently increase

capital levels above Congress' mandated statutory minimum capital levels?

Mr. LOCKHART. The minimum capital rules were set 15 years ago. These companies have changed pretty dramatically since then, and I think you have to reevaluate at the minimum capital rules. I am not saying they have to be increased but I think they need to be reevaluated, and particularly, I think, the operational risk that they have so manifest over the last 3 or 4 years may mean that there may have to be some extra charge. It may not be the 30 percent, it could be lower, but going forward I think there is such a large operational risk component to these two companies, and they are in the process of remediating it but it will never go away, so I think it is important as we go forward to just reexamine at the minimum numbers.

Ms. BEAN. Let me just come back before I go to Mr. Steel. So you are basically not necessarily supporting going back to the original levels once the conditions have been met?

Mr. LOCKHART. I am not supporting it at this point, but I think it is certainly an issue that we have to look at given the large risk that these companies are taking.

Ms. BEAN. Can you be more specific of what specific instance you would make those increased levels permanent?

Mr. LOCKHART. Well, I think it would be done through, as the legislation states an open rulemaking process. There would be discussed in that process, reasons for increasing it if that is what we thought was appropriate. And then we would go back and forth, and I think we could get a lot of input from a lot of different players.

Ms. BEAN. Okay. Mr. Steel?

Mr. STEEL. I think really that I approach it in a little bit of a different lens, but I think maybe to an answer that will speak to the question. I think that the regulator should be given the right tools and then by dint of the transparent rulemaking process, a sense of how people would like those tools to be applied and then have the judgment of the regulator solve the puzzle. And proscribing in advance whether it should be permanent or not permanent, roll-back or not roll-back, is the wrong strategy. The regulator, as developed by the bill, is empowered by, and takes great advice from, the transparent rulemaking process and then has the responsibility to apply the right capital relative in a risk-based approach to the assets.

Ms. BEAN. If I have a couple of seconds, let me ask a further question to both of you as well. In Chairman Frank's legislation, H.R. 1427, it charges the new director with developing standards by which the enterprise's portfolio holdings would be deemed to be consistent with their mission and safe and sound operations. Is your reading such that systemic risk can be interpreted to be a factor or standard by which the portfolio can be reduced or capped?

Mr. LOCKHART. My reading of systemic risk is it is part of a regulator's job, it is part of safety and soundness, that you have to make sure that they do not have a problem that could spread risk to the rest of the financial system. And so from that standpoint, yes, if they for some reason had assets in their portfolios that could

cause them a dramatic problem that would spread to the rest of the financial system, it would have to be considered.

Mr. STEEL. Yes.

Ms. BEAN. Thank you. I yield back.

Mr. LYNCH. [presiding] Thank you. Does the gentleman from Colorado have a question?

Mr. PERLMUTTER. Thanks, Mr. Chairman. And I will get back to systemic risk in a second. This is for all three of you, what do you consider the role of the director to be with respect to goals that are going to be established for low-income, moderate—low-income, moderate, four-plexes, all that sort of stuff? And I am going through this statute just as you all are and I am on about page 150, okay, what do you consider the role to be, what do you expect to do if we pass this legislation?

Mr. LOCKHART. Well, first of all, it is a well-trodden path. HUD has looked and worked on that for many years, and I think they have developed a good program. That program would actually be brought over to their new regulator; it would be merged into the new regulator. But obviously the legislation has different rules and so working with the legislation, the new regulator would be guided by the legislation and work towards making sure that the two enterprises meet their affordable housing goals.

Mr. PERLMUTTER. So on an annual basis you would establish goals?

Mr. LOCKHART. We would establish goals in accordance with the proposed legislation, yes.

Mr. PERLMUTTER. And if we added something about energy-efficient mortgages to this legislation, would you consider that as being a goal, if we added that as a goal?

Mr. LOCKHART. I had not really thought about that. I would have to get back to you on that one.

Mr. PERLMUTTER. Okay. There has been a lot of conversation about the—I think I come to this with some skepticism, I have not been in the Congress before and I have not heard all the “parade of horrors,” I have our briefing packet that says that Fannie Mae overstated its earnings by \$5 or \$6 billion, and I am not quibbling, it is a lot of money, but against \$1 trillion or \$2 trillion in assets, it is like five/one-thousandths or something like that. And that Freddie Mac, did it understate its earnings by \$5 billion or \$6 billion, is that right?

Mr. LOCKHART. Well, certainly both companies did not comply with GAAP and misstated earnings. Yes, Freddie’s was more of an overstatement and Fannie’s was an understatement. The proper comparison to me is their capital and not their assets and in both cases it was a major portion of their capital. And the capital there is really what we are protecting.

Mr. PERLMUTTER. Okay, so let’s talk about capital for a second. As I understand it under this legislation there is risk-based capital and then there is minimum capital, and I am not quite sure—my experience has been more with credit unions and banks where they I think—I do not know if it is by regulation or by statute that they have to have like a 5 percent capital minimum. And then they, based on their board of directors, can increase or lower it. If they go below 5 percent, then they are rated by their particular regu-

lators. What is the minimum capital for Fannie Mae and Freddie Mac today?

Mr. LOCKHART. The minimum capital requirement, the one comparable to your 5 percent—and many banks hold well over 6 percent, as you know—is 2.5 percent. The Enterprises also have to hold .45 percent or 45 basis points against their mortgage-backed security guarantees.

Mr. PERLMUTTER. And then I heard you say that right now because of regulatory risks, you are 30 percent above that?

Mr. LOCKHART. Right.

Mr. PERLMUTTER. What is a regulatory risk and does that have anything to do with a systemic risk?

Mr. LOCKHART. The reason for putting on the additional requirement was operational risk, and it was related to the fact that these companies could not produce financial statements, their internal controls were not there, the risk management was not there, their systems were not there, and they were high risk. And so that extra 30 percent was put on which makes, I think I said earlier, 3.25 percent.

Mr. PERLMUTTER. Do you think that the minimum capital for these organizations needs to be increased or are you okay with that 2.5 percent except for when there is this regulatory risk factor?

Mr. LOCKHART. I think it has to be looked at.

Mr. PERLMUTTER. That is a good answer, it has to be looked at, considered by you as the director or how will that minimum capital be determined?

Mr. LOCKHART. Again, the way we would look at it is as we look at other financial institutions. We look at the risk inherent in these two companies, and we will go through that process. And if we think there needs to be a change, we would go through an open rulemaking process and there would be comments on any proposal and then we would go through the normal process.

Mr. PERLMUTTER. Okay. This gets more to the systemic risk, and I would like all three of you to comment on it, but somebody said this is a huge problem, there is a systemic risk, and I can tell you walking the precincts of Arvada, Colorado, regulation, re-regulation of Fannie Mae did not come up once. I had a lot of other things that came up a number of times but not this. What difference does this bill make to a resident of Arvada, Colorado? How is it going to save them from something?

Mr. STEEL. Well, I will start, I think, if that is okay. I think this is a good example, and I am sure you are right that this did not come up when you were walking among your constituents, but this is the right way of dealing with this before it is a problem. We can look at this and Federal Reserve chairmen, the last two, have come and talked in this group to you about this in the House, and we are completely consistent with their view that these are issues that need to be dealt with before they are a problem.

And there are two aspects to this, one is the systemic, but, two, they will be better able to do their job over time with the right capital and the right regulator, and we should deal with it now before it is a problem and when your constituents do not talk to you about it. And if your constituents never talk to you about because the right moves were made today, that would be a win.

Mr. PERLMUTTER. Okay. Sorry, I was just going to ask about systemic risks.

Mr. CORNICK. Mr. Chairman, would I be able to respond briefly?

Mr. LYNCH. Very, very, very briefly, thank you, yes, please?

Mr. CORNICK. On the issue of the regulator set, monitor, enforce, we would just offer that there is missing an overall affordable housing goal that would apply broadly speaking, we speak to it in the written testimony at length and hope you would refer to that and would just echo what Treasury said, the cost of not doing something is profound.

Mr. LYNCH. Okay, I thank the gentleman. I thank the gentleman from Colorado. I think this panel has suffered enough, I think we should thank you for your attendance and your willingness to work with the committee. This is an ongoing process. I am told by the Chair that we will continue to reach out to you and ask for your advice and recommendations with respect to this bill, and we look forward to our working together on this. Thank you.

Mr. CORNICK. Thank you, very much. I just want to put forward to your staff the fair lending cite, page 151 of the bill, section 131.

Mr. LYNCH. Okay.

Mr. CORNICK. Transferring authority for fair housing and fair lending to the Director from the Secretary.

Mr. LYNCH. We will accept that into the record, without objection.

Mr. CORNICK. Thank you.

Mr. LYNCH. Thank you. The next panel consists of the Honorable John Dalton, president of the Housing Policy Council, Financial Services Roundtable; Mr. Richard F. Syron, chairman and chief executive officer of Freddie Mac; Mr. Daniel H. Mudd, president and chief executive officer for Fannie Mae; and Mr. Gerald M. Howard, executive vice president and chief executive officer for the National Association of Home Builders.

First of all, let me welcome you to the committee. I am told that we may have some votes on the Floor in the near term. However, in the interest of time, I would like to offer a 5-minute opening statement to each of the panelists. Again, thank you for your willingness to come before the committee and help us with our work.

And I would like to begin with Mr. Dalton.

**STATEMENT OF JOHN H. DALTON, PRESIDENT, HOUSING POLICY COUNCIL, FINANCIAL SERVICES ROUNDTABLE**

Mr. DALTON. Thank you very much, Mr. Chairman, Ranking Member Bachus, and members of the committee.

I am John Dalton, president of the Housing Policy Council of the Financial Services Roundtable. Thank you very much for the opportunity to present the views of the Housing Policy Council on the supervision and regulation of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

I have a prepared statement for the record, and I'd like to summarize the key points of that testimony. The Housing Policy Council or HPC is part of the Financial Services Roundtable. HPC is comprised of 23 of the Nation's leading mortgage lenders. We estimate that our members originate over 64 percent of the home mortgages in this country. Our members support a competitive,

well-regulated marketplace that provides mortgages and financial products that American consumers want and need.

The Housing Policy Council continues to strongly support enactment of legislation to strengthen the regulatory oversight of the housing GSEs. That regulation is long overdue. The housing GSEs are an important part of our Nation's housing finance system.

The members of the Housing Policy Council do a significant amount of business with Fannie Mae and Freddie Mac. Those two GSEs are the largest purchasers of the conforming mortgages originated by the members of the Housing Policy Council.

Many of our members are also members of the Federal Home Loan Bank System. We have a strong interest that these housing GSEs be healthy and responsible business partners. Legislation to strengthen the supervision and regulation of housing GSEs will not only safeguard our housing finance system, it will also help consumers who seek to become homeowners and it will protect the interests of all taxpayers.

Frankly, the current system for regulating and supervising Fannie Mae and Freddie Mac is just not up to the task.

Mr. Chairman, earlier in my career, I served as chairman of the Federal Home Loan Bank board and president of Ginnie Mae. I have firsthand experience in the authority that a Federal services regulator must have in order to be effective and the tools that are necessary. The present regulator's authority to oversee Fannie Mae and Freddie Mac is simply not adequate.

Mr. Chairman, we have the strongest banking system in the world. It is also strongly regulated. It is time for the housing GSEs to have that same type of world-class regulation.

This committee has worked hard on this issue for a number of years. It is now time to complete the task. We urge the committee to act on reform legislation as soon as possible so that a bill can be finalized in this session of the Congress. We also urge the committee to resist proposals to water down this reform legislation or weaken the authority of the GSE regulator.

The Housing Policy Council and the Financial Services Roundtable believe that GSE reform legislation should contain the following key provisions:

First, a strong independent regulator. Legislation should create an independent regulator for Fannie Mae, Freddie Mac and the Federal Home Loan Banks. A single regulator will ensure that each of these institutions will be examined on a comprehensive basis and will permit examiners and analysts to share relevant operational and other information as necessary. An independent regulator will ensure that the agency will not be subject to undue political influence.

Second, comprehensive supervisory and regulator powers. The new regulator must have clear, strong and broad regulatory and supervisory powers that are comparable to the powers Congress has given to the Federal banking regulators. This must include the authority to both set risk-based and minimum capital for the GSEs and to place a troubled housing GSE into receivership if necessary.

And finally, independent funding.

Mr. LYNCH. Mr. Dalton, if I could ask you, there's a 5-minute time limit, which you have long since exceeded. Perhaps we could

reach some of that during your testimony. And if I could, ask you just kindly and respectfully just to sum up.

Mr. DALTON. I'll be glad to.

Mr. LYNCH. Thank you, sir.

Mr. DALTON. In short, we believe that H.R. 1427 includes the compromises that are worked out by this committee, led by Chairman Frank, and the Treasury that you heard from in the previous panel, and that bill is a clear improvement over current law.

While we have concerns with some specific provisions, we recognize that this effort has been a long, hard fight. It would be a mistake to make the perfect the enemy of the good. It is now time to enact legislation to improve the regulatory structures for the GSEs.

Mr. Chairman, I salute you for the leadership that you have demonstrated in getting us to this point. I want to thank Ranking Member Bachus and also particularly Congressman Baker for the leadership that he's shown on this issue for some time.

I think this legislation will indeed help consumers, the housing economy, and the GSEs. We urge the committee to approve H.R. 1427 and to resist any amendments that would weaken the authority of the new Federal regulator. Thank you very much.

[The prepared statement of Mr. Dalton can be found on page 112 of the appendix.]

The CHAIRMAN. Thank you. We have a couple of votes, and then we will be back. I thank the panel members for staying. We're going to go vote, and we will come right back and get right to it.

There are two votes, which should take about 20 minutes. We should be back in about 20 minutes or less.

[Recess]

The CHAIRMAN. An explanation is owed. The Appropriations Committee was reputedly close to finishing the supplemental appropriation, and the vote was held up because of that. And apparently everybody was afraid that if they had gotten close to a vote, but left and came back, people would have thought of new reasons not to be close to a vote. We regret the inconvenience to these witnesses in the next panel. Some of us did not think it was a good idea to hold it up this long, but that's for another day.

I believe we had heard from Mr. Dalton. Next, Mr. Richard Syron, who is the CEO of Freddie Mac.

**STATEMENT OF RICHARD F. SYRON, CHAIRMAN AND CHIEF  
EXECUTIVE OFFICER, FREDDIE MAC**

Mr. SYRON. Thank you, Chairman Frank, Ranking Member Bachus, and members of the committee. I appreciate the opportunity to appear before you today, and I'll be very brief.

GSE regulatory reform is vitally important to the Nation's economy and to its homeowners. I must say I'm a victim of my circumstances like all of us and my views have been profoundly shaped by my experience as a Federal Reserve and Treasury official where I learned the critical need of balancing adequate capital and safety and soundness with sufficient credit flows, particularly in times of economic transition in different markets such as the housing market is in today. The recent downturn in the housing market is slowing GDP growth. Mortgage delinquency rates are up, particularly in subprime.

Now Congress created the GSEs to help cushion U.S. housing markets from economic disturbances like these. When housing activity contracts, Freddie Mac and Fannie Mae increase their relative provision of funds to the mortgage market, and the opposite obviously applies when the market is expanding vigorously from the private sector. This ability to provide stability to the market is what, in my mind, makes the GSEs a congressional success story.

To be clear, Freddie Mac supports regulatory reform that ensures both the continued strong franchise and mission achievement. Many proposals are under consideration, and it is my hope that each will be measured against the twin criteria of safety and soundness and mission as well. This inevitably involves striking a delicate balance.

In a number of cases, we believe the proposed legislation would strengthen GSE regulation without upsetting that balance, but certain combinations of provisions, depending on how they're interpreted and implemented, could significantly—I said “could” not “would”—impair either our ability to remain financially viable or to serve our mission or both.

Now I'm not talking about short-term concerns. GSE legislation has been many years in the making, and once it happens it seems to me it's unlikely to be revisited very quickly. And I do have every confidence that Congress will strike the right balance.

A few weeks ago, Freddie Mac announced that beginning in September of this year, we will restrict our subprime ARM purchases to mortgages that have been written at a fully indexed level, and with tighter underwriting requirements. We also announced efforts to develop model subprime products that we hope will provide safer funding alternatives for the consumer.

These steps will help stabilize the subprime market while ensuring sustainable homeownership. In my mind, that's what the GSEs are all about, but we can only serve this function if we have the right capital and the operational flexibility to respond quickly to market transitions. Business cycles will come and go but these economic realities should not keep families from achieving their goal of homeownership.

I know in some areas my views are controversial. My purpose in raising them is not to be quarrelsome or make myself unpopular, rather it's because the issues before this committee are so important that I think it would be unfair and irresponsible of me in my duties to you to shy away from candor.

In closing, let me affirm that Freddie Mac is a creature of the Congress, and we are committed to doing what you want us to do.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Syron can be found on page 193 of the appendix.]

The CHAIRMAN. Thank you, Mr. Syron.

Next, Mr. Daniel Mudd, the CEO of Fannie Mae.

**STATEMENT OF DANIEL H. MUDD, PRESIDENT AND CHIEF  
EXECUTIVE OFFICER, FANNIE MAE**

Mr. MUDD. Thank you, Mr. Chairman, and Ranking Member Bachus, for inviting me here today.

Our company is making progress. We still have much more to do. High on the list is working with Congress to adopt a bill that will strengthen GSE regulatory oversight. I would mention that there's a backdrop to our discussion today, which is the troubles in the subprime market.

As for Fannie Mae, although this is a market where we play a very limited role consistent only with our very strong anti-predatory standards, I do want to assure you that we are doing what we can to help homeowners to stabilize the market and to avoid foreclosures. And if anyone wonders what the alternatives are to a market with well-regulated GSEs playing a stability and liquidity role, we now have reality TV with respect to subprime.

So if anyone wonders why Fannie Mae has taken the positions we have on GSE regulatory reform legislation, it is precisely so that we can continue to serve markets, especially in times of upheaval. We would like our portfolio to be able to provide liquidity when the market needs liquidity. We would like our capital structure to allow us to provide the maximum amount of capital to housing and to communities.

We would like our product approval process to allow us to respond quickly to market needs and constantly roll out and modify affordability products, and we would like to have a world-class regulatory oversight regime to ensure that we attain all these goals in a safe and sound manner.

So let me reiterate what we've said consistently over the past 2 years. We support the creation of a stronger, independently funded, bank-like regulator that combines safety and soundness supervision with authority over mission and activities, and we seek to play a constructive role in that process.

Let me touch quickly on capital, portfolio, products, and the fund. We support capital authority, and we believe reform legislation should provide the GSE regulator with a clear process that ensures proper deliberation, consultation and fairness before capital requirements are changed. Clearly any increase in our minimum and risk-based capital levels would adversely affect our ability to fulfill the mission you gave us, so the capital levels established by Congress should be the norm, not the starting point.

We feel the best way to address that in legislation would be to require the regulator to withdraw any special capital requirements when the circumstances that gave rise to those requirements no longer exist.

With respect to the regulation of our portfolio, we also support an approach similar to that exercised by bank regulators. Bank regulators have consistently taken the approach that asset growth by itself does not cause safety and soundness risks but only unplanned or poorly managed asset growth.

To that end, the legislation should identify the specific safety and soundness factors that would lead to regulatory limits on the size or growth of our balance sheet. We believe that systemic risks should not be included in these factors unless bank regulators agree on the method for applying such a standard to all financial institutions.

On new product approval, bank regulation also provides a useful guide. Submitting every new product to public review and comment

would entail submitting our customers' proprietary new products to public review and comment. This would not only be cumbersome; it would present serious competitive concerns. And again, our regulatory regime should be no different.

Certainly, significant new programs should be pre-approved, but not the literally thousands of new products that we offer.

Finally, Fannie Mae supports the creation of an affordable housing fund similar to that provided in H.R. 1461 that passed in the last Congress, and we continue to believe that GSEs should manage the fund. I believe that you want us to care what happens to the grants and investments made under such a program to ensure that they are effective community building blocks, and not simply a levee on our business. Of course, all of the fund's activities should be regulated, disclosed, reviewed, and supervised by a new regime.

To conclude, yes, we have a mission and a business, and when they work together, everyone wins. The \$20 billion we have invested in the Gulf since the storm is an important example of our company using all the tools at its disposal—portfolio, capital, products, people, and speed—to serve a public need even as it serves its shareholders. Our regulator should have the tools it needs to make sure that we do that safely and soundly to fulfill this dual promise.

Thank you for the opportunity to be here today.

[The prepared statement of Mr. Mudd can be found on page 183 of the appendix.]

The CHAIRMAN. Thank you, Mr. Mudd.

Next, Mr. Gerry Howard, who is the executive vice president and chief executive officer of the National Association of Home Builders.

**STATEMENT OF GERALD M. HOWARD, EXECUTIVE VICE PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL ASSOCIATION OF HOME BUILDERS**

Mr. HOWARD. Thank you, Mr. Chairman. I am pleased to be here on behalf of the National Association of Home Builders.

The GSEs were chartered by Congress to serve a critical public purpose. That public purpose at the time was to provide liquidity in the conventional housing markets. Subsequently an additional mission was added to the GSEs, the mission of focusing on affordable housing. The instant legislation that we're here to discuss today must take into account the preservation of those two important missions as it also seeks to balance the very important and much needed safety and soundness of entities as big as the GSEs.

I would like to make 6 points with respect to the instant legislation.

First, on the structure of the regulator, NAHB supports the provisions in H.R. 1427 that would establish a standalone regulator outside of any Cabinet department or regulatory agency. NAHB also supports the bill's inclusion of a deputy director for housing mission, but we'd also like to see the restoration of two independent advisory board members with housing experience to further enhance the mission for the focus of the agency.

Second, on capital requirements, NAHB supports the fundamental principal that adjustments to minimum capital require-

ments must be temporary and that the regulator should deal with longer term risks through the risk-based system.

In addition, all changes to GSE capital, risk-based and minimum, should be undertaken through the regulation that provides public notice, comment except in emergency situations of course where increases could be instituted and then reevaluated in a subsequent review and comment period.

NAHB appreciates that H.R. 1427 establishes criteria for temporary increases in minimum capital that are exclusively focused on safety and soundness while providing a process where temporary capital increases would be regularly reviewed and returned to the statutory level once the triggering issue has been resolved.

Third, NAHB appreciates that portfolio provisions contained in the bill have no hard limits or criteria mandating huge reductions, which would have significant adverse effects on the mortgage finance system. Both Fannie Mae and Freddie Mac hold sizeable portfolios of mortgages and mortgage-backed securities, which play an important role in stabilizing the supply and reducing the costs of housing credit.

The provisions also do not directly reference the systemic risk, which has been a rallying cry for critics advocating major shrinkage in the enterprise's portfolios. However, as we have stated publicly before, the vagueness of some of the criteria for portfolio regulation has led our members to express concerns that such language could be subject to overly broad interpretation, and we appreciate, Mr. Frank, your questioning the prior panel on this very subject.

Fourth, in the area of program approval, NAHB supports a process that is sufficiently rigorous to ensure charter compliance and safety and soundness while facilitating the ability for the GSEs to engage in program, product, and technological innovation needed to address the market needs in a timely manner. NAHB feels the process contained in the bill passed last year is superior to that contained in the current legislation.

Fifth, NAHB supports the high-cost area provisions that have been addressed by you and earlier by Mr. Miller in his questioning. NAHB believes that H.R. 1427 would allow the conforming loan limit in the high-cost areas the flexibility needed so that the GSEs could be providers of housing in high-cost areas such as Massachusetts and California.

And finally, while the GSEs' advantages should be preserved, NAHB believes that the GSEs can and should do more to accomplish their affordable housing mission. As such, we support the establishment of a new affordable housing fund contained in H.R. 1427 as well as the bill's tougher affordable housing goals.

On the affordable housing fund, NAHB believes that it is imperative that the money therein be used for sticks, bricks and mortar, that it not go to overhead or any other purpose. Further, we believe that there should be a competitive process so that the fund is used most cost-effectively and that the most housing possible is developed and built due to the expenditures from that fund.

Thank you, Mr. Chairman, and I look forward to answering any questions.

[The prepared statement of Mr. Howard can be found on page 145 of the appendix.]

The CHAIRMAN. Thank you, Mr. Howard.

You had a point in there about the high-cost areas that I want to pursue, and I appreciate your raising it. I think we may need to do further definition.

There are a lot of us who, as far as housing policy is concerned, can't think of a single housing policy elsewhere in the country where we use a flat dollar figure for the whole country. But I guess maybe, was it having the same dollar amount that applies to the greater Boston area as to Omaha would make about as much sense as paying the same Section 8 rents in Omaha and Nebraska.

Houses aren't mobile and therefore housing prices don't have that same uniformity. You do raise an important question about how we measure that, and I agree with that. Although the proposal you made is to do it on a statewide basis; obviously we wouldn't want to apply it statewide. If there are some areas in the State that are high cost and others that aren't, you don't apply it.

We need to further refine that, and I agree. Certainly our intention is, to the extent that you can identify median house prices in as small an area as possible—let me put it this way. We want to apply the high-cost loan limit as narrowly as possible. Our job will be to work together with people, and we have time to do this, so that we get the best preexisting statistical measure of house price costs in particular area.

I assume we must have that for SMAs and SMSAs, and if we do, that's what we would do. So we do agree that it has to be applied more narrowly.

The other issue you raised on your testimony—on page eight—and I appreciate that you alluded to my discussion of that with Mr. Steel, and there is some ambiguity in the language. There is a section that says that the regulator is, in dealing with the portfolio, to be focused on mission and safety and soundness. And then as you noted—those factors. Actually there were two, any potential risks posed by the nature of the portfolio holdings and any additional factors. It seemed clear to me that we intended those to be within the limitation of safety and soundness of mission.

You raised that before, and I was pleased to see Mr. Steel agreed to that. It may be that that needs to be made clearer, but I do think that's the common understanding. I appreciate it.

Mr. Steel acknowledged that, and with that, it's possible to do a better directing job. But we want to be clear, we are talking here in terms of safety and soundness of mission. These are not ways to bootleg back in concerns about interfering with the purity of the market's allocative function or systemic risk more broadly defined, and I appreciate that.

Let me just say to Mr. Mudd and Mr. Syron, as you know when we originally passed the bill that had a housing fund, an affordable housing fund, it did have you in charge. And it is not that people lack confidence in your management skills that has led me to have to support changing that. It is that they have indeed great confidence in your skills, and they think that you are smart enough to decide between members who have influence and members who don't.

And look, I have to be honest about this. There is no purely objective way to dispense a limited pot of funds. We are talking about

maybe \$500 million. If we had 4 times that much, we wouldn't meet the need for 30 percent, 50 percent of median. And what they are saying is that—and it has nothing to do with the skills. They don't want to enhance your political situation.

You know, there's a song, I saw some reference to it. Tom Lehrer had a song, "The Old Dope Peddler", about doing well by doing good. People of a certain age will recall that. They are afraid that if you dispense the affordable housing funds you will be doing well by doing good.

And let me even put it this way. Even those who would accept the purity of your motives, to some extent it is protecting you from us. That is, we will retain a jurisdiction over you because you have these Federal charters.

And I think people are foreseeing a day, clearly not now but at some point in the future, where an influential member of this committee who had in his district a housing proposal about which he or she cared deeply approached you to make that point clear.

Well, as I said, from the standpoint of efficiency—and certainly the Federal Home Loan Banks Program is run by them, but I cannot make effective arguments against that. That's our problem.

I will say this. We have in the housing fund, let me say it publicly, in the first year, I think we have pretty much agreement for those of us who want a housing fund, it's going to go to Louisiana and Mississippi, and it's going to go because—to the Louisiana and Mississippi State housing authorities in a ratio—we've talked to members is what we intend, three to one Louisiana and Mississippi.

You know, the Administration's figures were more than half of the rental units in New Orleans were destroyed. And where more than half of the rental units are destroyed, a voucher program doesn't do you a great deal of good because it's going to increase demand without meeting that supply need, so we need to deal with that.

Beyond that, we have in there the housing—let me urge people now, the disposition of the Housing Trust Fund that we vote if we vote a bill now is not going to take effect for more than a year because in the first year, the money will go to Louisiana and Mississippi. I'm ready to keep talking. We have to do something in the bill, and I want to make sure that we do something that doesn't mean that CBO gets its hands on it, if we ever want to use it again we get a budget score.

But there's some flexibility on that. And I'll urge people, we intend to continue to work with people, but we will not reach the point of distributing the housing fund, if we have one, beyond Mississippi and Louisiana until sometime in the next calendar year. And we will work on that.

I think there is agreement that we want it to go for housing. I do say, you remember when we did it last year there weren't sufficient restrictions and some—while this committee rejected a proposal to restrict it, there was a proposal adopted by that fount of housing expertise, the Rules Committee, which adopted the bill and then did not let it come up to a vote. And they said an organization seeking to build housing could only receive the funds if it was an organization whose primary purpose was housing.

Now one of the problems is that we have a number of religious institutions in this country who do a great job of building housing. In my home area and Mr. Syron's, we're both familiar with the Boston Archdiocese, an office of urban planning which has done a great job of building housing. But I have to say that as good as the Boston Archdiocese has been at building housing, they cannot claim that housing is their primary purpose. God is their primary purpose. Housing might come a strong second, but no religious organization could agree that housing was its primary purpose. That was part of the problem.

We will work closely together, but I hope you understand what the problem is with regard to your doing it. Once we get past the philosophical argument, I think we will be able to work this out.

Mr. Bachus.

Mr. BACHUS. Thank you. The mortgage market has undergone a lot of rapid changes in the products they've offered recently. How do the GSEs help provide a stable housing marketplace? I'll ask Mr. Syron first.

Mr. SYRON. Well, sir, I think you raise an absolutely valid and very important point that has to be the context for considering this whole piece of legislation. And that is, if you went back 25 years ago, and this is very relevant to the concerns in subprime now, institutions made loans, they put them in portfolios, and they held them.

Now we're in a world where, quite honestly, pieces of loans—I happen to have a conforming loan on something—I don't know where the pieces of that loan are. They're scattered all over the world in CDOs and everything else.

In this kind of world, and there have been experts like Lew Ranieri who have commented on it, it's harder and harder to get a discipline on the market, because quite candidly, we are a creature of the Congress. When you have us, I think, it's probably fair to say you're able to have very substantial influence over us. We control much less of the market now than we used to. For example, in our retained portfolio, and I know there's been a lot of concern about that, the retained portfolio used to be 21 percent of the mortgage market, and now it's down to 13 percent. If we're trying to dominate a market, Dan and I are going in the wrong direction.

So I think what we have to do is to provide leadership in the market, develop new products, which I know both institutions are trying to do now, having hopefully a chance to address some of the problems in the subprime market, and hopefully to be enough of a factor that the ability to sell to us influences people's behavior. We don't have as much influence in that regard as we used to have.

Mr. BACHUS. Mr. Mudd?

Mr. MUDD. Thank you. We basically do two things. We provide affordability and we provide stability, and we do it through two businesses. There's a popular myth that these two businesses are like two businesses in a holding company and they're divisible. But, in fact, Ranking Member Bachus, they basically do the same thing. They provide affordability and stability. The guarantee business enables lenders to take the loans they have, package them up, sell them into the market, and get money back so they can reissue the debt and originate more mortgages.

On the liquidity side, when there's a crisis or an interruption in the market and there's a need for capital to come in so that those funds continue to flow, that's when that other business of ours, the portfolio, steps in and is able to provide the liquidity so that you see through most of the recent financial interruptions the flow of funds into the mortgage market stays very level and very stable.

Mr. BACHUS. So is it your testimony that during this recent subprime lending problems that you all provided stability or that you've been a positive influence?

Mr. MUDD. Mine would be slightly different. We said a couple of years ago that this market was evolving in a direction that we didn't like. The layering of some of the products presented excessive risk to consumers. We stepped away from it.

What happened was, the market went around us, and there were arguments that I think you've heard that say you don't need the GSEs. Others can perform this function. That's what happened. Others performed the function, and a lot of risk went out into the marketplace. Now some of those chickens are coming home to roost, and you're seeing a disruption in the subprime market.

That said, I'm not at all happy about that, and I think there is a role the GSEs can play. We have provided liquidity. It's tightened up in the multi-family market. We've provided it there. We've put together something we call rescue mortgages to help people who are getting hit by a reset in subprime to refinance their mortgage so they don't lose their home in the process. Yes, we can play a role, and we're spooling up to do that.

Mr. BACHUS. All right. Mr. Howard, what impact have the current problems in the subprime market had on your industry, particularly maybe the production of new homes?

Mr. HOWARD. Mr. Bachus, the home building industry is quite concerned about this issue really for three reasons. The first is, as you know, we're in a downward cycle in the industry in and of itself. There's a lot of inventory already on the market. This subprime issue in addition to potentially leading to restrictions in the capital markets and the mortgage markets themselves, number one. Number two, this could lead to significantly more units being thrown back into the marketplace, which we don't need right now. And number three, it could lead to an overreaction by the Congress which could impede the ability of the mortgage markets to recover from this crisis.

So, we think that there are three concerns that we have, and we're working and look forward to working with you and others to sort of correct the situation.

Mr. BACHUS. Do you think that the current affordable housing fund as it's set up will provide equal access to both profit and non-profit entities?

Mr. HOWARD. We're concerned about that, sir. We think, as I mentioned in my oral testimony, that when you're talking about the creation of a fund, and taking money from these two entities, that we have a responsibility to ensure that the money is as best spent as possible. And to us, that means a competitive process, open up to for-profit and not-for-profits, whoever can build the most best housing with that money should be awarded it. There should

be no distinction made between profit or not-for-profit. It simply should go to the production of housing.

Mr. BACHUS. Okay. I think my time has expired.

Mr. KANJORSKI. [presiding] I think I will direct my attention first to getting the opinion of the panel on the selection of representatives for the boards of directors for both the Federal Home Loan Bank System and Fannie Mae and Freddie Mac. Does anyone want to express an opinion on that?

Mr. SYRON. Well, sir, I will express not necessarily an opinion on—because I think ultimately, this is a question for the Congress. But I think one of the inherent difficulties that putting presidential appointees brings up has to do with everything else, and that is that these are interesting institutions.

We have three responsibilities: we have a responsibility to safety and soundness; we have a responsibility to mission; and we have a responsibility, because we are publicly chartered, shareholder-owned corporations, to our shareholders.

Now, in that regard, there's been an enormous amount of research that's been done, and a lot of opinions, a lot of case law that says that the obligation of directors of a Freddie Mac or a Fannie Mae is identical to the obligations of a director of General Motors, or AT&T, or anyplace else.

And I think, you know, our world is one in which we are always not maximizing one of these things. We're trying to balance between the three. And a complexity I think, and it's much more so for shareholder-owned corporations like ours, than it would be maybe for the Home Loan Banks—a complexity for us is I can see those directors, if they were quote/unquote "political appointees" and sent to carry out—I'm not saying this would be the case—sort of a mission or a direction that might be different than that for the shareholders. Why I'm making this up, to some extent, I'm looking at how that could be contradictory to their obligation to shareholders, and maybe that has something to do with the nervousness and concern about this.

Mr. KANJORSKI. Do you have—maybe I do not understand the similarities and differences between Fannie Mae, Freddie Mac and normal corporations, public corporations. But your corporations have a special mission.

Mr. SYRON. Yes we do, sir.

Mr. KANJORSKI. That is beyond and different from just profit for shareholders.

Mr. SYRON. That's absolutely true, sir, and I think the issue is how we properly balance that. And I will freely admit, at least in my own institution, I didn't think we did properly balance it.

Mr. KANJORSKI. So if we had really effective outside appointed directors, we may have heard of some of the problems at the two organizations a little earlier here in Congress or in the White House?

Mr. SYRON. Well, I think they could have been a voice for other kinds of approaches. But those people—it's very, very difficult for the directors. And, you know, we recruited essentially almost an entirely new board of directors, and I'd put them up against boards of directors of any corporation in the world, but they are always having to judge that their actions—and they are fully cognizant of

the broader public purpose of these organizations—that whatever they do has to be consistent with shareholder value as well. Because as you know, our corporation has been sued by shareholders in a class action suit. Fortunately, we've resolved that.

Mr. KANJORSKI. So it would be reasonable for me to conclude as to whatever the Congress decides on that issue, it would be acceptable?

Mr. SYRON. Sir, I think that is ultimately a question for the Congress. We're a creature of the Congress. We should do what the Congress tells us, and I totally agree with the Congress resolving it.

Mr. KANJORSKI. Very good.

Mr. MUDD. Congressman, I would agree. I've seen it both ways. I've seen our board operate with presidentially-appointed directors and without. It's worked in both ways. I would just echo Mr. Syron's comments in that they are very complicated companies. And to ensure that any directors who come in have some tenure and have some background are important factors I'd consider.

Mr. KANJORSKI. On that issue, would you—rather than a yearly appointment, would you recommend a 2- or 3-year term?

Mr. MUDD. If the debate was the tenure, I think longer would be better than shorter, yes, sir.

Mr. KANJORSKI. Very good. How about Home Loan Banks? Does anyone—I know no one is a specialist, but—yes?

Mr. HOWARD. Mr. Kanjorski, with respect to the Home Loan Banks, and we also think that it has merit with respect to Fannie Mae and Freddie Mac, one of the elements to their boards which we think has served them quite well is the appointment of public interest directors, and in this instance, public interest directors who have experience in the provision of housing.

We think that has been a very effective element to their boards, and we would encourage its continuation as well as an implementation of that kind of a board member for the other GSEs, too.

Mr. KANJORSKI. All right. There are some elements in Washington that are expressing the opinion that we need more expert members of the board, and the outside appointees do not necessarily meet that level of criteria. And my counterargument to that, obviously everyone knows where I stand on this, for continuation and furtherance of those outside appointments.

But does anyone there see the likelihood that if we either took them off the board, made no outside presidential appointments, or if we allowed the institutions to guide and identify the appointments, would that not over a period of time lead to an incestuous type relationship internally within those organizations?

Mr. SYRON. Well, sir, one thing that we have done, and I want to be sure I'm answering the right question. I'm addressing kind of our current board now, is that we have a nominating and governance committee. In 2004, we totally redid our entire governance process. I don't select board members for the board.

As a matter of fact, my role is, if they want, for me to get in touch with people, but it's very much—and we've been religious on this, as I think we should be, making up for some of the things that you allude to perhaps in the past—that it is our nominating and governance committee that actually interviews potential direc-

tors; that's all made up of independent directors now, and then makes a recommendation to our board as a whole on how they do that. But they are not in any sense a choice—

Mr. KANJORSKI. Sort of like the AG's office, the chief of staff makes the inquiry?

[Laughter]

Mr. SYRON. Well, it's—we don't have one person.

Mr. KANJORSKI. No, I appreciate that. I am just trying to be humorous. We have to find something in this town to be humorous about.

Does anyone have—my last question. Anything that has been missed in the bill that perhaps we should pay more attention to or that would be more efficient or effective for the organizations to be regulated? Do you see anything there that we have missed?

Mr. SYRON. No, sir, I don't see anything that you missed. I would just make one plea in this entire issue, is that these institutions and the way that they were created—now I think they've done a lot of good. They're not without a lot of controversy. But they inevitably involve a lot of balance.

It's just like the issue in the subprime market, making sure that people can get into homes, but not that people who can get into homes can't afford to stay in them.

So, the only issue I would raise is that as we go through this, we are continuously aware that, you know, we have these multi-missions, and we're always balancing one against the other, and we want to be sure we can address all three.

Mr. KANJORSKI. Thank you, sir.

Mr. MUDD. I would add that it's a comprehensive bill and it's just important to keep in mind in the process that it's both a mission and it's a business, and both of those things have to be successful for the other one to work.

So, if that's my version of balance, I think it's very important. If the costs of maintaining the regime, if the costs of compliance become so high, that obviously has an effect on the business, and that then impacts the amount of money that we can drive back into housing.

Mr. KANJORSKI. All right.

Mr. HOWARD. And from our perspective, Mr. Kanjorski, we'd like to see the regulator include people with housing expertise in addition to financial expertise, just as we mentioned with the boards, we think it's important that the regulators understand the complexities of the missions as well.

Mr. DALTON. Mr. Kanjorski, from our perspective, we think that the bill is balanced, and that it's appropriate. You've addressed all the major issues, and we're in support of the legislation.

Mr. KANJORSKI. Thank you. And now I am in support of my chairman.

The CHAIRMAN. Mr. Dalton, I appreciate that, and I appreciate your calling it balance, but just don't call it fair and balanced, because—

[Laughter]

The CHAIRMAN.—then you'll make some of us very uncomfortable at the company in which you will be putting us. I appreciate this. Let me just to follow up on what Mr. Howard said about housing

people. Yes, I would make another plea, although because of the First Amendment, it is purely oratory.

I wish the media would assign some people who specialize in housing to cover this issue. One of the things we have suffered from is that, understandably, there's coverage from people who do the financial aspects, and these are important financial entities. But they are housing entities. And the people who cover this often know a great deal about the financial side but not as much about housing. And I think we would benefit if there was more attention to the fact that these are major housing entities.

I mean, we do have on our next panel, and I apologize for the fact it's delayed, groups that are especially concerned with housing, who know a great deal about it. And it's not surprising that Fannie Mae and Freddie Mac are among their major foci because of what they do.

Mr. HOWARD. From your mouth to the editors' ears, Mr. Chairman.

The CHAIRMAN. Thank you. I will say it again, Mr. Howard, because you know we continue to work with the home builders, I do want to note, and I don't think this is competitive, but I note the presence of my colleague from Indiana who represents a large number of manufactured housing places, and we do want to stress again to both Fannie Mae and Freddie Mac that we think in this overall balance, there's room for some manufactured housing along obviously with the major reliance we have on home building, and we hope that as we go forward, we will get that full attention. I know that's something that Mr. Donnelly continues to remind us of, as does Ms. Carson, also from Indiana. But Mr. Donnelly has Notre Dame and mobile homes to worry about.

[Laughter]

Mr. DONNELLY. What a way to be famous.

The CHAIRMAN. I thank the panel. And it wasn't all bad that we waited so long, because you had a lot fewer people to ask you questions.

Mr. BACHUS. Mr. Chairman?

The CHAIRMAN. The gentleman from Alabama.

Mr. BACHUS. Thank you. Could I follow up?

The CHAIRMAN. Sure.

Mr. BACHUS. One thing I don't know, were you present when Roger Ailes received that First Amendment award Monday night?

The CHAIRMAN. Was I present when Roger Ailes—no, I was not.

Mr. BACHUS. I thought maybe you walked out with Senator Kennedy and—

The CHAIRMAN. No, I did not. I was not there. I do like comedy shows, but I wasn't invited to that one.

[Laughter]

Mr. BACHUS. Mr. Dalton, he was talking about fair and balanced, so I thought I'd better ask you a question.

Mr. DALTON. Sure.

Mr. BACHUS. And I knew that the appointments would come up. I just didn't think it would take this long. So I'm not going to ask any questions on that. But is voluntary SEC filing sufficient by the GSEs, do you think?

Mr. DALTON. Mr. Bachus, I think so. I mean, I don't have any—we don't have any strong feelings in terms of requiring compliance with 1933 and 1934.

Mr. BACHUS. Okay. Are the GSEs' portfolios any more risky than a bank's portfolio of loans? I mean, well, a bank portfolio which is not just loans. I mean, I guess Freddie Mac and Fannie Mae, it's mostly interest rate risk, I would think.

Mr. DALTON. Well, the risk is that their portfolios are primarily—they're in the mortgage sector of the market, whereas banks are completely diversified, and they're all over the lot. So, there is risk in that one sector of the marketplace, and that's wherein lies the risk.

Mr. SYRON. Can I just add something?

Mr. BACHUS. Yes.

Mr. SYRON. I'm sorry. I didn't mean to interrupt.

Mr. BACHUS. Mr. Syron.

Mr. SYRON. Sir, we are in one sector of the marketplace, but it is generally considered, and if you look at the Basel II standards which the international regulators been working on for over 30 years, they would say that it's the lowest risk asset in the marketplace.

Mr. BACHUS. And that's what this committee has argued, that it is the least risky, unless you engaged in subprime or some questionable adjustable rate mortgages, like we've seen recently.

Mr. SYRON. And our loss rate, at least I can speak for Freddie Mac, our loss rate historically has been 1 basis point. The loss rate of commercial banks in the same product has been 14 basis points historically, and I think all products, and I think this has only gone over the last 20 years, has been 83 basis points.

So, you know, 1 basis point to 83 basis points is a pretty big difference.

Mr. BACHUS. Almost no default.

Mr. SYRON. Almost none.

Mr. BACHUS. And you have not engaged in the subprime market? You hadn't gone there to a great extent. Is that right?

Mr. SYRON. No, sir. Yes, sir, that's true. We have bought in part for goals purposes AAA tranches of some of these mortgage securities which we think are very secure. But I do think that it's our obligation, and it's consistent with what we did a few weeks ago, to really see, and we have people I think at both institutions working assiduously at trying to develop, you know, getting into the subprime market.

But this again, sir, demonstrates the balance issue. To get into that, right, is definitely more mission-friendly. It's a little less shareholder-friendly, and some could say, well, gee, is it as safe and sound? But we do feel if you set us up and this is a primary obligation of ours, we are going to search for ways to serve that market.

The CHAIRMAN. If the gentleman would yield, that's why in the paragraph that Mr. Howard and I were talking about where the—which sets the portfolio, it mentions safety and soundness and mission, and that's to prevent safety and soundness from being in effect a way to stay away from anything that's lower income and

risky. That's why safety and soundness and mission are the linked—the lodestars there.

Mr. MUDD. On the answer for Fannie Mae, on behalf of subprime, is that it's important to remember there is subprime and there is predatory. Subprime simply means—

Mr. BACHUS. Oh, absolutely.

Mr. MUDD.—you have a credit blemish, and we think those people are part of the market. It's less than 2.5 percent of our book. It's 80 percent insured. It's highly unsubordinated. We've been in it very carefully, consistent with some very strong anti-predatory lending guidelines we have.

Mr. BACHUS. In fact, I would take the position that the CRA in 1977, I think—they did actually when it said that you could not discriminate against low-income populations or neighborhoods, those neighborhoods, our experience is their credit ratings are somewhat less than perfect, so there is probably on banks, and I would say, Mr. Dalton, there's probably an obligation to make loans, subprime loans, on behalf of the financial institution.

But let me ask this question. This is a follow-up on what you just said, maybe. There are new affordable housing goals in this legislation. How can—and Mr. Frank said—this is Chairman Frank—others have thought, how can the two GSEs better focus on low-income families in underserved areas than you're doing now? How would you do a better job than you're doing now?

Mr. MUDD. We do a lot already. We financed about \$8 billion below 30 percent of AMI. So we have a representation there that's about similar to where the population is. That said, we do agree that an affordable housing fund, if structured properly, could be an effective way for us to play a larger role.

Mr. BACHUS. How would you change the affordable housing fund to serve some of your lower-income, underserved areas?

Mr. MUDD. Well, it seems to me that the issues in lower income housing exist now in this country because housing has done so well in specific geographical areas. Each of those areas has a different and specific set of needs. Some may be manufactured housing. Some may be rental housing. Some may be something else. But if the—if our companies were able to bring the full set of resources, not just a housing fund, but maybe equity investments or maybe loans or maybe other products, to the table, you could really begin to turn around communities.

So that was what I was trying to express in my testimony.

Mr. DALTON. Mr. Bachus, if I could just make one point, sir, with respect to your question concerning the SEC registration.

Mr. BACHUS. And I didn't mean to hit you—

Mr. DALTON. No, no. That's fine. I just want to let you know that our members do support registration under the 1934 Act.

Mr. BACHUS. So the exemption pitch should be eliminated, in your opinion?

Mr. DALTON. We support registration under the 1934 Act, yes, sir.

Mr. BACHUS. And I apologize for coming in with little—

Mr. DALTON. No, that's fine.

Mr. BACHUS.—differences.

The CHAIRMAN. I thank the panel, and we will call the next panel.

The CHAIRMAN. Be polite to each other later. Sit down and let's get started here. We're running late.

We will now begin. We'll ask that doors be closed. Our last panel, again, we regret that we were held up. But even though there are not a lot of members here, this is going to be a very important part of the record, and we appreciate it. And I assure you that what you're saying will have an impact. We begin with Judy Kennedy, who is the president and CEO of the National Association of Affordable Housing Lenders. Ms. Kennedy.

**STATEMENT OF JUDITH A. KENNEDY, PRESIDENT AND CEO,  
NATIONAL ASSOCIATION OF AFFORDABLE HOUSING LENDERS**

Ms. KENNEDY. Thank you, Mr. Chairman. I won't take too long on this, but you got me off on a tangent when you were talking about the song you remembered.

Think back for a minute, because it is the 30th anniversary of CRA. And by the way, that's pearls; I didn't bring any today.

But think back to where you were 30 years ago. Barbra Streisand and Robert Redford were young and attractive and starred in "The Way We Were." Carole King had issued her first album. Anyway, it's a long time.

But in the 30 years since CRA was enacted, the path to helping low- and moderate-income people become homeowners and have apartments they're proud to call home has been incredibly well-forged. Unfortunately—and by the way, I hope you look at the back of my statement, there are pictures of some incredible properties—

The CHAIRMAN. Are there pictures of Robert Redford and Barbra Streisand?

Ms. KENNEDY. No. I hadn't had that thought.

The CHAIRMAN. Let's get to housing.

Ms. KENNEDY. Curtis Johnson Homes Preservation in LA and on and on, a beautiful one from Boston, by the way.

I want to say this. I want to say that the primary market for affordable housing is very evolved. It's very sophisticated, and it's very constipated, after 20 to 30 years of making loans on properties affordable to people under 80 percent and under 50 percent of area median income, sometimes without subsidy in certain parts of the country.

Unfortunately, Fannie Mae and Freddie Mac are still AWOL on support for these loans, so the current goals, which we now know from documentation that they continue to fudge, have really not worked. Your proposed reform, I think, will be a good beginning to getting Fannie and Freddie back on the path to affordable housing and should make an enormous difference. Let me put it in perspective. Last year alone insured institutions made over \$300 billion of single family loans to people who earned under 80 and under 50 percent of area median income. That was about 23 percent of the total. Nonprofit lenders alone made over \$70 billion of private capital loans for housing affordable mostly to people under 60 percent of area median income.

So we could do so much more if Fannie Mae and Freddie Mac were present in the market. When Freddie Mac brags about the

fact that their losses are one basis point, I think that sums it up. Thirty years ago, insured institutions were told that the trade off for Federal insurance was that they meet the credit needs of the entire community.

Today, the GSEs don't meet the credit needs of the entire community, and frankly, that requires large institutions—the biggest banks in America, including in Chairman Frank's home State—to have somebody on the road like a Fuller Brush man, peddling loans door-to-door across the country to try to get more capital to replenish the supply of affordable loans.

Our members have done private placements of their loans and mortgage-backed securities. Fannie Mae and Freddie Mac not only don't buy many mortgages, they don't buy the AAA-rated tranches of securities backed by multifamily loans on affordable properties. Unfortunately, we have recently learned that Fannie Mae and Freddie Mac have been the primary enablers of subprime lending. For 5 years, the best seller servicers of Fannie Mae and Freddie Mac have complained to them that the GSEs refuse to buy a CRA loan because the borrower need to pay 32 percent of his income monthly for a mortgage payment rather than the 30 percent or whatever the GSE guideline is now.

So primary lenders often are limited in the amount of those loans they can make, and the borrower walks down the street to the competitor of Fannie and Freddie's best seller servicers and gets a "piggyback" adjustable rate loan that Fannie and Freddie are financing. The chickens have come home to roost. We now know the outcome; 44 percent of all subprime issuances in 2004 were financed by Fannie and Freddie.

Worse, the GSEs actually used these AAA-rated tranches of securities backed by subprime loans that the advocates say are 80 percent explosive, half of which Freddie Mac has estimated are to borrowers who qualify for prime loans. So while Fannie and Freddie have been missing from the primary market for consumer friendly, legitimate, CRA-credited loans that our major insured institutions and their nonprofits are making, they have been the principal financiers of subprime loans. As the entity that has the AAA-rated tranches, the GSEs themselves probably are not at risk, but everyone else in the chain, including the borrower and the community, suffers.

As a good first step to help restore balance to the mortgage market, H.R. 1427 aligns the goals of the GSEs with those of the banks. Thirty years after CRA and 15 years after Congress told Fannie and Freddie to support this market, it's about time.

[The prepared statement of Ms. Kennedy can be found on page 161 of the appendix.]

The CHAIRMAN. Thank you.

Mr. Fishbein. I'm sorry. I didn't introduce you fully. Alan Fishbein is director of housing and credit policy at the Consumer Federation of America.

**STATEMENT OF ALLEN J. FISHBEIN, DIRECTOR OF HOUSING AND CREDIT POLICY, CONSUMER FEDERATION OF AMERICA**

Mr. FISHBEIN. Thank you, Mr. Chairman, and Ranking Member Bachus. We appreciate the invitation to testify here today. We com-

mend the members of the committee and both of you in particular for your diligence and particularly your perseverance in working to develop improved regulatory oversight of the three Government-Sponsored Housing Enterprises.

Consumers have a huge stake in the outcome of GSE legislation. These entities are extremely valuable to the Nation's housing finance system, making important contributions to expanding the mortgage market, and increasing homeownership levels. Their business model requires that all three operate as for-profit entities, however it is their public mission and affordable housing mandates as prescribed by Congress that make the GSEs unique and that ultimately justifies their government charters and the benefits afforded them through this status.

Strengthening financial oversight to ensure the GSEs' ongoing safety and soundness is a very worthwhile public policy objective. We believe that such legislation can and should be achieved in a manner that is consistent with these entities' congressionally chartered status, their housing mission, and affordable housing activities and urge that the committee follow this course.

Accordingly, we support revising the present regulatory structure in the creation of a new independent regulator with jurisdiction over all three housing GSEs. We also believe that both financial and mission oversight should be performed by the same regulator. It is also critical that the new financial oversight powers provided are commensurate and appropriate to the tasks at hand while not unnecessarily diminishing the ability of the GSEs to continue to perform their vital housing mission.

Reaffirming and strengthening the GSE's mission and related affordable housing activities should also be a central part of any new regulatory regime. Current consideration of GSE legislation provides an important opportunity to accomplish this objective, we believe, for all three GSEs. And Mr. Chairman, we especially thank you for working to ensure that mission considerations and important new affordable housing mandates are a vital part of GSE legislation.

With a few notable exceptions, the bill introduced last week, HR 1427, largely tracks the provisions that were part of the legislation passed by this committee and the House in the last Congress. And I want to summarize my written testimony in which we focus on the bill's affordable housing provisions.

First, we agree with the underlying premise of the bill that these mandates serve an important public purpose and have increased GSE activities in serving low- and moderate-income and other underserved households and communities. At the same time, we share the view that this can be improved upon and expanded to encourage deeper and more consistent focus by the GSEs on segments of the market with the greatest needs. These three entities have accomplished a lot over the years, but we believe they are capable of doing much more.

Second, the affordable housing goal structure that applies to Fannie Mae and Freddie Mac would benefit from tighter targeting. It would encourage them to step up their activities with respect to lower income households. So would the provision in the bill to establish a more comprehensive multifamily purchase requirement

and one that would create a statutory duty to serve requirement for certain specified affordable housing needs.

We are also pleased that the bill would create a single family home refinance goal for low-income households. Such a sub-goal would help protect low-income consumers from falling victim to predatory lenders that are extremely active in this segment of the market, and enhanced GSE presence in this market can help provide these borrowers with safer and more sustainable loan options.

In my written testimony, I also make a number of recommendations for refinements to the provisions in the bill.

Third, we are very supportive of the establishment of an affordable housing fund through specified annual contributions from the two enterprises. Such an entity, we believe, would provide an invaluable source of funds for extremely-low-income and low-income households not served directly through the mortgage market.

Fourth, my written testimony also suggests some additional items we would recommend for consideration for incorporation in the bill. In particular, we believe there should be more transparency to the public regarding the GSE's activity in fulfilling their affordable housing mandates, and we suggest some steps and ways to achieve that.

Further, we believe that additional public purpose requirements are warranted to help ensure a greater portion of the Federal Home Loan Banks' core business and mortgage purchase programs be devoted to the needs of lower income households. Accordingly we recommend that the bill include provisions directing the new regulator to establish performance goals that would help accomplish this purpose.

We welcome additional opportunity to submit comments after this hearing on some other aspects of the bill because this is complicated legislation. But let me wrap up by saying we thank you again for the opportunity to offer our views on this important subject and we look forward to working with you and other committee members as the bill progresses. Thank you.

[The prepared statement of Mr. Fishbein can be found on page 120 of the appendix.]

The CHAIRMAN. Thank you, Mr. Fishbein. The committee will be glad to receive any further information.

Next, Sheila Crowley, who is the president of the National Low Income Housing Coalition.

**STATEMENT OF SHEILA CROWLEY, PRESIDENT, NATIONAL  
LOW INCOME HOUSING COALITION**

Ms. CROWLEY. Thank you, Chairman Frank and Ranking Member Bachus, for the opportunity to testify today. My testimony will focus only on the proposed affordable housing fund, which is a top priority for the National Low Income Housing Coalition.

We view the affordable housing fund as an important new contribution to the solutions to the affordable housing crisis in our country. And while the affordable housing crisis has many dimensions, the fundamental problem is the mismatch between what people earn or otherwise have to spend for their homes and what housing costs.

The people for whom this mismatch is the most acute are those with the lowest incomes, precisely who the affordable housing fund is intended to help. All of the fund would produce or preserve homes that are affordable to extremely low and very low income households. Extremely low income households are those with incomes at or below 30 percent of area median. In Boston, those are households with incomes at \$25,000 a year or less, and in Birmingham, that's \$17,000 a year or less. These are elderly and disabled people on fixed incomes or people in the low wage workforce.

Extremely low income renters are the only group of people in the United States for whom there is an absolute shortage of housing units. There are 9,022,000 extremely low income renter households and there are only 6,187,000 homes renting at prices these households can afford if they pay the standard of 30 percent of their income for their housing. This is a shortage of 2.8 million units.

Higher income people may not always have the choice of homes that they prefer and in some markets there may be shortages affordable to people in higher income groups, but these 9 million families are the only ones who are playing this very dangerous game of musical chairs.

What are the consequences of a housing shortage of such proportions? Well, most of these families spend way more than they can afford for their homes. Seventy-one percent of all extremely low income renters in the United States pay more than half of their income for their housing. This is up from 68 percent in 2001, so the numbers keep growing. And this leaves very little left for other basic necessities, forcing impossible choices.

Otherwise, adults have to work two or more jobs, leaving little time for their children, or they are prey to unscrupulous landlords who can run substandard housing, or they're living in overcrowded conditions or they move from one short-term dwelling unit to the next making employment and education very unstable, and ultimately people end up becoming homeless.

And so the ultimate consequence of this housing shortage is homelessness in the United States. This is a housing shortage that's not going to be solved by the very robust and remarkable U.S. housing market. I'm not a housing finance person, but I can—my basic economics understanding is that, given that there is a huge demand for housing, rental housing, for the extremely low income population that they could afford, if somebody could make money building and operating that housing, they would have figured out how to do so by now.

It hasn't happened. We need a government solution. Nor can the housing problem be solved by the existing Federal, State, and local programs. And I'll be happy to go into greater depth about the state of our current programs. Given the size of the deficit and the constraints on Federal spending, we have to figure out some way out of this problem, and the affordable housing fund is doing that.

It is not a new concept. It is a conceptual cousin of the affordable housing program of the Federal Home Loan Banks. Fannie Mae and Freddie Mac would be required to contribute revenue to a fund that is administered by the new regulator that this bill establishes.

And in the first year, these funds would be directed to the Gulf, which we support. We do suggest expanding the eligible States to include Texas and Alabama.

The Affordable Housing Fund is intended primarily for capital grants to produce and preserve housing for extremely low and very low income families. Under the homeownership provisions, funds could also be used for downpayment and closing cost assistance. There is also a provision that not less than 10 percent of the funds are to be spent on homeowner activities.

We suggest a change that would assure that the majority of the funds are actually spent on physical housing units, the construction or rehabilitation of units, and this can be achieved by setting a cap on the amount of funds that can go towards homeownership.

One of the most controversial questions about the affordable housing fund was whether or not these funds could be used for anything other than bricks and mortar capital costs. HR 1427 makes it clear what can and cannot be done with the funds, so let me assure any members of the committee who are concerned about the potential uses or misuses of these funds that there is no one who is more dedicated to assuring that doesn't happen than the National Low Income Housing Coalition.

I just want to close by congratulating Chairman Frank and Mr. Watt and Mr. Miller and Mr. Baker for coming together to sponsor this important bipartisan legislation. The history of Federal housing legislation is that the very best bills have been bipartisan, and thank you for continuing in that tradition.

[The prepared statement of Ms. Crowley can be found on page 108 of the appendix.]

The CHAIRMAN. Thank you.

Next, Thomas Gleason, who is listed here as a board member of the National Council of State Housing Agencies, but is incidentally the president of Mass Housing, our State housing finance agency in Massachusetts.

Mr. Gleason.

**STATEMENT OF THOMAS GLEASON, BOARD MEMBER,  
NATIONAL COUNCIL OF STATE HOUSING AGENCIES**

Mr. GLEASON. Thank you, Chairman Frank, and good afternoon.

The CHAIRMAN. I understand that you have to leave to catch a plane, so whenever you have to leave, you can go ahead.

Mr. GLEASON. Okay. Thank you.

The CHAIRMAN. I know where you live, so if I need you, I can find you.

[Laughter]

Mr. GLEASON. Thank you very much. Chairman Frank, Ranking Member Bachus, and members of the committee, good afternoon. My name is Tom Gleason, and I am the executive director of the Massachusetts Housing Finance Agency.

Thank you for inviting me here today to testify on behalf of the National Council of State Housing Agencies in support of the Federal Housing Finance Reform Act of 2007. We commend the chairman and members of the committee for recognizing in this legislation the need to sustain and strengthen Fannie Mae and Freddie

Mac in their affordable housing mission while preserving the GSE's safety and soundness.

NCSHA strongly supports the bill's creation of the affordable housing fund, capitalized with annual contributions from Fannie Mae and Freddie Mac. I believe this is a modest assessment of the GSEs' resources that is fully appropriate given the many advantages that they have through their Federal charters.

NCSHA believes that the affordable housing fund should be administered by States for several important reasons. Specifically, States are in the best position to prioritize housing needs across their jurisdictions. States have a proven track record of allocating housing resources fairly and effectively. States have become the central point through which all Federal and State housing resources are now coordinated, and perhaps most importantly, State housing agencies have the technical expertise necessary to structure complex housing finance transactions that will get housing built and keep it affordable over the long run.

I think that the most important role that I can play here this afternoon is to offer some specific examples of how these funds might be utilized. In Massachusetts, our State legislature created several years ago an affordable housing trust fund. The fund's flexibility is its greatest strength.

One example of this flexibility is a project known as Maverick Landing. It's a 396 unit HOPE VI development in East Boston. The rehabilitation of this property turned some of Boston's worst housing into some of its best and has spurred the development of market rate housing along what was once an abandoned waterfront area in the City of Boston.

The combination of tax-exempt financing, HOPE VI funds, State housing trust funds, and green building resources has proven to be so successful that Maverick Landing was named the number one affordable housing development in the country this past year by Affordable Housing Finance magazine.

Another example is Project Place, a development in Boston's south end. It has used State funds, new market tax credits, home resources, and green building grants to create 14 units of affordable housing. All 14 units will be targeted to formerly homeless individuals, all of whom will have incomes at or below 30 percent of the median income.

Project Place is a mixed-use development that brings together housing, commercial space, and resident services, including job training. This is housing at its very best, and this is housing that changes people's lives.

These kind of developments are the future of affordable housing in Massachusetts and, in fact, all across the country. The affordable housing fund envisioned in this legislation would be a perfect complement to what is already being done in all 50 States and would allow even more of this housing to be built.

As importantly, it would allow us to go deeper, to reach even more people at very low incomes who are not being adequately served at this time. Beyond all of this, States are best—

Mr. BACHUS. Mr. Chairman, I missed a point. Could he—would it be proper for him to back up about 30 seconds and replay that?

The CHAIRMAN. Certainly, if Mr. Gleason would do that.

Mr. GLEASON. Mr. Bachus, anything specific that I can—  
 Mr. BACHUS. What you proposed as a perfect compromise?  
 [Laughter]

Mr. GLEASON. I was saying that I thought the affordable housing fund, as envisioned in this legislation, would be the perfect complement to what is already going on from our perspective in all 50 States all across the country. And, as importantly, it would allow us to go even deeper than we are already doing, to reach down and serve people with very low incomes who aren't currently being adequately served.

Beyond all of this, I think States are best able to respond quickly to emerging problems that threaten housing affordability in their States. Massachusetts, like many States, has thousands of homeowners who have fallen victim to subprime loans. The "American Dream" of homeownership has, for them, become a nightmare.

In Massachusetts, 12 percent of the mortgages are subprime, yet they represent 70 percent of all the foreclosures that are taking place in our State. States could use a portion of the new grant funds to respond to problems like this. Saving these homeowners from foreclosure will be difficult but critical, not only to the homeowners themselves, but to the economy of our State.

NCSHA also strongly supports the bill's affordable housing goals provisions and urges this committee to encourage continued and expanded GSE investment in housing credits and bonds by awarding the GSEs goal credit for these investments.

Finally, NCSHA supports the GSEs' conforming loan limit increase. Seventeen percent of Massachusetts cities and towns have median home sale prices that are above the existing loan limits. We need to encourage homeowners to seek out safer mortgage products, and this is one very important way to do that.

I thank you for your time this afternoon, and NCSHA stands ready to assist you in any way possible to move forward this important legislation.

[The prepared statement of Mr. Gleason can be found on page 138 of the appendix.]

The CHAIRMAN. Thank you. We appreciate your patience. Next, Mr. Michael Flynn, who is the director of government affairs at the Reason Foundation.

**STATEMENT OF MICHAEL FLYNN, DIRECTOR OF  
 GOVERNMENT AFFAIRS, REASON FOUNDATION**

Mr. FLYNN. Thank you very much, and I appreciate the special obligation on the last speaker on the last panel of a long hearing day, so I will be brief in my remarks. The committee has my full written remarks and also a list of studies and research the Reason Foundation has done.

Chairman Frank, Ranking Member Bachus, and members of the committee, thank you for the opportunity to be here today. My name is Michael Flynn, and I am the director of government affairs for the Reason Foundation.

Reason is a nonprofit, nonpartisan think tank that, for more than 40 years, has researched the consequences of government policy and worked to advance liberty and develop ways for the market to improve the quality of life for all Americans.

My remarks will concentrate on the affordable housing fund. Reason has published several studies on the issue of affordable housing and housing policy with a special focus on California. As a matter of policy, we have very significant concerns about this proposed new fund. In many parts of the country, as you know, the unavailability of affordable housing is a very serious concern.

In California, where Reason is headquartered, the demand for all housing outstrips the supply by half-a-million to a million units. Unfortunately a new Federal affordable housing fund will not fix this situation. In the end, we believe it will fail. It will not fail because of a lack of resources, it will fail because it doesn't address the fundamental problem; there are too few housing units being built to meet the demand.

Simply put, this policy fails three tests: it ignores the real problem; it creates a veneer for action, which may stymie more substantive reforms; and it also creates a host of unintended consequences that not only could distort the housing market but also further waste and misuse of these funds. I'll discuss these briefly.

In recent years, the Nation has experienced a burst of homebuilding. New construction, however, has not met this demand. It is not for a lack of capital. There is nothing in the fundamental economics of housing that would skew building towards any particular segment of the market. Housing would be no different from every other sector of the economy but for one factor, and it's government policy.

It's no small irony that while this committee meets to deliberate and decide how to further affordable housing in this country, there are governmental bodies everywhere meeting to consider new growth limits, new growth boundaries, increased impact fees, more stringent zoning requirements, prevailing wage laws, new environmental regulations, open space requirements, or building standards. While many of these may seem individually reasonable, taken together they have a cumulative effect. Today it is increasingly expensive, cumbersome, and time consuming to build a single family dwelling.

Reason Foundation did a study of price trends, just real quickly, in Washington and Florida State, that found that 20 to 25 percent of the increase in housing prices in those States was due to the statewide growth management law. Growth management land use restrictions artificially limit the supply of housing that can be built. The result of this higher level of regulation is to make building lower and middle income housing, which already involves very thin profit margins, economically risky and less viable.

This causes a ripple effect that is felt all the way down the housing ladder. Middle income and young professional families, who otherwise might move to larger homes, are priced out of that market and as a result they seek out older, smaller homes and push up those prices beyond families who could otherwise afford it.

I realize my time has dwindled, and I do want to say that I have a good, finely calibrated, Irish sense of fatalism, and I realize that my testimony here today is not going to alter you from moving forward on an affordable housing fund. But I would like to say two things. One, again, no matter how much money the Federal Government puts in there, you're going to run into the real architects

of housing policy in this country, and that's State and local officials. And as long as they're able to continue to have land use restrictions and regulations, you're not going to crack that knot.

I hope that this is not another case where we declare victory and go home, where we think we passed this fund and the issue is resolved and all we've done is put the crisis off for another day.

I also think there are very, very real concerns about how this money is spent. In the past, housing programs have been a fount of misuse and even fraud. I do think you need to look to put very, very particular requirements on how that money is spent.

I'd be remiss if I did not quickly mention one particular organization, ACORN, who has carved a very lucrative niche out of housing programs over the years. ACORN is a national conglomerate, an umbrella group of about 70 different organizations—

The CHAIRMAN. Mr. Flynn, if ACORN were here, I'd allow you. I don't feel comfortable in this hearing listening to an attack on an organization that's not represented. They have no particular stake in this, and I don't think that's appropriate.

Mr. FLYNN. I understand that. I only want to stress that there is a very, very real need to put very clear restrictions on how this money is used so that it is not misused, and that there has been a pattern in the past of misuse. I'm not singling out any; I just used it as an example. Make sure you restrict that.

[The prepared statement of Mr. Flynn can be found on page 128 of the appendix.]

The CHAIRMAN. No, to the contrary, Mr. Flynn. You did single one out.

Mr. FLYNN. Because I was going to go through some particular facts.

Mr. BACHUS. Mr. Chairman, do you yield?

The CHAIRMAN. Yes.

Mr. BACHUS. I think that we, in our testimony, do single out organizations and things. And these are our witnesses, and I know that the chairman disagrees with what the gentleman said, but—

The CHAIRMAN. The gentleman's time has expired. I think I haven't sat while anybody attacked an organization that wasn't here, wasn't represented. It's irrelevant to the issue before us in my judgment because we aren't talking about empowering any particular organizations. And I would extend the same courtesy to any organization that was being criticized without an ability to respond.

Mr. BACHUS. Would the gentleman yield?

The CHAIRMAN. Yes.

Mr. BACHUS. While I have great respect for you as chairman, I will tell you that some of our members—and their concern is that this money will go into organizations like ACORN as opposed to for bricks or mortar, and don't feel like that is legitimate.

The CHAIRMAN. I understand that, and so they adopted an amendment that kept money from going to the Catholic Church, the Methodists, and a whole range of other organizations. So I appreciate the concern, but I—one, we are not here, I think, talking about any particular organizations. We're talking about a bill that's—it's very different.

You were talking about Fannie Mae, and you were referring to a bill which said that Fannie Mae and Freddie Mac would disburse themselves; today we're talking about the State housing finance agencies. And if people want to warn them about dallying with these—organizations, it's a different story. But the policy issue is separate from an attack on an organization, a very critical attack on an organization not here represented, not able to defend itself. I don't see any reason why our hearing should be a forum for that.

The general principle is not at issue here.

Mr. Flynn, do you want to summarize?

Mr. FLYNN. Again, I think it is—this money, let me just say—in a sense, we're shadowboxing here with this kind of proposal. And we are thinking we can throw some money into the issue, that somehow that will take care of it, but again, we're not actually fundamentally dealing with what causes the problem of affordable housing.

And I hope that as you go forward in this you will look into what kind of regulations and restrictions State and local governments put into this area, what they do with the money, so that this is not just somewhere where we declare victory and go home and put off the crisis until another day.

[The prepared statement of Mr. Flynn can be found on page 00 of the appendix.]

The CHAIRMAN. I'll begin with the questions. First, Mr. Flynn, did you hear anybody say that if we got this \$500 million we could, (a), declare victory and go home, (b), resolve the problem? Excuse me, has anyone in your hearing engaged in the kind of hyperbole you have just rebutted?

Mr. FLYNN. No, but I also do not—I have not heard anything about what growth restrictions do.

The CHAIRMAN. I understand that. But that's a separate question. I will get to that in a minute.

Mr. FLYNN. That's the question.

The CHAIRMAN. I will get to that in a minute, but I am objecting to this argument by hyperbole, this strawman. No one says this is going to—no one who is knowledgeable thinks it's going to solve everything; no one thinks that we're going to declare victory and go home. I think some find that helpful.

Now as to growth, let me ask you because this would be, I think, a problem for some of my Republican friends. I agree with you, those growth restrictions are a problem. I have complained about them a great deal. They are almost all at the State and local level and county level. Do you advocate the Federal Government overturning State, local, and county zoning restrictions?

Mr. FLYNN. No, not at all. However—

The CHAIRMAN. Okay, thank you.

Mr. FLYNN. But I also don't know that you want to reward those officials with extra money so that they never bear the cost of what recessions could pass.

The CHAIRMAN. Well, of course, by definition, the bill wouldn't be doing that because if you did this right—

Mr. FLYNN. We don't know how the money is going to be divided in the bill.

The CHAIRMAN. Well, I know something about how State housing authorities work. And I would say this; by definition, those people who exclude affordable housing by their zoning aren't going to get it. And in fact, you're being illogical here, it seems to me, because you say, well, they're going to exclude it. If they exclude it, they don't get it. It's only the people who include it, who get it. If they have zoned it out and made it impossible for us to build that there, then they don't get it.

Mr. FLYNN. Well, but this always goes to a very inherent—a misconception of this entire debate is that somehow affordable housing is new housing.

The CHAIRMAN. Excuse me. You're changing the subject.

Mr. FLYNN. No, I'm not.

The CHAIRMAN. That's not the question about whether or not it's—you were asking me—yes, I was asking you about local zoning restrictions, and you said, no, you don't want the Federal Government to overturn these restrictions, but you don't want us to reward them. And I'm saying nothing in this bill would allow us to reward them. In fact, the money would go to places that hadn't done that.

Let me just turn to Mr. Gleason now on the—and I appreciate it because one of the things that was raised by Mr. Howard was making sure that we get it right when we talk about the high end loans, the jumbo loans here, and you talked about 17 percent of Massachusetts cities.

I take it from that, that preexisting statistics would allow us to decide where the a median house price would trigger the higher loan and where it wouldn't. Is that correct?

Mr. GLEASON. Yes, Chairman Frank, it would. My number of 17 percent of our cities and towns in Massachusetts was based on data from 2006.

The CHAIRMAN. All right. So I just want to take—I don't mean to get specific. We will make sure, in the bill, as we write it, that the issue Mr. Miller talks about, the issue of the high cost areas, that we as nearly as possible use preexisting statistics so those only apply to where they are justified. I appreciate that.

Mr. Bachus.

Mr. BACHUS. I thank the chairman. You know, this committee, I think the chairman has said, I have said, and some of these panelists have said, that we try to work in a bipartisan way to address different issues. One issue here is the safety and soundness of the GSEs.

The chairman feels very strongly about the need for an affordable housing fund, and members of the minority recognize the need for affordable housing. And I will say that the testimony of Ms. Crowley, Dr. Crowley—I won't speak for all the members of the minority, but I will say that I see the greatest need is what you said the greatest need of; it's people who can't afford homeownership.

We talk a lot about homeownership, and that's the best thing. I mean for most people, that's the ultimate goal. But as you say, there are elderly, disabled, people on fixed income, or people in the low wage workforce where really homeownership, at least for some, will not be, it was and it is—but for most it is not the best option, and that option is renting affordable housing and not rundown di-

lapidated housing as we've all seen in Birmingham. I think that's a real problem.

And I will say this. The option for a lot of those people is public housing. And quite frankly, a lot of times that's unsafe because maybe the management is not there and it's—regrettably it is.

I recently saw some statistics from the State of Georgia where they profiled the prison population, and it was just amazing how many of the young men, young boys who were raised in public housing projects, in just a few of them, ended up in the penitentiary. It was just an amazing number.

Ms. KENNEDY. Mr. Bachus, along those lines, if you look at page eight of my testimony, I'm particularly proud of a new development in Montgomery, Alabama. We have a picture of Rosa Parks Homes there.

This is the new face of affordable housing. It's a beautiful, three story, red brick building that—Mr. Gleason's counterpart for Alabama brought together 34 banks and formed a consortium patterned on the Massachusetts version. And these 34 banks with low income housing tax credits and the State of Alabama's tax abatement created the first elderly and disabled affordable rental property in the City of Montgomery that people are proud to call home.

Mr. BACHUS. I don't think that anybody on this committee, if they knew the facts, would oppose a project like that. I can't imagine them doing that.

The CHAIRMAN. I'll give you a couple.

Ms. KENNEDY. If they saw the picture, they wouldn't.

Mr. BACHUS. You would get your great majority, in my opinion.

The CHAIRMAN. That I might.

Mr. BACHUS. One of the debates on New Orleans was do we build it back just like it was when there were tremendous problems there. That's a debate for another day, but maybe—you know, hearings don't always convince me of anything.

But Ms. Crowley, you said that the affordable housing fund is the conceptual cousin of the highly successful affordable housing program of the Federal Home Loan Bank. I'm going to give you that. You know, I may be criticized by some of my colleagues, but I will sign on to 98 percent of that.

Ms. CROWLEY. Okay.

Mr. BACHUS. We are concerned—I am concerned that this fund will not be that effective. And I know that, Mr. Gleason, you want the money to come to the States, you represent the people who spend it in those States, so I'm not going to ask you for your opinion. Well, I will. In fairness, I'll ask you for your opinion, but what is this money—but you know, that money goes to banks, member banks, and they've been very efficient in creating projects, I think, that you've talked about Ms. Crowley, very, very, very efficient.

If we design this program, what—and a number of people would say, well, you can't take it from one GSE and give it to another, but if we're doing a short-term program, we're talking about a temporary program for 4 or 5 years, that program is very proscriptive. It has none of the problems that members on my side fear, you know, other than those that just simply say that it's going to raise the costs to all homeowners.

But what if we did that? What if we took that money and put it into the affordable housing program of the Federal Home Loan Bank? You'd have to—we have the Louisiana, Mississippi thing, but even have them address that—

The CHAIRMAN. That's just for the first year.

Mr. BACHUS. Just for the first year. What if we did that as a bipartisan solution that most members could take?

Ms. CROWLEY. Here is what's exciting about your question. It is that we've gotten past the notion that we should have the fund and now we're just talking about the mechanics of getting the money out. And that's really a wonderful step forward that really makes us very, very happy.

Our view of how to get the money out is that we should figure out how to get it out quickly and efficiently to the people who can get the housing built in the most—in the quickest way and do the best job. And you can—and I've been in these discussions for a couple of years now about what all the options are. And you can do your pluses and minus signs on every single one of those various options. And the whole issue of having it be also run through the Federal Home Loan Banks or the Affordable Housing Program is one very good option.

There are others that people have talked about. I think that is—I think that we have reached a point where we've agreed that it shouldn't be Fannie Mae and Freddie Mac doing it. I think everybody has agreed to that, and I think that the remaining questions are simply things that are logistical to work out.

Now I know my friends at the State housing agencies feel very strongly about State housing agencies doing that. And our members, we have some members who think that their State housing agencies are wonderful and we have some members who think their State housing agencies are not so wonderful, so it does vary considerably from State to State.

It is certainly a very valid option, if that answers your question.

The CHAIRMAN. Would the gentleman yield to me, because I would say this—we want to look at all of these things, and I think we may not get—since we're going to go Louisiana and Mississippi in year one, we don't have to resolve this in a definite way right away as this goes forward. But I would say this. I don't believe that any of the restrictions people have been looking to put into the bill before are in that. That is, I think the Federal Home Loan Banks do a very good job without any restrictions of the sort about how they can do it—it's a pretty general thing. I like that idea, but it also, if you look at it, it does not have any of these, "You can't give it to this one, you can't give it to that one." Nature took its course there in a very good way.

Ms. CROWLEY. Right.

Mr. BACHUS. Well, I'm just saying, instead of building a whole new—I know that you could probably—another way to split this baby is to, if it can be split, is to give part of it to the State. And then after 5 years you could look at it and see if it worked, you could see what worked best. But as far as the—I'm talking about a bill that you get out here, get out here quick and pass.

Ms. CROWLEY. Those are really good questions for us to be talking about at this point.

The CHAIRMAN. And I want to say, I would again just repeat, in the first year, the fund is going to Louisiana and Mississippi in that three-to-one ratio. I think we will be—the Senate is going to take this bill up; we're going to go to conference, I believe, and I don't think—and there's no urgency to solve where it goes in years two through five, because it's a 5-year thing, as of now, and I want to look at that. And frankly, if that helps us get this whole thing forward, you know, there's something to be said for that.

Mr. BACHUS. I think that what I would say to the panelists and to the chairman is what it helps us with is to get it not only passed the House put perhaps, I think, if the House had a very good vote then it might help the Senate pick it up. And it would certainly, some of the questions that my House Members have—

The CHAIRMAN. That the gentleman from Alabama would go home and do what a good citizen would do and write his Senator.

Mr. BACHUS. I'm not talking about—Mr. Chairman, I'm not talking about—

The CHAIRMAN. Let me just—

Mr. BACHUS. I'm talking about—support.

Ms. CROWLEY. Can I comment on Mr. Bachus's comment about some people needing to be in the rental market? That's absolutely true, and that's why we need a strong rental housing sector because you have to have a balanced housing sector.

But the way that it's so imbalanced now is that the people who are in the rental housing market who have the potential of perhaps becoming homeowners, not people on fixed incomes but who have the potential of becoming homeowners, they have no hope of doing that because they are spending so much of their income on that rent that they can't save; they can't get ahead. And if they have the ability to have a stable rental home, establish a good record as a good renter paying their rent that they could afford and did that over time, then in fact they would be very good potential prospects for the homeownership market, but under the current situation, they have no hope.

The CHAIRMAN. I appreciate that. One of the things we will be looking at when we revisit the credit is part of the problem with people establishing credit. People who have been paying their rent regularly and their utility bills and everything else—we should find some way so that that can be taken into account in terms of credit ratings.

Thank you, very much. The hearing is adjourned.

[Whereupon, at 3:52 p.m., the hearing was adjourned.]

# **A P P E N D I X**

March 15, 2007

Opening Statement

Rep. Shelley Moore Capito  
Committee on Financial Services  
Hearing on H.R. 1427

March 15, 2007

This is certainly an important hearing on significant legislation, H.R. 1427. The issue of appropriate regulation of Fannie Mae, Freddie Mac and the Federal Home Loan Banks is critical to the stability of our economy and Mr. Chairman I commend you for your leadership on this issue.

To most of my constituents, today's topic may seem distant from their own concerns about job security, health care and affordable housing; however, the Federal Home Loan Bank of Pittsburgh is making an impact in my district in all of these areas in a number of ways.

For example:

- Minnie Hamilton Health Care Center in rural Calhoun County is open and treating patients thanks to low interest financing from Calhoun County Bank through FHLBank Pittsburgh.
- Dental practices in areas like Clay and Cabin Creek, West Virginia are open thanks to the FHLBank's small business program.
- Fiber optic cable is being installed throughout West Virginia thanks to direct investment by FHLBank Pittsburgh in Economic Development Bonds issued by the West Virginia Housing development Fund.
- These contributions are of course in addition to the 225 units of affordable housing available in my district today thanks to \$1.6 million from the Bank's Affordable Housing Program.

I want to ensure that any new statutory framework enables the Bank to continue to serve community needs in my district. Affordable housing is important, but if there are no jobs in a region, no one can afford a home. If there is not adequate water treatment, no new houses can be developed. So you see the role of the Federal Home Loan Banks is to support affordable housing, and the fabric of the community that must exist as a predicate for that housing.

Opening Statement

Rep. Shelley Moore Capito  
Committee on Financial Services  
Hearing on H.R. 1427

March 15, 2007

I am pleased that HR 1427 recognizes the unique structure and role of Federal Home Loan Banks by creating separate divisions for the Banks and Fannie Mae and Freddie Mac.

However, I am somewhat concerned that these differences be recognized by the proposed regulator's third division charged with regulating mission. A uniform approach to national organizations like Fannie Mae and Freddie Mac are incompatible with the regionally based FHLBanks. Even more importantly, I am concerned that, absent congressional direction, the deputy mission regulator might create burdensome regulations on the Federal Home Loan Banks' primary product, loans to member banks. Let us keep in mind that the ultimate mission test is applied to the profits generated by these loans in the form of a ten percent tithe that is applied to affordable housing grants.

Secondly, I believe the Federal Home Loan Banks represent an untapped resource for community and economic development. Their ability to issue letters of credit, provide direct investment in qualifying projects and provide financing for economic development makes them an important resource as federal, state and local dollars become more constricted. I am pleased that H.R. 1427 includes the provision subcommittee Chairman Kanjorski authored last year to allow Federal Home Loan Banks to provide credit to community banks to support economic development. I can assure you this will have a direct positive impact in my district and throughout the state.

I know that the matter of economic development activities of Federal Home Loan Banks is on the committee's oversight agenda for the 110<sup>th</sup> Congress and I look forward to working more on this area.

**Opening Statement**

**Congressman Paul E. Gillmor (R-OH)**

**Committee on Financial Services**

***Hearing entitled: "Legislative Proposals on GSE Reform"***

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Thank you, Mr. Chairman, for calling this important hearing today. I am encouraged by the Committee's work over the past several years to address the regulation of the housing GSEs. I believe that there are still several outstanding issues to be addressed before we move this legislation to the floor, but I am encouraged that the base text of H.R. 1427 contains strong regulation as well as my language dealing with charitable contributions.

This language would authorize the Federal Housing Finance Agency to require that Fannie Mae and Freddie Mac make publicly available, each year, the total value of contributions made to non-profit organizations during the previous fiscal year. It would also request specific disclosures on donations to insider-affiliated charities.

Fannie Mae and Freddie Mac were established by congressional charter and given special privileges to provide a service to the American people by creating a secondary mortgage market and increasing liquidity. Given their unique status, it is both their shareholders' and the American public's right to know how their profits are being spent. It is my hope that this type of disclosure is extended to all public companies and to that end, I have introduced H.R. 1208.

I look forward to continuing to work with my colleagues on both sides of the aisle to craft the best GSE reform legislation possible and I yield back the balance of my time.

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**Committee on Financial Services  
March 15, 2007**

*Hearing entitled "Legislative Proposals on GSE Reform"*

**Statement of Congresswoman Deborah Pryce**

Thank you Mr. Chairman. Let me first say that I hope this is the last hearing we hold on this legislation in this Congress or any Congress, and we can quickly move to a markup.

For seven years, Congressman Baker, former Chairman Oxley and others have spent countless hours drafting and debating the correct legislative action needed to reform the oversight of the GSEs.

The testimony today and the comments by many of my colleagues are evidence that there has been a sea change both here in Congress and at Fannie Mae and Freddie Mac.

There is now broad consensus that we are long over due in creating a world-class regulator to oversee Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. In recent memory, we have witnessed accounting irregularities leading to earnings restatements, and an ill-equipped regulator unable to properly supervise the safety and soundness of these entities.

With the bipartisan legislation introduced by Chairman Frank, and negotiated with the Department of Treasury, we can finally address these concerns.

The legislation will create a new, independent regulator with broad capital powers comparable to current banking regulators. The bill also establishes clear product approval standards, and a mandatory receivership in the case of a critically undercapitalized GSE.

We need only look to the numbers to know who action is so important.

As Director Lockhart has pointed out before, the GSEs have become some of the largest private debt issuers in the world. All together, Fannie, Freddie, and the Federal Home Loan Banks hold over \$5.4 trillion in outstanding debt and Mortgage-Backed Securities, larger than the \$4.9 trillion publicly held debt of the U.S.

Clearly proper regulation of the GSEs is needed to maintain a healthy housing finance system, and the possible systemic risk posed by inaction is too great to sit on our hands.

I would also like to applaud the commitment H.R. 1427 puts on rebuilding the affordable housing stock devastated by the recent hurricanes on the Gulf Coast. The Office of Federal Housing Enterprise Oversight has estimated that less than 30 percent of the retained portfolios of Fannie and Freddie actually contribute to the GSEs' stated mission of affordable housing. The bill highlights the need for the GSEs to pay a deeper commitment to these goals.

At the same time, I share the concerns of some of my colleagues that funds distributed through the states under the proposed Affordable Housing Fund could still be used to offset political activities by organizations, which do not have affordable housing as their primary purpose.

This reservation aside, I look forward to the testimony today, and comments on whether the legislation under consideration ensures that the GSEs will better meet their dual public purpose of promoting affordable housing, and maintaining stability of the nation's housing finance system

I yield back the balance of my time.

**Opening Remarks of the Honorable Maxine Waters**

**Hearing: “Legislative Proposals on GSE Reform”**

**Committee on Financial Services**

**2128 Rayburn House Office Building**

**March 15, 2007**

Good morning ladies and gentlemen. I want to thank Chairman Frank and Ranking Member Baucus for holding this hearing on Legislative Proposals on GSE Reform. Mr. Kanjorski should also be applauded for his work on this issue. I want to thank the staff for its hard work as well.

Just last week we were greeted by Chairman Frank’s bill, H.R.1427. Since that time and before, the bill has generated a great deal of interest among Members of

Congress and the public. As many of you know, the House passed a GSE reform bill during the last session of Congress, but only to see it languish in the Senate. From all indications we are likely to see a bill pass both Houses of Congress this year.

This has not been any easy issue because Members have a passion about GSEs and their role in the housing markets as well as their initiatives in communities across this country related to affordable housing and community development. The Affordable Housing Program (AHP) of the Federal Home Loan Banks is one example. I believe that balancing effective regulation with continued innovation is critical to making GSE reform work. I am one who would like to see GSEs continue to play a major role

in these activities without being constrained unnecessarily by a new regulator.

Let me outline several concerns that I have related to GSE reform. I believe that there is ample room for compromise on these issues.

(1).The establishment of an Affordable Housing Fund within the GSEs is absolutely essential to their mission and to their ability to meet affordable housing goals.

However, the bill does not contain a leveraging mechanism tied to the AFH. The leveraging mechanism had been part of the House passed bill.

(2).The Federal Housing Finance Agency (FHFA) Director or regulator should have the authority to limit the size or growth of a GSE's portfolio as it relates to safety and soundness issues. However, I believe that

any arbitrary limit needs to be lifted once safety and soundness requirements are met by the GSEs.

(3) The FHFA Director or the regulator should be allowed to increase required capital levels of a GSE to meet a safety or soundness issues. Minimum capital should be allowed to return to the statutory level once safety and soundness concerns are met.

(4) The governance model for the Federal Housing Finance Agency (FHFA) includes the Federal Housing Enterprise Board (the Board). The Board would be made up of the Secretary of HUD, Treasury and the Director of FHFA. These individuals are nominated by the President and confirmed by Congress. This governance structure does not provide for independent voting on the Board to perform oversight of the GSEs and the FHLBs. For example, adding the head of the

Federal Financial Examination Council to the Board might create a more independent entity.

(5) The early GSE legislation included language to promote the role of minorities and women in the investment activities of the GSEs, although the GSEs have not established solid measures to achieve the goal of minority inclusion. I believe that the GSE bill needs to address this issue.

(6) Current measures of housing affordability are not uniform and data about the number of affordable housing units nationwide are not readily available. For the AHF to work, it would be useful to know the level of the affordable housing stock on an annual basis. New construction or filtering are the primary ways to add affordable housing stock, and the housing stock is reduced by abandonment and demolition. Perhaps,

these parameters can provide the basis for the appropriate data set to be required as part of the bill, which will allow for measuring performance and outcomes related to the affordable housing goals in the bill.

(7) Each Federal Home Loan Bank has 14 directors, 6 are appointed by the Board and 8 elected by the institutions. GSE bills have differed on the governance issue related to the Banks. My major concern is whether having public interest directors selected by the industry directors makes good sense. Diversity and the reduction in the number of public interest directors from 5 to 6 could be hampered under this approach.

Mr. Chairman, I am still reviewing the bill and would be happy to share my insights with you as we move

forward. If we can begin to address these types of concerns, I believe that the debate on GSE reform will be an extremely productive one. Today's witnesses represent the regulators and the regulated GSEs. Earlier this week we heard from the industry witnesses. We must hear from all sides of this debate before we consider the most sweeping GSE reform legislation in several years. Thank you.

**Statement of L. Carter Cornick**

**General Deputy Assistant Secretary  
Office of Congressional & Intergovernmental Relations  
U.S. Department of Housing and Urban Development**

**Hearing before the House Committee on Financial Services  
United States House of Representatives**



**“Legislative Proposals On GSE Reform”**

**March 15, 2007**

**INTRODUCTORY COMMENTS**

Good morning Chairman Frank, Ranking Member Bachus, and distinguished members of the Committee. I want to thank you for the opportunity to speak today about the Federal Housing Finance Reform Act of 2007 (H.R. 1427). This is important regulatory reform legislation that HUD believes is needed to strengthen the Federal government's oversight of the housing government sponsored enterprises: Fannie Mae, Freddie Mac, and the Federal Home Loan Banks. The legislation introduced last week improves the oversight of the GSEs by creating a regulator on par with the existing financial regulators. It is a regulator with the necessary tools to monitor safety and soundness, as well as the mission of the GSEs.

HUD endorses establishing a new regulator for all three of the housing GSEs that would combine safety and soundness authority with oversight of their respective housing missions, and we urge Congress to act now. This would include moving certain responsibilities, such as new program review, from HUD to the new regulator.

HUD and its predecessor agencies have played a key role in implementing Congress' long-standing housing policies, both through its Federal Housing Administration (FHA) and Government National Mortgage Association (Ginnie Mae) programs and as a regulator of Fannie Mae and Freddie Mac. Because of HUD's history in regulating Fannie Mae and Freddie Mac, as well as its role in ensuring that the Nation's affordable housing needs are addressed through both public and private initiatives, we are especially interested in ensuring that new legislation continues to promote important affordable housing objectives by building upon the progress that has been made over the past decade.

**A DECADE OF IMPROVEMENT IN AFFORDABLE HOUSING LENDING**

The last ten years have been years of increased affordable lending for low-income and minority families in the conventional mortgage market. Lenders introduced and marketed special lending programs to low-income families and their neighborhoods, revamped their underwriting standards, to deal with the special circumstances of these families, and attempted to prevent mortgage defaults and keep new homeowners in their homes by offering homebuyers counseling programs and developing innovative foreclosure prevention programs. Others operating in the conventional markets, including Fannie Mae and Freddie Mac, also played important roles in what some have termed a revolution in affordable lending.

Home Mortgage Disclosure Act (HMDA) data show substantial growth in conventional lending to low-income and minority borrowers. This suggests that these new affordable lending initiatives have had a measurable impact. Most observers generally agree that in addition to low interest rates and economic expansion, enhanced regulation of depositories' Community Reinvestment Act (CRA) obligations and HUD's

affordable housing goals also contributed to a renewed emphasis on low-income and minority lending in the conventional markets.

President Bush has made expanding homeownership opportunities, especially for first time homebuyers and minority homebuyers, a priority goal for his Administration. Fannie Mae and Freddie Mac are well positioned to have played a significant role in funding mortgages that serve these potential homeowners. Both are substantial market forces in the conventional markets, and originators often rely upon the GSEs' mortgage products and underwriting standards. The significant role of the GSEs in the conventional mortgage market means that they can, and should, continue to play a key role in funding mortgages for very low, low- and moderate-income homebuyers and those families which are historically underserved by the mortgage markets.

Today, we are talking about reforming the manner in which the GSEs will be regulated. An important part of that discussion concerns how the Government will continue to measure Fannie Mae's and Freddie Mac's performance in meeting the affordable housing objectives that will be set for them going forward. In a broader context, two other issues, calculating the conforming loan limits, especially in high cost areas, and managing an Affordable Housing Fund, also impact affordable housing, so I will also address those proposals today as well.

For HUD, the affordable housing goals have been a key focus of our regulatory oversight work, so I will begin with our experiences in this area.

#### **HUD'S CURRENT AFFORDABLE HOUSING GOALS**

In 1992, Congress expressed concern about the GSEs' funding of affordable loans for low-income families, particularly those living in inner-city neighborhoods that had been "redlined" by primary market lenders. For this reason, Congress called for HUD to establish three annual housing goals that the GSEs must meet. These are the:

Low-and Moderate-Income Housing Goal, which targets families earning no more than area median income (AMI);

Special Affordable Housing Goal, which targets very-low income families (to 60% AMI) and low-income families (to 80% AMI) living in low-income areas; and the

Underserved Areas Goal, which targets low income and high minority neighborhoods.

The main objective of the housing goals is to encourage Fannie Mae and Freddie Mac to introduce new affordable lending programs and to make prudent adjustments in their mortgage purchase standards that take into account the special circumstances of low-income families and others who have found it difficult to access credit in the conventional mortgage market.

In carrying out its responsibilities to set, monitor, and enforce the housing goals, HUD established progressively higher goal levels by regulation in 1995, 2000, and again in 2004. These goal levels were based on HUD's estimates of how much the overall conventional conforming market, including single family and multifamily housing, and both purchase and refinance loans, would originate in qualifying mortgages over the time period covered by each regulation.

Current goal levels, which HUD established in its 2004 Rule, rise year-by-year beginning in 2005 and extending through 2008. HUD set the goals at levels that will move Fannie Mae and Freddie Mac up to market levels. For instance, HUD projected that, under normal circumstances, special affordable housing will account for about 27 percent of all single-family and multifamily housing financed in the conventional conforming market. Therefore, the 2008 goal is set at 27 percent so that the GSEs will "match the market" by 2008.

In its 2004 rule HUD also established three home purchase subgoals under each housing goal. These subgoals measure the GSEs' acquisition of qualifying owner-occupied home purchase mortgages in metropolitan areas. The subgoal levels were set about 2-3 percentage points above HUD's estimates of the market because it was HUD's intent that the GSEs should lead, rather than match, the market. HUD concluded that the GSEs have the expertise, resources, and ability to lead the single-family owner home purchase market, which is their core business.

Over the past few years, HUD's analysis of the GSEs' performance shows that Fannie Mae led the home purchase market from 2002 to 2005 on its special affordable housing business and from 2001 to 2005 on purchases serving low- and moderate-income families. In fact, on the two income-based goals, Fannie Mae sharply improved its performance beginning in 1999, thereby erasing its gap with the market. In the underserved areas category, Fannie Mae also sharply improved its performance beginning in 1999, exceeding market levels by 2002. However, Fannie Mae lagged the underserved areas market during 2004 and 2005.

Freddie Mac also improved its performance on the three home purchase subgoal categories, particularly between 2004 and 2005. The year 2005 was the first time that Freddie Mac led the market on the two income-based goals. However, like Fannie Mae, Freddie Mac lagged the market in 2005 in the underserved areas category.

#### **THE PROPOSED AFFORDABLE HOUSING GOALS**

With respect to affordable housing goal provisions of the H.R. 1427, HUD is pleased to see that Congress continues to be concerned with the role that Fannie Mae and Freddie Mac play in serving affordable housing markets and has retained the housing goal structure as a means of measuring their performance. We were also glad to see some improvements over the current statute. For example, establishing an 80 percent

AMI ceiling for defining underserved census tracts is a positive enhancement as is providing monetary penalties for a GSE's failure to achieve a housing goal.

With respect to the proposed goals, however, we would like to offer some suggestions and "food for thought" based upon our own experience in analyzing affordable housing markets and the GSEs' role in serving these markets over a considerable period of time.

One of the first differences we noticed was the discontinuation of what are now the Low-and Moderate-Income Housing Goal and the Underserved Areas Goal. It seems that the new single-family home purchase goals are mostly derived from HUD's current Special Affordable Home Purchase Subgoal.

In HUD's regulations, the Special Affordable Home Purchase Subgoal is defined as home purchase mortgages financing very-low income borrowers (to 60-percent AMI) and low-income borrowers (to 80-percent AMI) living in low-income areas. Similarly, the new single-family goals are Very Low-Income (to 50-percent AMI), Low Income (to 80-percent AMI) and Low-Income Areas (to 80-percent AMI).

However, HUD also has a broader-based Special Affordable Housing Goal, defined in the same way as its home purchase subgoal, but including mortgages that finance both purchase and refinance transactions, and both single-family and multifamily mortgages. This broader definition ensures that affordable housing markets are served in the context of the types of housing the marketplace is financing in any given year. In other words, because goal levels are based on estimated markets that include all types of residential mortgages, the goal is not especially vulnerable to unforeseen trends or events in the marketplace. It is also large enough to warrant special programs, products and services from the GSEs that they would be less inclined to initiate for especially small goal levels.

In that regard, I would like to describe some concerns HUD has identified with the proposed single-family goals, including why we think some of them may not achieve the desired result.

#### Size of the Single-Family Home Purchase Markets

With respect to the Very Low-Income Goal, the conventional market for very low-income home purchase mortgages is so small, it would be unlikely to achieve the objective of parity with the Community Reinvestment Act (CRA). Very small markets also create a higher degree of uncertainty from year-to-year in setting the appropriate goal level.

To understand the small magnitudes of mortgage involved, consider these recent figures:

<b>0-50 AMI Home Purchase Loans</b>	<b>2004</b>	<b>2005</b>
Conventional Conforming Market Originations	6.9% <sup>1</sup>	6.1%
Fannie Mae Purchases	7.5%	7.5%
Freddie Mac Purchases	6.7%	7.6%

As shown, the percentages are quite low, in the single digits, and in 2005, both GSEs already exceeded the very-low income home purchase market.

HUD's Special Affordable Housing Goal overcomes this "small percentage" problem by raising the affordability category to 60-percent AMI. This extra 10 percent of coverage includes almost as many borrowers as the entire less-than-50-percent AMI group. If H.R. 1427 defined Very Low-Income as 60-percent AMI, then the home purchase goal would be in the double digits, ranging from about 12-13.5 percent. By creating an affordable goal of sufficient size relative to the market, there is greater likelihood that the GSEs could serve that market through targeted products and outreach.

HUD recommends that the Committee consider imposing either a single home purchase goal with incomes to 80 percent of area median income, which would increase market share to about 30 percent, OR retain the two income-based home purchase goals but define them somewhat more broadly at 0-60 percent AMI and 0-90 percent AMI. Goals that include a range of incomes offer sufficient market share for the GSEs to invest in the development of products targeted to lower-income borrowers and to maintain a consistent presence in those markets regardless of market trends over time. Goals set at very low ranges of affordability, such as to 50 percent of AMI, would encourage the GSEs to purchase private label securities, mortgage revenue bonds, and similar instruments that are already financed adequately by the capital markets.

#### FHA's Role

On another note, I think it is important for the Congress to consider FHA's role in these markets. Homebuyers at the very low-income level pose greater risks to private lenders and the capital markets. For this reason, FHA can provide the needed entrée too mortgage financing for these borrowers. For example, 14 percent of FHA-insured loans in metropolitan areas are for very-low income borrowers, compared with only 6 -7 percent of the conventional conforming market.

In fact, FHA's mission is to provide financing for those borrowers who are at the margins of homeownership. FHA serves an important function in the overall continuum of financing that is available in the marketplace. HUD is currently working with the

<sup>1</sup> The "6.9%" is interpreted as follows: 6.9% of all home purchase loans originated during 2004 in the conventional conforming market in metropolitan areas were for borrowers with incomes less than or equal to 50 percent of AMI.

Congress and will shortly submit legislation to modernize FHA so that it can continue to fulfill its mission of providing safe, accessible, and efficient financing to those who are most underserved by the mortgage markets. I would urge the Congress to consider the FHA Modernization proposal this spring.

#### New Goals Do Not Count Single-Family Rental Units

HUD is concerned that because H.R. 1427 does not include overall housing goals, which would include single-family rental mortgages, there would be less incentive for the GSEs to purchase “goals rich” rental mortgages.

The housing goals established in H.R. 1427 would not require the GSEs to play any particular role in the single-family rental mortgage market, a very important source of affordable housing. Specifically, American Housing Survey data indicate that in 2005, 18.4 million single-family rental units (i.e., rental units in 1-4 unit properties) accounted for 54 percent of all occupied rental units, and 45 percent of these units were occupied by households with incomes less than 50-percent AMI.

Thus, even though H.R. 1427 includes a Multifamily Goal, there would be no incentives for the GSEs to purchase single-family rental mortgages, an important market segment for lower income families and families in underserved areas. Final legislation should encourage the GSEs to continue to grow their single-family rental business. This is unlikely to occur if that market segment is removed from goals consideration.

#### Separate Multifamily Goals Would Be Difficult to Establish

With respect to multifamily markets, H.R. 1427 calls for at least three multifamily housing goals. The small market coverage of one, dealing with low-income housing tax credits, which HUD estimates to be about 7 percent of the multifamily dwelling units financed in 2003, makes it inappropriate for a separate goal. Again, it is a “small markets” issue, and the GSEs would likely meet any such goal by purchasing state-issued bonds that finance such units.

The other two multifamily goals (very low-income and low-income) have ample affordability coverage, but data are not readily available for these market segments. That is also true of the small 5-50 unit subgoal. In the past, HUD has had to piece together estimates of the multifamily market from different sources, recognizing that there was uncertainty with any estimate, particularly with respect to the number of dwelling units financed. Separate multifamily goals raise serious issues about the uncertainty of the data, making it less likely that meaningful and challenging goal targets will be possible.

Under the current goals structure, which is based on targets that include the overall market for both single-family and multifamily mortgages, HUD finds that the GSEs have to be active in the multifamily market in order to meet the targets that HUD has established. This is because the majority of multifamily dwelling units are affordable to families with incomes equal to or less than 60-percent of AMI. This compares with

about 13-15 percent of single-family owner units. For this reason, the GSEs have every incentive to purchase multifamily mortgages in order to meet an overall goal target.

H.R. 1427 Eliminates Overall Performance Goals for the GSEs

H.R. 1427 does not include overall standards for evaluating the GSEs' performance in serving lower-income families and their neighborhoods. This would represent a significant reduction in legislative and regulatory scrutiny of the GSEs' affordable lending efforts, particularly since the housing goals have shown that they are effective tools for moving the GSEs from sub-par to market performance across all their books of business.

**HUD's current goals include all mortgages financed by the GSEs.** That is, each goal is based on market share that includes single-family and multifamily mortgage financing, as well as both home purchase and refinance mortgages. H.R. 1427 excludes GSE purchases of mortgages on single-family rental housing, a very important source of affordable housing, and fragments the other markets into separate categories. The reasons for doing this are unclear, especially in light of the substantial improvements that the GSEs have made in serving targeted markets:

For example,

- For the **Low-and Moderate-Income Goal**, which targets families with incomes below area median income, Fannie Mae's performance improved by 10 percentage points between 1996 and 2005. Freddie Mac's performance improved by nearly 13 percentage points.
- For the **Underserved Areas Goal**, which targets families in low-income and high-minority areas, Fannie Mae's performance improved by more than 8 percentage points between 1996 and 2005 while Freddie Mac's rose by more than 13 percentage points during the same period.
- For the **Special Affordable Housing Goal**, which targets very low-income (0-60-percent AMI) families and low-income families (to 80-percent AMI) in low-income areas, Fannie Mae's performance rose by 11 percentage points in the 1996-2005 period while Freddie Mac's rose by over 10 percentage points during the same period.

HUD's overall housing goals have been a major success in that they have led to a significant decrease in the gap between the GSEs' and the market's performance. For example, in 1996, the special affordable share of the primary market was 27.3 percent. This means that Fannie Mae's 15.4-percent performance on the special affordable goal in that year represented a market gap of 11.9 percentage points. By 2005, Fannie Mae had increased its special affordable performance to 26.3 percent, eliminating much of its gap with the market. And under its 2004 regulation, HUD established goals at levels that will cause the GSEs to match HUD's estimate of the market by 2008. If H.R. 1427 (without

its overall housing goals) had been implemented in 1993, the above increases in overall goal performance would not have taken place and the GSEs would not have closed their gaps with the market. Given that the GSEs are now active in all major segments of the affordable market, it is important that their overall performance continue to be actively monitored and enforced.

Overall goals also allow for more challenging goal levels. As the table below indicates, the GSEs already meet or exceed most of the proposed single-family goals based on current originations as reported in HMDA:

	<u>2004</u>		
	<u>Market</u>	<u>Fannie Mae</u>	<u>Freddie Mac</u>
1) Very Low-Income Families (0 – 50% AMI)	6.9%	7.5%	6.7%
2) Low-Income Families (0 - 80% AMI)	29.4%	30.1%	26.6%
3) Low-Income Area Goal	22.3%	22.2%	18.5%

	<u>2005</u>		
	<u>Market</u>	<u>Fannie Mae</u>	<u>Freddie Mac</u>
1) Very Low-Income Families (0 - 50% AMI)	6.1%	7.5%	7.6%
2) Low-Income Families (0 - 80% AMI)	26.9%	29.5%	31.1%
3) Low Income Area Goal	22.4%	20.9%	23.9%

Finally, overall goals are consistent with the GSEs' charters, which require them to, among other things, provide stability in the secondary markets for residential mortgages and to provide ongoing assistance to the residential mortgage market, including the affordable markets. This means they must be willing to purchase, within their charter limitations, all single family and multifamily mortgages, including purchase and refinance mortgages, that their selling lenders originate, including those that do not qualify as affordable mortgages. They are required to do this regardless of market trends. Goals that are too narrowly construed – and segmented – could lead to credit allocation at the expense of the other markets that the GSEs must also serve. It could also encourage a pull-back from the gains achieved to-date in closing market gaps across all of the GSEs' books of business.

HUD would like to see overall market based goals reinstated in the new legislation. Otherwise, it is likely that progress made in serving the housing needs of all income levels below area median income will not be sustained.

#### The “Duty to Serve” Provisions Require Clarification

H.R. 1427 requires that the GSEs lead the market in developing products and underwriting guidelines for several areas deemed to be underserved. The Director must establish a manner for evaluating whether or not a GSE has met its various duties, but

this provision is **qualitative** in nature. For most of the programs covered, there is little to no data readily available on the extent to which any of the listed markets are underserved.

With respect to the Affordable Housing Preservation provisions, the enumerated programs are operated and managed, in most instances, by HUD and are, therefore, already served with products, guidelines, and programs. Examples include HUD's Section 8 programs; FHA Section 221(d)(4) below-market interest rate multifamily programs; the Section 202 housing for the elderly; and supportive housing for persons with disabilities. Ginnie Mae already provides a secondary market for some of these programs. HUD is unclear about how, and to what extent, Congress intends the GSEs to support these programs.

HUD urges the Congress to, at a minimum, provide the Director with clarity on how the "duty to serve" provisions are to be implemented and managed, including their purposes, and how the Director should measure the GSEs' performance in either serving, or working with, these HUD programs.

#### **CONFORMING LOAN LIMITS PROVISIONS IN HIGH COST AREAS**

In addition to the housing goals, there are other proposals of concern to HUD, including the conforming loan limits provision.

H.R. 1427 would increase the conforming loan limit in high-cost areas to the lesser of the median house price in each area or 150 percent of the conforming limit. HUD questions the need for this provision, especially since the markets that are likely to qualify as "high cost areas" are already well served by private lenders and the capital markets. In fact, we are not aware of any reported mortgage liquidity issues in those metropolitan statistical areas (MSAs) that might be classified as "high cost areas" under this provision.

With respect to affordable housing factors, HUD's preliminary analysis of 12 high-cost MSAs (as identified using the NAR median house price list) found only 1,207 low-income (to 80-percent AMI) loans out of the 153,950 current jumbo home purchase loans that would be added under this proposal. In this regard, the high cost provision seems inconsistent with H.R. 1427's emphasis on affordable housing markets. For example, at 50 percent over the current conforming limit of \$417,000, the GSEs would be authorized to finance mortgage loans up to \$625,500. HUD finds no reason to authorize this type of expansion to the GSEs' charter authorities, and for this reason, HUD opposes the "high cost areas" provision.

With regard to the conforming loan limit provisions in general, H.R. 1427 permits downward adjustments to the conforming loan limit when the housing price index falls from one year to the next. We think there also needs to be a provision that protects loans originated at the previous, higher limit but not delivered for sale until after the effective date of the new lower limits. This provision should also extend to loans refinancing in

years when the current limit is less than the limit in effect at the time the original loan was closed.

#### **THE AFFORDABLE HOUSING FUND**

While HUD does not advocate for the creation of an affordable housing fund, we believe any such fund should have a cap. HUD does, however, note that important improvements over the original proposals have been made in H.R. 1427. These include having the fund managed by the Director, rather than the GSEs, greater clarity regarding eligible grantee recipients, and a more precise sunset provision.

#### **CONCLUSION**

In conclusion, I would like to commend the Congress and especially its leadership, both present and past, for the extraordinary efforts it has made to the important and critical work of creating a new regulator. This is a difficult undertaking, but a worthwhile one that HUD fully supports. Because the housing government sponsored enterprises are so vitally important to the financial markets, anything less than a world-class regulator fully empowered to oversee their activities is simply not in the public interest.

HUD believes the time is right for a change, and we look forward to working with Congress in this endeavor.



*Dedicated solely to ending America's  
affordable housing crisis*

*Sheila Crowley, President*

*Board of Directors*

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Pittsburgh, PA*

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Albuquerque, NM*

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*Moises Loza  
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*Tim Moran  
Burlington, VT*

*Regina Morgan  
Peoria, IL*

*Rey Ocañas  
Austin, TX*

*Barbara Sand  
Brookline, MA*

*Lydia Tom  
New York, NY*

*John Zinker  
Nashville, TN*

*Founded in 1974 by  
Cushing N. Dolbear*

**Testimony of Sheila Crowley, MSW, Ph.D.  
President of the National Low Income Housing Coalition  
presented to the  
Financial Services Committee  
United States House of Representatives  
March 15, 2007**

Chairman Frank, Ranking Member Bachus, and Members of the Committee, thank you for the opportunity to testify today on H.R. 1427, the Federal Housing Finance Reform Act of 2007.

I am Sheila Crowley, President of the National Low Income Housing Coalition (NLIHC). Our members include non-profit housing providers, homeless service providers, fair housing organizations, state and local housing coalitions, public housing agencies, private developers and property owners, housing researchers, local and state government agencies, faith-based organizations, residents of public and assisted housing and their organizations, and concerned citizens. The National Low Income Housing Coalition does not represent any sector of the housing industry. Rather, NLIHC works only on behalf of and with low income people who need safe, decent, and affordable housing, especially those with the most serious housing problems. NLIHC is entirely funded with private donations.

My testimony will focus solely on the proposed Affordable Housing Fund, which is a top priority for NLIHC. We are solely dedicated to ending the affordable housing crisis in the United States, and view the Affordable Housing Fund in this bill as a crucial step in that direction. While the affordable housing crisis has many dimensions, the fundamental problem is the mismatch between what people earn or otherwise have to spend for their homes and what housing costs.

The people for whom this mismatch is the most acute are those with the lowest incomes, precisely who the Affordable Housing Fund is intended to help. All of the Affordable Housing Fund would produce or preserve homes that are affordable to extremely low and very low income households. Extremely low income households are those with incomes at or below 30% of the area median. In the Boston, that is \$25,230 a year or less. In Birmingham, that is \$17,220 a year or less.<sup>1</sup> These are elderly and disabled people on fixed incomes or people in the low wage workforce. In order to afford to rent a modest one bedroom home

<sup>1</sup> Wardrip, K., Pelletiere, D., & Crowley, S. (2006). *Out of reach 2006*. Washington, DC: NLIHC.

in Boston, the members of the household have to earn \$46,560 a year; for a one bedroom home in Birmingham, the annual income needed is \$21,680.<sup>2</sup>

Extremely low income renters are the only group of people in the United States for whom there is an absolute shortage of housing units. There are 9,022,000 extremely low income renter households and only 6,187,000 homes renting at prices these households can afford, paying the standard of 30% of their income for housing. This is a shortage of 2,835,000 units.<sup>3</sup> Higher income people may not have the choice of homes they would prefer and in some markets, there may be a shortage of units affordable to people in higher income categories. But these nine million families are the only ones playing this dangerous game of musical chairs.

What are the consequences of a housing shortage of these proportions? How do these families cope? Many of them spend much more than they can afford for their homes. An analysis of data from the 2005 American Community Survey shows that 71% of all extremely low income renter households in the United States pay more than half of their income for their homes.<sup>4</sup> Spending that much of household income on housing means there is not enough income left for other basic necessities, and people are forced to make impossible choices between rent and food or medicine or heat. Certainly, they are not able to save.

Another way to cope is for the adults in the family to work two or more jobs to bring in the needed income. This means children are left alone or in the care of others for long stretches of time and the parents are unable to do what we expect of them to raise healthy and productive children.

Or they are prey to unscrupulous landlords who rent substandard housing that tenants do not dare complain about for fear of losing the only homes they can afford. Or they double-up with family members or friends creating overcrowding and all the related health and mental health stressors that come with too many people living in too little space. Or they move from one short term dwelling to another, making stable employment and school attendance impossible to maintain. High rates of residential mobility among low income families is correlated with high rates of school mobility for their children, which means these kids never stay long enough in one school to be successful.<sup>5</sup>

The ultimate consequence of this housing shortage is that people lose their homes and become homeless. In circumstances where there is such a gap between supply and demand, those who are the most vulnerable, those with the most complex problems and the weakest support systems, are the least able to compete and at highest risk of homelessness.

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<sup>2</sup> Ibid.

<sup>3</sup> Pelletiere, D. (2007). *American Community Survey estimate shows larger national, state affordable rental housing shortages. Research Note #07-01*. Washington, DC: NLIHC.

<sup>4</sup> NLIHC tabulations of 2005 American Community Survey PUMS.

<sup>5</sup> Crowley, S. (2003). The affordable housing crisis: Residential mobility of poor families and school mobility of poor children. *Journal of Negro Education*, 72(1), 22-38.

This housing shortage is not going to be solved by market forces. Given the huge pent-up demand for rental housing that this population can afford, if there was money to be made building and operating such housing, someone would have figured out how to do so by now. Nor can this housing shortage be solved by existing federal, state, and local housing programs at the level of investment we are currently making. Moreover, most public programs serve a higher income population. Given the size of the federal deficit and the resulting constraints on federal programs, we have to think outside the box for creative answers. That is what the Affordable Housing Fund in this bill is.

At the same time, it is not a new concept. The Affordable Housing Fund is the conceptual cousin of the highly successful Affordable Housing Program of the Federal Home Loan Banks, through which 10% of their profits must go into a grant program to support affordable housing activities.

Under the proposed bill, Fannie Mae and Freddie Mac would be required to contribute revenue equal to 1.2 basis points for each dollar of their average total mortgage portfolios for the preceding year to a fund that is administered by the new regulator that this bill establishes. In the first year, these funds would be directed to the Gulf Coast states facing ongoing rental housing shortages due to 2005 hurricanes. This is a very fitting use of these funds, which NLIHC enthusiastically supports. We would suggest however that some portion of the funds be directed to Alabama and Texas, as well as Louisiana and Mississippi. While majority of damage occurred in the latter two states, all four states lack sufficient funding to restore lost housing affordable to the households who would be eligible for help under this bill.

The Affordable Housing Fund is intended primarily for capital grants to produce and preserve rental housing for extremely low and very low income families, with activities that would produce homes for purchase by first time home buyers also allowed. Under the homeownership provisions, funds could also be used for non-bricks and mortar activities such as down payment and closing costs assistance. There is also a provision that no less than 10% of the funds are to be spent on homeowner activities. We suggest a change that will assure that a majority of the funds will be spent on the construction or rehabilitation of physical housing units. This can be achieved by setting a cap on the amount of funds that can go toward homeownership activities.

One of the more controversial aspects of H.R. 1461, the earlier version of this bill that was passed by the House in the last Congress, was whether or not these funds could be used for activities other than bricks and mortar capital costs. H.R. 1427 makes it clear what can and cannot be done with these funds. Let me assure all Members of the Committee who are concerned about other potential uses or misuses of these funds that there is no one more dedicated to assuring that does not happen than those of us at NLIHC.

We want these funds to go to addressing the most pressing housing need in our country, the shortage of rental housing that extremely low income families can afford. The Affordable Housing Fund will be an important new tool in the toolbox of responsible developers that will allow them to include a portion of units in each project that are affordable for this population.

Let me close by congratulating Chairman Frank, Mr. Watt, Mr. Baker, and Mr. Miller for coming together to introduce this important bipartisan legislation. The history of federal housing legislation is that it has always enjoyed bipartisan support. You are continuing in that fine tradition.

Thank for the opportunity to testify today. We look forward to working with you to assure its successful passage.

**HOUSING POLICY COUNCIL  
THE FINANCIAL SERVICES ROUNDTABLE**



**STATEMENT OF**

**JOHN H. DALTON  
PRESIDENT  
HOUSING POLICY COUNCIL OF  
THE FINANCIAL SERVICES ROUNDTABLE**

**BEFORE THE  
COMMITTEE ON FINANCIAL SERVICES  
OF THE U.S. HOUSE OF REPRESENTATIVES  
ON**

**THE FEDERAL HOUSING FINANCE REFORM ACT OF 2007, H.R. 1427**

**MARCH 15, 2007**

Mr. Chairman and Members of the Committee, I am John Dalton, President of the Housing Policy Council of The Financial Services Roundtable. Thank you for the opportunity to present the views of the Housing Policy Council on the supervision and regulation of Fannie Mae, Freddie Mac and the Federal Home Loan Banks.

The Housing Policy Council is part of The Financial Services Roundtable. The Housing Policy Council is devoted to mortgage finance issues of significance to consumers, the economy and the members of the Roundtable. Today, the Housing Policy Council consists of twenty-three of the nation's leading mortgage lenders. We estimate that our member companies originate over 64 percent of the home mortgages for American home buyers.

The Housing Policy Council Strongly Supports GSE Reform Legislation

The housing GSEs are an important part of our nation's housing finance system. As you might expect, the members of the Housing Policy Council do a significant amount of business with Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac guarantee a substantial portion of conforming mortgages and are the largest purchasers of conforming mortgages originated by the members of the Housing Policy Council. Many of our members also are members of the Federal Home Loan Bank System. We want these housing GSEs to be healthy and responsible business partners. Therefore, we strongly support the enactment of legislation to enhance and improve the supervision and regulation of their operations and activities. Appropriate supervision and regulation of the housing GSEs will not only safeguard our housing finance system, but it also will help consumers who seek to become homeowners, and it will protect the interests of all taxpayers.

Recent developments have shown that the current system for regulating and supervising these enterprises is not adequate. The regulation and supervision of Fannie Mae and Freddie Mac is divided between two federal agencies, the Office of Federal Housing Enterprise Oversight (“OFHEO”) and the Department of Housing and Urban Development (“HUD”). The twelve Federal Home Loan Banks are supervised and regulated by yet another federal agency, the Federal Housing Finance Board. The lack of centralized supervision and regulation for these entities has not worked well. During the past 15 years, Fannie Mae and Freddie Mac have grown significantly in size and complexity, and federal regulators have not been able to effectively oversee their operations and activities. As a result, both Fannie Mae and Freddie Mac have experienced serious financial and managerial problems.

Furthermore, these agencies lack the tools and resources to do the job. Fannie Mae and Freddie Mac are major financial institutions that are subject to significant operational risks. Yet OFHEO’s supervisory powers are far weaker than those Congress has given to the federal banking agencies. OFHEO has less authority over capital regulation than the federal banking agencies, and its enforcement powers are much more constrained than those available to the federal banking agencies. Likewise, HUD’s ability to review the programs and activities of Fannie Mae and Freddie Mac is not as broad as the power of the federal banking agencies.

The establishment of a strong, world class regulator for Fannie Mae, Freddie Mac and the Federal Home Loan Bank system is long overdue. The current debate over the regulation and supervision of Fannie Mae and Freddie Mac began in earnest in 2003 after the serious managerial and accounting problems were found at both Freddie Mac and then at Fannie Mae. OFHEO has done a commendable job of addressing these problems with limited resources and

authority. However, OFHEO was able to act effectively largely because of the magnitude of the problems and the publicity they received.

We urge the Committee to act on reform legislation as quickly as possible, so that a bill can be finalized in this session of the Congress. Any further delay in the enactment of legislation increases the danger that reform essential for the well being of our economy will never occur. We also urge the Committee to resist proposals to water down this reform legislation or weaken the authority of the new GSE regulator.

#### Key Features of GSE Reform Legislation

The Housing Policy Council and The Financial Services Roundtable believe that GSE reform legislation should contain the following key provisions.

- *An Independent Regulator* – Federal reform legislation should provide for the creation of an independent regulator for Fannie Mae, Freddie Mac and the Federal Home Loan Banks. A single, independent regulator is central to effective reform. The housing GSEs perform similar functions in our nation's housing finance system. They should be overseen by one, not three, regulators. A single regulator ensures that each of these institutions will be examined on a comprehensive basis, and permits examiners and analysts to share relevant operational and other information. An independent regulator ensures that the agency will not be subject to undue political influence. Independence has been a benchmark of the federal banking agencies.
- *Comprehensive Supervisory and Regulatory Powers* – The new federal regulator must have clear, strong and broad regulatory and supervisory powers that are comparable to the powers Congress has given to the federal banking regulators. Following the savings

and loan crisis of the 1980's and the banking crisis in the early 1990's, Congress expanded the powers of the federal banking regulators to ensure that they had the tools to supervise our nation's banks and thrift institutions. The federal banking regulators have used these powers wisely, and, today, our banking system is recognized as the strongest in the world. Fannie Mae and Freddie Mac should be subject to a similar, world-class, system of regulation and supervision. Comprehensive supervision and regulation should include the authority to set both risk-based and minimum capital for the housing GSEs, and to place a troubled housing GSE into receivership.

- *Independent Funding* – To ensure the independence of the new federal regulator, the regulator should not be subject to the Congressional appropriations process. A regulator cannot effectively oversee complex organizations with trillion dollar balance sheets, such as Fannie Mae and Freddie Mac, if it is not certain that the regulator will have the examiners, accountants and financial experts to do the job. OFHEO is the only federal safety and soundness regulator that is subject to the Congressional appropriations process.
- *Product Review and Approval* – The new federal regulator should have authority to review all products and activities of the housing GSEs. The authority to review current and proposed products and activities is a fundamental power for any effective regulator. The federal banking agencies have such authority. OFHEO does not, and HUD has testified to the Committee that its authority over Fannie Mae and Freddie Mac in this area is inadequate. Giving the new regulator authority over all products and activities will help ensure the safe and sound operation of Fannie Mae and Freddie Mac.

- *Market Discipline* – Fannie Mae and Freddie Mac should be subject to transparency and disclosure requirements similar to other publicly-traded companies.
- *Strong Affordable Housing* – Fannie Mae and Freddie Mac should be required to increase their commitment to low- and moderate-income borrowers. The definitions of low- and moderate-income that apply to the affordable housing requirements should be consistent with the definitions used in other federal housing programs and the Community Reinvestment Act (e.g., reduce moderate-income definition to 80 percent of area median income from 100 percent, and reduce low-income to 50 percent of area median income from 80 percent). Such a change would focus the affordable housing programs on the borrowers most in need.

#### Pending Legislation

During the last Congress, the Housing Policy Council supported H.R. 1461. We were pleased that the Committee and the House approved that legislation. Now, our initial review of H.R. 1427 is that the bill, while not perfect, addresses the core issues needed for effective reform.

- *Minimum Capital* – H.R. 1427 would give the federal regulator adequate authority to increase the minimum capital requirements for the housing GSEs, as well as the authority to make temporary adjustments in capital based upon the condition of the enterprise or its activities. These are appropriate changes. Our principal concern is that these capital provisions not be weakened. The federal banking agencies have the unconditional authority to increase minimum capital requirements in response to safety and soundness problems. The new GSE regulator should have the same authority.

- *Portfolio Limits* – H.R. 1427 would give the federal regulator broad authority to place limitations on the portfolios of Fannie Mae and Freddie Mac in response to safety and soundness concerns. This is an improvement over current law. However, we would recommend that the amendment be modified to specifically permit the regulator to base portfolio restrictions upon systemic risk, as well as safety and soundness concerns.
- *Product Review and Approval* – H.R. 1427 would require Fannie Mae and Freddie Mac to notify the new federal regulator before engaging in any new “activity, service undertaking or offering,” and would require the affirmative approval of the regulator, following a public notice and comment period, if an activity, service, undertaking or offering is deemed to be a product. We view this procedure as an improvement over current law, which does not reach “activities,” and does not provide for public notice and comment. We would recommend that the standards for reviewing a product track the standards in S. 190, as approved last year by the Senate Banking Committee, that the Committee define the term “product” in order to avoid any ambiguity over the scope of that term, and that the term “program” in Sections 112 and 129 of the bill be replaced with the term “product.”
- *Affordable Housing Fund* – The Housing Policy Council has long supported the creation of an affordable housing fund as an additional means for Fannie Mae and Freddie Mac to serve low- and moderate- income Americans. The Federal Home Loan Banks contribute to an Affordable Housing Program that has worked very well in providing financing for affordable housing. Fannie Mae and Freddie Mac could also contribute to a similar effort. We support allocating this new fund to State housing finance agencies, trust funds or other appropriate state-based conduits based upon a national formula. These

organizations are staffed with individuals, who exercise their duties in a professional and non-political manner to meet the needs of State residents.

- *Conforming Loan Limits* – We do not support any increase in the conforming loan limits for high cost markets for Fannie Mae and Freddie Mac. There is an active, growing, highly competitive secondary market for larger loans outside of the housing GSEs. Thus, we do not believe an increase in the conforming loan limits is necessary to serve this segment of the market. Moreover, increasing the loan limits will further remove Fannie Mae and Freddie Mac from maintaining their mission focus on serving -low- and moderate-income households.

- Conclusion

In conclusion, we believe that H.R. 1427 would be an improvement over current law. We do have concerns with some specific provisions, especially the proposed change in the conforming loan limits, and we believe others, like the product review and program approval process, could be improved even further. However, this effort has been a long, hard fight. We do not want to make the perfect the enemy of the good. It is time to enact legislation to improve the regulatory structure for the GSEs. It will help consumers, the housing economy and the GSEs. We urge the Committee to approve H.R. 1427, with the compromises developed by Chairman Frank and the Treasury Department, and to resist any amendments that would undermine the difficult compromises that have been achieved or otherwise weaken the authority of the new federal regulator. The Housing Policy Council and the Financial Services Roundtable look forward to working with the Committee to enact GSE reform



**Consumer Federation of America**

**TESTIMONY OF**

**ALLEN FISHBEIN  
DIRECTOR OF HOUSING AND CREDIT POLICY  
CONSUMER FEDERATION OF AMERICA**

**BEFORE THE**

**COMMITTEE ON FINANCIAL SERVICES  
OF THE  
UNITED STATES HOUSE OF REPRESENTATIVES**

**REGARDING**

**LEGISLATIVE PROPOSALS ON GSE REFORM**

**MARCH 15, 2007**

Thank you Chairman Frank and Ranking Member Bachus for inviting me to testify before you today on “Legislative Proposals on GSE Reform.” My name is Allen J. Fishbein and I am the Director of Housing and Credit Policy for the Consumer Federation of America. We commend you for your leadership and dedication in working to improve regulatory oversight of the Government Sponsored Housing Enterprises – Fannie Mae, Freddie Mac, and the Federal Home Loan Banks (GSEs).<sup>1</sup>

CFA is a non-profit association of some 300 pro-consumer organizations, founded in 1968, to advance the consumer interest through education, research and advocacy.<sup>2</sup> My background in the area of GSE regulation includes tenure at the U.S. Department of Housing and Urban Development (HUD), where I served as the Senior Advisor for GSE Oversight. In this capacity I assisted with supervision of the department’s public mission regulation of Fannie Mae and Freddie Mac and with coordination of rulemaking to establish affordable housing goals for the two Enterprises.

Consumers have a huge stake in the outcome of GSE legislation. The GSEs are extremely valuable to the nation’s housing finance system, making important contributions to expanding the mortgage market and increasing homeownership levels. Their business model requires that all three operate as for-profit entities. However, it is their public mission and affordable housing mandates as prescribed by Congress that make the GSEs unique and that ultimately justify their government charters and benefits afforded them through this status.

Strengthening financial oversight to ensure the GSEs’ ongoing safety and soundness is a worthwhile public policy objective. We believe that such legislation can and should be achieved in a manner consistent with these entities congressionally chartered status, their housing mission, and affordable housing activities, and urge that the Committee follow this course. Accordingly, we support revising the present regulatory structure and the creation of a new independent regulator with jurisdiction over all three housing GSEs. We also believe that both financial and mission oversight should be performed by this same regulator. It is also critical that the new financial oversight powers provided are commensurate and appropriate to the task at hand, while not unnecessarily diminishing the ability of the GSEs to continue to perform their vital housing mission activities.

Reaffirming and strengthening the GSEs’ mission and related affordable housing activities also should be a central part of any new regulatory regime. Pending consideration of GSE legislation provides an important opportunity to accomplish this objective for all three GSEs. Mr. Chairman, we especially thank you for working to ensure mission considerations and important new affordable housing mandates are a vital part of GSE legislation.

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<sup>1</sup> For today’s testimony I use the term “GSEs” when referring to all three entities and the term “Enterprises” when only referring to Fannie Mae and Freddie Mac.

<sup>2</sup> [www.consumerfed.org](http://www.consumerfed.org)

With a few notable exceptions, the bill introduced last week, H.R. 1427, largely tracks the provisions that were part of the legislation passed by this Committee and the House of Representatives in the last Congress (H.R. 1461). I offer specific comments on the bill's affordable housing provisions later in my testimony.

#### **The GSEs' Public Mission Matters to Consumers**

Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBs) were established at different times by Congress to ensure the smooth flow of mortgage credit throughout the nation. Each engages in activities that are valuable to promoting a sound housing market and targeting resources for affordable housing activities to benefit less affluent families. Fannie Mae and Freddie Mac accomplish this through their secondary market activities, while the twelve FHLBs are cooperative entities that function somewhat independently of each other and serve as a "wholesale lender" to their financial institution members. Collectively, these entities hold 46 percent of the total mortgage debt outstanding in the United States.<sup>3</sup> Although the Enterprises market share has declined in recent years, through their underwriting and the other standards they employ they continue have sway over who gets credit and on what terms.

The GSEs are owned by private shareholders and operated for-profit or, in the case of the FHLBs, for the mutual benefit of their owner-members. Yet they differ from fully private companies in that they are intended to serve as an instrument of national housing policy and therefore are required to perform a broad public mission and also fulfill certain public policy objectives that are set by Congress. For this reason, the GSEs are granted certain legal privileges and exemptions not generally available to others. They are also limited to a narrow range of business activities deemed important to public policy. Because of the importance of their mission as reflected by their charters and the collection of privileges conferred to achieve that mission, the capital markets continue to infer an implicit government guarantees behind the GSEs. Consequently, the GSEs' are able to fund their operations at lower cost than other firms with similar financial characteristics.

Fannie Mae and Freddie Mac (and in different ways the FHLBs) make important contributions to bringing capital to the mortgage market, which in turn, has helped improve credit access for many consumers. Fannie Mae and Freddie Mac purchase residential mortgages from originating lenders that they use these proceeds to make additional mortgages. Although they hold some whole mortgages in their portfolios, most mortgages are placed in mortgage pools to support Mortgage Backed Securities (MBS) that are issued and then either sold to investors or held in their retained portfolios. They also guarantee timely payment of interest and principal on MBS that they issue. Through these functions Fannie Mae and Freddie Mac have been highly successful at bringing capital into the housing loan market from domestic and international sources which, in turn, works to make mortgage credit available more broadly to U.S. consumers.

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<sup>3</sup> Lockhart, James, Director of the Office of Fair Housing Oversight, Remarks before America's Community Bankers Association, Wash, DC, March 5, 2007.

The FHLB system is comprised of twelve publicly chartered and privately owned regional banks which collectively have over 8,000 member financial institutions. Originally members were exclusively savings and loan associations, but today most of these are commercial banks, thrifts and credit unions. Traditionally the primary function of the regional banks was to make loans, known as credit advances, to their members. More recently, the FHLBs have experimented with programs to purchase mortgages directly from their members and hold them in their retained portfolios. This process is similar to Fannie Mae's and Freddie Mac's traditional business activities, although it is not clear that the FHLBs' currently have authority to securitize mortgages.

### **Congressional Mandates Help Bolster the GSEs' Affordable Housing Activities**

In addition to serving the broad mission to promote homeownership, Congress decided more than a decade and one-half ago to require the GSEs to devote more of their investment capital to serving special demands for low- and moderate-income housing finance.

Fannie Mae and Freddie Mac by statute presently are required to meet three broad annual percentage-of- business goals – a low and moderate income goal (up to area median income), an underserved geographic areas goal and a special affordable housing goal directed at very low income and low income households. Established in 1992, the annual housing goal levels are currently set by HUD, the Enterprises mission regulator. These goal levels have risen steadily since 1996.

In November 2004 HUD issued a final rule that established new housing goal levels for calendar years 2005 through 2008. Under this rule the goals increase gradually over this period. For 2007 the overall low and moderate income goal is 55 percent, meaning that at least 55 percent of the dwelling units in properties whose mortgages are purchased by each of the Enterprises' must be occupied by eligible low and moderate income households.

Both GSEs have regularly met the annual housing goals set for them. There is also some research evidence indicating that the affordable housing goals have played a role in helping to boost low-income and minority homeownership rates.<sup>4</sup>

The HUD analysis for the most recent rulemaking to set goal levels indicated that the GSEs' on average tended to be less successful in purchasing qualifying mortgages than their share of the overall market. Important market segments where the department's analysis indicated that the GSEs could step up their performance include first-time homebuyers, especially minority first-time home buyers, credit impaired borrowers, the single and multifamily rental housing market, including loan purchases for rehabilitation of these properties. At the same time, the most recent HUD data (through 2003) shows that Fannie Mae in particular matched or led the market in many low and

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<sup>4</sup> Ambrose, Thibodeau, Temkin, *An Analysis of the Effects of the GSE Affordable Housing Goal on Low- and Moderate-Income Families*, prepared for HUD by The Urban Institute, 2002.

moderate income loan categories. Freddie Mac also has shown improvements in many of the same market segments.<sup>5</sup>

Congress also expanded the role of the FHLBs in providing capital for affordable housing as part of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989. This act, among other things, mandated the establishment of an Affordable Housing Program (AHP) that requires each FHLB to devote at least 10 percent of net earnings to the program. These funds are used to provide grants and write-downs of loans to support the financing of lower income homeownership and rental housing. FIRREA also required the establishment of a targeted cash advance program for eligible affordable housing and community development activities. Such advances are provided to member institutions at the FHLBs' cost of funds.

#### **H. R. 1427 Would Strengthen Affordable Housing Mandates for Fannie Mae and Freddie Mac**

The statutory affordable housing responsibilities for the GSEs have remained mostly unchanged since their inception in the early 1990s and late 1980s. H.R. 1427 seeks to update and expand upon existing requirements. This includes extensive revisions to the affordable housing goals structure, the creation of an Affordable Housing Fund, and other steps to improve mission oversight:

- *Establishment of Assessment Authority for Mission Oversight (Sec 106)*

Although often overlooked, the lack of mission oversight assessment authority has hampered efforts by HUD, the present mission regulator, to provide needed oversight in some areas. Unlike most bank regulators, HUD continues to be dependent upon the congressional appropriations process to fund its activities in this area. When I was at the department direct appropriations for this work was not provided and consequently, this important work tended to be under-funded. The new authority the bill provides should enable the mission oversight function to be sufficiently funded in the future.

- *Revisions to the Affordable Housing Goals (Sec. 125)*

HR 1427 (as did the former House passed bill) revises the goals structure. In particular, it replaces the three present goals with more targeted purchase money goals. It also provides tighter income targets that bring these standards into alignment with Community Reinvestment Act (CRA) income requirements for banks and thrifts. The hope is that through tighter income targeting Fannie Mae and Freddie Mac would be directed to increase the focus of their mortgage purchase activities low income households and communities.

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<sup>5</sup> Final Rule, HUD's Housing Goals for Fannie Mae and Freddie Mac for the years 2005-2008, 69 Federal Register 63580, November 2, 2004.

We are particularly pleased that this year's legislation would require a separate home refinance subgoal for low income families. The inclusion of a home refinance component has been part of the housing goals structure from the beginning. Establishing annual home refinance subgoals will encourage the Enterprises to be active in this market. Their increased involvement provides alternatives for low income homeowners who otherwise may be forced to refinance their homes with predatory lenders that continue to plague this market.

We also favor establishment of a new Multifamily Special Affordable Housing Goal. HUD currently applies an annual volume figure that operates more like a floor than a goal. A new needs based goal would provide an incentive for the Enterprises to become more active in financing multifamily rental housing, including smaller multifamily rental housing, serving low income households.

Creation of a new Enterprise "duty to serve" for certain designated underserved markets should also help. Market segments specifically included are manufactured housing, affordable housing preservation and rural housing. The Enterprises would be evaluated on the activities they undertake to serve important housing needs that may not represent the volume look to for their normal book of business. We suggest that this provision enable the regulator from time to time to add to this list.

Recommendations for additional refinements to these provisions:

First, based on my reading, the bill excludes single family rental housing from future goals' calculations. Since single family rental housing represents a rich source of housing for lower income families we suggest it remain as part of the single family housing goals.

Second, the method for calculating annual housing targets may work to understate market size in rural areas. Home Mortgage Disclosure Act data would be used to make the initial determination on market size based on a three year rolling average. However, while HMDA represents a reasonably accurate measure for sizing metropolitan area markets, it tends to be less useful for rural areas. Permitting the use supplemental data for determining rural housing market size would help to correct for this problem.

Third, we have concerns about the deletion of "ability to lead the market" as a factor for determining annual goal levels. This factor recognizes that Fannie Mae and Freddie Mac through their activities are have great capacity to expand market size not just seek to match it. In fact, has proven quite useful to establish stretch goals that seek to increase mortgage activity for underserved markets.

Finally, much has changed in mortgage lending since the affordable housing goals were first mandated. Today's problems often have more to do with the quality of mortgage credit provided to consumers rather than credit access problems that once were all too prevalent. HUD regulations at present permit the department to make a

determination through rulemaking to disallow goals credit for the purchases of mortgage loans with features deemed to be “contrary to good lending practices.” A number of practices already identified are based on corporate policies adopted by Fannie Mae and Freddie Mac. Indeed, both Enterprises have gone further than these rules with their own corporate practices. Several years ago they decided to discontinue the purchase of mortgages with mandatory arbitration clauses and to also limit prepayment penalties. These steps have helped reduce the use of these often predatory practices by lenders.

Freddie Mac’s recent announcement that it would stop buying or otherwise invest in certain subprime hybrid adjustable rate mortgages is yet another example. Presently, HUD can take similar steps to prevent these mortgages from being counted for goals qualifying purposes.<sup>6</sup> Accordingly, we think it useful for the new regulator to be specifically directed through the legislation to continue to use this authority.<sup>7</sup>

- *Establishment of an Affordable Housing Fund (Sec. 128)*

We strongly support the establishment of an Affordable Housing Fund as part of any GSE legislation. Such a fund would provide an estimated \$500 million a year to support a host of very need activities, many of which are not supporting through the mortgage purchase activities of the Enterprises. The bill would require that funds from the two Enterprises be earmarked through contributions and would be tightly targeted to serve the needs of very low income and extremely low income households primarily through bricks and mortar rental housing production and rehabilitation.

- *Annual Housing Report Regarding Regulated Entities (Sec. 124)*

Detailed annual reporting by the regulators on affordable housing activity would help to address the long-standing “information vacuum” that seems to surround GSE affordable housing activities. Thus we favor this requirement, but suggest an addition: that subsection (7) also require annual reporting on any activities undertaken by the regulator with regard to ensuring that the Enterprises underwriting and appraisal guidelines are consistent with the Fair Housing Act (see Sec. 1325 (6)).

Greater transparency also would help to improve the utility for users of the Public Use Data Base. The PUDB is intended to provide the public with information on the annual mortgage purchase activities of Fannie Mae and Freddie Mac. At a minimum, this data base should parallel the data elements reported by mortgage lenders under the Home Mortgage Disclosure Act. This is not now the case.

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<sup>6</sup> “Freddie Mac announces tougher subprime lending standards to help reduce the risk of future borrower default,” February 27, 2007.

<sup>7</sup> Mortgage Contrary to Good Lending Practices, 24 CFA Sec. 81.16.

- *Federal Home Loan Banks (Title II)*

We continue to believe that GSE legislation provides an opportunity to strengthen the affordable housing and community economic development financing requirements for the FHLBs. To the In particular, we favor the establishment of public use data base that discloses loan level data for each FHLBs' core business activities, affordable housing and community investment activities comparable to the data base that exists for the mortgage purchase activities for Fannie Mae and Freddie Mac.

We also favor the inclusion of a provision that would direct the new regulator to establish appropriate public purpose performance goals for the FHLBs' core advance and mortgage purchase activities. The current requirement that at least 40 percent of the board of directors' seats for each FHLB be comprised of Public Interest Director, including at least two specifically for Community Interest Directors should be retained.

Thank you again, Mr. Chairman for the opportunity to offer our views on this important subject. We look forward to working with you and other committee members as the bill progresses.



*Reason*

**House Committee on Financial Services  
United States Congress**

**“Legislative Proposals on GSE Reforms”**

**Testimony of**

**Michael Flynn  
Director of Government Affairs  
Reason Foundation**

**March 15, 2007**

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Chairman Frank, Ranking Member Bachus, and members of the Committee. Thank you for the opportunity to speak to you today. My name is Michael Flynn and I am Director of Government Affairs for the Reason Foundation. Reason is a non-profit, non-partisan think tank that, for almost four decades, has researched the consequences of government policy and worked to advance liberty and develop ways the market can be used to improve the quality of life for all Americans.

The legislation before you today is a massive undertaking. Over 300 pages long, it could have a significant impact on America's housing sector, as well as the aspirations of millions of families. At a time when segments of the housing market are showing wear and even vulnerability, I know you do not take the task before you lightly.

My remarks will concentrate on the Affordable Housing Fund that would be established by the legislation. Reason has published several studies on the issue of affordable housing, focusing especially on the housing market in California. As a matter of policy, we have significant concerns about this proposed new federal fund.

With housing prices at record highs in many parts of the country, it is understandable that you would be interested in examining ways to make housing more affordable. In many parts of the country, the unavailability of affordable housing is a serious concern. In California, where Reason is headquartered, the demand for housing outstrips the supply by 500,000 to 1 million units. In many parts of the state, the most commonly used 'index of affordability' is about half that in the nation as a whole. Nationally, about 50

to 60 percent of families earning the median income can afford a home in their community, but in many parts of California, only about 25 to 30 percent can.

Unfortunately, a new federal Affordable Housing Fund will not fix this situation. In the end, we believe it will fail. It will not fail because of a lack of resources, although there will be many who clamor for more funds. If the Fund were doubled or tripled—as many groups will request—it would still fail. It will fail because it doesn't address the fundamental problem: too few housing units are being built to meet the demand.

Simply put, this proposal fails three tests:

1. It ignores the real problem;
2. It creates a veneer of action, which will stymie more substantive efforts for meaningful reform; and,
3. It creates a host of unintended consequences, ranging from distortions in the housing market which may exacerbate the problem to wasting resources on activities that have nothing to do with improving the affordability of housing.

I will discuss these briefly.

In many parts of the country, there is a severe shortage of housing. This, combined with monetary policy that has effectively increased the demand for housing, has dramatically increased the cost of housing in many areas. While in recent years the nation has experienced a burst of homebuilding, new construction has not met the robust demand.

It is not for lack of capital. I do not need to tell the members that unprecedented resources have been devoted to construction over the last decade. These figures are well-known. It is also not due to any inherent economic flaw in the housing market, *per se*. There is nothing in the fundamental economics of housing that would skew building towards any particular segment of the market. Entire industries have sprung up catering to the demands of low and moderate income consumers in virtually every other sector of the economy. Housing would be no different, but for one factor: government policy.

No matter how much money from the federal treasury is devoted to housing, it will ultimately run into the chief architects of housing policy in this country, which are state and local governments.

It is no small irony that while this committee deliberates over measures to increase the stock of affordable housing, governmental bodies elsewhere are meeting to consider new growth limits or boundaries, increased impact fees, more stringent zoning requirements, prevailing wage laws, new environmental regulations, open space requirements, or building standards.

While some of these may seem individually reasonable, taken together, they have a cumulative effect that makes homes less affordable for more and more Americans. Moreover, these, as well as other land use restrictions have exploded over the last decade. Today, it is increasingly expensive, cumbersome, and time consuming to build a single-family dwelling. Researchers from the University of California at Berkeley found

that prevailing wage mandates on affordable housing projects alone drive up the cost of construction by anywhere from 9 to 37 percent. Reason Foundation's study of housing price trends in Washington State and Florida found that 20 to 25 percent of the housing price increases in these states could be attributed to their statewide growth management laws. In Florida, the impact was significant enough to reverse trends toward more housing affordability in urban counties.

Growth management and land-use restrictions artificially limit the supply of housing that can be built. These restrictions work in two ways. First, housing units are explicitly limited through large lot zoning, housing permit caps, or urban growth boundaries (or limit lines). Second, regulatory burdens increase the uncertainty of the permitting process and dramatically increase the upfront costs needed to apply for and receive approval. Reason Foundation studies have empirically investigated both these effects. The result of this higher level of regulation is to make building lower and middle-income housing, which already involves very tight profit margins, economically risky and less viable. In light of this, it is no surprise that builders often focus at the upper-end of the market. If you are pressured to build fewer units than you otherwise would, you will focus on higher margin products, to achieve the necessary return on capital.

This causes a ripple effect that is felt all the way down the housing ladder. Middle-income or young professional families who might otherwise move to larger, newer homes are priced out of that market. As a result, they seek out older, smaller homes and push these prices up beyond the means of low-income and blue-collar families.

A 2005 study by the Harvard Institute for Economic Research found that, over the last several decades, there have been a growing number of metro area housing markets in which housing prices have risen substantially higher relative to the costs of physical construction. The authors concluded that these changes do not appear to be the result of a dwindling supply of land; rather, they reflect the increasing difficulty of obtaining local regulatory approval for building new homes, making large-scale development increasingly difficult. This problem has been most acute in coastal regions like the Bay Area, Southern California, Seattle, and Boston, but it is increasingly spreading to interior regions like Austin, Denver, and Raleigh-Durham. In other words, regulation is artificially constraining the supply of housing, so we're left with higher prices and fewer new homes being built.

It is the total stock of housing that dictates the relative affordability of homes. There is a general misconception that affordable housing is lacking because no one is building it. But, affordable housing is not generally new housing. It is housing that is made available as families move into newer, more expensive housing. Any artificial falloff in new construction creates bottlenecks throughout the system.

Unless we deal with this bottleneck, which again is mostly the result of regulations and restrictions that limit growth and construction, we're simply applying a band-aid to a gaping chest wound. Special subsidies, loan guarantees, credits, or even blanket changes in the measure of affordability

can't alter this equation, as the recent meltdown in the sub-prime market shows.

Now, even the smallest band-aid will stop some bleeding. If the federal government decides to pump billions of dollars into affordable housing initiatives, no doubt some new units will be built. Some number of families will be lucky enough to benefit from this. But, a great opportunity will be lost. We will have lost the opportunity to review the range of regulations and restrictions that impact the housing market. State and local officials, content to see millions of dollars flowing into their community, will never consider the consequences of the restrictions they enact. The fundamental factors that artificially limit the supply of housing will remain in place; the crisis will simply be put off until another day.

Of course, a lot of that money will be wasted. First, there are state and local elected officials, who often treat new money from Washington as a lotto jackpot and view the stipulations for their use as suggestions. It may be redirected to uses only tangential to housing or it may simply replace resources that were being spent, resulting in fewer new resources than would be expected. Or, even if spent as directed, it may exacerbate distortions in the housing market that will further reduce the overall supply of affordable housing. Several Reason studies examining particular programs in California are cited at the end of my testimony.

Housing policy has often created distortions which can be gamed by many of the players. There are of course some developers and landlords who have manipulated the system. In many places, inclusionary zoning

restrictions, which mandate that a certain percentage of a development be set-aside for low-income groups, have sparked a cottage industry in the selling and buying of these set-asides. While lucrative for some, they fail to improve the lives of families searching for housing.

Moreover, statistical analyses of these programs by economists at San Jose State University found that cities that adopted inclusionary housing programs experienced dramatic declines in private market housing construction. The number of units created through these programs were minor compared to the measured need in these communities and could not come close to compensating for the lower level of housing construction in these communities. In Los Angeles and Orange Counties, for example, 17,296 fewer homes were produced in the eight cities with inclusionary zoning ordinances while just 770 “affordable” units were produced. Because housing supply was reduced but lower rate housing was subsidized through the private market, the effect of the inclusionary housing ordinances was to increase housing prices by \$33,000 to \$66,000 per unit.

I would be remiss if I didn't mention one particular organization that has carved itself a lucrative niche from housing programs. The Association of Community Organizations for Reform Now (ACORN) is a multi-national conglomerate that acts as the umbrella for more than 70 organizations. Among these are a number of state housing associations or corporations, as well as the ACORN Housing Corporation, which operates nationally. In the mid-1990s, the ACORN Housing Corporation received a \$1.1 million grant from the AmeriCorp program to train AmeriCorp workers to assist low-income families trying to purchase homes. According to evidence uncovered

by the program's Inspector General in 1994, these workers were directed to inform these families that they had to become dues-paying ACORN members in order to receive the assistance. Because they effectively were using the grant to increase the membership of ACORN, which engages in political advocacy, AmeriCorp terminated the grant.

This commingling of government grants between affiliated organizations and the ACORN political organization continues. According to tax records, between 1997 and 2003, ACORN Housing Corporation received more than \$11 million in government grants. Almost half, over \$5 million, was paid out to other ACORN entities as either fees, rent, or grants.

The examples of ACORN's misuse of government grants, especially housing grants, are too many to cover in this single hearing. I would be happy to provide the Committee with other instances, but suffice it to say that it stretches back for 30 years. In almost all cases, the misuse of funds has been tied to political advocacy. The prospect that such an organization – rather than low- and middle-income Americans—could benefit from a new infusion of federal housing resources is troubling.

Even if Congress were able to construct a Housing Fund in such a way that such waste and abuse were eliminated and it were certain that every single dollar went to affordable housing initiatives, it couldn't achieve its intended goal. There isn't a lack of resources to build housing; there is an overabundance of regulation limiting the construction of any housing. This causes a bottleneck that is felt through every segment of the housing market.

Thank you. I would be happy to take any questions you have.

**Selected policy studies on affordable housing published by Reason Foundation:**

Chris Fiscelli, *New Approaches to Affordable Housing*, April 2005, [http://www.reason.org/update20\\_affordablehousing.pdf](http://www.reason.org/update20_affordablehousing.pdf)

Benjamin Powell and Edward Stringham, *Do Affordable Housing Mandates Work? Evidence From Los Angeles County and Orange County*, June 2004, <http://www.reason.org/ps320.pdf>

Benjamin Powell and Edward Stringham, *Housing Supply and Affordability: Do Affordable Housing Mandates Work?*, April 2004, <http://www.reason.org/ps318.pdf>

Geoffrey Segal, William Fulton et al., *Smart Growth in Action II: Case Studies in Housing Development From Ventura County, California*, May 2003, <http://www.reason.org/ps311.pdf>

Samuel R. Staley and Leonard Gilroy, *Smart Growth and Housing Affordability: Evidence from Statewide Planning Laws*, December 2001, <http://www.reason.org/ps287.pdf>

William Fulton, Chris Williamson, Kathleen Mallory, and Jeff Jones, *Housing Capacity and Development in Ventura County, California*, January 2002, <http://www.reason.org/ps288.pdf>



**Testimony on the Federal Housing Finance Reform Act of 2007, H.R. 1427,**

**Submitted to the**

**House Committee on Financial Services**

**by Thomas Gleason, Executive Director, MassHousing,**

**on behalf of the National Council of State Housing Agencies**

**March 15, 2007**

Chairman Frank, Ranking Member Bachus, and members of the Committee, I am Tom Gleason, executive director of MassHousing and a member of the board of directors of the National Council of State Housing Agencies (NCSHA). I am also a co-chair of NCSHA's Fannie Mae Single-Family Product Development Group, which has worked with Fannie Mae over the last 18 months to develop and implement special Fannie Mae mortgage products to help HFAs reach more homebuyers.

Thank you for this opportunity to testify on behalf of NCSHA in support of the Federal Housing Finance Reform Act of 2007, legislation to strengthen the regulatory oversight of the housing GSEs, ensure their safety and soundness, and expand their role in providing affordable housing to America's lower-income families. NCSHA represents the Housing Finance Agencies (HFAs) of the 50 states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands.

State HFAs allocate the Low Income Housing Tax Credit (Housing Credit) and issue tax-exempt private activity bonds (Housing Bonds) to finance apartments for low-income renters and low-cost mortgages for lower-income first-time home buyers in nearly every state. They administer HOME Investment Partnerships (HOME) funding in 42 states to provide both homeownership and rental housing opportunities for low-income families. State HFAs operate the Housing Choice Voucher program in 21 states and administer Section 8 project-based contracts in 42 states.

State HFAs and the GSEs partner in a number of ways. The GSEs purchase Housing Credits and HFA-issued taxable and tax-exempt Housing Bonds. They also guarantee HFA bonds, securitize and purchase HFA-financed mortgages, and provide HFAs loan underwriting assistance.

The GSEs play an indispensable role in the nation's affordable housing delivery system. They supply critical liquidity and stability in the mortgage market.

NCSHA supports a regulatory system that allows the GSEs to continue to play this vital role. We caution the Committee against allowing the regulator to impose capital standards and portfolio restrictions that may cause the GSEs to curtail their affordable housing activities, unless such steps are necessary to ensure the GSEs' safety and soundness.

State HFAs have a large stake in the GSEs' ability to continue their affordable housing activities and a profound desire to expand them. While preserving the GSEs' safety and soundness is important, Congress should also preserve and strengthen Fannie Mae and Freddie Mac's affordable housing mission. Though their affordable housing contributions are significant, Fannie Mae and Freddie Mac can and should do more.

#### **Establish a GSE-Financed, State-Administered Affordable Housing Fund**

NCSHA strongly supports requiring Fannie Mae and Freddie Mac to commit significant resources annually to an affordable housing grant fund. The GSEs enjoy substantial financial benefits from their federal charters. In exchange, they have a responsibility to devote some of these benefits to increasing affordable housing opportunity. With unmet affordable housing needs so great, opportunities for increased federal appropriations so limited, and the GSEs' responsibility to support affordable housing so clear, a modest assessment on their resources in return for the advantages their federal charters convey is appropriate and timely.

#### **State HFA Administration**

NCSHA supports the bill's provision that the administration of the affordable housing grant fund be entrusted to the states. We recommend the Committee specifically designate state HFAs to administer the fund, as they are best positioned to make maximum use of these new resources for the many reasons described below.

State HFAs have a proven system and strong track record of effectively and fairly allocating housing resources. States are the only point where all federal and state housing resources—Housing Bonds, Housing Credits, HOME funds, vouchers, Federal Home Loan Bank advances, FHA insurance, and state-provided funds and credits—can be accessed in one place and brought to bear on housing needs. Through their existing distribution structures, state HFAs would use the new funds to leverage their existing resources, extend their reach, and serve as a one-stop shop for addressing housing needs.

State HFAs are in the best position to determine and allocate the grant funds to their most pressing housing needs, wherever they exist in each state, in amounts sufficient to make a difference. Housing needs in cities, suburbs, and rural areas do not often exist in isolation from one another. Moreover, housing needs, employment challenges, transportation burdens, health care availability, human services demands, and other neighborhood development requirements flood across city and county boundaries, sometimes across broad areas of a state. These interrelated needs cannot be addressed as fairly, effectively, or efficiently by a national entity or by a proliferation of individual subdivisions acting alone as by statewide planning and administration.

State HFAs have the ability to bring together state agencies and resources in ways the federal government and local communities cannot. For example, state HFAs have partnered with welfare agencies to use Temporary Assistance to Needy Families funds to provide housing assistance to families attempting to make the transition from welfare to work. They have teamed up with state health and human services agencies to obtain Medicaid waivers to cover the cost of services in HFA-financed assisted living. They work with state mental health agencies to provide quality housing linked to supportive services for people with mental illness and disabilities.

State HFAs also successfully partner with local governments, nonprofits, the private sector, resident and community groups, and service providers to address the diverse housing challenges they confront. Through comprehensive and coordinated state, regional, and local planning, state HFAs can assure that housing is developed where it is most needed and in sustainable communities with access to jobs, transportation, schools, health care, and other services. This is critically important because providing affordable housing today means much more than providing shelter. Families and those with special needs require services and proximity to economic opportunity to have the best possible chance to achieve self-sufficiency and a stake in their communities.

The funds potentially available for this grant program will be too scarce to be divided among more than the 50 states, if relative needs in all parts of each state are to be considered and prioritized adequately, and the funds marshaled to meet them. Dividing the grant funds into more than 50 parts would dilute those funds in many places to amounts too little to be effective or meaningful.

A single federal entity, alternatively, will not have the awareness of and perspective on all the various needs within each state to address them fairly. State HFAs are uniquely positioned. They are close to real local issues and housing needs, but have the perspective to bring a state and regional focus to problems that cannot be solved within individual municipal boundaries. States are in an unparalleled position to ensure that funding is applied where it is most needed and integrated with other public investments in our physical, economic, and human infrastructure.

Only state HFAs have the capacity in every state to administer sophisticated multifamily financing. State HFAs possess sophisticated finance, underwriting, and asset management skills, and a multi-decade record of responsibility, effectiveness, accountability, and success in administering tens of billions of dollars of housing assistance. They are investment grade rated.

State HFA administration will minimize oversight bureaucracy. The new regulator's oversight burden will grow as the number of grantees increases. The regulator will need a much larger staff to oversee programs spread among hundreds of states and municipalities than it will for programs concentrated among only 50 entities. In addition, the regulator will be able to use compliance reports and reviews from other HFA-administered programs to streamline monitoring of HFA affordable housing fund administration.

In Massachusetts, we would put these new, flexible affordable housing fund resources to immediate use with the Housing Credit, Bonds, HOME funds, and state housing trust

funding to produce more rental housing affordable to very low- and extremely low-income people, populations they struggle to serve on their own. We could produce many more outcomes like the 14-apartment mixed-use building we recently developed in Boston's South End for formerly homeless families enrolled in job training and the 396-apartment HOPE VI redevelopment project we recently completed in East Boston, recognized by *Affordable Housing Finance* magazine as the Number One Affordable Housing Development in the country in 2006.

#### Income Targeting

NCSHA supports the bill's requirement that funds be targeted to very low- and extremely low-income families. Of the 16 million families with severe housing problems, 80 percent are very low-income, and nearly 60 percent have extremely low incomes. According to recent data from the Census Bureau's American Community Survey, less than 50 housing units are affordable and available for every 100 extremely low-income families in need of affordable rental housing.

While states consistently use the Housing Credit, Bonds, and other resources to serve families earning considerably less than the programs' income limits allow, MassHousing and state HFAs across the country are finding it increasingly difficult to do so. There simply are not enough subsidies to combine with the Housing Credit and other housing production resources to meet the large and growing affordable housing need among very low- and extremely low-income families.

#### State Allocation Plans

NCSHA supports the flexibility the bill provides states to determine in consultation with the public and their housing partners how to best utilize the affordable housing grant funds to address their most pressing housing challenges. We endorse the allocation plan process for identifying and prioritizing housing needs and setting forth application requirements and selection criteria. This process has worked effectively in the Housing Credit program, bringing a high degree of program transparency and flexibility to respond to changing housing needs, market conditions, and policy goals.

#### Eligible Activities

NCSHA appreciates the bill's broadly defined eligible activities. We recommend the bill provide state HFAs additional flexibility to fund project-based rental assistance, operating subsidies, and project reserves.

Capital subsidies alone often are not enough to make rental housing affordable to very low- and extremely low-income families. Even if those subsidies are sufficient to cover a property's development cost, the rent necessary to pay operating costs is often still more than very low- and extremely low-income households can afford.

Vouchers sometimes help cover these operating costs. However, the voucher program is already hopelessly oversubscribed, and Congress has not funded any new vouchers since 2002. State HFAs and other Public Housing Authorities struggle to renew existing vouchers and are

hard pressed to make scarce vouchers available to support new production. That is why NCSHA called for a new state-administered project-based rental assistance program in our recent voucher reform testimony before this Committee's Housing Subcommittee.

We recognize that allowing states to use the new affordable housing grant fund to support properties' operating costs could sap its production strength. Given the limited size of the new fund and the desire to ensure it produce as many new units as possible, NCSHA again urges the Committee to allocate new project-based rental assistance to state HFAs to combine with affordable housing fund grants and the other production resources. At a minimum, however, we urge the Committee to make project-based rental and operating assistance eligible fund activities.

#### Fund Contribution Suspension

NCSHA understands the regulator may need to suspend GSE payments to the fund when those payments threaten the GSEs' financial stability. The GSEs' safety and soundness must come first. We encourage the Committee, however, to authorize the regulator to reduce rather than suspend payments if the GSEs' financial condition can support partial payments. In addition, we recommend the regulator be authorized to recover lost contributions in future years, if the GSEs' financial recovery makes that possible.

### **Strengthen the GSE Affordable Housing Goals**

#### Income Targeting and Enforcement

NCSHA believes the GSEs should be required to meet strong and aggressive affordable housing goals. We support the bill's deeper income targeting requirements for the single-family low-income, low-income area, and very low-income goals. We also endorse the bill's establishment of a statutory multifamily special affordable housing goal with subgoals for very low-income families, low-income families, and mortgages on Housing Credit properties. These more focused goals will help direct more housing help to those who need it most.

We also support the bill's establishment of a GSE "duty to serve" underserved markets and specifically manufactured housing, preservation, and rural area markets. We also agree with the authority the bill provides the regulator to establish additional requirements for small and rural mortgage purchases.

NCSHA supports extending the regulator's enforcement authority to subgoals, as the bill provides. Enforcement authority is necessary to make sure the goals are realized in GSE action and to provide for proper oversight and accountability.

#### Housing Credit and Bond Investments

NCSHA urges the Committee to encourage continued and expanded GSE investment in Housing Credits and Bonds by awarding the GSEs goal credit for such purchases. The GSEs' active role in these markets has driven up Credit and Bond pricing, ultimately lowering housing costs for renters and homebuyers. Giving the GSEs a nonfinancial incentive to invest in Credits and Bonds will help sustain and potentially increase their appetite for these investments.

We thank the Chairman for including the bill provision awarding multifamily special affordable housing goal credit to the GSEs for purchasing HFA-issued non-investment grade multifamily bonds and guaranteeing HFA-issued multifamily bonds. We recommend the Committee expand this provision to give the GSEs credit for their purchases and guarantees of any HFA-issued bonds that finance properties otherwise meeting any of the multifamily housing goals. We further suggest the Committee give the GSEs credit for purchases and guarantees of any HFA-issued bonds that finance single-family mortgages that otherwise meet any of the single-family housing goals.

#### **Increase the GSE Conforming Loan Limit in High-Cost Areas**

NCSHA supports adjusting the GSEs' conforming loan limit to increase homebuyer access to GSE financing cost advantages in high-cost areas. In some areas of the country, including some areas of Massachusetts, the GSE conforming loan limit prevents Fannie Mae and Freddie Mac from purchasing some mortgage loans because it is less than the median home price.

Allowing the GSE conforming loan limit to rise to the local median home price or 150 percent of the current conforming loan limit, whichever is lower, will help many families in high-cost areas across the country achieve the American dream of homeownership. In Massachusetts, the bill's new limits would benefit approximately 17 percent of our cities and towns.

#### **Allow Fannie Mae and Freddie Mac to Develop and Launch New Products Expeditiously**

NCSHA supports giving the GSEs as much flexibility as possible to develop and launch new affordable housing products. The GSEs' product innovation and technological breakthroughs contribute significantly to their success in meeting their affordable housing mission. The GSEs' ability to offer new products quickly to address urgent or temporary market inefficiencies and financing gaps is vital.

We are concerned the bill's product approval requirements may be more cumbersome than necessary to preserve the regulator's ability to ensure the GSEs' safety and soundness and charter fidelity. We fear the formal public notice and regulator review periods for new products may stifle innovation.

We are also concerned the regulator's authority to determine that any new activity, service, undertaking, or offering consists of, relates to, or involves a product—and thereby necessitates the new product approval process—is so broad that the GSEs will be unable to respond quickly to market changes and invites micromanagement.

**Testimony of**

**Gerald M. Howard**

**On Behalf Of the  
National Association of Home Builders**

**Before the  
United States House of Representatives  
Financial Services Committee**

**Legislative Proposals on GSE Reform**

**March 15, 2007**

**Introduction**

Chairman Frank, Ranking Member Bachus and members of the Committee, my name is Jerry Howard and I am the Executive Vice President and Chief Executive Officer of the National Association of Home Builders (NAHB). The 235,000 members of NAHB appreciate the opportunity to present their views to the House Financial Services Committee on legislation to overhaul the regulatory oversight of the housing Government Sponsored Enterprises (GSEs) – Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBanks). The GSEs are critical components of the nation's housing finance system and are largely responsible for the efficiency and resiliency of that system, as reflected in the tremendous advances recorded in the availability and affordability of mortgage products for home buyers and providers of rental housing. The success and value of our housing finance system has been clearly evident in recent years from both a human perspective, as demonstrated by the record homeownership rate, and from an economic perspective, with the housing sector serving as an important engine of growth.

One of the reasons the GSE regulatory reform initiative is so challenging is because of the uniqueness of the U.S. housing finance system. This extremely efficient and liquid system is a blend of public and private components. The linchpin is a sophisticated secondary market that facilitates the flow of credit to housing from investors in the domestic and international capital markets. The system has evolved to provide a reliable supply of housing credit at relatively low and affordable mortgage interest rates from coast-to-coast, and during rising and falling economic cycles.

The U.S. housing finance system's public-private partnership framework is particularly prominent in the secondary mortgage market arena. At the core of the secondary market are the GSEs. Fannie Mae, Freddie Mac and the Federal Home Loan Banks are private entities, each with a public mission to provide liquidity to the housing finance system and lower housing borrowing costs. Studies show that the GSEs lower mortgage rates by as least 25 basis points, and NAHB estimates that this results in increased homeownership opportunities for approximately 1.2 million households.

To be sure, accounting scandals and corporate governance shortcomings present a disturbing picture to those who placed their trust in these entities to serve an important public purpose. NAHB agrees that the current GSE regulatory system would benefit from renovation and enhanced supervisory powers. To that end, NAHB appreciates your commitment to enacting legislation to improve the regulatory framework for the housing GSEs. NAHB supports the establishment of a regulator that can ensure that Fannie Mae, Freddie Mac and the Federal Home Loan Banks operate in a safe and sound manner and effectively pursue their housing mission. NAHB believes that the housing GSEs are essential components of the nation's housing finance system and our foremost interest is that change in the regulatory regime should not, in any way, diminish the benefits that these entities provide to home buyers and renters.

NAHB believes that the GSE bill passed in October 2005 by the House was a good start toward achieving this objective. We also commend the efforts undertaken in the closing days of the 109<sup>th</sup> Congress to reach compromise on issues that have been obstacles to further legislative

progress. That work seems to have provided traction for this year's deliberations. With the recent introduction of H.R. 1427, the "Federal Housing Finance Reform Act of 2007," NAHB is pleased to see a continuation of the ongoing bipartisan movement towards comprehensive GSE regulatory reform legislation.

Although there is a myriad array of factors and ingredients to consider in the reform debate, NAHB believes the optimal approach to GSE reform incorporates four guiding principles: First, the advantages inuring to the GSEs through the public/private partnership of the housing finance system should be retained. Second, reform measures should reinforce the obligation of the GSEs to channel those advantages to the nation's home buyers and renters. Third, the most efficient and demonstrable method of accomplishing this objective is through enhanced safety and soundness regulation and stronger GSE affordable housing requirements. Fourth, there must be a balance between safety and soundness oversight and mission regulation so as not to impede the GSEs' housing mission.

NAHB's views on the current GSE regulatory reform discussions can be effectively distilled down to six key components: (1) regulatory structure; (2) capital requirements; (3) portfolio limits; (4) program oversight; (5) conforming loan limits; and, (6) affordable housing requirements. The remainder of NAHB's statement addresses these components.

#### **Regulatory Structure**

An overriding issue in the GSE regulatory reform discussion is achieving the appropriate balance between safety and soundness and mission oversight in the structure and governance regime of the regulator. It is a priority for NAHB that Congress establishes a strong system for regulating the safety and soundness of the GSEs without displacing the focus on the housing mission of the GSEs.

Currently, the Department of Housing and Urban Development (HUD) oversees the mission of Fannie Mae and Freddie Mac, including approving new programs and establishing and enforcing affordable housing goals (annual mortgage purchase targets that Fannie Mae and Freddie Mac must reach). The Office of Federal Housing Enterprise Oversight (OFHEO), an independent agency within HUD, oversees the financial safety and soundness of Fannie Mae and Freddie Mac. For the FHLBanks, another independent agency, the Federal Housing Finance Board (FHFB) regulates both mission and financial safety and soundness.

Several questions have been raised as to how to better configure this oversight system. One area of inquiry with bearing on the mission/safety and soundness balance is the location and independence of the GSE regulator. NAHB believes the regulator should be an independent entity outside the control of any cabinet department or regulatory agency. The agency must have independence or autonomy in pursuing its regulatory duties. Thus, NAHB supports the provisions in H.R. 1427 that would establish a stand-alone regulator outside any other cabinet or government unit. Further, NAHB supports granting the regulator the authority over Fannie Mae, Freddie Mac and the FHLBanks.

Perhaps the greatest concern for NAHB in this area is the governance of a new GSE regulatory agency. H.R. 1427 would place control of the new regulator in the hands of a single director and would create an advisory board which would not have executive powers. The Board would be comprised of the Treasury and HUD Secretaries and the Director of the Federal Housing Finance Agency (FHFA), who would serve as Chairperson. Of significant concern, H.R. 1427 eliminates the provisions in the 2005 House bill that would have included two independent members on the advisory board. The independent members in the 2005 bill were required to have expertise in housing finance and capital markets activities and issues. NAHB opposes the limited board approach taken in H.R. 1427 because it removes the additional housing mission emphasis and capital markets perspective that the independent board members would convey. In addition, a regulator headed by a single individual and advised by a small board could be subject to political influence and might not exercise independent judgment. Also, such a structure would open the door for the regulator to take actions of tremendous importance without adequate accountability for such actions.

Ideally, NAHB believes the new regulator should be governed by a board modeled on the Federal Deposit Insurance Corporation (FDIC), where the board seats are divided between government representatives and private individuals with appropriate regulatory expertise. In the case of the GSE regulator, the board would be made up of the Secretaries of HUD and Treasury and three private individuals, one of whom would serve as the board chair. The goal is to infuse additional expertise in and concern for housing and housing finance through the appointment of individuals with such credentials. NAHB also would support the advisory board structure in the 2005 bill as an acceptable compromise solution.

As an additional counterbalance between mission and safety and soundness regulatory objectives, NAHB supports the creation of deputy director positions to oversee the various regulatory elements. In this regard, NAHB supports the three separate regulatory divisions provided for in H.R. 1427, including: oversight of safety and soundness for Fannie Mae and Freddie Mac, FHLBank regulatory oversight, and housing mission for all of the GSEs. NAHB encourages the Committee to ensure that the FHLBank mission and safety and soundness oversight reflects the unique mission, operating structure and charters of the FHLB System.

#### **Capital Requirements**

Capital requirements for financial institutions establish the level of reserves that these organizations must maintain to protect against their exposure to various types of risks, including credit risk of loans and guarantees, interest rate risk of the balance sheet, and management and other operational risk. Capital requirements also limit the degree to which financial institutions can leverage their sources of funds in pursuing business opportunities. Generally, financial institutions are held to two separate capital standards: a risk-based requirement that is driven by the composition of an institution's loan and investment portfolio and other operating characteristics, and a minimum capital requirement that ensures some capital cushion regardless of the outcome of the risk-based standard. This is the case for Fannie Mae, Freddie Mac and the FHLBanks, where risk-based and minimum capital requirements are established by law.

The Committee should be mindful that changes in the GSEs' capital requirements have a direct impact on the availability and cost of mortgages in the housing finance system. Higher capital requirements limit GSE activity, reduce the range of GSE products and programs (impairing the ability to serve low- and moderate-income borrowers) and increase the cost of mortgage borrowing. Capital requirements that exceed those dictated by the risk of GSE activities and operations unnecessarily reduce the flow of capital to the housing finance system and add unnecessarily to the cost of those funds. The result would be a significant setback to current efforts to expand affordable homeownership and rental housing opportunities.

There is fairly widespread agreement that the new GSE regulator must have much greater authority to adjust capital requirements than the current regulators possess. Concepts and systems for determining risk-based capital requirements have evolved significantly since statutory requirements for Fannie Mae and Freddie Mac were established and it is argued that the current specificity of the statute in this area makes it difficult, if not impossible, for the regulator to adopt and maintain a state-of-the-art risk-based capital framework. The most debated policy questions, however, appear to be whether the minimum capital requirements should remain unchanged in statute and what degree of authority should be granted the new regulator to adjust the minimum requirements.

NAHB agrees with the approach taken in H.R. 1427, which would give the GSE regulator full authority to establish and adjust the risk-based capital system as the state of the art evolves. NAHB supports the removal of the current statutory criteria governing risk-based capital requirements for Fannie Mae and Freddie Mac to allow the new regulator full freedom to establish and adjust such standards through regulation. Comparable authority should be granted to the regulator with regard to the risk-based capital requirements of the FHLBanks.

Minimum capital requirements are intended to function as a backstop to risk-based systems and NAHB believes the minimum standard for the GSEs should continue to serve that purpose. NAHB does not support the imposition of bank minimum capital requirements on the GSEs, since the portfolios of the GSEs contain primarily residential mortgage-related assets that, historically, have proven to be low-risk. Indeed, the chart attached to the end of this statement shows that residential mortgages have the lowest charge-off rates compared to other assets held by financial institutions. NAHB also believes that the GSE capital requirements should address only risks that are internal to the GSEs, not external risks such as systemic risk in the financial sector.

NAHB supports maintaining the current statutory minimum capital requirements as is done in H.R. 1427. Further, we support authority for the GSE regulator to adjust minimum capital requirements, as long as such adjustments are justified by changes in actual or perceived risk to a GSE and do not unnecessarily impair the GSEs' ability to achieve their mission. In that regard, NAHB appreciates that H.R. 1427 establishes criteria for temporary increases in minimum capital that are exclusively focused on safety and soundness of the GSEs. NAHB also appreciates that H.R. 1427 accommodates concerns about the possible impact of capital provisions on mission by providing for a process where temporary capital increases would be regularly reviewed and returned to the statutory level once the "triggering" issue or issues are resolved. The bill states that temporary increases in capital "shall not remain in place for a period

of more than 6 months unless the Director makes a renewed determination of the existence of an unsafe and unsound condition.”

NAHB supports the fundamental principle that adjustments to minimum capital requirements must be temporary and that the regulator should deal with longer-term risks through the risk-based system. In addition, all changes to GSE capital – risk-based and minimum – should be undertaken through proposed regulation that provides public notice and comment, except in emergency situations, where increases could be instituted and then reevaluated in a subsequent review and comment protocol.

### **Portfolio Limits**

Proposals to arbitrarily limit or reduce the portfolios of Fannie Mae and Freddie Mac are misguided and would have significant adverse effects on the housing finance system. Both Fannie Mae and Freddie Mac hold sizeable portfolios of mortgages and mortgage-backed securities, which play an important role in stabilizing the supply and reducing the cost of housing credit.

First, the portfolios support the provision of mortgage credit through instruments, such as multifamily mortgages and various homeownership loans designed for lower-income borrowers that are not attractive to secondary market investors and, therefore, cannot be packaged and sold in mortgage-backed securities. Such products are expanding as more focus and requirements are placed on the GSEs to address the housing finance needs of more difficult to reach segments of the population.

Second, the GSE portfolios have served as an important shock absorber for housing borrowers in times of economic crisis. This is evidenced by the relative stability in mortgage availability and interest rates as other sectors of the financial markets were experiencing severe volatility in credit availability and cost during the 1998 international debt crisis and again following the 9/11 terrorist attacks in 2001. Most recently, the portfolios of Fannie Mae and Freddie Mac allowed them to play a major role in efforts to rebuild housing and other pressing housing finance needs in the Gulf Coast areas that suffered hurricane devastation in 2005. Fannie Mae and Freddie Mac stepped up their portfolio purchases to stabilize the mortgage markets in all of these periods and mortgage credit remained available at affordable rates.

Third, the added demand from Fannie Mae’s and Freddie Mac’s portfolio purchases helps to lower yields on mortgage-backed securities which flow through to lower rates on the underlying mortgages. Some have argued that removing Fannie Mae and Freddie Mac as buyers in this market would have no impact on mortgage borrowing costs. NAHB believes that such a position ignores the basic economic principle of supply and demand. Cutting GSE portfolio holdings by more than a trillion dollars, as some have proposed, would certainly have a major adverse impact on mortgage rates, even if the reduction were phased in over a number of years.

Finally, GSE portfolio operations have facilitated an expansion of investors in the U.S. housing markets. Foreign investors are supplying increasing amounts of capital for residential mortgages in this country through purchases of GSE debt and currently account for a significant portion of

such holdings. Some foreign investors are reluctant to invest in mortgage-backed securities, primarily due to unfamiliarity with fixed-rate, long-term mortgage collateral and concern over prepayment risk on such loans. The GSEs have successfully negotiated this obstacle by purchasing and holding mortgage-backed securities through funding provided by sales of their debt to foreign investors. GSE portfolio restrictions, therefore, would constitute a major setback to successful efforts to broaden the sources of capital for the U.S. housing markets.

NAHB recognizes that Fannie Mae and Freddie Mac also are able to generate profits through their portfolio operations by virtue of the spread between their advantaged borrowing costs and market yields on mortgage-backed securities. NAHB shares the concern that has been expressed that such profits have been directed too extensively to GSE shareholders and executives. However, NAHB believes the best way to address this is not through restricting and shrinking GSE portfolios. Such actions would undercut the GSEs' ability to continue the pursuit of the valuable results outlined above. Instead, NAHB believes that the recommendations contained elsewhere in this statement to toughen GSE affordable housing requirements, including mandating annual Fannie Mae and Freddie Mac contributions to an Affordable Housing Fund, would succeed in more effectively directing GSEs' portfolio profits to mission purposes.

With regard to safety and soundness, the new regulator should hold each GSE accountable to have the strategies, systems, personnel and capital that are adequate to fully mitigate any risk to the Enterprises associated with the holding of mortgages and mortgage-backed securities as well as other portfolio investments. This would include the establishment of risk-based capital requirements to provide appropriate capital coverage for all portfolio-related activities. In addition, review of portfolio functions and operations should be an integral part of the regular safety and soundness examinations conducted by the regulator. Specific limits on the GSEs' portfolios therefore are overreaching and unnecessary in addressing their safety and soundness.

On that basis, NAHB supported the approach in the bill approved by the House in the 109<sup>th</sup> Congress, where the regulator would be granted authority to oversee the on-balance sheet and off-balance sheet assets and liabilities of each Enterprise and, based on such reviews, require an Enterprise to dispose of, or acquire, any asset or liability if the regulator determines that such action is consistent with the safe and sound operation of the Enterprise. The House-approved bill also directed the regulator, within a year, to submit a report to Congress that would include a description of Fannie Mae's and Freddie Mac's portfolio holdings; an analysis of the risk implications for the Enterprises of such holdings, and the effectiveness of risk management measures undertaken by the Enterprises to address such risks; an analysis of portfolio holdings for safety and soundness purposes; an assessment of whether portfolio holdings fulfill the Enterprises' mission purposes; and, an analysis of the potential systemic risk implications of the portfolio holdings for the Enterprises, the housing and capital markets, and the financial system as well as whether such holdings should be limited or reduced over time.

In contrast, H.R. 1427 requires the regulator to issue regulations, within 180 days, that establish standards for evaluating whether the portfolio holdings of Fannie Mae and Freddie Mac, or rate of growth of those portfolio holdings, are consistent with the mission and the safe and sound operations of the Enterprises. The bill sets forth a list of factors that the regulator must consider in developing these standards:

1. The size or growth of the mortgage market;
2. The need for the portfolio in maintaining liquidity or stability of the secondary mortgage market;
3. The need for an inventory of mortgages in connection with securitizations;
4. The need for the portfolio to directly support the affordable housing mission of the Enterprises;
5. The liquidity needs of the Enterprises;
6. Any potential risks posed by the nature of the portfolio holdings; and
7. Any additional factors the regulator determines to be appropriate.

As in the House bill passed in the 109<sup>th</sup> Congress, H.R. 1427 grants the new regulator authority to oversee Fannie Mae's and Freddie Mac's portfolios and to require the disposition, or acquisition, of assets. In a positive addition, as advocated by NAHB, H.R. 1427 grants the regulator the leeway to make temporary adjustments to the established portfolio standards to allow the Enterprises to support the mortgage and housing markets during times of economic distress or market disruption.

NAHB appreciates that the provisions in H.R. 1427 contain no specific limits or criteria mandating huge reductions in the GSEs' portfolios. The provisions also do not directly reference the term "systemic risk," which has been a rallying cry for those advocating major shrinkage in the Enterprises' portfolios. Nevertheless, the vagueness of the last two criteria on the list of factors to be considered by the regulator in issuing portfolio regulations has led NAHB's members to express concerns that such language could be subject to overly broad interpretation and could be employed to unnecessarily constrain the portfolio activities of Fannie Mae and Freddie Mac to the detriment of mortgage market stability and the Enterprises' pursuit of their housing mission. These concerns were heightened significantly by recent remarks by Federal Reserve Chairman Ben Bernanke, where he advocated requiring Fannie Mae and Freddie Mac to focus their portfolios almost exclusively on holdings of mortgages or mortgage-backed securities that support affordable housing. The Wall Street Journal reported that, "if implemented, Mr. Bernanke's suggestion would entail drastic reductions in the companies' portfolios."

NAHB would like to see revision of H.R. 1427's portfolio criteria language to prevent such an outcome.

#### **Program Approval**

An important part of the mission oversight responsibilities of a GSE regulator is the review of activities to ensure conformance with a GSE's charter and public purpose. In addition to providing liquidity and lowering borrowing costs in the housing finance system, the housing-related GSEs support innovation in mortgage products and programs as well as technological improvements that address housing needs. In considering a new GSE regulatory regime, a key challenge involves developing a program review and approval process that is sufficiently rigorous to ensure charter compliance, support for achievement of affordable housing goals, and safety and soundness while facilitating the GSEs' ability to continue to engage in program, product and technological innovation to address market needs in a timely manner.

NAHB supports a program approval process for the Enterprises which ensures that they are operating within their charters and undertaking activities in a safe and sound manner. The program approval process should also accommodate innovation and prompt responses to market needs. To accomplish that, program oversight should focus on broad categories of programs and should not involve micromanagement of individual activities within an approved program area.

Prior approval should only be required for new “programs” that represent broad areas of “products” and/or “activities” that are significantly different from those previously undertaken. New activities under previously approved programs should not require prior approval. However, the regulator should be notified in advance before a new activity under an approved program is undertaken. Review of previously approved programs and activities should occur only as a part of safety and soundness supervision. The regulator should be granted a reasonable, but limited period of time for review of new programs submitted for prior approval.

The key criteria in the program approval process should be whether a program is permitted under a GSE’s charter and needed to facilitate achievement of mission, including affordable housing goals. Safety and soundness of new activities should be a factor only if it is determined that the nature or scope of the activity cannot be adequately addressed through risk-based capital requirements and that the proposed activity poses a significant threat to the financial health of the GSE.

NAHB is concerned that the product approval provisions in H.R. 1427 could open the door to unneeded interference with the development of products and activities that are within the GSEs’ charters. Further, the approval standards called for in H.R. 1427 – particularly the impact on the mortgage finance system – goes beyond safety and soundness and housing mission principles. The net effect of this burdensome process will be to slow or impede the Enterprises’ ability to respond to changing market needs. NAHB supports the program approval approach in the 2005 House bill, which retained the current law definition of new program and did not require a market impact test.

NAHB is pleased, however, that H.R. 1427 excludes from the definition of product existing automated underwriting systems and modifications to mortgage terms and conditions or underwriting criteria for mortgages purchased by the Enterprises. NAHB also applauds the decision not to include language establishing a “bright line” boundary between primary and secondary market activities in H.R. 1427. Bright line language, such as that contained in legislative proposals introduced in the 109<sup>th</sup> Congress, would be disruptive to the operation of the secondary market, stifle innovation and lead to higher mortgage costs. The Enterprises’ charters already clearly define their mission and functions. It is redundant to require regulations to define the primary and secondary mortgage markets as provided for in the 2005 House-passed bill. NAHB is pleased that the provision was dropped in H.R. 1427.

#### **Conforming Loan Limits**

By their charters, Fannie Mae and Freddie Mac are restricted to purchasing mortgages with loan amounts at or below their statutory loan purchase limit, referred to as the “conforming” loan

limit. The conforming loan limit is increased annually on the basis of the annual percent change in the average home price index computed by the Federal Housing Finance Board (FHFB). The loan limit ceiling is 50 percent higher in Alaska, Hawaii, Guam and the U.S. Virgin Islands to account for higher housing costs in these areas.

Loans with initial balances equal to or less than the conforming loan limit typically carry interest rates of 25 or more basis points less than non-conforming loans. A 25 basis point difference might not appear at first to be significant, however, NAHB estimates that almost 1.2 million U.S. households would be priced out of the housing market if mortgage interest rates increased from 5.75 percent to 6.00 percent!

NAHB supports the current statute, which only allows for percentage increases in the conforming loan limit that correspond to increases in the underlying index. NAHB opposes provisions contained in H.R. 1427 that would permit the conforming loan limit to decrease in proportion to a year-to-year decline in the Federal Housing Finance Agency home price index. A mechanism such as the one proposed would disrupt mortgage markets and, considering the length of the mortgage process, would be a source of apprehension among borrowers. The conforming loan limit has been held at the previous year's level in those years when the index has declined and these decreases have been netted out of increases in subsequent years. This system has worked well and has provided stability in times when the home price index has increased, as well as when it has decreased.

The current statutory system, however, inhibits origination of conforming loans in states where average home prices exceed the conforming loan limit. Thus, borrowers in these states cannot benefit from lower rates on conforming loans. To rectify this situation, NAHB supports the high-cost area provisions in H.R. 1427 that would allow the conforming loan limit in high cost areas to be equal to the median home price up to 150 percent of the national loan limit. This provision recognizes that special consideration should be given to mortgage borrowers who live in areas that have relatively high house prices.

However, NAHB cautions that the high cost area provision should be based on statewide median home prices. Applying the high cost definition to areas smaller than states could have the unintended consequence of giving states not typically considered high cost areas a benefit only truly needed in more limited geographies.

NAHB also has reservations about restricting the conforming loan limit for high cost areas to mortgages which are securitized and sold. Ultimately, borrowers are unaware of the workings of the secondary market for mortgage loans. These borrowers should not be affected differently if a loan is targeted to be held in a GSE's portfolio or if a loan will be used as collateral for a mortgage-related security.

#### **Affordable Housing Requirements**

NAHB believes the housing GSEs can and should do more to accomplish their affordable housing mission. The affordable housing requirements for Fannie Mae, Freddie Mac and the FHLBanks should be strengthened to ensure a more effective and targeted transfer of GSE

benefits to the housing marketplace. Such changes, however, should not be undertaken in a manner that impairs the GSEs' ability to achieve their mission of providing liquidity to the mortgage markets.

Presently, Fannie Mae and Freddie Mac are required by law to meet annual housing goals established by the Department of Housing and Urban Development (HUD). The housing goals track Fannie Mae's and Freddie Mac's purchases of mortgages for low- and moderate-income people (the low/mod goal); loans in underserved geographically targeted areas (the underserved areas goal); and, mortgages for very-low income people and neighborhoods (the special affordable goal). Each of the 12 FHLBanks is required by law to contribute at least 10 percent of its annual net earnings to an Affordable Housing Program (AHP). The AHP subsidizes the cost of housing for very-low-income and low- or moderate-income owner-occupied and rental housing. The subsidy may be in the form of a grant ("direct subsidy") or a below-market interest rate on an advance (loan) from the FHLBank to a member lender.

#### Affordable Housing Goals for Fannie Mae and Freddie Mac

NAHB supports the proposed revisions to the affordable housing goals for Fannie Mae and Freddie Mac outlined in Section 125 of H.R. 1427. The proposed language is a significant improvement over current housing goals regulation and adopts several of NAHB's previous recommendations.

#### *Single-Family Housing Goals*

Housing goals levels should continue to be established through regulations that incorporate general statutory criteria. NAHB supports the use of HMDA data as a benchmark for setting the single-family housing goals. We also are pleased that the Committee has eliminated "ability of the Enterprises to lead the industry" as a factor in establishing higher goals than those based solely on HMDA.

In addition, NAHB supports the tighter income definitions in H.R. 1427. Lowering the percent of area median income thresholds used in the definitions of low-income, very low-income and low-income areas, as well as establishing an extremely low-income definition will focus the Enterprises more directly on lower-income populations. NAHB believes that more narrowly tailored income definitions will result in more concentrated efforts by the GSEs and expand affordable homeownership and rental housing opportunities to people and areas most in need.

Further, we support the decision to focus the single-family goals on purchase money mortgages, excluding refinance mortgages from the goals calculations. The volatility of refinancing activity has a significant impact on the ability of the Enterprises to meet the housing goals without disrupting the secondary market. Refinancing volume is driven by interest rate fluctuations, not by enterprise outreach activities. Removing single-family refinance transactions from the goals calculations will eliminate these negative effects and will focus Fannie Mae's and Freddie Mac's activities directly on supporting affordable housing home purchase transactions. For these same reasons, we question the need for a refinance subgoal under the low-income single-family housing goal. The volatility of interest rates and refinancing activity will make it difficult to

establish an annual target *a priori* and could dilute the Enterprise's focus on purchase money mortgages.

*Multifamily Special Affordable Housing Goal*

NAHB supports the proposed definition of the multifamily special affordable housing goal in H.R. 1427. In particular, we support the expansion of the current statutory definition to include dwelling units assisted by the low-income housing tax credit as well as credit for units financed by Housing Finance Agency (HFA) bonds. These provisions address serious shortcomings in the present housing goal statute which does not permit such investments to be counted as goals-qualifying activities. These instruments finance much of the newly built multifamily rental housing that is affordable to households with low- and moderate-incomes. Thus, the Enterprises should get goals credit for purchases of mortgages on properties that were financed with these instruments.

Further, NAHB strongly supports the additional requirements for smaller projects, particularly for projects of 5 to 50 units. These units are key sources of affordable housing for large numbers of low- and moderate-income households, first-time homebuyers and minorities. NAHB has long supported improved financing mechanisms for small projects. Financing for small projects often is difficult to obtain and relatively expensive compared to financing costs for larger projects. Small project loans are generally made by portfolio lenders who hold the loans in portfolio. Given the importance of small projects in providing affordable housing, HUD provided bonus points for the GSEs' purchase of such loans in its 2001-2003 Housing Goals rule. The bonus points system worked as the GSEs doubled their purchases of small multifamily loans during this time. Unfortunately, HUD eliminated the bonus point system in the current housing goals rule and the GSEs' focus on smaller properties has waned. Establishing small projects requirements will re-focus the GSEs on this important source of affordable housing.

NAHB recommends that the additional small property requirements should be extended to include 2- to 4- unit owner-occupied and investor-owned rental properties. These properties were also included in HUD's bonus points system since these are also an important source of affordable housing, but have weak secondary market support.

*Duty to Serve Underserved Markets*

NAHB supports the provisions in H.R. 1427 that establish a duty for the Enterprises to serve underserved markets. Specifically, these provisions direct the Enterprises to develop products and engage in activities to reach the most difficult underserved housing markets, including manufactured housing, affordable housing preservation, rural and other underserved markets. NAHB notes that these provisions will encourage the Enterprises to expand beyond better-served markets, similar to the bonus point system under HUD's 2001-2003 housing goals rule. NAHB believes that the proposed underserved markets requirements will work in a similar way as a means to direct GSE purchases toward specific market segments. NAHB recommends, however, that the list of underserved markets should be expanded to include very low-, low- and moderate-income first-time and minority home buyers.

Affordable Housing Fund for Fannie Mae and Freddie Mac

As stated earlier, NAHB strongly supports the creation of an affordable housing fund established through annual contributions by Fannie Mae and Freddie Mac and modeled on the statutorily prescribed Affordable Housing Program (AHP) of the Federal Home Loan Bank System. Such a fund would, in combination with more challenging housing goals standards, raise the bar for Fannie Mae's and Freddie Mac's mission activities to more effectively channel benefits of their GSE charters to serve housing needs that are currently unmet. The goal of the fund is to support activities that cannot be undertaken as part of Fannie Mae's and Freddie Mac's traditional lending and investment business.

NAHB is pleased to see that H.R. 1427 establishes an Affordable Housing Fund (AHF). The focus of this fund is to increase affordable homeownership and rental opportunities for very-low and extremely-low income households, increase and preserve the supply of housing for such households and support infrastructure development in connection with housing. In addition, the AHF would seek to leverage investments from other sources to support development financed by AHF grants. NAHB supports this framework.

*Calculation of the GSEs' Contribution*

NAHB believes that the calculation of the GSEs' annual contribution to the AHF should provide a relatively stable flow of funds. H.R. 1427 provides that contribution amounts equal to 1.2 basis points on each Enterprise's total outstanding mortgages (including those held in portfolio and those backing securities) would be required each year. NAHB supports this provision, as it should result in less volatility in annual fund contributions than previous proposals for calculating the Enterprises' contributions.

*Administration of the Fund*

H.R. 1427 removes Fannie Mae and Freddie Mac from managing the AHF, which is a major change from the bill passed by the House in the 109<sup>th</sup> Congress. Rather, funds would be distributed to states in block grants based on a formula developed by HUD. The states would decide which of its agencies (e.g., the state housing finance agency, housing and community development entity, or tribally designated entity) should administer the program and allocate the grants. Each state is required to develop an allocation plan for the distribution of the grants, based on priority housing needs, in accordance with the regulations that are to be established for the program. In addition, the states are required to notify the public of the establishment of the plan and provide an opportunity for public comment.

NAHB's primary concern regarding the administration of the AHF is that the funds are distributed fairly. The allocation process for individual applications should ensure that funding goes to the projects providing the most and highest quality housing meeting the needs identified by the states. The allocation criteria should also ensure that only qualified, experienced sponsors are awarded funds. NAHB members report that under many current housing programs, state allocation criteria produce a bias in favor of nonprofits. Our members feel that the allocation criteria fail to consider whether sponsoring entities have sufficient experience to undertake and

sustain affordable housing development and management activities. NAHB believes that this bias, by excluding companies with strong experience and capacity in efficient housing production, undercuts the effectiveness and diminishes the results of these programs. Applications for funding should be judged on the merits of the housing to be produced, not on the tax paying status of the sponsoring company.

#### *Eligible Activities*

NAHB supports the proposed eligible activities as set forth in H.R. 1427. NAHB also supports the requirement that not less than 10 percent of a grantee's allocation be used for homeownership activities. Homeownership applications are often at a disadvantage in a competitive process because it is more difficult to serve households at the very lowest income levels through homeownership projects, and most such proposals consist of smaller numbers of units.

NAHB also supports the list of prohibited uses as provided in H.R. 1427. NAHB strongly believes that the funds should be used for direct housing production and preservation activities, rather than the administrative costs of grantees or other activities not directly related to the specific project.

#### *Eligible Recipients*

As mentioned above, NAHB strongly believes that the allocation process should not contain a bias against participation by for-profit companies. We strongly believe that companies with proven experience and capacity for carrying out housing development meeting stated needs should be considered the best candidates for the grants, regardless of their tax status. NAHB, therefore, appreciates the fact that H.R. 1427 includes for-profit, nonprofit and faith-based organizations as eligible recipients of AHF grants. NAHB also supports the bill's direction that recipients must demonstrate a capacity for carrying out the activities that are to be funded by the grant, as well as make assurances that they shall comply with all regulations and requirements of the program.

NAHB suggests that the language related to the qualities of the sponsor be strengthened to ensure that sponsors have a demonstrated successful track record of carrying out similar activities, as well as the capacity to undertake new activities. In addition, for rental projects, sponsors should have demonstrated success in the management of affordable housing properties. Strong management capabilities are critical to the success of affordable rental properties over the long-term.

#### *Accountability of Grantees and Recipients*

H.R. 1427 requires the grantees to provide annual reports to the Director describing the activities funded and the manner in which they complied with its allocation plan during the year. The Director is required to make these reports available to the public. H.R. 1427 establishes penalties to be imposed on grantees that fail to comply substantially with their allocation plan, including a reduction of the amount of assistance, repaying of any amounts determined to have been misused and limiting the availability of funding to the grantees.

To further ensure the most appropriate and effective use of program funds, NAHB continues to advocate for the creation of an Affordable Housing Advisory Council, which would assist the regulator in evaluating whether the purposes of the AHF are satisfied, as well as overseeing the competitive equity of the fund distribution process and the system for scoring fund applicants. The council members should include a cross-section of affordable housing industry professionals, including for-profits, nonprofits and government agencies. The creation of a council would increase the transparency of the grant-making process and provide the public with additional access to information about the AHF, its mission, activities and results.

#### Revisions to the FHLBank Affordable Housing Program

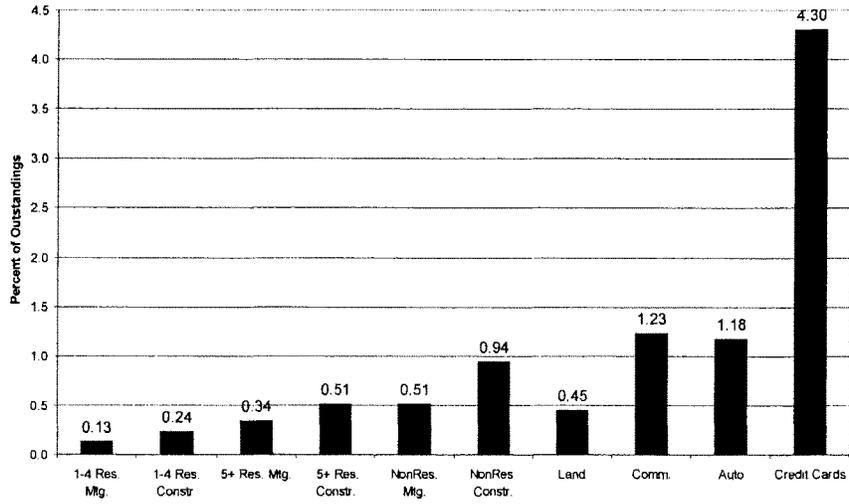
NAHB recommends revising the statute for the Federal Home Loan Bank Affordable Housing Program (AHP) in order to remove the current statutory priority for allocations to nonprofit sponsors in the competitive selection criteria. This part of the law has impeded participation by NAHB's members in the AHP and, as we have stated, the exclusion of capable and experienced for-profit housing producers needlessly works against the goal of providing housing most efficiently in areas where it is needed most.

#### Conclusion

NAHB appreciates the opportunity to share our views on the world-class regulation of Fannie Mae, Freddie Mac and the Federal Home Loan Banks, the housing GSEs. It goes without saying that the GSEs have been and continue to be critical components of the nation's housing finance system, a system without equal anywhere in the world and one that contributes so much to the national economy. These entities were chartered to uphold an important public purpose and must be held accountable for actions that violate that public purpose or erode confidence in the GSEs or their mission.

NAHB is pleased to be part of the process to improve a clearly lacking oversight system, establish a world class regulator and ensure that the GSEs continue to expand housing opportunities for American families. We believe that this process can be a success without undercutting the GSEs' housing mission if the following areas are addressed: one, balance housing with safety and soundness concerns; two, employ capital as a precise instrument of risk management; three, preserve GSE portfolios as tools for achieving liquidity and affordable housing mission; four, maintain the GSEs' flexibility to respond promptly, within their charters, to market needs; five, raise the conforming loan limit in high cost areas; and, six, focus and enhance GSE benefits to expand affordable housing opportunities. NAHB looks forward to working with the Congress to use these principles to achieve our mutual goals as the legislative process moves forward.

Comparison of Net Chargeoff Rates by Loan Type for All OTS Thrifts  
Annual Averages, 1990-2006



Source: Office of Thrift Supervision; Compiled by NAHB

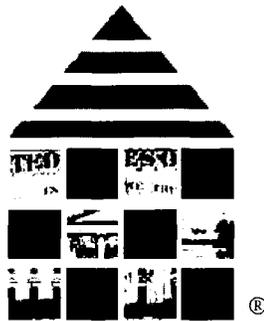
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**Statement  
of  
Judith A. Kennedy  
President and CEO**

**National Association of Affordable Housing Lenders  
on  
“Legislative Proposals on GSE Reform”**

**House Committee on Financial Services  
U.S. House of Representatives**

**March 15, 2007**



NAAHL represents America's leaders in moving private capital to those in need, 200 organizations committed to increasing lending and investing private capital in low- and moderate-income (LMI) communities. This "who's who" of private sector lenders and investors includes 50 major banks, 50 blue-chip non-profit lenders, and others in the vanguard of affordable housing, including insurance companies, community development corporations, mortgage companies, financial intermediaries, pension funds, and foundations. I have worked in the field of affordable housing and community development for nearly 30 years, for HUD, the U.S. Congress, Freddie Mac, and now the National Association of Affordable Housing Lenders (NAAHL).

NAAHL strongly supports improved GSE regulation. Congress has bestowed upon Fannie Mae and Freddie Mac very substantial proprietary advantages. The challenge for government is to channel the GSEs to follow the path forged by primary lenders to provide private capital, on fair terms, for affordable housing. Given the GSEs' inexperience and resistance to linking capital markets to underserved areas, that will involve prohibiting certain actions, compelling certain other actions, with a strong and enforceable legal and regulatory scheme, and a highly capable regulator. Our experience of OFHEO Director Jim Lockhart suggests that he is just such a regulator.

**THE PATH IS CLEAR, NEITHER PRIMROSE NOR YELLOW BRICK ROAD**

One of our California non-profit lenders often says, "We're all in love with the problem!" of the *lack of affordable housing*, but it is way past time to get from being "in love" to solving this problem in very practical ways. We all know that it is a deepening national crisis, with millions of Americans experiencing severe housing problems, from high cost burden to overcrowding, poor quality, and even homelessness. At least 65 million Americans with housing problems have household incomes of 80% or less of area median income. Moderate income families are "driving 'till they qualify", to purchase a home, consuming transportation infrastructure and clogging roads when they could be with their families or contributing to their home communities. Employers having trouble attracting employees who need affordable housing often leave high cost areas, while governments and hospitals that can't leave are increasingly stressed for skilled workers.

Seniors subsisting on Social Security income want to live near their grandchildren. We know that these problems and many more are forcing trade-offs that not only erode quality of life as essential expenditures for food, health care, transportation and clothing must be reduced, but also undermine our communities and our social fabric.

Thirty years ago, the Community Reinvestment Act (CRA) was signed into law directing, FDIC-insured institutions to help meet the credit needs of their communities. Determined that if there is a will, there is a way, Congress made clear with CRA the expectation that the deposits gathered from individuals and businesses be put to work to make loans in underserved parts of the community. Since enactment in 1977, CRA has provided a regulatory incentive for funneling literally hundreds of billions of dollars into low and moderate income communities.

This infusion of private capital leverages public subsidy as much as 10-25 times, so more affordable homes can be built with a limited amount of government support. In an era of shrinking federal subsidy, an active and growing primary market for affordable housing lending is key to achieving homes affordable to persons whose income is classified as "low" (those under 50% of area median income) and "moderate" (those under 80%). Every academic study of CRA has confirmed that the law has been enormously successful. This increased lending and equity investing have spurred economic growth and demand, thereby increasing banks' opportunities to make even more loans and sell more services.

Pioneering lenders, both insured institutions and their non-profit business partners, have over time forged a clear path, *one pebble at a time*, that is helping to meet the credit needs of the underserved and increase the availability of affordable homes. They do this often by leveraging increasingly scarce public subsidies, but also by understanding and managing the risks associated with lending private capital, with or without subsidy, to qualified borrowers who may have little cash to bring to the table. Affordable housing lending has become increasingly sophisticated as experienced practitioners develop new products and share best practices. Given two decades of innovation and solid experience, financing affordable housing is now a very well marked, established path in many states, limited only by lenders' needs to replenish their supply of loan funds so that the cycle can begin again.

#### **HOW LONG CAN THIS KEEP GOING ON?**

Thirty years after enactment of CRA, and nearly 15 years after Congress directed Fannie Mae and Freddie Mac to "lead the industry" in ensuring that access to mortgage credit is available for very low, and low and moderate income families, Fannie Mae and Freddie Mac have not yet brought the benefits of the government sponsored secondary market to most CRA loans.

The huge profits these GSEs generated for years made it clear that the companies, like banks, could generate strong returns while complying with their charter mandate to focus on affordable housing, even if the return "is less than the return earned on their other activities". But highly respected researchers William Apgar and John Weicker, HUD appointees in Democratic and Republican administrations, have documented that both GSEs continued to lag far behind the primary market in financing consumer-friendly mortgages on affordable housing. Primary lenders find that both companies continue to ignore not only CRA loans, but even the "triple-A-rated" tranches of securities backed by seasoned multifamily mortgages on properties affordable to under 60% of area median income, saying they are "too small" and "not profitable enough", even when the return exceeded most institutional investors' expected return by one-half of one percent. As one of our lenders put it: "I've spent too much of my 15-year career in this stuff bringing the GSEs to the table, only to be exhausted, disappointed and insulted many times by the response".

Worse, for the past several years, Fannie and Freddie's own seller/servicers have complained to the GSEs that while the government-sponsored companies refuse to help primary lenders to meet the credit needs of their entire community through purchasing or securitizing consumer-friendly CRA-eligible conventional, prime loans, so that lenders can replenish their supply of loan funds, both companies finance the subprime competitors of their best seller/servicers by investing in MBS backed by subprime, often exploitative loans. There have been unfortunate consequences of Fannie Mae and Freddie Mac ignoring these increasingly sophisticated primary markets in both single family and multifamily CRA-eligible mortgages on affordable housing.

First, lacking the benefits of the government-sponsored secondary market for loans on houses and apartments that low and moderate income borrowers are proud to call home, the primary market for CRA loans is increasingly "constipated" for lack of capital. Billions of dollars in CRA-eligible loans remain on the hooks of the originating lenders, unless and until the lenders peddle their loans like Fuller Brush men to pension funds, insurance companies, and other investors through expensive, time consuming private placements.

Second, since experienced lenders in both the for-profit and non-profit sectors characterize the GSEs' underwriting and servicing guidelines as outdated, extremely conservative, and unrealistic, they believe that the GSEs continue to leave a lot of good, LMI business on the table across the country. Yet Fannie and Freddie have fueled the extreme increase in subprime loans through their "flirting and skirting" of "affordable housing goals" that one commentator called "superficial", and are at best characterized as a "Gentleman's C".

Finally, by losing touch with their obligations to help other lenders to meet the credit needs of their communities, they perpetuate past practices. Fannie Mae and Freddie Mac's resistance to making a market in loans on homes affordable to households earning under 50% and 80% of area median income is reminiscent of earlier foot-dragging. Until policymakers insisted, both GSEs had resisted buying "small", i.e. "low balance" single family mortgages, just as they continue to resist (either through outright refusal to purchase or inappropriate pricing) the low balance multifamily loans (\$1-3 million dollars) that are the bread and butter of affordable housing in many major cities and rural areas, and also single family mortgages that don't fit the GSEs' mold.

#### **WHERE IS THE OUTRAGE?**

*"But fundamentally, it's wasted money, a dead-weight loss. It's thousands of jobs and millions of dollars being wasted on work that is no more productive than raking leaves. It's money that could have gone not only to shareholders, but also to support **low-income housing** and the Fannie Mae foundation, the company's charitable arm, which is struggling through cutbacks."* (Washington Post 5/15/06)

Unlike the hue and cry that erupted over the GSEs' financial accounting and the cost of developing accurate statements, reaction to reports of how Fannie Mae and Freddie Mac fudged claims of achieving even their "Gentleman's C" affordable housing goals has been strangely muted. Both this committee and the media documented some of the lengths to

which Fannie Mac and Freddie Mac went to avoid making a market in prime, performing, conventional loans on affordable housing. These included: 1) double and triple counting one loan in multiple goal categories and in multiple years; 2) "renting" eligible mortgages at the end of a goals' period that are returned to the primary lender in the next period; 3) counting the same loan in different periods; and 4) emphasis on "jumbo" multifamily and even single family loans on million dollar homes that met existing definitions, to the exclusion of lower balance mortgages.

As an industry paper opined:

*"The GSEs are notorious for avoiding any risk and making sure the lender is on the hook if anything goes wrong. Fannie and Freddie also are well known for refusing to disclose real numbers on purchases of specific loan product. They generally conceal such information in the mist of "proprietary information" and keep it out of the hands of the press and the public domain...with loan products that generate press releases, some initial hoopla, and barely an echo in the mortgage market".*

(National Mortgage News)

It has recently become clear that the GSEs were the major financiers of private label, mortgage-backed securities backed by subprime loans, while billions of prime, consumer-friendly CRA-eligible mortgages piled up on lenders' books. OFHEO's website indicates that one-third, or about \$500 billion in GSE debt issued was to invest in mortgage-backed securities, half of which were private label securities backed by subprime loans. Published market data report that in 2004 Fannie and Freddie together purchased 44% of the \$401 billion in securities backed by subprime loans issued that year, 35% of the \$507 billion issued in 2005, and 25% of the total subprime MBS sold. Consumer advocates believe that the vast majority of these loans are potentially "explosive", and Freddie Mac has estimated that half of all subprime borrowers qualified for a prime loan.

Finally, it appears that "a healthy chunk" of these subprime MBS were used by Fannie Mae and Freddie Mac for "affordable housing" goals' credit.

"Several experts call Fannie Mae and Freddie Mac key enablers of sub-prime excess. 'What are they doing,' Chuck Cross, a former Washington State official, asked rhetorically, 'buying loans from a company that just suffered the second-biggest predatory-lending settlement in history?' Fannie Mae has said it never supports predatory lending. Freddie Mac has said it refuses 'to do business with financial institutions that engage in predatory lending.' Federal investigators, however, have found that Fannie Mae and Freddie Mac have failed to meet industry standards of ethics. In 2003, the investigators said, Freddie Mac cast aside accounting rules, internal controls, disclosure standards, and the public trust in the pursuit of steady earnings growth." (LA Times 1/8/07)

**RETURNING TO THE PATH**

Among other important charter changes, H.R. 1427 proposes to get the GSEs back on the path of increasing the availability of funds for affordable housing.

- It recognizes that after decades of primary lenders' success in lending on homes for those under 50% and 80% of area median income, the GSEs should help to link underserved areas with capital markets – and on fair terms.
- It directs the GSEs to purchase “small” as well as large multifamily loans. Most affordable rental housing in America result from loans to “Ma and Pa landlords” to purchase and renovate existing buildings. The GSEs have left much of this profitable business on the table. But “small” \$1-\$3 million dollar mortgages are critical to keeping housing affordable in states like New York and Massachusetts, as much as in Alabama, Utah, Florida and Indiana.
- It puts a cop on the beat of enforcing legitimate affordable housing goals.

History has taught us that linking Wall Street to communities' low- and moderate-income neighborhoods and persons is too important to be a discretionary activity, available only to a favored few. We look forward to working with you and the GSEs to develop a national secondary market that helps to meet the credit needs of all communities and all Americans.

**Nonprofit Lenders Meeting Local Affordable Housing Need  
A Few Examples**

In only seven years, the Alabama Multifamily Loan Consortium has originated more than \$70 million in mortgages financing over 2,000 affordable apartments across the state, 10 percent of which must be accessible to tenants with disabilities (See attachment 1).

Over 15 years, Massachusetts Housing Investment Corporation has provided over \$1 billion in financing for over 11,000 units of affordable housing (See attachment 2).

The California Community Reinvestment Corporation in 17 years has provided more than \$800 million in affordable housing loans and made 26,000 apartments available to residents who earn 60 percent or less of area median income (AMI) (See attachment 3).

Attachment 1



**Rosa Parks Place – Montgomery, Alabama  
56 seniors apartments – financed in 2001**

First affordable housing for seniors and the disabled in Montgomery, Alabama.

Attachment 2  
Alexander Magnolia Cooperative in Boston



Designed to look like a large single-family house, this is a two-family building where each family has their own entrance, driveway, and backyard. The housing was built on scattered vacant lots donated by the city, and is 100% affordable.



1213, 1215 West 39<sup>th</sup> Street



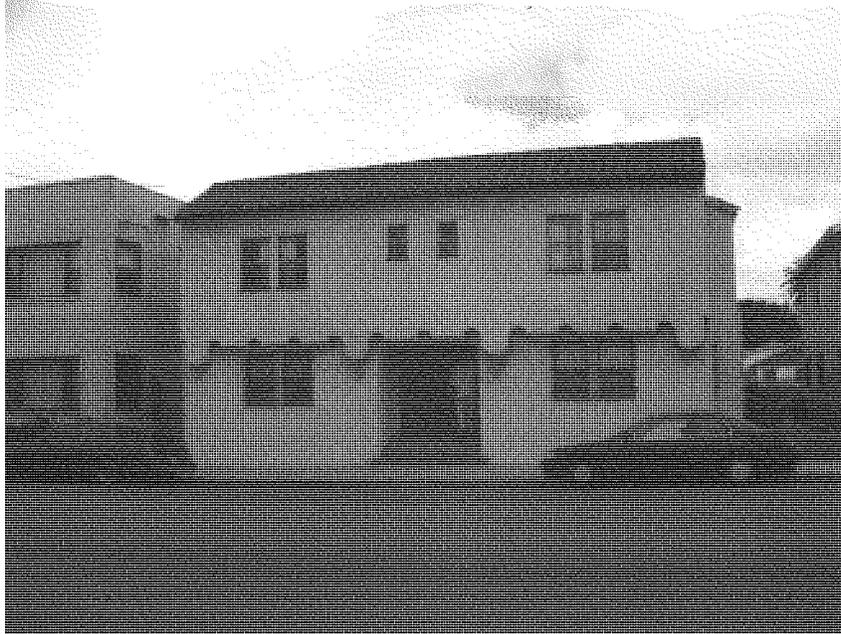
727, 729, 731, 733 West 47<sup>th</sup> Street  
Preservation of at-risk HUD 236 and Section 8 apartments.



831, 833 West 41<sup>st</sup> Street



860, 866, 868, 870 West 42<sup>nd</sup> Place  
Preservation of at-risk HUD 236 and Section 8 apartments.



897 West Vernon Ave.



903 West Vernon Ave.

Preservation of at-risk HUD 236 and Section 8 apartments.

# AMERICAN BANKER

THE FINANCIAL SERVICES DAILY

Friday, March 31, 2006

## VIEWPOINTS

### Fostering Multifamily Purchases by GSEs



JUDITH A. KENNEDY

Congress sponsored Fannie Mae and then Freddie Mac to increase the availability of credit for low- and moderate-income borrowers.

But the devil has truly been in the details; decades later the benefits of a government-sponsored secondary market have yet to accrue to many low- and middle-income borrowers, despite two decades of primary market progress.

Through staunch leadership by House Financial Services Committee Chairman Michael Oxley, R-Ohio, and Rep. Bob Ney, R-Ohio, that may be fixed. They have spearheaded successful efforts to have the House pass HR 1461, which would reform the affordable-housing goals for Fannie and Freddie.

The Senate should follow the House's lead by amending S 190 to conform with the House bill.

The House bill makes clear that GSEs have a duty to serve low- and moderate-income people, defined as those with incomes of under 50% and 80% of the area median — people whose credit needs insured depository institutions are also expected to serve.

Significantly, the bill requires the GSEs to purchase mortgages on rental properties affordable to low and moderate-income people, and it directs their regulator to ensure that Fannie and Freddie purchase "small" (\$1 million-\$3 million) multifamily mortgages that are the bread and butter of affordable rental housing everywhere.

The bill sets out regulatory authority — with teeth — to make it all happen.

This would begin to align GSEs' affordable-housing goals with primary lenders' Community Reinvestment Act responsibilities for helping to meet these credit needs.

For years, banks and nonprofit lenders (many of them members of my organization) have originated and now hold on their books billions of dollars of conventional, multifamily mortgages that provide housing for the elderly and disabled, among others.

Because the GSEs have not been

required to purchase these loans, the increasingly sophisticated primary market has lacked the secondary-market liquidity that would have meant more funds for many more, profitable affordable-housing loans.

NAAHL members are sitting on billions of multifamily mortgages, good business that Fannie and Freddie leave on the table. Access to the government-sponsored, national secondary market that GSEs pioneered for other products would dramatically, and almost immediately, increase funds available to underserved borrowers and communities, and ultimately reduce costs.

Those of us who work to channel private capital into our nation's neediest neighborhoods see this as a rare opportunity to bring the benefits of Wall Street to help Main Street — good business for both.

Will it happen? The Senate should remove the question mark by passing a bill like HR 1461 that directs the GSEs to look for loans in the right places.

*Ms. Kennedy is the president of the National Association of Affordable Housing Lenders in Washington. Its member lenders include financial institutions and state, local, and national nonprofit organizations.*

**STATEMENT OF  
THE HONORABLE JAMES B. LOCKHART III  
DIRECTOR  
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT  
ON "LEGISLATIVE PROPOSALS ON GSE REFORM"  
BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES  
MARCH 15, 2007**

Chairman Frank, Ranking Member Bachus and Members of the Committee, thank you for inviting me here today to discuss the very important issue of regulatory reform for the housing GSEs. I am pleased to see that process start again quickly with the introduction of H.R. 1427, as introduced by you, Mr. Chairman, as well as co-sponsors Congressmen Baker, Watt and Miller. The views that I will be expressing today are OFHEO's and do not necessarily represent those of the President or the Secretary of Housing and Urban Development.

Legislation to reform the regulation of the housing Government-Sponsored Enterprises (GSEs) has been discussed and debated for years. It is now time for action. I am especially grateful to you Mr. Chairman, the Ranking Member and other members of this Committee for your hard work in reaching what I believe is a balanced approach to needed statutory reforms. As a relatively new entrant to the debate, I was struck by the passion that this legislation has evoked, but there are excellent reasons for this passion. Housing and homeownership are critical components of the American dream and the American economy, as we see every day in the news. The housing GSEs play an important role in both. Together the 12 Federal Home Loan Banks (FHLBanks), Fannie Mae and Freddie Mac through loans, advances, investments and guaranteed mortgage-backed securities (MBS) are involved in 46 percent of the total mortgage debt outstanding in the U.S. That is a dominant role by any measure.

To finance such a large market share, the housing GSEs are among the largest borrowers in the world. A comparison I like to make is when you add Fannie's and Freddie's outstanding debt of almost \$800 billion each, with the FHLBanks' debt outstanding of \$900 billion, and Fannie's and Freddie's net guaranteed MBS of \$2.9 trillion, it comes to \$5.4 trillion. That is bigger than the \$4.9 trillion publicly held debt of the U.S.

Like other financial institutions, the housing GSEs face a full range of risks, including market risk, credit risk, and operational risk -- only on a much larger and more concentrated scale than other financial institutions. Fannie Mae, Freddie Mac and some of the FHLBanks have each experienced serious difficulties handling those risks over the years. Current remediation efforts will help reduce operational risks, in particular, but all three risks will continue into the future.

I venture to say that their performance fell far short of what their shareholders and Congress expected. For our part, OFHEO should have done better. A lot has been learned from these problems. The most important lesson, in my view, is that there is a compelling need for this legislation to create a new and stronger regulator.

The new regulator will have an important role and must be responsible and forceful in fulfilling its congressionally-established mission to ensure that the housing GSEs operate in a safe and sound manner and fully support the housing finance market, especially affordable housing.

### **Progress Report on Remediation**

As the safety and soundness regulator of Fannie Mae and Freddie Mac, I want to give you a progress report on their remediation before I turn to the provisions of H.R. 1427. The two companies have made significant progress, but they have much work to do especially in systems, controls and financial reporting. It has taken much more time and money to fix their problems than either the two Enterprises or OFHEO expected. Fannie's and Freddie's Boards and management are focused on their efforts and they have been responsive to OFHEO's concerns. I have met recently with both Boards and I continue to be impressed by the caliber and commitment of the Directors, most of whom are new to the Boards.

OFHEO will be delivering its Annual Report to Congress in early April this year and it will detail the current condition of the Enterprises. Although the report will show that both still have problems that they are working to correct, I am hopeful that next year's report will be more positive. A key indicator to OFHEO of a successful remediation will be the timely filing of annual and quarterly financial statements with the SEC that have a clean audit opinion based upon a controls-based audit. Both companies are working hard to achieve this goal within the next year or so.

### Bank Regulators

I am very pleased that there is a general consensus that the new GSE regulator's authorities and responsibilities should not be weaker or more limited than those of the Federal banking agencies. Let me start by describing briefly how the banking agencies came to some of their current authorities, which will help explain why we think these same authorities make sense for the new GSE regulator.

Some common bank regulatory authorities have been in place for many years, such as flexibility to set capital requirements, independent litigating authority, and freedom from the appropriations process. Still, during the 1980s, more than two thousand banks and thrifts failed as the supervisory structure in place failed to keep pace with the rapid growth, severe stresses and structural weaknesses existing in the regulated institutions at that time. In response, Congress enacted major banking legislation in the late 1980s and early 1990s designed to equip the federal banking agencies with additional tools to

identify and respond promptly to safety and soundness problems. These changes also made the authorities of the various federal banking agencies more uniform.

Among the strengthened authorities given to regulators during this time period were:

- Adding coverage for institution-affiliated parties to enforcement authorities;
- Expanding civil money penalties and penalties for reporting violations;
- Making certain banking conduct criminal and creating new regulations for golden parachutes;
- Providing authority for early intervention procedures, including limits on corporate actions when capital ratings are lowered;
- Enhancing receivership and conservatorship authorities; and,
- Increasing authority to act on “safety and soundness” concerns.

With these strengthened authorities, came responsibilities. In particular, Congress directed the regulators to take prompt corrective action when a bank’s capital falls below required levels and to resolve failed institutions promptly and at least cost to the deposit insurance fund. I would note that, since enactment of these important reforms, bank failures have declined dramatically.

OFHEO’s statutory authorities appear to follow those of the Federal banking agencies yet they fall short in several important ways. Like the Federal banking agencies, OFHEO is charged with overseeing the safety and soundness of financial institutions that undertake credit risk, market risk, and operational risk. Among the key shortcomings in OFHEO’s toolkit as a safety and soundness regulator are:

- Limited flexibility in establishing minimum and risk-based capital requirements;
- Enforcement authorities that are not on par with the banking agencies;
- Lack of independent litigating authority;
- No authority to appoint a receiver for a failed Enterprise; and
- Constraints associated with the annual appropriations process.

These are all authorities recognized as essential to solid safety and soundness oversight. All the banking regulators have these authorities, as does the Federal Housing Finance Board. The GSE reform legislation that has been under debate for several years and is before us today would remedy these shortcomings in the government’s safety and soundness oversight of Fannie Mae and Freddie Mac.

#### **New, Stronger GSE Regulator Needed**

Fannie Mae and Freddie Mac support the mortgage market and its stability, affordable housing and the liquidity of entities involved in housing finance. The new regulator must understand the housing GSEs’ mission in supporting housing finance, the risks involved in that business, the private ownership of these firms, their accountability to their shareholders, and their need to earn a fair rate of return. A key aspect of the GSE

role is to be ready providers of credit under all market conditions and the regulator must ensure that Fannie Mae and Freddie Mac are prepared to provide for stability during times of economic stress. That means the housing GSEs should be financially strong with top-quality management and internal controls.

Like other financial intermediaries, Fannie Mae and Freddie Mac incur risks to fulfill their missions, but they should not take unnecessary risks. Financial regulators are not in the business of eliminating risk-taking, but they must make sure that the boards and management of financial institutions understand the risks they take, manage them prudently, have appropriate systems and controls in place, and have sufficient capital to withstand potentially bad outcomes for themselves, financial markets and the American economy.

The regulator must also understand that the GSEs are not subject to the normal market disciplines faced by other financial institutions. Despite their problems over the last several years, the debt markets continued to lend freely to the Enterprises with no significant increase in interest cost. This lack of market discipline, the GSEs' importance to the housing market and the economy, the challenges and risks that they face, and the limitations of OFHEO's regulatory regime are all compelling reasons for reform.

The legislation that the Committee is now considering is fundamental to the long-term development of the Nation's housing finance system. Only with a much stronger, bank-like regulator can the housing GSEs fulfill the promise of their charter acts. I believe that any reform must be built on a bank regulator model with six basic building blocks. These building blocks are: strong enforcement powers similar to those of banks; strengthened GSE oversight through combining the FHFB with OFHEO; combining safety, soundness, new product mission oversight, strengthened regulatory independence; full authority over capital; and the ability to regulate the Enterprises' portfolios. OFHEO believes the proposed legislation provides all six building blocks.

#### **Bank-Like Enforcement Powers**

The new regulator must have regulatory, supervisory and enforcement powers equivalent to those of the other safety and soundness regulators. Receivership powers are especially important. These powers, in particular, provide one way to prevent problems in one financial institution from spilling over to others and might enhance market understanding of the limits on the GSEs and, thereby, market discipline. Improved enforcement powers including the authority to address misconduct by employees, executive officers, directors, and affiliated parties are also crucial. For example, in attempting to forestall executives accused of alleged misconduct from taking undeserved bonuses or benefits, OFHEO sought to freeze benefits until entitlement was litigated. A Federal court ruled that this authority could not be implied from OFHEO's statute. The pending legislation would remedy this situation.

Additionally, the legislation codifies the regulator's ability to act on safety and soundness concerns. It would:

- Make clear that the agency had incidental powers similar to banking regulators;
- Codify corporate governance responsibilities of the GSEs;
- Permit actions against entity-affiliated parties for harms they cause;
- Make clear that the regulator may "de-bar" employees guilty of misconduct from future employment at the Enterprises; and,
- Expand civil money penalties to cover violations related to unsafe and unsound conditions and increase the amount of penalties.

### **Strengthen Enforcement through a Merger of the GSE Regulators**

All of the housing GSEs should be supervised under one regulatory roof. As Comptroller General David Walker has stated in congressional testimony before the U.S. Senate, "A single housing GSE regulator could be more independent, objective, efficient and effective than separate regulatory bodies and could be more prominent than either one alone. We believe that valuable synergies could be achieved and expertise in evaluating GSE risk management could be shared more easily, within one agency."

It is also critical that the new regulator respect the differences and similarities of the Enterprises and the Banks. Certainly their ownership and capital structures are different. Distinctions in missions need to be preserved as well as the unique regional characteristics of the twelve Banks. Similarities in mission and goals relating to housing should also be recognized and will be beneficial to the new regulator's comprehensive oversight of these companies.

A single housing GSE regulator for Fannie Mae, Freddie Mac and the Federal Home Loan Banks creates within the government a single regulatory voice focused on the health and effectiveness of the housing finance markets, and how those markets connect countless local mortgage providers to broader capital markets. This perspective will be very useful, especially in relation to the nation's need to provide more affordable housing for all Americans. Additionally, since the Banks and the Enterprises are engaged in similar investment, funding and risk management activities, there will be benefits from the examination teams sharing information, examination strategies, and "lessons learned" strategies. A level playing field should emerge regarding expectations for safety and soundness for all of the housing GSEs.

In short, Fannie Mae, Freddie Mac and the FHLBanks will all benefit from being regulated by a stronger, more effective and more prominent regulator. And the Federal Government will benefit from having a single, credible agency contributing to important policy discussions on the condition and role of the housing finance market and its interaction with broader capital markets. That perspective can be useful in informing

public policy on numerous important issues, including financial safety and soundness, systemic risk, affordable housing, consumer protection, and predatory lending.

#### **Mission and New Product Authority**

Currently, authority over the charters of the Enterprises, their mission and new products, is placed within HUD. This is different from the current practice for the banking regulators and the FHFB which exercise both authorities. OFHEO is in the difficult position of being able to review only the safety and soundness aspects of activities that could be in violation of the Enterprise's charter. The new, stronger GSE regulator needs to have both safety and soundness powers as well as mission and new product powers. This combined structure will allow for a more comprehensive view of proposed new programs and products while preserving the important distinction between primary and secondary market activities.

#### **Stronger Independence**

The new regulator needs to have independent litigating authority. Currently, we are in litigation with former officers of both Enterprises. Unlike bank regulators, we must act through the Justice Department when these matters go before a Federal court. The Department of Justice has done a fine job for us, however, this can involve difficult procedural steps that would not be necessary if we were directly presenting and advocating our case. In addition, Justice itself may not have all the needed resources at a given point in time. The bill affords the new regulator the ability to call on Justice for its valued expertise, while permitting the regulator, in appropriate situations, to bring a case or defend itself directly in a Federal court proceeding.

As this Committee knows too well, OFHEO remains the only safety and soundness regulator that must be congressionally appropriated, even though OFHEO has no impact on the Federal budget since it is funded by the Enterprises it regulates. Currently, OFHEO is operating under a Continuing Resolution at FY 2006 spending levels. I appreciate your letter Mr. Chairman, Ranking Member Bachus, Capital Markets Subcommittee Chairman Kanjorski and Ranking Member Pryce supporting OFHEO's request that our full funding be restored as the Congress considers supplemental funding needs for FY 2007. Without our full funding, planned resources in critical supervisory areas may have to be cut, impacting our ability to oversee Fannie Mae and Freddie Mac.

#### **Ability to Strengthen Capital Requirements**

Fannie Mae and Freddie Mac have lower regulatory minimum capital requirements compared with other regulated financial institutions. The 1992 Act that created OFHEO requires the two Enterprises to maintain stockholder's equity equal to 2.5 percent of assets. Currently the FHLBanks hold 4 percent, albeit with a different capital structure,

and major banks hold over 6 percent. No financial institutions are directly parallel to the Enterprises, but these capital requirements may be an indication that the present requirement is too low. Due to operational issues at both Enterprises, OFHEO has required each of the Enterprises to hold an additional 30 percent capital cushion or 3.25 percent of assets. Like other areas of OFHEO's current statute, this additional capital surcharge is based on incidental and implied authority. Passage of reform legislation will make our authority certain.

The same 1992 statute that created OFHEO also prescribed a risk-based capital test that needs to be modernized. As a former risk management executive, I know that there are a number of improvements that can and should be made to modernize the risk-based capital test. At a minimum, risk-based capital should be based on the full array of Enterprise risks including market, credit and operational risk. There also needs to be consideration given to the risks that large housing GSEs present to the overall financial markets. A new, stronger regulator needs the flexibility and authority to adjust both the risk-based and minimum capital requirements. This authority should be exercised through an open regulatory process, but supplemented with the ability to respond quickly to changing Enterprise and market conditions.

#### **Authority to Regulate the Portfolios**

It is clear that the portfolios of Fannie Mae and Freddie Mac have grown tremendously in the absence of effective market discipline. Over the 15 years through 2005, mortgages outstanding in the U.S. tripled, the Enterprises' largest business of guaranteeing MBS grew four-fold, and yet the portfolios of the Enterprises have grown ten-fold. This growth slowed considerably in the wake of their problems but the portfolios remain huge, over \$1.4 trillion. Both CEOs have told me that they agree that the portfolios grew too fast and contributed to some of the operational difficulties that they faced. Under our current statute, however, OFHEO's authority over the portfolios is not set forth clearly. This needs to be codified in the new legislation.

H.R. 1427 provides specific guidance to the regulator that would focus the Enterprise portfolios on their charter missions of supporting affordable housing and contributing to the stability and liquidity of the secondary mortgage markets while considering the risks of the portfolios. I would note that less than 30 percent of the current portfolios of both Enterprises directly contribute to meeting their affordable housing goals and over half of the portfolios are comprised of their own MBS. Although these MBS contain affordable loans, they count toward the goals when they are securitized, but not again if an Enterprise purchases those MBS for its retained portfolio. That would be double counting.

The language in the compromise specifically requires the new regulator to lay out its portfolio regulation under a notice and comment rule-making that will allow all interested parties to comment on the proposal. I commend Chairman Frank and Secretary Paulson for this effective compromise and I believe that it strikes a fair balance between

appropriate regulatory oversight and the legitimate profit-making and market support activities of the Enterprises.

Using this legislative guidance, and under a notice and comment rule-making, I believe that it is unlikely that any regulation will force “drastic reductions” in these portfolios. I would expect, however, to see some changes and, over time, a reallocation that encourages investments that more closely support the affordable housing, liquidity and stability missions. In fact, over the last three years, Fannie Mae and Freddie Mac have actually increased their overall support for the mortgage market despite the shrinkage of their portfolios. They sold their own MBS or did not purchase as much as they had in previous years. Those MBS were purchased by other investors – domestic and foreign. In 2006, despite the restrictions on growth of their portfolios and significant competition, their total book of business grew 8 percent because their guaranteed MBS grew at double-digit rates.

A shift of some of their MBS from their portfolios to other owners would free up billions of dollars of capital while not reducing their support of the mortgage market. That excess capital could be used to increase their market support especially in times of turmoil by guaranteeing more MBS. Alternatively, it could be returned to shareholders.

Once a regulation is in place and the Enterprises have fixed their problems, a mission-focused regulation could certainly allow the portfolios to grow again. In fact, the proposed legislation instructs the agency to consider the size and growth of the mortgage markets in formulating a regulation. Once healthy and depending on competitive forces, Fannie Mae’s and Freddie Mac’s support for the secondary mortgage market could actually grow faster than the overall housing market.

#### **Administrative Issues**

OFHEO has submitted comments on less critical, but still important issues that we request to be considered in the legislation. We are in favor of the Federal Housing Enterprise Board structure in H.R. 1427. We would suggest that the agency share a similar name, especially as the name and acronym FHFA may get confused with the FHA. As OFHEO and FHFB already have a close working relationship, OFHEO recommends that the new agency be created on enactment of the bill. Given the proposed structure of a Deputy Director for FHLBanks and one for the Enterprises, we believe the quick creation of the new agency would be smoother and more efficient. All personnel, including Finance Board members, would be protected as they are in the current bill. In the governance area, we believe that the appointment of Presidentially-appointed Directors to Fannie Mae’s and Freddie Mac’s Board of Directors is unnecessary and inappropriate. The present practice of selecting strongly credentialed Directors recommended by executive search firms, vetted by OFHEO, and elected by shareholders is working well.

**Conclusion**

It is time to move forward on reform legislation to ensure the safety and soundness of the housing GSEs and their full dedication to their important mission of supporting the mortgage market, its liquidity and stability, and especially affordable housing. I am grateful to the leadership of this Committee, Democratic and Republican, for undertaking the hard work of developing a bi-partisan bill that can accomplish this worthwhile objective. I also commend President Bush's Administration for its work in this area and for promoting compromise to give the new regulator the tools it needs to do its job and to assure that the numerous benefits enjoyed by the GSEs are directed at serving their very important public purposes. Thank you and now I will be happy to answer your questions.

**EMBARGOED UNTIL THURSDAY, MARCH 15<sup>th</sup>, 2007 @ 10:00 A.M.**

**Hearing Before the U.S. House Committee on Financial Services  
“Legislative Proposals on GSE Reform”**

**Testimony of Daniel H. Mudd  
President and CEO, Fannie Mae  
March 15, 2007  
Washington, D.C.**

Thank you Chairman Frank, Ranking Member Bachus, and members of the Committee for inviting me here today.

Over the past two years, Fannie Mae’s mantra has been “change, progress, more to do.” On change and progress, we have achieved several milestones. We completed the restatement of our financial results for 2001 through 2004. We’re well on our way to becoming a current SEC filer. We’ve been restructuring our company from the bottom up, and taking active steps to strengthen and improve our culture.

We still have more to do. High on that list is working with Congress to adopt a bill that will strengthen GSE regulatory oversight.

Mr. Chairman, you’ve asked me to come to this hearing to express Fannie Mae’s views on H.R. 1427, the Federal Housing Finance Reform Act of 2007. But before I do, first let me reiterate what we’ve consistently said over the past two years: We support the creation of a stronger, independently funded, bank-like regulator that combines safety and soundness supervision with authority over our mission and activities. And we seek to play a constructive, supportive role in the legislative process. I offer my testimony today in that spirit.

You have asked me to express our views on certain aspects of this legislation. I will speak as the head of our company, but I believe the outcome will affect many GSE stakeholders – homeowners, renters, our shareholders and employees, as well as the housing industry. So I will get into the details, because the details really matter. And while we may differ on certain points, we share the same overall goal – to adopt legislation.

Our views are rooted in the principle that any regulatory regime should balance the needs of oversight with the imperatives of private enterprise. In our case, the GSE charter adds another dimension to this balancing act. That charter, around which our entire business model is based, says our number-one job is to provide an unwavering, secure source of private capital for the secondary market for conforming mortgages. The conforming market includes not only lower-income families, but also middle-class families struggling and saving to own a home – teachers, nurses, police officers, and the many other working Americans who deserve the benefits of affordable mortgages and a stable mortgage market.

Finding that regulatory balance – the convergence of seemingly conflicting forces – is the standard by which all financial institution regulators in the United States are measured. And we believe that same standard should be the basis of the new regulatory regime for the GSEs.

With this balance in mind, I would like to comment on four specific elements of the legislation – capital, portfolio, new products, and the affordable housing fund.

### **Capital Levels**

First and foremost, we support a GSE regulator with authority over our minimum and risk-based capital levels.

We also believe this reform legislation should provide the GSE regulator with a clear process that, like the interagency consultation of bank regulators, ensures proper deliberation, consultation and fairness before any new capital requirement is adopted. Clearly, any permanent increase in our minimum and risk-based capital levels would adversely affect our ability to fulfill the mission Congress gave us. In other words, the capital levels established by Congress should be the norm, not the starting point. We feel the best way to address this in the legislation would be to require the regulator to withdraw any special capital requirements when the circumstances that gave rise to those requirements no longer exist.

### **Portfolio**

With respect to regulation of our portfolio, we also support an approach similar to that exercised by bank regulators. Bank regulators have consistently taken the approach that asset growth, by itself, does not cause a safety and soundness risk – only unplanned or poorly managed asset growth.

Fannie Mae's mortgage portfolio – our original line of business since our creation in 1938 – provides liquidity to the market by raising capital from around the globe to fund U.S. mortgages. This function is especially important when the market lacks buyers.

This is not a purely academic debate. In the 1980s, the oil patch disaster in Texas severely squeezed residential real estate capital, and in the 1990s, New England experienced significant illiquidity. The periods in between these shocks were calmer and there were plenty of investors in mortgages. But liquidity crises can and will happen because markets inevitably behave in ways we don't like or expect. That is happening now in the subprime mortgage market. Many investors are, frankly, fleeing from a market they couldn't seem to get enough of just six months ago. The result: home buyers are being left in the lurch.

Fannie Mae was created to keep such shocks from infecting the entire mortgage system, and it is a responsibility we believe this legislation should give us appropriate flexibility to meet.

To that end, the legislation should identify the safety and soundness factors that would lead to regulatory limits on the size or growth of our balance sheet. We believe “systemic risk” should not be included in these factors unless bank regulators agree on the method for applying such a standard to all financial institutions. In other words, the entire financial system, not just two companies. Finally, when portfolio limits are imposed for a specific safety and soundness condition, they should be lifted when the specified safety and soundness condition no longer exist.

#### **New Product Approval**

On new product approval, bank regulation also provides a useful guide and one that should serve as the basis for this legislation.

Submitting our new products to public review and comment would entail submitting our customers’ proprietary new products to public review and comment. This would not only be cumbersome, it would present serious competitive concerns. No regulatory approval process that I know of requires public disclosure of proprietary information. Our regulatory regime should be no different.

Banks keep regulators apprised of new business initiatives through the examination process and by regular communication with their supervisors. So should the GSEs. In practice, banks consult their regulators routinely on business plans and developments without formalized notice and approval, except for major new initiatives such as bank mergers or acquisitions. Banks are able to offer new products as the market demands without a burdensome pre-approval process. So should the GSEs.

#### **Affordable Housing Fund**

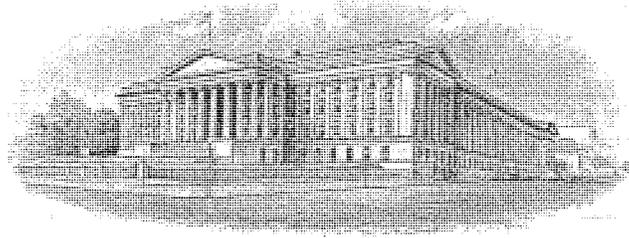
Fannie Mae supports the creation of an Affordable Housing Fund similar to that provided for in H.R. 1461, passed by the House in October 2005. First, our view is that the Fund should not only be integrated into our annual affordable housing goals, but should also be the first step in a comprehensive modernization of the complex goals-based affordable housing regime under which we operate. Secondly, we believe the legislation should provide for the GSEs to manage the fund. I believe you want us to care what happens to the grants and investments made under such a program – to ensure that they are effective community building blocks – NOT simply a levy on our business. Of course, the fund’s activities should be regulated, disclosed, reviewed and supervised by a new regulatory regime.

**Conclusion**

Let me close by illustrating what Fannie Mae can do when we get it right; and no other endeavor demonstrates the combined value of the many facets of our business and our mission than our work along the Gulf Coast. Throughout the Gulf Opportunity Zone, we've arranged for more than \$2.6 billion in special financing, with another \$650 million in the pipeline, to rebuild affordable housing. That's over and above the \$17.5 billion of home loans we've funded in the GO Zone since the storm. From the day after Katrina, we continued to fund loans from local banks that needed capital to keep lending. We gave borrowers time to rebuild by expressly prohibiting foreclosure of loans in our portfolio for one year after the storm. We've had a dozen employees on the ground since the storm going house to house to understand the damage and advise our loan servicers as they work with borrowers. Our employees themselves donated more than 4,000 volunteer hours.

I tell you this not to brag about Fannie Mae, because in reality Fannie Mae is only one player in a massive rebuilding effort. But I do think it's an important example of the ways our company can use *all* the tools at its disposal – portfolio, capital, products and people – to serve a public need even as it serves its shareholders. Our regulator should have the tools it needs to make sure that we safely and soundly fulfill this dual promise.

Thank you for the opportunity to be here today.



**U.S. TREASURY DEPARTMENT  
OFFICE OF PUBLIC AFFAIRS**

**EMBARGOED FOR 10:00 A.M., March 15, 2007  
CONTACT Jennifer Zuccarelli, (202) 622-8657**

**TESTIMONY OF TREASURY UNDER SECRETARY ROBERT K. STEEL**

**BEFORE THE U.S. HOUSE FINANCIAL SERVICES COMMITTEE  
ON GOVERNMENT SPONSORED ENTERPRISE REFORM**

**Washington, DC-** Thank you Chairman Frank, Ranking Member Bachus, and Members of the Committee for inviting me to appear before you today.

The United States has one of the most successful housing finance systems in the world. Our nation's housing finance system provides consumers with a wide range of mortgage finance options that open the door for home ownership. In today's mortgage market, consumers can choose from mortgage products designed to match their desired payment characteristics. Consumers also have greater flexibility regarding down payment options, and reductions from the once standard 20 percent down payment have played a critical role in expanding home ownership opportunities. In addition, consumers have increasingly used the mortgage market to tap illiquid housing wealth that has accumulated over time with cash out refinancing or through the use of home equity lending products.

The underlying structure of our nation's housing finance system is supported by various types of financial institutions: federally insured depository institutions and mortgage banks that both originate, service, and invest in mortgages; private mortgage insurers that provide insurance on low down payment mortgage loans; mortgage brokers that assist consumers in obtaining mortgages; investment banking firms that arrange securitization transactions and invest in mortgages; and, of course, the housing government sponsored enterprises (GSEs) – Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBanks).

Fannie Mae and Freddie Mac operate in the secondary mortgage market by providing credit guarantees on mortgage-backed securities (MBS) or by directly investing in mortgages and mortgage-related securities through their retained mortgage portfolios. In the credit guarantee business, Fannie Mae and Freddie Mac generally enter into swap agreements with mortgage lenders under which individual mortgages are transformed into MBS guaranteed by the GSEs. Fannie Mae and Freddie Mac also have the ability to purchase mortgages and package them into MBS. Treasury continues to believe that the credit guarantee function provides a useful mechanism in the operation of an effective secondary market for mortgages. In the mortgage investment business, Fannie Mae and Freddie Mac issue debt securities to fund an investment portfolio of mortgage-related securities. In comparison to the credit guarantee business where credit risk is the main exposure, the mortgage investment business involves both credit and interest rate risk. Treasury continues to believe that the mortgage investment businesses of Fannie Mae and Freddie Mac present the greatest potential risks, while at the same time having a much more tenuous connection to their housing mission than the credit guarantee business.

Recent accounting/corporate governance problems and regulatory restrictions have limited the growth of Fannie Mae and Freddie Mac over the last few years. Nonetheless, they are still a significant presence in our nation's housing finance system. As of year-end 2006, the retained mortgage portfolios of Fannie Mae and Freddie Mac totaled \$1.4 trillion, which is off slightly from the \$1.6 trillion outstanding as of year-end 2003. In addition, as of year-end 2006, Fannie Mae and Freddie Mac provided credit guarantees on \$2.9 trillion of MBS. Together, Fannie Mae and Freddie Mac have about \$4.3 trillion of mortgage credit exposure as of year-end 2006, which was about 40 percent of total outstanding mortgage debt. And while it is difficult to calculate precisely, given that fixed-rate mortgages make up the significant portion of the credit guarantees and mortgage assets of Fannie Mae and Freddie Mac, their share of the fixed-rate mortgage market would be even higher.

The FHLBanks also are significant participants in our nation's housing finance system, but they operate under a different business model than Fannie Mae and Freddie Mac. The FHLBanks' primary business is making advances – or secured loans – to member institutions that are involved in housing finance to various degrees. As of year-end 2006, FHLBank advances were \$641 billion. The FHLBanks are also active mortgage investors. As of year-end 2006, they directly held \$225 billion in mortgage assets – \$98 billion as individual mortgages and \$127 billion as MBS. At year-end, the FHLBanks also held \$144 billion in fed funds and other investments, and total assets were \$1 trillion.

#### **Core Objectives of Housing GSE Regulatory Reform**

It is Treasury's view, and it appears to be generally recognized, that the regulatory system for housing GSEs neither has the tools, nor the stature, to deal effectively with the current size, complexity, and importance of these enterprises. While some of these issues have been raised for years, it was the accounting/corporate governance problems that emerged first at Freddie Mac in 2003 then later at Fannie Mae in 2004 that brought these issues to the forefront. In addition, the FHLBanks were not immune to these problems as the

regulatory actions associated with problems at the FHLBank of Chicago and the FHLBank of Seattle illustrated.

Treasury has been an active participant in the housing GSE regulatory reform debate. We have continually stated that we have two core objectives: the need for a sound and resilient financial system, and increased homeownership opportunities for less advantaged Americans. In line with our core objectives, our reform proposals have been designed to minimize risks that the housing GSEs pose to the broader financial system and clearly focus the housing GSEs on their mission. More specifically, our reform proposals have included provisions to improve regulatory oversight, enhance market discipline, and allow for the establishment of appropriate capital requirements for the housing GSEs. If the housing GSEs are going to continue to accomplish their mission, it is paramount that the risks undertaken by the housing GSEs are properly managed and supervised; otherwise there may be a threat to their solvency, and importantly to the stability of other financial institutions and the strength of our economy.

It is widely recognized that there is a deficiency in the oversight of the housing GSEs and Congress has worked to improve the regulation of the housing GSEs. We at Treasury appreciate this effort and pledge to continue to work with you to establish a new regulator that has all the authorities necessary to oversee these complex and sophisticated institutions.

#### **Key Elements of Housing GSE Regulatory Reform**

Throughout the debate on housing GSE regulatory reform, Treasury's focus has been on ensuring the new regulator has all of the powers, authority, and stature needed to do its job. In this regard, a core tenet of our position is that the new regulator's powers should be comparable in scope and force to those of our nation's other financial institution regulators. As I have mentioned, the housing GSEs have grown into large and complex financial institutions that require strong and effective oversight. In addition, later in my testimony, I will describe what makes the housing GSEs different than a typical financial institution. It is just as important that the new regulator have the appropriate authority to consider the unique characteristics of the GSEs and their housing missions.

In terms of comparable powers, we must ensure that the new housing GSE regulatory agency is not encumbered by the current restrictions that are placed on the Office of Federal Housing Enterprise Oversight (OFHEO). Some key elements of housing GSE regulatory reform that have been debated in recent years include the following:

- **Capital Requirements** – Under current law, the minimum capital requirements for the housing GSEs are fixed in statute, and the risk-based capital requirement for Fannie Mae and Freddie Mac is based on a highly prescribed stress test that is set forth in statute. These limitations are inconsistent with the ability of other financial regulators to broadly set both minimum and risk-based capital requirements. The new housing GSE regulatory agency must have enhanced flexibility to set both minimum and risk-based capital requirements. Sections 111 and 112 of H.R. 1427 largely accomplish

this goal. We would be strongly opposed to changes that weaken the new regulatory agency's ability to effectively implement the capital provisions.

- Receivership/Conservatorship – Under current law, OFHEO has the authority to place Fannie Mae or Freddie Mac into conservatorship, but not into receivership. Should such circumstances arise, the new housing GSE regulatory agency must have more than the powers associated with conservatorship. In particular, the new regulatory agency must have all the receivership authority that is necessary to direct the liquidation of assets and otherwise to direct an orderly wind down of an enterprise. The new regulatory agency must also be required to take mandatory receivership actions under certain circumstances. Such receivership authority can be established 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 by clarifying that investors may suffer losses. Enhanced market discipline is essential to promoting safe and sound operations, which is consistent with maintaining the GSEs' role in our housing finance system and protecting our broader financial system from problems at a GSE. Section 144 of H.R. 1427 largely accomplishes this goal.
- New Activity Approval and Mission Oversight – Under current law, the Department of Housing and Urban Development (HUD) is responsible for approving new programs, setting housing goals, and overall mission oversight. The authority for approving new activities of Fannie Mae and Freddie Mac and ensuring compliance with their mission must be transferred from HUD and combined with the other supervisory/enforcement powers of the new housing GSE regulatory agency. This authority 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, with their prudential operation, or with the public interest. Section 122 and other provisions of H.R. 1427 largely accomplish this goal.

Other important aspects of housing GSE regulatory reform that represent a significant improvement over current law and further provide comparability to other U.S. financial institution regulators include ensuring that the new housing GSE regulatory agency has: independent funding outside of the appropriations process; independent litigating authority and other related powers; and the full set of regulatory and enforcement tools. H.R. 1427 largely accomplishes these goals.

In addition to ensuring that the new housing GSE regulatory agency has powers and authority consistent with that of other U.S. financial institution regulators, the housing GSEs also have unique characteristics that must be addressed in regulatory reform legislation. The housing GSEs were created to accomplish a mission, and they were provided a certain set of statutory benefits to help in the accomplishment of that mission. For example, in terms of specific benefits the housing GSEs are not subject to state or local taxation and they have access to a line of credit with the Treasury Department

(\$2.25 billion each for Fannie Mae and Freddie Mac and \$4 billion for the FHLBank System, which pales in comparison to the size of their debt obligations). The GSEs also greatly benefit from the market's perception that the U.S. government guarantees or stands behind GSE obligations, which results in preferential funding rates being provided to the GSEs. On behalf of Treasury, I want to reiterate that the GSEs' debt and other financial obligations are not backed by the federal government. There are differing views on the precise amount of this benefit, but general agreement that the benefit exists. It is this benefit and a lack of effective market discipline that largely drove the rapid expansion of the retained mortgage portfolios of Fannie Mae and Freddie Mac throughout the 1990s.

As Treasury has noted previously, the combination of three key features of Fannie Mae's and Freddie Mac's retained mortgage portfolios warrant the attention of policymakers: (1) the size of the retained mortgage portfolios of Fannie Mae and Freddie Mac – \$1.4 trillion as of year-end 2006; (2) the lack of effective market discipline; and (3) the interconnectivity between the GSEs' mortgage investment activities and the other key players in our nation's financial system (both insured depository institutions and derivative counterparties). The combination of these three factors causes the GSEs to present the potential for systemic risk to our financial system and the global economy. This view has not changed.

In addition, given that Fannie Mae and Freddie Mac have a specified housing mission, and that the potential for broader risks to our financial system is associated with their retained mortgage portfolios, a sensible approach is to ensure that the mortgage investment activities of these GSEs are necessary to accomplish their housing mission. To address these issues, the new housing GSE regulatory agency must be provided specific review authority over the retained mortgage portfolios of Fannie Mae and Freddie Mac. Such authority should establish a clear and transparent process based on direction from Congress on how the new regulatory agency will evaluate the retained mortgage portfolios in terms of risk and consistency with mission. Section 113 of H.R. 1427 largely accomplishes this goal for Fannie Mae and Freddie Mac. While the broader risk issues related to the FHLBanks are less than those that are present with Fannie Mae and Freddie Mac, a review of the investment portfolios of the FHLBanks for mission consistency would also be appropriate.

In terms of the new regulator's authority or other changes related to the unique characteristics of the housing GSEs, other appropriate elements of housing GSE regulatory reform should include:

- Government-Appointed Directors – Treasury supports clarification that the government should not be involved in the appointment of directors to the Boards of Fannie Mae, Freddie Mac, and the FHLBanks. Consistent with long-standing principles of corporate governance, directors of the housing GSEs have a fiduciary responsibility to shareholders. The government appointment of directors does not change this fiduciary responsibility, but does give the impression that government may have a say or influence in the operation of the housing GSEs. That is not the

case, and this should be corrected to improve corporate governance and to further clarify that the housing GSEs are not backed by the Federal government.

- Combining the Regulatory Authority of the Housing GSEs – Treasury continues to believe that the FHLBanks 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. This would enhance the critical mass of financial expertise needed to oversee the GSEs. At the same time there are many common synergies, such as the FHLBanks' investments in mortgages and MBS, and the mortgage investments of the other housing GSEs. In addition, combining regulatory authority over all of the housing GSEs under one regulator has the potential to increase the stature of the new agency and better enable it to deal with these large and influential companies. In other words, the potential for regulatory capture should be reduced. Title II of H.R. 1427 largely accomplishes this goal.

### **Conclusion**

In conclusion, we at Treasury appreciate the efforts of the Chairman and Members of the Committee in working toward achieving resolution of the housing GSE regulatory reform issue. H.R. 1427 will establish a new regulator with powers that are comparable to other financial institution regulators, which will greatly improve the oversight of the housing GSEs. We still have strong concerns with certain aspects of H.R. 1427. In particular, if an Affordable Housing Fund is going to part of this legislation, the Fund must be: controlled by the Federal government not by Fannie Mae and Freddie Mac; temporary; and capped. In addition, the provision increasing the conforming loan limit in high cost areas is inappropriate because there do not appear to be problems in the provision of mortgage credit in these areas, and it could detract from the affordable housing efforts of Fannie Mae and Freddie Mac. Nonetheless, Treasury is supportive of the regulatory enhancements contained in this legislation as they are a significant improvement over current law. Any efforts to limit these powers or weaken the new regulator will not be viewed favorably.

We look forward to continuing to work with you on this important issue. Thank you.

**Testimony of Richard F. Syron  
Chairman and CEO, Freddie Mac**

**COMMITTEE ON FINANCIAL SERVICES  
UNITED STATES HOUSE OF REPRESENTATIVES  
March 15, 2007**

Chairman Frank, Ranking Member Bachus and members of the Committee:

My name is Dick Syron. I am the Chairman and Chief Executive Officer of Freddie Mac, a position I took just about three years ago. I greatly appreciate the opportunity to appear before the Committee today to report on our accomplishments and challenges, and to discuss key aspects of H.R. 1427, the proposed legislation on regulatory reform of the oversight of Freddie Mac and Fannie Mae (GSEs), and the Federal Home Loan Banks (FHLBs).

The issue of GSE regulatory oversight is vitally important to our nation's economy and to homeowners. My views on this important topic have been profoundly shaped by my 25 years spent regulating financial institutions. Before heading the Federal Reserve Bank of Boston, I was CEO of the Federal Home Loan Bank of Boston. Prior to that, I was privileged to serve as assistant to then-Federal Reserve Chairman Paul Volcker. Earlier, I was Deputy Assistant Secretary for Economic Policy of the United States Treasury Department. Perhaps the most salient thing I learned in these capacities was the critical need for maintaining safety and soundness while, at the same time, assuring adequate credit flows, particularly in times of economic transition.

I would also like to thank the Chairman, the ranking member, members of the Committee, the Administration and both our safety and soundness and mission regulators for their hard work in forging the proposed GSE regulatory oversight legislation under consideration today.

Before I comment on specific aspects of H.R. 1427, I would like to report on Freddie Mac's progress on two important fronts: our financial remediation and reporting timeline, and mission fulfillment. I would also like to frame the current discussion about the GSEs in the context of our legislative history, and suggest that any substantial modifications to the GSE business model

be undertaken with great care and with legislative objectives carefully balanced, lest we unnecessarily weaken or impair the GSEs' ability to continue fulfilling their mission.

### **Financial Remediation and Reporting**

In early 2005, in testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, I called 2005 a "bridge" year in terms of getting our financial house in order. Today I confess I had in mind what Eastern Shore Marylanders know as the Kent Narrows Bridge, but the reality of the task bears greater resemblance to the four-mile Chesapeake Bay Bridge. This is because the nature of the financial remediation required to return Freddie Mac to timely financial reporting turned out to be far more complicated than anticipated. Rather, what we've been engaged in is nothing short of a top-to-bottom transformation of the entire company.

To begin, we needed to attract and hire top-notch leaders to get the job done. In the past three years we completely rebuilt Freddie Mac's senior management team. We've also progressed in redesigning, updating and overhauling nearly every financial and management system at Freddie Mac. We've instituted new governance structures, new compliance and ethics requirements, and new employee engagement programs designed to retain a strong workforce and effect cultural change. In short, restating earnings was the tip of the iceberg.

While much of our financial remediation work has not been visible to the public, we have made significant progress on a number of important initiatives designed to improve Freddie Mac's financial reporting infrastructure and remediate our control environment. These activities are part of Freddie Mac's comprehensive plan for returning to quarterly financial reporting. The plan includes mitigation and remediation of identified control issues; strengthening of the financial close process; implementing critical systems initiatives; and completion of a review of the company's system of internal controls related to the processing and recording of all financial transactions.

Our risk management has always been strong, but strengthening our risk management capabilities even further remains a key focus. During 2006 we rebuilt our enterprise risk management infrastructure, including a governance structure that links the Board of Directors, executive management and line management and staff. We also augmented our credit and interest rate risk management capabilities by increasing our focus on the identification, assessment and remediation of operational risks.

While upgrading our systems and internal controls, we released audited financial results for 2003, 2004 and 2005. Further, we expect to release our 2006 audited financial results on March 23, 2007, bringing us up to date on our annual reporting. We expect to resume quarterly financial reporting during the second half of 2007. Once we have returned to regular quarterly reporting we look forward to beginning the process to register our common stock with the SEC.

Sound accounting systems, timely financial reporting, strong internal controls, and state-of-the-art operational risk management are critical to our future financial success and our credibility with policymakers and the financial markets. While we wish this process had been simpler and faster, we are making steady progress.

#### **Mission Fulfillment**

By law, the housing GSEs have a broad and important public mission to provide liquidity, stability and affordability to the nation's residential mortgage markets. While affordability is a keystone of our public mission, it is not our sole reason for existence. Affordability is an extremely important mission responsibility, but, as I will discuss shortly, both liquidity and stability are vitally important. Far from being relics of a quainter era in U.S. mortgage markets, the stability and liquidity provided by the GSEs is key to the continued vibrancy of the nation's housing markets and broader economy. Further, we consider the affordability component of our mission as broader than achieving annual HUD housing goals.

*Mortgage Liquidity: Financing for 50 Million Homes*

In chartering Freddie Mac and Fannie Mac, Congress gave us the responsibility of being a continual presence in the mortgage marketplace. Freddie Mac does that by providing a stable supply of low-cost mortgage funds whenever and wherever qualifying families need them – and we’ve been doing it for 37 years. In recent months, Freddie Mac reached an important milestone: the financing of our 50 millionth home. These mortgage investments have supported homeownership in communities around the country, as well as financed apartment units affordable to millions of low- and moderate-income families.

Our continuous presence in the market also promotes affordability. As can be seen from a quick scan of the Internet or newspapers, conventional fixed-rate mortgages eligible for sale to the GSEs typically bear lower interest rates than mortgages above the conventional conforming loan limit.<sup>1</sup> A study co-authored for us by former OMB Director James Miller estimates that these lower rates save American homeowners between \$16 and \$21 billion in housing costs every year.<sup>2</sup> Low-cost mortgages funded by Freddie Mac have also enabled families to refinance their mortgages into lower-cost instruments, saving consumers billions of dollars in mortgage interest and prepayment penalties over the years.

Notwithstanding novel developments in mortgage finance, the classic fixed-rate mortgage remains the product of choice for many borrowers because it protects them from upward swings in mortgage interest rates – and allows them to refinance whenever they want without penalty. At the end of 2005, the fixed-rate mortgage market most heavily supported by the GSEs comprised more than 80 percent of prime conventional conforming mortgages outstanding. In

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<sup>1</sup> The real estate section of the *Washington Post* on March 10, 2007 (Section G, page 2) showed that, among the lenders listed, quoted rates for 30-year, fixed-rate mortgages up to \$417,000 (the current conforming loan limit) were on average 26 basis points lower than rates on 30-year, fixed rate mortgages above \$417,000.

<sup>2</sup> James C. Miller III and James E. Pearce, “Revisiting the Net Benefits of Freddie Mac and Fannie Mae,” at 24-25 (November 2006).

contrast, fixed-rate mortgages comprised less than 40 percent of higher-balance jumbo mortgage debt, and only one-fourth of subprime debt.<sup>3</sup>

The widespread availability of low-cost fixed-rate mortgage financing is largely the result of a well-functioning GSE system of housing finance. As secondary market entities, the GSEs purchase conforming mortgages that banks and other primary market originators do not wish to hold on their own balance sheets. We provide this outlet by offering an attractive “take out” bid for the conforming mortgages originated by banks. In this way, GSEs are constantly replenishing the funds available for home purchase and refinancing.

Banks typically hold adjustable-rate mortgages (ARMs) in their own portfolios and sell “long tail-risk” mortgages, such as the prepayable 30-year fixed-rate product, to the GSEs. In this way, banks can reduce the amount of interest-rate risk they must hedge. GSEs take on this interest-rate risk and diffuse it through domestic and international capital markets by securitization, the issuance of long-term callable debt or the use of hedging instruments.

The transfer of interest-rate risk from mortgage originators to the GSEs is vital to the long-term viability of the housing finance system – and to the prospects of sustainable homeownership. ARMs typically pose much less interest-rate risk for portfolio investors; instead, the challenge of dealing with changes in interest rates is borne by ARM borrowers. In flat or declining rate environments, the risk to the homeowner is usually manageable. However, as mortgage rates rise, these risks can be extremely difficult for families to manage, as demonstrated by the subprime market today.

The subprime market has grown markedly in recent years, and while there are many drivers of this growth, let me turn to economics and mention the important role of supply and demand. On the demand side, many subprime borrowers sought mortgage products with low monthly

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<sup>3</sup> LoanPerformance, a subsidiary of First American Real Estate Solutions, gives the fixed-rate share of prime conventional conforming debt as 83 percent as of December 31, 2005, of prime jumbo debt as 39 percent from its servicing database, and of subprime debt at 26 percent from its securities database. OFHEO has estimated that 85

payments, largely in response to the run-up in house-price inflation. As long as house prices continued to rise, home equity was building up and the transactions costs associated with refinancing could be absorbed. On the supply side, subprime investors were driven by a nearly insatiable demand for yield, which is a function of the higher risks associated with subprime mortgages. To manage these risks, highly structured and complex subprime securities were developed that diffuse these risks to an increasingly large and global investor base.

The confluence of strong borrower demand for low-payment mortgages and strong investor appetite for high-yielding securities fueled the origination of 2/28 and 3/27 hybrid ARMs. Because of their short reset periods, floating rates, prepayment penalties and high margins, these mortgages were well suited to investor securitization needs. In times of low mortgage interest rates and rising home prices, many homeowners fared well in this market. However, as we see now, the combination of rising short-term interest rates and softening house prices has made these mortgages much more onerous for many credit-impaired borrowers.

The point here is not to make adverse comparisons to adjustable-rate products or the subprime market. Both serve important housing finance needs. Rather, I am trying to draw a distinction between the segment of the mortgage market most heavily supported by the GSEs and alternative market solutions to the challenge of providing long-term mortgage financing. Over time the GSE market has evolved to serve household needs, and there is no better example than the high share of low-cost fixed-rate mortgages made possible by GSE mortgage purchases and investments. In contrast, the subprime market, as we know it today, is largely investor-centric. Investor preferences tend to drive what gets originated. Further, when yields dry up, investors will look for better opportunities elsewhere. This is not the case in the GSE market, where we ensure a continuous presence. This responsibility to serve markets in good times and bad is a responsibility not shared by private equity funds, hedge funds, non-bank financial institutions or even depositories. These institutions have the freedom, and indeed an obligation to their owners, to deploy their assets as they wish.

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percent of conventional conforming debt was fixed-rate as of the end of 2005, and that 15 percent of jumbo debt was fixed-rate (<http://www.ofheo.gov/Research.asp>).

In summary, the GSEs statutory requirement to provide liquidity to the nation's mortgage markets remains a highly important aspect of their congressional charter. Mortgages financed by the GSEs are lower cost, highly available, and permit households to shift interest rate risk – at will – to financial institutions that are highly qualified to manage it.

*Mortgage Market Stability: Our Hurricane Response*

Freddie Mac's second statutory purpose is to provide stability to the nation's housing markets. Like liquidity, stability is another under-appreciated aspect of our statutory purposes, that is, until things become unstable. Whether it was our mortgage purchases following the meltdown of the Long Term Capital Management hedge fund in 1998, or our confidence-building debt issuances in the extremely chaotic financial aftermath of 9/11, the combination of Freddie Mac's financial strength and mission focus has brought needed stability to financial markets. Our response to the 2005 hurricanes was no exception.

After Hurricanes Katrina, Rita and Wilma battered the Gulf Coast in the fall of 2005, Freddie Mac's actions helped cushion the impact of the hurricanes on struggling families, our lending partners and the region's housing sector as a whole. In the immediate aftermath of the storms, Freddie Mac and the Freddie Mac Foundation donated \$10 million in humanitarian assistance, with special emphasis on finding temporary or permanent housing and providing supportive services for displaced families. Working with our nonprofit and business partners, Freddie Mac placed more than 2,100 families into housing, including single-family homes and apartments donated from our real estate-owned (REO) portfolio.

To help affected families keep their homes, we implemented a series of temporary policies. Through our lender customers and mortgage servicers (many of whom were themselves facing extraordinary hardships), we provided mortgage payment relief to any homeowner who needed it for up to as many as 21 months. By the end of last year, Freddie Mac had provided forbearance to more than 34,000 families, with the option for our servicers to continue to extend forbearance

until June. Moreover, Freddie Mac implemented policies to avoid penalizing those who were attempting to rebuild their homes and lives. We instructed our servicers to suspend credit reporting, stop charging late fees, and stop pursuing collections on affected families who fell short on their mortgage payments.

In addition to providing mortgage payment relief, Freddie Mac streamlined our loan modification requirements so that servicers could easily assist homeowners seeking to hold on to their homes. In some cases, servicers restructured mortgages so borrowers would have lower and more manageable monthly payments. In other cases, servicers established repayment plans. By the end of 2006, Freddie Mac had provided workouts on more than 4,000 loans for Gulf homeowners. More loan workouts are underway.

Finally, to help begin the process of rebuilding in the Gulf region, Freddie Mac pledged to purchase \$1 billion of mortgage revenue bonds (MRBs) from state and local housing finance agencies. Within one year, Freddie Mac had fulfilled the \$1 billion commitment. The bonds are helping as many as 10,000 low-and moderate-income families obtain low-cost mortgages and home repair loans from participating lenders. The MRB initiative, as well as several other steps we took to assist lenders, servicers and their borrowers, depended heavily on our retained portfolio and its ability to allow us to spring into action quickly. Later in the testimony, we discuss in more detail how we use the portfolio to fulfill our mission.

*Mortgage Affordability: Affordable Housing Goals*

Promoting mortgage affordability is the third “leg” of the GSE statutory responsibilities. In this era of declining housing affordability and a critical shortage in the supply of affordable housing any and every effort to lower the cost of buying or renting a home is sorely needed. Over the years, Freddie Mac has made important contributions to affordability, including driving down the cost of origination through automated underwriting; developing new products, with very low down payments and other underwriting flexibilities, like Home Possible<sup>®</sup>; and making sizeable

investments in housing related tax credits and MRBs.

For example, for the past three years, Freddie Mac has set records in new multifamily business transactions, totaling \$78.8 billion in financing for approximately 1.5 million apartment homes. This figure includes \$4.9 billion in targeted affordable housing products which finance apartments that receive some form of government subsidy; \$3.1 billion in low-income housing tax credits (LIHTCs) which provides important support for the creation or rehabilitation of rental housing for America's lowest-income families; and over \$2.7 billion in rental housing for senior citizens. Freddie Mac has a long history of increasing the availability of affordable rental housing in the United States. More than 90 percent of the rental units we have financed are affordable to people whose incomes are at or below area median income.

The affordable housing goals, administered by the Department of Housing and Urban Development (HUD), are perhaps the most well-known measure of our success in meeting the affordability aspect of our mission. Established by Congress, the three statutory housing goals direct that specific percentages of our mortgage purchases and investments be targeted to borrowers at the lower end of the income scale, or living in particular communities that may be underserved by mortgage markets.

We make strong efforts to make all the goals and subgoals each year, but the challenge of meeting housing goals that have been increasing significantly in recent years begs the question of whether we are over-relying on housing finance to solve the nation's housing affordability problem. In the current environment, we are being reminded that housing finance that is not sustainable is *not* affordable housing. Instead, we need solutions that embrace the totality of the housing equation. A growing body of research suggests that some of the greatest opportunities for progress may be found on the supply side of the equation – including such things as zoning, permit requirements, and other man-made restrictions on supply that raise the cost of housing.<sup>4</sup>

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<sup>4</sup> See, for example "Regulation and the Rise of Housing Prices in Greater Boston" by Edward L. Glaeser, Jenny Schuetz, and Bryce Ward, Cambridge: Rappaport Institute for Greater Boston; "Zoning's Steep Price" by Edward L. Glaeser and Joseph Gyourko, *Regulation*, Fall 2002, pp. 24-30; "Why Have Housing Prices Gone Up?" by Edward L. Glaeser, Joseph Gyourko and Raven E. Saks, Harvard Institute of Economic Research Discussion Paper Number

### **Genius of the GSE Model: Attracting Private Capital for Public Purposes**

One of the principal reasons for the success of the GSE model is that it attracts private capital to achieve a public purpose. Throughout our history, the government has sought to harness private enterprise and individual initiative to develop our nation, strengthen our economy and improve the lives of our people.<sup>5</sup> The housing GSEs fit solidly within this tradition.

Freddie Mac and Fannie Mae are federally-chartered corporations financed by the capital of private shareholders. Fannie Mae was created in 1938 to provide a secondary market for mortgages insured by the Federal Housing Administration (FHA). Originally chartered by the Depression-era Reconstruction Finance Corporation, Congress rechartered Fannie Mae in 1954 as an agency within the Housing and Home Finance Agency (the predecessor to today's Department of Housing and Urban Development). The 1954 Act contemplated that Fannie Mae would eventually become a privately-owned corporation, and accordingly, Congress required that Fannie Mae's operations were to be self-supporting and financed by private capital to the maximum extent possible.<sup>6</sup> Congress's vision of Fannie Mae becoming a privately-owned and financed company became reality in the 1968 Act that privatized Fannie Mae and created Ginnie Mae.<sup>7</sup>

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2061, February 2005. See also "An Economic History of Zoning and a Cure for its Exclusionary Effects" by William A. Fischel, *Urban Studies*, Vol. 41, No. 2, pp.317-340, February 2004.

<sup>5</sup> Among the best known examples of this approach are the Erie Canal to spur development of the Midwest, railroad land grants to encourage creation of an advanced transportation system, the Homestead Act, which gave land to those willing to develop it, and the creation of what were essentially public-private partnerships to bring rural electric and telephone service throughout our nation.

<sup>6</sup> The act mandated two types of capital: preferred stock held by the Secretary of the Treasury and common stock issued to sellers of mortgages to Fannie Mae.

<sup>7</sup> The 1968 Act provided for the retirement of the preferred stock held by Treasury and transfer of control of Fannie Mae's board of directors to its common stockholders. By 1970 both objectives were achieved, and Fannie Mae has since operated as a business corporation financed exclusively by private capital.

Freddie Mac was created in 1970 to create a secondary market for mortgages originated by thrift institutions. Its board consisted of the members of the Federal Home Loan Bank Board (the predecessor to the Office of Thrift Supervision) and its initial capital consisted of contributions from the Federal Home Loan Banks, which became the shareholders. From its inception, Freddie Mac was designed to operate in a self-supporting manner. As part of its resolution of the thrift crisis in 1989, Congress created a corporate governance structure for Freddie Mac virtually identical to that of Fannie Mae. The preferred stock was converted into common stock, and Freddie Mac has since then been a shareholder-owned, publicly-traded corporation.

The shareholder-owned nature of the GSEs is reflected in our governance structures set forth in our charters. We each have a federal charter that provides that our Board of Directors is responsible for the operation of the company. Our directors have the same common law and statutory duties of care, good faith and loyalty to the corporation and to its shareholders as the directors of any other private corporation. This is equally true of shareholder-elected and Presidentially-appointed directors. The late Chief Justice Rehnquist, writing in his prior capacity as head of the Justice Department's Office of Legal Counsel, opined that "the directors of [the then newly privatized Fannie Mae] are undoubtedly subject to" the standard common law and statutory fiduciary duties applicable to all corporate directors.

I bring up this history for a reason. The genius of the GSE model as it has evolved since the Great Depression is the ability to harness private capital as much as possible to promote the public purpose of a liquid secondary market for housing finance. To that end, Congress has given the GSEs the freedom they needed, within the context and confines of their charters, to successfully compete for private capital and achieve attractive returns on that capital. Imposing too many conflicting demands on the GSEs risks crippling this highly successful model.

#### **GSE Regulatory Reform: A Balancing Act of Competing Policy Objectives**

Freddie Mac has testified on numerous occasions on the issue of GSE regulatory oversight and our basic position has not changed. We continue to support legislation that enhances the GSE current regulatory structure in a way that ensures continued public confidence in the financial

viability of the housing GSEs, which remain two key pillars of our nation's housing industry and broader economy. That said, we have a responsibility to take into account the full impact of any proposed legislation on our continuing ability to fulfill our statutory mission of providing liquidity, stability and affordability to the nation's housing markets.

As I will describe below, GSEs are highly adaptable institutions, having demonstrated considerable willingness and ability to adjust to changing policy emphases within the context of our statutory mission. Created in 1970, Freddie Mac spent a good part of our first 15 years focused on creating a vibrant secondary market for conventional conforming loans. We did this by introducing standardization and securitization to the mortgage market. In the late 1990s, we turned to the mortgage purchase side of the business and were the first to develop new automated tools to help lenders originate and sell mortgages into the secondary market with greater efficiency and lower costs. Homeowners were the chief beneficiaries of these innovative efforts, enjoying a fairer, faster and cheaper origination process. In 2001, the focus was on protecting subprime borrowers from certain predatory lending practices, and Freddie Mac took the lead by establishing a number of consumer protections that have largely become industry norms. We are subject to increasingly stringent HUD affordable housing goals; on average, the 2008 goals are about two-thirds higher than the first permanent goals in 1996. Today, over fifty percent of our mortgage purchases and investments support mortgage financing for families with incomes below the area median or who live in underserved communities.

That brings us to the present. Witnesses testifying at a recent Senate Banking Committee hearing urged the GSEs to voluntarily restrict investments in short-term hybrid ARMs. As announced a few weeks ago, Freddie Mac once again took the lead and did just that. Beginning in September 2007, we will restrict our subprime purchases to those mortgages that have been underwritten to a fully-indexed level, with concomitant restrictions on the use of stated income and excessive debt-to-income ratios. We also are working to develop model subprime products, consistent with safety and soundness, which will provide safer financing alternatives for families with blemished credit.

Freddie Mac is pleased to be able to promote greater borrower protections in the subprime market. Unfortunately, at some point, such leadership actions may conflict with other policy and regulatory expectations of the company.

Perhaps the broader point – particularly in the context of new legislative and regulatory requirements that may be placed on the GSEs – is that while the GSEs have proven to be highly adaptive, even elastic, over the years, they are not infinitely so. This is because the GSEs, by design, were structured along three key dimensions that must be held in some sort of balance for the whole franchise to work. These three dimensions are mission, capital and shareholder return. While I will admit that, at certain times in our past, these objectives may not have been properly balanced, I am pleased to say that we've worked hard in the past three years to bring things back into a proper balance.

In the same way, the legislation before us also needs to achieve this same type of balance. While there is a fair degree of “elasticity” in this balance, it is critical to note that there is a tipping point: GSEs are not infinitely elastic. We cannot be all things to all people at the same time.

While I am not sufficiently prescient to say that point has arrived, I believe we are approaching a time of difficult tradeoffs. These tradeoffs are what we are talking about today. Without a doubt, the GSE charters are valuable assets resulting in lower GSE borrowing costs. These savings are largely passed through to borrowers in the form of lower interest rates than can be obtained through the higher-cost jumbo market. Lower borrowing costs also provide the GSEs the ability to subsidize certain less profitable mortgage investments, as envisioned by our charters.

On the other hand, the GSE charters also come with a number of business restrictions and mission responsibilities. Unlike banks, to which the GSEs are so often compared, Freddie Mac's business is confined to the residential mortgage market – in good times and bad. We can't diminish our support for this market when there are more profitable investments to be had elsewhere.

Unfortunately, in the past few years, GSE reform legislation has become a tug of war over these two aspects of the GSE charters. One side of the debate appears to support provisions that would minimize the value of GSE charters in the name of reducing potential systemic risk and increasing competition for mortgage assets. The view is that the GSEs are too big, too risky and should be constrained in their ability to develop new products or innovate in ways that might affect the competitive landscape of the primary mortgage market. Proponents of this view support legislative provisions that would raise capital requirements, shrink the size and growth of our mortgage portfolio, and limit innovation through excessive regulation of virtually every aspect of our business.

At the same time, others want to take advantage of the value of the GSE charters by increasing the scope of GSE mission responsibilities and making them legally enforceable. These mission expansions would include the establishment of new financial obligations tied to our total mortgage portfolios; additional and greater targeting of the annual housing goals toward higher-risk borrowers, and the addition of explicit legal duties to serve underserved markets.

These two policy objectives -- minimizing the value of the GSE charters while expanding GSE responsibilities -- cannot be achieved simultaneously. A few examples:

- Requiring capital above the actual risks of our business will slow growth and reduce dollars going to the new affordable housing fund.
- A greatly constrained retained portfolio will mean little or no ability to provide market support for mortgages when other investors leave the market. Conventional conforming mortgage rates likely will rise for consumers.
- Extremely aggressive housing goals that are targeted in very-low-income areas may result in unintended negative consequences. Excessive demand-side mandates can result in an over-extension of credit to some borrowers, with consequences like those

we are seeing in the subprime market today.

- Restraints on growth and increased mission responsibilities combined with sustained excess capital will greatly reduce franchise value and diminish investment in GSEs.

Thus, the “awkward reality” – GSE regulatory reform is a delicate balancing act. Policymakers and regulators must solve a complex equation that strikes appropriate balances and tradeoffs.

#### **Balance of Congressional Policy and Regulatory Discretion**

A second balancing act that must be achieved in GSE reform legislation is the need to balance Congressional policy direction and regulatory discretion. I am exceptionally passionate on this point due to my experiences as former head of the Boston Fed during the New England credit crunch of the early 1990s. As I describe later in this testimony, unintended regulatory action turned what should have been a modest downturn into a regional recession.

Freddie Mac supports the intent and direction of H.R. 1427. However, we have concerns about how certain provisions in H.R. 1427 will be understood, interpreted and ultimately implemented. I am not talking about short-term concerns. GSE legislation has been many years in the making, and, if enacted, is unlikely to be revisited for years to come.

As currently drafted, the provisions dealing with issues such as capital, mortgage portfolios and business activity oversight are very broad. As an example, consider the proposed language on regulatory oversight of our mortgage portfolio. In contrast to portfolio provisions contained in last year’s Senate GSE bill (S. 190), H.R. 1427 does not specifically require or direct the regulator to reduce our mortgage portfolio. This has been widely interpreted as meaning that the regulator would not impose the drastic reductions in our portfolio called for by our critics.

However, the language does provide the regulator with very broad authority to limit or substantially reduce the size of GSE portfolios, if they choose to do so – making it possible to achieve the policy objectives of S. 190 through the provisions of H.R. 1427.<sup>8</sup>

The high degree of discretion has cheered some GSE critics – and that worries us. A Fellow with the American Enterprise Institute and long-time GSE critic recently noted that these requirements give the regulator the authority to substantially and permanently reduce the size of GSE portfolios. In a recent article, he wrote that “the language gives the director the necessary authority, if he chooses to use it” to force reductions in GSE portfolios, and thus H.R. 1427 “deserves the support of those who have sought this goal.”<sup>9</sup>

In my view, similar issues exist with regard to how a regulator might interpret other key provisions in the legislation. For this reason, we believe it is essential that Congress provide greater clarity and direction regarding the continued role of the GSEs. Will the GSEs remain a vital force in the provision of low-cost mortgage money to America’s homebuyers and renters? Or will the GSEs be pared back to serve an FHA-sized market? We think it is for Congress to decide.

#### **Balance Among Other Regulated Entities**

A final balancing act is the need to ensure that GSE regulatory reform is consistent with regulatory trends in financial services. While the regulatory pendulum during the past several years has swung toward increased regulation generally, in recent months there has been growing concern that it may have swung too far in financial services. From Treasury Secretary Paulson and a number of other key financial leaders, we have heard wise calls for “striking the right

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<sup>8</sup> The bill would direct the regulator to “establish standards by which the portfolio holdings, or rate of growth of the portfolio holdings, of the enterprises will be deemed to be consistent with the mission and the safe and sound operations of the enterprises.” The regulator would be required to consider six specific criteria in establishing these standards, including “the potential risks posed by the nature of the portfolio holdings,” as well as seventh which covers “any additional factors the Director determines to be appropriate....”

<sup>9</sup> Peter Wallison, “Viewpoint: House Bill To Authorize GSE Portfolio Lid,” American Banker, January 12, 2007.

balance” in regulation – warning that “[e]xcessive regulation slows innovation, imposes needless costs on investors, and stifles competitiveness.”<sup>10</sup> A report jointly commissioned and issued by U.S. Senator Charles Schumer and New York Mayor Michael Bloomberg warns that overregulation is one of the principal factors endangering New York’s position as the global financial center.<sup>11</sup>

Likewise, there is reluctance for the most part to substantially increase regulation in the financial services industry, even of lightly regulated sectors. For example, some policymakers and industry observers have called for greater regulation of hedge funds. The 1998 failure of a then little-known hedge fund, Long Term Capital Management, sparked a broader crisis in the financial markets that required the active intervention of the Federal Reserve System to address. However, just last month, financial regulators such as the President’s Working Group on Financial Markets (which is comprised of the Secretary of the Treasury and the Chairmen of the Federal Reserve Board, the Securities and Exchange Commission and the Commodity Futures Trading Commission) indicated that instead of increasing direct regulation of hedge funds, their preferred approach is to focus on using existing regulatory structures to encourage improved transparency and market discipline among hedge funds and stronger risk management by counterparties and creditors.<sup>12</sup>

What is perhaps most striking about the public discussion over GSE regulatory oversight is how disconnected it is from this broader discussion of financial services regulation. None of the concerns being expressed about the dangers of overregulation are being applied to the GSEs – indeed, they are completely absent from the policy discussion. An outside observer might thus surmise that when it comes to regulation, the GSEs are infinitely elastic – no amount of regulation will materially impact their ability to function. This is just not the case. While

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<sup>10</sup> Remarks by Treasury Secretary Henry M. Paulson on the Competitiveness of U.S. Capital Markets, Economic Club of New York (November 20, 2006).

<sup>11</sup> *Sustaining New York and the US’ Global Financial Services Leadership*, January 22, 2007.

<sup>12</sup> See President’s Working Group on Financial Markets, *Principles and Guidelines on Private Pools of Capital*, February 22, 2007.

Congress can impose any mandates or requirements it deems fit on us, it cannot compel anyone to invest in the GSEs, nor can it require anyone to do business with them. Like other companies, the GSEs must attract shareholder capital, and they must compete for the business of lenders. If we operate under legislative and regulatory restrictions that prevent us from providing shareholders a competitive return, we will not attract their capital. If we operate under restrictions that make it unattractive for lenders to do business with us, then they won't – they will go elsewhere. And then we will be unable to fulfill the purposes for which we were created – an outcome we believe no one in Congress wants.

Of course, some might respond that the GSEs brought this on themselves – and in many ways, they are right. I am acutely mindful of the mistakes we made in the past and how they sparked the debate we are having today. But the company I am privileged to lead today is vastly different from the company I joined a little over three years ago. While our work is not yet complete, Freddie Mac has rectified many of the mistakes of the past and continues to focus its efforts on regaining the public trust. We are more committed than ever to fulfilling our mission and serving the needs of our nation's homebuyers and renters. It is our obligation, and the times demand it.

But regulation must be rooted in the recognition that the GSEs are businesses that have to compete with other businesses in the marketplace. Capital is one key issue about which we ought to be particularly aware of competitive impacts. It is especially puzzling to contemplate a dramatic increase in required capital for the GSEs, at the same time as our main competitors are arguing that their capital requirements should be substantially *eased* under the implementation of Basel II. In a recent study for the Mortgage Bankers Association, Professor Mark Flannery of the University of Florida found that even at current GSE capital levels, large banks under Basel II may be allowed to hold lower levels of equity capital against prime mortgage credit risk than the GSEs.<sup>13</sup> If Professor Flannery is right, that will put a big squeeze on the GSEs' securitization

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<sup>13</sup> Mark J. Flannery, "Likely Effects of Basel II Capital Standards on Competition within the 1-4 Family Residential Mortgage Industry," manuscript, University of Florida, October, 2006.

business – the one area where there is the least controversy over the GSE role. Furthermore, many of our competitors enjoy both explicit and implicit government guarantees. For example, banks' insured deposits fund more than three-quarters of their loan portfolios, providing a low-cost and stable funding base because of government backing. In addition, beyond insured deposits, many large banks also benefit from the market's perception of implicit government guarantees. A recent Moody's report estimated there is a 98 percent probability that the government would bail out some of the nation's largest banks in the event of a crisis.<sup>14</sup>

We support strengthening GSE oversight, but not at the cost of crippling our ability to compete in the marketplace. On capital, for example, we urge that any new capital requirements avoid placing us at a disadvantage in relation to our competitors. Modern financial service regulators acknowledge the competitive impact of disparate capital requirements: one reason the bank and thrift regulators proposed Basel IA was to level the playing field for depositories not subject to Basel II's substantial reductions in capital requirements for residential mortgages. Striking the right balance in regulation is just as important for us as it is for banks, insurance companies, broker/dealers, and hedge funds.

### **Systemic Risk**

In response to these statements, our critics likely would assert that the GSEs require much stronger regulation than other financial institutions because their investments in mortgages pose unique risks to the financial system as a whole. This is an issue on which there has been a great deal of heated debate (and I will admit at times there has been more heat than light on both sides). I would like to offer several facts and observations for the Committee's consideration that hopefully will help clarify this issue.

Systemic risk is an issue to which the Administration has devoted considerable attention. Thus, it may be useful to look at the very recent work of the President's Working Group on Financial

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<sup>14</sup> "Moody's Announces Bank Rating Actions Resulting From Implementation of JDA Methodology – United States," March 2, 2007.

Markets cited above that set forth broad principles for use by the financial regulators in mitigating potential systemic risks posed by “private pools of capital” (e.g., hedge funds). Hedge funds differ from GSEs in critical ways. Unlike the GSEs, hedge funds are unregulated, loosely capitalized and opaque; they are not required to publicly disclose their portfolio holdings, trading strategies or even their financial performance. They also invest in a wide range of asset classes while we are generally restricted to investing in high-quality mortgage related assets.

That said, and even though we present much less risk to counterparties than a typical hedge fund, many of the Working Group’s findings are applicable. For example, in its two “overarching principles,” the Working Group argues, first that “public policies that support market discipline, participant awareness of risk, and prudent risk management are the best means of protecting investors and limiting systemic risk” and second, that “supervisors should use their existing authorities...to foster market discipline.” I agree wholeheartedly with these two principles and believe that market discipline and strong supervision are the most effective way to manage the systemic risks posed by large financial institutions. As for GSE supervision, over the past three years I have seen just how tough a safety and soundness regulator OFHEO can be. H.R. 1427 would make that oversight even stronger. As a former bank regulator, I am also very confident in the federal banking agencies’ abilities to monitor their institutions’ counterparty risks. With regard to market discipline, we have made important efforts, such as our issuance of subordinated debt, to enhance the degree of market discipline.

Moreover, in the context of the debate regarding the GSEs, systemic risk is routinely used as shorthand for the view that these institutions somehow present a special degree of risk to the U.S. financial system (or even the world’s financial markets). The simple fact is that while the GSEs are large financial institutions, they are only two of a group of large financial institutions within the U.S. Our financial system is quite resilient and innovative – the subject of constant changes and improvements. Further, the nation’s system for financing residential real estate mortgages is the envy of the world – as is shown by the investments in it from various sources around the globe. While we agree that the system could be stronger, we strongly disagree that the GSEs

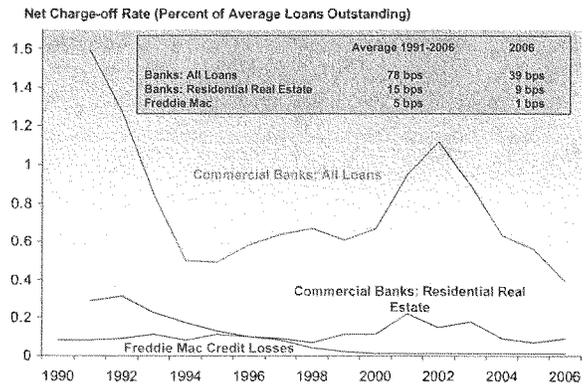
represent a unique, large looming problem waiting to happen, particularly given the intense scrutiny we have received.

The assets the GSEs own are considered to be among the safest financial products, evidenced by the reduced level of capital called for by the Basel II accord for high quality residential mortgages. A mortgage in our portfolio is no riskier than a mortgage held in the portfolio of a bank, insurance company, hedge fund, or central bank – the risks are exactly the same. As a means of allocating capital, regulatory capital requirements for a particular asset should be comparable regardless of whether the asset is held by a bank, an insurance company, a central bank or a GSE, taking into account the risk management capabilities of the institution holding the asset.

Freddie Mac has a demonstrated track record of managing the risks of mortgages very effectively over many years. As shown in the table below, Freddie Mac's credit-related losses have averaged only one basis point annually throughout this decade. Compare this to the credit losses of the commercial banking sector, which from 2001-2005 averaged 83 basis points for all loans and 14 basis points for residential mortgages.



**Freddie Mac Has Lower Charge-Offs and Charge-Off Volatility than Banks**



Note: Freddie Mac 2006 data is an estimate as of December 31, 2006 and is subject to change. Office of the Chief Economist  
 Source: FDIC, OFHEO, Freddie Mac.

Our management of interest-rate risk has been equally effective. We do not retain all of the interest-rate risk in our portfolio – we disperse most of it into the capital markets through the use of callable debt and derivatives. The record refinancing boom of 2003 provides a prime example of how we do this. During 2003, we financed nearly \$835 billion in new mortgages, as borrowers refinanced to take advantage of historically low mortgage rates. During this time, more than half of our total mortgage portfolio prepaid. To manage the effect of this boom on our retained portfolio, we also called and refinanced much of our debt. This is the type of shift in the market to which our critics assert that we are uniquely vulnerable. In fact, our reported risk measures were consistently low, and our fair value of net assets increased by 19 percent. These same disclosures show that our duration gap – which contrasts the expected life of our assets and liabilities – has been at zero months in every month but one since January 2004. A duration gap of zero months indicates that assets and liabilities are expected to mature at the same time, demonstrating they are properly matched. All of this can be verified by reviewing our monthly disclosures.

None of this is meant to suggest that there are no risks involved in GSE mortgage investment. Ensuring that we manage these risks well should be key to the new regulatory regime. But the risks of the GSEs investing in mortgages, as opposed to other investors, are not unique, nor are they uniquely difficult to manage.

Now let me turn briefly to specific proposals under consideration in this Committee.

#### **Legislative Proposals**

It is my hope that each aspect of H.R. 1427 will be measured against the twin criteria of safety and soundness and mission. Each should advance, or at least do no harm, to the safety and soundness of the GSEs. And each should advance, or at least do no harm, to the GSEs' ability to fulfill their mission.

While fulfilling our mission and remaining safe and sound are each necessary, in practice, achieving both requires a delicate balance. We believe there are a number of legislative proposals that can be combined into a bill that strengthens regulatory oversight without upsetting that balance. But there are other combinations of provisions that could create significant tension between fulfilling our mission and ensuring safety and soundness, such as:

- Proposals that lead to higher borrowing costs or that significantly harm our ability to attract debt and equity investors
- Requirements to hold capital beyond levels indicated by our actual risks
- Potentially onerous new product or activity constraints that inhibit innovation and our ability to offer competitive products to our customers
- Provisions that could lead to unwarranted restrictions on our investment portfolios

- Provisions that create a proliferation of affordable housing obligations rather than consolidating existing and new ideas into the most effective package

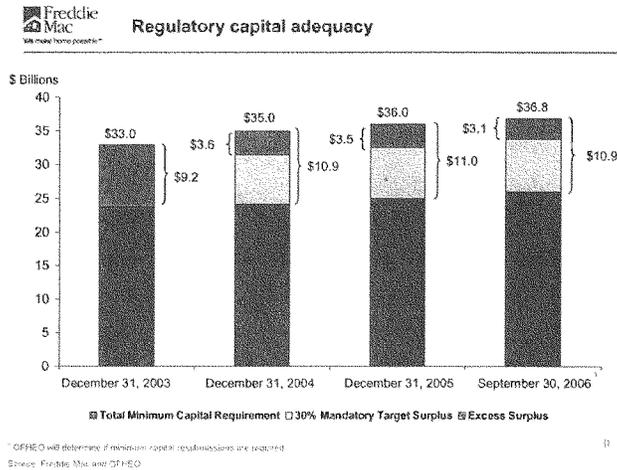
These are challenging issues, but I have faith that Congress will strike the right balance.

### **Capital Requirements**

H.R. 1427 gives the regulator new authority to adjust the existing minimum capital ratios and risk-based capital standards for both the GSEs and the FHLBs.

As an initial matter, Freddie Mac has always been more than adequately capitalized under both the risk-based and minimum capital ratios – for us, the more stringent of the two – established under current law. As the graph below clearly illustrates, before OFHEO’s imposition of the current 30 percent add-on for operational risk, we held a surplus over regulatory minimums, and even now hold a \$3 billion cushion over the OFHEO mandatory target surplus.

This is real, permanent, at-risk capital that provides the first line of defense in the unlikely event of a financial catastrophe at Freddie Mac. Since shareholders are the ones providing the capital, they – and not the taxpayers – will be the ones to bear the losses. Shareholders expect an adequate return on their investments in exchange for putting their money on the line, but like any other investor, they buy our stock at their own risk.



As a mortgage guarantor, it goes without saying that being adequately capitalized is a *sine qua non* of our business. But we fundamentally believe that our mission as a GSE depends on capital requirements that are tied to the *actual risks of our business*. Under our charter, we can deal solely in mortgages. This business gives rise to three basic risks: mortgage credit risk, interest-rate and other market risks, and operational risks. We should be required to hold sufficient capital against each of those risks to ensure that we can weather unexpected losses, without requiring so much capital that we become inefficient and uncompetitive.

Some critics nevertheless would like us to have much higher capital. For example, some argue our capital should mirror bank capital. As a general matter, all financial institutions should hold comparable capital against comparable assets, but as institutions, banks hold a wider array of assets and have very different risk profiles than the GSEs. Others want us to hold capital against a doomsday scenario, based on the view that we present a unique systemic risk to the global financial system. Either would create a capital regime divorced from risks we actually present, and are thus inherently arbitrary and speculative. Most importantly, raising GSE capital apart from their actual risks would make it much harder for us to meet our mission of ensuring

liquidity, stability and affordability, without adding meaningfully to our financial safety and soundness.

Requiring capital above and beyond actual risks also can have very real and very serious market effects. From my days as President of the Federal Reserve Bank of Boston, I know firsthand the painful effects that can ensue in a market in transition from my analysis of the early 1990s credit crunch that particularly affected New England. As I noted in my testimony before a House Subcommittee at the time, the drop in real estate prices triggered a substantial rise in nonperforming assets among lenders, which ate away at the capital base of banks and other lenders.<sup>15</sup>

Ultimately, this led to a “capital crunch” that curtailed credit availability for all types of real estate lending save one: conforming residential loans. In contrast to the rising costs and declining availability of construction and development loans, commercial-property loans, jumbo mortgages, and small business loans, the conforming home-mortgage market remained robust with conforming mortgage rates remaining on par with those in other markets.<sup>16</sup> The reason is because Freddie Mac and Fannie Mae were doing the job that Congress had set out for them: providing liquidity and responding appropriately to capital market trauma so as to mitigate economic shocks and hence support a recovery.

As in the early 1990s, we are at one of these transition times right now. The recent downturn in the housing market has led to a drop in home values in many markets across the U.S., has sliced a percentage point from annualized GDP growth over the last three quarters, and will slow

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<sup>15</sup> Richard F. Syron, Statement before the Subcommittee on Domestic Monetary policy of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, May 8, 1991, reprinted in “Are We Experiencing a Credit Crunch?”, *New England Economic Review*, July/August 1991, pp. 3-10.

<sup>16</sup> Mortgage rate data compiled by HSH Associates show that mortgage rates on jumbo fixed-rate loans in the Boston metropolitan area averaged 0.2 percentage points *above* the national average jumbo rate during the fourth quarter of 1990, after a full year of falling real-estate values. In contrast, conforming rates in Boston averaged up to 0.1 percentage points *below* the national average each quarter of the recession.

expansion during the first part of this year as well.<sup>17</sup> Mortgage delinquency rates are up at banks and savings institutions, and subprime servicers have experienced a sharp deterioration in loan performance over the past year.<sup>18</sup> Furthermore, the latest Federal Reserve survey of senior loan officers at major banks found that, on net, home mortgage credit underwriting had tightened over the last quarter of 2006.<sup>19</sup>

One reason Freddie Mac and Fannie Mae were created was to mitigate the impacts on the housing finance system of a transition like the one we are experiencing right now. Freddie Mac and Fannie Mae perform this role through every recession and each downturn in the residential housing market. We provide stability to the housing sector by providing funds *counter-cyclically* to lenders. That means that at the point in the business cycle when economic activity is contracting, Freddie Mac and Fannie Mae *increase* their relative provision of funds to the mortgage market, and vice versa. In contrast, other mortgage investors make credit available pro-cyclically, such that fewer funds are available during a housing downturn. By acting *counter* to the business cycle, Freddie Mac and Fannie Mae help reduce the depth of a housing recession and support credit flows during an expansion in an “as needed” basis.<sup>20</sup>

We can only serve this function if we have the capital (and operational flexibility) to respond quickly to market transitions. For example, if regulators require us to hold capital in excess of

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<sup>17</sup> Bureau of Economic Analysis News Release BEA 07-06, February 28, 2007, “Gross Domestic Product: Fourth Quarter 2006 (Preliminary),” Table 2, shows that the fall in residential fixed investment subtracted an average of 1 percentage point from real GDP growth over the second to fourth quarters of 2006.

<sup>18</sup> The Federal Reserve Board’s *Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks* shows that the 30-day delinquency rate on residential loans had risen to its highest level in nearly four years as of December 31, 2006, and charge-off rates to the highest level in nearly three years. *Moody’s Special Report*, “Early Defaults Rise in Mortgage Securitizations,” reports a large increase in subprime and alt-A early-payment default rates during 2006 (January 18, 2007).

<sup>19</sup> Federal Reserve Board, *The January 2007 Senior Loan Officer Opinion Survey on Bank Lending Practices*, reported that “On balance, about 15 percent of domestic banks reported that they had tightened credit standards on residential mortgage loans over the past three months, the highest net fraction posted since the early 1990s.”

<sup>20</sup> See two papers by Joe Peck and James A. Wilcox: “Secondary Mortgage Markets, GSEs, and the Changing Cyclicity of Mortgage Flows,” ed. Andrew H. Chen, *Research in Finance* Volume 20, pp. 61-80, 2003; and “Housing, Credit Constraints, and Macro Stability: The Secondary Mortgage Market and Reduced Cyclicity of Residential Investment,” *American Economic Review*, May 2006, pp. 135-140.

our actual risks, we may not have the financial base that allows us to inject liquidity into the marketplace by buying and holding mortgages. We should be careful not to damage the successful GSE business model, especially at a time when GSEs may be needed to sustain the world's most liquid and successful housing finance system.

### **GSE Mortgage Portfolios**

Let me now turn to our mortgage investment portfolios. We are gratified that H.R. 1427 does not mandate the draconian cutbacks mandated by last year's Senate bill. But, as the head of National Association of Home Builders pointed out a few weeks ago, the bill would allow the regulator to compel the same massive portfolio cuts as the Senate bill. Because our ability to invest in mortgages is a critical tool for achievement of our mission, we, like the Home Builders, would like to see revision of the bill to prevent such an outcome.

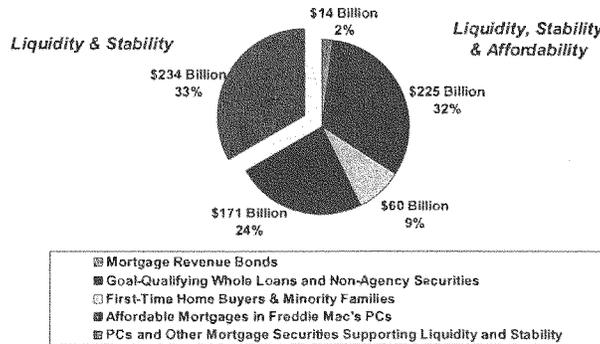
Why do we say that the portfolios are critical to our mission? Our charter gives us the obligation to ensure the liquidity, stability, and affordability of mortgage credit across the country, in good times and bad. We fulfill these obligations through intermediating mortgage assets, largely through securitization, but also – because the demand for mortgage assets is volatile and unpredictable – through supporting demand through purchases of mortgages for our portfolio. The portfolios contribute to our mission even when we are not buying, because investors know we will provide a “backstop bid” and buy their mortgages if they later need to sell. This helps keep markets liquid and mortgage rates low across economic environments.

Recently, we have heard that only 30 percent of our portfolios fulfills our affordable housing mission. We respectfully disagree with this characterization as too narrow a view of our mission, as well as the contributions we make to affordable housing. First, since we can only invest in mortgages permitted by our charter, by definition every mortgage asset we invest in is mission-related. Every mortgage asset, whether a whole loan, multifamily security, or mortgage revenue bond, fulfills at least one of our mission purposes of providing liquidity, stability and affordability. The same can be said of investments in Freddie Mac's own mortgage-backed

securities. I do concede the difficulty of quantifying the additional mission benefit of investing in securities we have already guaranteed, but our constant presence and scale provides ongoing liquidity in our securities, helps keep rates low, and ensures a back-stop bid for mortgages in times of market volatility.

As the chart below shows, we estimate that about two-thirds of our retained mortgage portfolio either directly or indirectly supports the affordable component of our mission. This “affordable” share is comprised of a number of different investments: bonds financing low-cost housing (including the \$1 billion in MRBs we bought to help rebuild the Gulf Coast); goal-qualifying whole loans and non-agency securities; non-goal-qualifying mortgages and securities supporting first-time homebuyers and/or minority families; and affordable mortgages contained in Freddie Mac securities.

**Freddie Mac's Retained Portfolio Supports Our Statutory Mission**



**Freddie Mac's Retained Portfolio as of December 31, 2006: \$704 Billion**

- Mortgages \$66 billion (including \$6 billion restructured and non-performing mortgages)
- Freddie Mac securities: \$354 billion
- Other mortgage securities: \$284 billion

Source: Freddie Mac

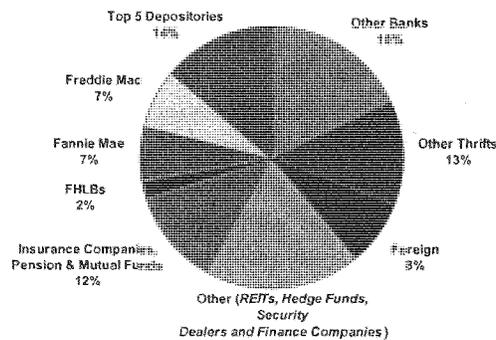
Another argument is that the GSE portfolios are too big. While the GSEs, have in the past, comprised a relatively larger share of the overall market, this is not true today. Numerous

investors compete vigorously for mortgage assets, and as a result both companies' share of U.S. residential mortgage debt outstanding (MDO) has dropped significantly, while the MDO share for competing investors has grown dramatically.

At the end of 2003, Freddie Mac held about 8.5 percent of MDO, and Fannie Mae just under 12 percent. Data released by Federal Reserve Board last week showed that MDO was nearly \$11 trillion as of the end of 2006. Of that amount, the shares of MDO held by Freddie Mac and Fannie Mae were less than 7 percent for each – down approximately 40 percent from three years ago. In contrast, the mortgage portfolios of the five largest depositories grew by 29 percent in the last year alone. The largest of these portfolios is now approaching half a trillion dollars and in total these depositories hold more than \$1.6 trillion in mortgages. This is more than 14 percent of MDO, a larger share than the GSEs combined.<sup>21</sup>

### Mortgage Risk Is Widely Dispersed Among Many Investors

June 30, 2006: \$10.5 Trillion



Sources: Freddie Mac and Fannie Mae January 2007 Monthly Volume Summaries, Inside MBS & ABS (October 20, 2006), FDIC and the Federal Reserve Board

Several observations can be made from these data. First, the large banks also hold large mortgage portfolios, collectively larger than the GSEs. Second, the data show that mortgage risk

is already widely dispersed throughout the global economy, with the seven largest mortgage investors together owning less than 28 percent of MDO.

This is not a criticism of the banks. In our view, the key question is not *size per se*, for us or for the banks. It is whether we are able to manage the risks of our businesses without jeopardizing our financial safety and soundness. With respect to mortgage risk, our track record is second to none. Even in the darkest days of our accounting problems, the low volatility of our risk measures evidenced that we manage mortgage risk conservatively and successfully.

A final source of opposition to the GSEs' retained portfolios is that they are profitable, and that is true. However, profits are indispensable to the GSE model. Profits are what allow us to be private sector institutions, using private-sector methods and private capital, to respond to market realities. It is my sincere hope that this candid explanation helps the Committee understand why we are extremely apprehensive about how the regulator might exercise his authority over the retained portfolios. OFHEO's Director has been very open about his view that the portfolios are too big and uniquely risky. We respectfully but strongly disagree with him on this question, but do agree that the regulator should have clear authority to ensure that our investment portfolios (and those of the FHLBs for that matter) be operated safely and soundly and in compliance with our charters.

#### **Prior Approval**

As noted earlier in my remarks, the GSEs have a long and distinguished record of innovation. Whether we're talking about the creation of new securities, new mortgage products, or new technologies, GSE innovations have brought incalculable benefits to the mortgage market and homebuyers. Superimposing thickets of regulation on this process is a sure way to slow things down – if not shut them down altogether. For example, many have called for the GSEs to develop so-called subprime “rescue” products, and we are interested in doing just that.

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<sup>21</sup> Sources: Federal Reserve Board; Freddie and Fannie year-end MVS; Bloomberg; FDIC.

However, overburdening GSE product development with excessive comment and approval requirements could greatly slow our ability to bring this needed product to market.

In our view, the Director's prior approval authority should only apply to major changes in GSE offerings to ensure compliance with our charter and safety and soundness. Although a bureaucratic prior approval process may offer a competitive benefit to individual market participants, there is no discernible public benefit to crippling our ability to innovate, compete, and respond to our customers' needs as we do routinely in our everyday business.

#### **Conforming Loan Limit Increases**

This Committee is considering including in GSE legislation a provision that would increase the maximum conforming loan limit in areas with high housing costs. Depending on how a high cost area loan limit is defined and implemented, this change would provide needed relief to families squeezed by high housing costs by extending the benefits of the conforming market to them.

#### **Affordable Housing**

Congress is considering making fundamental changes to the affordable housing obligations of the GSEs. Possible changes being discussed are creating an affordable housing fund that would be financed through contributions made by Freddie Mac and Fannie Mae, redefining the housing goals, and creating a statutory "duty to serve" underserved markets. With regard to the proposed fund, I do not believe the CEO of any shareholder owned company would enthusiastically support an additional cost imposed on his or her business, and I'm no exception. At the same time, I understand the interest in Congress in creating such a fund.

Each of these changes to our affordable housing obligations would have a significant impact on the GSEs. All three simultaneously – especially in combination with the capital, portfolio and prior approval provisions discussed above – could push us past the tipping point I warned about

earlier. Our ability to perform our mission depends upon our ability to attract shareholder capital and compete in the marketplace. And this ability is affected by the cumulative amount of regulation and obligations we operate under – this is the focus of our concern.

Accordingly, we would urge Congress to consider the following principles in the context of reform of GSE mission responsibilities:

- Legislative reform that addresses the GSEs' affordable housing mission must be holistic in approach. In the context of current legislative proposals, efforts to amend the goals regime, create an affordable housing fund, and establish a duty to serve underserved markets, must consider the interplay among, and cumulative impact of, these proposals.
- Efforts to amend the goals regime (and related proposals) should foster innovation, leveraging market developments and strategies, in expanding homeownership and rental opportunities for low-income families and underserved communities.
- The goals regime should refrain from imposing numerous, difficult-to-administer goals with potentially overlapping objectives. Rather, the goals should promote efficiency in directing benefits through the secondary market to targeted groups, align with the GSEs' other mission objectives – liquidity and stability, and encourage the development of affordability initiatives through incentives (rather than simply through rigid mandates).
- The goals regime, and any targets thereunder, must be reflective of market conditions, recognizing the GSEs' role as secondary market participants.

In short, expansion of the GSE mission responsibilities is a very important component of this legislation. Expanded affordable housing mission requirements should be designed to work synergistically with each other, and more broadly with the other GSE statutory purposes of providing liquidity and stability. Further, they should not create unintended negative consequences for the long-term viability of the franchise, the markets we support and the

homeowners and renters we serve. In this vein, we acknowledge the efforts of HUD Secretary Jackson in his administration of the GSE housing goals.

### **Conclusion**

Freddie Mac supports legislation that enhances the GSE regulatory structure in a way that ensures continued public confidence in the financial viability of the housing GSEs, which remain two key pillars of our nation's housing industry and broader economy.

As stated earlier in this testimony, we urge policymakers to take into account the full impact of proposed legislation on our continuing ability to serve the full breadth of our statutory mission of providing liquidity, stability and affordability to the nation's housing markets. We believe the successful implementation of this legislation will require striking a delicate balance on three important dimensions. Without a proper balance between the desire to both minimize and take advantage of the charter; regulatory balance among other regulated entities; and a careful balance between statutory direction and regulatory discretion, we remain highly concerned that this legislation will not only shrink the size of the GSEs – but also the very strong, safe, consumer-focused mortgage market we serve. We respectfully submit that in this time of relative weakness in the U.S. housing market, over-engineering the GSE-model of housing finance, including requiring capital in excess of actual risks, may lead to further market weakness, higher mortgage rates for borrowers and a diminished supply of long-term fixed-rate financing, which is critical to ensuring sustainable homeownership for America's families.

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Thank you for the opportunity to appear before the Committee today. I know the views contained in this testimony are potentially controversial. My purpose in raising them is not to be quarrelsome. Rather, the issues before this Committee are so important that it would be irresponsible of me to shy from candor. Nevertheless, let me affirm that Freddie Mac is a creation of the Congress, and we are committed to doing what you want us to do.

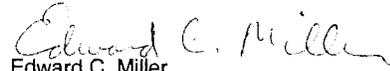
Testimony of Richard F. Syron  
Chairman and CEO, Freddie Mac  
COMMITTEE ON FINANCIAL SERVICES  
UNITED STATES HOUSE OF REPRESENTATIVES  
March 15, 2007

I look forward to working with Chairman Frank, Ranking Member Bachus and the members of this Committee. I look forward to your questions.



industry, or consumer information on title insurance, please link to our website at [www.alta.org](http://www.alta.org) or contact me.

Sincerely,

A handwritten signature in cursive script that reads "Edward C. Miller".

Edward C. Miller  
Chief Counsel and Vice President of Public Policy

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**CONSUMER MORTGAGE COALITION**

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March 14, 2007

The Honorable Barney Frank  
Chairman  
U.S. House Committee on Financial  
Services  
2129 Rayburn House Office Building  
Washington, D.C. 20515

The Honorable Spencer Bachus  
Ranking Member  
U.S. House Committee on Financial  
Services  
2129 Rayburn House Office Building  
Washington, D.C. 20515

Dear Mr. Chairman and Ranking Member Bachus:

The Consumer Mortgage Coalition respectfully submits testimony for the record to the U.S. House Committee on Financial Services for the March 15, 2007 hearing entitled, "Legislative Proposals on GSE Reform."

Thank you.

Sincerely,



Anne C. Canfield  
Executive Director

CC: Jeanne Roslanowick  
Larry Lavender

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**CONSUMER MORTGAGE COALITION**

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**Testimony Submitted for the Record**

**Committee on Financial Services  
United States House of Representatives**

**Regarding Legislative Proposals on  
Government-Sponsored Enterprise Reform**

**March 15, 2007**

The Consumer Mortgage Coalition (“CMC”) is pleased to submit testimony for the record regarding legislative proposals on Government-Sponsored Enterprise (“GSE”) reform. The Consumer Mortgage Coalition is a trade association of national mortgage lenders, servicers, and service providers committed to expanding homeownership and providing access to affordable housing to all Americans.

The CMC has been a long-time proponent of legislation to reform the regulation of the housing GSEs. We commend the efforts of this Committee to create a strong, reliable, and coherent regulatory structure for the housing GSEs by enhancing the mandate, capacity, and statutory authority of the regulator of these GSEs. We are very appreciative of the Committee’s focus and efforts on this critically important legislative initiative. Our comments in the testimony we are submitting today are focused on the aspects of the GSE reform proposals that would affect Fannie Mae and Freddie Mac (“GSEs”).

**Background**

When Congress chartered Fannie Mae as a GSE in 1968, it stated that the purpose of the company was to “provide *supplementary assistance* [emphasis added] to the secondary market for mortgages by providing a degree of liquidity for mortgage

investments, thereby improving the distribution of investment capital available for home mortgage financing.”<sup>1</sup>

In the process of addressing the savings and loan debacle, Congress expanded that statement of public purpose in 1989, to provide, among other purposes, that Fannie Mae and Freddie Mac were to “provide stability in the secondary market for residential mortgages.” In the 1992 reform legislation, both Fannie Mae and Freddie Mac were given an expanded affordable housing mission, as well.

The GSEs have grown dramatically since Congress made those changes. Their market share grew from 25% of total mortgage debt in 1990 to 47% in 2003 when their accounting difficulties were uncovered and they were forced to curtail their portfolios. Today, Fannie Mae and Freddie Mac fund just under 40%<sup>2</sup> of all mortgage debt outstanding, and approximately 70%<sup>3</sup> of the conforming mortgage market. Today, despite Congressional intent that the GSEs supplement and/or stabilize the mortgage market, the GSEs now dominate the mortgage market.

In 1989, the two GSEs together held \$129 billion in mortgages and securitized another \$489 billion. Ten years later, in 1999, the two GSEs held almost a trillion dollars in mortgages and securitized another \$1.2 trillion. Although the GSEs have not been able to prepare timely audited financial statements for some years, the Office of Federal Housing Enterprise Oversight (OFHEO) estimates that in the third quarter 2006 the two GSEs held or securitized approximately \$4.3 trillion in mortgages.

The growth of the GSEs is fueled by their special federal benefits

- The GSEs have lower capital requirements than other financial institutions, thereby allowing the GSEs to maximize their use of leverage.
- The GSEs have lower borrowing costs, either through direct access to the Treasury, or in the debt markets, where the GSEs are perceived to have implied government backing. The “implied federal guarantee” of their debt allows the GSEs to issue bonds whenever they seek funding, regardless of market conditions, at interest rates lower than those granted to the best fully private companies.
- Federal support also allows the GSEs to increase their financial flexibility by issuing callable long-term debt.
- With an “implied federal guarantee” of GSE debt, investors do not judge them with the same risk standard as applied to other companies, providing a benefit to both their debt and their stock. The high leverage they employ gives the GSEs exceptional returns on equity.

<sup>1</sup> Fannie Mae Charter Act, Section 301(a) 12 U.S.C. Section 1716(a).

<sup>2</sup> Office of Federal Housing Enterprise Oversight, “Total Mortgage Held or Securitized by Fannie Mae and Freddie Mac as a Percentage of Residential Mortgage Debt Outstanding, 1990-2006Q3” available at [www.ofheo.gov](http://www.ofheo.gov).

<sup>3</sup> Testimony presented by the Mortgage Bankers Association to the Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises, Committee on Financial Services, U.S. House of Representatives, hearing on “Legislative Proposals on GSE Reform,” March 12, 2007.

- The GSEs' debt securities are eligible for open-market transactions by the Federal Reserve, and for investment, without limit, by insured banks and thrifts.
- The GSEs' debt securities are eligible for collateral for the federal government's deposits of tax revenues in banks.
- The GSEs' securities held by banks and thrifts require only a 20-percent risk weighting, as compared to the 50-percent risk weighting assigned to prudently underwritten private MBS under the Basel Accord.
- The Secretary of the Treasury is authorized to purchase up to \$2.25 billion of their securities, effectively providing each GSE a \$2.25 billion line of credit to the U.S. Treasury.
- The GSEs are exempt from state and local taxes.
- The GSEs are exempt from filing with the SEC, saving both the expense of filing and the time needed to compile and write SEC disclosures.<sup>4</sup> The SEC exemption gives the GSEs the advantage of not having to properly disclose financial data on a timely basis, and exempts them from provisions in other laws, such as the Foreign Corrupt Practices Act.
- The GSEs' exclusive charters ensure their shared-monopoly (or duopoly) status.

The implied guarantee provides an immensely valuable benefit to the GSEs – an essentially “free” federal credit enhancement that the Congressional Budget Office estimated to be worth over \$23 billion in 2003.<sup>5</sup> The implied guarantee provides them with a significantly lower cost of borrowing than private companies, giving the GSEs the ability to earn profits above competitive levels even while undercutting the pricing of the private sector.<sup>6</sup> The federal subsidies afforded the GSEs make it impossible for non-subsidized market participants to compete effectively against the GSEs in any line of business or transaction the GSEs decide to enter.

The Federal Reserve Board estimates that only 5% of the GSEs' subsidies flow through to consumers in the form of lower mortgage interest rates. This implies that mortgage interest rates dropped by less two basis points in recent years as a result of the GSEs involvement.<sup>7</sup>

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<sup>4</sup> Under an agreement reached with the Department of the Treasury and the Securities and Exchange Commission, both Fannie Mae and Freddie Mac agreed to register their companies with the SEC under the 1934 Act. They did not agree to register their securities under the 1933 Act. Fannie Mae filed initially, but then because of its accounting irregularities has been unable to file audited financial statements on a timely basis. Freddie Mac has not yet complied with its commitment to register with the SEC because it too has been unable to file audited financial statements on a timely basis.

<sup>5</sup> Statement given by CBO Director Douglas Holtz-Eakin, “Aligning the Costs and Benefits of the Housing Government-Sponsored Enterprises,” Senate Committee on Banking, Housing, and Urban Affairs, April 21, 2005. The \$23 billion estimated federal subsidy in 2003 included Fannie Mae, Freddie Mac, and the Federal Home Loan Banks.

<sup>6</sup> Barbara Miles, “*Government-Sponsored Enterprises: The Issue of Expansion into Mission-Related Business*,” Congressional Research Service Report for Congress, January 1999.

<sup>7</sup> Wayne Passmore, Gillian Burgess, Diana Hancock, Andreas Lehnert, and Shane M. Sherlund, “Federal Reserve Research on Government-Sponsored Enterprises,” presentation at the Federal Reserve Bank of Chicago Bank Structure Conference, May 18, 2006.

The GSEs' unique structure invites conflict because it combines the advantages of government sponsorship with a shareholder-owned organization. The GSEs' dramatic growth combined with failures of internal controls and management at both of these companies have demonstrated that the need for a strong, independent and well-funded regulator with the resources and expertise needed to evaluate the GSEs has never been greater.

The new regulator must have the tools necessary to evaluate the GSEs' performance, both as financial institutions and as public purpose entities. As a financial institutions regulator, the new regulator must be able to ensure that the GSEs are operating in a safe and sound manner and are not a catalyst for systemic risk that might spread to the rest of the housing market and financial services industry. As a regulator that oversees the GSEs' public purposes, the regulator needs to ensure that the GSEs are not displacing available private sector capital and expertise, but are instead adding value, and that they are creating liquidity in the affordable housing – or “CRA” market segment.

#### **Principles for GSE Reform**

- The proper regulatory approach to Fannie Mae and Freddie Mac must recognize that (1) effective regulation is essential for the health of our mortgage market and financial system, and (2) the GSEs should be required to focus on the highest priority public purposes.
- The new regulator should have the statutory mandate, institutional capacity, and authority that are at least as strong as those of the federal bank regulators, including analogous enforcement, cease and desist, and receivership powers, the ability to set appropriate minimum, critical, and risk-based capital requirements, and all other regulatory tools available to the federal banking regulators.
  - *With respect to the mandate, capacity, and statutory authority that should be available to the GSE regulator, the structure of federal bank supervision provides a good benchmark. Even the best-managed banks are subject to rigorous oversight by their regulators. Both federally regulated and non-federally regulated financial institutions are also subject to thorough review by the rating agencies and the discipline of the market itself -- a review and discipline that Fannie Mae and Freddie Mac, as GSEs, largely escape because of their implied government backing.*
- The new regulator should be funded by assessments paid by the GSEs that are not subject to the Congressional appropriations process.
- The new regulator should have the authority to review both ongoing and new programs, products and activities – i.e., any undertaking -- to ensure that the GSEs are acting consistently with their secondary market purposes; do not encroach into the primary market but, instead, assist primary market lenders; are safe and sound; are acting in the public interest; and that their undertakings are authorized and do not distort the competitive mortgage market by displacing available private sector capital and resources.
  - *By giving clear direction to review all of the GSEs undertakings and establishing standards for that review, the new regulator could assure*

- improved competition in both the primary and secondary markets while allowing the GSEs to innovate and carry out their mission in a timely manner.*
- The GSEs' affordable housing goals should be refocused to mirror Community Reinvestment Act ("CRA") requirements imposed on federally-regulated financial institutions, and thereby facilitate liquidity in that important market segment. The GSE affordable housing goals should be designed to match the size of the CRA market.
    - *The GSE conforming loan limit should not be raised to cover the so-called "high-cost" areas. High income borrowers do not need the benefit of the two-basis point subsidy the Federal Reserve Board has estimated the GSEs provide homebuyers. This proposal would benefit only a very narrow segment of wealthy borrowers and have a negative impact on affordability for the low- and moderate-income consumers.*
  - If an Affordable Housing Fund is established, it should be designed so that it is not a tax on consumers or lenders. The assessment should be levied on nonmortgage investments, as well as other assets, or it will give the GSEs an incentive to increase nonmortgage investments. In addition, the new regulator should be empowered to assure the proper use and administration of the funds. Finally, an advisory board of industry practitioners should be established to ensure that funds are distributed appropriately.
  - The new regulator should have the authority to set limits on the size of the GSEs' portfolios for both safety and soundness purposes and to prevent systemic risk.
  - The new regulator should require the GSEs to comply with the full range of SEC requirements (including the 1933 and 1934 Acts) to which other federally regulated financial institutions are subject.
    - *Transparency has always improved market performance, not hindered it.*

It is in the interests of the GSEs, the industry, the consumers, communities, the taxpayers and the economy, more generally, to ensure that the GSEs are properly focused and regulated. With improved regulation of the GSEs, the GSEs and the industry can together ensure that competitive financing opportunities are available to homebuyers and to those involved in providing affordable rental opportunities across this country.

#### **Specific Policy Issues:**

H.R. 1427 makes some significant improvements to the supervisory framework of the GSEs, but does need to be strengthened in several important respects. We understand that Chairman Frank intends to introduce further changes to the legislation and appreciate the opportunity to comment now.

- ***Funding the Regulator***

H.R. 1427 would fund the new regulator (The Federal Housing Finance Agency or "Agency") through assessments on the GSEs without regard to the Congressional appropriations process. However, the Agency's authority to obtain prompt payment of assessments needed for effective supervision of a GSE is much more constrained than the

authority of the federal bank regulators. It would be advisable to compare the broad language of 12 U.S.C. Sections 1817 (g) and (h) with the confining language of sections 106 and 164 of H.R. 1427. For example, the Agency lacks express authority to go to court to enforce an order that the GSEs make timely payments. Given the public reports that GSEs have used the appropriations process in the past to pressure their regulator, the Agency need to have express authority to issue an order for payment and then enforce it.

- ***New Program Approval***

An effective process of new program approval is needed to assure that the GSEs use their government subsidies to focus on their core missions without being diverted to activities that may be more profitable but are of less public value or that might displace available private sector capital and resources.

Currently, Fannie Mae and Freddie Mac may not undertake a new program without obtaining the prior approval of HUD. The statutory framework has a number of shortcomings: (1) the regulator must disapprove the new program within 30 days (plus a possible 15 day extension), or the program is deemed to have been approved, (2) HUD's prior approval authority is limited to new *programs*, which are defined in the 1992 Act to mean mortgage programs, (3) the GSEs often contend that new activities do not constitute new programs subject to the prior approval requirement, and (4) the GSEs are not required to submit complete information before the 30-day clock begins to run.

H.R. 1427 would require that the GSEs submit a written request for approval of a *product*.<sup>8</sup> The request must describe the product in such form as the Agency requires. The Agency must publish notice and invite public comment regarding the proposed new product. If the Agency has not approved the new product within 30 days after the close of the 30-day comment period, the product will be deemed to be approved.

If a GSE determines that any new activity, service, undertaking, or offering is not a product, it is required to provide notice to the Agency before commencing. The Agency must determine immediately whether the new activity, service, undertaking or offering relates to or involves a product. If the Agency notifies the GSE that it does involve a product, then the GSE must withdraw its request or submit a request for approval of the new product. The Agency may impose conditions in connection with the approval of any product.

The GSEs would be able to continue to offer their automated underwriting systems (AUS) in existence on the enactment date of the legislation, including any upgrade to the technology, operating system, or software to operate the underwriting system. While this does not affect the Agency's authority to review products or activities for safety and soundness, and consistency with the GSE's statutory mission, it does greatly limit prior approval authority for mission-related reasons.

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<sup>8</sup> The term "product" in H.R. 1427 would seem to be narrower than the current prior approval of a GSE "program." For example, the provision states that changes to mortgage terms and conditions are not included in the definition of "product" (except for changes that would increase the risk borne by the GSE).

As noted in our principles above, our view is that Congress should ensure that the Agency fully understands the distinction between the primary and secondary markets, and that the Agency should be given clear direction to review all GSE programs, products and activities – i.e., all undertakings, not just “products” – to ensure that the GSEs are acting consistently with their secondary market purposes; do not encroach into the primary market but, instead, assist primary market lenders; are safe and sound; are acting in the public interest; and are authorized and do not distort the competitive mortgage market by displacing available private sector capital and resources.

By giving clear direction to review all of the GSEs undertakings and establishing standards for that review, the Agency could assure improved competition in both the primary and secondary markets while allowing the GSEs to innovate and carry out their mission in a timely manner.

- ***The Regulator’s Principal Duties***

H.R. 1427 provides that a principal duty of the Agency shall be, among other duties, “to ensure that ...the operations and activities of each regulated entity foster...national housing finance markets that minimize the cost of housing finance...”

Since Fannie Mae and Freddie Mac operate with substantial government subsidies, their activities usually lower the cost of any housing finance activity in which they engage. That means that H.R. 1427 arguably places the Agency in a position of being required to encourage the expansion of the GSEs. This creates untenable pressure on the Agency’s safety and soundness and mission oversight responsibilities. The Committee’s 2005 report language attempted to mitigate the impact of this language, but did not fully do so.

We urge that the words “that minimize the cost of housing finance” be removed from H.R. 1427. The bank regulators do not have any comparable duty with regard to the entities they regulate.

- ***Enforcement Authority of the Regulator***

H.R. 1427 does improve the enforcement powers in current law. However, the bill continues to be significantly weaker than the statutory authority granted by law to the federal bank regulators. Of most importance, both H.R. 1427 and S. 190 would leave in place the limitations that currently apply to OFHEO in subtitle B of the 1992 Act, but not currently to the Federal Housing Finance Board or to the federal bank regulators. These limitations generally preclude OFHEO from requiring important corrective actions except if a GSE is undercapitalized. Capital is a lagging indicator; significant damage can occur before a GSE restates its books to account for the loss of capital.

In addition, Section 164 of H.R. 1427 does not allow the Agency to go directly to court to enforce orders issued under subtitle A of the 1992 Act. This needs to be corrected since H.R. 1427 itself requires or authorizes the Agency to issue orders with respect to

correcting deficiencies in prudential management and operations standards (Section 102), corporate governance (Section 114), or prior approval (Section 122). In addition, Section 164 fails to authorize the Agency to go directly to court to enforce an order under a GSE charter act, even though Section 123 of H.R. 1427 would amend the Fannie Mae and Freddie Mac charter acts and authorize the regulator to issue orders with respect to high-cost areas.

Other important areas where the Agency might issue orders include with respect to assessments to fund supervision (Section 106) and requirements that the GSEs register a class of securities with the SEC (Section 115). While it may be possible to work-around some of these deficiencies, the negative inference created by excluding enforcement of orders under Subtitle A will deprive the Agency of needed enforcement tools.

H.R. 1427 contains a number of other technical drafting issues that do not agree with the statutory framework of the federal bank regulators, which is far superior. The enforcement language in S. 190 is more closely aligned with the enforcement authority afforded the bank regulators. If the Committee does not choose to adopt the language included in S. 190 from the last Congress, but does want to provide the Agency with bank-like enforcement powers, we recommend an alternative approach that Congress used when giving the Federal Housing Finance Board enforcement authority. Very simply, we urge the Committee to add the enforcement language of the Federal Deposit Insurance Act, 12 U.S.C. 1818 (b) (6) and (7), that also applies currently to the Federal Housing Finance Board, through 12 U.S.C. Section 1422b (a)(5),<sup>9</sup> to the cease-and desist provisions (Section 161) of H.R. 1427. The new language would read as follows:

*(b) Affirmative action to correct conditions resulting from violations or practices.*  
*- The authority to issue an order under this section and section 1372 of this Act which requires a regulated entity or any related entity-affiliated party to take affirmative action to correct or remedy any conditions resulting from any violation or practice with respect to which such order is issued includes the authority to require such regulated entity or such party to -*

*(A) make restitution or provide reimbursement, indemnification, or guarantee against loss if -*

*(i) such regulated entity or such party was unjustly enriched in connection with such violation or practice; or*

*(ii) the violation or practice involved a reckless disregard for the law or any applicable regulations or prior order of the Director;*

*(B) restrict the growth of the regulated entity;*

*(C) dispose of any loan or asset involved;*

*(D) rescind agreements or contracts; and*

*(E) employ qualified officers or employees (who may be subject to approval by the Director at the discretion of the Director); and*

*(F) take such other action as the Director determines to*

<sup>9</sup> H.R. 1427 would change this so that those sections no longer apply directly to the Federal Home Loan Banks.

*be appropriate.*

*(c) Authority to limit activities. - The authority to issue an order under this subsection or subsection (c) of this section includes the authority to place limitations on the activities or functions of a regulated entity or any regulated entity-affiliated party.*

*(d) This authority is in addition to any other authority that the Director may have under this Act or any other law.*

This language is taken directly from the relevant language that applies to the federal bank regulators. Subsection (d) is needed to remove any negative inference from the capital-based enforcement provisions of the 1992 Act that would remain after the enactment of H.R. 1427.

1. We urge the Committee to add the term “order,” to Section 161 after “rule” (p. 251, at line 24).
2. We also urge the Committee to substitute the words “Act or any other law” in Section 164 for the words “subtitle or subtitle B” (p. 257, line 12).

• ***Conforming Loan Limits for “High-Cost Areas”***

H.R. 1427 would allow the conforming loan limit to increase for so-called high cost areas, where the median house price exceeds the median house price used in the index. The conforming limit for such areas would become the lesser of (1) the median house price, or (2) 150 percent of the conforming loan limit that otherwise would apply.

The conforming loan limit determines the maximum mortgage loan size that can be purchased by Fannie Mae or Freddie Mac. Under current law, the conforming loan limit in 2007 would be \$417,000, but an increase proposed in H.R. 1427 would allow Fannie and Freddie to purchase loans up to \$625,000. A calculation of the minimum household income required to qualify for these loans clearly shows that this increase would benefit only wealthy borrowers with annual incomes between \$130,000<sup>10</sup> and \$180,000<sup>11</sup>. The **low** end of that range reflects households making 281 percent of the U.S. median household income; clearly not the low- and moderate-income consumers who might benefit from the taxpayer-subsidized assistance provided by the GSEs. Moreover, loans between \$417,000 and \$625,000 make up only 6 percent of the market, according to data filed for 2005 by lenders under the Home Mortgage Disclosure Act.

<sup>10</sup> Assumes a 30-year, fixed-rate, mortgage of \$417,000, representing a 95% loan-to-value, \$5,000 annual real estate taxes, \$800 annual homeowners insurance and a monthly payment of \$167 for private mortgage insurance.

<sup>11</sup> Assumes a 30-year fixed-rate, first mortgage of \$625,000, representing a 95% loan-to-value, \$6,000 annual real estate taxes, \$800 annual homeowners insurance and a monthly payment of \$252 for private mortgage insurance.

Giving Fannie Mae and Freddie Mac the authority to purchase these higher-dollar loans will necessarily require the GSEs to devote resources to this segment of the market and away from the affordable housing segments. This will hinder their efforts to serve these markets and will likely make it more difficult for Fannie and Freddie to achieve their affordable housing goals. The higher dollar loans will add to the total of loans purchased by the GSEs but very few will be counted toward their affordable housing goals. Since both GSEs have achieved their goals by only small margins in the past—and Fannie Mae actually failed to meet two affordable housing subgoals for 2005—even a slight increase in overall loan purchase volume without a corresponding increase in affordable loan activity could cause them to fail to meet their affordable housing objectives.

Another element to consider is that the cost of housing in so-called high-cost areas already is factored into the nationwide conforming loan limit and without those areas the limit for the rest of the country would be well below the current level. This means that higher income borrowers making up to \$130,000 in areas where housing is significantly more affordable already benefit disproportionately from the government subsidized GSE benefits. As a result, increasing the limit in the high cost areas would only further skew the subsidies to the benefit of wealthier borrowers and away from low- and moderate-income Americans.

One important issue that has not been addressed in the debate over raising the conforming loan limits is the fact that while it arguably would benefit a small subset of wealthy borrowers—those who can qualify for loans between \$417,000 and \$625,000—it almost certainly will raise costs for borrowers taking out smaller loans, who represent 91 percent of the total mortgage market, and for very wealthy borrowers taking out loans larger than \$625,000. Larger loans have historically featured faster prepayment speeds than smaller loans because borrowers with larger payments obtain a greater benefit by refinancing when there are smaller movements in interest rates. Once purchased by the GSEs, however, these faster-paying, higher-dollar loans would be pooled with slower paying smaller loans, thereby increasing the average prepayment speeds of GSE loan pools and raising the cost to fund the smaller-dollar loans. At the same time, pools of larger loans would be stripped of their slower paying loans and prepayment speeds would increase beyond current levels.

Finally, when read together with the principal duty of the Agency to encourage expansion of the GSEs, discussed above, the regulator, under Section 102 will be under pressure to adopt a narrow definition of the ambiguous term “area” in this section of H.R. 1427 and serve high-income neighborhoods across the country. This provision is a classic example of the way that the GSEs seek to expand their activities to more profitable areas, in this case to serve a narrow segment of wealthy homebuyers at the expense of low- and moderate-income homebuyers.

We urge the Committee to delete subsections 123(a)(2), for Fannie Mae, and 123(b)(2), for Freddie Mac, of the House-passed bill (pp. 80-82).

- ***Strengthening Some Supervisory Powers***

The authority granted by the 1992 Act and H.R. 1427 remains far weaker than the authority of the federal bank regulators. In particular, many of the enforcement remedies granted to the federal bank regulators under 12 U.S.C. Section 1818 are tied by the 1992 Act, as amended by H.R. 1427, to whether a GSE is adequately capitalized. Since capital is a lagging indicator of problems, remedies need to be applied before rather than solely after a GSE's capital levels drop. H.R. 1427 does not expressly permit this.

- ***Affordable Housing Goals***

H.R. 1427 changes the definition of "very-low income" to 50 percent of the area median income. This helps to target GSE performance on a lower income category of borrower than under the current law and regulations. The bill also strengthens the Agency's enforcement powers with respect to the affordable housing goals. On the other hand, the expansive high-cost area provision of H.R. 1427 opens the doors to channel GSE resources into the higher end of the market at the expense of lower-income homebuyers.

- ***Authority over Capital Levels***

Section 111 is a significant improvement over current law with respect to the authority of the Agency to set risk-based capital standards. On the other hand, Section 112, while an improvement over current law, falls short of the authority provided to the bank regulators by 12 U.S.C. Section 3907.

- ***Mandatory Receivership***

H.R. 1427 would add language to the receivership provision and make it mandatory for the Agency to appoint a receiver under certain conditions.

- ***Structure of the Regulator***

H.R. 1427 improves the composition of the board of the Agency, compared to earlier versions of the legislation, and makes clear that, "The Board may not exercise any executive authority, and the Director may not delegate to the Board any of the functions, powers, or duties of the Director." This is beneficial. It creates accountability of the Secretaries of the Treasury and HUD to assure that the regulator has the capacity to do its job.

- ***Directors of Fannie Mae and Freddie Mac***

Late last year the Treasury Department proposed to strike the presidentially-appointed directors from the boards of Fannie Mae and Freddie Mac so that all directors are elected by shareholders. H.R. 1427 did not include this improvement. The anachronism of presidentially-appointed directors adds nothing to the quality of governance of Fannie Mae and Freddie Mac.

**Conclusion**

H.R. 1427 would make some improvements over current law, albeit without bringing the financial soundness or affordable housing/CRA provisions up to the standards of federal bank regulation. Some parts of H.R. 1427 remain far short of the supervisory framework that is needed for the GSEs today, particularly if they were to have financial or operational problems comparable to their internal control failures evidenced in recent years.

By incorporating our guiding principles and technical changes for reform, this Committee can be confident that it has indeed created a regulator that has a reasonable chance to protect the safety and soundness of the GSEs, the housing finance markets, and the larger financial system from harm and a regulator that can focus the GSEs on the mission they were initially created to fulfill.

We appreciate the opportunity to comment on reform proposals, and would be pleased to work with the Committee as the legislative process moves forward.

Thank you.

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Contact Information  
(effective April 1, 2007):

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The Honorable William Lacy Clay, MO-01

**Questions for the Honorable James B. Lockhart III (Hearing, GSE Reform)**

In your testimony on March 15, 2007, you assured the House Committee on Financial Services that you knew of no time when OFHEO released Fannie Mae's confidential information. This assurance took me some of the way to understanding how the regulator protects the proprietary information of Fannie Mae and Freddie Mac, but I write now to inquire further as to the controls in place and the culture at OFHEO that protects information learned in the course of its examinations from inadvertent or deliberate public disclosure.

The independence of the new housing regulator is of utmost importance to its success. Similarly, because the regulator is entrusted with highly confidential information that it learns in its audits and reviews of Fannie Mae and Freddie Mac, an increased professional focus on protecting the propriety systems and confidential financial information of those companies goes hand in hand with increased regulatory powers.

**QUESTIONS**

1. Do you agree that it would be inappropriate for OFHEO to leak a GSE's financial information anonymously to the press, when that information was learned during the course of an investigation of a housing GSE? Would it similarly be inappropriate for OFHEO to leak information anonymously to the press regarding the results of an OFHEO examination of a GSE, even if that leak did not disclose a GSE's confidential or proprietary information?

The following two articles rely on anonymous sources. Though these articles preceded your time at OFHEO, can you, as Director, assure the Committee that an OFHEO employee was not the anonymous source?

- Jonathan Weil and James R. Hagerty, "Fannie Faces Billion in New Losses--Fresh Accounting Concerns for the Mortgage Company May Further Dent Capital," *Wall St. J.*, Mar. 3, 2005, at A3.
- Dawn Kopecki, "Fannie Accounting Probes Turn up New, Pervasive Problems, Sources Say," *Dow Jones*, Sept. 28, 2005.

Please explain what controls you have in place to ensure that your employees do not leak Fannie Mae's or Freddie Mac's confidential information to the public. Have you ever suspected a leak at OFHEO? If so, how did you investigate it? Should H.R. 1427 include a provision specifically targeted to prevent and to punish leaks?

2. I have been made aware of the HUD Inspector General's October 5, 2004, Report on Director Armando Falcon's OFHEO. The Inspector General's Report found several problems with OFHEO, including an obsessive focus on reining in Fannie Mae through damaging its stock price, and a willingness to make anonymous leaks of information to the press to this end. This activity preceded your appointment to OFHEO, but I remain concerned that the problems in culture identified in this report have not been addressed adequately.

What specific steps have you taken to change OFHEO's culture? Can you assure me that the release of information about Fannie Mae or Freddie Mac has never been timed with an eye toward its impact on the GSEs' stock price? Do you view protecting the investments of the GSEs' shareholders and debt holders to be part of OFHEO's mission?

3. During your March 15, 2007 testimony, I questioned you about your comment to the media in mid-January 2007 that Fannie Mae had experienced a loss in the third quarter of 2006 on a GAAP basis. In particular, we asked you whether you violated 18 U.S.C. § 1905, which prohibits the disclosure of information that comes to OFHEO employees during the course of employment, including information about the "amount . . . of any income, profits [or] losses . . ." You testified that you had not violated the statute, because your comments to the media were based on capital classification reports released publicly by OFHEO.

You stated to the Committee that "through those numbers [on the capital report] it shows that Fannie Mae had a loss for the third quarter." As regulator of only two companies, Fannie Mae and Freddie Mac, you must have known that Fannie Mae's capital is reduced by approximately \$300 million each quarter through its disclosed payments of common and preferred stock dividends. Because of these payments, the information discernable to the public from the capital classification reports (namely, a modest \$29 million decline in Fannie Mae's core capital between June 30 and September 30) could have led investors to infer, if anything, that Fannie Mae had a third quarter *profit* of over \$250 million – not a loss. In light of this analysis, what assurances can you provide this Committee that you did not improperly release Fannie Mae's confidential financial information this past January?



In many cases, OFHEO brings a potential release of information to the attention of an Enterprise for its input and to address any concerns that may be voiced. This procedure is set forth in OFHEO guidelines.

In sum, several federal laws apply. OFHEO has implemented these through regulation, an Employee Nondisclosure Oath for new employees, a guideline on the release of information, procedures for consideration of requests to release information and briefings for separating employees on their ethics obligations after leaving OFHEO including non-disclosure of information. This information is included as part of our annual ethics briefing for employees and is included in information security briefings on data and systems integrity.

The following summarize applicable laws and OFHEO implementing regulations and guidelines:

A. Regulations -- OFHEO by regulation and internal guidelines addresses the protocol for review of information prior to any external release to the public or other government agencies.

1. Release of Information Regulation (12 CFR 1703) prohibits employees from disclosing nonpublic information or releasing documents "[e]xcept as authorized by this part [of the regulation] or otherwise necessary in performing official duties."

2. Privacy Act Regulation (12 CFR 1702) applies requirements of the Privacy Act, 5 USC 552a, to protect personal information held at OFHEO.

B. Guidelines -- OFHEO guidelines provide specific procedures involving senior officers of the agency in review of external releases of information or of publications. Reviews by the Office of General Counsel are required and experienced attorneys are assigned on an ongoing basis to this function.

1. Guideline 105 Releasing Information sets forth OFHEO internal policy and procedures for releasing information to non-OFHEO persons or organizations, in response to their requests for information and applies the strictures of FOIA (5 U.S.C. § 552), the Privacy Act (5 U.S.C. § 552a) and the Trade Secrets Act (18 U.S.C.A. §1905). OFHEO employees are directed to protect vigorously business information in their possession as well as any information they generate for OFHEO.

2. Guideline 108 Obtaining and Documenting Prior Management Approval to Public and/or Present Research establishes internal clearance procedures for approval to externally release research. The guidance includes review by Office of General Counsel to consider any potential use of nonpublic information-- even if it is purportedly sanitized by aggregation or is a statistical analysis that arguably could not be inferred or reconstructed by a third party-- to preclude any adverse affect on the agency or Enterprises. Also, the clearance process requires review by senior management for any policy issues or concerns. Research papers cannot

be released externally (for publication, presentation, or third-party peer review) without completion of internal clearance and written authorization of the Director.

3. Guideline 109 Management of Information Policy and Procedures for Release of Information in OFHEO Publications creates a presumption that information received from an Enterprise is to be reviewed prior to any public release.

C. Procedures -- Several items relating to procedure should be of interest to you. First, the Office of General Counsel reviews and determines whether information may be released pursuant to the Director's statutory authorities and implementing rules, *i.e.*, legal standards that either prohibit or permit release (Trade Secrets Act, Privacy Act, FOIA). This review by OGC may include contact directly with the Enterprises for their input or direction to the lead author or their supervisor to contact one or both Enterprises. Second, OFHEO requirements under regulation and guidelines are referenced in the OFHEO Employee Nondisclosure Oath and apply to current and former employees. Third, the Enterprises have been encouraged in their information submissions to characterize information or data as confidential or request confidential treatment where appropriate.

As to current experience, I have no suspicion of leaks and have undertaken a policy of open discussion with the media that seeks to avoid any favoritism or other problems that selective release of information could engender. Where possible, within OFHEO guidelines, we may respond to a reporter's question, however, in general we prefer that information releases are provided contemporaneously to all relevant media outlets.

I see no need for additional statutory or regulatory direction on this matter. Current law, made available to OFHEO employees at all times and embedded in our internal procedures, provide clear guidance as to improper release of information. As the responsible party, I have set a tone for adherence to those statutes. These laws, as you know, contain both disciplinary sanctions including possible removal from federal service and, in certain cases, criminal sanctions.

#### **Question 2. OFHEO Culture**

While I cannot speak to OFHEO's "culture" prior to my arrival, I am satisfied that current employees fully understand our responsibilities under law to serve the mission established by Congress for oversight of Fannie Mae and Freddie Mac. My new Deputy Director, the senior management team and I are all committed to maintain high standards of regulatory integrity in private communications with the Enterprises. As to specific actions, I directed staff last year to review all OFHEO internal materials and external communications with the Enterprises or other government agencies to assure that we have appropriate reminders of the confidentiality of our materials and of our communications. That has been put in place with standardized statements in both. This is a daily reminder of our obligations.

It is not OFHEO's mission to assure the value of stock for shareholders or debt for debt holders. Our mission is to assure safe and sound operations so the Enterprises may meet their

congressionally-set obligations. Such oversight, as I have testified, may benefit shareholders in the long run by assuring the Enterprises are on a solid footing. Additionally, OFHEO has acted to increase Enterprise disclosures that provide investors a stronger understanding of the companies and enhances Enterprise access to capital markets to support their mission. This may benefit shareholders and bondholders as well.

The stock price of an Enterprise is not a consideration, except if we believe the information to be released may impact trading in the stock, in which case we would release it before the New York Stock Exchange opens or after it closes in line with stock exchange practices.

### **Question 3. January Reports of Capital and Profit or Loss**

I have reviewed the information released by OFHEO regarding Fannie Mae's capital numbers and gains or losses to the company as well as the relationship of this information to 18 USC 1905. There is no violation of law or regulation as OFHEO's release and commentary on the release fit within our required capital adequacy determination for the Enterprise. When I said on January 18, 2007, that both Enterprises had losses in the third quarter of 2006, I was reflecting information provided in our third quarter capital classification press release of December 28, 2006 (see attached). Freddie Mac, a non-SEC registrant, released their actual third quarter loss information on January 5, 2007.

The press release does indeed show core capital declining by only \$29 million from the second quarter. However, the press release under a section entitled "Third Quarter Capital Results" notes in the second paragraph that "Core capital remained unchanged because the positive \$1.0 billion core capital restatement adjustment was offset by a \$0.8 billion reduction in retained earnings after a dividend payment of \$0.4 billion, and additional ongoing accounting adjustments to core capital of about negative \$0.2 billion." As retained earnings are basically impacted by net profits or losses and payment of dividends, it is easy to calculate that the reduction of \$0.8 billion of retained earnings was caused by \$0.4 billion in dividend payments and \$0.4 billion in losses.

The press release referenced the \$1.0 billion restatement capital increase in the second section of the press release "Effect of 2004 10-K on Core Capital." If we had not referenced the \$1.0 billion number, the previously released restatement number of \$1.9 billion would have led the public to believe that Fannie Mae lost \$1.3 billion instead of the actual loss of \$.4 billion.

Dividend payments may be easily calculated from Fannie Mae's quarterly dividend notification press release even if OFHEO did not refer to dividend amounts in our press release. OFHEO publishes core capital numbers as required under the capital classification process. Therefore, the public may always derive with reasonable accuracy the net income for the Enterprise. The third quarter release was only different or more complicated because of the 2004 10-K restatement effect on core capital. Finally, we share drafts of the financial analysis section of the press release with each Enterprise prior to release to the public. As early as December 14, Fannie Mae was aware of our intent to release information that would allow the public to determine that Fannie Mae lost several hundred million dollars. No comment was offered suggesting a concern with such a release of information.

The Honorable William Lacy Clay

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Next, I would note that 18 USC 1905, as verified by counsel, addresses trade secrets and proprietary information. Disclosure of capital positions are mandated for the Enterprises and once released may be subject to analysis by OFHEO or any other party. My comments addressed information contained in these reports and provided an understandable calculation that any party could have made. No proprietary calculation model was employed. Fundamentally, it is not a "calculation" that 18 U.S.C. 1905 would address in this instance, but rather whether the information on which a calculation was based should be made public. Here, information was properly released.

I trust that these responses provide the information you are seeking. I would be glad to further discuss any of these matters with you.

Sincerely,



James B. Lockhart  
Director

Enclosure

cc: The Honorable Barney Frank  
Chairman, House Financial Services Committee

The Honorable Spencer Bachus  
Ranking Member, House Financial Services Committee



Office of Federal Housing Enterprise Oversight (OFHEO)  
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**FOR IMMEDIATE RELEASE**  
December 28, 2006

**CONTACTS:**  
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**OFHEO ANNOUNCES THIRD QUARTER 2006  
MINIMUM AND RISK-BASED CAPITAL CLASSIFICATION  
FOR FANNIE MAE; RECLASSIFIES FOURTH QUARTER 2002 AND 2003 AS  
SIGNIFICANTLY UNDERCAPITALIZED**

**WASHINGTON, D.C.** — James B. Lockhart III, Director of the Office of Federal Housing Enterprise Oversight (OFHEO), the safety and soundness regulator for Fannie Mae and Freddie Mac, classified Fannie Mae as adequately capitalized as of September 30, 2006. This classification is based on estimated numbers submitted by Fannie Mae and not financial statements released to shareholders. Fannie Mae's third quarter 2006 capital results also incorporate adjustments for the accounting impacts identified in the company's 2004 10-K, which was filed with the Securities and Exchange Commission on December 6, 2006.

OFHEO is also issuing updated capital results for the fourth quarters for 2002, 2003, and 2004 as a result of Fannie Mae's recent 2004 10-K release.<sup>1</sup> With the new information, OFHEO has reclassified Fannie Mae as significantly undercapitalized for the fourth quarters of 2002 and 2003.

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires the OFHEO Director to determine the capital level and classification of the Enterprises not less than quarterly, and to report the results to Congress. OFHEO classifies the Enterprises as adequately capitalized, undercapitalized, significantly undercapitalized or critically

<sup>1</sup> Fannie Mae requested, and OFHEO granted, an extension of 15 business days for the refiling of Q1-3 2004 quarterly capital results. OFHEO also granted a waiver regarding the refiling of Q1-3 2002 and 2003 quarterly results, although OFHEO has informed Fannie Mae that it will disclose Fannie Mae's estimated quarterly results for these years. Fannie Mae's analysis of the risk-based capital results for all applicable periods also received an extension. Once OFHEO receives and analyzes this information, additional disclosures will be forthcoming.

undercapitalized. The Enterprises are required by Federal statute to meet both minimum and risk-based capital standards to be classified as adequately capitalized.

#### **Effect of 2004 10-K on Core Capital**

Beginning with the September 2004 capital classification, OFHEO reported to the public adjusted capital results for Fannie Mae reflecting estimated losses for accounting errors identified. For year-end 2004, Fannie Mae reported the "adjusted" capital numbers to OFHEO reflecting Fannie Mae's best estimate of the impact of the pending accounting adjustments. OFHEO's original December 31, 2004 capital classification dated May 19, 2005 adjusted Fannie Mae's core capital by a negative \$11.14 billion, based on the best conservative estimates of the losses at the time. Reconciling the original December 31, 2004 capital classification to the equivalent information in the recently issued 2004 10-K, results in an increase in core capital of \$1.9 billion as of December 2004. OFHEO has continued to carry forward and report the estimated accounting impacts as reported by Fannie Mae throughout 2005 and 2006. Fannie Mae now reports that the net impact of the restatement on core capital as of September 30, 2006 is an increase of only \$1.0 billion, which is now reflected in OFHEO's reported capital results. Thus, while the numbers for September 30, 2006 remain estimated numbers and will likely be subject to revision in forthcoming 2005 and 2006 financial disclosures, the impact of the 2004 accounting restatements are fully reflected in the capital position reported today by OFHEO.

#### **Third Quarter 2006 Capital Classification**

Fannie Mae made important progress in its restatement efforts with the issuance of the 2004 10-K, reflecting restated financials for 2002, 2003, and 2004. Further, Fannie Mae's efforts to carry the 2004 accounting adjustments of \$1.0 billion forward into the September 30, 2006 reported core capital estimates gives OFHEO and the public, additional assurance that the company is maintaining a capital surplus in excess of the OFHEO-directed requirement.

While progress is evident and OFHEO is classifying Fannie Mae as adequately capitalized, significant work remains before Fannie Mae becomes a timely financial filer and corrects the internal control and operational weaknesses evident. It is therefore prudent for Fannie Mae to hold capital in excess of the OFHEO-directed requirement to compensate for these uncertainties.

Fannie Mae's surplus as a percent of the OFHEO-directed requirement increased to 11.4 percent from the prior quarter's 9.9 percent. Fannie Mae continues to operate under growth restrictions for its retained portfolio and has maintained compliance with this agreement throughout the quarter.

#### **Restated Capital Classifications for 2002-2004**

For the years-ending 2002 and 2003, Fannie Mae's restated results indicate it was significantly undercapitalized for these periods, rather than adequately capitalized, as previously disclosed. Consequently, Director Lockhart has reclassified Fannie Mae as significantly undercapitalized for fourth quarter 2002 and 2003. In both of these time periods,

core capital remained above the statutory critical capital level. From a historical perspective, had Fannie Mae been following appropriate accounting rules and had the financial position been appropriately disclosed by Fannie Mae at the time, statutory regulatory intervention would have occurred during 2002 requiring Fannie Mae to develop a capital plan and restore capital to an adequate level. That action instead took place following the September 2004 classification.

Director Lockhart has determined not to reconsider the original Fannie Mae December 31, 2004 capital classification of significantly undercapitalized.

While the significantly undercapitalized position for these time periods is indeed noteworthy and reflective of financial reporting errors, additional regulatory action is not needed at this time as Fannie Mae is adhering to the terms and conditions of its Capital Restoration Plan, including maintaining capital above the OFHEO-directed requirement and restricting retained portfolio growth. OFHEO will appropriately reflect the update to reported capital in the historical tables found on OFHEO's web site. It should also be noted that there was no restatement prior to 2002, which means that Fannie Mae could have been significantly undercapitalized for some time prior to 2002.

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**THIRD QUARTER CAPITAL RESULTS:****Minimum and Critical Capital**

Fannie Mae's adjusted<sup>2</sup> OFHEO-directed capital requirement on September 30, 2006 was \$37.7 billion and its adjusted statutory minimum capital requirement was \$29.0 billion. Fannie Mae's adjusted core capital of \$42.0 billion exceeded the adjusted OFHEO-directed capital requirement by \$4.3 billion. Fannie Mae's adjusted core capital exceeded the adjusted statutory critical capital requirement by \$27.0 billion.

Fannie Mae Minimum Capital Requirement (Billions of Dollars) (a,b,c,d)		
	30-Sep-06	30-Jun-06
Minimum Capital - Statutory Requirement	29.010	29.419
Minimum Capital - OFHEO Directed Requirement	37.714	38.245
Core Capital	42.008	42.037
Surplus (Deficit) (based on OFHEO Directed Requirement)	4.294	3.792

Fannie Mae Critical Capital Requirement (Billions of Dollars) (a,b,d)		
	30-Sep-06	30-Jun-06
Critical Capital Level	14.959	15.145
Core Capital	42.008	42.037
Surplus (Deficit)	27.049	26.892

- a. Numbers may not add due to rounding  
b. Subject to revision based upon results of ongoing financial restatement and audit processes  
c. OFHEO has directed Fannie Mae to maintain an additional 30% capital in excess of the statutory minimum capital requirement. This has been an additional requirement since September 30, 2005. The minimum capital requirement and minimum capital surplus numbers stated in these charts reflect the inclusion of the additional 30% OFHEO-directed capital requirement.  
d. Fannie Mae's minimum capital, critical capital, and core capital are adjusted for accounting errors identified to date, including adjustments identified in the 2004 10-K issued on December 6, 2006

During the third quarter of 2006, Fannie Mae's adjusted minimum capital surplus increased by \$0.5 billion to \$4.3 billion, approximately 11.4 percent over the adjusted OFHEO-directed capital requirement of \$37.7 billion. The surplus amount increased because the minimum capital requirement decreased due to a decline in assets while core capital remained unchanged. Core capital remained unchanged because the positive \$1.0 billion core capital restatement adjustment was offset by a \$0.8 billion reduction in retained earnings after a

<sup>2</sup> The term "adjusted" reflects that Fannie Mae's minimum capital submissions adjust book capital based upon estimated accounting change impacts, including the roll-forward of 2004 adjustments.

(more)

dividend payment of \$0.4 billion, and additional ongoing accounting adjustments to core capital of about negative \$0.2 billion.

Changes in critical capital mirrored changes in minimum capital.

#### Risk-Based Capital

The risk-based capital requirement reported below has not been updated to reflect the full roll-forward effect of the 2004 10-K accounting adjustments.<sup>3</sup>

**As of September 30, 2006, Fannie Mae's risk-based capital requirement was \$22.5 billion. Fannie Mae's total capital of \$41.8 billion on that date exceeded the requirement by \$19.3 billion.**

Enterprise Risk-Based Capital Requirement (Billions of Dollars) <sup>(a,b)</sup>				
Interest Rate Scenario	Fannie Mae			
	30-Sep-06		30-Jun-06	
	Up	Down	Up	Down
Risk Based Capital Requirement	22.524	16.447	18.843	26.330
Total Capital	41.820			42.888
Surplus (Deficit)	19.296			16.558

a. Numbers may not add due to rounding.

b. Subject to revision based upon results of ongoing financial restatement and audit processes.

By statute, stress test interest rate levels are a function of the average 10-year Constant Maturity Treasury (CMT) over the most recent nine months. At the end of the third quarter of 2006, the nine-month average of the 10-year CMT rose to 4.85%, 14 basis points higher than the nine-month average at the end of the second quarter of 2006. As a result, 10-year CMT levels at the end of the first year in the risk-based capital stress test increased from 8.24% to 8.48% in the up-rate stress test, and from 2.35% to 2.42% in the down-rate stress test.

In the third quarter of 2006, the yield curve shifted downward as compared to last quarter, and remained flat. As interest rates declined, expected prepayment speeds increased and the duration of fixed-rate mortgage assets decreased. To maintain a tight asset/liability gap, the Enterprise adjusted its debt and derivative portfolios.

Fannie Mae's risk-based capital surplus increased from \$16.6 billion to \$19.3 billion. Falling rates in the quarter caused rebalancing actions that increased exposure in the up-rate scenario and reduced exposure in the down-rate scenario. Fannie Mae's risk-based capital requirement in the up-rate stress test was \$22.5 billion, \$3.7 billion higher than the second quarter of 2006. The Enterprise's risk-based capital requirement in the down-rate stress test

<sup>3</sup> The total capital number is understated and does not reconcile to the core capital submission because only the latter includes the effect of the roll-forward of the 2004 accounting impacts.

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fell by \$9.9 billion to \$16.4 billion due largely to significant increases in its receive-fix swaption position.

**FOURTH QUARTER 2002, 2003 and 2004 RESTATED CAPITAL RESULTS:**

Fannie Mae's restated December 31, 2002 statutory minimum capital requirement was \$27.7 billion. Fannie Mae's restated core capital of \$20.4 billion resulted in a deficit statutory capital position of (\$7.3) billion. Fannie Mae's restated core capital exceeded the restated statutory critical capital requirement by \$6.3 billion.

Fannie Mae's restated December 31, 2003 statutory minimum capital requirement was \$31.8 billion. Fannie Mae's restated core capital of \$27.0 billion resulted in a deficit statutory capital position of (\$4.9) billion. Fannie Mae's restated core capital exceeded the restated statutory critical capital requirement by \$10.7 billion.

Fannie Mae's restated December 31, 2004 statutory minimum capital requirement was \$32.1 billion. Fannie Mae's restated core capital of \$34.5 billion exceeded the statutory capital position by \$2.4 billion, which was the result of a \$5 billion preferred stock issue in December, 2004. Fannie Mae's restated core capital exceeded the restated statutory critical capital requirement by \$18.1 billion.

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<b>Fannie Mae Minimum Capital Requirement</b> (Billions of Dollars) <sup>(a,b)</sup>			
	<i>December 31, 2002</i>		
	<b>Restated</b>	<b>Originally Reported</b>	<b>Change</b>
Minimum Capital - Statutory Requirement	27.688	27.203	0.485
Core Capital	20.431	28.079	(7.648)
Minimum Capital Surplus (Deficit)	(7.257)	0.877	(8.134)
Critical Capital Requirement	14.126	13.880	0.246
Core Capital	20.431	28.079	(7.648)
Critical Capital Surplus (Deficit)	6.305	14.199	(7.894)

<b>Fannie Mae Minimum Capital Requirement</b> (Billions of Dollars) <sup>(a,b)</sup>			
	<i>December 31, 2003</i>		
	<b>Restated</b>	<b>Originally Reported</b>	<b>Change</b>
Minimum Capital - Statutory Requirement	31.816	31.520	0.296
Core Capital	26.953	34.405	(7.452)
Minimum Capital Surplus (Deficit)	(4.863)	2.885	(7.748)
Critical Capital Requirement	16.261	16.113	0.148
Core Capital	26.953	34.405	(7.452)
Critical Capital Surplus (Deficit)	10.691	18.292	(7.601)

<b>Fannie Mae Minimum Capital Requirement</b> (Billions of Dollars) <sup>(a,b)</sup>			
	<i>December 31, 2004</i>		
	<b>Restated</b>	<b>OFHEO Adjusted and Reported on May 19, 2005 <sup>c</sup></b>	<b>Change</b>
Minimum Capital - Statutory Requirement	32.121	32.166	(0.045)
Core Capital	34.514	32.641	1.873
Minimum Capital Surplus (Deficit)	2.393	0.475	1.918
Critical Capital Requirement	16.435	16.455	(0.020)
Core Capital	34.514	32.641	1.873
Critical Capital Surplus (Deficit)	18.078	16.186	1.892

a. Numbers may not add due to rounding.

b. Restated and resubmitted on December 8, 2006.

c. OFHEO further "adjusted" Fannie Mae's December 31, 2004 capital submission resulting in a total estimated reduction of core capital by \$11.1 billion based upon Fannie Mae generated and certified best estimates of the impact of pending accounting adjustments

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### QUALIFICATIONS AND COMPLIANCE

Fannie Mae's capital classification is based upon Fannie Mae's best estimates of its financial condition, as certified and represented as true and correct to the best of Fannie Mae management's belief and knowledge. The third quarter 2006 capital classification remains subject to revision pending Fannie Mae's submission of audited 2006 financial statements and corresponding regulatory capital reports.

Fannie Mae remains subject to the requirements imposed by the Consent Order dated May 23, 2006 and the Capital Restoration Plan approved February 17, 2005. The Capital Restoration Plan required Fannie Mae to achieve a 30 percent capital surplus over the minimum capital requirement by September 30, 2005 (OFHEO-directed capital requirement). Fannie Mae is required to maintain a capital surplus above the OFHEO-directed requirement on an ongoing basis. Fannie Mae met the initial September 30, 2005 achievement of 30% surplus and they have continued to maintain the surplus through the third quarter 2006.

### THIRD QUARTER QUALIFYING SUBORDINATED DEBT RESULTS

Additionally, OFHEO is releasing qualifying subordinated debt positions of Fannie Mae in accordance with the September 1, 2005 Agreements between OFHEO and the Enterprises. (See 9/2/05 release at <http://www.ofheo.gov/News.asp?FormMode=Releases&ID=237>)

Fannie Mae's total capital and qualifying subordinated debt for the third quarter 2006 exceeded the requirements outlined in the Agreement dated September 1, 2005.

Qualifying subordinated debt levels are disclosed below.

Fannie Mae Enterprise Qualifying Subordinated Debt Disclosure (Billions of Dollars) <sup>(2)(b)</sup>		
	30-Sep-06 <sup>(c)(d)</sup>	30-Jun-06 <sup>(c)(d)</sup>
Total Capital & Qualifying Subordinated Debt	50.453	50.744
Sub Debt Requirement <sup>(e)</sup>	41.488	42.324
Surplus (Deficit)	8.965	8.421

- a. Numbers may not add due to rounding.
- b. Qualifying Subordinated Debt is defined as subordinated debt that contains the interest deferral feature. The interest deferral requires the deferral of interest payments for up to 5 years if:
- 1) The corporation's core capital falls below 125% of critical capital, or
  - 2) The corporation's core capital falls below minimum capital AND, pursuant to the corporation's request, the Secretary of the Treasury exercises discretionary authority to purchase the company's obligations under Section 306(c) of the Freddie Mac Charter Act and Section 304(c) of the Fannie Mae Charter Act
- c. Subject to revision based upon results of ongoing financial restatement and audit processes
- d. Fannie Mae's minimum capital, critical capital, core capital and qualifying subordinated debt are adjusted for accounting errors identified to date.
- e. The sum of outstanding net MBS times 0.45 percent and on-balance sheet assets times 4 percent

(more)

#### DEFINITION OF CAPITAL STANDARDS

**Core** Capital is the sum of outstanding common stock, perpetual, noncumulative preferred stock, paid-in capital, and retained earnings. Core capital does not include Accumulated Other Comprehensive Income (AOCI), which is captured as part of stockholder's equity.

**Total** Capital is the sum of Core Capital plus the allowance for loan losses.

**Minimum** capital represents an essential amount of capital needed to protect an Enterprise against broad categories of business risk. For purposes of minimum capital, an Enterprise is considered by law adequately capitalized if core capital — common stock; perpetual noncumulative preferred stock; paid in capital; and retained earnings — equals or exceeds minimum capital. The minimum capital standard is 2.5 percent of assets plus 0.45 percent of adjusted off-balance-sheet obligations, including guaranteed mortgage securities.

The **OFHEO-directed** capital requirement is the amount of capital the Enterprise needs to maintain to compensate for increased operational risks including systems, accounting, and internal control risks. The level is prescribed by the Director of OFHEO. At this time, both Enterprises are required to hold 30 percent over the statutory minimum capital requirement. This is calculated by multiplying the minimum capital requirement by 1.3 times.

OFHEO's **risk-based** capital requirement is the amount of total capital — core capital plus a general allowance for loan losses less specific reserves — that an Enterprise must hold to absorb projected losses flowing from future adverse interest-rate and credit-risk conditions specified by statute, plus 30 percent mandated by statute to cover management and operations risk. The risk-based capital standard is based on stress test results calculated for the two statutorily prescribed interest rate scenarios, one in which 10-year Treasury yields rise 75 percent (up-rate scenario) and another in which they fall 50 percent (down-rate scenario). Changes in both scenarios are generally capped at 600 basis points. The risk-based capital level for an Enterprise is the amount of total capital that would enable it to survive the stress test in whichever scenario is more adverse for that Enterprise, plus 30 percent of that amount to cover management and operations risk.

The **critical** capital level is the amount of core capital below which an Enterprise must be classified as critically undercapitalized and generally must be placed in conservatorship. Critical capital levels are computed consistent with the Federal Housing Enterprises Safety and Soundness Act of 1992 as follows: One-half of the portion of minimum capital requirement associated with on-balance-sheet assets plus five-ninths of the portion of the minimum capital requirement associated with off-balance-sheet obligations.

#### QUALIFYING SUBORDINATED DEBT

**Qualifying subordinated debt** is defined as subordinated debt that contains the interest deferral feature described below:

- The interest deferral requires the deferral of interest payments for up to 5 years if:
  - o The corporation's core capital falls below 125 percent of critical capital, or
  - o The corporation's core capital falls below minimum AND, pursuant to the corporation's request, the Secretary of the Treasury exercises discretionary authority to purchase the company's obligations under Section 306(c) of the Freddie Mac Charter Act and Section 304(c) of the Fannie Mae Charter Act.

The September 1, 2005 agreement requires that:

Subordinated debt will be issued in a quantity such that the sum of total capital (core capital plus general allowance for losses) plus the outstanding balance of qualified subordinated debt will equal or exceed the sum of outstanding net MBS times 0.45 percent and total on-balance sheet assets times 4 percent.

*Technical questions regarding these results should be directed to: [rbcquestions@ofheo.gov](mailto:rbcquestions@ofheo.gov).*

###

*OFHEO's mission is to promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac.*



**OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT**

1700 G STREET NW WASHINGTON DC 20552 (202) 414-3801

**OFFICE OF THE DIRECTOR**

April 25, 2007

The Honorable Melvin L. Watt  
2236 Rayburn House Office Building  
United States House of Representatives  
Washington, D.C. 201515-3312

Dear Congressman Watt:

In your letter of April 13, 2007, you asked me to re-assert my responses to the questions you posed to me concerning OFHEO's independence and protection of proprietary or confidential information at the March 15 hearing.

As I said at the hearing, during my tenure the White House has not interfered with any reports OFHEO has issued or the financial evaluations contained in those reports. During my tenure, the key reports were the May 23, 2006 Report of Special Examination of Fannie Mae and the 2006 and 2007 Annual Reports to Congress.

Since you inquired about actions prior to my tenure as Director, I asked the primary examiners who conducted the two special examination reports of Fannie Mae, our associate director for compliance and our chief accountant, whether they had been the object of any interference in their work. They indicated they had not been interfered with either as to the content, direction, or timing of the reports, one issued in September 2004 and the other, as referenced above, in May 2006. Further, they indicated to me that the final reports – as published – reflected what they found, what the evidence revealed and did not diverge from their findings. Also regarding annual examination reports prior to my tenure, I asked the same question of our examiners-in-charge and they also indicated that the reports – which are published in our Annual Report to Congress – reflected what they found, what the evidence revealed and did not diverge from their findings.

One of OFHEO's three strategic goals is to provide support for reform legislation. As such, we have had extensive discussions with members of Congress, members of the Administration, and interested parties. During these discussions, we have welcomed input and given our opinions but there has been no interference by the White House.

As to release of confidential information, I asked our General Counsel, Alfred Pollard, to summarize his knowledge of OFHEO's practices concerning release of information, any possible violations of law, and OFHEO's processes for assuring that information is not improperly released. I have enclosed a copy of that memorandum. You also asked

The Honorable Melvin L. Watt

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whether clarification of 18 USC 1905 might be in order. I do not believe so. The strictures of the Trade Secrets Act are well known, have been the subject of court review and are made known throughout the agency as reflected in the enclosed memorandum.

I trust this is responsive to your questions during the hearing. As to other matters raised, it would be beneficial to meet with you to discuss the information you are seeking.

Sincerely,



James B. Lockhart III  
Director

Enclosure

cc: The Honorable Barney Frank  
Chairman, House Financial Services Committee

The Honorable Spencer Bachus  
Ranking Member, House Financial Services Committee

## MEMORANDUM

April 16, 2007

TO: Director James Lockhart

FROM: General Counsel Alfred Pollard *Alfred Pollard*

RE: OFHEO Controls on Information Release

In response to your question, I am aware of no violation by OFHEO of the Trade Secrets Act at 18 USC 1905 or other federal statute relating to the release of proprietary information received from Freddie Mac or Fannie Mae or to the release of regulatory information held by OFHEO. My tenure as General Counsel commenced in March 2000.

OFHEO operates under strict rules and procedures, founded in a range of laws, in regards to any release of information from the agency, be such release in response to congressional or external inquiry or upon the decision of the Director. OFHEO maintains, by regulation and internal guidelines, safeguards necessary and appropriate to protect the supervisory information it receives or generates that is nonpublic in nature and may be subject to legal privilege for the agency such as trade secrets and commercial/financial information privilege, investigative privilege, examination privilege, deliberative process privilege or any privilege that generally flows from the statutory exemptions from disclosure under the Freedom of Information Act. My experience has been one of vigorous defense by OFHEO of not releasing information when protected by such privileges and to do so only with compelling public interest and, as provided in statute, with a determination by the Director to permit such release.

In many cases, OFHEO brings a potential release of information to the attention of an Enterprise for its input and to address any concerns that may be voiced. This procedure is set forth in OFHEO guidelines.

In sum, several federal laws apply. OFHEO has implemented these through regulation, an Employee Nondisclosure Oath for new employees, a guideline on the release of information, procedures for consideration of requests to release information and briefings for separating employees for their ethics obligations after leaving OFHEO including non-disclosure of information.

The following summarize applicable laws and OFHEO implementing regulations and guidelines:

#### I. Key Federal Statutes

*OFHEO enabling statute* addresses information release in providing that the Director is the ultimate decisionmaker regarding information release. The statute favors releases of information, as do other federal banking laws, where information relates to final agency orders or agreements; 12 USC 4522. Additionally, OFHEO's statute requires an annual report to Congress of its examination of the Enterprises, a unique requirement among federal financial regulators.

*Trade Secrets Act*, 18 USC 1905, prohibits with criminal penalties release of certain proprietary business information.

*Freedom of Information Act*, 5 USC 552, generally favors release of information, however, exemptions are provided that relate to OFHEO's work as an examining agency and one with legal deliberative functions.

*Privacy Act*, 5 USC 552a, generally protects information maintained by a government agency that relates to private individuals, be they at a regulated entity or within the agency.

## **II. OFHEO Implementation**

### **A. Regulations**

OFHEO by regulation and internal guidelines addresses the protocol for review of information prior to any external release to the public or other government agencies.

#### **1. Release of Information Regulation (12 CFR 1703)**

*General Provision 1703.6* prohibits current and former employees from disclosing nonpublic info or nonpublic document in possession of OFHEO, "[e]xcept as authorized by this part [of the regulation] or otherwise necessary in performing official duties."

*OFHEO Examination Reports (1703.8)* provides that these reports may only be disclosed in accordance with part 1703 or with the prior written consent of the Director. Reports remain the property of OFHEO and unauthorized use or disclosure of report may be subject to criminal penalties under 18 USC 641. Director may make available such reports for use federal agencies investigating or enforcing Federal laws for their confidential use.

FOIA is included in the regulation, as to the process of review under FOIA for public requests of OFHEO records

OFHEO requirements under regulation and guidelines are referenced in the OFHEO Employee Nondisclosure Oath.

#### **2. Privacy Act Regulation (12 CFR 1702)**

The regulation follows requirements of Privacy Act, 5 USC 552a, to protect personal information held at OFHEO.

### **B. Guidelines**

OFHEO guidelines provide specific procedures involving senior officers of the agency in review of external releases of information or of publications. Reviews by the Office of General Counsel are required and experienced attorneys are assigned on an ongoing basis to this function.

**1. Guideline 105 Releasing Information** – *[implements OFHEO Release of Information Regulation at 12 CFR 1703]* This guideline establishes OFHEO internal policy and procedure for releasing information to non-OFHEO persons or organizations, in response to their requests for information. Responsive to FOIA (5 U.S.C. § 552), the Privacy Act (5 U.S.C. § 552a) and the Trade Secrets Act (18 U.S.C.A. §1905).

The overall policy is that OFHEO shall release information in accordance with procedures and standards set forth in the guideline. The guideline names those OFHEO positions authorized to release information and directs OFHEO employees to address requirements for freedom of information, the right to privacy, and the obligation of careful protection of both proprietary, business-sensitive information and government-sensitive information.

**2. Guideline 108 – Obtaining and Documenting Prior Management Approval to Public and/or Present Research.** This guideline establishes internal clearance procedures for approval to externally release research. The guidance includes review by Office of General Counsel to consider any potential use of nonpublic information-- even it is purportedly sanitized by aggregation or is a statistical analysis that arguably could not be inferred or reconstructed by a third party-- to preclude any adverse affect on the agency or Enterprises. Also, the clearance process requires review by senior management for any policy issues or concerns. Research papers cannot be released externally (for publication, presentation, or third-party peer review) without completion of internal clearance and written authorization of the Director.

**3. Guideline 109 - Management of Information Policy and Procedures for Release of Information in OFHEO Publications.** Under this Guideline, information received from Enterprises is presumed subject to review prior to any public release. The guideline addresses release of info by OFHEO to the public on its own initiative, whether released as received or subsequent to revision, analysis or other changes by OFHEO.

### C. Procedures

As to processing information, two additional items merit notation. First, the Office of General Counsel reviews and determines whether information may be released pursuant to the Director's statutory authorities and implementing rules, *i.e.*, legal standards that either prohibit or permit release (Trade Secrets Act, Privacy Act, FOIA). This review by OGC may include contact with the Enterprises for their input or direction to the lead author or their supervisor contact one or both Enterprises.

Second, the Enterprises have been encouraged in their information submissions to characterize information or data as confidential or request confidential treatment where appropriate.



For release on delivery  
2:00 p.m. EST (9:00 a.m. HST)  
March 6, 2007

GSE Portfolios, Systemic Risk, and Affordable Housing

Remarks

by

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

(via satellite)

before the

Independent Community Bankers of America's

Annual Convention and Techworld

Honolulu, Hawaii

March 6, 2007

The subject of my remarks today is the regulation and supervision of two large financial companies: the Federal National Mortgage Association (known familiarly as Fannie Mae) and the Federal Home Loan Mortgage Corporation (or Freddie Mac). Fannie Mac and Freddie Mac were created by acts of the Congress and are thus known as government-sponsored enterprises, or GSEs. The Congress chartered these two companies with the goal of expanding the amount of capital available to the residential mortgage market, thereby promoting homeownership, particularly among low- and middle-income households. Although they retain their government charters, Fannie and Freddie were converted (in 1968 and 1989, respectively) to private, publicly traded, for-profit companies.<sup>1</sup>

Fannie and Freddie are regulated by the Office of Federal Housing Enterprise Oversight (OFHEO), with additional oversight by the Department of Housing and Urban Development (HUD). The regulatory framework under which the GSEs operate has two principal objectives: first, to support the GSEs' mission of promoting homeownership, especially access to affordable housing; and second, to ensure that these two companies operate in a financially prudent manner. For various reasons, including recent problems with accounting and internal controls at the GSEs, a consensus appears to exist that the regulatory and supervisory framework needs to be strengthened, and the leaders of the banking committees in the Congress have expressed optimism that agreement on legislation can be reached this year.

The Federal Reserve Board concurs that a stronger regulatory framework for the GSEs is needed, and we hope to see a bill passed this year that addresses the important

public policy issues raised by the operations of these entities. Because of its responsibility to help ensure financial and economic stability, the Federal Reserve Board must be concerned with any potential financial difficulties at the GSEs that might have broader systemic implications. In addition, the Federal Reserve Board recognizes the great value that the Congress attaches to the GSEs' affordable-housing mission. In my remarks today, I will offer some thoughts on how GSE regulatory reform could reduce the systemic risks posed by these organizations while increasing their institutional focus on promoting access to affordable housing.

**Public Policy Issues Raised by GSE Operations**

I will begin by discussing GSE operations and some issues of public policy raised by these activities. Broadly speaking, Fannie Mae and Freddie Mac each run two lines of business. Their first line of business involves purchasing mortgages from primary mortgage originators, such as community bankers; packaging them into securities known as mortgage-backed securities (MBS); enhancing these MBS with credit guarantees; and then selling the guaranteed securities. Through this process, securities that trade readily in public debt markets are created. This activity, known as securitization, increases the liquidity of the residential mortgage market. In particular, the securitization of mortgages extended to low- and middle-income home purchasers likely has made mortgage credit more widely available.

The GSEs' second line of business is the main focus of my remarks today. It involves the purchase of mortgage-backed securities and other types of assets for their own investment portfolios. This line of business has raised public concern because its fundamental source of profitability is the widespread perception by investors that the U.S.

government would not allow a GSE to fail, notwithstanding the fact that--as numerous government officials have asserted--the government has given no such guarantees. The perception of government backing allows Fannie and Freddie to borrow in open capital markets at an interest rate only slightly above that paid by the U.S. Treasury and below that paid by other private participants in mortgage markets. By borrowing at this preferential rate and purchasing assets (including MBS) that pay returns considerably greater than the Treasury rate, the GSEs can enjoy profits of an effectively unlimited scale. Consequently, the GSEs' ability to borrow at a preferential rate provides them with strong incentives both to expand the range of assets that they acquire and to increase the size of their portfolios to the greatest extent possible.

The GSE portfolios have been the subject of much controversy. First, analysts disagree about whether the GSE portfolios serve any public purpose. The GSEs themselves argue that their purchases of MBS provide additional support to the mortgage market, particularly during periods of financial stress. In contrast, research at the Federal Reserve Board and elsewhere has found that the GSE portfolios appear to have no material effect on the cost or availability of residential mortgages.<sup>2</sup> At the margin, the GSEs finance their purchases of MBS by issuing equal amounts of debt, and thus the net supply to the market of housing-related debt is unchanged by GSE purchases. Thus, standard economic reasoning does not predict large effects from these purchases on the mortgage market.<sup>3</sup> Indeed, contrary to what would be expected if GSE portfolios lowered the funding costs of mortgages, over the past decade or so the spread between yields on thirty-year fixed-rate mortgages and Treasuries of similar duration has tended to *rise* in periods in which the GSEs have increased the share of the single-family residential

mortgages held in their portfolios and to *fall* when the GSE share has fallen.<sup>4</sup> All that being said, for the purpose of the policy recommendations that I will make today, I will stipulate that GSE portfolios may serve to enhance liquidity and reduce costs in the mortgage market in some circumstances. In particular, the GSE portfolio purchases may create benefits for home purchase mortgages extended to lower-income households, to low- and moderate-income first-time homebuyers, and to buyers of homes in lower-income neighborhoods. These are all mortgage markets in which the private sector might have greater difficulties making mortgage credit more widely available and thus for which the case for government support may be stronger.

A second element of the controversy surrounding the GSE portfolios arises from the fact that they are not only large but also potentially subject to significant volatility and financial risk (including credit risk, interest-rate risk, and prepayment risk) and operational risk. Many observers, including the Federal Reserve Board, have expressed concern about the potential danger that these portfolios may pose to the broader financial system; that is, the GSE portfolios may be a source of *systemic risk* (Greenspan, 2005a). Systemic risk is the risk that disruptions occurring in one firm or financial market may spread to other parts of the financial system, with possibly serious implications for the performance of the broader economy.

Financial crises are extremely difficult to anticipate, and each episode of financial instability seems to have unique aspects, but two conditions are common to most such events. First, major crises usually involve financial institutions or markets that are either very large or play some critical role in the financial system. Second, the origins of most financial crises (excluding, perhaps, those attributable to natural disasters, war, and other

nonfinancial events) can be traced to failures of due diligence or “market discipline” by an important group of market participants.

Both of these conditions apply to the current situation of Fannie Mae and Freddie Mac (Eisenbeis, Frame, and Wall, forthcoming). The two GSEs are certainly large, having a dominant presence in U.S. mortgage markets and a substantial role in other financial markets, particularly in public debt and derivatives markets. Beginning in the mid-1990s, the GSEs began to rapidly increase the quantity of mortgages and other assets that they purchased and retained in their portfolios. From the end of 1990 until the end of 2003, the combined portfolios of Fannie Mae and Freddie Mac grew more than tenfold, from \$135 billion to \$1.56 trillion, and the share they hold of outstanding residential mortgages increased from less than 5 percent to more than 20 percent.<sup>5</sup> Moreover, to finance their own holdings of MBS and other assets, in 2005 the two GSEs together issued almost \$3 trillion in debt. Today, the two companies have \$5.2 trillion of debt and MBS obligations outstanding, exceeding the \$4.9 trillion of publicly held debt of the U.S. government (Lockhart, 2007). The activities of the GSEs are not confined to debt markets; because the GSEs engage in extensive hedging activities, these companies are among the most active users of derivative instruments. Thus, by any measure, the GSEs have a significant presence in U.S. financial markets.<sup>6</sup>

In most situations, policymakers can rely on market forces to constrain the risk-taking behavior of privately owned financial organizations. Market discipline is effective because, normally, the creditors of private firms have powerful incentives to monitor the risk-taking and risk-management activities conducted by these organizations. In particular, if creditors believe that an organization is taking on increased risk, they will

reduce their exposure to the organization or demand greater compensation for bearing the additional risk. These market responses act as a brake on an organization's risk-taking behavior and consequently reduce the likelihood that the company will fail.

Unlike other private firms, however, the GSEs face little or no market discipline from their senior debt holders because of the belief among market participants that the U.S. government will back these institutions under almost any circumstances. As a result, increased risk-taking by the GSEs does not significantly increase their cost of funding or reduce their access to credit, as it would for other private firms. Indeed, as I have already noted, GSE debt trades at a narrow spread over U.S. Treasury debt and at spreads below those of other highly rated financial institutions, including the largest U.S. bank holding companies.<sup>7</sup> Moreover, the spread of GSE debt over Treasuries has been remarkably unresponsive to the recent problems of the GSEs (including the turnover of senior management and the inability of either company to provide current financial statements), suggesting that investors' faith in an implicit government guarantee remains unshaken.

As I have also noted, their low cost of borrowing gives GSEs an advantage over market participants in profitably financing the acquisition of just about any market-priced asset (other than U.S. Treasuries), and it creates a strong incentive for these companies to look for new types of assets to acquire and to find new lines of business to enter.<sup>8</sup> These ingredients--the large presence of the GSEs in financial markets, the lack of market discipline exercised by investors in GSE senior debt, and the incentives for continued portfolio growth--led the Federal Reserve Board to conclude that while the GSEs do not seem to pose an immediate risk of financial difficulty, their portfolios continue to

represent a potentially significant source of systemic risk.

Some observers have suggested that the systemic risks raised by GSEs are not qualitatively different from those posed by the largest bank holding companies, which are also a sizable presence in financial markets and enjoy some government guarantees (notably deposit insurance). However, this comparison is invalid for several reasons. First, uninsured deposits and other uninsured debt of bank holding companies--which are the marginal sources of funding for these organizations--pay rates of interest that are higher than both Treasury and GSE rates and that are sensitive to the financial condition of the firm. This behavior of banks' cost of funds suggests that debt holders do not believe that their investments will be fully protected if the bank gets into trouble, and consequently these debt holders exert market discipline on the firm.<sup>9</sup>

Second, because of both regulatory requirements and the force of market discipline, banks hold much more capital than GSEs hold. The very largest bank holding companies generally hold equity capital equal to 6 percent or more of assets, and the largest regional banks generally have capital ratios of about 8 percent. (As I am sure you are keenly aware, community banks often have a capital-to-assets ratio exceeding 10 percent.) In comparison, the GSEs hold capital equal to roughly 3.5 percent of assets.<sup>10</sup> The justification for the low capital holdings of GSEs relative to banks is unclear. The largest banks are more diversified than the GSEs; and although banks likely assume greater credit risks, they probably are less subject to interest-rate risk than are GSEs.<sup>11</sup> Moreover, the recent experience of the GSEs suggests that they are subject to at least as much operational risk as the large banks.

**Measures to Reduce the Systemic Risk of GSE Portfolios**

I have argued today that the size and the potentially rapid growth of GSE portfolios, combined with the lack of market discipline faced by GSEs, raise substantial systemic risk concerns. How should this issue be addressed? In recent years, the Federal Reserve Board has laid out three essential elements for the effective regulation of the GSEs that we believe would mitigate those concerns while promoting more effectively the important public purposes that they serve (Greenspan 2004; 2005b; 2006). First, the GSE regulator should have the broad authority necessary to set and adjust GSE capital requirements in line with the risks posed by the GSEs. Second, the GSEs should be subject to a clear and credible receivership process, a process that would establish that both shareholders and debt holders of a failed GSE would suffer financial losses. Third, the GSEs' portfolios should be anchored firmly to a well-understood public purpose approved by the Congress.

The concentrated and potentially volatile nature of the GSEs' portfolios, together with the lack of market discipline on GSE activities, makes ensuring adequate capital--the first element--especially important. To ensure the safety and soundness of the GSEs and to reduce systemic risks, the GSE regulator should have capital authority that is on a par with that of the bank regulators. For example, the GSE regulator should have clear authority to establish and modify both the minimum and the risk-based capital standards for the GSEs. Moreover, the GSE regulator should be able to adjust capital requirements quickly and as needed to address developing or foreseeable concerns, rather than being required by cumbersome procedures to wait until after the damage has been done. A strong capital base would significantly reduce the implicit subsidy and incentive

problems that now distort GSE investment decisions (Lucas and McDonald, 2006), while also increasing their safety and soundness.

The establishment of a clear and credible GSE receivership process, the second element, is needed to create market discipline for these companies. Reform legislation should establish (1) a well-defined and mandatory process for placing a GSE in receivership and (2) a method for resolving a GSE once it is placed in receivership. Both parts are necessary for the receivership process to be meaningful and credible. Market participants should clearly understand that, once certain conditions arise, regulatory forbearance will be impermissible and a GSE receivership will be established. Importantly, the GSE receivership process should include a mechanism for ensuring that both the shareholders and creditors of a failed GSE will bear financial losses. Only if GSE debt holders are persuaded that the failure of a GSE will subject them to losses will they have an incentive to exert market discipline.

Third, the GSE portfolios should be anchored to a clear and well-defined public purpose. Tying the portfolios to a purpose that provides measurable benefits to the public would help to ensure that society in general--not just GSE shareholders--receives a meaningful return in exchange for accepting the risks inherent in the portfolios. Moreover, defining the scope and purpose of the portfolios in this way would reduce the potential for unbridled growth in those portfolios while avoiding the imposition of arbitrary limits or caps.

#### **Affordable Housing and the GSE Portfolios**

What public purpose should be served by the GSE portfolios? An obvious and worthy candidate is the promotion of affordable housing.<sup>12</sup> The Congress has frequently

expressed the priority it attaches to affordable housing through, for example, the provision of various housing programs and tax incentives aimed at increasing the availability of moderately priced homes and rental housing. The Congress has also determined that financial institutions have a role in providing credit to low- and moderate-income households. Most notably, the Community Reinvestment Act (CRA) obligates insured depository institutions to help meet the credit needs of their entire local communities, including low- and moderate-income borrowers and neighborhoods, consistent with the institutions' safe and sound operation.<sup>13</sup>

Along similar lines, in 1992 the Congress established an affordable housing mission for Fannie Mae and Freddie Mac by directing HUD to create specific mortgage purchase goals for these GSEs. However, evidence that Fannie and Freddie have had beneficial effects on the supply of affordable housing (over and above the benefits of their securitization activities for the mortgage market as a whole) has been difficult to find.<sup>14</sup> After conducting several studies of the effects of GSEs on the mortgage market and establishing the GSEs' disappointing results, HUD in 2004 raised the numerical goals that these institutions must reach to fulfill their affordable housing mission. As noted by HUD, "With respect to these public purposes, Congress does not simply expect the GSEs to strive toward achievement of these purposes but rather *to lead the mortgage finance industry and to ensure that citizens throughout the country enjoy access to the public benefits provided by these federal entities.*"<sup>15</sup>

Thus, a standard for determining the public benefit of Fannie's and Freddie's portfolios seems readily available: Do the GSE portfolios support affordable housing? At the present time, Fannie and Freddie appear to fail this test. Indeed, by OFHEO's

estimation, less than 30 percent of the GSEs' current portfolio holdings are oriented toward affordable housing (Lockhart, 2007).

A straightforward means of anchoring the GSE portfolios to a clear public mission would be to require Fannie and Freddie to focus their portfolios almost exclusively on holdings of mortgages or mortgage-backed securities that support affordable housing. The evolution of mortgage markets since the GSEs were created strongly suggests that a concentration on affordable-housing products would provide the greatest public benefit. Markets for highly rated assets--including most residential mortgages and the pools of MBS backed by such mortgages--have become extremely deep and liquid, with more than \$25 trillion in outstanding instruments. These markets are international in scope, and market participants include thousands of banking organizations, insurance companies, pooled investment vehicles, institutional investors and, increasingly, foreign governmental authorities. Given the size and depth of the secondary market for most residential mortgages, the GSEs' purchase and retention of highly rated mortgages and of their own MBS are unlikely to do much to enhance liquidity in the secondary markets for these assets or to promote affordable housing. On the other hand, the vast size of the market for highly rated assets greatly increases the potential for rapid growth of GSE portfolios and, consequently, systemic risk.

In contrast, the market for affordable-housing products--particularly mortgages extended to households with below-median-income--is less deep and liquid than the broader market for residential mortgages. GSE portfolio purchases might add significant liquidity to the secondary markets for such assets, thereby reducing costs and increasing credit availability to prospective home purchasers. In addition, increasing the presence of

the GSEs in the market for affordable housing could help banks fulfill their CRA obligations by providing them with greater opportunities for securitizing such loans. In all, from a social perspective, focusing the GSE portfolios on affordable housing could provide benefits that might offset some of the risks that these more-targeted portfolios might pose to financial markets and to taxpayers. The key principle here is that the GSEs' senior debt--which investors view as government-backed--should be used only to finance assets (such as affordable-housing mortgages) that have, in the view of the Congress, a clear and measurable public benefit.<sup>16</sup> Such an approach would set some functional limits on the size of the portfolios and on the range of assets that GSEs would be allowed to purchase, while preserving the ability of these companies to operate profitably.

To be clear, I am not advocating a change in the exposure of GSEs to subprime loans.<sup>17</sup> Orienting the GSEs' portfolios more toward affordable housing is an approach which can succeed under the current GSE credit standards. Indeed, the credit risks associated with an affordable-housing portfolio need not be any greater than mortgage portfolios generally, so long as the GSEs continue to adhere to sound underwriting practices. Moreover, a renewal of the GSE affordable-housing mission might stimulate the development of innovative approaches to measuring and managing the credit risks associated with such mortgages.

### **Conclusion**

Legislation to strengthen the regulation and supervision of GSEs is highly desirable, both to ensure that these companies pose fewer risks to the financial system and to direct them toward activities that provide important social benefits. Financial

safety and soundness can be enhanced by giving the GSE regulator capital powers comparable to those of bank supervisors and by creating a clear and credible receivership process that leads debt holders to recognize that they would suffer financial losses should a GSE fail. Finally, the Federal Reserve Board believes that the GSEs' investment portfolios should be firmly anchored to a measurable public purpose, such as the promotion of affordable housing. I believe that this approach provides a reasonable balance of social costs and benefits for the GSE portfolios. In particular, this approach would re-focus the GSEs on the affordable housing objectives given to them by the Congress.

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<sup>1</sup> Frame and White (2005) provide a general description of GSEs and the associated policy debates.

<sup>2</sup> See Lehnert, Passmore, and Sherlund (forthcoming). There is also much debate about whether GSE activities more generally lower the cost of mortgage credit, with estimates of the GSEs' overall effect on fixed-rate mortgages ranging from zero to around 25 basis points (see Ambrose, LaCour-Little, and Sanders, 2004; Geradi, Rosen and Willen, 2006, Passmore, Sherlund, and Burgess, 2005; and Passmore, Burgess, Hancock, Lehnert, and Sherlund, 2006).

<sup>3</sup> The corporate debt issued by the GSEs has somewhat different risk characteristics than MBS—less exposure to prepayment risk, for example. However, the GSEs attempt to hedge most of the risks of MBS that they hold through callable debt and the use of derivatives, so those risks ultimately end up in the broader market as well.

<sup>4</sup> As discussed later, the combined portfolios of the GSEs grew more than tenfold between 1990 and 2003; their market shares peaked in 2003 at slightly more than 22 percent. GSE market shares have fallen over the past three years to about 14 percent, partly as the result of the companies' accounting and internal control problems, which resulted in agreements with OFHEO to limit portfolio growth (presumably on a temporary basis). The spread between mortgage rates and Treasury yields rose during the second half of the 1990s, peaked in late 2002 and 2003, and has declined since, implying that higher mortgage spreads are associated with higher GSE market shares. Lehnert, Passmore, and Sherlund (forthcoming) find that a similar result obtains over shorter periods; using monthly data, they show that the mortgage spread appears to rise when GSE purchases rise and contract when GSE purchases contract.

<sup>5</sup> Data on the GSEs' portfolios can be found at [www.ofheo.gov/Research.asp](http://www.ofheo.gov/Research.asp).

<sup>6</sup> See OFHEO (2006) and Inside Mortgage Finance Publications (2006). I should also note that in 2003, Fannie and Freddie together accounted for almost 70 percent of all mortgage securitizations and about 75 percent of all mortgage-backed securities outstanding. The GSEs' market shares of mortgage securitizations and outstanding MBS have fallen since 2003, reflecting the growth of private securitizations.

<sup>7</sup> The funding advantage of the GSEs relative to large bank holding companies has varied significantly over time, ranging from 20 to 45 basis points. Much of this variation reflects changes in the credit risk premiums embedded in the debt of large bank holding companies, which mainly reflect systematic credit risks. In the past several years, this credit premium has narrowed substantially.

<sup>8</sup> Under normal market conditions, the substantial profits of the GSEs would attract competitors. But competitors, which are subject to market scrutiny when conducting their business, cannot provide a check on the GSEs because they cannot compete with the GSEs' low cost of funds.

<sup>9</sup> Legal provisions such as prompt corrective action and the least-cost-resolution requirement probably contribute to the perception of bank debt holders that their investments are not guaranteed if the bank gets into financial trouble. Recently, the Federal Deposit Insurance Corporation (FDIC) has proposed to require that large banks maintain depositor records in a common format to help ensure that those creditors do not escape losses in the event of a bank failure. Also, the ability of bank holding companies to increase their government-backed funding is limited. By law, banks cannot make additional banking acquisitions if the resulting firm would control more than 10 percent of U.S. insured deposits.

<sup>10</sup> This comparison excludes the temporary 30 percent additional capital currently required by OFHEO because of the operational risks posed by the GSEs' recent accounting problems.

<sup>11</sup> Interest rate risk depends on the degree of hedging, which is at the discretion of firm management. However, because the GSEs' portfolios are concentrated in the mortgage-backed securities market and thus

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are subject to rapid changes in market value, the risk profile of the GSEs can change rapidly in response to unexpected movements in interest rates. In contrast, banks hold a more diversified mix of liabilities and assets, many of which are less sensitive to unexpected changes in interest rates, suggesting that banks as a general matter are less prone to interest rate risk. Regardless, little social benefit is gained by encouraging the concentration of the substantial interest rate risks associated with long-term mortgages into only two government-sponsored organizations, when such risk could be easily distributed across tens of thousands of entities, both domestic and foreign, through the process of mortgage securitization.

<sup>12</sup> According to the Department of Housing and Urban Development (HUD), “The generally accepted definition of affordability is for a household to pay no more than 30 percent of its annual income on housing” ([www.hud.gov/offices/cpd/affordablehousing](http://www.hud.gov/offices/cpd/affordablehousing)). Presumably, this definition would apply only for low- and moderate-income households. One difficulty of discussing GSE reform and affordable housing is that there is no straightforward link between this definition of affordable housing and the activities of the GSEs. Better data and methods are needed to measure accurately the GSEs’ contributions to affordable housing.

<sup>13</sup> In addition, the Congress in 1934 established the Federal Housing Administration (FHA) and gave it the mission of helping to increase the availability of affordable housing by extending the provision of mortgage insurance to many lower-income and liquidity-constrained households. More recently, the Congress required the Federal Home Loan Banks (FHLBs) to establish an affordable housing fund.

<sup>14</sup> As one recent study stated: “A substantial literature has now developed analyzing the efficacy of HUD housing goals for promoting home ownership among lower-income families. The consensus conclusion is that the affordable housing goals (AHGs) have achieved very little in terms of increasing homeownership among low-income families” (Jaffe and Quigley, 2007, p. 12).

<sup>15</sup> Department of Housing and Urban Development (HUD), (2004a), p. 63581. Italics are quotes taken by HUD from Senate Report, No. 102-282, at 34 (1992). For reviews of HUD’s studies comparing the GSEs to the primary mortgage market, see HUD (2004a and 2004b).

<sup>16</sup> Subordinated debt might be used to fund any assets allowed by Congress and held by Fannie and Freddie that did not have a strong and easily measurable link to making housing more affordable. In principle, subordinated-debt spreads should be more responsive to market developments than senior-debt spreads, particularly if issuance was mandatory and the Congress establishes a clear and credible receivership process for the GSEs. Fannie and Freddie took a step in the direction of enhancing GSE market discipline when they issued subordinated debt in 2000. But during the recent period of accounting problems, neither GSE has chosen to issue subordinated debt, likely because doing so would have been too costly. Only recently has Freddie Mac resolved its problems sufficiently so that subordinated debt could be issued.

<sup>17</sup> The role of the GSEs in subprime lending and whether to increase or decrease their exposure to such lending are important questions for Congress. The GSEs have been only indirect players in the subprime market, purchasing mainly AAA-debt that has been collateralized with subprime mortgages and leaving the higher risk components of the subprime mortgages to be funded by other market participants.