NAHB
NATIONAL ASSOCIATION OF HOME BUILDERS

ACROSS THE COUNTRY HOME BUILDERS CARE

Testimony Of

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On behalf of the

National Association of Home Builders

Before the

United States House of Representatives

Committee on Financial Services

On

Proposals to Restructure the Regulatory Framework for the Housing-Related Government Sponsored Enterprises

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Introduction

The 211,000 members of the National Association of Home Builders (NAHB) appreciates the opportunity to present their views to the House of Representatives' Financial Services Committee on the regulatory framework for the housing-related government-sponsored enterprises (GSEs), including safety and soundness oversight, new program approval and the establishment and enforcement of affordable housing goals. The GSEs – Fannie Mae, Freddie Mac and the Federal Home Loan Bank System -- 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 housing finance system has also allowed the housing sector to sustain economic performance as other sectors have faltered.

NAHB believes it is important that the regulatory framework for the GSEs is credible and effective to ensure these organizations fulfill their mission in a safe and sound manner. However, any changes in the current system must be carefully considered to avoid disruptions to the efficient operation of the mortgage markets and the impediments to the development of effective programs to address the nation's housing needs.

As discussed in detail below, the Department of Housing and Urban Development (HUD) is the appropriate agency to regulate the mission of Fannie Mae and Freddie Mac, including approving new programs and establishing affordable housing goals. We do not feel that the Department of Treasury, which is well suited to oversee the safety and soundness of Fannie Mae and Freddie Mac's financial operations, has sufficient expertise and involvement in housing issues to also serve as the program regulator. NAHB is opposed to changes to the current regulatory arrangement for the Federal Home Loan Bank System.

Background

Housing and the Economy

The housing market has been an engine of growth in recent years, sustaining the economy during a difficult stretch. That performance continues this year, with new home sales heading toward a record performance of more than a million closings. Single-family home construction has been robust and should total about 1.4 million units in 2003. Multifamily activity has been more subdued, but should still post a respectable showing, pushing total housing starts above 1.7 million units for the second consecutive year.

While low interest rates and favorable demographics have spurred demand, these results would not have been possible without the support of the finance system for housing. The bedrock of that system is a liquid and vibrant secondary market that is the product of the activities of Fannie Mae and Freddie Mac. These enterprises have not only contributed to the affordability of housing credit but also have taken the lead in expanding the menu of affordable housing programs and products. The Federal Home

Loan Banks also continue to play an important role both by providing liquidity to housing lenders and by developing innovative programs to address housing needs.

GSEs and Housing Finance

The housing-related GSEs are American success stories. As mentioned above, they have brought enormous benefits to home buyers, renters and the housing finance system. These include:

> Reduction of mortgage interest rates -- Home buyers with conforming loans -- mortgages eligible for purchase by Fannie Mae and Freddie Mac, those up to $322,700 for one-unit properties -- pay mortgage rates that are approximately 25 to 50 basis points lower than rates paid by other conventional mortgage borrowers. This fact was substantiated in the 1996 studies by the General Accounting Office, the Congressional Budget Office, HUD and the Treasury Department.
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> Reliable and stable flow of mortgage credit -- The linkage that the GSEs provide to the national and international capital markets sustains the flow of capital to housing, even under changing economic conditions. While the economy has undergone major shocks over the past decade, home buyers have experienced no interruption in the availability of mortgage credit.
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> Elimination of regional disparities in interest rates -- The GSEs provide a nationwide market for mortgage funds, a key factor in the elimination of regional disparities in the availability and cost of mortgage credit, which occurred regularly before Fannie Mae and Freddie Mac came on the scene. Today, interest rates in conforming mortgage markets around the country vary by no more than 10 basis points.
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> Cushion against local economic downturns -- When regional economies begin to slow, some participants in the mortgage industry have restricted credit or abandoned markets in search of opportunities elsewhere. This is not the practice of the GSEs. They maintain a presence in all markets under all economic conditions, cushioning the impact of local or regional declines in economic activity.
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> Market standardization and innovation -- The GSEs have brought both standardization and innovation to the mortgage markets, involving a variety of mortgage instruments and securities structures. Standardization is key to obtaining and retaining investor confidence and supports the innovation that has addressed a broad range of borrower and investor preferences. In the primary market, the GSEs have supported the development of hybrid mortgages that combine the benefits of adjustable and fixed-rate mortgages. The GSEs also have established reduced downpayment programs to help cash-strapped first-time home buyers. Recently, both Fannie Mae and Freddie Mac have introduced mortgage products to assist borrowers with tarnished credit histories. In addition, Fannie Mae and Freddie Mac are at the forefront of technological innovations to

streamline the mortgage process in order to reduce the time and cost involved in obtaining a mortgage.

Expansion of homeownership and rental housing opportunities -- The housing GSEs have made significant strides in expanding homeownership opportunities and increasing the supply of affordable rental housing in underserved areas. The housing goals enacted by the 1992 GSE Act have successfully encouraged both Fannie Mae and Freddie Mac to significantly increase their service to the market sectors targeted by the housing goals. These accomplishments are the result of concerted efforts by both Enterprises in the affordable housing arena. Both GSEs have introduced products and services to expand homeownership opportunities for low-and moderate-(low/mod) income borrowers, renters and residents of areas underserved by the broader housing finance system.

Current GSE Regulatory Framework

The 1992 GSE Act established a dual regulatory oversight structure for Fannie Mae and Freddie Mac. HUD is the programmatic (or mission) regulator and the Office of Federal Housing Enterprise Oversight (OFHEO) is the safety and soundness regulator.

The 1992 GSE Act also requires Fannie Mae and Freddie Mac to obtain prior approval by HUD of any new mortgage programs. The Act defines new programs as any programs that are significantly different from programs previously approved or engaged in prior to 1992. HUD also is required to review new programs to ensure that they are consistent with the GSEs' charters and are in the public interest. In addition, Fannie Mae and Freddie Mac are required by law to meet annual housing goals established by HUD.

Finally, The 1992 GSE Act established OFHEO as an independent office within HUD to oversee the safety and soundness of Fannie Mae and Freddie Mac. OFHEO's primary responsibilities are to establish and enforce capital standards for Fannie Mae and Freddie Mac and to conduct annual on-site examinations of the firms to ensure that they are operating in a safe and sound manner. Fannie Mae and Freddie Mac are required to meet two capital standards, a minimum leverage ratio and a risk-based capital (RBC) standard.

Context for GSE Oversight Evaluation

NAHB believes that debate and discussion on the future of GSE regulation should be grounded in the fact that the housing-related GSEs were created to provide liquidity and stability to the housing market. NAHB believes it would be a tremendous mistake to turn discussion on GSE regulation into a referendum of our highly successful housing finance system. It would be ironic for debate and action on regulatory changes to undermine the success that has been achieved in these areas.

The key to the GSEs' success is their steadfast focus on their mission. They are in one business, housing finance – a relatively low-risk endeavor. This narrow focus should be recognized in the discussion of any future regulatory framework. The GSEs are not banks operating in far-flung and highly risky product lines and markets and should not be regulated as such.

No one has stated concern of an imminent crisis in the GSE system. There is no need to rush to judgment. Hasty action could have catastrophic consequences for housing. NAHB urges a careful and thoughtful approach on GSE regulation and believes such a course will produce tremendous rewards to those with most at stake in the process – America's homeowners and renters.

Guiding Principles for GSE Oversight

NAHB endorses continued federal government support of America's housing finance system through GSEs, including Fannie Mae, Freddie Mac and the Federal Home Loan Banks. NAHB believes that government oversight of these GSEs should be guided by the following principles:

1. The GSE status of these institutions must be maintained. Efforts to privatize, withdraw any of the federal privileges and legal exemptions, or otherwise diminish the ability of the GSEs to provide housing financing at the lowest possible cost should be opposed.

2. The GSEs should fulfill their public mission by conducting activities authorized by their charters in a safe and sound manner and by promoting access to mortgage credit to address the needs of affordable housing throughout the nation.

3. The regulatory framework of the GSEs should be strong and credible, possess adequate authority and resources and reflect the differences inherent in the charters and operating structures of the GSEs. Further, the regulatory framework should foster competition among the GSEs to develop and implement innovative, low-cost funding and other programs to meet the nation's housing credit needs.

4. The mission oversight of Fannie Mae and Freddie Mac (including approval of new programs and enforcement of affordable housing goals) should be conducted by the Department of Housing and Urban Development (HUD), an entity with a thorough understanding of and extensive involvement in housing-related issues.

5. The safety and soundness oversight of Fannie Mae and Freddie Mac should be conducted by an independent regulatory agency through rigorous examinations, enforcement of regulations (including capital standards) and transparency, without unnecessarily impairing the ability of these GSEs to accomplish their mission.

6. The recently implemented risk-based capital standards for Fannie Mae and Freddie Mac should be allowed to remain in place for a period of time sufficient to evaluate the effectiveness of the new standards.

7. There should be no alteration in the Federal Housing Finance Board's (FHFB) responsibilities for regulation of the mission and safety and soundness of the Federal Home Loan Bank System.

Administration's Proposal

In outlining the Administration's proposal during testimony before this Committee on September 10, Treasury Secretary John Snow stated that "we have two core objectives that should guide us: a sound and resilient financial system, and increased homeownership opportunities for less advantaged Americans." These objectives are consistent with NAHB's guiding principles, but we are concerned that the administration's proposal may not accomplish these objectives and could undermine the housing finance system.

The Bush Administration proposes to create a new federal agency within the Treasury Department to regulate and supervise the financial activities of the housing GSEs. The new agency would have general regulatory, supervisory and enforcement powers for GSE oversight, including the authority to establish, enforce and revise capital standards. Oversight of existing GSE activities and approval of new activities would be shifted from HUD to the new Treasury agency. HUD would be left with minimal regulatory authority, limited to oversight of the annual affordable housing goals and a consultative role in program oversight.

Importantly, the Administration does not recommend any changes in the GSEs' agency status. This is consistent with NAHB's first principle of GSE regulation. Further, we believe that the regulatory framework outlined by Secretary Snow should be limited to only Fannie Mae and Freddie Mac. Secretary Snow indicated in his testimony that the Administration also would like to bring the Federal Home Loan Banks under this regulatory structure. NAHB would oppose such a move. The structure of the Federal Home Loan Bank System is unique and substantially different from that of Fannie Mae and Freddie Mac. The Federal Home Loan Banks should continue to have their own independent regulator, currently housed in the Federal Housing Finance Board.

Mission Regulation

It is imperative that HUD retains current status as mission regulator for Fannie Mae and Freddie Mac. NAHB has grave concerns with the Administration's proposal to transfer program authority from HUD to the new Treasury office. Stripping HUD of any mission oversight functions constitutes a devastating attack on the mission of HUD by removing the agency's ability to improve housing opportunities for America's working families. Such a move would gut HUD's role as our nation's primary housing advocate and threatens to jeopardize the success of the housing finance system and undermine the vibrant housing market that sustained the economy in recent years.

There are three main aspects to GSE mission oversight: general charter compliance; program approval and oversight; and, housing goals enforcement, monitoring and enforcement. These functions form the core of mission regulation and cannot be separated as the Administration recommends.

Program Oversight

The objective and focus of program oversight is not safety and soundness, it is mission compliance. The legislative history of program oversight provisions makes this clear.

The 1968 Fannie Mae Charter Act, which reconstituted Fannie Mae as a government-sponsored private corporation, granted HUD general regulatory power to ensure Fannie Mae's compliance with its housing mission as specified in the charter. In 1970, HUD was vested with prior approval of all new Fannie Mae programs through the Emergency Home Finance Act, which also created Freddie Mac. HUD was granted regulatory oversight of Freddie Mac in 1989 through the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), which transferred this authority to HUD from the Federal Home Loan Bank Board. Finally, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the GSE Act) reaffirmed HUD as the program regulator of Fannie Mae and Freddie Mac and gave HUD the authority to establish, monitor and enforce affordable housing goals.

The legislative history reflects the recognition by Congress that program oversight is a function of mission regulation that must be conducted by HUD, the only cabinet agency with a thorough understanding of and extensive involvement in housing-related issues. Indeed, during consideration of the 1992 GSE Act, Senate Banking Committee Chairman Riegle stated that "in order to properly coordinate national housing policy, ... regulations relating to the housing missions of Fannie Mae and Freddie Mac should be issued only with the review of the HUD Secretary."

Under current law, Fannie Mae and Freddie Mac must submit a new program approval request to HUD if the initiative is "significantly different" from a program previously approved; is an activity in which the GSE had not engaged prior to passage of the 1992 GSE Act; or, represents an expansion in terms of dollar volume, number of mortgages or securities involved above limits expressly contained in any prior program approval. Further, if HUD believes an activity should be subject to prior approval, HUD may also request additional information or require a GSE to submit a program request. (Prior to one year after the effective date of the risk-based capital regulations, the GSEs were required to simultaneously submit new program requests to the Director of OFHEO. With the implementation of the RBC capital rule in September 2002, OFHEO now has a consulting role, at HUD's discretion, in the evaluation of new programs.) HUD is required to approve any new program request unless it is not authorized by the GSEs' Charter Acts or is not in the public interest.

The existing program approval requirements and process have served the housing market well, by ensuring effective regulatory oversight and encouraging product innovation to fulfill the GSEs' housing mission. This is particularly true in the affordable housing area where both GSEs have introduced products and services to expand homeownership opportunities for low-and moderate- (low/mod) income borrowers, renters and residents of areas underserved by the broader housing finance system. Technological innovations by the GSEs, such as their automated underwriting systems

(AUS), also have contributed to their efforts to expand homeownership opportunities. In the affordable multifamily market, both GSEs have established forward commitment programs that support much-needed production of new units. Further, each has developed partnerships and alliances at the national and local levels to expand affordable housing opportunities.

The present program approval structure strikes an appropriate balance between mission and safety and soundness oversight. Safety and soundness are not criteria for new program approval. Indeed, the Treasury Department reached the same conclusion in its 1990 study on the GSEs. Treasury stated,

> "<u>the regulatory authority which monitors a GSE's fulfillment of its Congressional mandate should be different from the entity implementing financial safety and soundness standards. Separating these two regulatory functions will remove risks to the taxpayers by removing a perceived conflict of interest</u> [emphasis added]. … The Treasury recommends that the current program regulator continue to be responsible for ensuring that the GSE meets its Congressional mandate by effectively serving its intended beneficiaries." <u>Report of the Secretary of the Treasury on Government-Sponsored Enterprises</u>, May 31, 1990.

It is interesting that the Treasury and HUD now view program approval as a function of safety and soundness oversight to be overseen by the Treasury. NAHB believes Treasury is the wrong place to put program approval. Treasury lacks experience in and knowledge of housing. Treasury presently has oversight for two important housing tax programs, low-income housing tax credits and mortgage revenue bonds. Operation of these programs is left to the states and HUD to set program specifics. Outside of these tax programs, Treasury has little experience in evaluating the effectiveness and appropriateness of housing policies.

Applying safety and soundness criteria, in conjunction with Treasury's longstanding bias against programs that facilitate the flow of capital to housing, would severely retard the development of programs needed by Fannie Mae and Freddie Mac to fulfill their housing mission. It will stifle innovation necessary to provide liquidity to the housing credit markets, particularly in areas that otherwise would not be adequately served. Such activities, by definition, involve higher risk and would be greatly constrained if program approval were solely a component and function of safety and soundness regulation.

The purpose of safety and soundness regulation is to ensure that Fannie Mae and Freddie Mac are adequately capitalized for the mission-related programs they are operating, and that appropriate governance structures and procedures are in place to operate those programs in a safe and sound manner. Safety and soundness regulation should not be a vehicle for disapproving programs so the enterprises undertake little or no risk. We don't need GSEs for such a purpose and they could not fulfill their mission if they were regulated in such a manner. Safety and soundness regulation should focus on ensuring that there is adequate capital and strong effective risk management.

The ability of Fannie Mae and Freddie Mac to spur innovative solutions and to develop new products that increase homeownership and rental housing opportunities will only continue if the mission of these corporations is regulated by HUD.

Housing Goals

The Administration is proposing to strengthen HUD's housing goals authority over Fannie Mae and Freddie Mac. As HUD Secretary Martinez outlined in his September 10 testimony, this will include the creation of a new GSE office within HUD, independently funded by the GSEs, to establish, maintain and enforce housing goals. HUD would be granted new administrative authority to enforce housing goals, enhanced civil penalties for failure to meet the goals, and expanded authority to set housing goals and sub-goals beyond the three currently established.

NAHB supports HUD as the regulator for the GSEs' housing goals. We agree with Secretary Martinez that "HUD is the appropriate agency to develop and enforce housing goals. Institutionally, [HUD's] mission is devoted to furthering the goal of affordable housing and homeownership and HUD has the most expertise in this area." Indeed, NAHB believes that housing goals authority is one of HUD's key functions as mission regulator for Fannie Mae and Freddie Mac.

NAHB has always been a strong supporter of the affordable housing goals for Fannie Mae and Freddie Mac since HUD was granted this authority by the 1992 GSE Act. The housing goals establish percent of business purchase goals for three categories: low- and moderate-income, underserved areas and special affordable. The first set of goals was established by regulation in 1995, and was updated in 2000 to cover the years 2001-2003. Current goals levels, as a percent of annual purchases, are: 50% for low-mod; 31% for underserved areas; and, 20% for special affordable

The 2000 rule also provided for bonus points for the 2001-2003 period for units financed for GSE mortgage purchases in small (5-50 unit) multifamily properties and for units in 2- to 4-unit owner-occupied units. In addition, there is a temporary adjustment factor for Freddie Mac multifamily purchases that counts each unit in a property with more than 50 units as 1.35 units.

Both GSEs have consistently exceeded all of the housing goals since the initial goals were established in 1995. The goals have encouraged Fannie Mae and Freddie Mac to reach deeper into the affordable housing market with tangible benefits. The GSEs financing of housing for low-and-moderate-income families has increased from under 30 percent of their purchases in 1992 (prior to passage of the GSE Act) to over 51 percent in 2002.

NAHB supported HUD's increase in the goals for the 2001 – 2003 period, from the original goals put in place in 1995. NAHB feels that more needs to be done to encourage the GSEs to increase their activities in some market segments, such as rural areas and multifamily production.

At the same time, NAHB believes that any proposed changes to the housing goals should undergo careful examination. Fannie Mae and Freddie Mac were created to serve a broad range of housing needs and we would not want overly stringent or complex goals to impede that mission. Continual increases in the percentage targets will have diminishing returns and run the risk of adversely impacting other housing programs, such as FHA's single family program.

Safety and Soundness Regulator

NAHB supports strong and credible safety and soundness oversight for Fannie Mae and Freddie Mac. As discussed above, NAHB believes that the focus of safety and soundness regulation is to ensure that the GSEs are adequately capitalized and have appropriate risk management practices to fulfill their housing mission in a safe and sound manner. The safety and soundness of Fannie Mae and Freddie Mac should be ensured through rigorous examination, enforcement of capital standards and transparency, without unnecessarily impairing the ability of the GSEs to perform their housing mission. It is imperative that the safety and soundness functions be separate from mission regulation, specifically program oversight and housing goals.

Safety and soundness oversight of Fannie Mae and Freddie Mac presently resides with OFHEO, an independent office within HUD. The events of the last few months with respect to Freddie Mac's accounting practices raises serious questions about OFHEO's ability to perform these regulatory functions. Thus, NAHB would support the transfer of safety and soundness oversight of Fannie Mae and Freddie Mac from OFHEO to an office within the Treasury Department. We recognize that Treasury is the premier financial institution regulator because of its expertise and experience with financial issues. However, the authority of the office must be limited to safety and soundness functions only, mission oversight must continue to reside with HUD.

Further, NAHB believes that the safety and soundness regulator must be completely independent and statutorily protected from the Treasury's political influences, the same as regulatory agencies within Treasury. To this end, NAHB is concerned about any proposal that would require that all new regulations and Congressional testimonies prepared by the new office to be cleared through the Treasury Department. We strongly urge Congress to construct legislation that appropriately protects the independence between any new Treasury regulator over Fannie Mae and Freddie Mac and the Treasury's politically appointed policy makers.

Capital

NAHB has consistently supported the establishment and enforcement of capital standards for Fannie Mae and Freddie Mac. Pursuant to the 1992 GSE Act, Fannie Mae and Freddie Mac are required to meet two capital standards, a minimum leverage ratio and a risk-based capital (RBC) standard. The minimum leverage ratio is 2.5 percent of assets plus 0.45 percent of adjusted off-balance sheet obligations. By law, the RBC standard, is based on a stress test which calculates the amount of capital that Fannie Mae and Freddie Mac must hold to maintain positive capital over a 10-year period of adverse credit and interest rate conditions, plus an additional 30 percent of this capital level to cover management and operations risk. The firms must meet both the RBC and minimum capital standards to be classified as adequately capitalized. Failure to meet the capital standards would trigger enforcement actions ranging from limits on growth and activities to conservatorship.

Fannie Mae and Freddie Mac have consistently met their capital standards and thus have been classified as adequately capitalized. Prior to the implementation of the RBC standard, the firms were required to meet the minimum leverage ratio. The RBC standard became enforceable on September 13, 2002 after nearly 10 years of development. The RBC test is the first regulatory capital standard to be based on a stress test and has been hailed as the most dynamic and stringent capital standard for any financial institution.

Given the importance of capital to the financial condition of the GSEs, we agree with Sec. Snow that there is a need for stability in capital standards and that capital standards should not be subject to frequent change. NAHB applauds Sec. Snow's decision not to recommend any changes in the GSEs' RBC regulation at this time, given that the standard took ten years to develop and has been in effect for only one year. We are pleased that the Treasury is giving the RBC standard a chance to work. NAHB recommends against any changes in the GSEs' minimum capital standard as well.

Longer-term, NAHB agrees that the safety and soundness regulator should have the flexibility to adjust capital standards as necessary. However, NAHB cautions against any significant changes in the GSEs RBC standard or any significant increase in the GSEs minimum capital standard. Overcapitalization of the GSEs, beyond the level of risk, is not economically efficient and could have unintended consequences for the housing markets, by reducing the level of capital for housing and increasing mortgage rates.

NAHB would also oppose the imposition of bank-like capital standards for the GSEs as some have proposed. Congress rejected this notion and intentionally drafted a separate capital regime for Fannie Mae and Freddie Mac under the 1992 GSE Act. The present capital framework takes into account the unique nature of the GSEs business, that there are only two firms (as compared to thousands of banks) and they engage in a monoline business, focused on low-risk residential mortgages (unlike banks which engage in a wide range of activities). During the lengthy development process of the current RBC standard, OFHEO took great pains to ensure that the standard appropriately ties capital to risk. Bank regulators have recognized that bank capital standards do not tie capital to risk and are now engaged in a process to revise bank capital standards through the Basel II Accord.

Conclusion

NAHB appreciates the opportunity to share our views on the regulatory framework for the nation's housing government-sponsored enterprises. The critical supports provided by the housing GSEs, Fannie Mae, Freddie Mac and the Federal Home Loan Bank System, were an essential component to the recent success of the housing market in sustaining the nation's economy. NAHB appreciates the Committee's efforts to assess and seek improvements to the regulatory framework of the housing GSEs. We look forward to working with the Committee as you progress towards fashioning a narrow regulatory solution to the oversight of these important housing institutions.