

**– REVISED –**

**Testimony of**

**America's Community Bankers**

**on**

**H.R. 2575**

**Secondary Mortgage Market Enterprises Regulatory Improvement Act and  
the Administration's Proposals on GSE Regulation**

**before the**

**Committee on Financial Services**

**of the**

**United States House of Representatives**

**on**

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**and**

**Chairman  
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Washington, DC**

Mr. Chairman and Members of the Committee, my name is D. Russell Taylor, President and CEO of Rahway Savings Institution in Rahway, New Jersey and I am also Chairman of America's Community Bankers. ACB members include state and federally chartered savings institutions and commercial banks. Our members are both stock- and mutually owned. As community bankers, many are specialists in mortgage lending and actively involved in the secondary market.

Before outlining ACB's position on the pending legislation to reform the regulation of Fannie Mae and Freddie Mac, it is important for the committee to understand the relationships ACB and our members have with these firms. ACB has long supported the traditional role these entities serve in the secondary mortgage market. They have provided great benefits to homebuyers and mortgage originators. In fact, they have significantly increased their commitment to community banks over the last several years. ACB helped initiate these changes by entering into business relationships with both companies that enable community banks to be more competitive in the marketplace. My own institution is an active participant in these programs.

In addition, ACB members hold substantial amounts of mortgage backed securities and other debt issued by Fannie Mae and Freddie Mac. Therefore, they have a great interest in the financial health of these firms.

While actively supporting the secondary market role for Fannie Mae and Freddie Mac, ACB has continued to oppose plans to use their government-granted advantages to extend their activities beyond their secondary market role. For example, we have opposed initiatives that would result in their competing directly with mortgage originators in the primary market and financing their operations in competition with the retail depository institutions.

As a result of our strong support for the secondary market role of Fannie Mae and Freddie Mac, our equally strong opposition to movement into the primary market, and our members' role as investors in their securities, ACB has an intense interest in proposals to reform the regulation of Freddie Mac and Fannie Mae. We also believe that any solution the Congress develops for Fannie Mae and Freddie Mac may have a direct impact on the Federal Home Loan Bank System, a system we care deeply about. Therefore, we appreciate this opportunity to provide our comments to the committee. Our testimony will focus on the various issues raised both by pending legislation and the Administration's proposals to reform the regulatory structure over Fannie Mae and Freddie Mac. ACB wishes to commend Chairman Baker and Representative Royce on their long-time interest and hard work on these issues. Their years of background work will make it easier for Congress to craft legislation to respond to the current difficulties facing Freddie Mac and the Office of Federal Housing Enterprise Oversight.

### **Agency Structure, Funding, and Independence**

The Administration proposal and the pending legislation would eliminate OFHEO and move its functions into the Department of the Treasury. This structure works for two key regulators, the Comptroller of the Currency and the Office of Thrift Supervision that have the necessary independence from the Treasury.

Importantly, both the OCC and OTS enjoy – and OFHEO does not have – the ability to fund its operations without resort to the annual Congressional appropriations process. ACB strongly endorses the repeated recommendation of OFHEO Director Falcon to eliminate this anomaly and allow the regulator of Fannie Mae and Freddie Mac to assess those companies without the cumbersome appropriations process. We are concerned that, while H.R. 2575 creates a permanent appropriation, it does not remove assessments on Freddie Mac and Fannie Mae from the appropriations process. It is important that the committee’s bill provide the new agency with a complete exemption from the appropriations process, similar to that provided to other financial regulators.

Independence is the other characteristic of the various financial regulators that ACB strongly believes must also be in the regulator for Freddie Mac and Fannie Mae. Again, this has served our financial system and consumers very well. If a new agency is created within Treasury, it should have autonomy in the following key areas:

- Appointment of Director. The director should be appointed by the President and confirmed by the Senate for a fixed term and be removable by the President only for cause.
- Testimony. Congress should be able to count on receiving the agency’s unvarnished views on all issues it faces.
- Rulemaking. There should be no opening for politically appointed officials to delay or prevent the agency from issuing rules it believes necessary.
- Supervision and Examination. All parties involved will benefit from a strict separation between political appointees and supervisory and examination staff.
- Enforcement. The agency’s enforcement actions must be independent from any outside interference.
- Litigation Authority. The director should be able to act in his own name and through his own attorneys rather than have the Attorney General represent the agency.
- Employment Authority. The director should have the ability to employ officers and employees under authority comparable to that of other financial regulators.

### **Authority over Mission and Programs**

ACB strongly endorses the Administration’s position that the new agency must have the authority to review both current and future programs of Freddie Mac and Fannie Mae. In particular, new activities should be subject to an application and approval process similar to what is in place for bank holding companies today. For over a decade, the Department of Housing and Urban Development has not exercised its current program approval authority. As a result, Fannie Mae and Freddie Mac have engaged in or attempted to engage in activities inconsistent with their secondary market responsibilities.

For example, both entities have issued retail debt instruments in denominations of as little as \$1,000. These are being marketed by third parties to consumers with considerable emphasis on their implied federal government backing, when there is no such guarantee. Fannie Mae and Freddie Mac have responded to this problem by significantly improving disclosures. However,

we doubt the public is adequately protected. In addition to principal risk, these notes carry interest rate and call risk that relatively unsophisticated investors do not understand. Of course, these risks do not exist for traditional deposit products, such as certificates of deposit. Nevertheless, these small-denomination notes unfairly compete with CDs, weakening community banks' ability to meet housing finance and other community credit needs.

ACB is concerned that these debt programs may be part of an attempt to create a "name brand" image for Fannie Mae and Freddie Mac in the mind of average consumers. Their extensive retail advertising is further strong evidence that this is a major goal for these entities.

This branding effort could help Fannie Mae and Freddie Mac's efforts to move into the primary mortgage market. In one example of this, Freddie Mac entered into an agreement with an on-line mortgage company that attempted to reduce primary mortgage originators to, at best, a nominal role in the process. An effective mission regulator is needed to prevent Freddie Mac and Fannie Mae from using their government-provided advantages to supplant private firms that compete in the primary mortgage market.

The Administration proposal and various legislative proposals make clear that HUD would retain its authority to set affordable housing goals for Fannie Mae and Freddie Mac. As Secretary Mel Martinez testified, HUD would actually gain authority – being authorized to set sub goals and to enforce those goals with new regulatory clout. ACB recommends that you include this proposal in your legislation.

Some have expressed concern that, if HUD does not retain mission and program oversight over Fannie Mae and Freddie Mac, their commitment to housing, particularly low- and moderate-income housing will suffer. However, if Congress provides for a substantial degree of independence for the new agency and affirms the companies' housing mission, there should be no decrease in their support for housing. And, as mentioned, under the Administration's proposal HUD's role would be enhanced in the area of affordable housing.

## **Capital Requirements**

ACB strongly agrees with the Administration position that, while the existing capital regulation adopted by OFHEO should be the new agency's starting point, there should be no limit on its ability to increase capital requirements for Fannie Mae and Freddie Mac if it finds that necessary. Capital is the foundation for the safety and soundness of our financial system. Therefore, the new agency must have complete authority to increase capital requirements as necessary, subject to rulemaking. This must apply both to increases in the leverage ratio and the risk-based capital requirement. The Baker bill, H.R. 2575, includes language that appears to accomplish this purpose.

As Congress has recognized, the taxpayers are ultimately at risk when a major part of the financial system is undercapitalized. While there is no explicit federal guarantee for Fannie Mae and Freddie Mac, it is impossible to believe the government would stand aside if either of these companies faced serious difficulty. Requiring them to maintain adequate capital will provide vital insulation for the taxpayers.

Community bankers are particularly sensitive to this issue. We are already concerned that the proposed Basel II accords could result in lower capital standards for the large banks that will adopt the new system. We would be equally troubled if regulatory reform for Fannie Mae and Freddie Mac had a similar result. The capital requirements for Freddie Mac and Fannie Mae should reflect the specific financial risks facing each, including realistic treatment of counter-party risk and massive direct investment in mortgages.

### **Enforcement Authority**

The Administration proposal and various legislative proposals before the Congress would each provide the new agency with enforcement authority comparable to that of the banking agencies. Both the Baker bill (H.R. 2575) and the Royce bill (H.R. 2803) have substantial detail on what – in the words of Treasury Secretary John Snow – constitutes “world-class” regulatory authority. ACB recommends that the committee adopt these and similar proposals to improve the regulation of Fannie Mae and Freddie Mac.

### **Scope of the Agency**

Secretary Snow suggested in his testimony before this committee that the FHLBanks should also be regulated by the new agency. Representative Royce’s bill would eliminate the Federal Housing Finance Board and move its regulatory responsibility over the FHLBanks into the new agency. ACB has traditionally supported separation between the regulation of Fannie Mae and Freddie Mac and that of the FHLBanks. The FHLBanks are cooperatives, rather than public companies, and pose different regulatory issues from those of Fannie Mae and Freddie Mac. While the Finance Board has substantially increased its commitment to safety and soundness regulation recently, ACB also believes there is substantial room for improvement and change in the regulation of the FHLBank System.

Our members who support a merged agency are concerned that Freddie Mac and Fannie Mae will enjoy a cost-of-funds advantage if the market believes that those companies are subject to more effective regulation than are the FHLBanks. They also note that the FHLBanks, Fannie Mae, and Freddie Mac are all engaged in extensive interest rate risk management and believe a combined agency would be better able to supervise these risks.

ACB’s policy bodies are weighing these and other arguments. Our members firmly believe that a new agency – whether it regulates just Freddie Mac and Fannie Mae or also covers the FHLBanks – must be as independent as the nation’s other financial regulators.

If the new agency does become the regulator for the FHLBanks, it should maintain the Banks’ access to the capital markets and their current well-defined mission support the mortgage finance, affordable housing, and community development activities of member banks. The advance programs of the FHLBanks ensure that homebuyers have ready access to home mortgage financing through FHLBank members.

In addition, the legislation would have to ensure that the new regulatory structure recognizes the unique and successful business model of the FHLBank System. Unlike Freddie Mac and Fannie Mae, the System is a cooperative owned by its member institutions. The FHLBanks' stock is not publicly traded and does not fluctuate in value. In addition, each of the FHLBanks is jointly and severally liable to all the others. Each of these GSE business models has their strengths. Any revised regulatory system should advance the goals of expanded mortgage finance and affordable housing shared by Fannie Mae, Freddie Mac, and the FHLBanks.

### **Conclusion**

I wish to again express ACB's appreciation for your invitation to testify on these important issues. We strongly support the committee's effort to strengthen the regulation of Freddie Mac, Fannie Mae, and the Federal Home Loan Banks. We look forward to working with you as you craft legislation to accomplish this goal.