Testimony

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It is an honor today to appear before this distinguished Subcommittee to discuss the urgent need to improve the regulatory framework of the housing government-sponsored enterprises (GSEs). I am Karen Shaw Petrou, managing partner of Federal Financial Analytics. I last testified before this panel on GSE reform in June of 2003, when I suggested that the problems then evident at Freddie Mac were also a serious concern at Fannie Mae. I argued then for significant enhancements to the Office of Federal Housing Enterprise Oversight (OFHEO). Since then, of course, Fannie Mae and Freddie Mac have both demonstrated severe internal-control failings that leaves them ill-prepared to meet their mission. At the same time, several of the Federal Home Loan Banks have shown similar problems. There is, thus, no longer debate over the need for a world-class GSE regulator with powers akin to those long granted the federal banking agencies.

Now, the debate turns on just what constitutes "bank-like" regulation and just how this should be adapted because of the unique nature of the GSEs. Here, the details can be critically important, as Congress learned at considerable cost when the failings at the S&L and banking agencies were revealed in the late 1980s and 1990s. Reflecting this lesson, the House in the last Congress passed H.R. 1461, a bill that is a substantial improvement over current law. Chairman Frank then worked closely with Treasury Secretary Paulson to enhance that bill, building a strong platform from which I hope the 110th Congress will move quickly to final passage of this long-overdue legislation.

Today, I would like to walk through key provisions in last year's legislation to highlight how they promote the bank-like regulator we all agree must soon be put in place for all of the housing GSEs. I will address the more controversial safety-and-soundness provisions: capital, new-product review, and the portfolio. However, I would also like to remind the Subcommittee of critical sections in the legislation – new prudential powers for the regulator, for example – that may not get as much attention as they deserve. Sometimes, long-accepted provisions in a bill surprisingly end up on the cutting-room floor in the middle of the night. Too much hard work and too disturbing a history at the GSEs have occurred to allow this to happen now.

Major points in this testimony include:

- The reform bill should, as provided in the pending compromise, give the new regulator discretion over the amount and components of GSE minimum and risk-based capital. To make the measure more "bank-like," the bill could also dictate standards for well-capitalized GSEs, not stipulate only that they be "adequately" capitalized as is now the case. Some have suggested the new regulator be allowed only to raise capital under defined, limited conditions, but this would be a sharp departure from banking-agency practice and prove particularly risky for the GSEs.

- The proposed compromise rightly provides for appropriate advance regulatory and public scrutiny of new GSE ventures. When Congress last reviewed this issue for banks (in Gramm-Leach-Bliley), it required such a process. This is why Congress learned in advance of the proposal to expand real-estate agency powers. Early warning of controversial GSE ventures is at least as vital. Unlike banks, GSEs are not subject to competition or market discipline that would otherwise provide early warning of new products and ensure appropriate risk mitigation.

- Different proposals are under consideration regarding GSE portfolios. It should be noted that banks are in fact subject to express portfolio limits. For example, these bar commercial investments.

- H.R. 1461 as passed included specific direction to the new regulator to issue rules or guidance on topics such as asset quality, credit and counterparty risk, operational risk and liquidity. These are now major gaps in the GSE rulebook and this language should be maintained to ensure a specific mandate for the standards on a short turn-around.

- H.R. 1461 as passed also included important corporate-governance standards not in last year's Senate bill. These would strengthen the new regulator's hand in an area in which the GSEs have shown significant problems.

Capital Requirements

It is my understanding that the proposed legislation would eliminate the restrictions in current law that block the GSE regulators – both OFHEO and the Federal Housing Finance Board (FHFB) – from setting minimum and risk-based capital without the minimums and other restrictions set in law for Fannie and Freddie in 1992 and the FHLBanks in 1999. The bill would also expressly authorize the new regulator to set capital and – importantly – reserves not only for each GSE, but also on a product-by-product basis. Some have argued against this, based on the view that the unique nature of the GSEs argues for significant constraints on their regulator, but I believe Congress should enact legislation along the lines included in the pending compromise proposal.

If I may, I would like quickly to outline what bank regulators do on regulatory capital and how this applies to the housing GSEs:

- First, Congress has given the regulators full authority to set minimum and risk-based capital. It has, however, also specified the level at which a bank is deemed "well capitalized," as well as sanctions that must apply as capital falls. The pending legislation requires only that GSEs be "adequately" capitalized, but flexibility should be provided to ensure that GSEs meet or

exceed this minimum capital level. The bill also enhances the sanctions that must be applied under "prompt corrective action" provisions, a critical (if often overlooked) proposal that should be included in final legislation.

- Bank regulators have flexibility over what constitutes capital because of significant market changes that often warrant regulatory rewrites. For example, derivatives were not envisioned in 1988 when the current capital rules were crafted, leading the banking agencies to a series of significant revisions and the pending overhaul in the Basel II rules. The anachronistic and specific nature of the current GSE capital standards makes it very difficult for the regulator not only to react to change, but – more importantly – to anticipate it.

- Bank regulators can and often do require one bank to hold more capital than another based on a risk profile. Specific statutory minimums assume all GSEs are alike, which history has proven they are not.

- Bank regulatory capital standards are supplemented by additional charges for concentration risk – that is, big bets on one thing. The new GSE regulator must have authority to compensate for the fact that GSEs are exposed principally to only one risk – that related to residential mortgages. This is the classic "all the eggs in one basket" problem and the new regulator should be equipped in advance to compensate for it with appropriate capital. The regulator should also have full authority to stress test minimum capital requirements, again paralleling what the banking agencies do.

New-Product Powers

It is my understanding that the compromise legislation includes new-product authority for the GSE regulator similar to that in last year's Senate legislation. This is, I believe, a considerable improvement over the new-product language in H.R. 1461 and should be included in the final legislation.

There are, to be sure, differences in the way each of the banking agencies looks at new ventures, complicating a precise "bank-like" comparison. However, there's one clear parallel: the last time Congress looked at this issue, it opted for advance public notice and comment before regulators authorized new ventures. This was the model included in the Gramm-Leach-Bliley Act in 1999. As you know, it was precisely this provision which alerted Congress to proposed new real-estate agency and brokerage powers for financial holding companies. Congress, like all other interested parties, should get advance warning of any new ventures contemplated by the GSEs to be sure they are prudent, consistent with the GSEs' mission and, if approved, that appropriate safeguards are in place in advance.

Transparency is always beneficial, but it's particularly important when market discipline doesn't apply, which is the case for the GSEs. Banks have many competitors in and out of the business, which means push-back if a regulator goes too far and allows inappropriate ventures without public scrutiny. GSEs, however, only compete with each other. This means that high-risk, non-mission ventures would start without the needed early warning that would protect market efficiency, vulnerable borrowers and the financial system more generally.

Because of their implicit guarantee, GSEs fund themselves at far lower cost than other market participants, including large banks. As has been proven in the last few years, GSE risk premiums – that is, the difference between their borrowing cost and that of the Treasury – did not rise even as Fannie Mae and Freddie Mac ceased to file current financials. This means that, if a GSE launches a new venture, it has formidable power with which quickly to control a market. Even seemingly minor ventures can be important sources of profit or customer service to other institutions, including community banks. Thus, early warning of all new ventures must be insured in the reform legislation.

Would the GSEs get into high-risk, non-mission ventures? They have tried in the past and doubtless will again, especially if portfolio restraints pressure shareholder returns. Fannie Mae has, for example, received a patent that ostensibly protects its right to engage in a wider range of mortgage ventures and, going farther, consumer finance. Fannie Mae and Freddie Mac are also considering new ventures in the credit-derivatives arena. Credit derivatives are over-the-counter traded complex financial instruments that transfer credit risk between buyers and sellers. Initially developed for corporate credit, credit derivatives are now beginning to be used in residential mortgages. They are, though, a very new product that has yet to be tested under the stress now evident in the mortgage sector. In areas where credit derivatives have been used for longer periods of time, the Federal Reserve and other bank regulators have significant concerns. Credit derivatives are increasingly used by hedge funds and other speculative investors not to transfer risk, but instead to take short-term bets. If Fannie Mae or Freddie Mac weighs into this market, they could do so with tremendous market clout because of their implicit guarantee, even as their bets are backed with far less capital than required of regulated market participants.

Some have suggested that a bank-like prior product review would be "cumbersome" and slow down needed innovation. To counter, I would first note that the FHFB has in the past issued proposals for public comment before authorizing new programs like the Mortgage Purchase Plan for the Home Loan Banks. This was wise, as the initial proposal lacked many of the safeguards that now insulate the Banks from some of the risks of these ventures. More importantly, though, one should look at the broader U.S. banking system. It's by far the most innovative in the world and this occurs despite the need for prior supervisory review.

GSE Portfolios

The degree to which the legislation should limit the portfolios held by Fannie Mae and Freddie Mac is, of course, a major bone of contention as the final legislation is crafted. There are numerous ways to set a portfolio limit to address systemic risk, perhaps taking Chairman Bernanke's suggestion last week to ensure an improved GSE focus on affordable housing.

Some have said that there are no comparable constraints on bank holdings, thus suggesting that a portfolio limit violates the "bank-like" regulatory context at which all say they aim. However, the law in fact is quite specific on what assets may and may not be held by a bank and any of its affiliates. The law stipulates, for example, that banks may not hold commercial assets. When these are held in financial holding-company merchant-banking subsidiaries, as authorized under Gramm-Leach-Bliley, the law contains numerous safeguards to protect against prudential risk and conflicts of interest. Numerous percentage limits – loan-to-one-borrower ones, for example – also both define bank portfolios and limit risk.

Other Facets of Bank-Like GSE Regulation

In addition to these high-profile issues, many provisions in H.R. 1461 and the pending compromise are critical to ensure the new GSE regulator is fully empowered. As Chairman Bernanke made clear in his speech on March 6, none of the housing GSEs is subject to market discipline. If there were any doubt on this point, the GSEs' ability to maintain their AAA ratings as they fall ever farther behind on financial statements should dispel them. Market discipline is one of the three "pillars" in the global bank-regulatory framework adopted by the Basel Committee. Without it, it is even more essential that GSE capital and prudential standards be at least as robust as those applied to banks

With this in mind, the following provisions in H.R. 1461 and/or the pending compromise are essential components of effective GSE regulation:

- Meaningful, Mandatory Prudential Standards: H.R. 1461 (Section 102) requires the new regulator to issue rules, orders or guidance on an array of critical prudential issues. The list in the House bill is more complete than that in S. 190 and the requirement is mandatory, not optional. The House language is thus preferable to ensure that the new regulator moves quickly to issue standards comparable to those long in place for insured depositories and their holding companies.

- Corporate Governance: H.R. 1461 (Section 114) includes specific corporate-governance standards for Fannie Mae and Freddie Mac not included in the Senate legislation. This language clarifies OFHEO's authority to impose

appropriate corporate-governance standards, ensuring attention and improvement in this critical area.

- Receivership: Both the House and Senate bills rightly give the new GSE regulator authority to put a GSE into receivership if critical capital thresholds are crossed or other threats to solvency occur. In the conservatorship now permitted, the government would step in and act as the GSE, protecting investors from loss and reinforcing the view that the GSEs are guaranteed by the Treasury. Under a receivership, in contrast, a bankruptcy-like process would be put in place to provide for greater market discipline. This is how large banks are handled, even in the event of systemic-risk situations and it should be the model for the GSEs going forward.

- M&A Review: Both the House and Senate bills expressly provide that the regulator may review acquisitions or transfers in a GSE's controlling interest in advance. This is comparable to the power the banking agencies have over acquisitions and changes in control. Absent this authority, a GSE could effectively transfer its government status to a large private person without any advance warning to its regulator or any chance for the regulator or Congress to intervene.

- Regulatory Independence: All of the pending bills rightly structure a new regulator freed from the appropriations process and insulated from undue political influence. H.R. 1461 does include a board that reviews the GSE regulator. If this provision is retained, it should be kept as is to avoid undue influence or inappropriate delay in regulatory actions. In the past, all of the housing GSEs have had success capturing their regulators and preventing them from needed prudential action in critical areas like capital controls. This must not happen again.

- Enforcement: With some differences in detail, all of the bills would significantly enhance the ability of the new GSE regulator in contrast to the powers now provided to OFHEO and the FHFB with regard to such critical issues as institution-affiliated parties, the timing of enforcement actions, the penalties that can be imposed and the ability of the regulator to act without the consent of a regulated entity. It should be noted that this new enforcement framework is comparable to that of the bank regulators, not that of the SEC or FTC, which rely on post-hoc punitive measures frequently cited as potential constraints on corporate innovation and competitiveness.