TESTIMONY

EFFECTIVE GSE SUPERVISION WILL LOWER THE COST OF HOME OWNERSHIP

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It is an honor to appear before you today to testify on ways to improve the safety-and-soundness supervision of Fannie Mae and Freddie Mac that enhance their mission. I am managing partner of Federal Financial Analytics, a consulting firm that offers both information and advisory services. Among the information services is one that focuses on the GSEs, and I am pleased that clients of this service include those on all sides of the debate. Our consulting service assists both private firms and governmental entities, and we have over the years advised bank regulators in the U.S. and abroad on ways to enhance their operations. We are active now in the debate over the rewrite of the Basel risk-based capital rules, and we also advise companies and associations concerned that Fannie Mae and Freddie Mac have strayed beyond their mission.

Today, I would like to outline the keys to effective bank supervision that can be quickly adopted for Fannie Mae and Freddie Mac. These standards have not impeded the ability of American banks and savings associations to promote home ownership – indeed, record home-ownership rates are due at least as much to their ability to originate mortgages as to the GSEs' ability to purchase them. In considering the pending Basel Accord, the leadership of this Committee has rightly recognized that effective U.S. bank supervision is critical not only to a secure financial market, but also to the innovation that has made the U.S. financial services industry a global leader. I see no way in which effective supervision – good as it is for insured depositories – isn't also appropriate for government-sponsored enterprises (GSEs). Indeed, I believe it will strengthen them, reduce their funding costs and, therefore, enhance their ability to promote home ownership and fulfill their Congressional mission.

Like effective bank governance, GSE supervision should be founded on the three pillars on which international bank supervisors rely: sound capital, effective supervision and market discipline. As you consider legislation to overhaul GSE regulation, these bank principles can be translated for the GSEs to ensure:

- Real minimum and risk-based capital standards that rely on real shareholder equity, not complex models that attempt to anticipate risk in untested ways. More capital would drop the cost of home ownership because the GSEs would raise funds more cheaply and they could then pass these savings on to the low-income and minority home-buyers who especially rely on them.

- Real supervision – backed by meaningful penalties – which checks and re-checks the GSEs against examiner findings, board-of-director responsibility, outside benchmarks and the experience of other large institution supervisors. OFHEO's failure to anticipate the Freddie Mac problem – indeed, its cheerleading when the restatement was first announced – cannot be repeated. As the Freddie case makes clear, supervision must ensure effective internal controls and audit standards. One must ask why the GSEs' regulator has not

done what bank regulators have in recent months to address these risks, and Congress should ensure that this is done apace. The new regulator must have ample resources and the full panoply of legal powers. Like bank regulators, it must also learn in advance of new GSE ventures to be sure they do not put taxpayers or consumers at undue risk.

- Effective disclosure to ensure that policy-makers, investors and risk counterparties have all the information they need to make informed judgments that, in turn, supplement supervisory assessments and permit a real review of how well the GSEs serve affordable housing needs across the country. SEC registration is the first step, and reports analogous to those filed by banks ("call reports") would also be worthwhile.

Today, you – like the rest of Congress and the Administration – are facing an array of unpleasant choices because the regulatory structure established in 1992 for Fannie Mae and Freddie Mac is, quite simply, broken. The housing GSEs then had a total of $1 trillion in obligations; now, they have $3.2 trillion. Arguably, the 1992 scheme never could have worked because of the divide-and-conquer structure resulting from the complex compromises embodied in law. Certainly, it did not work. Although home ownership rates have continued to climb – a tribute to all participants in U.S. housing finance, not just the GSEs – GSEs have grown gigantic atop tiny regulatory capital bases, backed by an implicit taxpayer guarantee that may protect them from real market discipline.

Were there any doubt about the adequacy of GSE supervision, events in the past few weeks have dispelled them. The fact that OFHEO was clearly caught flat-footed by the Freddie Mac board decision and subsequent management dismissals on June 6 – two days after OFHEO blessed the GSE's auditing and corporate governance – is undisputed. The regulator has frequently opined – it did so just last Friday, for example – that disclosures wrought by investigative reporting or other sources looked A-OK to it, only to find as the facts came out – through others, not its examiners – that the Enterprise wasn't all that hunky-dory after all.

Bank supervisors have a long tradition of saying nothing about the condition of their charges unless or until they have to say that the bank is closed and depositors have nothing to fear. They do this to promote market discipline and avoid the inference that nothing can go wrong at a bank because bank regulators will make it all right. Bank regulators call this "constructive ambiguity," and it is imperative that the new GSE regulator maintain this posture for the housing GSEs. Without it, GSE bond and shareholders have the same bet on the table as Texas S&L shareholders in the 1980s: heads I win, tails you lose. All very large financial services firms – Fannie, Freddie, big banks and big non-banks – are too big to fail, but none should be too big to liquidate at cost to shareholders and other investors. GSE supervision should ensure that this message is understood loud and clear across the financial market.

Real Capital Means Real Risk Reduction

In the 1980s, the nation's S&Ls grew bigger and bigger atop less and less capital. As many of you will recall, the industry's regulator began this problem with "net worth certificates" – Monopoly money sanctioned by the government as a substitute for real shareholder dollars – and Congress then blessed this fiddle and several thereafter in the desperate hope that the thrift industry would right itself without a taxpayer bail-out. That didn't work, of course, and allowing GSEs to operate on capital bases that make those of the S&Ls in the 1980s look generous is a similarly dangerous bet.

Based on the hard experience of the 1980s, Congress established minimum capital standards for banks and savings associations, backing these up by the "prompt corrective action" (PCA) sanctions included in the FDIC Improvement Act of 1991. Further recognizing the importance of capital, Congress in the Gramm-Leach-Bliley Act of 1999 allowed only "well capitalized" firms to become financial holding companies and engage in the expanded products authorized by the Act. As a result, insured depositories now operate with risk-based capital of 13% and 9% leverage standards across the industry. Importantly, PCA not only encourages this high capitalization – which has been critical in recent years as the economy turned down and the dot.com bubble burst – but also includes stiff sanctions when capital falls. At the "critical" capital ratio – 2.5% under the RBC framework – regulators must close insured depositories.

In sharp contrast, Fannie and Freddie operate at bare ratios above the levels set by Congress for "adequate" capitalization. AT year-end 2002, Fannie Mae's core capital exceeded its minimum capital requirement by 3.2%, while Freddie Mac's comparable capital cushion was 10%. I shall discuss the OFHEO risk-based capital rule in a moment, but a simple RBC calculation – GSE core capital against on- and off-balance sheet assets gives Fannie a 1.5% ratio and Freddie a 1.6% one. As noted, insured depositories hold 13% in RBC. One could argue that they need to do so because of the wider risk range of their assets. However, the risk-based requirement against prudent mortgages for well-capitalized banks is 5%. Looked at this way, Fannie and Freddie still hold about 20% of the RBC required by bank regulators for high-quality mortgages, and they are well below the "critical" capital ratios at which insured depositories should be shut.

Risk-Based Capital Should Be Just That

As noted, Congress knew that simple leverage standards are a primitive way to impose regulatory capital, and it thus mandated a risk-based rule as well. As Chairman Baker knows well, it took OFHEO more than eight years finally to craft such a rule and, when it did, the results should have sent it back to the drawing board. For whatever reason, OFHEO decided to go its own way on RBC – it decided it didn't like the way the Federal Reserve, Office of the Comptroller of the Currency and – in fact – all of the regulators in the world's largest banking systems calculated risk-based capital. It set its own model-builders to work and – constrained to be sure by provisions in the 1992 Act – OFHEO

brought forth a 700-plus page capital rule that, we now know, would permit the GSEs to operate at ratios of as much as 300:1 if Congress hadn't also imposed the minimum leverage standards noted above.

Under the OFHEO RBC rule, Congress has in essence double-downed its bet on GSE capital. First, it allowed them to operate at leverage ratios not otherwise permitted for regulated firms. Then, it went further by allowing OFHEO to craft its own model for capital that in turn relies entirely on GSE decisions in complex derivatives markets. In sharp contrast to the bank rules, OFHEO permits Fannie and Freddie to offset interest-rate risk and credit risk – thus eliminating regulatory capital despite the fact that these risks are highly correlated in the mortgage market.

Effective regulatory capital comparable to that required by other regulators on comparable risk will benefit home ownership, not hurt it. Fannie and Freddie were chartered by Congress to create mortgage-backed securities – off-balance sheet credit risk – not necessarily to hold the combined $1.6 trillion in portfolio assets now on their books. Importantly, this shift in their business has put Fannie Mae and Freddie Mac into the interest rate-risk game, although their charter and regulatory structure arguably are premised on the limited credit-risk one intrinsic to the securitization business. Effective capital will put the GSEs back into the arena where they best serve low-income and minority home buyers: guaranteeing risk the market might otherwise be reluctant to take.

Effective Supervision is Essential

The reason bank supervision is premised on three pillars is that none is sufficient on its own. Regulatory capital will always differ to some degree from economic capital standards dictated by the market and, in any case, they are not the sole driver of risk-taking. Although capital was the predicate cause of the collapse of the nation's S&Ls in the 1980s, several banks – Superior FSB, for example – have failed even as they complied in full with regulatory capital standards. These failures resulted in part from problems in the regulatory capital requirements then in effect and, in part, from aggressive risk-taking – or even outright fraud – at the failed banks supervisors overlooked.

Proven components of effective financial institution supervision include:

- *Independence*. Political control of bank supervision doesn't work. Policy-makers must have major input into regulatory decisions, but these should ultimately be made on the facts – sometimes highly technical ones – as seen by expert examiners. The law should dictate how regulated institutions should serve social objectives, and independent supervisors should then enforce these laws along with those mandating strict safety and soundness.

- *Recognition of All Relevant Risk.* Bank regulators review institutions in a "supervision by risk" framework that analyzes and – when necessary – acts on possible credit, interest-rate, transaction, compliance, legal, reputational strategic and other risks. Some of these non-traditional risks – reputational risk in particular – are the most serious ones, yet OFHEO now has very limited ability to address them at the GSEs.

- *Risk Anticipation, Not Reaction.* Bank regulators review new activities in advance, especially when a venture raises policy or safety-and-soundness concerns. This has not adversely affected industry innovativeness; indeed, the U.S. financial services industry leads the world in numerous areas (derivatives, asset securitization, etc.). Our market also serves consumers better than any other, which can be seen through a quick comparison of not only home ownership, but also education finance and many other forms of consumer lending. Prior review also ensures that new programs are offered in full compliance with all necessary consumer safeguards, including any additional restrictions on possible conflicts of interest, abusive lending or other problems regulators may fear. Effective advance review of new GSE programs is essential to protecting their safety and soundness and U.S. home owners, and this should thus be done by an independent agency with technical skills, buttressed by clear direction from Congress as to how the GSEs are to serve the nation's housing market.

- *Attention to Internal Controls.* As noted, bank regulators have broad risk powers which Congress has so far not provided to the GSEs' regulator. In recent months, the banking agencies have taken aggressive action in such areas as internal controls and audit standards, areas that have proven critical in financial institutions and, sadly, now also at the Freddie Mac. Clear power must be provided to the GSEs' regulator to ensure appropriate corporate governance and controls, and penalties should be readily at hand to ensure these powers are backed by enforcement as is the case at insured depositories.

Disclosure Means Discipline

Finally, I would suggest that Congress review the disclosures now made by the housing GSEs and ensure that these promote effective market discipline. If investors believe that they don't need to know much about the GSEs because the taxpayers will correct any mistakes, the risks of these giant enterprises is exacerbated. As Chairman Greenspan said on May 9, transparency is essential to a disciplined financial market especially in light of growing reliance on highly-complex financial instruments.

As with other safety-and-soundness improvements, better disclosure will enhance the GSEs' housing mission. First, it will allow Congress and the markets to see clearly the degree to which the GSEs are in fact serving the affordable-housing sector for which their

benefits are aimed. It will also provide a far clearer picture of financial risks, supplementing supervisory decisions by early market intervention. Steps to improve transparency include:

- *A Real Stand-Alone Rating*. None of the "stand-alone" ratings – including that of the GSEs' subordinated debt – in fact is a real assessment of just how much risk the enterprises would run without their implicit guarantee. This should quickly be done by an objective, independent and expert agency to promote effective policy-making and investor decision-making.

- *SEC Disclosure*. Recent studies by the SEC, Treasury and OFHEO have affirmed that SEC disclosure for GSE obligations will have no adverse impact on the housing market. Reforms may be appropriate for the entire MBS market, including the GSEs, but the overall framework for the GSEs should be the same as that for all other large issuers.

- *Risk Disclosures*. Insured depositories now file quarterly "call reports" with their supervisors – which then disclose much of this data to the markets. This ensures that key risk factors unique to regulated financial services firms are available to all decision-makers, hedging the FDIC's bet as well as that of the Federal Reserve as lender of last resort. Comparable disclosures for the housing GSEs would protect taxpayers, as well as provide debt-holders and others with more information that should reduce GSE funding costs and, thus, that of home ownership.