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Consumer Federation of America

TESTIMONY OF

ALLEN J. FISHBEIN
DIRECTOR FOR HOUSING AND CREDIT POLICY
CONSUMER FEDERATION OF AMERICA

BEFORE THE

COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

REGARDING

H.R. 2575, THE SECONDARY MORTGAGE MARKET ENTERPRISES
REGULATORY IMPROVEMENT ACT AND OTHER PROPOSALS ON GSE
REGULATION

SEPTEMBER 25, 2003

WASHINGTON, D.C.

Chairman Oxley, Representative Frank, members of the committee, my name is Allen Fishbein and I am the Director of Housing and Credit Policy for the Consumer Federation of America. I am testifying today on behalf of CFA, which is a non-profit association of some 300 consumer organizations, with a combined membership of 50 million that was founded in 1968 to advance the consumer interest through advocacy and education. CFA and many of our members have had long-standing interest and involvement on housing finance matters, including advocating for expanding the role of the GSEs in serving important housing needs. As for my own background, I have been an advocate for many years on GSE issues and have served at HUD as Senior Advisor for GSE Oversight, where my responsibilities included assisting with supervision that led to the establishment of the present affordable housing goals for Fannie Mae and Freddie Mac. Thank you for affording us with the opportunity to present our views on various proposals the committee is considering revising the regulatory structure governing these two government sponsored housing enterprises.

Consumers – whether existing or future homebuyers, renters, or investors – have a great stake in the outcome of these deliberations. Fannie Mae and Freddie Mac, along with the Federal Home Loan Bank System are government sponsored enterprises (GSEs) created by Congress to help ensure the smooth flow of housing credit throughout the nation. CFA believes that the GSEs’ play an important, indeed essential role, in promoting a sound housing market and by providing expanded homeownership and other housing opportunities. The GSEs’ public charters limit their activities to their housing mission and in return, they are afforded special competitive privileges not enjoyed by fully private financial institutions. The GSEs also have additional statutory mandates that require them to serve special housing finance needs, such as expanding mortgage credit opportunities to low and moderate income households and underserved communities. Changes to the GSEs’ regulatory structure, therefore, must be undertaken with great care and precision so as not to work at cross purposes with the GSEs’ ability to carry out these important mission activities.

Does the GSEs’ regulatory structure require changing?

Fannie Mae and Freddie Mac are the nation’s two largest home finance companies. Through their secondary market activities the two GSEs own or guarantee more than \$3 trillion in mortgages --almost one-half of all outstanding mortgage debt -- and fund nearly 80 percent of the estimated total of all conforming, non-government insured mortgages made. Further, because of their market dominance, the underwriting standards of the GSEs also have much sway over who is eligible for mortgage credit and on what terms.

The 12 Federal Home Loan Banks (FHLBs) that make up the Federal Home Loan Bank System are a somewhat different form of government sponsored enterprise, but one that is also mandated to serve broad housing finance needs as well as particular affordable housing needs. The system also provides an important source of funding for lenders, which in turn, use these funds to finance home loans and other residential mortgages. The System has over 8,000 financial institution members at the end of 2002 and assets of

over \$700 billion. My written testimony today focuses largely on issues of oversight structure pertaining to Fannie Mae and Freddie Mac and not the FHLBanks since this seems to be the most immediate focus of the committee's deliberations. However, we are prepared to supplement this testimony by providing additional views on the merits of combining FHLB oversight with that of Fannie Mae and Freddie Mac.

Freddie Mac's announcement of plans to make a substantial restatement of its earnings for prior years, coupled with more recent revelations about the departure of its three top executives and other reports of irregularities attracted considerable attention this summer and seemed to have unnerved the financial markets. The sheer size of the GSEs and their importance to the housing market mean that investors are sensitive to any hint of trouble. We are aware that members of this committee expressed concerns that these difficulties were not detected earlier by regulators and do not believe the current structure has the capabilities to provide adequate oversight in this area.

Still others had called for a regulatory overhaul even before these recent developments came to light. Unquestionably, the tremendous growth in the size of the GSEs over the past decade has raised the stakes for regulatory oversight. Indeed, Fannie Mae's and Freddie Mac's mortgage investments have increased by over 620 percent and the GSEs today are two of the largest private debt issuers in the world (CRS Report to Congress, September 8, 2003, 2). Similarly, the FHLB System's business has sextupled and its membership has more than tripled since 1992, with commercial banks instead of savings institutions now constituting a majority of the system's membership. Government, the GSEs, consumers, residents of underserved communities, lenders, the housing industry and taxpayers all have a strong interest in effective oversight of enterprises financial condition. Thus, it would be hard to argue against the need for Congress to review the adequacy of a regulatory structure that was put into place a decade or more ago.

The existing regulatory structure governing Fannie Mae and Freddie was established in 1992 as part of the Federal Housing Enterprises Safety and Soundness Act (or GSE Act). The GSE Act established OFHEO as an independent agency, within the U.S. Housing and Urban Development (HUD) to oversee the safety and soundness of the two enterprises and to help ensure that they are adequately capitalized. The GSE Act also reaffirmed HUD as the GSEs' mission regulator, with general regulatory responsibility for ensuring that Fannie Mae and Freddie Mac operate within their public charters and otherwise fulfill their statutory mandates, including authority to review the GSEs new mortgage programs, establish and monitor the GSEs' fulfillment of their annual affordable housing performance goals, and ensure that they abide by fair lending requirements.

Review of Proposed Changes

There appears to be some consensus for taking steps to enhance the safety and soundness oversight of the GSEs. There also is growing recognition that OFHEO does not have all the powers it needs to perform this oversight. Unlike banking regulators, OFHEO does not have authority to assess the financial institutions it supervises for the full cost of

oversight. Funds for its budget are provided through congressional appropriations although collected from Fannie Mae and Freddie Mac in the form of semi-annual assessments. This approach limits the agency's funding in comparison to the direct assessment approach used by federal banking regulators. For example, OFHEO's budget for FY 2002 was just over \$27 million. Rep. Baker and others have estimated that Office of the Comptroller of the Currency assessment for banks of the size of the GSEs would be around \$70 million.

In addition, OFHEO is not equipped with the full range of enforcement tools commonly afforded to financial regulators. It is my understanding, for example, that the agency's "cease and desist" authority is limited to capital related matters and does not encompass other areas of safety and soundness regulation. Enhancing the agency's authority in this area would appear to make sense.

Perhaps the simplest way to correct this problem, in our view, would be to upgrade OFHEO. But we know that some on this committee have concluded that a mere upgrade alone would not be sufficient and that further changes to the regulatory structure are also needed. For example, H.R. 2575 introduced by Capital Markets Subcommittee Chairman Baker would abolish OFHEO as an independent agency within HUD and transfer safety and soundness authority and general regulatory authority HUD now has to a revamped Office of Thrift Supervision, an independent unit within the Treasury Department that also regulates savings institutions. The bill would retain HUD as the supervisor of the affordable housing mandates, expanded enforcement authority for these mandates, and also provides the department with new authority to pre-approve any new activities the GSEs want to undertake. H.R. 2575 would provide both HUD and the new regulator with authority to assess the GSEs directly for the costs of their oversight activities.

H.R. 2803 introduced by Rep. Royce generally follows a similar approach, although the bill also abolishes the Federal Housing Finance Board, which supervises the FHLBanks and designates the new office to handle combined oversight for all three GSEs.

Secretary Snow and Secretary Martinez in their testimony before this committee earlier this month outlined their proposal for making even more extensive changes to the existing regulatory restructure. Their plan calls for a major shifting of regulatory functions to a new cabinet department. It would reconstitute the safety and soundness regulator, along with HUD's general mission oversight and what expanded authority to review "new lines of business, new types of investments, and acquisitions" into a single new bureau to be located at the Treasury Department. HUD still would retain authority to oversee the GSEs' affordable housing goals and fair lending enforcement, but not much else. The two Secretaries also proposed that supervision of the FHLBanks would eventually come under the purview of this new bureau as well.

Strengthened financial oversight can be achieved without making major changes to the existing regulatory structure

CFA is supportive of steps to enhance GSE safety and soundness oversight. Along these lines, we believe that providing GSE regulators with authority to assess the enterprises themselves for the reasonable costs of oversight and removing funding for these activities from the annual appropriations process would go a long way in addressing many of the concerns cited. Banking regulators fund their supervisory activities this way and so should the GSE regulators. Improving the mechanism used to fund the cost of GSE oversight would enable these regulators to increase their capacity and bring on additional financial expertise needed to perform their important functions.

However, we are not convinced that OFHEO is inherently flawed in its capacity to serve as the safety and soundness regulator. Accordingly, we question whether creating a new agency is the wisest and most efficient means for achieving the immediate impact that many say are needed. Those that favor the transfer to Treasury apparently believe, as Secretary Snow testified, that it would confer “additional benefits of stature and policy support.” In other words, that the GSE regulator could benefit from Treasury’s financial expertise and prominence as a cabinet agency. The connection could also reinforce the importance of safety and soundness oversight, which may help to calm down market jitters raised by the events at Freddie Mac.

Yet moving the GSE regulator to Treasury could also carry with it disadvantages. Because Fannie Mae, Freddie Mac, and Treasury are the major issuers of debt in the capital markets, questions about potential conflicts of interest could conceivably arise from the department’s exercise of its new oversight powers over GSE activities. Also, it seems inevitable that the transition would create administrative disruptions that would work at cross purposes with the objective of enhanced oversight, at least in the short term. We also are troubled by the suggestion that the new Treasury bureau would not be fully independent along the lines of the OCC and OTS. Secretary Snow indicated that this would be case by stating that the new bureau would be “required to clear new regulations and congressional testimony through the department.”

CFA also has great concerns with other aspects of the plan being proposed. We believe strongly that the general charter oversight and new program approval should remain at HUD. Switching this authority to Treasury we fear would detract from maintaining important regulatory focus on GSE housing mission performance. Treasury’s primary focus on safety and soundness concerns must be balanced carefully with an equally strong regulator that is in a position to offer different policy perspectives on regulatory matters, particularly as they pertain to mission related concerns. Experience should teach us that there will be tensions from time to time between safety and soundness and mission considerations. Thus, both functions should be afforded a comparable seat at the decision-making table to resolve these differences, otherwise the safety and soundness perspective will tend to override other legitimate considerations. We believe it would be more difficult for this proper balancing to be achieved should both functions be combined under one roof at Treasury.

In opposing this transfer, we are mindful that the two Secretaries sought to assure this committee that HUD would be consulted on mission matters. But consultation does not equate with decision-making authority. Moreover, downsizing HUD authority in these two areas is likely to undercut the department's ability to perform its remaining functions (i.e., affordable housing goals and fair lending oversight). In any event, this shift would clearly establish HUD as a second tier GSE regulator.

Further, we believe that Treasury is not necessarily in the best position make important determinations about whether the GSEs are acting within their charters and undertaking housing finance programs that serve the public interest. HUD as the principal federal department responsible for housing is uniquely suited to provide important housing policy perspective in deciding these matters. Whatever changes in oversight, if any, may occur we would anticipate that HUD would continue to work in conjunction with the safety and soundness regulator, as it presently does with OFHEO, whenever issues of financial condition arise. However, we believe maintaining the current arrangement is far less cumbersome than requiring a new bureau at Treasury to bulk up its capacity to undertake supervision of issues with broad housing impact.

Please do no harm to the housing mission

I also would like to comment on proposals that are being considered by this committee to make changes to other key aspects of GSE regulation: the program approval process and the capital requirements.

First, with respect to the program approval process. The 1992 GSE Act reaffirmed HUD's authority to approve new programs initiated by Fannie Mae and Freddie Mac. At the same time, the statute narrowly prescribed the scope and circumstances under which this review can be undertaken. The statute defines "new program" basically in the context of a mortgage related program that is either "significantly different from programs that have been previously approved, either under the GSE Act or engaged in before this 1992 legislation was enacted. The statute provides that new programs must be approved UNLESS HUD first determines that the program: 1) is not authorized by specific sections of the GSEs' Charter Acts; 2) is not in the public interest; and/or 3) OFHEO determines that the program would risk significant deterioration of the financial conditions of the enterprise. Thus, the burden is on HUD to determine whether there are sufficient reasons to keep the GSE from going ahead with its new initiative.

It has been my experience that the statutory prescriptions I described and the limited staffing that HUD traditionally has devoted to the performance of this function have combined to limit the occasions for these reviews. To my count, HUD has approved only three new programs from 1995-2000 and may have approved one other since then. At the same time, the department has elected not to review major new GSE initiatives, such as GSE entry into the subprime market and implementation of automated underwriting systems.

H.R. 2575 proposes to expand authority with HUD, but expand the authority to all new “activities” rather than just “programs.” “New Activity” is defined by the bill as meaning “any program, activity, business process, or investment” that directly or indirectly affects the financing and other services related to mortgages. While H.R. 2575 incorporates standards for approval comparable to existing HUD authority, the bill requires prior approval for these activities and eliminates the 45 day time frame for review that is part of the present requirement. In effect, this provision shifts the burden to the GSE to demonstrate how the program meets the statutory criteria and should therefore be approved.

Given the limited use of review authority up to now it appears that improvements in the process are needed. However, program review should remain centered around public purpose objectives. Unless carefully crafted revising the provisions governing program reviews could end up the regulators micromanaging each GSE’s day-to-day business. This outcome would be counter-productive and hamstringing the ability of the GSEs to bring new products to market and to otherwise perform their housing mission. Thus, we urge the committee to move with care in this area and avoid the establishment of an overly bureaucratic and unnecessarily complex approval regimen.

Similarly, making changes to the GSEs capital requirements as part of regulatory restructuring legislation is another area that could have far reaching ramifications for the GSEs housing mission and affordable housing activities. Inevitably there will be tensions and tradeoffs between steps aimed at addressing the GSEs’ financial exposure and their ability to increase funding for important mortgage related activities. Moreover, the GSEs’ charters provide safeguards to help ensure proper balance in oversight and explicitly recognize that “activities relating to mortgages on housing for low and moderate income families involving a reasonable economic return that may be less than they return earned on other activities. . .” (12 U.S.C. Section 1431 note, 1716) The existing capital rules in place were a long time in coming and are based on statutory guidelines and were fashioned after much deliberation. Congress should proceed cautiously in providing new authority to make frequent changes to capital rules, which may ultimately serve to detract from the GSEs’ ability to carry out their mission.

Strengthening oversight of the affordable housing goals

Finally, let me also use this opportunity to comment on HUD’s oversight of the GSEs affordable housing goals and on ways that this function can be strengthened. The 1992 GSE Act established a procedure for setting three percentage of business goals for Fannie Mae and Freddie Mac – a Low and Moderate Income Goal (with at least 50 percent of the dwelling units financed by a GSE’s mortgage purchases must be for families with incomes no greater than the areas median income), a Special Affordable Goal (with at least 20 percent of dwelling units financed by a GSE’s mortgage purchases must be for very low income families (below 60 percent of area median income) or for low income families (below 80 percent of median income) living in low income areas) , and a Geographically Targeted Goal (with at least 31 percent of the dwellings units financed by each GSE’s mortgage purchases must be for units in underserved areas (i.e., central

cities, rural areas, and other underserved areas based on income and minority concentration) as defined by HUD rules).

Implementation of the housing goals has had a substantial impact on Fannie Mae's and Freddie Mac's activities, more than doubling their low and moderate income housing business since they were first established in 1993. Both GSEs almost always have met and usually exceeded the goals levels in place through the year 2000 (the last year for which data have been published by HUD). Yet despite these improvements, HUD noted last year that the "market share for each (GSE) of the affordable housing lending categories is less than their share of the overall market; and they account for a very small share of the market for important groups such as minority first-time homebuyers." (Bunce, 2002, 5). The GSEs' have pledged to do better and Fannie Mae, for example, has undertaken a major initiative to increase funding of minority home purchase loans. Yet the HUD data suggests that there is considerable room for improvement.

Thus, we were pleased that Secretary Martinez in his testimony before this committee made a number of constructive proposals aimed at spurring additional improvements in the GSEs' affordable housing performance. The GSE Act prohibits HUD from establishing enforceable subgoals for the low and moderate income housing goal and the geographic area goal. Subgoals are a logical tool to ensure that the GSEs adequately consider the most underserved sectors of the mortgage market. For example, targeting minority and other underserved geographies would be ideal candidates for subgoals and would help to boost minority homeownership levels.

However, the Secretary's proposal is not sufficient unless HUD places greater emphasis than it has on performing these important responsibilities. For example, HUD let slip the establishment of new goals for 2004. The existing goals were originally set to end at the end of this year. HUD's failure to take action this year means that the current levels rollover for at least another year.

Both Fannie Mae and Freddie Mac say they surpassed their goal levels in 2001 and 2002, yet HUD tallies have yet to be released for these years. But we know that both enterprises rely on regulatory bonus points that provide 2 for 1 weighting found in the current rules to achieve their goal levels. These bonus point provisions are intended to increase the GSEs activity in the small multi-family and single family rental housing finance market. They are set to expire in December necessitating a substantial increase in both GSEs' affordable housing activities next year in order to meet their goal levels. We believe that these bonus points should not be extended without a full rulemaking process that would include opportunities for public comment to help the department assess the impact of this feature and considering whether they are worth continuing.

Also, the 2000 affordable housing goal rule implemented an additional bonus point system that is exclusive to Freddie Mac. Called a "temporary adjustment factor" (TAF), this additional bonus point system permits Freddie Mac to receive additional credit for each qualifying multifamily mortgage for properties with more than 50 units. Although HUD had originally established the TAF as 1.2 (i.e., 20 percent added weighting per

eligible unit, Freddie Mac was able to obtain a legislative amendment which increased the TAF to 1.35 units of credit (or 35 percent additional weighting per unit). According to data provided by Freddie Mac, the TAF added almost 3 percentage points to Freddie Mac's low and moderate income housing goal performance, over 1 percent to its geographically targeted goal performance, and 1.4 percent to its special affordable goal performance. The TAF is due to expire this year and should not be extended.

Additionally, we are extremely disappointed that HUD has continued to resist disclosing the results of a major fair lending review the department has undertaken and completed of the GSEs automated underwriting systems (AUS). The vast majority of mortgages made by lenders today are run through these systems, which rely on credit scoring and other statistical measures to rate creditworthiness. In effect, these systems determine who qualifies for prime mortgages and at what price. Borrowers that do not meet GSE standards, therefore, often are relegated to the more expensive subprime market. Credit scoring models almost always have disparate impacts for minorities, but they have not been subject to a full-scale regulatory review to determine whether they are discriminatory. The purpose of the HUD fair lending review of the AUS is to determine an answer to this essential question. Chairman Baker and others in Congress have written to HUD asking for the results of this inquiry, but to my knowledge they have yet to be forthcoming with the requested information.

The 2000 HUD rule establishing the existing goals levels also recognized that the GSEs, "have a public responsibility to help eliminate predatory mortgage practices which are inimical to the home financing and homeownership objectives that the GSEs were established to serve." (Federal Register, October 31, 2000, 65044) The rule affirmed corporate policies adopted by the GSEs at the time indicating that they would not purchase predatory mortgages by disallowing them from receiving goals credit for predatory loan purchases. HUD should be building on these prior actions by continuing to challenge the GSEs to expand upon these prohibited features and act more aggressively to challenge predatory practices in the subprime market. Unfortunately, HUD has not taken these critical steps.

In addition to a number of the suggestions recommended by Secretary Martinez, we believe that GSE performance toward meeting their goals could be improved through expanded public disclosure of these GSEs mortgage activities and through better reporting to Congress by HUD. Specifically, we recommend the following actions be taken:

■ ***Improving the GSE Public Use Data Base.***

The 1992 GSE Act required HUD to establish a public use data base and provide expanded public disclosure of GSE mortgage activity. Unfortunately, this data base does not provide sufficiently useful information for enabling housing consumers and local community groups to determine for themselves how active the GSEs are in their own localities. While some data is provided on GSE activity at the census tract level is not as detailed as data provided by mortgage lenders under the Home Mortgage Disclosure Act

(HMDA). In particular, local GSE data does not specify at the census level mortgage type as well as other important loan characteristics (e.g., whether the purchase was a home purchase loan or a refinancing, whether it was a prime or subprime loan, loan to value ratios, loan amount). Expanded reporting of these data elements would greatly improve the utility of this data base and assist with a more complete analysis of GSE activities in communities throughout the nation.

■ ***Better reporting to Congress on GSE affordable housing activities and departmental plans for establishing new goals.***

The GSE Act requires each GSE to report annually on its affordable housing performance, but does not require their regulator to report in a comparable way. While HUD publishes reports on GSE activities, annual reporting detailing the goal levels the GSEs' achieved and the activities undertaken to reach these levels would help to circulate this information more widely. These reports should distinguish between home purchase and refinancing purchases, purchase levels by different household income levels, and detail the extent to which the levels were achieved through the purchase of subprime mortgages. The department should also be required to report to Congress to explain delays in undertaking new rulemaking to set new housing goals in situations where the original term for these goals has expired or due to expire.

In closing, let me reiterate that we believe it is in everyone's interest to have strong regulatory oversight of the GSEs. In so doing, we urge the committee to proceed with caution and resist the urge to make needless changes that detract from the GSEs' ability to perform their public mission.

Mr. Chairman, this concludes my written testimony. Thank you again for the opportunity to testify today and I will be glad to answer any questions that you and other committee members have for me.