

**THE ADMINISTRATIVE PERSPECTIVE
ON GSE REGULATORY REFORM**

HEARING
BEFORE THE
COMMITTEE ON FINANCIAL SERVICES
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THE ADMINISTRATIVE PERSPECTIVE ON GSE REGULATORY REFORM

Wednesday, April 13, 2005

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to call, at 10:07 a.m., in Room 2128, Rayburn House Office Building, Hon. Michael Oxley [chairman of the committee] presiding.

Present: Representatives Oxley, Leach, Baker, Bachus, Castle, Royce, Ney, Kelly, Paul, Ryun, Miller of California, Tiberi, Kennedy, Hensarling, Garrett, Barrett, Harris, Neugebauer, Price, Davis of Kentucky, McHenry, Frank, Kanjorski, Maloney, Watt, Carson, Sherman, Meeks, Lee, Moore of Kansas, Capuano, Clay, Baca, Lynch, Scott, Green, Cleaver, Wasserman Schultz.

The CHAIRMAN. [Presiding.] The committee will come to order.

Pursuant to Rule 3(f)(2) of the rules of the Committee on Financial Services for the 109th Congress, the Chair announces he will limit recognition for opening statements to the Chair and Ranking Minority Member of the full committee, the Chair and Ranking Minority Member of the Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprise, or their respective designees, to a period not to exceed 16 minutes, evenly divided, between the majority and minority.

The prepared statements of all members will be included in the record.

The chair recognizes himself for an opening statement.

I want to welcome Secretary Snow and Secretary Jackson back to the committee this morning. I am looking forward to your views on H.R. 1461, the Federal Housing Finance Reform Act of 2005, and the administration's perspectives on GSE reform in general.

We have been working on this issue for a long time. Since the 106th Congress, this committee has held 22 hearings and has heard from 101 witnesses on GSE-related matters.

Chairman Baker should be commended for his hard work in monitoring the GSEs over the years, and I am proud to be a co-sponsor to the legislation he introduced to create a new GSE regulatory agency.

This legislation will foster confidence by granting the agency the necessary powers to ensure the safe and sound operations of these complex enterprises.

I would encourage my colleagues to join in support of this legislation.

At this time, in 2003, we were all led to believe that the GSEs were running smoothly with only a routine accounting restatement in progress at Freddie Mac. What we have learned since then is that these enterprises were involved in revenue smoothing, the misapplication of accounting standards and irresponsible corporate governance.

The Federal Home Loan Bank system has also had its share of problems over the years with accounting problems and inadequate management. The governance situation in Seattle seems to be particularly troubling.

It is time for a new oversight structure for the GSEs that will give the regulator the tools it needs to prevent these problems from developing and permit swift action when problems do arise.

We have learned in our hearings that the current regulator, OFHEO, lacks the critical tools needed to supervise these enterprises. It is our duty to structure a strong regulator to ensure that the housing market, the taxpayers and the financial system as a whole remain safe. H.R. 1461 strikes the right balance of strong regulation that is not overly burdensome.

Authority over minimum capital, program approval and receivership are all concepts that this committee has discussed over the years.

This regulator is independent from the political process. That means there is no influence on safety and soundness or on mission compliance.

Some argue that HUD has the expertise in housing mission. However, I would contend that it is not HUD that has the expertise but rather it is the people at HUD who have that expertise. These people can move to the new regulator and make decisions that are independent and in the best interest of the U.S. housing market.

H.R. 1461 also grants the regulator the authority to adjust the portfolios of the enterprises. This is an important power, and it will ensure that the enterprises do not hold portfolios that are unsafe and unsound or in violation of their mission.

In a similar manner, banks are forced to keep their portfolios in check through capital levels mandated by the Basel Accords. This structure encourages the holding of a diverse portfolio of assets, since the holding of too much of a particular asset, or a risky asset, results in a higher capital charge.

We have heard from some that Congress should be cautious in its efforts to create a new regulator and that we need to be mindful not to harm the housing market. In truth, the housing markets are being threatened now by the various accounting and regulatory problems at the GSEs and by the lack of a regulatory agency with a real and real authority.

A regulator with enhanced powers will assure that our housing financing system recovers and becomes stronger and more resilient in the future. The goal of this bill is to create a credible GSE regulator—nothing more, nothing less.

I also want to remind members of the committee that both Secretary Jackson and Secretary Snow have been generous with their time. Last week Secretary Jackson appeared before us, and next week Secretary Snow will be back to discuss international financial issues.

I would urge members to keep their statements and questions focused on GSE-related issues this morning so that we can have a productive session.

Thank you both for appearing today, and I look forward to your testimony.

Now I recognize the gentleman from Massachusetts, the Ranking Member, Mr. Frank.

Mr. FRANK. There are three sets of concerns that have been brought out with regard to the government-sponsored enterprises, and I will talk particularly Fannie Mae and Freddie Mac.

I think we are all fairly clear that the reason the Federal Home Loan Banks are going to be included in this legislation is that it would look funny if they were not. That is, absent the concern over Fannie and Freddie, we would almost certainly not be dealing with the Federal Home Loan Banks, but people are afraid that the markets would react negatively if we did this new scheme and they were not included, so they will be included.

I trust they will be included in ways that will recognize the very quite distinct differences between Fannie Mae and Freddie Mac.

Now, with regard to Fannie Mae and Freddie Mac, it seems to me there were sets of concerns. I want to begin with what I think is some context that has gotten too little attention.

We have a serious housing problem in this country. We have a particular problem in many parts of the country. But housing affordability is one of the gravest social problems we have.

And while general prosperity, which we all welcome, helps alleviate some social problems, reduces unemployment, can increase real wages, in some ways it makes the housing situation in some parts of the country worse.

The prosperity of the 1990s, because of market imperfections, meant that in some parts of the country the demand for housing increased far beyond what the supply of housing could meet. And so in many parts of the country, the 1990s made things worse.

We have decided—over my objection, but I see no near-term reversal of that—substantially to reduce the direct federal role in housing affordability production. We are basically out of the production business at HUD. We have rental assistance programs, but we are not constructing much housing.

In addition, we have hundreds of thousands of units of housing that has been built over the years with federal assistance, under the 221(d)(3) and 236 program, the rural housing programs, which is at risk because of market forces and the expiration of legal restrictions of going out of the affordable housing inventory.

So if we were to project current housing policies forward—I will be opposed to that, but I cannot guarantee obviously it does not happen—we will have 5 years from now many fewer affordable units than we now have federally provided for.

There are a couple of offsets to that. One, has been the most successful thing we have done in a long time. It was originally very partisan when it was done, but it is now universally accepted. The former chairman of this committee, Henry B. Gonzalez, was the leader in it. We mandated an affordable housing program to the Federal Home Loan Banks with a percentage of their profits that has become a major source of housing affordability production.

And now we come to Fannie Mae and Freddie Mac. And the context is that Fannie Mae and Freddie Mac are important sources of affordable housing, and in my judgment should become even more important sources of affordable housing, and that is one of the things I hope we will do in this bill.

There are three sets of concerns. One has to do with the financial safety and soundness of these two large institutions. And here I think there is general consensus that we should increase the ability of regulators to take action necessary to protect safety and soundness.

I would say that I think the situation is not nearly as critical as people have thought. We have found with both Fannie Mae and Freddie Mac inappropriate behavior, bad accounting—I think influenced probably by the compensation schemes of the top officials—and we have been able to step in through the regulator and correct those.

What is interesting to me is that in both cases, multibillion dollar mistakes happened. The leadership committed—the mistakes were not made; people made the mistakes. Mistakes do not happen by themselves.

No one should be allowed to use the passive voice when talking about screw-ups. We ought to identify who did it. The leadership of Fannie Mae and Freddie Mac did it. And they have—all those I believe have left. I am sorry that their compensation lingers on, and I would like in the bill to make sure that we can more adequately cut off compensation for people who misbehave.

But in neither case has the safety and soundness of Fannie Mae or Freddie Mac or the housing market or the United States been implicated. In other words, there was more solidity there than people think.

But in any case, I agree that we should take action to strengthen the safety and soundness regulation.

But there are two other agendas at stake here. One is the notion that it is inappropriate for the federal government to interfere with the allocate of functions of the capital market. I believe this partly motivates Mr. Greenspan.

There is obviously a very respectable, intellectual tradition that says: The market knows all, the market is smart and government is dumb—to quote a former majority leader from Texas, a current former majority leader from Texas—and he said the markets are smart and the government is dumb.

And the view is that Fannie Mae and Freddie Mac, with a particular set of legislative and executive arrangements, biases capital allocation towards housing. And there are people who want to stop that. I very much disagree with that.

There are also competitors. There are organizations of people who compete or resent the fact that Fannie Mae and Freddie Mac can borrow money more cheaply than others, because of a perception in the market that we are going to bail them out. I am not going to bail them out, and if they want to lend money to Fannie and Freddie cheaper, that is their judgment. Do not come to me if it does not work out.

But there are competitors who want to reduce that advantage, who want to restrict what Fannie Mae and Freddie Mac can do.

I find the latter two inappropriate. I will cooperate in trying to enhance safety and soundness. But I will resist efforts to impose an ideological agenda to get them out of the housing business, as people try to get the government out of the housing business in general. I will oppose efforts to hinder their ability to do things that competitors do not want them to do.

And I would make the final point with this—with your indulgence, Mr. Chairman, and I appreciate it: I agree with those who say that Fannie and Freddie are not spending enough of their resources on affordable housing in particular.

They get an advantage from the market. So there is a general agreement on that. But there are two approaches to it. There is the administration prediction, and the administration predilection is: “Fannie and Freddie get certain advantage because of this market perception, and they can borrow money more cheaply, and they do not do enough for affordable housing, let’s reduce their overall activity, let’s cut down what they do.”

Others of us believe—and I think this is overwhelmingly the case on our side, and it is certainly the case with virtually every organization in America that is concerned about housing production and affordable housing—instead, let’s leave them at the current level, unless safety and soundness dictate otherwise, and have them do more about affordable housing.

So our effort is going to be, one, to enhance safety and soundness; and two—unlike, frankly, the administration position—to advocate a greater allocation of resources toward affordable housing.

That is the approach that we will be taking, and I think those are the issues that we will be dealing with in the legislative situation.

The CHAIRMAN. The gentleman’s time has expired.

The gentleman from Louisiana, Mr. Baker, chairman of the subcommittee.

Mr. BAKER. I thank you, Mr. Chairman.

And I want to start by acknowledging your hard work and, frankly, tolerance on this issue over the years. I am most appreciative of your leadership in this area.

I also wish to make clear that the bill now pending is not a bill drafted in a void by any individual, but a collaborative effort led by the Chairman, in consultation with Secretary Snow, Secretary Jackson, Chairman Greenspan, Director Falcon—all those who have had some significant interest in this matter for many years and who bring to this perspective the insights that are extremely important in having a bill which is constructed appropriately and is balanced.

Just without reviewing history, why do we need this bill? There are some who would suggest that circumstances are not sufficient to cause great change in the current oversight of these enterprises.

If any other public operating company issued an announcement that we will have a multibillion dollar restatement over multiple years, that we cannot perform our duty to report our financials in a timely manner to the market and cannot yet give a date by which that financial information will be provided, the market reaction to that news for that public operating company would be immediate and extremely adverse.

The reason why we have not seen such reaction in this case is clearly because of the market perception of the federal backstop. It skews market discipline, it prevents management from reacting in a manner which is appropriate in all other circumstances, and therefore the need to change the regulatory regime is absolutely essential and immediate.

I am grateful that we have not had more significant adverse consequences, that interest rates have not gone through the ceiling, that homeownership has not been precluded for millions of the Americans who chose to pursue that vision, and that we are able in a relatively calm and dispassionate environment to discuss the needs for regulatory reform.

I think it is also important to recognize what the bill does not do. It does not, for example, repeal the line of credit, it does not set arbitrary limits on investment portfolio, it does not make immediate or requisite adjustments to capital.

It does create a world-class regulator, with the ability to act not only in the interest of taxpayers but in the interest of homeownership.

There is the authority to adjust capital, to assess risk, to approve programs and to act in the interest of homeownership.

It is much like having a fire extinguisher in a commercial building. You may never have a fire. But if a fire breaks out, you would be well served to have the fire extinguisher on the wall.

This bill is the fire extinguisher. We hope none of these powers are ever essential or necessary.

And let me speak to one point about limitations on growth of the GSEs.

Prior to the innovation of the investment portfolio and mortgage-backed securities, and even in the early days, one CEO—former now—sitting at that very table said, “Oh, we would never repurchase our own MBS, because we are moving interest rate risk and prepayment risk off our books and into the market.”

Now we see in substantial number these enterprises repurchasing their own mortgage-backed securities without concurrently increasing their capital to offset or hedge against that risk.

Prior to the creation of MBS, these enterprises, principally and only, securitized home mortgages—a very profitable line of business. The G-fees are significant, the margins are great.

Without the investment portfolio, these enterprises can grow, and substantially grow, and remain highly profitable without the adverse risk that the investment portfolio brings to the issue.

However, we only vest the authority in the regulator to make judgments, going forward, after appropriate study, if the investment portfolio should be constrained in any manner.

I want to make clear that this bill is not about artificial, arbitrary statutory regulation. It is about creating a regulator with sufficient tools to respond to any adverse conditions—not only in the interest of taxpayers, but in the promotion of homeownership for every American who hopes one day to live in the luxury of their own home.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman’s time has expired.

The gentleman from Pennsylvania, Mr. Kanjorski?

Mr. KANJORSKI. Mr. Chairman, we need to have a strong, independent and a world-class GSE regulator. Such a regulatory system will promote confidence in the GSEs, protect the continued viability of our capital markets, ensure taxpayers against systemic risk and expand housing opportunities for all Americans.

To ensure that we have appropriate GSE regulation, I believe that any future legislative reform efforts should also adhere to several key principles.

For example, the regulator must have a funding stream separate and apart from the annual corporations process. In order to be credible and effective, the regulator must additionally have genuine independence from the political system. Such independence must consist of complete autonomy from the enterprises, include sufficient protection from outside special interests and provide substantial insulation from political interference.

A strong regulator must further have robust supervisory and enforcement powers. In this regard, many have suggested that we should model GSE safety and soundness regulation on that of other financial institutions. I agree with this sensible concept.

In fact, the general goal of our reform debates heretofore has been to make GSE supervision more bank-like. However, some recent reform proposals, such as those aimed at imposing arbitrary portfolio limits and requiring a burdensome approval process before the GSEs can go to market with new innovations, would appear to be more than bank-like. These proposals, therefore, cause me considerable concern.

Moreover, we must ensure that we continue to remember why we created these public-private entities as we work to develop regulatory reform legislation. We created GSEs to make credit available to finance home purchases because the private market was not effectively meeting credit needs. The GSEs' charters limit business activities to their public missions. And they receive benefits from the government that help them carry out those public missions.

Beyond ensuring that GSEs can continue to fulfill their missions, we must maintain a public interest in the boards of these public-private entities. In that vein, I have been very concerned that the administration has failed to appoint independent directors at Fannie Mae, Freddie Mac and the Federal Home Loan Banks as it is required to do under the law.

Public participation on these boards helps to focus the GSEs on their missions.

Additionally, I am very concerned that the removal of the presidential appointment authority in any legislation, as some have regrettably suggested, would result in a greater probability of privatization in the future.

Privatization of the housing GSEs is a very bad idea for financial institutions of this size and of such importance to our economy.

In sum, Mr. Chairman, in developing any enhanced GSE regulatory system, we should perform deliberate surgery. We should abstain from considering radical proposals that would fundamentally change the ways in which the GSEs operate or undermine their charters.

Finally, as we implement strong independent and world-class GSE regulation, we must also ensure that the GSEs continue to

achieve their statutory objectives and carry out their public missions.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Paul E. Kanjorski can be found on page 52 in the appendix.]

The CHAIRMAN. I thank the gentleman.

We now turn to our distinguished panel. Our first witness is Secretary Jackson.

Secretary, welcome back. It is good to have you back. You seem very comfortable before the committee after all this experience that you have had.

[Laughter.]

We welcome you, and you may proceed.

**STATEMENT OF HON. ALPHONSO JACKSON, SECRETARY,
UNITED STATES DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**

Secretary JACKSON. Thank you very much, Chairman Oxley and Ranking Member Frank and members of the committee.

I welcome the opportunity to join Secretary Snow in discussing the administration's views on how best to improve and reform regulatory oversight of the housing government-sponsored enterprises.

The President has set an ambitious goal: to build an ownership society where everyone has a chance to own a home, a retirement account, a health care plan, and to gain permanent stake in the American dream.

Ownership brings stability to our neighborhoods and security to our families. To build on an ownership society, the President is committed to helping even more Americans buy homes.

This commitment is embodied in the President's challenge to the housing industry to join with us to create 5.5 million new minority homeowners by the end of this decade. It is embodied in the Blueprint for the American Dream Partnership, through which HUD has brought together the private sector, not-for-profit and government agencies to meet the President's challenge.

Secretary Snow will outline the core principles that the administration believes should underline any GSE regulatory reform. He and I are in full agreement: Congress and the administration has an opportunity and an obligation to strengthen the regulatory structures of the GSEs.

A strong regulator is in everyone's best interest: the administration, the Congress, the housing industry, Wall Street, investors worldwide and the American homebuyer.

The administration has two goals in this process: First, we must ensure that the GSEs continue to fully carry out the mission granted to them by Congress of promoting affordable housing and homeownership; second, we must ensure that the GSEs are subject to rigid oversight so that they serve the public purpose.

To ensure that the GSEs have appropriate finance oversight and are held accountable, the administration supports strengthening the power of the GSE regulator. Doing so would make the regulator more comparable in terms to statute, power, authority and resources to other financial regulators charged with safety and soundness oversight.

Seventeen months ago, in the wake of Freddie Mac's 2000 accounting scandal, 2003 accounting scandal, Secretary Snow and then-Secretary Martinez came before the committee to make a case for reform. As Secretary Snow will describe in his testimony, other troubling problems that impact the safety and soundness of the GSEs have come to light.

In addition, in July 2004, HUD reported that Fannie and Freddie continued to substantially lag the conventional markets in serving first-time homebuyers, especially minority first-time homebuyers.

In October of 2004, HUD determined that Freddie Mac overstated its 2002 performance under the low-and moderate-income and underserved-area housing goals by doubling the account by 45,000.

Recently HUD determined that some of Fannie Mae's international activities may not be consistent with the chartered purpose. Therefore, HUD has advised Fannie that it must obtain prior written approval from HUD before it engages in any international activity.

Last week, HUD ordered Fannie to cease and desist serving sale programs for third-party lenders. Again, this activity is inconsistent with the charter purpose.

The best way to prevent similar or worse abuse in the future is through the oversight of a strong regulator empowered to hold Fannie Mae and Freddie Mac accountable to the highest standards their size and statute demands.

The administration strongly supports retaining the core element of oversight of Fannie and Freddie, setting enforcement and affordable housing goals at HUD.

Congress established the housing goals to ensure that the GSEs fulfill their mandate to provide leadership to the mortgage market. To transfer this role from HUD could delay years of implementing of the new regulatory plan.

We also consider it important that the fair housing requirement and enforcement pertaining to the housing GSEs remain at HUD, given HUD's expertise in housing discrimination. HUD should have full enforcement power for those authorities in the same way it enforces the Fair Housing Act.

Secretary Snow will testify of the additional powers for the new regulator, and I would add one more: allowing the regulator to establish conforming limits on a local basis each year using the best available data to more appropriately serve low-and moderate-income families.

Let me stress that we believe that such encompassing of changes to the regulatory structure will boost the confidence of the GSE stakeholders. Investors will be better protected under the regulatory system that empowers the regulator to do the job we expect them to. And the American public will ultimately benefit.

As the same time, we will strengthen the GSEs' ability to serve low-and moderate-income families pursuing homeownership.

I join Secretary in saying that I look forward to working with the committee.

And my full statement will be submitted to you, Mr. Chairman and the Ranking Member.

[The prepared statement of Hon. Alphonso Jackson can be found on page 54 in the appendix.]

The CHAIRMAN. Without objection.

Thank you, Secretary Jackson.

Secretary Snow, it is good to have you back before the committee and look forward to your appearance next week as well.

STATEMENT OF HON. JOHN W. SNOW, SECRETARY, UNITED STATES DEPARTMENT OF TREASURY

Secretary SNOW. Thank you very much, Mr. Chairman. It is a great pleasure to be here.

Chairman Baker, former Chairman Leach, Mr. Frank, Mr. Kanjorski, members of the committee, I appreciate the invitation you have given me. And as with Secretary Jackson, I look forward to working with you to make legislation to strengthen the regulation of the GSEs a reality.

I am heartened by the comments. I am heartened by private conversations.

Mr. Chairman, thanks to you, Chairman Baker and others on the committee, we have made a lot of progress over the last 2 years.

The administration's position on this is clear. I think it is unequivocal.

Secretary Jackson has stated the commitment of the administration to housing, to advance the housing objective. Underlying the housing objectives is a strong and secure mortgage market.

The GSEs play a very important role in providing liquidity to the mortgage market through their operations in the secondary market. The strong regulator plays an essential role in assuring the soundness and safety of that market, and thus continuing to make sure that liquidity is available to advance the important goal of homeownership.

The need for the strong regulator is clear. These are large and important financial institutions that affect not only the housing markets and the mortgage markets, they also affect, because of their size, the financial risks to the country as a whole.

The strong regulator we envision would focus primarily on soundness and safety of the housing markets, but it would also take into account the broader issue of systemic risks to the financial system.

That regulator ought to be world-class. It ought to have the authorities and powers and responsibilities that other world-class financial market regulators have—like the Federal Reserve Board, like the OCC—the sorts of authorities laid out in the Basel Accords.

I think your legislation advances that objective in a very positive way, and we commend you for that.

The new regulator ought to have powers at a minimum over risk-based capital and minimum capital, the ability to set those standards, not through statute but through administrative discretion, taking into account the changing marketplace conditions that the entities find themselves in.

It ought to have independent funding, as Congressman Kanjorski said.

It ought to have, also, broad supervisory powers to review the activities of the entities.

Importantly, it ought to be able, if the entities find themselves in deficiency, in default, to trigger a receivership process.

And also it needs to have the ability, consistent with making sure liquidity is available to carry on the primary mission, to limit the GSEs' retained mortgage investments. That is a very important power as it goes directly to this issue of systemic risks.

As I say, I think your efforts are to be deeply commended. We have made tremendous progress here.

And we want to continue, "we," the administration, Secretary Jackson and I want to continue to work with you and the committee, Mr. Chairman, to try and make a reality of new legislation to establish that strong regulator with all the powers necessary to have a world-class regulator supervising the activities of these very important entities.

Thank you very much.

[The prepared statement of Hon. John W. Snow can be found on page 58 in the appendix.]

The CHAIRMAN. Thank you, Mr. Secretary.

Thanks, both of you, for your excellent presentations.

Let me begin, Secretary Snow, with an issue. First of all, it seems to me that over the last year, a lot of the issues that were very contentious and very difficult have tended to become less so for a lot of reasons that I will not get into. The receivership issue, for example, stands out.

There is one issue that is a relatively new issue to the debate, at least in terms of how high it has been perceived, and that is the portfolio limits issue. Some cite it as systemic risk—Chairman Greenspan and others—because so many financial institutions hold GSE debt and the obvious potential problem that exists.

Could you lay out for us the GSE-related risks that concern you the most as Secretary of the Treasury? And are the risks related to investments and securities held by the GSEs and their portfolios? And lastly, do the GSEs hold inherently risky investments in and of themselves?

Secretary SNOW. Thank you very much, Mr. Chairman. That is a question that gets at the heart of this important issue.

The problem of systemic risk grows not out of the holdings themselves, or the nature of those holdings. Mortgages are a pretty secure holding. MBSs themselves are a pretty safe and secure holding.

The systemic risk issue arises because of the vast size of these holdings that have grown just enormously over the past decade and a half or so. And the size of these holdings is what concerns me—I think it concerns Chairman Greenspan—but not the holdings themselves.

These holdings of the paper of the GSEs are heavily concentrated in financial institutions, in pension plans, in insurance companies, in community banks, and in the financial system generally. A very heavy percentage of all the GSE paper is held in those institutions.

But derivatives, the hedging mechanisms that are used to deal with the risks that the GSEs properly are trying to spread and

hedge against, are concentrated in five or six very large financial institutions.

What concerns the Treasury Department and the Federal Reserve Board is the concentration of these risks in our financial institutions which, in the event of a default or even the threat of a default, could have far reaching, contagious effects across the financial system, creating this thing we call systemic risk.

Our proposal would limit the GSEs to holdings of MBSs or mortgages or other investments to the extent required to carry out their primary function. We understand they need liquidity. We understand there may be a case for holding some amount of this paper and making these investments.

The precise amount I think is best left to the regulator to determine against a standard which would say they should not hold anymore than they need to hold to carry out their primary function to make the secondary market.

The CHAIRMAN. Well, that raises the issue that I wanted to—and I am glad you set that up, because the issue is: How do we deal with that systemic risk in terms of portfolio? Some have, as you know, talked about a prescriptive, in the legislation, that is, that would shrink the portfolios by a particular dollar amount each year.

And it strikes me that, given the fact that markets change, interest rates change and the like, that to enact something like that in a prescriptive nature invites some real problems, that in fact if we are going to create a world-class regulator, then we ought to have some faith in that world-class regulator, given the authority by Congress to make those kinds of decisions going forward.

What is your opinion on that?

Secretary SNOW. Mr. Chairman, I would agree with those thoughts.

Regulatory agencies are set up to have expertise to deal with day-in, day-out changing circumstances and conditions. It is hard to legislate once and for all. And this is a case that, it seems to me, cries out for the application of that sort of regulatory expertise and discretion.

I do not know whether the liquidity requirements of the GSEs call for portfolio reductions of X, Y or Z. But a good regulator, given a good staff and the resources to get into those issues, could make that determination.

I would urge you, though, to direct the regulator—and this is such an important issue—to direct the regulator in a policy sense that they should not permit the GSEs to hold more of these assets than is necessary to carry out their primary function.

They do need liquidity. The regulator is in the best position, I would think, to determine the role of MBSs, mortgages and other paper in fulfilling that requirement for liquidity to carry out their primary function.

So I am much more comfortable leaving it to the regulator, with strong policy guidance from the Congress.

The CHAIRMAN. Thank you.

My time has expired.

The gentleman from Massachusetts?

Mr. FRANK. I said earlier that I think it is important to sort out some strains. And I will tell you that I am concerned.

Until well into the administration, this administration ignored the affordable housing mission. When this administration took power 2001, they inherited affordable housing goals for the government-sponsored enterprises which covered 2001 and 2002. They had been promulgated to people in the administration.

The administration had the authority then to promulgate goals that would have taken effect in 2003 and 2004, new goals. They forgot.

We finally inquired whether they planned to do anything about goals, and HUD said they did. But by the time they said they did, the time had expired. And when I asked them why—I think I may have asked you, Mr. Secretary—but somebody said to me, well, it was an oversight.

So HUD deliberately or negligently failed to do anything to increase the goals.

The concern for the goals, which I share—indeed, not share, which I had before they did—did not come until there was an assault on Fannie and Freddie. There were other issues.

One of the most important things you are going to have to do if you want to expand homeownership beyond the current income level is fully to take advantage of manufactured housing. Manufactured housing is an indispensable asset as part of the effort to expand it.

Fannie Mae decided to pull back from manufactured housing because it was being pressed by regulators, by financial credit-raters to do that.

Several of us, on both sides of the aisle, rural and urban, wrote to Fannie Mae and said, “Please do not do this. We need you to get back into manufactured housing.” We tried to work with HUD on that.

We wrote to Secretary Martinez, then the Secretary of HUD, and asked him for a meeting. The answer was that he was too busy to meet with us.

HUD, to my knowledge, still has not done anything about helping us get them into manufactured housing.

We found Fannie and Freddie not taking advantage of some of the rural housing programs. And, again, it has been a congressional initiative to do that.

So let me say I welcome this interest in affordable housing. I wish it had come earlier.

And now let me ask some specific questions.

Mr. Secretary, to Secretary Jackson, are you aware of what HUD is doing with regard to manufactured housing with Fannie and Freddie, because we have found that to be a gap. We tried to get HUD interested, and we were brushed off.

Is HUD working on trying to do anything? Do you agree with us, that they ought to be engaged with manufactured housing?

Some people say, “Well, it is too risky.” But we have been pressing them to do more. Is HUD doing anything in that regard?

Secretary JACKSON. First of all, let me say this, that your analysis, from the inception, is very well correct. And let me address

first the affordable housing goals and then the manufactured housing.

Yes, it is clear that in 2001, 2002, we did not come up with the affordable housing goals. Some were still in play. And the reason was that in many cases, as you know, Mr. Ranking Member, even when we came up with them, we were constantly in dispute.

What I did—

Mr. FRANK. In dispute with whom?

Secretary JACKSON. With Fannie Mae as to whether they were—may I finish, please?

One of the things that occurred in the 2003 when we started the goals is, I made a conscious decision that we were no longer going to debate with Fannie and Freddie or members of this body about whether the goals were acquirable or obtainable or not. We said that “these are the goals and you are going to have to meet them.”

Mr. FRANK. Mr. Secretary, I asked about manufactured housing. The fact is—

Secretary JACKSON. And I am ready to answer that question—

Mr. FRANK. I wish you would. You raise the thing on the goals, let me go back.

2002 went by, you had the ability to raise the goals, you said—nobody here in 2002 was telling you not to do it. We raised it with you, and the answer we got was, well, it just was not on the agenda.

So it is clear—

Secretary JACKSON. That is not the answer.

Mr. FRANK. HUD had the ability in—well, I will go back and get you the transcript, when we asked why. HUD could have done it, and nobody would have tried to stop you from doing it.

We had some suggestions about how to do it, but not about increasing the goals.

But let me ask you about manufactured housing: What has HUD been doing—

Secretary JACKSON. Well, we have no authority to tell them what to do about manufactured housing. We have talked to them, we will continue to talk to them.

Mr. FRANK. I didn't say authority. I do not have any authority, either, Mr. Secretary, but, you know, there is jaw-boning, there is pressure. People speak, and we try to, as I said, to get them into manufactured housing. Could you tell me what HUD has been doing to persuade them?

Secretary JACKSON. We have tried to get them—and I think you have said something that is very important. You work with them too. It has been very difficult to get Fannie Mae and Freddie Mac to work with us until now.

Mr. FRANK. It has been easier to get them to work with us on affordable housing than it is get you to work with us.

Secretary JACKSON. That is not true.

Mr. FRANK. Well, it certainly is to me.

Secretary JACKSON. You know why?

Mr. FRANK. Let me ask you about affordable housing. We have in our version of the legislation—those of us on the Democratic side in the Senate and the House, and it is not in the bill—a requirement that they put a certain percentage of their profits into an af-

fordable housing program modeled after, in general, the Federal Home Loan Bank program.

Could I ask both of you what you think of that, that proposal that we take a percentage of their profits, that we mandate that a percentage of their profits go into an affordable housing program, direct production subsidy, similar to what the Federal Home Loan Banks have done?

Secretary JACKSON. But you know, Mr. Ranking Member—

Mr. FRANK. What do you think of that proposal—

Secretary JACKSON. May I finish? Mr. Ranking Member, why should they do it? Their charter mandates that they must do it. Why should they set aside something that the charter mandates that they do?

Mr. FRANK. So, you will not answer the question, I guess. Are you in favor of—

Secretary JACKSON. The charter does not mandate with the Federal Home Loan Banks should do. They have decided to do that. But charter is mandated—

Mr. FRANK. Excuse me, the Federal Home Loans Banks were mandated to do it by an act of Congress. And the charter does require them to do something that does not, as explicitly as we think it should, require them to put the profits—not just in the loans.

We are talking about going beyond the charter. The charter says that as they lend the money, as they do the secondary market stuff, that they should do affordable. We want to go beyond that get them more directly into, as the Federal Home Loan Banks are, into more direct stuff.

So are you in favor of that provision?

Secretary JACKSON. My position is, I have as long as they want to do more, that is fine.

Mr. FRANK. Are you in favor of us mandating it? That is English. I am sorry for my diction, but you can understand that.

Secretary JACKSON. But you are the Chairman, I am not—I mean, you are the Ranking Member. This is the finance—

Mr. FRANK. Yes, I am the Ranking Member asking the—excuse me, Mr. Secretary, but you have come before us to make recommendations about legislation. I asked you about a specific piece, and you act as if somehow I am invading your privacy.

The point is this: We have legislation. I do not want to wait for Frannie or Freddie to decide to do it.

This is the point: I think we are doing more to get them into affordable housing than you have done.

Are you in favor of an amendment to this bill that would mandate that 5 percent of their profits go into subsidized affordable housing?

Secretary JACKSON. That is your decision to make.

The CHAIRMAN. The gentleman's time has—

Mr. FRANK. Why are you here?

Secretary JACKSON. I am here to tell you what our viewpoint is.

Mr. FRANK. Well, then tell me your viewpoint on that.

Secretary JACKSON. That is my viewpoint.

Mr. FRANK. I know it is my decision. What is your viewpoint on our decision?

The CHAIRMAN. The gentleman's time has expired.

Secretary JACKSON. If you choose to do that, that is fine.

The CHAIRMAN. The gentleman from Louisiana?

Mr. BAKER. I thank the Chairman.

Good morning, Secretary Jackson. Welcome.

I would just like to comment that from my perspective, the department has been very forthcoming and aggressive in seeking out ways to get Fannie and Freddie to the table.

I have repeatedly pointed out that when we look at the function these enterprises engage in, you would assume that they would have a degree of mortgages in their portfolios that have high loan-to-value correlation.

I have made the brash assumption that poor people do not have money. So that if they are to buy \$100,000 home that requires a \$5,000 down payment and \$3,000 in attorney's fees, that \$8,000 cannot be easily accumulated and therefore they cannot purchase homes.

There are programs that allow 100 percent of the purchase price to be financed. And so you would look at the portfolio thinking you would find an aberrant amount of loan-to-values in their portfolio in excess of 95 percent to 100 percent, meaning they are loaning \$98,000 out of \$100,000 or \$100,000.

When you go back and examine the portfolio, you find that in each enterprise's case, it is less than one-half of 1 percent held in portfolio fits that characterization.

So where are they making loans? They are making them in the fat and middle part of the market where the homeowner has 30 or 40 percent down payment, and the typical home-loan value is well in excess of \$250,000, with mom and pop both working, with two kids, a dog, a Chevrolet pickup truck and a bass boat. These are not the folks that the charter says they should be focusing on to help fulfill the dream of homeownership.

I have long been troubled by it. I have long known they underperform the market. Commercial banks hold on average 13 percent of those loans in their own portfolio. And Fannie and Freddie are stumbling over getting beyond 3 or 4 percent.

So there is much work to be done, and I commend you for your efforts.

Secretary Snow, I just want to hit a couple of points very quickly as they, I believe, were raised in the course of Senate considerations that did not get the attention I think they needed to receive.

One, with regard to the debate over limitations on investment portfolio versus the activity known as securitization: For many years there was in the life of both enterprises no mortgage-backed securities. It is a relatively recently developed financial entity.

You could constrain the mortgage-backed security acquisition, an issuance process, and the investment portfolio, and is it not true that the enterprises could continue to grow quite successfully with handsome margins by only engaging in the activity known as securitization?

Secretary SNOW. I think there is a big market, and they have shown they have a comparative advantage in that market.

Of course, if we move down the road we are suggesting, they would have an incentive to focus more of their efforts on making that secondary market and providing those guarantees.

Mr. BAKER. Sure. And to a great extent, the portfolio in the past has been the basis on which they have returned double digit rates of return, enabling shareholders' profit, and perhaps some might suggest, executives to earn rather large compensation—no comment expected.

Secondly, with regard to concentration of holdings: Under the rules requiring the aggregation of tier-one capital for institutions insured by the FDIC, there are three things permissible for a bank to hold, meeting the tier-one capital requirement: U.S. treasuries, cash and GSE securities.

It is now my understanding that an excess of 4,000 banking institutions meet their tier-one capital requirements to the extent of 100 percent is now constituted by GSE securities.

By contrast, if a bank is to make any other investment, there is an investment cap of 10 percent of assets on that particular investment.

With regard to loan obligations, there is a loan limit to one borrower rule of 20 percent of assets.

So, then, all other cases, except for the GSE securities, there are statutory and regulatory limits on how far one may go as a CEO of a banking enterprise in investing in a single course of business activity.

Do you think it advisable for us to examine the concentration question and authorize the regulator to take appropriate action to limit this concentration?

Secretary SNOW. I think it is a subject that deserves consideration. And I would urge you to continue to look at it.

I think having the strong regulator in place with the power to limit those portfolios is probably even more important in dealing with this issue of systemic risk.

But, clearly, the numbers you have laid out for us suggest how broad the systemic risk is and why we need that strong regulator.

Mr. BAKER. Just in closing, I want to commend both of you for your leadership in this tough area. It has been a battle over many years, and under your leadership, something finally might happen.

Thank you.

Secretary JACKSON. Let me say this to you, Mr. Chairman, I think to add to what Secretary Snow said is, that if we look at today's GSE portfolio, it could easily be reduced by prepayments on a number of the mortgages, and that would reduce it in itself.

Also I think that the Secretary alluded to something that was important.

In 1990, the securitized market for the GSEs was \$740 million. If you look at it today, it is \$3.8 trillion. That is a huge difference.

And I think that, clearly, what the Secretary is saying, that if we have world-class regulator, they can look at many ways and will not hurt the market at all with the abilities of the GSEs to continue to fund low-and moderate-income loans, and even the top end of the loans, it will not affect them. They will not be able to hold as many mortgage-backed securities as they do.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Pennsylvania?

Mr. KANJORSKI. First of all, Mr. Secretary, I think you have come a long way, from what I recall a year or so ago, and I want to congratulate you on that.

Secretary JACKSON. Thank you.

Mr. KANJORSKI. I think that shows good flexibility. And we are now working towards something we may be able to get our hands around.

I have a couple of questions.

But one is—and maybe I am wrong and you can fill me in, Mr. Secretary—I understand that normally the regulator of banks has the flexibility to require greater capital if they anticipate or see risk on whatever formula that they lay out. And, clearly, the proposed legislation would contain that type of authority in this new regulator.

Would you tell me, though, is there a limitation or a strength or authority for the regulator to dictate the investments of any private banking institution?

Secretary SNOW. The OCC and the Federal Reserve Board have broad regulatory supervision, including lines of business and, as you say, broad authority over capital, minimum and—

Mr. KANJORSKI. Well, I understand the capital side. I am talking about the portfolio side.

Secretary SNOW. No. But let me say that the reason that sort of authority is really important here, is critical here, is to deal with the incentives that exist for the GSEs to continue to take on more and more debt, because they have a borrowing advantage which allows them to make an above-normal rate of return on any interest-based asset they buy.

And that is an incentive for continuing expansion of their loan portfolios, which is leading to this situation where systemic risks are created.

Normal bank regulators do not have—

Mr. KANJORSKI. Mr. Secretary, but if a system risk appears to be possible, the regulator will have the authority to increase the need for capital, and that we have all agreed on.

But you are capping both sides. You are giving the power to increase capital to avoid systemic risk, but you also, for the first time, want to get very involved, by the regulator, in the portfolio, and that seems a very strange inconsistency if we are going to look at these institutions as similar to other financial institutions, other than the fact that they have a special charter.

Secretary SNOW. Congressman, we would limit it only to the extent they hold more of these investments than is necessary to carry on—

Mr. KANJORSKI. The regulator is going to determine what is necessary.

Secretary SNOW. The regulator would—per my exchange with the Chairman—have the power to determine what is necessary.

Mr. KANJORSKI. And we all wish we get a very good and fair regulator, but we are—sometimes some administrations tend to appoint individuals that are necessarily enamored with the institutions they are appointed to serve in. I think there is something happening in the Senate on that issue today.

And that raises the question: How do we know what this regulator's propensity will be?

Once appointed, he will have a term and have this extraordinary power to decide that he does not like this idea of a portfolio of Freddie or Fannie, and by fiat, without a standard—does not have to show systemic risk, does not have to show anything—he can just limit that investment concept that these institutions have determined on their own, for good purposes, and in a sound way, and fulfilling their mission will have to bend their corporate decision-making authority to this regulator who may have no justification in the world other than the fact that he decides that is good practice.

Secretary SNOW. Congressman, I would set a standard. My recommendation is, you do set a standard. You tell the regulator that they can hold such paper—MBSs, mortgages, other paper, outside of treasuries—but only to the extent they need to, to have the liquidity to carry on their mission. Seemingly, that is consistent—

Mr. KANJORSKI. If we should do that, we should be worried probably even more so about the derivatives. That seems to be a major problem as to just how good the derivatives are, how effective are the counterparties, how over-invested are the counterparties.

Are you suggesting, then, that this committee and the Congress legislate regulatory authority over hedge funds and other derivative purchasers?

Secretary SNOW. No, I am not at all, Congressman.

Remember why we have the extensive derivatives. We have the extensive derivatives because of these vast and growing portfolios of investments which are subject to both prepayment and interest risks. And the GSEs appropriately say, "We have better hedge this," and this is sophisticated hedging that ends up being held by the counterparties that are five or six very large financial institutions that hold virtually all of these derivatives.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Iowa, Mr. Leach?

Mr. LEACH. Thank you, Mr. Chairman.

First, I think it very important to underscore that great credit goes to Mr. Baker and to you for bringing forth an approach the thrust of which I strongly agree with.

But I would go a little bit further, Mr. Secretary.

You have underscored systemic risk. I think there is enormous free market risk that is under the table and never raised. These institutions that come under the rubric of GSEs have advantages in the market, and they stilt the market in very profound ways.

It is not simply coming from the perspective of advantages on cost of money and the cost of funds.

They also have regulatory advantages that are profound. A small institution that competes against the GSEs for the holding of a mortgage has to carry more capital than they do. And one of the most interesting aspects of the American mortgage system is that it is quite possible, contrary to all regulatory history at this moment in time, that the larger an institution, the greater capital it needs, not the less capital it needs.

The risk gets greater when size gets to be of a different dimension. And we have had a system where bigness has meant less reg-

ulatory intrusion rather than more. At a minimum we need comparability; quite possibly you need more regulation with “the big”.

There is also this issue of once you get great powers, you tend to want to spread your wings. And one of the things that I would like to add to this bill, and I will attempt to do so, is that I believe that the same regulatory authority ought to apply to all GSEs. And that includes the Farm Credit System, it includes Farmer Mac.

There is no more egregious example of stretching government powers than Farmer Mac.

There is no more interesting model of inappropriate spreading of power than the Farm Credit System which tries to get out of serving farmers and into serving the market economy itself, using the advantages of GSE powers.

I think this committee does a great disservice not to put all GSEs under comparable regulation that is being set forth today.

Finally, I would stress again, when you give someone power at a governmentally mandated level and they grow, the oversight should not only be about prudence, it ought to have something to do with competition. It might be sensible for this new regulator that is set up should not have an FTC kind of component.

I raise these thoughts for your consideration and would ask for your comment.

Secretary SNOW. Congressman Leach, you raise some very good issues there, issues that it seems to me we ought to think about. I do not know that we have moved far enough down the road in thinking on those that we at least, from the Treasury side—maybe Secretary Jackson has thought about them more—would be in a position to come down hard and fast one way or another.

But there is a commonality to government-sponsored entities. And they do have certain advantages.

Whether the Farm Credit Bureaus and the other, the GSEs, fit this pattern in the same way, I just do not know.

What I do know about this situation, though, is that the marketplace treats the paper of these entities far different than the paper of other financial institutions because of that implied guarantee, because of the sense that the market gives that these entities are too large to fail.

Mr. LEACH. I appreciate that. My time is about over.

I just want to make one final point: The word “Farm Credit System” has the word “farm” in it. But if you took the word “farm” out and just called it “credit system,” and you look at what the entity is attempting to do, which is to serve all the functions of all banks, it is more pervasive and powerful than either the two housing GSEs and affects Treasury concentration of interest far greater than the two housing GSEs.

And from the Banking Committee’s perspective, I would stress that this issue of the Farm Credit System, as a banking institution with GSE powers, that wants to operate as a bank, not simply serving the farm economy, is very, very concerning and is potentially far more explosive than the two-housing GSE circumstance.

If we do not deal with it today, it becomes more explosive tomorrow.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman’s time has expired.

The gentleman from New York, Mr. Meeks?

Mr. MEEKS. Let me first go to Mr. Snow.

One of the things that has bothered me all throughout this incidence with Fannie Mae and Freddie Mac, et cetera, is that—and as Mr. Falcon had stated in his testimony, that they were able to recognize problems with major—where major accounting firms had certified financial statements. And some of the issues went back 20 years or so.

My question is: What do you see in this new legislation that would allow a regulator to recognize problems within a more reasonable time frame, say within a year at least? Is there anything that you see in this—the regulator, in this bill, have that problem?

Secretary SNOW. Congressman Meeks, I think the new regulator will have more robust authorities, better funding, funding not dependent on the appropriations process, and freer of all political constraints, as we envision it, and with more resources, the ability to attract more resources.

I would put it outside the civil service system. I would give them the ability to hire the people who have these skills and understanding the mathematical models that underlie the derivatives, that understand the complicated accounting that goes with derivatives.

It is essential that they get access to those sorts of people with that sort of expertise.

I think the legislation creates that environment where this would be a much more robust and muscular agency, capable of doing a lot more, capable of attracting just top-flight people, and top-flight people will get on top of these things better.

Mr. MEEKS. That being said, you know, next week, I guess as the Chairman has indicated, we are going to have a hearing on Sarbanes-Oxley, and that, I guess, legislation will be focused on auditing firms and their qualifications and responsibilities.

It seems as if the role of the auditor, not only in regards to GSEs but in corporate America, is generally falling short of being the watchdog it was meant to be.

Do you think that the role of the auditor needs to be addressed in this legislation also? For instance, should we force GSEs to rotate auditors every few years?

Secretary SNOW. Congressman, I think strengthening the general oversight, corporate governance, as has been done through Sarbanes-Oxley, clearly should apply to the GSEs in totality, including registration under the Securities Acts, which some have agreed to do but have not yet done.

So, yes, I think part of this that we recommend is required registration under the 1934 Act.

Mr. MEEKS. And one for Secretary Jackson: Since the Treasury does not have a history of understanding the needs of the housing market, what responsibilities do you believe that your agency should have in relations to the GSEs, such as its missions and goal?

Secretary JACKSON. Well, I still believe, as I said in my opening statement, that we should have the fair housing component because we have the necessary staff to address that.

And secondly, I think, clearly, the housing goals—because the goals are to meet low-and moderate-income standards, and I think that we are in a better position to do that. We are doing it now.

And in fact, as I stated to you all before, the acting chairman and the present chairman and CEO of Freddie Mac, we have worked with him and we have come up with goals we think that are obtainable, and they are working toward those goals.

But I would think we would still—those goals should stay necessarily with HUD.

Mr. MEEKS. What about program approval?

Secretary JACKSON. Well, I think program approval really could be with the regulator or with HUD.

I mean, the problem is, a new program—I think that the new regulator clearly will have on their mind safety and soundness in new programs to make sure that the GSEs conform to the charter.

Mr. MEEKS. But would not it—I mean, the experience with reference to the program, it belongs to you. Treasury has not—

Secretary JACKSON. Well, today it is with HUD.

Mr. MEEKS. And would not you believe that your expertise—I mean, you do not think that you should have some role as far as approval of programs.

Secretary JACKSON. I think so, advisory role or some role if it goes to the new regulator, clearly, because we could get with them and give them experience that we have had in this process for the last 20 years or so.

Mr. MEEKS. Last, Mr. Jackson, let me ask: Am I correct in understanding that HUD has the authority to prevent breaches of the charter of GSEs now?

Secretary JACKSON. Well, we have general regulatory authority.

You know, we have been trying, Congressman, to decide what that general regulatory authority is. We have made efforts to stop new program authorities, we have made efforts to make sure that they conform to the program limits.

But in many cases we have not been very successful because—and I am going to be very candid—because we were consistently being contested by the GSEs as to what we had the power to do.

And I can tell you, over the last 3 years that has not been the case. We have, as my mother would say, we have put our foot down and told them it is not really relevant what they think; it is the decisions that we make since we have the general regulatory authority.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from California, Mr. Royce?

Mr. ROYCE. Thank you, Mr. Chairman. Thank you very much for holding this hearing.

And I would also like to thank Secretary Snow and Secretary Jackson for their very able service to our country.

And I really want to commend you, Mr. Chairman, and Chairman Baker, for your efforts in crafting legislation to reform oversight of the three housing GSEs.

I continue to support the creation of a single new regulator with the authority to set minimum and risk-based capital standards, to place a troubled entity into receivership, to review product ap-

proval and mission, and to be independently funded outside of the appropriations process.

And I am very pleased to see that this H.R. 1461, the Federal Housing Finance Reform Act, contains all of these critical components.

Now, since the introduction of H.R. 1461, Chairman Greenspan and Secretary Snow have both testified that any new legislation should place limits on the portfolio holdings of Fannie Mae and Freddie Mac.

And in Chairman Greenspan's remarks, he said that the Federal Reserve is concerned that the large concentration of mortgage assets in the two enterprises puts the safety and soundness of the entire financial system in jeopardy.

In fact, in all my years here in Congress, this is the strongest and most stern warning I can recall coming from a chairman of the Federal Reserve. And the words from Chairman Greenspan were, "To fend off possible future systemic difficulties which we assess as likely"—as likely—"if GSE expansion continues unabated, preventative actions are required sooner rather than later."

In light of the Federal Reserve's warnings, Mr. Chairman, I would respectfully request that this committee hold a hearing on the risks associated with Fannie and Freddie holding large quantities of mortgage assets on their balance sheets before we mark up legislation.

And such a hearing would allow this committee to understand more fully the concerns expressed by the Federal Reserve chairman and by Secretary Snow.

Mr. Secretary, my question to you is: In your testimony to the Senate Banking Committee last week, you suggested that Congress give the new regulator the authority to limit portfolio growth. However, you did not recommend a statutory cap, as proposed by Chairman Greenspan.

And I remember reading a comprehensive equity research report in 2002 which forecast that together Fannie and Freddie would own \$12 trillion of mortgages on their balance sheet by the year 2020, and that this would amount to 53 percent of the total mortgage debt in 2020.

In 2002, Fannie and Freddie owned about 20 percent of mortgage debt outstanding.

I presume that you and Chairman Greenspan have seen similar forecasts.

If Fannie and Freddie one day own 50 percent, or even 40 percent, of all mortgage debt outstanding, would that concern you?

And if so, would your proposed solution to give the regulator the authority to limit portfolio holdings, as opposed to a statutory solution as proposed by Chairman Greenspan, be enough to ease systemic fear at Treasury?

The last question I wanted to ask you was: I understand that the OCC usually gets public comment before letting national banks into a new line of business. In your view, has this process harmed innovation by the national banks?

Secretary Snow?

Secretary SNOW. Thank you, Congressman Royce.

No, that review process has not harmed innovation. We have seen lots of innovation in national banks that are subject to the OCC regulation.

On the subject of the systemic risks, the concern is with the present, but it is also very much, as you point out, with the future. And the rule that I would urge you to think about hard is one that says: GSEs can hold such amounts of this paper—

Mr. ROYCE. As is necessary for liquidity? Or how would you define—

Secretary SNOW. As is necessary for liquidity.

Mr. ROYCE. How would you define liquidity under that?

Secretary SNOW. Well, I would define it the way regulators normally define it. There are exigencies that come up. There may be needs for them to step in and make the market.

And maybe—and this is a hard case to make—maybe there is some case for their holding some MBSs and some mortgages for unique circumstances. But it is hard to see that it would be very much, because treasuries provide the closest thing to liquidity, the best form of liquidity and the safest form of liquidity.

So I would think this rule would, in the hands of a good regulator, lead over time to a gradual reduction in the holdings of mortgage-based paper, and they could fulfill their liquidity needs through treasuries and such amount of mortgage-based paper that the regulators says they really need.

But I would not have the regulator make an affirmative finding that they need to hold it.

Mr. ROYCE. Thank you very much. My time has expired. Thank you, Mr. Secretary.

The CHAIRMAN. The gentleman's time has expired.

The gentleman from Georgia, Mr. Scott?

Mr. SCOTT. Thank you very much, Mr. Chairman.

Secretary Snow, I take it from your testimony that the administration does support legislation that creates an independent regulator for housing GSEs outside of the Treasury Department. Correct?

Secretary SNOW. Yes, Congressman Scott. We think the important issue here is not where the regulator is housed, but that the Congress establish that strong regulator with the powers I laid out.

Our point is that if you decide to put it into Treasury—and I take it there is not overwhelming sentiment to do that—but if you did put it in Treasury, then we suggested some conditions that we thought ought to be met.

Mr. SCOTT. Well, do you believe, then, that if the Treasury Department had full policy control of the GSEs that the markets would perceive that control as full backing of the GSEs by the government?

Secretary SNOW. Congressman, there is a risk of putting the GSE regulator inside Treasury that the market would presume the relationship of the government to these entities is strengthened and enhanced. That is the very perception that we would want to disabuse the markets of.

And that is why I am saying, if you put it in Treasury, then Treasury would need to be able to have certain oversight powers, in order to disabuse the market of that perception, that the rela-

tionship between the Treasury and the entities has been strengthened.

Mr. SCOTT. Let me ask you this also as a follow up on that point: Last week we had the Commerce Secretary and Mr. Jackson in, and I raised some points then that I just want to get your opinion on.

That was proposed that about 18 programs be shifted over to Commerce Department from housing, and in effect reduction of about 35 percent of the budget of HUD goes over to Commerce, just the idea, the plan, about \$4 billion could be transferred there.

Today we are talking of further erosion of HUD.

Do you feel that the American people would perceive this as a dismantling of HUD?

For you, Secretary Snow, I would like your opinion on that.

Secretary SNOW. Well, Secretary Jackson is probably in a much better position to address that than I am.

Mr. SCOTT. I had asked that Secretary Jackson before, in view of the fact that Treasury now is getting involved in this, particularly from the oversight and the regulation of the prior responsibility of HUD, via GSEs, Treasury now is beginning to be a part of that.

Just your opinion, do you feel that we are dismantling HUD?

Secretary SNOW. No. What I think we are doing, as I understand this—and I am not as close to this as Secretary Jackson or Secretary Gutierrez is—what I think is being done here is an effort to concentrate these programs, streamline them, and provide for the delivery of the underlying services more effectively.

Mr. SCOTT. Let me go to you, Secretary Jackson: Do you believe that H.R. 1461 will provide enough input from HUD regarding the housing goals of the GSEs?

Secretary JACKSON. No, because if we look at the present bill, the housing goal and the fair housing component is encompassed within this present bill. And as I stated in my opening statement, I believe that clearly we are the best persons to handle it.

But let me say this to you, Congressman, which I think is very important: Even today in OFHEO, even though it sets in HUD, we really have no control over OFHEO. OFHEO is basically an independent body.

And I agree that if we are going to regulate the GSEs, it has to be an independent body with the appropriate powers to do.

But then to answer the latter part of your question: No, we still believe that those two components are best served at HUD.

Mr. SCOTT. Okay, I want to take advantage of my time. I have a number of questions.

Do you believe, then, Mr. Jackson, that HUD should maintain oversight of the housing mission?

Secretary JACKSON. I really do. I think that HUD, because it has the appropriate staff, understands what the mission of the GSEs are, and we are quite capable and prepared to address those missions.

Mr. SCOTT. Now, the flip side of that: Do you believe that Treasury currently has the expertise to oversee the GSEs' housing mission?

Secretary JACKSON. Well, we are not talking about Treasury getting the program; we are talking an independent agency. And I am not sure whether any independent body at this point in time, until we can see the configuration, has that power. I cannot say no and I cannot yes.

The CHAIRMAN. The gentleman's time is expired.

The gentlelady from New York, Ms. Kelly?

Mrs. KELLY. Thank you, Mr. Chairman.

Secretary Snow, I would like to get your thoughts on BSA compliance.

As you know, currently the GSEs are exempt from BSA compliance. In the first beneficial case, others—the filing of SARs may have allowed fraud against the taxpayers to be detected sooner.

In addition, sound public policy ought to demand, I think, that all financial institutions be subject to this key component of our fight against money laundering and terror-finance.

Casinos, the post office, small community institutions are subject to the law. Yet institutions with hundreds of billions in financial assets, like Fannie Mae, are exempt.

So I would like your thoughts on this issue.

And, secondly, concerning the BSA, can you comment on the recent action taken by the OCC against Arab Bank. Might this yet be another instance of where the regulator is consistently giving a clean bill of health to a bank, found out, then, only in retrospect, that there were problems they had not identified.

I want to know what we can do to meet our objectives of a solid BSA compliance regime that prevents money laundering, provides good intelligence, protects banks and their customers from the harmful uncertainty that they are currently experiencing.

As we examine the Arab Bank issue, I am afraid that we are going to find the kind of missteps and gaps between the relevant entities, like OCC and FinCen, that contribute so much to the current jumbled regulatory environment.

I am going to be having a hearing next week, and I hope that Treasury will be there, and Treasury will be there to present their views on this. And I want to know if I can count on Treasury to be there at the hearing to discuss the Arab Bank issue.

But I also would like you to go back and talk to me about the BSA and whether or not we should apply it to Fannie and Freddie.

Secretary SNOW. Congresswoman Kelly, the BSA Act lies at the forefront of our efforts on terrorist finance, as you know. And while it is not perfect, I think we are making good inroads with it and clearly having effects.

We yield to no one in our commitment to enforcing it and enforcing it effectively and having the resources to make sure we do that.

Whether or not Fannie and Freddie should be directly subject to it is something let get back to you on, think about.

And be delighted to participate in your hearing.

On the Arab Bank, certainly OCC found some very questionable behaviors there and entered into some orders against the bank. But that matter is still under investigation, so I better not go any further in responding to it, except to say that we are monitoring it, we are vigilant with respect to it.

And we have had follow-on meetings with the Jordanians to try and make sure that they understand BSA, how it applies, and the need for the scrutiny that BSA calls for and due diligence in the conduct of the affairs of their financial institutions.

Mrs. KELLY. Well, thank you, Mr. Secretary. And I appreciate the fact that you said that you would be delighted to come to the hearing. I look forward to having you there. I think it is very important Treasury be there and present what is going on.

Secretary SNOW. I understand you are having discussions with our staff now, and if we can work it out, I certainly would look forward to it.

Mrs. KELLY. Thank you.

I yield back.

The CHAIRMAN. Ms. Kelly yields back.

The gentleman from Texas, Mr. Green?

Mr. GREEN. Thank you, Mr. Chairman and Mr. Ranking Member.

Mr. Secretaries, I am very much concerned about the power to regulate possibly becoming the power to eliminate. And I am concerned because much consternation has developed as a result of what appears to be consolidation that can possibly lead to the elimination of some programs.

We have programs that have been traditionally a part of HUD that are finding their way to another department—at least one now, two, maybe others.

And I do believe that the consternation is becoming greater as we perform additional investigations. We see that the Brownfields Grants are being moved and defunded, the Empowerment Zones, Rural Housing and Economic Development, Section 108 CDBG loans, capacity-building grants, EDI set-asides.

My concern is whether or not we are seeing the alpha of HUD's omega. Are we witnessing the genesis of revelations yet to come that will reveal that we had this opportunity to save a program that has been of great benefit to the American people, but somehow we missed the opportunity and at some point later we will be sitting here deciding whether there should be a HUD at all.

Mr. Secretary?

Secretary JACKSON. Thank you very much, Mr. Congressman.

To me those are two clearly separate issues.

The shifting of the block grant to Commerce is quite different than the proposal before us that has been presented by Chairman Baker in the sense that I have said that we still believe that the fair housing goals for the GSEs, the new fair housing goals, and the housing review of the appropriate housing goals should stay with HUD.

But as a whole, moving OFHEO to an independent regulator does not at all disturb me, because, clearly, OFHEO does not have all of the necessary powers that is inclusive in this bill to make sure that the GSEs are regulated. And that is all we are saying.

We want the GSEs to be as strong as possible. And I think Secretary Snow has said it. But at the same time, as I said when I was before the Senate committee, this belief that they have the tacit backing of the federal government has given it a great deal of leeway.

And let me give you an example of what I mean.

If you deal with most commercial bankers, the most that they can leverage their money is 11 to 1. The GSEs have been 50 to 1. That is the advantage.

And I am saying to you that if it is going to be brought in compliance, we must have a strong regulator, and that regulator's name might not be OFHEO. It might be something else.

But the point is, I think, really, it needs to be regulated.

And that is not to destroy them; that is to keep them strong.

Mr. GREEN. I yield back the balance of my time. Thank you.

The CHAIRMAN. The gentleman leads back.

The gentleman from California, Mr. Miller?

Mr. MILLER OF CALIFORNIA. Thank you, Mr. Chairman.

Welcome, Secretaries.

My question is for Mr. Jackson: Freddie and Fannie are chartered to operate in every district across this country, and they have a difficult time operating in my area. If you look at Hawaii, Alaska, Guam, Virgin Islands, conforming in that area is about \$539,475. Yet in Hawaii, Honolulu, the medium home price is \$460,000.

In Orange County, California, the medium home price is \$627,500. In L.A. County it is \$470,990. Even L.A. County is \$10,000 higher than Hawaii. And the current limits are \$359,650.

How can you ensure the high-cost areas of the country are served by conforming loan-limit market?

Secretary JACKSON. I would think that, clearly, we cannot have a set conforming loan limit, the same as I have said we cannot have a nationwide fair market housing rent. It is impossible, because, clearly, the obstacles that you face in California are certainly different than what we face in Texas.

So, therefore, I would say the regulator must have the flexibility to work with the specific areas to make sure we address those needs. And in your case, it is very, very critical that the regulator has that flexibility.

So I would say absolutely not the same thing as I would say with capital. I think the regulator should be flexible.

And the question was asked, Mr. Chairman, "Well, how do we know the regulator will be prone to do that?"

Well, I would hope that any regulator that we put there would have the expertise and the fairness to look at it, the same as the Chairman of the Federal Reserve or the OCC. And when we chartered those, we did not know who the persons were going to be at that point in time. But they have worked out very well.

And that is the confidence and faith I have in this country, that when we look at the new regulator, their job is to regulate based on what is best for this country, not what is best for an individual.

Mr. MILLER OF CALIFORNIA. If they are given the discretion to adjust limits, what would you envision a process to be?

Secretary JACKSON. I really cannot tell you today.

Mr. MILLER OF CALIFORNIA. Would you, then, suggest that we include high-cost areas in statute? Would that be more appropriate? Or would you allow the leeway for them to go to high-cost areas and raise it?

Secretary JACKSON. I would say statute-wise, because when we are talking about California or New Hampshire or Maine or

Vermont or Massachusetts, the high-cost might be \$550,000 today, but next year it might be \$575,000, and the year after that it might be \$600,000.

Mr. MILLER OF CALIFORNIA. But you do believe it has to be addressed.

Secretary JACKSON. It has to be addressed, because otherwise, we would be doing your constituents a disservice, we would be doing the Ranking Member's constituents a disservice. I mean, because, clearly, we have a unique situation in both places.

Mr. MILLER OF CALIFORNIA. Would you say that applying to FHA currently is \$312,895, which nobody in our area can qualify for FHA, where that is needed in many cases, and yet applying to them also?

Secretary JACKSON. Yes, it clearly is. And we just did it a couple of months—well, about 4 or 5 months—in Nevada, because we clearly knew we were out of sync.

Mr. MILLER OF CALIFORNIA. Temporarily I would like to yield to Ms. Kelly. She had a question at the last moment.

Mr. FRANK. Well, would the gentlemen yield to me, briefly?

Mr. MILLER OF CALIFORNIA. After Ms. Kelly, I would love to.

Mrs. KELLY. Thank you very much, Mr. Miller.

I just wanted to ask the Secretary: I understand that Treasury today has taken a very important step in designating a financier of the al-Zarqawi network in Iraq, an individual named al-Hiyari. I want to know if you could elaborate a little bit on that. I think that people here are interested in it.

Secretary SNOW. Thank you very much, Ms. Kelly.

Yes, today we have—at about 10:30, while this hearing was under way—designated a Zarqawi financier, Mr. al-Hiyari, who has been providing support for the Zarqawi network. We did this pursuant to the executive order, 13224, which is aimed at freezing the assets, designating and freezing the assets, of terrorists and their financiers.

This is one more important step in our efforts. It is the third in a series of strikes by the government to undercut the foundations of the Zarqawi network.

This fellow, al-Hiyari, to Mr. Zarqawi two decades almost, back to late 1980s, when they met in Afghanistan.

This is another important step on the part of the United States government in taking actions to deal with terrorist finance.

I thank you for the chance to mention that.

Mrs. KELLY. I congratulate you on taking that step.

Mr. MILLER OF CALIFORNIA. You are taking my time.

Mr. Frank, I yield.

Mr. FRANK. Thank you.

I just wanted to thank the Secretary, first, for the graciousness of including my district, and you are right.

And also just to express my appreciation with answers to the gentleman from California on both FHA and Fannie Mae and Freddie Mac.

I think you are right that we can be flexible out there, so there ought to approach, and I thank you for that. And I thank the gentleman from California—

Mr. MILLER OF CALIFORNIA. Thank you, Mr. Secretary.

Mr. SHERMAN. Mr. Chairman, if I could just say amen.

The CHAIRMAN. The gentleman's time has expired.

Mr. FRANK. I am not sure under the Constitution you can, but you go ahead anyway.

[Laughter.]

The CHAIRMAN. The gentleman's time is expired.

The gentleman from Massachusetts, Mr. Capuano?

Mr. CAPUANO. Thank you, Mr. Chairman.

Gentlemen, I generally do not have a whole lot of specific concerns with the bill. I am not terribly thrilled with changing some of the proposals that would allow the regulator to set policy goals. That bothers me a lot. I think policy should be with policy-makers and regulation should be with regulators. But that is a specific item that hopefully we can work out over time.

And honestly, I do not disagree with any of the regulator items that you have raised. I mean, I like strong regulation. I used to think that was Democratic philosophy; I guess now it is a Republican one as well, and that is a good thing.

I have no problem with strengthening the regulators. I actually always thought that the regulators that were there had the power to do something and chose not to do it for several years. That is not a problem with the legislation; that is a problem with the individuals who are the regulators.

And I am particularly of that opinion in the last couple of years when the regulators finally did step up and do their job.

But all that being said, on some levels I do not really care where regulators are, I do not really care what you call them, I do not care where the chairs on the ship as long as they are there.

But I am concerned about housing markets. And my question to you is relative not for the regulation aspect of it but more to the scope of allowed activity for the GSEs.

And, again, not because I am interested in specific scope of activities, that is of no concern to me. The only concern I have is: What is the impact on mortgage rates.

And I am specifically starting with mortgage rates for the average applicant—and we are now, give or take, I do not know, in the 6, 6.5 percent range, if I remember correctly.

If this legislation were in place and activated in a manner that would satisfy you two gentlemen, have you looked at what the mortgage rates would be today?

Secretary JACKSON. Congressman, I really do not think that it is going to adverse or negatively affect the market.

I think a few minutes ago I said to you that if we decide—if the regulator decided to limit the mortgage-backed security that the GSEs owned, that would not have a significant effect.

When people prepay their loans, their mortgages, it would just go away, and they could continue to make loans that should be made to low-and moderate-income people at the same level.

We looked at it—

Mr. CAPUANO. So you are satisfied that—in general, I am not going to hold you to decimal points—that people today would be able to walk into their local bank, apply for mortgage and get it on the same rates as we have today.

Secretary JACKSON. Because I believe—and I said this before your committee before; I think the Ranking Member asked—I think that Fannie Mae and Freddie Mac will be very competitive.

Mr. CAPUANO. Mr. Snow, do you agree with that general assessment?

Secretary SNOW. Congressman, I absolutely do. Because remember, we are saying that all the liquidity they need to carry on their primary mission should be available to them. And that is a directive I would urge you to give the directorate of this agency, that they be allowed to have all the liquidity they need to carry their—

Mr. CAPUANO. And I presume that is just not rates but also terms as well, because that is just as equally—

Secretary SNOW. This legislation should not adversely affect the terms or rates on which mortgages are available.

Mr. CAPUANO. Fair enough.

I would also ask, again, a similar question along the same lines. The availability of those loans, as well, to the people who are qualifying for those loans. It will not do me any good, if the rates stay the same, if my constituents are no longer qualified to apply because I do not have sufficient income or whatever the changes might be.

So to me it is rates, it is terms, it is qualifications, and I just want to make sure we are clear.

Secretary JACKSON. And we agree with you.

Mr. CAPUANO. Thank you.

I guess the last part of it is, again, I understand fully well—I think that the Ranking Member made some good points as far as I would love to see Fannie and Freddie and anybody else step up to the plate in affordable housing because I think—it is not the only thing I focus on. That is why I focused on rates for people who do not qualify for affordable housing.

I think it is a whole ladder of housing. But affordable housing is part of that ladder.

And the availability of capital to support affordable housing—we can argue about the policies and who should give them and everything else—but the capital available, I also want to make sure that you feel that this legislation would not adversely impact the amount of capital that is on the table that is available for those items.

Secretary JACKSON. Congressman Capuano, no, it would not.

And let me say this to you: Not only do you feel that way about affordable housing, President Bush has emphasized to the GSEs the importance that they lead the market in carrying out their mission. And my responsibility is to make sure that they do, and we are doing everything within our power.

And I must say this, on behalf of the acting chairman at Fannie Mae and the Chairman and CEO at Freddie Mac: Over the last 12 to 14 months, they have been working very well with us to try to address and meet those goals. I think that it is finally settled, or they finally realize, that not only is the President and the administration serious about this, but Congress is serious about it also.

The CHAIRMAN. The gentleman's time has expired.

Mr. CAPUANO. Mr. Chairman, I would just like to get Mr. Snow's answer to it as far as—

Secretary SNOW. I agree with Secretary Jackson.

Mr. CAPUANO. Thank you.

The CHAIRMAN. The gentleman from Texas, Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman. First, I want to commend you and Chairman Baker for bringing this very important piece of legislation before us today.

Secretary Jackson, it is good to see you again once again. The last time I looked, I think we are enjoying the highest rate of homeownership in the entire history of the United States of America. So contrary to some opinions, you must be doing something right.

Secretary JACKSON. Well, we are enjoying it because the President has put in motion the necessary tools for us to increase homeownership. We have Congresswoman Katherine Harris, who was very, very helpful to us in the American Dream Down Payment Act, which helps 40,000 families a year become new homeowners, because we can help them with the closing costs and down payment.

And we have a number of other avenues that the President has put in place to make sure that low-and moderate-income people and middle-income people understand the responsibility of being homeowners, and it is working.

Mr. HENSARLING. Thank you, thank you.

The question I have has to do with what some call "mission creep." And one of my colleagues brought up whether or not there is a meeting of the minds on regulation between both sides of the aisle.

The concern that I have is that obviously Congress has granted the GSEs some very special benefits, but ostensibly the quid pro quo is that they use these benefits purely to engage in what is their charter-approved activities.

So in your testimony you speak, I believe previous international consulting work that was done by Fannie, third party real estate-owned management and services activities. I think previously they have engaged in airplane lease activities, activities related to loan originations, for example, automated underwriting systems.

We know they are engaged in retail brand-building, because you cannot watch the television without seeing one of their excellently produced television spots.

But it would seem to me that all of this would detract from what their charter says they are supposed to be doing with these government-granted benefits. And I am also concerned about the unfair competition, because I believe that indeed the consumer's best friend is a competitive marketplace, and if they are going to leverage these benefits into non-charter activities, it is not a level playing field.

So my first question is: Is this an ongoing problem with the GSEs in seeing new activities that are not specific to their charter?

Secretary JACKSON. It has been in the past, but let me say this to you: We have taken a firm stand, as I said a few minutes ago to another congressperson, that when we see these kinds of activities taking place, we are stopping them very quickly.

We believe the same as you do, that they should address their mission, and their mission is to provide low-and moderate-income secondary mortgage liquidity to the market. And that is what we think they should be doing. And when we find them doing things that they should not we are going to stop them.

But at the same time, I want to reiterate again, because I think that the last 12, 14 months the kind of cooperation that we have gotten out of the GSEs is much better, and our relationship is much more amiable than it had been before.

Mr. HENSARLING. Well, we have a couple of pieces of legislation out there now dealing with new product approval. And certainly in the House version of the bill, some might argue that there is not as bright a line test between the primary and the secondary market, as some might argue would be in the Senate language.

So in your opinion, given that you have had to exercise some discretion over new product approval, is the line sufficiently bright in the House language for the new regulator to get the job done?

Secretary JACKSON. From reading the language that Chairman Baker has done, to me it is clear that they delineate between the primary and secondary market.

Now, I have to tell you, the GSEs have—we have had serious debate about some of the programs, because they will not call them products, “new programs,” and they said they are not in the primary market. We believe that they were.

And we are saying now that, clearly, when you look at the bill, it says “activities,” “all activities,” which in this case, they will not be able to use the logical argument, “Well, this is a program, not a product. This is not a new product.”

So I think, clearly, it will be delineated in the new bill.

From my understanding, their responsibility is the secondary market.

Mr. HENSARLING. In the seconds I may have left, if I could switch to Secretary Snow and talk about systemic risk.

With respect to GSEs’ portfolio holdings, I would assume they would argue that somehow they are adequately hedging the various risks that are involved, the default prepayment interest rate. But your concern is, is that most of these derivatives are held by perhaps by five or six firms. Can you elaborate on the systemic risk that this presents?

Secretary SNOW. Yes, yes, Congressman.

The systemic risk comes from the fact that so much of the GSE paper is out there in the marketplace, held by all sorts of financial institutions—insurance companies, pension plans, community banks, thrifts, commercial banks.

And on the derivative side, since they have these large portfolios that are subject to down payment and interest risks, they have to hedge it. They should hedge it.

The counterparties to those hedges are concentrated in five or six very large financial institutions, and the aggregate amount of this hedging is gigantic. The concern is, if something unravels, it could cause systemic risk to the whole financial system.

The regulator needs to have the authority to look at systemic risks, not just housing soundness and safety but systemic risks

generally. I think the legislation does that, and I think it is awfully important that it stay in the legislation.

The CHAIRMAN. The gentleman's time is expired.

The gentleman from Missouri, Mr. Clay?

Mr. CLAY. Thank you, Mr. Chairman.

I thank both of the witnesses for being here.

First, for Secretary Snow: Chairman Greenspan has recently argued that the portfolios of the GSEs are too big. He has suggested that they may have to be reduced to maybe \$100 billion. Mr. Greenspan has defended higher mortgage interest rates as a positive development and that capital would be made available to consumers who otherwise cannot get mortgage loans.

The St. Louis Post Dispatch writes that this is like saying the inner-city poor should be thankful for the high interest rates because nobody else is providing the service.

Do you feel the same way, Mr. Secretary?

Secretary SNOW. Congressman, on that issue of the limits and how best to approach the limits, I agree that the holdings of the mortgage assets should be constrained, should be limited, and I think what the Chairman said is that one option was to do it through legislation. I do not think he said that was the better option.

We think it needs to be constrained, and I would suggest that the appropriate way to do it, as I have suggested, is by giving the regulator broad authority against a directive that they not hold more than is required.

Mr. CLAY. Well, do you favor a 90 percent reduction in the portfolios of the GSEs?

Secretary SNOW. No, I would not put that in legislation, but I would allow the regulator, this expert regulator that would be created by the statute, to render whatever judgment regulator, after due process, felt was appropriate.

Mr. CLAY. Mr. Secretary, do you believe that the inner-city poor should be thankful for having to pay higher interest rates? Secretary Snow?

Secretary SNOW. I do not think anybody should be thankful for having to pay more than a competitive rate for anything.

Secretary JACKSON. That is right.

Mr. CLAY. Okay, just to make you aware. Secretary, thank you for your response.

Secretary Jackson, the St. Louis Post Dispatch also stated that the question should not be whether mortgage lending is occurring in underserved communities but whether minority consumers are being ripped off through unjustifiable, high interest rates and fees.

They also quoted a study by the National Community Reinvestment Coalition that says about 29 percent of African Americans who bought or refinanced homes last year were stuck with high-cost loans compared with about 10 percent of whites.

Will the change to the GSEs help alleviate this condition? And are these disparities in interest rates considered in this proposal being advanced in the handling of the GSEs? And will the situation worsen? What do you think?

Secretary JACKSON. I cannot tell you about the language in the present bill. I can tell you what we are doing at HUD to address

predatory lending, which is exactly what you are speaking in terms of.

Mr. CLAY. Sure.

Secretary JACKSON. We do not condone it. We have been absolutely—we have just tremendously been dealing with this issue almost since day one, when we got here.

I just do not believe that in the refinancing process that the education of many of the persons who are doing the refinancing, or buying their first home, has been very, very good. That is why that when we came in here, came to office, there was \$8 million being spent on counseling; today we are spending \$45 million to work with people so, Congressman Clay, we will not have that situation.

That is appalling. I read the study, and it is not a good study. I have talked to the people in Planning, Development and Research to come up with a solution how HUD can better curtail what has been occurring.

Secretary SNOW. Since I am running out of time here—as we emphasize reducing the size of the portfolio held by the GSEs, has anyone measured the positive effect that Fannie Mae and Freddie Mac have had on increasing minority homeownership through their programs and through their influence on the entire industry regarding minority homeownership.

And then what happens now? We are basically changing the mission of these GSEs.

Secretary JACKSON. We are not changing the missions.

Let me say this to you, Congressman. Though, I do not want in any way contradict you, but Fannie does not have a sparkling record of addressing first-time minority homebuyers. It has a dismal record compared to the other industry.

If you look at the other commercial banks, there are many of them that are doing much better addressing minority homeownership than Fannie Mae and Freddie Mac.

Now, we have been working with them and we will continue to work with them, but I do not want you to be under any illusion that they have been leading the market, they have been even coming close to leading the market in the process. They have not been. And that is one of the criticisms that we have had with Fannie.

Mr. CLAY. Well, don't you think we pretty much brought them all along kicking and screaming?

Secretary JACKSON. No, I can tell you some of the commercial banks are not kicking and screaming.

Mr. CLAY. The results of this study, Mr. Secretary—

Secretary JACKSON. I am telling you some of the commercial banks are not—

Mr. CLAY. Do you want to name some?

Secretary JACKSON. No, I am not going to name any today.

Mr. BAKER. [Presiding.] The gentleman's time has expired.

Mr. CLAY. Thank you, Mr. Secretary.

Mr. BAKER. Thank you, Mr. Clay.

Mr. Garrett?

Mr. GARRETT. Thank you, Mr. Chairman.

And thank you, Secretary Snow and Secretary Jackson as well.

I am pleased today that some of my colleagues agree with myself and also with Chairman Greenspan, as one of the main focuses of

our debate here should be to dealing with first and foremost the rapid growth of the portfolio of these entities, and also as Mr. Hensarling just mentioned, also the issue of mission creep as well.

Chairman Greenspan has previously testified here that the limitation or the slowdown in the portfolio size should occur over a period of time, and you have already, Secretary Jackson, addressed that issue, doing payback and what have you.

Is this something that we need to look at over a long period of time? Or could we simply look at it today to say that they have no role for them to have this portfolio of this size and that we could simply say that they should stop immediately adding to the portfolio and let the rest of it simply pay itself off over a short period of time?

Secretary SNOW. Congressman, that is sort of the approach implicit, I think, in the legislation.

Secretary JACKSON. Right.

Secretary SNOW. And over some fairly short period of time, if they are not adding to the portfolio—which I think would be the policy implicit in the statute that you are looking at then the portfolio would wind down. And it should wind down to a level that is consistent with achieving the statutory purpose, giving them the liquidity they need from these instruments to serve their underlying statutory purpose—

Mr. GARRETT. And no more, though.

Secretary SNOW. And no more, because I agree with you: The real issue here is the rapid growth of the portfolios.

Mr. GARRETT. Right, and Secretary Snow, you had indicated that, to put it one way, size does matter as being the main problem as far as the interest rate risk as far as portfolio size.

And if you look at some of the numbers at the end of last year, you were looking at \$757 billion in derivatives, that was more than the \$732 debt that they held.

We have to look a ways back to get any financials out of them, of course, to see what they say. But if you go back to June of last year, they were looking at a trillion dollars in derivatives, again in excess of the \$940 billion in debt that they had at that period of time. So size is certainly an element here.

But I would suggest that in addition to the size aspect, even if they were to bring it down to a certain element of size to it, is not there an aspect of this that they have been engaging in cherry-picking?

And in the portfolio that they have engaged in, keeping the better risk, from their point of view, as far as their stockholders are concerned, by keeping those who are not prepaying, which for the short-term benefits them and benefits the stockholders, because it adds to the bottom line because you do not have the prepay, but for the taxpayers, we are put on the risk because that there is a greater interest rate risk at that point of time.

And then what happens is—and you can comment on this—is that you shift the bad risks over to those securities that are over at the other side of the table where they are securitizing them, and by doing so, that you are adding a premium to those securities, and that that has added to the cost to the consumers.

So in essence, they are cherry-picking, benefiting their bottom line, benefiting their stockholders, benefiting their profit line, hurting the taxpayer, and also—and this goes to the question, that is why I bring it up, it was just said on the other side—that if we do not do something, that they will continue to add this premium to the other side of the securitization.

Secretary SNOW. Congressman, the fundamental problem is that the dynamics of the business therein, structured as it is with the implied guarantee, creates an incentive for these entities to continue to buy paper, market-priced paper, because any market-priced paper they buy other than treasuries is a good arbitrage.

Any, that they buy, any interest rate instrument they buy, creates an opportunity for above-market rate of return, because their borrowing costs are low relative to the returns on that paper, except for one instrument: that is treasuries.

That is why we think that for liquidity needs, their focus ought to be on treasuries to deal with the systemic risk.

Mr. GARRETT. I appreciate that.

And perhaps Secretary Jackson could address the point.

But what they are doing, though, is by the other side of the equation, is that the risk that they are putting into the securitization aspect of it are these risks that do have the earlier pre-payback basis to them. So those people who are then in the market that are buying those securities know that this is not as good a risk as the risk that they are holding, and therefore there is a premium added to that.

Secretary JACKSON. That is correct.

Mr. GARRETT. And that goes to the question that was raised over here: Is not this bad for the consumer, what they are doing? No matter what level of securities they are holding in their portfolio, if they are allowed to continue to cherry-pick that portfolio, this is bad for the consumer.

Secretary JACKSON. Yes, sir.

Mr. GARRETT. The other aspect to this—Mr. Hensarling got to the aspect of secondary markets and primary markets, and I guess you are addressing this, saying this is going to be addressed in the legislation.

I would just close by saying the administration has certainly said that we should be looking towards a more competitive and private sector approach to all this, and of course you have already said, Secretary Jackson, the private sector is doing a better job.

Can we look to you to come back to us with additional avenues that we could go to the private sector to encourage them to be able to compete on a fair, level playing field in this market?

Mr. BAKER. And that has to be the gentleman's last question.

Secretary JACKSON. Yes, I will be happy to do that for you.

Mr. BAKER. I thank the gentleman. His time has expired.

Mr. Cleaver? No questions?

Mr. Davis is not here.

Ms. Harris?

Ms. HARRIS. Thank you, Mr. Chairman. Thank you for holding this important hearing.

To our speakers, thank you for being here and for all your important answers.

I would like to address three quick questions to Secretary Jackson.

Fannie and Freddie are playing critical roles as the administration strives to increase the rate of homeownership in low and moderate households. And I appreciate all of your efforts and all the great ideas. You have worked with me and our district so closely.

But achieving this goal is going to require Fannie Mae and Freddie Mac to develop programs for these underserved markets. And I share concerns with the gentleman from Massachusetts when we ask what measures that Congress can undertake to ensure that this mission remains their central objective—first quick question.

Secretary JACKSON. We have put in place housing goals that are measurable, both for the primary and secondary market—and I do not mean in the sense that it is primary or secondary. But we have three specific goals that deal with the different sectors of society, with low-and moderate-income communities, low-and moderate-income households, and we measure those goals.

And I think that sitting through with Fannie and Freddie over the last year, we made some adjustments, and we think that those goals can be met. And we are meeting with them periodically to make sure that those goals are being met.

Ms. HARRIS. We are desperate in our region for affordable housing when we read that affordable housing is a \$290,000 home. So obviously, our first responders, teachers, everyone needs that type of opportunity.

But as you are increasing these housing goals for both Fannie and Freddie, is not it going to force the GSEs to engage in a little bit more risky opportunities? And don't you think there should be some sensitivities as to how that impacts their safety and soundness?

And don't you think it makes more sense that there would be one authority that would be governing or weighing those two conflicting issues, one against the other, so there is that kind of accountability as we move forward?

Secretary JACKSON. Let me say this to you: I have heard before that if we stress that they meet the housing goals serving the low and moderate market that it is going to affect their abilities.

Well, I will just pose a question as I posed a year ago: What affected their abilities to carry out their responsibilities more than those derivatives? That is affected their abilities, not serving low-and moderate-income people.

And if you notice today, Fannie and Freddie are not making that argument to you all again. They made it a little over a year ago, but that is not an argument they are making. We worked through it, and I think they will be able to do it. And they can still serve the high-end and the middle market just as well.

Ms. HARRIS. I am extremely interested in the low and moderate, that there are affordable opportunities.

Concerning the bright line, the mortgage brokers have approached me. I really would like to know kind of what you believe is the intent of that.

In my discussions, it is clear that there are distinctions between the primary and secondary markets. But they are concerned that

there will be a negative impact on their ability to provide these kind of immediate services for eligibility.

They believe that those loan creations are going to really fall more closely in the hands of the large banks, and right now that could extend the time frame up to 90 days in terms of loan approval, which would be devastating to our housing markets.

They still believe that they are the most efficient delivery of services, and so consequently, I just really do not understand that intent. They feel they will be precluded from those loan originations, and that efficiency would be devastated.

Secretary JACKSON. You know, Congresswoman, I really cannot answer that specifically, but it would seem to me that competition is absolutely good. And the only thing that I see in Chairman Baker's bill is he is saying: We are going to delineate what the GSEs' responsibilities are between the primary and secondary market.

I just think that the competition will be there, and they will still be able to serve the market. And I could be wrong, but I do not think I am.

Ms. HARRIS. We will have further discussions with the Chairman. I am sure he can help us out with those answers.

Thank you.

Secretary JACKSON. Thank you.

Ms. HARRIS. One quick question for Secretary Snow: The demand for the GSE to create in the market more mortgage—they always say that the more mortgages, that that will help drive down the mortgage costs. And have you taken a look or are there any studies that determine what the impact on mortgage rates would be if the hard cap were enacted?

Secretary SNOW. If what?

Ms. HARRIS. The more mortgages that exist, the more competitive, how it drives down the mortgage rates. So if a hard cap is enacted, is that going to lessen the amount of mortgages?

Secretary SNOW. I think I can say without much fear of contradiction here that all the evidence and all the theory suggests that limiting their holdings of mortgages, as we suggest, or of mortgage assets, as we have suggested, will have little or no effect on the mortgage rates. Because, remember, our focus is to say they should hold what they need but no more to have the liquidity to pursue their primary purpose.

So we would allow them to hold what they need, as determined by the regulator, to have the liquidity to make that secondary market. So they would continue to play the large and significant role in the secondary market they play today.

In fact, they might begin to play a larger role, because now, rather than making money off the arbitrage in their portfolio, taking their low borrowing costs and then buying other market-based paper, they would have an incentive to focus on their primary mission: making the secondary market.

Mr. BAKER. The gentlelady's time has expired. I thank the gentlelady.

Mr. Paul?

Mr. PAUL. Thank you, Mr. Chairman.

I have a question for Secretary Snow.

You know, there is a free market axiom that says that when government intervenes in the market, they sometimes solve the problem and sometimes they do not. But they inevitably create two new problems which requires two more regulations. And I happen to believe that.

And the gentleman on the other side of the aisle earlier mentioned that he thought that the Democrats were the good regulators, but he was very pleased to know that we have joined the crowd and that now we are the regulators.

And that suggests to me that the problem we face with the GSEs is that we believe that it is come about because of lack of regulation, and all of a sudden, if we have more regulations, we are going to solve our problems. And I think it is much deeper than that.

You mentioned that the—and I think everybody has conceded here that the size of the holdings is a significant problem, and it introduces the notion of risk. And I would agree with that. But nobody seems to be asking the question: Why are they so large?

You know, we are dealing with—this to me is somewhat like thinking back in January of 2000, and there were many who predicted that there was a Nasdaq bubble. And they said, “Well, we have a Nasdaq bubble, and we are going to have a collapse, and we need to do something about it, we need to regulate it so that we do not have a collapse,” which the bubble was already there.

And if we have the distortions built into the system, regulations may even help precipitate a major crisis or a major change if we do not look at it.

And I would suggest that there are two major reasons why we have this huge size of the holdings of the Fannie Mae and Freddie Macs, and that is, one, it deals with Federal Reserve policy that makes credit easy, interests rates low, it causes the speculations the same as it has in stock markets in the past.

And of course, I know you are not in charge of interest rates, and we cannot deal with that, but we have a line of credit to the Fed and to the treasury, which you mention in your written report, that it is not a guarantee, it is only a perception. But markets’ perceptions are just about everything on the short run because they are anticipating what the benefits are.

So I would say that if that is part of it, why do not we deal with that and move toward a market, and say, “Why do not we limit that or get rid of it?” because that helps to build these giant holdings.

And I think that, to me, would be so much more important than waiting for the day—interest rates may be controlled by the Fed on the short run and in the short term, but ultimately the market overtakes.

And we are dealing with a major problem with the dollar. If the dollar goes down, which many people predict it will, especially with our current account deficit, we are going to see rising interest rates. And if there truly is a bubble—as those who have predicted correctly about the bubble in the Nasdaq—if it is there, I think we face a lot more serious problems than just dealing with a few more new regulations and think we are going to solve it.

If you would comment, please?

Secretary SNOW. Yes, I will be happy to.

You asked, why the rapid growth? I think that the single most important factor in the rapid growth of these portfolios is the fact that beginning about 1990 or so, the entities decided that there was a very sizable profit to be made from simply arbitraging their lower borrowing costs against holding other market-priced paper, and, in effect, became in many ways like a hedge fund simply arbitraging a cost advantage in one market to get higher returns in another.

And you are absolutely right, Congressman Paul, that the problem here is the growth of these portfolios. And our concern is, without a strong regulator, there will be ineluctable pressures here for that portfolio to grow and grow and grow and grow, because the incentives are so large when you can borrow at a rate lower than anybody else and then invest in another market, in any market-priced paper, and make a large profit.

That just creates huge incentives to continue to take out loans and then turn around and buy the mortgages and the mortgage-backed securities.

Mr. PAUL. Does that mean that you would be sympathetic to removing that benefit they have, this line of credit to the treasury, as Alan Greenspan has suggested?

Secretary SNOW. Congressman, yes. In my testimony, I said we would only use that line of credit in furtherance of a receivership where it might serve a useful purpose. But other than that, absolutely.

Mr. PAUL. Thank you.

Mr. BAKER. Let me make an announcement for the benefit of members. Secretary Snow has informed me of a need to depart here by 12:30. I do have three members in regular order who would be recognized. I know others have an interest in a second round, but we are going to proceed in regular order—Mr. Davis, you are next—and I will try to enforce the five-minute rule to make sure all members get recognized.

Mr. Davis?

Mr. DAVIS OF KENTUCKY. Thank you, Mr. Chairman.

First of all, I want to commend you and Chairman Oxley and the Ranking Member on bringing this bill forward to introduce the Federal Housing Finance Agency. I think it is important that we restore credibility to our government agencies and trust in them.

My question is for Secretary Jackson, kind of a follow-on to Congressman Hensarling's questions earlier, two points around that.

The proposed regulatory authority I think has the much needed just common sense guidelines in terms of authority to set minimum and risk-based capital levels, approving new programs, placing failed GSEs in receivership, which I think is an important statutory authority, among other things.

And one question is, we have talked about primary and secondary market operations so that I am curious. The administration has been very forthright, very pro-small business community development, encouraging homeownership in many ways. You and I have had some discussions on this as well.

Secretary JACKSON. That is right.

Mr. DAVIS OF KENTUCKY. And I guess my first question would be: Do you believe that the new agency should define what are primary

and what are secondary market operations in order to, you know, better understand the types of programs that should be permitted and what should not, to avoid the type of snowball effect that we had with Fannie Mae?

Secretary JACKSON. Yes, I do. I do believe that that is important, and having briefly read over the legislation that is put forth by Chairman Baker, I think that makes a good delineation of what is primary and what is secondary.

Mr. DAVIS OF KENTUCKY. I guess my follow-on to that: Since you all have advocated these very open market policies and the idea of less regulatory intrusion, do you think that it would follow logically that you would want to curtail the encroachment of government-sponsored enterprises into the private sector to the detriment of businesses from the standpoint they do not enjoy some of these special governmental privileges?

Secretary JACKSON. I think they should be put in a position where they have to compete.

It is clear to me, Congressman Davis, that if you get an allocation from the treasury, and 33 to 35 percent of it goes directly to your shareholders, and then the other portion is used exactly as Secretary Snow said, to buy down loans at a lower price and sell off the others, it does give you an advantage, there is just no question about it.

And I think that if they are forced to compete in the market with a strong regulator saying that "This is the way you are going to operate," yes, I think the competition will still be there. But at the same time, it will not diminish their ability to carry out their charter.

Mr. DAVIS OF KENTUCKY. I appreciate that.

The concern I have had is that, particularly knowing Dave Hehman, who is the CEO of the Federal Home Loan Bank in our region, in the Cincinnati region, the home loan banks run a totally different operation.

Secretary JACKSON. Absolutely.

Mr. DAVIS OF KENTUCKY. They tremendously serve the market sector. In fact, Mr. Hehman is actively involved in urban housing initiatives to get working families into housing. It is a much more true and friendly face of compassionate conservatism, I think, in terms of involvement in the trenches.

And my bigger concern is making sure that they compete openly and fairly and serve a specific market sector, but to make sure that the other GSEs toe the line and are good stewards of our taxpayer dollars.

Secretary JACKSON. And let me say this: The Federal Home Loan Banks have a regulator, and he can make the necessary adjustments, and you can see it right now in a number of the Federal Home Loan Bank boards, which is quite different than the other two GSEs.

And the other thing, as I said a few minutes ago, with him setting aside the affordable housing goals, they have done a very excellent job in making sure that they are carrying out that, which was not initially part of their mission.

Mr. DAVIS OF KENTUCKY. Thank you very much, Mr. Secretary. I yield back my time.

Mr. BAKER. I thank the gentleman.

Mr. NEY?

Mr. NEY. Thank you, Mr. Chairman.

Because my time is limited, I just want to get a couple of major questions in. So I am not going to cut you off on certain things, but I want to just try to get as much in as possible.

A lot of people are suggesting, or some, that there should be a bright line between the primary and secondary mortgage markets?

This is for Secretary Jackson.

Do you support this? And if so, should Congress or the regulator define the bright line?

Secretary JACKSON. Yes, I do support it. And I think that clearly it should be defined, in my mind, in the legislation, because we have tried in many cases to deal with the situation, as you know, between new products and new programs, and that has been a very difficult process.

Mr. NEY. So do you think this should be part of the program approval?

Secretary JACKSON. I think in this present legislation, it is within the legislation introduced by Chairman Baker.

Mr. NEY. Something I found surprising with your testimony—and this has nothing to do with you personally as Secretary reversing any position, but it is a position reversal, which I am not saying is bad in my mind, from previous, probably a year ago—but you mentioned in your testimony that HUD's expertise in developing and enforcing the housing goals makes it appropriate for the department to retain the authority to set the affordable housing goals.

I think before, it was going to be moved from the department—this is prior to your being Secretary—but it was going to be moved from the department. What changed everybody's mind? I am just curious.

Secretary JACKSON. Well, I think if you look at the last 12 to 14 months where HUD has really asserted its authority, and we have had to work with the GSEs, and they realized for the first time that we were serious about meeting our—well, I will not say the first time—that we were serious about having them meet the housing goals.

It was clear we have the expertise, and we utilized the expertise in the way that it should have been utilized for a number of years. And therefore, I still think that we are the appropriate place that it should.

Mr. NEY. If this legislation passes, then, do you view that HUD will have to go through a different type of process to establish new goals? Or will a lot of it stay as it is? I mean, do you have any, not details, say, but any ideas about that?

Secretary JACKSON. The present way that Chairman Baker's proposal is put, we are not involved at all. I mean, that would be clearly within the independent regulator, and we would, for transitional purposes I would think, give them all the information that is necessary.

Mr. NEY. We know safety and soundness is important, and we have to have a good regulator so that some of the past problems are avoided. One of the questions—how does it go together? In

other words, you have a mission. How do we make sure we have standards and regulations in place, safety standards and mission, and how do we do it without risking damage to the markets?

Secretary JACKSON. We are doing it now. I mean, we have the HUD mission, the fair housing goals, and OFHEO is making sure that in essence the safety and soundness is done. I think that if you work together, it can be done.

Others would say, "Why do not we have it in one specific place, housed?" as the Chairman has said. I am convinced that that would work too. It would take some time. And let me say this to you: That is my only concern, is if all aspects are in one place and we are trying to regulate the GSEs—

Mr. NEY. I guess if you have separate—my question would be, if you have separate regulators, would that cause a problem?

Secretary JACKSON. No, it does not, from my perspective.

Mr. NEY. Okay.

My yellow light is on, so I wanted to just make a note as I close here, and it is on manufactured housing.

I have been, for 10 years, onto this issue. We have talked with you and we have appreciated you talking with us. But in manufactured housing, I think there has been a reluctance to the bureaucracy, there has been problems, and, you know, there is not one fit for people in housing in one particular area. There is urban centers, and you know the whole story of housing.

So I do hope down the line we can continue to, you know, make things go decently with manufactured housing, walk through some of the problems that are out there, and just even when it comes to, you know, some of the ways that—there was a bureaucracy that was tough to get even some of the units approved.

This has been endemic for quite a few years, and I just want to mention it. I think it is a problem, and I know Mr. Frank spoke on it earlier, and I just want to continue to stress that we need to, you know, work with that issue.

Thank you, Mr. Chairman.

Mr. BAKER. The gentleman's time has expired.

Mr. Bachus?

Mr. BACHUS. Thank you.

This question is for Secretary Snow.

Secretary Snow, I am sure I am just like anybody else, if I go out to get a mortgage, if I buy a new house or refinance, I am going to look for the cheapest rate, cheapest interest rate. You know, if I can get something for an eighth of a point less in someplace else, that is where I am going to go. So if you can offer a lower interest rate, you have a tremendous advantage in the market.

Now, having said that, the GSEs charge loan originators, mortgage companies, a G-fee, guarantee fee.

Secretary SNOW. Right.

Mr. BACHUS. And that determines to a large extent, I mean, to some extent, exactly what interest rate they can charge the public or mortgage company.

Now, I understand that these G-fees are not set on how safe or sound a mortgage is, like an 80 percent mortgage or a 90 percent mortgage; it is based on volume. And what they do is, they negotiate in private confidential agreements with mortgage originators,

and they charge some one fee, they charge others other fees. And I understand that that can vary by as much as 15 percent. Obviously, the more volume you do, the lower fee you get.

And I am not sure I think this is good public policy for a government-sponsored entity, because it obviously favors your biggest mortgage companies, and it puts your smaller mortgage companies or your local mortgage companies at a disadvantage.

So my questions to you is, I guess number one, what they charge companies, since it is a government-sponsored entity, should it be made public where the public can scrutinize that? Because it can be a tremendous advantage. And it is my understanding that some mortgage companies, some of the smaller ones, are being charged 15, 20 basis points more. So I would just like you to comment on that.

And Secretary Jackson, if you would also like to comment.

But we want to promote competition, and we also want to promote a level playing field in any government-sponsored entity.

Secretary SNOW. Well, this is really a subject that Secretary Jackson knows a lot more about than I do.

I would say two things: It certainly is an issue that I think deserves consideration and review and monitoring and so on. How best to do that, I would leave to you, Congressman.

But as you do it, you also want to make sure that we do not interfere with whatever appropriate economics are at play that create those differentials, because there probably are some lower costs associated with large bundling that justify somewhat lower rates on just a market cost basis. But clearly it should not be beyond that.

And that certainly seems to me to be something that ought to be subject to being monitored and looked at and followed up on, but Secretary Jackson—

Secretary JACKSON. Congressman, I would echo exactly what Senator Snow said—senator—

Secretary SNOW. You promoted me.

Secretary JACKSON.—Secretary Snow—quite a Freudian slip—has said.

I think you will have to address the issue.

We really cannot address it at HUD because they do not report to us. We have no knowledge of how that system works. We can tell you how our system works at FHA and Ginnie Mae.

It is clear, we set a standard, and we abide by those standards, and they are public knowledge.

I think you will have to make the decision as to whether they are public knowledge.

Now, as you know, I think you raised the question because there has been great criticism in areas, especially about those who are not large institutions dealing with the two. And in many cases, it has been said that that is why they have not been able to address the low and moderate market because of that situation, because the smaller institutions usually are the ones who are addressing the marginal people we were talking about earlier with the Ranking Member.

But we have no way of knowing how they set the system.

Mr. BACHUS. Well, you know, that is one thing that I sort of disagree with. If you are going to have a government-sponsored entity that securitizes loans, the public ought to know. And they are charging different people different guaranty fees, different rates, and when these rates can amount to 15, 20 basis points, that is a big difference.

Secretary JACKSON. Yes, it is.

Mr. BACHUS. It is a competitive advantage. So they could be showing favoritism.

So, number one, I think as a public policy they ought to reveal their guarantee rates; and number two, I think that it is a guarantee rate that the mortgage will be paid, that they will not lose their money. It ought to be based on credit-worthiness of the mortgages as opposed to volume.

And I think there is a strong right to know by the public.

The second question is this—

Mr. BAKER. The gentleman's time has expired.

Mr. BACHUS. Okay, thank you.

Mr. BAKER. I appreciate the gentleman.

I want to recognize Mr. Cleaver for his question.

Mr. CLEAVER. This is a question for both of you. It is one simple question, although the history of the world will change based on what your answer is.

[Laughter.]

And it is very important.

A lot of people are saying, "Well, you know, we do not want to throw out the baby with the bathwater." I am not there. I think that, you know, what we need to do is probably just bathe the baby and not adopt a new baby.

My concern is that—well, let me ask the question: Are either of you experiencing, even slight discomfort, with the fact that if all these changes are in fact brought about, that we are making major changes to the GSEs and that we are not in any way going to damage their ability to continue to bring new homeowners across the length and breadth of this country? Do you have perfect calmness in your spirit over what we are doing?

Secretary JACKSON. I do, because, Congressman, I believe that it is in our best interests that we keep the three GSEs healthy for this economy. If we do not, then it presents a serious problem.

So I would be remiss and I think the administration would be remiss to support anything that would be causing of the demise of these GSEs. That is not what we are saying.

We are saying strengthen them, but at the same time, take some of the risk that they have afforded us out of their hands.

Secretary SNOW. Congressman, I would agree with Secretary Jackson and say without any hesitancy that the actions that are being proposed in the legislation will strengthen the mortgage markets, will remove risks that otherwise could be there, and therefore lead to, in my view, much healthier markets long term for mortgages.

Mr. CLEAVER. We are recording that for history.

Thank you, Mr. Chairman.

Mr. BAKER. I thank the gentleman.

I believe that is the last person who is here to be recognized for questions.

I wish to, on behalf of Chairman Oxley, express our deep appreciation to Secretary Jackson and Secretary Snow, not only for your participation but for your lengthy commitment to get resolution on this important public policy matter. We are indeed appreciative of your leadership.

Our meeting stands adjourned.

Secretary SNOW. Thank you very much.

Secretary JACKSON. Thank you very much.

[Whereupon, at 12:35 p.m., the committee was adjourned.]

A P P E N D I X

April 13, 2005

Opening Statement
Chairman Michael G. Oxley
Committee on Financial Services

The Administration's Perspective on GSE Reform
Wednesday, April 13, 2005

I want to welcome Secretary Snow and Secretary Jackson back to the Committee this morning. I am looking forward to your views on H.R. 1461 the Federal Housing Finance Reform Act of 2005 and the Administration's perspectives on GSE reform in general.

We have been working on this issue for a long time. Since the 106th Congress, this Committee has held 22 hearings and has heard from 101 witnesses on GSE-related matters. Chairman Baker should be commended for his hard work in monitoring the GSEs over the years, and I am proud to be a cosponsor of the legislation he introduced to create a new GSE regulatory agency. This legislation will foster confidence by granting the agency the necessary powers to ensure the safe and sound operations of these complex enterprises. I would encourage my colleagues to join in support of this legislation.

At this time in 2003, we were all led to believe that the GSEs were running smoothly with only a routine accounting restatement in progress at Freddie Mac. What we have learned since then is that these enterprises were involved in revenue smoothing, the misapplication of accounting standards, and irresponsible corporate governance. The Federal Home Loan Bank System has also had its share of problems over the years with accounting problems and inadequate management. The governance situation in Seattle seems to be particularly troubling.

It is time for a new oversight structure for the GSEs that will give the regulator the tools it needs to prevent these problems from developing and permit swift action when problems do arise. We have learned in our hearings that the current regulator – OFHEO – lacks the critical tools needed to supervise these enterprises. It is our duty to structure a strong regulator to ensure that the housing market, the taxpayers, and the financial system as a whole remain safe.

H.R. 1461 strikes the right balance of strong regulation that is not overly burdensome. Authority over minimum capital, program approval, and receivership are all concepts that this Committee has discussed over the years. This regulator is independent from the political process. That means there is no influence on safety and soundness or on mission compliance. Some argue that HUD has the expertise in housing mission; however, I would contend that it is not HUD that has this expertise, but rather it is the people at HUD who have this expertise. These people can move to the new regulator and make decisions that are independent and in the best interest of the U.S. housing market.

Oxley, page two
April 13, 2005

H.R. 1461 also grants the regulator the authority to adjust the portfolios of the enterprises. This is an important power, in that it will ensure that the enterprises do not hold portfolios that are unsafe and unsound or are in violation of their mission. In a similar manner, Banks are forced to keep their portfolios in check through capital levels mandated by the Basel accords. This structure encourages the holding of a diverse portfolio of assets since the holding of too much of a particular asset or a risky asset results in a higher capital charge.

We have heard from some that Congress should be cautious in its efforts to create a new regulator and that we need to be mindful not to harm the housing market. In truth, the housing markets are being threatened now by the various accounting and regulatory problems at the GSEs and by the lack of a regulatory agency with real power and real authority. A regulator with enhanced powers will ensure that our housing finance system recovers and becomes stronger and more resilient in the future. The goal of this bill is to create a credible GSE regulator, nothing more and nothing less.

I also want to remind Members of the Committee that both Secretary Jackson and Secretary Snow have been generous with their time. Last week Secretary Jackson appeared before us, and next week Secretary Snow will be back to discuss international financial issues. I would urge Members to keep their statements and questions focused GSE related issues this morning so that we can have a productive session.

Thank you both for appearing today and I look forward to your testimony.

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**OPENING STATEMENT OF CONGRESSMAN PAUL E. KANJORSKI
COMMITTEE ON FINANCIAL SERVICES
HEARING ON GOVERNMENT SPONSORED ENTERPRISE REFORM
WEDNESDAY, APRIL 13, 2005**

Mr. Chairman, we need to have strong, independent and world-class GSE regulation. Such a regulatory system will promote confidence in the GSEs, protect the continued viability of our capital markets, insure taxpayers against systemic risk, and expand housing opportunities.

To ensure that we have appropriate GSE regulation, I believe that any future legislative reform efforts should also adhere to several key principles. For example, the regulator must have a funding stream separate and apart from the annual appropriations process.

In order to be credible and effective, the regulator must additionally have genuine independence from the political system. Such independence must consist of complete autonomy from the enterprises, include sufficient protection from outside special interests, and provide substantial insulation from political interference.

A strong regulator must further have robust supervisory and enforcement powers. In this regard, many have suggested that we should model GSE safety-and-soundness regulation on that of other financial institutions. I agree with this sensible concept.

In fact, the general goal of our reform debates heretofore has been to make GSE supervision more bank-like. However, some recent reform proposals, such as those aimed at imposing arbitrary portfolio limits and requiring a burdensome approval process before the GSEs can go to market with new innovations, would appear to be more-than bank-like. These proposals therefore cause me considerable concern.

Moreover, we must ensure that we continue to remember why we created these public-private entities as we work to develop regulatory reform legislation. We created GSEs to help make credit available to finance home purchases, because the private market was not effectively meeting credit needs. The GSEs' charters limit business activities to their public missions, and they receive benefits from the government that help them carry out those public missions.

Beyond ensuring that the GSEs can continue to fulfill their missions, we must maintain a public interest in the boards of these public-private entities. In that vein, I have been very concerned that the Administration has failed to appoint independent directors at Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, as it is required to do under the law. Public participation on these boards helps to focus the GSEs on their missions.

Additionally, I am very concerned that the removal of this presidential appointment authority in any legislation, as some have regrettably suggested, would result in a greater probability of privatization in the future. Privatization of the housing GSEs is a very bad idea for financial institutions of this size and of such importance to our economy.

In sum, Mr. Chairman, in developing any enhanced GSE regulatory system, we should perform deliberate surgery. We should abstain from considering radical proposals that would fundamentally change the ways in which the GSEs operate or undermine their charters. Finally, as we implement strong, independent and world-class GSE regulation, we must also ensure that the GSEs continue to achieve their statutory objectives and carry out their public missions.

Opening Statement
Rep. Ed Royce (CA-40)
"The Administration Perspective on GSE Regulatory Reform"
13 April 2005

Mr. Chairman, thank you for holding this hearing on "The Administration Perspective on GSE Regulatory Reform." I would also like to thank Secretaries Snow and Jackson for being here today and for their very able service to our country.

Mr. Chairman, I would like to commend you and Chairman Baker for your efforts in crafting legislation to reform oversight of the three housing Government Sponsored Enterprises. I continue to support the creation of a single new regulator with the authority to set minimum and risk-based capital standards, to place a troubled entity into receivership, to review product approval and mission, and to be independently funded outside of the appropriations process. I was pleased to see that the H.R. 1461, the Federal Housing Finance Reform Act, contains all of the aforementioned components.

Since the introduction of the H.R. 1461, Federal Reserve Chairman Greenspan and Treasury Secretary Snow have both testified to the Senate Banking Committee that any new legislation should place limits on the portfolio holdings of Fannie Mae and Freddie Mac. In Chairman Greenspan's remarks he said that the Federal Reserve is concerned that the large concentration of mortgage assets in the two enterprises puts the safety and soundness of the entire financial system in jeopardy. In fact, in all of my years in Washington this is the strongest and most stern warning I can recall coming from Chairman Greenspan:

"to fend off possible future systemic difficulties, which we [*the Federal Reserve*] assess as likely if GSE expansion continues unabated, preventive actions are required sooner rather than later."¹

In light of the Federal Reserve's warning, Mr. Chairman, I would respectfully request that this committee hold a hearing on the risks associated with Fannie and Freddie holding large quantities of mortgage assets on their balance sheets before we mark up legislation. Such a hearing would allow this committee to understand more fully the concerns expressed by the Fed Chairman and Secretary Snow. Again, Chairman Oxley thank you for holding this hearing. I yield back.

¹ Testimony of Chairman Alan Greenspan: Senate Banking Committee (4/6/05)

**STATEMENT OF
SECRETARY ALPHONSO JACKSON
U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT**



**BEFORE THE
U.S. HOUSE OF REPRESENTATIVES
COMMITTEE ON FINANCIAL SERVICES**

APRIL 13, 2005

INTRODUCTORY COMMENTS

Chairman Oxley, Ranking Member Frank, Distinguished Members of the Committee:

I welcome the opportunity to join Secretary Snow in discussing the Administration's views on how best to improve and reform regulatory oversight of the housing government-sponsored enterprises, or GSEs.

The President has set an ambitious goal: to build an ownership society where everyone has a chance to own a home and a retirement account or health care plan, and to gain a permanent stake in the American Dream. Ownership brings stability to our neighborhoods and security to our families. To build an ownership society, the President is committed to helping even more Americans buy homes. That commitment is embodied in the President's challenge to the housing industry to join with us in creating 5.5 million new minority homeowners by the end of this decade. It is embodied in the Blueprint for the American Dream Partnership, through which HUD has brought together the private sector, not-for-profits, and government agencies to meet the President's challenge.

This Administration has demonstrated a steadfast commitment to housing and homeownership through programs such as the American Dream Downpayment Initiative, the homeownership voucher, and the President's Blueprint for the American Dream Partnership. Our interest in regulatory reform builds on that commitment and is rooted in a responsibility to those whom the GSEs were established to serve: low- and moderate-income individuals who seek affordable homeownership opportunities.

Secretary Snow has outlined the core principles that the Administration believes should underlie any GSE regulatory reform. He and I are in full agreement. Congress and the Administration have an opportunity *and an obligation* to strengthen the regulatory structure of the GSEs. A strong regulator is in everyone's best interests – the Administration, the Congress, the housing industry, Wall Street, investors worldwide, and the American homebuyer.

The Administration has two goals in this process. First, we must ensure that the GSEs continue to fully carry out the mission granted to them by Congress of promoting affordable housing and homeownership. Second, we must ensure that the GSEs are subject to rigorous oversight, so that they serve their public purpose.

HOUSING AND THE ECONOMY

Housing and the housing industry have a direct and substantial impact on our nation's economy. The housing market continues to perform exceptionally well; single-family housing starts posted a new monthly record in February, while sales of new single-family homes rose to their fourth-highest level in 42 years. The sales of both new and existing homes set annual records in 2004.

Today the housing industry accounts for roughly 14 percent of the Nation's total Gross Domestic Product. The potential impact of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System upon the economy and housing programs makes it critical that we ensure their safety and soundness.

STRENGTHENING THE GSEs' REGULATOR

To ensure that the GSEs have appropriate financial oversight and are held accountable, the Administration supports strengthening the powers of the GSEs' regulator. Doing so would make the regulator more comparable in terms of stature, powers, authority, and resources to other financial regulators charged with safety and soundness oversight.

Seventeen months ago, in the wake of Freddie Mac's 2003 accounting scandal, Secretary Snow and then-Secretary Martinez came before this Committee to make the case for reform. As Secretary Snow has described in his testimony several other troubling problems impacting the safety and soundness of the GSEs have come to light. In addition:

- In July 2004, HUD reported that Fannie Mae and Freddie Mac continued to substantially lag the conventional market in serving first-time homebuyers, especially *minority* first-time homebuyers.
- In October 2004, HUD determined that Freddie Mac had overstated its 2002 performance under the Low- and Moderate Income and Underserved Areas housing goals by double counting 45,000 units.
- Recently, HUD determined that some of Fannie Mae's international activities may not be consistent with its charter purposes. Therefore, HUD has advised Fannie that it must obtain prior written approval from HUD before it engages in any international activity.
- Last week, HUD ordered Fannie Mae to cease and desist its third-party Real Estate Owned (REO) management and servicing activities. Again, this activity is inconsistent with its charter purposes.

The best way to prevent similar – or worse – problems in the future is through the oversight of a strong regulator, empowered to hold Fannie Mae and Freddie Mac accountable to the high standards their size and stature demand.

PROPOSED REFORMS

Secretary Snow has recommended that safety and soundness oversight of the housing GSEs be consolidated and strengthened in a single regulator, housed within the Treasury Department – and I agree. This regulator would also have enhanced authority to review and approve new programs and activities contemplated by the three housing GSEs, with a continued strong role for HUD in this process. Treasury has a long history of regulating safety and soundness matters throughout the financial system. Treasury also has an institutional structure already in place that would allow it to take on new responsibilities with minimal start-up time.

The Administration strongly supports retaining a core element of oversight of Fannie Mae and Freddie Mac – setting and enforcing the affordable housing goals – at HUD. Congress established the housing goals to ensure that these GSEs fulfill their mandate to provide leadership to the mortgage market. The goals direct Fannie Mae and Freddie Mac to serve low- and moderate-income families and provide

funding in underserved areas, such as central cities and rural areas. A third goal directs these GSEs to finance housing for very low and low-income families in low-income areas.

To better ensure these two GSEs' leadership in the mortgage market, HUD recently strengthened the affordable housing goals. By 2008, the new goals will require that the GSEs at least "meet the market" – in other words, their purchases of mortgages in each goal category must be proportional to the share of all mortgages in the conventional conforming market that fall within that category. In the past, HUD's goals have been set "below the market." Other conventional lenders – without the GSEs' Charter Act privileges – have served lower-income families and underserved areas better than the two GSEs have done. HUD believes the GSEs can do at least as well as other conventional lenders.

HUD's expertise in developing and enforcing the housing goals makes it appropriate that the Department retain this authority. Institutionally, our mission is devoted to furthering the goal of affordable housing and homeownership, and HUD has the most expertise in this area. The housing industry looks to HUD as the agency in which this authority should reside. And to transfer this role from HUD could delay for years the implementation of a new regulatory plan.

As Secretary Snow has mentioned, it is important to clarify the mission that the Federal Home Loan Banks play in supporting affordable housing.

We also consider it important that fair housing requirements and enforcement that pertain to the housing GSEs remain at HUD, given HUD's expertise in fighting housing discrimination. HUD should have full enforcement power for those authorities, in the same way it enforces the Fair Housing Act.

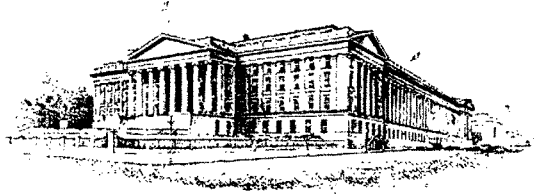
Secretary Snow testified about additional powers for the new regulator, and I would add one more – allowing the regulator to establish the conforming loan limits on a local basis each year, using the best available data, to more appropriately serve low- and moderate-income families.

Events at the housing GSEs during the past year have reinforced the Administration's commitment to additional reforms of the GSEs and their regulator. You have heard Secretary Snow and I testify about many of them. However, there are other possible reforms that would also advance our common interest in a strong and secure housing finance system. The Administration is open to considering additional ideas for reform.

CONCLUSION

Let me stress that we believe such a comprehensive change to the regulatory structure will boost the confidence of all GSE stakeholders. Investors will be better protected under a regulatory system that empowers the regulator to do the job we expect of them... and Americans will ultimately benefit. At the same time, we will strengthen the GSEs' ability to serve low- and moderate-income families pursuing affordable homeownership.

I join Secretary Snow in saying that I look forward to working with the Committee members as we move forward.



**DEPARTMENT OF THE TREASURY
OFFICE OF PUBLIC AFFAIRS**

Embargoed Until 10 a.m. EST
April 13, 2005

CONTACT: Rob Nichols
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**Testimony of Secretary John W. Snow
Before the
U.S. House Financial Services Committee
Proposals for Housing GSE Reform**

Thank you Chairman Oxley, Ranking Member Frank, and members of the Committee for inviting me to appear before you today.

The United States has the broadest, deepest, most successful housing markets in the world, supported by an interdependent financial services infrastructure. That financial services infrastructure includes institutions such as federally insured depositories, mortgage banks, private mortgage insurers, and Wall Street investment banking firms. And a unique and prominent role in that infrastructure is performed by the housing government-sponsored enterprises (GSEs) – Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System (FHLB).

With the aid of these financial institutions, Americans have ready access to a wide array of mortgage finance options. Our national system of housing finance plays an important role in promoting home ownership – a key priority of this Administration. We have seen tremendous progress in increasing home ownership in America, which now stands at 69 percent. Secretary Jackson and I share the commitment made by the President to expand home ownership to 5.5 million more minority homeowners by the end of the decade.

Our national system of housing finance needs to remain strong and healthy so that it can continue to make mortgage credit available and provide financing opportunities for new homeowners. Secretary Jackson and I are here today to discuss reforms for the GSEs that will achieve these objectives. These reforms are intended to ensure greater regulatory oversight, enhanced market discipline, and appropriate capital requirements for the GSEs. As we consider these reforms, we are guided by two core objectives: the need for a sound and resilient financial system and increased opportunities for home ownership, especially for less advantaged Americans.

Secretary Jackson will describe in greater detail the role that the GSEs were created to perform, and the home ownership goals we have set forth for them. Allow me to state succinctly why the Administration is so committed to bring about real reform. The risks undertaken by the GSEs, if not properly managed,

may pose a threat to their solvency, the stability of other financial institutions and the strength of our economy.

Essential Elements of GSE Regulatory Reform

In 2003, the Administration set forth what we consider to be essential elements for creating a new, stronger, more credible regulatory system for the GSEs. The Administration's position is that without these essential reforms, any new regulatory system would be little improved from the inadequate system we have today. In light of the recent events at the GSEs, the need for meaningful reform has become even more clear. Half-measures will only exacerbate the risks to our financial system.

As we outlined in detail in 2003, the regulator for the GSEs should have powers comparable in scope and force to those of other world-class financial supervisors and fully sufficient to carry out the agency's mandate. The regulator must have clear general regulatory, supervisory, and enforcement powers with respect to the GSEs. These powers must include the authority to set both minimum capital standards and risk-based capital standards; the power to assess the entities for independent funding outside of the appropriations process; and the ability to place a failed GSE in receivership. An effective receivership mechanism, similar to that held by other safety-and-soundness regulators, should help bring about critical market discipline to ward off the prospect of a GSE falling into significant financial distress. In addition, I wish to note the interplay between an effective FDIC-like receivership mechanism and the so-called line of credit that exists between the Treasury and the GSEs. As members of this Committee are aware, the Treasury Secretary has discretion to issue debt in the amount of \$2.25 billion to each of Fannie Mae and Freddie Mac and \$4 billion to the FHLBs. Some commentators believe that this credit availability reinforces the perception that the Federal government backs the debt obligations of the Enterprises. This perception is false. In fact, I would exercise the line of credit (which pales in comparison to the size of the debt obligations of the GSEs today) only in the event that a GSE was in significant financial distress and needed the capital to emerge successfully through the receivership process. Congress may wish to consider reforms in this area as well.

As I said in my testimony of September 10, 2003 before this Committee, in order to address the unique mission of these enterprises as chartered by Congress, an effective regulator must have an integrated package of authorities. The package must empower the regulator to address problems that may arise (like those which we have witnessed in the last two years) before they cause damage to the financial system.

Another key power for the new regulator is the ability to review the activities of a regulated entity, whether they be new activities or those in which the regulated entity already participates. We need to strengthen the activity review process, including greater public participation through notice and comment rulemaking. Meaningful reform will also give greater clarity to the types of activities that fall within the GSEs' mission, thus ensuring that new and existing activities focus the GSEs on promoting housing opportunities. These tools should be a meaningful part of the oversight of the housing GSEs.

Events that have transpired since I testified before this Committee in 2003 reinforce concerns over the systemic risks posed by the GSEs and further highlight the need for real GSE reform to ensure that our housing finance system remains a strong and vibrant source of funding for expanding homeownership opportunities in America. The Administration remains troubled that neither Fannie Mae nor Freddie Mac has financial statements filed with the SEC that can be relied upon. Freddie Mac has yet to file any financial statements in conformity with the securities laws, and Fannie Mae is not expected to be able to issue financial restatements for many months or even years. We recognize some of the unique characteristics of the GSEs, but believe strongly that they, as well as the Federal Home Loan Banks, should be held to public reporting requirements with the SEC comparable to other large, complex public companies.

We believe that reform legislation must provide the regulator with the authority, tools, and guidance from Congress as to what is expected of the GSEs going forward. Consistent with the Administration's vision for strong and effective regulatory and market discipline, I would like to expand on some other key elements that are needed in order to adequately protect the stability of our housing markets, our financial system, and our overall economy. Most notably, I would like to describe the need to control the size and scope of the GSEs' investment portfolios.

Financial and Accounting Problems at the Housing GSEs

The Administration's proposal in 2003 was presented against the background of serious financial and accounting problems at the housing GSEs, including the June 2003 Freddie Mac announcement that it would restate its 2000-2001 financial statements and further delay the release of its 2002 financial statements. Since the last time I appeared before you, the following events have transpired:

- OFHEO released a report of initial findings on Fannie Mae in September 2004 citing improper accounting procedures and practices, internal control deficiencies and questionable management oversight.
- The SEC concurred in the findings of inappropriate accounting practices, and directed Fannie Mae to restate its earnings for 2001-2003. Fannie Mae, then, estimated that it would be forced to recognize \$9 billion in losses.
- OFHEO concluded in December 2004 that Fannie Mae was "significantly undercapitalized" in the third quarter of 2004, and demanded that the minimum capital requirement be increased by 30 percent to ensure that the Enterprise strengthened its financial position.
- And just a few weeks ago, Fannie Mae disclosed to the SEC that it could be forced to recognize an additional \$2.4 billion of losses, stating that it is unable to reasonably estimate the effect of these issues on reported results of operations.
- In 2004 the FHLBanks of Chicago and Seattle entered into written agreements with their regulator, the Federal Housing Finance Board (Finance Board), to implement changes to enhance their risk management, capital structure, governance and other practices and procedures. In March of 2005, ten FHLBanks implemented new risk-based and leverage requirements. The others are expected to comply soon.

These events demonstrate that the GSEs do not have reliable financial controls to manage their operations risk. Such failures in controls, particularly in such highly leveraged institutions, jeopardizes not only the GSEs' safety and soundness, but also poses risks to the entire financial system.

Limitations on the GSEs' Debt-Financed Portfolio Investments

As additional financial and accounting problems have surfaced with the GSEs, and as the Administration has continued to evaluate the overall structure of the GSEs' operations in relation to their mission, we believe that meaningful reform of the regulatory structure of the GSEs must include mechanisms to protect our broader financial markets from unnecessary risks. More than six out of ten institutions in the banking industry hold as assets GSE debt in excess of 50 percent of their capital. We share the view expressed by Chairman Greenspan and others that the sheer size of the mortgage-based investment portfolios of the GSEs has grown well beyond anything needed in carrying out their housing mission. As Chairman Greenspan has stated:

"... these institutions, if they continue to grow, continue to have the low capital that they have, continue to engage in the dynamic hedging of their portfolios, which they need to do for interest rate risk aversion, ... create ever growing potential risks down the road."

Fannie Mae and Freddie Mac operate two independent main business lines today: (1) a credit guarantee business associated with securitizing mortgages; and (2) a portfolio investment business that involves

purchasing mortgages and various mortgage-related securities (including their own mortgage-backed securities) and non-mission related assets. The first of these—the guarantee and securitization of mortgages—is integral to the operation of an effective secondary market for mortgages. The business of investing and holding an investment portfolio of mortgages and other higher-risk assets for its own proprietary trading account and inventory, however, has a much more tenuous connection to the housing mission of the GSEs.

Freddie Mac and Fannie Mae, as we know them, were largely a product of the turbulent financial period of the late 1960s and early 1970s. One of the primary goals of creating Fannie Mae and Freddie Mac was “... to provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments, thereby improving the distribution of investment capital available for home mortgage financing.” Initially, Fannie Mae provided this assistance primarily by buying mortgages while Freddie Mac concentrated on securitizing mortgages, a pattern that continued throughout the 1980s.

Since 1990, however, the mortgage portfolio business of both of the housing GSEs has grown rapidly, much to the financial benefit of the Enterprises' management and shareholders. From 1990 through 2003, Fannie Mae's mortgage investments increased from \$114 billion to \$902 billion, and the ratio of mortgage investments to outstanding guaranteed mortgage-backed securities increased from 40 percent to 69 percent. Freddie Mac's growth in mortgage investments was even more dramatic. From 1990 through 2003, Freddie Mac's mortgage investments increased from \$22 billion to \$660 billion, and the ratio of mortgage investments to outstanding guaranteed mortgage-backed securities increased from 7 percent to 88 percent.

In general, the risks of the mortgage investment business are more complex to manage than the risks of the credit guarantee business. For example, with the rising interest rates in the early 1980s, Fannie Mae's cost of funds rose above the interest rate it was earning on its long-term, fixed-rate mortgages. This interest rate mismatch was similar to that faced by the savings and loan industry, and Fannie Mae became insolvent on a mark-to-market basis. Only a combination of legislative tax relief, regulatory forbearance, and a decline in interest rates allowed Fannie Mae to grow out of its problem.

The mortgage investment portfolio of the housing GSEs has grown rapidly, beginning in the 1990s, motivated by high profit margins and made possible by a substantial debt funding advantage. This funding advantage arises because markets incorrectly assume that the Federal government provides some form of guarantee to GSE debt. This rapid growth has created a new dimension of risk, one that not only involves our national system of housing finance, but the potential for systemic risk to financial markets in general. The potential for systemic risk is associated with Fannie Mae's and Freddie Mac's large portfolios of mortgages and mortgage-backed securities and other non-related assets, funded at extremely high rates of leverage. The GSEs hold less than one-half the capital of similarly sized financial institutions. The value of these large portfolios can fall dramatically when interest rates change because individuals can prepay their mortgages.

Some of this risk can be hedged through the use of derivatives and other risk transfer mechanisms. Nevertheless, the risk does not disappear altogether, and in the event of an unforeseen problem, the GSEs might not have the funds to pay off their debtholders, which could lead to ripple effects throughout our entire financial system. For example, GSE debt is widely held by banks, so that if this debt declined in value, some banks could find their solvency endangered. Concerns about the GSEs' hedging strategies are reinforced by the regulatory enforcement actions of recent months. Neither Fannie Mae nor Freddie Mac has been able to put forth fair and accurate financial statements. Given this lack of accurate and reliable information, Congress and the Administration are correct in worrying whether the risks that have been undertaken by the GSEs are properly understood, measured, and made public.

These portfolio holdings thus raise fundamental concerns. Are there benefits that outweigh the potential costs? Neither the Treasury nor the Federal Reserve has found evidence that these portfolio holdings (above some minimum threshold) provide meaningful benefits to borrowers. We believe that Congress could usefully consider whether there are meaningful benefits to such holdings, and whether such benefits outweigh the costs.

In order to protect against the systemic risks posed by the GSEs' mortgage investment business, the Administration recommends that limitations be placed on the size of the GSEs' retained mortgage investment portfolios. An appropriate phase-in period for the reduction of the existing portfolios would be needed so as not to disrupt mortgage or financial markets. After the appropriate phase-in period, given the overall advances in securitization, the large amount of data available on mortgages, and the increased sophistication of mortgage investors, we believe that our capital markets could adjust to a significant reduction in the presence of the GSEs as mortgage investors.

In addition to protecting our financial system against potential systemic risk, it is also very important that our national housing finance system continues to function smoothly and that the GSEs are able to accomplish their missions – in particular their support for affordable housing. Our recommendation to limit the investment portfolios of Fannie Mae and Freddie Mac does not in any way limit their ability to guarantee mortgage-backed securities. In that regard, it is worth noting that Freddie Mac operated a successful credit guarantee business throughout the 1980s with a retained mortgage portfolio that was only a small fraction of its current size. Therefore, given that these core functions of the GSEs are preserved, we see no reason why limits on the GSEs' retained mortgage portfolios should impair their ability to provide support for affordable housing, including the ability of Fannie Mae and Freddie Mac to meet their affordable housing goals set by HUD.

Location of the New Regulatory Agency

While the powers and authorities of the new regulator remain of paramount importance to the Administration, Congress should also continue to consider the location of the new regulator. In 2003, the Administration said it was open to making the new regulatory agency a part of the Treasury Department, provided that there were adequate elements of policy accountability to the Secretary of the Treasury. The advantages of placing the new regulator within the Treasury should not be overlooked. First, the start-up time and transition issues related to setting up the new agency would be lessened; housing another agency within Treasury, which is familiar with such relationships, is less time consuming than creating an entirely new agency, which would facilitate effectively transferring existing OFHEO and Federal Housing Finance Board operations to Treasury. Second, addressing issues associated with systemic risk is an important aspect of our proposal, and the Treasury Department is the Executive Branch agency with responsibility to adopt a holistic approach to systemic risk and oversee the proper functioning of financial markets. Third, improving market discipline is important, and the Treasury Department is in the best position to monitor the new regulator's activities while ensuring that investors have a proper understanding of GSE securities. Finally, we believe that there would be less opportunity for regulatory capture were the new regulator housed in Treasury, given the diversity and size of the interests which regularly appear before the Department.

However, as we described in detail last year, there are conditions that need to be met in order for the Administration to support establishing the new regulator as a part of Treasury. The new agency should be required to clear new regulations and policy statements to Congress through the Treasury Department. The Treasury Department and OMB should also have review authority over the new agency's budget to ensure that resources are being properly allocated. Nevertheless, in any such arrangement, the new regulatory agency should have independent responsibility over specific matters of supervision, enforcement, and access to the Federal courts. By housing the new regulator in Treasury with adequate oversight authority, we can achieve the best of both worlds: ensuring a strong, independent regulator while providing for accountability and expertise from the Executive Branch.

The Appropriate Role of the Federal Home Loan Banks

Over the last decade the Federal Home Loan Bank System has undergone considerable change. Membership in the System was extended to commercial banks and they now make up the overwhelming number of members of the System. The Federal Home Loan Banks greatly expanded their investment portfolios and some Banks aggressively moved into the mortgage investment business, types of activities that moved the Banks away from their traditional wholesale funding activities for members. And while perhaps not particularly new, large financial institutions account for the bulk of borrowing from many of the Federal Home Loan Banks.

The Administration continues to believe that the Federal Home Loan Banks should be placed under the same regulator with Fannie Mae and Freddie Mac, and that this new regulatory regime should be structured to take into account certain special differences between the Federal Home Loan Banks and the other GSEs. Consistent with the primary goal of creating an effective regulatory regime for Fannie Mae and Freddie Mac, I believe constructive steps can be taken in this context toward also improving the regulation of the Federal Home Loan Banks. To reach that goal, the regulatory structure of the system should be examined with a careful eye to converging regulation of all of the GSEs to the same extent that their operations (and the risks they present) have likewise converged. In particular, the Administration believes regulation of the Federal Home Loan Banks would be enhanced if Congress were to delineate an explicit mission for them. In addition, we believe that Congress should consider reforming the appointment of directors to the boards of the banks to ensure that the best corporate governance practices are employed. And while progress is being made to ensure that the Federal Home Loan Banks file their financial statements with the SEC much like other large financial institutions with outstanding public debt, Congress should formalize such obligations by statute.

Conclusion

In conclusion, our primary goals in developing our GSE reform proposal are to promote the strength and resilience of our housing finance markets, lessen the potential for systemic risk, and continue our progress in meeting the mortgage credit needs of all our Nation's homebuyers. To accomplish those purposes, the fundamental elements of reform that the Administration has proposed are essential.

In addition, events at the GSEs over the course of the last year reinforce the need for a strengthened regulatory regime. There are a range of other reforms which would also advance our common interest in ensuring the resiliency of the financial system and the robustness of the housing finance system. The Administration is open to consider additional ideas for reform.

I look forward to working with you on this important issue.