Office of Federal Housing Enterprise Oversight (OFHEO)

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STATEMENT OF THE HONORABLE ARMANDO FALCON, JR. DIRECTOR OF OFHEO BEFORE THE COMMITTEE ON FINANCIAL SERVICES US HOUSE OF REPRESENTATIVES

Chairman Oxley, Ranking Member Frank, and Members of the Committee. Thank you for inviting me to appear before you today. I am pleased to provide my views on improvements that can and should be made to the regulatory oversight of Fannie Mae and Freddie Mac. My views are my own and are not necessarily those of the President or the Secretary of Housing and Urban Development.

I would like to begin by stating upfront that I support legislation to strengthen the supervision of Fannie Mae and Freddie Mac.

Upon taking office as Director of The Office of Federal Housing Enterprise Oversight in October of 1999, I quickly realized that the Agency's long-term success was jeopardized by inadequate resources, a constraining funding mechanism, and a lack of powers equal to those of other regulators.

Over the past four years, I have been a consistent advocate of legislation designed to address those shortcomings, and so I was encouraged by the Administration's comprehensive proposal and your efforts, Mr. Chairman, to move forward. While I am in general agreement with the well-considered proposal that Secretaries Snow and Martinez have presented to the Committee, I do have a few concerns that I hope can be properly addressed.

Guiding Principles

I would like to outline my views in the context of five guiding principles. They are:

1) The regulator should remain independent;
2) The regulator should be permanently funded, outside the appropriations process;
3) The regulator should have powers equal to those of other safety and soundness regulators;
4) The regulator should have full discretion in setting capital standards; and
5) Legislation should build on progress made.

Adherence to each of these principles will strengthen supervision and the safe and sound operation of the Enterprises. Our ultimate goal and benchmark should be to establish a regulator that is on an equal plane with the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS), both of which operate as independent safety and soundness regulators within the Treasury Department. I would like to elaborate on the five principles.

Regulatory Independence

First, the regulator should remain independent. The concept of an independent Federal agency to oversee Fannie Mae and Freddie Mac was established in the legislative history of the 1992 Act that created OFHEO.

The need for regulatory independence was borne out of Congress' experience with the savings and loan crisis. I had the privilege of serving as Counsel to this Committee's predecessor during that difficult period. One of the clear lessons learned was that all safety and soundness regulators should be objective, nonpartisan, and protected from political interference. This is especially critical at times when regulators must make difficult and sometimes politically unpopular decisions.

In addition, independent regulation protects Congress' ability to receive the regulator's best judgment on regulatory matters unfiltered and without delay. With billions of dollars of potential taxpayer liability at stake, it is in everyone's interest that this

important safeguard not be weakened.

Like OFHEO, the Office of Thrift Supervision is another useful example of how a new independent regulator should be established as part of a Departmental organization. In 1989, Congress transferred responsibility for thrift regulation from the Federal Home Loan Bank Board to a newly created OTS within the Treasury Department. The OTS was established as a fully independent regulator. It has the same powers and unfettered ability to use those powers as the OCC.

Congress should ensure that the new regulator has full statutory independence.

Permanent Funding

Second, the regulator should be permanently funded, outside the appropriations process. Currently, OFHEO is funded annually through the Federal budget and appropriations process, even though the Agency does not utilize any taxpayer funds. OFHEO is funded through assessments on the Enterprises, but those assessments cannot occur until approved by an appropriations bill, and at a level set by the bill. OFHEO is the only safety and soundness regulator funded in this limited manner. At a minimum, this serious anomaly should be fixed.

Permanent funding will enable the regulator to fulfill its budgetary needs on a more reasonable basis without the timing constraint associated with the annual appropriations process.

There should also be clear authority for the Agency to levy special assessments or to establish a reserve fund as needed, to meet emergencies. Currently, any additional funds required to meet urgent, unexpected needs can be obtained only after a supplemental appropriation is enacted. This can delay action by the Agency to resolve problems early, before they threaten the safety and soundness of an Enterprise.
(Help with the President's supplemental request)

Enhanced Supervisory Authority

Third, the regulator should have powers equal to those of other regulators. While OFHEO's regulatory powers are fairly

comparable to those of other financial safety and soundness regulators, certain authorities need to be provided and others clarified.

For example, a safety and soundness regulator should have receivership authority, independent litigation authority, enhanced hiring authority, and a full range of enforcement powers provided to financial regulators. Also, the laws should be revised to provide clearly that the regulator is empowered to address misconduct by institution-affiliated parties and to exercise general supervisory authorities. I would be happy to provide the Committee with a more comprehensive package of suggestions later if you so desire.

Flexible Capital Regulation

Fourth, the regulator should have full discretion in setting capital standards. Capital is one of the fundamental bulwarks of effective safety and soundness regulation.

The regulator should have broad discretion to exercise his or her best judgment, using all the information available through the examination process and otherwise, to determine if capital adjustments are necessary. Other safety and soundness regulators have this discretion.

Going forward, the Agency needs to have the authority to modify both minimum and risk-based standards. This authority would help meet the changing mix of Enterprise business, the market environment in which they operate, and the changing nature of risk measurements themselves. As Secretary Snow said in his testimony before this Committee, "Broad authority over capital standards and the ability to change them as appropriate are of vital importance to a credible, world-class regulator." I agree.

Build on Progress

Fifth, legislation should build on the progress we have made over the last ten years. Regulating Fannie Mae and Freddie Mac requires a specialized skill set. The capacity to model the cash flows of all the mortgages, debt, and other financial instruments of the Enterprises, a necessity for the stress test, is unique among financial institution regulators.

Expertise in how these two secondary mortgage market

companies manage mortgage risk, including the broad use of sophisticated derivatives and callable debt is vital for effective regulation. In addition, an understanding of how the Enterprises are affected by the markets in which they operate is extremely important.

Over the past ten years, OFHEO has developed the specialized expertise, from our examiners and financial analysts, to our researchers and capital analysts, that is necessary to supervise these two unique companies. The cost in terms of lost regulatory capacity spent while trying to rebuild that infrastructure would be substantial.

That is why I recommend that, if a new regulator is established in the Treasury department, OFHEO's personnel, regulations, and administrative infrastructure should be transferred intact to the new agency. It would be highly counterproductive to do otherwise.

Additional Issues

There are a couple of other matters I would like to briefly discuss. First, I agree with Secretary Snow that the Presidentially appointed board positions should be discontinued. This is not a reflection of current or former Presidentially appointed directors. Rather, I think corporate governance would be enhanced if the shareholders were allowed to select all members of the board.

I also support granting authority to the safety and soundness regulator to determine whether the activities of an Enterprise are consistent with its' charter authority. This would mean that a single regulator would have the ability to review all of the Enterprises' activities – new and existing.

This change will consolidate the supervision of the Enterprises in a manner consistent with authorities of other regulators.

I appreciate the concern expressed about the primacy of the Enterprises' housing mission if and when the charter compliance responsibility is shifted. The goal, in fact, of enforcing charter

compliance is to ensure that the Enterprises remain properly focused on their housing mission and not stray into extraneous ventures.

Consistent with that goal, I think a mechanism can be instituted to ensure that a new regulator actively solicits and considers all views, including housing advocates, when exercising its authority.

The importance of their housing mission is actually why the Enterprises exist. Strengthening their safety and soundness regulation supports that mission by ensuring that they are strong enough to provide the financial services that make that mission a reality.

Conclusion

Mr. Chairman, that concludes my testimony. I look forward to working with the Committee as this important legislation moves forward. I will be happy to answer questions that you and the Committee may have.

OFHEO's mission is to promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac.