
# EXCHANGE

## Subcommittee on Capital Markets

## Richard H. Baker, Chairman

### Securities, Insurance, Government-Sponsored Enterprises

**The News from U.S. Rep. Richard H. Baker**
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Opening Statement
The Honorable Richard H. Baker, Chairman
House Financial Services Subcommittee on Capital Markets,
Insurance and Government-Sponsored Enterprises
June 25, 2003
Hearing on Regulatory Oversight of Freddie Mac and Fannie Mae

June 15, 2002, was an important day in the history of our economy. On that day the accounting firm of Arthur Anderson was found guilty of obstructing justice by a Texas jury. This decision ultimately led to the demise of the accounting firm and brought about a thorough reexamination of the entire accounting industry. But frankly, the outcome could have been a lot worse. Our understanding of corporate accounting practices was limited, and action was quickly taken to enhance the regulatory oversight with the passage of the Sarbanes-Oxley Act.

However, there continue to be important elements of our economy, left improperly in my opinion, outside the scope of Sarbanes-Oxley. They are the only two Fortune 500 corporations exempted from these essential reforms. Why were they exempted? The answer was that they are too well run to worry about. They "set the standard to emulate for corporate governance practices." And we want to make sure we never do anything to "throw someone out of a home ownership opportunity."

The events surrounding the fall of Enron were indeed unfortunate not only for the employees, but for all who had financial resources at risk. However, if either of the nation's GSEs were to suffer a financial reversal, the systemic consequences to us all are truly incalculable.

The Capital Markets Subcommittee is meeting today as a result of events that are not of our own making. The announcement by Freddie Mac that their recent accounting practices did not properly reflect their operations, is cause for significant concern. In fact, the initial restatement announcement was again amended just this morning, raising the total misreported income from $1 or $3 billion to $4 billion. This revelation underscores the importance of what has been previously observed by many—that current regulatory oversight is not adequate.

And to those who point out that this is an increase in revenue, not losses, don't miss the troubling point of this news if you were a shareholder. If you sold your interest in the company before this balance sheet adjustment was corrected, you were denied your fare distribution of company earnings by this manipulation. I believe you will find adequate legal filings to confirm this view. More importantly, the explanation given for the misstep is that the corporation did not have enough properly trained staff to oversee the complicated

derivatives portfolio. This leads to important questions: Why were they exempted from Sarbanes-Oxley? Where was the regulator during the three years this error went unreported? If Freddie did not have enough invested in staff to properly oversee complex activities, how can anyone argue that OFHEO did?

Congress should be more than just concerned; in fact, we should feel just like any other corporate CEO in America whose oversight has been found lacking. These enterprises are our creation and clearly our responsibility. Today, nothing stands between Congress and the ultimate responsibility should there be a GSE failure. We are the regulator of last resort.

In spite of this circumstance, some still suggest that any examination of the GSEs will result in market instability and potentially throw unsuspecting victims out of home ownership. I have only one question to those who believe this could possibly be true: How is it that a now readjusted restatement figure, up from $3 billion to now a reported $4 billion, over a three year period of operations has not crippled corporate activities and the housing market generally? Is there any action this Congress could take that could possibly approach the significance of this revelation? When such disclosures were made by Enron, Worldcom, and other corporate wrongdoers, the consequences were devastating to employees and shareholders alike. The value of corporations was decimated, and some executives are now in court defending their actions.

What is even more troubling than the restatement at Freddie Mac is the realization that market observers looked past the corporate misstatements and directly into the taxpayers' pockets. There was no reason to be concerned about corporate misconduct, as long as the taxpayers were standing by ready to pick up any loss. This is, in my opinion, the most troubling reality of all. What stands between corporate losses and the pockets of tax-paying working families is the regulator, and not much else.

Looking to the current regulatory structure, in fairness, the effort it made has been significant in light of the resource limitations placed on the organization. If Fannie and Freddie were regulated OCC banks, they would be assessed almost $70 million annually for their regulation. We have fought difficult battles in the appropriations process to get OFEHO to a $30 million level. Either the OCC has it really wrong, or OFEHO is dramatically under-funded, particularly given the financial sophistication of the enterprises. These problems have persisted for too long. It is no longer possible just to put another coat of paint on the walls and regain the respect of the marketplace. It is time to construct a new regulatory mechanism. It must be funded by assessment on the enterprises. It must have real authority to act on par with other financial regulators. It must be constructed to insure independence and marketplace credibility. HR 2575 is built on these principles. I have not proposed any controversial modifications to the charters of either GSE. I have not suggested a repeal of the current line of credit to the U.S. Treasury. I have not included the Federal Home Loan Banks in this proposal. This is a narrowly drawn, carefully crafted resolution, intended not to create political debate, but to effect real change.

This legislation is carefully constructed to bring about only three goals: (1) to insure we have an independent regulator; (2) to insure there is reasonable funding for the supervision; and (3) to equip this regulator with all the tools that any other financial marketplace regulator utilizes. That is it. There should be no controversy over this legislation at all, in light of the revelations over accounting irregularity.

However, where there are identified concerns that can be supported by logical argument, I am open to any constructive modification of the proposal that gets us to the stated goals of this effort. Some may suggest an alternate location for the regulatory home. That's fine. Others may have some objection to a particular enforcement authority. Make those concerns clear. But I cannot envision such disagreements resulting in a failure to act on this reform.

To date we have been fortunate in that no significant reversal in the housing market has occurred on our watch. But do no forget that these enterprises exist as a result of a congressional act. We created them. They

continue their favored market position with our concurrence, and as long as there is profit to share, the market works well and shareholders are happy.

The Congress is, however, directly responsible for their supervision and regulation. If we fail in this effort to provide the minimal resources for a competent regulatory structure, the fall will be disastrous. When a GSE fails, it will quickly fall through it's limited capital, and then through the shareholders, landing squarely on the taxpayers. That is an outcome we cannot accept. HR 2575 is a modest step to give some assurance this will never happen.

I began my remarks this morning revisiting the events of June 15, 2002, the day Arthur Anderson was found guilty of obstruction of justice by a Texas court. Another historic event occurred just 24 hours earlier on June 14, 2002. An object known as 2002 MN passed within 75,000 miles of Earth. In astronomical terms this was a "near miss". How close is that in astronomical terms? The closest we approach our moon is about 137,000 miles. So this object passed the Earth, inside the orbit of the moon. As far as we know, this was the second closest near miss of an asteroid impact in human history. So what else is significant about this event? How about this fact? Scientists on Earth did not know about 2002 MN until three days AFTER it passed the Earth.

How is this possible in this world of technological sophistication? The answer is simple. We just don't have enough resources committed or enough people watching to insure against a clearly cataclysmic event from occurring. Now I do not want to turn the Capital Markets hearing into a Science and Technology assessment, but the parallel is clear. Unless we act to enhance our supervisory capacity of the two housing GSE's that Congress created, we may not see the next systemic event coming until it's too late. I sincerely hope that is not your decision.

Today, we will hear from four different individuals and their concerns, and their recommendations for action this committee may consider. It is my hope that the committee will find the adoption of HR 2575 as an appropriate next step in this most important work.

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