



DEPARTMENT OF THE TREASURY OFFICE OF PUBLIC AFFAIRS

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**Testimony of
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Secretary of the Treasury
Before the Committee on Financial Services
United States House of Representatives
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Thank you Chairman Oxley, Ranking Member Frank, and members of the Committee for inviting Secretary Martinez and me to appear before you today. This Committee has a strong record of interest in the effective supervision and regulation of government sponsored enterprises.

There is a general recognition that the supervisory system for housing-related government sponsored enterprises (GSEs) neither has the tools, nor the stature, to deal effectively with the current size, complexity, and importance of these enterprises. As we attempt to remedy this situation, we must be mindful that we have two core objectives that should guide us: a sound and resilient financial system, and increased homeownership opportunities for less advantaged Americans.

To serve both of these objectives we need to devote careful attention to the resilience of our system of housing finance. That system is the envy of the world, but we cannot be complacent. I am here to outline the Administration's recommendations for important improvements that we can make to the oversight of our housing finance system. Secretary Martinez will discuss in particular the measures that the Administration would like to see implemented to reinforce the focus on the objective of increasing homeownership opportunities.

Recommendation

The Administration recommends that Congress enact legislation to create a new Federal agency to regulate and supervise the financial activities of our housing-related government sponsored

enterprises. Housing finance is so important to our national economy that we need a strong, world-class regulatory agency to oversee the prudential operations of the GSEs and the safety and soundness of their financial activities consistent with maintaining healthy national markets for housing finance. Such legislation should fulfill this underlying purpose and not be merely an exercise in moving existing agencies from one part of the government to another.

We should keep our eye on the crucial task of getting the regulatory organization right. In addition to the housing goals which Secretary Martinez will discuss, the legislative objective should be to create a strong, credible, and well-resourced supervisor with all of the powers needed to do its job.

It is of central importance in this endeavor that Congress provide the new agency with a clear mandate. This mandate should be to oversee the prudential operations of the enterprises and the safety and soundness of their financial activities in order to foster liquid, efficient, competitive, and resilient national housing financial markets, including secondary mortgage markets.

Powers of the New Agency

This new agency's powers should be comparable in scope and force to those of other world-class financial supervisors, fully sufficient to carry out the agency's mandate. This means that the agency should have general regulatory, supervisory, and enforcement powers with respect to the enterprises, including responsibility for ongoing prudential review of GSE activities in keeping with the terms of their charter, with the evaluation of new activities being made in consultation with the Secretary of Housing and Urban Development. With respect to conservatorship/receivership powers, the new agency should have all of the authority necessary to direct the liquidation of assets and otherwise to direct an orderly wind down. However, rescinding a GSE charter would require an act of Congress.

Taking into account the particular nature and unique mission of the enterprises as chartered by the Congress, the powers of the new agency should meet the following standards, which are widely recognized as essential for effective financial supervision. The agency must have an integrated package of clear authorities, including the following:

- The agency should possess operational independence and adequate resources, including provision for ongoing supervision, and powers to address compliance with laws as well as safety and soundness concerns.
- The agency should have authority for and supervisory practices that consist of some form of both on-site and off-site supervision.
- The agency should have the authority to review and reject any proposals to transfer significant ownership or controlling interests to other parties.
- The agency should have the authority to establish and enforce the criteria for acquisitions, new lines of business, or investments by the GSE and for ensuring that corporate

affiliations or structures do not expose the GSE to undue risks or hinder effective supervision.

- An essential element of supervision is the ability of the agency to supervise the consolidated GSE organization. The agency should decide which prudential requirements will be applied on an enterprise-only (solo) basis, which ones will be applied on a consolidated basis, and which ones will be applied on both bases.
- The agency should have the authority to ensure that the GSE has in place systems that accurately measure, monitor, and adequately control market risks; the agency should have powers to impose specific limits and/or a specific capital charge on market risk exposures, if warranted.
- The agency should have at its disposal adequate supervisory measures to bring about timely corrective action when a GSE fails to meet prudential requirements, including when there are regulatory violations.
- The agency should have independent litigation authority and related powers.
- The agency should set prudent and appropriate minimum capital adequacy requirements for the GSE. Such requirements should reflect the risks that the GSE undertakes, and should define the components of capital, bearing in mind the ability of the GSE to absorb losses.

Capital

The regulator should also have authority with regard to capital for the GSEs. A key issue is the setting of appropriate levels for risk-based capital. The current statute establishes the standard for the basic, minimum capital, the resources that are reserved for the general, indefinable, perhaps unforeseen risks that are present with any financial enterprise.

The statute also treats, in some detail, the question of risk-based capital. We do not propose any changes at this time to the risk based capital regulation that is now in place. That rule took ten years to develop and is in only its first year of operation. Capital is the fundamental element of the financial condition of an enterprise, and the capital standards should not become the subject of frequent change. There is a need for stability in capital standards. There is some degree of flexibility in the current risk-based capital rule to deal with changes in the risk profile of the enterprises, at least with regard to the near term.

Having said this, I am in no way proposing a moratorium on making any adjustments to risk-based capital. The existing statutes place a clear responsibility on GSE supervisors to ensure that each GSE retains adequate capital to support its risks and they give supervisors the power and duty to require capital changes as risks change. We expect the supervisors to make full and proper use of that authority as need arises.

But ultimately, the new agency should have more flexible authority to adjust risk-based capital standards for GSEs than what is currently provided in the law. Broad authority over capital standards and the ability to change them as appropriate are of vital importance to a credible, world class financial regulator. Capital standards need to be flexible enough to employ the best regulatory thinking, conscious of the enterprises' own measures of risk, adequate to ensure that the enterprises operate in a safe and sound manner, with capital and reserves sufficient to support the risks that arise in their business. We believe that legislation should provide the new agency with this more flexible authority.

Duties

The new agency must have the duty to exercise its authorities for a number of essential tasks, such as the following:

- An essential part of the agency's responsibility must be the evaluation of a GSE's policies, practices, and procedures related to the extension of credit and the making of investments and the ongoing management of the credit and investment portfolios, including GSEs' fulfillment of their missions.
- The agency should satisfy itself that the GSE establishes and adheres to adequate policies, practices, and procedures for evaluating the quality of assets and the adequacy of loan loss provisions and loan loss reserves.
- The agency should satisfy itself that the GSE has management information systems that enable the management to identify concentrations within the portfolio, and the agency should set prudential limits to restrict GSE exposure to single counterparties or groups of related counterparties.
- The agency should satisfy itself that the GSE has in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor, and control all other material risks and, where appropriate, to hold capital against these risks. The agency should determine that the GSE has adequate and well-tested business resumption plans for all major systems, with remote site facilities, to protect against disruptive events.
- The agency should determine that the GSE has in place internal controls that are adequate for the nature and scale of its business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the enterprise, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets, and appropriate independent internal or external audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.
- The agency should determine that the GSE has adequate policies, practices, and procedures in place, including strict rules for identifying customers/counterparties, that promote high ethical and professional standards in the financial sector and prevent the enterprise being used, intentionally or unintentionally, by criminal elements.

- The agency should have a means of collecting, reviewing, and analyzing prudential reports and statistical returns from GSEs on a solo and consolidated basis.
- The agency should have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.
- The agency should satisfy itself that each GSE maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the agency to obtain a true and fair view of the financial condition of the enterprise and the profitability of its business, and that the enterprise publishes on a regular basis financial statements that fairly reflect its condition.
- The agency should set risk-based capital standards and review and change them as prudent.
- The agency should exercise authority over new lines of business, new types of investments, and acquisitions.

Application to All GSEs

In my remarks, I have not limited myself to one group of housing GSEs. The importance of our housing finance markets requires that all of the housing GSEs be included in a program of world-class supervision. We see the need for this for the Federal Home Loan Banks just as we see it for Fannie Mae and Freddie Mac.

We recognize the development of a consensus for action on how to provide that supervisory system for Fannie Mae and for Freddie Mac and are ready to work with Congress on a new agency for their supervision. A similar consensus may not exist with regard to the Federal Home Loan Banks, but we look forward to working with Congress, the Home Loan Banks, and other interested parties to achieve a resolution of these matters.

Location of the New Agency

Today we recommend that Congress create a new regulatory agency that is strong, credible, possessing all of the standards and duties for effective financial supervision as I have outlined above. The Administration is prepared to consider placing the agency within a cabinet department, if Congress considers the additional benefits of stature and policy support that can come from such an arrangement to be valuable.

Any such arrangement would need to protect the independence of the agency over specific matters of supervision, enforcement, and access to the federal courts. The agency should be structured like other financial institution regulators currently embedded in cabinet departments. But to provide real value, placing the new agency within a cabinet department should draw upon the resources of that department for depth of policy guidance. At a minimum, the new agency should be required to clear new regulations and congressional testimony through the department.

In addition, while the agency should be adequately funded by assessments on its regulated entities, without going through the appropriations process, the agency budget and fee assessments should be subject to review by the Administration to avoid any long-term temptation to gold-plate agency operations and to ensure an appropriate allocation of resources among the agency's responsibilities.

In the context of this combination of operational independence and policy oversight, the Administration would be willing to support proposals to establish the new agency as a bureau of the Treasury.

Corporate Governance

In addition, good corporate governance, as we all have come to recognize, requires that there be great clarity that the people running large companies are there to serve the interests of the shareholders and that their incentives and loyalties be clearly aligned in this way. One man cannot serve two masters. Fannie Mae and Freddie Mac are large, experienced, publicly-traded enterprises that have grown significantly and taken important places in our capital markets. Reflecting on that fact, the Congress should consider whether the statutory requirement for presidential appointment of members to publicly-traded GSE boards of directors has become obsolete, and we would support their elimination.

Before I conclude, I wish to make one more essential point. We are pleased with the action of Fannie Mae to register under the Securities Exchange Act of 1934. Such registration operates as an important window into the operations of that GSE to see how it is promoting its mission in keeping with the highest standards of corporate disclosure. This is consistent with our view that GSEs should serve as models of good corporate governance and disclosure, not as exceptions from these standards.

We all regret that Freddie Mac has not yet been able to fulfill its pledge to come into compliance with registration under the 1934 Act, but we look forward to their doing so in the near future. Secretary Martinez and I recently joined with Federal Housing Finance Board Chairman John Korsmo in calling upon the Federal Home Loan Banks also to come into compliance with the 1934 Act, as administered by the Securities and Exchange Commission. Their doing so will be a crucial immediate step in regularizing their important participation in our nation's capital markets.

Conclusion

Treasury will continue, in a study, to review GSEs and the secondary mortgage markets, and the operation of the regulatory system that supervises the GSEs to ensure that they are subject to proper standards of capital, corporate governance, and other levels of conduct, and in general serve the objectives I described in the beginning of my remarks. We will keep you posted on the results of our studies.

In conclusion, let us consider once again our purpose here this morning. It is to discuss how best to promote the strength and resilience of our housing finance markets, in order to increase our

progress in advancing home ownership throughout the nation. The housing-related government sponsored enterprises were created by Congress to assist in that mission. Our aim must be to give them the caliber of supervisor that the importance of their mission requires.

-30-