Statement of Franklin D. Raines
Chairman and CEO of
Fannie Mae
Before the U.S. House Committee on Financial Services
September 25, 2002

Chairman Oxley, Congressman Frank, and members of the committee, thank you very much for inviting me here today. I am here to testify on legislation that would alter Fannie Mae's regulatory framework. To give some context to these proposals, I would like to begin by describing the fundamental health and dynamism of our mortgage finance system, the efficiencies Fannie Mae has helped to bring to the system, our impact on broadening homeownership, and our leadership in disclosure, risk management and corporate governance.

Let me start by saying, I am appearing today in support of legislation – the right legislation – to strengthen Fannie Mae's regulatory oversight. I am here today to ask Congress to take action to make our housing finance system even stronger by enacting the Administration's proposal to move our financial regulator to a bureau of the US Department of Treasury.

We support the Administration's proposal for three main reasons:

First, we support having a strong, well-funded, highly credible financial regulator, and this move would help ensure that.

Second, the proposal supports our charter and mission, including our freedom to continue to innovate with our lender customers and housing partners to expand affordable housing to new people and places.

And third, the proposal supports the advanced capital structure Congress provided in 1992, which ensures that we remain safe and sound through even the worst conditions while allowing us to direct the maximum amount of low-cost financing to homebuyers. The proposal also calls for giving the regulator full and more flexible authority to adjust risk-based capital standards over time, to incorporate evolving best practices. We support giving the regulator this additional flexibility.

Fannie Mae looks forward to working with Congress and the Administration to adopt the proposal into law this year.

I believe that strengthening our financial regulator is the natural next step in a sequence of Congressional actions that have made the GSE construct an enormous success. Over the last 65 years, Congress has created a remarkable and unique public policy model that today marshals private capital – at no cost to the government -- to carry out the public policy goal of making homeownership more affordable. Let me review the history that has brought us to this opportunity today.

I: THE SUCCESS OF THE AMERICAN SYSTEM

When Fannie Mae was first created in 1938, the 30-year fixed rate mortgage was little more than an idea. Most homes were financed nearly entirely with cash. The standard mortgage product available in the market was a 5-year loan with a balloon payment at the end. When the federal government decided to start making 30-year fixed rate loans, no one really knew if the product would work. Today, it is the standard mortgage in the United States.

Again in 1968, innovative policymakers took another bold step, creating the GSE model we know today. Fannie Mae was privatized. It became a private, shareholder-owned company with a public mission to expand homeownership. This was a novel idea at the time. And the GSE model has proven an overwhelming success, marshalling private capital for a public mission.

In 1992, Congress established Fannie Mae's modern regulatory framework. It included specific affordable housing goals, a rigorous capital framework, and a constant, on-site program of supervision. In the decade since that law was enacted, Fannie Mae has played a central role as our mortgage markets have become increasingly efficient and we have done so maintaining strong, safe, and sound financial performance.

Our mortgage finance system is the envy of the world. Nowhere else in the world are low-downpayment, long-term, fixed rate, prepayable mortgages the market standard. Other nations have noticed our success and are eager to imitate it. Many have figured out how to use government guarantees and government funds to expand homeownership, but none have yet accomplished the success of the GSE model, galvanizing private companies to attract low cost funding to the mortgage market, without spending a dime of the taxpayers' money.

According to the Federal Housing Finance Board, last year in the United States, 83 percent of residential mortgages had fixed rates, with the predominant product being a thirty-year fixed-rate mortgage. By contrast, in Canada borrowers can get a fixed rate for only the first one to five years, and face a prepayment penalty equal to 3 months interest. And in Spain only about 10 percent of the market is fixed rate. In Germany, the typical downpayment is 35 to 40 percent, and in Japan homebuyers have to put down 50 to 60 percent.

In the UK, Chancellor of the Exchequer Gordon Brown is convinced that variable rate mortgages have contributed to housing booms and busts, by exposing homeowners to interest rate swings that create sudden leaps in monthly mortgage payments. He has a team working on creating a market for long-term fixed rate mortgages, and has made the introduction of a fixed rate mortgage product a pre-condition of the UK's adoption of the euro. Brown believes that this will help to reduce the boom and bust cycle in the property market in the UK.

Why are low down payment fixed rate prepayable mortgages so common here and a rarity elsewhere? The difference is Congress' long-standing commitment to homeownership and its decision to foster a sophisticated secondary mortgage market that continues to meet the needs of both homebuyers and investors.

The GSE model has succeeded where other nations have failed because it taps deep pools of capital around the world and disperses mortgage risk across the capital markets. Fannie Mae offers lenders the ability to shed the credit and interest rate risk inherent in a long-term fixed rate mortgage, and to transform mortgage risk into the various forms that investors want to buy. We do that in two ways, both of which have a positive impact on our housing mission by lowering costs to current and potential homeowners.

The Credit Guaranty Business

First, we manage credit risk when lenders come to us with a pool of mortgages and we create a mortgage-backed security (MBS), which the lender can then hold or sell in the market place. Because we guarantee the timely payment of principal and interest on that MBS, investors who do not want to take on the credit risk of a mortgage can purchase MBS. Through our credit guaranty business, we have created and sustained a deep and liquid market for conventional, conforming MBS, which are the bedrock of today's secondary mortgage market.

Mortgage-backed securities are sometimes referred to as pass-through certificates, because the security passes through to investors the principal and interest payments each month from the mortgages backing the security. An investor in an MBS owns an interest in a pool of mortgages and receives the cash flows from this pool. A nationwide network of lenders such as mortgage bankers, savings and loan associations, and commercial banks originates the loans backing the MBS. Securitization by Fannie Mae converts a pool of relatively illiquid mortgage loans into a very liquid security, carrying a guarantee to the investor of timely payment of principal and interest. Fannie Mae's obligation under this guarantee is solely Fannie Mae's and is not backed by the United States government.

The market for these mortgage-backed securities functions with such efficiency that it is able to provide an abundant supply of mortgage credit to American homeowners at low cost, and it is one of the most liquid markets in the world. According to the Bond Market Association, in 2002, Fannie Mae, Freddie Mac, and Ginnie Mae combined MBS issuances totaled $1.46 trillion. On a typical trading day in 2002, more than $154 billion of conforming MBS changed hands. The ultimate beneficiaries of this vast liquidity are homeowners, because they have access to mortgage credit constantly at a lower cost.

The Portfolio Business

Second, we purchase mortgages directly and hold them in portfolio. In fact, while Fannie Mae did not begin guaranteeing MBS until 1981, the company has purchased mortgages for its portfolio since 1938. Today, Fannie Mae's mortgage portfolio remains a vital tool that enables the company to fulfill its housing mission.

Because many investors are not comfortable with the payment uncertainty of mortgages and MBS, the portfolio business has been, and continues to be, an important tool for achieving Fannie Mae's housing mission. By purchasing mortgages and MBS for our portfolio, Fannie Mae expands the universe of mortgage market investors, bringing more capital into the mortgage market and bringing down mortgage rates. Investors who do not want to manage the unpredictability of mortgages, which can prepay before maturity, can instead invest in Fannie Mae debt securities, whose payments are far more predictable. In this manner, Fannie Mae can attract additional investors in support of housing, providing value to homeowners and investors alike.

When Congress chartered Fannie Mae as a shareholder-owned company in 1968, the company's only line of business -- its only way to provide the residential mortgage market with liquidity -- was to purchase mortgages for its portfolio. By purchasing mortgages for its portfolio, Fannie Mae has been able to move independently to stabilize the mortgage market during a crisis. In so doing, it has provided an important source of stability to the market.

This was clearly evident during the fall of 1998, when markets for many other securities dried up, while the market for conforming mortgages was relatively stable due to the extensive purchase activity by Fannie Mae and Freddie Mac. In a recent study by Andy Naranjo and Alden Toevs of the First Manhattan Consulting Group, the authors found that conforming rates would have been 66 basis points higher during this crisis without the stepped up purchasing activity of Fannie Mae and Freddie Mac.

An additional benefit of the portfolio is that it fosters innovation at Fannie Mae and in the broader mortgage market. New or unusual products are often difficult to securitize, at least initially. The ability to buy loans directly improves the company's flexibility when working with lenders who want to sell new mortgage products into the secondary market. Although these new products cumulatively make up a small portion of the portfolio, the ability to design new products is greatly enhanced when lenders know that Fannie Mae can directly purchase the product in the secondary market.

Through the securitization of mortgages and through the transformation of risk in the portfolio, Fannie Mae attracts investors from around the world into the U.S. mortgage market, and lowers mortgage costs for homeowners. As a result, the average difference in 2002 between the conforming mortgages we can purchase and the jumbo mortgages we cannot purchase was 29 basis points, which translates into $19,300 in savings to consumers over the life of a 30-year fixed-rate loan.

Lowering the cost of a mortgage is critical to the bipartisan public policy goal of making homeownership available to Americans for whom the American Dream has long been out of reach. For every 25 basis point (one-quarter of a percentage point) decrease in mortgage rates, nearly 400,000 additional families can qualify to become first-time homebuyers.

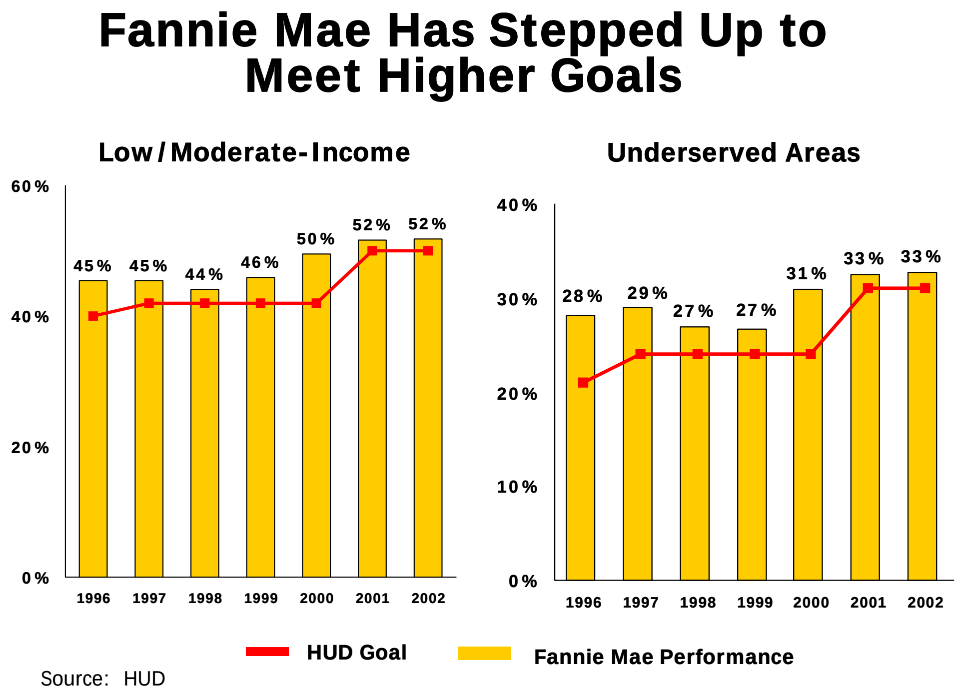
II: FULFILLING OUR MISSION

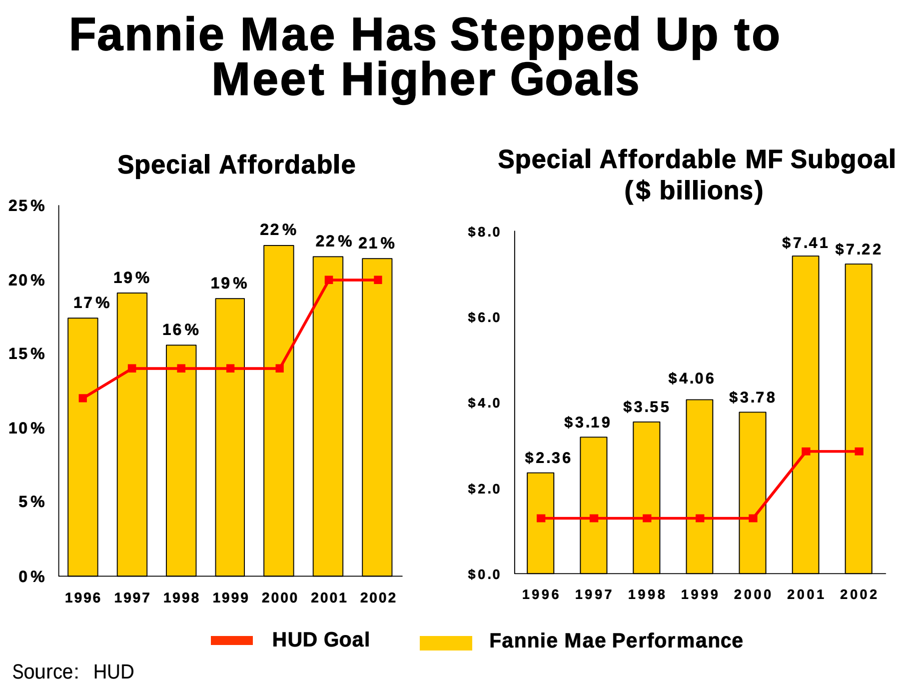
Serving Underserved Communities

Fannie Mae has a special responsibility to focus on some of the nation's toughest housing problems. We do that every day in furtherance of our mission to expand homeownership. In 1994, Fannie Mae launched a *Trillion Dollar Commitment* dedicated to expanding markets and increasing access to mortgage credit. Upon completion of the *Trillion Dollar Commitment* in 2000, we announced our $2 trillion *American Dream Commitment*, a decade-long effort to close homeownership gaps and strengthen communities. Since 1994, Fannie Mae has served more than 12 million low- and moderate-income families and more than 4.8 million minority families.

As the 1992 Act established, HUD has responsibility for our housing mission. HUD has used this responsibility to ensure that we remain focused on our affordable housing mission and to ensure that our business continues to promote housing as a national public policy priority. In addition to operating under HUD's regulation, Fannie Mae also has worked with HUD on a variety of initiatives --including the President's Minority Homeownership Initiative, The Trillion Dollar Commitment, the American Dream Commitment, and important anti-predatory lending initiatives – that have furthered our affordable housing mission. We support a continued role for HUD as our mission regulator.

As the 1992 Act mandated, HUD has established affordable housing goals for the company, to quantify our mission responsibilities. HUD sets specific share of business goals for purchasing loans to low- and moderate-income borrowers, purchasing loans to borrowers in underserved communities, and purchasing loans to very low-income families and low-income families living in low-income areas.





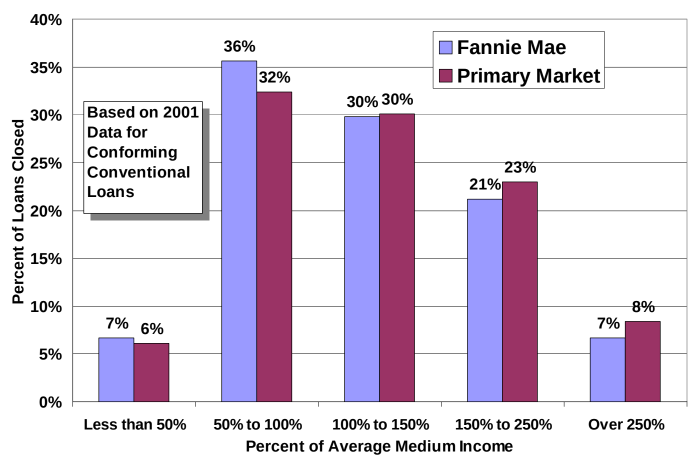
Those goals have increased substantially over the past ten years, and we have consistently met those goals, even as they have become more demanding.

While we consistently meet the HUD affordable housing goals, we carry out a mission that is broader than specific governmental mandates. We are dramatically increasing our impact in underserved communities; we are responding to President Bush's challenge to expand minority homeownership; and we are providing leadership in the market in both qualitative and quantitative ways.   We work every day to innovate and develop creative ways to bring homeownership opportunities to all corners of the nation.

<u>Expanding Fannie Mae's Impact</u>

Fannie Mae is the largest single provider of mortgage credit to low- and moderate-income and minority families. In 2002 alone, Fannie Mae provided more than $279 billion in credit serving low- and moderate-income households. Further, as the chart below demonstrates, a greater share of Fannie Mae's business serves households with incomes below 100 percent of Area Median Income (AMI) than the conventional conforming market.

Fannie Mae Leads the Market in Serving Lower-Income Borrowers

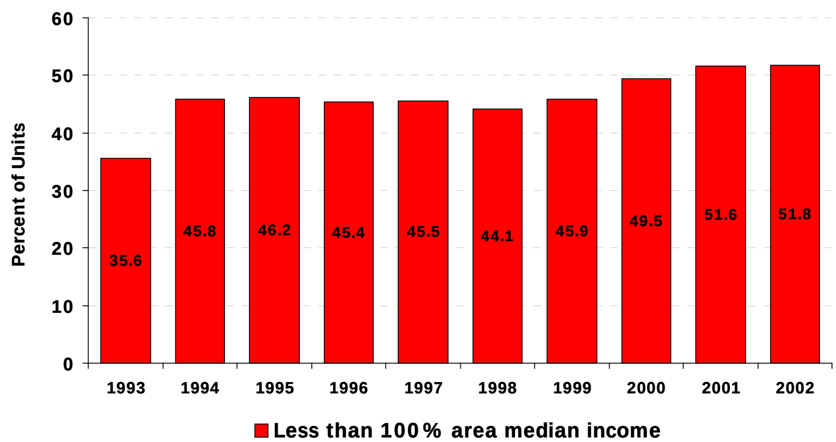


Source: Fannie Mae

In fact, since Congress enacted the 1992 Act, we have steadily increased the share of our mortgage purchases that are loans to low- and moderate-income families. Over the past decade, the percentage of low-and moderate-income Americans we serve has grown substantially, from 35 percent to over 50 percent.

Low-Mod Borrowers Represent Greater Share of Business Over Time

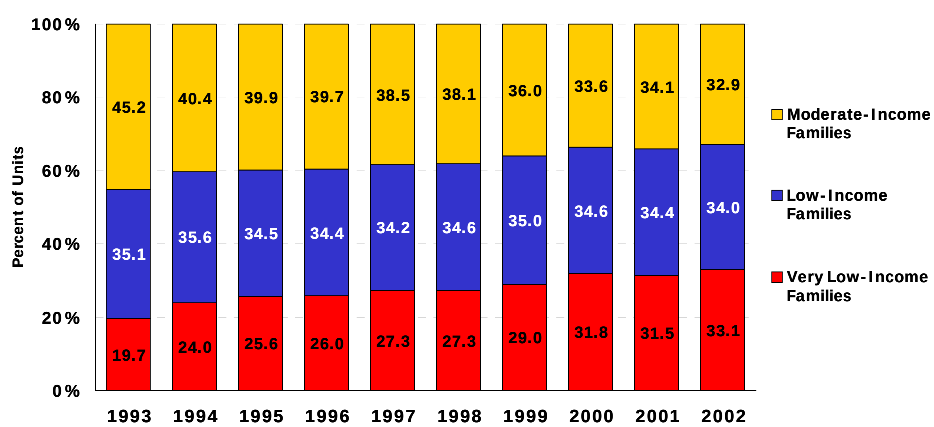
Fannie Mae Low- and Moderate-Income Score



Source: Fannie Mae

And within that population of borrowers, we have steadily increased the share of mortgage purchases that are loans to borrowers earning between 60 percent and 80 percent of area median income, and the share of borrowers earning less than 60 percent of area median income.

Lower-Income Borrowers Represent Greater Share of Business Over Time



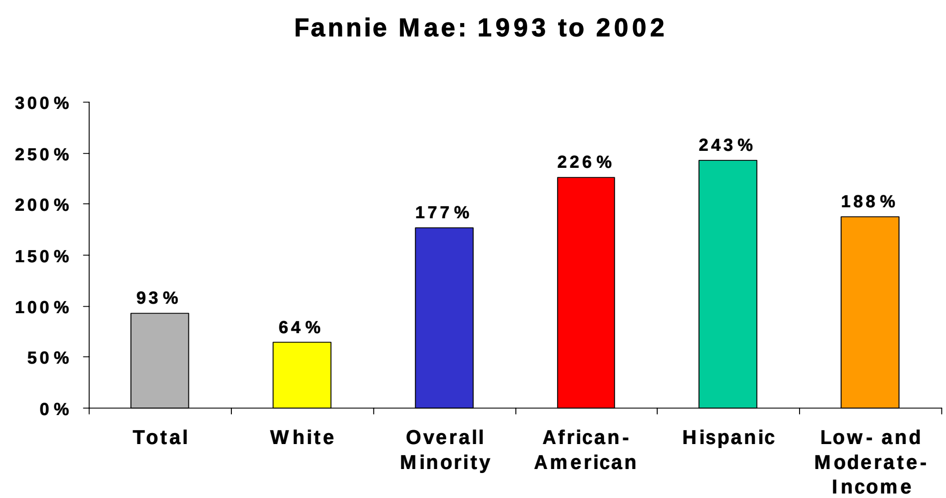
Source: Fannie Mae

Expanding Minority Homeownership

Last year, President Bush challenged the housing industry to work with the Administration to create 5.5 million new minority homeowners by the end of the decade. Fannie Mae made a 10-point commitment to President Bush's Minority Homeownership Initiative, including a pledge to invest at least $700 billion to finance mortgages for minority families between 2000 and 2009. As of the end of June 2003, we had invested $381 billion toward that commitment, while we worked to solve difficult problems through innovative partnerships with lenders, faith-based institutions, counseling agencies, and state and local housing finance agencies.

In 2002 alone, Fannie Mae invested $136.2 billion in mortgages to minority families, exceeding that of any other private financial services institution and even greatly exceeding the Federal Housing Administration's $46.4 billion in minority loan originations that year. Our growth in minority lending over time has been extraordinary. Comparing 1993 to 2002, purchases of loans to African Americans increased 226 percent and purchases of loans to Hispanics increased 243 percent, while our purchases of loans to non-minorities increased by only 64 percent.

Growth in Families Served

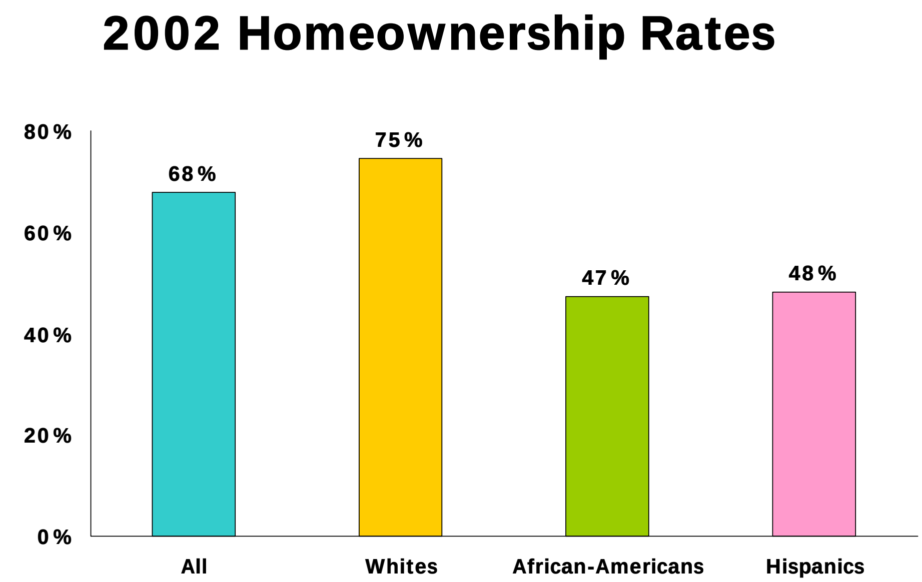


Source: Fannie Mae

We are determined to lead in minority lending, not just because it's the right thing to do, but also because it is what the market demands. We know that the biggest growth markets in the mortgage business are the same markets that have not been served very well in the past. By the year 2020, while the white population is projected to grow by about 5 percent, the African-American population will grow by 24 percent, the Hispanic American population by 70 percent, and the Asian American population by 75 percent.

In some places, Hispanic families are fast becoming a majority. By the end of this decade, Hispanics will contribute nearly half of the nation's population growth. We expect the US population, as a whole, to grow by about 30 million during this decade alone, driven in large part by a healthy influx of new Americans. And that population growth will create 13-15 million new households.

Meanwhile, fewer than half of minorities own their homes, versus almost three-quarters of white families. That means there is an untapped market of millions of minority families right now waiting to be served.



Source: U.S. Census

In other words, the so-called emerging markets are the surging markets. If we are to grow as a company and continue to achieve our mission to expand affordable housing, we must find better ways to reach and serve these markets. Emerging markets are the future of Fannie Mae.

Innovation

Innovation has been critical in our efforts to reach new markets and underserved communities. Harnessing the powers of technology, Fannie Mae has made it possible for more people to access mortgage credit and to have more choices at better prices.

Since 1992, Fannie Mae and the mortgage finance industry have created a revolution in underwriting, product innovation, and streamlined technology processes, to produce significant gains in lending to low- and moderate-income, minority, and other traditionally underserved borrowers.

For example, a downpayment is often the single largest obstacle preventing a family from purchasing a home. Fannie Mae was at the forefront of the mortgage industry expansion into low-downpayment lending and created the first standardized 3-percent-down mortgage. Fannie Mae financing for low down payment loans (5 percent or less) has grown from $109 million in 1993 to $17 billion in 2002.

We've also used technology to expand our underwriting criteria, so that we can reach underserved communities. For example, our Expanded Approval products make it possible for people with blemished credit to obtain a conforming mortgage loan. And we've added a Timely Payments Reward feature to those loans, enabling borrowers to lower their mortgage payment by making their payments on time. These mortgage features have been crucial tools in reaching into communities that were previously underserved. The mortgage market today has a wider variety of products available than ever before, and therefore is better poised to meet the individual financing needs of a broader range of home buyers.

Not only has innovation created a wider variety of mortgage products targeted to individual borrowers' needs, it has also streamlined the cost of processing a new mortgage loan. Our system has brilliantly harnessed the power of information technology to make the process of financing or refinancing a home faster, cheaper and easier for consumers, and more efficient for the industry.

The highly liquid and efficient mortgage market laid the foundation for the refinance boom of the last two years. This has enabled borrowers to take advantage of the lowest interest rates in decades and thereby save billions of dollars in interest costs. In a speech delivered on March 4, 2003 to the Independent Community Bankers of America, Federal Reserve Chairman Alan Greenspan reported that in 2002, close to 10 million mortgages were refinanced, and that households "cashed out" almost $200 billion of their accumulated home equity, likely using as much as half of that amount to modernize their homes and for personal consumption -- spending that directly affected GDP and jobs. He went on to say that approximately half of that cashed out equity went to consumption – consumption spending that provided much needed support to an otherwise flagging economy.

Greenspan acknowledged the significance of record low mortgage rates in the refinancing wave. He also pointed out that the relative ease in the process of refinancing, compared to ten years ago, played a significant role in prompting these additional household expenditures.

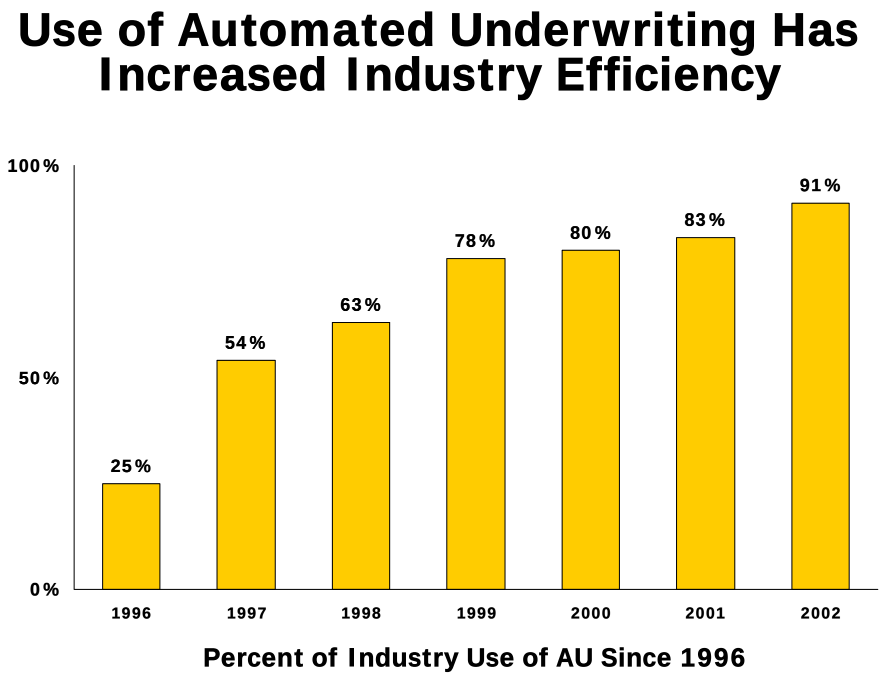
> *"Even as recently as the late 1980s, a family that wanted to use housing wealth to finance consumption would have faced an expensive and time-consuming process…Although substantial home equity wealth has existed for many years, only in the last decade or so has secured borrowing against home equity become a cost-effective source of credit in a wide variety of circumstances."*

He concluded his remarks by noting, "Home equity extraction may be the household sector's realization of the benefit of a rapidly evolving financial intermediation system."

Fannie Mae has played an integral role in standardizing the mortgage process through technology, to make it faster and less expensive for lenders and for consumers to refinance into lower cost mortgages and to cash out some of the equity in their homes.

From the inception of our technology efforts, Fannie Mae's vision has always been to create technology that was scalable through economic ups and downs. Through our technology, our underwriting flexibilities and our access to capital, Fannie Mae has been able to work with lenders across the country to insure that, no matter the size of the market, lenders are able to service their borrowers effectively and efficiently. Without that technological progress, the industry may well have been overwhelmed and unable to accommodate the refinance wave of the last two years.

In a 2002 study, MORTECH, a company specializing in research on the mortgage industry and its use of technology, found that the use of automated underwriting systems (AUS) was nearly universal. That represents a complete transformation of the industry over the last ten years. Virtually all underwriting was manual in 1993. By 2002, 91.3 percent of lenders had implemented automated underwriting. An estimated 75 percent of loan applications were underwritten using automated underwriting in 2002.



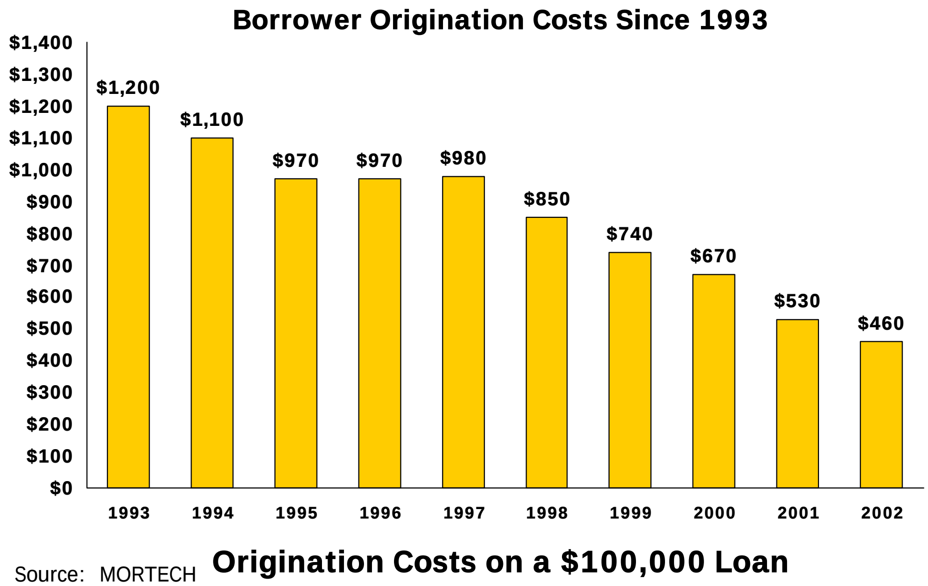
Source: MORTECH 2002/03

Technology has enabled lenders to handle volumes that have more than tripled in the last ten years. During the 1993 refinance boom, the mortgage industry originated $1.0 trillion in mortgage loans, of which 52 percent was comprised of refinance transactions. This year, we are projecting that the mortgage industry will originate over $3.3 trillion, with over 67 percent being refinance transactions.

Without today's technology, the 1993 mortgage market was both paper and people intensive. In 1993, refinancings were treated no differently from regular purchase mortgages. A homeowner seeking to refinance had to fill out a complete application, wait two weeks or longer for approval, order a full house inspection and wait an average of 45 days to close. The inefficient process added dollars and time to the homeowners' cost.

Today is quite different. The introduction of technology has dramatically improved lender efficiencies. With automated underwriting, a lender can provide a borrower with an approval in minutes. In fact, more than 75 percent of applicants are now approved in two to three minutes. And more importantly, lenders who have integrated technology into their business processes witnessed tremendous cost savings. Automated underwriting systems have cut origination costs for mortgage banks, commercial banks, and thrifts. And borrowers have reaped the rewards, in lower mortgage costs.

Automated Underwriting Has Lowered Borrower Costs



Source: MORTECH 2002/03

Technology also impacted our ability to do business at lower costs. Fannie Mae had difficulty handling the volumes in 1993. In the peak month of the 1993 refinance boom, we had 631 people processing 320,000 loans. We hired a large number of temporary employees to handle the huge volume of paper. This year, at the peak of the refinance wave, 250 Fannie Mae employees processed one million loans a month

Providing Leadership in the Market

The 1992 Act focused Fannie Mae on our mission and gave us the flexibility to innovate to meet that mission. As a result, we now lead the market in funding mortgages for low-income and minority home buyers.

There have been many studies that have attempted to measure Fannie Mae's impact in the market. Last week, you heard that some of these studies showed that Fannie Mae lags the primary market in funding mortgage loans for low-income and minority homebuyers. Actually, the most recent data show that Fannie Mae leads the market, by measurements HUD uses and by more common measurements.

Fannie Mae is the nation's largest private investor in affordable housing and minority lending. Since 1994, Fannie Mae has financed homes for more than 12 million low- and moderate-income families and more than 4.8 million minority families. Further, the fact is that – when measured against the market in which we operate – Fannie Mae's performance on affordable housing lending has consistently surpassed the primary market's performance.

Two weeks ago, Secretary Martinez's testimony repeated analysis from the President's budget that Fannie Mae's affordable housing performance in our single-family business lagged the primary market as measured by Home Mortgage Disclosure Act (HMDA) data. The Secretary's testimony cited data from 1999 that HUD believes showed that we lagged the market that year.

Over the years, Fannie Mae has disagreed with HUD's methodology for defining market leadership primarily because the Department has used a definition of the primary market that includes a large part of the subprime market, where Fannie Mae has traditionally not operated. If the subprime market is not included, a HMDA-based market leadership analysis shows that we have consistently led or matched the conventional market in the past.

In 2001, 43.1 percent of Fannie Mae's single-family business served low- and moderate-income borrowers compared to 42.0 percent for the conventional, non-subprime market. A total of 23.0 percent of Fannie Mae's business served minority homebuyers compared to 21.3 percent for the conventional conforming market. We led the conventional conforming market in lending to African Americans, 5.2 percent to 4.4 percent, and matched the market in lending to Hispanics at 9.0 percent. These comparisons are based on owner-occupied, home purchase mortgages in MSAs – the appropriate subset for comparisons between HMDA and Fannie Mae data.

In recent years, Fannie Mae has sought to extend financing to those with imperfect credit, but those advances are not captured in the analysis cited by the Secretary, which focused on data from 1997 through 1999. As a result, since 2001 Fannie Mae has led the market even using the broader definition of the comparison market employed by HUD. Using HUD's definition of the primary market, the 2001 data reveals that Fannie Mae led the market in purchasing loans to low- and moderate-income households (43.1 percent to 42.7 percent), minority borrowers (21.9 percent to 20.8 percent), and African-American borrowers (5.2 percent to 5.0 percent). This represents our own best efforts to replicate HUD's methodology, as HUD has not yet published any analysis using 2001 data.

Fannie Mae's affordable lending performance in 2002 was also excellent, with the percentages of our single-family business serving low- and moderate-income and minority borrowers increasing over the exceptional 2001 levels. For owner-occupied, home purchase lending in metropolitan areas Fannie Mae achieved a 45.7 percent level in low-mod lending (representing a total investment of $69.3 billion for these borrowers), a 26.2 percent level in minority lending ($46.1 billion), a 5.4 percent level in lending to African Americans ($8.3 billion), and 11.0 percent level in lending to Hispanics ($18.3 billion). The 2002 HMDA data for the market were released in August, but cannot be fully analyzed until HUD provides its list of subprime lenders reporting to HMDA – which we expect to receive in October.

Finally, HUD data is focused entirely on single-family homes. None of this analysis includes any of the impacts from our investments in Low Income Housing Tax Credits, multifamily affordable rental housing, Mortgage Revenue Bonds or the other community development investments we make through our American Community Fund.

Market leadership is about qualitative as well as quantitative contributions. Fannie Mae has been an innovative leader in the affordable housing field. The company was at the forefront of the mortgage industry expansion into low-downpayment lending, initiating the purchase of the Fannie 97 mortgage in 1994 as the first widely available and standardized 3 percent down mortgage product and offering loans with as little as a $500 contribution from the borrower today.

We've also harnessed technology to break down the lending barriers minorities often face, mainly by making our automated underwriting system even more flexible so lenders could provide Fannie Mae financing to families with atypical financial profiles. For example, we provided more feedback in the underwriting findings so that lenders could help consumers understand what went into the decision so they could try to fix any problems and get a “yes” decision from that lender.

Our investments in technology have expanded markets for our lender partners, and by reducing the cost of originations, enhanced affordability for the homebuyer. More recently, Fannie Mae has launched new efforts to serve borrowers with blemished credit histories. Our Expanded Approval and Timely Payment Rewards product lines are examples of how we help conventional mortgage lenders broaden their markets to serve borrowers previously left only to subprime lenders.

We’ve also used our role in the secondary market to change practices in the primary market to reduce the prevalence of predatory lending. We are working in local communities throughout the nation to help develop solutions to the problem of predatory lending. For example, in Essex County, NJ, Fannie Mae worked with New Jersey Citizen Action, the U.S. Department of Housing & Urban Development, Essex County, and interested lender partners to develop a workout solution was specifically crafted to help more than 100 families primarily in Essex County who were victims of a property flipping scheme that occurred from 1999 to 2001.

We work to support and increase public advocacy to protect mortgage consumer rights. We believe that all home-buying consumers should be treated equally and should have access to the lowest cost mortgage for which they qualify. We also want home-buying consumers to know the true cost of the mortgages they are being offered -- including all fees and charges.

We have established industry-leading anti-predatory lending policy guidelines to combat abusive lending practices in the marketplace. By setting tough standards and at the same time making conventional mortgage products more widely available, we are working to see that good practices chase bad practices out of the mortgage market.

III: SOUND BUSINESS

Best in Class Disclosure

Fannie Mae has worked with Congress and the last two Administrations to create best-in-class disclosure and corporate governance practices for the company.

In 2000, in consultation with the Treasury Department and members of this committee, Fannie Mae crafted a set of proposals designed to place it at the leading edge of safety and soundness practices. These voluntary initiatives include commitments to issue subordinated debt, obtain an annual “risk to the government” rating, enhance our liquidity planning, disclose more information about interest rate risk and credit risk sensitivity, and implement and disclose the results of an interim risk-based capital standard. In several cases, we created financial structures and disclosures that have little precedent among financial institutions. Taken together, these initiatives give investors and policymakers more information about Fannie Mae’s risk exposure -- and confidence that Fannie Mae can manage that exposure -- than they can get from any other financial institution. We continue to meet every one of the voluntary initiatives.

These disclosures, combined with the regulatory mechanisms Congress enacted in 1992, place Fannie Mae at the vanguard of risk management and disclosure practices worldwide, with cutting-edge regulatory discipline bolstered by cutting-edge market discipline.

In the post-Enron environment, policymakers expressed some concern that some of our disclosures were voluntary rather than mandatory. Some were concerned that our financial statements were not on the SEC's EDGAR website. We responded by consulting with the Treasury Department and members of this committee about their concerns, and then committing to voluntarily register our common stock with the SEC under the 1934 Securities and Exchange Act. In March, we completed that registration, and we are now permanently subject to all SEC disclosure rules and fully subject to all provisions of the Sarbanes-Oxley Act of 2002 just like any other SEC registrant. We cannot ever back out of this registration.

And we took further disclosure steps earlier this year. While the SEC has detailed guidelines for disclosures for many types of securities and issuers, the SEC currently does not have such guidelines for issuers of asset-backed or mortgage backed securities. Instead it reviews the disclosures of each private-label issuer. In a comparable process, a joint Treasury-SEC-OFHEO task force undertook a similar review of our MBS disclosures. When the task force recommended that we add six new pool level disclosures to our MBS issuances, we agreed. As of April, those disclosures are in place. As a result of this process, there are no significant difference between our MBS disclosures and those of private-label issuers.

Fannie Mae has relied on multilayered, redundant risk management practices for the past decade. We now have added multilayered, redundant disclosure and transparency practices, with both a greater quantity and a greater quality of information and disclosure. We now put out more -- and more timely -- information to the public, investors and policymakers than any other financial institution in the world.

If policymakers or investors have a question or concern about how Fannie Mae is doing, there are several ways to find out. They can look at the results of our supervision exams, which are public, unlike those of other financial institutions. They can look at our capital levels, our stress test results, our external rating reports, our regular reports on how the economy is affecting our business, or changes in the value of our subordinated debt. No financial company in the world will give policymakers and investors more information about its financial condition than Fannie Mae does.

Our voluntary initiatives ensure that Fannie Mae will remain one of the safest, soundest financial institutions in the world. Our subordinated debt rating and our risk-to-the-government rating are among the strongest in the industry. We have more than adequate liquidity to survive for three months assuming no access to the capital markets. We could endure the worst economic shocks in history -- shocks that few other financial institutions could survive -- with significant capital left over.

As several financial regulators have noted, there is a world of difference between disclosure and transparency. It is easy to post reams of information on a web site or to include mountains of extraneous material in a financial report. It is a difficult, ongoing process to ensure that not only does the company disclose information, but that we do so in a way that investors, policymakers, and other stakeholders can truly understand the nature of our business. We believe we have achieved a market-leading level of transparency, and we have some external support for this belief.

In summarizing the value of the package of disclosures to which Fannie Mae and Freddie Mac committed themselves in 2000, Moody's stated:

> *These financial disclosure commitments by Fannie Mae and Freddie Mac set new standards not only for them, but also for the global financial market.*
>
> *The provision by Fannie Mae and Freddie Mac of periodic, detailed risk information to the broad market will permit better independent reviews and monitoring of their risk profiles and should substantially reduce the uncertainty about their actual financial health as well as dampen any systemic risks they present.*
>
> *The regular disclosure of their interest and credit risk exposure, combined with stress testing of their capital base, should significantly increase market comfort with their risk management disciplines and capital adequacy. The stress test, in particular, will show whether the two GSEs have sufficient capital to withstand very harsh market developments over a long period.*

In addition, Professor Benton E. Gup, testifying before your Subcommittee on Financial Institutions and Consumer Credit on July 19, said, "The *Fannie Mae 2002 Annual Report* does an outstanding job explaining how this [GSE] uses derivatives to hedge interest rate and credit risk….The annual report of Fannie Mae should be read by all real estate lenders to gain insights about how to mitigate the risks associated with such loans."

Excellence in Risk Management

This country is unique in that our financial system offers homeowners the option of a 30-year, fixed-rate mortgage with a prepayment option. It is the most consumer-friendly, consumer-favored mortgage option available because it allows the homeowner to lock in current rates for 30 years and refinance to lower rates during that time. But if you want to give homebuyers the prepayment option, someone is going to have to manage the prepayment risk. Fannie Mae was created to make long term, fixed-rate mortgages with a prepayment option available nationwide. When you compare various potential mortgage investors in this country, you have to ask, who will bear the risk, and to what extent will that investor hedge that risk?

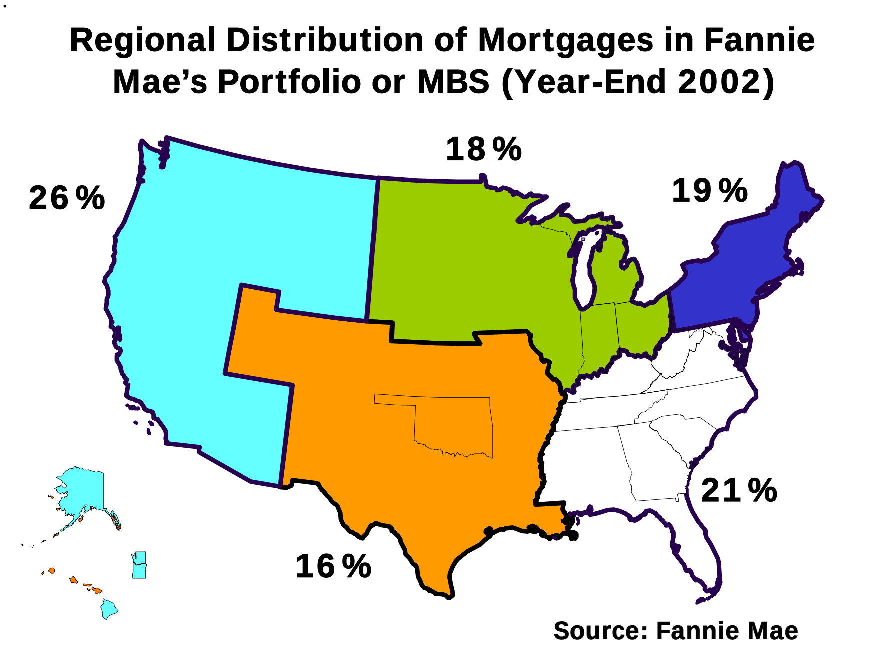
In Fannie Mae's case, the answer is that we consistently, conservatively manage these risks. Fannie Mae's core competencies are the management of mortgage interest rate and credit risks. That is why we are the low-cost, low-risk provider of these risk management services.

Credit Risk Management

Residential mortgages are relatively low-risk assets from a credit perspective. However, Fannie Mae's credit performance clearly shows that by specializing in managing mortgage credit risk, we have achieved significant gains in efficiency and performance. Homeowners and taxpayers alike are better off with Fannie Mae managing this risk.

Unlike other financial companies, Fannie Mae has one main business line, mortgages, which are among the safest products in the financial services sector. Most other financial institutions engage in a broad array of lending activities, ranging from mortgages, auto loans, credit cards, and commercial lending, to far riskier and more obscure activities.

Fannie Mae takes steps to further reduce the already low level of risk in mortgages. The company's first line of defense is the equity in the homes securing the mortgages. On average, owners have 38 percent equity in the homes financed by Fannie Mae mortgages. Furthermore, these homes are spread relatively evenly across the country so that the company is not overly exposed to a downturn in any one area.

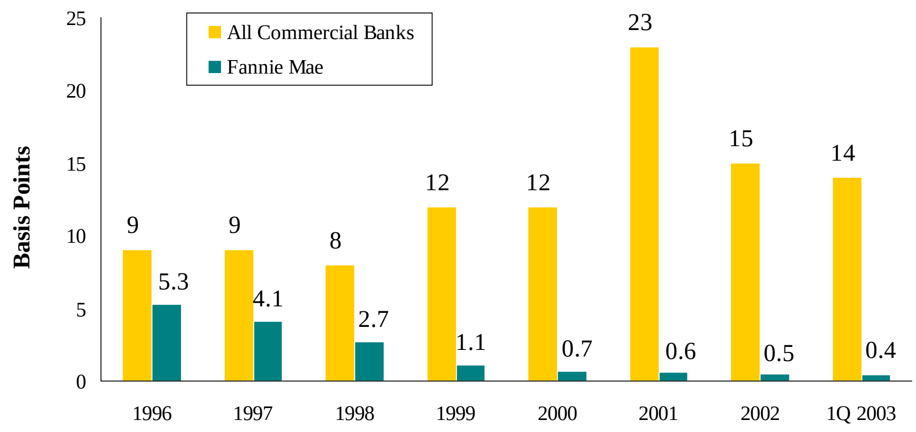


Source: Fannie Mae

Fannie Mae also disperses its risk by sharing credit exposure with various partners. Credit enhancements include primary loan-level mortgage insurance, pool mortgage insurance, recourse arrangements with lenders, and other customized contracts. As of the end of 2002, we shared with others the credit risk on $491 billion of single-family mortgages in Fannie Mae's portfolio or outstanding MBS. In 2002, credit enhancements absorbed $317 million, or 82 percent, of $386 million in gross single-family losses. As a result, while the company's book of business more than doubled between 1995 and 2002, its credit losses were cut by a factor of more than four—even while its total book of business grew.

Observers might attribute these stellar results to a strong housing market in recent years. Strong house prices have certainly helped keep credit losses low. But that is not the whole story. After all, credit losses in the mortgage portfolios of banks have not shown a similar decline. Thus, for instance, Fannie Mae's credit losses of 0.5 basis points in its single-family portfolio in 2002 compares with bank credit losses on mortgages of 15 basis points. Furthermore, while Fannie Mae's losses have trended sharply lower in the last five years, banks' losses have not followed a similar pattern.

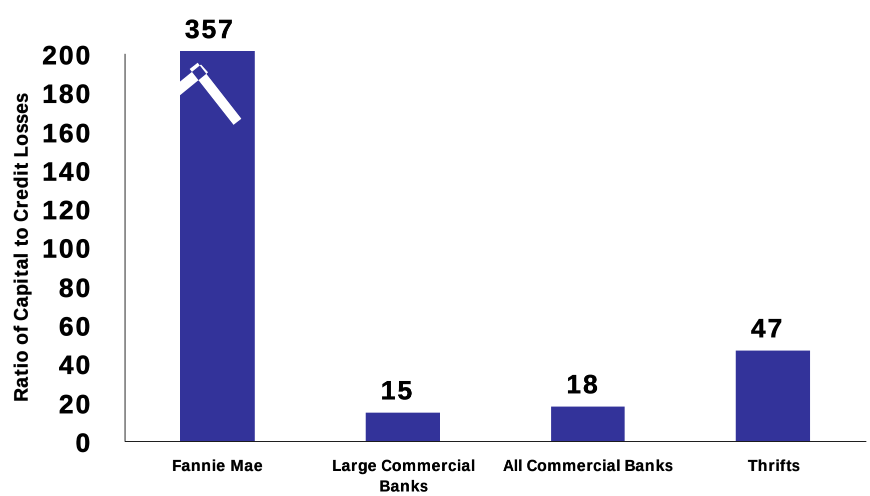
Single Family Net Charge Off Ratios



Bank amounts include home equity activity.
Fannie Mae amounts are net credit-related losses as a percent of average net portfolio and net MBS; Fannie Mae credit-related losses include net charge offs and foreclosed property expenses.
Source: Fannie Mae Annual Reports and Investor/Analyst Reports, and FDIC.

In summary, Fannie Mae's exceedingly strong credit risk performance is not simply the result of a robust economy. Instead, the company's credit management and loss mitigation techniques have borne increasing fruit over the last several years.

Ratio of Capital to Credit Losses



Note: As of Q3 02, there were 80 commercial banks with assets > $10 BN. These 80 are part of 59 larger banking companies (i.e., multiple commercial banking subsidiaries of Bank of America have assets >$10 BN, but are part of one banking company. Bank of America's subsidiaries with assets < $10 BN are not included).

Source: FDIC and OTS, from FDIC website, and Fannie Mae Q3 02 Investor/Analyst Report

Reflective of its low level of risk, Fannie Mae's ratio of capital to credit losses for the first three quarters of 2002 was 357 The thrift industry, which also specializes in mortgages, had a comparable ratio of 47, less than a quarter the capital coverage that Fannie Mae had. Large commercial banks, on the other hand, had a capital coverage ratio of only 15, with the entire banking industry at 18. The further one gets away from specialization in mortgages, the greater the level of losses relative to capital.

The question for policymakers is not how to eliminate credit risk from the system. That is not possible. The question is which institutions best manage this risk and are best able to withstand credit crises. In the event of a credit crisis, Fannie Mae is in a stronger position to survive than are the other potential holders of mortgage credit risk. If credit losses were to increase by a factor of 20, Fannie Mae would have sufficient capital to cover the resulting losses. Banks would not.

Interest-Rate Risk Management

With respect to interest-rate risk management, Fannie Mae's primary role is to manage, and largely disperse, the risk inherent in long-term, fixed-rate mortgages. The concept follows that outlined in a speech a year ago by Federal Reserve Chairman Alan Greenspan:

> "The development of our paradigms for containing risk has emphasized dispersion of risk to those willing, and presumably able, to bear it. If risk is properly dispersed, shocks to the overall economic system will be better absorbed and less likely to create cascading failures that could threaten financial stability."

Fannie Mae carries out this role by investing in assets and issuing liabilities that perform similarly in different interest rate environments in the context of a reliable, diversified, and disciplined approach to the management of interest rate risk. . Fannie Mae's approach to the management of this risk is really quite different from approaches used by other mortgage investors.

Fannie Mae's mortgage portfolio consists mostly of long-term fixed-rate amortizing mortgages. If mortgages paid off according to their scheduled cash flows, match-funding them would be simple. One would simply raise liabilities with laddered maturities far into the future that matched the monthly return of principal of the amortizing mortgage portfolio. The resulting ladder would be a mixture of short, medium and long-term debt instruments.

However, most fixed-rate mortgages give borrowers the option to prepay, thereby clouding with uncertainty the future cash flows from a mortgage portfolio. The biggest determinant of their choice is the future course of interest rates. There will always be a certain level of loan prepayments because of life-circumstance changes. In a falling interest rate environment, this core will be swamped by the amount of prepayments that are part of the refinancing wave that takes place when interest rates decline significantly. A subsequent rise in interest rates would then see a scale-back in the amount of prepayments to somewhere close to the core level.

The future course of interest rates is unpredictable. Therefore, the future level of mortgage prepayments (and, hence, of mortgage cash flows) is also unpredictable. To hedge this prepayment risk, Fannie Mae relies on the broad issuance of callable debt. Callable debt gives the mortgage investor the ability to call debt in response to mortgage prepayments prompted by a fall in interest rates. This enables the investor to reissue debt at a lower rate and fund new mortgages that are now at a lower yield, maintaining a relatively stable net interest margin.

Callable debt is not always the most efficient or effective method of hedging interest rate and prepayment risk. Derivatives are used, by Fannie Mae as well as many others, to complement callable debt in achieving the optimal funding mix for mortgage portfolios. They add flexibility to Fannie Mae's portfolio rebalancing because their terms can be restructured in response to changing market conditions in ways that are difficult if not impossible to accomplish with debt issued in public markets.

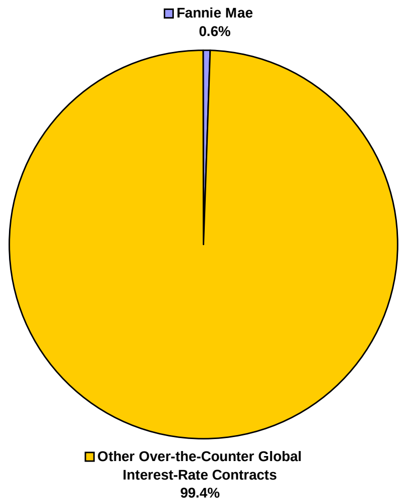
Fannie Mae uses only the most straightforward types of derivatives—such as interest rate swaps, swaptions, and interest rate caps—whose values are easy to model and predict. The company also acts only as an end user of derivatives. It does not trade, take positions or speculate in derivatives. Its counterparties are highly rated financial institutions, and it requires these institutions to post collateral to secure their obligations to Fannie Mae.

Derivatives have conferred substantial benefits on financial markets. Federal Reserve Chairman Greenspan has commented on the benefits of using derivatives to manage interest rate and other risks:

> "Financial derivatives … have grown at a phenomenal pace over the past fifteen years…These increasingly complex financial instruments have especially contributed, particularly over the past couple of stressful years, to the development of a far more flexible, efficient, and resilient financial system than existed just a quarter-century ago."

Fannie Mae is a relatively small player in a huge global derivatives market. Data from the Bank for International Settlements show that the total notional principal balance of the over-the-counter (OTC) derivatives market as of December 2002 was $142 *trillion*. At that date, $102 trillion were interest rate contracts as opposed to those based on commodities, currencies, or equities. Fannie Mae's $657 billion in notional principal as of the same date was 0.64 percent of the total notional amount of interest-rate-based contracts and less than one-half of one percent of total contracts. By comparison, as of the end of 2002, U.S. commercial banks held $56 trillion in notional volumes. Holdings were quite concentrated. At the end of the second quarter of 2003, the three largest banks accounted for approximately 90 percent of notional value held by the banking sector.

Fannie Mae Share of the Over-the-Counter Interest Rate Contracts



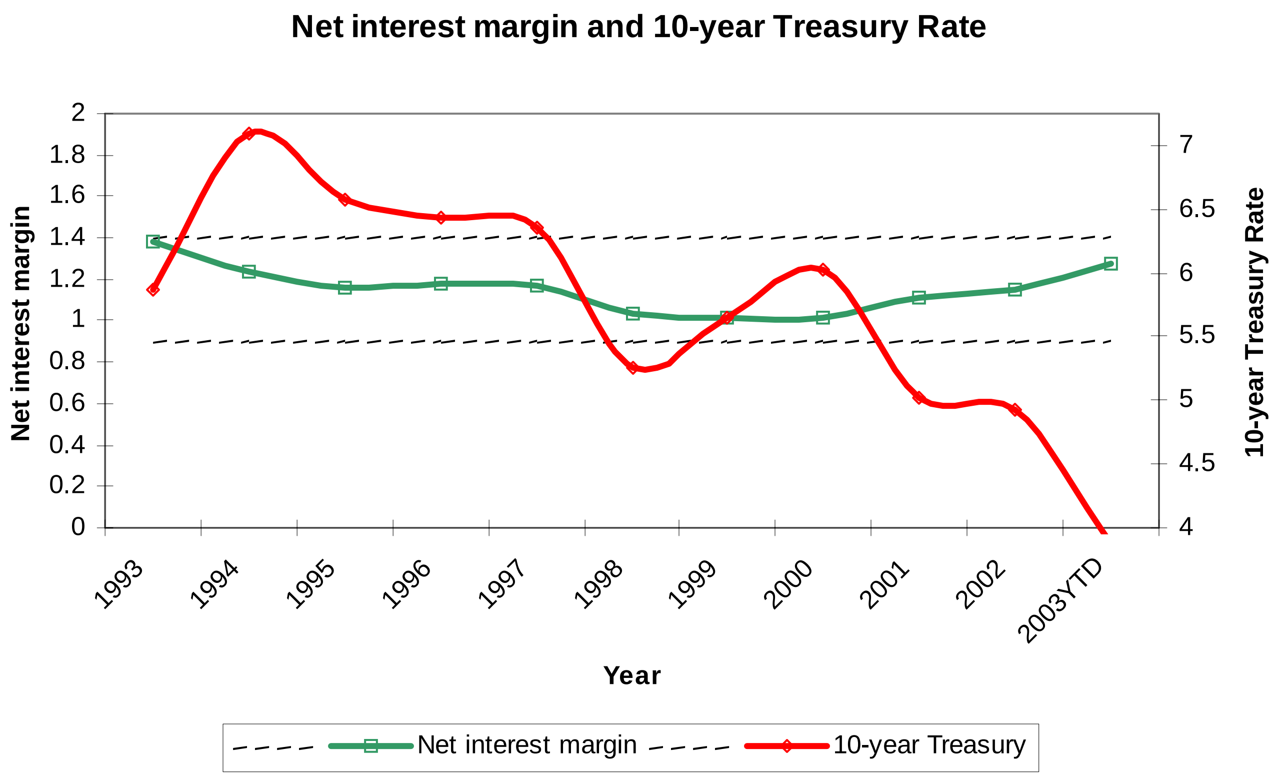
However, these notional values are often a source of confusion. Notional values, as their name implies, do not represent exposures to loss. Neither of the parties to an interest-rate swap, for instance, owes the notional value or is ever going to have to pay it. The notional value is used as the basis for calculating the much, much smaller payments that actually change hands between the contracting parties.

The actual exposure to a counterparty is also much lower. In Fannie Mae's case, its total derivatives exposure on December 31, 2002 was $3.3 billion. Against that exposure it held collateral valued at $3.1 billion, making the net exposure just $197 million. This means that even if every derivatives counterparty defaulted simultaneously and without warning, it still would cost Fannie Mae only $197 million to replace the economic value of those contracts. The replacement need not necessarily be in the form of derivatives. An alternative replacement could be an issuance of callable debt. By contrast, according to the OCC, top banks have on average credit exposure equal to 240 percent of their risk-based capital as of the second quarter of 2003.

It is worthwhile to put this total net exposure in perspective: net income for Fannie Mae in 2002 was $4.5 billion so that the $197 million credit exposure in derivatives could be covered by approximately two weeks of net income.

To limit the risk of a default on a derivatives contract, Fannie Mae engages in new derivatives contracts only with well-established, high credit quality counterparties that are experienced in managing derivative books. As of the end of 2002 all of its derivative contracts were with counterparties rated A or higher.

The effectiveness of Fannie Mae's interest rate risk management strategies can be seen in the fact that the company has never suffered a loss from a credit default by a counterparty and has continually produced remarkable stability in net interest margin in a variety of interest rate environments. Indeed, if the interest rate scenario of the early 1980's were repeated today, Fannie Mae would not only avoid losses—the company would continue to show strong earnings.



Liquidity Risk Management

During the financial crises in the fall of 1998 and following the events of September 11, Fannie Mae provided liquidity to the financial markets. By dealing almost exclusively in easily-valued residential mortgages and MBS, as opposed to heterogeneous, illiquid, and hard-to-value assets found on the books of other institutions, Fannie Mae is largely protected against to any liquidity risk.

A vital part of risk management at a financial institution is the management of liquidity risk. Fannie Mae has pledged to meet the very highest standards of liquidity management. In this regard, it has several natural advantages in its favor. In the first place, much of the company's funding is long term. At the end of 2001, for instance, 55 percent of the company's debt had a remaining maturity of more than one year. These funds are not suddenly redeemable by creditors unlike most of the deposits in a commercial bank. A major part of the company is insulated, therefore, against a sudden "run."

Secondly, the company maintains a liquid investment portfolio (LIP) of liquid, high credit quality, non-mortgage securities that it could draw upon in the event of a market disruption for its debt.

Third, Fannie Mae has a huge pool of mortgages and mortgage-backed securities. The company could also borrow (using repurchase agreements) against this unencumbered portfolio. As part of its calculation of resources available to meet liquidity needs, the company assumes that securities in its portfolio would trade at a substantial discount during any liquidity crisis.

As part of its October 2000 Voluntary Initiatives Fannie Mae committed to maintain contingency plans for handling a liquidity crisis based on the assumption that it was unable to access the new-issue debt markets for a period exceeding three months. Under this commitment, the company pledged to maintain at least five percent of its on-balance sheet assets in a liquid, marketable portfolio of non-mortgage securities and to maintain additional, highly liquid securities in unencumbered form in order to facilitate liquidity. The company also pledged to comply with the 14 principles for sound liquidity management established by the Basel Committee.

Moody's complimented the liquidity commitment of Fannie Mae and Freddie Mac: "The two GSEs' commitment to maintain in excess of three months of on-balance-sheet liquidity will reduce their already modest exposure to unforeseen liquidity crises. These commitments should provide a higher level of comfort to the market about Fannie Mae and Freddie Mac's strong liquidity position."

Fannie Mae included a liquidity component in its six initiatives based on discussions with policymakers who specifically recommended the formulation of a liquidity policy. Fannie Mae's liquidity needs are fairly straightforward, and the relevant provision of the voluntary initiatives responds to concerns about a significant disruption in the market.

Certainly, it is difficult to foresee how a future liquidity problem might unfold, but it is unlikely that such a problem would last beyond a certain number of days. The Basel Committee has set three months of liquidity as the outer limit of what a large financial institution should maintain. For Fannie Mae, it is a minimum. The company's actual liquidity significantly exceeds its three-month commitment.

Taxpayers are better off with Fannie Mae

Clearly, homeowners and our financial system are better off with Fannie Mae actively pursuing our housing mission. And while critics charge that taxpayers are at risk, that is not the case. The alternatives make that clear. If Fannie Mae were to stop guaranteeing and investing in mortgages, the credit and interest rate risks inherent in mortgages would not go away, they would be borne by other institutions, primarily commercial banks and thrifts. These institutions take insured deposits that have an explicit guarantee from the government. Our debt securities have an explicit disavowal of any government support. If risk migrated from Fannie Mae to the banking system, there is no doubt that taxpayers would be at higher risk.

In order to fulfill our mission of attracting low-cost funding to the mortgage market, we must maintain our position as a low-risk, very high credit quality company. That is, our mission requires us to be one of the top-rated financial institutions in America and the world.

We have committed to maintain a stand-alone "risk-to-the-government" credit rating from Standard & Poor's of at least AA-, and a stand-alone "bank financial strength" credit rating from Moody's of at least A-, on a scale in which A is the highest. We have also committed publicly to capitalize and hedge our mortgage portfolio and credit guaranty business so that each is able to withstand internal or external "stress tests" set to at least a AA standard. Finally, we have as a goal to keep our mortgage prepayment and credit risk low enough that over time our core business earnings are less variable than the median of all AA and AAA companies in the S&P 500.

Our public commitment to maintain very high credit ratings is intended to provide investors with external validation of our low-risk posture. Let me note that a AA-level rating is very strong. For the past 70 years the creditworthiness of the debt of AA-level companies has been indistinguishable from that of AAA-rated companies.

Of the more than 24,000 registered financial institutions in America, only about three dozen have AA or AAA ratings. Companies earn a AA rating by showing objective third parties they can weather virtually any economic and financial environment - and by posting a consistent pattern of earnings growth that reflects a low-risk business strategy.

Fannie Mae's exposure to a severe economic scenario is more than adequately captured by the risk-based capital test that is now in force. The risk-based capital rule is rigorous and closely aligns required capital with the risks that an institution takes. A recent study, written by Joseph Stiglitz, winner of the 2001 Nobel Prize in economics, confirms the rigorous nature of this test, and the comfort policymakers should take regarding the inherent financial strength of any institution that can pass such a test. The Stiglitz paper, "Implications of the New Fannie Mae and Freddie Mac Risk-Based Capital Standard," examines the likelihood of the risk-based capital scenarios occurring. The Stiglitz econometric analysis finds that the probability of the stress test scenarios is conservatively one in five hundred thousand and may be smaller than one in three million. Stiglitz concludes that the risk of default by Fannie Mae, if it holds sufficient capital to meet the risk based capital rule's stress test, is "effectively zero". If the chances for a Fannie Mae default under the stress test are effectively zero, then the potential for Fannie Mae to pose any risk to taxpayers must also be effectively zero.

A comprehensive examination of our activities reveals that the possibility of any event that would cause Fannie Mae to default on its commitments, and hence pose a risk to other financial institutions or to the financial system is extremely low and approaches zero.

<u>Corporate Governance</u>

Fannie Mae's conservative risk management, and disclosure of our risk measures, give investors a solid understanding of our business. That openness is critical to our ability to raise private capital to pursue our mission. To raise low-cost funds for the U.S. mortgage market, it is also critical that we earn and ensure the trust of investors, shareholders, and other stakeholders every day.

Openness. Integrity. Responsibility. Accountability. Fannie Mae puts a premium on upholding these simple, core principles in our corporate mission, business, and culture for an important reason: Trust is uniquely crucial to our company. To fulfill our mission, Fannie Mae needs to be active in the capital markets every working day. Our job is to raise billions of dollars in private capital from investors all over the world, at the lowest cost possible, to finance homeownership. Before they entrust us with their money, investors need to trust Fannie Mae.

Last year, even before the passage of Sarbanes-Oxley legislation, I set in motion a 6-month corporate governance project, working with our board, to make Fannie Mae best in class in corporate governance. The Corporate Governance Committee of our board of directors -- under the leadership of Ann McLaughlin Korologos -- met for six months to put together a best-in-class model that works for Fannie Mae. They looked at the best practices in the market, including those offered by the New York Stock Exchange, The Business Roundtable, the Conference Board and others to see where we might make our governance even better.

This spring, our board voted to approve and adopt a series of corporate governance guidelines. In most ways, we already matched up to best in class, but the board's action will codify and strengthen our practices.

There are two key principles embedded in our policy. First, the roles of the board and management are clear and distinct. That is, the board picks the CEO -- the CEO does not pick the board. The board monitors the CEO -- the CEO does not manage the board. The CEO serves at the pleasure of the board.

The CEO is not a free agent or an independent player. He is an employee of Fannie Mae. He works for the shareholders. And he is personally responsible for making sure the company is operating ethically and effectively.

The second key principle is that, to hold the CEO accountable, the board must be independent and free from issues of conflict of interest. As The Business Roundtable and others recommend, a significant majority of our board members are independent from management. By independent, we mean these directors have no material relationships with the company that might impair their independent judgment.

Additionally, to further facilitate the ability of our directors to bring their independent judgment to the issues facing the company, Fannie Mae's non-management directors meet as a group on a regular basis in executive sessions without management present. Those sessions allow the nonmanagement directors to assess management's performance in as open and candid a setting as possible.

The board committees that watch over our audits, our compensation, the selection of board members and our corporate governance policies are comprised entirely of independent members. They meet whenever they want. They have meetings without management in the room. And they can hire whatever outside advisors and experts that they need to do their jobs.

We have established a corporate governance website for Fannie Mae, where we post background on our board, our Corporate Governance Guidelines, our bylaws, the charters of our committees and other key corporate governance materials. We also publish ways in which any shareholder, employee or other interested person can contact our nonmanagement directors or audit committee directly with any concerns or questions they might have.

Last fall, we asked S&P to examine our corporate governance and transparency, to let us know where we can improve, and let others know where we stand. In fact, Fannie Mae was the first U.S. company to receive and publish Standard & Poor's corporate governance score.

The Standard & Poor's announcement noted, "By being the first U.S. company to publish its governance score from Standard & Poor's, Fannie Mae is not only demonstrating its own strong governance practices, but is also showing leadership in the U.S. with regard to providing greater openness and disclosure about its corporate governance standards."

Let me describe some of the highlights of the report. First, the report made an interesting observation. More than most companies, Fannie Mae operates in a fishbowl thanks to our unique corporate status, our size and influence in the housing market, our public interest mission and the scope of our activity in the fixed-income markets.

These factors, the report notes, "increase [Fannie Mae's] public visibility and invite scrutiny from the private and public sectors and the media," which allows "more scope for external stakeholder influence at Fannie Mae than would be the case for companies with lower public profiles."

In addition, the report states, "Fannie Mae is among the most tightly regulated financial companies in the world." Our regulatory oversight and voluntary initiatives, it said, provide "disclosure about Fannie Mae's financial health that is unavailable from other, similar financial institutions."

Fannie Mae scored very highly on corporate governance. Standard & Poor's gave Fannie Mae a corporate governance score of 9.0 out of a possible 10, saying, "Fannie Mae's corporate governance practices are judged . . . to be at a very strong level on a global basis of comparison." As the report states, our board "combines a good mix of new and longer-serving directors, directors of high caliber and with a diversity of skills and a strong voice of independence and engagement."

The report affirms that our board structure meets the latest rules on board composition proposed by the New York Stock Exchange for member companies, and has for some time. The report also concurs that our board has a substantial majority of independent, non-executive directors and independent board committees.

As the report says, "The [Fannie Mae] Board appears to be an effective leader of the company and monitor of management." And, "directors appear to be engaged and show a desire to demonstrate leadership in board effectiveness and governance." And, "Fannie Mae's audit committee demonstrates a commitment to the independence of the audit process. Its members are actively engaged with both the internal audit team and the outside auditors."

Fannie Mae's corporate governance has also been recognized by the Corporate Library, an independent ratings group. In June, The Corporate Library presented Fannie Mae's Board with a special citation as the best "stakeholder board" for its explicit commitment to setting the standard for outstanding corporate governance. In addition, Governance Metrics International, in its most recent rating from July of this year, commended Fannie Mae's stepped-up governance practices, giving the company a rating of 8.5 out of 10, well above the 6.2 average rating for the diversified financial industry.

<u>Summing Up 10 Years of Progress</u>

Since Congress enacted legislation in 1992, Fannie Mae has helped achieve dramatic changes in the mortgage market. We have fostered innovation and facilitated a remarkable increase in efficiency. We have expanded homeownership, especially among underserved communities, and the nation now enjoys the highest homeownership rate in our history. We have consistently met the affordable housing goals set by HUD. We have done this while constantly improving our disclosure, our corporate governance, and our financial strength.

In short, we believe Fannie Mae is achieving the mission given it by Congress. And, if my discussions with many of you on the committee are any indication, we believe Congress remains firmly committed to that mission of expanding homeownership. Therefore, as Congress considers legislation affecting our regulatory framework, we believe it should focus on addressing regulatory shortcomings, not on changing the features of our charter and mission that made the successes of the last decade possible.

IV: TODAY'S LEGISLATIVE CHALLENGE

Secretaries Snow and Martinez appeared before this committee last week, and I'd like to comment on the recommendations they laid out. First, I believe it is important to note that they focused on fixing the shortfalls in our safety and soundness supervisory regime, not on making changes to the companies or their charters. That is the right focus for this legislative process.

<u>Supervision</u>

We support the creation of a new bureau at the Treasury Department with the resources necessary to oversee the safety and soundness of Fannie Mae and Freddie Mac.

Given our mission and charter, we have no doubt that we should be subject to safety and soundness regulation. Safety and soundness are integral to the success of any private financial services institution. In fact, there are several large, complex financial institutions that are not subject to safety and soundness regulation today. Congress may want to examine that issue at another time. At Fannie Mae, we welcome strong, credible safety and soundness oversight.

It is critical to be clear on the singular mission of safety and soundness regulation of privately capitalized, privately managed companies. That mission is to focus on the survival of the companies in stressful economic conditions. In other words, the job of a safety and soundness regulator is to ensure the companies have the capital necessary to withstand severe economic stress. As long as the company is well-capitalized, safety and soundness regulation is not about questioning day-to-day business operations or routine management decisions.

This distinction between supervision and management is the foundation of commercial regulation throughout the marketplace. In the financial services sector, our public policy has found the right balance between private management and public supervision. In the private sector, companies thrive when management is allowed to take some risks, innovate, and experiment, and even to see a new innovation fail, as long as that failure doesn't put the entire enterprise at risk. Companies that take no risks and do not innovate cannot evolve to meet the demands of consumers and improve living standards for all Americans.

The 1992 Act struck a good balance between private management of the companies and public supervision to ensure that management doesn't put the companies at risk of failure. The financial services industry has evolved dramatically in those 11 years, as financial institutions have merged and broadened their lines of business. The housing finance industry has evolved as well, developing products and technology that have given both homebuyers and mortgage investors more choices. It is appropriate that, 11 years later, Congress look at our safety and soundness regime to see if that balance is still correct.

Over the last 11 years, our safety and soundness regulator, OFHEO, has steadily increased its budget and grown its examination staff. Today, OFHEO has a staff of 40 examiners, or 20 per institution. This is comparable to the size of the typical on-site OCC exam team dedicated to any of the largest OCC-regulated banks. OFHEO's current budget includes a plan to expand to 66 examiners.

The creation of an independent bureau in the Treasury Department to regulate the safety and soundness of Fannie Mae and Freddie Mac – a bureau armed with the powers and resources needed to do the job – can mark a further significant improvement in the quality, consistency, and focus of the financial regulation of the two companies.

The bureaus within the Treasury that currently regulate the banking industry are highly regarded financial regulators that keep pace with evolving best practices and attract high quality staff. Establishing a new, world-class financial regulator for Fannie Mae and Freddie Mac within the Department of the Treasury, with a reliable funding base and the flexibility necessary to do its job effectively, would be a landmark achievement for the Bush Administration and the 108th Congress. It would also be in the best interests of Fannie Mae, our investors, the housing finance sector, and the housing mission we serve.

That bureau should not only have reliable funding but also a clear plan in how to employ its resources. The OCC and OTS devote over three-quarters of their budgets to examination and supervision. This apportionment of funding reflects the fact that these agencies' have a single, clear priority: examination and supervision to monitor continuously the safety and soundness of the regulated enterprises. A new regulator for the GSEs should have similarly clear focus on examination and supervision, with a similar division of resources to ensure the regulator's priority remains on on-site, daily oversight of the safety and soundness of all operations of the regulated companies.

We believe that effective regulation must also ensure that Fannie Mae can continue to carry out its mission. As I have shown, Fannie Mae has made dramatic strides in the past ten years, expanding access to capital, broadening homeownership among low- and moderate-income Americans, and supporting breathtaking innovation in the mortgage market.

In order to continue that success, Fannie Mae must continue to operate under a regulatory regime that does not damage our ability to support homeownership. That damage can be incurred by changing our mission, status, or charter, or through excessive and intrusive regulation of our business, through unwise changes in capital standards, or through unneeded regulation that undermines the efficiencies of the markets in which we operate.

<u>New Program Approval</u>

To carry out our mission effectively, Fannie Mae must be able to harness the innovation and efficiency of the private sector to promote affordable housing as a clearly articulated public policy goal.

The new program approval requirements must ensure Fannie Mae's continued freedom to work with lenders, non-profits, community organizations and local governments to support innovation in the market. In order for Fannie Mae to achieve our mission of making homeownership available to underserved families, we must be able to work directly with our partners to develop new products and new business processes without intrusive regulation that seeks to replace business judgment with the government's judgment. And we must be able to bring these initiatives to market in a timely way.

The standard Congress created in 1992 has fostered an environment of unprecedented innovation in the mortgage industry over the last ten years. Despite the constantly changing interest rate environment, and unprecedented volumes of business, Fannie Mae and the mortgage finance industry have created a revolution in underwriting, product innovation, and streamlined technology processes, to produce significant gains in lending to low- and moderate-income and other traditionally underserved borrowers. For example, Fannie Mae financing for low down payment loans (5 percent or less) has grown from $109 million in 1993 to $17 billion in 2002.

We have been able to respond quickly to market needs and to ideas presented by our partners, such as low down payment loans through Flexible 97 and 100, My Community Mortgage products to meet CRA needs, and Expanded Approval to reach out to underserved borrowers with blemished credit. These mortgage features have been crucial tools in reaching into communities that were previously underserved. The mortgage market today has a wider variety of products available than ever before, and therefore is better poised to meet the individual financing needs of a broader range of home buyers. This has been possible because the program approval requirements in the 1992 law respect the need for innovation and strike an appropriate balance between charter enforcement and managerial discretion.

Many of our lenders partners and leaders in the housing industry, like the National Association of Home Builders, the National Association of Realtors, the Independent Community Bankers of America, Enterprise, and Self-Help, fear that moving program approval authority away from HUD could diminish housing as a public policy priority, and could create a barrier to innovation that hinders us from achieving our mission within our charter. We share those concerns. We urge the committee to carefully consider these issues and ensure that any program approval process does not in any way diminish the emphasis on our housing mission in our regulation.

In our conversations with leaders in the housing industry, we have focused on the importance of how program approval authority is exercised, wherever it is ultimately located. We believe any legislation must again reiterate the congressional view that Fannie Mae should support innovation in the market as it carries out its mission. Congress needs to make clear again that the companies are encouraged to innovate and be responsive to market needs. In addition, we believe that any change in this area must take into account the very strong concerns that have been raised from many within the housing industry, to ensure that innovation can remain strong.

The words of our partner Angelo Mozilo, chairman of Countrywide, summarize industry concerns, "I applaud your [Congress'] efforts to ensure that these companies are effectively and competently regulated. However, I urge you to avoid any proposal that seeks to micromanage these companies and to constrain their ability to innovate and respond to market demands. It is critical that the appropriate balance be struck between safety and soundness and the industry's ability to quickly and effectively provide new and innovative products to the housing market."

Capital

Capital requirements are a fundamental part of financial regulation. The approach announced by Treasury last week focuses on ways to give the regulator more flexibility in aligning capital requirements with the risks Fannie Mae takes on, while ensuring that Fannie Mae can continue to fulfill its mission. It is this balance that Congress struck in 1992, and it is a balance Congress must continue to maintain in this legislation.

As you know, Fannie Mae has two capital standards, the minimum capital, or leverage, requirement, and the risk-based capital requirement. The minimum capital requirement sets a floor and covers the indefinable and perhaps unknowable risk present with any institution.

Fannie Mae's minimum capital requirement should not be viewed in isolation. It is coupled with restrictions on our business: we invest only in residential mortgages, which are less risky than many bank investments like consumer debt, commercial real estate, or third-world debt. Furthermore, our book of business is more geographically diverse than most banks, and the company is required to have loss-sharing agreements on higher risk loans.

For these reasons, Fannie Mae's minimum capital requirement should remain set in statute at 2.5 percent for on-balance-sheet assets and 0.45 percent for off-balance-sheet assets. Increasing minimum capital when there is no increase in risk raises the cost of capital to housing and undercuts our ability to fulfill our mission. Quite simply, if you choose to double capital for the same level of risk, you will cut in half the impact Fannie Mae can have in fulfilling its mission.

It is entirely appropriate for a regulator to increase the capital requirement if an institution takes on added risk, and regulators achieve this through a risk-based capital standard. In Fannie Mae's case, this requirement is determined by a statutory "stress test," computing the capital needed to survive a prolonged adverse economic environment. This standard, which took ten years to complete, has been in place for one year, and Fannie Mae has met the requirements of the test every quarter.

In setting risk-based capital requirements, a regulator must adjust to changes in the economy and in the assessment and measurement of risk. Under the current statute, our regulator has flexibility to adjust the standard, and Treasury has asked for additional flexibility in this area. We support giving the regulator fuller and more flexible authority in this area, while recognizing that there is a need for stability in capital standards, which should not be subject to frequent change.

As I noted earlier, in 2001, Fannie Mae began to issue subordinated date in significant amounts. Subordinated debt is counted as tier-two capital by bank regulators, and Fannie Mae now has $10 billion in such debt. This additional capital component supplements the $30.7 billion in core capital that Fannie Mae held on June 30, 2003, or 3.4 percent of the assets on our balance sheet. As we have pledged, we will continue to issue subordinated debt until equity capital plus subordinated debt equal 4 percent of on-balance sheet assets.

Housing Goals

HUD sets housing goals as a regulatory requirement to ensure that Fannie Mae focuses particular attention on low- and moderate-income borrowers and underserved areas. We have consistently met or exceeded those goals. The agency is currently developing proposed goals for next year and beyond.

Over the years, HUD has sought to establish goals that require the company to stretch beyond levels we might otherwise achieve, without threatening our safety and soundness or jeopardizing the liquidity of the mortgage finance system. HUD relies on predictions of market growth to establish these goals. This kind of forecasting is not easy and predictions are likely to be inexact. The refinance boom of the last two years, for instance, highlights that fact.

It is critical that the housing goals structure allows Fannie Mae the ability to make business decisions based on actual market conditions. Under the structure created by the 1992 Act, HUD has considerable flexibility in establishing the goals in its rulemaking process, and can use that authority to focus our efforts toward specific high-priority portions of the market.

HUD's recasting of the goals in 2000 is an example of that flexibility. The Department increased all three housing goals. The goal for Fannie Mae's purchase of loans to low- and moderate-income borrowers was increased from 42 percent in 1999 to 50 percent in 2000. In addition, the new goals created bonuses that incented Fannie Mae to pay special attention to financing small multi-family properties and owner-occupied 2-4 unit properties.

Going forward, it is critical that housing goals are not increased to the point that they threaten our safety and soundness or undermine our ability to serve a market that includes middle-class as well as low-income borrowers. Today, we work to expand the pie – increasing the low-cost funding available for mortgages for middle class families as well as for underserved communities. Housing goals that segment our business could force us to stop expanding the pie and focus only on the allocation of our business among various populations. Goals that become too numerous or narrow can lead to fragmentation in the market and credit allocation. This would distort Fannie Mae's business and undermine the critical role we play in the market.

H.R. 2575

Fannie Mae supports a strong, credible, well-funded regulator, and we believe that the Department of Treasury has proposed a plan to strengthen our regulator while ensuring that no harm comes to housing or the contribution housing makes to a strong economy.

However, I must also be clear that we do not believe that H.R. 2575 in its current form is a basis for consensus legislation. We believe it would harm the functioning of the housing finance system and would not improve regulation, and it goes well beyond a plan to enhance the effectiveness of our safety and soundness regulator. I have many concerns with many provisions of the bill. Let me cite briefly just a few of the provisions in the bill that would most egregiously undermine our ability to carry out the mission Congress has given to us.

H.R 2575 would stifle innovation in the mortgage market by requiring prior approval for any new "program, activity, business process, or investment that directly or indirectly provides financing or other services to conventional mortgages." It would replace the current standard, which is to review any program that is "significantly different" from a program already in place in 1992, with a standard that sanctions a virtually limitless scope of review. This provision would also allow HUD to reject new programs even if they comply with our charter and are in the public interest.

This would affect not just Fannie Mae; its impact would be felt across the industry. Any lender who wanted to develop a new business process or mortgage product with Fannie Mae would have HUD as a silent partner, requiring approval on a wide range of innovations. The number of changes requiring government authorization could overwhelm the review process, including things as simple as changing the processes of acquiring mortgages. It would particularly disadvantage small and medium-sized lenders, who work with Fannie Mae to innovate in order to compete with large lenders.

In addition, the proposed legislation includes many provisions that go far beyond any initiative focused simply on strengthening our regulator. It would make unwise changes in our capital standards. It would impose on Fannie Mae an enforcement and prompt corrective action regime that is far more harsh than the provisions applicable to any other financial institution. It would take away from Congress the ultimate ability to dissolve the GSEs. It would change the formulation by which our loan limit is calculated, even though the GAO has said that the current process works well. It would force disclosure of proprietary information – information no other financial institution is required to divulge. It would micro-manage the assets we hold for liquidity purposes. And it requires a series of studies by an unwieldy panel that would simply revisit issues that have been reviewed closely in great detail by Congress and the Administration over the past several years.

For these reasons, we urge the committee to steer a different course and reject H.R. 2575 in its current form. We believe policymakers will find consensus around the approach outlined by Secretary Snow, which will enhance regulation while preserving our ability to carry out the mission Congress has given to us.

Conclusion

Homeownership is available today to more Americans than ever before. And homeownership continues to be a priority of this Administration and this Congress. You have before you an opportunity to reiterate your commitment to broadening access to the American Dream.

I look forward to working with the entire Congress to strengthen our safety and soundness regulator, to ensure that the new agency has the resources to do its job effectively and adopt best practices in financial regulation appropriate to the risk the company faces. A strong safety and soundness regulator is in the best interest of Fannie Mae and the mission we serve. By strengthening our safety and soundness regulator, and avoiding any change to the mission, status or charter of the company, you will set the stage for the continued expansion of homeownership in communities across America.