An Analysis of Key Sections in H.R. 3703, the
"Housing Finance Regulatory Improvement Act of 2000"

Purpose: This Act is to consolidate regulation of the three housing-related government-sponsored enterprises, Fannie Mae, Freddie Mac and the Federal Home Loan Banks (FHLBanks), under a newly created agency (the Housing Finance Oversight Board) that would replace OFHEO (which currently regulates Fannie Mae and Freddie Mac) and the Federal Housing Finance Board. The new Board also would succeed to HUD's current regulatory responsibility vis-à-vis mission achievement by Fannie Mae and Freddie Mac. The purpose for introducing the bill is the view that combining safety and soundness regulation and mission achievement regulation over the three housing GSEs under a single regulator would lead to more effective and efficient regulation.

Impact to FHLBanks: The Act makes a number of significant changes that would impact the FHLBanks beyond simply having a new regulator. Among these are:

- Elimination of FHLBanks existing super lien protection
- Repeal of Treasury's back-up lines of credit
- New approval requirements for any new business activities
- New threshold for a FHLBank's placement in receivership
- New regulatory limits on non-mission-related assets
- Equal treatment of private label mortgage-backed securities (MBS)

<u>A section-by-section review of the sections of the Act most important to the FHLBanks follows:</u>

Section 101. This section would establish the new Oversight Board with five full-time members. Its composition includes the Secretaries of HUD and Treasury (or their designees, provided such designees are appointed by the President with the consent of the Senate) plus three U. S. citizens (with appropriate financial or regulatory experience) appointed by the President. No more than three Board members can come from the same political party. Board members' terms are six years (or as long as the Secretary or the Secretary's designee remains in that position); initial terms of the three appointed members are staggered.

<u>Comment:</u> While Congress has the responsibility to set up the regulatory framework for the GSEs, we believe the proposed makeup of this Board is not the best structure for promoting unbiased and strong safety and soundness regulation. Consistent with the purpose of the Act, the primary focus of any new regulator should be safety and soundness of the GSEs. The regulatory role in regard to mission should be ensuring that any specific goals established for a GSE by statute should be met. While the

Council does not take a position on whether a single regulator for all three housing-related GSEs could fulfill this role better than the current two regulators, the Council does feel strongly that any effective regulator must be as non-political and unbiased as practicably possible.

Sections 102 through 115 (except for Sections 103, 106, 110 and 111). These sections enumerate the duties and authorities of the new Board, how it would succeed to the personnel, resources and assessment powers of the Finance Board, OFHEO and HUD (in certain areas) and how the Board should enforce its new duties via regulations. While many of the enumerated duties and authorities are consistent with those of existing regulators, there are areas of concern, as noted below.

Sections 103 and 106. These sections would impose additional public disclosure requirements regarding financial, business and related information, as well as regulatory orders and agreements, on the FHLBanks, Fannie and Freddie.

<u>Comment</u>: While the Council supports legitimate disclosure requirements, the Council is concerned about the extent to which any new requirements would generate additional costs and burdens for the FHLBanks with little additional public benefits. In this regard, requiring the regulator to do some type of cost/benefit assessment before imposing additional disclosure requirements seems appropriate.

Sections 110. Section110 would require prior Board approval before any "new activity" can be conducted by any of the three GSEs.

<u>Comment</u>*:* It is also vitally important that new activities be developed in close coordination with their FHLBank members to ensure member participation, which is vital to success of any new activity. In the context of the FHLBanks, which are cooperatives that serve their member-stockholders, it is important regarding new business activities that the needs of and impact on FHLBank members of any new business activity be fully considered. This is something that needs to be done by the FHLBanks themselves at the regional and local levels; a regulator isolated inside the Washington beltway cannot effectively accomplish this. Accordingly, the Council believes the Act should clarify the role of the regulator in this area. Its role should be limited to reviewing proposed new activities and asset composition from a safety and soundness standpoint as well as the statutory parameters set out by Congress in order to determine that the new business activity is consistent with the charter established for the GSE by Congress. In addition, any regulatory review process must be expeditious and effective insofar as the GSEs are concerned.

Section 111. This section would require the Board, by regulation, to limit the non mission-related assets held by any of the GSEs. The Act would give the Board wide

latitude in deciding what "new activities" would require approval and how to define "nonmission-related assets."

Comment: This section needs to be revised. By giving the Board broad powers to determine how "nonmission-related assets" can be defined and what nonmission-related assets limits should be imposed, the Act could easily deprive a GSE of the ability to effectively manage its balance sheet in all business cycles. As previously noted, the Council fully supports the regulator's role in ensuring any "new activities," as well as "mission" and "nonmission" related assets of a GSE are conducted consistently with safety and soundness. However, it is Congress' role to define the mission parameters. In the case of the FHLBanks, which as lenders to their members serve as liquidity providers, it seems clear that MBS are consistent with their congressionally defined purpose of providing support for housing and ensuring an adequate central system of liquidity for community financial institutions that finance housing. MBS are a readily tradable commodity that our members use daily that offer a very low-risk investment. Our activity in this market helps to provide market stabilization and is an ideal investment, as provided for in statute, for the FHLBanks to invest surplus funds. The housing finance market is a cyclical business, which means our advances business is also cyclical. MBS has been crucial in managing that cyclicality.

Section 135. This section provides for the appointment of a qualified receiver by the Board for Fannie or Freddie, if the GSE should become "critically undercapitalized" and for any FHLB that fails to meet its capital requirements.

Comment: The threshold for a Home Loan Bank to go into receivership is significantly low (i.e. fail one capital requirement). The threshold should be the industry accepted standard for financial institutions (i.e. FDICIA standards) rather than this low artificial standard.

Section 136. This would repeal and remove the long-standing lines of credit extended from the U. S. Treasury to each of the three GSEs.

Comment: The Council believes this repeal would be unwise and counterproductive, since it would lead to higher costs for GSE funding and correspondingly higher costs for housing. These back-up lines of credit have rarely, if ever, been used and provide a flexible and convenient vehicle for the Treasury to provide support to a GSE in the unlikely event that such action is required. The existence of a strong and continuous framework of safety and soundness regulation for the GSEs provides appropriate protection against the need to use these back-up lines of credit.

Section 138. This section would remove the FHLBanks' super-lien status vis-à-vis the FDIC and other creditors of depository institutions with respect to assets pledged to secure advances.

Comment: The provision is unacceptable since it would effectively eliminate the FHLBanks' ability to use a "blanket lien" to secure advances and, consequently, cause significant unneeded regulatory costs and burdens for many borrowing members. This would be particularly difficult for smaller members who rely on the "blanket lien" to liquefy their entire non-conforming residential mortgage loan portfolios. In addition, both the FHLBanks' super-lien and perfected lien have the first claim on assets in the event of a bank's liquidation or failure. Consequently, repeal of the super-lien authority would not place the FDIC in a better position when a bank failure occurs, since the FHLBanks would protect their priority claim against their collateral by holding a perfected security interest in the failed bank's assets. As a perfected secured creditor the FHLBank's claim would still have priority over the FDIC. Eliminating the super lien would merely raise the cost of credit that member financial institutions provide to their communities not put the FDIC in a better position.

Section 140. This provision expresses Congressional preference for the proposed regulatory rules issued by the Federal Reserve, FDIC, OCC and OTS that give AAA-rated private label MBS the same risk-based capital treatment as agency MBS.

Comment: The provision is clearly a positive step in reinforcing the need for and correctness of equalizing capital treatment for securities that carry the same level of credit risk.

Sections 161 to 204. These are the remaining sections of the bill, which contain technical provisions and conforming amendments to existing law. They deal with abolishment of OFHEO and the Finance Board (since the Oversight Board replaces them), transfer of OFHEO and Finance Board employees and property to the Oversight Board and the effective date of the new Act, which is 270 days after its enactment.

Comment: The Council is concerned that the mere existence of these provisions, without providing some certainty for employment, could cause instability in the regulatory agencies personnel which clearly would not be a goal of the legislation. Consequently, clarification of the status of affected personnel in the Act itself would seem desirable.