

SUITE 13 EAST
555 THIRTEENTH STREET, NW
WASHINGTON, DC 20004

202 637-8281
202-637-5910
WWW.FMPOLICYFOCUS.ORG

THE HONORABLE J.C. WATTS
CHAIRMAN

MIKE HOUSE
EXECUTIVE DIRECTOR

June 11, 2004

Mr. Alfred M. Pollard
General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, NW, Fourth Floor
Washington, DC 20552

RE: Comments/RIN 2550-AA24

Dear Mr. Pollard:

FM Policy Focus, a coalition of six financial services and housing-related trade associations, appreciates the opportunity to submit its views to the Office of Federal Housing Enterprise Oversight ("OFHEO") on proposed additions to the corporate governance standards (69 *Federal Register* 19,126) governing Fannie Mae and Freddie Mac ("the GSEs" or "the Enterprises"). We strongly support the general thrust of the proposal, believing as OFHEO does that effective corporate governance is critical to Enterprise safety and soundness. While supportive of the proposal's efforts, we believe that it should be clarified and tightened to address specific issues raised by the Enterprises. Because of their size and market dominance, not to mention the leverage specifically cited in the proposal, Fannie Mae and Freddie Mac pose unique risks to the housing and financial markets. Further, as Chairman Greenspan has made clear, their implicit guarantee significantly lessens the market discipline that governs other large financial institutions, making effective corporate governance all the more essential.¹

When organized as FM Watch, FM Policy Focus commented on December 13, 2001 at length on the OFHEO initial proposal to establish corporate governance standards (now codified at 12 C.F.R. Part 1710). We were pleased that OFHEO at the time moved forward with the basic proposal despite strong criticism from the GSEs, but we then proposed and here reiterate numerous additional standards we think necessary, appropriate and fully within OFHEO's authority. As discussed in more detail below, FM Policy Focus recommends that OFHEO supplement the corporate

¹ Testimony of Federal Reserve Chairman Alan Greenspan before the Senate Committee on Banking, Housing and Urban Affairs. (February 24, 2004).

governance standards with explicit risk management ones comparable to those mandated by bank regulators.

In our initial comments, FM Policy Focus also argued that OFHEO should go beyond its proposal to mandate specific conflict of interest and other board responsibilities. We are pleased that OFHEO is now proposing these additional corporate governance standards, many of which are modeled after the Sarbanes-Oxley Act ("SOA") and New York Stock Exchange ("NYSE") requirements. However, we concur with OFHEO's discussion in the proposal's preamble on the special nature of the GSEs, and we therefore urge OFHEO to adapt the SOA and NYSE standards specifically to address the unique corporate governance challenges posed by Fannie Mae and Freddie Mac. Thus, we also urge you to:

- Clarify that the codes of conduct to be established by GSE boards should address specific potential risks, including the potential for GSEs to retaliate against those who oppose their political objectives;
- Mandate that board "risk policy" and "compliance responsibilities" include charter compliance, as well as strict adherence to other critical regulations, including those governing new programs and affordable housing; and
- Make clear that the revised executive compensation standards should focus on long-term stockholder value but must not reward GSE executives for undue use of the GSE subsidy.

Details on all of these points and several additional comments follow.

I. Additional Risk Management Standards/New Compliance and Risk Management Structure

FM Policy Focus supports the proposed new requirement that each Enterprise have a compliance officer and a risk manager who reports directly to the chief executive officer (CEO). Alternatively, to further insure independence, the compliance and risk officers could report directly to the Board audit committee or another committee consisting solely of independent directors. However, simple appointment of such officers is far from sufficient to ensure the world-class prudential standards and compliance with them essential at the GSEs. Thus, we recommend that OFHEO clarify its initial proposal to ensure not only that officers are appointed, but also that they have the independence and resources to do their jobs properly. We further recommend that OFHEO move quickly to adopt a range of prudential standards with specific board responsibility comparable to those mandated by the banking agencies, revising them as appropriate for the GSEs.

A. Compliance/Risk Management Function

As noted, we believe this corporate-governance proposal should be revised and clarified with respect to the compliance and risk-management officials. FM Policy Focus recommends that the final rule:

- Clarify that the compliance and risk-management officials are to be compensated by incentives that reinforce their functions, not link them to achievement of profit objectives;
- Require that each business unit have independent compliance and risk-management officials who are similarly compensated with incentives appropriate to their functions, not those of their business units. All such officers should report to the compliance and risk-management officials who in turn report to the CEO, audit committee of the Board or another Board committee consisting solely of independent directors;
- Require board compensation committees to review and approve these compensation arrangements;
- Require board audit committees to review and ensure appropriate independence and quality from the compliance and risk-management functions, validated by internal and external audit;
- Ensure the compliance and risk-management officials have the right to request meetings with appropriate board committees, specifying participation only of independent directors if necessary; and
- Require board review of the resources dedicated to compliance and risk management, with the corporate-governance standard mandating board responsibility for adequate resources.

B. Prudential Regulation

FM Policy Focus remains deeply concerned that Fannie Mae and Freddie Mac are not governed by prudential standards comparable to those mandated by the federal banking agencies. We recognize that OFHEO has a staff of examiners looking into safety and soundness, but the banking regulators – who have far more examiners for large, complex organizations – believe it is essential to stipulate specific safety-and-soundness standards, many of which are also required by law, and to detail board and senior management responsibility for them. Among the standards OFHEO should adopt comparable to those long in place by the banking agencies are:

- credit risk standards, with particular attention to appropriate and effective credit risk transfer;²
- new-program risk management and review;³

² 12 C.F.R. Part 30, Appendix A.

³ 12 U.S.C. § 1841, and 12 C.F.R. Part 225.

- operational risk standards;⁴
- economic capital allocation;⁵
- interest-rate risk management;⁶
- audit quality;⁷ and
- community service.⁸

The banking agencies and the Securities and Exchange Commission will shortly issue guidance on structured finance, with a recent speech from FRB Governor Susan Bies providing considerable detail on it.⁹ We urge OFHEO quickly to issue comparable guidance, as recent revelations from the Enterprises make clear that this is a growing concern, especially given their huge size and the potential systemic risk of improperly structured transactions. Of all financial institutions, the GSEs have a particular responsibility to ensure that their transactions have a true economic rationale, rather than being structured to promote inappropriate accounting or to serve tax objectives of interest to themselves or third parties.

II. Specific Board Standards

A. Codes of Conduct

OFHEO is proposing to amend Section 1710.14 of its current rules by adding the specific code of conduct standards mandated for publicly traded companies in Section 406 of SOA. Consistent with SOA, the OFHEO rule would require the GSEs to have "reasonable" standards to, among other things, bar conflicts of interest and to ensure legal and regulatory compliance. As noted, FM Policy Focus believes OFHEO should use its expertise regarding the GSEs to ensure that its corporate governance standards supplement, as needed, general ones to address the additional risks posed by Enterprise status and market dominance. Thus, we suggest that OFHEO:

⁴ *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System*, Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission, (April 8, 2003); and *Corporate Business Resumption and Contingency Planning*, Federal Financial Institutions Examination Council (March 1997).

⁵ *Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles*, Supervisory Letter SR 99-18, Board of Governors of the Federal Reserve System, (July 1, 1999).

⁶ *Interest Rate Risk*, Comptroller's Handbook, Office of the Comptroller of the Currency; and 12 C.F.R. Part 30, Appendix A.

⁷ *Internal and External Audits*, Comptroller's Handbook, Office of the Comptroller of the Currency; and 12 C.F.R. § 9.9.

⁸ 12 U.S.C. § 2901 and 12 C.F.R. § 228.

⁹ *Financial Innovation and Effective Risk Management*, Speech by Federal Reserve Governor Susan Bies, (April 6, 2004).

- Ensure that compliance with applicable rules and regulations include charter compliance, adherence to Department of Housing and Urban Development (HUD) new-program prior approval standards (24 C.F.R. § 81.51) and HUD affordable-housing rules (65 *Federal Register* 65,044 and 69 *Federal Register* 24,228).
- Clarify that “conflicts of interest” to be governed in the corporate codes of conduct must address situations in which a GSE can use its size or the unique benefits afforded to it by virtue of its charter to exact terms and conditions from service providers or counterparties not consistent with those generally available in the marketplace. For example, the Enterprises should not use their market dominance to demand unduly high guarantee fees that are unrelated to risk.
- State that conflicts of interest between a GSE’s business goals and its political objectives should be sanctioned by the code of conduct. For example, the code should bar retaliation against entities or individuals doing business with an Enterprise who may disagree with it on public-policy issues. Failure to sanction such conflicts creates a safety-and-soundness problem because sources of information about emerging GSE problems are stifled when the Enterprises use their market dominance to suppress such comment.

We believe that these clarifications will ensure that OFHEO has full authority, as it must, to implement safety-and-soundness enforcement actions should GSE practices result in non-compliance with rules not explicitly within OFHEO’s purview. OFHEO has previously made clear that new programs can pose safety-and-soundness problems,¹⁰ but it may not learn of them until far too late because of an initial failure by an Enterprise to obtain mandatory HUD prior approval.

FM Policy Focus supports OFHEO’s proposal that the Enterprises review their codes of conduct at least every three years to ensure they are consistent with relevant best practices. However, we recommend that, in addition to annual review, OFHEO mandate that the codes be revised as required whenever a new market practice or a substantive change in law or rule defines new standards to which the GSEs must ensure compliance. As you well know, a range of major safety-and-soundness related initiatives have been initiated in your agency and in Congress. If the GSEs do not update their codes quickly as new standards are mandated, they could be seriously out of date for a very critical period. Further, HUD is of course also revising its affordable-housing rules. A delay in coordinating code-of-conduct compliance standards with these enhanced requirements could similarly provide for a compliance

¹⁰ *OFHEO’s FY 1998–2003 Strategic Plan*, Office of Federal Housing Enterprise Oversight, pg.7. (February 10, 1998).

loophole that would limit OFHEO's ability to implement needed enforcement actions.

B. Independence

In our 2001 comment, FM Policy Focus proposed that OFHEO supplement the NYSE board independence standards¹¹ with tougher ones to reflect the unique market power the Enterprises exercise based on their taxpayer-supported benefits. We are pleased that OFHEO is now proposing the tougher independence standards mandated by the revised NYSE rules and SOA. However, we continue to believe that even these tougher standards do not reflect the special challenges to effective corporate governance created by the GSE structure. Thus, we again urge OFHEO to revise its definition of "independence" to include not only the various business relationships described, but also political ones.

Specifically, political officials and their spouses and relatives should not be permitted to serve as independent Enterprise directors if any jurisdiction over which the political official has or has had responsibility receives Enterprise support through foundation assistance or direct grants, loans or other financial support. The desire to serve constituents or to advance one's own political career could well cloud the ability of such political officials and their related parties to the risks posed by new GSE ventures, especially if these are in whole or part to benefit the official's jurisdiction. Since many officials and related parties also lack a high level of financial expertise, an abundance of caution regarding their status as directors is especially appropriate.

C. Compensation

1. Incentives

The proposal would revise Section 1710.12 (redesignated as 1710.13) to add a new compensation standard that expressly mandates that compensation not only be "reasonable," but also "appropriate," with particular attention to the promotion of long-term stockholder value. FM Policy Focus supports this additional standard, which we suggested in our December 2001 letter. We believe that the unique nature of the Enterprises requires a higher obligation for directors to ensure that compensation does not provide inappropriate incentives that reward stockholders at the expense of the taxpayers who provide all of the unique benefits enjoyed by the Enterprises. We thus again recommend that OFHEO expressly mandate that GSE executive incentives include no compensation that rewards officers or employees for undue reliance on the subsidy or any activity that would enlarge it. In 2001, when we

¹¹ Section 303A, Listed Company Manual, New York Stock Exchange (approved by Securities and Exchange Commission November 4, 2003).

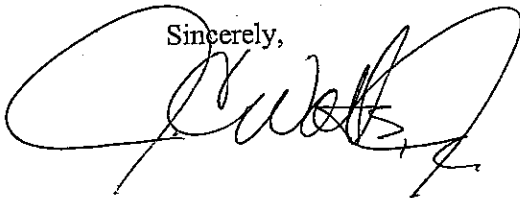
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first made this proposal, CBO estimated the Fannie and Freddie subsidy at \$10.7 billion, with \$3.9 billion going to stockholders. The most recent CBO subsidy estimate is now \$19.6 billion, with \$6.2 billion going to stockholders. Quick intervention here is required to ensure that the GSE subsidies do not grow still more huge based on inappropriate executive compensation incentives.¹²

2. GSE Subsidiaries

In connection with the proposal to bar GSE insiders from receiving inappropriate extensions of credit, the OFHEO rule would govern any such extension from an Enterprise "subsidiary." FM Policy Focus believes that this reference should be deleted to avoid any inference that OFHEO intends that the GSEs establish subsidiaries for any purpose, replacing the reference to subsidiaries with one that makes clear that the Enterprise may not arrange in any fashion for inappropriate extensions of credit. The degree to which an Enterprise may have subsidiaries, the manner in which its benefits support such subsidiaries, the degree to which the charters govern them and many other critical questions are yet to be addressed in GSE governing law and applicable regulation. Current law (12 U.S.C. § 1828(s)(1)) bars the Enterprises from affiliation with insured depositories, making it unlikely that extensions of credit could come from such subsidiaries. We urge OFHEO to avoid any terminology that might lead the Enterprises at some point going forward to argue that OFHEO sanctions the establishment of subsidiaries.

Sincerely,



¹² *Federal Subsidies and the Housing GSEs*, Congressional Budget Office, (May 2001) and *Letter to the Honorable Richard Shelby Regarding Updated Estimates of the Subsidies to the Housing GSEs*, Congressional Budget Office, (April 2004).