Statement of
The Honorable James B. Lockhart III, Director
Office of Federal Housing Enterprise Oversight
On
"Reforming the Regulation of the Government Sponsored Enterprises"
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Introduction

Chairman Dodd, Ranking Minority Member Shelby, and Members of the Committee, thank you for the opportunity to testify on the critical need to reform and restructure the housing Government Sponsored Enterprises' (GSE) regulatory regime. The views that I will be expressing today are OFHEO's and do not necessarily represent those of the President or the Secretary of Housing and Urban Development. However, I can tell you the Secretaries of HUD and Treasury, President Bush and Fannie Mae and Freddie Mac support GSE reform.

These are unprecedented times for the housing GSEs – Fannie Mae, Freddie Mac, and the twelve Federal Home Loan Banks (FHLBanks). Their business expanded rapidly in 2007 with their market share rising to record levels in the fourth quarter of 2007. The GSEs have become the dominant funding mechanism for the entire mortgage system in these troubling times. They are fulfilling their missions of providing liquidity, stability, and affordability to the mortgage markets. In doing so, they have been reducing risks in the market, but concentrating mortgage risks on themselves. Fannie Mae and Freddie Mac support their missions by guaranteeing and issuing mortgage backed securities (MBS), which represents approximately 70 percent of their business in 2007. Their other business activity is buying mortgages and MBS for their retained mortgage portfolios.

The risks are beginning to take their toll. Public disclosures indicate that Freddie Mac will report annual losses for the first time in its history and Fannie Mae for the first time in 22 years. Their missions, as well as Congressional and many other pressures, are demanding that they do more and take on more risks in areas new to them – subprime and jumbo mortgages. As the safety and soundness regulator of Fannie Mae and Freddie Mac, I have to tell you that expansion of their activities would be imprudent unless the regulator has significantly more powers and more flexibility to use those powers. Given the tremendous stresses on the mortgage markets, the American people cannot afford to have Fannie Mae, Freddie Mac, or the 12 FHLBanks incapable of serving their mission.

During 2007, the housing GSEs debt and guaranteed MBS outstanding grew $870 billion or 16 percent to $6.3 trillion. It is very hard for anyone to put trillions into perspective, but probably the easiest comparison is to the public debt of the United States, as you can see from the chart (1). The left-hand column is the public debt of the United States. It is $5.1 trillion, of which about $700 billion is owned by the Federal Reserve, so there is only about $4.4 trillion in public hands. The total of Fannie Mae's and Freddie Mac's debt and guaranteed MBS, their credit owned by the public, is $5.1 trillion. If you add on top of that the rapidly growing FHLBanks' debt of about $1.2 trillion, you get to that $6.3 trillion of housing GSE debt and securities.

Market Conditions

As has been widely reported, housing market conditions in many parts of the country are quite weak. Virtually all measures of the health of the market have deteriorated very sharply over the last two years, with particularly sharp declines over the latest few quarters.

Home prices are falling in many parts of the country. OFHEO's national purchase-only index fell 0.3 percent on a seasonally adjusted basis in the third quarter, but other indices show much larger drops. Of course, prices are declining at a much quicker pace in many areas such as California and Florida, which had the greatest price run-ups during the boom. Fannie Mae and Freddie Mac are using 4 to 5 percent house price decreases in their 2008 projections, but others are predicting more severe outcomes.

These price declines are closely associated with increases in delinquencies and foreclosure rates. In virtually every state, property foreclosure rates have skyrocketed over the latest year, as have loan delinquency rates. For the third quarter, the Mortgage Bankers Association reported that the overall loan delinquency rate of 5.6 percent was at its highest point since 1986.

Builder confidence and housing starts are at extremely low levels, as inventories of unsold properties have risen. The latest existing home sales data from the National Association of Realtors indicate that, at the current pace, there is approximately 9.6

months worth of supply on the market today, a level well above the six month benchmark for a so-called "balanced" market. With inventory overhang also quite high for new homes, the rate of housing starts has plummeted. In the fourth quarter, the seasonally-adjusted annual rate of housing starts was 44 percent below its rate from the same quarter, two years ago.

The Enterprises' Response

What have the Enterprises been doing given these challenging market conditions? (Chart 2) They have been fulfilling their mission of providing stability and liquidity to the secondary conforming mortgage market. That has been very critical since early August. They have been securitizing almost a hundred billion dollars a month in mortgages as you can see in blue. The green, which is their mortgage portfolios, has not grown because of their internal control and other operational problems and the related OFHEO imposed limits with respect to capital and portfolios. Given the market conditions and their progress, OFHEO loosened the portfolio limits in September of 2007. Despite that added flexibility, the Enterprises have not increased their portfolios. With accompanying capital they could increase their combined portfolios by over $100 billion for the next 6 months without violating the new limits.

As OFHEO directed, the Enterprises adopted the bank interagency guidances on non-traditional mortgages and subprime mortgages. The guidances were implemented in September last year. The guidances are not only for all mortgages that the Enterprises directly hold and guarantee, but also the underlying mortgages in private label securities

(PLS) that they acquire. At the same time we gave portfolio cap flexibility, they agreed to enhance their programs to support the refinancing of subprime into less risky mortgages.

The Enterprises' Conditions

Status and Regulatory Action. When I arrived at OFHEO in May of 2006, we were in the process of finalizing a report on the past misadventures and misdeeds at Fannie Mae, which led to a consent agreement listing 81 areas for correction. One element of the agreement was to freeze the growth of their portfolios and another was a renewal of a requirement that they keep capital levels 30 percent higher than the minimum required by law because of their operational, accounting, systems, internal controls and risk management problems. Thus, the effective capital requirement is 3.25 percent of assets rather than the 2.5 percent required in OFHEO's statute. Both are low compared to other financial institutions.

Freddie Mac had earlier agreed to a consent agreement and the 30 percent extra capital requirement. In July of 2006, they voluntarily agreed to restrict the growth of their portfolio as well. In retrospect, those agreements and, especially, the growth restrictions and the capital requirements, were extremely important in reducing the credit losses at Fannie Mae and Freddie Mac and preventing major disruptions of the conforming loan market system.

I am pleased to report that both Enterprises have made major progress on these operational remediation efforts, which required billions of dollars and many thousands of consultants, but significant issues remain.

In OFHEO's 2007 Annual Report to Congress, both Enterprises were rated as having "significant supervisory concerns." They both published third quarter financials for the first time in over three years. The accomplishment was somewhat dampened by the $3.5 billion of losses that they reported for the third quarter. They have both stated that they expect to produce timely financials at the end of this month for 2007 results. Unfortunately, they expect to report significant losses for the fourth quarter.

Market Share. In 2006, Fannie Mae and Freddie Mac were losing market share to Wall Street private label MBS (PLS). There is a certain irony that one of the ways they prevented their market share from falling even farther was that they became the biggest buyers of the AAA tranches subprime and Alt-A of these PLS. The Enterprises' earlier problems, OFHEO's constraints, and the loose underwriting standards in the market made it hard for them to compete. Some observers even suggested that, due to shrinking of market share, their support of, and therefore their risk to, the mortgage market were no longer relevant.

In the last half of 2007, the PLS world shrunk to minimal levels as a result of a long list of well reported problems (Chart 3). As a result, even with the OFHEO constraints, Fannie Mae and Freddie Mac mortgage purchases as a share of new originations grew to unforeseen levels, rising from less than 38 percent in 2006 to over 60 percent in the third quarter of 2007. The just reported fourth quarter results of 75.6 percent are double 2006's market share. If you add in the net increase in outstanding FHLBank advances, especially in the third quarter, the combined market share of the housing GSEs may be 90 percent.

Credit Risk. Another related change over the period was the growth of credit risk. Operational risk and to a lesser extent market risk had been the key focuses of the Enterprises and they still are extremely important with the volatility of the markets and heavy reliance on models for market and credit risk pricing. I remember listing credit risk concerns in an early presentation I did to one of their Boards. Some members were mystified that I thought it was an issue given their track record. I am afraid that was a sign of the times.

The Enterprises were then reporting credit losses of 1 to 2 basis points, a third of normal levels and now they are approaching double normal levels and climbing. Some of this growth in losses was because they lowered underwriting standards in late 2005, 2006, and the first half of 2007 by buying more non-traditional mortgages to retain market share and compete in the affordable market. They also have very large counterparty risks including seller/servicers, mortgage insurers, bond insurers and derivative issuers.

Basis points sound small, but they become important when you are leveraged the way Fannie Mae and Freddie Mac are, as seen in Chart 4. This graph shows the gross mortgage exposure of the Enterprises' combined guaranteed MBS and mortgage portfolios relative to their capital, measured two ways. The statutory core capital is shareholder's equity excluding Accumulated Other Comprehensive Income (AOCI), which is primarily marking their Available for Sale portfolios to market. As AOCI is a large negative number, core capital is significantly higher than shareholder's equity, especially at Freddie Mac, which also has losses on some old closed hedges in AOCI. Their leverage increased in the first nine months of 2007, with Fannie Mae's at 66 times core capital and Freddie Mac's at 58 times core capital as of September 30th. Fair value capital is calculated by marking all on- and off-balance assets and liabilities to market. Measured this way, each Enterprise's leverage increased dramatically in the first nine months of 2007, exceeding 80 times their fair value of equity as of September 30th. Or if you look at it the other way around, there is only 1.2 percent of equity backing their mortgage exposure.

For the first three quarters of 2007, they have each lost $8 to $9 billion in fair value of equity. Their combined fair value equity at the end of the third quarter was $58 billion compared to $5.1 trillion in mortgage exposure. I should hasten to add in the fourth quarter they raised almost $14 billion in equity in the form of perpetual preferred stock and cut their dividends as well. That additional capital is critical as both CEOs recently said at a Wall Street conference, they are going to have very tough fourth quarters and 2008s.

In short, deterioration in the housing and credit markets, along with substantial declines in interest rates that negatively affected the market value of their derivatives, will result in both Enterprises reporting net GAAP losses for the year. Very importantly, they did fulfill their critical mission of providing liquidity and stability to the conforming loan mortgage market. In doing so, however, the systemic risk of the secondary mortgage market has become more concentrated in the housing GSEs, especially Fannie Mae and Freddie Mac.

Conforming Loan Limit Increase

Now, I will turn to the temporary increase in the Conforming Loan Limit (CLL) as proposed in the Economic Stimulus package. OFHEO believes any increase in the CLL should be coupled with quick enactment of comprehensive GSE reform. The CLL provision in the stimulus package would increase the Enterprises risks by allowing them to enter the "jumbo" loan market. It would increase the maximum size loan those GSEs could purchase or guarantee from $417,000, to the lower of 125 percent of median area prices or $730,000, for mortgages originated between July 1, 2007 and December 31, 2008. This change should help lower interest rates on some jumbo mortgages, but other potential implications deserve attention.

Jumbo loans would present new risks to the already challenged GSEs. The prepayment and credit risks are different than those of conforming loans. The provision also pushes the GSEs to increase their geographic concentration in some of the riskiest real estate markets. Roughly half of all jumbos are in California. Underwriting them successfully will require new models and systems to ensure safe and sound implementation. Capital also would present challenges even if all newly conforming mortgages are securitized. A $600,000 loan requires as much capital as three $200,000 loans.

Tying the new limits to FHA limits will likely result in a large number of different loan limits across the country, requiring additional operational challenges. That could delay lender participation, especially for non-FHA lenders. Like the GSEs, they may have to reprogram and adjust their guidelines and agreements to account for a large number of different local loan limits.. All that being said, OFHEO promises to work closely with Fannie Mae and Freddie Mac to ensure that an increase is implemented quickly, and as safely and soundly as possible.

Critical Need for GSE Reform

The key question is whether Fannie Mae and Freddie Mac will be able to continue to support the conforming mortgage market in a safe and sound manner while assuming additional responsibilities in the subprime and jumbo markets.

My answer as the safety and soundness regulator is yes, but only if Congress passes comprehensive GSE reform.

Why is GSE reform so critical now?

- As never before the Enterprises and FHLBanks have become the backbone of the mortgage market in very troubling times. They were created for this kind of market. They need to provide liquidity to the mortgage market today and in the future.
- We need to maintain confidence in the GSEs and their capital position, especially with the holders of their $6.3 trillion of securities, both foreign and domestic.
- We need to start to rebuild confidence in the housing and mortgage markets. The conforming loan market continues to perform well, but Fannie Mae and Freddie Mac are now being asked to expand their missions by providing liquidity in the subprime world and temporarily in the jumbo market. We have encouraged the Enterprises to increase subprime rescue mortgages, but we must ensure that they have the capital, models and systems to take on the additional subprime and jumbo risks.
- Their large losses, growing credit and market risks, model risks, sheer size and market share requires a stronger regulatory framework to reduce the potential for risks to the financial and mortgage markets.

To achieve those goals we need a stronger, single and unified regulator for the housing GSEs. That regulator needs to have all the powers of the bank regulators and more given the Enterprises size, systemic importance, and GSE status. Capital is king in this market. The regulator also has to ensure that they stay focused on their mission of supporting the housing markets, especially affordable housing.

When normal financial institutions get into trouble, the rating agencies downgrade them and the cost of their debt goes up. Fear of such a negative sequence incents them to restrain their risks. However, even during the periods when the Enterprises could not put out financial statements for several years, they were rated AAA. In fact, their debt sells better than AAA paper. Without debt market discipline, there is limited offset to shareholders' pressures to grow. When present, debt market discipline helps to ensure that growth is safe. We need a stronger regulator as a substitute for that lack of debt market discipline.

Elements of GSE Reform

Let me now speak briefly to components of comprehensive GSE reform. First, as in the House-passed bill, GSE reform should create a single, unified and independent GSE regulator. This combination would strengthen the GSE regulators, OFHEO and the Federal Housing Finance Board (FHFB). Comprehensive GSE reform would also transfer HUD's mission and new product authority to the new regulator. Comptroller General David Walker testified before this Committee in April 2005: "…A single housing GSE regulator could be more independent, objective, efficient and effective than separate regulatory bodies and could be more prominent than either one. We believe that valuable synergies could be achieved and expertise in evaluating GSE risk management could be shared more easily within one agency."

Unlike any other financial regulator, OFHEO is lacking mission and new product authority. That can lead to tensions as there is often a trade-off between mission and safety and soundness. Mission can push you too far to take too many risks and safety and soundness can pull you back. What needs to be done is that significant new products and programs must be evaluated on a balanced basis at one time through both mission and safety and soundness lenses, before they are launched.

There is a strong consensus, including from the Enterprises, that the new regulator needs bank regulator-like powers. Bank regulators have receivership authority which can provide more market discipline and certainty in uncertain markets. We only have conservatorship authority. Another component is stronger independence and that means independent litigation and budget authority. We are very actively engaged in litigation in the federal courts related to Fannie Mae's past problems and reliance on the Justice Department makes for a cumbersome process.

We have this strange budget mixture where we are funded by Freddie Mac and Fannie Mae, but yet we are appropriated by Congress as if we were funded by taxpayers. In only two of our fifteen years has OFHEO known how much money we had to spend when the year started. Uncertain funding levels and the resulting under-staffing is not the way to run a regulator.

Most critically, OFHEO needs the flexibility to adjust capital requirements. The statutory minimum capital requirements for on-balance sheet assets are too low at two and half percent. While I do not know if the thirty percent increase is the right level, I do know we need more flexibility to regulate minimum capital. I also know our risk-based capital

(RBC) requirement is just not working, as it has yet to capture the risks we are currently observing. The problem was that RBC parameters were specified in law and this does not really give OFHEO the flexibility bank regulators have, which is needed to create a modern economic capital framework.

Finally, we need to ensure their focus on mission, not only mortgage market liquidity and stability, but also affordable housing. Only 30 percent of their mortgage assets in their combined retained portfolios represent funding for units that count toward HUD's affordable housing goals beyond that provided by securitization. To continue to provide stability and liquidity, market, credit and operational risks of the retained mortgage portfolios must be understood and managed. Half of their portfolios are in their own MBS. As that represents 17 percent of all their outstanding MBS, it seems excessive for liquidity purposes. The rest of their portfolios are split between mostly AAA subprime and Alt-A PLS mortgage securities and whole mortgage loans. What the new regulator needs is the ability to produce a regulation that considers the missions and risks of the Enterprises. That would give it the tools to more effectively get the job done well to ensure the Enterprises' long-term safety and soundness and mission achievement.

Changes that Would Enhance GSE Reform Legislation

I hope that I have conveyed to the Committee the market conditions and the status of the Enterprises that emphasize the urgency of acting upon GSE regulatory reform. It is our highest priority. OFHEO is fully committed to working with you to address any questions you may have and to provide our insights on approaches that you set forth for consideration.

Over the years, there have been many proposed GSE reform bills. I believe that the House-passed measure, H.R. 1427 is a good starting point. It is a strong, balanced and bi-partisan bill that addresses many of the key issues. I would add a few topics that would enhance a final GSE reform bill:

- Requiring an immediate effective date for legislation. Key authorities are now needed by OFHEO to address current safety and soundness issues such as the potential increase in the CLL. Immediate enactment will add to confidence in the financial markets of continuity and certainty in regulatory oversight.

- Clear guidance on portfolio limits along the lines of the House legislation but which adds consideration not only of risks to the Enterprises but to the housing markets and individuals as well.

- Assuring the new agency has discretion with respect to the critical capital levels for Fannie Mae and Freddie Mac as it does for the FHLBanks.

- Allowing the regulator to refine the definition of core capital with notice and comment rulemaking, in light of changing accounting standards.

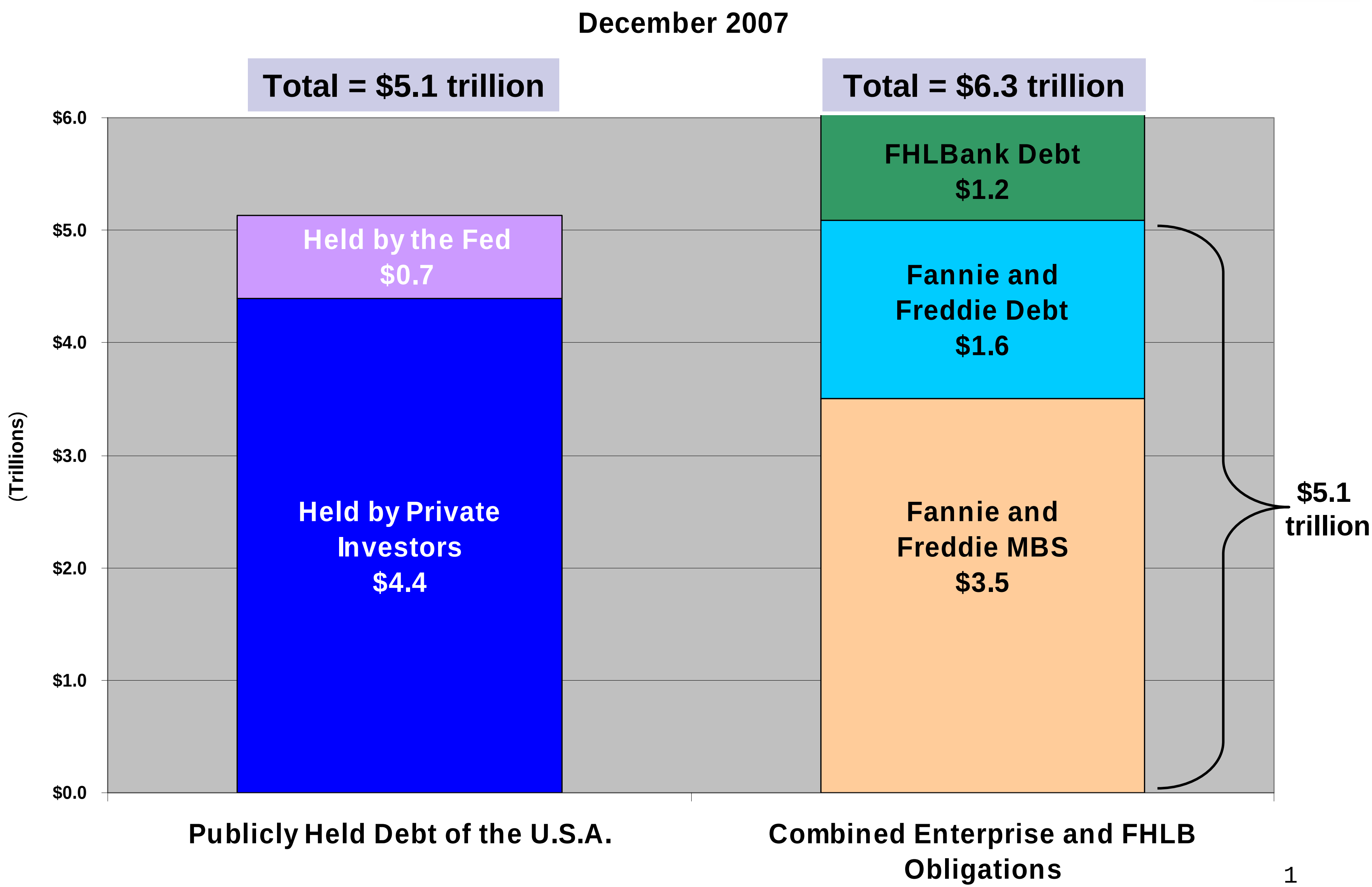
- Providing receivership authority with regulator discretion to select the best method of managing the receivership.

Conclusion

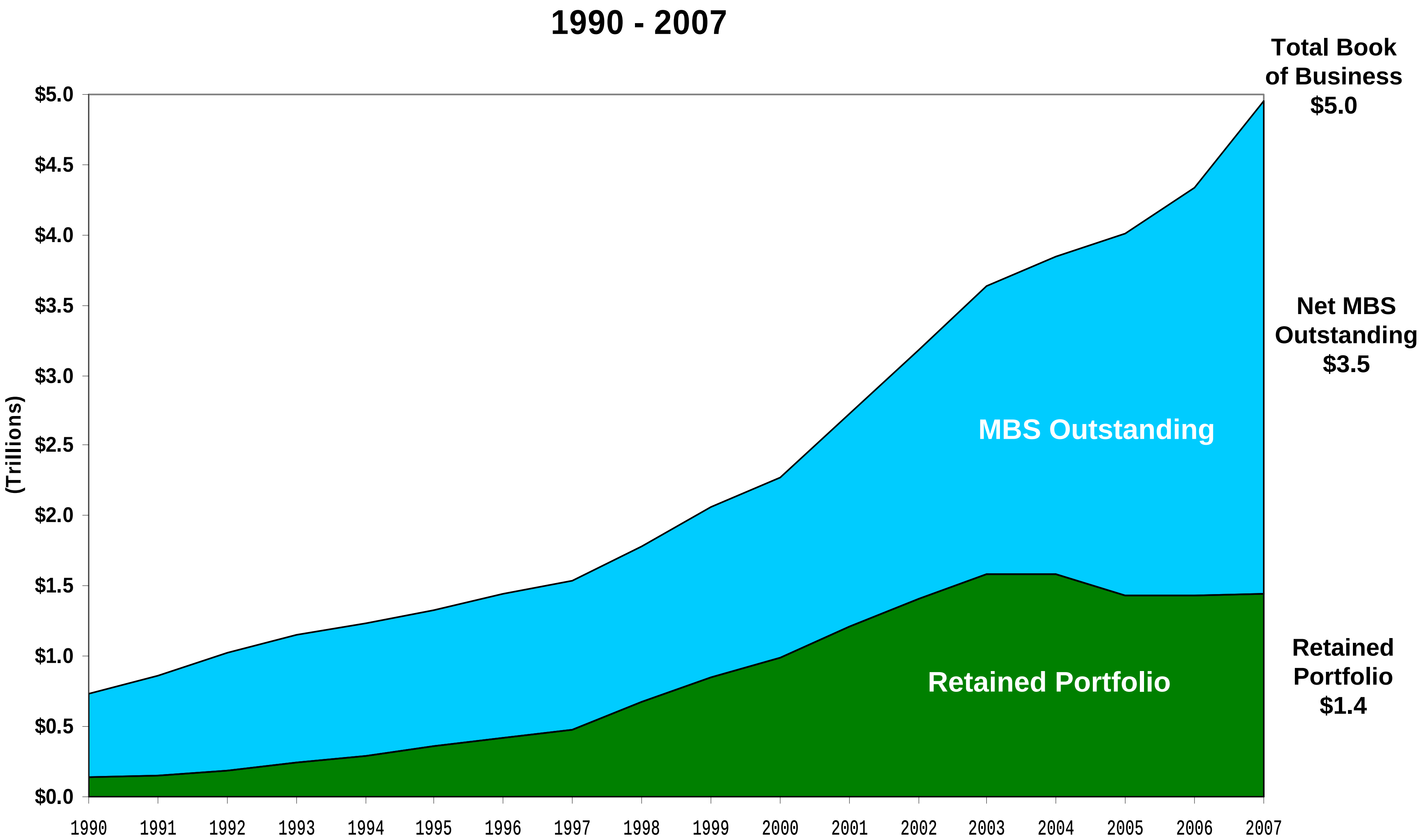
Housing is a key component to the U.S. economy, and it currently is a very troubled component. We need quick actions that will also yield long term positive effects. The GSEs have been very helpful over the last six months providing stability and liquidity to the conforming market segment, but they are stretched. We need to shore them up going forward to help restore confidence in the mortgage market. Fannie Mae and Freddie Mac face growing pressures to expand their mission and risk levels, especially into the jumbo market. We need to create a much stronger, unified regulator to support the U.S. housing finance system. I look forward to working with you Chairman Dodd, Senator Shelby and all members of this Committee towards achieving a stronger housing finance system with an empowered, unified regulator. GSE reform is critically needed now.

Thank you.

The Housing GSEs are Huge

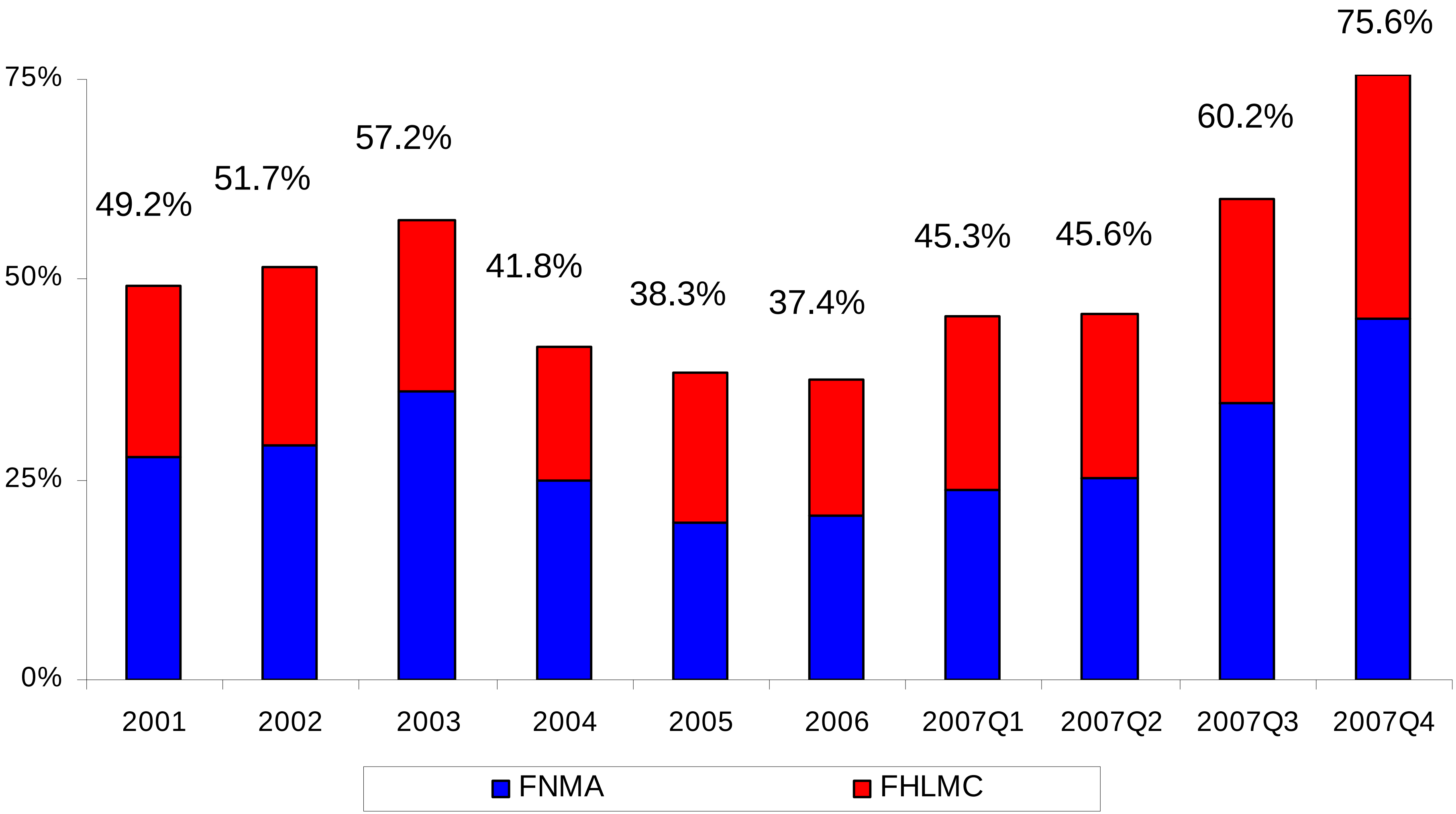


Business Growth is Accelerating



Dramatic Increase in Share of Mortgage Originations

2001 – 2007



Source: Inside Mortgage Finance

Very High Mortgage Credit Leverage

12/31/2006 & 9/30/2007