<u>TIME TO GET THE HOUSING GSEs IN ORDER</u>

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Thank you for the opportunity to speak before Women in Housing & Finance (WHF) once again and in particular, on this very timely panel on GSE Regulatory Reform and Related Issues. As Congress is about to reconvene for its final lame-duck session, the issue of whether Government-Sponsored Enterprise (GSE) reform legislation will be enacted this year is certainly foremost on our minds at OFHEO.

I am at the half-year point as Director of OFHEO and its also been six months since the agency released its Report of the Special Examination of Fannie Mae. So it is a good time to reflect briefly on where we are and what our goals are for next month and next year. As you are all aware, we continue to focus on ensuring the Enterprises fix the problems created by their accounting scandals, earnings manipulation, and management failures. Both companies are making progress, but it will take several more years. Although not on the same scale, several of the Federal Home Loan Banks (FHLBanks) are working their way out of similar problems as well.

I have three major priorities for OFHEO: The first is vigorous supervision of the Enterprises. The second is to continue to support legislation for a more empowered regulator of the Enterprises and the FHLBanks so that we have the tools to do a better job in the future. A third is to continue to build our team to face ongoing and future challenges.

I am still hopeful that we can get something done on that second goal: the legislation. As both CEOs acknowledge, their problems and unconstrained growth have established the need for a stronger regulator. There is strong bipartisan support for reform and only a couple of issues that need to be resolved.

Nearly one year ago, at the end of 2005, Fannie Mae and Freddie Mac owned or guaranteed over 40 percent of the residential mortgages in the U.S. or approximately $4 trillion dollars, comprised of two main businesses:

- $2.6 trillion of mortgage-backed securities (MBS) guaranteed by the Enterprises and
- $1.4 trillion of portfolio holdings including their own MBS.

With respect to the FHLBank system, the Banks held $800 billion in advances, mortgages, and private-label MBS that support residential mortgage lending, which represented 8.0 percent of residential mortgage debt outstanding at that time. In combination with the Enterprises, the total is 47 percent of mortgage debt outstanding at year-end 2005 (#1). In 2003, the total market share was over 54 percent. In short, the GSEs dominate the U.S. mortgage market.

Let me now turn to why legislation is needed to get these housing GSEs in order.

Why is Legislation Needed? (#2)

There are many components in the GSE legislation pending in the House and Senate which I am pleased to report have a very broad consensus in Congress and the Bush Administration. Even Fannie Mae and Freddie Mac support them. The sticking points appear to be focused on two areas but progress continues on a compromise. The first issue is how to properly structure an affordable housing fund. The second is how to control their portfolios to ensure the Enterprises do not take unnecessary risks through their large portfolios. Before addressing these issues, let me first discuss the reforms that all agree are needed.

Certainty for the Enterprises

As I have said before, legislative uncertainty is a cloud over the Enterprises. Both CEOs say that a stronger regulator will strengthen their credibility and new legislation will lessen the uncertainty that they and their shareholders face. Both have also said they support legislation to create a strong, well-funded regulator that would oversee the safety and soundness and the housing mission of the Enterprises. It is time for them to prove this support.

OFHEO Needs Bank Regulator-Like Powers

OFHEO is not on the same playing field as other financial regulators. The new regulator needs the same safety and soundness powers that bank regulators have to help prevent problems. Explicit legal authorities and better enforcement powers are crucial for a stronger GSE regulator. Receivership powers, which bank regulators have, provide one way to prevent problems from one financial institution from spilling over to others. Enhanced enforcement powers, including those that address misconduct by employee, director, and affiliated parties, are needed too.

OFHEO Needs More Independence

Regulatory independence must be strengthened, including independent litigating and budgeting authorities. It is perverse that OFHEO must be congressionally appropriated while bank regulators are not, even though we are all funded by our regulatees and have no impact on the budget.

Mission and New Product Authority Need to be Combined

Currently, authority over the charters of the Enterprises, their mission, and new products is placed in HUD. OFHEO is in the difficult position of considering only safety and soundness elements of activities that could be in violation of an Enterprise's charter. Other financial regulators have authority over mission, products and services, and safety and soundness. A stronger GSE regulator needs these authorities too.

Capital Requirements Need Strengthening

Presently, the Enterprises have low regulatory minimum capital requirements. The 1992 Act requires them to maintain stockholder's equity equal to 2.5 percent. To be considered well-capitalized, banks have much higher limits and hold significantly more "excess" capital than the Enterprises do. Specifically, the Tier 1 capital ratios of the five largest banks are 6.4 percent, while the Enterprises' are much lower at 4.6 percent. If you adjust for their large off-balance-sheet MBS guarantees, the ratio falls to 3.5 percent.

OFHEO's risk-based capital requirements have been too constrained by the 1992 law and are much lower than the minimum capital requirements. Risk-based capital should be based on the full array of Enterprise risks: market, credit, and operational risk. Systemic risks they present to the overall financial markets should also be considered. More flexibility to enhance capital requirements is a critical component of the future regulation of the Enterprises.

Strength Through Combining the Three GSE Regulators

Greater regulatory muscle and independence will also be provided by combining OFHEO with the Federal Housing Finance Board (FHFB). Combining these two regulators will provide more capability to ensure the safety and soundness of the U.S. housing finance system.

Done properly, a combined workforce will have enhanced skills, lower costs and be more responsive. The new agency would benefit from different ideas and approaches in areas such as examinations, capital, and accounting, while retaining expertise on the differences between the Banks and the Enterprises. And as I have said before, adding HUD's mission authority function is also important to a new regulatory regime. OFHEO's new responsibilities for affordable housing goals would benefit from expertise of the FHFB and the Banks.

Let me now address the two major sticking points in the legislation that I believe have bipartisan solutions.

Affordable Housing Fund

The first sticking point is how to structure an affordable housing fund, which is in the House-passed bill. There seems to be a growing consensus that this fund should not be controlled by the GSEs, should not be related to profits because of their volatility, and should require reauthorization. I believe these objectives are achievable.

Reduce Risks to the Financial Markets

The second is how to prevent the Enterprises' portfolios from growing to dangerous levels, while enabling them to continue to focus on fulfilling their very important mission. Until recently, the growth of the Enterprises' portfolios has been focused on shareholders' returns rather than their mission. Their size alone will continue to subject financial markets and institutions to unnecessary risk.

Part of the logjam on compromise portfolio language is tied to the term "systemic risk." OFHEO's definition of systemic risk is: "… the risk that a financial institution unexpectedly experiences severe financial difficulties and those difficulties disrupt the financial sector enough to cause a reduction in economic activity." All large financial institutions present some systemic risks, but some much more than others.

A key reason that the bank regulators and deposit insurance were created was to reduce the systemwide risk of losses to financial markets, other financial institutions, and individuals. Likewise, OFHEO's safety and soundness regulatory activities are designed to reduce "unexpected, severe financial difficulties," but if they do occur the impact could be quite detrimental to financial markets and institutions. Sources of systemic risk include not only the quantity of risks and the quality of risk management, but also the importance to other institutions and to financial markets.

The new regulator needs the powers to address the risks that these massive portfolios present. A legislative solution should provide the regulator with discretion to address portfolio limits. The regulator should be empowered to set limits based upon guidelines that ensure the companies can fulfill their housing mission and upon the risks the portfolios present.

Although the Enterprises have questioned portfolio limits, I believe that a key part of restoring confidence is to convince the markets that they will never grow out of control again. Reform opponents say that limits would hurt their ability to fulfill their liquidity, stability and affordability missions. But none of the legislative solutions under consideration limit their largest, fundamental business of buying mortgages and then packaging them with guarantees for securitization (#3). Not counting the $750 billion held in their portfolios, this $2.6 trillion MBS business represents 26 percent of the total U.S. mortgage market. Remarkably, they have retained this market share since 1992.

Less than 30 percent of the Enterprises' combined retained mortgage portfolios of $1.4 trillion are used to fulfill their very important affordable housing mission (#4). About 54 percent of their portfolios are invested in their own MBS, which are easily sold, and are much higher than necessary for liquidity. Their private-label MBS and whole mortgages could be much better utilized as only half qualify as supporting affordable housing.

Some have argued that it would be a violation of the Board of Director's fiduciary duty to shareholders to support limits. I disagree. If there is one lesson that these two companies should have learned from their multi-billion dollar scandals, large SEC fines, and massive shareholder lawsuits, it is that unconstrained growth focusing on earnings-per-share is much worse for shareholders. Boards, especially GSE Boards, must be concerned about safety and soundness, corporate culture, internal controls and mission, as well as growth. Placing a company at risk does not maximize shareholder value or meet fiduciary duties.

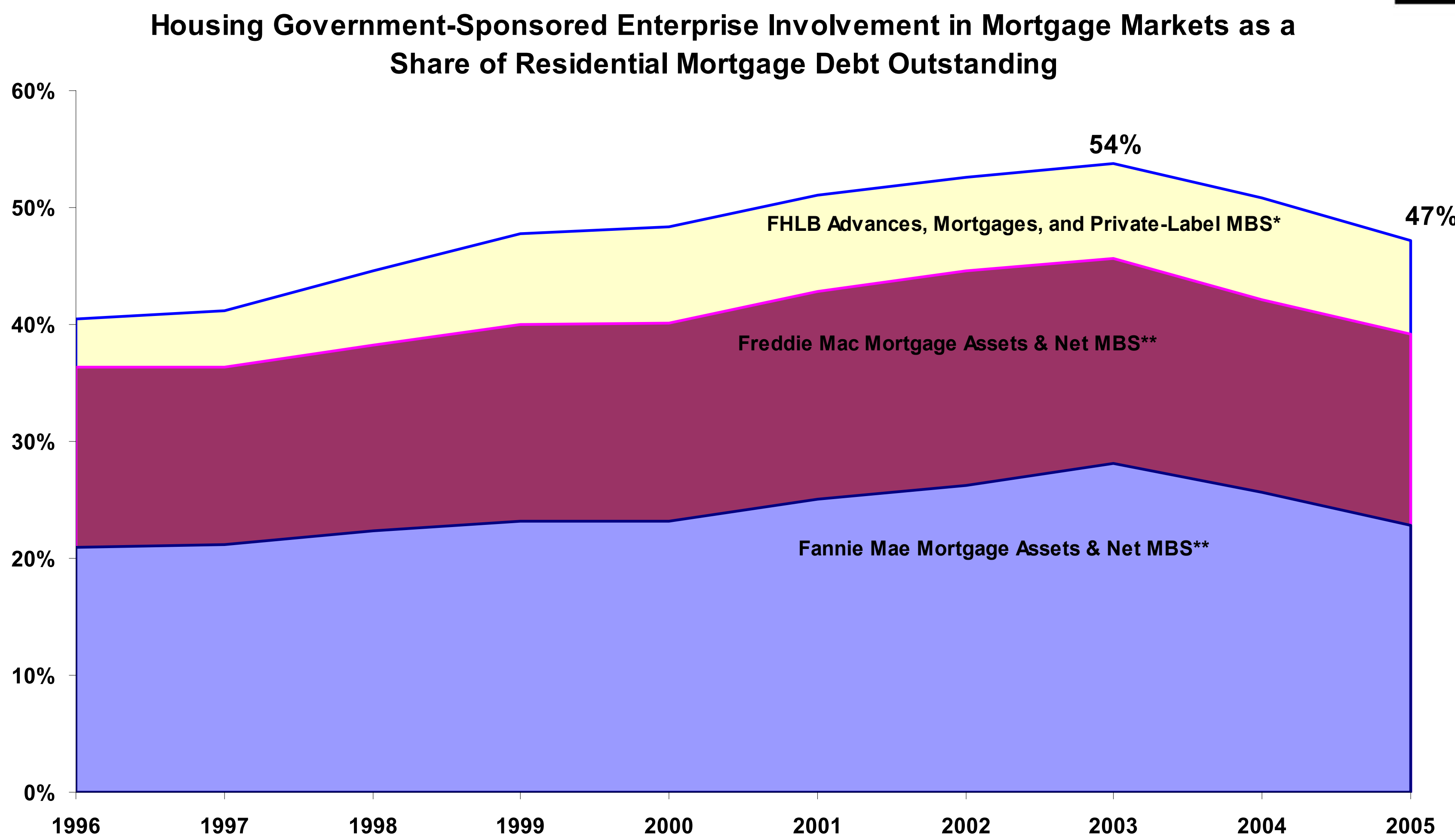
Some have suggested that reducing the portfolios would cause mortgage market turmoil while just transferring the risks elsewhere. Much of the prepayment risk is already transferred elsewhere through derivatives and callable debt. If the portfolios' downsizing were handled through normal repayments and a gradual sell-off, the market impact would be minimal. Over the last two years, the Enterprises' agency MBS portfolios shrank by over $280 billion without market disruption as these sales were easily absorbed by investors. Over the last four years, the Enterprises' share of total mortgage-related securities fell 10 percentage points while foreign investors' increased nine percentage points (#5).

The Enterprises could perform their important mission and respond rapidly during times of turmoil with smaller portfolios. Shrinking their portfolios would reduce the risk of Enterprise failure and any potential adverse effects on the secondary mortgage and other financial markets.

A new, stronger regulator with bank regulator-like powers is needed to oversee these institutions that are so important to the housing market and the U.S. economy. Make no mistake, these Enterprises are huge. (#6) As of September, their combined guaranteed MBS and debt outstanding of $4.3 trillion is not much smaller than the $4.9 trillion publicly held debt of the U.S. If you add in the FHLBanks, the total of $5.2 trillion well exceeds the publicly held debt of the U.S.

OFHEO has made much progress in regulating these two companies, but we need more tools. I have been impressed with the work and dedication of the OFHEO team, and we will continue to build on that team. However, there is no doubt in my mind that GSE reform legislation is critically needed to enhance supervision and reduce risks. I believe this will strengthen regulatory oversight of Fannie Mae and Freddie Mac so that they can better fulfill their mission of working with the private capital markets and providing liquidity, stability and affordability to the nation's housing market.

GSEs Dominate the U.S. Mortgage Market



* FHLB members use advances for short-term liquidity and asset/liability management in addition to funding mortgages. Excludes Enterprise MBS held for investment, to avoid double-counting, and private-label MBS before 2004, when detail on FHLB MBS holdings is unavailable.

** Excludes holdings of MBS guaranteed by the other Enterprise.

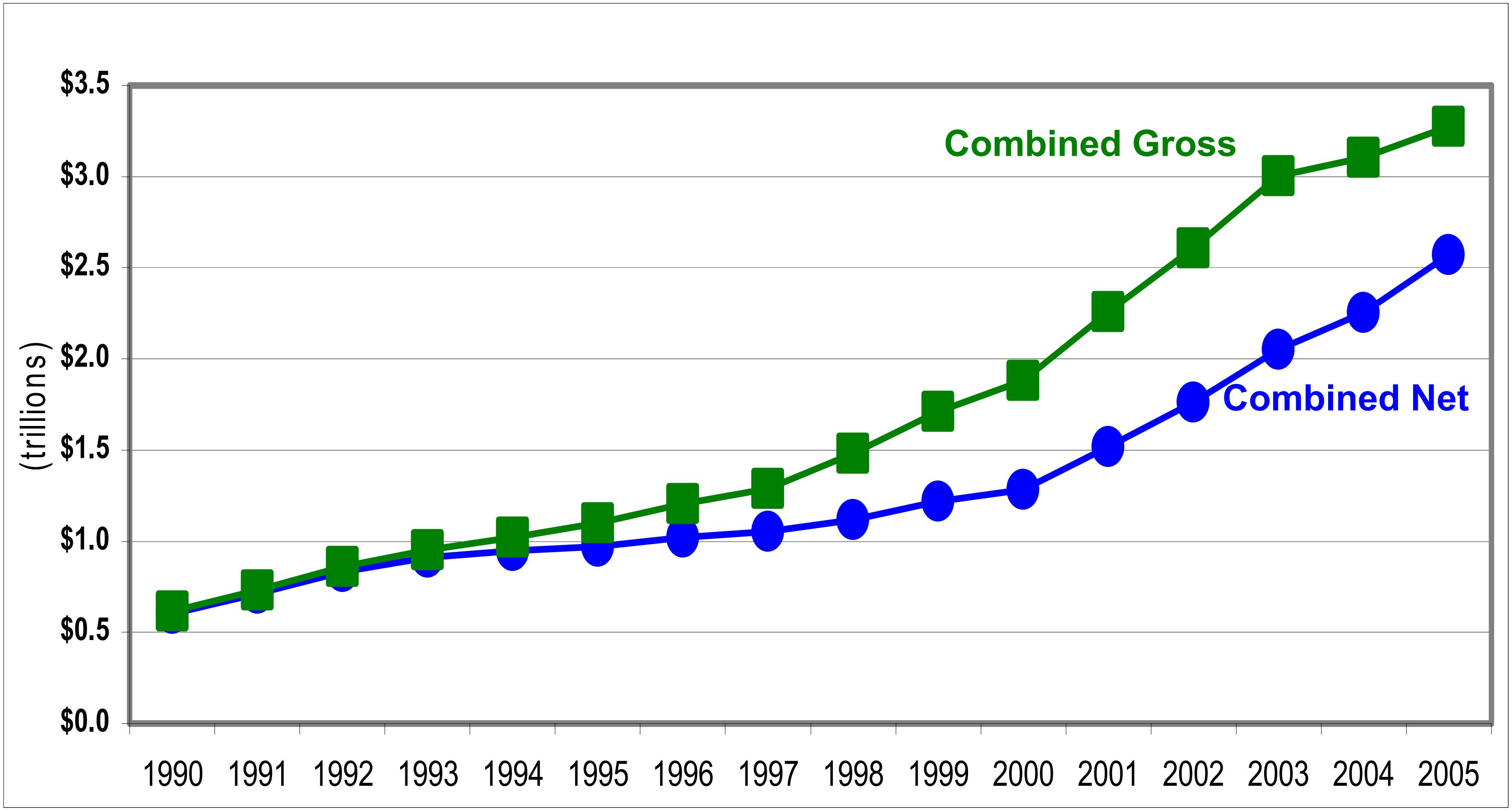
Why is Legislation Needed?

- Certainty for the Enterprises
- OFHEO Needs Bank Regulator-Like Powers
- OFHEO Needs More Independence
- Mission and New Product Authority Need to be Combined
- Capital Requirements Need Strengthening
- Strength Through Combining the Three GSE Regulators
- Affordable Housing Fund
- Reduce Risks to the Financial Markets

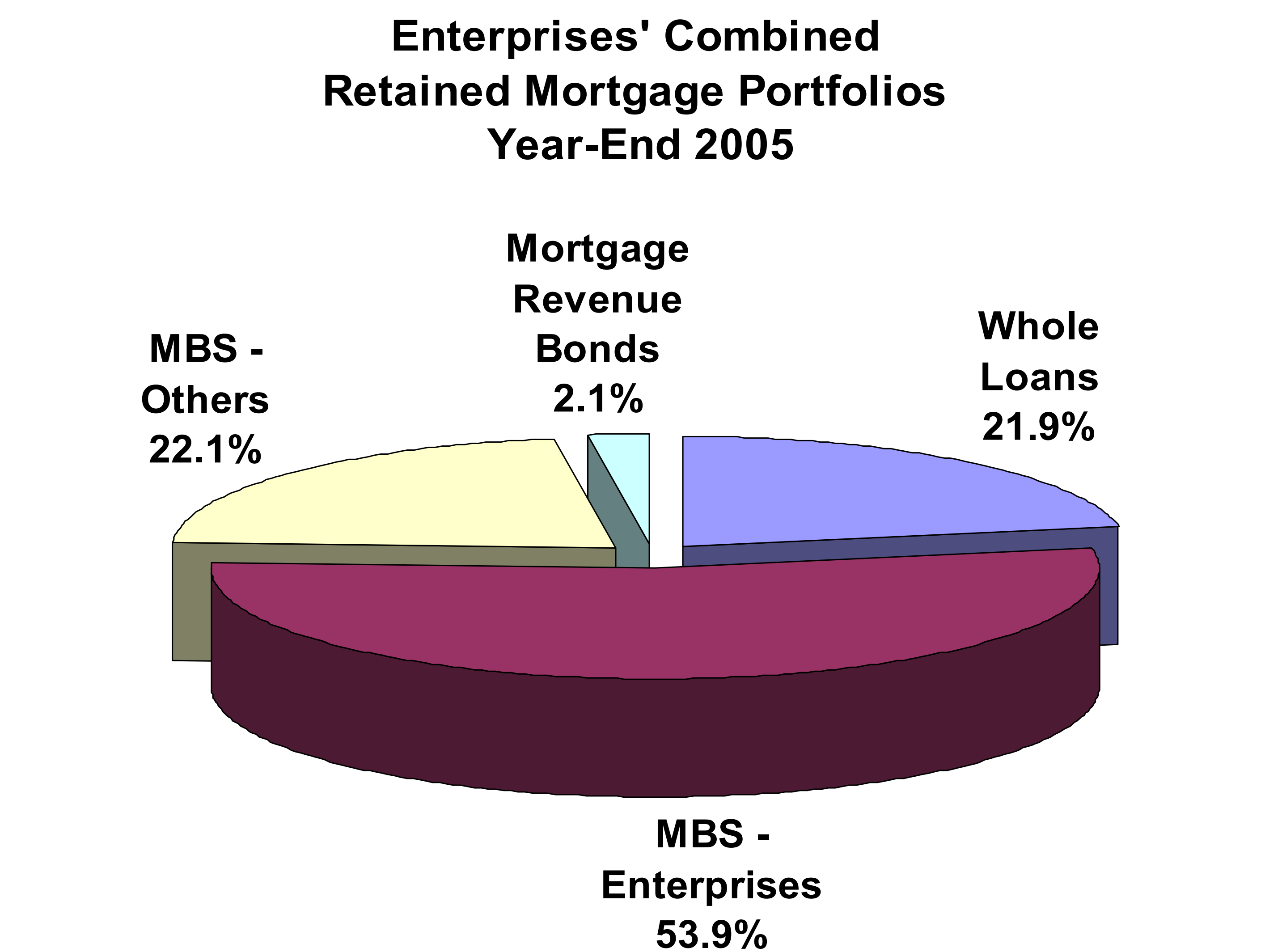
Guaranteed MBS Continuing to Grow

OFHEO

Fannie Mae and Freddie Mac MBS Outstanding
Gross and Net Basis
1990 - 2005

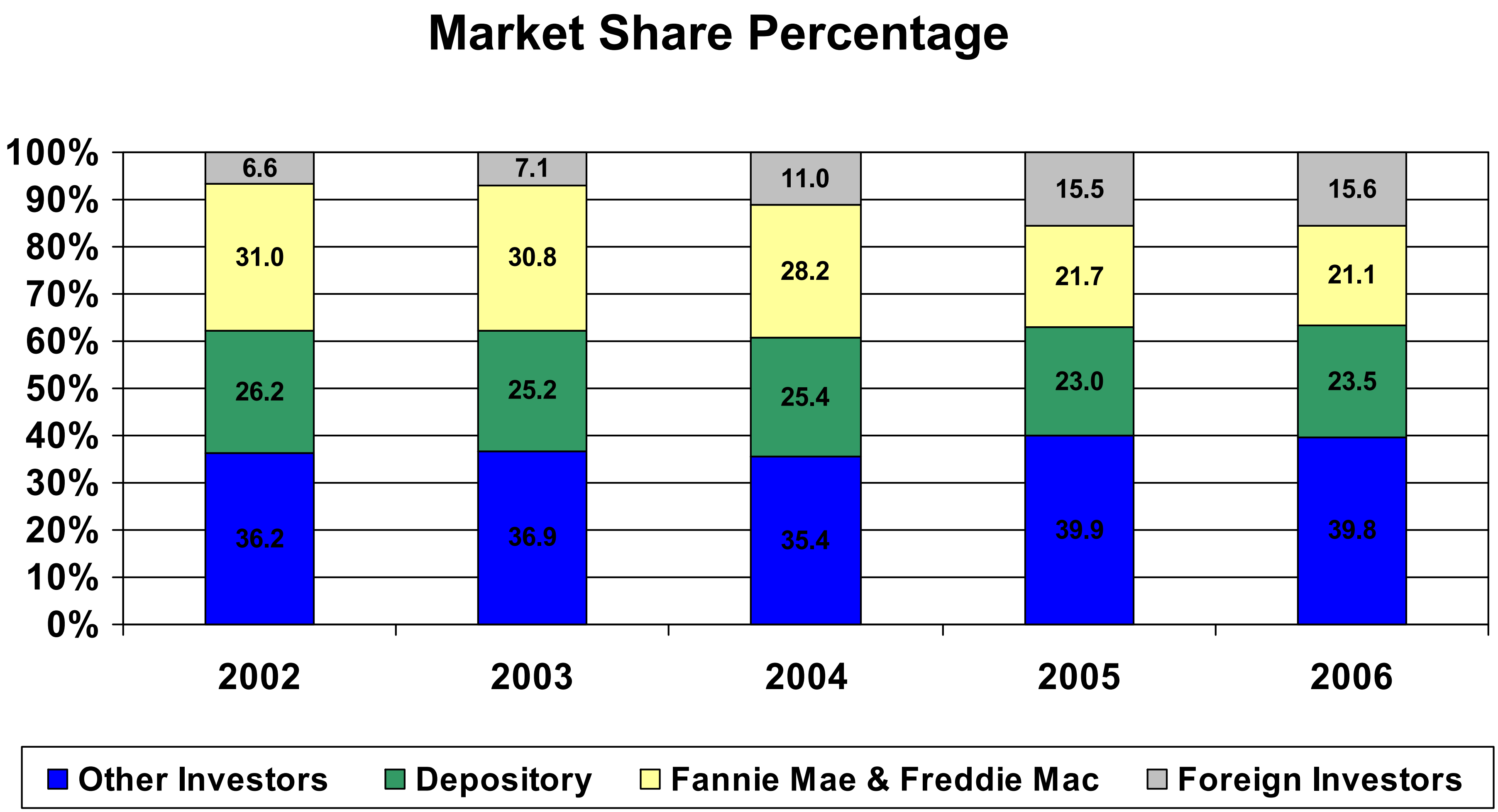


Portfolios Dominated by Own MBS



Contribution to Affordable Housing Goal Less Than 30%

Enterprises' Share of Mortgage-Related Securities Falling



The Enterprises are Huge