GETTING IT RIGHT IN NOVEMBER

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Thank you for the opportunity to speak before the Hudson Institute. I read with interest the paper that will be presented and discussed here shortly that deals with the benefits of financial deregulation in the mortgage market. A key part of the paper focuses on whether Fannie Mae and Freddie Mac have had measurable effects on assisting individuals to buy houses that reflect their future incomes. This is an important question. The answer has obvious implications for forthcoming policies regarding these two Government-Sponsored Enterprises (GSEs). But one policy that should not be affected is the government's commitment to ensuring the safety and soundness of these enormous institutions, and reducing the risks to the financial systems that they pose. This is an area where action is needed now.

The case for GSE reform is very strong given Fannie Mae's and Freddie Mac's mismanagement history and the risks caused by their massive size. Their combined $4.1 trillion in debt and guaranteed mortgage backed securities (MBS) at year-end 2005 is not that much smaller than the whole debt of the U.S. held by the public of $4.7 trillion or, for that matter, a number engraved in my mind, the 75-year net present value Social Security shortfall of $4.6 trillion (#2).

Both companies, a large bipartisan group of Senators and Members of Congress, and the Bush Administration all support reform. We now need to get the ball across the goal line when Congress returns in November.

You are all aware of Fannie Mae's and Freddie Mac's accounting scandals, earnings manipulation, and management failures. OFHEO is focused on making them fix these problems which will take several more years. What we have learned from these failures is that the companies have serious problems and need strengthening and that OFHEO did not have the powers to prevent those problems.

You are also all aware of the dramatic weakening of the nation's housing market. OFHEO has a strong interest in housing markets as they have a powerful effect on the credit quality of mortgage loans owned or guaranteed by Fannie Mae and Freddie Mac. They own or guarantee over 40 percent of the residential mortgages in the U.S. or approximately $4 trillion dollars (#3). Dividing the total into their two main businesses, $2.6 trillion represents MBS guaranteed by the Enterprises and $1.4 trillion represents portfolio holdings including their own MBS.

We track house price trends through a quarterly House Price Index (HPI). Over the past five years, we have witnessed an extraordinary change in the relative price of houses. (#4) The general level of house prices soared 56 percent from the Spring of 2001 to the Spring of 2006. On an inflation-adjusted house prices are now 38 percent higher than 5 years ago. That is three times the real growth in the last half of the 1990s. Not surprisingly, over the past year, the pace of house price increases over most of the country has moderated dramatically.

Some people have argued that a softening market means that it is not the time to make changes in the regulatory framework. I disagree. First, softening is not a result of a lack of mortgage funds, but rather it is a natural deceleration due to the fact that appreciation rates have exceeded income growth rates for many years. In fact, because of market conditions, both companies have said the portfolio caps put into effect this year have not been constraining. Secondly, if the market experiences more credit losses, the companies must be strong and the oversight of them must be stronger which is what the legislation currently pending is all about.

Safety, Soundness and Systemic Risk

Before getting into the specifics of what is needed to reform the current GSE regulatory environment, I would like to address 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."(#5)

Both Fannie Mae and Freddie Mac have said that they want a stronger regulator with bank regulator-like powers, but they question broad authority to address portfolio limits, and their portfolios' impact on systemic risk. In fact, just yesterday, one Enterprise suggested they reduce risk to the financial system. So there is a two-prong debate going on as to whether bank regulators address systemic risk and whether the Enterprises' portfolios increase systemic risk.

I believe the key reason that bank regulators and deposit insurance were created was to reduce risk of losses to financial markets, other financial institutions, and individuals. Therefore, bank regulators are responsible for reducing systemic risk as part of their core regulatory responsibilities. Indicators of systemic risk include not only an institution's risk profile and its quality of risk management, but also measures of its importance to other institutions and to financial markets. Some key indicators of concern for the Enterprises are their high leverage, their continued inability to produce financial statements, their weak internal control environment, their huge mortgage asset portfolios that contain substantial interest rate and operational risks, the very limited market discipline they face, the importance of their obligations to other institutions and markets, uncertainty about the status of claims against an insolvent Enterprise, and the degree of reliance placed on them by many mortgage lenders.

In their charters, both Fannie Mae and Freddie Mac were created to foster a stable and liquid housing finance market, thereby reducing systemic risk. They have done that, but as they grew rapidly as GSEs they began to increase their own potential for causing systemic events. Some may debate whether OFHEO was created to help reduce those systemic risks, but there is no doubt OFHEO does not have all the powers that a bank regulator has to help avoid such events.

Yesterday, one of the CEO's said that the systemic risk is being "misapplied to the GSEs." His argument is that by concentrating risk into two massive portfolios and then hedging their duration with some callable debt and large derivative portfolios makes the system "safer." Of course, the callable debt and derivatives just pass the mortgage prepayment risk elsewhere. Also, it is a fact that they do retain some of this prepayment risk to increase their returns. He ignores the inability of the GSEs to diversify to reduce risk, unlike banks. He also ignores the fact that systemic risk is much broader than market risk and can be caused by operational problems, including deficient models or unauthorized trading. A stronger regulator and smaller portfolios should help to reduce the potential for systemic risk.

What's Needed?

What is needed to get it right when Congress returns in November? (#6) Let's view it first from the Enterprises' standpoint and then by each component of legislation currently pending before Congress.

Certainty for the Enterprises

Legislative uncertainty is another cloud over the Enterprises. As a result, both Enterprises say they support legislation. They believe that a stronger regulator will strengthen their credibility and new legislation will lessen the uncertainty that they and their shareholders face. Fannie Mae and Freddie Mac have each 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

If Congress fails to act on legislation this year, OFHEO will not be on the same playing field as other financial regulators. Our field will continue to be tilted toward the Enterprises and their risks will be much larger than necessary. The new regulator needs the same powers that bank regulators have to help prevent problems. Explicit legal authorities, such as independent litigation authority, receivership, and better enforcement powers are crucial for a stronger GSE regulator. The absence of receivership authority, which bank regulators have, creates uncertainty and contributes to the possibility of a systemic disruption in the financial sector if something goes wrong at one of the Enterprises. Enhanced enforcement powers, including addressing misconduct by employee, director, and affiliated parties, are needed too.

OFHEO Needs More Independence

Regulatory independence must be strengthened. A better-funded OFHEO, free from the appropriations process, will ensure it has the necessary resources going forward to keep up with the growth and complexity of the Enterprises. It is perverse that OFHEO is required to be congressionally appropriated while the bank regulators are not, even though we are all funded by the regulatees and therefore have no impact on the budget deficit. If the agency remains under the appropriations process, it will be tied to continuing resolution freezes and political battles on unrelated budget matters. Greater regulatory muscle and independence will also be provided by combining the agency with the Federal Housing Finance Board (FHFB), the regulator of the 12 Federal Home Loan Banks. Combining these two regulators will also provide more capability to ensure on a comprehensive basis the safety and soundness of the U.S. mortgage market.

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. As both companies have said, a stronger GSE regulator needs these authorities too.

Capital Requirements Need Strengthening

Presently, the Enterprises have low regulatory minimum capital requirements. The OFHEO 1992 Act requires them to maintain stockholder's equity equal to 2.5 percent of assets they hold in portfolio, which is about half of what large banks must maintain in order to be classified as well-capitalized. And on top of the required capital, many banks hold significantly more "excess" capital than the Enterprises do.

OFHEO's risk-based capital requirements have been 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; which are market, credit and operational risk. Systemic risk also should be considered. The law focuses too narrowly on just two very precise scenarios that were designed 15 years ago and is no longer consistent with best regulatory practices. More flexibility to enhance capital requirements is a critical component of the future regulation of the Enterprises.

Portfolios Need Constraints

Until recently the growth of the Enterprises' portfolios has been focused on shareholders' returns rather than their mission. Their size will continue to subject financial markets and institutions to unnecessary systemic risk. A major reason that these companies grew rapidly is that the credit markets do not provide the normal market discipline to offset shareholders' pressure to grow. During the last 15 years, the nation's GDP doubled, the mortgage market tripled, the Enterprises' guarantees quadrupled and their portfolios grew ten-fold as you can see in this chart (#7).

Bank regulators are strongly supported by credit market disciplines. If a bank faces accounting, management, or market problems, the rating agencies will downgrade its debt and it will be much harder and more expensive to borrow. We have seen that despite all their problems, the Enterprises were not downgraded and did not experience funding issues, even in subordinated debt, because they are GSEs. Management teams of both companies agree that growth was too rapid from 1992 to 2003. Unconstrained growth can cause market, credit and operational risks and significant systemic risk. In insurance terminology, it creates a "moral hazard."

The Senate bill provides stronger guidance on portfolios than the House bill, but needs to be more flexible. The new regulator needs some discretion to set and enforce portfolio limits. For example, the regulator could be empowered to set annual limits based upon the risks the portfolios present to the companies and financial markets and upon guidelines that ensure that the companies can fulfill their housing mission.

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. However, neither the Senate nor House bill limits their largest, fundamental business of buying mortgages and then packaging them with guarantees for securitization (#8). This strongly growing $2.6 trillion MBS business represents 26 percent of the total U.S. mortgage market. The chart says "net of portfolio holdings" as in addition they own over $700 billion of their own MBS.

Reform opponents also maintain that reducing the portfolios wil1 increase mortgage rates and that this will impact the ability to purchase homes. However a recent Federal Reserve study noted: "Our results suggest that curbing the growth of these portfolios might not increase mortgage rates paid by new mortgage borrowers while mitigating the risks posed to taxpayers and the financial system." [1] The authors also observed: "We found that portfolio purchases have economically and statistically negligible effects on both primary and secondary market rate spreads." [2]

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[1] GSEs, Mortgage Rates, and Secondary Market Activities, Finance and Economics Discussion Series, Divisions of Research & Statistics and Monetary Affairs, Federal Reserve Board, Washington, D.C. 20006, p.6.
[2] Id., p.34.

Professor Rosen's paper is no less clear: "The results…provide no evidence that the retained portfolio has made the housing market less imperfect for households."[3]

Less than 30 percent of the Enterprises' combined retained mortgage portfolios of $1.4 trillion is used to fulfill their very important mission of affordable housing (#9). About 54 percent of their portfolios are invested in their own MBS, which receive no additional credit toward their affordable housing goals and are easily saleable. At 23 percent of their total MBS, these holdings are much higher than is needed for liquidity. Their private label MBS and whole mortgages could be better utilized as only a half qualify as supporting affordable housing. An active trading capability coupled with an inventory of securities backed by the ability to expand rapidly to cope with market liquidity emergencies should provide market liquidity and stability.

Some have suggested that reducing the portfolios would cause mortgage market turmoil while just transferring the systemic risk elsewhere. As noted earlier, much of the prepayment risk is already transferred elsewhere. If the portfolios downsizing were handled through normal repayments and a gradual sell-off, I believe, along with many experts, that 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 (#10).

Another argument against change is the claim that international investors only buy Enterprise debt, but there is a large and growing international demand for agency MBS. Not including foreign assets managed by U.S. money managers, total foreign investment in agency MBS grew rapidly to $259 billion by mid-2005. And based on a recent poll of central bankers, UBS estimated that those institutions will increase their investments in agency MBS by $116 billion in the year ending next June.

The benefits of the Enterprises' large asset portfolios are limited, but the risks are significant. Despite the higher risk and volatility of their mortgage portfolios than their basic MBS business, the returns on equity are very similar. They are not rewarded for the extra risks caused by their portfolios. Weighing the risk/reward tradeoff, it seems clear that the portfolios should be smaller. Over time that shrinkage should enhance their ability to concentrate on their congressionally mandated mission.

Bottom Line

The bottom line is legislation is needed for a stronger regulator so that the rebuilding of the Enterprises can be completed (#11). They have a critical mission and also significant funding and other advantages, arising from their status as GSEs. They need to be strengthened to deal with changing markets and so does the regulator. We simply must have more bank regulator-like powers to meet our responsibilities. Unconstrained growth led to and compounded operational and management problems at both companies. The rapid growth of the portfolios size over a 10-year period was dictated by the shareholders

[3] Do Households Benefit from Financial Deregulation and Innovation? The Case of the Mortgage Market, Federal Reserve Bank of Boston, Princeton University, September 2006, p. 34.

and not the companies' mission. Moreover, there is no credit market discipline to reduce systemic risks to the financial markets and institutions.

Bank regulators have acted to limit growth and to restrain actions where safety and soundness concerns are involved. They also have more flexibility when addressing capital needs of the institutions they regulate. OFHEO's capital requirements are too low and too inflexible. Improved capital requirements and portfolio limits with clear, but flexible guidance to the new regulator could significantly reduce systemic, market, credit and operational risks. The portfolio reduction could be through a transparent rulemaking process. After a gradual reduction, they could grow again with the mortgage market. The reduction would allow the Enterprises to free up capital that could be used for their core MBS business or returned to shareholders.

It is my hope and belief that Congress will act on GSE reform legislation when they return this November. The enhanced supervision and stronger regulatory regime, as proposed by the Congress and supported by OFHEO, the Bush Administration, and the Enterprises, will strengthen Fannie Mae and Freddie Mac so that they can better fulfill their mission of providing liquidity, stability and affordability to the nation's housing market.

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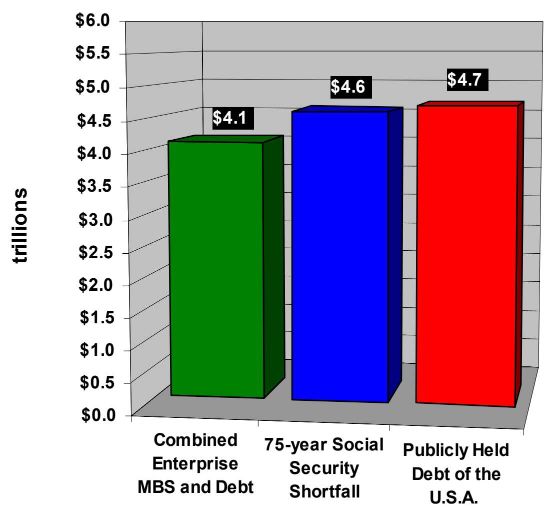
The Enterprises are Massive

Relative Size of Enterprise Obligations
(Year-End 2005)



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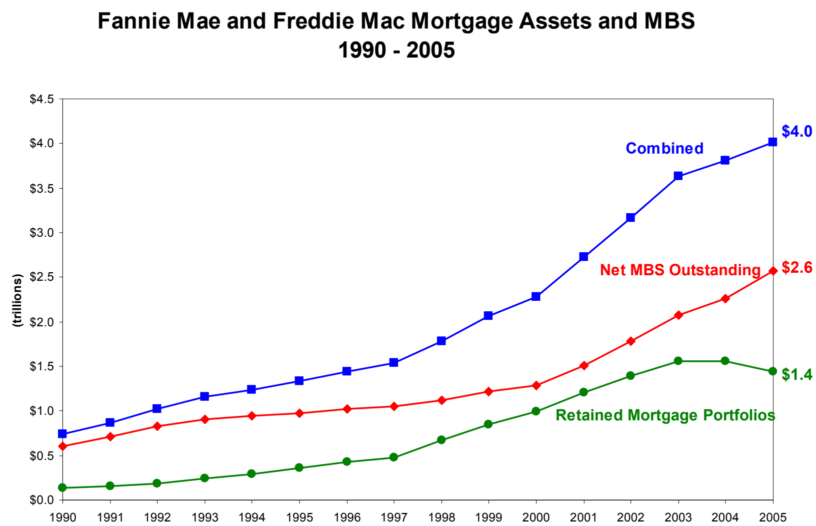
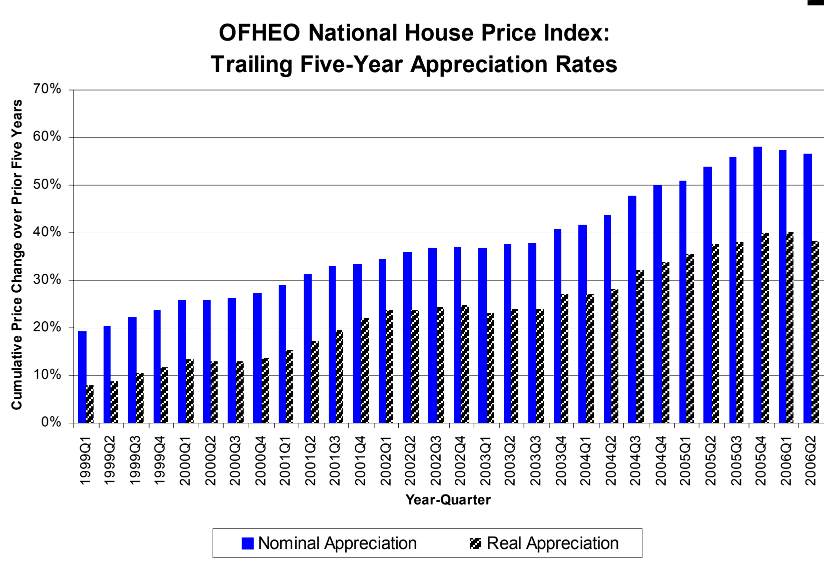
Enterprises' Two Businesses Have Grown Rapidly

OFHEO



House Price Growth

OFHEO



Safety, Soundness and Systemic Risk

OFHEO

- 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.
- Reducing systemic risk is an important reason bank regulators were created and an important part of their ongoing responsibility.

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What's Needed?

OFHEO

- Certainty for the Enterprises
- Bank Regulator-Like Powers
- More Independence
- Combined Mission and New Product Authority
- Stronger Capital Requirements
- Enterprises Portfolio Constraints

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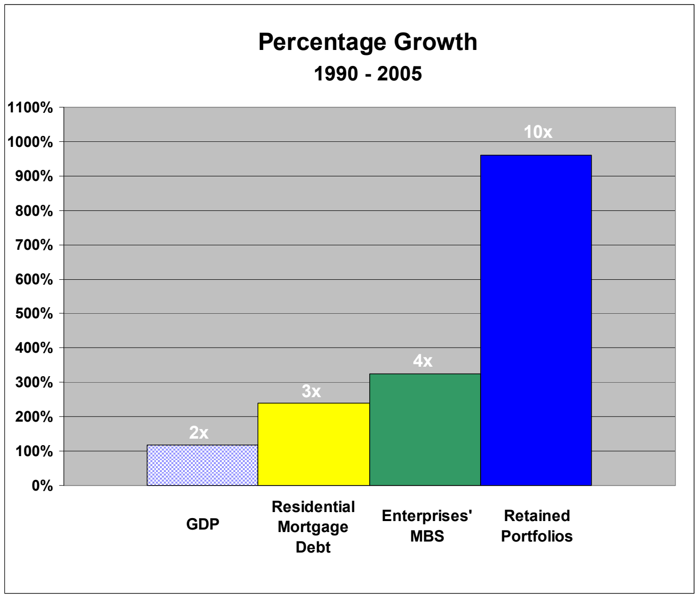
Portfolios have Grown Very Rapidly



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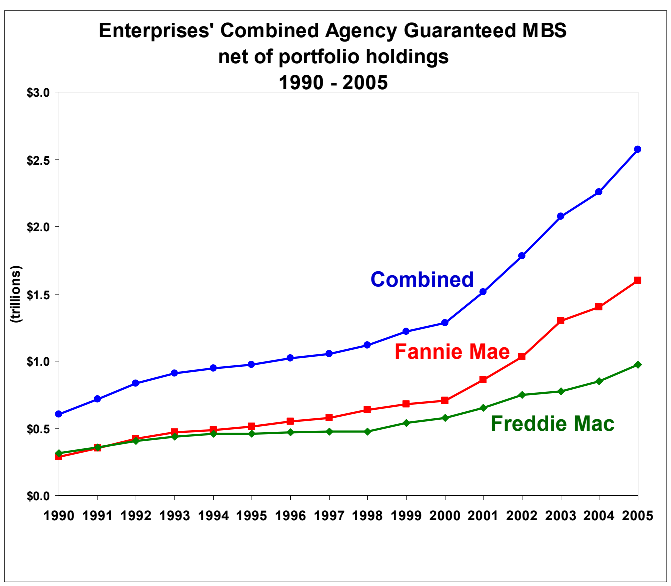
Guaranteed MBS Continuing to Grow



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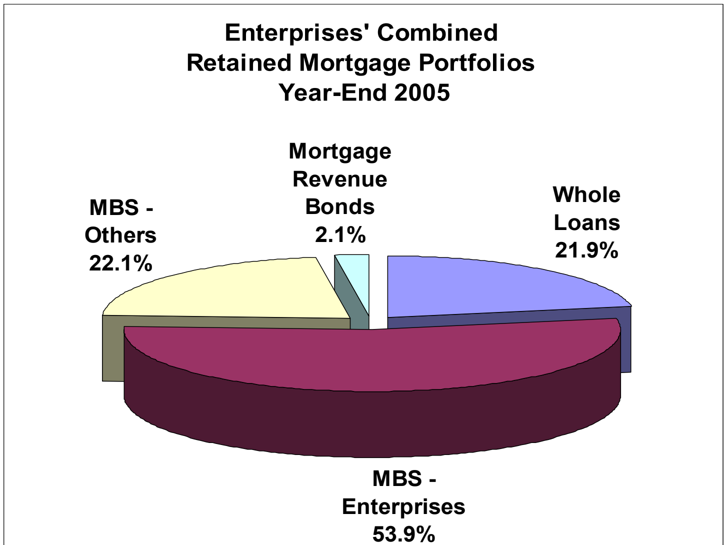
Portfolios Dominated by Own MBS

OFHEO



Contribution to Affordable Housing Goal Less Than 30%

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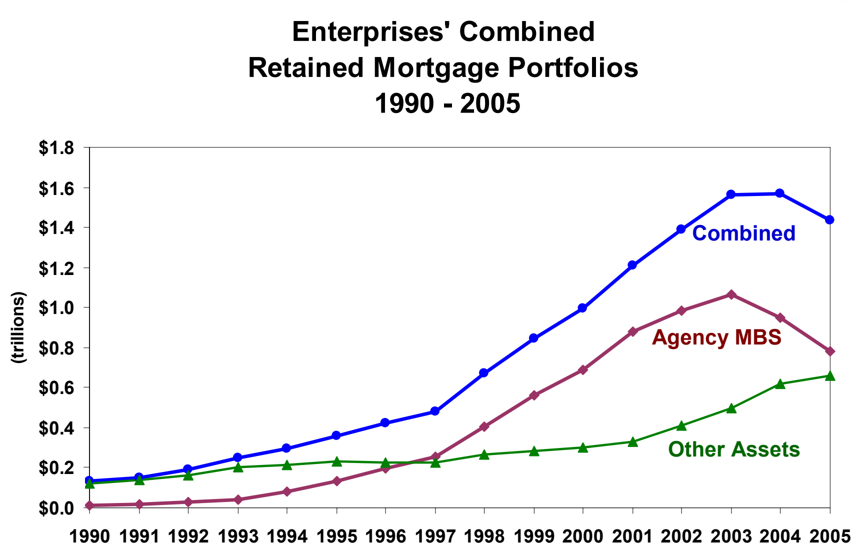
Agency MBS Driving Portfolio Growth

OFHEO



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Stronger Regulator Needed

- Enterprises have a critical mission
- OFHEO lacks powers to meet responsibilities.
- Unconstrained growth led to and compounded operational problems and mismanagement.
- Portfolios sized for shareholders and not mission.
- No credit market discipline to reduce systemic risks to financial markets and institutions.
- Capital requirements are low and inflexible.

Therefore, regulator should be empowered to address capital requirements and portfolio limits.

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