FIXING FANNIE MAE, FREDDIE MAC & OFHEO

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WASHINGTON, DC

SEPTEMBER 28, 2006

Thank you for the opportunity to speak today before the National Economists Club. Although I have worked closely with economists in my Washington career, this is my first time to address your distinguished group. Speaking of my Washington career it has been a trifecta of challenges: PBGC, Social Security, and now OFHEO. Or as an editor of the Wall Street Journal said, what did I do to make the President mad at me?

All three needed reform. The case for Government Sponsored Enterprise (GSE) reform is very strong with Fannie Mae's and Freddie Mac's mismanagement history and the risks caused by their massive size. Their combined $4.2 trillion in debt and guaranteed mortgage backed securities (MBS) is not that much smaller than the whole debt of the U.S. held by the public or for that matter the 75 year net present value Social Security shortfall.

Both companies, a large bi-partisan group of Senators and Congressman, and the Bush Administration all support reform, but we cannot get the ball across the goal line. If Congress - - as would now seem to be the case - - does not act on legislation to strengthen the regulatory framework before leaving, there is a lot at stake for OFHEO to do its job and for the companies as they work to correct their problems. It would be my hope that Congress will come back in November and complete action on this critical legislation.

You are all aware of the Fannie Mae Special Examination Report issued in May, which detailed the accounting scandals, earnings manipulation, and management failures at that Enterprise. OFHEO is focused on making Fannie Mae fix these problems and Freddie Mac fix similar ones arising from our earlier Special Examination. What we have learned from these failures is that the companies have problems and need strengthening and that OFHEO had problems and needs strengthening too.

You are also all aware of the dramatic weakening of the nation's housing market. OFHEO has a strong interest in housing markets and particularly in house prices because they have a powerful effect on the credit quality of mortgage loans owned or guaranteed by Fannie Mae and Freddie Mac. These Enterprises own or guarantee over 40 percent of the residential mortgages in the U.S. or approximately $4 trillion dollars. (#2) 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. The general level of house prices soared 56 percent from the Spring of 2001 to the Spring of 2006. The prices of other goods and services rose much less, so that inflation-adjusted house prices are now 38 percent higher than 5 years ago.

Over the past year, the pace of house price increases over most of the country has moderated dramatically.(#3) Our most recent HPI, issued earlier this month, shows house price changes in the housing market slowing rapidly - - from a super heated market, where annualized quarterly appreciation rates reached as high as 17.9 percent to a calmer, moderate market with annualized appreciation rates of close to 4.7 percent this Spring. And the speed with which the market is changing is a reminder that the housing market is cyclical. A more recent, but less comprehensive report of the National Association of Realtors, says prices actually fell in August over the preceding 12 months. Other reports show housing starts and permits falling rapidly and housing inventories at 7 ½ months have reached a 13 year high.

Some people have argued that a softening market means that it is not the time to make changes in the regulatory framework. I would argue just the opposite. First, softening is not a result of 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. 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 in Congress is all about.

<u>Safety, Soundness and Systemic Risk</u>

Before getting into the specifics of what is needed to fix Fannie Mae, Freddie Mac and OFHEO there is an issue I would like to address. There is a debate going on whether bank regulators address systemic risk as part of their safety and soundness regulations, examinations and preventive actions. Being an American Studies major in college, I certainly remember that the key reason that many of the regulators and deposit insurance were created was to reduce risk of losses to financial markets, other financial institutions, and individuals.(#4) To me that is systemic risk even though we use a longer definition which is "the potential for a financial institution to experience severe difficulties that disrupt financial markets and other financial institutions enough to substantially reduce economic activity." Again going back to American Studies that means it hurts the American people.

And so my answer to the question is yes. Bank regulators are responsible for reducing systemic risk as part of their core regulatory responsibilities. Indicators of systemic risk include size, concentrations, rapid growth, lack of internal controls, management shortcomings, complexity, and operational problems that can impact inter-relationships with other firms.

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

What's Needed? (#5)

Why does Congress need to act this year? Let's view it first from the Enterprises standpoint and than 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 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. In particular, Fannie Mae has 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. This comprehensive approach would lessen the uncertainty they face. Freddie Mac has commented that the protracted debate over how to regulate the companies has been a distraction, noting that both financial markets and management do not like uncertainty. Stronger up-to-date capital rules, especially risk-based capital, would increase their credibility too. The status quo means the Enterprises and their shareholders will continue to confront uncertainty.

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 towards the Enterprises. All the bank regulators and OFHEO were created to protect the U.S. financial system by regulating the financial institutions that they oversee. The new regulator needs the powers that bank regulators share to help prevent future problems. Explicit legal authorities, such as independent litigation authority, receivership, and better enforcement powers are crucial for a stronger GSE regulator. With respect to receivership authority, current law does not provide OFHEO with such powers, which are the most effective and credible tool for addressing claims in insolvency. The absence of receivership authority, which bank regulators have, creates uncertainty and contributes to the possibility of a systemic disruption in the financial sector. 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 needs congressional appropriations while the bank regulators do 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 continue to be tied to the uncertainties, continuing resolution freezes and political battles on unrelated budget matters. When we need to secure funds quickly for an investigation, a regulated party will still be able to go to Congress to slow down the authorization; which has happened. Greater regulatory muscle and independence also will be provided by combining the agency with the Federal Housing Finance Board (FHFB), the regulator of the Federal Home Loan Banks. Combining these two regulators will also provide more capability to ensure the safety and soundness of the U.S. mortgage market.

Mission and New Product Authority Need to be Combined

Currently, authority over the charter 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 including the Finance Board have authority over mission, products and services, and safety and soundness. A stronger GSE regulator needs these authorities too. Both Enterprises believe that one regulator should oversee all their activities.

Capital Requirements Need Strengthening

Currently, 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 any mortgage 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. Perversely, the numbers 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 for inclusion. Current law focuses too narrowly on just two very precise scenarios that were designed 15 years ago. Moreover, the statutory model approach now in place is no longer consistent with best regulatory practices. More flexibility to enhance both minimum and risk-based capital requirements is a critical component of the future regulation of the Enterprises.

Growth of the Enterprises Needs Constraints

The growth of the Enterprises until this year has been focused on shareholders rather than mission. Their size will continue to subject financial markets and institutions to added 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. (#6)

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 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 also importantly, significant systemic risk.

The Senate bill provides stronger guidance than the House bill, but needs to be more flexible. As is now being discussed, the new regulator needs 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 missions. Also, the regulator could have the authority to make temporary adjustments in times of significant market disruption. Absent our present agreed upon portfolio limits, Fannie Mae and Freddie Mac could each increase their portfolios by well over $100 billion without exceeding the present minimum capital rules, including the 30 percent operational risk requirement that OFHEO imposed.

Despite the growing consensus about the need to constrain the Enterprises' growth, some argue against any limits. The Enterprises agree that they need legislation creating a stronger regulator in order to restore the market's confidence in them, but they have questioned growth limits. My belief is 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 support the secondary mortgage market and to fulfill their liquidity, stability and affordability missions. However, neither the Senate nor House bill limits their major, fundamental business of buying mortgages and then packaging them with guarantees for securitization (#7). This strongly growing $2.6 trillion MBS business represents 26 percent of the total U.S. mortgage market.

Reform opponents also maintain that reducing the portfolios wil1 increase mortgage rates and that this will impact the ability to purchase homes. However as noted in a recent Federal Reserve Study: " 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] Moreover, this same study observed: "We found that portfolio purchases have economically and statistically negligible effects on both primary and secondary market rate spreads." [2]

Less than 30 percent of the Enterprises' combined retained mortgage portfolios of $1.4 trillion is needed to fulfill their very important mission of affordable housing (#8). 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. These positions help provide liquidity to the MBS market, but at 23 percent of their total MBS outstandings it would appear to be much higher than needed for liquidity. Almost half of their private label MBS and whole mortgages do not qualify as supporting affordable housing. They do need the capability to continue to expand their reach into affordable housing. As for market liquidity and stability, an active trading capability coupled with an inventory of securities backed by the ability to expand rapidly to cope with market liquidity emergencies should serve those purposes. This expansion capability should only be granted for short periods, after which portfolios would gradually return to their previous size in an orderly fashion.

Some have suggested that reducing the portfolios would cause mortgage market turmoil while just transferring the systemic risk 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 small. The driver of their portfolio growth until recently has been the increased investment in their own MBS. However, over the last two years, the Enterprises' agency MBS portfolios shrank by over $280 billion without market disruption (#9).

Some of the proceeds from the sale of these investments were used to repay Enterprise debt. In many cases, investors may have replaced Fannie and Freddie direct debt with higher-yield MBS guaranteed by the Enterprises with no change in outstanding debt in the market place. Obviously, there would be less concentration of the market if other investors bought the MBS securities divested by the Enterprises. Many of the new investors may be better capitalized than the Enterprises. They also may be better able to take the risk of long-term mortgage assets which might lessen the need to utilize the derivative markets.

Another argument against changes is the claim that international investors only buy Enterprise debt, but there is a large and growing international demand for agency MBS. Foreign holdings of agency MBS rose from $176 billion to $259 billion between mid-2004 and mid-2005, including foreign central bank holdings which rose from $23 billion to $66 billion. These data do not include foreign assets managed by U.S. money managers, so total foreign investment likely is substantially larger. And based on a recent

[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.

poll of central bankers, UBS Mortgage Strategist 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. It should be noted that 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 to be rewarded for the extra risks caused by their portfolios.

Mortgages, especially fixed-rate mortgages, have complex and difficult to anticipate payment patterns requiring extensive hedging activities. For example, despite no growth in their portfolios this year one of the Enterprises' derivative book has grown by over $100 billion. The interest rate risk in its portfolio caused massive losses to Fannie Mae in the early 1980s and more recently in 2002, and the operational risk in their portfolios has caused serious problems for both Enterprises in recent years.

Their massive size, importance to housing finance markets, exposure to counterparties, and holders of their securities combined with high leverage ratios, concentration risk, lack of market discipline, and lack of bankruptcy or receivership provisions present significant systemic risk to the financial markets. Weighing the benefits and the risks of the Enterprises' mortgage portfolios, it seems clear that such should be smaller. Over time that shrinkage should enhance their ability to concentrate on their congressionally mandated mission.

Bottom Line

The bottom line is that without legislation an important component of the rebuilding of the Enterprises will be missing. They need to be strengthened to deal with changing markets and so does the regulator. Bank regulators have acted to limit growth and to restrain actions where safety and soundness concerns are involved. Improved capital requirements and portfolio limits with clear, but flexible direction to the new regulator could significantly reduce systemic risk while also reducing market, credit and operational risks. A deadlock over the proposed growth limit has posed the biggest stumbling block to Congressional action but that is a hurdle that can - - and should - - be overcome. I believe the two sides are not very far apart at all. Everybody agrees that a strong regulator is needed. With Congress heading home soon, the window of opportunity for bridging the gap is fast closing. If done properly, the reduction of the portfolios would be through a transparent rulemaking process. After a gradual reduction to strengthen the safety and soundness, including systemic risks, the Enterprises could grow with the market. The reduction of these portfolios 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 and the Bush Administration, will be better for continued homeownership growth, affordable housing, the nation's housing finance system and all the stakeholders of Fannie Mae and Freddie Mac.

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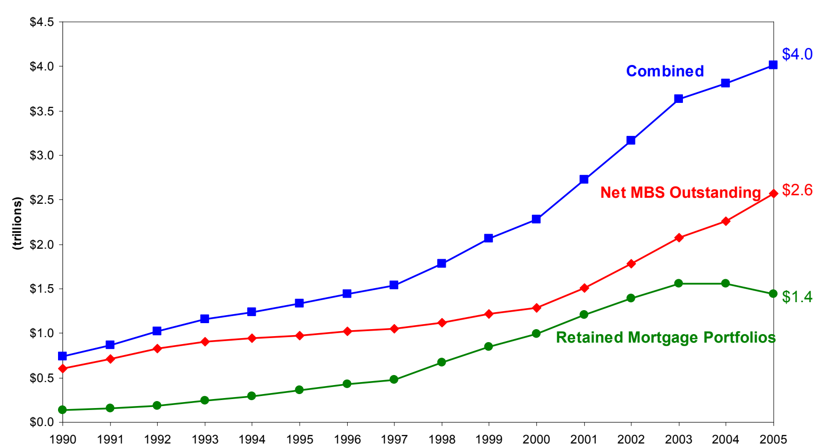
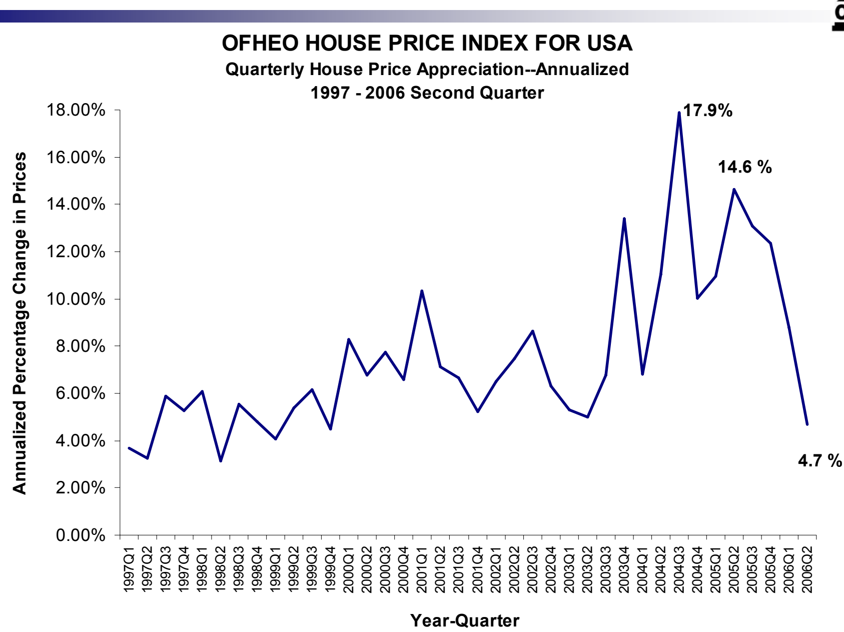
Enterprises' Two Businesses Have Grown Rapidly

Fannie Mae and Freddie Mac Mortgage Assets and MBS
1990 - 2005



House Price Appreciation Slowing Rapidly



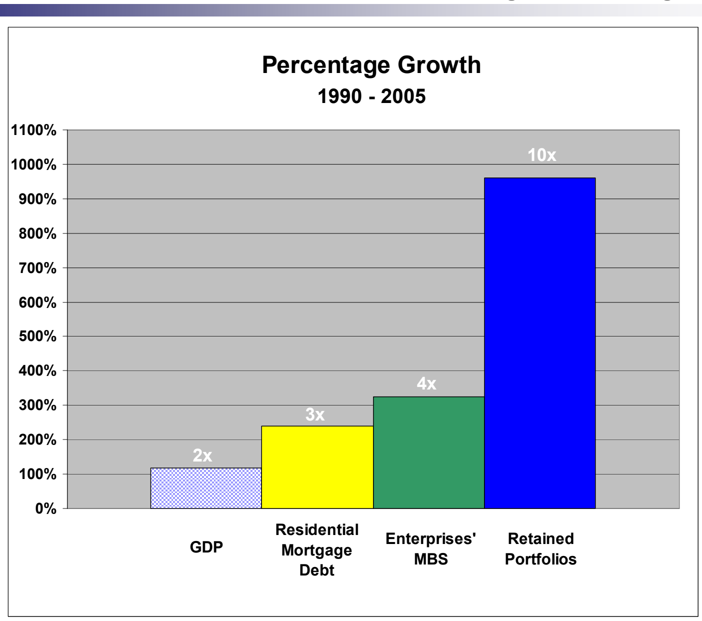
Safety, Soundness and Systemic Risk

- Systemic Risk is the potential for a financial institution to experience severe difficulties that disrupt the financial markets and institutions enough to substantially reduce individual's economic activity.
- Reducing systemic risk is an important reason bank regulators were created and an important part of their ongoing responsibility.

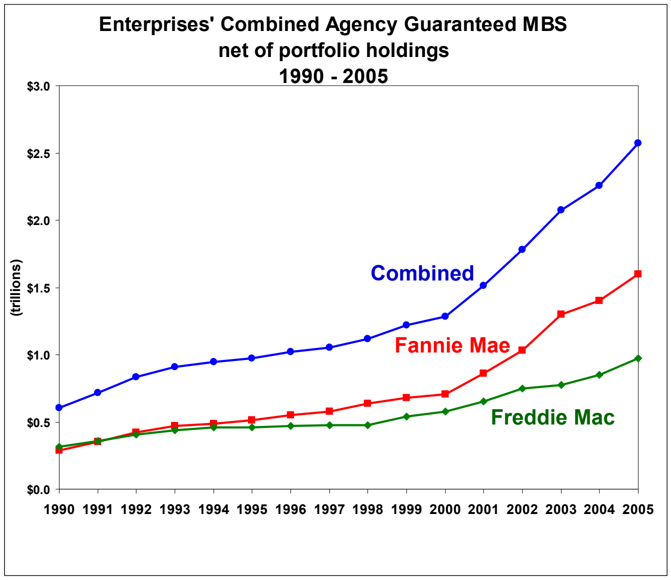
What's Needed

- 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
- Growth of the Enterprises Needs Constraints

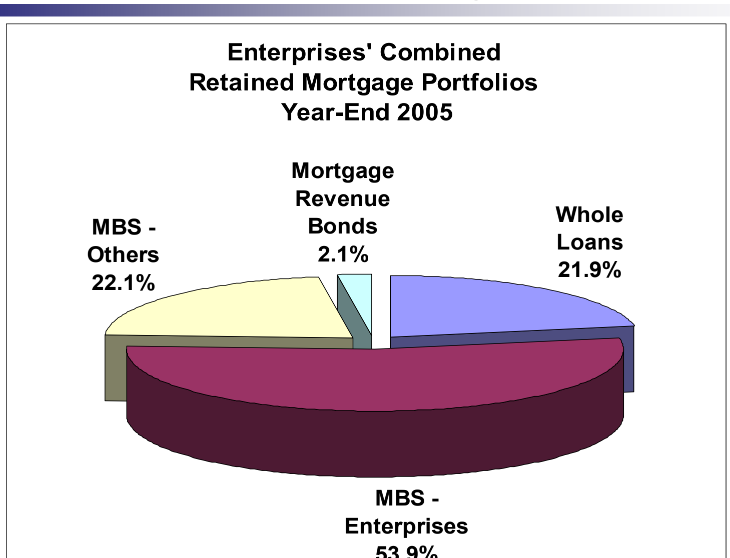
Portfolios have Grown Very Rapidly



Guaranteed MBS Continuing to Grow

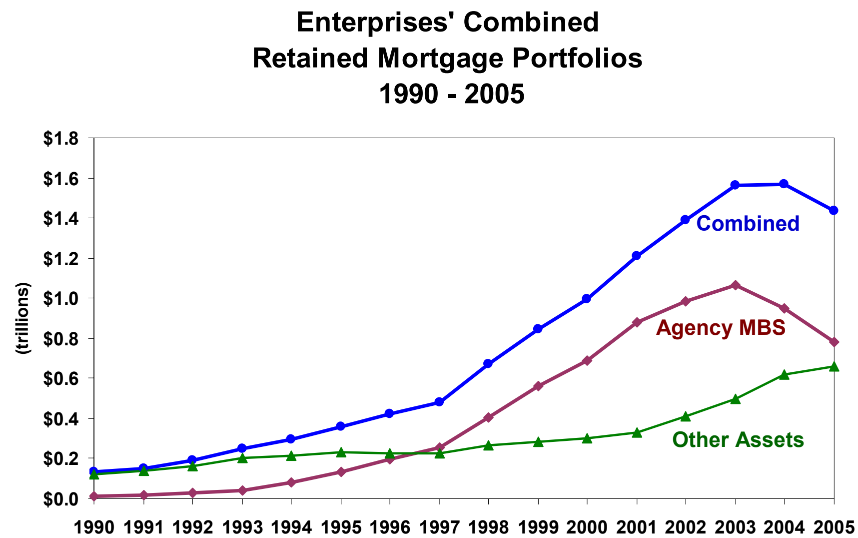


Portfolios Dominated by Own MBS



Contribution to Affordable Housing Goal Less Than 30%

Agency MBS Driving Portfolio Growth



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