THE URGENCY OF GSE REFORM: WHAT'S AT STAKE?

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Thank you for the opportunity to speak this morning before the American Enterprise Institute (AEI). Since I joined OFHEO as its third Director in its 13 year history in May, I have had an opportunity to speak before many groups about the need to reform the current GSE regulatory environment, but I am especially pleased to speak at AEI which has a long history of supporting that effort.

Today, I thought I'd approach the discussion of the need for legislation - - and rest assured, OFHEO strongly believes there is a need - - from a different perspective. And that is in the context of four notable reports that the agency has issued during my tenure.

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.

In June, we transmitted our Annual Report to Congress on the 2005 Examinations of the Enterprises which reinforced the message that significant remedial actions are still needed at both companies. The Report noted that Fannie Mae and Freddie Mac had made progress in 2005 but that much more work and several years are needed to fully achieve safe and sound practices. It further observed that although the Enterprises have differences, the key areas that need significant remedial attention are similar: accounting systems, internal controls, risk management, human resources, corporate governance and rapid portfolio growth. In the Report OFHEO once again recommended legislative enhancements to the agency's authority, consistent with those proposed by Congress.

And just last week we issued a third report, the quarterly House Price Index (HPI), which showed deteriorating conditions in the U.S. housing market. House prices can potentially have a big impact on Fannie Mae and Freddie Mac, because these Enterprises own or guarantee approximately 40% of the residential mortgages in the U.S. or approximately $4 trillion dollars. (#2) In recent years, the Enterprises have had low credit losses. However, our HPI shows house price changes in the housing market - - from a super heated market, where annualized appreciation rates reached as high as 17.9% to a calmer, moderate market with annualized appreciation rates of close to 4.7% this Spring.

And the speed with which the market is changing is a reminder that it is not a given that the strength of the market in the last few years will continue. (#3) Some people have argued that a softening market means that no changes should be made. 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 the last several 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.

The fourth document is OFHEO's draft Strategic Plan. It may seem the least interesting, but it says how we intend to support OFHEO's important mission: "to promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac."

The plan sets three Strategic Goals (#4): 1) Enhance supervision to ensure the Enterprises operate in a safe and sound manner, are adequately capitalized and comply with legal requirements; 2) Provide support for statutory reforms to strengthen our regulatory powers; and 3) Continue to support the national policy of an efficient secondary mortgage market which promotes homeownership and affordable housing.

For the purposes of today's discussion, I thought I'd highlight Strategic Goal 2, given its focus on legislation. This Goal is a new addition to the agency's Plan, and a noteworthy one in terms of what we hope the Congress can accomplish this year. Our ability to ensure the financial safety and soundness of the Enterprises faces limitations within current law. More simply put, we need more authorities. As OFHEO has identified problems through its Special Examinations of both Enterprises, the agency has had to rely on consent or even voluntary agreements with each to affect change. Going forward, we must have the full set of regulatory powers similar to the tools available to bank regulators so we may act quickly to address problems. Fannie Mae and Freddie Mac also recognize the need for a stronger regulator with bank regulatory powers. I encourage you to take a closer look at the 5 year plan. But I hope it is a 1 year Plan and that this is OFHEO's last year and a new GSE regulator is established. But what will happen if Congress fails to act this year? Let's view it from each component of legislation currently pending before Congress and discuss what is at stake if legislation is not enacted this year.

What's At Stake? (#5)

Uncertainty for the Enterprises Will Continue

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, they are supportive of giving OFHEO bank regulator-like powers and uniting mission and new product authority with safety and soundness authority. This comprehensive approach would lessen the uncertainty they face. 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 will not Have 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. Bank-like regulator powers are needed to ensure that the new regulator has stronger powers 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 employee and director malfeasance penalties, are needed too.

OFHEO will not be Independent

If Congress fails to act on legislation this year, OFHEO will not be sufficiently independent. 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 unlike the bank regulators even though we are all funded by the regulatees and therefore we have no budget impact. If the agency remains under the appropriations process, it will continue to be tied to the uncertainties, continuing resolution freezes and political battles of 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. That is an important component of the legislation.

Mission and New Product Authority Will Remain Separate

Without legislation, mission and new product authority will remain separate. 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 have authority over mission, products and services, and safety and soundness. A stronger GSE regulator needs these authorities too.

Capital Requirements Will Not be Flexible

Capital requirements will continue to be inflexible weakening OFHEO's ability to strengthen regulation of the Enterprises. 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 practices. More flexibility to enhance these requirements is critical.

Growth of the Enterprises Will be Unconstrained

Growth of the Enterprises will continue unconstrained if legislation is not enacted to provide the new regulator with explicit authority to set portfolio growth limits. Their size will continue to subject financial markets and institutions to added systemic risk. A major reason that these companies continue to grow 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 nine-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 it 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 were government-sponsored enterprises. Both management teams would agree that growth was too rapid from 1992 to 2003. Unconstrained growth can cause market, credit and operational risks and also importantly, systemic risk (#7). Systemic risk is the potential for a financial institution to experience severe difficulties that disrupt the financial sector enough to reduce aggregate economic activity by a substantial amount. An institution poses systemic risk to the extent that it serves as a channel for the transmission of problems to other institutions or financial markets with which it is highly interdependent. The new regulator must have the tools to address all these risks.

The Senate bill provides stronger guidance than the House bill, but needs to be more flexible. The Enterprises have grown too fast. Since 1990, Fannie Mae's mortgage assets grew 13 percent and Freddie Mac's mortgage portfolio grew 26 percent. In contrast, the residential mortgage market grew at an average rate of 8.5 percent. 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. For example, the Enterprises agree that they need legislation creating a stronger regulator in order to restore the market's confidence in them, but they do not support specific 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 business of buying mortgages and then packaging them with guarantees for securitization (#8). These mortgage backed securities (MBS) not owned by the Enterprises total about $2.6 trillion or 26 percent of the total U.S. mortgage market.

Less than 30% of the Enterprises' combined retained mortgage portfolios of $1.4 trillion is not needed to fulfill their very important mission (#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. A significant percentage of their private label MBS and whole mortgages do not qualify as supporting affordable housing.
As for market liquidity and stability, an active trading capability coupled with a 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 which garner no credit in meeting their affordable housing goals. However, over the last two years, the Enterprises' agency MBS portfolios shrank by over $280 billion without market disruption.

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 divested securities. 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. There is a large and growing international demand for agency MBS.

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.

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 5.5 trillion size and importance to housing finance markets, counterparties, and holders of their securities combined with high leverage ratios, concentration, 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, it seems clear that Enterprise mortgage portfolios should be much smaller. Over time that shrinkage should enhance their mission.

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. Other regulators have acted to limit growth and to restrain actions where safety and soundness concerns are involved or where prudential regulatory action is needed. Improved capital requirements and portfolio limits - - particularly those set forth in the Senate bill, with added flexibility- - could significantly reduce systemic risk while also reducing market, credit and operational risks.

It is my hope that Congress will act on GSE reform legislation this year. I believe that enhanced supervision and a 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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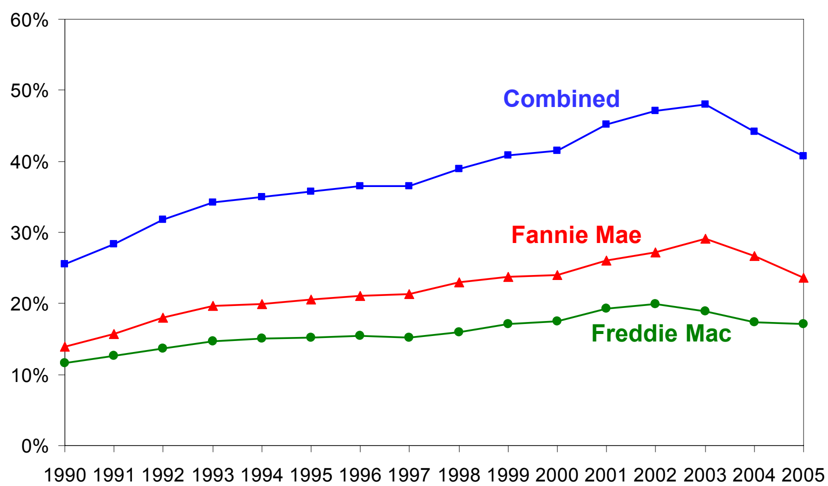
Mortgage Market Share Peaked, but over 40%

Fannie Mae and Freddie Mac Mortgage Assets and MBS as a Share of Residential Mortgage Debt Outstanding 1990 - 2005



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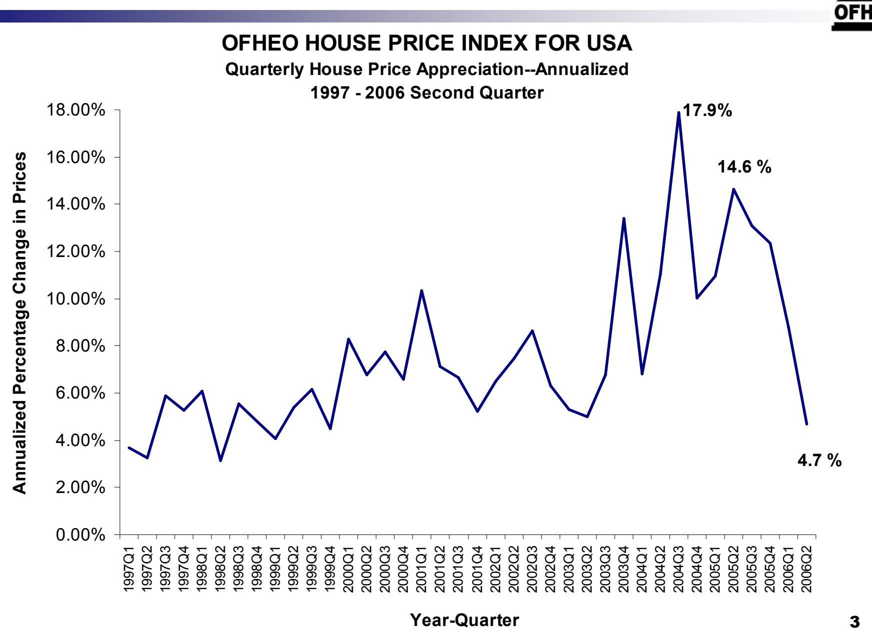
House Price Appreciation Slowing Rapidly

OFHEO



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OFHEO's Three Strategic Goals

OFHEO

1. Enhance supervision to ensure the Enterprises operate in a safe and sound manner, are adequately capitalized and comply with legal requirements

2. Provide support for statutory reforms to strengthen our regulatory powers

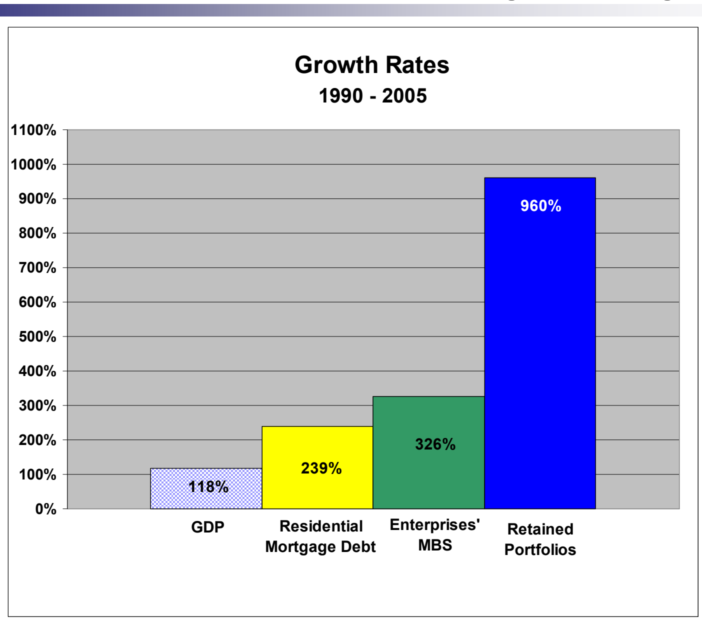
3. Continue to support the national policy of an efficient secondary mortgage market which promotes homeownership and affordable housing

4

What's At Stake?

- Uncertainty for the Enterprises will Continue
- OFHEO will not Have Bank Regulator-Like Powers
- OFHEO will not be Independent
- Mission and New Product Authority will Remain Separate
- Capital Requirements will not be Flexible
- Growth of the Enterprises will be Unconstrained

Portfolios have Grown Very Rapidly



Significant Systemic Risk

- Systemic Risk is the potential to disrupt the financial sector enough to reduce aggregate economic activity.
- Concentration and high leverage may pose more systemic risk than other financial institutions of comparable size.

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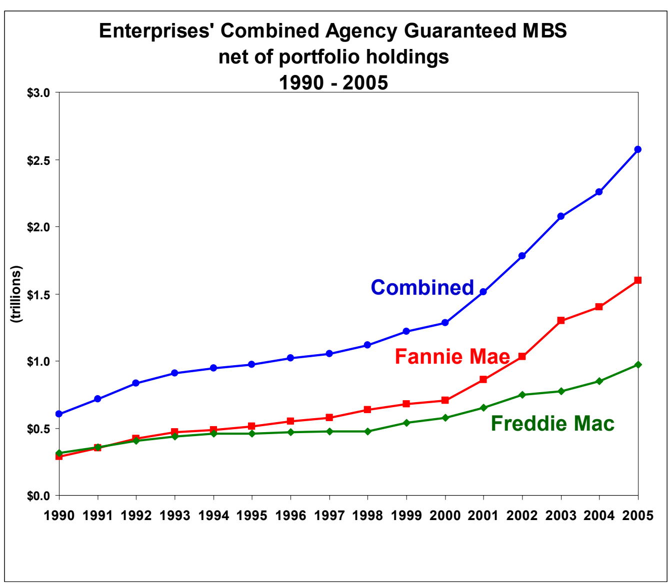
Guaranteed MBS Continuing to Grow



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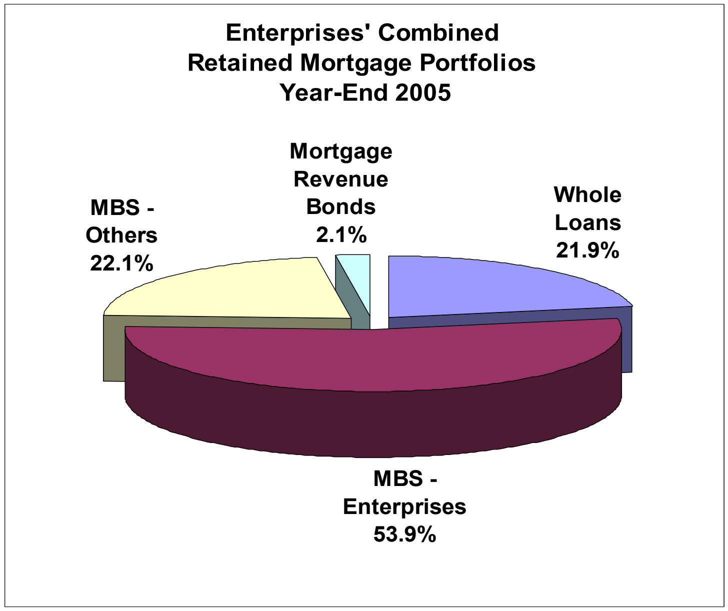
Portfolios Dominated by Own MBS



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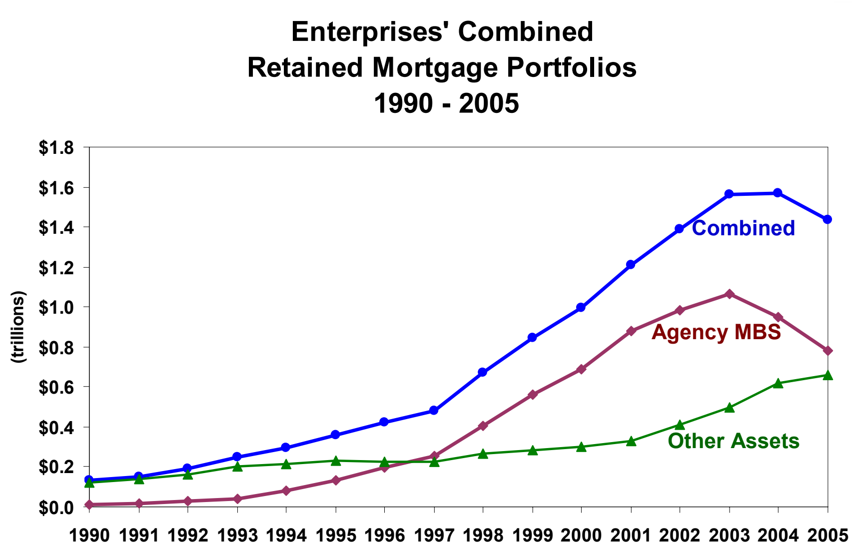
Agency MBS Driving Portfolio Growth



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