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**THE CURRENT GSE REGULATORY ENVIRONMENT AND
THE NEED FOR REFORM
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**ADMINISTRATIVE LAW AND REGULATORY PRACTICE SECTION,
BANKING AND FINANCIAL INSTITUTION COMMITTEE,
AMERICAN BAR ASSOCIATION**

AUGUST 9, 2006

(Note: corresponding Powerpoint slides accompanied the speech – see attached)

I have been at OFHEO for a while now and I am beginning to discover that although OFHEO is a small agency, we do get around. Last week, I gave a speech before Women in Housing & Finance and I was introduced by a past President, OFHEO's head of Congressional Affairs, and your group is co-chaired by David Roderer, an OFHEO Deputy General Counsel. I must admit that I have been impressed with the OFHEO team and I am glad to see others agree. I am delighted to meet with the American Bar Association's Administrative Law Section of the Banking and Financial Institution Committee today. Many of the critical issues facing OFHEO center on points of administrative law. Our ability to effectively oversee Fannie Mae and Freddie Mac, two of the largest financial institutions in the U.S., relates to our ability to exercise a broad range of authorities in a timely fashion.

Fannie Mae and Freddie Mac were created by Congress to increase affordable homeownership by enhancing the secondary mortgage market. That is an important role and one of the reasons that homeownership is near an all-time high. As many observers point out, their primary and most effective means of enhancing the secondary market is through their mortgage securitization activities.

Let me now discuss the current regulatory environment. OFHEO has consent agreements with both Enterprises. The Fannie Mae agreement signed in May has over 60 requirements. We also have placed 30 percent capital surplus charges on each of the Enterprises due to their operational risk problems. As of last week, both companies are now subject to specific portfolio growth limits as they get their houses in order. The costs of the accounting and management problems at the Enterprises are that earnings were misstated by an estimated \$16 billion, fines exceeded one-half billion dollars, lawsuits will total well over a billion dollars and remedial costs will exceed \$2 billion.

Fannie Mae and Freddie Mac are making progress in fixing their problems, but it is slower than they or we would like or expect. It will take several more years. Remedial actions taken to date will help, but legislation is needed to make sure that these two companies do not falter again.

THE NEED FOR REFORM

Why do we need reform (#2)? One way to answer this question is to look at it from the perspective of Basel II, the proposed international regulatory rules for banks. These rules lay out three pillars for ensuring sound financial institutions. They are: 1) strong capital rules; 2) a strong regulator; and 3) market discipline. Unfortunately, with Fannie Mae and Freddie Mac, one of the pillars is missing - - market discipline - - and the other two are weak. The weakness of the regulatory framework helped contribute to their problems. It is also why reform of the current regulatory environment is needed.

From the beginning, OFHEO has been no match for the responsibility assigned to it of being the safety and soundness regulator of Fannie Mae and Freddie Mac. Together, they represent more than a 40 percent share of the residential mortgage market, a share that has doubled since 1990. This unconstrained growth led to significant operational problems, mismanagement and earnings manipulation.

The key reason that these companies have continued to grow is the credit markets have not provided the normal market discipline to offset shareholders' pressure to grow. Their triple-A ratings, which are critical to their business, are dependent on their GSE status and not their balance sheets. Another way to look at this growth is (#3) that during the last 15 years, the nation's GDP doubled, the mortgage market tripled, the Enterprises' guarantees quadrupled and their portfolios grew ninefold as you can see in this chart.

Unconstrained growth can cause market, credit and operational risks and also importantly, systemic risk (#4). 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. As an example of the Enterprises' interdependencies, 60 percent of U.S. banks have over half their capital invested in agency securities.

Fannie Mae and Freddie Mac, like all financial institutions, are in the business of taking and managing financial risks. They are also highly leveraged for financial institutions of their size, lines of business, and importance. Further, each Enterprise has had significant problems with internal controls, corporate governance, and risk management, and is in the process of reforming its corporate culture and management practices. Even if these problems were corrected today, each Enterprise would still pose substantial systemic risk. I believe a strong case can be made that each Enterprise poses more systemic risk than other financial institutions of comparable asset size, among other reasons, because by law they hold less capital and cannot diversify.

KEY COMPONENTS OF LEGISLATION

Both the House-passed bill and Senate Banking Committee-passed bill contain many key components to give the new regulator stronger powers to help prevent future problems and at the same time present interesting matters relating to administrative law. Both are designed to ensure that Fannie Mae and Freddie Mac have the ability to fulfill their missions of supporting affordable housing and providing liquidity and stability to the mortgage market. There are several key provisions (#5):

1. Bank Regulator-Like Powers

First, powers similar to a bank regulator are needed. 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. Finally, the bills under consideration add key administrative tools that permit us to seek damages from institution-affiliated parties and provide a longer statute of limitations to go after separated employees.

2. Independence

Secondly, regulatory independence must be strengthened. As proposed in the House and Senate legislation, 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. Like other financial regulators, OFHEO is funded by the regulatees and therefore we have no budgetary impact. Yet because we remain under the appropriations process the administrative capacity of OFHEO is tied to the uncertainties and political battles of unrelated budget matters. When OFHEO needs to secure funds quickly for an investigation, a regulated party could go to Congress to slow down the authorization; which has happened. Also, OFHEO has been hit with continuing resolution freezes at times when more funds are needed to meet regulatory challenges. Greater regulatory muscle and independence will be provided by combining the agency with the Federal Housing Finance Board (FHFB), the regulator of the Federal Home Loan Banks.

3. Mission and New Product Authority

Third, is the issue of mission and new product authority. Currently, administrative authority over the charter authorities 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. Again, other financial regulators have authority over mission, products and services, and safety and soundness. HUD will continue to play an important role in fair housing oversight under the proposed regulatory regime as well as general oversight as the HUD Secretary would be a Board member of the revamped GSE regulator.

4. Flexible Capital Requirements

Fourth, flexible capital requirements are needed 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 requirements in the 1992 law. Perversely, the numbers, which are based on two stress tests, 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.

From an administrative law point of view, it is clear that providing detailed rules in fixed legislation creates problems where businesses evolve and change over time. New methods for estimating risk and appropriate capital become available and the need always exists for addressing emergency situations. Banking regulators have developed their risk-based capital rules over time and set prudential minimum capital levels. The revamped regulator needs these levels of flexibility in setting capital standards as well.

5. Limits on Portfolio Growth

Fifth, legislation to revamp the current GSE regulatory environment should provide explicit authority to set portfolio growth limits. The Senate bill provides stronger guidance than the House bill, but needs to have some added flexibilities. The Enterprises have grown too fast. Since 1990, Fannie Mae's mortgage assets grew 13 percent annually to about \$727 billion last year. Freddie Mac's mortgage portfolio grew 26 percent per annum to \$710 billion. In contrast, the residential mortgage market grew at an average rate of 8.5 percent. Absent the 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. They say that limits would hurt their ability to support the secondary mortgage market and to fulfill the Enterprises' 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 which is the key liquidity mechanism for the secondary mortgage market (#6). These MBS not owned by the Enterprises total about \$2.6 trillion or 26 percent of the total U.S. mortgage market.

A substantial part of the Enterprises' combined retained mortgage portfolios of \$1.4 trillion is not needed to fulfill their very important mission (#7). About 54 percent of their portfolios are invested in their own MBS, which receive no additional credit toward their affordable housing goals. A significant percentage of their private label MBS and whole mortgages, which average about 22 percent each, do not qualify as supporting affordable housing. Overall, OFHEO estimates that less than 30 percent of their portfolios contribute to affordable housing.

As for market liquidity and stability, an active trading capability coupled with a small 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. As you can see on the bottom lines (#8) of this chart, the driver of their portfolio growth until recently, has been the increased investment in agency MBS which are not mission related. However, over the last two years, the Enterprises' agency MBS portfolios shrank by over \$280 billion without market disruption. Actually they shrank significantly more than their total portfolios did.

In many cases, investors replace 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.

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.

REFORM IS NEEDED FOR A STRONGER HOUSING MARKET

Fannie Mae and Freddie Mac have demonstrated that rapid, unconstrained growth can cause serious problems. If they were not GSEs, the market would have made them shrink quickly in both their MBS guarantee and portfolio businesses. The markets are not performing that discipline and OFHEO does not have the powers or tools to be a strong regulator let alone be a substitute for market discipline. Systemic risk is being ignored. We need the Basel II framework of a strong capital rule, a strong regulator, and market discipline (#8). GSE reform legislation achieves these desired goals. The regulator would be stronger and market uncertainty would be reduced. I believe this will be better for homeownership growth, affordable housing, the housing and financial markets, and all the GSEs' stakeholders.

I hope that I have conveyed to you the important role OFHEO has to play in oversight of Fannie Mae and Freddie Mac, the need for legislative changes and the focus of much of the legislation on administrative law. Once a law is enacted, I encourage you to contribute to the new agency by providing comments on the regulations that will inevitably be required to make the agency fully operational.

Thank you and I would now be happy to answer questions.

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GSE REGULATORY ENVIRONMENT AND THE NEED FOR REFORM



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Basel II Pillars

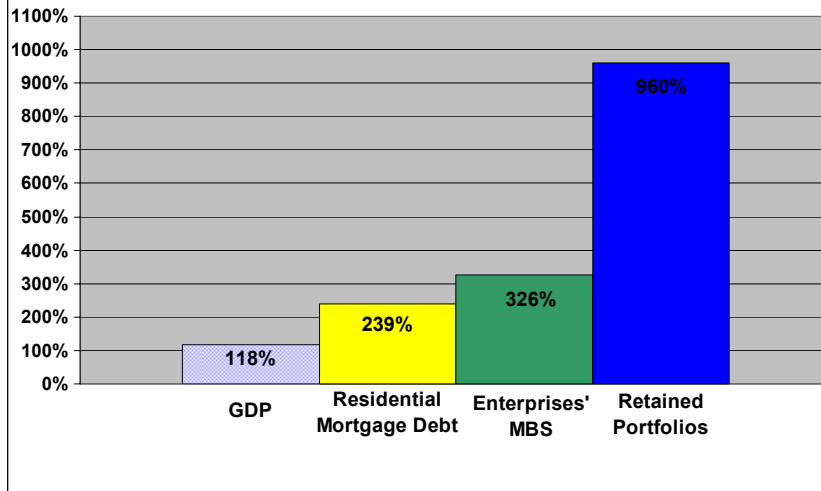


Today



Result: Unconstrained growth led to operational problems and mismanagement

Enterprises' Retained Portfolios Have Grown Very Rapidly
1990 - 2005



3

SYSTEMIC RISK

- Systemic Risk is the potential to disrupt the financial sector enough to reduce aggregate economic activity.
- Highly leveraged.
- Significant problems with internal controls, corporate governance, and risk management. Even if corrected, still pose substantial systemic risk.
- May pose more systemic risk than other financial institutions of comparable size.

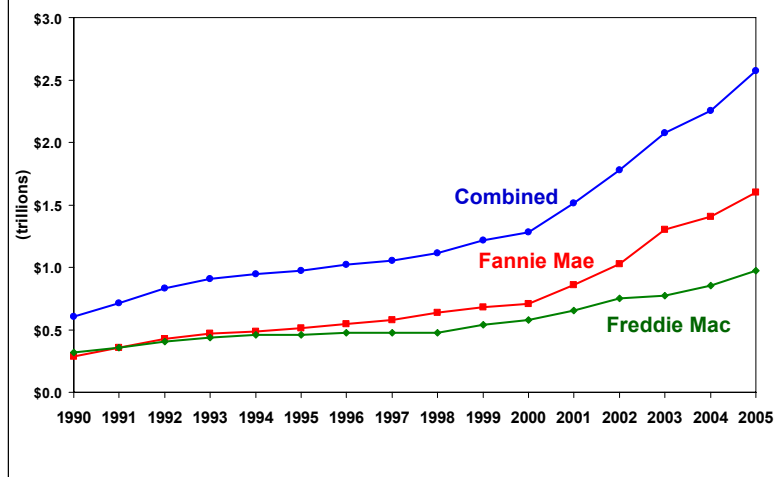
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KEY COMPONENTS OF LEGISLATION

1. Bank Regulator-Like Powers
2. Independence
3. Mission and New Product Authority
4. Flexible Capital Requirements
5. Limits on Portfolio Growth

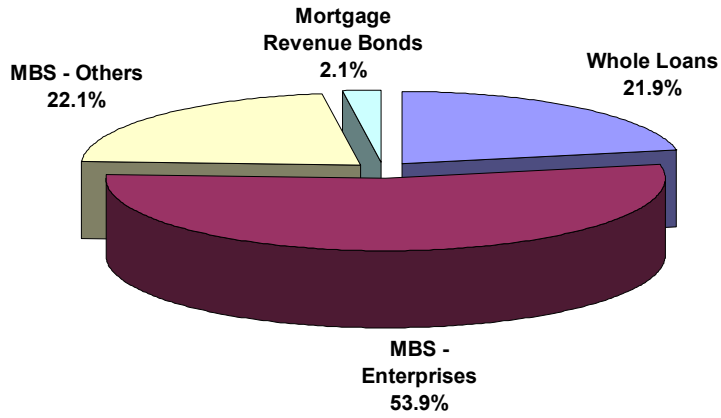
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Enterprises' MBS Continuing to Grow
1990 - 2005



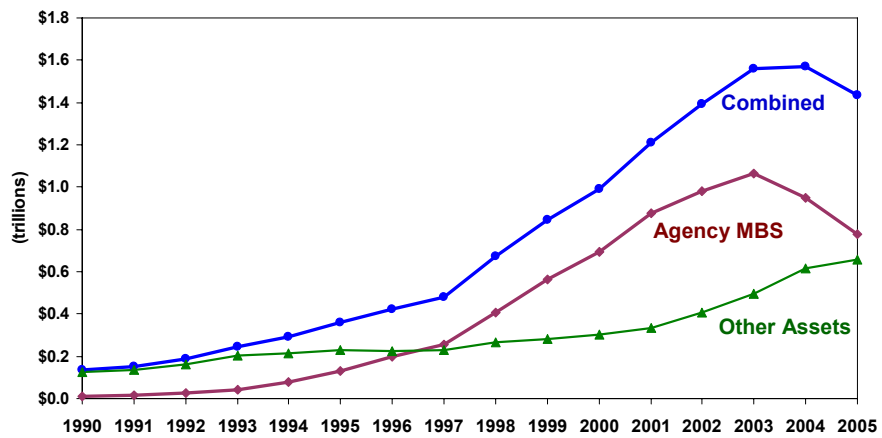
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**Combined Retained Mortgage Portfolios
Dominated by Enterprises' MBS
Year-End 2005**



7

**Agency MBS Holdings Have
Driven Growth in Portfolios
1990 - 2005**



8



**REFORM IS
NEEDED FOR
A STRONGER
HOUSING
MARKET**



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