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THE NEED FOR A STRONGER GSE REGULATOR
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WOMEN IN HOUSING & FINANCE
HOTEL WASHINGTON, WASHINGTON, DC

JULY 26, 2006

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

I am delighted to appear before Women in Housing & Finance (WHF) today. I have heard much about your group's programs on financial services and housing issues. As OFHEO is central to your issues, I look forward to sharing my views on the proposed, comprehensive legislation to revamp and strengthen the current regulatory framework for the two Enterprises OFHEO regulates, Fannie Mae and Freddie Mac.

It is a critical and historical juncture for OFHEO, the Enterprises, and the housing markets. Given the importance of Fannie Mae and Freddie Mac to the affordable housing market it is important that legislation gets it right. As Director of OFHEO, I look forward to being actively involved.

I joined OFHEO in May just as the agency was moving toward completion of its second Special Report of Examination on Fannie Mae. The report details mismanagement, violation of accounting rules and earnings manipulation to maximize bonuses. In 2003, OFHEO produced a similar report about Freddie Mac, detailing accounting and management problems. Both companies have now made significant management changes and are working on improving their internal controls, accounting policies, systems and risk management. OFHEO has consent agreements with both companies and placed 30 percent capital surplus charges on the Enterprises. The consent agreement places on Fannie Mae specific portfolio growth limits as they get their house in order. OFHEO is in discussions with Freddie Mac as well with respect to portfolio limits. The costs of these missteps at both companies were that earnings were misstated by an estimated $16 billion, fines exceeded one-half billion dollars, and remedial costs will exceed $2 billion.

It may seem to some as if we are overlooking the progress Fannie Mae and Freddie Mac are making in fixing their problems. We are not. They are making progress, but it is slower than they or we would like or expect. It will take several more years. We are not just discussing whether the glass is half-full or half-empty. It is really about whether the glass is strong enough. Remedial actions will help, but legislation is needed to make sure that these two companies do not break again.

THE NEED FOR A STRONGER GSE REGULATOR

Why do we need a stronger GSE regulator (#2)? The short answer is that OFHEO has been no match for the responsibility assigned to it of being the safety and soundness regulator of Fannie Mae and Freddie Mac, two of the country's largest financial institutions. As we have seen, unconstrained growth can lead to significant operational problems and mismanagement. Together, they represent more than a 40 percent share of the residential mortgage market, a share that has doubled since 1990.

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 that 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 (#3).

This next graph (#4) shows the growth, on an individual and combined basis, of the GSEs' net guaranteed mortgage-backed securities (MBS) and mortgage assets held in their portfolios. They have grown from $750 billion in 1990 to over $4 trillion in 2005. You will note that the growth continued, albeit at a slower pace, since the problems of 2003. Even with the freeze on Fannie Mae's portfolio and the proposal to limit Freddie Mac's mortgage portfolio growth, their larger guarantee business will continue to grow.

Unconstrained growth can cause market, credit and operational risks and also importantly, systemic risk.

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. (#5) 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.

Fannie Mae and Freddie Mac, like all financial institutions, are in the business of taking and managing financial risks. In some cases those risks could produce losses that render them insolvent. 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. Because they are concentrated on one market, I believe a strong case can be made that each Enterprise poses more systemic risk than other financial institutions of comparable asset size.

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. At the same time, 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 (#6):

1. Bank Regulator-Like Powers

First, powers similar to a bank regulator are needed. Explicit legal authorities, such as independent litigating, receivership, and better enforcement powers are crucial for a stronger GSE regulator. With respect to receivership authority specifically, 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.

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. It also will ensure that the revamped agency is on par with its sister financial regulators. Importantly, 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. GSE regulation would be enhanced by having both new products and affordable housing oversight located within the same agency that oversees safety and soundness. This is the model of bank regulators and has worked very well. OFHEO has worked cooperatively with HUD. As the proposed legislation has the HUD Secretary as a Board member, the revamped GSE regulator would continue to cooperate with and seek advice from HUD.

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. Low capital requirements combined with unusually low funding costs have allowed them to build huge mortgage asset portfolios.

OFHEO's risk-based capital rules need substantial revision. The rules, which are prescribed in the original law, amount to a few stress tests. OFHEO needs the power to revise these rules and make them more flexible. 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.

Limits on Portfolio Growth

Fifth, legislation to revamp the current GSE regulatory environment should include the ability 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 over too short a time period. Fannie Mae's mortgage assets grew from about $124 billion in 1990 to $905 billion in 2004, and then declined to about $727 billion last year. That's equivalent to average annual growth of more than 13 percent over the 15-year period. Freddie Mac's mortgage portfolio grew 26 percent per annum from less than $22 billion at year-end 1990 to $710 billion in 2005. In contrast, the residential mortgage market grew at an average rate of 8.5 percent. Absent agreed upon 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.

Furthermore, to fund these portfolios and manage the attendant risks, Fannie Mae and Freddie Mac issue huge amounts of debt, over $50 billion a month, and use very large volumes of interest rate derivatives. Managing the prepayment risk associated with fixed-rate mortgages is complex and difficult. Interest rate volatility combined with the ability of borrowers to prepay mortgages without penalty make the durations of fixed-rate loans highly uncertain. Although they actively manage this mortgage prepayment risk, like other financial institutions, Fannie Mae and Freddie Mac do not fully hedge their risk. Their funding and hedging activities link the Enterprises to a wide variety of market participants. Holdings of Enterprise debt and mortgage-backed securities (MBS) are concentrated at U.S. commercial banks and foreign central banks. Primary dealers in the markets for Treasury securities are also major holders. Those and other parties could expose the Enterprises to significant losses, or in the event either Enterprise unexpectedly developed liquidity or solvency problems, the other parties could incur large losses.

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 or House bill limits their major business of buying mortgages and then packaging them with guarantees for securitization. These MBS not owned by the Enterprises total about $2.6 trillion or 26 percent of the total U.S. mortgage market (#7).

A substantial part of the Enterprises' combined retained mortgage portfolios of $1.4 trillion is not needed to fulfill their very important mission. About 54 percent of their portfolios are invested in their own MBS, which receive no additional credit toward their affordable housing goals (#8). A significant percentage of their private label MBS and whole mortgages, which average about 22 percent each, do not qualify as supporting affordable housing. As for 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.

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 line of this chart, 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. Obviously, there would be less concentration of the market if other investors bought the divested securities. 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.

A STRONGER GSE REGULATOR IS VITAL FOR A STRONG HOUSING MARKET

In conclusion, systemic risk will not be eliminated by legislative reforms. However, better risk-based 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. The risks caused by high leverage and large asset, debt and derivative portfolios could be reduced by a stronger regulator with capital and portfolio limit authority.

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. The time to act is now. GSE reform legislation would strengthen the regulator of the Enterprises and reduce market uncertainty. I believe this will be better for homeownership growth, affordable housing, the housing and financial markets, and all the GSEs' stakeholders.

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

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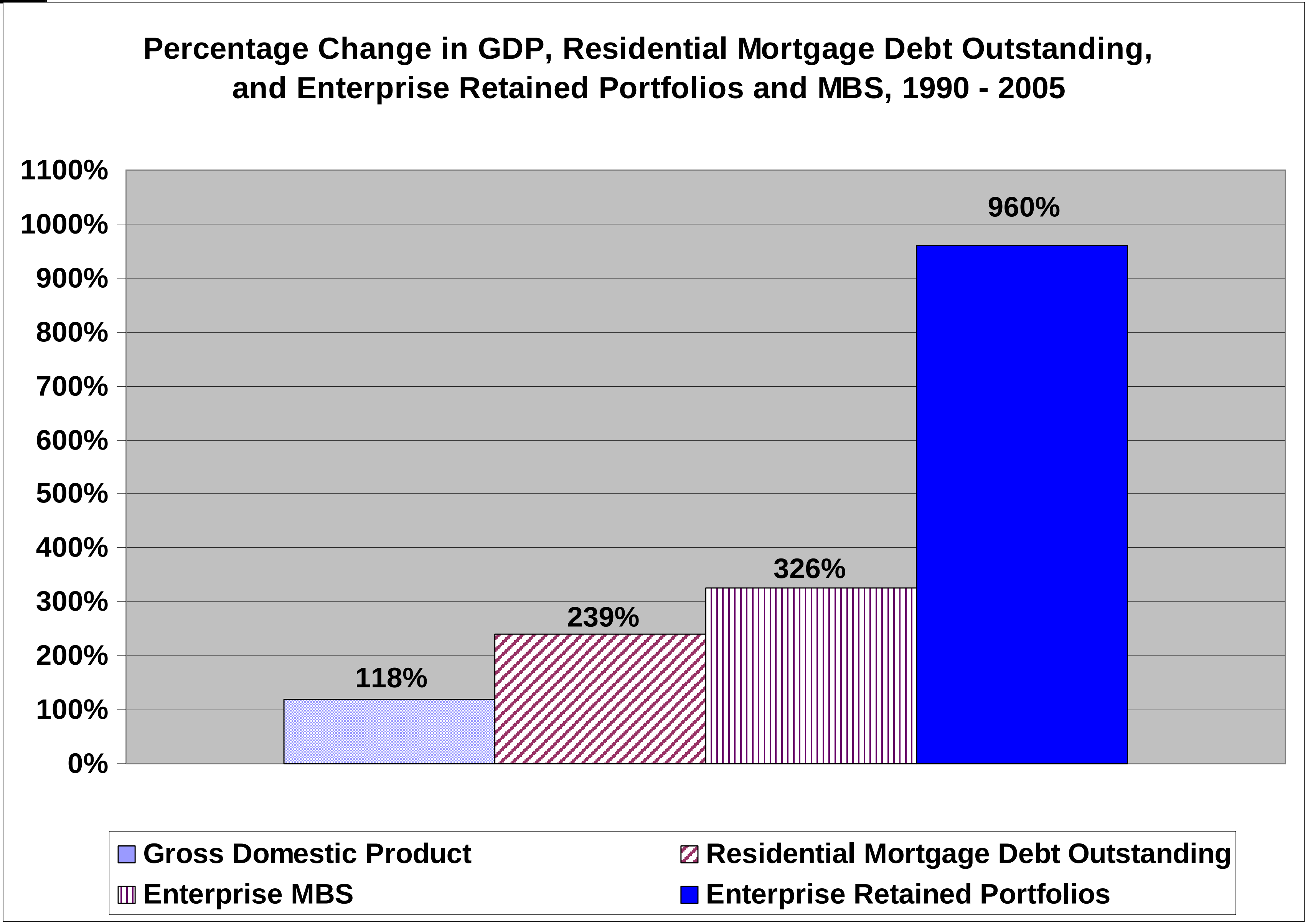
STRONGER REGULATOR NEEDED

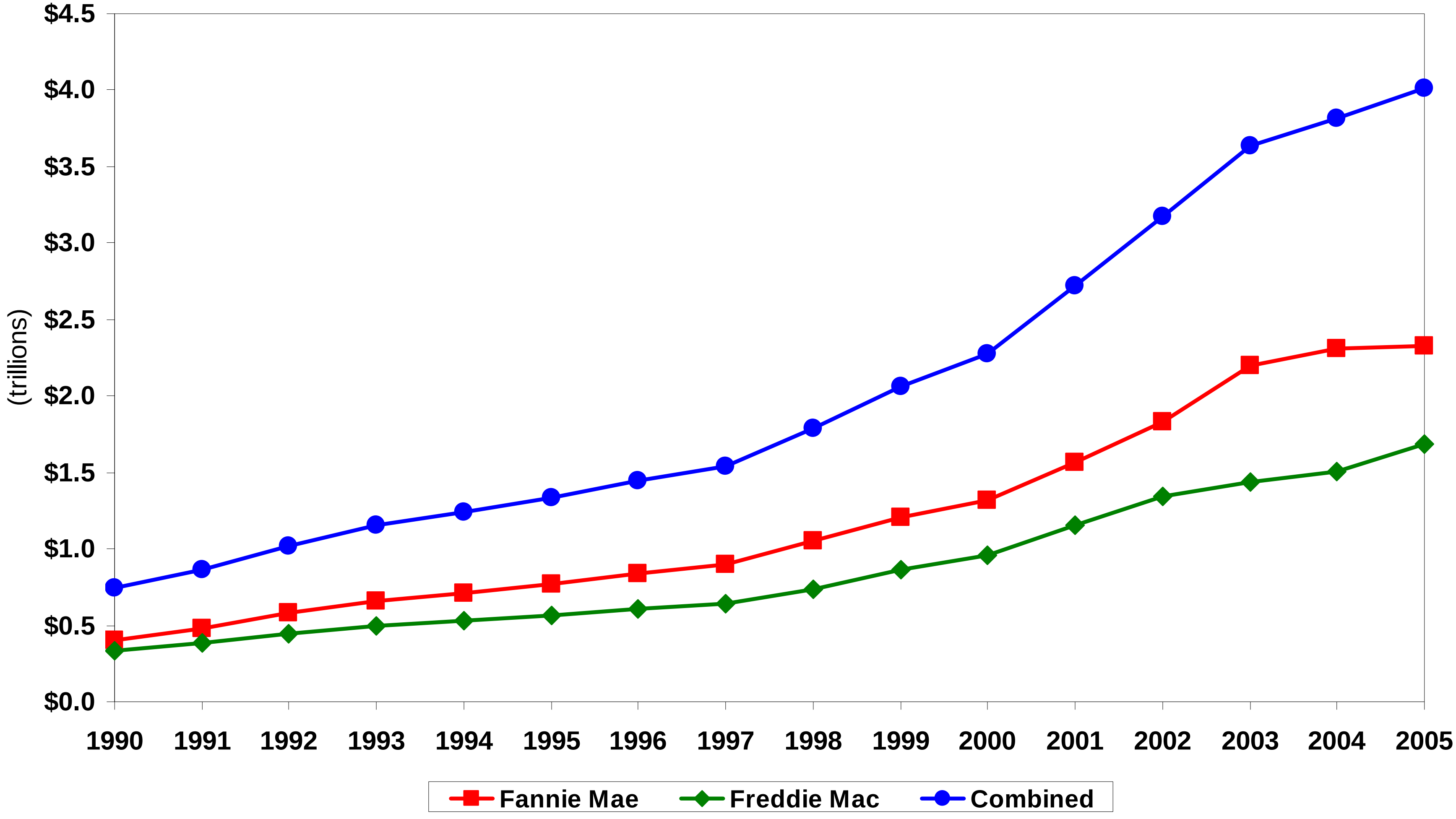
- OFHEO has been no match for the responsibility assigned to it.
- More than a 40% share of the residential mortgage market (doubled since 1990).
- Unconstrained growth led to operational problems and mismanagement.
- No credit market discipline.

OFHEO



Percentage Change in GDP, Residential Mortgage Debt Outstanding, and Enterprise Retained Portfolios and MBS, 1990 - 2005
1100%
1000%
900%
800%
700%
600%
500%
400%
300%
200%
100%
0%
118%
239%
326%
960%
Gross Domestic Product
Residential Mortgage Debt Outstanding
Enterprise MBS
Enterprise Retained Portfolios

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

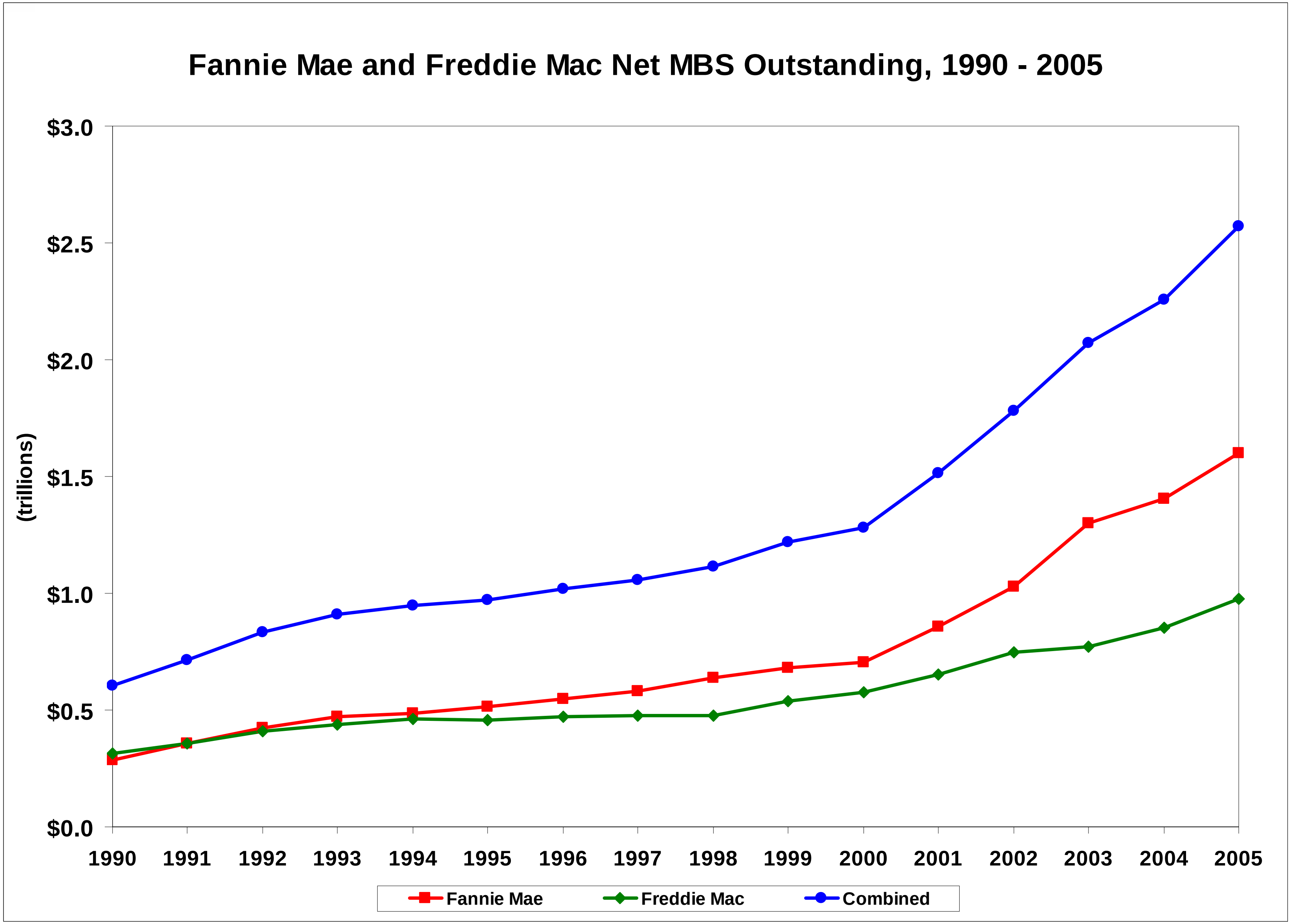


SYSTEMIC RISK

- 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.

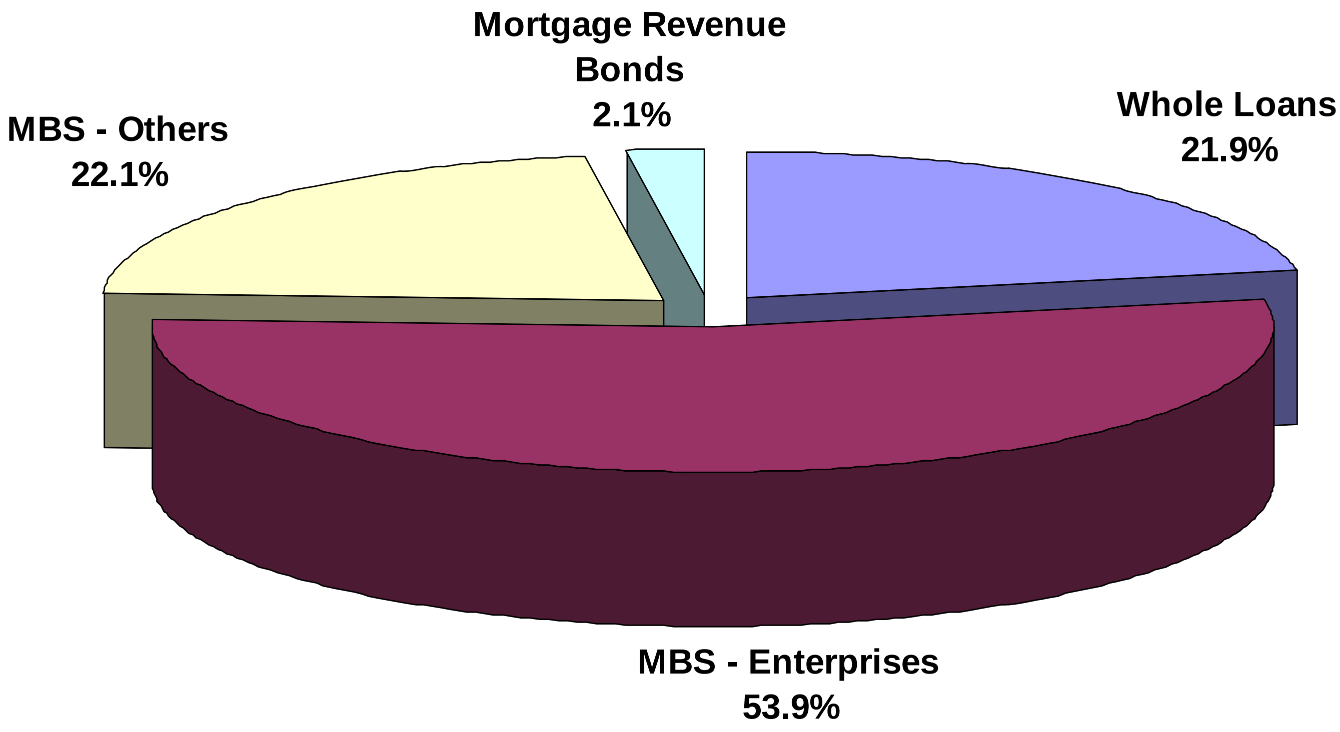
COMPONENTS OF A STRONGER GSE REGULATOR

- Bank Regulator-Like Powers
- Independence
- Mission and New Product Authority
- Flexible Capital Requirements
- Limits on Portfolio Growth



Fannie Mae and Freddie Mac Net MBS Outstanding, 1990 - 2005
$3.0
$2.5
$2.0
$1.5
$1.0
$0.5
$0.0
(trillions)
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
Fannie Mae
Freddie Mac
Combined

Composition of Combined Retained Mortgage Portfolios of Fannie Mae and Freddie Mac, Year-End 2005



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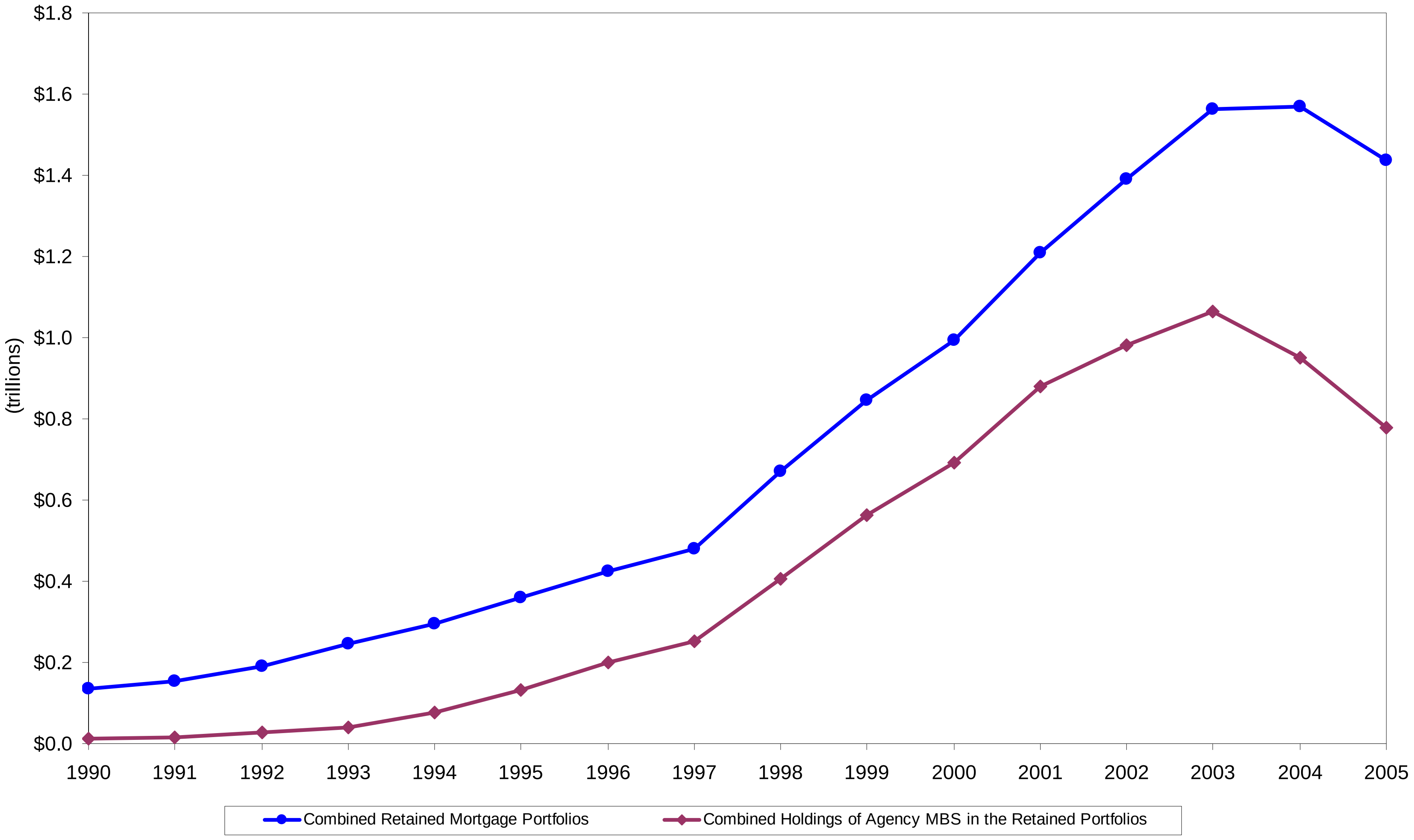
Fannie Mae and Freddie Mac Retained Mortgage Portfolios and Agency MBS Holdings, 1990 - 2005



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