COMMUNITY BANKS AND THE CASE FOR GSE REFORM
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Thank you for the opportunity to speak today before America's Community Bankers Government Affairs conference. I had the pleasure of meeting with ACB members at your recent Real Estate Lending Conference. Today, I will concentrate my remarks on the legislation to strengthen OFHEO's regulatory oversight of Fannie Mae and Freddie Mac as part of the creation of a new regulator that will include OFHEO, the Federal Housing Finance Board (FHFB), and HUD's mission oversight.

The new regulator will have an important role and must be responsible and forceful in fulfilling its mission established by Congress. That mission is to ensure that the housing Government Sponsored Enterprises (GSEs) carry out their own public missions in a safe and sound manner and that they are fully dedicated to carrying out their responsibilities to support the housing finance market, and especially affordable housing.

I believe Congress and the Bush Administration with input from the many interested parties including the ACB and other trade groups, affordable housing groups and the housing GSEs made good progress last year. A lot of hard work has gone into getting to this point. As a relatively new entrant to the discussion, I am struck at the passion on all sides of this issue. In my view, the carefully constructed compromise appears to be the best hope of achieving the essential legislative goals. Several years of discussion and debate are enough. It is time for action.

Overview

There are excellent reasons for this passion. Housing and homeownership are critical components of the American dream and the American economy. The housing GSEs play an important role in both. (Chart 2) Together the 12 Federal Home Loan Banks (FHLBanks), Fannie Mae and Freddie Mac through loans, advances, investments and guaranteed Mortgage Backed Securities (MBS) represent 46 percent of the total mortgage debt outstanding in the U. S. That is a dominant role by any measure.

To finance such a large market share, the housing GSEs are among the largest borrowers in the world. A comparison I like to make is when you add Fannie's and Freddie's outstanding debt of almost $800 billion each with the FHLBanks' debt outstanding of $900 billion and Fannie's and Freddie's net guaranteed MBS of $2.9 trillion, it comes to $5.4 trillion, which is bigger than the $4.9 trillion publicly held debt of the U.S. (Chart 3)

Like other financial institutions, including community banks, the housing GSEs face a full range of risks, including market risk, credit risk, and operational risk -- only on a much larger and concentrated scale. Fannie Mae, Freddie Mac and some of the FHLBanks have each experienced serious difficulties handling those risks over the years. Due to earnings manipulation, poor accounting systems, lack of proper controls, risk management failings, and misapplication of accounting principles, Fannie Mae's and Freddie Mac's earnings were misstated in excess of $10 billion.

I venture to say that their performance fell far short of what their shareholders and Congress expect. For our part, OFHEO could and should have done better. A lot has been learned from these problems. The most important lesson, in my view, is that there is a compelling need for this legislation.

At OFHEO, we continue to work on overseeing the multi-year and multi-billion dollar remediation efforts necessitated by these problems. Both companies are making significant progress, but they continue to have major operational risk and technology issues, and they need to return to timely filing of their financial statements.

Housing Market

The importance of the housing market to the American economy was seen last year and is being seen this year through its negative impact on economic growth. Housing permits, starts and sales have fallen and unsold inventories are high. Housing prices in some parts of the country have fallen. However, OFHEO's quarterly House Price Index (HPI), the most recent released last week, that includes repeat sales and refinancings, shows on a nation-wide basis house prices are still increasing albeit at a much lower level than the previous 5 years. OFHEO's latest data suggest that house prices grew only 1.1 percent from the third to fourth quarters of 2006. This rate pales in comparison to the robust three percent appreciation in the same quarter one year before. As one looks at the 10 year chart (Chart 4) of annual increases, the latest price growth of 5.9 percent is a big drop from 2005's levels of 13.2%, but it falls more in line with historical trends. The purchase-only index in red, which was not as high as the total index in 2004 and 2005, was lower than the total HPI, registering a one year appreciation of 4.1%. (Chart 5)
I will make no predictions about next year, but I will say that in times like this it is very important to have both a strong regulator and strong housing GSEs. Market uncertainty is increasing, credit risks are growing, competitive pressures are increasing, and operational risks are abundant. Mortgage delinquencies are rising. There are major concerns, in particular, with nontraditional and subprime loans.

Late last year, OFHEO directed the Enterprises to review their practices in line with those referenced in the banking regulators' interagency guidance, and to report on the steps that they will take in response to the guidance by February 28. We are now reviewing those reports and continuing our discussions with both Enterprises about their policies on subprime and nontraditional mortgages. It should be remembered that both products, if properly structured, play a constructive role in promoting homeownership and especially affordable housing for lower income households.

With the numerous privileges associated with the GSE charter, come important responsibilities. Among those are the duty to play leadership roles in developing innovative solutions to difficult issues, such as those we face today with subprime mortgages and non-traditional mortgage products. Within the limitations and requirements of their respective charters, the housing GSEs each have a responsibility to be thoughtful and active participants in developing sound standards and guidelines in these segments of the market. They also need to be more innovative in supporting affordable housing mortgages originated by community banks.

New, Stronger GSE Regulator Needed

As community bankers, major shareholders in the FHLBanks, and customers of Fannie Mae and Freddie Mac and the Banks, you know that they are an integral element of the American housing market and an important component of our overall financial markets. The Federal Home Loan Bank System, Fannie Mae and Freddie Mac have parallel housing finance missions, as they all support the mortgage market, affordable housing and the liquidity of entities involved in housing finance.

The new regulator must understand the housing GSEs mission in supporting housing finance, the risks involved in that business, the private ownership of these firms, and their need to earn a fair rate of return and be accountable to their shareholders. A key aspect of the GSE's role is to be ready providers of credit under all market conditions. The regulator must understand that role and ensure that the GSEs are prepared to provide for stability during times of economic stress. That means the housing GSEs should be financially strong and capable of achieving acceptable returns for shareholders.

The housing GSEs must operate in a safe and sound manner in order to be able to fulfill their public purposes today and in the future. Like other financial intermediaries they incur risks to fulfill their missions, but they should not take unnecessary risks. Financial regulators are not in the business of eliminating risk-taking. They are in the business of making sure that the boards and management of financial institutions understand the risks they take, manage them prudently, have appropriate systems and controls in place, and have sufficient capital to withstand potentially bad outcomes for themselves, financial markets and the American economy.

The regulator must also understand that as GSEs they are not subject to the normal market disciplines of other financial institutions. Despite their problems over the last several years, the debt markets did not decrease the amount of money they were willing to lend or increase the cost of that money. This lack of market discipline, the GSE's importance to the housing market and the economy, the challenges and risks that they face, and the limitations of OFHEO's regulatory regime are all compelling reasons for reform. Now, let's turn briefly to the key aspects of reform legislation. (Chart 6)

Bank Regulator Powers

The new regulator needs to have all the powers that a bank regulator has to help prevent future problems. This is a major lesson learned from Fannie Mae's and Freddie Mac's troubles. Explicit legal authorities and better enforcement powers are crucial for a stronger GSE regulator. Receivership powers, in particular, provide one way to prevent problems from one financial institution from spilling over to others and might enhance market discipline. Stronger enforcement powers, including those that address misconduct by employees, directors, and affiliated parties, are needed.

Strength through Combining the GSE Regulators

A second important part of the legislation is combining all of the housing GSEs under one regulatory roof. As Comptroller General David Walker in Congressional testimony said: "A single housing GSE regulator could be more independent, objective, efficient, and effective than separate regulatory bodies and could be more prominent than either one alone. We believe that valuable synergies could be achieved, and expertise in evaluating GSE risk management could be shared more easily, within one agency."

The Board structure proposed in the legislation would enhance the new entity's regulatory oversight. Specifically, including the Secretaries of Treasury and HUD on the Board should help ensure that the new regulator has a broad perspective on achieving the twin public goals of GSE safety and soundness and fulfilling their housing mission.
A single housing GSE regulator creates within government a single regulator focused on the health and effectiveness of the housing finance markets and how the nation's capital markets connect to countless local markets for mortgages. The Federal Government will have a single, strong, credible agency that can contribute to important policy discussions by providing a perspective on the condition and role of the housing finance market and its interaction with broader capital markets. That perspective can be useful in multiple policy discussions, including discussions of financial safety and soundness, affordable housing, consumer protection, privacy, or even systemic risk.

As the Banks and the Enterprises are engaged in similar investment, funding and risk management activities, there will be benefits from sharing information, lessons learned, and examination strategies. A level playing field should emerge in terms of regulatory expectations with regard to safety and soundness. Fannie Mae, Freddie Mac, and the FHL Banks will all benefit from being regulated by a stronger, more effective and prominent regulator.

Mission and New Product Authority

Currently, authority over the charters of the Enterprises, their mission, and new products is placed in HUD. FHFB and bank regulators have combined powers. 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. A new, stronger GSE regulator needs the combined safety and soundness and mission and new products powers.

I appreciate ACB's support on this issue, and I agree with you that the combined structure allows for a more comprehensive view of proposed new programs and products, preserving the important distinction between primary and secondary market activities. This single regulator should be better able to assess the competitive effects of the housing GSEs and to ensure consistency of regulation for GSEs that operate in similar markets.

Stronger Independence – Litigation and Budget

The new regulator should have strengthened regulatory independence including independent litigating authority. One component of this is freedom from the appropriations process. OFHEO is the only safety and soundness regulator that must be congressionally appropriated, even though we have no impact on government finances as we are funded by the entities we regulate. Being under the appropriations process is currently constraining our operations as we are now under a Continuing Resolution at last year's spending levels. We are hopeful that this will change as Congress considers supplemental funding needs for Fiscal Year 2007. Without additional funding, planned resources in critical supervisory areas will be cut, limiting our ability to monitor the safety and soundness of the Enterprises.

Ability to Strengthen Capital Requirements

Presently, Fannie Mae and Freddie Mac have low regulatory minimum capital requirements compared with other financial institutions. The 1992 Act that created OFHEO requires them to maintain stockholder's equity equal to 2.5 percent of assets. The FHLBanks hold 4 percent, albeit with a much different capital structure, and major banks hold over 6 percent. Given Fannie Mae's and Freddie Mac's present condition, I am certainly more comfortable with today's extra 30 percent add-on for operational risk.

OFHEO's risk-based capital test is also prescribed by that 15-year-old statute and needs to be modernized. Risk-based capital should be based on the full array of Enterprise risks -- market, credit, and operational risk, as well as the risks they present to the overall financial markets. A new, stronger regulator needs the flexibility and authority to change both the risk-based and minimum capital requirements through a regulatory process supplemented by the ability to respond quickly to changing conditions.

Power to Regulate Portfolios

Absence of effective market discipline has clearly contributed to the large growth of both Enterprises' portfolios. Over the past 15 years, mortgages outstanding tripled and yet the Enterprises' portfolios grew ten-fold. (Chart 7)

Their portfolios could be more closely aligned with their mission. Less than 30 percent of their portfolios contribute to meeting their affordable housing goals and over half their portfolios are in their own MBS. (Chart 8)

The compromise legislative language gives guidelines to the regulator that would focus the Enterprises' portfolios more tightly on their missions of supporting affordable housing and the stability and liquidity of the secondary market for residential mortgages. It would also direct that potential risks posed by their holdings should be considered by the regulation. A regulation would occur under a notice and comment rule-making, allowing all interested parties to comment on the proposed rule.

Using the legislative guidance focusing on mission, it is unlikely that there would be "drastic reductions" in those portfolios, but rather a reallocation. The portfolios represent about a third of Fannie Mae's and Freddie Mac's total book of business. Over the last three years, they have actually increased their support for the mortgage market despite the shrinkage of their portfolios. They sold their own MBS or did not purchase as much as they had in previous years. Those MBS were purchased by other investors – domestic and foreign. Whether you are a borrower, banker, broker, builder or housing advocate, it should not matter to you once the Enterprises guarantee a MBS package, whether they own or sell it to other investors.

Their total book of business grew again in 2006. (Chart 9) As you know, both Enterprises' portfolio growth was capped because of their serious operational problems. As you can see on the light and dark green sections of this graph, their portfolios did not grow in 2006, but there was a change in composition. The light green area is whole loans and private label securities which actually grew, while their own MBS holdings (dark green) shrank as they either did not replace maturing MBS or they sold some holdings. As a result of those actions and their MBS new issuance, their MBS outstanding, as you can see in blue, grew at a double digit percentage growth rates. Over all, despite the portfolio caps and significant competition, their total book of businesses grew 8 percent.

As the capital requirement for a guaranteed MBS is one-sixth of that of a portfolio investment, significant capital could be freed up. That excess capital could be used to increase their market support by guaranteeing more MBS. Alternatively, it could be returned to shareholders in the form of dividends and share repurchases or held as a reserve to be utilized to support the mortgage market in times of turmoil.

The last point I want to make on the portfolios is that once their houses are in order, it is certainly possible that a mission-focused regulation would allow the portfolios to grow with the mortgage market. The proposed legislation instructs the agency to consider the size and growth of the market. Again, their guaranteed MBS issuance would not be constrained by the regulation. Therefore, depending on competitive forces, their support for the mortgage market could actually grow faster than the market as it has in the past.

Conclusion

It is time to move forward on reform legislation to ensure the safety and soundness of the housing GSEs and their full dedication to their important mission of supporting the mortgage market and especially affordable housing.

I am grateful to the House and Senate leadership, Democratic and Republican, for undertaking the hard work to develop a bill that would create a strong, credible housing GSE regulator equipped to handle the responsibility of ensuring the GSEs carry out their housing mission safely and soundly.

I also appreciate the steadfast work of the Bush Administration to promote legislation that gives the new regulator the tools it needs to do its job and that assures the GSEs numerous benefits are directed at serving their important public purposes.

There is still some hard work to do, but we are nearing the goal line. I look forward to continuing to work with the Congress, the Administration and all the GSE stakeholders, including the ACB, to bringing a carefully crafted compromise to a successful conclusion. It is time to ensure that the housing GSEs continue to fulfill their crucial mission of supporting the housing finance markets, affordable housing and the American dream of homeownership.

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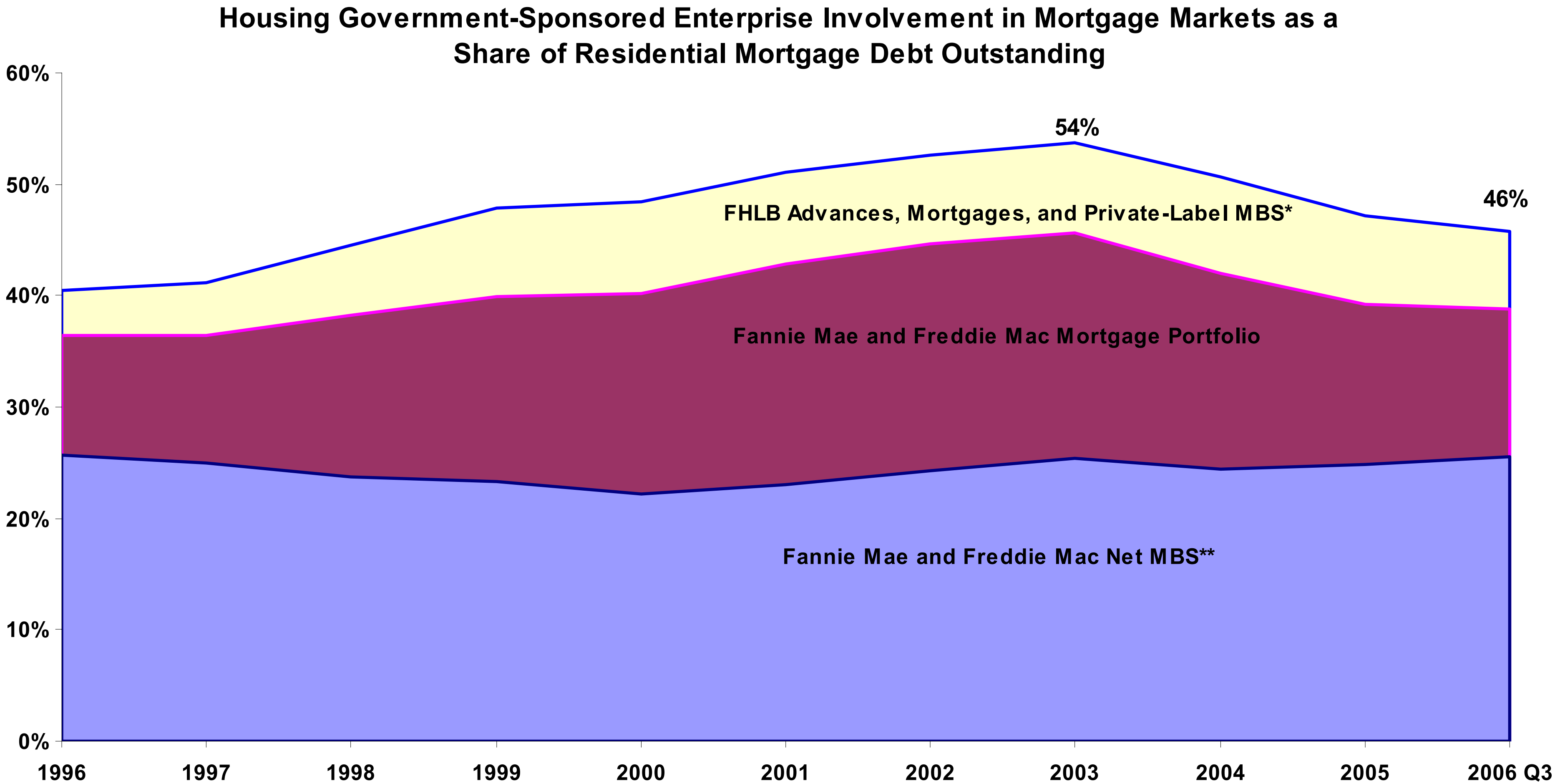
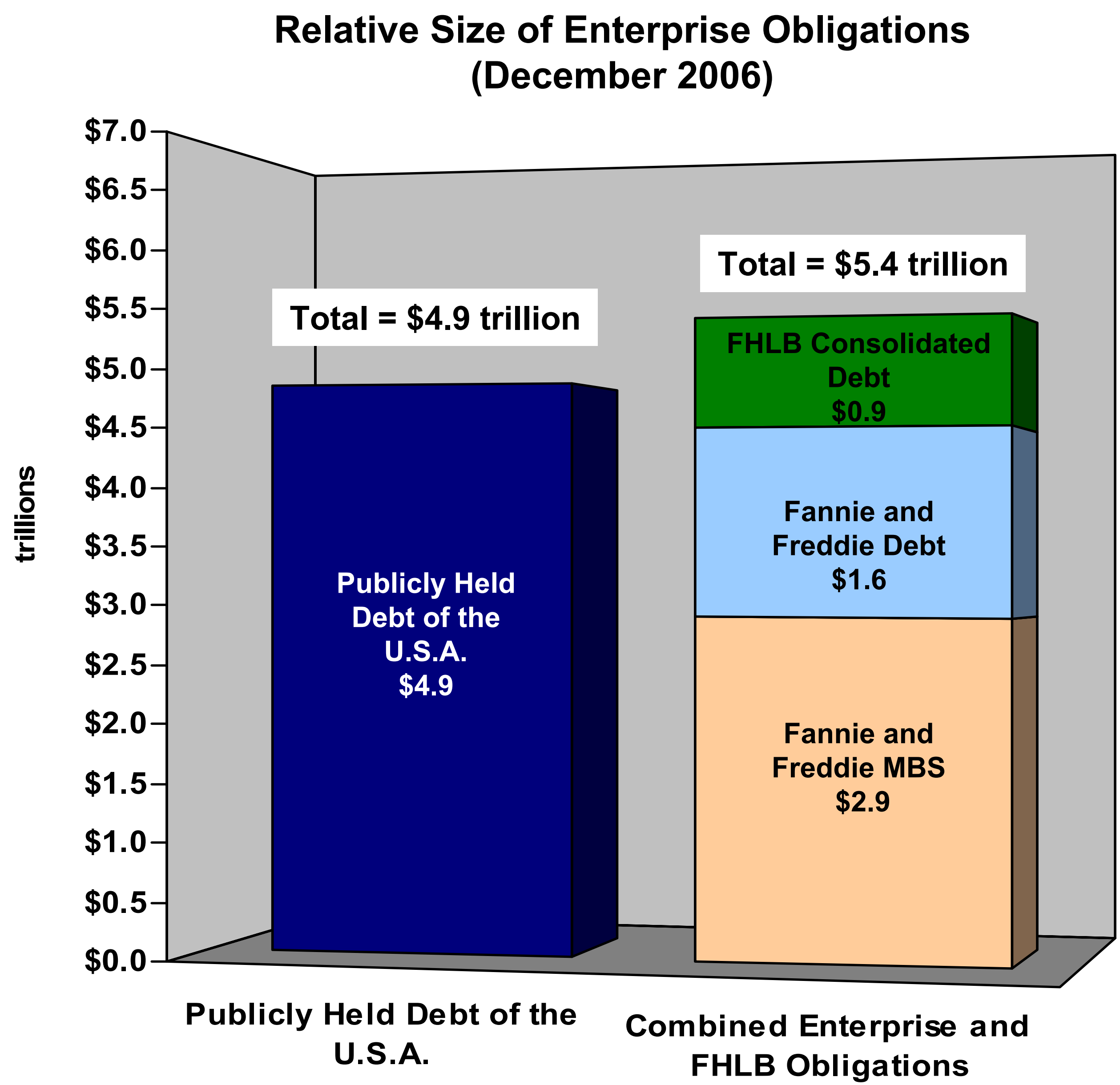
GSEs Dominate the U.S. Mortgage Market

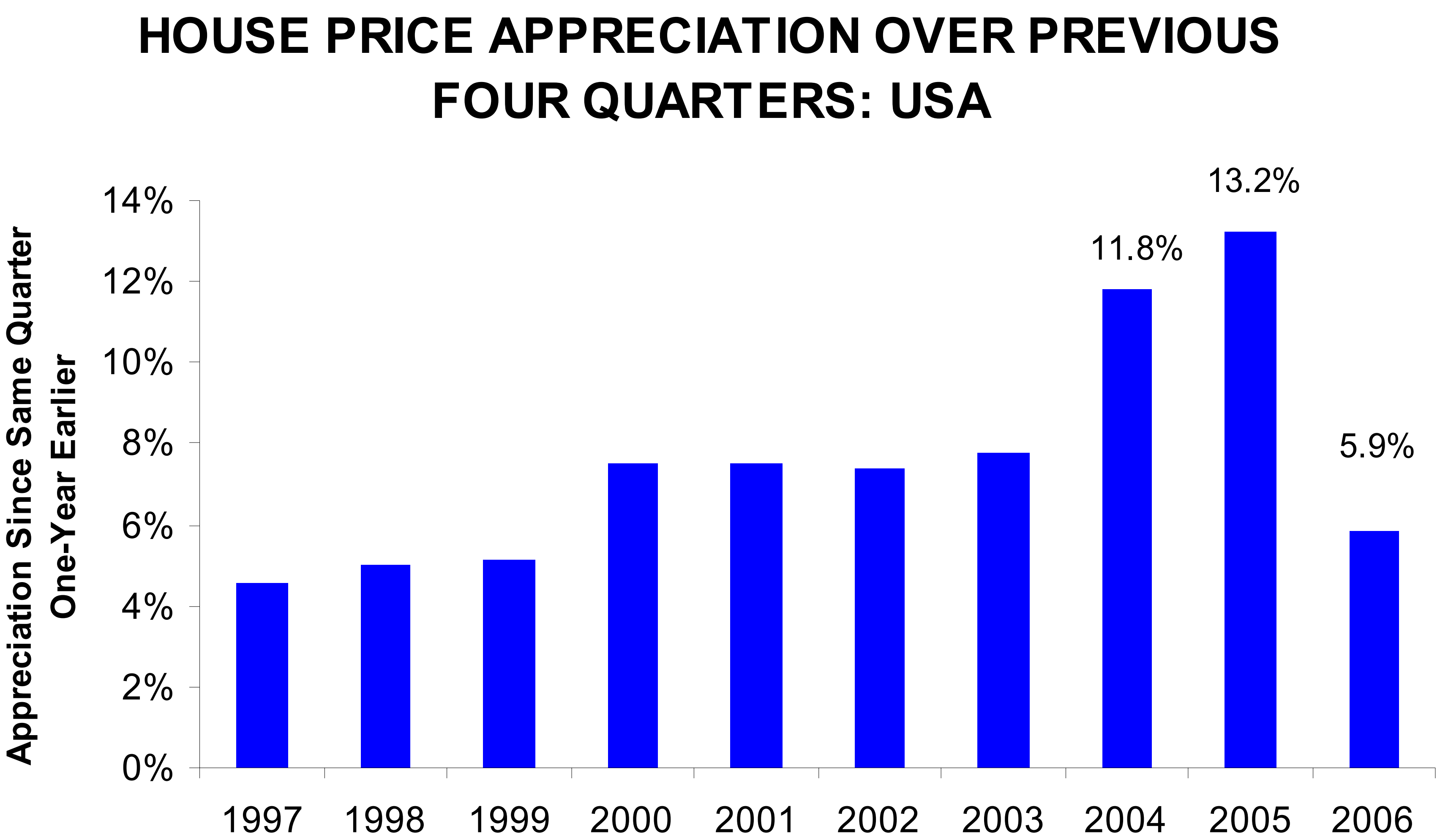


* FHLB members use advances for short-term liquidity and asset/liability management in addition to funding mortgages. Excludes Enterprise MBS held for investment, to avoid double-counting, and private-label MBS before 2004, when detail on FHLB MBS holdings is unavailable.
** Excludes holdings of MBS guaranteed by the other Enterprise.

The Housing GSEs are Huge



HOUSE APPRECIATION IS FALLING



HOUSE APPRECIATION IS FALLING

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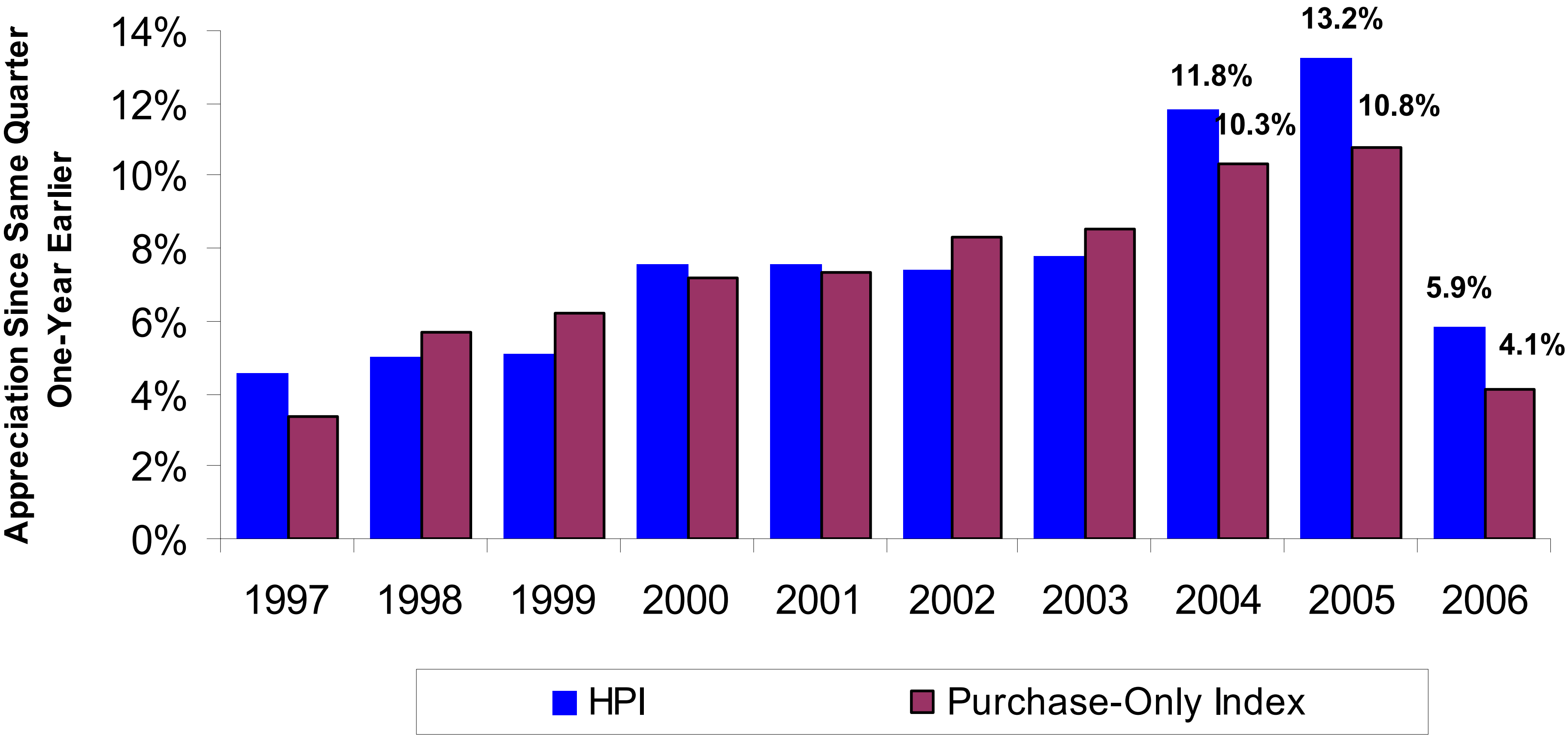
HOUSE PRICE APPRECIATION OVER PREVIOUS FOUR QUARTERS: USA

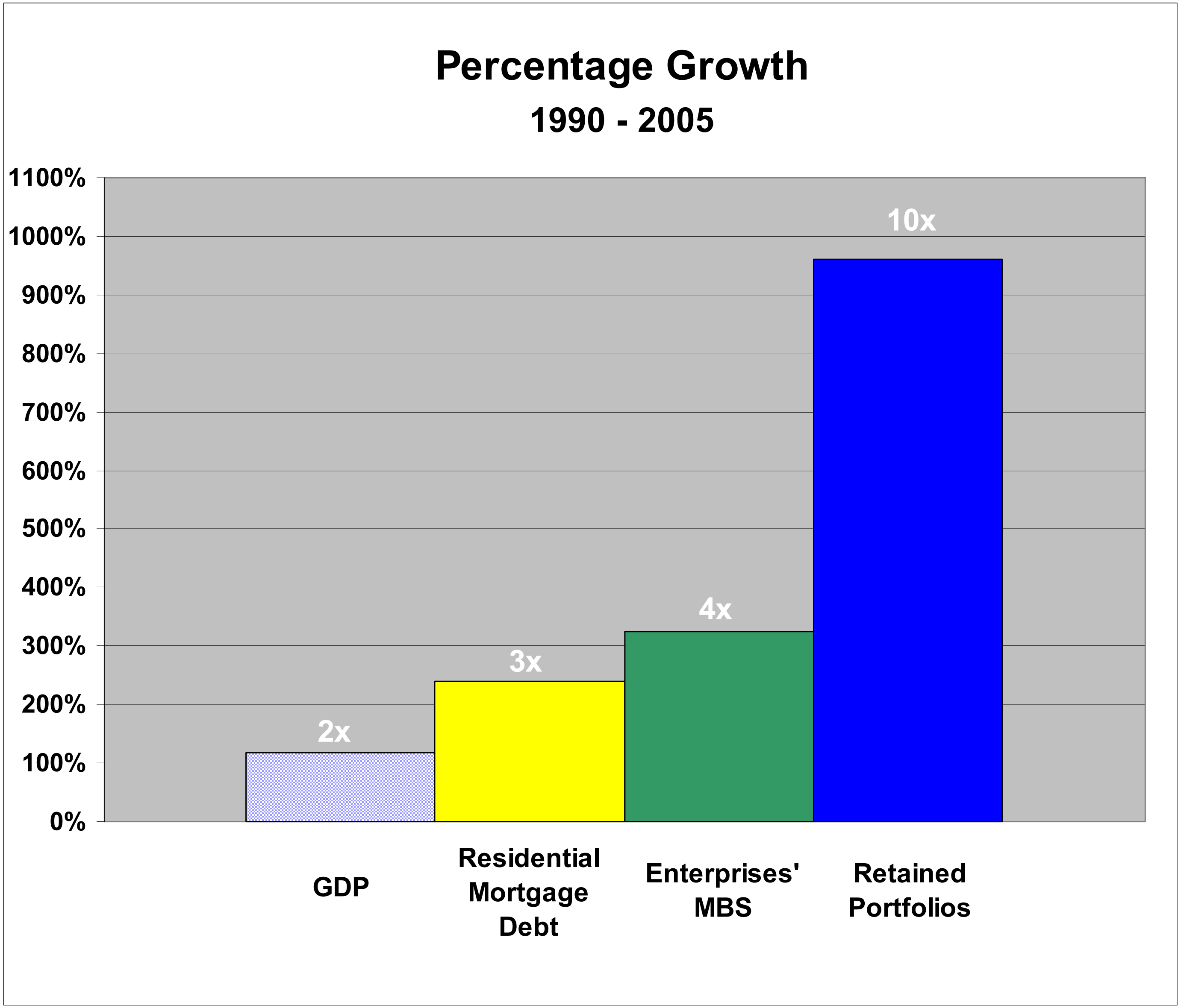


New, Stronger Regulator Needed

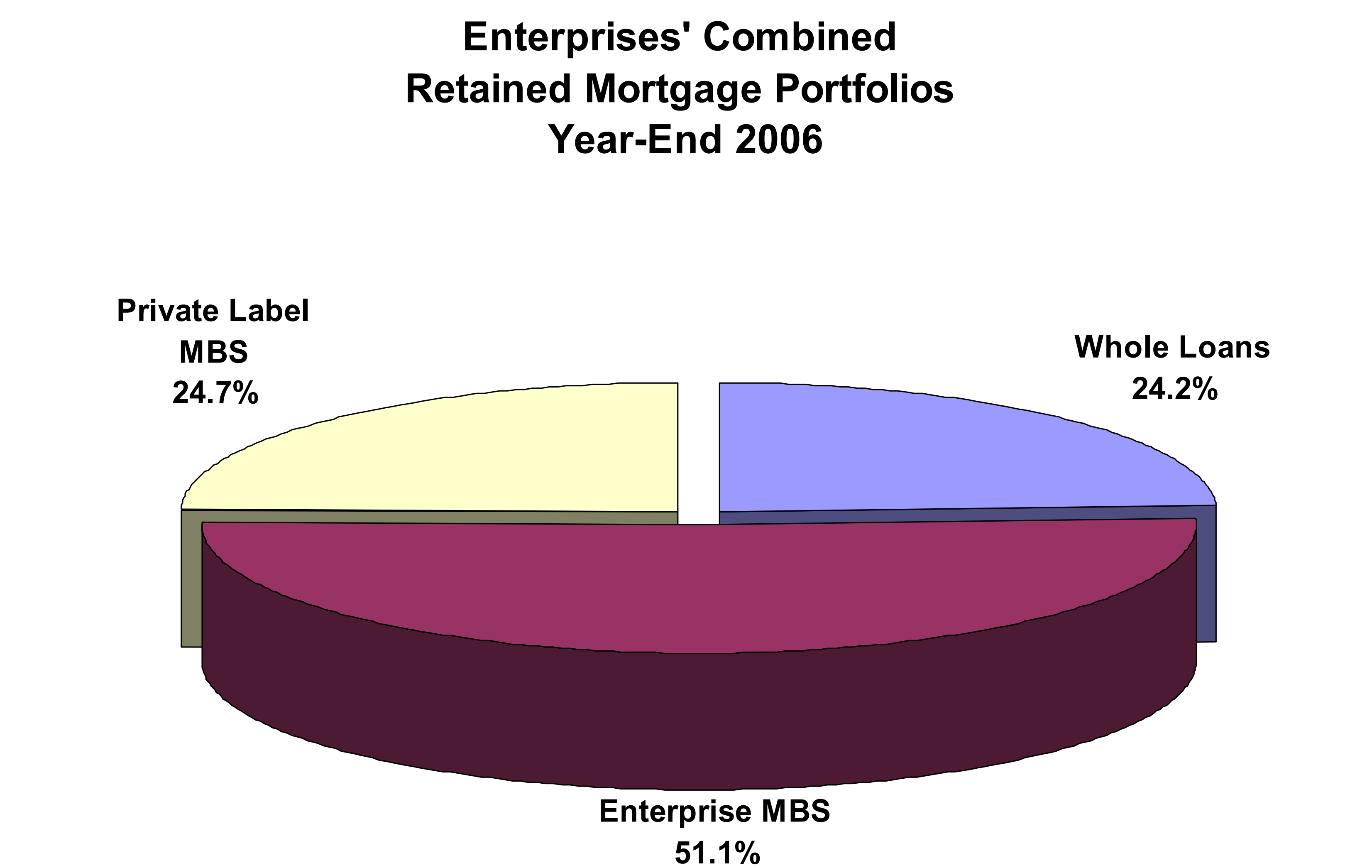
OFHEO

- More bank regulator-like powers
- Strength through combining the GSE regulators (OFHEO and FHFB)
- Mission and new product authority (HUD)
- Stronger independence – litigation and budget
- Ability to strengthen capital requirements
- Clear guidance to regulate portfolios

Enterprises Have Grown Very Rapidly



Portfolios Dominated by Own MBS



Contribution to Affordable Housing Goal Less Than 30%

Combined Book of Business Continues to Grow