

**STATEMENT OF  
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OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT  
ON “LEGISLATIVE PROPOSALS ON GSE REFORM”  
BEFORE THE HOUSE COMMITTEE ON FINANCIAL SERVICES  
U.S. HOUSE OF REPRESENTATIVES  
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Chairman Frank, Ranking Member Bachus and Members of the Committee, thank you for inviting me here today to discuss the very important issue of regulatory reform for the housing GSEs. I am pleased to see that process start again quickly with the introduction of H.R. 1427, as introduced by you, Mr. Chairman, as well as co-sponsors Congressmen Baker, Watt and Miller. The views that I will be expressing today are OFHEO's and do not necessarily represent those of the President or the Secretary of Housing and Urban Development.

Legislation to reform the regulation of the housing Government-Sponsored Enterprises (GSEs) has been discussed and debated for years. It is now time for action. I am especially grateful to you Mr. Chairman, the Ranking Member and other members of this Committee for your hard work in reaching what I believe is a balanced approach to needed statutory reforms. As a relatively new entrant to the debate, I was struck by the passion that this legislation has evoked, but there are excellent reasons for this passion. Housing and homeownership are critical components of the American dream and the American economy, as we see every day in the news. The housing GSEs play an important role in both. Together the 12 Federal Home Loan Banks (FHLBanks), Fannie Mae and Freddie Mac through loans, advances, investments and guaranteed mortgage-backed securities (MBS) are involved in 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. That is bigger than the \$4.9 trillion publicly held debt of the U.S.

Like other financial institutions, the housing GSEs face a full range of risks, including market risk, credit risk, and operational risk -- only on a much larger and more concentrated scale than other financial institutions. Fannie Mae, Freddie Mac and some of the FHLBanks have each experienced serious difficulties handling those risks over the years. Current remediation efforts will help reduce operational risks, in particular, but all three risks will continue into the future.

I venture to say that their performance fell far short of what their shareholders and Congress expected. For our part, OFHEO 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 to create a new and stronger regulator.

The new regulator will have an important role and must be responsible and forceful in fulfilling its congressionally-established mission to ensure that the housing GSEs operate in a safe and sound manner and fully support the housing finance market, especially affordable housing.

### **Progress Report on Remediation**

As the safety and soundness regulator of Fannie Mae and Freddie Mac, I want to give you a progress report on their remediation before I turn to the provisions of H.R. 1427. The two companies have made significant progress, but they have much work to do especially in systems, controls and financial reporting. It has taken much more time and money to fix their problems than either the two Enterprises or OFHEO expected. Fannie's and Freddie's Boards and management are focused on their efforts and they have been responsive to OFHEO's concerns. I have met recently with both Boards and I continue to be impressed by the caliber and commitment of the Directors, most of whom are new to the Boards.

OFHEO will be delivering its Annual Report to Congress in early April this year and it will detail the current condition of the Enterprises. Although the report will show that both still have problems that they are working to correct, I am hopeful that next year's report will be more positive. A key indicator to OFHEO of a successful remediation will be the timely filing of annual and quarterly financial statements with the SEC that have a clean audit opinion based upon a controls-based audit. Both companies are working hard to achieve this goal within the next year or so.

### **Bank Regulators**

I am very pleased that there is a general consensus that the new GSE regulator's authorities and responsibilities should not be weaker or more limited than those of the Federal banking agencies. Let me start by describing briefly how the banking agencies came to some of their current authorities, which will help explain why we think these same authorities make sense for the new GSE regulator.

Some common bank regulatory authorities have been in place for many years, such as flexibility to set capital requirements, independent litigating authority, and freedom from the appropriations process. Still, during the 1980s, more than two thousand banks and thrifts failed as the supervisory structure in place failed to keep pace with the rapid growth, severe stresses and structural weaknesses existing in the regulated institutions at that time. In response, Congress enacted major banking legislation in the late 1980s and early 1990s designed to equip the federal banking agencies with additional tools to

identify and respond promptly to safety and soundness problems. These changes also made the authorities of the various federal banking agencies more uniform.

Among the strengthened authorities given to regulators during this time period were:

- Adding coverage for institution-affiliated parties to enforcement authorities;
- Expanding civil money penalties and penalties for reporting violations;
- Making certain banking conduct criminal and creating new regulations for golden parachutes;
- Providing authority for early intervention procedures, including limits on corporate actions when capital ratings are lowered;
- Enhancing receivership and conservatorship authorities; and,
- Increasing authority to act on “safety and soundness” concerns.

With these strengthened authorities, came responsibilities. In particular, Congress directed the regulators to take prompt corrective action when a bank’s capital falls below required levels and to resolve failed institutions promptly and at least cost to the deposit insurance fund. I would note that, since enactment of these important reforms, bank failures have declined dramatically.

OFHEO’s statutory authorities appear to follow those of the Federal banking agencies yet they fall short in several important ways. Like the Federal banking agencies, OFHEO is charged with overseeing the safety and soundness of financial institutions that undertake credit risk, market risk, and operational risk. Among the key shortcomings in OFHEO’s toolkit as a safety and soundness regulator are:

- Limited flexibility in establishing minimum and risk-based capital requirements;
- Enforcement authorities that are not on par with the banking agencies;
- Lack of independent litigating authority;
- No authority to appoint a receiver for a failed Enterprise; and
- Constraints associated with the annual appropriations process.

These are all authorities recognized as essential to solid safety and soundness oversight. All the banking regulators have these authorities, as does the Federal Housing Finance Board. The GSE reform legislation that has been under debate for several years and is before us today would remedy these shortcomings in the government’s safety and soundness oversight of Fannie Mae and Freddie Mac.

### **New, Stronger GSE Regulator Needed**

Fannie Mae and Freddie Mac support the mortgage market and its stability, 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, their accountability to their shareholders, and their need to earn a fair rate of return. A key aspect of the GSE

role is to be ready providers of credit under all market conditions and the regulator must ensure that Fannie Mae and Freddie Mac are prepared to provide for stability during times of economic stress. That means the housing GSEs should be financially strong with top-quality management and internal controls.

Like other financial intermediaries, Fannie Mae and Freddie Mac incur risks to fulfill their missions, but they should not take unnecessary risks. Financial regulators are not in the business of eliminating risk-taking, but they must make 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 the GSEs are not subject to the normal market disciplines faced by other financial institutions. Despite their problems over the last several years, the debt markets continued to lend freely to the Enterprises with no significant increase in interest cost. This lack of market discipline, the GSEs' 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.

The legislation that the Committee is now considering is fundamental to the long-term development of the Nation's housing finance system. Only with a much stronger, bank-like regulator can the housing GSEs fulfill the promise of their charter acts. I believe that any reform must be built on a bank regulator model with six basic building blocks. These building blocks are: strong enforcement powers similar to those of banks; strengthened GSE oversight through combining the FHFB with OFHEO; combining safety, soundness, new product mission oversight, strengthened regulatory independence; full authority over capital; and the ability to regulate the Enterprises' portfolios. OFHEO believes the proposed legislation provides all six building blocks.

### **Bank-Like Enforcement Powers**

The new regulator must have regulatory, supervisory and enforcement powers equivalent to those of the other safety and soundness regulators. Receivership powers are especially important. These powers, in particular, provide one way to prevent problems in one financial institution from spilling over to others and might enhance market understanding of the limits on the GSEs and, thereby, market discipline. Improved enforcement powers including the authority to address misconduct by employees, executive officers, directors, and affiliated parties are also crucial. For example, in attempting to forestall executives accused of alleged misconduct from taking undeserved bonuses or benefits, OFHEO sought to freeze benefits until entitlement was litigated. A Federal court ruled that this authority could not be implied from OFHEO's statute. The pending legislation would remedy this situation.

Additionally, the legislation codifies the regulator's ability to act on safety and soundness concerns. It would:

- Make clear that the agency had incidental powers similar to banking regulators;
- Codify corporate governance responsibilities of the GSEs;
- Permit actions against entity-affiliated parties for harms they cause;
- Make clear that the regulator may “de-bar” employees guilty of misconduct from future employment at the Enterprises; and,
- Expand civil money penalties to cover violations related to unsafe and unsound conditions and increase the amount of penalties.

### **Strengthen Enforcement through a Merger of the GSE Regulators**

All of the housing GSEs should be supervised under one regulatory roof. As Comptroller General David Walker has stated in congressional testimony before the U.S. Senate, “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.”

It is also critical that the new regulator respect the differences and similarities of the Enterprises and the Banks. Certainly their ownership and capital structures are different. Distinctions in missions need to be preserved as well as the unique regional characteristics of the twelve Banks. Similarities in mission and goals relating to housing should also be recognized and will be beneficial to the new regulator's comprehensive oversight of these companies.

A single housing GSE regulator for Fannie Mae, Freddie Mac and the Federal Home Loan Banks creates within the government a single regulatory voice focused on the health and effectiveness of the housing finance markets, and how those markets connect countless local mortgage providers to broader capital markets. This perspective will be very useful, especially in relation to the nation's need to provide more affordable housing for all Americans. Additionally, since the Banks and the Enterprises are engaged in similar investment, funding and risk management activities, there will be benefits from the examination teams sharing information, examination strategies, and “lessons learned” strategies. A level playing field should emerge regarding expectations for safety and soundness for all of the housing GSEs.

In short, Fannie Mae, Freddie Mac and the FHLBanks will all benefit from being regulated by a stronger, more effective and more prominent regulator. And the Federal Government will benefit from having a single, credible agency contributing to important policy discussions on the condition and role of the housing finance market and its interaction with broader capital markets. That perspective can be useful in informing

public policy on numerous important issues, including financial safety and soundness, systemic risk, affordable housing, consumer protection, and predatory lending.

### **Mission and New Product Authority**

Currently, authority over the charters of the Enterprises, their mission and new products, is placed within HUD. This is different from the current practice for the banking regulators and the FHFB which exercise both authorities. OFHEO is in the difficult position of being able to review only the safety and soundness aspects of activities that could be in violation of the Enterprise's charter. The new, stronger GSE regulator needs to have both safety and soundness powers as well as mission and new product powers. This combined structure will allow for a more comprehensive view of proposed new programs and products while preserving the important distinction between primary and secondary market activities.

### **Stronger Independence**

The new regulator needs to have independent litigating authority. Currently, we are in litigation with former officers of both Enterprises. Unlike bank regulators, we must act through the Justice Department when these matters go before a Federal court. The Department of Justice has done a fine job for us, however, this can involve difficult procedural steps that would not be necessary if we were directly presenting and advocating our case. In addition, Justice itself may not have all the needed resources at a given point in time. The bill affords the new regulator the ability to call on Justice for its valued expertise, while permitting the regulator, in appropriate situations, to bring a case or defend itself directly in a Federal court proceeding.

As this Committee knows too well, OFHEO remains the only safety and soundness regulator that must be congressionally appropriated, even though OFHEO has no impact on the Federal budget since it is funded by the Enterprises it regulates. Currently, OFHEO is operating under a Continuing Resolution at FY 2006 spending levels. I appreciate your letter Mr. Chairman, Ranking Member Bachus, Capital Markets Subcommittee Chairman Kanjorski and Ranking Member Pryce supporting OFHEO's request that our full funding be restored as the Congress considers supplemental funding needs for FY 2007. Without our full funding, planned resources in critical supervisory areas may have to be cut, impacting our ability to oversee Fannie Mae and Freddie Mac.

### **Ability to Strengthen Capital Requirements**

Fannie Mae and Freddie Mac have lower regulatory minimum capital requirements compared with other regulated financial institutions. The 1992 Act that created OFHEO requires the two Enterprises to maintain stockholder's equity equal to 2.5 percent of assets. Currently the FHLBanks hold 4 percent, albeit with a different capital structure,

and major banks hold over 6 percent. No financial institutions are directly parallel to the Enterprises, but these capital requirements may be an indication that the present requirement is too low. Due to operational issues at both Enterprises, OFHEO has required each of the Enterprises to hold an additional 30 percent capital cushion or 3.25 percent of assets. Like other areas of OFHEO's current statute, this additional capital surcharge is based on incidental and implied authority. Passage of reform legislation will make our authority certain.

The same 1992 statute that created OFHEO also prescribed a risk-based capital test that needs to be modernized. As a former risk management executive, I know that there are a number of improvements that can and should be made to modernize the risk-based capital test. At a minimum, risk-based capital should be based on the full array of Enterprise risks including market, credit and operational risk. There also needs to be consideration given to the risks that large housing GSEs present to the overall financial markets. A new, stronger regulator needs the flexibility and authority to adjust both the risk-based and minimum capital requirements. This authority should be exercised through an open regulatory process, but supplemented with the ability to respond quickly to changing Enterprise and market conditions.

### **Authority to Regulate the Portfolios**

It is clear that the portfolios of Fannie Mae and Freddie Mac have grown tremendously in the absence of effective market discipline. Over the 15 years through 2005, mortgages outstanding in the U.S. tripled, the Enterprises' largest business of guaranteeing MBS grew four-fold, and yet the portfolios of the Enterprises have grown ten-fold. This growth slowed considerably in the wake of their problems but the portfolios remain huge, over \$1.4 trillion. Both CEOs have told me that they agree that the portfolios grew too fast and contributed to some of the operational difficulties that they faced. Under our current statute, however, OFHEO's authority over the portfolios is not set forth clearly. This needs to be codified in the new legislation.

H.R. 1427 provides specific guidance to the regulator that would focus the Enterprise portfolios on their charter missions of supporting affordable housing and contributing to the stability and liquidity of the secondary mortgage markets while considering the risks of the portfolios. I would note that less than 30 percent of the current portfolios of both Enterprises directly contribute to meeting their affordable housing goals and over half of the portfolios are comprised of their own MBS. Although these MBS contain affordable loans, they count toward the goals when they are securitized, but not again if an Enterprise purchases those MBS for its retained portfolio. That would be double counting.

The language in the compromise specifically requires the new regulator to lay out its portfolio regulation under a notice and comment rule-making that will allow all interested parties to comment on the proposal. I commend Chairman Frank and Secretary Paulson for this effective compromise and I believe that it strikes a fair balance between

appropriate regulatory oversight and the legitimate profit-making and market support activities of the Enterprises.

Using this legislative guidance, and under a notice and comment rule-making, I believe that it is unlikely that any regulation will force “drastic reductions” in these portfolios. I would expect, however, to see some changes and, over time, a reallocation that encourages investments that more closely support the affordable housing, liquidity and stability missions. In fact, over the last three years, Fannie Mae and Freddie Mac have actually increased their overall 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. In 2006, despite the restrictions on growth of their portfolios and significant competition, their total book of business grew 8 percent because their guaranteed MBS grew at double-digit rates.

A shift of some of their MBS from their portfolios to other owners would free up billions of dollars of capital while not reducing their support of the mortgage market. That excess capital could be used to increase their market support especially in times of turmoil by guaranteeing more MBS. Alternatively, it could be returned to shareholders.

Once a regulation is in place and the Enterprises have fixed their problems, a mission-focused regulation could certainly allow the portfolios to grow again. In fact, the proposed legislation instructs the agency to consider the size and growth of the mortgage markets in formulating a regulation. Once healthy and depending on competitive forces, Fannie Mae’s and Freddie Mac’s support for the secondary mortgage market could actually grow faster than the overall housing market.

### **Administrative Issues**

OFHEO has submitted comments on less critical, but still important issues that we request to be considered in the legislation. We are in favor of the Federal Housing Enterprise Board structure in H.R. 1427. We would suggest that the agency share a similar name, especially as the name and acronym FHFA may get confused with the FHA. As OFHEO and FHFB already have a close working relationship, OFHEO recommends that the new agency be created on enactment of the bill. Given the proposed structure of a Deputy Director for FHLBanks and one for the Enterprises, we believe the quick creation of the new agency would be smoother and more efficient. All personnel, including Finance Board members, would be protected as they are in the current bill. In the governance area, we believe that the appointment of Presidentially-appointed Directors to Fannie Mae’s and Freddie Mac’s Board of Directors is unnecessary and inappropriate. The present practice of selecting strongly credentialed Directors recommended by executive search firms, vetted by OFHEO, and elected by shareholders is working well.



## **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, its liquidity and stability, and especially affordable housing. I am grateful to the leadership of this Committee, Democratic and Republican, for undertaking the hard work of developing a bi-partisan bill that can accomplish this worthwhile objective. I also commend President Bush's Administration for its work in this area and for promoting compromise to give the new regulator the tools it needs to do its job and to assure that the numerous benefits enjoyed by the GSEs are directed at serving their very important public purposes. Thank you and now I will be happy to answer your questions.