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KEYNOTE ADDRESS
REGULATING FANNIE MAE AND FREDDIE MAC

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I would like to begin by thanking the Bond Market Association, the Hong Kong Capital Markets Association, the Treasury Markets Forum of Hong Kong, the International Capital Market Association, and the Asian Development Bank for the opportunity to speak to you today.

I have two objectives in my presentation today:

- to review developments in the regulation of Fannie Mae and Freddie Mac, collectively referred to as "government sponsored enterprises" or "GSEs";

- and how proposed changes in the regulation of the GSEs could dramatically impact these companies and how they conduct their business.

As debt market professionals, you know who Fannie and Freddie are. The U.S. government made housing a national priority and most of the government's efforts have focused on increasing the availability and affordability of housing finance. Accordingly, in 1968, Congress established the Federal National Mortgage Association (Fannie Mae) and in 1970,

the Federal Home Loan Mortgage Corporation (Freddie Mac) as government-sponsored enterprises, that is, they have federal charters but are owned by the public. Their fundamental role is to expand the pool of available mortgage financing by acting as an intermediary between the homeowner and investors. By law, they operate in the prime conventional conforming mortgage market, which covers mortgages below the 2004 "conforming" limit of $359,650.

Fannie Mae and Freddie Mac issue bonds to private investors and use the proceeds to purchase mortgages for their own portfolios. They also provide credit guarantees on conforming mortgages, which are bundled together in mortgage-backed securities that are held by investors. As of June 30, 2005, residential mortgages outstanding amounted to $9.2 trillion. Commercial banks, credit unions, and thrifts held 46 percent of these mortgages. Fannie Mae and Freddie Mac held 18 percent of the outstanding mortgages. The other 36 percent was held by a combination of life insurance companies, foreign investors, pension funds, individuals, and other investors.

Asian interest in GSE debt, both Agency bonds as well as mortgage-backed securities, has been increasing. Some estimate that Asian investors account for more than 40 percent of the investor orders placed in syndicated bond offerings of the GSEs. In the past two years, a handful of Asian central banks have entered the mortgage-backed securities market. The additional demand generated by these central banks building up their holdings to reach their benchmark allocation amid a period of relatively low mortgage originations has had a meaningful effect on the pass-through market.

I need not go on describing the business of the GSEs; you are familiar with their portfolio and credit guaranty business. You may be less familiar, however, with the "business" of their federal safety and soundness regulator, the Office of Federal Housing Enterprise Oversight, known as OFHEO.

Economic turmoil in the mid to late 1980s led to the failure of hundreds of mortgage lending institutions such as savings and loans and banks. Historically high interest rates left many of these institutions with portfolios of long-term, fixed-rate mortgages that were funded by shorter-term, higher-priced deposits and debt. Regional downturns, such as the oil-related decline in the south central part of the U.S., primarily Texas, Oklahoma, and Louisiana, intensified the pace of financial institution failures. The government was required to step in to help resolve this crisis and make good on the thousands of deposit insurance claims from these failed institutions. The final taxpayer bill resulting from this bailout totaled well over $150 billion.

As a result of this crisis, Congress strengthened regulatory oversight of financial institutions by establishing tougher risk-based capital requirements on depository institutions. In addition, regulators promulgated formal rules for regulatory intervention known as "prompt corrective action." Concern that the government might be exposed to a potential failure or major disruption of service from housing related government-sponsored enterprises such as Fannie Mae and Freddie Mac, led Congress to create the Office of Federal Housing Enterprise Oversight (OFHEO) in 1992.

This legislation set the course for oversight of Fannie Mae and Freddie Mac over the next decade. The Department of Housing and Urban Development (HUD) was given responsibility for developing and enforcing regulations designed to ensure that the GSEs accomplish their "mission." OFHEO, an independent office within HUD, was created to ensure that the GSEs operate with little risk of financial failure. This agency is the safety and soundness, as opposed to mission, regulator.

Until recently OFHEO was a very small operation. At the time Director Armando Falcon assumed office in October 1999 as only the second Director of the agency, OFHEO employed a whopping 70 people. Falcon regularly petitioned Congress for money and staff so that by 2003, when the Freddie Mac scandal materialized, OFHEO had grown to 140 employees -- doubling in size. The events at Freddie and Fannie demonstrated to Congress, however, that OFHEO still needed dramatically more resources. Today OFHEO has 221 people and has a $60 million budget. The agency has tripled in size in six years but let's keep that in perspective. Sixty million to run an examination and enforcement agency responsible for the regulation of two companies whose combined assets exceed $4 trillion, and are the second and fifth largest financial institutions in the United States is not really that much.

In the wake of the Freddie Mac accounting scandal in the summer of 2003, Director Falcon and I set about reorganizing the OFHEO Office of Examinations and the examination functions of the agency. The examination staff was doubled in size, with OFHEO recruiting senior people from the bank regulators. In addition to growing the regular examination force, OFHEO created an Office of Compliance, responsible for special examinations and an Office of Chief Accountant. In short, we tore the structure down to its foundations and rebuilt the agency. Indeed, the most important change we made was to the culture of OFHEO. We strive to be the most aggressive regulator in the U.S. government and OFHEO employees now know that the path to greater responsibility and remuneration is each day to be a little smarter, a little faster and a little more effective than the day before. Enter the "new" OFHEO.

At the same time the agency was being reorganized, a decision was made that turned out to be prescient. One of the recommendations of the report of the special examination of Freddie Mac was that OFHEO should conduct a similar special examination of Fannie Mae.

That decision and the events that followed were historic. OFHEO uncovered accounting and other deficiencies at Fannie Mae that will produce what is currently estimated to be an $11 billion restatement. For the first time a financial institution safety and soundness regulator identified a major scandal before it manifested itself and destroyed the company at a time when the auditor of the company, the internationally recognized "Big Four" accounting firm of KPMG, was certifying the financial statements as accurately reflecting the financial condition of the company.

The two special examinations produced settlement agreements between each of the companies and the agency. OFHEO insisted upon plans of remediation at both GSEs. We actively monitor their implementation. Freddie Mac has completed its restatement and expects to be a "timely filer" of financial reports in the first quarter of 2006. Even though

neither the special exam of Fannie Mae nor its restatement of financials is complete, that company is already engaged in a massive program to remedy deficiencies identified by OFHEO and now, by their own intensive self examination. Regulation is not a series of unrelated events; it is a dynamic process in which the regulator and regulated entity interact every day. Many problems remain and perhaps additional ones will be identified, but I am pleased that the interactive process of regulation of the GSEs and addressing those problems is working well.

The regular examination process continues but with a new intensity. The GSEs are entitled to broad discretion in how they run their businesses. They are, after all, their companies to run. OFHEO, however, is responsible for their regulation and we defer to no one. We do not forebear. We identify potential regulatory problems, insist the company address them, work with them, and if need be, we are prepared to take official action to force compliance. That last step has not been necessary. The response of the new management at both companies to the dramatic events that have occurred, is rapidly transforming their respective cultures into those in which the respective rights and responsibilities of the regulator and regulated entity are understood and mutually accommodated. This is in everyone's interest.

What does this recounting of history mean for the debate that is currently underway in Congress about the need for legislation? It means that an adequately funded, staffed, and authorized regulator can get the job done.

Legislation is now pending before Congress that will restructure OFHEO and change the way the GSEs are regulated. While the House and the Senate bills each take a somewhat different approach to regulatory reform, both bills would:

- merge OFHEO with the regulator of the Federal Home Loan Banks (FHFB) to create a new GSE regulator
- increase the autonomy of the new regulator by exempting its budget from the annual Congressional appropriations process
- enhance the safety and soundness and enforcement authorities of the new regulator by making its powers equivalent to those of the U.S. federal banking regulators
- give the new regulator full authority over both minimum and risk-based capital
- allow the regulator to place the GSEs into receivership
- give the new regulator authority over any new programs initiated by the GSEs.

Recently the House of Representatives, by an overwhelming vote of 331 – 90, passed its version of GSE reform and the Senate has legislation under consideration. Treasury Secretary Snow and Federal Reserve Board Chairman Greenspan have each criticized the House-passed bill. It is clear that their opposition is primarily based upon the fact that the House bill does not mandate that the new regulator reduce the size of the portfolios of mortgages and mortgage-backed securities that each enterprise maintains. OFHEO has not taken an official position on the issue of portfolio limits. We view that as a public policy decision that lies exclusively within the discretion of elected representatives. The new agency will carry out the mandate of the Congress.

It is important, however, to commend the actions of the House in passing a comprehensive bill that will significantly improve the regulatory climate for GSE supervision. It is worth noting that under the House-passed bill, the agency will receive significant new authority as well as a stable source of funding independent of the Congressional appropriations process. These are both needed changes that have been identified as such by numerous studies and Congressional hearings over the years and endorsed by the Administration. While the House bill can certainly be improved, the important point is that Congress act -- and soon -- before this current pro-reform climate passes. If Congress does not act, OFHEO will continue to do its job, but it will face the increasing pressure of inadequate regulatory authority and an unpredictable funding mechanism that makes planning and management extremely difficult.

Let me comment on what is involved in the debate on the specific issue of portfolio limits. Those who support limits believe that Fannie and Freddie are too big, that their retained portfolios serve no other purpose than increasing their profitability, and they play no part in lowering the costs of obtaining mortgages or the interest rates people pay on them. They maintain that the need to hedge interest rate and credit risk of the retained portfolio requires the GSEs to be major users of the over-the-counter derivatives market which may or may not be able to efficiently hedge their ever-growing needs. Further, they maintain that the accounting scandals that erupted at both companies can be directly linked to their retained portfolio businesses. Finally, they claim the consequences of either of the GSEs failing, presumably as the result of inadequately hedging the risks of their retained portfolios, are so great they pose a “systemic risk” to the American and perhaps, world economies. These are the arguments made by Secretary of the Treasury Snow and Federal Reserve Board Chairman Greenspan.

It should come as no surprise that both GSEs oppose portfolio limits. The opponents of portfolio limitations argue that retained portfolios support and fund affordable housing activities, providing a subsidy for programs that are socially desirable but may not be profitable. They also argue that retained portfolios help the GSEs attract international capital for the mortgage markets of the United States. With regard to the portfolios themselves, opponents of limitation argue the GSEs manage the interest rate and credit risks associated with the retained portfolios very conservatively and transparently. The transparency of their actions subjects the companies to additional market discipline. Finally, they believe that forced shrinking of the portfolios, even over several years, will result in a decrease of the availability of the long-term, fixed-rate prepayable mortgages and this would hurt both the housing market and U.S. economy.

Other commentators suggest that the real goal of the proposed portfolio limits is privatization. This view says the way to address systemic risk issues satisfactorily is to privatize the GSEs, and portfolio limits are the means to that end. In this scenario, it could be argued, portfolio limits reduce the market share of the GSEs and over time, as the market grows, their competitors gain a larger and larger share of the market. Eventually the segment left to the GSEs becomes uncompetitive. In effect the competitors of the GSEs slowly liquidate them in the marketplace. At some time in the future, as the GSEs become much smaller companies, they can be allowed to go into any business without Congress fearing they will immediately dominate those industries.

In addressing the issue of privatization, the real question is how much risk is Congress willing to accept from the operation of GSEs? What you cannot do with regulation is completely eliminate risk. Fannie and Freddie are in the business of identifying, assuming and managing risk. They do that well. Their credit risk management has been exceptional and their actual experience with interest rate risk should satisfy even the most critical. Their problems were not the result of inadequate risk management but accounting and management impropriety. The concerns about the risk these companies pose to the economy are concerns about "potential" impacts and not based on actual experience.

The key is to not look exclusively to the GSE regulator, either OFHEO or the new agency, and instead recognize that addressing systemic risk requires a collective effort of GSE and financial services regulators as well as other participants in the financial system.

Congress is not addressing the issue of legislating portfolio limits in a vacuum. For example, there are a number of existing safeguards available should the need arise. First, the Treasury Department currently has authority to limit debt issuance by the GSEs.

Second, federally chartered financial institutions may invest in GSE securities in unlimited amounts. The Federal Reserve and other federal bank regulators could reduce demand for those securities by imposing limits on the amount of agency debt that can be held as bank capital. In 2003, OFHEO published a "Systemic Risk" report that showed at that time 27 percent of U.S. banks held Fannie Mae debt in an amount that exceeded 50 percent of their capital. Twelve percent had similar exposure to Freddie Mac debt.

Third, the securities of the GSEs are eligible for Federal Reserve open market purchases, as collateral for most state and local deposits, and as collateral for loans from Federal Reserve and Federal Home Loan Banks. This too, could be subject to revision.

All these items are within the authorities of regulators under existing law and regulation. Whatever steps Congress believes must be taken should first take into account the potential for exercise of existing regulatory authority. The challenge Congress and financial regulators face is to address safety and soundness issues surrounding the size of retained portfolios while still allowing Fannie Mae and Freddie Mac to accomplish their missions.

In conclusion, as the Congress continues to debate the issue of GSE regulation reform, the original reason Congress became involved in the subject in the first place should not be lost. In order for the public to be better protected, the current regulatory structure for the GSEs needs to be strengthened and improved. Legislation should be passed and signed into law to remedy that situation, and I look forward to working with all interested parties to accomplish this.

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