HOUSING, SUBPRIME AND GSE REFORM: WHERE ARE WE HEADED?
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I just finished, I think celebrated might be the wrong word, my first year at OFHEO. Like my almost four years at the Pension Benefit Guaranty Corporation (PBGC) and four-plus years at the Social Security Administration (SSA), it has been action-packed. While I expected the challenges of finalizing the Fannie Mae Special Examination and Consent Agreement, the intensive remediation efforts and getting legislation reforms, I did not foresee the dramatic softening of the housing market, let alone the subprime mess. First, I will address the expected and then the unexpected challenges.

Each one of the agencies I served merits a full speech here, but I promise not to give three. However, there is a common theme among all three. It is not just helping to fulfill the twin American dreams of homeownership and a secure retirement. It is that government agencies are often created with the best of intentions, but not the best foresight. And if they do not adapt to changing conditions, they can create unintended consequences such as excessive risk-taking, adverse economic impacts or, in extreme cases, a savings and loan crisis necessitating a taxpayer bailout. Being government agencies that adaptation to change usually requires legislation.

<u>Need for Legislation</u>

Congress created OFHEO in 1992 to ensure that Fannie Mae and Freddie Mac were effectively regulated to reduce their risk of failure, and hence disruption of their public missions. Fannie Mae and Freddie Mac have an important mission of supporting the mortgage market, its liquidity and stability, and especially affordable housing. These two companies -- chartered by Congress to support housing finance, but owned by shareholders -- are now responsible for 40 percent of all mortgages in this country.

These Enterprises are huge. To put their size in perspective, as of March 31, the combination of the mortgage-backed securities (MBS) that they guarantee ($3.0 trillion) and their debt outstanding ($1.5 trillion) totaled $4.5 trillion; not that much smaller than the publicly held debt of the U.S. of $5.1 trillion. (#2)

As the Federal Reserve holds $800 billion of those "publicly held" Treasury securities, the public, including a rapidly growing number of foreign investors, actually own more Enterprise paper than that of the U.S. government. The Enterprises' rapid growth has continued despite their management, systems, internal control and accounting problems, including the inability to publish timely financial reports for three to four years. The Enterprises are now planning to finally start publishing timely reports early next year. The debt markets have ignored those problems because they believe in an "implicit" U.S.

government guarantee, despite it being stated clearly in the law and on the face of the bonds that they are not guaranteed.

The Enterprises' total book of business through the first quarter of 2007 was $4.5 trillion, with a retained portfolio (in green) of $1.4 trillion, $170 billion of which is subprime AAA Private Label Securities (PLS). (#3) You will note that the blue section, which is their largest business, continues to grow at double-digit rates, which, over the last year, have much higher than market growth rates. This basic business is to buy, package, and guarantee MBS. It is much less risky than their second business of portfolio investments and requires significantly less capital.

As I've said before, considerable safety and soundness problems at one or both of these companies could have serious repercussions not just for their stockholders, but also the holders of their bonds and MBS, which could spill over to at least the housing finance market. There is much at stake. We can lessen the chances of serious problems by enactment of comprehensive GSE reform legislation. H.R.1427 has already passed the House. That bill is a good, balanced start, but needs some work. Now, it is the Senate's turn to act.

Key components of the House legislation include the following principles: (#4)

<u>Bank Regulator-Like Powers</u>

The new regulator must have regulatory, supervisory and enforcement powers equivalent to those of the other bank regulators. Receivership powers are especially important. These powers provide one way to prevent problems in one financial institution from spilling over to others. Improved enforcement powers including the authority to address misconduct by employees, executive officers, directors and affiliated parties are also crucial.

<u>Strength Through Combining the GSE Regulators</u>

All of the housing GSEs - -including Fannie Mae, Freddie Mac, and the 12 Federal Home Loan Banks (FHLBanks) - - should be supervised under one regulatory roof. As Comptroller General David Walker stated in Senate testimony, "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."

<u>Transfer Mission and New Product Authority from HUD</u>

Currently, authority over the charters of the Enterprises, their mission and new products, is placed within the Department of Housing and Urban Development (HUD). This split of regulatory responsibilities for the Enterprises contrasts with the unified roles of the banking regulators and the FHFB for their respective regulatees. It is sub-optimal.

Combining safety and soundness powers and mission and new product powers will allow for a comprehensive view of proposed new programs and products.

Stronger Independence – Litigation and Budget

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 Department of Justice when these matters go before a Federal court, which can be cumbersome.

OFHEO is 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. For all but two years of our 15-year existence, we did not know what our budget was at the start of the year. This year was worse than usual. We were almost two-thirds of the way through the Fiscal Year when we finally received the last piece of our funding request, and that was in the Iraq War supplemental funding bill.

Ability to Strengthen Capital Requirements

The 1992 Act that created OFHEO requires the two Enterprises to maintain equity capital 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 their capital requirements may be an indication that the Enterprises' present legal requirement is too low.

The same statute also prescribed a risk-based capital test that needs to be modernized, adopting the principles of economic capital including market, credit and operational risk. A new, stronger regulator needs the flexibility and authority to adjust both the risk-based and minimum capital requirements. In H.R. 1427, this authority would be exercised through an open regulatory process, and supplemented with the ability to respond quickly to changing conditions.

Clear Guidance to Regulate Portfolios

The portfolios of Fannie Mae and Freddie Mac grew tremendously in the absence of market discipline. Over the 15 years through 2005, mortgages outstanding in the U.S. tripled and the portfolios of the Enterprises grew ten-fold. As you can see on this pie chart of their portfolios at the end of March (#5), about half their $1.4 trillion portfolios are invested in Enterprise MBS. A portion of these holdings make sense for market liquidity and stability purposes, but much of these could be sold or allowed to run off without replacement, leading to a larger float and even deeper market for their MBS securities.

Doing so would also free up significant capital as holding their own MBS in their portfolios requires five times as much capital as just guaranteeing them. Specific statutory guidance is necessary to ensure the regulator can promulgate a regulation to focus the Enterprises' portfolios on their charter missions of supporting affordable housing and contributing to the stability and liquidity of the secondary mortgage markets, and ensure safety and soundness by considering all relevant risk factors and not just those to the Enterprises' shareholders.

House Prices and Subprime Trends

Let me now turn to those unexpected challenges: house prices and subprime. Both demonstrate why there needs to be a new, stronger GSE regulator. Fannie Mae and Freddie Mac are starting to play a bigger, more risky role in the subprime market by buying and holding subprime mortgages directly. Over time, these purchases should help reduce some of the pain in the subprime market. OFHEO will be monitoring them closely to ensure that they make and manage these purchases in a safe and sound manner.

Although their $40 billion-plus planned commitment to subprime over the next several years is small compared to the $1.5 trillion subprime market and well less than 1 percent of their combined book of business, it does represent over half their combined GAAP capital.

There is a certain irony that the insertion of three words on the House Floor in H.R. 1427 might cause a regulator to greatly reduce this subprime commitment. As originally written, the section giving the regulator the ability to regulate the size and growth of the Enterprises' portfolios charged the regulator to consider risks of the portfolios; but the change was to consider only the risks "to the Enterprises." A regulator could interpret that to require focus on subprime mortgages' risks to shareholders rather than the housing finance markets just when the Enterprises should be fulfilling their mission of stabilizing the housing markets. I hope the Senate will recognize this potential unintended consequence and that the risks to the housing finance markets should be considered in their deliberations.

With respect to house price trends, as has been widely reported, appreciation rates have fallen dramatically over the last two years. (#6) Both OFHEO's "all-transactions" House Price Index (HPI), which uses purchase prices and appraisals for refinancings, and OFHEO's "purchase-only" index show sharp slowdowns. The annualized rate of appreciation between the fourth quarter of 2006 and the first quarter of 2007 was 1.8 and 1.1 percent, respectively. This is a sharp drop from previous years and lags the rate of inflation.

The next slide, using the purchase only index, reveals that every region of the country has seen a sharp decline in appreciation rates over the last year. (#7) The deceleration has been particularly extreme in the areas of the country that once had the hottest markets, such as the West and South Atlantic. However, in the lower growth areas of the East North Central region, the so-called "rust belt," and New England, price appreciation was actually negative over the latest four quarters. If other price indices are any indication, we may see more negative states in our second quarter HPI release.

Now, let's take a look at the subprime market. Over the last several years, you might say there were "triple-witching" factors that created the subprime turbulence we are seeing today. First, the share of subprime mortgage originations tripled from 2002 to 2006 to 22 percent of the mortgage originations, so that there is now about $1.5 trillion outstanding. Second, as this graph shows (#8), the type of subprime loans shifted dramatically. In 2002, about 95 percent of new subprime loans were the traditional, fully amortizing loans -- either fixed or adjustable rate mortgages -- and that fell to about 35 percent in 2006. Nontraditional mortgages, including interest-only and negative amortization, made up most of the difference. In some cases, these loans were not explained well to the borrowers. Third, lending standards fell dramatically. In the first quarter, only about 50 percent of subprime loans were fully documented and only 50 percent had debt to income ratios lower than 40 percent.

Not surprisingly, delinquencies and foreclosures on subprime mortgages began to rise in 2005. Two statistics are presented in this chart (#9). Serious delinquencies are loans 90 days past due or already in foreclosure processing. They were 5.8 percent of all subprime loans in the second quarter of 2005 and have risen significantly to 8.3 percent in the first quarter of 2007. Subprime loans starting foreclosure processing almost doubled. Expectations are that both of these numbers will escalate over the next year as many hundreds of thousands of "teaser," adjustable-rate mortgage subprime loans will reach their payment reset dates.

The map shows seriously delinquent subprime mortgages in the first quarter of this year. (#10) As you can see in red, many of the Central Midwest states are experiencing extremely high rates of serious delinquency of over 10 percent, partially due to a decline in automobile and other manufacturing industries. Mississippi and Louisiana are still suffering from the after-effects of Hurricanes Katrina and Rita.

In 2007 subprime originations are 30 percent off 2006 levels. More than 90 subprime lenders have folded. There have been a massive number of downgrades in lower-rate subprime Private Label MBS. Some subprime hedge funds are being restructured or liquidated. Assets sold from these funds are compounding problems, lowering prices in the MBS and Collatarized Debt Obligation (CDO) markets. Subprime credit option (ABX) pricing keeps falling to new lows. (#11) The BBB- index has gone from a high of 97.5 in January to the current low of 45.0 today. As mentioned earlier, Fannie Mae and Freddie Mac are very large holders of the highest rated AAA Private Label MBS. The downgrades of lower-rated tranches are now starting to impact the prices of these AAAs.

Regulatory Responses

The financial regulators have responded to the subprime market deterioration. The bank regulators issued the *Interagency Guidance on Nontraditional Mortgage Product Risks* in October 2006. In December 2006, OFHEO notified Fannie Mae and Freddie Mac that they must comply with that guidance. At OFHEO's request last Friday, Fannie Mae and Freddie Mac sent letters to all their originators of mortgages saying that they will not buy mortgages originated on or after September 13 that do not comply with the *Interagency Guidance on Non-traditional Mortgages*, which includes:

- an evaluation of the borrower's ability to pay the mortgage loan at the fully indexed rate, assuming a fully amortizing repayment schedule;
- limitations on reduced documentation requirements for such mortgages;
- limitations on risk-layering without compensating factors;
- a focus on consumer improved consumer disclosure requirements; and
- strengthened portfolio and risk management practices.

OFHEO also told the Enterprises in March 2007 that they must follow the *Interagency Statement on Subprime Mortgage Lending* which took effect last week. In their nontraditional letters, the Enterprises said that they will be issuing in the near future similar rules for purchasing subprime mortgages. Those deal primarily with mortgage loans that have become increasingly common in the subprime lending marketplace -- so-called "2/28" and "3/27" loans -- by advising that underwriting standards should qualify potential borrowers not at an artificially low initial or teaser rate but at the fully indexed, fully amortized rate. In addition, the guidance cautions against the use of "stated income" and low-documentation subprime loans and recommends limitations on the length of time in which a prepayment penalty applies.

To prevent future problems in the subprime market, we must ensure that both the *Non-Traditional Mortgage Guidance* and *Subprime Statement* are implemented and not just for regulated but also non-regulated mortgage lenders.

We are working closely with the Enterprises so that going forward these rules will apply to mortgages they purchase directly and through Private Label MBS.

The regulators are encouraging forbearance and loan modifications rather than foreclosures. Mortgage servicers will play an important role in that effort and of course, borrower education will be critical to the process. With respect to Fannie Mae and Freddie Mac specifically, we continue to encourage safe and sound rescue mortgages. As we regulators focus on reforms, we remain mindful that we need to be careful that credit to subprime borrowers and the affordable housing market are not threatened unnecessarily.

<u>Conclusion</u>

Despite the many problems in the subprime mortgage market it has made a positive contribution toward getting low-income individuals into their first homes. (#12) Hopefully, the changes I have been talking about today will be continued to help place people into affordable housing without putting them and their neighborhoods into high-risk situations.

It is my belief that Fannie Mae and Freddie Mac can do even more to help in what is one of their key mission areas – affordable housing. It is also my belief that to do so they must be fully remediated with strong systems to address the credit issues in this sector and that they need a strong regulator to help ensure that they are healthy, well-managed companies.

Reform legislation is critically needed to create a stronger regulator for these two companies so essential to the U.S. housing finance system. Enhanced powers will allow the new unified, stronger regulator to focus on the housing GSEs and prevent the problems of the past from recurring. Reform legislation has already passed the House. As I said, now it is the Senate's turn. At stake is the future health of a key component of our economy, housing and ultimately, increased homeownership.

Housing, Subprime and GSE Reform: Where Are We Headed?

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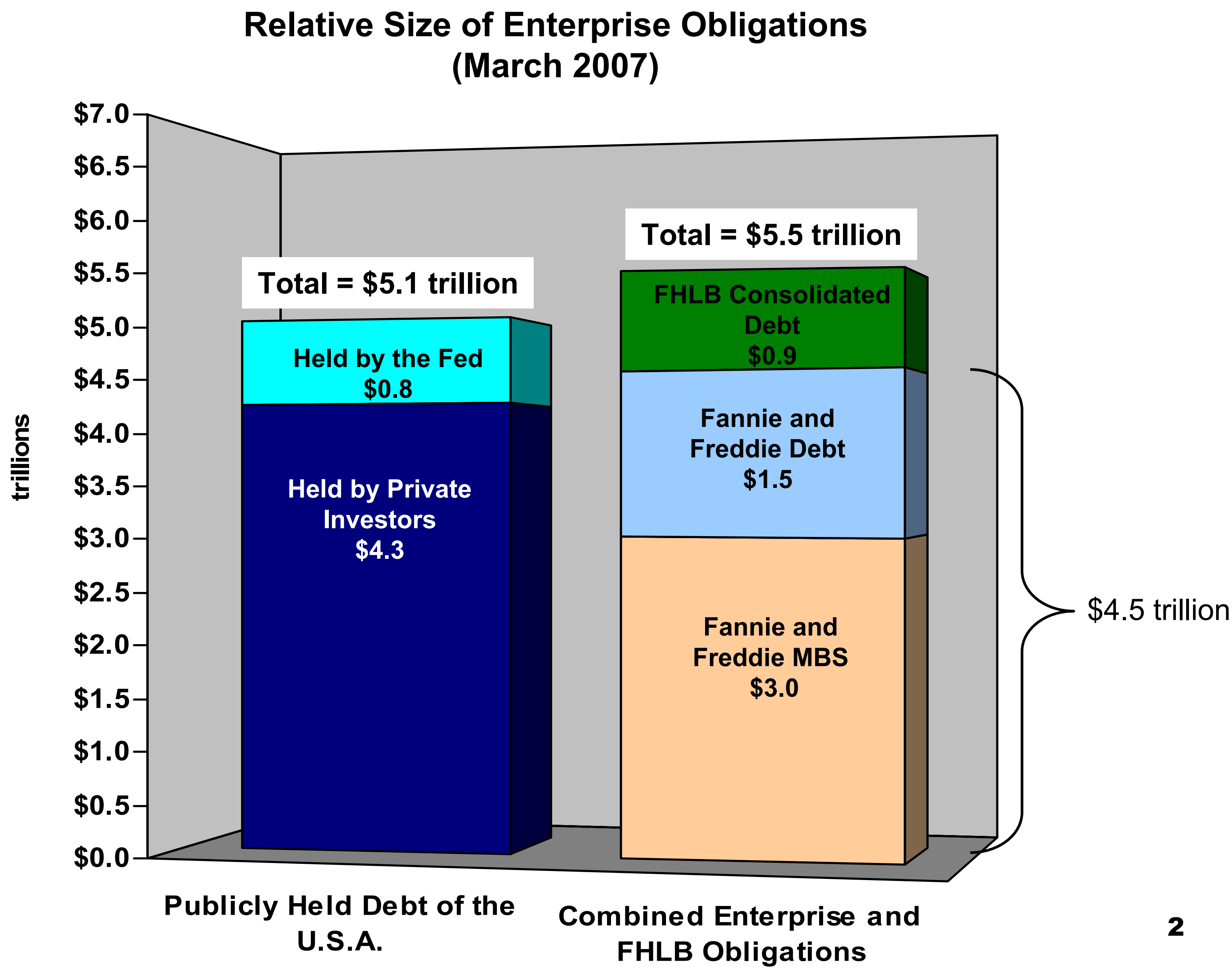
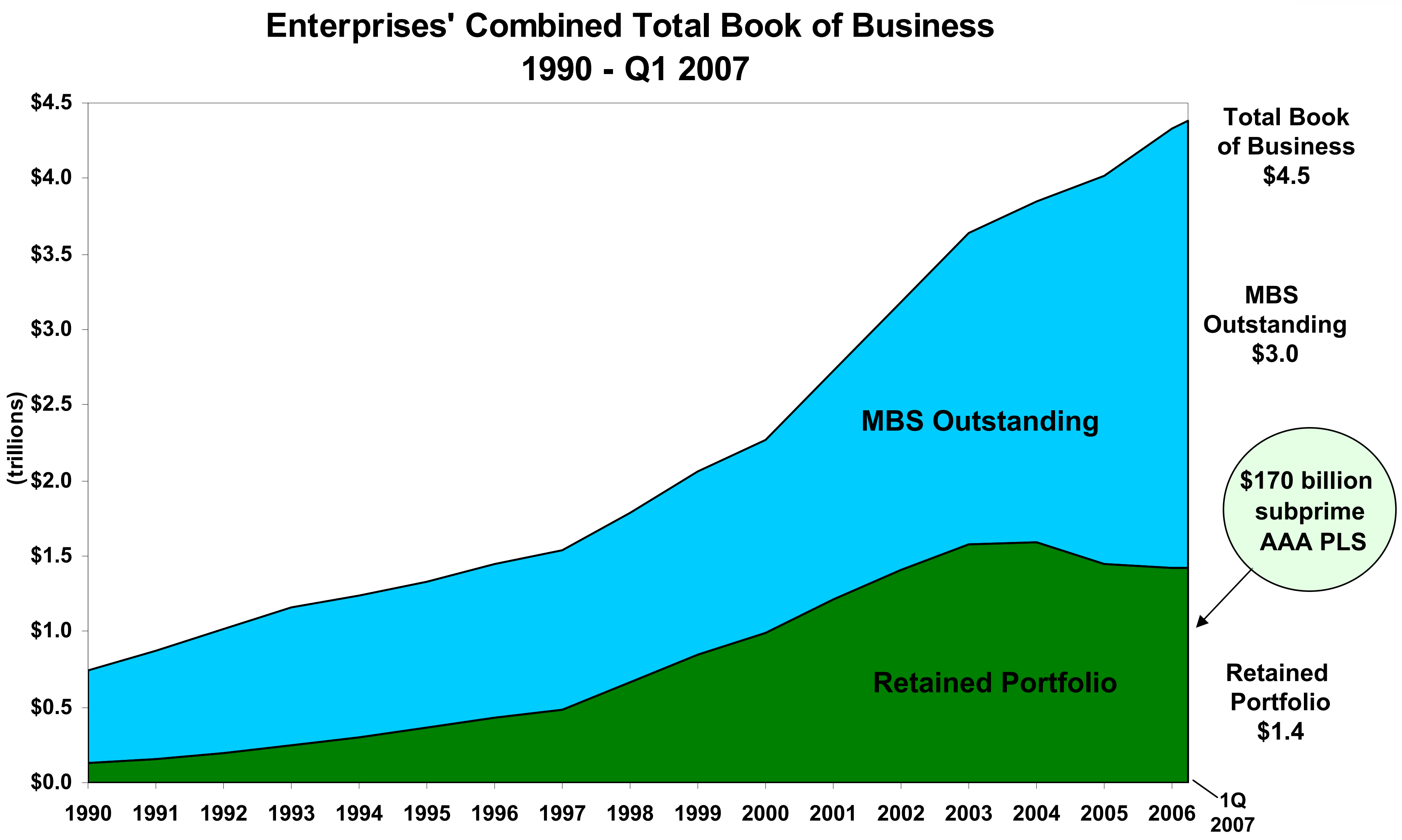
The Housing GSEs are Huge



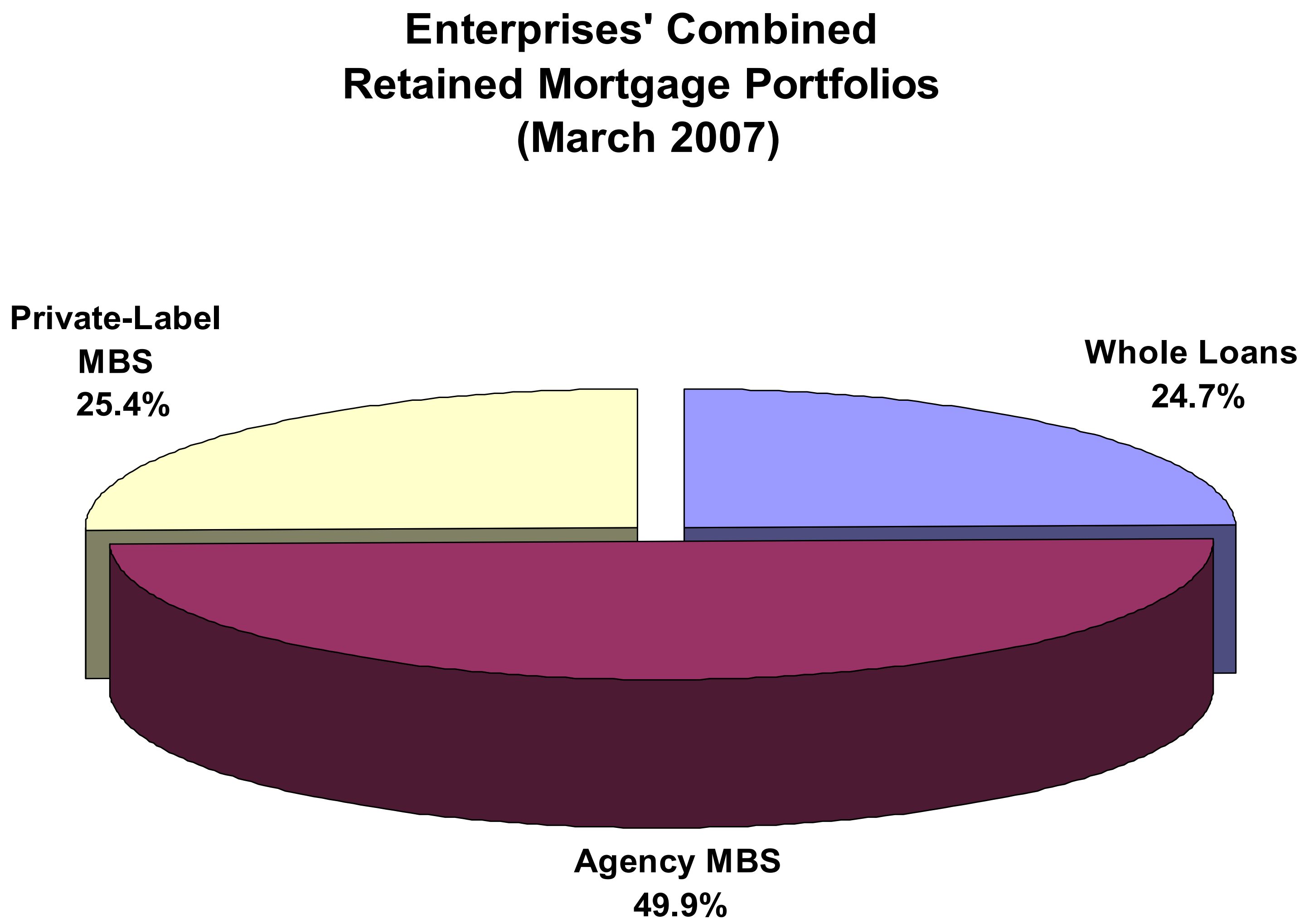
Combined Book of Business Continues to Grow



New, Stronger Regulator Needed

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

Portfolios Dominated by Own MBS

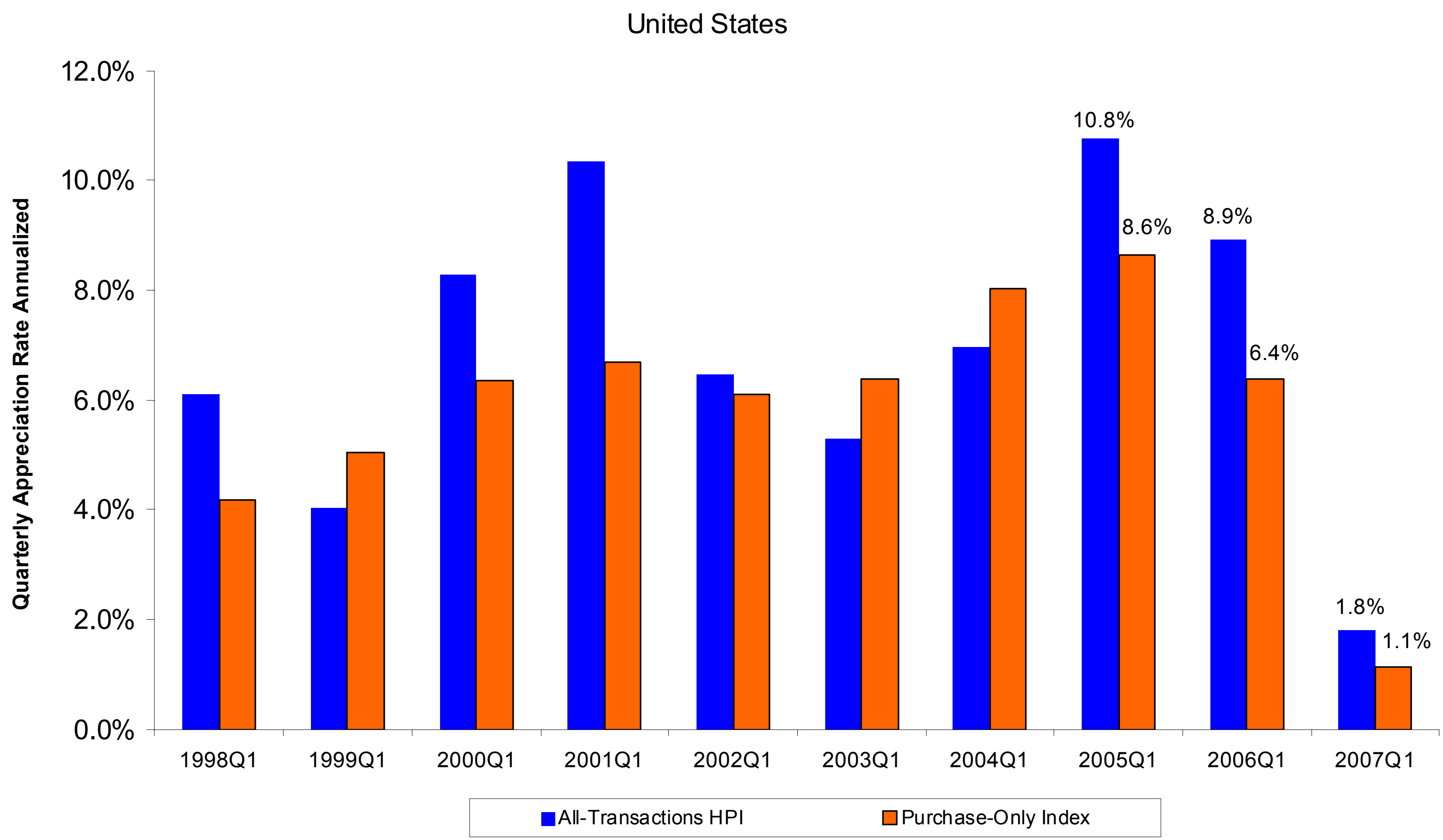


Contribution to Affordable Housing Goal About 30%

HOUSE APPRECIATION IS FALLING

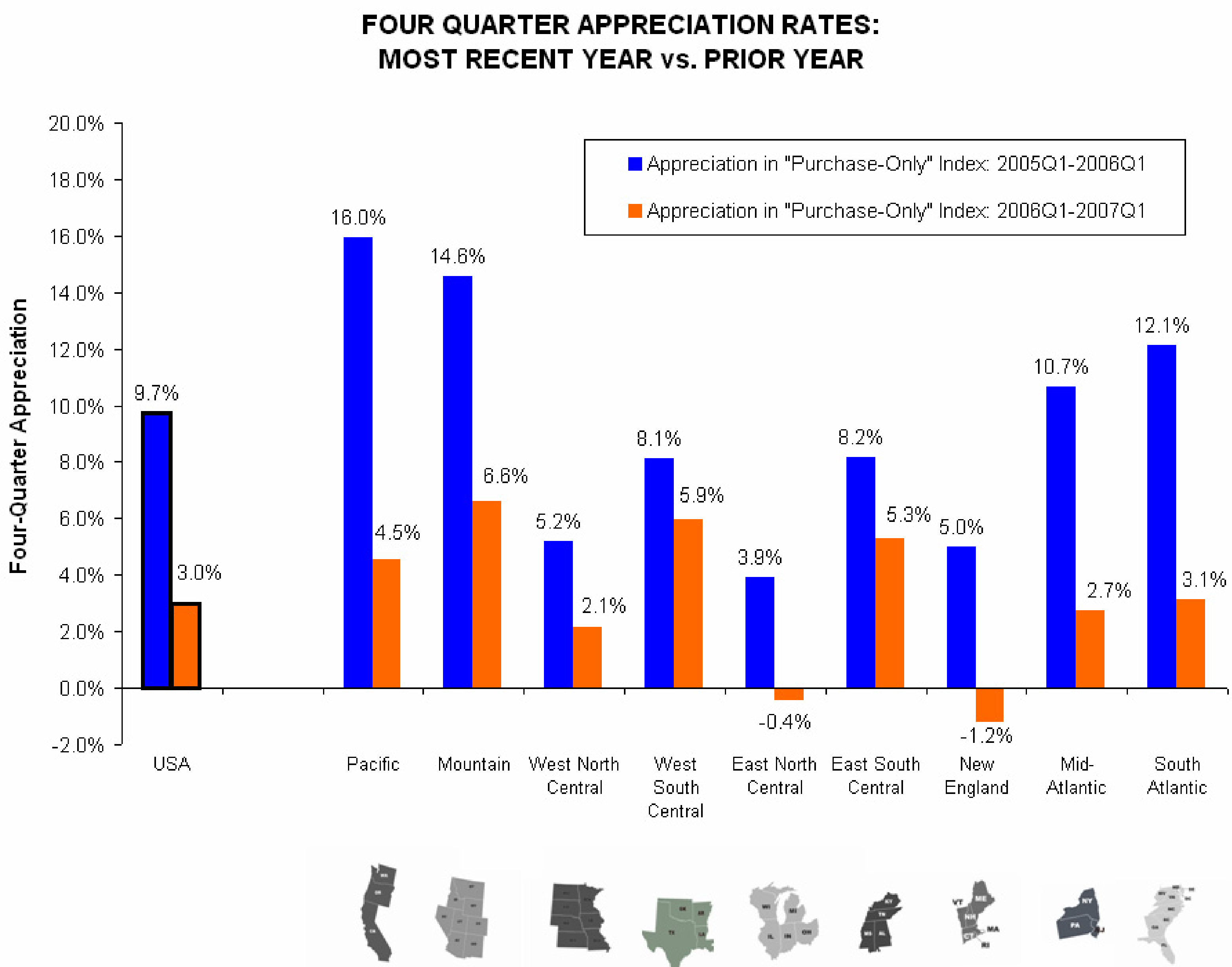
OFHEO

ANNUALIZED RATE OF HOME APPRECIATION IN FIRST QUARTER

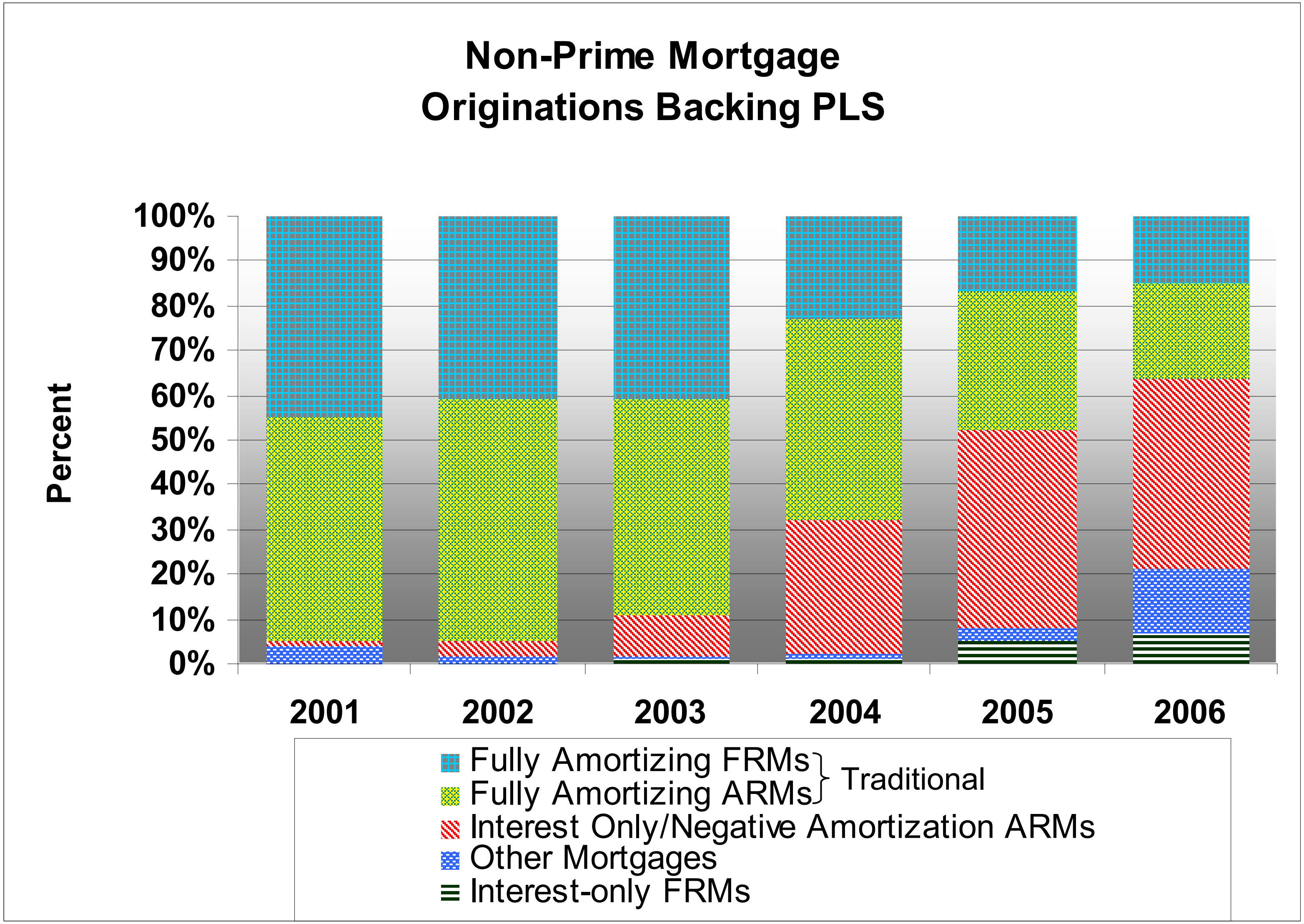


Note: These rates compare prices in each year's first quarter with prices in the fourth quarter of the previous year, with the percentage change annualized, not seasonally adjusted.

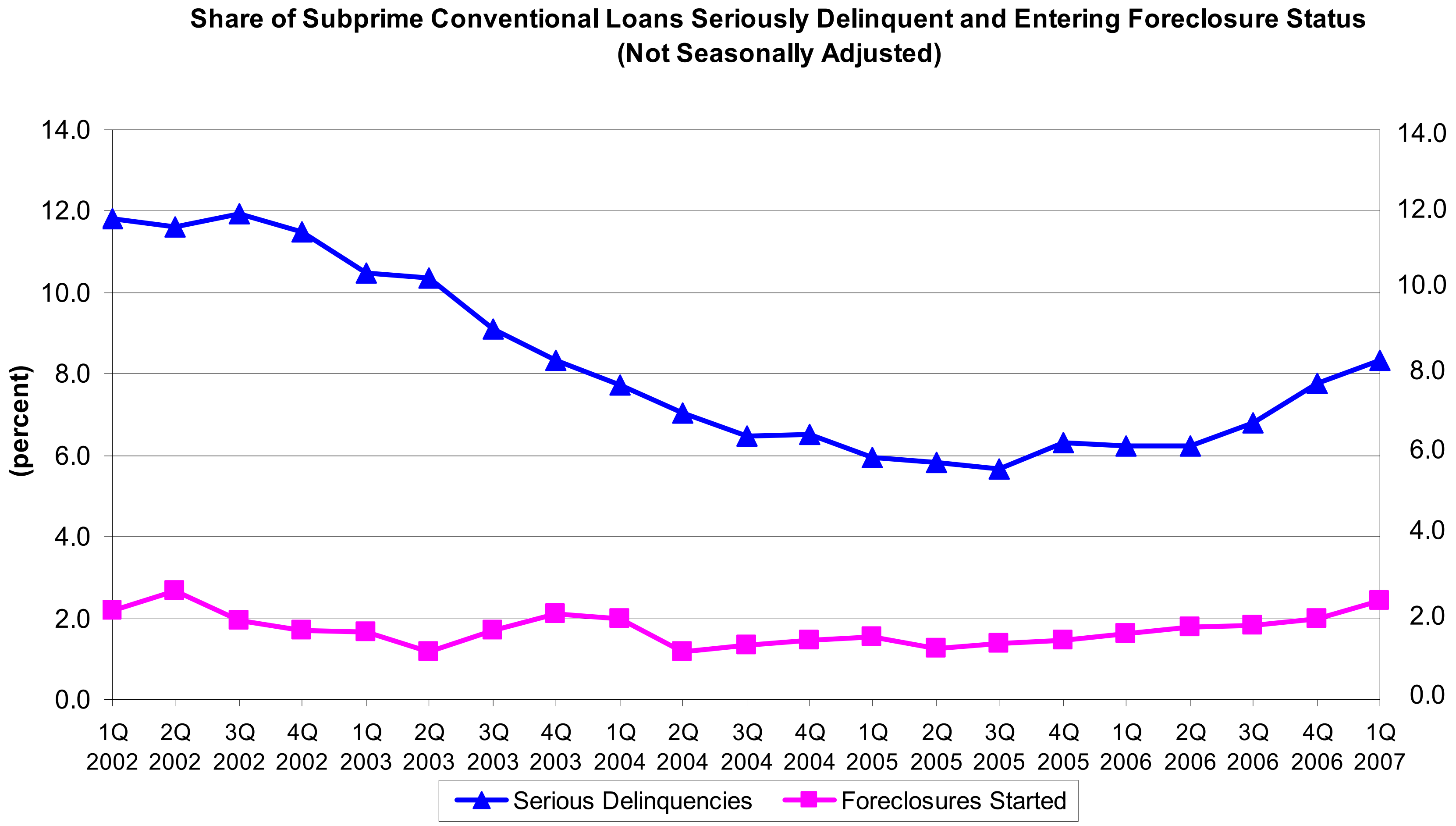
Appreciation Rates have Fallen Sharply



Shares of the Subprime Market 2001 - 2006



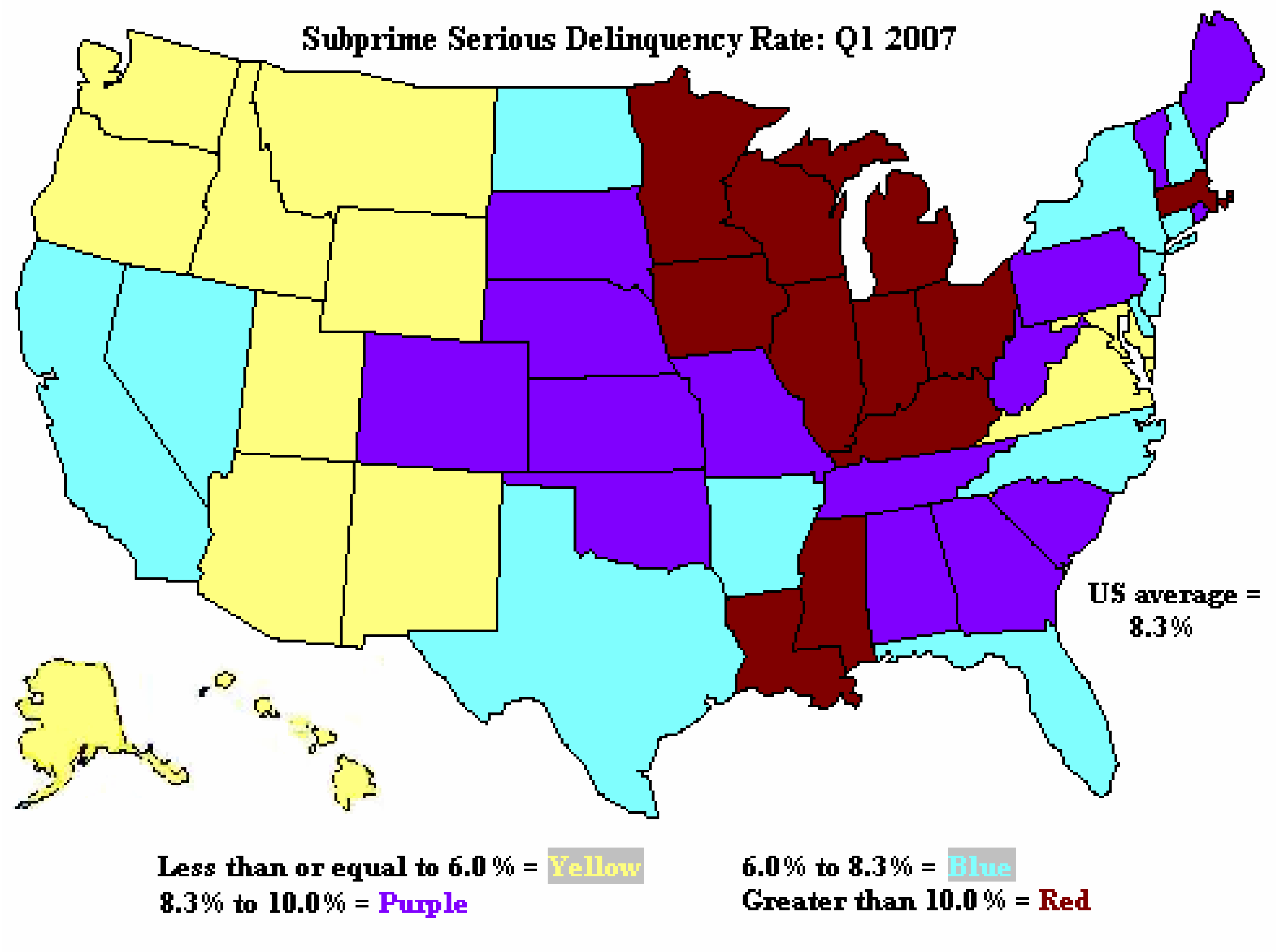
Subprime Delinquencies and Foreclosures Rising



Note: Seriously delinquent loans are 90 or more days delinquent or in foreclosure processing. Foreclosures started are loans entering foreclosure during the current quarter.

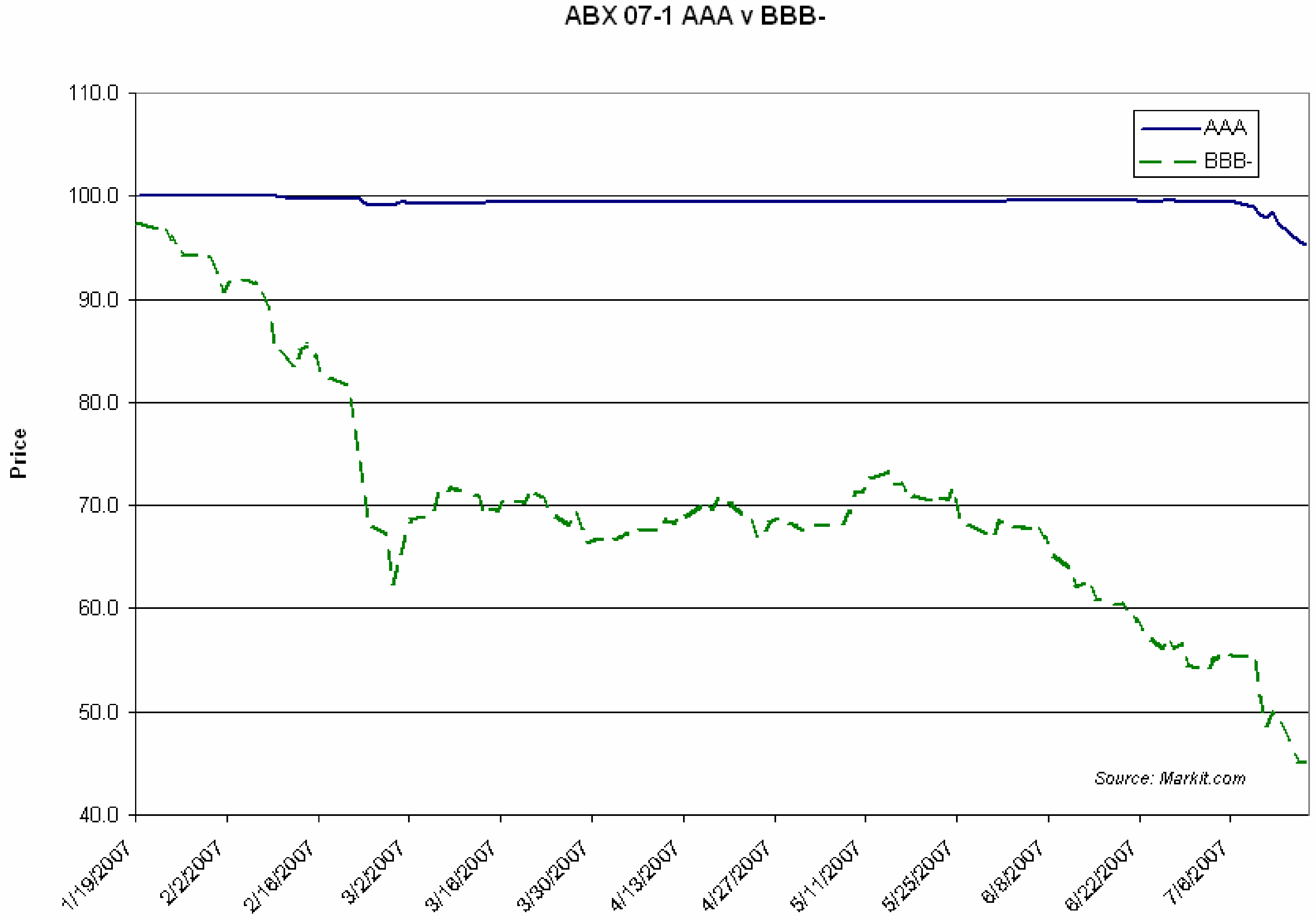
Source: MBA National Mortgage Delinquency Survey

Seriously Delinquent Subprime Mortgages



Source: MBA National Mortgage Delinquency Survey

Credit Options (ABX) Prices Fell Rapidly



Conclusion

- Housing is a key component of the U.S. economy
- Reformed subprime lending will help affordable housing growth
- It is time to create a new, stronger GSE regulator

OFHEO + FHFB + HUD = Stronger, safer U.S. Housing Finance System

mission compliance