CURRENT CHALLENGES TO GSE REGULATORY OVERSIGHT
JAMES B. LOCKHART III
DIRECTOR, OFHEO
ICBA WASHINGTON POLICY SUMMIT
WASHINGTON, DC
APRIL 23, 2007

Thank you for asking me to be your lead-off batter this morning at ICBA's Policy Summit. I recognize the importance of your almost 5,000 members to the housing finance system. I started my career at what was then considered a regional bank, the First National Bank of St. Paul, Minnesota with $1 billion of assets which would be a community bank today.

I note on Wednesday you have Chairman Frank as your clean-up batter. As I will be discussing later, I believe he hit a home run in crafting a bipartisan, balanced bill (H.R. 1427) that creates a new, stronger regulator for Fannie Mae, Freddie Mac and the 12 Federal Home Loan Banks (FHLBanks). I realize that all 14 are very important to your business and that they could do even more to support you. I believe this legislation will do that. We are hopefully in the ninth and last inning, some might even say the ninth year. With support from groups like ICBA, I believe that we can soon get legislation to strengthen the nation's housing financing system at a critical time.

Two weeks ago OFHEO sent to Congress, our 2006 Annual Examination Reports of Fannie Mae and Freddie Mac. As we are pressing Fannie Mae and Freddie Mac to be timely and transparent reporters, it is only appropriate that we act accordingly ourselves so we published our report two months earlier than required by law.

The report also discussed OFHEO's three strategic goals that are part of our new five-year strategic plan for meeting our mission of ensuring the safe and sound operation of Fannie Mae and Freddie Mac. (#2) These goals are:

1. Enhance supervision to ensure the Enterprises operate in a safe and sound manner, are adequately capitalized and comply with legal requirements;

2. Provide support for statutory reforms to strengthen our regulatory powers; and

3. Continue to support the national policy of an efficient secondary mortgage market which promotes homeownership and affordable housing.

In support of the first goal, the 2006 annual examinations of both Fannie Mae and Freddie Mac, summarized in this report, detail the current condition of both Enterprises. OFHEO concludes that both companies remain a significant supervisory concern. OFHEO also concludes that in 2006 both companies made progress in correcting their problems in systems, controls and financial reporting. Nonetheless, it has taken much more time and money to correct them than either the Enterprises or OFHEO expected.

Both companies are complying with a 30 percent additional capital requirement due to operational risk problems, and both are subject to specific limits on the growth of their portfolios. Despite these constraints necessitated by their operational weaknesses, their support of the mortgage market grew in line with the market by 8 percent in 2006 to $4.3 trillion as their guaranteed mortgage-backed securities (MBS) outstanding grew at double-digit rates. It is important to note that there are no constraints now or in the proposed legislation over their guarantee business which represents two-thirds of their total book of business.

A key indicator to OFHEO of a successful remediation will be the timely filing of annual and quarterly financial statements by each company with the Securities and Exchange Commission (SEC) with a clean audit opinion based upon a controls-based audit. I am pleased to report that both companies are working hard to achieve this goal, but they still have much to do. It is my hope that our next annual examination will have more positive news about the two Enterprises' remediation.

Housing Market Slow-down

Now let me turn to the third goal before addressing the second one of legislation. OFHEO's quarterly House Price Index (HPI) provides important information about the state of the housing markets. As measured by the HPI (#3), the nation's housing markets experienced a marked deceleration in home prices in 2006. After two years of double-digit rates of appreciation nationally, house prices increased at a more moderate pace, 5.9 percent, from the fourth quarter of 2005 to the fourth quarter of 2006 and only 4.1 percent for the purchase only index as shown in red. That was the lowest appreciation rate since 1999.

Some areas of the country have experienced particularly sharp decelerations as seen in the next chart. (#4) The most dramatic slowdowns have generally occurred in areas that previously exhibited the fastest appreciation. The blue bars report appreciation in 2006 and the red 2005 bars reflect appreciation between the fourth quarters of 2004 and 2005.

The graph clearly illustrates the breadth of the slowdown. With the exception of the South and East Central Divisions, which includes the states hit by Hurricanes Katrina and Rita, price appreciation was sharply lower in the most recent year. In the Pacific Census Division, for example, the four-quarter appreciation rate fell from about 19.7 percent in 2005 to 7.1 percent in 2006. California's decline played a big role in that sharp reduction. Appreciation in the South Atlantic Division fell from 18.3 percent to 7.3 percent, in no small part because of much weaker market conditions in Florida.

Subprime Market Problems

That is somewhat old news. The new housing news has been the problems in the subprime market, which represents about 15 percent of the total mortgage market; but it has been the fastest growing component.

The subprime news is not good, but I believe the problems will be manageable within existing markets, mortgage servicer's practices and financial institutions including community banks and the GSEs. We are going through a typical end of credit cycle correction. It is being moderated by the strong economy and relatively low interest rates. Subprime is bearing the brunt of this correction, which is not surprising given that the subprime market grew from 10 percent in 2002 and 2003 of new mortgages to 28 percent last year. One of the reasons for this growth was a deterioration in underwriting standards. (#5) From 2003 to 2006, the debt to income ratios grew rapidly and the percent of full documentation loans fell from 75 percent to only 55 percent. I do want to note here that it is generally agreed that mortgage lenders not regulated at the federal level contributed to that deterioration in standards. OFHEO is now working with the Enterprises on guidance that would have the effect of applying-- through the GSEs' market activities-- the strictures of federal guidances on these unregulated firms.

Additionally, it must be recognized that some of this recent lending supported unsustainable speculation by investors and, at the same time, put some people into mortgages that they could not afford. Going forward, underwriting standards must be strengthened in the subprime and non-traditional mortgage markets.

Although subprime mortgages defaults (#6) have been concentrated in the rust belt and Hurricane affected states, we are beginning to see rapid growth in the West Coast and Florida. As shown earlier they are the ones with the most rapid decline in house prices, but they are also some of the ones with the highest percentage of subprime mortgages.

Last week was subprime week in Washington. On Monday, OFHEO co-hosted the FDIC-sponsored subprime meeting with industry and other experts. Tuesday and Wednesday there were Senate and House hearings and meetings that Fannie Mae and Freddie Mac attended. I also met with both CEOs on their subprime initiatives.

One of the most important conclusions from these meetings is that it is much better for the borrowers and cheaper for the lenders to keep people in their homes and prevent foreclosures. The Enterprises can certainly play an important role in refinancing many of the better subprime loans. I was especially pleased to hear that they are going to roll out their existing programs to many more lenders. This should benefit community banks in particular. Given their many operational risk issues, we will be monitoring their implementation from a safety and soundness perspective. Market conditions like this only strengthen the message that they need to remediate their problems and that they need a stronger regulator.

It has been suggested by some that their present portfolio growth caps and extra capital requirements will lessen their ability to serve the growing need to get subprime borrowers into safer and less volatile mortgages. That is not true. As I said earlier, there is nothing constraining their ability to buy, guarantee and then sell mortgages packaged as MBS. And, they have enough excess capital above the current regulatory requirements to securitize over $1 trillion in additional MBS. Further, the Enterprises have an opportunity at this time to lead the market, as they have in the past, by the development or adaptation of programs in the MBS arena, this time with an eye toward greater transparency and equity in MBS standards for subprime mortgages.

They also have room within the caps to buy new subprime loans and hold them. Their combined excess retained portfolio capacity could fulfill their tens of billions of dollars of commitments over the next several years. More importantly, they own over $700 billion of their own guaranteed securities that could be easily sold to raise more capacity, if needed. Additional capacity for new holdings of subprime loans will also come from shrinkage in their current subprime holdings, which are mainly in the form of private label securities, as a large portion of the loans backing those securities refinance. Lastly, as under the proposed legislation, they can approach their regulator for relaxation of standards in times of market turmoil. In sum, there is nothing in the proposed legislation or present rules that prevent them from fulfilling their mission of providing stability and liquidity to the mortgage market. Their major constraint is and will be internal-- their systems and risk management capabilities.

Legislation

As to our second strategic goal, I am pleased that the House Financial Services Committee passed out of committee a strong bill that strikes a balanced approach to needed statutory reforms. H.R. 1427 provides the basic building blocks of a strong, bank-like regulator for the GSEs. Those building blocks are: (#7)

- Strong enforcement powers similar to those of federal banking regulators;
- Strengthened housing GSE oversight as a result of combining OFHEO with the Federal Housing Finance Board (FHFB);
- Combining safety and soundness authority with mission authority in a single regulator;
- Full regulatory independence by being out of the appropriations process;
- Full authority over capital; and
- Ability to regulate the Enterprises' portfolios.

Now is the time for action on this important issue. OFHEO looks forward to continuing to assist the Congress and the Administration as the legislative process moves forward.

New, Stronger GSE Regulator Needed

Housing and homeownership are critical components of the American dream and the American economy. The housing GSEs play an important role in both. Together the 12 FHLBanks, Fannie Mae and Freddie Mac through loans, advances, investments and MBS are involved in 46 percent of the total mortgage debt outstanding in the U.S.

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. (#8)

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.

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 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. Like other financial intermediaries, they incur risks to earn returns, but they should not take unnecessary risks. A key aspect of the GSEs' role is to be ready providers of credit under all market conditions. The regulator must ensure that they 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.

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. OFHEO believes H.R. 1427 provides the required six building blocks for a strong regulator:

1. Bank-Like Regulator Powers

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, in particular, 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.

2. Combine OFHEO with FHFB

All of the housing GSEs 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."

It is also critical that the new regulator respect the differences and similarities of the Enterprises and the Banks, a concern I know your group shares. Certainly their ownership and capital structures are different. Their missions and the regional characteristics of the twelve Banks should be preserved. Providing for equal deputies for each under the new regulator will also recognize and preserve distinctions.

A single housing GSE regulator for Fannie Mae, Freddie Mac and the FHLBanks creates within the government a single regulatory voice focused on the health and affordability of the housing finance markets, and how those markets connect countless local mortgage providers to broader capital markets. A level playing field should emerge regarding expectations for safety and soundness for all of the housing GSEs. In short, Fannie Mae, Freddie Mac, the FHLBanks and all Americans will benefit from having a single, more credible agency contributing to important policy discussions on the condition and role of the housing finance market and its interaction with the broader capital markets.

3. Mission Authority

Currently, authority over the charters of the Enterprises, their mission and new products, is placed within HUD. This split is different from the current practice for the banking regulators and the FHFB and is suboptimal. 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. Combining safety and soundness powers and mission and new product powers will allow for a comprehensive view of proposed new programs and products while preserving the important distinction between primary and secondary market activities.

4. Regulatory 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 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.

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. Without our full funding, planned resources in critical supervisory areas are being cut, impacting our ability to oversee Fannie Mae and Freddie Mac.

5. Capital Regulatory Authority

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.

The same 1992 statute that created OFHEO also prescribed a risk-based capital test that needs to be modernized. As a co-founder of a risk management firm that had several of the FHLBanks as clients, 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. 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, but supplemented with the ability to respond quickly to changing conditions.

6. Retained Portfolios Regulatory Authority

It is clear that 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, the Enterprises' largest business of guaranteeing MBS grew four-fold, and yet the portfolios of the Enterprises have grown ten-fold. (#9) 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.

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. (#10) Although these MBS contain some affordable loans, it would be double counting to count them when they are securitized, and in their portfolios.

The bill's language ensures that any growth limits would not be arbitrary as it specifically requires the new regulator use an open, notice and comment rule-making that will allow all interested parties to provide input on the proposal. I believe this is a fair balance between appropriate regulatory oversight and the legitimate profit-making and market support activities of the Enterprises.

It will not limit the ability of Fannie Mae and Freddie Mac to purchase mortgages from you, their community bank customers. 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 as you can see the in the two greens in the graph. (#11) In particular, as you can see in the dark green, 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 to $4.3 trillion because their guaranteed MBS, in blue, 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.

Conclusion

This year will be one of challenges for the housing markets. OFHEO is working with the Enterprises to provide guidance on subprime and non-traditional mortgages. It should also be a year of significant progress as Fannie Mae and Freddie Mac accelerate their remediation programs. It is my hope that an enhanced new regulatory regime, as proposed by the Congress and the Administration, will be enacted to benefit all the stakeholders in the nation's housing finance system.

Challenges to GSE Regulatory Oversight

James B. Lockhart III, Director
Office of Federal Housing Enterprise Oversight
ICBA Washington Policy Summit
April 23, 2007
Washington, DC

OFHEO's Strategic Goals

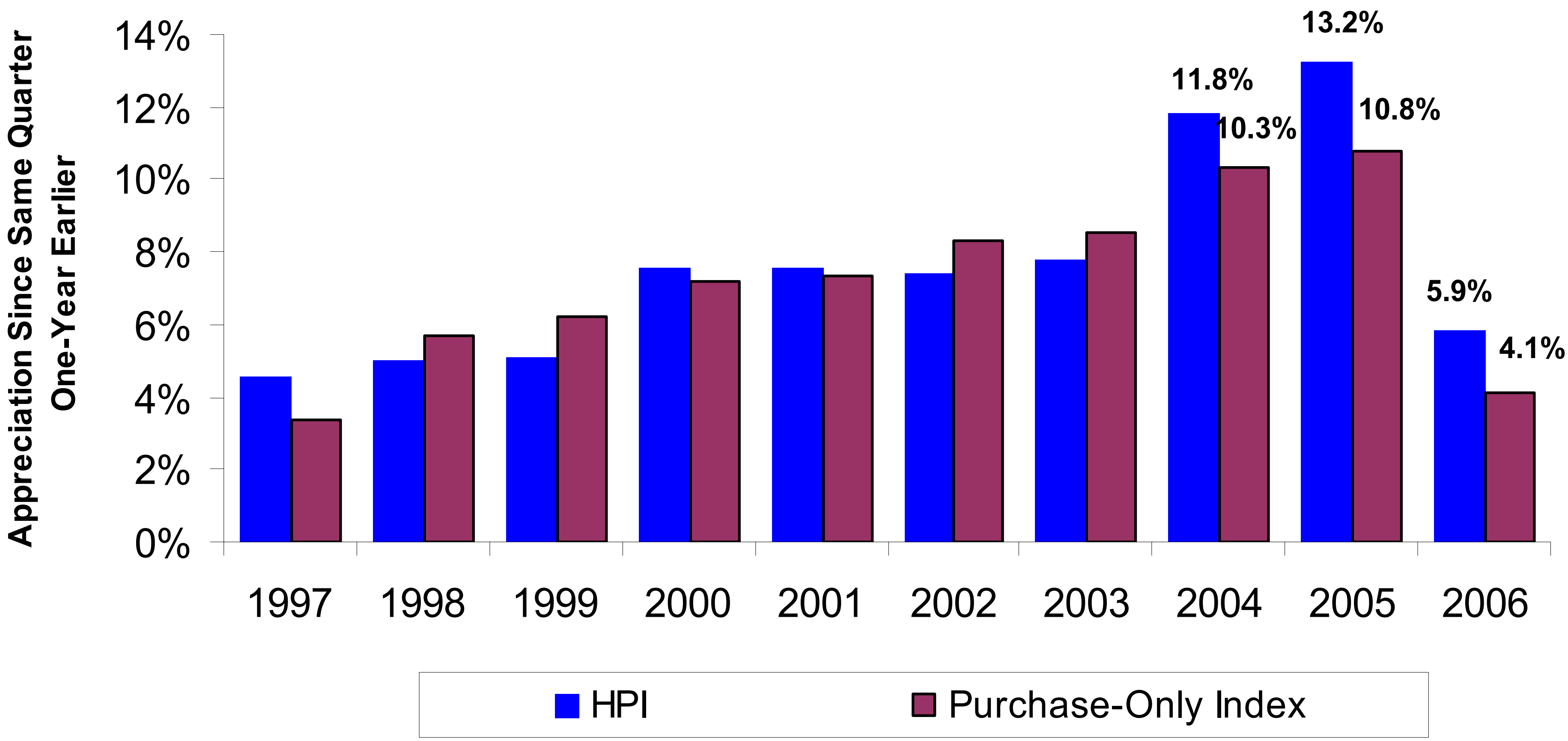
1. Enhance supervision to ensure the Enterprises operate in a safe and sound manner, are adequately capitalized and comply with legal requirements.

2. Provide support for statutory reforms to strengthen our regulatory powers.

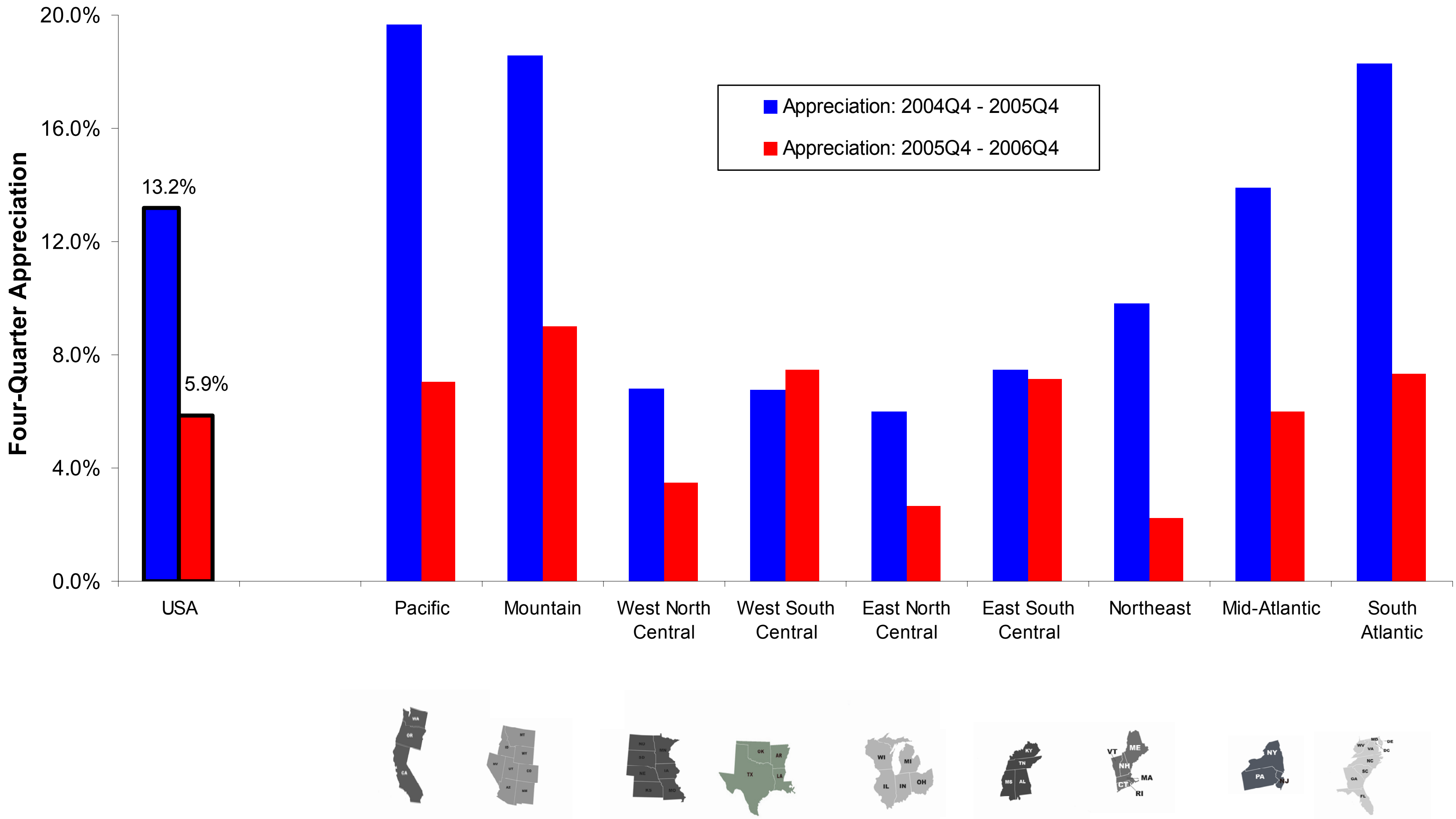
3. Continue to support the national policy of an efficient secondary mortgage market which promotes homeownership and affordable housing.

HOUSE APPRECIATION IS FALLING

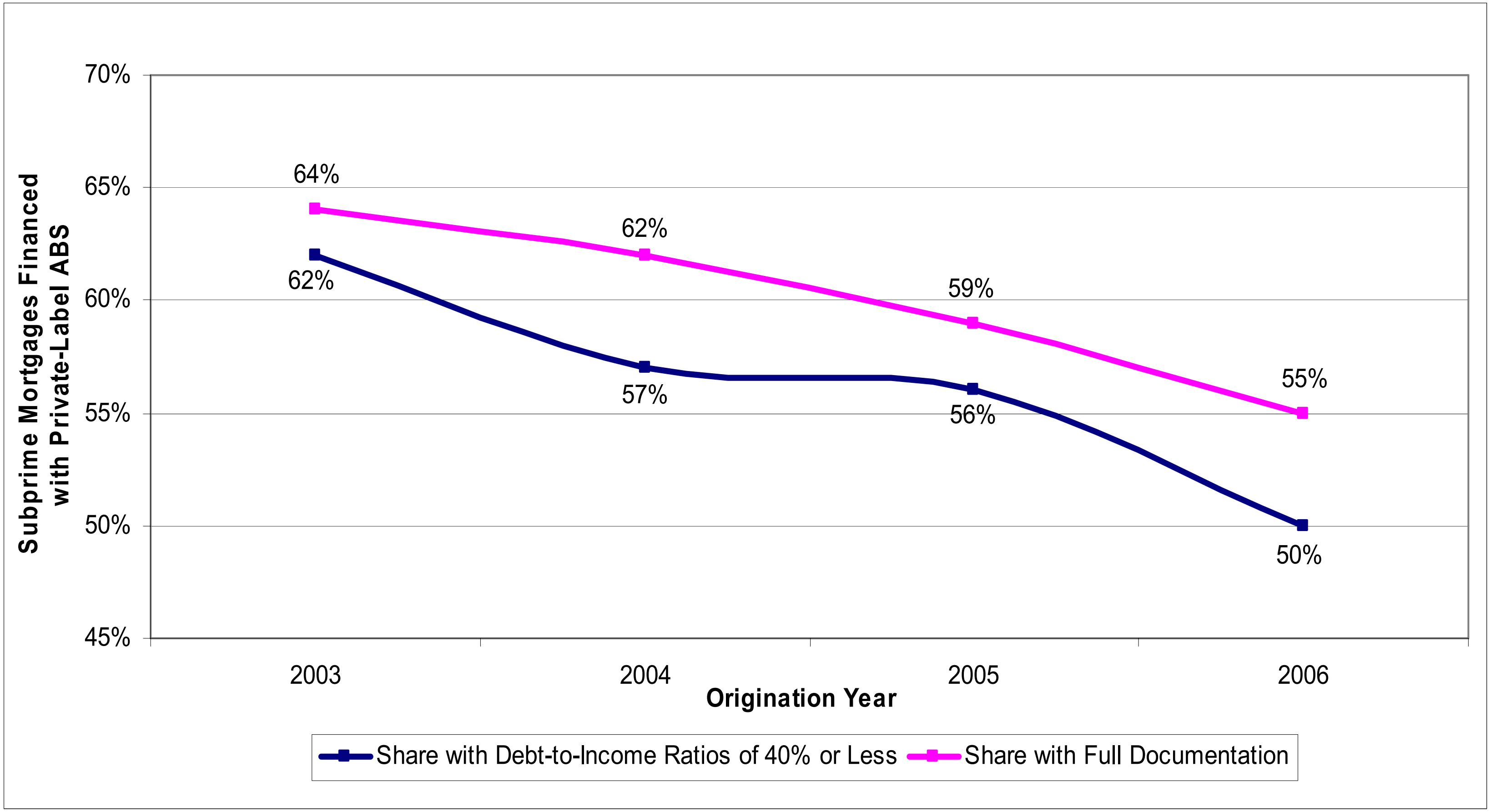
HOUSE PRICE APPRECIATION OVER PREVIOUS FOUR QUARTERS: USA



Appreciation Rates have Fallen Sharply

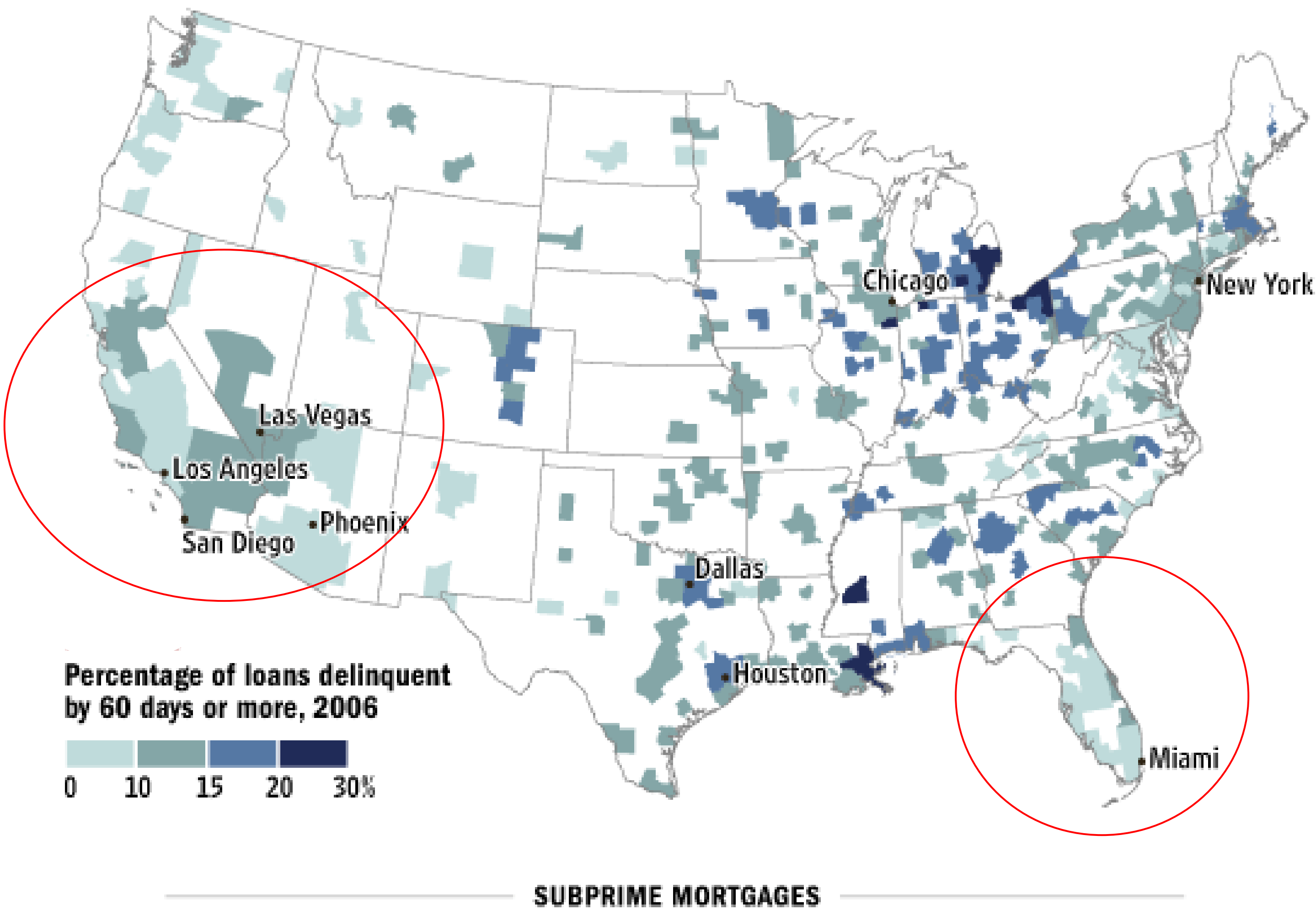


Subprime Underwriting Has Deteriorated



Source: OFHEO based on LoanPerformance.com data

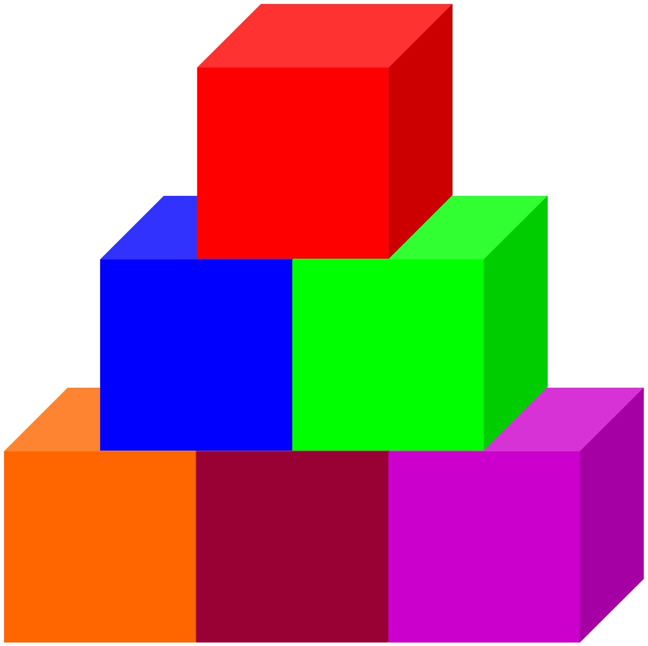
Subprime Delinquencies in 2006



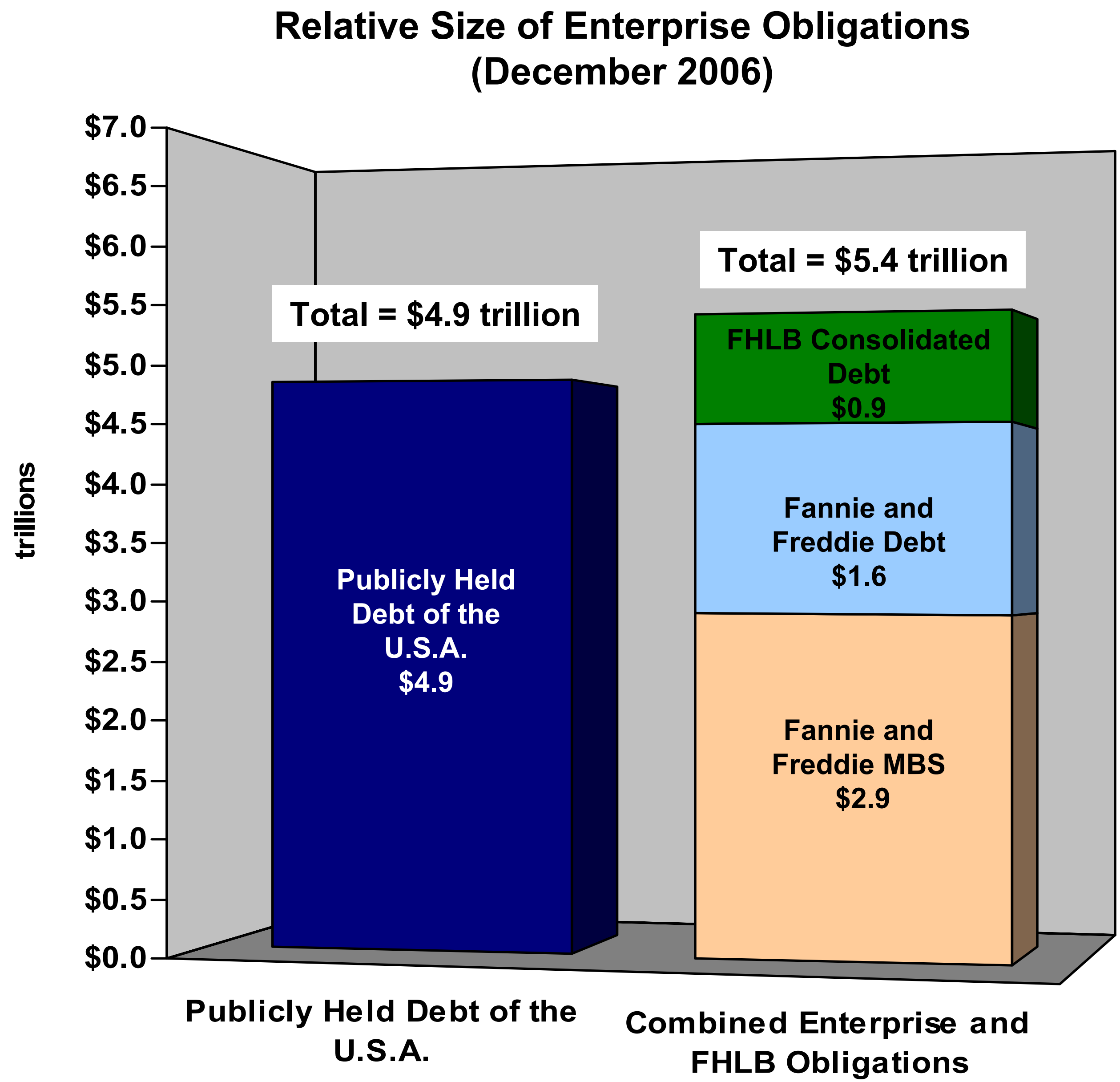
Source: WSJ

Building Blocks of New, Stronger Regulator

- Bank-Like Regulator Powers
- Combine OFHEO with FHFB
- Mission authority
- Regulatory independence
- Capital regulatory authority
- Retained portfolios regulatory authority

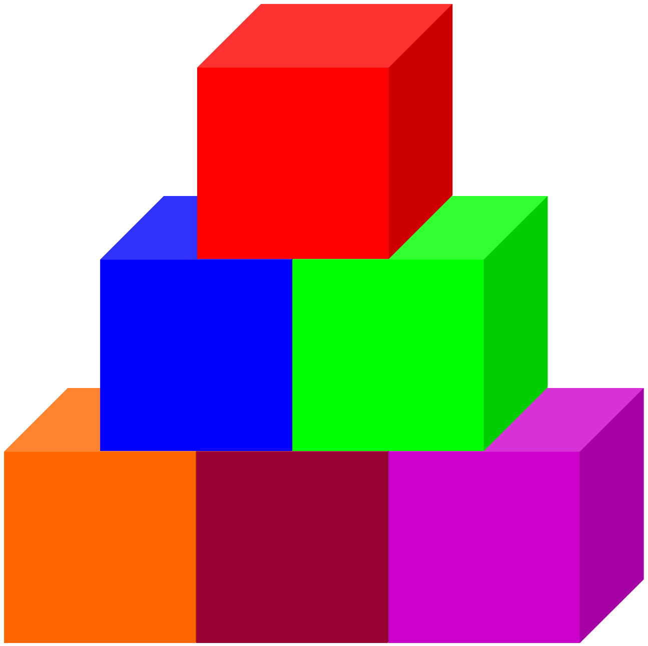


The Housing GSEs are Huge

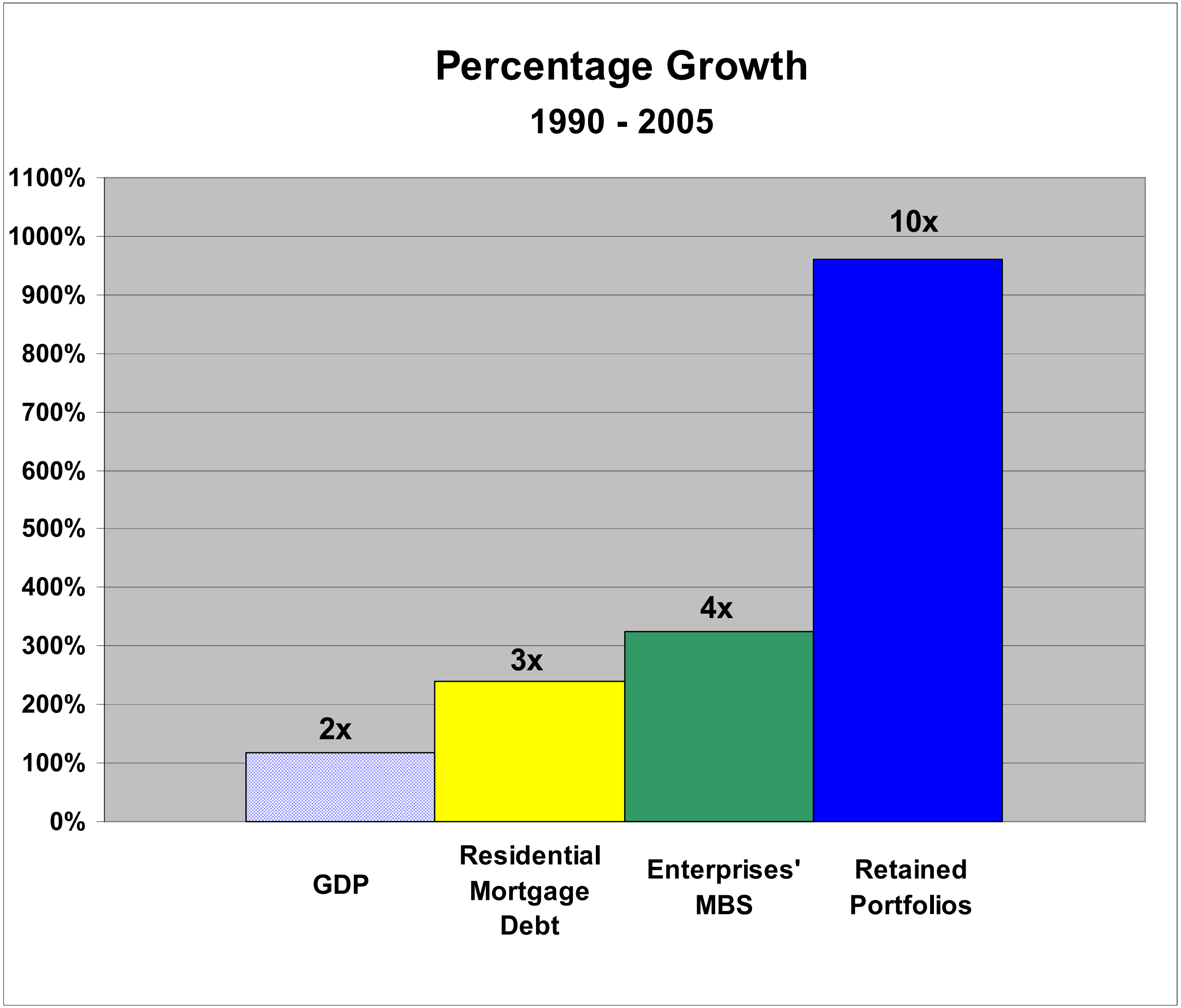


Building Blocks of New, Stronger Regulator

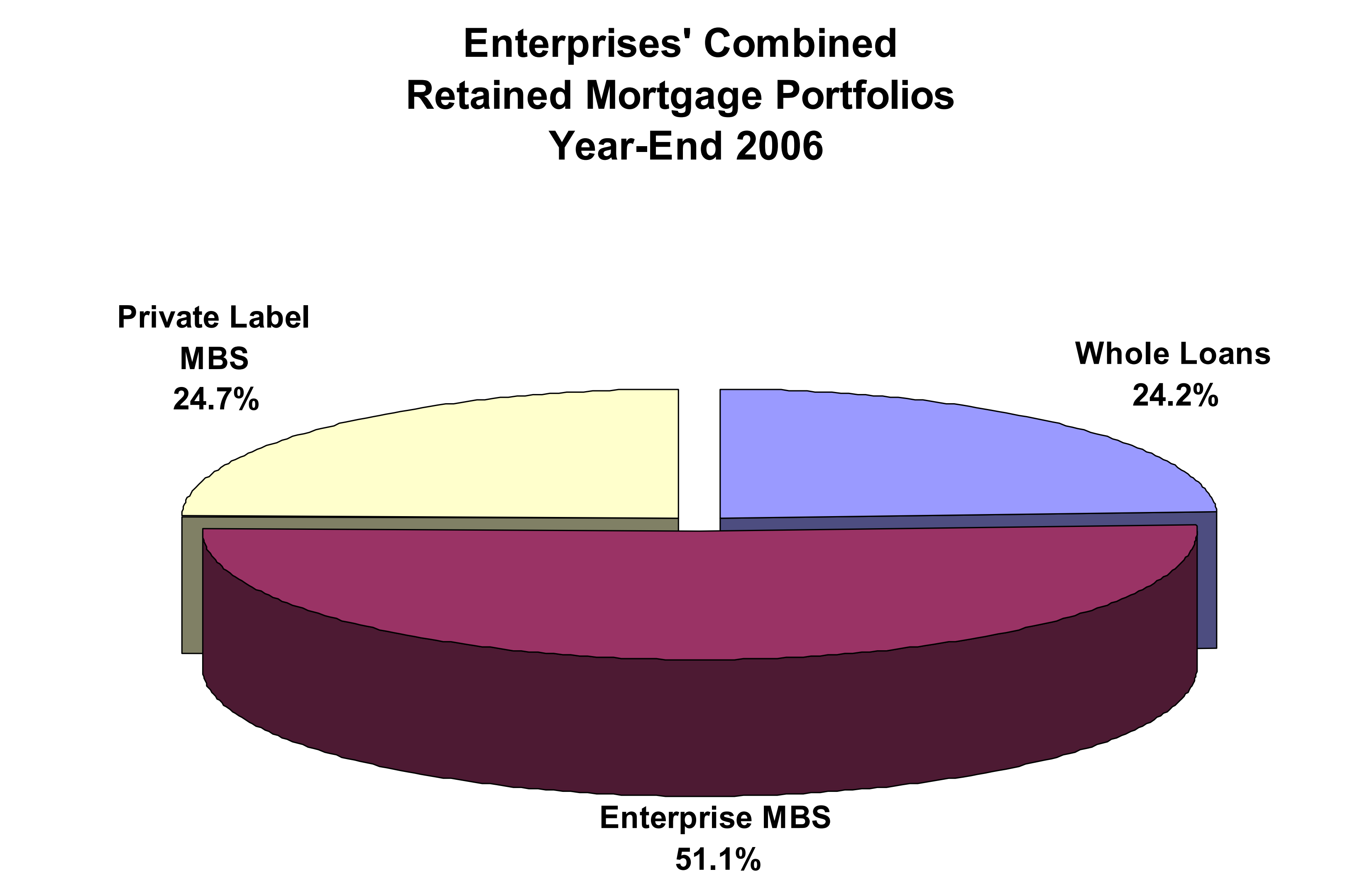
- Bank-Like Regulator Powers
- Combine OFHEO with FHFB
- Mission authority
- Regulatory independence
- Capital regulatory authority
- Retained portfolios regulatory authority



Enterprises Have Grown Very Rapidly

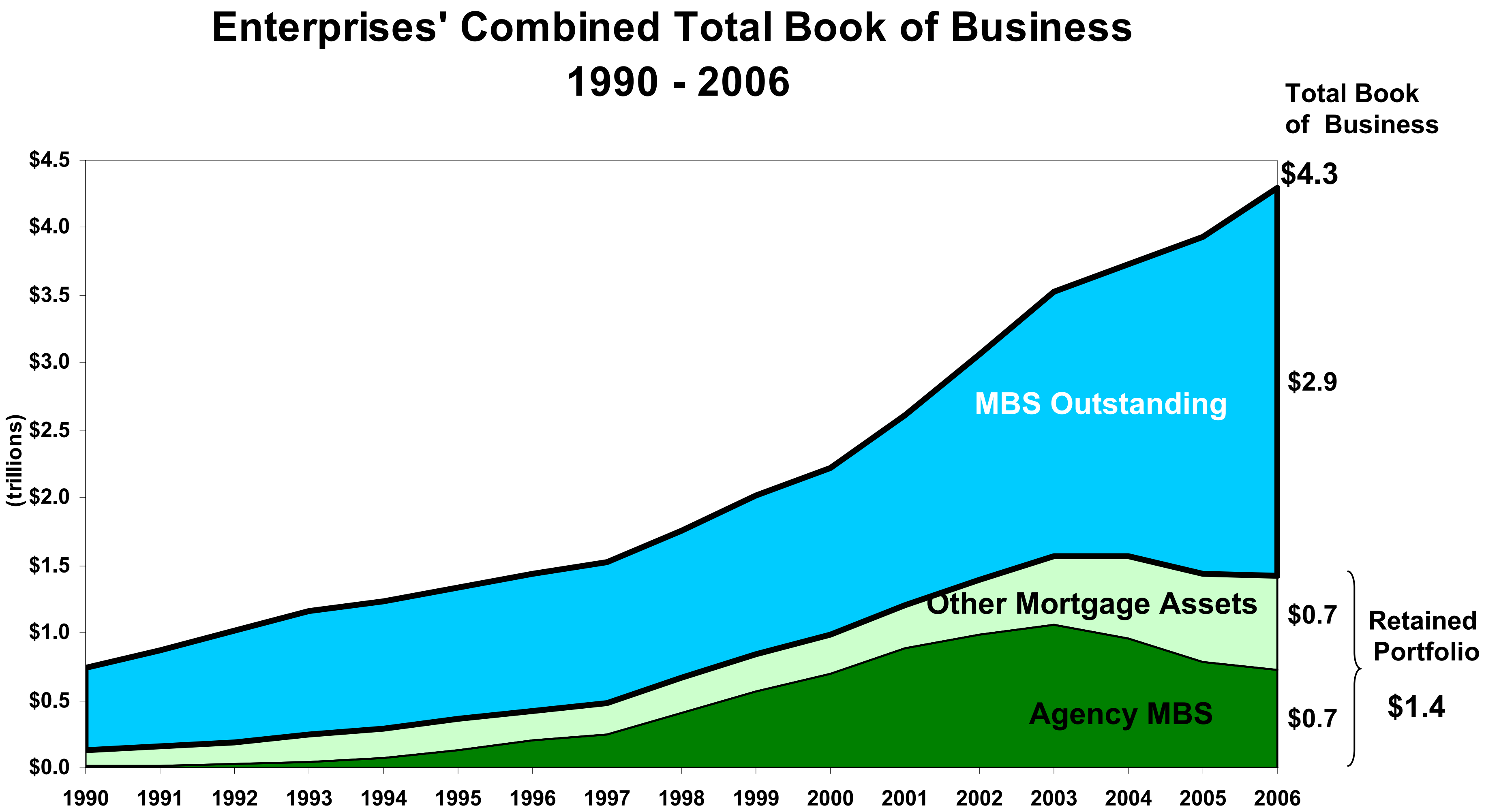


Portfolios Dominated by Own MBS



Contribution to Affordable Housing Goal Less Than 30%

Combined Book of Business Continues to Grow



www.ofheo.gov