

SECURING THE BUILDING BLOCKS OF OUR HOUSING FINANCE SYSTEM
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Thank you for the opportunity to speak today before America's Community Bankers Annual Real Estate Lending Conference. I look forward to sharing with you my perspective on OFHEO, our agency's regulatory oversight of Fannie Mae and Freddie Mac and how best to secure the foundation of our housing finance system. The cement is legislation to create a new, stronger regulatory agency that would oversee Fannie Mae, Freddie Mac and the 12 Federal Home Loan Banks (FHLBanks).

Overview

OFHEO's mission is "to promote housing and a strong national housing finance system by ensuring the safety and soundness of Fannie Mae and Freddie Mac." That is a very tall order for a small agency that does not have all the tools needed to do the job. We are utilizing the tools we have, but they are just not adequate.

The housing finance system is extremely large with well over \$10 trillion in mortgages outstanding -- Fannie and Freddie represent 40 percent of that total. One comparison I like to make is when you add Fannie's and Freddie's outstanding debt and mortgage-backed securities (MBS) to the FHLBanks' debt outstanding of \$900 billion, the total equals \$5.2 trillion, which is bigger than the \$4.9 trillion publicly held debt of the U.S. (Slide #1)

Unfortunately, Fannie Mae and Freddie Mac lost sight of their mission in the late 1990s and early 2000s and used their GSE status to grow out of control. Both companies misapplied accounting rules and manipulated earnings while neglecting to build adequate accounting systems, internal controls and risk management disciplines. Even though these Enterprises are listed on the New York Stock Exchange they have not been able to put out current financial statements for four years and it may take them another year. Unfortunately, OFHEO did not have the tools or resources to help prevent the problems.

And their role in today's housing market is particularly important. The housing market is currently in a state of transition. House price appreciation, as measured by OFHEO's House Price Index (HPI), has decelerated dramatically from the rates of the last few years. OFHEO's latest data suggest that house prices grew only 3.5 percent on an annualized basis from the second to the third quarter of 2006. (Slide #2) This rate pales in comparison to the unsustainable quarterly rates of 17.7 percent and 14.5 percent we were seeing in 2004 and 2005. Virtually all other indicators suggest a far different landscape

than we have seen in recent years: inventory levels are way up, housing starts are down, mortgage activity has declined, and mortgage delinquency rates are on the rise.

As you know more than most, navigating these waters are difficult for even the best run companies. The Enterprises, with their significant operational deficiencies, will be even more challenged. The growing uncertainty associated with future house price appreciation will make it difficult to manage credit, as well as market risk. We need a strong regulator to ensure that they are adequately managing their risks and to make certain their capital buffer is sufficient to weather market conditions.

Although the Enterprises are not subject to the new, international banking capital rules, Basel II, it is instructive to compare their regulatory environment to the three pillars that Basel II uses. (Slide #3) The three pillars are capital rules, regulatory strength and market discipline. As I will discuss, the capital rules and regulatory powers of OFHEO are weak compared to those of the bank regulators, and the debt markets provide very limited discipline because of their GSE status and the so-called “implicit” Federal guarantee. The lack of market discipline relative to that faced by banks and other financial institutions makes capital and regulatory oversight of the GSEs even more important.

Goals for 2007 – Strengthen Supervisory Activities

In 2007, we will build upon our 2006 accomplishments. (Slide #4) Our top priority and **first** goal is to further strengthen the agency’s supervisory activities to ensure the Enterprises operate in a safe and sound manner.

- We continue to work on overseeing the remediation efforts necessitated by the Enterprise’s management failures. Both continue to have major operational risk and technology issues. Both need to return to timely filing of their financial statements.
- We continue to make sure both Enterprises are adequately capitalized, a task that is made more difficult by lack of up-to-date audited financial statements.
- We are beefing-up the exam program by conducting targeted, risk-based exams.
- We are conducting an agency-wide regulatory initiative, which will include looking at conforming loan limit rules to address what happens if there is a decline in housing prices.

Enhanced Authorities through Legislation

Secondly, we will continue to support legislation for a stronger and more independent regulator for Fannie Mae and Freddie Mac and the FHLBanks. While we came close last year, we simply must get the ball across the goal line this year.

Legislation will give the new regulator the powers that it needs to prevent the Enterprises from growing out of control again. These Enterprises own or guarantee \$4.2 trillion of residential mortgages in the U.S., across their two lines of businesses:

- The largest and primary business is \$2.8 trillion of guaranteed MBS.
- The second and more volatile business is the \$1.4 trillion mortgage portfolio holdings, including their own and others' MBS.

If you total the FHLBanks (Slide #5) with Fannie Mae and Freddie Mac mortgage holdings and guarantees, they represent 46 percent of mortgage debt outstanding at the end of the third quarter 2006. In 2003, their market share peaked at nearly 54 percent. Despite the 3 year drop, which was caused by the Enterprises' problems, the GSEs still dominate the U.S. mortgage market.

This dominance and the importance of the mortgage market to the American economy are key reasons why they need a strong regulator. The good news is that there is strong bipartisan support for reform legislation. In that regard, I would like to acknowledge ACB's support of this legislation.

Key components of GSE reform legislation are (Slide #6):

Bank Regulator-Like Powers

The new regulator needs the strong powers a bank regulator has to help prevent future problems. 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. Enhanced enforcement powers, including those that address misconduct by employees, directors, and affiliated parties, are needed too.

Independence

Regulatory independence must be strengthened, including independent litigating and budgeting authorities. 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 Enterprises. We have a painful example today as to why this is important. Congress is expected to complete action on a Continuing Resolution, which will freeze our budget at last year's level. This results in a \$60 million budget for OFHEO, 11 percent lower than President Bush's budget request.

Without this \$7.6 million in additional funding, planned resources in critical supervisory areas will be cut, threatening our ability to monitor the safety and soundness of the Enterprises. In comparison to our small budget, Fannie Mae and Freddie Mac are spending billions of dollars to fix their problems.

Combining OFHEO and the FHFB will also provide greater regulatory muscle, independence and capability to ensure the safety and soundness of the U.S. mortgage market. It will also enhance OFHEO's affordable housing knowledge.

Combine Mission and Safety and Soundness Authority

Currently, authority over the charters of the Enterprises, their mission, and new products is placed in HUD. FHFB regulates both the mission and safety and soundness of the FHLBanks. Bank regulators also have combined powers. A stronger GSE regulator needs the combined safety and soundness oversight and responsibility for mission compliance and new product approvals.

Flexible Capital Requirements

Presently, the Enterprises 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 on assets and 0.45 percent on MBS outstanding. To be considered well-capitalized, banks must have 5 percent and hold significantly more "excess" capital than the Enterprises do. The Enterprises are now running at higher capital levels as OFHEO imposed a 30 percent capital surcharge on each due to their ongoing problems. They also have built a cushion on top of that, which is certainly more comfortable than the 2.5 percent level under present law.

In addition, OFHEO's risk-based capital requirements have been too constrained by the 1992 law and are much lower than the minimum capital requirements. 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. More flexibility to enhance capital requirements is a critical component of the future regulation of the Enterprises and would be more comparable to the authority banking regulators have in setting capital requirements.

Portfolio Regulation

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

The huge size of their portfolios is not required by their mission. Less than 30 percent of their portfolios contribute to meeting their affordable housing goals and over half of their portfolios are in their own MBS. (Slide #8) If growth is not tied to their mission, the portfolios could pose increasing risk to financial markets.

The regulator needs the flexibility to write a regulation based upon clear congressional guidance. While not perfect, I believe the compromise achieved near the end of the 2006 congressional session achieved that objective.

It is designed to focus the portfolios tightly on their missions which include affordable housing, and stability and liquidity of the secondary market for residential mortgages. It also states that potential risks posed by their holdings should be considered by the regulator. A regulation would occur under a notice and comment rule-making, allowing all interested parties to comment on the proposed rule. An area to consider will be that largest pie slice, their MBS portfolios, which does not add to achieving affordable housing goals and yet create unnecessary market and operational risks. Many of these MBS could have been easily sold directly to the market. As this graph depicts (Slide #9), the recent shrinkage of their portfolios, which was necessitated by their problems, was achieved by the run-off and sale of almost \$300 billion of their MBS. Despite this reduction, the MBS market has continued to strengthen.

Portfolio regulations would do nothing to impede the Enterprises ability to support the mortgage markets by guaranteeing MBS packages. Their ability to fulfill their important public mission of providing liquidity and stability to the market, supporting affordable housing and responding appropriately to private capital markets could be enhanced over time as investors purchase more agency MBS and less Enterprise debt.

Affordable Housing Fund

There are other issues being discussed in the context of GSE reform. As you all know, an Affordable Housing Fund is a priority issue for House Financial Services Committee Chairman Frank. While managing the Fund is not a responsibility that OFHEO seeks, if it is in the legislation that passes, we will certainly do our best to implement the statute quickly. Issues of concern to the Administration – that the Fund not be controlled by the Enterprises, that it not be based directly on profits, and that there be a sunset – have moved in the right direction. Another question is whether there will be a cap on annual contributions. A last concern we have is that there should be tight controls around the Fund so that it is appropriately and effectively distributed.

Affordable Housing Goals

The proposed Affordable Housing Goals address the need to equip the regulator with stronger enforcement powers – for mission oversight and safety and soundness. This is a crucial improvement as are the closer targeting of Enterprise activities to the low and moderate income families they are meant to serve, the better alignment of Enterprise goals with the Community Reinvestment Act goals, and the specific requirements for Enterprise purchase of mortgages for smaller multifamily projects.

Strong Housing Finance System

Successfully achieving the first two goals will contribute to OFHEO's **third** goal (Slide #10) of supporting an efficient secondary mortgage market, which promotes homeownership and affordable housing. Other ways we will look to contribute to this objective are to continue to improve on our HPI, publish reports and research to increase understanding of mortgages and the mortgage markets, communicate with stakeholders,

and cooperate with other Federal agencies. On the research side, an area of growing interest that we are examining is conforming loan limits. A current example of our work with other Federal agencies is the recent guidance on nontraditional mortgage activities.

Late last year, OFHEO directed the Enterprises to develop mechanisms to support practices outlined in an interagency guidance by the bank regulators on nontraditional mortgage products. We are directing the Enterprises to incorporate the principles of that guidance into their risk management and business practices. I believe this will enhance the overall level of underwriting standards, risk management practices and consumer protection in the mortgage market. This guidance should include mortgage loans backing the securities in which they invest.

Conclusion

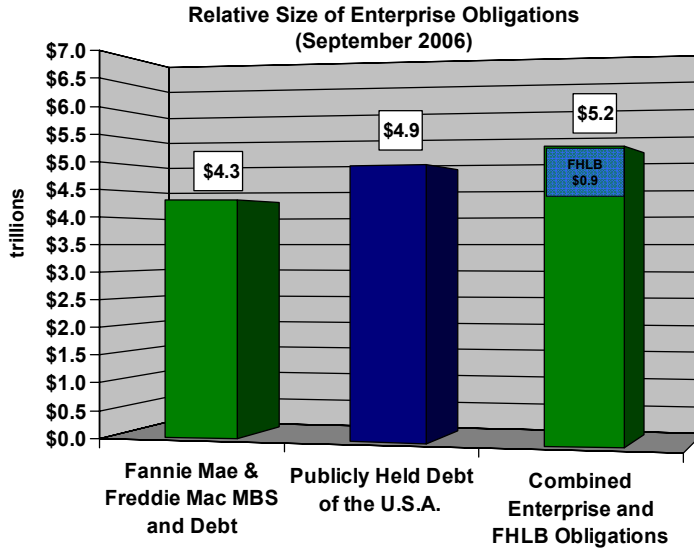
I have talked a lot today about having a stronger regulator, but that is not just for the sake of having a stronger regulator. It is to ensure that the housing GSEs are strong and do an even better job of supporting the mortgage market in the U.S. As both Fannie Mae's and Freddie Mac's CEOs have told me, a stronger regulator will help restore their image in the marketplace. And, as I have told them, there is no point in having a strong regulator if the Enterprises are too weak to fulfill their missions. Therefore, the reforms should be directed to ensuring that Fannie Mae and Freddie Mac do a better job of fulfilling their missions while reducing unnecessary risk. After their remediation efforts are complete and legislative reforms including the capital and portfolio regulations are implemented, there is no reason why these two Enterprises could not produce a competitive rate of return on equity and grow with the mortgage market.

A new, stronger and independent regulator with the powers similar to those of bank regulators is needed to oversee Fannie Mae, Freddie Mac and the Federal Home Loan Banks. All are important to our housing market, the economy and the American dream of homeownership. We have made much progress, but we need more tools. I am encouraged by the bipartisan statements supporting GSE reform, including Chairmen Dodd and Frank and Ranking Members Senator Shelby and Congressman Bachus. Certainly, there is strong support in the Administration, including President Bush and Secretaries Paulson and Jackson. Many groups, including the ACB, have endorsed reform. Fannie Mae and Freddie Mac have also repeatedly said that they support reform legislation.

We all agree that the GSEs have a very important public mission of supporting affordable housing and helping to ensure the foundation of the nation's housing finance system. The proposed legislation should ensure that they remain safe and sound and that they and the system remain strong.

Thank you.

The Enterprises are Huge

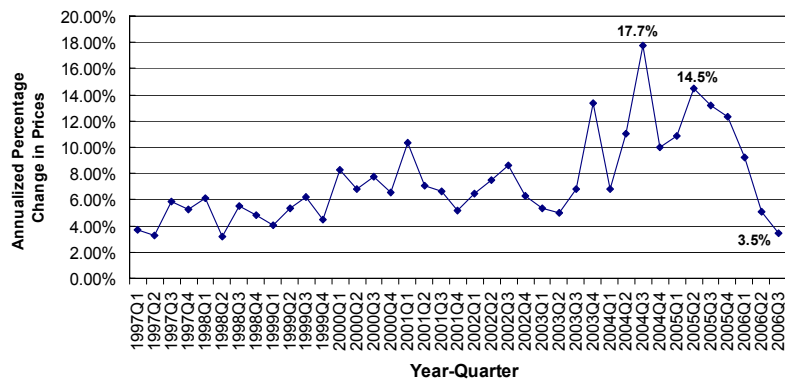


1

State of the U.S. Housing Market



OFHEO HOUSE PRICE INDEX FOR USA
Quarterly House Price Quarterly Appreciation -- Annualized
1997 - 2006 Third Quarter



2

Basel II Pillars



Today



Result: Unconstrained growth led to operational problems and mismanagement

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OFHEO's Strategic Goals



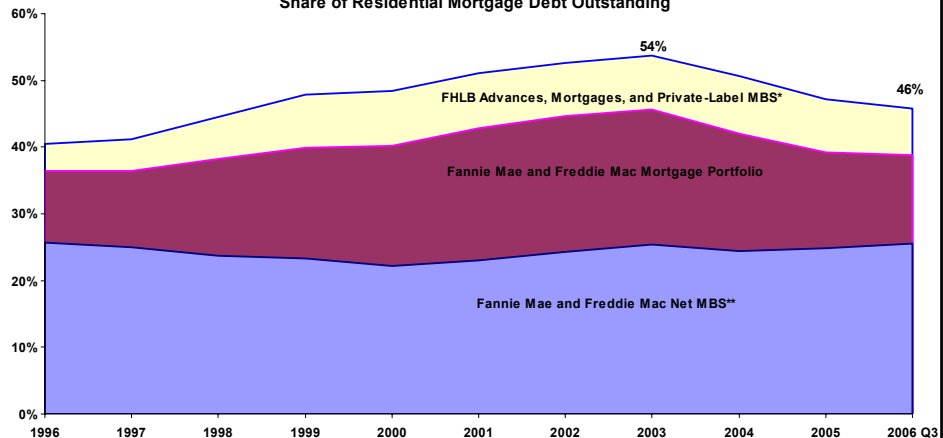
1. Enhance supervision to ensure the Enterprises operate in a safe and sound manner, are adequately capitalized and comply with legal requirements.
2. Provide support for statutory reforms to strengthen our regulatory powers.

4

GSEs Dominate the U.S. Mortgage Market



Housing Government-Sponsored Enterprise Involvement in Mortgage Markets as a Share of Residential Mortgage Debt Outstanding



* 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.

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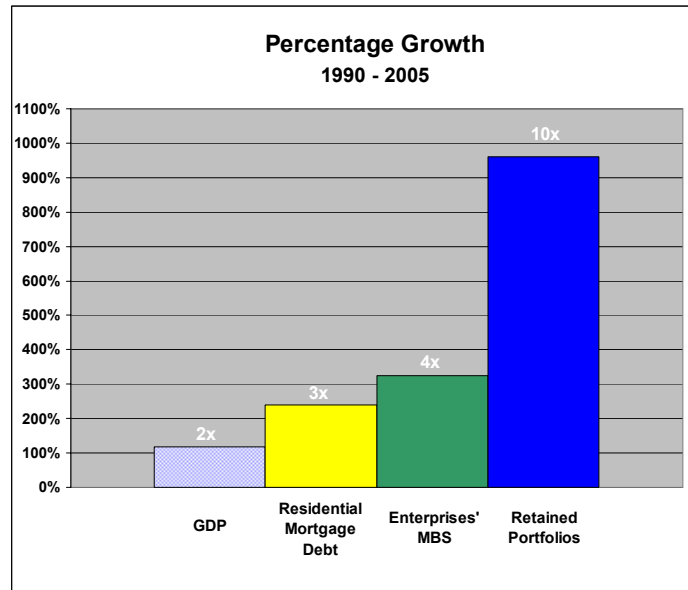
Key Components of GSE Reform Legislation



- Bank Regulator-Like Powers
- Independence
- Combine Mission and Safety and Soundness Authority
- Flexible Capital Requirements
- Portfolio Regulation

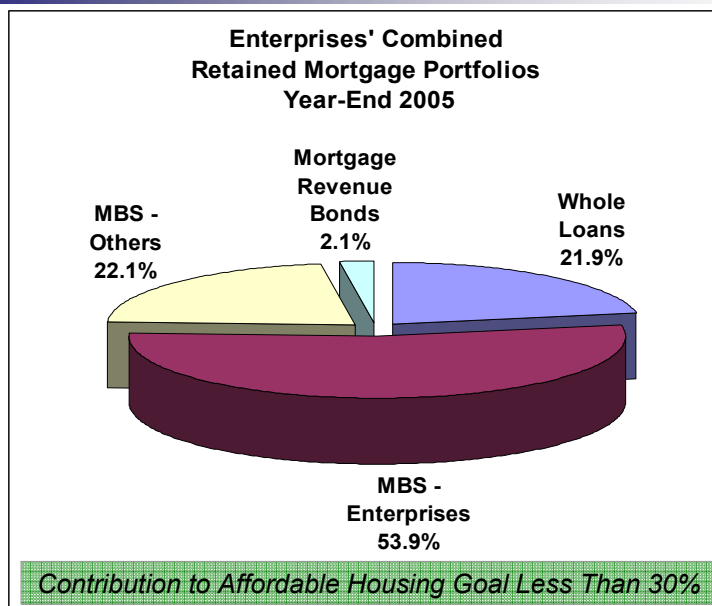
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Portfolios have Grown Very Rapidly



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Portfolios Dominated by Own MBS

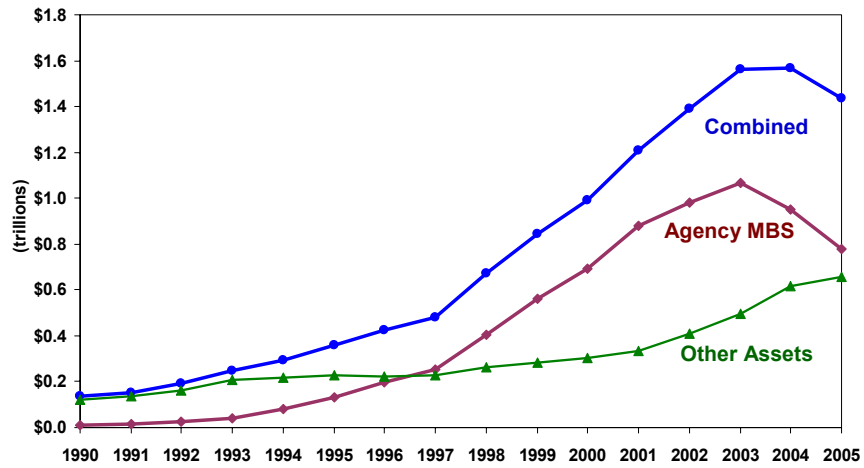


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Portfolios Remain Large



Enterprises' Combined Retained Mortgage Portfolios 1990 - 2005



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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.

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