

GSE REFORM: A PRIORITY FOR 2007
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Thank you for the opportunity to speak to you today on the topical issue of GSE reform. Citizens Against Government Waste has a noteworthy mission to eliminate waste, mismanagement, and inefficiency in the Federal government. All laudable goals and certainly ones that can be applied to our work at OFHEO and my previous job as Chief Operating Officer of Social Security. For those four years, I also served as a member of President Bush's Management Council and participated in developing its Program Assessment Rating Tool, or PART. I am pleased to say OFHEO was recently "PARTed" for the first time. I am not as pleased to report that the grades, which will be published next week on www.ExpectMore.gov, are not as good as I would like, but they reflect the problems I will be discussing today.

I look forward to sharing with you my views on OFHEO, our agency's regulatory oversight of Fannie Mae and Freddie Mac and the need for this 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 that are needed to do the job. We are utilizing all the tools we have, but they are just not enough. Fannie Mae started out as a government agency in 1938 and Freddie Mac in 1970. In 1968 and 1989, respectively, they became GSEs wholly-owned by a broad range of shareholders. This unique status gives them significant advantages as they can borrow more and at lower rates than other financial institutions. In turn, they have very important missions of supporting affordable housing, helping ensure the stability and liquidity of the secondary mortgage market, and responding appropriately to private capital markets.

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) with the FHLBanks' debt outstanding of \$900 billion, it is \$5.2 trillion, which is bigger than the \$4.9 trillion publicly held debt of the U.S. (#1)

Unfortunately, Fannie Mae and Freddie Mac lost sight of their mission in the 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, as we call them, 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. Also, unfortunately, OFHEO did not have the tools or resources to help prevent the problems.

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. (#2) The three pillars are capital rules, regulatory strength and market discipline. As I will discuss, the capital rules and regulatory powers are weak compared with 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 that banks and other financial institutions have makes capital and regulatory oversight even more important.

OFHEO’S 2006 Accomplishments

The year 2006 was a year of substantial accomplishments for OFHEO, but we have a long way to go. We completed the Fannie Mae special exam. We have spurred Fannie Mae and Freddie Mac to make progress on remediation but they too, have a long way to go. We made improvements to our own management processes and our supervisory program. For example, we centralized all supervision offices under one senior executive; we have more consistent assessment and treatment of issues; and we built up accounting, risk management, financial and operational expertise. We made progress on GSE reform legislation, but did not get across the goal line.

Goals for 2007 – Strengthen Supervisory Activities

Much more needs to be done. Turning to our goals for 2007(#3), our top priority and **first** goal for 2007 is to further strengthen the agency’s supervisory activities to ensure they operate in a safe and sound manner.

- We continue to work on overseeing the remediation efforts necessitated by their 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,
- 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 when there is a decline in housing prices, risk-based capital, and other areas.

Enhanced Authorities through Legislation

Secondly, (3) 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 across the goal line this year. Strengthened oversight of these companies is critical to the housing and financial markets.

Legislation is still needed to give the new regulator the powers that it needs to prevent the Enterprises from growing out of control again. They continue to present large market, credit, and operational risks which could infect other financial institutions and markets. As I said earlier, these Enterprises own or guarantee about 40 percent of residential mortgages in the U.S. or approximately \$4.2 trillion dollars, comprised of two businesses:

- The largest and primary business is \$2.8 trillion of MBS. To do this, they buy mortgages, package them together, guarantee the MBS and then sell them to investors.
- The second and more volatile business is the \$1.4 trillion mortgage portfolio holdings including their own and others' MBS. They fund these investments by issuing bonds to investors.

The FHLBanks, overseen by the Federal Housing Finance Board (FHFB), hold about \$800 billion in advances, mortgages, and MBS that support residential mortgage lending. (#4) Combined with Fannie Mae and Freddie Mac, the total is about 46 percent of mortgage debt outstanding at the end of the third quarter 2006. In 2003, the total market share peaked at nearly 54 percent. Despite the drop, which was caused by the Enterprises' problems, the GSEs still dominate the U.S. mortgage market.

Key components of GSE reform legislation are (#5):

Bank Regulator-Like Powers

Legislation is needed to ensure that the new regulator has 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 employee, director, 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 very painful example currently as to why this is important. Congress is considering a Continuing Resolution for the remainder of

the 2007 fiscal year that would continue to operate the government at 2006 budget levels. This results in a \$60 million budget for OFHEO, 11 percent lower than President Bush's budget request of \$67.6 million. This lower funding will put extreme pressure on OFHEO. Evolving litigation needs and corresponding expenses alone necessitate funding at the full 2007 level. Without this funding, planned resources in critical supervisory areas will be cut threatening our ability to monitor the safety and soundness of the Enterprises.

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.

Combine Mission and Safety and Soundness Authority

Currently, authority over the charters of the Enterprises, their mission, and new products is placed in HUD. As the other bank regulators do, FHFB regulates both the mission and safety and soundness of the FHLBanks. OFHEO is in the difficult position of considering only safety and soundness elements of activities that could be in violation of an Enterprise's charter. A stronger GSE regulator needs the combined safety and soundness and mission and new products powers.

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. To be considered well-capitalized, banks have much higher limits and hold significantly more "excess" capital than the Enterprises do. Specifically, the Tier 1 capital ratios of the five largest banks are 6.4 percent, while the Enterprises' are much lower at 4.6 percent. If you adjust for their large off-balance sheet MBS guarantees, the ratio falls to 3.5 percent.

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. Systemic risks they present to the overall financial markets should also be considered. More flexibility to enhance capital requirements is a critical component of the future regulation of the Enterprises.

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 the Enterprises' portfolios more than tripled by growing ten-fold. (#6)

The \$1.4 trillion size of their portfolios is not based on their mission as less than 30 percent of their portfolios contribute to meeting their affordable housing goals and over half their portfolios are in their own MBS. (#7) If growth is unconstrained, the portfolios could pose increasing risk to financial markets.

Legislation in 2006 addressed the portfolio issue, but the Senate Bill was too restrictive and the House Bill could be subject to very wide interpretations. What is needed is more flexibility, with clear guidance. While not perfect, I believe the compromise achieved near the end of the 2006 congressional session achieved those objectives.

We believe this language is a major improvement over the House-passed bill of last year. The proposed language does not have “hard caps,” but neither did the Senate bill. Both the compromise and Senate Bills required regulations. The compromise language ties the portfolios tightly to 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. Even with the broadest interpretations it would be hard to justify them holding over \$750 billion (54 percent of their total portfolios) in their own MBS. These holdings, which are 26 percent of their total MBS, could easily be sold to investors, and as previously noted, do nothing to increase affordable housing. As this graph depicts (#8), the recent shrinkage of almost \$300 billion of their portfolios, which was necessitated by their problems, was achieved by the run-off and sale of their MBS. Despite this reduction, the MBS market has continued to strengthen. After rightsizing, the portfolios could be allowed to grow with the housing market.

Limiting Enterprise portfolios would do nothing to impede their ability to support the mortgage markets by guaranteeing MBS packages. The Enterprises’ ability to fulfill their important public mission of providing liquidity and stability to the market, and supporting affordable housing would be enhanced over time as investors purchase more agency MBS and less Enterprise debt. The Enterprises would retain an active trading capacity that allows them to expand rapidly to ensure market liquidity especially in emergencies. They could also return to their shareholders some of the excess capital generated by reducing their portfolios.

Affordable Housing Fund

There are a few other issues being addressed. As you all know, an affordable housing fund is a priority issue for House Financial Services 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 is a sunset – have moved in the right direction. I believe that one open question is whether there will be a cap on annual contributions. If one aim is to generate a fairly stable source of funds, using new business purchases as a fee base is certainly better than profits, but it is still volatile. Perhaps a fee on total book of business or outstanding liabilities would be even better.

Strong Housing Finance System

Successfully achieving the first two goals will contribute to OFHEO's **third** goal 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 House Price Index (HPI); publish reports and research to increase understanding of mortgages and the mortgage markets; communicate with stakeholders; and cooperate with other Federal agencies.

Conclusion

A new, stronger and independent regulator with the powers of bank regulators is needed to oversee Fannie Mae, Freddie Mac and the Federal Home Loan Banks that are so important to our housing market, the economy and the American dream of homeownership. We have made much progress but we need more tools. I believe the bills proposed last year and the compromise offered near the end of the 2006 congressional session would give a new regulator the necessary powers. 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. Fannie Mae and Freddie Mac have also repeatedly said that they support reform legislation as it will strengthen them. They have a very important public mission of supporting affordable housing and helping to ensure the liquidity and stability of the nation's housing finance system. The proposed legislation should ensure that they remain safe and sound and that the system remains strong. Thank you.

GSE Reform: A Priority for 2007



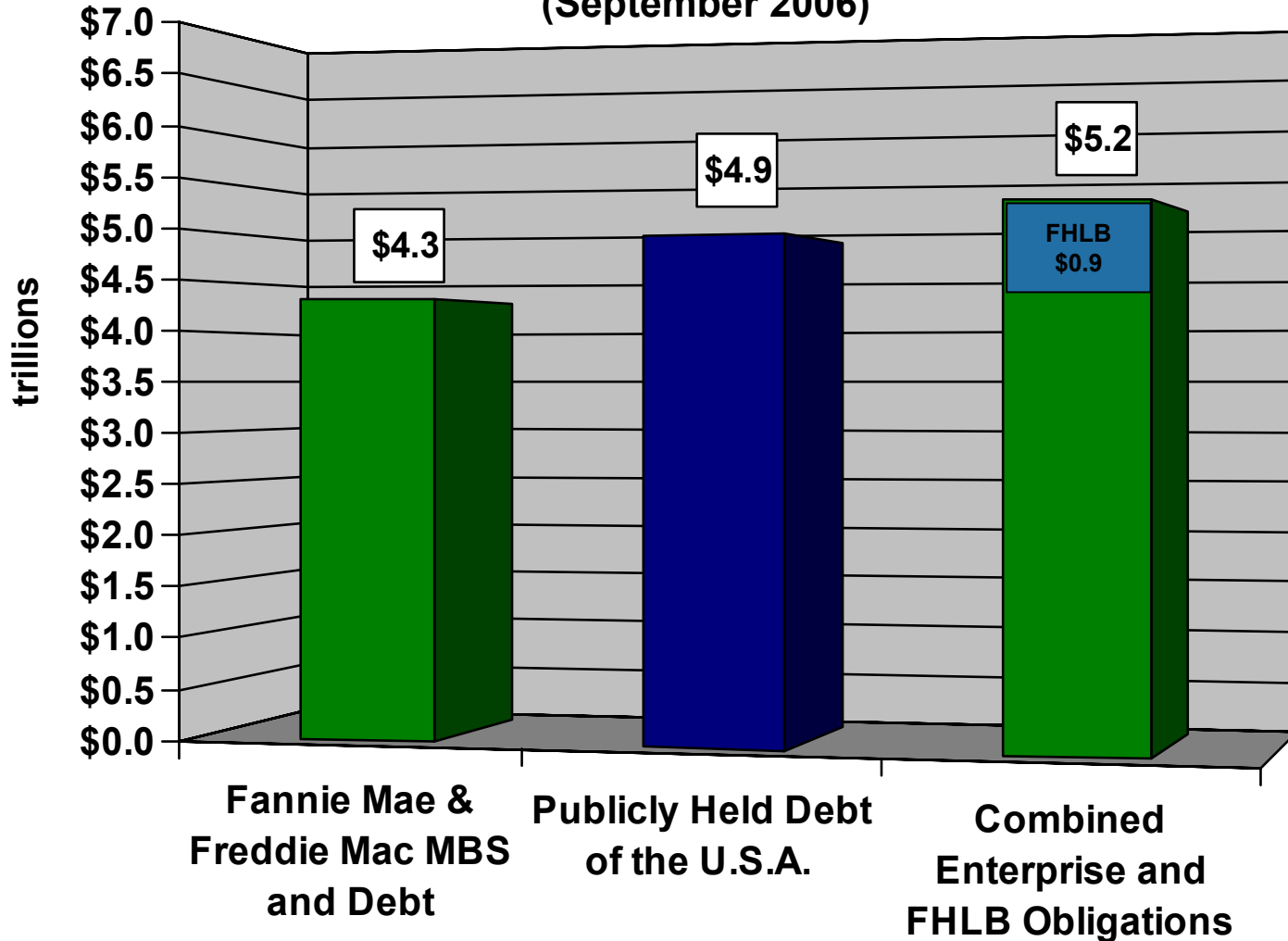
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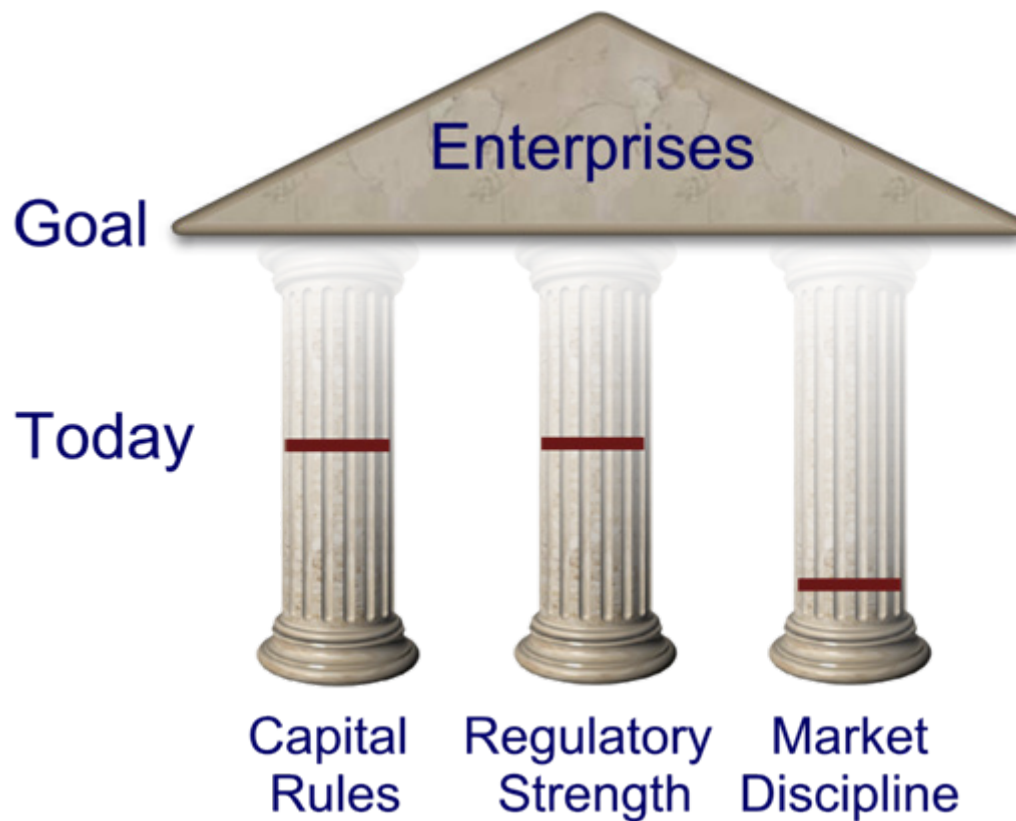
The Enterprises are Huge



Relative Size of Enterprise Obligations
(September 2006)



Basel II Pillars



Result: Unconstrained growth led to operational problems and mismanagement

OFHEO's Strategic Goals

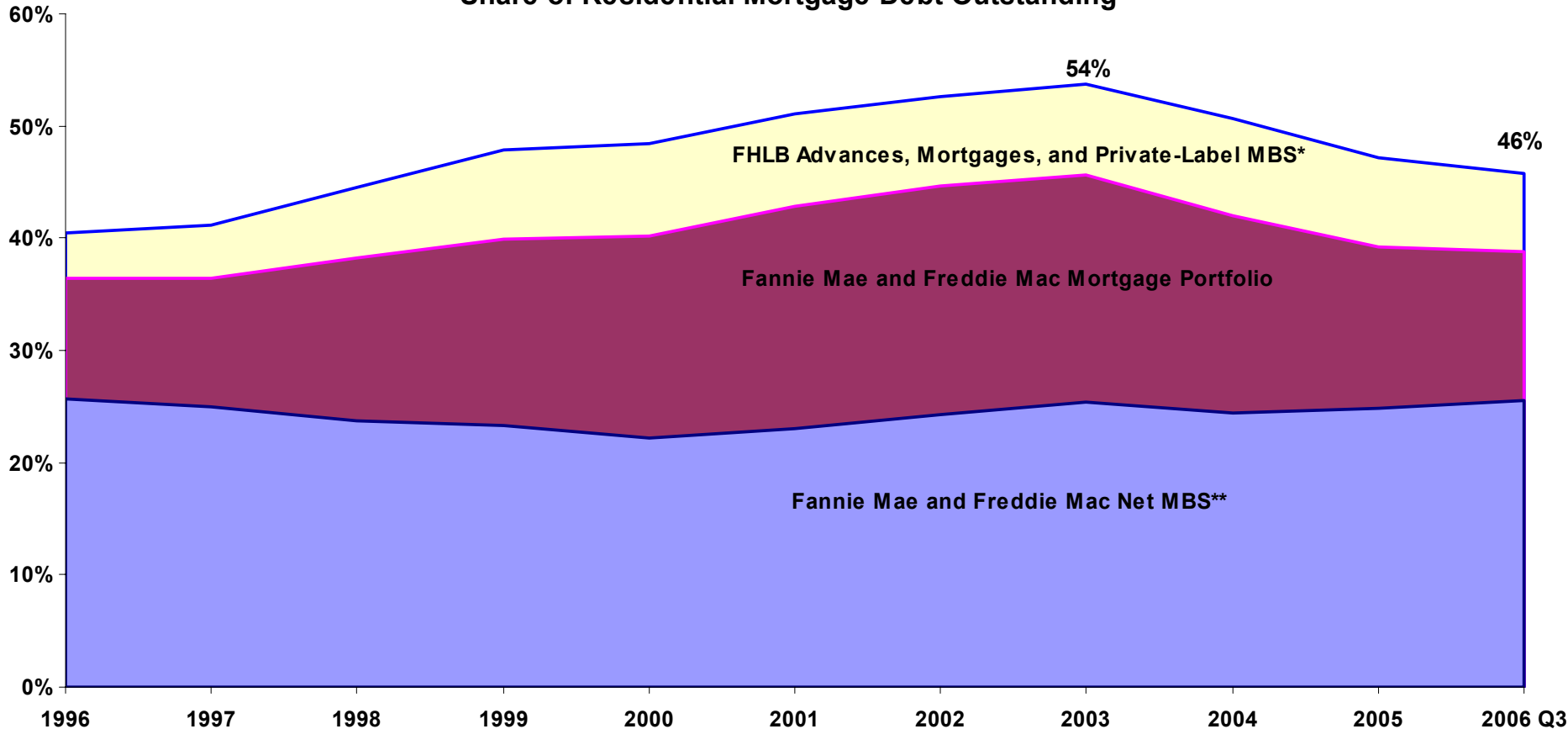


1. Enhance supervision to ensure the Enterprises operate in a safe and sound manner, are adequately capitalized and comply with legal requirements.
2. Provide support for statutory reforms to strengthen our regulatory powers.
3. Continue to support the national policy of an efficient secondary mortgage market which promotes homeownership and affordable housing.

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.

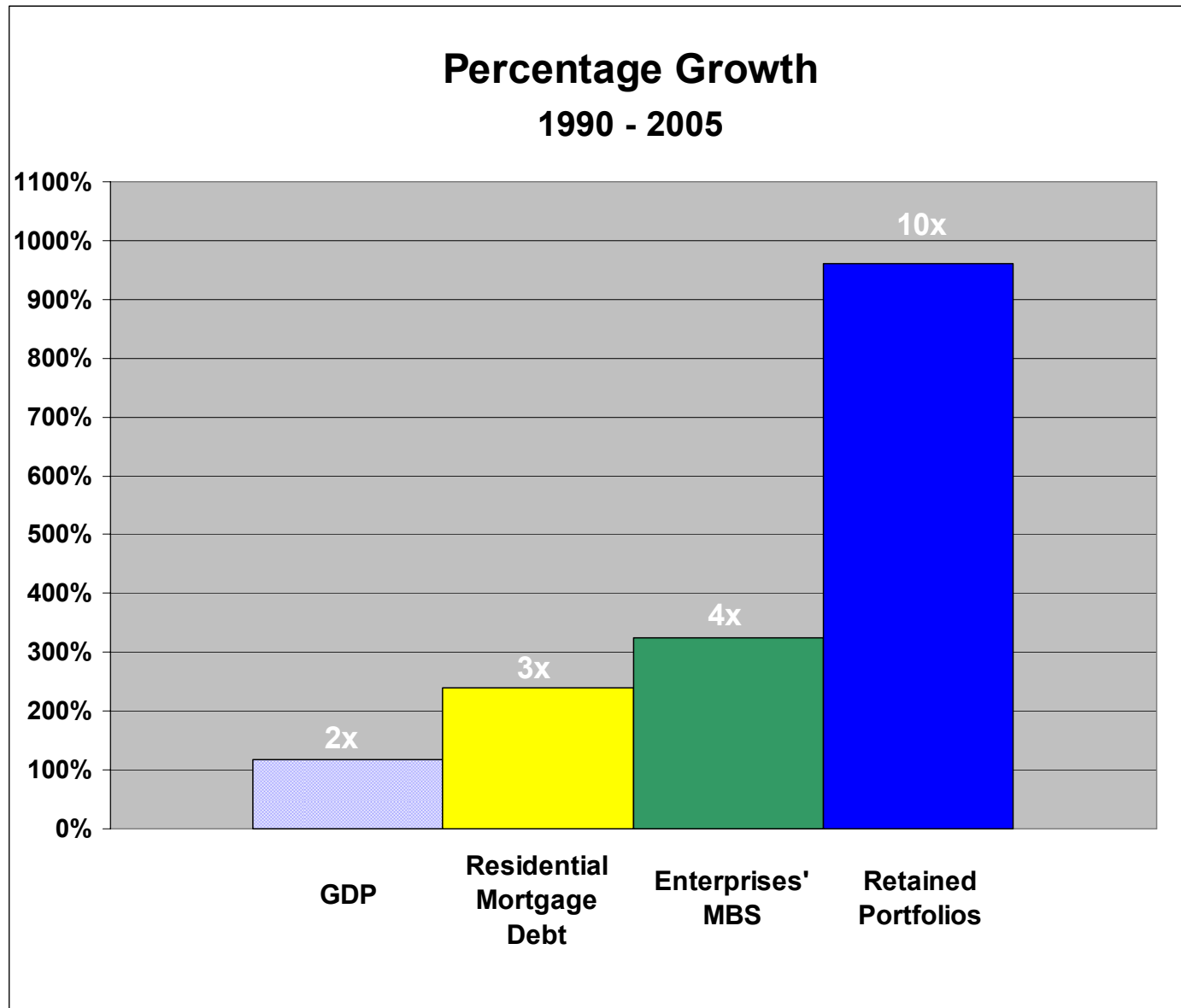
** Excludes holdings of MBS guaranteed by the other Enterprise.

Key Components of GSE Reform Legislation



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

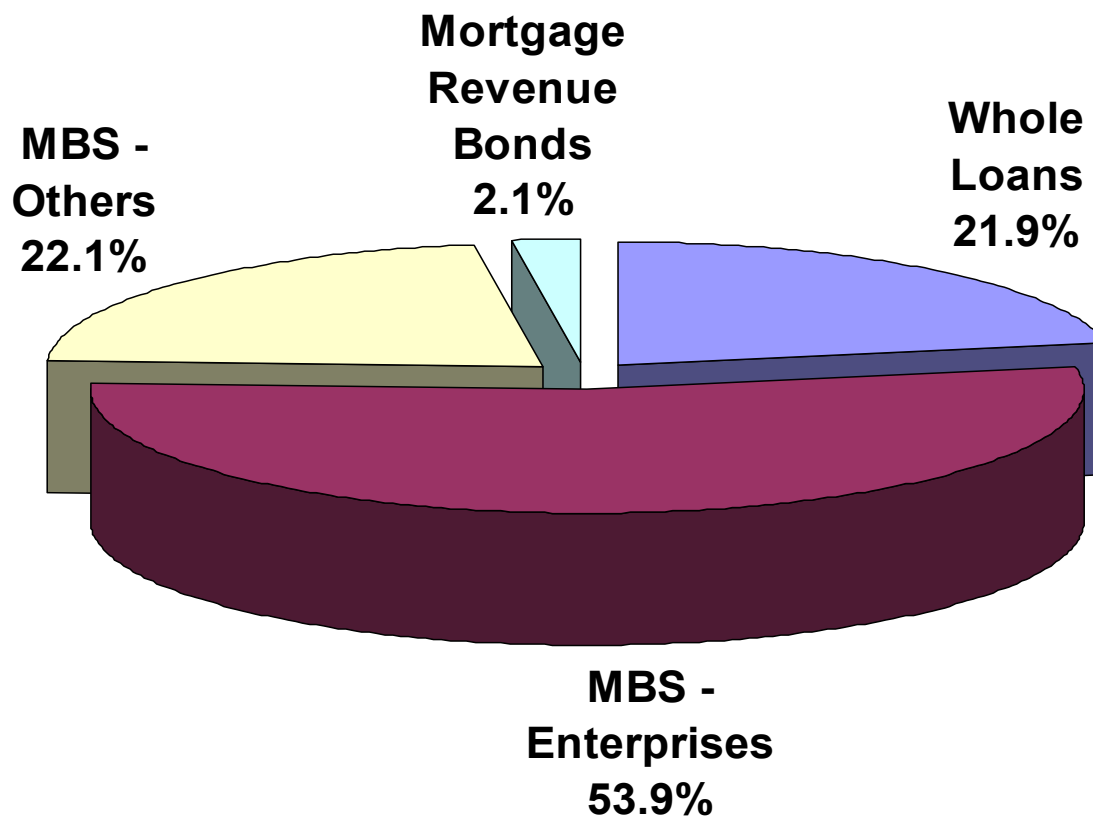
Portfolios have Grown Very Rapidly



Portfolios Dominated by Own MBS



Enterprises' Combined Retained Mortgage Portfolios Year-End 2005

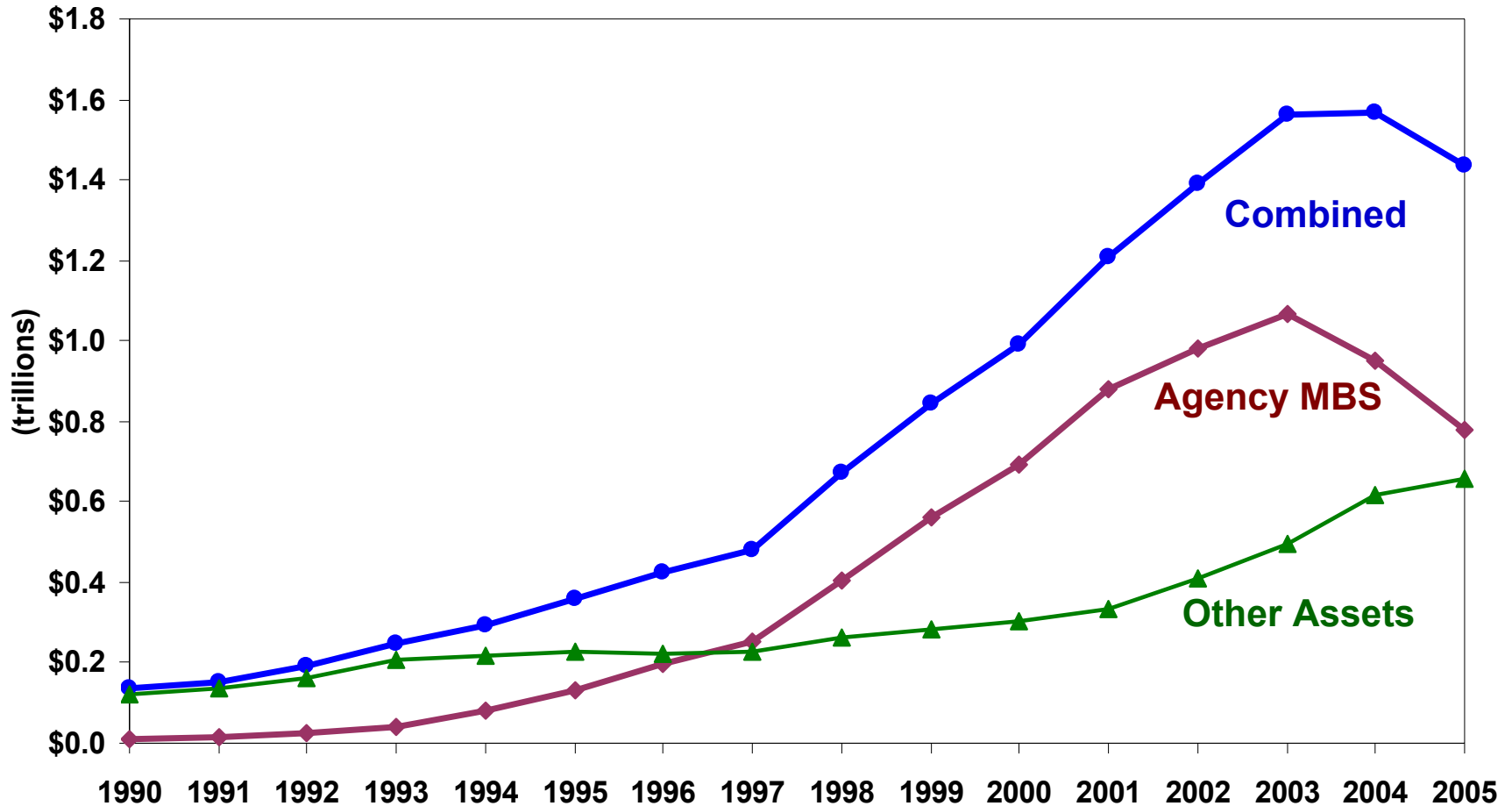


Contribution to Affordable Housing Goal Less Than 30%

Portfolios Remain Large



Enterprises' Combined Retained Mortgage Portfolios 1990 - 2005





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