GSE REFORM CRITICAL TO REDUCING RISKS

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Thank you for the opportunity to speak before the New York Bankers Association and especially to do it here in Arizona. It is not a bad time to be out of Washington as the dust from the elections continues to settle.

As I am at the half-year point as Director of OFHEO, I thought I'd briefly discuss where we are and what our goals are for the rest of this year and next. As you are all aware, we continue to focus on making the Enterprises fix the problems created by their accounting scandals, earnings manipulation, and management failures. Both companies are making progress, but it will take several more years.

I have three major priorities for OFHEO: The first is vigorous supervision of the Enterprises. The second is to continue to support legislation for a more empowered regulator of the Enterprises and the Federal Home Loan Banks so that we have the tools to do a better job in the future. A third is to continue to build our team to face ongoing and future challenges.

Despite the hard-fought election, I am still hopeful that we can get something done on that second goal. Unlike Social Security reform, the need to reform Fannie Mae and Freddie Mac was not hotly debated. As they acknowledge, their problems and unconstrained growth have established the need for a stronger regulator. There is strong bipartisan support for reform and only a couple of issues that need to be resolved. On the most contentious issue of reducing the size of their massive portfolios, which I will be discussing in detail, I am pleased to report progress is being made on a compromise approach.

At last year-end, Fannie Mae and Freddie Mac owned or guaranteed over 40 percent of the residential mortgages in the U.S. or approximately $4 trillion dollars, comprised of two main businesses (#2):

- $2.6 trillion of mortgage-backed securities (MBS) guaranteed by the Enterprises and
- $1.4 trillion of portfolio holdings including their own MBS.

With respect to the Federal Home Loan Bank system, the Banks held $725 billion in advances and mortgages that support residential mortgage lending, which represented 7.2 percent of residential mortgage debt outstanding at that time. In combination with the Enterprises, the total is 47.1 percent of mortgage debt outstanding at year-end 2005 (#3). In 2003, the total market share was over 55 percent. In short, the GSEs dominated the U.S. mortgage market.

Now, I will turn to that contentious issue of the Enterprises' portfolios with a particular focus on the systemic risk that they create.

<u>Systemic Risk to Financial Markets and Institutions</u>

In my previous job at Social Security, "privatization" was the lightning rod word. Thankfully, "privatization" is not part of the GSE reform debate, but the fighting word seems to be "systemic" risk. So what does it mean? OFHEO's definition of systemic risk is "…the risk that, first, a financial institution unexpectedly experiences severe financial difficulties and, second, that those difficulties disrupt the financial sector enough to cause a reduction in economic activity." (#4) All large financial institutions present some systemic risks, but some much more than others.

A key reason that bank regulators and deposit insurance were created was to reduce the systemic risk of losses to financial markets, other financial institutions, and individuals. Likewise, OFHEO's safety and soundness regulatory activities are designed to reduce "unexpected, severe financial difficulties," but if they do occur the impact could be quite detrimental to financial markets and institutions. Sources of systemic risk include not only an institution's risk profile and its quality of risk management, but also the importance to other institutions and to financial markets.

Both Fannie Mae and Freddie Mac were created to foster a stable and liquid housing finance market, thereby reducing systemic risk. They have done that, but as they grew rapidly as GSEs they began to increase their own potential for causing systemic events. Some may debate whether OFHEO was created to help reduce those systemic risks, but all agree that OFHEO does not have all the powers that a bank regulator has to help avoid such events.

<u>Sources of Systemic Risk</u>

Let me now elaborate on sources of Enterprise systemic risk and, given today's audience, highlight some bank-related issues. <u>High leverage</u> is a key source of systemic risk for the Enterprises. (#5) Enterprise core capital ratios are lower than the Tier 1 capital ratios of the largest banks. The top five banks are about 6.4 percent, while the Enterprises are 4.6 percent. When the Enterprises' very substantial off-balance sheet obligations are recognized, the difference in leverage is much more pronounced, with their capital to assets ratio falling to 3.5 percent.

Operational deficiencies (#6) are another source of systemic risk for the GSEs. Deficiencies in this area include: the inability to produce financial statements; weak internal control environments; risk management weaknesses; and systems and data problems.

The risks of the GSEs' retained mortgage portfolios also provide another avenue for systemic risk. These include convexity risk resulting from incomplete hedging of prepayment risk; risk that market conditions will make rebalancing ineffective; basis and liquidity risk associated with the derivatives used to create synthetic long-term debt; counterparty risks; and operational and model risks.

The Enterprises are subject to very limited market discipline. Debt investors have little incentive to monitor an Enterprise's financial condition as the rating agencies give them Triple-A ratings based on the so-called "implicit" government guarantee. If a bank faces accounting, management, or market problems, the rating agencies will downgrade its debt making it harder and more expensive to borrow. Because they are GSEs, we have seen that despite all their problems, the Enterprises' senior debt was not downgraded and the Enterprises did not experience funding issues or significant moves in interest spreads versus Treasuries, even in their subordinated debt.

The importance of Fannie Mae's and Freddie Mac's obligations in financial markets cannot be discounted and is especially relevant to banks. As of year-end 2005, over 60 percent of banks held Enterprise debt and MBS worth over 50 percent of those banks' Tier 1 capital. MBS make up an increasing share of the portfolios of foreign central banks and other foreign investors.

Uncertainty about the status of claims against an insolvent Enterprise also creates a source of systemic risk. Specifically, the relative priority and classes of debt are uncertain. Bank regulators all have receivership authority and thus more certainty; OFHEO does not.

Mortgage lenders rely heavily on the Enterprises. If either Enterprise experienced severe financial difficulties and greatly reduced or sharply curtailed its mortgage purchases, many lenders would have difficulties maintaining their business models, especially in illiquid market conditions.

And finally, because of many of these factors, the growth of the Enterprises' retained mortgage portfolios has been too rapid. During the last 15 years, the nation's GDP doubled, the mortgage market tripled, the Enterprises' guarantees quadrupled and their portfolios grew ten-fold as you can see in this chart (#7).

Implications of Systemic Risk

Implications stemming from severe financial difficulties at an Enterprise would be significant. Lenders would incur losses, which could reduce housing activity. Risk spreads for Enterprise and GSE obligations would increase as the Enterprises and other investors attempt to sell their debt and MBS. Investors would incur losses and have liquidity problems.

In particular, banks with large amounts of GSE debt could experience these problems, resulting in a reduction in bank lending or even bank failures. And with respect to the broader financial markets, a general decline in market liquidity could result as firms with large losses sought to unwind their positions, risk spreads widened, and a "flight to quality" ensued.

Comparison with Large Banks

Defenders of unconstrained portfolios say that a major bank presents larger systemic risk than Fannie Mae and Freddie Mac. Well, I disagree. Banks are less leveraged and more diversified. Also, large banks tend to invest in short-duration mortgage assets and, thus, have less need to hedge. They are subject to much more debt market discipline. They have stronger regulators. On the other hand, the Enterprises have lower credit losses, but their key support is from the perception of an implied U.S. government guarantee.

Severe financial difficulties at a large bank are less likely to threaten markets or harm the economy. No major national loan market or sector of the economy is heavily dependent on one bank, while the Enterprises dominate the secondary mortgage market. No large bank's debt is important for the operations of capital markets. There is little uncertainty about the status of claimants on large banks.

Recently, one of the CEOs indicated that systemic risk is being "misapplied to the GSEs." His argument is that by concentrating risk in two, massive portfolios and then hedging their duration with some callable debt and very large derivative positions the system is "safer." Of course, the callable debt and large derivatives just pass the mortgage prepayment risk elsewhere. Also, it is a fact that both companies retain some of this prepayment risk to increase their returns. His statement also ignores many of the points I have just made. GSEs cannot diversify their risk; banks can. Systemic risk is much broader than market risk and can be caused by credit or operational problems, including deficient models or unauthorized trading.

Legislation is Needed to Address Systemic Risk

Until recently, the growth of the Enterprises' portfolios has been focused on shareholders' returns rather than their mission. Their size alone will continue to subject financial markets and institutions to unnecessary systemic risk.

OFHEO needs the powers to address this risk. As is now being discussed in Washington, a legislative solution should provide the new regulator with discretion to address portfolio limits. The regulator should be empowered to set limits based upon the risks the portfolios present to the Enterprises and financial markets and upon guidelines that ensure the companies can fulfill their housing mission.

Although the Enterprises have questioned portfolio limits, I believe that a key part of restoring confidence is to convince the markets that they will never grow out of control again. Reform opponents say that limits would hurt their ability to fulfill their liquidity, stability and affordability missions. But none of the legislative solutions under consideration limit their largest, fundamental business of buying mortgages and then packaging them with guarantees for securitization (#8). This strongly growing $2.6 trillion MBS business represents 26 percent of the total U.S. mortgage market. In addition, the Enterprises hold more than $700 billion of their own MBS.

Less than 30 percent of the Enterprises' combined retained mortgage portfolios of $1.4 trillion are used to fulfill their very important affordable housing mission (#9). About 54 percent of their portfolios are invested in their own MBS, which are easily saleable. At 24 percent of their total MBS, these holdings are much higher than is needed for liquidity. Their private label MBS and whole mortgages could be better utilized as only half qualify as supporting affordable housing.

There is another argument against portfolio limits that I have heard recently. It is that it would be a violation of the Board of Directors and management's fiduciary duty to shareholders to support limits. That is nonsense. If there is one lesson that these two companies should have learned from their multi-billion dollar scandals, large SEC fines, and massive shareholder suits, it is that unconstrained growth focusing on earnings-per-share is much worse for shareholders. Boards, especially GSE Boards, must be concerned about safety and soundness, corporate culture, internal controls and mission, as well as growth. Placing a company at risk does not maximize shareholder value or meet fiduciary duties.

Some have suggested that reducing the portfolios would cause mortgage market turmoil while just transferring the systemic risk elsewhere. As noted earlier, much of the prepayment risk is already transferred elsewhere. If the portfolios' downsizing were handled through normal repayments and a gradual sell-off, the market impact would be minimal. Over the last two years, the Enterprises' agency MBS portfolios shrank by over $280 billion without market disruption as these sales were easily absorbed by investors (#10). As this chart shows, the Enterprises' share of mortgage-related securities fell 10 percent while foreign investors increased 9 percent.

The systemic risk of Fannie Mae and Freddie Mac is real and the benefits of shrinking their portfolios are significant. Risk of Enterprise failure would be reduced, as well as any potential adverse effects on financial markets. The Enterprises could perform their important missions and respond rapidly during times of turmoil with much smaller portfolios.

Legislation is Needed for a Stronger GSE Regulator (#11)

Portfolio constraints are an important component of any GSE reform package, but there are many others which I am pleased to report have a very broad consensus in Congress, and the Bush Administration. Even Fannie Mae and Freddie Mac support them.

OFHEO Needs Bank Regulator-Like Powers

OFHEO needs to be on the same playing field as the other financial regulators. The new regulator needs the same powers that bank regulators have to help prevent problems. Explicit legal authorities, receivership, and better enforcement powers are crucial for a stronger GSE regulator. Enhanced enforcement powers, including addressing misconduct by employee, director, and affiliated parties, are needed too.

OFHEO Needs More Independence

Regulatory independence must be strengthened, including independent litigating and budgeting authorities. It is perverse that OFHEO is required to be congressionally appropriated while the bank regulators are not, even though we are all funded by the regulatees and therefore have no impact on the budget deficit.

Mission and New Product Authority Need to be Combined

Currently, authority over the charters of the Enterprises, their mission, and new products is placed in HUD. 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. Other financial regulators have authority over mission, products and services, and safety and soundness. A stronger GSE regulator needs these authorities too.

Capital Requirements Need Strengthening

Presently, the Enterprises have low regulatory minimum capital requirements. The OFHEO 1992 Act requires them to maintain stockholder's equity equal to 2.5 percent. Banks to be well-capitalized have much higher limits and hold significantly more "excess" capital than the Enterprises do.

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; which are market, credit, and operational risk. Systemic risk should also be considered. More flexibility to enhance capital requirements is a critical component of the future regulation of the Enterprises, and another means to address systemic risk.

Strength Through Combining the Three GSE Regulators

Greater regulatory muscle and independence will also be provided by combining the agency with the Federal Housing Finance Board. Combining these two regulators will provide more capability to ensure the safety and soundness of the U.S. mortgage market. And as I said, adding HUD's mission authority function is also important.

Amongst the synergies arising from the combination is that a combined workforce would have enhanced skills, lower cost and be more responsive. The new agency itself would benefit from different ideas and approaches in areas such as examinations, capital, and accounting, while retaining expertise on the differences between the Banks and the Enterprises. OFHEO's new responsibilities for affordable housing goals would benefit from expertise of the FHFB and the Banks.

It will take a much stronger regulator with powers to limit portfolios to oversee these institutions that are so important to the housing market and the U.S. economy. Make no mistake, these Enterprises are huge. (#12) Their combined guaranteed MBS and debt outstanding of $4.1 trillion is not much smaller than the $4.7 trillion publicly held debt of the U.S. and the $4.6 trillion Social Security shortfall, a figure engraved in my head. It is much larger than the $3.0 trillion total of corporate bonds outstanding.

The agency has made much progress in regulating these two companies, but we need more tools. I have been impressed with the work and dedication of the OFHEO team. There is no doubt in my mind that GSE reform legislation is critically needed for more enhanced supervision and a stronger regulatory environment. I believe this will strengthen regulatory oversight of Fannie Mae and Freddie Mac so that they can better fulfill their mission of working with the private capital markets and providing liquidity, stability and affordability to the nation's housing market.

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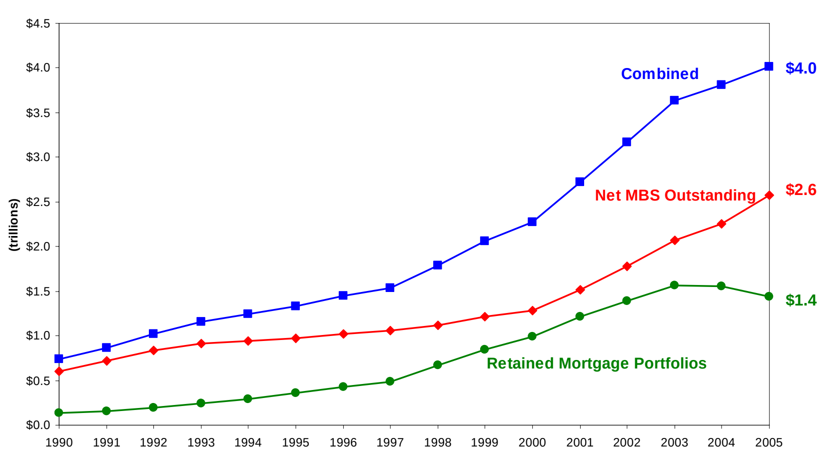
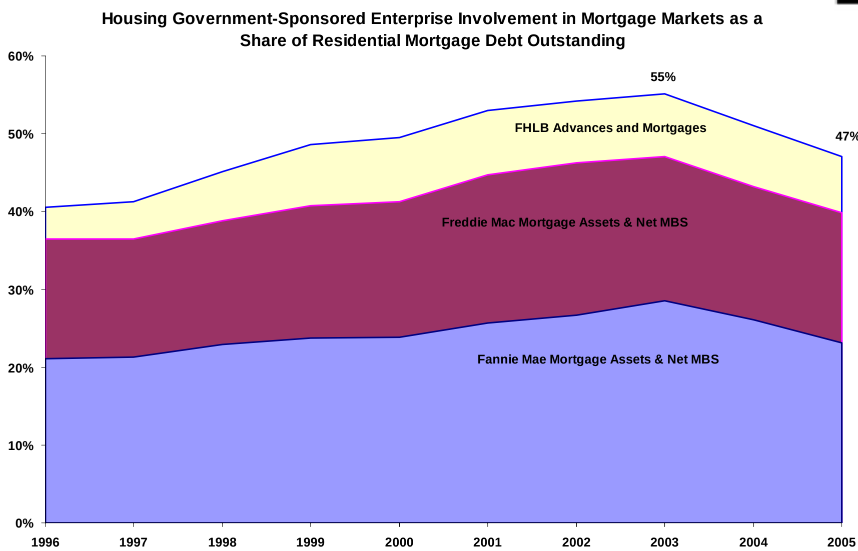
Enterprises' Two Businesses Have Grown Rapidly

OFHEO

Fannie Mae and Freddie Mac Mortgage Assets and MBS
1990 - 2005



GSEs Dominate the U.S. Mortgage Market



* FHLB members use advances for short-term liquidity and asset/liability management in addition to funding mortgages
** Excludes MBS held for investment to avoid potential double-counting with Fannie Mae and Freddie Mac

Systemic Risk to the Financial Sector

- Systemic risk is the risk that a financial institution
  1. unexpectedly experiences severe financial difficulties and
  2. that those difficulties disrupt the financial sector enough to cause a reduction in economic activity.

- Reducing systemic risk is an important role of bank regulators.

- OFHEO's powers need to be strengthened to help reduce the chances of unexpected, severe difficulties.

Enterprises Highly Leveraged Compared to Banks

Top 5 Banks
(6/30/06)

	Adjusted Total Assets ($ in billions)	Tier 1 Capital / Adjusted Total Assets
Average of 5 Largest Banks	$ 779	6.4%

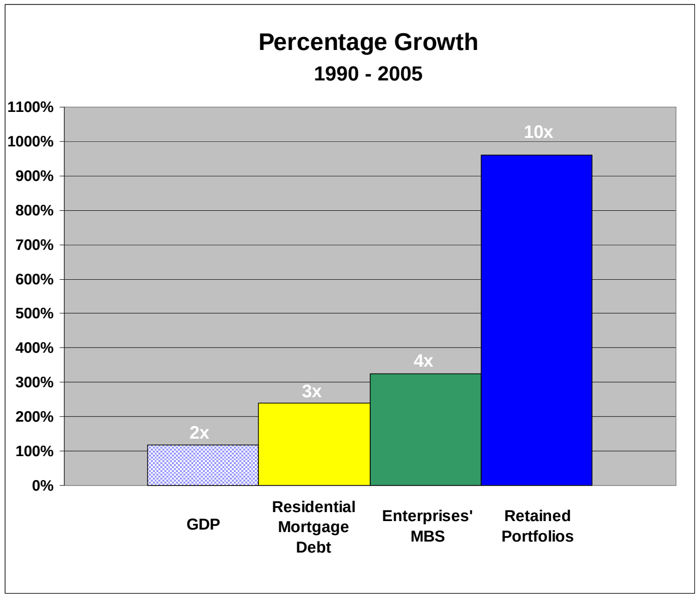
	Total Assets ($ in billions)	Core Capital/ Total Assets	Core Capital Less Capital for MBS / Total Assets**
Fannie Mae	$ 872	4.8%	3.5%
Freddie Mac	$ 855	4.3%	3.5%
Average	$ 863	4.6%	3.5%

* Mid-year 2006 data.
** Core capital surplus has been distributed to assets and MBS proportional to required capital.

Sources of Systemic Risk

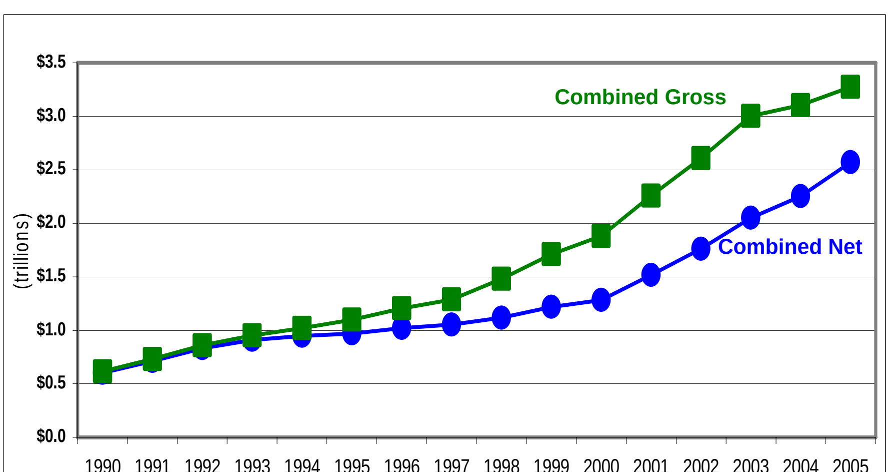
- High leverage
- Operational deficiencies
- Massive mortgage portfolios
- Limited market discipline
- Importance of MBS and debt
- Uncertainty about insolvency claims
- Reliance by mortgage lenders
- Rapid growth

Portfolios have Grown Very Rapidly

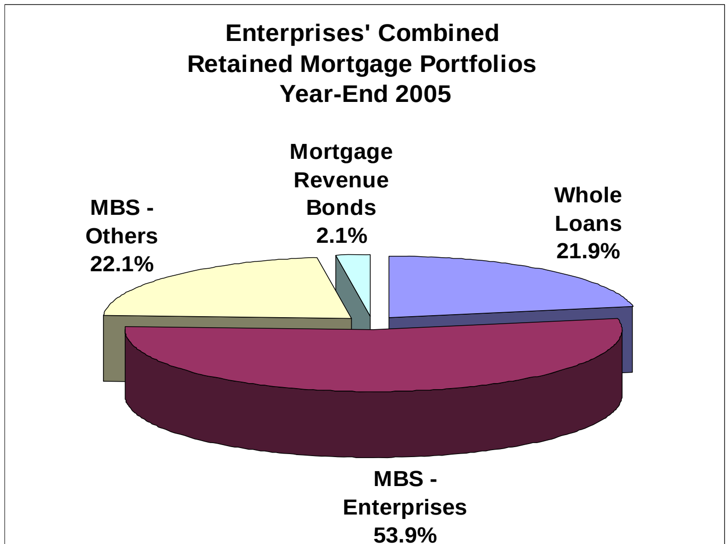


Guaranteed MBS Continuing to Grow

Fannie Mae and Freddie Mac MBS Outstanding
Gross and Net Basis
1990 - 2005

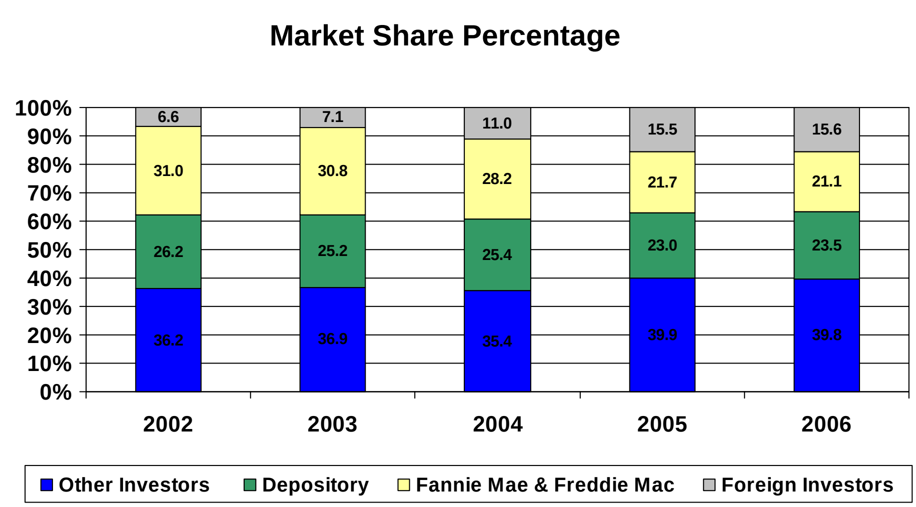


Portfolios Dominated by Own MBS



Contribution to Affordable Housing Goal Less Than 30%

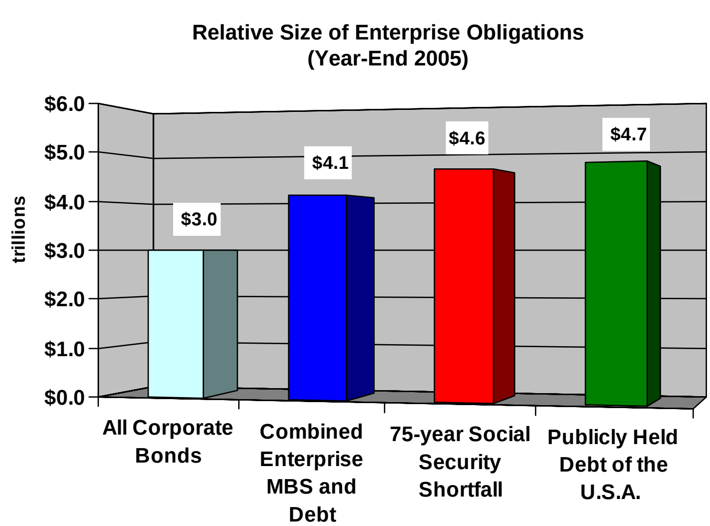
Enterprises’ Share of Mortgage Related Securities Falling



Stronger Regulator Needed

- Regulator needs discretion to limit portfolios
- Regulator needs more bank regulator-like powers
- Regulator needs more independence
- Mission and new product authority need to be combined
- Capital requirements need strengthening
- Strength through combining the GSE regulators

The Enterprises are Massive



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