Office of Federal Housing Enterprise Oversight (OFHEO)
1700 G Street, NW 4th Floor
Washington, DC 20552
Phone: 202-414-3800
Fax: 202-414-3823

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Contact: Stefanie Mullin 202.414.6376
www.ofheo.gov

FANNIE MAE, FREDDIE MAC AND THE NEED FOR GSE REFORM, NOW

JAMES B. LOCKHART III
DIRECTOR, OFHEO
REUTERS GSE PANEL
NEW YORK CITY

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Last month, the Office of Federal Housing Enterprise Oversight (OFHEO) celebrated its 13th anniversary. It may sound strange from someone who has only been Director for two months, but I hope it will be OFHEO's last anniversary. As I will discuss, and as both the Senate and House legislation propose, we need a new, stronger regulator.

From its inception, OFHEO was no match for the responsibility assigned to it of being the safety and soundness regulator of Fannie Mae and Freddie Mac, two of the United States' largest financial institutions. Together they represent more than a 40 percent share of the residential mortgage market, a share that has doubled since 1990.

Another way to look at this unconstrained growth is that during the last 15 years, the nation's GDP doubled, the mortgage market tripled, Fannie Mae's and Freddie Mac's (the Enterprises) guarantees quadrupled and their portfolios grew ninefold (Chart 1).

Obviously, risks come with such rapid growth. The risk at Fannie and Freddie is compounded because by law they cannot spread their risk through diversification. They have all their eggs in one basket. They kept adding eggs rapidly, but they chose not to maintain and strengthen their baskets. As a result, the unwatched baskets broke and so did many eggs. The baskets represent internal controls, accounting systems, corporate culture and governance and risk management. They were so poorly maintained that many systems will need replacement or total rebuilding. They have made some progress, but it will take several years.

Need for Stronger Legislation

One of the driving factors behind the Enterprises' rapid growth is the lack of credit market discipline. The normal corporation has the discipline of creditors, bankers, bondholders and credit rating agencies to ensure its growth is built on a solid foundation. Being Government Sponsored Enterprises with low capital requirements, the credit markets provided no discipline to counterbalance the equity market's call for more rapid growth.

Banks are permitted to invest unlimited percentages in GSE securities in contrast to their normal ceiling for corporate issuers of 10 percent of capital. As a result, over 60 percent of banks hold 50 percent or more of their capital in GSE debt and provide limited market discipline.

The result is that little OFHEO must act not only as the safety and soundness regulator, but as the constraining market force for these giants. That is a much larger challenge than banking regulators have and yet we are trying to do it with one hand tied behind our back. The result of the Enterprises' rapid growth unconstrained by market forces and a weak regulator was years of mismanagement, flagrant earnings manipulation, and systems and controls problems. Managements of both companies were forced out, earnings were misstated by an estimated $16 billion, fines exceeding one-half billion dollars were imposed, and remedial costs will exceed $2 billion.

Stronger legislation providing powers similar to those of a bank regulator will help untie our hand. I am glad to report that there seems to be a growing consensus on many aspects of the legislation to give the new regulator stronger powers including explicit legal authorities such as independent litigating and receivership powers, flexible capital standards, budget flexibility outside of appropriations process, better enforcement powers, mission and new product authority, employee malfeasance penalties and limitations on growth. Both the Senate and House bills merge OFHEO with the Federal Housing Finance Board, which oversees the 12 Federal Home Loan Banks. That will further strengthen our independence and provide more regulatory muscle.

Despite the growing consensus about the need to constrain the Enterprises' growth, some argue against any limits. They say that limits would hurt their ability to support the secondary mortgage market and to fulfill their liquidity, stability and affordability missions. However, neither the Senate nor House bill limits the Enterprises' major business of buying mortgages and then packaging them with guarantees for securitization. These mortgage-backed securities (MBS) total about $2.6 trillion or 26 percent of the total U.S. mortgage market (Chart 2). That total excludes their own MBS' held in their portfolios.

A substantial part of the Enterprises' combined retained mortgage portfolios of $1.4 trillion is not needed to fulfill their very important mission. About 54 percent of their portfolios are invested in their own MBS, which receive no additional credit toward their affordable housing goals (Chart 3). A significant percentage of their private label MBS and whole mortgages, which average about 22 percent each, do not qualify as supporting affordable housing. As for liquidity and stability, an active trading capability coupled with a small inventory of securities backed by the ability to expand rapidly to cope with market liquidity emergencies should serve those purposes.

The key issue remaining is how to limit growth. Proponents of limits suggest that the $1.4 trillion of mortgage investments, $1.5 trillion of debt to fund the investments and the $1.3 trillion in derivatives to hedge mortgage investments cause excessive risks. The risks are the Enterprise risks of market, credit and, especially, operational risk given their current problems; but also systemic risk.

Systemic Risk

Systemic risk is the potential for a financial institution to experience severe difficulties that disrupt the financial sector enough to reduce aggregate economic activity by a substantial amount. An institution poses systemic risk to the extent that it serves as a channel for the transmission of problems to other institutions or financial markets with which it is highly interdependent.

Fannie Mae and Freddie Mac, like all financial institutions, are in the business of taking and managing financial risks which could produce losses that render them insolvent. They are also highly leveraged for financial institutions of their size, lines of business, and importance. Further, each Enterprise has significant problems with its internal controls, corporate governance, and risk management, and is in the process of reforming its corporate culture and management practices. Even if these problems were corrected today, each Enterprise would still pose substantial systemic risk. Indeed, I think a strong case can be made that each Enterprise poses more systemic risk than other financial institutions of comparable asset size.

There are five unique factors to Fannie Mae and Freddie Mac that together create the unusual degree of systemic risk that they pose.

First, Fannie Mae and Freddie Mac maintain a high degree of leverage because they are not subject to debt market discipline and they have low regulatory minimum capital requirements. The OFHEO 1992 Act requires Fannie Mae and Freddie Mac to maintain stockholders equity equal to 2.5 percent of any mortgage assets they hold in portfolio, which is half what large banks must maintain in order to be classified as well-capitalized. Many banks hold significantly more “excess” capital than the Enterprises do.

Second, Fannie Mae’s and Freddie Mac’s low capital requirements and unusually low funding costs because of their GSE status allow them to build huge mortgage asset portfolios. Fannie Mae’s mortgage assets grew from about $124 billion in 1990 to $905 billion in 2004, and then declined to about $727 billion last year. That’s equivalent to average annual growth of more than 13 percent over the 15-year period (Chart 4). Freddie

Mac's mortgage portfolio grew 26 percent per annum from less than $22 billion at year-end 1990 to $710 billion in 2005. In contrast, the residential mortgage market grew at an average rate of 8.5 percent. Absent regulatory constraints, Fannie Mae and Freddie Mac could each increase their portfolios by well over $100 billion without exceeding the present minimum capital rules including the 30 percent operational risk requirement that OFHEO imposed.

Third, to fund their mortgage portfolios and manage the attendant risks, Fannie Mae and Freddie Mac issue huge amounts of debt, over $50 billion a month, and use very large volumes of interest rate derivatives. Managing the prepayment risk associated with fixed-rate mortgages is complex and difficult. Interest rate volatility combined with the ability of borrowers to prepay mortgages without penalty make the durations of fixed-rate loans highly uncertain. Although they actively manage this mortgage prepayment risk, like other financial institutions, Fannie Mae and Freddie Mac do not fully hedge their risk. Their funding and hedging activities link the Enterprises to a wide variety of market participants. Holdings of Enterprise debt and MBS are concentrated at U.S. commercial banks and foreign central banks. Primary dealers in the markets for Treasury securities are also major investors. Those and other parties could expose the Enterprises to significant losses or in the event either Enterprise unexpectedly developed liquidity or solvency problems they could incur large losses.

Fourth, residential mortgage lenders rely heavily on Fannie Mae and Freddie Mac for long-term funding of conventional, single-family mortgages. That reliance provides considerable benefits to the housing sector; but, if either Enterprise experienced severe financial difficulties, housing activity and aggregate economic output would be reduced significantly.

Fifth, current law does not provide OFHEO with receivership powers, the most effective and credible tool for addressing claims in insolvency. The absence of receivership authority creates uncertainty, contributing to the possibility of a systemic disruption in the financial sector and a decline in economic output.

Systemic risk will not be eliminated by legislative reforms, but provisions in the Senate bill, with regulatory flexibility, could significantly reduce systemic risk while also reducing market, credit and operational risks. In particular, the risks caused by high leverage and large asset, debt and derivative portfolios could be reduced by a stronger regulator and growth and capital limits. Uncertainty in insolvency could be resolved by receivership powers.

Some have suggested that reducing the portfolios would cause mortgage market turmoil while just transferring the systemic risk elsewhere. If the portfolios downsizing were handled through normal repayments and a gradual sell-off, I believe, along with many experts, that the market impact would be small. Over the last two years, the Enterprises' agency MBS portfolios shrank by over $280 billion without market disruption. In many cases, investors replace Fannie and Freddie direct debt with higher yield MBS' guaranteed by them. Obviously, there would be less concentration of the market. The new investors may be better capitalized than the Enterprises, and better able to take the risk of long-term mortgage assets which might lessen the need to utilize the derivative markets.

A Strong Regulator is Vital for a Strong Housing Market

Not only has there been an ongoing debate on whether to impose growth limits on the two Enterprises, but also how. I commend the Senate bill for providing guidance on what assets could be held and for giving the new regulator critical authority to set limits based on safety and soundness and systemic risk. It also gives the new regulator critical authority to change both the risk-based and minimum capital rules. With adequate flexibility, we would agree that both approaches are crucial for the new regulator. The ultimate goal is to develop a comprehensive, risk-based capital approach that encompasses Enterprise and systemic risk while ensuring there is sound growth in homeownership and affordable housing in America.

In conclusion, Fannie Mae and Freddie Mac have proved that unconstrained growth can cause serious problems. If they were not GSEs the markets would have made them shrink rapidly in both their MBS guarantee and portfolio businesses. As the markets are not performing that discipline and OFHEO does not have the power or the tools to do so and be as effective as a bank regulator, there is a strong need for legislative reform now. The legislation would strengthen the regulator of Fannie Mae, Freddie Mac and the Federal Home Loan Banks and reduce market uncertainty, which I believe will be better for homeownership growth, housing and financial markets and all the GSEs.

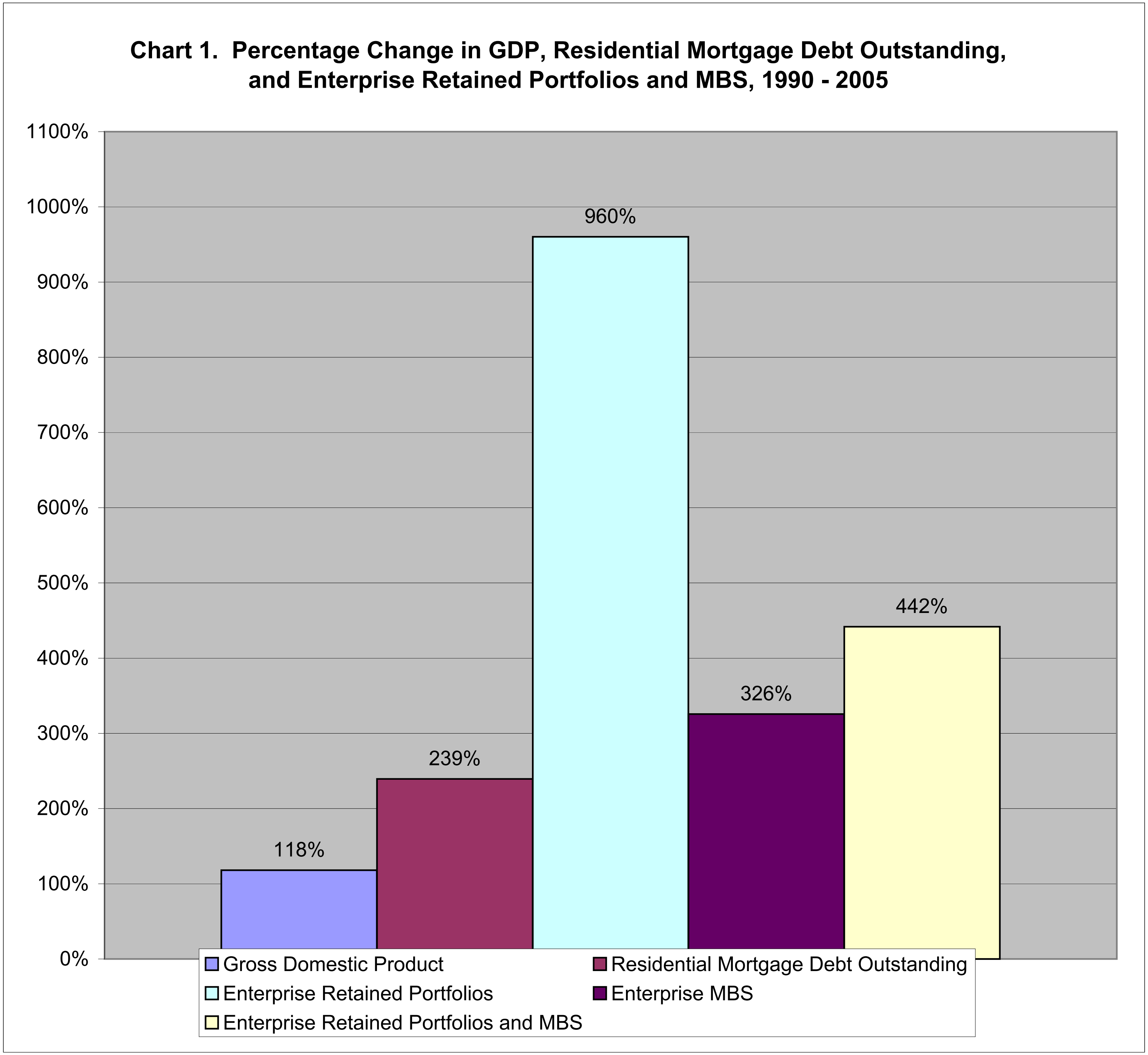
Chart 1. Percentage Change in GDP, Residential Mortgage Debt Outstanding, and Enterprise Retained Portfolios and MBS, 1990 - 2005
1100%
1000%
900%
800%
700%
600%
500%
400%
300%
200%
100%
0%
118%
239%
960%
326%
442%
Gross Domestic Product
Residential Mortgage Debt Outstanding
Enterprise Retained Portfolios
Enterprise MBS
Enterprise Retained Portfolios and MBS

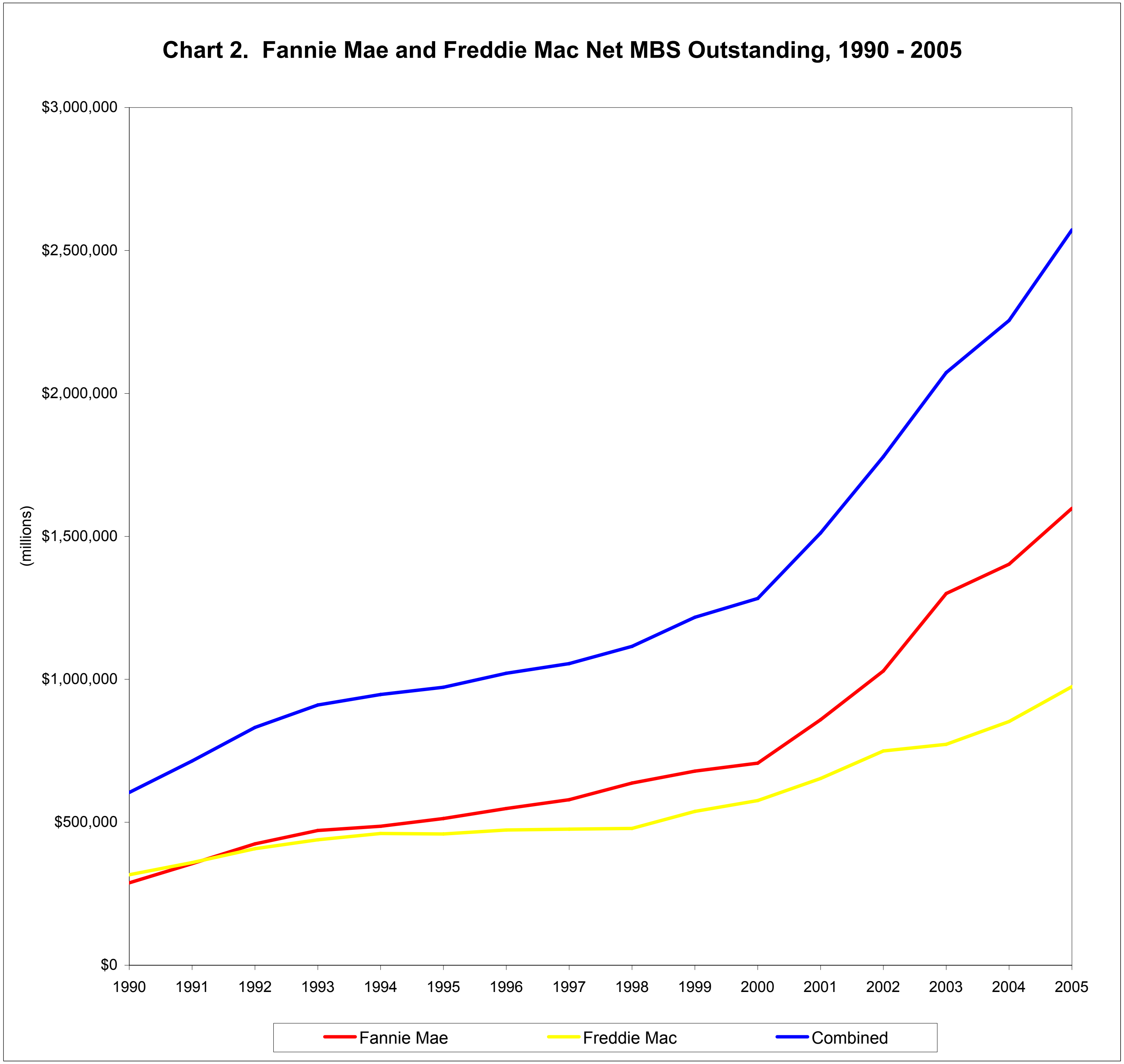

Chart 2. Fannie Mae and Freddie Mac Net MBS Outstanding, 1990 - 2005
$3,000,000
$2,500,000
$2,000,000
$1,500,000
$1,000,000
$500,000
$0
(millions)
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
Fannie Mae
Freddie Mac
Combined

Chart 3. Composition of Combined Retained Mortgage Portfolios of Fannie Mae and Freddie Mac, Year-End 2005

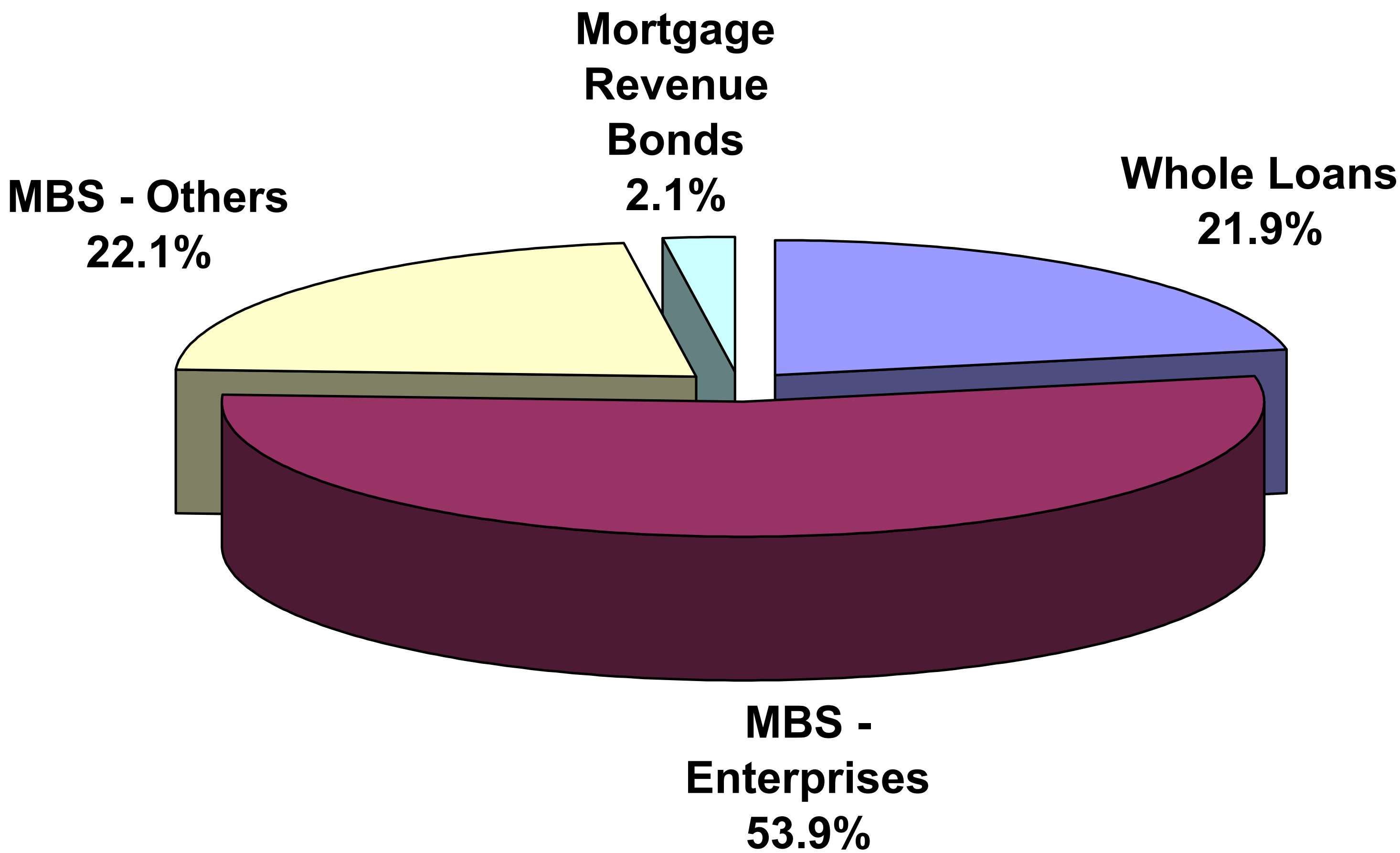

Chart 4. Fannie Mae and Freddie Mac Retained Mortgage Portfolios, 1990 - 2005