

GSEs: WHAT DOES THE FUTURE HOLD?
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Thank you for the opportunity to speak at the Secondary Market Conference here in New York City. It's a pleasure to discuss with you the latest developments in Washington. As you know, Congress has convened its final session of the year, and the issue of Government-Sponsored Enterprise (GSE) reform legislation is certainly foremost on our minds at OFHEO.

I am at the half-year point as Director of OFHEO and it's also been six months since the agency released its Report of the Special Examination of Fannie Mae. So it is a good time to reflect briefly on where we are and what the future holds for next year. As you are all aware, we continue to focus on ensuring 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. Although not on the same scale, several of the Federal Home Loan Banks (FHLBanks) are working their way out of problems.

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 stronger and more independent regulator of the Enterprises and the FHLBanks 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.

We have made great progress on that second goal of legislation, but time is running out in this brief session of Congress. If it does, I hope that we can get it done early next year. As both CEOs acknowledge, their problems and unconstrained growth have established the need for a stronger regulator. There is strong bipartisan support in Congress and the Bush Administration for reform and only a couple of issues that need to be resolved.

As you know, Fannie Mae and Freddie Mac have an important mission – to provide liquidity and stability to the secondary mortgage market while promoting affordable housing. At the end of the second quarter of 2006, these Enterprises owned or guaranteed about 40 percent of residential mortgages in the U.S. or approximately \$4.2 trillion dollars, comprised of two businesses:

- \$2.7 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 FHLBank system, overseen by the Federal Housing Finance Board (FHFB), the Banks hold \$800 billion in advances, mortgages, and private-label MBS that support residential mortgage lending.(#2) Combined with Fannie Mae and Freddie Mac, the total is about 47 percent of mortgage debt outstanding at mid-2006. In 2003, the total market share was nearly 54 percent. Despite the drop which was caused by the Enterprises' problems, the GSEs still dominate the U.S. mortgage market.

In terms of where the U.S. housing market is today, OFHEO tracks housing trends through a quarterly House Price Index (HPI). In recent years, our HPI has confirmed what we all know, that there has been an extraordinary and sustained "sizzle" in house price appreciation. However, that is changing now.

Over the most recent quarter, average house price gains have been less than 1 percent or 3.5 percent on an annualized basis.(#3) The housing market is cooling off. Sales of existing homes, as reported by the National Association of Realtors, dropped over 11 percent over the last year. Inventories of housing for sale have steadily increased during that period as well.

If home price appreciation continues to be low nationwide, and prices continue to decrease in some areas, there will be a substantial rise in loan losses. This is important given the significant role the Enterprises have in the mortgage market. It is also significant in terms of stronger regulatory oversight. If the market experiences more loan losses, the companies must be strong and the oversight of them must be stronger which is what the legislation is all about.

Let me now turn to the specifics of why legislation is needed.

Why is Legislation Needed? (#4)

There are many components in the GSE legislation pending in the House and Senate. The sticking points appear to be focused on two areas. The first issue is how to properly structure an affordable housing fund. The second is how to control their portfolios to ensure the Enterprises do not produce unnecessary risks. Before addressing these issues, let me first discuss the reforms that all agree are needed.

Certainty for the Enterprises

Legislative uncertainty is another cloud over the Enterprises. Both CEOs say that a stronger regulator will strengthen their credibility and new legislation will lessen the uncertainty that they and their shareholders face. Both have also said they support legislation to create a strong, well-funded regulator that would oversee the safety and soundness and the housing mission of the Enterprises. It is time for them to prove this support.

OFHEO Needs Bank Regulator-Like Powers

OFHEO is missing many of the tools that other financial regulators have. The new regulator needs the same safety and soundness powers that bank regulators have to help prevent problems. Explicit legal authorities and better enforcement powers are crucial for a stronger GSE regulator. Receivership powers in particular, which bank regulators have, 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.

OFHEO Needs More 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, like them, have no impact on the budget as we are funded by our regulatees.

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 1992 Act 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.

Strength Through Combining the Three GSE Regulators

Greater regulatory muscle and independence will also be provided by combining OFHEO with the FHFB. Combining these two regulators will provide more capability to ensure the safety and soundness of the U.S. housing finance system.

Done properly, a combined workforce will have enhanced skills, lower costs and be more responsive. The new agency would benefit from different ideas and approaches in areas such as examinations, capital, and accounting, while retaining dedicated teams working with the Banks and the Enterprises. Giving the new regulator responsibility for affordable housing goals will benefit from the added expertise of the FHFB and the Banks. And as I have said before, adding HUD's mission authority function is also important to a new regulatory regime.

Let me now address the two major sticking points in the legislation that I believe have bipartisan solutions.

Affordable Housing Fund

The first sticking point is how to structure an affordable housing fund, which is in the House-passed bill. The consensus now is that this fund should not be controlled by the GSEs, should not be related to profits because of their volatility, and should require reauthorization.

Reduce Risks to the Financial Markets

The second is how to prevent the Enterprises' portfolios from again growing to dangerous levels, while still providing incentives so they continue to focus on fulfilling their very important mission. 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 risk. They have grown too rapidly.(#5) Over the last 15 years, mortgages outstanding tripled and the Enterprises' portfolios more than tripled that by growing ten-fold.

Surprisingly, the logjam in reform legislation has been the term "systemic risk" and whether a regulatory agency should have the powers to prevent such risk.(#6) OFHEO's definition of systemic risk is: "... first, the risk that 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." All large financial institutions present some systemic risks, but some much more than others.

A key reason that the bank regulators and deposit insurance were created was to reduce the system wide 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 would be quite detrimental to financial markets and institutions. Sources of systemic risk include not only the quantity of risks and the quality of risk management, but also interactions with other financial institutions and markets.

The new regulator needs the powers to address the risks that these massive portfolios present. The legislative solution is now to provide the regulator with the power to address portfolio size and composition. The regulator would do so by regulation, based upon guidelines that ensure the companies can fulfill their housing mission and that recognize the risks the portfolios present.

Although the Enterprises have questioned the need for portfolio constraints, 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.(#7) Not counting the \$750 billion held in their portfolios, this \$2.7 trillion MBS business represents 26 percent of the total U.S. mortgage market. Remarkably, they have retained this market share since 1992.

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.(#8) About 54 percent of their portfolios are invested in their own MBS, which are easily saleable, and are much higher than necessary for liquidity. If the reduction is done through the sale of their MBS holdings, there should be no impact on the credit available to the housing market. The Enterprises would use the proceeds to redeem their debts. Investors would effectively be trading low-yielding Enterprise debt for higher-yielding MBS.

Some have suggested that reducing the portfolios would cause mortgage market turmoil while just transferring the risks elsewhere. Much of the prepayment risk is already transferred elsewhere through derivatives and callable debt. 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, especially foreign investors. In fact, over the last four years, the Enterprises’ ownership share of total mortgage-related securities fell 10 percentage points while foreign investors’ increased nine percentage points.(#9)

Shrinking their portfolios would reduce the risk of Enterprise failure and any potential adverse effects on the secondary mortgage and other financial markets. The legislation would ensure that the Enterprises could still perform their important mission and respond rapidly during times of turmoil by temporarily growing their portfolios.

A new, stronger and independent regulator with the powers of bank regulators is needed to oversee these institutions that are so important to the housing market and the U.S. economy. Make no mistake, these Enterprises are huge.(#10) As of September, their

combined guaranteed MBS and debt outstanding of \$4.3 trillion was not much smaller than the \$4.9 trillion publicly held debt of the U.S. If you add in the FHLBanks' debt, the total of \$5.2 trillion well exceeds the publicly held debt of the U.S.

OFHEO 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, and we will continue to build on that team. However, there is no doubt in my mind that GSE reform legislation is critically needed to enhance supervision and reduce risks. 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. If it does not happen this week, it will certainly be a top goal for OFHEO in 2007.

GSEs: What Does the Future Hold?



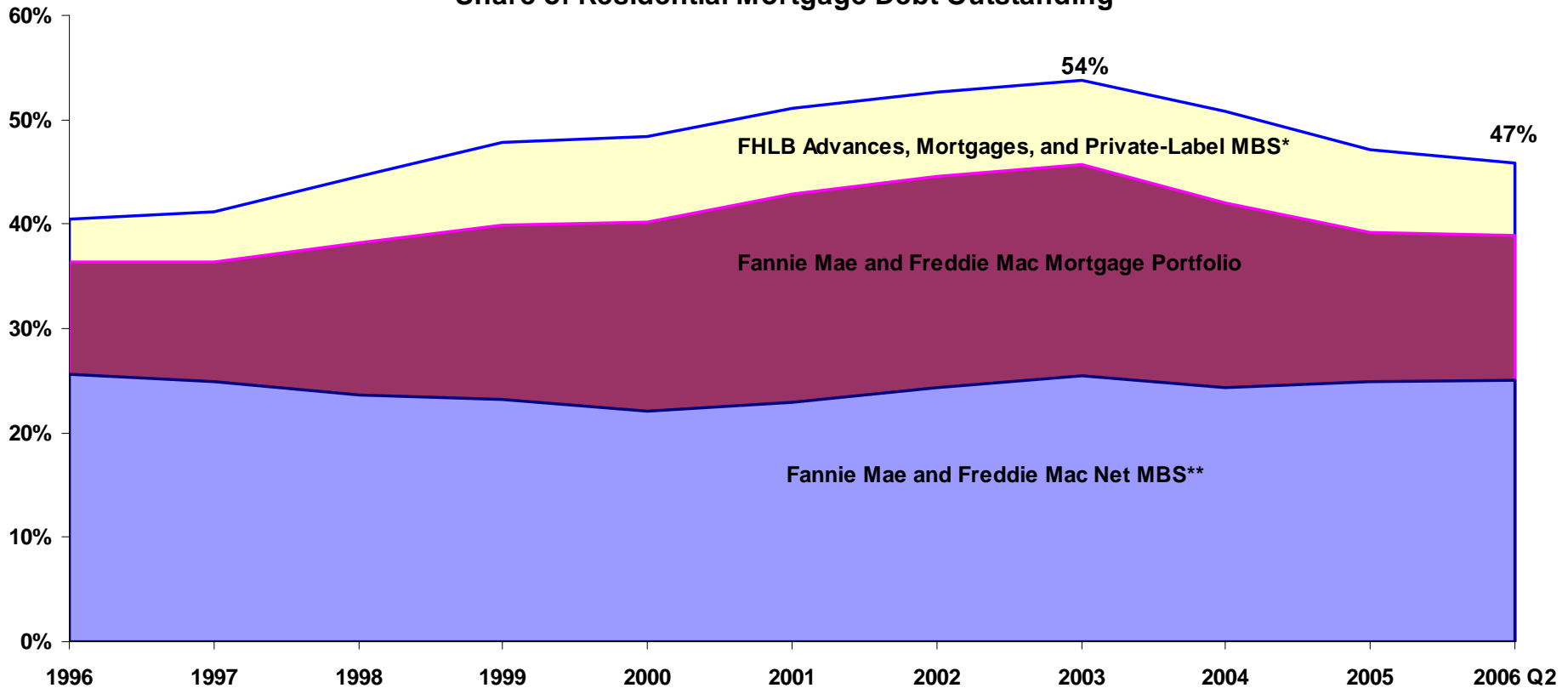
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GSEs Dominate the U.S. Mortgage Market



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



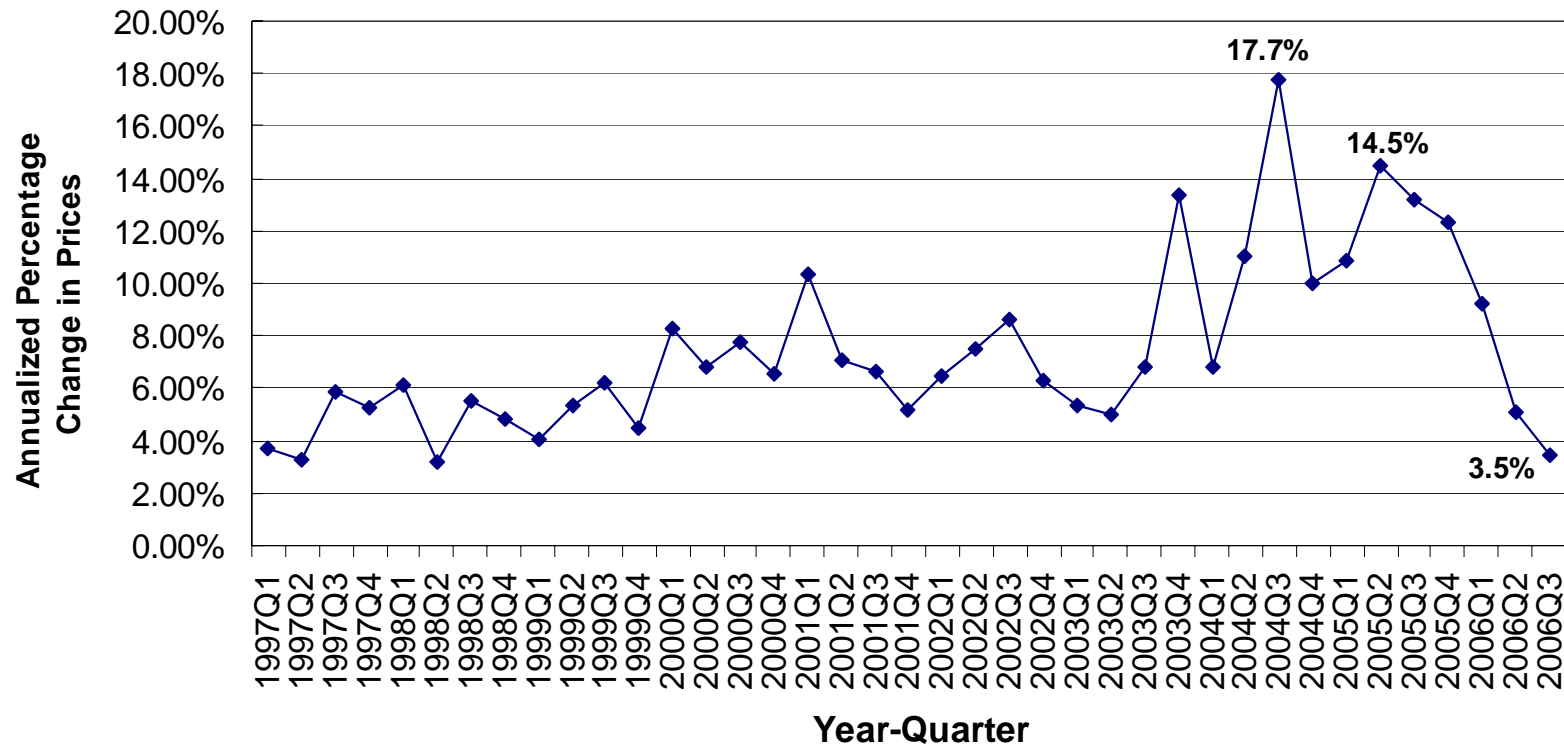
* FHLB members use advances for short-term liquidity and asset/liability management in addition to funding mortgages. Excludes Enterprise MBS held for investment, to avoid double-counting, and private-label MBS before 2004, when detail on FHLB MBS holdings is unavailable.

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

State of the U.S. Housing Market



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

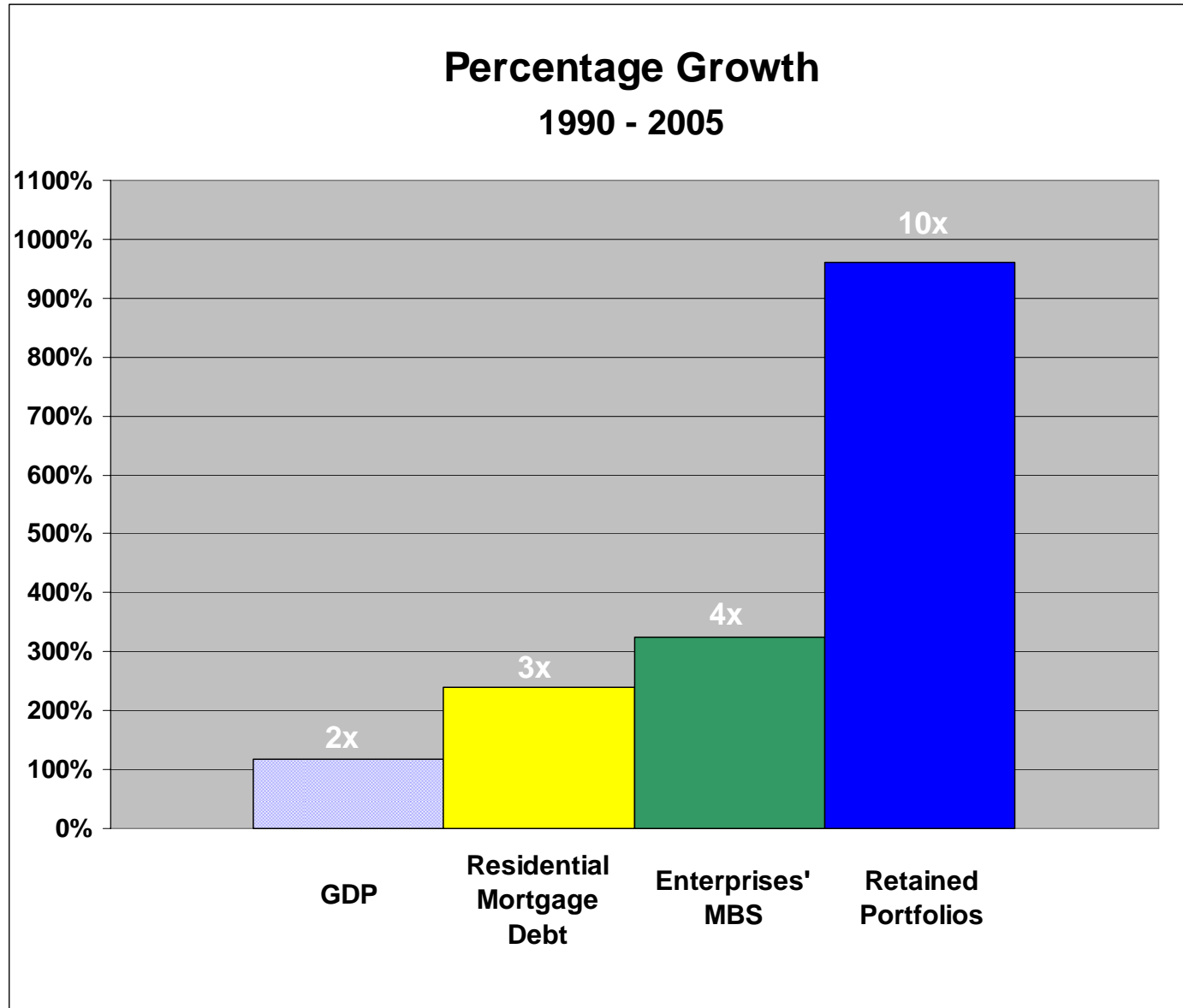


Why is Legislation Needed?



- Certainty for the Enterprises
- OFHEO Needs Bank Regulator-Like Powers
- OFHEO Needs More Independence
- Mission and New Product Authority Need to be Combined
- Capital Requirements Need Strengthening
- Strength Through Combining the Three GSE Regulators
- Affordable Housing Fund
- Reduce Risks to the Financial Markets

Portfolios have Grown Very Rapidly



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.

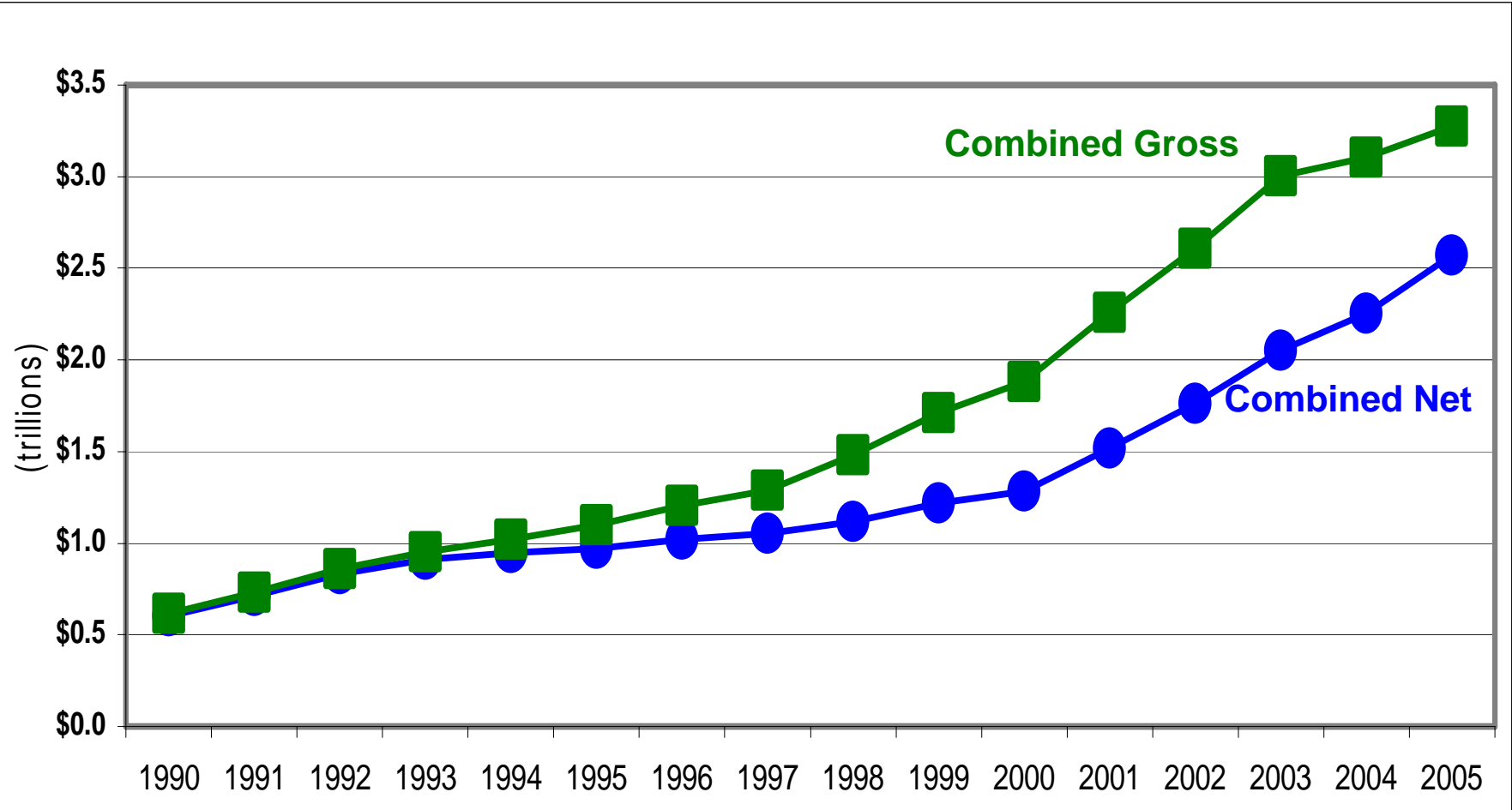
- Reducing systemic risk is an important role of bank regulators.

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

Guaranteed MBS Continuing to Grow



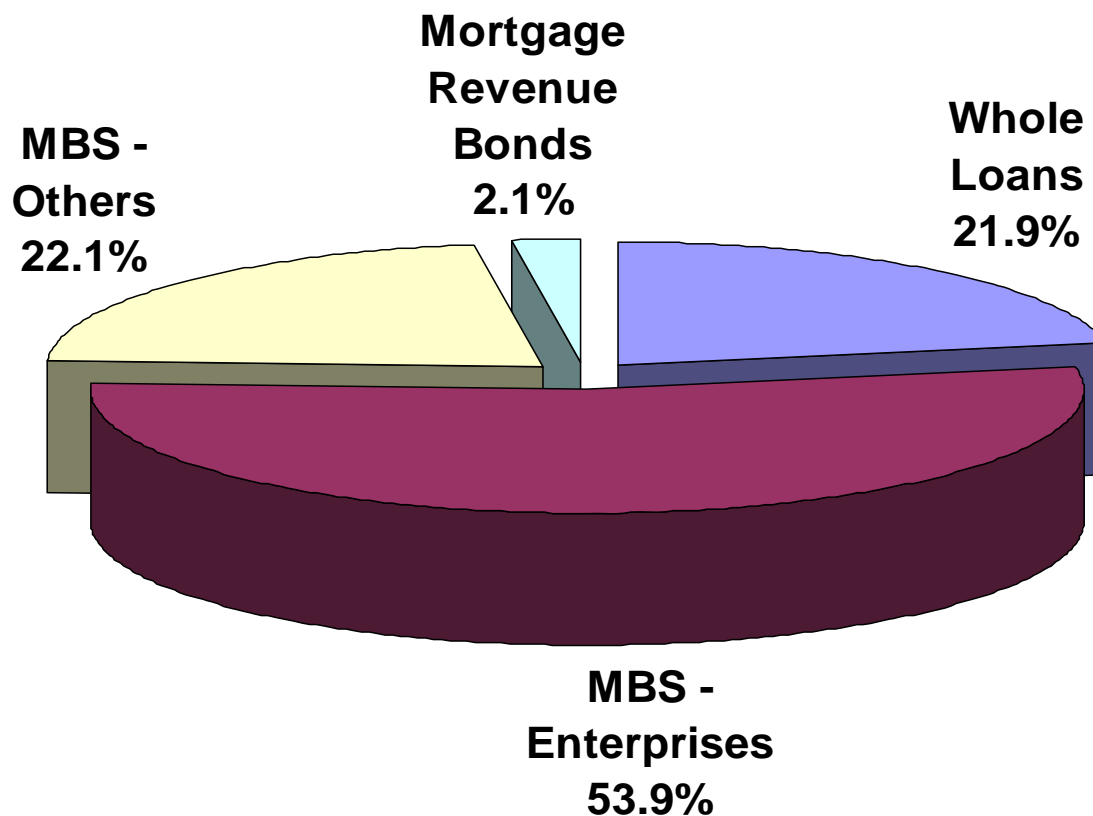
Fannie Mae and Freddie Mac MBS Outstanding
Gross and Net Basis
1990 - 2005



Portfolios Dominated by Own MBS



Enterprises' Combined Retained Mortgage Portfolios Year-End 2005

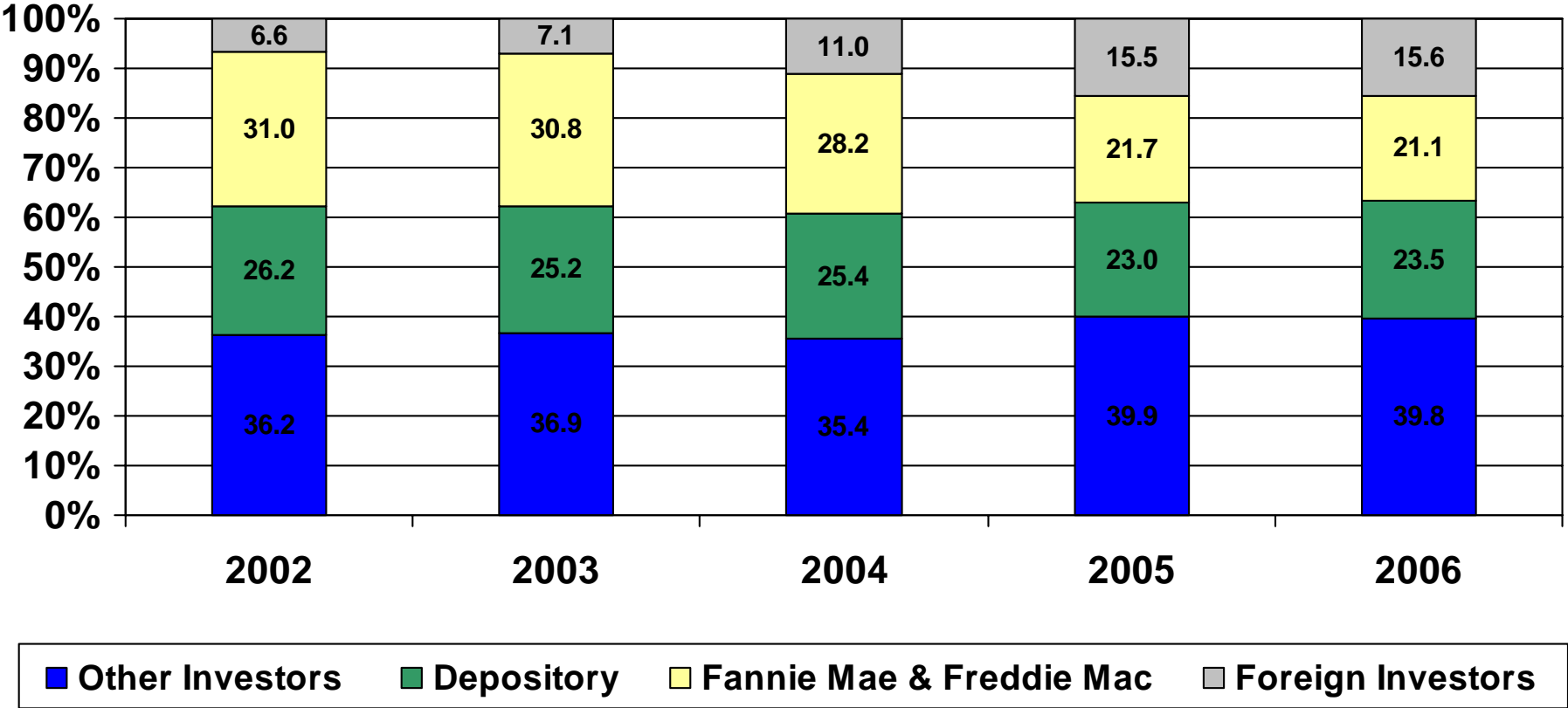


Contribution to Affordable Housing Goal Less Than 30%

Enterprises' Share of Mortgage-Related Securities Falling



Market Share Percentage



The Enterprises are Huge



Relative Size of Enterprise Obligations
(September 2006)

