

Leveraging the Housing Crisis

■ A federal regulator says that Fannie Mae and Freddie Mac should get new opportunities—if they accept stricter oversight.

By John Maggs

The subprime mortgage crisis has prompted calls to allow Fannie Mae and Freddie Mac—two government-sponsored companies that dominate the market for housing finance—to expand their lending. But the Bush administration has long questioned whether Fannie and Freddie already take on too much risk, and take advantage of the implicit guarantee that the Treasury would bail them out if they ran into trouble. Related accounting scandals forced the two companies to sign temporary consent agreements last year capping their lending portfolios at about \$725 billion each.

The House has passed legislation that would impose new regulatory controls on Fannie and Freddie, and administration officials are dangling incentives to try to move the bill through the Senate, in the face of Democrats' reluctance to tinker with a mechanism designed to use private markets to increase "affordable" housing. One inducement is to allow the two companies to temporarily lend money for "jumbo" loans above \$417,000, a lucrative market currently off-limits to Fannie and Freddie.

The legislation would create a powerful new agency to regulate the companies, a job that has been carried out by the Office of Federal Housing Enterprise Oversight, a small office within the Housing and Urban Development Department. James Lockhart, a veteran of government and the insurance industry, has headed OFHEO since 2006. His mission is to see that Fannie and Freddie bring their financial books up to date, and to get legislation approved to create a stronger regulatory agency. He sat down with *National Journal* last week for an update on those efforts. Here are edited excerpts.

■ **NJ: There is some pessimism about getting reform legislation done this year, and it begs the question: What would be the point of loosening the restrictions on Fannie Mae's and Freddie Mac's lending if they can't act on a**

timely basis? The legislation really would have to be completed in the next few weeks, right?

■ Lockhart: I've been optimistic. I think the legislation passed by the House is a very strong bill. There are some pieces of it that we'd like to see improved, but overall it gives some of the regulatory powers that are needed.

■ **NJ: Senate Banking Committee Chairman Christopher Dodd, D-Conn., has been noncommittal about moving a bill, and the body language seems to be that he's not interested in moving one this year. How do you read him?**

■ Lockhart: I've had conversations with him, not recently but several months ago, and he's indicated a willingness to work on the legislation. He's certainly had lots of public statements to that effect. There has been some shifting of priorities, given what's been going on in the subprime area, but it is very much on his agenda.

■ **NJ: Freddie Mac and Fannie Mae say they want freedom to buy more subprime mortgage securities, but these seem to be a bad investment now. Why do they want to do this in the current environment? And if it is a good investment, why would you as a regulator be so wary?**

■ Lockhart: As you know, we do have portfolio caps on [how much mortgage debt] they can buy, and we gave them some additional flexibility last week—\$20 billion each—to live up to their commitments to finance affordable housing over the next six months. Their mission is affordable housing and liquidity in the mortgage markets. And certainly there is instability and illiquidity in the subprime area. Obviously, there are some significant trade-offs. Both these companies [present] significant supervisory concerns. They are still not timely in their financial reporting, they have significant control

and risk-management problems. As a regulator, we are trying to make these trade-offs.

■ **NJ: Freddie and Fannie say they can't grow and compete without much bigger increases in those caps.**

■ Lockhart: These companies have been growing very dramatically this year, which isn't that well reported—12 percent growth, a very big number, even though their portfolios are capped at a very small growth rate.

■ **NJ: How is that happening?**

■ Lockhart: About 70 percent of their business is securitization, which is not capped—buying up mortgages, putting them in packages, putting their guarantee on them, and reselling them.

■ **NJ: Have you identified that as a concern?**

■ Lockhart: I think that's what has kept the conforming loan market [for mortgages under the \$417,000 limit] working so well. Obviously they, and we, are aware of the extra credit risk that is coming on because of that, and we are monitoring the two companies closely. They put in, on a net basis, something like \$360 billion in new business this year. Thirty percent of that is in the portfolios and the rest is in the securitization side.

■ **NJ: Does the rapid growth concern you?**

■ Lockhart: It is certainly an issue that we have to pay a great deal of attention to.

■ **NJ: And if growth is currently not capped, how would you do that?**

■ Lockhart: We're the safety-and-soundness regulator, that's what we do, so it is not capped at the moment, but it is definitely regulated. We have daily conversations with both companies on what is happening that day in the marketplace, so we are working with them very closely.

■ **NJ: So, let me ask again, why would they want to buy more of these subprime loans that are generally causing trouble for other investors? You seem to say they want to do it out of a sense of selflessness, to help out a troubled market. Are these good investments?**

■ Lockhart: There is definitely a profit motive. Certainly they have high [profit] margins at the moment.

■ **NJ: With higher risks as well.**

■ Lockhart: That's right.

■ **NJ: In the past, Fannie and Freddie have worked hard to defeat legislation that would strengthen oversight, while expressing neutrality or support in public. Any indication that that strategy has changed, and that they support an overhaul, or at least aren't working as hard as before to defeat it?**

■ Lockhart: Both CEOs have indicated to me and members of Congress that they want legislation. The enterprises were actively involved in commenting on the House bill before it passed, and they both expressed satisfaction with the bill. I would expect them to encourage prompt Senate action.

■ **NJ: There is an implicit guarantee that Treasury would bail out Freddie and Fannie if need be. The Bush administration has long been concerned that this implicit guarantee encourages risky borrowing. If they are allowed to expand now, isn't that creating more of a moral hazard?**

■ Lockhart: I come out of the insurance world, and moral hazard is something I understand well. Because of the implicit guarantee, there is a significant moral hazard at these two companies. They can basically borrow with no market discipline, and to me that is a moral hazard. So, yes, it is a concern, and that is why we are monitoring it very closely. And that is certainly one of the reasons why, in addition to all the safety and soundness reasons, we didn't allow their portfolios to grow by 10 percent as they wanted.

■ **NJ: If they bring their financial books up to date in February, as planned, the limitations on their portfolio investing will disappear. Is that wise?**

■ Lockhart: This assumes that there are no other safety and soundness issues. The way the [consent] agreements read, if they get their financials out, they comply with the Sarbanes-Oxley law, and the caps would be removed. Unfortunately, the law doesn't give us any power over that, which is why we need reform. We need reform to look at the capital rules, because these companies are highly leveraged.

■ **NJ: How leveraged?**

■ Lockhart: They have about \$4.7 trillion in mortgage risk on their books, on the basis of \$80 billion in capital. Under the consent agreement, this amount is about 30 percent higher than it was before, because of their safety and soundness condition. Without it, that \$80 billion could be even lower.

■ **NJ: What would the legislation do?**

■ Lockhart: The new regulator would have the power to set limits on the portfolios and capital [reserves]. It would continue to look at safety and soundness, liquidity in the marketplace, and then put forward a regulation that could limit the growth of portfolios. On the capital side, there are currently two [ways of setting the reserve requirements]. One is a risk-based capital model, adopted 15 years ago, and it is really out of date and really ineffective. The other kind of minimum is [simply an arbitrary number], and it was two and half percent by law [raised to 3.25 percent under agreements with Fannie and Freddie].

■ **NJ: How does that compare with other financial institutions?**

■ Lockhart: Well, the Federal Home Loan Banks [have reserves set at] 4 percent, major banks are running well over 6 percent, so it is a lot less. And part of the argument is that the mortgages are safer, but in this market that may not be totally true. The other counterargument is that they are not diversified like those other financial institutions, so they have all their eggs in the U.S. mortgage market.

■ **NJ: On September 20, Treasury Secretary Henry Paulson Jr. said that if the House measure is enacted, the administration would support Fannie and Freddie getting involved in "jumbo" mortgages, those loans above \$417,000. Is that something that OFHEO has advised Treasury about?**

■ Lockhart: The conforming loan limit is a number that has been calculated over the years. It is now \$417,000, but the median house price in this country is \$233,000, so the limit is much higher. But on the other hand, go to Oklahoma City, for example, and the median house price there is \$130,000, while out in San Francisco, it is over \$800,000. So having one number [is wrong], some people complain. And in the House legislation, there are allowances for high-priced markets.

■ **NJ: Does OFHEO back that change?**

■ Lockhart: Our position is, we took no position. We provided everyone a lot of information.

■ **NJ: So if Fannie and Freddie were to be allowed to go above the conforming rates, the jumbo loans would be securitized? The administration had previously opposed this.**

■ Lockhart: Yes, the administration has been against it. Now, what Secretary Paulson said is that it would be temporary, so it would kick in now when there is a little dislocation in the market.

■ **NJ: But that would have to happen very soon to affect the current market. How soon would this legislation have to clear?**

■ Lockhart: Soon. But this is legislation that has been worked over for years. All the issues are out there, and there are really only a handful left to resolve.

■ **NJ: But the Senate hasn't dealt with this as extensively as the House.**

■ Lockhart: Well, they passed a bill out of committee last year. It was definitely not bipartisan, but they have dealt with all the issues. And I've said, there are probably less than a handful of issues that need to be resolved. So it could be done quickly.

■ **NJ: When the administration opposed Fannie and Freddie entering the jumbo-loan market, what were the reasons?**

■ Lockhart: The reason was that Fannie and Freddie were created to help in affordable housing, and it is hard to imagine that someone with a mortgage over \$417,000 is in affordable housing. So it is diluting their mission somewhat. I think that's the primary reason, and normally that market is extremely well served by banks. And it is still being served by banks—they are just charging more because credit is more scarce.

■ **NJ: Well, in that circumstance, does it make sense to say, "Let's get the government involved"?**

■ Lockhart: My view is that on a temporary basis it might make sense, but it makes absolutely no sense unless you have a regulator who can control those moral hazards, and at the moment we just don't have that regulator to do that.

■ **NJ: Are the small increase in the caps and the offer to allow Freddie and Fannie into jumbos just incentives to get this legislation enacted?**

■ Lockhart: I don't want to make political judgments. ■

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