



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

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OFFICE OF THE DIRECTOR

October 31, 2007

The Honorable Paul E. Kanjorski
Chairman, Subcommittee on Capital Markets
Insurance and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives
2188 Rayburn House Office Building
Washington DC 20515-3811

Dear Chairman Kanjorski:

Thank you for your October 24 letter requesting my views on H.R. 3838 and S. 2169. As you know, both bills would increase for 6 months the portfolio caps applicable to Fannie Mae and Freddie Mac (the Enterprises). I believe that it would not be in the best interest of the safety and soundness of the Enterprises to enact this legislation. The legislation is unnecessary, difficult to enforce and sets an unfortunate precedent of overriding a safety and soundness regulator's judgment. It is also counter-productive to the important goal of achieving comprehensive GSE regulatory reform.

As noted in your letter, the legislation would specifically require OFHEO to increase the mortgage portfolio limitations set forth in the Fannie Mae Consent Decree and the Freddie Mac Letter by not less than 10 percent. It would also require that 85 percent of the increase be used to refinance subprime mortgages at risk of foreclosure (\$125 billion or approximately \$20 billion per month).

The current portfolio limitations are in place as a direct result of serious safety and soundness problems at each Enterprise. Both Enterprises have made progress in remediating the major operational, financial reporting, systems and risk management problems that resulted in the imposition of portfolio caps and other restrictions, but much work remains to be done. They also have growing exposures to credit risk. The legislation would directly contradict the safety and soundness determinations made by OFHEO. I believe that Congress should avoid interfering with a supervisory judgment on an important safety and soundness issue.

The Enterprises' presence in the conventional conforming loan market over the last 3 months has been very important in preventing more problems for the mortgage and overall financial markets. I believe that 3 key reasons that they were able to fulfill their mission were the portfolio constraints, extra capital requirements and strong

emphasis on prudent risk management imposed by OFHEO over the last 3 years. I share your concern that this proposed legislative "short-term solution" could produce "long-term detrimental consequences for our financial markets." The right long-term solution is comprehensive GSE reform.

On September 19, we announced several flexibilities to the portfolio limits, consistent with our ongoing safety and soundness concerns and with the Enterprises' mission of providing support and liquidity to the secondary mortgage market. At that time, we said that the portfolio cap flexibility plus the Enterprises' ongoing ability to securitize mortgages, sell assets, and replace maturing assets, would enhance each Enterprise's ability to purchase or securitize subprime mortgages, refinanced mortgages for borrowers with lower credit scores, and affordable multi-family housing mortgages. These efforts should assist lenders in helping some subprime borrowers avoid foreclosure. We also required each Enterprise to report to us monthly their subprime and affordable multi-family activities.

Despite this additional cap flexibility, the Enterprises' own public commitments to offering rescue mortgages, and their issuance of \$1.5 billion of preferred stock in September, both Enterprises *reduced* their retained mortgage portfolios in September. Freddie Mac cited as the reason for its \$19 billion portfolio reduction "activities to maintain a regulatory capital surplus over the 30 percent mandatory target capital surplus."

It is important to recognize that the subprime related portion of the legislation can be achieved by the Enterprises today, if it is prudent and possible without any further increase in the size of their mortgage portfolios. Given the new portfolio cap flexibility, portfolio maturities and sales and securitizations, on a combined basis, Fannie Mae and Freddie Mac could buy and securitize more than the legislative goal of \$125 billion over a 6-month period in subprime rescue mortgages without an increase in the portfolio caps. Using existing capacity, they can address the need for a deliberate process of expanding GSE subprime activities, maintain a strong safety and soundness regime, and address the ongoing requirements for adequate capital, which is required by regulation and desired by market participants. Also by using existing capabilities, the Enterprises would not have to shed the subprime mortgages after 6 months, which could cause a market disruption. Rest assured OFHEO will monitor growth in subprime exposure very closely, with ongoing review of the program's risk management and operations.

As a safety and soundness regulator with concerns about the Enterprises' risk management, systems, accounting, internal controls and growing credit losses due in part to shrinking house prices, OFHEO would be concerned about the rapid and substantial portfolio growth, and the considerable growth in subprime exposure, implied by the pending legislation. I believe that such a change would be imprudent and would

materially increase credit, market and operational risk for the Enterprises when they are ill-equipped to handle it. It would also add considerable strain to already limited capital resources and higher potential risks to the financial markets.

In conclusion, in my view, legislation increasing the portfolio is unnecessary, unsafe and unsound, and could have the unfortunate effect of appearing to set a target for subprime purchases that the Enterprises may not be able to meet safely. However, the recent mortgage market turmoil has once again shown that we do need legislation for a stronger regulator for the housing GSEs to ensure they can fulfill their critical missions in times of mortgage market turmoil. I appreciate your and the House's bi-partisan support of this crucial legislation (H.R. 1427) and look forward to continued work with you on its enactment.

Sincerely,

A handwritten signature in black ink, appearing to read "J. Lockhart III". The signature is written in a cursive, flowing style.

James B. Lockhart III
Director