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HEADLINE: Setting an OFHEO Plan, But Wishing Otherwise

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As another year ends without passage of a bill to reform the government-sponsored enterprises, James Lockhart, the director of the Office of Federal Housing Enterprise Oversight, finds himself in a position he has tried to avoid - thinking about his agency's future.

"Hopefully it doesn't have a future," Mr. Lockhart said, only half-joking during a recent interview. "It'll be very tough to manage this agency with one or two hands tied behind your back."

The OFHEO chief remains optimistic that legislation creating a new, stronger regulatory agency will emerge from the Senate early next year. But he is also aware that Fannie Mae and Freddie Mac are on track to become timely and current in their regulatory filings in February and that Congress may not act before then.

This scenario would undercut OFHEO's strategy of supervising Fannie and Freddie through consent orders and written agreements, which have included a $735 billion cap on their mortgage portfolios and a requirement that they hold an extra 30% of capital.

Mr. Lockhart has long used the GSEs' return to filing timely quarterly and annual reports with clean opinions from auditors as the benchmark for beginning talks on easing those restrictions. But many observers had hoped that, by the time this occurred, a new agency would be in place to oversee Fannie, Freddie, and the 12 Federal Home Loan banks.

Mr. Lockhart appears resigned to easing some constraints if Congress does notact.

"At the end of February, assuming they've got their ... [financial reports] out on a timely manner and with clean opinions and there are not material weaknesses, it is certainly possible that we will lift the portfolio caps," he said. "Without legislation, I'm very reluctant to lift the caps, ... but we have to live up to the agreements we made with the companies."

He acknowledged that removing the caps may have little near-term effect because both companies would still need to raise capital to increase their mortgage holdings.

"The question does become, 'Does that matter at this point, if they're capital-constrained?'" he said. "I'm not sure."

Mr. Lockhart is much less willing to remove the extra 30% capital requirement and says he will only discuss the matter once the GSEs bring their accounting up to date.

"The first test to me is to get the financials out, and if they can't get their financials out, there's really no reason to have the conversation," he said. "I've told the two companies we'll look at the cap when they put out their financials in February, and at that point we'll discuss what the tests are to get the 30% removed. ... Both companies would like the 30% removed, and in my view, it would be premature. They haven't resolved all their operational problems, and until they do that, especially in this market, I don't think it would be a very safe and sound thing to do."

Mr. Lockhart is considering his options as both GSEs find themselves battered by the subprime crisis. Fannie's third-quarter net loss more than doubled from a year earlier, to $1.4 billion, and Freddie's nearly tripled, to $2 billion.

Freddie's third-quarter report also revealed it had just $600 million more than its required capital. Both GSEs have struggled with capital requirements and have responded by selling preferred stock. Mr. Lockhart said both proved unprepared for such a significant housing downturn.

"Frankly, they could have conserved capital better than they did, in my view, and we've told them that," Mr. Lockhart said. "That's why they had to react so quickly and issue such a big amount of preferred" stock.

Despite the GSEs' stumbles, he said, they are doing almost everything they can to help the subprime mortgage market.

"They can only be as active as the banks themselves that are doing this, and they haven't been as active," he said. "There's a real tradeoff ... between safety and soundness and ... [the GSEs'] affordable-housing mission and their mission of keeping the secondary market liquid. And we're encouraging them, obviously, to fulfill their mission, but at the same time we have to worry about safety and soundness."

Mr. Lockhart also defended the GSEs' right to charge "adverse market" fees on the loans they buy during the housing slump.

"There's a lot of risk in this marketplace, and that's really related to the potential for bigger losses, and so from our standpoint as a safety and soundness regulator, we can't say you shouldn't raise your fees," he said. "The problem is, everybody so underpriced their product for the last three or four years that you really don't know what the right price is. ... I think they're trying to reprice to get to the right risk level."

As the GSEs move closer to emerging from their accounting scandals, they are still hitting some bumps. Investors were shaken in November by the way Fannie handled the disclosure of a $670 million provision for credit losses.

"The bottom line was not affected, but the way they disclosed it was probably not as forthright as it could have been, and that concerned the analysts," Mr. Lockhart said. "The analysts now understand what happened. But it was a confusing disclosure of a change."

Mr. Lockhart said hindsight has shown he was right to oppose a proposal offered this fall by Sen. Charles Schumer, D-N.Y., and House Financial Services Committee Chairman Barney Frank, D-Mass., to temporarily raise the portfolio caps by 10% to ease the housing crisis.

"My concern back in September and August when there was a lot of pressure to raise it 10% was, frankly, what happened - that there was a lot of credit risk out there that was going to start to be reflected and potentially hit their capital," he said. "If we'd increased that 10%, that would have been a significant amount of additional capital they would have had to raise."

From his vantage point, Mr. Lockhart says there is near universal agreement that regulation of the GSEs should be reformed, despite tension surrounding proposals to raise the conforming loan limit and require Fannie and Freddie to contribute to an affordable housing fund. Though the House passed a GSE bill in May, the issue has stalled in the Senate, he said, because it has simply failed to become a top priority.

"We've never sort of gotten it to the front burner," he said. "Other bills have passed and I just wish ours was on the front burner but it hasn't made it there."

In part that is because Senate Banking Committee Chairman Chris Dodd is busy campaigning for president. "He is out in Iowa, so obviously he's not spending as much time on this as he normally would," Mr. Lockhart said.

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GRAPHIC: photo, Lockhart

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