OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

NEWS RELEASE

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Speech by the Honorable Armando Falcon, Jr.
at the Mortgage Bankers Association of America's Annual Convention
October 31, 2000

Good Morning. It's a pleasure to be here. I appreciate the opportunity to speak to you about GSE regulatory issues. Having just completed my first year as Director of OFHEO, I am proud of our accomplishments and anticipate another productive year. I plan to give you an update of our regulatory initiatives and share with you some of my thoughts on the recent voluntary measures announced by Fannie Mae and Freddie Mac.

As you know, Congress charged OFHEO with developing a comprehensive regulatory program. We have done that. We have in place an annual risk-based examination program, a traditional minimum capital standard, and a research capacity necessary to support those efforts. And by the end of this year, we will send our risk-based capital rule to the Office of Management and Budget. After the OMB review, the final rule will be published in the Federal Register early next year.

OFHEO's risk-based capital regulation represents a significant advancement in the ability of regulators to closely tie capital to risk. The regulation utilizes a stress test which calculates the amount of capital necessary to remain solvent through stressful economic conditions. This standard will work in tandem with OFHEO's existing minimum capital regulation. The importance of getting the job done is more critical than ever.

The combined retained mortgage portfolios of the Enterprises are rapidly approaching 1 trillion dollars. That means the Enterprises are managing more mortgage interest rate risk than the entire thrift industry. The rule will ensure that the capital they hold corresponds to the risks they face while giving them the flexibility to decide for themselves how best to meet the requirements.

In developing the stress test, OFHEO has developed expertise with uses beyond the risk-based capital rule. Let me give you an example. The rule requires that we have reliable data on movements in real estate values. As such, we developed a repeat sales index which we call our House Price Index. We now make that index available to the public on our website on a quarterly basis.

In addition, OFHEO has developed computer modeling expertise which will remain a part of our regulatory program. That modeling expertise will allow us to analyze the impact of external factors, such as regional economic trends, on the Enterprises' business.

As I mentioned a moment ago, the risk-based capital test is merely one component of OFHEO's overall regulatory program. Another part of this program includes ongoing efforts to enhance public disclosure of the Enterprises' risks and activities. While I will say more about this in a moment, enhanced disclosure will promote market discipline as a complement to our supervisory activities.

Another component of our overall supervisory program is our highly-regarded examination team. This team of examiners provides me with up-to-date analysis of the Enterprises' business. To ensure adequate oversight, I will continue to seek the resources necessary to enhance and improve our examination program.

In addition, OFHEO's research helps us understand the ever-changing world in which Fannie Mae and Freddie Mac operate. OFHEO is undertaking a study of the systemic risks posed by the Enterprises. Just yesterday, we published a notice in the Federal Register requesting comments on a series of questions related to this topic. I encourage everyone here to look at these questions and to provide OFHEO with your thoughts and analysis on systemic risk.

Now I want to turn to the voluntary steps recently announcement by Fannie Mae and Freddie Mac. As you've likely heard, the Enterprises announced they would (1) self-implement a risk-based capital standard on an interim basis, (2) issue subordinated debt, (3) meet certain liquidity standards, (4) enhance their disclosure of interest rate and credit risk, and (5) obtain and disclose annual credit ratings.

Let me say unequivocally any effort to enhance public disclosure of the Enterprise's risks and activities is very sound public policy. As government-sponsored enterprises, the public has a right to know what the Enterprises are doing and how they are doing it. Furthermore, these initiatives are certainly not a substitute for OFHEO's plans to improve transparency.

I'd like to talk about the Enterprises' effort to simulate our risk-based capital regulation on an interim basis. I wholeheartedly agree that regular disclosure of Fannie Mae and Freddie Mac's capital position is a vital element in any meaningful program of transparency.

We are already looking at ways to enhance public understanding of the capital adequacy of the Enterprises. As a case in point, earlier this year we began a comprehensive review of our minimum capital regulation. The review was prompted by my concern that the Enterprises met our capital standard by only a thin margin at times and our further finding that one of the Enterprises was very close to being undercapitalized between reporting periods. I therefore instructed the Enterprises to report their capital positions to OFHEO on a monthly basis. As a result, the capital cushions have improved, and we are closely monitoring them and will act quickly if a similar situation arises. This is prompt corrective action.

Now I don't normally discuss such supervisory matters, but in the current political environment I think it is important for everyone to understand that OFHEO is on the job, day in and day out, making sure that the Enterprises are operating safely and are adequately capitalized.

We plan to seek comments early next year on proposed amendments to our minimum capital regulation. First, the proposal will require monthly public reporting of the Enterprises' capital. Second, the proposal will provide greater disclosure of how the GSEs meet the standard. And third, the proposed revisions will provide incentives for the Enterprises to maintain a healthy cushion above the minimum requirement.

Let me add one more thought to the Enterprises' announcement on the interim stress test. There are hundreds of large and small issues that arise in designing and building a stress test. The manner in which those issues are resolved can have a large impact - both individually and cumulatively - on the amount of capital required. Anyone who has reviewed our proposed risk-based capital rule understands this. The 1992 Act gives specific guidance on only a few of these issues.

The manner in which the Enterprises' version resolves all these other issues will impact the strength and reliability of their interim test. Indeed, many of their comments on OFHEO's rule would have significantly weakened our stress test.

Fannie Mae and Freddie Mac also announced that they plan to issue subordinated debt. It is not clear how useful subordinated debt would be in strengthening market discipline for government-sponsored enterprises.

While I remain open-minded, it's hard for me to imagine that their GSE status would not in some way influence how their sub debt will trade. Currently all Enterprise securities carry an explicit statement that they are not backed by the full faith and credit of the U.S. government. Yet the market treats these securities as though they are government guaranteed. How and why would the markets treat sub debt any differently?

For arguments sake, lets accept for a moment that the market does price Enterprise sub debt as though there is no implicit guarantee. For subordinated debt to be effective as a market discipline tool, several issues must be properly resolved.

First, what are the characteristics of the debt itself? As a general matter, sub debt is more effective if it is convertible to equity on a permanent basis rather than simply having interest payments suspended, especially when the investor is later made whole.

Second, the event that triggers the suspension of interest or the conversion of the debt to equity should occur well in advance of potential insolvency. This would provide for maximum market scrutiny and provide the Enterprises with additional incentives to maintain a significant capital cushion.

Finally, the issuance and trading of sub debt must be sufficiently large and liquid.

While I reserve judgement on the utility of sub debt for a government sponsored enterprise, there is one point on subordinated debt that I want to make crystal clear. I do not believe that subordinated debt is or should be a substitute for real equity capital. A strong regulatory capital standard using real capital is in everyone's best interest. Currently, subordinated debt does not count for purposes of meeting our minimum or risk-based capital requirements. I have no plans to change that.

The Enterprises also announced that they will provide more frequent and enhanced disclosure of interest rate risk and credit risk. This initiative is consistent with OFHEO's views on transparency.

The Enterprises also announced voluntary liquidity standards. Specifically, they intend to maintain at least three months' liquidity and 5 percent of their assets in the form of liquid investments. Frankly, this decision has no practical effect on the Enterprises. They both currently far exceed these standards.

Finally, the Enterprises announced they will obtain annual credit ratings. These ratings would be similar to risk-to-the-government ratings OFHEO obtained from Standard & Poor's in 1996. Like other disclosures, ratings such as these can be useful to assess the financial health of each company at a particular point in time, but they are no substitute for a comprehensive regulatory program.

In closing, let me say that it has been a good year at OFHEO. We are going to get the risk-based capital rule done. We are moving aggressively to fulfill all of our other responsibilities. And despite all of the political undercurrents on GSE issues, we will continue on a steady course and fulfill our mission. I look forward to another successful year for OFHEO.

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OFHEO was established as an independent entity within the Department of Housing and Urban Development by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title XIII of P.L. 102-550). OFHEO's primary mission is ensuring the capital adequacy and financial safety and soundness of Fannie Mae and Freddie Mac.