



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

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**Speech by the Honorable Armando Falcon, Jr. at
the Prudential Financial Service Group Regulatory Conference
October 3, 2000**

OFHEO's job of ensuring that Fannie Mae and Freddie Mac remain safe and sound is integral to maintaining the world's best housing finance system and the market's confidence in the system. That confidence keeps capital flowing into the system, to the benefit of homeowners.

In fulfilling our oversight responsibilities, OFHEO is similar to the U. S. bank regulatory agencies in a number of ways. Like the other agencies, OFHEO:

- Enforces statutory and regulatory standards, including, and perhaps most notably, both minimum and risk-based capital standards;
- Conducts examinations; and
- Conducts research on the institutions we oversee, the environment in which they operate, and the nature of the risks they face.

While these functions are similar to those of the other regulators, OFHEO's implementation is quite unique.

First, OFHEO's risk-based capital standard for the Enterprises utilizes a stress test for determining capital requirements. It is very different from the asset classification system used by the banking regulators. A stress test models the economic performance of an Enterprise's current book of business when subjected to severe credit and interest rate conditions. This involves modeling cash flows associated with mortgage defaults and prepayments, callable and noncallable debt, derivatives, and nonmortgage investments. The financial models for the stress test were written by an OFHEO team with extensive experience modeling financial instruments for Wall Street, and were estimated using combined historical data from both the Enterprises.

As you know, OFHEO has dedicated an extraordinary amount of time and resources to complete our risk-based capital regulation. It will be a major component of OFHEO's multifaceted regulatory program for the Enterprises, which includes capital regulation, examinations, and research and financial analysis.

The risk-based capital standard will work in tandem with OFHEO's minimum capital standard to determine the capital adequacy of each Enterprise. The minimum capital standard is a simple ratio-based capital standard for on-balance sheet assets and off-balance sheet obligations. The minimum capital standard is designed to grow the capital base as the Enterprises grow in size. The risk-based capital standard is designed to grow the capital base as risk increases. Each Enterprise will be required to hold capital equal to the higher of the minimum or risk-based standards.

We are on track to finalize the risk-based capital rule and send it to OMB for review by the end of the year. And once OMB has cleared the rule, we will publish the stress test in the federal register and release the source code for the stress test models to the public. This will make the stress test fully transparent to all interested parties.

While the risk-based capital standard is identical for each Enterprise, the resulting capital requirement will be different for each company. It will be different because the stress test measures the unique risks associated with each company's book of business, including the way in which these risks are managed. For example, a well-hedged mortgage investment portfolio will have a lower capital requirement than a portfolio that is not well hedged. Thus, by tying capital closely with risk, the stress test gives the Enterprises a strong incentive to manage risk effectively.

A stress test is a particularly useful regulatory capital standard because of its forward-looking nature. It requires that each Enterprise to hold capital for expected losses resulting from severe economic conditions before actual losses work their way through to the balance sheet. This enables the stress test to serve as an early warning indicator.

In addition to an early warning indicator of financial trouble, the stress test has the benefit of helping the Enterprises and OFHEO diagnose the cause(s) of potential trouble. For example, the cause of losses associated with large swings in interest rates can be identified by the stress test. With this analysis, action can be taken by the Enterprises, such as buying more hedges, to better insulate themselves from interest rate risk. Also, the stress test can help to quantify potential risk exposures to the Enterprises from regional economic recessions. For example, we will be able to simulate the impact of a recession in California on the Enterprises balance sheets and capital. Conversely, the stress test can help to measure the benefits of diversification and hedging. It will also help to better identify the economic trends that serve as warning signs to trouble ahead.

Regarding exams, like other regulators, OFHEO has a group of talented and experienced examiners. They evaluate the Enterprises for the quality and quantity of risk they bear and for the quality of risk management. We have gone a step further by making our examination program completely transparent. Both the Enterprises and the public know the exact criteria on which assessments are made.

Our examination program is comprehensive and risk-based. We examine the risks faced by the GSEs and their management of those risks through ten program areas: Credit Risk, Interest Rate Risk, Liquidity Management, Information Technology, Internal Controls, Business Process Controls (which focuses on the control framework for new or substantially revised business initiatives), Audit, Board Governance, Management Information and Management Processes.

Every year OFHEO's exam staff rates each company on more than 100 assessment factors within these program areas. The criteria used as the framework for each assessment factor is explicitly identified – for me - for the Enterprises – and for the public in OFHEO's Examination Handbook. Further, OFHEO provides greater transparency because we report to Congress annually about the results and conclusions of our examinations of Fannie Mae and Freddie Mac.

Also, like other regulators, OFHEO conducts research and analysis on the institutions we regulate, the markets in which they operate, and the risks that they face. Research is vital for effective regulation. It provides the regulator a clearer understanding of today's environment and an ability to better anticipate future challenges. Like many sectors of our economy, the mortgage industry is rapidly changing, spurred by advances in technology. Indeed, Fannie Mae and Freddie Mac are constantly striving to keep pace with this change.

OFHEO, as well, must adapt or become ineffective. Research, analysis, and the ability to discern trends are key to the successful evolution of our regulatory program. For example, OFHEO has recently initiated a study on the systemic risks posed by the Enterprises' activities. The study will help OFHEO ensure that our regulatory program is adequate to preserve the safety and soundness of the Enterprises.

Of course there is always room for structural improvement at OFHEO, especially in the way the agency is funded. Unlike all other financial regulators, OFHEO is subject to the uncertainty of the annual Congressional appropriations process. As we speak, OFHEO is operating under a temporary one week appropriation. My concern is that this lack of financial independence and flexibility could prevent OFHEO from fully carrying out our mission, particularly during a financial crisis at either Enterprise. I have urged Congress to remedy this flaw and exempt OFHEO from the appropriations process.

Let me now step back from the specifics of OFHEO's regulatory program and consider the big picture. In these challenging and changing times, consider some of the questions that weigh on all our minds:

- What will the housing finance system look like in one, five and ten years?
- What further effects will technology and e-commerce have on the mortgage process?
- How will the distribution of various risks change over the course of this decade?
- Will the market's understanding and pricing of mortgage risk keep pace with the changes?

Of course there are numerous opinions on the answer to each of these questions. But there is one thing that everyone agrees on, that there is no certainty.

From this uncertainty, emerges a form of strategic risk.

We must evaluate the Enterprises' exposure to such strategic risk, just as we review credit or interest rate risk. OFHEO's examination program dedicates substantial resources in assessing the nature and extent of "strategic risk" through our examination program areas. When we examine for strategic risk, we look not only at the business plans, but also at management's vision and direction. We assess the company's ability to implement and execute its articulated strategy. We assess visioning, or how business plans advance the company's overall strategy. In short, we assess how the GSEs manage change.

It has always been important for a regulator to understand the strategic directions and philosophies of the companies it regulates. But it has never been more important than it is today, in this new information and electronic age. The pace of change for all financial intermediaries is sobering, and most observers expect that pace to continue and to even accelerate. In this new information age, the traditional rules are changing and a company's past success has little predictive value in this new economy.

To evaluate strategic risk properly, we particularly need the input and results of research. Thorough research and analysis will allow OFHEO to understand the opportunities and dangers of the environment in which the GSEs operate. Research will allow OFHEO to evaluate changes in business and technology — that can present real challenges to the Enterprises' business lines, and to their financial safety and soundness.

Thus, as OFHEO continues to carry out its statutory mission, we are examining for strategy, execution and vision. And we will continue to refine all our efforts to ensure these companies are safe and sound as they seek to fulfill their public mission.

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