



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

NEWS RELEASE

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Contact: Stefanie Mullin
202.414.6921
www.ofheo.gov

Remarks of the Honorable Armando Falcon, Jr.

**Mortgage Bankers Association of America (MBAA)
Washington Leadership Conference**

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I am pleased to be a part of the MBA Washington Leadership Conference. I've had the pleasure of working with the Mortgage Bankers Association over the years in my previous capacity as Counsel to the House Banking Committee, and I look forward to continuing that relationship in my new capacity as Director of the Office of Federal Housing Enterprise Oversight (OFHEO).

There are obviously many important issues facing the mortgage industry right now, and they arise in a climate of much uncertainty.

Having heard Charlie Cook's report earlier today, political uncertainties may be on your minds right now.

Questions like:

- (1) Who will win the White House in November?
- (2) Who will be appointed to key positions in the next Administration?
- (3) Which party will control Congress?
- (4) And what are the prospects for various legislative proposals that impact the mortgage market?

Add to those questions the many business uncertainties in today's mortgage market. Automation is quickly changing the way the industry operates from top to bottom. This automation — along with the new activities and growth of Fannie Mae and Freddie Mac — is blurring the line between the primary and secondary mortgage markets.

These trends are very likely to continue as the Enterprises search for new opportunities to meet their stated financial goals of continued strong earnings growth.

1700 G STREET N.W., WASHINGTON, D.C. 202.414.6922 FAX 202.414.3823

With these and other developments, no one can say for certain what the mortgage business will look like in five or ten years.

To help address these uncertainties, Congress created OFHEO in 1992 as an independent agency within HUD, responsible for maintaining the integrity of the secondary mortgage market. It is a responsibility that I take very seriously.

As with other financial regulators, Congress also insulated OFHEO from partisan politics and the potential turnover of a new Administration every four years.

Last June, the President nominated me to be Director of OFHEO. In late September, the United States Senate approved my nomination by confirming me to a five-year term. I intend to serve out my full term and fulfill my duties in a completely nonpartisan and unbiased manner.

Seven years after its creation, OFHEO has matured into a strong and very capable regulator. We have a top-notch regulatory program in place to ensure the safety and soundness of Fannie Mae and Freddie Mac.

I would match our examination program against any in the government, and our risk-based capital regulation will be state-of-the-art when it is implemented. I will say more about that later.

OFHEO does, however suffer from one institutional deficiency: Lack of financial independence.

Unlike all other federal safety and soundness regulators, OFHEO is subject to the appropriations process.

Although our funding comes directly from the Enterprises, Congress must approve our budget annually. We do not have the flexibility to respond quickly to changing conditions, especially a deteriorating one, of the Enterprises or the market.

This is simply unsound public policy, and I have asked Congress to put us on par with all other safety and soundness regulators by removing OFHEO from the appropriations process.

OFHEO has significant oversight responsibilities under the law. Our primary focus has been, and always will be, in the examination and capital regulation areas, which are essential to ensuring the safety and soundness of the Enterprises.

But it is now time to expand the other activities that are part of our oversight responsibility.

We are now taking a more active interest in the operation of the entire secondary mortgage market and enforcement of the laws within our jurisdiction.

In addition, we are putting our resources to work analyzing and understanding the changes taking place in the primary market. With the mortgage industry so deeply intertwined and interdependent, to do otherwise would be irresponsible. A healthy secondary market relies on a healthy primary market, and vice versa. With a thorough understanding of the Enterprises' activities and changes in the mortgage industry, we can better assess how those changes impact the Enterprises.

Any changes in risk to the Enterprises will then be incorporated into our regulatory program. In addition, OFHEO will be able to provide policymakers with sound and authoritative research on the policy implications of developments in the industry.

Now that I've tried to share with you the direction for OFHEO, let me discuss some activities of current interest.

First and foremost is OFHEO's risk-based capital regulation. My number one priority is to bring the rulemaking process to a conclusion and implement a final rule.

After 11 months, the comment period on this rule will close Friday.

I understand that many of you may be involved in one way or another, in finalizing the MBA's comments on this rule. I appreciate the hard work you have done and look forward to receiving your comments.

We will review all comments with an open mind, and won't hesitate to incorporate suggestions that improve the rule.

As background, allow me to very briefly describe how the rule works, as it is much different from a risk-weighted leverage standard. Now this description will be true test of your ability to stay awake during a dinner speech.

The rule uses a stress test to simulate the financial performance of the Enterprises under severe economic conditions.

This financial simulation then produces a risk-based capital requirement.

The economic conditions are defined in law and include high levels of mortgage defaults and associated losses, and large sustained movements in interest rates.

Computer models are used to simulate the performance of mortgages and other assets and obligations under these stressful conditions.

The modeling of cash flows thus captures the risks associated with enterprise assets and obligations, as well as the benefits of hedges.

The Enterprises must have sufficient capital to survive the losses under these difficult circumstances for ten full years — that's every quarter of every year. After this figure is determined, the statute requires that the capital requirement be further increased by 30 percent for management and operations risk.

The stress test will, of necessity, be dynamic. It will need to evolve and change over time to reflect new products, innovations in risk management, and new techniques for measuring risk. The stress test will give the Enterprises immediate credit for reducing risk, and quickly increase capital when risk increases.

This allows the Enterprises flexibility to operate their businesses while closely matching capital to risk. It will represent state-of-the-art risk-based capital regulation.

I understand that the Enterprises have recently shared their views on the regulation with the MBA and other interested parties. In their comments they highlight four goals for a final risk-based capital standard.

They stated that it should:

- (1) be consistent with the law,
- (2) be operationally workable,
- (3) accommodate innovation, and
- (4) tie capital to risk.

I wholeheartedly agree with all four of these goals. OFHEO has shared those objectives from the beginning and I am confident that the final rule will meet those goals.

Now let me turn to HUD's recently released proposed affordable housing goals regulation. This regulation, mandated by Congress in the same 1992 legislation which established OFHEO, set goals for loan purchases by the Enterprises in several categories.

They are:

- (1) low- and moderate-income families,
- (2) special affordable housing, and
- (3) geographically underserved areas.

We have reviewed the increased goals from a risk perspective and have concluded that the Enterprises can meet the goals in a manner consistent with safety and soundness.

Coinciding with the new goals, there were press reports criticizing the Enterprises' minority lending policies. In response, last week Fannie Mae announced an intention to move aggressively into the subprime market. OFHEO will look very closely at this effort. There are three points to make here.

First, Fannie's charter, like Freddie's, requires that the Enterprises' operations be limited to mortgages which are of "such quality, type, and class as to meet, generally, the purchase standards imposed by private institutional mortgage investors."

We must review compliance with this provision of the law, which is obviously vague. In doing so — I of course understand the benefit to consumers from lower cost mortgages.

Second, we must carefully assess the risks associated with subprime loans, how the Enterprises manage that risk, and set capital at an appropriate level.

With effective risk management, including adequate credit enhancements, the Enterprises exposure to risk from these loans need not necessarily be higher than that for other mortgages. But to the extent that the risk is higher, we will require the Enterprises to hold more capital.

And third, the Enterprises should be mindful of another provision in their charters. A stated purpose of the creation of the Enterprises is to engage in “activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities.” This was added to the Enterprises’ charters by the same law that created OFHEO.

Congress expressed its desire that the Enterprises accept a lower return on affordable housing as an appropriate trade-off for the substantial public benefits they receive. Such an effort would help borrowers who may be on the margin of affording a mortgage.

Another issue that is much discussed lately is the question of what will replace Treasury bonds as the next market benchmark.

About a month ago, on February 10, the Treasury Department held an auction of 30-year bonds. It turned out to be an “auction heard ‘round the world.” While it was not undersubscribed, there was a very startling lack of demand for the Treasury offering. It was described as a “disaster” and “disappointing” in the press.

Wall Street analysts pointed to supply pressures resulting from a Fannie Mae bond announcement the day before, and confusion about Treasury’s long-term borrowing plans. Wall Street has now begun to search for a new long-term debt benchmark.

A frequently mentioned alternative is Enterprise debt. Last year, the two Enterprises’ issued \$268 billion of long-term debt. While still less than Treasury’s issuance of \$365 billion, the bulk of the Enterprises’ issues reflected new borrowing as compared to Treasury net reduction of debt outstanding.

Consider this: In just a few years, Fannie Mae and Freddie Mac could be issuing more long-term debt than the entire U.S. Government.

The Enterprises are well aware of their increasing importance in the global economy and aggressively market their products. In a January speech, Freddie Mac’s CEO Leland Brendsel said: “Freddie Mac’s Reference Notes and Reference Bills provide global investors with the liquidity and predictability they have traditionally found in

U.S. Treasury securities. In the last 18 months, the number of central banks holding our notes has risen from just a handful to almost 60.”

Fannie Mae also recognizes its expanding role in global financial markets.

In a series of recent advertisements, Fannie Mae boasts, “Our financial strength and innovation allow us to attract global investment funds and put them to work for low- and moderate-income families. One example is our Benchmark Notes, which were created to meet increasing investor demand for safe, sound, and highly liquid investments.”

Also, on the same day as the ill-fated Treasury auction, the New York Federal Reserve Bank reported that it now holds \$82 billion of GSE securities on behalf of foreign central banks.

These developments constitute a role reversal of seismic proportions. Only eight years ago, long-term Treasury debt issues were 13 times as large as those of the two Enterprises.

Even the statistics I’ve mentioned, regarding the Enterprises’ growth, understate the taxpayers’ and the economy’s growing stake in the Enterprises’ financial well being.

As the debt of Fannie Mae and Freddie Mac assume a more central role in international debt markets, disruption caused by failure of one of these Enterprises could extend well beyond housing finance.

The Treasury Department has also voiced concern about the systemic risk of the Enterprises. Secretary Summers stated recently that any discussion of systemic risk had to include the Enterprises.

And — the Department has asked the Treasury Borrowing Advisory Committee of the Bond Market Association to comment at its next meeting on the risks to the financial system of the growth of government sponsored enterprises.

Benchmark status for securities of Fannie Mae and Freddie Mac would add to the benefits they receive by virtue of their GSE structure. But those additional benefits imply additional responsibilities. If the Enterprises’ debt does become the new benchmark, then the pricing and distribution of those securities should be subject to safeguards and standards of transparency comparable to those of Treasury debt.

Finally, I want to express my strong support for the mortgage industry’s efforts to combat fraud. OFHEO has been consulting with industry working groups and trade associations, including the Mortgage Bankers Association, to address mortgage fraud.

The voluntary industry effort to establish a national registry for mortgage brokers is a very positive development. A national registry would be a very useful tool for

weeding bad actors out of the system. The bad actors create hardship and increased costs to all participants: lenders, investors, the secondary market, the government, and most unfortunate of all, the homebuyer.

OFHEO will explore ways to use such a registry to help fight fraud. Adding broker specific information to our comprehensive loan level database may allow us to help identify possible fraud. This would of course also reduce the risk of loss to the Enterprises and portfolio lenders.

We also assist other government agencies in their efforts to combat mortgage fraud. OFHEO is a member, with other financial regulators, of the Bank Fraud Working Group.

The Group promotes awareness among bank and thrift regulators of new developments in mortgage fraud.

In addition, OFHEO has been providing technical assistance and formal training for Federal law enforcement authorities and the Department of Justice regarding mortgage fraud.

I've tried to cover a lot of ground for a dinner speech, and I appreciate your indulgence. But I wanted you to understand what OFHEO is all about, and the agency's role in a broad range of issues.

There is much for me to do at OFHEO, and only four years and seven months left in my term to do it. So I'll try to get to work even earlier tomorrow.

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.

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