



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

NEWS RELEASE

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**SPEECH OF ARMANDO FALCON
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NATIONAL REAL ESTATE LENDING CONFERENCE AND SUPER MARKETPLACE
AMERICA'S COMMUNITY BANKERS
SCOTTSDALE, ARIZONA
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Good Morning.

Thank you for having me here.

As the name America's Community Bankers implies, you and your institutions are the backbone of the world's best housing finance system. You make the loans that put Americans in homes.

As community bankers, you deal intimately with Fannie Mae and Freddie Mac, so I am grateful to have this opportunity to speak about the Office of Federal Housing Enterprise Oversight and the future of GSE regulation.

As you know, Fannie Mae and Freddie Mac are two of the largest and most sophisticated financial institutions in the world -- owning or guaranteeing over \$2 trillion in mortgages.

As the largest investors in mortgages, with portfolio holdings exceeding \$800 billion, the Enterprises have become, next to the U.S. Treasury, the largest issuers of debt.

Fannie Mae and Freddie Mac play an important role in our nation's housing finance system -- especially the affordable housing market.

The Office of Federal Housing Enterprise Oversight was created to ensure that they maintain the financial strength necessary to fulfill that mission. OFHEO, created in 1992 as an independent office within the Department of Housing and Urban Development (HUD), is like the Office of the Comptroller of the Currency within the Treasury Department.

OFHEO was not spun off from a pre-existing agency, but started from scratch. In 1993, OFHEO had one employee, my predecessor, Aida Alvarez. OFHEO has grown, of course, and must now move to a new phase in its development. And that is a broader mission I envision OFHEO must fulfill in order to properly meet its responsibilities.

I view OFHEO's primary role as protecting the integrity of the secondary mortgage market. Central to this goal is the financial safety and soundness of Fannie Mae and Freddie Mac.

OFHEO is working hard to make sure that they are adequately capitalized relative to the risks that they bear and that they operate in a safe and sound manner.

But given the size of the Enterprises and their dominance of the mortgage market, OFHEO must take an increasingly broader view of its mission.

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We must understand the impact of the Enterprises' growth and new activities on the entire mortgage market and its participants, both in the short- and long-term.

We must do so because all of the participants in the mortgage market are firmly intertwined and dependent on each other. Our secondary mortgage market is the safest and most efficient in the world. I will work to keep it that way. The speed and magnitude of the Enterprises' growth in recent years have been truly extraordinary. Since OFHEO was created in 1992, the Enterprises have doubled in size.

From the basic use of Fannie and Freddie forms to the extensive use of Enterprise-controlled technology, like their automated underwriting systems, the Enterprises' influence extends to every step of the mortgage process.

As you likely are aware, the Enterprises receive substantial benefits from their GSE status. They are exempt from state and local income taxes, their securities are exempt from SEC registration, and they have a potential \$2.25 billion line of credit from the Treasury.

The largest benefit they receive comes from the fact that the market treats their securities as though they were guaranteed by the federal government, despite explicit disclaimers.

This favorable market treatment allows the Enterprises to borrow money more cheaply than fully private AAA-rated companies and almost as cheaply as the U.S. Treasury.

It is the combination of their GSE status as well as good management that have enabled both Enterprises to grow to their extraordinary size and consistently reward their stockholders with returns in excess of 20 percent. At the same time, this combination has helped to lower mortgage rates, increase homeownership, and make the market more efficient.

And no one should deny them the proper credit for all the good they have done.

However, because of the pressures on the Enterprises to maintain their shareholder returns, they are constantly looking for new business opportunities and markets to enter. In doing so, the Enterprises are raising important public policy questions that need to be fully analyzed and addressed.

In chartering the GSEs, Congress determined that because of the substantial benefits conveyed to the Enterprises from their GSE status, they should stay focused on fulfilling their public mission and not expose the taxpayers to unnecessary risks.

I recognize the growing tension that exists between the Enterprises and other participants in the mortgage market.

I believe ACB's July GSE policy statement is representative of a view held by many like you, and that the Enterprises' movement into more nontraditional activities is a strategic threat to their business. This view is driven by the technological revolution in mortgage lending which is blurring the line between the primary and secondary markets.

OFHEO looks at all activities of the Enterprises - new and existing - to assess their safety and soundness implications. We have a top-notch examination program and soon will have a risk-based capital rule in place. But prudent oversight requires that we do more.

Therefore, to complement this strong foundation, we are enhancing our already active research and analysis capability to help us understand not just the safety and soundness implications of new activities, but also the policy implications.

This is an essential part of the broader mission of OFHEO. We must understand all the implications of the rapid changes in the mortgage market, as well as help educate the public and policymakers on these issues.

Some of the important questions that our sound and authoritative research can help address are, for instance:

- * What are the risks and policy implications of the Enterprises' expanding activities such as home equity and subprime lending?

- * Can automated underwriting systems more precisely measure credit risk over a complete housing cycle? And what will its long-term impact be on the primary market?
- * What are the trends in the housing market and the broader economy which will shape the housing climate in the future?

These issues are also part of a larger question: What are the systemic risk implications to the mortgage market and the broader capital markets of continued Enterprise growth and expansion?

One thing I can say for certain is that OFHEO is best positioned to address these questions. We have the responsibility, the expertise, the information, and, hopefully, the resources from Congress.

Now I will update you on the status of OFHEO's major regulatory activity. As you may already know, I extended the comment period on OFHEO's risk-based capital regulation until March 10 so that all interested parties would have sufficient time to comment on the rule.

We have been working very diligently with the Enterprises and other interested parties, including the ACB, to explain how our rule works. As a result of the tremendous interest in our rule, I expect to receive many useful comments that will make the rule better.

My highest priority as OFHEO's Director is to bring the rule-making process to a conclusion as soon as possible and implement a strong and fair risk-based capital standard. This is especially important given the rapid growth of the Enterprises.

I must make an important distinction here between a final risk-based capital regulation and a final stress test, which determines the risk-based capital standard. We will have a final regulation, but the stress test will, of necessity, be dynamic.

By its nature, the stress test 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 needs to give the Enterprises immediate credit for reducing risk, as well as quickly increase required capital for incurring additional risk.

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

OFHEO has approached the development of the risk-based capital requirement with great care and diligence. After all, the capital requirements we promulgate for Fannie Mae and Freddie Mac will have important ramifications for the entire housing finance industry.

The main point that I want to emphasize about our approach to the development of this important capital requirement is that we have consistently reached out and listened to the concerns of the entire industry.

I will continue this approach by keeping an open and objective mind when evaluating the comments on our proposed capital rule. In the end, I want a strong capital rule that ensures that the Enterprises are able to perform their important public mission in good times and in bad times.

As I mentioned earlier, as the Enterprises continue to expand their business, it is essential that OFHEO has sufficient resources to do our job. Like all of the other federal financial regulators, OFHEO funds its regulatory activities through direct assessments on the Enterprises.

However, OFHEO is the only financial regulator which must get prior approval from Congress through annual appropriations. This hampers my ability as a regulator to ensure that I have adequate resources for the task.

I believe that as a matter of sound public policy, OFHEO should be exempt from the appropriations process. OFHEO needs the capacity to operate, as do all other financial regulators, free from the uncertainties of the appropriations process.

Equally important, an exemption from the appropriations process allows a safety and soundness regulator the flexibility to respond quickly to deteriorating conditions of individual institutions or even greater systemic problems. Again, unlike other regulators, if OFHEO ever needed to quickly increase its examination staff in response to a sudden deterioration of an Enterprise, we could not do so.

This is vital to have effective and independent regulation of Fannie Mae and Freddie Mac.

Let me close by saying that as OFHEO's new Director, I am looking forward to working with the ACB, the Enterprises, Congress, and all interested parties as OFHEO strives to continually improve its regulatory oversight of Fannie Mae and Freddie Mac.

I would be happy to answer any questions you may have.

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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