

**STATEMENT OF
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BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND
GOVERNMENT-SPONSORED ENTERPRISES
U.S. HOUSE OF REPRESENTATIVES
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Mr. Chairman and members of the Subcommittee, I appreciate the opportunity to appear here today to discuss the General Accounting Office report on HUD's role as a mission regulator of Fannie Mae and Freddie Mac. In addition, I will discuss the work that OFHEO is doing as the safety and soundness regulator of Fannie Mae and Freddie Mac, and I will address the questions you posed to me in your letter of invitation for this hearing. This testimony represents the views of the Office of Federal Housing Enterprise Oversight, which are not necessarily those of the President or the Secretary of Housing and Urban Development.

HUD's Mission Oversight of Fannie Mae and Freddie Mac

I believe HUD has performed its responsibilities well given the resources available to it. It has established goals for government-sponsored enterprise (GSE) purchases of affordable housing loans and a public use data base of GSE purchases. It has conducted research on the impact of GSE purchases on housing opportunities, and has fulfilled other regulatory responsibilities such as new program review.

Communication between HUD and OFHEO has been good, and the sharing of regulatory responsibility for the Enterprises is working. Our coordination on new program approval is an excellent example. We provided our assistance to HUD in the drafting of the GSE rule, which includes the affordable housing goals, and HUD has been providing assistance to us as we develop our risk-based capital regulation. In addition we provided suggestions on how they might proceed to ensure the integrity of the data submissions from the Enterprises.

We also share information on key industry trends such as credit scoring and automated underwriting through informal discussions. Fannie Mae and Freddie Mac are continually innovating in their secondary mortgage market activities, and it is important for OFHEO and HUD to leverage our respective capabilities as we evaluate safety and soundness and mission implications. One innovation involves the purchase of mortgages that previously would have been considered subprime quality. This activity raises issues ranging from safety and soundness to affordable housing opportunity to fair lending that OFHEO and HUD have discussed and will continue to have discussions about in the future.

Let me now turn to the questions you raised in your letter of invitation.

GAO Audit of OFHEO

In its October 1997 audit of OFHEO, GAO made recommendations with respect to OFHEO's examination program and development of a risk-based capital standard. We have made considerable progress in both areas. GAO recommended that I periodically report to Congress on OFHEO's progress toward completing a stress test and risk-based capital standard. I have done that, and do so again today.

GAO also recommended that OFHEO 1) examine the staff resources necessary to cover all risk areas on 1- and 2-year examination cycles, 2) identify the most appropriate examination cycle after considering the trade-offs between examination coverage and resource requirements, and 3) develop a strategy for obtaining the necessary examination office resources. We have designed and implemented a comprehensive annual risk-based examination program that addresses these recommendations. This revised examination program is described in detail in OFHEO's Annual Report to Congress that we submitted last month. I will describe briefly the attributes of the comprehensive annual risk-based examination program.

First, the examination program covers all the relevant areas of risk — credit, market, and operations — and the risk management techniques at the Enterprises. The examination program requires that each area of risk and risk management be examined every year at the Enterprises. By compressing the examination cycle and assessing all areas of risk and risk management annually, OFHEO will be positioned to communicate its findings to the Enterprises and the Congress on a timely basis.

Second, in order to enhance its effectiveness, the examination program establishes a standardized vocabulary and sets out our expectations in evaluating safety and soundness at the Enterprises. These materials have been shared and discussed with both Enterprises, are highlighted in our Annual Report to Congress, and will be incorporated in our Examination Handbook.

Third, building on the transparency of the examination program's standardized vocabulary and shared expectations, communication with the Enterprises is another key attribute of our examination program. Our examination staff and the director of the Office of Examinations and Oversight are continuously engaged in dialogue with all levels of the Enterprises' management teams and their Boards of Directors. Maintaining a meaningful dialogue and exchanging views with the Enterprises are critical to the effective implementation of our revised examination program. We have already seen that improved communications with the Enterprises, together with the increased transparency, or clarity, about the examination program have greatly enhanced the relationship between the Enterprises and OFHEO. We remain committed to ensuring that this dialogue continues and that OFHEO's relationship with each of the Enterprises strengthens even further.

I am also pleased to report that we have moved aggressively to remedy GAO's concerns about the examination staffing level. We have not only increased and filled positions in the Office of Examination and Oversight, but we have also hired individuals who possess significant experience and expertise. Each examination staff member brings particular skills and knowledge to the program, and all have demonstrated the ability to communicate effectively with the Enterprises.

Status of the Risk-Based Capital Regulation and Expected Implementation

You also asked about the status of our risk-based capital regulation and expected implementation. The risk-based capital rule for Fannie Mae and Freddie Mac will constitute a new approach in capital regulation. OFHEO is in a unique position relative to other regulators of financial institutions. Although Fannie Mae and Freddie Mac are very large companies, the range of their activities is narrow compared to the range of activities undertaken by the 10,000 banks and thrifts that operate in this country. Therefore, we can tailor a risk-based capital standard to the particular risk profiles of the GSEs in a way that has proven to be exceedingly difficult for the other financial institution regulators. We can use actual balance sheet information for the two institutions at a level of detail that is not possible for the regulators of significantly larger numbers of institutions. As a result, the risk-based capital standard for Fannie Mae and Freddie Mac will more closely align capital with risk and will promote an effective balance between financial safety and soundness and achievement by Fannie Mae and Freddie Mac of their public missions.

The stress test is a simulation of the financial performance of the Enterprises over a 10-year period. It begins with their actual assets, liabilities, and off-balance-sheet obligations and simulates the financial cash flows that might result under specific economic conditions. In this way, it captures the effect of both the credit risk and the interest rate risk embedded in the Enterprises' balance sheets.

The stress test subjects the Enterprises to a common set of assumptions about economic conditions while at the same time reflecting the unique risk positions of each company. The factors that drive the stress test are the same for both GSEs. For example, a mortgage with a 90 percent loan-to-value ratio poses the same credit risk, regardless of the institution that holds it. Interest rate shocks will cause mortgages to prepay at the same rate, regardless of who holds them. What differs from institution to institution is the mix of risk and risk management practices.

The stress test does not impose assumptions about relative risk as leverage ratios do. Instead, it models the cash flows of the Enterprises' assets and liabilities. The results of the stress test reflect the risk management decisions that the Enterprises make. As such, the Enterprises can achieve their risk-based capital requirement by determining their risk mix and making their own risk management decisions.

One other significant feature of the stress test is that it reflects changes in risk, both in terms of the financial condition of the Enterprises and in terms of the conditions of the housing market. The risk-based capital standard, therefore, is dynamic, changing as conditions change and providing early warning when potential financial problems occur.

We have made substantial additional progress on completing the proposed risk-based capital regulation since I was last before this Subcommittee. Our efforts are now focused in four main areas. First, we are completing the technical documentation of the model which involves documenting the data variables, the mathematical equations, and the computer code. Second, we are using this documentation in our ongoing testing efforts to ensure that the stress test specifications which will be described in the proposed regulation are accurate.

Third, we are running an extensive set of simulations of the model to demonstrate how changes in the Enterprises' risk profiles affect their capital requirements. The results of these simulations will be described in the regulation. Finally, we are drafting the proposed regulation. This is no easy task. We must provide sufficient detail for technical audiences to comment meaningfully on the stress test. Yet the regulation must be sufficiently clear for non-technical audiences to be able to comment. As a result, the proposed rule will contain both general descriptions of the stress test and the policy issues, and technical details such as data inputs and mathematical calculations. All of this material is in various stages of drafting at this time.

While significant challenges remain, it is still our goal to submit the risk-based capital proposal to the Office of Management and Budget (OMB) for interagency clearance by the end of September. Specifically, this will be in the form of a Notice of Proposed Rule-making (NPR). By Presidential order, OMB has ninety days to review regulations submitted by agencies. Because of the complex nature of this rule, OMB has suggested that it might need more than ninety days for review. However, OMB cannot be certain of the precise time that will be needed until it sees the proposed rule and until agencies like Treasury and HUD determine how much time they will need to analyze the rule. To facilitate the clearance process, OFHEO will continue to work closely with Treasury and HUD to brief them on the proposed rule both before and after the rule is submitted to OMB.

Following OMB review, OFHEO will submit the NPR to Congress for the mandatory fifteen-day review period. It is at this point, Mr. Chairman, that we will brief Congress on the specifics of the proposed rule.

Following the fifteen-day Congressional review, the proposed regulation will be published in the Federal Register for public comment. It is at this point that Fannie Mae and Freddie Mac, as well as all other interested parties, will have an opportunity to analyze and review the regulation. In our 1999 performance plan, we estimated that the rule would be open for public comment for four months. With respect to potential requests for a longer comment period, I will reevaluate the time needed for the public to submit comments once they have had the opportunity to read the rule.

The rule-making process is designed to provide the public with an opportunity to comment on proposed regulations. It is OFHEO's responsibility to fairly and fully analyze the comments that we receive on our proposed risk-based capital regulation. How much time this will take is hard to estimate at this point since we do not know the volume or nature of the comments that we will receive.

What happens to the proposed rule after OFHEO has analyzed all of the comments depends on the nature of the comments. If OFHEO decides significant changes are needed, we will be required to re-propose the rule and extend a new comment period. If OFHEO determines that significant changes are not needed, we will publish the rule in final form.

Protection Provided By the Minimum Capital Requirement

You asked whether the minimum capital standard still adequately protects the taxpayers until the comprehensive risk-based capital guidelines are completed. The minimum capital rule is a crucial component of a comprehensive framework for capital regulation of the Enterprises. The examination

and oversight program is another crucial component. Through our examination activities, we have concluded that Fannie Mae and Freddie Mac are financially sound at this time. In addition, they are presently operating in an environment that is very favorable for housing. We are well aware that the environment can change, therefore, over the longer term, the risk-based capital standard is necessary to ensure their capital adequacy.

Amendments to the 1992 Federal Housing Enterprises Financial Safety and Soundness Act

The legislation that created OFHEO generally provides sufficient authorities for an effective regulator and sufficient flexibility for the regulator to carry out its responsibilities. There is one legislative issue, however, and it is related to the budgeting process for OFHEO. Unlike other financial institution regulators, OFHEO's annual budget requests must go through the appropriations process. However, like the other financial institution regulators, OFHEO is not funded by monies from the federal budget.

There are no other legislative issues that I would recommend be considered at this time.

Combining Safety and Soundness and Mission Regulation for the Housing GSEs

As I testified before you last July, there are both advantages and disadvantages to consolidated regulation of Fannie Mae, Freddie Mac, and the Federal Home Loan Bank System. The current structure for regulating Fannie Mae and Freddie Mac is working. As currently structured, OFHEO has sufficient independence from HUD to do its job effectively. OFHEO has exclusive authority over safety and soundness matters, and has independent budget and management authority. At the same time, OFHEO has a link with HUD so that effective coordination on GSE matters can occur. OFHEO has a clear, focused safety and soundness mission which minimizes the potential for it to be diverted by a broad and diverse mission.

A unified regulator with responsibilities for public mission and safety and soundness regulation might produce better coordination between these activities, and would likely provide more sharing of expertise. A single agency for regulatory oversight might also facilitate assessing the Enterprises for the full cost to the government of that oversight. On the other hand, a single regulator for Fannie Mae, Freddie Mac, and the Federal Home Loan Banks could disrupt current regulatory activities without improving the effectiveness of regulation because the operations, the fundings, and the governance of the Enterprises and the Banks are different.

Mr. Chairman, I appreciate the opportunity to testify before this Subcommittee. I will be pleased to respond to questions.