

**REMARKS PREPARED FOR DELIVERY BY  
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TO  
NATIONAL ASSOCIATION OF HOME BUILDERS (NAHB)  
INTEREST RATES AND MORTGAGE CAPITAL MARKETS SUBCOMMITTEE  
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SHERATON WASHINGTON HOTEL  
WASHINGTON, D.C.**

Good afternoon. Let me start by thanking the Home Builders for inviting me to address this subcommittee meeting.....and for giving me the opportunity to update you on OFHEO's regulatory oversight of Fannie Mae and Freddie Mac.

After three years at OFHEO..... I realize that not everyone in the world finds GSE regulation a compelling topic. But I also know that most members of the housing finance community -- and certainly those of you here this afternoon -- understand the importance of OFHEO's regulatory mission .... its importance to the housing industry..... to the financial markets..... and to the American taxpayer.

We at OFHEO take our oversight mission seriously. We are committed to our two-pronged regulatory strategy of examination and capital adequacy as a means of ensuring the financial safety and soundness of Fannie Mae and Freddie Mac. And we are working diligently to carry out this assignment. So when Chellie Hamecs called and asked me to brief you on OFHEO's activities -- particularly the progress we are making toward completing our risk-based capital standard -- I was happy to accept. We have worked closely with Chellie and appreciate her thoughtful approach to OFHEO's regulatory mission ... Thanks Chellie.

**OFHEO BACKGROUND**

First..... let me give you 30-seconds of background on OFHEO. The Office was created by Congress in 1992. It got off the ground six months later when Aida Alvarez was sworn in as the first Director and the first employee. So we are a little less than four years old at this point. We have a staff of roughly 70 and a budget of \$15.5 million. The budget is underwritten entirely by assessments on Fannie Mae and Freddie Mac.

We are an independent office. We have an administrative relationship with HUD but we report directly to Congress. Ultimately..... we work for the American taxpayer..... since the rationale for OFHEO's regulatory effort is protecting the taxpayer from liability that might stem from the inability of Fannie Mae or Freddie Mac to meet their debt or guarantee obligations due to unforeseen economic or business problems.

OFHEO regulates Fannie Mae and Freddie Mac through ongoing..... on-site safety and soundness examinations. To date..... we have completed nine examinations at the two Enterprises..... covering topics ranging from credit and interest rate risk management to the Enterprises' use of non-mortgage derivatives. Results and findings of our examinations are published in our Annual Report..... which is sent to Congress in mid-June.

## **RISK-BASED CAPITAL**

We also regulate by ensuring that the Enterprises are adequately capitalized. This is the area that I want to discuss this afternoon..... since in recent months we have been asked by a number of parties..... including the Home Builders: What is the status of your risk-based capital test..... and when will it be finished?

I will address those questions as best I can. Understand that the stress test is still under development and we are in the middle of a regulatory rule-making process. So I may not be able to be totally responsive in some areas.

Our legislation requires that we establish a risk-based capital standard for the Enterprises. It's administered by a quarterly stress test that will determine how much capital each GSE must hold to maintain a positive capital position over a 10-year period characterized by an environment of high mortgage defaults and an initial severe interest rate shock. The resulting number..... plus an additional 30% to cover management and operations risk..... will constitute the risk-based capital requirement for Fannie Mae and Freddie Mac.

In assessing OFHEO's risk-based capital test..... and its development time line..... it's important to note that a stress test approach to determine capital adequacy is far more sophisticated than risk-based capital standards commonly in use today. OFHEO's stress test will measure the interest rate and credit risks associated with Fannie Mae's and Freddie Mac's business much more accurately than a risk weighting of asset categories currently used by regulators to set capital standards for banks and thrifts.

By factoring in a broad range of risk factors..... including mortgage and property characteristics and LTVs..... our test will model mortgage credit risk with much more precision.

For example..... if house prices fall..... causing homeowners to have less equity in their properties and increasing the probability of default in the future..... this will be immediately reflected in higher capital requirements. A rising house price scenario would produce the opposite effect. Additionally..... by modeling the liability side of the GSE's balance sheets..... the stress test will provide insight into how risk is being managed. The result will yield a more accurate match between capital standards and risk exposures than exists in other capital tests.

Some have suggested that a sophisticated risk-based test smacks of overly burdensome regulation. Actually..... the reverse is true. The dynamic nature of OFHEO's stress test gives Fannie Mae and Freddie Mac credit for effective risk-management. In other words..... the Enterprises will be able to lower their required capital by more fully hedging their risks. By tying their capital requirements very closely to real world risk..... OFHEO's stress test helps ensure adequate protection for taxpayers without introducing major distortions into their business decisions..... and without requiring excessive blanket coverage of general business risks.

## **HOW MUCH CAPITAL?**

You can submerge yourself in the process that I have just described..... but in the last analysis..... most people seem to have one simple question. Will OFHEO's risk-based standard require Fannie Mae and Freddie Mac to hold more capital? (The Enterprises..... by the way..... have to meet capital standards now. They are known as Minimum Capital Standards and they are calculated quarterly by OFHEO.) [ 2.5% on-balance sheet, .45% off-balance sheet]

The answer to the "more capital" question is probably yes..... but a lot depends upon the particular risks the Enterprises are taking at any point in time. To give you a more specific answer just "wouldn't be prudent..... " as a former President used to say.

Truthfully..... we won't know the size of the capital number until the stress test is complete and we apply the test to a specific book of business.

What we have said in the past..... however..... is that the risk-based capital standard will be "strong but reasonable." These are not inconsistent attributes.

*A strong capital requirement* for Fannie Mae and Freddie Mac is good for the housing finance markets..... because it helps ensure the stability..... and liquidity of those markets. *A reasonable capital requirement* recognizes the need of Fannie Mae and Freddie Mac to take risks in their lines of business. Risk is..... after all..... the essence of the mortgage industry.

In designing the risk-based standard..... we are mindful that Fannie Mae and Freddie Mac are the linchpins of the world's best housing finance system. The growth and health of that system depends on the ability and willingness of the two Enterprises to take risks..... not just with run-of-the mill mortgages..... but also with more difficult affordable housing loans that help extend the benefits of homeownership to a broader range of American families.

We at OFHEO see our job as creating a capital standard sufficient to provide reasonable protection to taxpayers but not so onerous to dissuade the Enterprises from taking prudent risk.

## STRESS TEST TIMETABLE

Let me say a few words about the stress test timetable. We have achieved several important milestones.

-- In early 1995..... we published an Advance Notice of Proposed Rulemaking that laid out our basic approach to the stress test..... posed a number of questions..... and invited public comment. We received a substantial amount of reaction..... including thoughtful and helpful comments from the Home Builders. We appreciate your input.

-- In March, 1996..... we began publishing a quarterly House Price Index..... which we call the HPI. This is a key component of the stress test..... because it allows us to estimate changes in the value of properties whose mortgages are held or securitized by Fannie Mae or Freddie Mac. The HPI measures average changes in house prices at the national..... regional and state level. It is the government's broadest statistical measure of changes in housing values available. In the 14 months since we began publishing the HPI..... we have received a huge number of requests for copies. I have brought copies of the latest HPI..... for the fourth quarter 1996 with me. You are welcome to pick up a copy after the session. It is useful reading for anyone in the housing industry.

-- Last June..... we took another important and required step down the road to completing the risk-based capital rule by publishing the first of two Notices of Proposed Rulemaking. It described the role of the HPI in the stress test. It also discussed the benchmark -- the time and place where mortgage defaults were highest -- that we plan to use in determining mortgage defaults.

-- This spring..... we reached another key milestone. We began testing the "alpha" version of what we call the Financial Simulation Model..... This is the combination of statistical models and computer programs that simulate the businesses of Fannie Mae and Freddie Mac. It is..... in effect..... the software behind the stress test..... and it has been largely created by a talented team of OFHEO employees. The Financial Simulation Model performs five basic functions:

1. *It simulates mortgage defaults..... prepayments and loss severities.*
2. *It simulates cashflows associated with GSE assets and obligations.*
3. *It implements assumptions about Enterprise operations. (For example..... when does callable debt get called.)*
4. *It translates cashflows into pro forma financial statements. (Here we are following GAAP rules as closely as possible.)*

*5. Finally..... it calculates the all-important capital number.( How much capital will an Enterprise need at the beginning of the stress period to survive the entire 10 years.)*

-- Concurrent with building the Financial Simulation Model..... we have also been building a database. It includes data on the historical performance of mortgages purchased by the Enterprises that will help predict how Fannie Mae and Freddie Mac may perform under economic stress. It also includes current business data that will be used to monitor financial performance and establish "starting positions" for the stress test. A significant obstacle in this task is the fact that Fannie Mae and Freddie Mac maintain their data in different formats and database structures. To avoid undue reporting requirements..... the Enterprises send us data in their own format and we normalize it for OFHEO's database.

-- Next year we plan to publish the second Notice of Proposed Rulemaking that will fully describe the stress test. It will address assumptions about interest rates..... mortgage performance..... and other issues not covered in the first NPR. That makes it likely that a final risk-based capital rule for Fannie Mae and Freddie Mac will be published in 1999. The Enterprises will have one year from the final rule publication date to bring their capital levels into line with OFHEO's standard.

In closing I want to reemphasize this point. Regulating two Enterprises as large and complex as Fannie Mae and Freddie Mac is complicated. It is a new activity and we at OFHEO are..... to a large extent..... writing the book. We are determined to do it right. We also believe OFHEO's presence is a net plus for every facet of the housing industry -- and that certainly includes the nation's home builders. And now I welcome your questions and comments.

Thank you.