STATEMENT OF

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I'm glad to have this opportunity to discuss the General Accounting Office (GAO) report on OFHEO's principal regulatory and supervisory activities. I think it is generally fair and accurate, and it contains reasonable recommendations. The report details OFHEO's considerable achievements, while it appropriately focuses on what needs to be done. We intend to implement GAO's recommendations and have, in fact, already begun to do so. My testimony this morning expresses my views, which are not necessarily those of the President or the Secretary of the Department of Housing and Urban Development (HUD). I will report on the current status of OFHEO's examination and capital regulation programs and on our plans going forward. Briefly, with respect to examinations, I am confident that beginning in January 1998 we will have the experience and resources to begin comprehensive annual exams of the Enterprises. With respect to our risk-based capital regulation, I can report that we are on schedule to send the Office of Management and Budget (OMB) our proposed rule by the end of the current fiscal year.

Mr. Chairman, I share your view of the importance of OFHEO's job. Fannie Mae and Freddie Mac now have more than $1.6 trillion of outstanding obligations, which are generally perceived as implicitly guaranteed by the Federal Government and ultimately by American taxpayers. Their on-balance-sheet holdings of mortgages and mortgage securities, where most of the risk is concentrated, have roughly doubled in the past four years. While both Enterprises are currently very profitable, financially healthy organizations, it is important that there be a complete program of supervision and regulatory control. Economic conditions and management practices are subject to adverse changes. Such changes rarely happen overnight, but we want to be fully prepared if they occur. OFHEO has two main tools to do the job, both equally important. We conduct risk-based examinations and determine required capital levels. GAO's report appropriately concentrates on these two areas.

Examinations

First, I would like to address the examination issues. While recognizing the quality of our examination staff and OFHEO's accomplishments in the examination area, GAO also raised important questions about the timing of OFHEO's examination program that I believe we are successfully addressing. Fannie Mae and Freddie Mac are financial intermediaries whose business is to take risks and earn a satisfactory return for their shareholders, while serving their public missions. Taking risks is essential. Our job is to ensure that they are managing those risks prudently. Given that no reasonable amount of capital can provide adequate protection if risk management is weak, OFHEO has put in place a robust and dynamic risk-based examination process.

The first phase of that process, a full set of core risk examinations at both Enterprises, will be complete in the next two to three months. This first set of exams has been particularly valuable because neither Enterprise had been examined previously by any Federal agency. While the exams have shown that risk management at both Fannie Mae and Freddie Mac is generally strong, OFHEO has made many recommendations to address weaknesses and to stimulate enhancements. Both Enterprises have responded satisfactorily and, as a result, are implementing better risk management strategies, practices, and controls.

It has taken more than three years to complete this set of examinations. We started in 1994 with what we described to GAO at the time as an "ambitious" plan; we had hoped to complete a full cycle of exams in two years. In retrospect, it is clear that our plan did not fully account for the substantial additional time required in doing initial examinations because of the need to fully acquaint ourselves with the Enterprises' activities, practices, and policies; to acquaint the Enterprises with the examination process; and to meet our own organizational and infrastructure needs. We also, frankly, misjudged the Enterprises when we formulated our 1994 plan. Given the similarities of the Enterprise charters and their role in the market, we expected more consistency between the Enterprises. In fact, we found two very different companies: in cultures, in management processes, in data captures and formats, in operating platforms, in approaches to technology, in approaches to their business, in management reporting, in accounting systems, and in an endless number of other ways. Any efficiencies we were expecting to gain from consistency were not present.

Early this summer, we reevaluated our program and determined that, given the size and importance of these Enterprises, a comprehensive annual examination is more appropriate going forward than a two-year examination cycle. Let me describe the key attributes of the revised program, and explain why we will be able to accomplish it.

First, the program will be ***transparent***. An examination program is most effective when the involved parties understand the philosophy, goals, approach, and the evaluative criteria being used by the regulator. Our program's transparency will be accomplished through an examination manual which OFHEO will be issuing.

Second, the program will be ***comprehensive.*** The examination program will cover those sources of risk which have the potential to threaten safety and soundness. Within the identified areas of risk, OFHEO's examination resources will be directed toward: assessing the appropriateness of the levels of risk; assessing the appropriateness of board and executive management oversight; determining the adequacy of the policies, procedures, and limits intended to mitigate risk; determining the appropriateness of the risk measurement and reporting systems; and evaluating the adequacy of the framework for internal controls.

Third, examination work plans will be ***tailored*** to each Enterprise's risk profile, and these profiles will be routinely updated. In addition to examining the similar portfolios of risk at each Enterprise, our examination program will accommodate any incremental portfolios of risk which may be unique to each Enterprise. Our understanding of the mortgage finance industry coupled with an in-depth knowledge of each Enterprise's risk profile, will allow us to develop and routinely update a customized examination strategy for each Enterprise. An examination strategy tailored to each Enterprise's risk profile will allow OFHEO to focus in-depth examination resources in the areas presenting the greatest risk. By routinely updating each risk profile, OFHEO will not only prioritize examination resources according to the existing portfolios of risk, but examiners will also be considering the risk and due diligence employed for new or reformatted businesses.

Fourth, the examination program will be ***timely.*** With the knowledge we have acquired from our discovery examinations, we have determined the need for a full coverage of all the core risk areas at least annually. Enhancements in our off-site monitoring, access to an information warehouse, and increased use of technology created for the stress test will contribute to the efficiency of our on-site activities and our responsiveness to emerging issues.

Fifth and final, the examination program will be ***flexible.*** By routinely evaluating and updating the Enterprises' business initiatives and risk profiles, OFHEO will introduce greater flexibility into its examination process. Quarterly, OFHEO will review its tailored examination plan at each Enterprise. In reviewing the plan, we will determine if adjustments in scheduling or resources are necessary to facilitate any revisions. But regardless of this flexibility, each core risk area will be examined at least annually with our conclusions communicated. Also, each annual examination plan will provide for a scheduled follow-up for any outstanding issues from prior examinations, at least until the issues are discharged.

In the areas of concern identified through OFHEO's ongoing monitoring and on-site testing, the issues and the corrective measures or business solutions will be thoroughly discussed with management. OFHEO will evaluate the appropriateness of the corrective measures. If a corrective measure is appropriate and timely, OFHEO will track the issue's resolution. If the corrective measure is not appropriate or timely, OFHEO will consider the appropriate enforcement tool and implement its use.

As GAO recommended, we have reevaluated the resources necessary to conduct comprehensive annual examinations. The first important consideration is that future examinations will require substantially less examiner time than our first set of exams. Not only did we not possess intimate knowledge of the Enterprises' processes and risk management frameworks, we did not have a wealth of historical data and information which other established financial regulators have. OFHEO now has, and we will continue to build, this base of information. Additionally, we will continue to introduce technological enhancements to introduce further efficiencies in our examination program and the routine monitoring of the Enterprises' risk profiles.

OFHEO's acquired base of knowledge, when coupled with the enhancements being implemented in our ongoing monitoring and the more frequent dialogue we are having with Enterprise management, will provide a more focused examination process. The improved focus will also prioritize the areas presenting the greatest risk to the Enterprises and focus the level of OFHEO's examination testing on the areas representing the greatest risk to the Enterprises' safety and soundness.

The final component which will allow OFHEO to move to an annual risk based examination process is due to the resources which have been committed to examinations. OFHEO has sought to assemble, in its start-up years, a quality examination staff. In addition to building an experienced and talented examination team, OFHEO is committed to maintaining the professional credentials and expertise of our staff through active attention to professional development and training. We have clearly been successful in this effort since we have experienced only three staff departures from the examination area since year-end 1993. In addition to these three departures, we were all saddened by the untimely loss of OFHEO's first Director for Examinations who passed away from cancer earlier this year. All in all, a total of four staff have departed the Office of Examination since OFHEO's inception, and we have since replaced each of them.

I would like to take this opportunity to introduce OFHEO's new director of the Office of Examination and Oversight, Scott Calhoun, formerly Deputy Comptroller for Risk Evaluation and Capital Markets at the Office of the Comptroller of the Currency. He has more than 20 years experience regulating commercial banks and was a principal architect of the OCC's risk-based supervision program. He served as resident examiner-in-charge at Chase and Citibank. After joining us in early September, Scott devoted his first weeks at OFHEO to evaluating OFHEO's examination program. He concluded that OFHEO's risk-based approach to examining the Enterprises for safety and soundness is sound. He has, however, suggested some useful modifications and enhancements to the program which have already introduced efficiencies to the examination process.

We have also reevaluated our examination resources as GAO recommends. This month I have reallocated two new permanent positions to our examination staff. Their addition, in combination with filling two existing positions, will give us an examination staff of 19. That will provide roughly double the average number of examiners and specialists that were available to us over the past three years as we have conducted the first set of exams. In addition, our examination function often makes use of staff from other operating units at OFHEO, and this is a practice we will continue.

As in the past, we will supplement these in-house resources with contractors and detailees from other regulatory agencies. To augment its own examination staff, OFHEO has used examiners from the banking and thrift regulatory agencies. We are committed to continuing this process, and we are planning accordingly. Also, we are increasing our involvement with working groups of the other financial regulators to leverage on their experience and talents. OFHEO has used, and we will continue to use, contracted resources to augment the examination process. In particular, we are using contract dollars in key areas of risk to augment the skill palette of our core examination staff.

Risk-Based Capital Regulation

Let me now turn to our other essential regulatory program -- capital standards. I think it is important to keep in mind that we have two types of capital requirements. The first is called the minimum capital standard. It is a key element of capital regulation, and it is in place. It represents a significant improvement over the pre-OFHEO standard. Using the minimum capital standard, which is based on a set of leverage ratios, OFHEO has classified each Enterprise's capital position every quarter since OFHEO's inception, as required by law. After initially using an interim procedure, we published last year a final regulation which incorporates a more careful evaluation of the credit risks associated with swaps and other off-balance-sheet obligations. The resulting standard is comparable in its construction to the risk-based capital standards of other financial institution regulators.

In establishing OFHEO, however, Congress recognized that a special opportunity for more advanced capital regulation exists. Because the entities OFHEO regulates are very similar and have limited lines of business, a risk-based capital regulation based on a stress test is possible and desirable. As specified in the statute, OFHEO's regulation must require each Enterprise to hold sufficient capital to survive a 10-year period characterized by severe credit losses and large sustained movements in interest rates, plus an additional 30 percent of that amount to cover management and operations risk.

To develop the stress test OFHEO needed to identify and measure the worst historical mortgage credit loss experience in any region of the country, which serves as a basis for projecting losses during the stress period; and build a model of the Enterprises' activities to project cashflows, operating expenses, profits and losses, dividends, and capital positions throughout the 10-year period. Creating such a regulation has taken longer than Congress or OFHEO anticipated. While time needed for organizing a new office was an important factor, we now realize that the 1½-year time frame provided by statute would have been much too short even for a fully established regulator. It will inevitably take nearly that long after we have completed our proposal to permit required review and comment by the Administration and the public, appropriate response by OFHEO, and further Administration review before publication of a final rule of this complexity.

In evaluating our process for developing a risk-based capital regulation, GAO recognized the expertise of our staff and many of our accomplishments to date. GAO concluded that the complexity and challenges inherent in our task and our decision to develop our own stress test were the key factors in accounting for the time it will take us to complete this regulation. We agree that these were important factors. Complexity is unavoidable if we are to achieve a stress test that meets statutory requirements and fairly measures the Enterprises' key risks. This involves projecting potential defaults and loss severities for a variety of mortgage products in a manner that reasonably relates them to a single historical experience. The quality of the projections is important. A model that over- or under-predicts mortgage credit losses by one-half percentage point on the Enterprises' combined mortgage portfolio of $1.5 trillion makes a $7.5 billion error. That would be more than one-third of the Enterprises' current capital. Accordingly, we have modeled the performance of a variety of both single and multi-family loan types with care.

We must also project potential losses associated with the interest rate risk characteristics of the Enterprises' asset and liability structures. Gross aggregations of asset and liability categories can easily produce misleading results. Perhaps the most obvious example is REMICs held by the Enterprises as investments. While two REMIC securities may appear to be very similar to one another, and behave similarly under normal conditions, they may perform very differently after a large swing in market interest rates. The timing of cash flows is also important. OFHEO has developed a monthly model. It would have been easier to construct an annual model, but errors in the timing of, for example, debt maturities could cumulate to billions of dollars of capital by the end of the ten-year stress period. Given the sophistication and variety of the Enterprises' interest rate hedging activities, failure to model cash flows accurately and in detail would create incentives for the Enterprises to use financing and hedging strategies that would take advantage of the model's inadequacies.

This points up a critical difference between our task and designing a model for management purposes or for assessments of an Enterprise's capital adequacy in a non-regulatory context. Our model will generate legal requirements to hold capital that will indirectly affect business costs, which the Enterprises will reasonably want to minimize. A stress test that does not measure risks well and provide appropriate incentives will not be an effective regulatory tool.

Before building our own model, we examined existing models. We determined that they would not be suitable, and that reworking any one of them would have taken longer than starting fresh. With respect to the Enterprises' own models, we believe they are useful management tools but are not designed to serve regulatory purposes. Their models are tailored to meet their separate needs, different books of business, and unique database structures. Using one Enterprise's model to regulate the other would raise legitimate questions of fairness; using either Enterprise's model could raise questions about OFHEO's independence.

We have made major strides toward completing the stress test and the risk-based capital regulation. We issued an Advance Notice of Proposed Rulemaking to obtain public comments on 65 issues involved in creating the stress test. We issued a Notice of Proposed Rulemaking with a methodology for determining the benchmark loss experience and with a proposal to use our House Price Index to assess the impact of changing house prices in the stress test. Most importantly, we have developed a financial simulation model (FSM) to project Enterprise financial performance in the stress test.

Establishing the benchmark loss experience and developing the FSM required identifying, acquiring, and reformatting for consistency historical Enterprise data on mortgage performance. The model also required developing econometric models to simulate default and severity behavior of a variety of mortgage types. In addition, OFHEO needed to create complicated software to accurately project cashflows of all the key financial instruments associated with the Enterprises' businesses and to translate the cashflows into pro forma accounting statements, which are the basis for determining Enterprise capital levels in the stress test. All of these steps toward the completion of the stress test are unheralded but critical work.

With basic FSM development complete, we are now well into sensitivity testing; that is, running complete sets of actual Enterprise data through the FSM to evaluate the appropriateness of various "settings" of its components for the stress test. For example, we must determine the appropriate specification governing the shape of the Treasury yield curve, the relationship between Treasury rates and Enterprise borrowing rates, and the relationship between house prices and interest rates. These full-fledged simulation runs help us evaluate stress test options, and also provide the additional benefit of helping to identify possible model anomalies or program bugs that we need to address. This is standard in a model development project of this type.

We have now made tentative decisions on most key aspects of the stress test and are in the process of evaluating a few remaining important choices. We expect to make final decisions on all key aspects of the stress test by the end of January. I will inform you when this is done. We have begun drafting several sections of the proposed rule. We also have been regularly briefing Administration analysts at OMB, Treasury, and HUD about the details of our financial simulation model. We will continue those briefings over the course of the next several months so that when our proposal is complete, they will be familiar with our stress test. That should facilitate the timely review of the proposal by Administration officials and speed its publication. We plan to have our written proposal ready to enter that formal clearance process by the end of this fiscal year.

We think this plan is fully realistic. I understand your frustration with OFHEO’s past estimates of the time needed. Frankly, I share that frustration. OFHEO’s planning clearly has been overly optimistic. But I can assure you I am doing everything I can to meet our current targets. During the next year, I have allocated as much of OFHEO’s resources to completing this proposal as I possibly can, without jeopardizing our examination goals. A majority of OFHEO’s personnel and OFHEO’s contracting funds will be directly involved in completing our risk-based capital proposal this year. We have put considerable effort into designing this plan. Earlier plans suffered from our not being able to predict the outcomes and success rates in the early stages of what has been essentially the development of an entirely new product, involving a large creativity component. The remaining tasks, while they still will present their share of novel challenges, are inherently more predictable. The likelihood of surprises is far lower, and we are diligently tracking our progress.

We will report to you about that progress every three months, particularly with respect to any problems that arise and actions planned to correct them. We have met frequently with staff of this Subcommittee to discuss the stress test in the past and look forward to continuing to do so, at your convenience.

I'm proud of the work OFHEO has done. Despite the sizable potential risks posed to the Government by Fannie Mae and Freddie Mac, before OFHEO they had never been examined by a Government regulator and had no meaningful capital requirements. Now, we have nearly completed a full set of examinations, and we have minimum capital regulations in place. These Enterprises are being supervised in much the same manner as depository institutions. The risk-based capital regulation will add a very valuable piece to our overall approach. It is taking longer to complete than we, and you, had hoped, but the approach we have taken is the right one, and the result will be worth the wait.