



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

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**Speech by the Honorable Armando Falcon, Jr.
Before the Eastern Secondary Mortgage Conference
Charlotte, North Carolina
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Good morning and thank you for the opportunity to join you today. Although it's a busy time in Washington, it's a nice change to get out of town. As the clock races toward the end of the fiscal year, the pace in DC becomes frantic. This is magnified in an election year because Congress wants to get out of town as soon as possible to return home to campaign. Add to that a presidential election, and the political undercurrents are as strong as a rip tide on the Outer Banks during a storm.

One place where this political maneuvering occurs most is during consideration of the annual appropriation – or spending – bills. These spending bills are considered “must pass” legislation in order to avoid a much-dreaded government shut down. As such, they often become the vehicle for addressing larger policy differences between many competing interests both inside and outside the government. Anyone with an interest in any program funded through an appropriation bill is on the edge of their seat until the ink is dry on the President's signature.

Unfortunately, I am in that very situation because OFHEO's budget is included in one of these spending bills – the VA-HUD Appropriations Act.

Unlike all other Federal safety and soundness regulators, OFHEO's budget is subject to the annual appropriations process. Every year, OFHEO must wait for Congress to set our funding level. The uncertainty associated with this process hinders effective long-term planning and limits OFHEO's ability to respond quickly to changing conditions.

OFHEO operates as a lean and efficient agency and maintains the minimum staff necessary to achieve its mission. Should a situation arise, such as an economic crisis, where OFHEO quickly needed to hire additional examiners or other staff in response, I would be unable to do so. In addition, during periods where the government is operating under a stopgap funding bill, OFHEO has been forced to cut back on its planned regulatory activities.

This is just bad public policy and I have asked Congress to remove OFHEO from the appropriations process. OFHEO must have the same tools as every other safety and soundness regulator. If Congress does not address the problem this year, I will raise the issue again next year, and, if necessary, the following year. I have an obligation to tell Congress what I need to do my job most effectively, and this is critical to the long-term success of OFHEO. And OFHEO's success is important to everyone here because the failure of either of the Enterprises could have a broad impact on the mortgage industry.

This issue, along with another debate occurring in Washington, will in one way or another certainly impact you. I am referring to proposed changes to the GSE regulatory oversight structure and the Enterprises' charters.

Earlier this year, Chairmen Richard Baker and Jim Leach introduced legislation which would consolidate the regulation of Fannie Mae, Freddie Mac, and the Federal Home Loan Banks into a new, independent agency and make several significant changes to the GSEs' charters.

Last week Congressman Baker's Capital Markets Subcommittee convened a roundtable summit on GSE issues and his legislation. Although not unprecedented, the format was a departure from regular order and provided a useful alternative approach to discuss the issues.

At the summit, there were approximately 25 participants representing diverse interests. Besides myself, the participants included HUD, the Enterprises, consumer groups, national trade associations, Washington think tanks, and even a few private companies. The discussion centered on three main topics that OFHEO is actively addressing:

- First, how well Fannie Mae and Freddie Mac are fulfilling their mission – including serving low- to moderate-income individuals – given the Federal benefits that they receive,
- Second, whether the GSEs' activities are consistent with their Federal charters or whether greater clarity of the charters is needed, and
- Third, whether the existing regulatory system is adequate or needs to be strengthened.

With respect to the first point, there was general agreement at the summit that the Enterprises can do more to help underserved populations. Even the Enterprises agreed they can do more. HUD Secretary Cuomo has proposed new affordable housing goals that will require Fannie Mae and Freddie Mac to do more for our underserved populations. I fully support these higher goals, and believe that the Enterprises can achieve these new requirements in a safe and sound manner. I am committed to ensuring that OFHEO's regulatory regime provides appropriate flexibility for the Enterprises to be innovative in meeting these new goals.

On the second point, whether the GSEs' activities are consistent with their Federal charters, there appears to be agreement outside the Enterprises on the need for a bright line to identify permissible Enterprise activities. Unfortunately, there is little agreement on where that line should be. OFHEO is in a position to help define that line through the exercise of its broad statutory authorities to enforce the Enterprises' compliance with all laws, including their charters.

I want to ask you, where would you draw the line? Consider some recently expanded activities and some hypothetical activities – What about subprime loans? Home equity loans used for season tickets to the Carolina Panthers? Equity investments in mortgage related or other businesses? Anything short of originating mortgages? Or do you just know it when you see it?

This issue is creating much anxiety in the mortgage industry. Each side has legitimate points to make. Fannie Mae and Freddie Mac argue that they must be allowed to innovate and use technology to make the mortgage industry more efficient and reduce mortgage costs. At the same time, the power of a GSE's lower borrowing cost makes it difficult for a non-GSE to compete with them. Observe that the GSEs purchase or guarantee roughly 70 percent of all conforming fixed rate mortgages. It is very understandable why any fully private company inside or outside the mortgage business would be concerned about a GSE such as Fannie Mae and Freddie Mac becoming a competitor.

Everyone has been taking sides and the battle lines are being drawn. Alliances have been formed such as FM Watch – a group of companies and industry trade groups committed to “containing” Fannie Mae and Freddie Mac; the Homeownership Alliance – a group established by Fannie Mae and Freddie Mac and consisting of housing industry trade groups to counter FM Watch; and the Homeowners Education Coalition, or HomeEC – a group of conservative think tanks advocating containment and potential privatization of Fannie Mae and Freddie Mac.

I want to let you know I will work, in coordination with HUD, to resolve the issues of dispute and ensure that the strength and vitality of the mortgage industry and housing finance system is maintained. To assist me in fulfilling this responsibility, I have established an internal OFHEO Charter Compliance Committee to examine the issues closely and to develop a mechanism for public input.

In a recent exercise of this responsibility, OFHEO reviewed a venture that Freddie Mac entered into with Microsoft and a number of large lenders which is known as HomeAdvisor Technologies Incorporated, or HTI. This venture integrates the various components of the mortgage lending process using an Internet platform. Concerns were raised about Freddie Mac's participation in this venture and whether it allows a few participants to dominate the market.

OFHEO reviewed the structure of the venture, its contractual terms, the associated risks to Freddie Mac, and the impact of Freddie Mac's involvement in this venture on the housing finance market. I concluded that Freddie Mac's participation in HTI posed no safety and soundness threats and was not inconsistent with the Enterprise's charter. Furthermore, in my letter to America's Community Bankers, I committed to continue our oversight to ensure that the venture does not consolidate into a closed system, which could provide a few large participants with a market advantage.

While OFHEO has not committed to review every activity that the Enterprises engage in, we will act when we believe greater clarity is needed.

Finally, on the point of regulatory oversight, summit participants agreed that there is a solid regulatory foundation in place but that OFHEO would benefit from broader “bank-like” regulatory powers. While I believe that a good regulatory system is in place, that does not mean that it can't be improved.

At the summit, I presented the Banking Committee with a legislative package that would enhance our ability to regulate the Enterprises. My legislative package will strengthen OFHEO's authority and independence by enhancing our enforcement powers, removing OFHEO from the annual appropriations process, and clarifying our safety and soundness regulatory authority. I am optimistic that this package is achievable before Congress adjourns next month.

While broader legislative changes are unlikely this year, one area where real change will occur is in the regulation of capital at Fannie Mae and Freddie Mac. OFHEO is on the verge of finalizing our risk-based capital rule. I plan on sending a final rule to the Office of Management and Budget (OMB) by the end of this year. OMB will probably complete their required review of the rule early next year. Once the rule is in effect, the Enterprises will be required to hold sufficient capital to withstand very stressful economic conditions. This will help to ensure the Enterprises' financial strength and ability to weather severe economic downturns.

Finally, OFHEO's responsibilities encompass a review of broader economic issues, including systemic risk of the Enterprises. The rapid growth of the Enterprises' outstanding debt and mortgage securities has increased concerns about the systemic risk that Fannie Mae and Freddie Mac may pose to the financial system. Systemic risks have the potential to cause a widespread crisis in the financial system—a disturbance that severely impairs the flow of credit, payments, or the pricing of financial assets. The Enterprises' debt and mortgage securities are widely held by domestic and foreign investors. Many of those investors are financial institutions that hold Enterprise obligations in amounts that are large relative to their capital. If either Fannie Mae or Freddie Mac got into financial trouble, their securities became illiquid, or they defaulted on their obligations, the consequences for a significant number of investors might impair the functioning of financial markets.

Since OFHEO's mission includes fostering a strong housing finance system and healthy financial markets, we must understand not just the risks faced by the Enterprises, but also the risks they pose to the financial system. To that end, OFHEO has initiated a comprehensive study of the systemic risk posed by the Enterprises. The topics we will examine include the nature of the systemic risk posed by Fannie Mae and Freddie Mac, the ways in which financial difficulties experienced by either Enterprise could cause other financial market participants to incur losses, and the likelihood that such losses could cause those firms to default or lead to disruptions in financial markets. We will also analyze the potential benefits and costs of options for limiting the systemic risk posed by the Enterprises. In preparing the study, we will solicit your views as well as those of other Federal agencies, the Enterprises, financial market participants, the academic community, and other interested parties. As a first step toward obtaining such input, OFHEO will soon issue a notice soliciting public comment on the key questions that our study will address.

Thank you again for this opportunity. I look forward to our continued relationship with the Eastern Secondary Mortgage Conference and to answering any questions that you might have.

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