OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

NEWS RELEASE

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Remarks of the Honorable Armando Falcon, Jr.
Director of the Office of Federal Housing Enterprise Oversight (OFHEO) at the
Mortgage Bankers Association of America's
National Secondary Market Conference
San Diego, California
Concurrent Panel Session on Regulatory Update
with William Apgar from HUD
May 9, 2000

Good morning. It is a pleasure to be here with you to discuss some of the regulatory issues facing the secondary mortgage market, specifically Fannie Mae and Freddie Mac. Today I want to discuss with you the evolving technology in the mortgage industry from a regulator's perspective as well as other issues of current interest, including of course, OFHEO's risk-based capital rule.

It is clear to anyone who reads the paper or turns on the TV that e-commerce is a rapidly expanding sector of the global economy. Toll-free numbers have been replaced by dot com addresses. Today, it is almost impossible to talk about our economy and existing business processes without incorporating e-commerce into those discussions. While e-commerce is not new, the Internet and new technologies are transforming the way we think about commerce and the way in which business is conducted.

In the 1970s and 80s we saw businesses extend their computing capabilities beyond company walls, using electronic networks to compile and transmit information between companies.

The 1980s and 90s saw even more new technologies enhance internal, as well as external business processes, and the quality of products and services that businesses offered. But the cost of installing and maintaining networks reserved electronic communication for only the largest and most profitable businesses. Even among the larger companies, the full potential for savings was not realized due to the fragmentation caused by incompatible systems.

But all that is changing. The Internet, and new technologies associated with it, are making electronic commerce uniform and more affordable to even the smallest businesses. Companies of all sizes can now communicate and exchange data with each other electronically, through the public Internet, through intranets, and through private value-added networks linking a company and its business partners. There are countless initiatives involving electronic commerce — B-to-B, B-to-C, and now P-to-P payment initiatives – the list is lengthy.

But the common thread among all of these initiatives is the role the Internet and other new technologies are playing and how they are reshaping the model that has been used for conducting business.

This impact is no more apparent than in the mortgage industry, where technology is being employed to streamline and even eliminate steps in the mortgage process. Steps which took days, or even weeks, to complete just a few years ago, now can be done in just minutes with a few computer key strokes. The result is lower costs to the consumers and reduced costs to lenders.

A prime example of this integration of technology was the recent formation of HomeAdvisor Technologies Incorporated, or HTI. HTI is a joint venture between Microsoft and a number of the nation's largest mortgage companies, with Freddie Mac playing an active role both financially and technologically. By creating an Internet mortgage portal such as this, loans can be originated, processed, closed, and securitized seamlessly among HTI business partners. I'm not here to promote this venture and we are carefully reviewing Freddie Mac's role in it. But it is certainly a development worth mentioning.

This integration is shortening the gap between Wall Street and the consumer. While certainly not the only or the last web-based mortgage system, the HTI venture is noteworthy because it is the first to bring the largest players at nearly every stage of the process – Internet service providers, lenders, and the secondary market – into one fully-integrated system.

Of course these changes do not come without controversy. Affected parties and government policymakers have raised legitimate questions about the expanding reach of the Enterprises. OFHEO and HUD will certainly have a role in that debate as it moves forward.

As I indicated, E-commerce is not new for Fannie Mae and Freddie Mac and OFHEO already conducts examinations for the risks associated with their current e-commerce activities. We evaluate and assess the quality of the Enterprises':

- data center operations;
- controls for protecting data and information security;
- plans for business continuity planning and contingency planning;
- development of new systems and maintenance of existing systems,
- application development and the attendant controls, and
- information technology strategic planning.

And as the Internet and new technologies introduce new risks, OFHEO will be further developing its examinations and research capabilities to ensure the risks are fully understood and managed.

As the availability and use of technology reaches critical mass, it still won't reach its full potential without standards allowing full network and systems interfacing. That is why I want to compliment the MBA for its initiative in establishing MISMO, the Mortgage Industry Standards Maintenance Organization. This initiative will maintain and administer standards for common data relevant to the mortgage origination and underwriting processes.

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A clear set of common standards allows all participants the opportunity to utilize and understand the data and technology which is being employed. Again, I applaud the MBA and look forward to working with you and others on this important initiative.

Now I want to turn to other regulatory issues which will affect Fannie Mae and Freddie Mac, and indirectly, the rest of the mortgage market.

Undoubtedly, the single most important regulatory issue related to the safety and soundness of Fannie Mae and Freddie Mac is OFHEO's risk-based capital rule, which is in the final stages of consideration.

OFHEO's risk-based capital standard is much different from the risk-weighted leverage standard used to regulate banking institutions. OFHEO's standard uses a stress test to simulate the financial performance of the Enterprises under severe economic conditions. The economic conditions used in the stress test include large, sustained movements in interest rates and high levels of mortgage defaults and associated losses.

Modeling cash flows associated with Enterprise assets and obligations will provide us with an accurate picture of the Enterprises' risk profiles, as well as the benefits produced by hedging. The Enterprises must have sufficient capital to survive the losses under these difficult circumstances for 10 full years — that's every quarter of every year. Finally, in order to fulfill their risk-based capital obligation, the statute requires an additional 30 percent capital to cover management and operations risk.

The comment period on our proposed capital rule has closed and I want to thank the MBA for taking the time to evaluate our proposal and provide us with many insightful comments. Your staff, particularly this session's moderator, Phyllis Slesinger, did an outstanding job combing through our proposal.

We are currently in the process of evaluating thousands of pages of comments. The comments range from broad points of public policy and the requirements of the underlying statute, to very technical points on measuring risk. Our goal is to complete our analysis and make any necessary changes as soon as possible. This is my greatest priority right now.

As a general matter, I share the same goals as the MBA and many other interested parties about the risk-based capital rule. I agree with the MBA's goal that we should publish a final rule as soon as practicable. Given the size of the two Enterprises, and the rate at which they are growing, it is vital that OFHEO quickly put a risk-based capital requirement in place.

The MBA has also correctly pointed out that the rule needs to accommodate change and innovation, and that the Enterprises must be able to manage their businesses under the rule. I am in full agreement with this point as well.

The final capital rule will have a process that will allow it to evolve and change over time to reflect new products, innovations in risk management, and new techniques for measuring risk. By adapting to changing conditions, it will reward the Enterprises for reducing risk and raise capital when risk increases.

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The risk-based capital standard will be state-of-the-art and will be the latest component in OFHEO's multi-faceted regulatory program.

When finalized, it will join a minimum capital requirement which has existed since the Office's early days and a comprehensive annual risk-based examination program. To ensure that we have an accurate picture of the industry these regulations will impact, OFHEO must also maintain a highly qualified research capability. Sound and authoritative research and analysis of developments and risks in the mortgage markets is essential for OFHEO to adequately fulfill its obligations.

As mortgage professionals, I am sure you have read or heard some of the recent comments regarding the possible systemic risk posed by the Enterprises to the financial system.

In recent testimony before the House Banking Committee, Treasury Undersecretary Gary Gensler testified that: "As the GSEs continue to grow and to play an increasingly central role in the capital markets, issues of potential systemic risk and market competition become more relevant…The public sector has three roles: Creating an environment in which market discipline can work effectively; promoting the maximum degree of transparency; and maintaining the competitiveness of the system as a whole."

In addition, the Chairman of the Capital Markets Subcommittee in the House, said: "I believe that market discipline, coupled with prudent supervision, is the best formula for mitigating systemic risk."

And Fannie Mae CEO Frank Raines has also said to the Wall Street community, "…Pre-1992 we did not have a safety and soundness regulator who was full time…who had a serious capital standard and who had a serious examination arm. We have that now. And each of those things is a great assurance to others."

Increased market discipline that Treasury and Congress are talking about will help OFHEO do its job, and we will look for ways to bring that about, including greater transparency.

Whatever perspective participants bring to the debate, one thing is clear: They all agree that prudent regulation is both necessary and appropriate. By providing the comprehensive regulatory approach I mentioned a moment ago, OFHEO is fulfilling its important public mission.

Finally, let me just say something about predatory lending, which is a much discussed topic in regulatory and Congressional forums right now. No honest lender condones the practice and we all have a desire to help combat it. OFHEO is on a task force with other regulators who are addressing the issue. Trafficking in these loans raises credit risk, reputational risk, and possibly legal exposure for the Enterprises.

One pending case certainly highlights that the possible legal risk related to predatory lending is not limited to the primary market. In a lawsuit against a subprime lender, a prominent Wall Street firm that securitized the lender's mortgages has been named as a defendant in the action for violations of Truth in Lending Act and various state laws, including unfair and deceptive laws.

The investment bank is included in the suit based on the theory that as the leading seller of bonds for subprime lenders, it is an underwriter of subprime loans and a source of funds to support

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fraudulent practices. So, while it is not suggested that the investment bank made any loan or holds a direct interest in allegedly illegal loans, the firm is a defendant for its financial support of such practices.

Whether or not the plaintiff prevails on its theory, secondary market purchasers of predatory loans should remember the warning "buyer beware." Predatory lending may have legal consequences for direct and even indirect actions. While many observers give this case a slim chance of success, just remember that's what they said about the Fleet Factors case, before the court ruled that banks could be liable for environmental clean-up costs.

I understand the MBA has just issued a best practices guideline and I commend them in this constructive first step in combating predatory lending.

To effectively deal with predatory lending, we need to better understand the subprime mortgage markets in which such behavior frequently occurs. These markets are themselves evolving rapidly, and the Enterprises' participation in these markets may have a critical effect on the path of that evolution. To ensure that the loans they are funding are not creating unacceptable risks, we are working to determine what additional loan level information OFHEO may need to obtain. We always need the best information possible to carry out our mission.

Thank you again for the opportunity to participate today. I look forward to continuing to work with the MBA to ensure that our nation has a strong, vibrant housing finance industry.

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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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