OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

NEWS RELEASE

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Tuesday, March 7, 2000

Remarks of the Honorable Armando Falcon, Jr.
Director
Office of Federal Housing Enterprise Oversight

America's Community Bankers Government Affairs Conference
March 7, 2000

I am pleased to be a part of America's Community Bankers Conference. I've had the pleasure of working with the ACB over the years in my previous capacity as Counsel to the House Banking Committee, and I look forward to continuing that relationship in my new capacity as Director of the Office of Federal Housing Enterprise Oversight (OFHEO).

There are many important issues facing the mortgage industry right now, and they arise in a climate of much uncertainty.

Automation is quickly changing the way the industry operates from top to bottom. This automation — along with the new activities and growth of Fannie Mae and Freddie Mac — is blurring the line between the primary and secondary mortgage markets.

These trends are very likely to continue as the Enterprises search for new opportunities to meet their stated financial goals of continued strong earnings growth.

With these and other developments, no one can say for certain what the mortgage business will look like in five or ten years.

To help address these uncertainties, Congress created OFHEO in 1992 as an independent agency within HUD, responsible for maintaining the integrity of the secondary mortgage market. It is a responsibility that I take very seriously.

Seven years after its creation, OFHEO has matured into a strong and very capable regulator. We have a top-notch regulatory program in place to ensure the safety and soundness of Fannie Mae and Freddie Mac.

I would match our examination program against any in the government, and our risk-based capital regulation will be state-of-the-art when it is implemented. I will say more about that later.

OFHEO does, however suffer from one institutional deficiency: Lack of financial independence.

Unlike all other federal safety and soundness regulators, OFHEO is subject to the appropriations process.

Although our funding comes directly from the Enterprises, Congress must approve our budget annually. We do not have the flexibility to respond quickly to changing conditions, especially a deteriorating one, of the Enterprises or the market.

This is simply unsound public policy, and I have asked Congress to put us on par with all other safety and soundness regulators by removing OFHEO from the appropriations process.

OFHEO has significant oversight responsibilities under the law. Our primary focus has been, and always will be, in the examination and capital regulation areas, which are essential to ensuring the safety and soundness of the Enterprises.

But it is now time to expand the other activities that are part of our oversight responsibility.

We are now taking a more active interest in the operation of the entire secondary mortgage market and enforcement of the laws within our jurisdiction.

In addition, we are putting our resources to work analyzing and understanding the changes taking place in the primary market. With the mortgage industry so deeply intertwined and interdependent, to do otherwise would be irresponsible. A healthy secondary market relies on a healthy primary market, and vice versa.

With a thorough understanding of the Enterprises' activities and changes in the mortgage industry, we can better assess how those changes impact the Enterprises.

Any changes in risk to the Enterprises will then be incorporated into our regulatory program. In addition, OFHEO will be able to provide policymakers with sound and authoritative research on the policy implications of developments in the industry.

Now that I've tried to share with you the direction for OFHEO, let me discuss two activities of current interest.

First and foremost is OFHEO's risk-based capital regulation. My number one priority is to bring the rulemaking process to a conclusion and implement a final rule. After 11 months, the comment period on this rule will close Friday.

We will review all comments with an open mind, and won't hesitate to incorporate suggestions that improve the rule.

As background, allow me to very briefly describe how the rule works, as it is much different from a risk-weighted leverage standard.

The rule uses a stress test to simulate the financial performance of the Enterprises under severe economic conditions.

This financial simulation then produces a risk-based capital requirement.

The economic conditions are defined in law and include high levels of mortgage defaults and associated losses, and large sustained movements in interest rates.

Computer models are used to simulate the performance of mortgages and other assets and obligations under these stressful conditions.

The modeling of cash flows thus captures the risks associated with enterprise assets and obligations, as well as the benefits of hedges.

The Enterprises must have sufficient capital to survive the losses under these difficult circumstances for ten full years — that's every quarter of every year. After this figure is determined, the statute requires that the capital requirement be further increased by 30 percent for management and operations risk.

The stress test will, of necessity, be dynamic. It will need to evolve and change over time to reflect new products, innovations in risk management, and new techniques for measuring risk. The stress test will give the Enterprises immediate credit for reducing risk, and quickly increase capital when risk increases.

This allows the Enterprises flexibility to operate their businesses while closely matching capital to risk. It will represent state-of-the-art risk-based capital regulation.

I understand that the Enterprises have recently shared their views on the regulation with other interested parties. In their comments they highlight four goals for a final risk-based capital standard.

They stated that it should:
(1) be consistent with the law,
(2) be operationally workable,
(3) accommodate innovation, and
(4) tie capital to risk.

I wholeheartedly agree with all four of these goals. OFHEO has shared those objectives from the beginning and I am confident that the final rule will meet those goals.

Now let me turn to HUD's affordable housing goals.

We have reviewed the increased goals from a risk perspective and have concluded that the Enterprises can meet the goals in a manner consistent with safety and soundness.

Coinciding with the new goals, last week Fannie Mae announced an intention to move aggressively into the subprime market. OFHEO will look very closely at this effort. There are three points to make here.

First, Fannie's charter, like Freddie's, requires that the Enterprises' operations be limited to mortgages which are of "such quality, type, and class as to meet, generally, the purchase standards imposed by private institutional mortgage investors." We must review compliance with this provision of the law, which is obviously vague. In doing so — I of course understand the benefit to consumers from lower cost mortgages.

Second, we must carefully assess the risks associated with subprime loans, how the Enterprises manage that risk, and set capital at an appropriate level.

With effective risk management, including adequate credit enhancements, the Enterprises exposure to risk from these loans need not necessarily be higher than that for other mortgages. But to the extent that the risk is higher, we will require the Enterprises to hold more capital.

And third, the Enterprises should be mindful of another provision in their charters.

A stated purpose of the creation of the Enterprises is to engage in “activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities.”

This was added to the Enterprises’ charters by the same law that created OFHEO.

Congress expressed its desire that the Enterprises accept a lower return on affordable housing as an appropriate trade-off for the substantial public benefits they receive. Such an effort would help borrowers who may be on the margin of affording a mortgage.

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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