Testimony of the Honorable Armando Falcon, Jr., Director,
Office of Federal Housing Enterprise Oversight (OFHEO)
before the House Budget Committee
Task Force on Housing and Infrastructure[1]

"Economic Implications of Debt Held
by Government Sponsored Enterprises"

July 25, 2000

Thank you Chairman Sununu, Ranking Member Bentsen, and Members of the Task Force. As you are aware, the Office of Federal Housing Enterprise Oversight (OFHEO) was established in 1992 as an independent entity within the Department of Housing and Urban Development. OFHEO's primary mission is to ensure the capital adequacy and safety and soundness of two government-sponsored enterprises (GSEs) – Fannie Mae and Freddie Mac. To fulfill this mission, OFHEO has regulatory authority similar to other Federal financial regulators such as the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve Board. Those authorities include annual examinations, broad rulemaking authority, setting capital standards, enforcement actions, and research.

The Task Force has taken an important step in convening this hearing to consider the economic implications of the size and scope of the housing GSEs activities. Because Assistant Secretary Apgar is here today representing the Federal Housing Finance Board, I will focus my discussion on the two entities within my jurisdiction.

In considering these issues, it is important to understand what the GSEs do and how they operate.

WHO ARE FANNIE MAE AND FREDDIE MAC?

Fannie Mae and Freddie Mac are publicly-held companies chartered by Congress. They were established to create a secondary mortgage market to ensure a ready supply of mortgage funds for affordable housing for American homebuyers. They fulfill this very important public mission by buying mortgages from commercial banks, thrift institutions, mortgage banks, and other primary lenders, and either hold these mortgages in their own portfolios or package them into mortgage-backed securities (MBS) for resale to investors. They have become two of the world's largest financial institutions.

[1] This testimony represents the views of the OFHEO Director, which are not necessarily those of the President or Secretary of Housing and Urban Development.

To assist Fannie Mae and Freddie Mac in achieving their public mission, they receive numerous explicit benefits from the Federal Government, including an exemption from state and local taxation, an exemption from the registration requirements of the Securities and Exchange Commission, and each firm has a potential credit line with the U.S. Treasury.

However, the most important benefit the Enterprises receive as a result of their GSE status is the special treatment the market bestows on their securities. Because of investors' belief in an implied U.S. government guarantee on their securities, the Enterprises have been able to borrow money more cheaply and without the practical volume restrictions faced by any fully-private triple-A rated company. This market perception allows the Enterprises to safely operate with a higher degree of leverage than fully private firms are able to do.

There is no doubt that the GSEs are large and rapidly growing. As they grow, the implications to the economy if they were to fail also increases. However, the actual likelihood of any failure depends critically on how they are managed and supervised. I want to assure you that both Fannie Mae and Freddie Mac are currently in excellent financial condition, are well-managed, and have exceeded minimum capital requirements every quarter that the requirement has been in place. And OFHEO has a strong regulatory program in place to ensure their continued safe and sound operation. If the need ever arose, OFHEO would move quickly and forcefully to correct any financial problems at the Enterprises.

OFHEO supervises the Enterprises primarily through its extensive, and continuous, examination work. Our examiners possess impressive skills and backgrounds, and came to OFHEO from banking and thrift regulatory bodies and from the mortgage industry itself. Our experts maintain a physical presence at the Enterprises at all times, and have unlimited access to all levels of management and to highly-sensitive corporate records. By staying apprised of the Enterprises' risks and business activities on an almost real-time basis, the examiners are able to evaluate an extensive array of risk-related factors and to assess the Enterprises' financial safety and soundness.

Each quarter, the OFHEO examination staff issue conclusions relating to more than 150 separate components of financial safety and soundness, and thereby provide me with a comprehensive picture of the Enterprises' financial condition. These conclusions pertain to such key risk management areas as credit risk, interest rate risk, liquidity risk, information technology, internal controls, business process controls, internal and external audit, management information and process, and board of director governance and activities.

Examiners meet frequently with management to discuss and assess business strategies and plans, financial performance results, risk management structure and practices, and each Enterprise's overall risk profile. These discussions include future trends and management's controls and practices to anticipate and prepare for potentially adverse trends in any risk areas, or combination of risk areas.

Examination teams identify opportunities for improvements in existing Enterprise risk management practices and work directly with management to address identified opportunities to enhance financial safety and soundness. Through our risk-focused examination framework, OFHEO constantly evaluates such critical areas as:

- The Enterprises' overall risk management practices
- The composition, risk profile, and significant trends in the Enterprises' retained, and guaranteed, mortgage portfolios
- The Enterprises' ability to effectively manage interest rate risk and other key financial exposures
- The Enterprises' ability to efficiently issue debt and hedge financial exposures
- The quality of financial performance-related information and market-related information on which the Enterprises' boards and management rely in reaching key decisions

In summary, the examination group provides us with an accurate and timely understanding of the Enterprises' financial condition.

WHAT DO THE ENTERPRISES DO?

Fannie Mae and Freddie Mac have two major lines of business. First, they guarantee mortgage-backed securities: securities backed by pools of residential mortgages. When investors purchase a mortgage-backed security they are entitled to the principal and interest payments made by the mortgage borrower, except for portions earned by mortgage servicers and by the Enterprise which guarantee the payment of principal and interest. In return for the portion the Enterprise earns, they agree to protect investors against losses caused by borrower defaults. Enterprise mortgage-backed securities are highly regarded by investors and can be issued at interest rates very close to a mortgage-backed securities with explicit government guarantees. This guarantee business has been quite profitable for the Enterprises, but mortgage borrowers receive most of the benefit from these lower borrowing costs. While there is no precise way to measure these savings, recent estimates are generally centered around 25 to 30 basis points.

The Enterprises' second major line of business is portfolio investment in mortgage-backed securities and, to a lesser extent, whole mortgages that are purchased directly from lenders and are not parts of pools backing mortgage securities. The Enterprises fund these investments primarily by issuing debt. The characteristics of the debt issues are designed so that, in combination with a variety of derivatives contracts and other hedges entered into by the Enterprises, the values of the debt and the mortgage securities will be similarly affected by interest rate changes. This help protect the Enterprises from a mismatch between the cost of funding its operations and the income derived from those operations.

Another risk in the portfolio business is that changes in borrowers' prepayment behavior, often in response to interest rate changes, are not fully predictable and may affect mortgage security values differently than expected.

Portfolio investment has been more profitable than the guarantee business. This activity may create additional interest savings for mortgage borrowers, though such savings would be much smaller than those created by the guarantee business. Because empirical data on this issue is scarce, OFHEO intends further study of this topic.

Both of these business lines have been growing at the Enterprises, particularly their portfolio investment business. Since the end of 1991, the Enterprises' mortgage assets have swelled from $155 billion to $900 billion, an increase of approximately 475 percent. The majority of the increase reflects purchases of mortgage securities they had previously guaranteed. To fund the growth in these assets, the Enterprises have increased their debt outstanding at a comparable rate from $164 billion to $963 billion over the same period.

Their guarantee business has also increased significantly. Total mortgage-backed securities guaranteed – both those held privately as well as those held in portfolio – has more than doubled from $731 billion in 1991 to over $1.76 trillion today. Although the Enterprises purchased roughly half of the increase in their guaranteed mortgage securities in recent years, the amounts held by other investors has still grown 73 percent to $1.2 trillion over that period.

The Enterprises debt and mortgage-backed securities outstanding now amounts to $2.2 trillion. Adding in the debt of the other GSEs, the total debt of all GSEs rises to $3 trillion, substantially above the total privately held, marketable debt of the U.S. Treasury. (Further detail about Enterprise mortgage portfolios, debt, and mortgage-backed securities outstanding can be found in the attached tables.)

WHO HOLDS THE DEBT?

Federal Reserve estimates for holdings of what is known as agency debt, about 85 percent of which is issued or guaranteed by GSEs, shows the following breakdown:

Depository Institutions	27%
Households, Mutual Fund, Trusts & Estates	21%
Public & Private Retirement Funds	16%
Foreign Investors (including 60+ central banks)	12%
Insurance Firms	9%
State & Local Governments	5%
Others	10%

As should be apparent from these data, a financial crisis at the Enterprises could have a disruptive impact on investors and the economy. OFHEO has developed and continues to improve upon a strong supervisory program.

The Enterprises' business lines will likely continue to grow. Recently Fannie Mae announced its continued desire to double earnings per share over the next five years. Freddie Mac has predicted double digit earnings growth over a similar period. These earnings targets will only lead to increased pressure to generate new revenues. The prudence and competence with which the Enterprises manage and balance their assets and liabilities becomes that much more important, the larger they grow.

In order for the Enterprises to continue to grow their asset portfolios, they have expanded the markets for their debt securities, and built demand for debt instruments, such as callable debt, that help them manage interest rate risk. They have expanded their domestic and international investor base, developing new products to appeal to different investor profiles. The introduction of debt issuance programs modeled after those of the U.S. Treasury is the most recent development in these efforts.

WHAT IS OFHEO'S ROLE?

OFHEO is aggressively fulfilling its obligation as a strong and effective regulator. By fulfilling our core mission well, OFHEO protects against systemic risks posed by Fannie Mae and Freddie Mac. As I have stated before, OFHEO takes a three-pronged approach to accomplish this goal —examinations, capital regulation, and research.

I have already spoken about our strong examination program, so I will next address our capital standards. OFHEO's minimum capital standard, one that is built on traditional, ratio-based approaches to regulation of insured depository institutions, ensures a base level of Enterprise capital to protect against risk.
Since our inception, we have imposed and enforced a minimum capital standard on the Enterprises. The Enterprises have met that standard every quarter and we are reviewing the necessity of updating the standard.

We are on track to complete our long-awaited Risk-Based Capital Standard by the end of the year. This standard will be the first to explicitly link capital and risk through use of a model that simulates the financial performance of the Enterprises under stress. This is my top priority and we will meet my deadline.

Finally, OFHEO is continuing to strengthen its research and analytical capability. We must stay on top of the changes taking place in the quickly evolving secondary and primary mortgage markets. This important research and analysis serves to better inform our examination and capital regulation efforts. In summary, the Enterprises' rapid growth raises important policy issues regarding their mission and the systemic risks they pose. However, because OFHEO is aggressively fulfilling its responsibilities, this discussion takes place not in a climate of urgency, but at a time when the Enterprises are financially sound and well regulated.

Table 1

Combined Fannie Mae and Freddie Mac Mortgage Assets, Debt, and MBS
($ in millions)

	Retained Mortgage Portfolio	Debt Outstanding	Total MBS Outstanding[1]
2000*	$900,485	$962,673	$1,240,000
1999	$846,855	$908,330	$1,217,052
1998	$670,185	$747,687	$1,115,494
1997	$481,221	$542,616	$1,055,123
1996	$424,878	$488,251	$1,021,238
1995	$361,217	$419,135	$972,275
1994	$298,228	$350,509	$947,001
1993	$246,799	$251,105	$910,335
1992	$191,748	$195,931	$831,958
1991	$155,650	$164,199	$714,447

1 -- Total MBS outstanding net of MBS in portfolio
* As of June 30, 2000

Table 2

Fannie Mae and Freddie Mac Select Financial Data
($ in Billions)

	Fannie Mae				Freddie Mac			
	2Q00	1Q00	4Q99	4Q98	2Q00	1Q00	4Q99	4Q98
Balance Sheet								
Retained Portfolio	$550	$ 537	$ 523	$415	$350	$ 334	$ 323	$255
MBS held in Retained Portfolio (1)	$299	$ 291	$ 282	$197	$226	$ 217	$ 211	$168
Non-Mortgage Investments	$47	$ 38	$ 40	$59	$39	$ 43	$ 32	$45
Total Assets	$609	$ 587	$ 575	$485	$413	$ 406	$ 387	$321
Total Debt	$578	$ 558	$ 548	$460	$384	$ 378	$ 361	$287
Total Stockholder's Equity	$19	$ 18	$ 18	$15	$12	$ 12	$ 12	$11
Off-Balance Sheet								
MBS Outstanding, net (2)	$697	$ 685	$ 679	$637	$543	$ 540	$ 538	$478
Other								
Average Guarantee Fee (basis points	19.60	19.40	19.30	16.50	19.40	19.40	19.50	20.6
Net Interest Yield (%)	1.02	1.02	1.01	0.90	0.75	0.76	0.80	0.84
Single-Family Delinquency Rate (%)	0.42	0.47	0.48	0.58	0.34	0.36	0.39	0.5
Multifamily Delinquency Rate (%)	0.13	0.18	0.12	0.29	0.07	0.08	0.14	0.37

(1) Enterprise holdings of its own MBS.
(2) Total MBS outstanding minus MBS held in Retained Portfolio.
(3) As of May 31, 2000, most recent data available

Table 3

	FHLB	Freddie Mac	Fannie Mae	Total Debt Outstanding
Debt Outstanding ($ in billions)				
2000*	$568.44	$384.15	$578.53	$1,531.12
1999	$529.00	$360.70	$547.60	$1,437.30
1998	$382.10	$287.40	$460.90	$1,130.40
1997	$313.90	$169.20	$369.80	$852.90
1996	$263.40	$157.00	$331.30	$751.70
1995	$243.20	$120.00	$299.20	$662.40
1994	$205.80	$93.30	$257.20	$556.30
1993	$139.50	$50.00	$201.10	$390.60
1992	$114.70	$29.60	$166.30	$310.60
1991	$107.50	$30.30	$133.90	$271.70
1990	$117.90	$30.90	$123.40	$272.20
1989	$136.10	$26.10	$116.10	$278.30
1988	$135.80	$22.80	$105.50	$264.10
1987	$115.70	$17.60	$97.10	$230.40
1986	$88.80	$13.60	$93.60	$196.00
1985	$74.40	$11.90	$93.90	$180.20

* As of June 30, 2000

Table 4

Effective Debt Outstanding
First Quarter 2000
($ in Billions)

	Fannie Mae		Freddie Mac		Aggregate	
Total Debt Due Within 1 Year	$	179	$	181	$	360
ST Debt Converted to LT	$	(141)	$	(135)	$	(276)
Effective Variable Rate Debt	$	30	$	-	$	30
Effective Short Term Debt	$	68	$	46	$	114
Total Debt Due After 1 Year	$	351	$	197	$	548
ST Debt Converted to LT	$	141	$	135	$	276
Effective Long Term Debt	$	492	$	332	$	824
% Effective Long Term Debt with call or rate adjustment features		52%		61%		56%

Notes:
Debt financing - debt securities created to finance the purchase of unsecurtized mortgages and mortgae related securities.
Short term (ST) debt converted to Long Term (LT) - The Enterprises use derivatives to convert much of their short term debt into long term debt.
Effective variable rate debt - liabilities originally issued as a fixed rate instrument, with an effective variable rate, that include the impact of derivative positions
Effective Short Term Debt - debt maturing in one year or less plus effective variable rate debt
Effective Long Term Debt - debt with an effective repricing date of more than one year; including the impact of derivative financial instruments.
Call or rate adjustment features - debt options that are callable after a specific period prior to maturity or provides interest rate protection similar to callable debt.

Table 5

Enterprise Mortgage-Backed Securities Outstanding

($ in Billions)

	Fannie Mae			Freddie Mac			Aggregate
	1Q00	**4Q99**	**4Q98**	**1Q00**	**4Q99**	**4Q98**	
Single-Family							
Long-Term	$686	$671	$558	$547	$535	$449	$1,233
Intermediate-Term	$198	$200	$187	$171	$175	$157	$369
ARMs/Floating Rate	$55	$54	$59	$35	$35	$37	$90
Total	$939	$925	$804	$753	$745	$643	$1,692
Multifamily	$37	$36	$30	$4	$4	$3	$41
Total	**$976**	**$961**	**$834**	**$757**	**$749**	**$646**	**$1,733**

Table 6

Enterprise Mortgage-Backed Securities Issuances

($ in Billions)

	Fannie Mae	Freddie Mac	Aggregate
2Q00	$49	$35	$84
1Q00	$39	$28	$67
1999	$301	$233	$534
1998	$326	$251	$577
1997	$149	$114	$263
1996	$150	$120	$270
1995	$111	$86	$197
1994	$131	$117	$248
1993	$221	$209	$430
1992	$194	$179	$373
1991	$113	$93	$206
1990	$97	$74	$171
1989	$70	$74	$144
1988	$55	$40	$95
1987	$63	$75	$138
1986	$61	$102	$163
1985	$24	$42	$66

Table 7

Combined Fannie Mae and Freddie Mac Retained Portfolio

($ in millions)

	Whole Loans	Own MBS Owned[1]	Other Mortgage Related Securities	Total Retained Portfolio
2000*	NA	$525,000	NA	$900,485
1999	$204,252	$492,912	$149,691	$846,855
1998	$213,524	$365,483	$91,178	$670,185
1997	$208,678	$233,844	$38,699	$481,221
1996	$214,466	$183,802	$26,610	$424,878
1995	$215,516	$125,735	$19,966	$361,217
1994	NA	$74,668	NA	$298,228
1993	NA	$40,096	NA	$246,799
1992	NA	$26,929	NA	$191,748
1991	NA	NA	NA	$155,650

1 Fannie Mae MBS in Fannie Mae's portfolio and Freddie Mac MBS in Freddie Mac's portfolio

NA Data unavailable

* As of June 30, 2000

Table 8

Enterprise Retained Portfolio Compostion
($ - Billions)

	Fannie Mae			Freddie Mac			Aggregate
	1Q00	**4Q99**	**4Q98**	**1Q00**	**4Q99**	**4Q98**	**1Q00**
Single Family							
Long-term fixed rate	$440	$426	$319	$254	$243	$192	$694
Intermediate-term fixed rate	$68	$69	$72	$51	$52	$45	$119
Arms/Floating Rate	$16	$14	$12	$17	$17	$10	$33
Total	$524	$509	$403	$322	$312	$247	$846
Multifamily	$15	$14	$12	$14	$12	$8	$29
Adjustments	$2	$1	$0	$3	$2	$0	$5
Total Retained Portfolio	**$537**	**$522**	**$415**	**$333**	**$322**	**$255**	$870

Table 9

Combined Fannie Mae and Freddie Mac Purchases
($ in millions)

	Single-family	Multi-family	Total[1]	Mortgage Securities [2]
1999	$548,748	$17,193	$565,941	$268,329
1998	$618,410	$15,338	$633,748	$272,907
1997	$275,081	$8,775	$283,856	$84,233
1996	$287,306	$8,680	$295,986	$81,840
1995	$215,974	$6,531	$222,505	$73,328
1994	$280,792	$4,786	$285,578	$44,369
1993	$518,877	$4,326	$523,203	NA
1992	$439,309	$2,879	$442,188	
1991	$233,280	$3,440	$236,720	

1 Loans purchased from lenders, excludes mortgage securities
2 Not included in totals
NA - Not available before this date

Table 10

Combined Fannie Mae and Freddie Mac Financial Derivatives
($ in millions)

	Interest Rate Swaps	Interest Rate Caps, Floors, Corridors	Foreign Currency	Futures, Options, and Forward Rate Agreements	Other	Total
1999	$318,612	$48,886	$12,604	$308,818	$10,294	$699,214
1998	$200,401	$36,345	$14,459	$234,313	$15,277	$500,795
1997	$203,845	$22,095	$11,120	$6,000	$13,888	$256,948
1996	$204,786	$14,395	$2,973	$0	$1,001	$223,155
1995	$171,063	$13,355	$1,224	$29	$999	$186,670
1994	$109,304	$9,363	$1,023	$0	$1,465	$121,155
1993	$67,346	$1,860	$1,023	$0	$1,425	$71,654

Table 11

Combined Fannie Mae and Freddie Mac Capital Summary
($ in millions)

	Core Capital	Regulatory Minimum Capital Requirements	Capital Surplus
2000*	$31,777	$30,836	$940
1999	$30,568	$30,057	$511
1998	$26,180	$25,667	$513
1997	$21,169	$19,785	$1,384
1996	$19,516	$17,983	$1,533
1995	$16,788	$16,035	$753
1994	$14,710	$14,299	$411
1993	$12,489	$10,846	$1,643

* As of March 31, 2000

Table 12

Combined Fannie Mae and Freddie Mac Earnings Components
($ in millions)

	Net Income	Net Interest Income [1,2]	Guarantee Fee Income [2]	Administrative Expenses	Credit Related Expenses [3]
1999	$6,135	$7,820	$2,301	$1,455	$286
1998	$5,118	$6,325	$2,248	$1,286	$603
1997	$4,451	$5,796	$2,356	$1,131	$904
1996	$3,968	$5,297	$2,282	$1,000	$1,017
1995	$3,235	$4,443	$2,173	$941	$876
1994	$3,115	$3,935	$2,191	$904	$803
1993	$2,659	$3,305	$1,970	$804	$829
1992	$2,245	$2,753	$1,770	$710	$777
1991	$1,918	$2,461	$1,467	$606	$789

1 Interest income net of interest expenses, nominal basis
2 Effective 1/1/96, Freddie Mac reports guarantee fees on retained MBS as guarantee fee income. Howeve, in this data, fees on retained MBS have been estimated and reclassified as interest income for to create comparability between the Enterprises.
3 Credit related expenses are defined as mortgage loan loss provision plus real estate owned expenses.