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Before the
Federal Agency Committee of the
Bond Market Association
Washington D.C.
May 6, 1998

Good Evening.

I'm pleased to have an opportunity to speak to this distinguished committee on a topic that we all have a keen interest in – Government-sponsored Enterprises (GSEs). I would like to thank Steve Huntly and Bonnie Caldwell for extending me an invitation, and I'll try to keep my remarks relatively short, but that's hard for me to do. Please enjoy your dinner while I speak, and I hope I don't give anyone indigestion.

As a long time observer of GSEs – 8 years at the Department of Treasury and 4 plus years at OFHEO — I would like to share with you tonight some observations about GSEs and why they need to be regulated. Next, I will discuss why GSEs need to be subject to risk-based capital standards. I will then close by providing you with an update on the risk-based capital standard that OFHEO will soon be proposing for the two largest GSEs – Fannie Mae and Freddie Mac.

When you deal with GSEs and GSE issues for a living, the first thing that you notice, and have to learn to deal with, is that everyone inside the beltway has very strong opinions about GSE issues. There is very little middle ground. The reason for this polarization of opinions, I believe, lies at the very nature of a GSE — it is a hybrid between a government agency and a private corporation. This unusual structure provides a GSE with a set of advantages that enable it to be successful. This success breeds tension, however, when the activities of a GSE overlap those of the private market, or when its activities have the potential to cost taxpayers money. I will touch upon a few of these tensions tonight.

The tensions derive from the unique GSE structure. A GSE is a federally chartered, publicly owned corporation that has a specific public mission. Congress provided GSEs with benefits that help them achieve their public mission that is intended to support public policy. These benefits allow them to operate as the lowest cost firm in the market, which in turn permit them to develop a high degree of market power.

Private ownership encourages operating efficiencies but also provides incentives to maximize the value of these benefits. From the business perspective of a GSE, they have the best of both government and private worlds.

By succeeding in their missions, GSEs provide significant benefits to targeted populations. In the case of Fannie Mae and Freddie Mac, these benefits have extended to the entire secondary mortgage market, and most of the primary market. Due to their success, the United States has the most efficient and expansive mortgage finance system in the world. The general availability of funds for housing at less than a percentage point above Treasuries, on an option-adjusted basis, is a remarkable achievement.

The profit motive that is the driving force in bringing efficiencies to its activities also provides strong incentives for a GSE to maximize the value of its GSE status. There is nothing intrinsically bad about this. In fact, management has a fiduciary responsibility to maximize stockholder value.
GSEs attempt to maximize the value of their GSE status by engaging in as many profitable activities as they believe can be supported by their charter.   When a GSE does engage in a new activity, it almost always finds itself competing with private market participants. This creates a tension between a GSE and private firms who fear they may be driven out of profitable areas of business or see substantial downward pressure on pricing.

A similar source of tension arises when a GSE engages in an activity that outside observers feel is not directly related to its public purpose, even though the activity may be safe and sound. A recent example is the controversy surrounding the non-mortgage investments at Freddie Mac, Fannie Mae, and Farmer Mac. Some observers have argued that these GSEs are using their favored status to earn arbitrage profits on non-mortgage investments that are unrelated to their public purpose. The Secretary of HUD issued an ANPR (Advanced Notice of Proposed Rulemaking) asking the public to comment on whether this type of activity at Fannie Mae and Freddie Mac should be regulated by the Department to ensure compliance with their public purposes. A number of firms represented in this room sent comments to the Department.

Let me give you some thoughts on this matter. I believe it is entirely appropriate for Congress and regulators to make sure that the activities of GSEs stay focused on their public missions. After all, Congress chartered the GSEs with specific public policy purposes in mind and gave them special benefits to use in carrying out their public mission.

A number of you commented to the Department that these activities should be subject to safety and soundness oversight. They already are. From our perspective as Fannie and Freddie's safety and soundness regulator, an acceptable investment is one that does not expose the corporation to unreasonable risk. We regularly monitor and examine their investments for compliance to this criterion.

There clearly are sound financial reasons to maintain a portfolio of high quality liquid assets as a place to park funds temporarily. As a safety and soundness regulator we look to see if there is enough liquidity, not if there is too much. I believe it will be a difficult task for HUD to devise a rule that will protect against the risk of a GSE abusing its investment authority to earn arbitrage profits. HUD is currently evaluating the comments it received on its ANPR and we will follow very closely any action that the Secretary might take in this area.

A third type of tension can arise between the Treasury and a GSE in the competition to raise funds in the capital markets. There is a phenomenon that is occurring today, with relatively little fanfare, that would have been of interest to me when I was at Treasury studying the GSEs. What I am referring to is the introduction by Fannie Mae and Freddie Mac, of their “Benchmark” and “Reference” note sales. When I was at Treasury, FIRREA charged the Department with assessing the potential impact of GSE operations on taxpayers. That charge included an assessment of the impact on Treasury borrowing costs from GSE debt market activity.

This assessment was operationally difficult to do, since at the time, the Treasury and the GSEs largely issued different types of debt and in different market segments. That has been changing. The GSEs are filling a void created by the declining supply of Treasury securities, especially at the note auctions, by supplying similar maturity debt (3 yr., 5 yr., and 10 yr.) to the market. They hope that this debt will be viewed by both domestic and foreign investors as close substitutes for Treasury securities.

The Enterprises are clearly benefiting from strong demand in the Treasury market, particularly as uncertainty begins to creep into certain global economies. In particular, foreign purchases of these notes at auction have been significant. Spreads on these new notes have been spectacularly low. For example, spreads on Fannie Mae five-year Benchmark notes have ranged from 11 basis points to 20 basis points since the beginning of January.

While there appears to be no obvious impact on Treasury borrowing costs in today's favorable environment, that could change if demand for Treasuries declines, or God forbid, from a taxpayer's perspective, the supply of Treasuries increases.

The final tension that I want to talk about today is one that resulted in the creation of OFHEO with the charge to examine the activities of Fannie Mae and Freddie Mac and develop risk-based capital standards for the two Enterprises. It is the tension that exists because of what we economists call the "moral hazard" problem associated with GSE status. Even though GSE securities are publicly traded, the marketplace does not provide the typical level of discipline to control risk taking at a GSE.

The way in which the private market disciplines corporations from taking on too much risk is through the price a corporation must pay for funds. The higher the perceived risk that a corporation will not be able to pay back money that it borrows, the higher the price the corporation must pay. Assuming complete transparency, that is, investors can easily and cost effectively collect and analyze information about the corporation, market discipline can work reasonably well.

In the case of government-sponsored enterprises, market discipline is short-circuited. Investors assume that the government will come to the rescue of a financially troubled GSE because of its ties to the federal government.   This is what is commonly referred to as an implied government guarantee that is associated with GSE debt securities. One only needs to observe that GSE domestic obligations, like Treasuries, typically receive no rating on an issue-by-issue basis, because investors and the rating agencies view the implied government backing of GSEs as a sufficient indication of the investment quality of their obligations. I am certainly not telling this group anything you don't already know. But what does this lack of market discipline mean for taxpayers?

Does this mean that the GSEs are taking on so much risk or managing their risk so poorly that they are a time bomb waiting to explode? Happily, the answer to that question is no. Today's economic environment is extremely favorable to risk taking. But that could easily change. This is where the potential concern about a lack of market discipline arises. Pressure to deliver earnings growth might result in a GSE taking on additional risk, without the typical signals from capital markets that more capital is required. In a severely unfavorable economic environment, this lack of capital could lead to serious problems.

This is why risk-based capital standards are a very good idea for any financial services company operating with implicit government or taxpayer support, and this is especially true for GSEs.   A risk-based capital standard that responds to the risk profile of a GSE will provide market like incentives that penalize additional risk taking by requiring higher capital.

Let me speak briefly to the risk-based capital standards that we are developing for Fannie Mae and Freddie Mac. Many of you know that we have been working on developing risk-based capital standards for several years. I am pleased to tell you that the wait is almost over. We intend to submit a risk-based capital regulation to OMB for administration clearance by the end of September. Assuming that process goes moves on schedule, we could have the regulation available for public comment early next year.

Now I can't tell you the outcome of this new requirement because we are in the rulemaking process. But I can generally describe to you how the legislation envisioned the risk-based capital standard to work and also give you examples of incentives that the standard will give to manage risk and create choices for Enterprise management between altering risk or capital. Rather than giving you a very technical description, let me start off by contrasting what we are doing for Fannie and Freddie with the risk-based capital standards for banks and thrifts.

Bank and thrift risk-based capital standards are simply a series of risk-buckets to which most categories of assets and off-balance sheet obligations are assigned. The risk buckets are, in the opinion of many observers including myself, at best loosely related to the degree of risk associated with the assets assigned to them. Bank and thrift requirements do not capture interest rate risk and do not account for substantial differences in risk within buckets.

Also, because the risk-based standards used by banks and thrifts are so rigid, they do not reflect the true economics of cash flows or promote risk reduction actions on the part of management. In fact, these rules can impede risk-reduction strategies. For example, lets look at how the bank and thrift standards currently would treat the use of credit derivatives.

Lets assume that a thrift has a loan for which it would like to hedge the credit risk and it enters into a credit derivative with a good quality private counterparty that reduces the thrift's credit risk. After this transaction is completed, the thrift still will have to hold 8% capital against the loan plus an additional amount of capital that would be related to the risks associated with the derivative. At the end of the day, the thrift will have to hold more capital even though the risk profile has been reduced.

In contrast, the risk-based capital standard for Fannie Mae and Freddie Mac is a model-based, or stress test, approach to measuring regulatory capital. It will model the performance, under stressful conditions, of Enterprise assets, liabilities, and off-balance sheet obligations.

In developing robust behavioral models for mortgage performance (and here I'm speaking of default and prepayment models), we used the world's largest mortgage database – the combined historical databases of Fannie and Freddie. As the legislation requires, we model mortgage performance along multiple risk dimensions (equity, type of property, type of mortgage, coupon rate, etc.) so that we more precisely measure the risk associated with the Enterprises' mortgage portfolios.

Our stress test was designed to provide management with incentives to manage risk. Because we model the cashflows associated with nearly every item on and off the balance sheet, we can give credit to the Enterprises for their effective risk reduction efforts. For example, we will model the positive effects of various types of credit enhancements that reduce mortgage credit losses. We will model the positive affects of calling debt that's callable in a down interest rate environment. We will also model the positive effects of hedging interest rate and credit risk with derivatives.

Let me use the same credit derivative example to demonstrate how the stress test will provide an incentive to manage risk. Everyone here is probably aware that Freddie Mac has announced that it will be involved with a new type of derivative security to offset some of the credit risk to the corporation associated with a particular pool of mortgages. This new type of security, called "MODERNS" (Mortgage Default Recourse Notes), can be an effective way for Freddie Mac to adjust its credit risk exposure. The stress test will appropriately reduce Freddie Mac's credit risk exposure by modeling, under stressful conditions, the cash flows associated with the contract terms of the agreement. Assuming a good quality counterparty, this in turn will lower their capital requirement.

Thus, a stress test will provide management with flexibility to adjust risk, capital, or a combination of the two, to meet regulatory requirements. Some of you may be wondering – how will the Enterprises be able to manage to this sophisticated capital requirement?

The answer to this question should be 'no problem.' The stress test should measure the relative risk associated with the Enterprises' activities consistent with the way they do themselves.

The risk profile that the Enterprises must manage to changes every day. Interest rates change, new and different types of mortgages are purchased, existing mortgages prepay and default, old debt matures and new debt is issued — the list goes on and on. This is what management gets paid to do – effectively manage risk. If Enterprise management is effective at maintaining a relatively stable risk profile over time, the resulting capital requirement should not be unduly volatile. If the requirement does change significantly, it will indicate that the risk profile of the Enterprise has changed in some meaningful way.

Earlier I talked about the need for transparency for the market to work efficiently. The same is true for the regulatory process. Because our risk-based capital standard is complex, our proposed capital regulation will be a lengthy document. Don't let the size of the document deter you from reading it and understanding it. We will do our part by trying our best to describe the stress test in readable language, and we will stand ready to answer any and all questions that you might have concerning the regulation once it is made public. Let me close by encouraging everyone here to provide OFHEO with your comments when the regulation is published in the Federal Register (hopefully early next year), be they good or bad. I guarantee you that I will read them and we will treat them as constructive input.

Thank you, and I would be happy to answer any question that I can.