



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

# NEWS RELEASE

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**REMARKS OF ARMANDO FALCON, JR.  
OFHEO DIRECTOR  
BEFORE THE WOMEN IN HOUSING AND FINANCE  
NOVEMBER MONTHLY LUNCHEON  
NOVEMBER 18, 1999**

I am honored and proud to serve as the second Director of OFHEO. OFHEO is unique among financial institution regulators. We are the safety and soundness regulator for only two institutions.

However, those institutions, Fannie Mae and Freddie Mac, are two of the largest and most sophisticated financial institutions in the world. In addition, the benefits they receive, and the responsibilities they bear as Government-Sponsored Enterprises, makes OFHEO's task all the more complicated and critical. As GSEs, Fannie Mae and Freddie Mac are not subject to normal market discipline because of their implied government guarantee. This lowers the cost of capital for the Enterprises, with an associated pass through of the benefits to both homebuyers and shareholders.

However, it creates a moral hazard issue for the government, much like deposit insurance, because the debt markets may not signal adequate cautions to the Enterprises for taking on excessive risk.

Fannie and Freddie play an important role in our nation's housing finance system as a provider of liquidity to the primary market especially to the affordable housing market. That is the role Congress intended for them to serve and Congress created OFHEO to ensure that they maintain the financial health necessary to fulfill that mission. I take that responsibility very seriously.

I would like to take a little time to speak about my vision for OFHEO. I like to think about OFHEO's mission as threefold:

- 1) examinations
- 2) capital regulation and
- 3) research and analysis.

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Each one is like the leg of a stool. Each is essential for both balance and the steady regulatory presence necessary to oversee these two huge companies.

OFHEO's examination program, the first leg of the stool, is designed to take a comprehensive look at all of the major risks faced by each Enterprise. We specifically look at how well each Enterprise identifies, monitors, and controls each of these risks.

Our annual report to Congress contains a detailed report on the findings and conclusions of the year's examination. As such, we have the most transparent examination program around. Transparency is a powerful tool that helps make OFHEO's examination program very effective. It creates a high standard of excellence for our examination program. It opens to congressional and public scrutiny the judgments that we have made and how we have made them. In addition, it provides the public with useful information about the Enterprises. It also provides the Enterprises with powerful incentives to take prompt corrective actions when needed.

While publishing the results and conclusions of examinations represents a significant regulatory tool it is accompanied by an enormous responsibility to be fair and to get it right. Especially since critical exam results will have negative market consequences, even for a Government-Sponsored Enterprise.

The second leg of our regulatory stool is the regulation of capital adequacy. It is important that the Enterprises maintain sufficient capital to weather bad times and still fulfill their public mission.

The Enterprises are subject to two capital standards: a minimum capital standard and a risk-based capital standard. They will need to meet the higher of the two standards. The minimum capital standard is a simple ratio based standard that has been in place since 1995. Both Enterprises have exceeded the minimum standard every quarter since then.

As most of you already know, OFHEO has issued a proposed risk-based capital standard, and we have extended the comment period until March 10. This will ensure that all interested parties have sufficient time to understand and comment on the proposal.

All I can and will say about the proposed regulation, is that my highest priority right now is to bring the rule making process to a conclusion as soon as possible and implement a strong and fair risk-based capital standard, as instructed by Congress.

I must make an important distinction here between a final risk-based capital regulation and a final stress test, which determines the risk-based capital requirement. We will have a final regulation, but the stress test will, of necessity, be dynamic. By its nature, the stress test 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 needs to give the Enterprises immediate credit for reducing risk, as well as quickly increase required capital for incurring additional risk. This allows the Enterprises flexibility to operate their businesses while closely matching capital to risk. This will represent state-of-the-art risk based capital regulation.

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The third leg of OFHEO's regulatory stool is the capacity to do meaningful research and analysis. To be an effective regulator, we need to understand how changes in the market might impact the Enterprises and conversely, how changes in Enterprise operations might impact the market. Information and insights gained from a good research and analysis shop will help OFHEO become more proactive in its oversight of the Enterprises. This is even more important in today's rapidly changing financial landscape.

Several important research topics come to mind. High on the list is an analysis of the use of credit scoring. The mortgage market is undergoing nothing short of a revolution in the way lenders are evaluating risk. Aided by new technology, credit scoring (including mortgage scoring) has enabled lenders to become more comfortable in assessing the risk in making loans. The Enterprises are at the forefront of this change. As such, OFHEO has a responsibility to ensure that scoring and other innovations are robust risk-predictors. The reliability of scoring as an accurate measure of creditworthiness has not yet been tested by the stresses of a wide spread economic downturn. We can only determine the capital adequacy of the Enterprises if we measure risk correctly over all phases of the business cycle.

In addition to this concern, credit scoring raises fair lending questions, and we will be working with HUD to address these important questions.

Another research issue is the measurement of risk associated with the various new activities of the Enterprises. Subprime lending and new forms of credit enhancements are two areas where the Enterprises have been very active. In addition to making sure the Enterprises' role in these activities is consistent with their charters, OFHEO must assess the impact of these activities on the risk profiles of the Enterprises.

Finally, the pace of change in the entire financial sector of our economy is about to increase as a result of the banking bill signed by the President last week. The implications of this law for the Enterprises and the mortgage industry could be significant. Banks will now be able to affiliate with more segments of the mortgage industry.

This may result in significant vertical integration in the mortgage business and spur additional consolidation in existing segments of the industry as well. We need to carefully assess the impact of resulting changes on the Enterprises and the market.

OFHEO is an organization that is working well. That does not mean, however, that it cannot be strengthened. One of the major areas that need to be strengthened is OFHEO's financial independence. Purely as a matter of sound public policy, OFHEO needs the capacity to operate, as do all other financial regulators, free of the uncertainties of the appropriations process.

As a financial safety and soundness regulator entrusted by the President and Congress to fulfill a very important responsibility, I have an obligation to inform Congress of any constraints on my ability to best perform my duties. That is why I am raising this issue.

All federal financial regulators, except OFHEO, fund their regulatory activities through direct assessments on their regulatees, without the need for prior approval by Congress. This allows a regulator the ability to ensure

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that resources are adequate to the task. OFHEO had to curtail its operations in certain areas during the first continuing resolution period due to funding uncertainties. We were the only financial safety and soundness regulator forced into this position.

Equally important, an exemption from the appropriations process allows a safety and soundness regulator the flexibility to respond quickly to deteriorating conditions of individual institutions or even greater systemic problems. Again, unlike other regulators, if OFHEO ever needed to quickly increase its examination staff in response to a sudden deterioration of an Enterprise, we could not do so.

I hope this issue will get addressed. But until it is - I need to ensure that OFHEO has adequate resources up front, with adequate depth to handle any crisis situation. Future budget requests will need to take this into account.

It makes sense, from a sound public policy standpoint, to treat OFHEO the same as all other federal financial regulators. I intend to ask Congress to take this under consideration.

Another area that I intend to strengthen is the coordination between OFHEO and the mission regulator of the Enterprises - HUD.

Because of the pressures on the Enterprises to maintain their over 20 % return on equity, they are constantly looking for new business opportunities and markets to enter. In doing so, the Enterprises are raising important public policy questions that need to be fully analyzed and addressed. The potential synergies that OFHEO and HUD can achieve from closer cooperation and coordination will result in more efficient regulation of the Enterprises.

Let me close by saying that I am looking forward to working with the Enterprises, Congress, other regulators, and all interested parties as OFHEO strives to continually improve its regulatory oversight of Fannie Mae and Freddie Mac.

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OFHEO is an independent office within the Department of Housing and Urban Development that reports to Congress. It is funded through assessments of Freddie Mac and Fannie Mae, and receives no government funds. In its regulatory authority, OFHEO is analogous to such other federal financial regulators as the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Federal Reserve Board.

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*OFHEO's Mission Statement*

*OFHEO effectively protects the interests of the American taxpayer and contributes to the strength and vitality of the nation's housing finance system through independent and fair safety and soundness regulation of Fannie Mae and Freddie Mac.*