OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

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(**San Francisco**) Good morning. As I was considering what I would say this morning about a new risk-based capital standard for Fannie Mae and Freddie Mac, I looked at the title of this session: ***"Sex, Lies, and Interest Rates."*** I tried to figure out just where among those topics my remarks would fit in. Sex, like beauty I guess, is in the eye of the beholder. And within the Washington beltway, even government regulatory proposals are sometimes considered sexy, but I thought that was unlikely to be the case on the West Coast where there are probably better alternatives. Lies, didn't seem like the right category either. The main point of a risk-based capital standard is to establish the truth about an Enterprise's need for capital so that an appropriate amount can be required. So, it must be interest rates. There is a fit here because interest rates play a key role, perhaps the key role, in OFHEO's risk-based capital proposal.

The Enterprises (Fannie Mae and Freddie Mac) need capital because they take risks. (Risk sounds sexier than capital doesn't it.) That the Enterprises take risks may be easy to lose sight of as their profits grow 10 to 20 percent every year, reaching $1½ billion last quarter, and their credit losses continue to shrink, falling to an almost invisible $75 million last quarter. Times are good now, but there are no guarantees that recent trends will continue. More than 2500 banks and thrifts have failed since 1980, and many of them appeared quite healthy a few years before they failed. Government-sponsored-enterprises are not immune from financial calamity. The Farm Credit System required government assistance in 1987, and Fannie Mae itself was losing a million dollars a day in the early 1980s, when it was a small fraction of its current size.

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The Enterprises now accept credit risk on nearly $2 trillion of mortgages. While credit losses are tiny now, in good times, they could be quite sizeable in really bad times. An even greater potential source of future losses would be very large sustained changes in interest rates if the Enterprises were not sufficiently well hedged. (I told you this was about interest rates.) The Enterprises now own more than $770 billion of mortgages and mortgage securities. That is about equal to the aggregate holdings of all thrift institutions, except that Enterprise holdings are almost all fixed-rate, not adjustable-rate, mortgages. Enterprise holdings have quintupled – increased 400 percent – over the past 7½ years. A 100 basis point increase in interest rates can lower the market value of an Enterprise's assets by substantially more than its balance sheet equity. Fortunately, both Enterprises are quite well hedged against interest rate changes of that magnitude and have not suffered seriously from swings in interest rates in recent years. Larger, less likely changes in interest rates, however, are more difficult and costly to hedge against because of borrowers' prepayment options and uncertainty about how they will be exercised.

For fully private firms with leveraged asset holdings, financial markets provide natural discipline of relationships between capital and risk. Firms with lots of unhedged credit and interest rate risk need to hold lots of capital or they will have to pay higher interest rates on their debt issues however, government-sponsored-enterprises, like Fannie Mae and Freddie Mac, are largely immune from such discipline. Investors in Enterprise debt securities show relatively little interest in Enterprise risk positions because they treat Enterprise debt as implicitly guaranteed by the government.

Given the importance of Fannie Mae and Freddie Mac to our nation's housing finance system, the relative lack of market discipline, and the magnitude of losses that potentially could occur if an Enterprise failed, Congress created OFHEO to require adequate Enterprise capital, to regularly examine the Enterprises' safety and soundness, and to take any necessary enforcement actions. In doing so, Congress required OFHEO to establish a risk-based capital standard that relies on a 10-year stress test of the Enterprises. The test subjects the Enterprises to very high rates of mortgage default and severity, and to very large and sustained changes in interest rates that are specified by statute. After determining how much capital each Enterprise needs to survive the credit and interest rate stresses in the test, the standard, again as required by statute, adds 30 percent of that amount to compute the total amount of capital required.

Stress tests are designed to expose hidden weaknesses in systems that may seem healthy and sound under normal conditions. The same concept is used by doctors when they ask individuals to run on a treadmill that stresses the heart so they can observe how well it functions. This enables the doctor to treat any weaknesses while the patient is relatively healthy, rather than after a heart attack, when treatment likely will be difficult and more costly, and may ultimately be unsuccessful. A capital stress test has a similar goal. It seeks to uncover risks that could cause future losses in order to ensure that sufficient capital exists now, when it is easy to raise if necessary.

The Enterprises have used stress tests internally for years. Rating agencies and other financial institutions also use them. Recently, bank regulators have required large banks to develop stress tests. But this will be the first time a stress test has been used as a regulatory tool to directly determine capital requirements. Doing so is much more feasible for the Enterprises than for other regulated institutions. The Enterprises have narrow lines of business and, for all the differences in their corporate personalities, their business activities are remarkably similar. To ensure equal treatment of the two companies and to ensure adequate protection for the public, the law requires that OFHEO develop its own stress test rather than rely on the Enterprises' internal models.

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Much work and information from a wide range of sources went in to developing the model. In 1995, OFHEO issued an Advance Notice of Proposed Rulemaking that posed 65 questions and generated a broad range of detailed comments from the industry on how to implement the law. In addition, OFHEO has held countless meetings with the Enterprises, rating agencies, industry groups, and individual companies to understand the business and the nature of Enterprise risks.

The resulting stress test incorporates all of the principal credit and interest rate risks of the Enterprises and their interactions to produce a summary measure of risk. Required capital will be directly proportional to that risk measure, tying the requirement for capital with the need for capital more closely than under any existing standard. This gives the Enterprises appropriate incentives. They do get credit for use of prudent risk management techniques, but they are much less likely to get credit for what bank regulators call regulatory capital arbitrage: switching the legal structure of a transaction in order to qualify for a different broad risk bucket.

The unified, comprehensive approach embodied in the stress test also gives the Enterprises enormous flexibility in meeting the risk-based capital standard. If their preferred risk and capital positions would cause them to fall short, they can always raise capital. But they can also meet the standard by reducing risk in whatever area they choose. Furthermore, rising risks in one area can be offset by falling risks in another. For example, an asset portfolio that is better-hedged against interest rate risk could allow an Enterprise to assume more credit risk without raising its overall capital requirement. The standard does not interfere with the Enterprise's choices about what activities to engage in or how to hedge their risks. They can pursue very different individual strategies. What the standard does is simply require that each Enterprise hold capital proportional to its overall risks.

To see how the proposed capital standard would affect Fannie Mae and Freddie Mac, OFHEO used it to evaluate the adequacy of their capital on two past dates: September 30, 1996 and June 30, 1997. Freddie Mac's capital would have been sufficient on those dates, but Fannie Mae's would have been about $3½ billion short.

OFHEO looked closely at the two companies' results to determine why one would have met the standard and one would not have. The two Enterprises had similar credit losses per dollar of mortgages. Fannie Mae's mortgages were a little bit riskier, on average, than Freddie Mac's, but the difference was not large. If Freddie Mac's mortgages had been just as risky as Fannie Mae's, Freddie Mac still would have met the capital standard. The key difference was interest rate risk. (This really is about interest rates.) Fannie Mae chose not to hedge interest rate risk as thoroughly as Freddie Mac did.

More thorough interest rate risk hedging would not have been very expensive. Fannie Mae has estimated that it would have cost less than $70 million, at an annual rate, to acquire sufficient hedges to meet the standard. At most, that would have lowered its return on equity from 24.6 percent to 24.0 percent. The cost of meeting this standard would have been only two percent of the capital shortfall. The cost would have been that low because what the stress test indicated that Fannie Mae needed was, in effect, catastrophic risk insurance. Such insurance is not expensive because it is not likely to be needed. But if it is, it can make all the difference in the world.

These results provide a useful background in considering the potential implications of the proposal regulation on the secondary mortgage market. The most important implication is that implementing this regulation can help ensure that Fannie Mae and Freddie Mac will continue to remain financially strong and able to perform their secondary market role. The second, very desirable, implication is that there is no reason to believe that the regulation would cause either Enterprise to change the

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manner in which it performs its secondary market role. Freddie Mac would have met the proposed standard without changing any fees, policies, or strategies. The risk-based capital standard would not give it any incentives to make changes. Fannie Mae would have needed to change something. Increased hedging of interest rate risk would have been an obvious and inexpensive choice. Raising secondary market fees to cover those costs, however, would certainly have been an unlikely choice. That would simply have cost it the loss of profitable business to its principal competitor.

Fannie Mae could also have considered purchasing fewer high-risk loans, but that also seems unlikely. Our analysis shows that the capital consequences of purchasing and securitizing mortgages has, on average, similar effects on required capital under the proposed rule as it does under the existing minimum capital standard. However, some relatively high-risk mortgages, particularly loans with high loan-to-value ratios, have significantly greater effects on required capital. This is as it must be with a truly risk-based capital standard. And, of course, the Enterprises have been anticipating such a standard for some time and have their own risk models, which also show the same loans to have higher risk. To ensure that they meet the requirements of their internal models, the Enterprises have already needed to incorporate the risk-based capital implications of such loans into their purchasing and pricing decisions. So the proposed rule should have no sizeable effects on the mix of loans purchased by the Enterprises or their pricing.

With respect to loan-mix, we examined the potential effects of the proposed rule on affordable housing more closely and concluded that it will not impede the ability of the Enterprises to achieve their affordable housing missions. The ability of the Enterprises to meet the proposed standard while continuing to meet their affordable housing responsibilities is demonstrated by Freddie Mac's risk-based capital surpluses in 1996 and 1997. Fannie Mae's deficits were not caused by the credit risk of affordable loans, but by unhedged interest rate risk. And, as I said before, although Fannie Mae had slightly riskier loans than Freddie Mac on those dates, Freddie Mac would still have met the proposed standard if its loans carried the same credit risk as Fannie Mae's.

Under the proposed rule, the capital implications of loans benefiting low- and moderate-income households are, on average, close to those of other loans. There is no special treatment for affordable housing loans, as such, in the stress test. The credit risk of a loan is measured by the effects of its characteristics, such as LTV and product type, but not by the characteristics of the borrower (such as income class, debt ratios, or source of downpayment). The mix of loan characteristics among the Enterprises' single family loans to low- and moderate-income borrowers is very similar to the mix for higher-income borrowers. The LTV distributions are actually more favorable for lower-income borrowers. Consequently, the capital implications of single family loans differ little by income class.

Loans benefiting low- and moderate-income households do include a higher proportion of multifamily loans, which are treated separately in the stress test. But while multifamily loans perform more poorly than single family loans in some stress test scenarios, they perform much better in others. On balance, it is unlikely that multifamily loans would have any significant effect on Enterprise capital requirements under the proposed rule.

Affordable housing activities do not have to adversely impact an Enterprise's capital position. Affordable housing loans have, in fact, been quite profitable for the Enterprises. The credit risk associated with these loans remains relatively low, with loan-to-value ratios that mirror those of their entire portfolio. The effect of the stress test will not be on affordable housing loans, but on the extent to which Enterprises hedge their interest rate risk.

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Before I finish, I'd like to mention another effect our proposed rule will not have. It will not produce a level playing field in capital requirements for the Enterprises and those who compete with them. Our rule is very specialized. It focuses carefully on the specific risks faced by the Enterprises, and it takes account of all the credit enhancements and hedge positions that the Enterprises have. The degrees of credit and interest rate stress the Enterprises are required to be able to withstand are specified in statute and are not related in any way to the levels of protection provided by the capital standards of other regulators. The result is that the proposed rule is easier than other standards in some ways and tougher in others. In general, the proposed rule is relatively easy on credit risk because it recognizes the quality of Enterprise loans, their ample credit enhancements, and the broad diversification of their loan portfolios. A move toward finer risk distinctions by bank and thrift regulators may ultimately reduce differences between their standards and this proposed standard. The proposed rule, on the other hand, is very tough on fixed-rate mortgages and mortgage security investments if they are not well hedged. The Enterprises will be able to meet this standard without meeting bank and thrift standards. At the same time, many banks and thrifts might fail the proposed Enterprise standard.

The Enterprises, by design, have advantages that other financial institutions do not have. This rule cannot be expected to change that. What we hope we have achieved is a rule that provides strong protection for the public that the Enterprises will not become a public burden, but rather will be financially able to provide the public benefits they were designed for.

Our rule was published on April 13, and comments will be welcomed until November 10. That is a very long comment period. But, the proposal is unusually complex. We are currently working to provide additional information requested by a variety of interested parties. And we are posting such additional information on our website at www.ofheo.gov. We look forward to your comments on the proposal, as I look forward to any questions you may have now.

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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.

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