OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

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Remarks by Mark Kinsey
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Before the
National Association of Affordable Housing Lenders
May 13, 1999

Thank you Phyllis for that kind introduction. Last week when we were preparing for this meeting we had a conference call with all of the participants on the panel, Judy Kennedy and Phyllis. During that call Phyllis asked a very pointed yet simple question. Why should NAAHL be interested in OFHEO's risk-based capital rule anyway? I think she was concerned that we might put you to sleep - especially right after lunch. I recognize that all of us up here live and breathe risk-based capital on a daily basis. I hope, however, that by the time you leave this session you'll walk away with a little more insight into how OFHEO's capital regulation of Fannie Mae and Freddie Mac is an important piece of the housing and mortgage industry puzzle.

It is my guess than some you were present for Frank Raines' speech to your group in Washington back in February. I know in his remarks he expressed concerns about our rule, which at that time was not yet in the public domain. — Of those of you who heard Mr. Raines, I bet you didn't even know that the Enterprises had a safety and soundness regulator. It is ok to admit it — we haven't been around too long and very few people outside of the beltway know we exist.

In his remarks, Mr. Raines expressed concern about what he believed would be a "risk-aversion" tone to our rule. He warned you that our rule might impede Fannie's ability to be the kind of partner that you've become accustomed to. I'm here today to tell you not to worry. Our rule encourages risk management, not risk aversion. It is the Enterprises' mission to provide assistance for affordable housing, and our rule will help ensure that they always will be able to do so.

The title of this session is **"What you Need to Know About Risk-Based Capital and Implications for Affordable Housing - But Were Afraid to Ask."** Maybe it is not that you were **afraid** to ask, but just that you didn't even know there were any questions pending. I know that my fellow panelists will be expressing a lot of questions about the rule and its implications. So I'd like to begin my remarks with the answers to those questions. No, I'm not a psychic — just an educated guesser. Phyllis made us promise not to use slides, so I'm not. But I'm going to go through these points very carefully and slowly.

* OFHEO's proposed capital rule will not cause interest rates to rise;
* The proposed rule will not give incentives to the Enterprises to raise guarantee fees;
* The proposed rule will not hinder the ability of the Enterprises to meet their affordable housing missions;
* The proposed rule will not hinder the Enterprises' ability to continue to provide innovative solutions to housing finance needs; and
* OFHEO's proposed capital rule will help to ensure the capital adequacy of the Enterprises so that they will continue to be able to perform their important public missions in both good and bad economic times.

It is important for you to remember these points today and throughout the public consideration of this rule. I am not naïve, I know that many of you have had long and important relationships with one or both of the Enterprises. They have worked with you on your unique situations and needs of your communities. OFHEO, through our regulatory oversight, wants to be sure that you can continue along this path. Our proposed rule allows the Enterprises to continue to make their own strategic business decisions. It does not dictate the kinds of activities the Enterprises should be involved in or how they should manage risks. It is only a tool to measure overall risk and set capital requirements for that risk.

Before I get too far into the weeds I should pause for a moment and say a sentence or two about OFHEO. Created by statute in 1992, OFHEO is a relatively new financial regulator. OFHEO's primary mission is to ensure the capital adequacy and financial safety and soundness of Fannie Mae and Freddie Mac. OFHEO is an independent office of HUD and is funded by assessments on the Enterprises, not taxpayer dollars. Many of you are probably more familiar with HUD's mission as it relates to Fannie and Freddie — that is — setting affordable housing goals. Our mission — ensuring the safety and soundness of Fannie Mae and Freddie Mac — is not at odds with HUD's goal of ensuring the availability of affordable housing for more Americans. As a matter of fact we work very closely with HUD to ensure the proper synergy of our independent missions.

OFHEO's statute requires us to promulgate a risk-based capital rule. Our rule was published in the Federal Register on April 13, 1999 and is currently open for public comment until August 11, 1999. We at OFHEO take our job very seriously, and welcome opportunities, like today, where we can have an open dialogue with our stakeholders. I understand that NAAHL is known for its interplay with speakers and I look forward to hearing your questions and comments after the panel is finished.

Let me briefly describe the rule and talk about the results.

In just three sentences let me describe how our proposal works. It basically utilizes a stress test, which is a technique for modeling the affects on an Enterprise from exposing its current book of business to severe economic conditions – namely credit and interest rate stresses. An Enterprise will be required to maintain sufficient capital to stay afloat during a ten year stress period, plus be required to hold an

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additional 30% to cover unmeasurable management and operations risk. Given that the stress conditions are prescribed in law, if an Enterprise fails to meet the risk-based capital standard, it can do one of three things: reduce risk, raise capital, or a combination of the two.

To demonstrate how the risk-based capital standard works, the proposed regulation includes calculations of capital requirements for Freddie Mac and Fannie Mae for two dates — September 30, 1996 and June 30, 1997. Freddie Mac would have comfortably met its risk-based capital requirement on both these dates with a surplus of about $1 ½ billion. Fannie Mae, on the other hand, would have had a capital shortfall of around $3 ½ billion on both dates.

The main reason Freddie Mac had met its capital requirement and Fannie Mae did not is that Fannie Mae had more interest rate risk than its capital base could support. Both Enterprises had relatively low credit risk. Freddie Mac had simply reduced its interest rate risk exposure to a greater extent than Fannie Mae had.

These results should be interpreted with caution. Given that underlying economic condition and the Enterprises' risk profiles constantly change, these results do not necessarily reflect what an Enterprise's current or future risk-based capital requirement might be. Furthermore, a projected capital shortfall, even a large one, does not imply that an Enterprise actually has to raise that amount of capital.

For example, let's focus on Fannie Mae's $3.68 billion capital shortfall on June 30, 1997. The number sounds very large. But because the rule is so flexible, Fannie Mae could have met its capital requirement by reducing its interest rate risk in a variety of ways at an annual cost of about $70 million. (This estimate is not mine, by the way. It is from Fannie Mae's Chief Financial Officer). Also, Fannie Mae's CFO stated that investors would see no perceptible change in the company's future financial performance as a result of this proposed capital standard, even if it remained unchanged.

Let me now get right to the meat of what you care about most. As I said in my opening:

The proposed capital rule will not cause mortgage rates to rise nor will it impede the ability of the Enterprises to meet their affordable housing missions. Here are a few strong and straightforward reasons.

The first reason is competition between Fannie Mae and Freddie Mac. Since Freddie Mac comfortably met its capital requirement, there would be no incentive for the company to raise the prices it charges lenders. If Fannie Mae attempted to raise its prices to recoup costs associated with complying with the risk-based capital rule, Fannie Mae would lose profitable business to Freddie Mac. As many of you might be aware, competition for market share has heightened in recent weeks, following the announcement of the exclusive Freddie Mac/Norwest deal.

Second, the capital costs for credit risk for the two stress periods we looked at are, on average, about the same as they are in the minimum capital requirement that the two Enterprises are required to meet now (2.5% of on-balance sheet assets and .45% of off-balance sheet obligations). OFHEO calculates the minimum requirement on a quarterly basis. The 45 basis points that the Enterprises are required to hold against MBS represents a good proxy for the credit risk component of the minimum capital requirement. Since both companies currently meet their minimum capital requirement there would be no

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incentive for either Enterprise to change the guarantee fees that it charges lenders for accepting credit risk.

Credit risk on affordable housing loans was not the reason Fannie Mae did not pass its risk-based capital requirement. When we looked at the credit risk at both companies, we discovered that the credit risk on Fannie Mae's loans was, on average, about 12% higher, on a per dollar basis, than on Freddie Mac loans. However, if we imposed the higher Fannie Mae credit losses on Freddie Mac's loans, Freddie Mac would still have easily met its risk-based capital requirements on both dates. Again, the reason that Fannie Mae failed its risk-based capital requirement and Freddie Mac passed, even with the higher Fannie Mae loss rates is because Fannie Mae had more interest rate risk. Freddie Mac chose to hedge its interest rate risk more extensively than Fannie Mae did on those selected dates.

Affordable housing loans have been quite profitable for both Enterprises. The credit risk associated with these loans remains relatively low, with loan-to-value ratios that mirror those of their entire portfolios. The far more important variable is the way an Enterprise chooses to fund all of the mortgages and mortgage-backed securities it holds in portfolio. It is these funding choices that comprise the interest rate risk that caused Fannie Mae to fall short of its capital requirement.

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.

OFHEO's proposed capital standard will not hurt the housing market. Our capital rule balances the need for capital with the important public missions of the Enterprises. We believe our proposed rule will have a long-term positive impact on the housing market. Our proposal will help to ensure that the Enterprises will remain financially strong and be able to perform their important public purposes in good as well as bad times, when they will be needed the most. Also, our proposal will provide market participants with additional information concerning the exposure of the Enterprises to credit and interest rate risk.

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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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