OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

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BEFORE THE MORTGAGE BANKERS ASSOCIATION'S
NATIONAL SECONDARY MARKET CONFERENCE
NEW YORK CITY, NEW YORK
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I would like to thank Phyllis Slesinger, Bob O'Toole, and especially Paul Reid for giving me this opportunity to speak to you today. The MBA membership is well served by their Washington representation. I have been working with Phyllis and Bob since I started at OFHEO in 1994, and more recently with Paul, and have appreciated their keen insights into the mortgage industry and the players involved.

The title of this session is ***"Regulation of the Housing GSEs: What Every Mortgage Banker Needs to Know."*** Here it is in a nutshell:

* OFHEO's proposed capital rule <u>will not</u> cause interest rates to rise;
* The proposed rule <u>will not</u> cause guarantee rates to go up;
* The proposed rule <u>will not</u> hinder the ability of the Enterprises to meet their affordable housing missions;
* The proposed rule <u>will not</u> hinder the Enterprises' ability to continue to provide innovative solutions to housing finance needs; and
* OFHEO's proposed capital rule <u>will</u> 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.

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Let me now spend about 20 minutes going into more detail about the proposed rule. I'd like to talk about four topics:

1. The need for and development of the regulation;
2. What a stress test is;
3. The benefits of using a stress test for capital regulation; and
4. The impact of our proposed regulation on the Enterprises and on the housing market.

OFHEO's risk-based capital standard for Fannie Mae and Freddie Mac is important to the continued success of mortgage banking businesses. Your respective businesses are dependent upon the ability of Freddie Mac and Fannie Mae to provide liquidity through a secondary mortgage market. OFHEO, through its regulatory oversight, helps to ensure that the Enterprises will always be there for lenders.

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. In the aftermath of last week's tax filing deadline, I thought it might be important to make that point.

The Need For and the Development of the Risk-Based Capital Regulation

In creating OFHEO and requiring us to develop a risk-based capital standard for the Enterprises, Congress enacted a law that makes good sense. Congress understood the importance of a financially strong Fannie Mae and Freddie Mac and the need for the Enterprises to be in a position to fulfill their important public purposes, not just in good times, but also in bad times when they will be needed the most. Congress also understood the potential costs if either Freddie Mac or Fannie Mae were to fail. The capital standard that OFHEO is proposing strikes the proper balance between safety and soundness and the need to perform their important public missions so that the ultimate beneficiaries of our effort will be American homebuyers and taxpayers.

A risk-based capital standard is needed to determine the capital adequacy of Fannie Mae and Freddie Mac. What I mean by capital adequacy is that the Enterprises must hold sufficient capital to cover risks that they pose to the housing finance market, from their inability to perform their public mission, and potentially to the government, in the case of insolvency. The marketplace cannot be relied on to achieve this result. Government sponsorship of Fannie Mae and Freddie Mac shields the two Enterprises from the type of market discipline faced by fully private firms that effectively links capital to the level of risk. This is a very basic point about government-sponsored Enterprises and one that I want everybody to understand.

Raising the cost of borrowing money is the primary mechanism that the market uses to discipline a company from taking too much risk. Put another way, the interest rates investors require to lend money to a company depend on investors' perceptions of the risk involved. The rating agencies (Moody's, S&P, etc.) provide information to market participants about the risk to investors of lending to specific firms. Normally the ratings are based on the financial condition of companies being rated, and capital is a key consideration.

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The debt obligations of Fannie Mae and Freddie Mac are rated triple A. But that rating is based primarily on the market's perception of an implied government guarantee, and not on the Enterprises capital position or general financial condition. This fact allows government-sponsored enterprises to borrow money in the capital markets more cheaply than fully-private triple A rated firms, and almost as cheaply as the U.S. Treasury. So, unlike the case for fully private firms, debt markets cannot be expected to penalize Freddie Mac and Fannie Mae if they have inadequate capital. Again, this is because investors rely primarily on the implied government guarantee as a basis for their decision to lend money to the Enterprises.

The statute requires OFHEO to use a stress test for assessing the capital adequacy of the Enterprises. Because the Enterprises are constrained by their charters to purchasing conforming residential mortgages, it is a straightforward, albeit not easy, task to measure the credit and interest rate risk associated with mortgage holdings and guarantees. It is a straightforward task because we are testing only two similar companies, not hundreds or thousands of diverse institutions, and the Enterprises have just two principal lines of business.

The largest line of business is their credit guarantee business. Here the Enterprises guarantee the timely payment of principal and interest to investors for pools of mortgages. They guarantee more than $1 trillion in mortgage-backed securities to investors all over the world. The Enterprises are exposed to credit risk on the mortgages associated with this activity.

The second line of business, and the fastest growing, is their mortgage investment business. Here, they purchase mortgages, and more recently mortgage-backed securities, and fund these investments with debt. Functionally, this is the same thing that thrifts do, except that thrifts fund most of their mortgage holdings with deposits. The scale of the Enterprises' activities in this area, however, has surpassed the entire thrift industry. At over $670 billion, Freddie Mac's and Fannie Mae's combined portfolio of mortgages and MBS exceeds the thrift industry holdings by over $100 billion. Here the Enterprises are exposed to both credit and interest rate risk.

OFHEO did not develop the proposed rule in an ivory tower. With the general approach and stress conditions outlined in law, OFHEO issued an Advanced Notice of Proposed Rulemaking (ANPR) in 1995 that asked the public, including the Enterprises, 65 questions that were designed to elicit a broad range of comments on how to implement the law. In addition, OFHEO has had countless meetings with the Enterprises to understand their businesses and exactly how they measure risk.

Just to make sure that we covered the waterfront, OFHEO met with mortgage insurance companies, rating agencies, and other large financial institutions to discover how they look at and measure risk. The result of all of this effort is that our risk-based capital rule implements familiar and broadly accepted techniques for how the market and the industry evaluate mortgage risk.

A Stress-Test Based Capital Standard

So what exactly is a stress test? Let me give you my 30-second definition. The stress test simulates the financial performance of Freddie Mac and Fannie Mae under severe economic conditions. These

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conditions are defined in the statute and include high levels of mortgage defaults and associated losses, and large sustained movements in interest rates. OFHEO's test uses computer models to simulate Enterprise cash flows associated with mortgages and other financial assets and obligations under these severe economic conditions. The modeling of incoming and outgoing cash flows captures the risks embedded in those financial assets and obligations and the benefits of the hedges each Enterprise has set in place. Freddie Mac and Fannie Mae must have sufficient capital to survive the losses under this scenario plus an additional 30 percent for unspecified management and operations risks to meet the proposed risk-based capital standard.

The specific credit and interest rate conditions that the Enterprises are required to capitalize against are severe. But that is appropriate. Markets continually present new ways to tank companies. For example, late last summer, an unexpected new set of market conditions proved very destructive to hedge funds like Long Term Capital Management. For a stress test to be useful as a tool for determining capital adequacy, the stress conditions that are used must be severe enough to encompass a wide range of bad market conditions, many of which cannot be specifically anticipated.

The beauty of OFHEO's stress test is that it is an early warning indicator of financial distress. It can expose hidden weaknesses in a system that seems perfectly healthy and sound under normal conditions. This is the same concept used by doctors when they ask individuals to run on a treadmill in order to stress the heart so they can observe how well it functions. This enables the doctor to treat any weaknesses today, while the patient is relatively healthy, rather than after the patient suffers a heart attack, when the treatment may be too little and too late. The same can be said for OFHEO's stress test. It is better to require the Enterprises to be adequately capitalized today, when the Enterprises are healthy, than to try to do it when they are not.

Stress testing is a common tool many firms use to quantify risk. Rating agencies use stress tests to analyze mortgage- and asset-backed securities as well as mortgage insurance companies. Mortgage insurance companies use stress tests to determine capital needs. The Enterprises, as well, use stress tests to simulate performance of their assets and obligations to project capital needs.

While the Enterprises have internal stress test models to determine capital adequacy, they are not suitable for OFHEO's needs. There are several reasons for this. First, the Enterprises' models were developed for their own business purposes. Their models have a different focus because they are concerned with shareholder risks, not public risks. Because of their government-sponsored status, the Enterprises do not have the incentive to hold an amount of capital commensurate with the risks that they pose to the housing and financial markets and, in the event of insolvency, possibly the government. Second, each model is significantly different from the other, and if they were used for regulatory purposes, they would result in unequal capital requirements. Third, the law requires that OFHEO develop a single model that is applied equally to both Enterprises to ensure regulatory fairness and complete transparency that comes with an open rulemaking process.

Benefits of the Proposed Capital Rule

Now that I have described to you what the stress test is and the effort we put into building it, let me tell you three good reasons why it works so well as a regulatory capital requirement. First, and foremost, it

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is a good way to measure risk at the Enterprises. The Enterprises are in the business of managing risks on mortgages and our proposed rule models the performance of mortgages according to multiple risk factors including loan-to-value ratios, mortgage type, the strength of the housing market, and the level of interest rates. Using the combined historical experience of the Enterprises, we model the well-documented relationships between these factors and mortgage defaults and prepayments. Using these models, we are able to project how mortgages would perform under the adverse economic conditions specified in the law.

Second, a major benefit of using a stress test to determine capital adequacy is that an Enterprise's capital requirement is determined holistically**.** By looking at each business from a holistic point of view, the proposal captures an Enterprise's net or "bottom line" exposure to both credit and interest rate risks, simultaneously. Therefore, how the Enterprises manage risk is just as important for determining their risk-based capital requirement as measuring risk inherent in financial instruments. Activities that reduce risk (issuing callable debt, use of credit enhancements, effective use of hedging, etc.) reduce regulatory capital requirements. Activities that increase exposure to risk (funding mismatches, reduced use of credit enhancements, reduced use of effective hedges, etc.) increase capital requirements.

Finally, just as the Enterprises are free to cross-subsidize the benefits from one activity to another, they will similarly be free to cross-subsidize the benefits from risk-reduction activities in one area to the benefit of another area. For example, a better hedged mortgage portfolio (reduced interest rate risk) could allow an Enterprise to assume more credit risk without raising its overall capital requirement.

In summary, our rule will provide an objective analysis of the risks borne by the Enterprises and will do so in a way that will increase the public's overall understanding of the risks associated with the activities of the Enterprises. This will include valuable insight into the risks associated with how the Enterprises choose to conduct their business. Our rule will allow the Enterprises to manage their own businesses according to their individual strategies. It does not dictate the kinds of activities they should be involved in or how they should hedge their risks. It is only a tool to measure overall risk and set capital requirements for it.

Impact of Our Capital Proposal

Most of the media's attention on our rule has been focused on the bottom line numbers contained in the proposal. Looking at how the two Enterprises would have fared under the proposal in the recent past, specifically on 9/30/96 and on 6/30/97, Freddie Mac would have comfortably met its risk-based requirement 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.

The main reason that Freddie Mac met its requirement and Fannie Mae did not is that Fannie Mae had more interest rate risk relative to its capital base. Both Enterprises have relatively low credit risk. Freddie Mac has simply done a better job of hedging its interest rate risk.

I need to caution everybody about how to interpret these numbers. Given that underlying economic conditions 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 pro-

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jected 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 shortfall on 6/30/97. The number sounds more onerous than it really is. Because the proposal is so flexible, Fannie Mae could have met its capital requirement far more cheaply than the costs associated with raising over $3 ½ billion in capital. For example, we estimated that by adjusting its debt structure (more long-term callable debt), Fannie Mae could have met its June 97 requirement at an after tax annual cost of under $200 million.

Recently, in a Fannie Mae sponsored investor/analyst conference call, Fannie Mae indicated that they could comply with our rule, as it currently stands, in a variety of ways, for no more than a third of that amount. For most of us here, that's still a lot of money. But for a company of Fannie Mae's size that's small potatoes. Fannie Mae stated that compliance with our proposed capital rule would not have any perceptible effect on its financial performance. Essentially, our stress test indicates that Fannie Mae did not have enough catastrophic risk insurance in 1996 and 1997. Catastrophic risk 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.

It is also interesting to note that Fannie Mae was able to mention nearly a half-dozen ways it could have met our proposed standard. This demonstrates the flexibility that the rule gives to both Enterprises when managing to the standard. This flexibility extends to the way the rule can be readily adapted to capture the appropriate risks from new and innovative mortgage programs.

Let me conclude my remarks by talking briefly about the impact of our rule on the housing market, an issue I'm sure is near and dear to all of you.

OFHEO's risk-based capital standard is unlikely to cause any changes in mortgage rates and will not give the Enterprises incentives to raise their credit guarantee fees.
As I just mentioned, Fannie Mae told its investors last week that it could meet our proposed capital standard without any perceptible change to its financial performance. This strongly suggests that Fannie Mae believes it can comply with our rule without any significant change to the way that it currently does business.

Even if Fannie Mae tried to pass on the added costs of complying with our capital rule, it probably couldn't. Since Freddie Mac comfortably met the capital requirement, competition between the two Enterprises would result in Fannie Mae losing profitable business to Freddie Mac if it tried to pass along any added hedging costs.

Another reason why our rule will not affect mortgage rates is that the Enterprises make a lot of money and can easily absorb any added costs. Studies by the Treasury Department and the Congressional Budget Office estimated that nearly a fourth of the guarantee fees collected by the Enterprises for accepting credit risk comprises profits over and above what is required to provide a normal return to shareholders. These "extra" profits reflect benefits they receive by virtue of their GSE status that are not passed on to homeowners. These excess profits provide a substantial cushion to absorb any added costs that might be associated with the proposed capital rule and still provide shareholders a healthy return.

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The proposed capital rule will not impede the ability of the Enterprises to meet 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 although Fannie Mae had slightly riskier loans than Freddie Mac on those dates, Freddie Mac would still have easily 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 far more important variable is the way an Enterprise chooses to fund all of the mortgages it holds in portfolio. It is these funding choices that comprise the interest rate risk that could cause an Enterprise to fall short of its capital requirement, not credit risk.

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. It will increase the future ability of the Enterprises to fulfill their important missions. A well-capitalized Fannie Mae and Freddie Mac will help ensure the future vitality of the best housing finance system in the world.

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