OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

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Remarks by Mark Kinsey
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Good Afternoon,

Thank you Joanne for your kind introduction.

I want to thank Judith Knight for providing me an opportunity to speak to this very knowledgeable group about our proposed risk-based capital regulation for Freddie Mac and Fannie Mae. OFHEO and WHF have close ties. Three former presidents (Mary Ellen Taylor, Nancy Hunt, and Jennifer Eccles) have worked at OFHEO, and a good dozen or so of our employees continue to be active members.

I want to speak today on three inter-related topics. The first is why we need to regulate the capital of the Enterprises. The second topic is our proposed regulation, including the results. And the third is the impact of our proposal on the housing market.

Need for Capital Regulation

Regulating the amount of capital that Freddie Mac and Fannie Mae are required to hold is important because a failure of an Enterprise could have serious consequences. The Enterprises are critical to our housing finance system. Together, the Enterprises have obligations of more than $1.8 trillion outstanding. They guarantee the timely payment of principal and interest on over $1 trillion in mortgage-backed securities to investors all over the world. Their retained portfolio of mortgages and MBS exceeds by over $100 billion the combined holdings of mortgages and MBS by the entire thrift industry.

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I am happy to report that, currently, the Enterprises are very healthy. While we do not see any problems today, we can not take it for granted that current circumstances will prevail indefinitely. Government-sponsored Enterprises are not immune to problems. The Farm Credit System experienced severe problems in the late 1980’s and required Federal assistance. And while Fannie Mae did not receive direct Federal assistance, at one point in the early 1980’s it was losing $1 million a day, and on a market-to-market basis the value of its liabilities far exceeded the value of its assets.

Another matter of importance is that the Enterprises are not subject to the normal market discipline that fully private firms face. What I am referring to here is the weakening and potential distortion of normal market forces that is created by their GSE status. Freddie Mac and Fannie Mae are able to borrow money from the credit markets more cheaply than fully private triple A rated firms, and at times, nearly as cheaply as the U.S. Treasury. But investors’ willingness to lend money to the Enterprises is based more on the perception of an implicit government guarantee and less on their evaluation of capital adequacy. Therefore, the Enterprises have the ability to increase their risk-taking, possibly significantly, without much effect on their cost of funds.

The Proposed Risk-Based Capital Standard

Let me speak now to the proposal itself. As people take the time to go through our rule, I expect, and welcome, constructive criticism from a wide range of interested parties. We believe that the basics of the rule are on target, and we encourage everybody to take the time to study the proposal and provide us with their insights.

As most everybody knows, the proposed risk-based capital standard is based upon a stress test. The beauty of OFHEO’s stress test is that it is an early warning indicator of financial distress. A stress test 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.

Congress provided OFHEO with many of the parameters for developing the stress test, including the specific credit and interest rate stresses that should be used. Both of the Enterprises were actively involved in the legislative development of the stress test and were extremely successful in molding the requirements to their liking. And the Enterprises were right to want a stress test. A stress test is the best way to determine the capital adequacy of Freddie Mac and Fannie Mae.

The stress test calculates capital requirements holistically. That’s my favorite one-word description of how our stress test works. It allows OFHEO to capture the “bottom line” exposure to the Enterprises from both credit and interest rate risks, simultaneously. It not only captures the risks inherent in the Enterprises’ assets and on- and off-balance sheet obligations, it also captures the effectiveness of hedges and credit enhancements that the Enterprises put in place.

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In designing the proposed regulation we had four goals in mind. First, we sought to create a model that measures risk consistently across the two companies. For example, if both Enterprises purchased mortgages with the same risk characteristics and fund them exactly the same, they should have the same capital requirement.

Second, we needed to meet the statutory requirements for transparency and replicability. The model can't be a black box. It has to be something that the Enterprises can use to anticipate what their capital requirements will be. It also has to be transparent so that everybody else can evaluate it, including investors. So when we say the Enterprises are adequately capitalized, investors will know exactly on what basis we make such decisions. This is a very important point. Our rule will strengthen market forces by increasing the ability of investors to evaluate the overall financial health of the Enterprises.

Third, we sought to develop a stress test that provided both OFHEO and the Enterprises with flexibility. The stress test allows 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.

The proposal also is flexible in its ability to address innovation. Because the Enterprises are restricted by their charters to activities associated with providing a secondary mortgage market, new products or risk-management techniques will be variations of existing activities. The techniques for measuring risk already in the proposal can easily be adjusted on a timely basis to effectively capture the risk impact of the new activity.

Finally, the proposed capital standard needed to recognize and reward appropriate management of risk. It will encourage the Enterprises to manage risk effectively because higher risk will be associated with higher capital, and vice versa. It will also discourage regulatory capital arbitrage. By tying capital very closely to risk, our regulation should discourage efforts to restructure transactions simply to receive a lower regulatory capital treatment even though the risk has not changed.

Most of the media's attention 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 6/30/97, Freddie Mac would have comfortably met its risk-based capital 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 projected capital shortfall, even a large one, does not imply that an Enterprise actually has to raise that amount of capital.

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For example, let's focus on Fannie Mae's 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 requirement far more cheaply than the costs associated with raising $3 ½ billion in capital. For example, Fannie Mae could have met the June 1997 requirement by adjusting its debt structure (more long-term callable debt) at an annual after-tax cost of under $200 million. This is only one simple example of how it could have met the standard at that time. There may have been even cheaper ways for Fannie Mae to have met its June 1997 requirement, and the proposal would leave it to the company to decide how to do it. In general, we would expect that under most economic environments, it would be cheaper to hedge risk than to raise capital.

At least one of our regulated institutions will be arguing that the stress test conditions are too stressful and that they already have more than enough capital. In support of this position they note that S&P rated Freddie Mac and Fannie Mae AA- in the "risk to the government" ratings that OFHEO commissioned in February 1997. However, as anyone familiar with how ratings are determined knows, they are based on a variety of objective and subjective factors, only one of which is capital.

What S&P actually said in their report was, and I quote "both companies maintain capital levels that are relatively low when compared with what S&P would expect to see at fully private companies with similar risk profiles at the AA- rating level." Other factors, including the existence of OFHEO, with its examination and capital regulation functions, enabled S&P to look past the capital weaknesses in their rating determination.

Impact of Our Capital Proposal

Let me conclude my remarks by talking briefly about the impact of our rule on the housing market. Our proposed capital standard is unlikely to cause any changes in mortgage rates nor will it curtail the Enterprises' ability to finance affordable housing. There are three good reasons why this is true.

One reason is the competition between Freddie Mac and Fannie Mae. Since Freddie Mac comfortably met the capital standard, there would have been no need for the company to change the way it did business. Freddie Mac would have had no reason to change its prices. If Fannie Mae attempted to raise its prices to recoup the costs associated with complying with the risk-based capital standard, Fannie Mae would have lost profitable business to Freddie Mac.

The second reason is a bit more complicated, but is just as convincing. The Enterprises are engaged in two basic businesses: a credit guarantee business and a mortgage portfolio business. In the credit guarantee business the Enterprises have duopoly market power because of their GSE status. It follows that because of their duopoly power the Enterprises have the ability to affect mortgage rates by altering the price they charge lenders for accepting credit risk (guarantee fees). In the mortgage portfolio business, however, the Enterprises are just two, albeit large, participants in a very large and competitive market. In this market, the Enterprises have no long-run ability to affect prices. They basically are price takers, not price makers.

The Enterprises' decisions about whether to accept credit and interest rate risk on a mortgage are made separately, and in most cases the decision is made

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by lenders who sell the Enterprises their loans. Most loans are purchased and swapped into securities that lenders hold. In this case the Enterprises bear no interest rate risk. For whole loans that are purchased and not swapped into securities, the Enterprises decide how to fund these loans (debt or MBS) after the decision to buy has been made. Furthermore, the majority of purchases for their retained portfolio in recent periods have been their own MBS. Purchasing MBS is solely a decision to take on interest rate risk.

In the June 1997 results for Fannie Mae (which is the up-rate scenario), the capital costs associated with credit losses totaled about 12 basis points. This is far below the 45 basis point capital cost of credit risk that the minimum capital standard requires for off-balance sheet guarantees on mortgage-backed securities. Therefore, in the business that they are price makers, the proposed rule gives no incentives for Fannie Mae to raise guarantee fees, and thereby mortgage rates, because the capital costs associated with credit risk are lower than the current minimum standard. The higher capital costs associated with Fannie Mae's mortgage investment portfolio will not translate into higher mortgage rates because they are price takers in this line of business.

The last reason that our rule will not affect mortgage rates or the Enterprises' ability to do lending for affordable housing is the most obvious. The Enterprises make a lot of money. 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 the Enterprises 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.

The proposed rule also will not impede the ability of the Enterprises to meet their affordable housing missions. The fact that Freddie Mac met the requirement suggests that there is no inconsistency between being adequately capitalized and meeting its affordable housing purchase requirements.

It is not Fannie Mae's affordable housing activities that adversely impact its 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 caused Fannie Mae to fall short of its capital requirement, not credit risk.

By helping to ensure their financial health, our proposed rule will help to ensure the Enterprises' continued ability to assist low- and moderate-income borrowers in good times as well as bad times, when they will be needed most.

Thank you and I would be pleased to answer any questions.

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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.

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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