OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

NEWS RELEASE

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Office of Federal Housing Enterprise Oversight
Before the
Conventional Finance and Lending Committee
National Association of Realtors (Midwinter Meeting)
Atlanta, Georgia — February 19, 1999

(**Atlanta**) I am pleased to have an opportunity to speak to this distinguished committee on the topic of OFHEO's pending proposal for the risk-based capital regulation for Fannie Mae and Freddie Mac.

OFHEO's risk-based capital requirement for Fannie Mae and Freddie Mac is important to Realtors. Your business is dependent upon the ability of mortgage lenders to lend. Fannie Mae and Freddie Mac, by providing liquidity through a secondary mortgage market, help to ensure mortgage funding is always available. OFHEO, through its regulatory oversight, helps to ensure that the Enterprises will always be there for the lenders.

Our proposed capital rule is in the final stages of an interagency governmental review process and my expectation is that the proposal will be out in the next week or so. Although I cannot speak to the specifics of the proposal, I can and will speak to some of the concerns that you and others might have about our proposal. And when I am finished, I'll be happy to address any questions I can.

The first point that I want to make today is that the sky will not fall when our proposed rule is released for public review. This is a proposed rule that will be open for public comment at least through summer. OFHEO will evaluate all of the comments that we receive on the proposal and, if we conclude that we can go to a final rule, it will probably not be issued until next year. And once the rule is final, the Enterprises have an additional year to comply with the rule before we can enforce its provisions.

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Let me first take a few minutes to explain the background that led to where we are today.

Congress understood the importance of a financially strong Fannie Mae and Freddie Mac. Congress also understood 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.

In developing our proposed rule for the Enterprises, OFHEO understood the need for a capital requirement that closely aligns capital with risk. At the same time, we also understood the Enterprises' need to fulfill their important public purposes, and that the capital standard should not be so burdensome as to make it impossible for the Enterprises to comply with, for example, their affordable housing goals. The capital standard that we will be proposing will strike the proper balance between these two important goals 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, especially when the Enterprises are experiencing significant pressure on earnings.

The rating agencies (Moody's, S&P, etc.) who traditionally provide information to market participants about the financial condition of companies rate the debt obligations of Fannie Mae and Freddie Mac triple A, largely based on the market's perception of an implied government guarantee. In fact, their government-sponsored status allows the 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. This fact has contributed to the Enterprises' remarkable profitability and to the generous returns they provide to their stockholders.

The Enterprises played a major role in the development of the capital standard outlined in OFHEO's enabling legislation. Congress gave OFHEO only limited discretion in developing this standard. In fact, Congress explicitly mandated a stress test-based standard to determine capital adequacy and provided detailed requirements for its development. This resulted from efforts on the part of the Enterprises to ensure that the risk-based capital standard developed by OFHEO would comport reasonably well with the methodologies that they use to determine capital adequacy internally. In this effort, they were very successful. Moreover, their efforts resulted in Congress doing the right thing.

So what is a stress test? Let me give you my 30-second definition. A stress test is a representation of how a company would fare under a scenario of severe financial distress. A computer model is used to project the cash flows from mortgages and other financial instruments under specified adverse economic conditions. The risks embedded in those financial instruments and the way the risks are managed by the companies are captured in the modeling of incoming and outgoing cashflows. That's what a stress test is. If anyone wants a slightly more detailed definition, I will refer you to copies of an article that I wrote that describes our stress test.

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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 project capital needs. The Enterprises, as well, use stress tests to simulate performance of their assets and obligations to project capital needs.

Well you might ask why couldn't OFHEO use the Enterprises internal stress test models to determine capital adequacy? There are multiple answers to this question. First, the Enterprises models were developed for their own business purposes. Each model is significantly different from the other, and if they were used for regulatory purposes, they would result in unequal capital requirements. Second, 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. 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.

A stress test is the most appropriate tool 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 the Enterprises principally have only two lines of business. And we are only testing two companies, not hundreds or thousands.

The fastest growing part of their business is their mortgage investment business. Here, they purchase mortgages, and more recently mortgage-backed securities, and fund these investments with debt. This is the same thing that thrifts do, except that thrifts fund their mortgages with deposits. The second line of business is a credit guarantee business. Here the Enterprises purchase mortgages and securitize them by guaranteeing the timely payment of principal and interest to investors.

The law requires OFHEO to develop a stress test that will require the Enterprises to hold enough capital to remain solvent during a 10-year period of severe credit and interest rate stresses. The risk-based capital requirement will be equal to the amount of capital needed to survive the stress test, plus an additional 30 percent to cover unspecified management and operations risk as specified by the law.

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. The unfortunate set of market conditions that toppled Long Term Capital (the Hedge Fund) was not foreseen by the company's risk managers. 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 anticipated.

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.

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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 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.

Now that I have described to you what the stress test is and the due diligence we put into building it, let me tell you why it works so well as a regulatory capital requirement. First, and foremost, it is a good way to measure risk at the Enterprises. 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.

This is not the end of the story for measuring risk. Our rule calculates capital requirements holistically, that is the proposal captures an Enterprise's net or "bottom line" exposure to both credit and interest rate risks. 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.) will also reduce their regulatory capital requirements. Activities that increase their exposure to risk (funding mismatches, reduced use of credit enhancements, reduced use of effective hedges, etc.) will also increase their 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 from 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 capital rule will, for the first time, provide an objective and transparent means for assessing the capital adequacy of the Enterprises. 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.

OFHEO would be remiss in its responsibility to Congress and the housing finance industry if we proposed a capital requirement that would hurt the housing market. Our proposed capital rule balances the need for capital with the important public missions of the Enterprises. We believe our rule will not affect the current ability of the Enterprises to meet their public mission, including their affordable housing purchase goals, and will increase the future ability of the Enterprises to fulfill this mission. 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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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.