Statement of
The Honorable Armando Falcon, Jr.
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Good Afternoon ladies and gentlemen. Marc, thank you for those kind words of introduction. I am pleased to be here this afternoon to speak with the members of the Exchequer Club. One year ago, I would have been up here giving a speech about the then-pending Risk Based Capital Stress Test -- all the interesting details like estimation methodologies, loss severities, ARIMA models, coefficients and so on. But fortunately for all of us, the rule is now done, I won't need to give that speech, and you won't have to sit through it.

I want to step back from the details of our regulatory duties at OFHEO and offer an assessment of Federal policy and expectations regarding Fannie Mae and Freddie Mac, as well as discuss some challenges for the future.

THE FEDERAL HOUSING INITIATIVE

Let's begin by putting the Enterprises into their historical context. Since the Great Depression, and especially since World War II, the Federal government has made housing and homeownership a national priority. Policymakers have employed many tools over the years to promote that objective, including FHA and VA mortgage guarantees, the home mortgage interest tax deduction, creation of the Department of Housing and Urban Development, Ginnie Mae guarantees, and the creation of three government-sponsored Enterprises to support housing finance.

Those Federal policies have contributed significantly to the increase in the homeownership rate in the United States over the last two generations. In 1940, the percent of households that owned their homes was less than 44 percent. The homeownership rate has climbed steadily since then, to nearly 68 percent in the last year. This is a success story for which the Federal government and all parts of the industry -- from homebuilders to mortgage bankers -- can take credit.

As part of the Federal effort to promote homeownership, Congress established Fannie Mae and Freddie Mac. Fannie Mae was spun off from Ginnie Mae in 1968. Freddie Mac, originally part of the Federal Home Loan Bank System, was established in 1970, and in 1989, was transformed into a publicly owned company following the Fannie Mae model. With their Federal charters and national reach, the Enterprises were created to overcome historical limitations in the nation's financial system. Those limitations led to credit crunches in regional and national mortgage markets and made housing one of the most volatile sectors of the economy. The Enterprises' secondary market activities help ensure that mortgage lenders in all regions of the country have continual access to funds on comparable terms. Fannie Mae and Freddie Mac grew at a rapid pace in the 1980s and 1990s. In 1980, Fannie Mae and Freddie Mac owned or guaranteed $77 billion in residential mortgages. Today they own or guarantee over $3 trillion in mortgages. This growth was facilitated by the substantial benefits they received from the Federal government.

FEDERAL BENEFITS

Those benefits, which are well-known, include:

- A specialized Federal charter. Fannie Mae and Freddie Mac are the only two for-profit shareholder-owned companies in the U.S. that enjoy their special status.

- Fannie Mae and Freddie Mac are exempt from state and local corporate income taxes.

- They enjoy statutory exemptions from the securities laws. While they will soon voluntarily register their stock under the 1934 Act, they retain their exemptions from securities registration under the 1933 Act.

- The Secretary of the Treasury has discretionary authority to purchase up to $2.25 billion in obligations issued by an Enterprise, the so-called Treasury line of credit.

- The securities of Fannie Mae and Freddie Mac are eligible for Federal Reserve open-market purchases, as collateral for most state and local deposits, and as collateral for loans from Federal Reserve and Federal Home Loan Banks.

- Federally chartered depository institutions may invest in the Enterprises' securities in unlimited amounts. Their securities are generally accorded the same treatment for investment purposes as are U.S. government obligations.

- Fannie Mae and Freddie Mac have access to Fedwire, the Federal Reserve's electronic system for transferring funds and securities.

However, the most significant benefit Fannie Mae and Freddie Mac enjoy is what many have described as the implied Federal guarantee. This refers to the perception of many market participants that the government implicitly guarantees debt issued and MBS guaranteed by Fannie Mae and Freddie Mac. The perception of an implicit Federal guarantee lowers the yields that investors require on Fannie Mae and Freddie Mac debt and MBS, and leads market participants to set less stringent limits on their credit exposures to each Enterprise. As a result, the Enterprises can issue much larger volumes of securities, without the necessity of obtaining private credit ratings on an issue-by-issue basis.

The perception also allows them to sell a much larger proportion of callable debt than private firms with comparable capital, and avoid the need to post collateral on derivatives transactions. Further, because of the perception of an implicit guarantee, materially higher risk is unlikely to raise the borrowing costs of either Enterprise to the same extent as it would in the absence of that perception.

The combined effect of these benefits lowers the Enterprises' operating costs. The Congressional Budget Office, for example, estimated that in the year 2000, government benefits reduced the Enterprises' operating costs by nearly $11 billion. Alternatively, Fannie Mae estimated that government benefits reduced the Enterprises' costs by $3 to $4 billion. However you add it up, the savings are substantial.

Expectations of the Enterprises

These Federal benefits bestowed upon Fannie Mae and Freddie Mac, collectively a subsidy, are not without certain expectations. There is a reciprocity inherent in Federal policy toward Fannie Mae and Freddie Mac. In exchange for their Federal subsidies, the Enterprises are expected to meet certain obligations and expectations. These obligations and expectations are embedded not just in Federal law and regulation, but also in an evolving recognition of the Enterprises full potential to do good, as well as to do harm. There are six, and I will now describe them for you:

1. Maintain a liquid and stable secondary market.

First, Fannie Mae and Freddie Mac have an obligation to maintain a liquid and stable secondary market for the residential mortgages they are eligible to purchase. A national secondary market promotes housing and homeownership by giving prospective mortgage borrowers, in all regions of the country, continual access to credit on comparable terms at all points in the business cycle.

To fulfill that obligation, Fannie Mae and Freddie Mac purchase and securitize mortgages originated throughout the country that meet their eligibility standards. Most of the loans the Enterprises buy and securitize are fixed-rate loans with balances under the conforming loan limit. Fannie Mae and Freddie Mac integrate local and regional mortgage markets into the national and international capital markets. That linkage has freed local housing markets from the volatility associated with a local credit supply dependent on depository institutions. Further, the linkage has minimized regional differences in the interest rates for conforming fixed-rate loans.

The Enterprises also provide liquidity and stability to the mortgage market by purchasing mortgage securities during periods of significant market turmoil. For example, in the Fall of 1998, after the Russian debt default, the Enterprises' purchases of mortgage securities stabilized those markets and narrowed bid-ask spreads. That increased the liquidity of lenders and encouraged them to continue making mortgage loans while other markets for other types of lending were temporarily closed down.

In addition, Fannie Mae and Freddie Mac are able to reduce the rate of interest homeowners pay for a mortgage. Economists estimate that in the late 1990s, the yields of conforming fixed-rate mortgages were about 20 to 25 basis points lower on average than the yields of jumbo loans.

In these and other ways, Fannie Mae and Freddie Mac have provided and continue to provide considerable benefits to mortgage borrowers and the housing sector.

2. Promote Affordable Housing

Second, the Enterprises have an obligation to promote affordable housing. Congress wanted the Enterprises to be aggressive in fulfilling their affordable housing obligation. Congress specifically provided in the Enterprises' charters that not only should they be involved in affordable housing, but that they should expect a lower economic return on those investments.

As you know, HUD issues regulations that subject the Enterprises to annual purchase goals for mortgages that finance housing for low- and moderate-income families. Also, the Enterprises must meet annual mortgage purchase goals for mortgages originated in underserved areas. These goals are intended to take advantage of the Enterprises' "ability to lead the industry in making mortgage credit available for low- and moderate-income families."

HUD first established affordable housing goals in 1995, revised them again in 2000, and will set new goals this year. The aim is to make sure that the Enterprises fully address the housing finance needs of low-income families, as well as residents of underserved areas. OFHEO will continue to work with HUD to ensure that new goals are consistent with safety and soundness.

3. Meeting Requirements of Comprehensive Regulation

Third, the Enterprises are obligated to meet the requirements of a comprehensive system of Federal regulation.

OFHEO is responsible for the safety and soundness of the two Enterprises and HUD ensures that they perform their public missions. Other Federal agencies also have oversight responsibilities. For example, the Treasury has authority to review and approve the debt issues of the Enterprises. Historically, that authority has been used to ensure that Treasury and the Enterprises did not come to market with similar debt offerings during the same time period.

This regulatory structure works well by allowing each agency to focus on what it does best, and coordination is accomplished through frequent communication on issues of common interest.

However, the regulatory structure could be improved in one respect. That is the mechanism for funding the regulation of the Enterprises. Fannie Mae and Freddie Mac should be responsible for bearing the full costs associated with their regulation, and the funding should be permanent and outside of the appropriations process.

While OFHEO is funded through assessments on the Enterprises, our budget is subject to the Congressional appropriations process. Permanently funding OFHEO would put the Agency's funding on an equal basis with all other safety and soundness regulators, and ensure that OFHEO's funding always enables it to meet its responsibilities.

In that same spirit, HUD's mission regulation of the Enterprises should be funded by assessments on the Enterprises, rather than by taxpayer dollars. The Enterprises should pay HUD for the full cost of their mission regulation and do so outside of the appropriations process to ensure that there will always be sufficient funding for this important responsibility of regulation. This is my opinion only, and I am not speaking on behalf of HUD or the Administration. But I think it is sound public policy and long overdue.

4. Meet the Highest Standards of Transparency

Fourth, the Enterprises have an obligation to meet the highest standards of transparency. This means not just conformance with general market practices, but meeting a higher standard than that expected of fully private companies.

All financial regulators have recognized transparency as a fundamental component of safety and soundness. Enterprise operations must be sufficiently transparent—with timely and meaningful disclosures—for markets to evaluate their financial condition and risk profile. This strengthens market understanding, market discipline and market stability. To this end, OFHEO's regulatory program seeks to promote transparency of the Enterprises.

As I discussed earlier, market discipline may be imperfect when applied to the Enterprises, but it can still be very effective. Fannie Mae's recent experience with its duration gap is a good case in point. This past Fall, Fannie Mae reported a higher than expected duration gap in its mortgage portfolio. The market reacted with concern and Fannie Mae took appropriate steps in response. This event caused the market to reevaluate Fannie Mae's risk profile relative to Freddie Mac, and Fannie Mae's stock is now trading lower and closer to Freddie Mac's than it has historically. It would be hard to find a clearer example of disclosure resulting in market review and discipline.

5. Maintain a Conservative Approach to Risk Management

Fifth, the Enterprises are expected to maintain a conservative approach to risk management. OFHEO's oversight of the Enterprises plays a vital role in ensuring that they remain financially healthy, but the Enterprises must also manage their business in a safe and conservative manner to help achieve this goal. They must resist pressure to take unnecessary or excessive risks. The desire to find new areas of growth, or the pressures of meeting self-imposed financial goals cannot take precedence over prudent risk management. It is in neither the public nor the shareholders' interests to put short-term gain ahead of long-term viability.

That is why Congress created OFHEO. Our oversight of the Enterprises plays a vital role in ensuring that they remain financially strong. Our risk-based capital regulation gives them strong incentives to manage their exposures to credit and interest rate risk. OFHEO's examinations allow us to monitor how they are managing their risks and give them an incentive to do so prudently.

6. Use Their Government-Conferred Market Advantages Responsibly

Sixth, the Enterprises are expected to use their government-conferred market advantages responsibly.

There is an expectation that they should employ their benefits consistent with the limits of their charters, and in a manner that will not harm competitive markets or companies that are not similarly advantaged.

National economic policy strongly supports competitive markets. Competition has proven to be especially effective in encouraging innovation and efficiency. However, the Enterprises' secondary mortgage market, intentionally operates as an exception to that rule. The Federal need to create and maintain a liquid secondary mortgage market overrode traditional competitive market goals, and the Enterprises were given the benefits I have described.

The Enterprises now obviously dominate the secondary market for conforming mortgages. The Federal benefits that put them in such a position, especially, their lower funding costs and central role as intermediaries, creates the potential for them to dominate almost any market they enter and strengthens their ability to promote ancillary services. For example, in 1995, the Enterprises began deploying their automated underwriting systems. As a result of their advantages, these systems soon swept the field and supplanted others that had been developed by major financial institutions. There is no doubt that the automated underwriting systems developed by the Enterprises have brought efficiencies to the mortgage process. Nevertheless, the market power enjoyed by the Enterprises gives them a strategic advantage, even against their largest and most sophisticated competitors.

Most markets comprising our housing finance system are very competitive, and it is important that they remain so. Those markets include, among many others, the primary mortgage market, the mortgage securities market and the mortgage insurance market. Such markets are not only the best means of insuring the continued success of housing finance, but they are also most likely to ensure the continued existence of the financially strong suppliers and customers on which the Enterprises' safety and soundness depends.

Although the natural temptation for any business is to engage in any activity promising sufficient profit, the Enterprises are expected to act carefully with respect to the activities they choose, the market shares they absorb, and their impact on firms and free markets.

These six obligations and expectations form the basis by which OFHEO goes about fulfilling its mission on a daily basis, and they will continue to guide us as we confront future challenges. I will now turn to a discussion of some of those future challenges.

THE CHALLENGES OF GROWTH

The financial success of Fannie Mae and Freddie Mac has been accompanied by rapid growth in their size, to the point that size itself has raised issues and challenges. Over the past ten years, since OFHEO was created, the dollar volume of outstanding mortgages that they own or guarantee has tripled to more than $3 trillion. As a share of all residential mortgage debts, that is about 45 percent, up from 32 percent a decade ago. In their principal business area — prime, conforming, conventional, fixed-rate, and single-family loans — their share is about 75 percent, up from perhaps 50 percent. These percentages will likely continue to rise substantially over the next ten years, especially in the multifamily, subprime, and adjustable-rate categories.

While today the Enterprises are able to prudently manage the risks associated with their size and growth, their ability to manage these risks will be increasingly challenged. Perhaps the most important challenge takes the form of managing the interest rate risk of their mortgage investment business. That business involves buying mortgages and MBS, holding them as long-term investments, financing those holdings primarily with debt, and using interest-rate derivatives as a risk-management tool.

As the total amount of mortgages owned or guaranteed by Fannie Mae and Freddie Mac has tripled over the past 10 years, the volume of Enterprise-guaranteed mortgage securities owned by others has increased only 60 percent. The more dramatic increase has been in their mortgage investment business. At $1.3 trillion, their portfolios are seven times their holdings at the end of 1992. As a share of all residential mortgages, this is an increase from less than six percent to nearly 20 percent. The upward trend in the Enterprises' market share is expected to continue, and they could hold 40 percent of these loans after another decade.

No other private financial institution has a long-term asset portfolio that can compare. Managing the interest rate risk of these portfolios is a significant undertaking. Virtually all of their mortgages can be prepaid at anytime without penalty. The Enterprises must acquire options that provide them with the flexibility to adjust the effective maturities of their assets and liabilities. So far, Fannie Mae and Freddie Mac have been able to find sellers of sufficient volumes of these options to enable them to grow their asset portfolios without increasing risk to unacceptable levels. Most of the options are channeled through a limited number of derivative counterparties with whom they have protective collateral agreements. However, they are already by far the largest end users of certain types of derivatives.

As Fannie Mae and Freddie Mac continue to grow, finding adequate additional volumes of new options could be challenging. Dependence on a small group of dealers as counterparties may also create challenges. Even with sound collateral agreements, the sudden failure of a key counterparty could result in substantial exposure before contracts with that counterparty were replaced.

Currently, the Enterprises hedge most, but not nearly all, of the prepayment risk associated with mortgages. For the remainder, they depend on their ability to rebalance their asset and liability maturities as interest rates change. That also may become more difficult as their size increases. As we witnessed in September, substantial rebalancing has the potential to move interest rates further in the direction of the changes that caused the need for rebalancing in the first place. Bigger portfolios could create bigger difficulties in rebalancing promptly.

These growth-related issues also involve systemic risk considerations. Over the past quarter-century, financial markets in many countries have experienced serious disturbances associated with numerous financial institution failures. Those events heightened our awareness of systemic risk, and the possibility that such a financial crisis could occur. That awareness, in turn, has fostered considerable research and discussion among financial regulators, policy makers, and the private sector about the nature of systemic risk and how the private and public sector can address the issue.

OFHEO will soon conclude our review of the Enterprises and systemic risk, and issue a report next month.

CONCLUSION

As you can see, we are spending a lot of time at OFHEO considering where the Enterprises and their regulator are today and thinking about where we are going to be tomorrow. We will remain vigilant at OFHEO as we fulfill our mission and confront any future challenges.

With that I will conclude my remarks and I want to thank the Exchequer Club for the opportunity to meet with you today.