



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

NEWS RELEASE

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Statement of
The Honorable Armando Falcon, Jr.
Director, Office of Federal Housing Enterprise Oversight
Before the Bond Market Association's
Eighth Annual Legal and Compliance Conference
New York, New York
February 4, 2003

Good Afternoon. I am pleased to participate in this distinguished conference. Throughout my career in Washington, I have known the Bond Market Association to be a top-notch organization representing the Nation's bond industry, with a highly regarded staff, led by Micah Green.

I would like to discuss three topics: today's release, by OFHEO, of a major report on systemic risk, the Report of the Interagency Task Force on MBS Disclosures that was announced yesterday, and OFHEO's upcoming symposium on the impact of home prices on the economy.

But first, let me give you an update on the state of OFHEO. This year we will celebrate our first ten years of service fulfilling our public mission. That may not sound like a long time, but we have come a long way.

OFHEO started from scratch with one employee and a massive task. It was a rocky start. As an infrastructure was put together, the agency struggled to complete a new risk-based capital stress test. On top of that, OFHEO had to manage as best it could for three years without a Director.

When I took over three and a half years ago, we all determined that it was time to roll up our sleeves and just get the job done - no excuses. And we have succeeded. I'm proud to say that OFHEO is now the strong, proactive and highly capable regulator that Congress intended, that the markets need, and that the public interest demands.

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The stress test is completed and fully implemented, we are on track to double the size of our examination program, essential rules and regulations are in place, and we are conducting research on issues vital to our mission.

Our research allows us to better understand and assess the larger issues and risks associated with the enterprises' activities. When appropriate, we will release our research product to the public. Accordingly, today we are releasing a report entitled "Systemic Risk: Fannie Mae, Freddie Mac, and the Role of OFHEO."

Systemic Risk

More than two years ago, I instructed the staff of OFHEO to assess the systemic risk implications of the Enterprises and the role of OFHEO in reducing systemic risk. This report deals with an issue that any regulator of large financial institutions should be fully informed about.

The importance of this issue is very evident. Housing is a significant part of the United States economy, accounting for over 11 percent of GDP. By all accounting, Fannie Mae and Freddie Mac are the dominant firms in this huge market. They own or guarantee 45 percent of all residential mortgage debt outstanding in the U.S. That's up from 25 percent as recently as 1990. The Enterprises' combined debt outstanding exceeded \$1.5 trillion at the end of 2002, more than eight times the level of a decade ago. Associated with that level of debt, Fannie Mae and Freddie Mac have become the largest end-users of interest rate derivatives. The notional amount of the derivatives outstanding of the two Enterprises increased from \$72 billion at the end of 1993 to \$1.7 trillion at year-end 2001.

As you can see, Fannie Mae and Freddie Mac's size, interdependencies, and vital role in housing finance and the capital markets present important systemic risk considerations. The report first examines a threshold question: "What is systemic risk?" There is no single answer, at least not one accepted by all economists. But that does not mean policymakers and governments ignore the potential impact of systemic events. The twentieth century is replete with examples of government responses to perceived threats to financial markets. From the creation of the Federal Reserve System and the enactment of deposit insurance, to the creation of international organizations like the World Bank and the IMF, our national government has often acted to prevent major, unexpected financial shocks from severely disrupting the financial system. Systemic risk then, may be nothing more than the recognition that certain economic actors, because of their unique position in the economy, can pose significant risks of disruption to the financial system if they experienced financial difficulties.

Let me now summarize the findings of OFHEO's Systemic Report and the recommendations that it makes. Fannie Mae and Freddie, without question provide considerable benefits to the housing sector of the U.S. economy. The Enterprises support housing activity by supplying ample, low-cost liquidity to the primary mortgage market. Fannie Mae and Freddie Mac are very strong financial institutions today, and the possibility of either Enterprise failing or contributing to a financial crisis is remote. The risk of either company causing a systemic disruption is unlikely as a result of the comprehensive safety and soundness regulation of OFHEO. We employ examinations, a stringent risk-based capital stress test, and other tools to fulfill our responsibility and reduce systemic risk.

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Nevertheless, it is useful to consider what systemic impact an Enterprise could have on the housing market and financial system in two very different situations. In the first case the Enterprises are strong and other parts of the financial system are destabilized. In the second, an Enterprise is itself experiencing financial difficulties.

If the Enterprises are financially strong during a stressful economic period they are a source of stability. Their activities can protect mortgage lending and the housing sector. In those circumstances, the liquidity of Fannie Mae and Freddie Mac debt and MBS can enhance the liquidity of institutions that hold those obligations and the overall liquidity in financial markets. In both ways, the Enterprises mitigate systemic risk. 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.

If Fannie Mae or Freddie Mac experienced financial difficulties, the systemic implications might vary depending upon the circumstances. Any systemic disruption would likely be minimal as OFHEO took prompt corrective action and other market participants filled the short-term market void. Alternatively, in the unlikely situation that an Enterprise did experience severe financial difficulties, there could be disruptions to the housing market and financial system. This should not come as a surprise to anyone, given the Enterprises size and central role in the housing and financial markets.

The scenarios used in the report are obviously examples of what could happen, not predictions of what will happen. Crisis simulation is a useful tool of regulators to prepare for all scenarios.

Congress addressed that possibility through the creation of a comprehensive safety and soundness regulatory regime in the form of OFHEO. OFHEO's examiners are onsite at the Enterprises every day. Our risk-based capital test ensures that the Enterprises have sufficient capital to weather periods of extreme financial distress.

It is also clear that the potential disruption from a systemic event involving Fannie Mae and Freddie Mac is much greater than it was a decade or two ago. In 1981, when Fannie Mae was insolvent on a mark-to-market basis, it had less than \$60 billion in outstanding debt and \$3 billion in guaranteed MBS. A failure then would probably not have seriously threatened a disruption of the housing or financial markets.

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. The consequences of an Enterprise's failure would be greater than in the past. The interdependencies between the Enterprises and the other participants in securities and derivatives markets are among the highest of all privately owned financial institutions.

What more can be done, then, to further minimize the occurrence of a systemic event involving a financially distressed Enterprise? Clearly the possibility of a systemic event cannot be reduced to zero, for a crisis may occur that even the most far-sighted policy cannot anticipate. That does not mean that there is nothing to be done.

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Recommendations

In order to ensure that OFHEO is best equipped to address any systemic risk issues, we will undertake the following four regulatory actions and offer two legislative recommendations.

Four Regulatory Actions

The four regulatory actions we will undertake are to enhance our supervisory tools, conduct additional research, increase Enterprise transparency, and clarify our conservatorship process.

First, we will continue to enhance OFHEO's supervisory tools. OFHEO is engaged in an ongoing process to enhance its ability to perform its safety and soundness mission by, among other things, significantly expanding its examination program, enhancing its data and analytical capabilities and its early warning systems, and fully utilizing the risk-based capital stress test as an analytic tool.

Second, we will conduct additional research. Research will help secure a better understanding of the economic effects of Enterprise activities at both a regional and national level, and building upon that, the implications of the operations of the Enterprises for systemic risk. Furthermore, additional research needs to be done on the complex networks of interdependencies between the Enterprises, Freddie Mac, mortgage borrowers, primary mortgage, securities, and derivatives markets.

Third, we will work to enhance Enterprise transparency to improve market discipline. The relationship of Fannie Mae and Freddie Mac to financial markets is critical to their viability, and they must have access to capital markets to accomplish their mission. That access is further dependent on the markets and investor's understanding of the Enterprises' risks and confidence in their financial health. We are currently looking at several disclosure initiatives, including comparability, and will have more to say on that subject soon.

Fourth we will clarify OFHEO's conservatorship process by regulation. OFHEO will issue a regulation to implement the Agency's conservatorship authority. A regulation will support OFHEO's ability to use that authority to manage the affairs of an Enterprise that experiences severe solvency problems.

Two Legislative Recommendations

Beyond regulation, I am recommending two legislative proposals to support OFHEO's efforts in the area of systemic risk. We need to permanently fund OFHEO and provide the Agency with receivership authority.

First, Congress needs to permanently fund OFHEO to insure that it has adequate resources and budget flexibility. OFHEO recommends that the Agency be permanently funded and exempt from the appropriations process. Currently OFHEO's assessments of Fannie Mae and Freddie Mac are subject to the annual Congressional appropriations process, whereas other regulators' assessments are exempt. Permanent funding would permit OFHEO to adapt more easily to changes in the Enterprises' activities and to quickly adjust resources should serious problems develop or a financial crisis become more likely.

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OFHEO's funding mechanism should be identical to that of all other Federal safety and soundness regulators.

Second, OFHEO recommends that the 1992 Act be amended to allow the Agency to close and appoint a receiver to manage the affairs of an insolvent Enterprise. If the condition of an Enterprise is such that it is not viable, then OFHEO should have the authority to place it into receivership and wind down the business of the company. Financial markets, the housing sector and creditors all would benefit from the final resolution of a non-viable Enterprise.

Overall, the systemic risk report sets the foundation for the actions and recommendations that support OFHEO's efforts to reduce further the possibility of systemic events and to oversee the continued evolution of Enterprise risk management programs.

Report of the Interagency Task Force on MBS Disclosure

Let me now comment briefly on the Report on MBS Disclosure released yesterday by OFHEO, the Treasury Department and the Securities and Exchange Commission. This study is the product of a joint task force formed in July 2002 to conduct a study of disclosures in the offering of mortgage-backed securities. It is an important contribution to the issue of financial transparency, and the promotion of a level playing field in this important market.

The report provides a review of the development of the MBS markets, current disclosure requirements for these securities, and market disclosure practices and standards. I am pleased that people have found this part of the report to be a very informative primer on the subject.

The Task Force interviewed a variety of MBS issuers and investors, and other experienced market participants to learn of their perspectives and recommendations. The Task Force sought evaluation, by the parties it interviewed, of the impact of additional disclosures on the efficient and liquid MBS market. The Bond Market Association was a very important participant in this process.

Overall, the significance of the MBS market has grown. In fact, the MBS market has grown by some 800% over the past 20 years and over that time period, the number of products and the range of participants have also increased.

Government sponsored enterprises remain the largest issuers, while buyers are dominated by institutional investors. Those investors described to us how their views of the MBS market and needed disclosures have changed over time. Their attention has now settled most clearly on evaluation of prepayment risk and, for private label MBS, on credit risk.

We determined that there was a clear desire and need for enhanced, pool-level disclosures. Furthermore, a review of the market's evolution led us to conclude that these enhancements could be made with no adverse impact on the efficiency or liquidity of the MBS market.

Accordingly, we have identified six areas where MBS disclosures can and should be enhanced. They are loan purpose, original loan-to-value ratios, standardized credit scores of borrowers, servicer information, occupancy status and property type.

The Task Force believes that these added pool-level disclosures would be valuable and their implementation would outweigh any costs. We have encouraged all issuers to adopt these enhancements.

OFHEO will monitor the implementation of the recommendations by Fannie Mae and Freddie Mac to ensure that they are properly executed. I welcome your input on this point.

The Task Force's work was a success because of the thoughtful input we received from the Bond Market Association and other market participants. We all share a common goal of increased transparency and market discipline.

A Note on Transparency

That is a common element in the MBS review and the systemic risk report. Of the many audiences I have addressed, I know this one cares deeply about disclosure - so do I. The liquidity of markets has been tied to effective disclosures and you certainly have a vested interest in markets remaining as transparent as possible.

At the same time, all financial regulators have recognized transparency as a fundamental component of safety and soundness. Timely and meaningful disclosures strengthen market understanding, market discipline and market stability. In other words, the market is our partner in fulfilling our mission.

We have several disclosure initiatives under consideration, including an initiative to promote uniformity and comparability of key Enterprise disclosures. I have heard from many investors about the benefits of such an effort. We will have more to say about these initiatives very soon.

OFHEO Symposium

Finally, let me tell you about an exciting symposium that OFHEO is sponsoring in Washington on March 10. One of the important economic indicators that those in the housing and financial markets watch is the trend in home prices. OFHEO publishes quarterly the leading indicator of home price appreciation-the OFHEO House Price Index. OFHEO's HPI measures changes in home prices nationally based upon actual resales. The symposium will discuss the impact of home price appreciation on the economy, recent trends in the data, and the sustainability of home values.

I am pleased that HUD Secretary Mel Martinez, The Chairman of the President's Council of Economic Advisors, Glenn Hubbard, and the President of the St. Louis Federal Reserve Bank, William Poole, will speak at the conference. This meeting should be timely and will explore topics that would be of interest to many of you who are involved in the housing and financial markets. Information on how to register can be found on OFHEO's website at www.ofheo.gov.

Thank you for the opportunity to speak with you today. Let me stop here and take your questions.

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