

**Speech by the Honorable Armando Falcon, Jr.,  
Director of the Office of Federal Housing Enterprise Oversight  
at the Federal Reserve Bank of Chicago's  
2001 Annual Bank Structure Conference  
"The Federal Safety Net: Costs, Benefits, and Implications For Regulation"  
May 11, 2001**

It is certainly a pleasure to be here today to participate in this highly-regarded conference on financial institutions and their regulation. With the rapid growth and rising importance of government sponsored enterprises, the increased attention given to them in this year's conference program is surely appropriate.

The theme of the conference is The Federal Safety Net: Costs, Benefits, and Implications For Regulation. In keeping with that theme, I will address the Enterprises' relationship to the government and our essential role in their regulation.

Fannie Mae and Freddie Mac have grown to become two of the world's largest financial institutions.

Together they own or guarantee roughly 40 percent of outstanding U.S. residential mortgages. Debt obligations that they have issued or guaranteed amount to nearly \$2.5 trillion in liabilities and mortgage-backed securities, roughly the same size as the insured deposits of the U.S. commercial banking industry.

However, there are some important differences between banks and these housing Enterprises. Fannie Mae and Freddie Mac were chartered by Congress for explicit public purposes – to provide liquidity and stability to the secondary mortgage markets, and promote access to mortgage credit throughout the Nation. They receive several benefits to accomplish these goals. Among many others, these benefits include an exemption from state and local income taxes to the ability of the Secretary of Treasury to provide liquidity by purchasing up to \$2.25 billion of obligations from each Enterprise.

Unlike the regulation of banks and thrifts, whose deposits are Federally insured, the safety and soundness regulation of Fannie Mae and Freddie Mac is not based on any explicit government guarantee.

For these Enterprises, there is no such guarantee. By statute, securities issued or guaranteed by Fannie Mae and Freddie Mac must expressly state that they are not guaranteed by the United States. However, financial markets treat the liabilities of Fannie Mae and Freddie Mac as implicitly backed by the United States.

The assumption that the government would take action to prevent losses to holders of the Enterprise obligations is of course uncertain. Even if the government chose to support an Enterprise that appeared to be failing, a number of questions would remain.

For instance:

- ☞☞What would be the form of assistance;
- ☞☞How timely would the assistance arrive; and
- ☞☞Would all obligations be covered and to what extent?

The answers to these questions are all unknown and might be difficult to resolve.

Regardless of whether or how the government would support a failing institution, it is clear that the best policy is to protect against the need to resolve those questions.

There continues to be a great deal of discussion about having private markets assist in regulating the risk-taking behavior among large financial institutions. While there is much merit to increasing investor awareness and market discipline, it should be viewed as a complement to, and not a substitute for, formal regulation of Fannie Mae and Freddie Mac.

First, the perception by investors that an implicit guarantee exists makes market discipline less effective. Materially higher risk would not raise the borrowing costs of these firms to the same extent it would in the absence of the perception.

Second, by creating these two Enterprises, the Congress has made an important market dependent on two firms. This has important ramifications for how these Enterprises should be regulated. The government has a strong incentive to see that the Enterprises it created to support affordable housing do not become a source of disruption to the U.S. housing markets.

The structural requirements for effective safety and soundness regulation of Fannie Mae and Freddie Mac are much the same as for large and complex

banking companies. Perhaps most important, an effective regulator needs independence. This is especially true for regulating very large enterprises with exceptional political skills. OFHEO's independence within the Executive Branch is comparable to the OCC and OTS.

We are part of the Department of Housing and Urban Development, however we conduct our safety and soundness activities independently of the rest of the Department. OFHEO's oversight comes from the Office of Management and Budget and the Congress. And like the OCC and the OTS, OFHEO's public communications are not subject to any Administration review. Consequently, my views today may not reflect those of the President or those of HUD.

An effective regulator also needs strong authorities -- examination, regulatory, and enforcement. We have them. Broadly speaking, our regulatory activities are very similar to those of banks and thrift regulators.

We conduct continuous on-site examinations of both Fannie Mae and Freddie Mac, and we produce formal examination reports every year. The reports and any serious concerns are communicated directly with members of the Enterprises' boards, while less formal discussions with senior management about examination findings and issues occur regularly throughout the year.

OFHEO also has two capital standards. One is based on leverage ratios, with a large component for off-balance-sheet risks that captures the large volume of the Enterprises' guarantees of mortgage securities. The other is a risk-based standard, about which I'll say more, shortly.

We also have a similar array of enforcement authorities, including cease and desist orders, civil money penalties, and enforceable written agreements. The cease and desist orders can be especially forceful, as they can require restrictions on growth, disposal of assets, or employment of officers subject to our approval.

However, in several important ways our regulatory activities are different. Because we regulate only two institutions of similar size and sophistication and with similar risk profiles, we can tailor our examination programs and our regulations closely to the specific business lines and risks posed by Fannie Mae and Freddie Mac. In doing so we have emphasized regulatory transparency.

This transparency serves several purposes. First, it helps the regulated institutions operate their businesses efficiently by making our goals, plans, requirements, and likely responses to future events more predictable. Second, it

enhances what market discipline does by making our regulatory requirements and the financial condition of our regulatees available to investors. And third, it gives Congress and others with an interest in the Enterprises' mission additional assurances that they are safe, sound, and appropriately capitalized.

OFHEO continues to take steps to enhance transparency. In the examination area, we have made publicly available our examination handbook, which details our goals, methodology, and procedures.

Our annual examination plans are closely tailored to the specific activities and internal issues at each Enterprise. Congress has greatly encouraged transparency in this area by requiring that we report publicly the results and conclusions of our examinations of each Enterprise.

This is unprecedented among financial regulators. Knowing that the results of our examinations will be made public provides an extra incentive for each Enterprise to manage its risks carefully and to heed the input and recommendations of our examiners.

We are also currently engaged in a project to place our supervisory practices and requirements in regulations. Recently we issued an expanded enforcement practices regulation and a revised assessment regulation. We also have proposed a new prompt corrective action regulation and a new executive compensation regulation.

A subpart of our prompt corrective action rule – which we refer to as prompt supervisory response – is especially innovative because it utilizes a number of non-capital factors which trigger increased supervisory scrutiny. I invite everyone here today to provide comments on this rule which is open for comment until July 9.

We also will soon propose amendments to our existing leverage-based minimum capital rule.

Perhaps our most important and innovative regulation is our risk-based capital rule. It is currently being reviewed by the Office of Management and Budget, and we hope to be able to issue the final rule soon. It is an excellent example of tailored and transparent regulation. Because we have only two institutions to regulate and because they are very similar to each other we are able to do something that bank and thrift regulators have not.

We can and have created a model-based capital rule that is finely attuned to the specific risks of the institutions we regulate.

And it will be fully transparent because we will release the actual computer code along with the regulation.

In addition to regulations, we also issue guidances in various areas where a less formal approach seems warranted. A recent example is our guidance on non-mortgage investments which establishes management and internal control standards.

We have also enhanced our research and policy analysis capabilities. In fast-changing markets with rapidly growing institutions, we will be left behind if we do not look ahead. With that in mind, we are concentrating on building our understanding of market changes and new or increasing risks.

Given the increasingly central role the Enterprises play in the mortgage markets and the financial markets as a whole, systemic risk is an area we are currently reviewing. As with any very large financial intermediary, a sudden problem at either Enterprise could be the source or contributing agent for a shock or systemic event. In other circumstances, these Enterprises may alleviate systemic risk by providing liquidity to mortgage markets.

We have solicited public comments on a number of related questions for this study, and the questions and comments we have received are available on OFHEO's web site.

The current regulatory system works. OFHEO is, and will remain, a strong and effective regulator. We have strong enforcement authorities and will not hesitate, should the need ever arise, to take appropriate action to meet our responsibilities. The heart of the issues currently surrounding the Enterprises are mostly related to their activities and their charters, not their financial health. The fact is they are currently safe and sound. That is not just because they are well-managed, but also because OFHEO is doing its job.

And so I am cautious about proposals that could disrupt current safety and soundness regulation in an effort to address a separate set of mission-related issues.

It is entirely appropriate for Congress to consider and debate those issues, but I hope that safety and soundness regulation is not harmed. I spent eight years on the staff of the House Banking Committee assisting the members in dealing with the savings and loan crisis. I am always mindful of that experience and a wise philosopher's adage, "Those who cannot remember the past are condemned to repeat it." That is what is really at stake in this debate and why

we should do no harm to safety and soundness regulation. Thank you for having me here today, and I will be happy to answer any questions you may have.

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