OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

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Speech of the Honorable Armando Falcon, Jr.,
Director, Office of Federal Housing Enterprise Oversight (OFHEO)
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Good afternoon. It's a pleasure to join you. It's hard to believe that a year has passed since I last spoke to you. And what a year it has been – for OFHEO, for Fannie Mae, for Freddie Mac, and for America's Community Bankers.

When I spoke to you last year, I was new to the job and full of ideas about how to best accomplish OFHEO's mission. One year later, I am pleased that we have accomplished much of what we set out to do, and I look forward to building on OFHEO's strong regulatory foundation.

As you know, Fannie Mae and Freddie Mac – or the Enterprises – and OFHEO received a lot of attention last year, both in Congress as well as in the press. Although the focus took many turns throughout the year, a consensus emerged at the end that strong oversight of the Enterprises is desirable to ensure they fulfill their public mission in a safe and sound manner.

While no consensus was reached that the current system needed overhauling, one theme often heard was that Fannie Mae and Freddie Mac should be subject to "bank-like" regulation.

I agree, and in fact OFHEO has a strong bank-like regulatory program in place. However, due to the unique nature of the entities we regulate, our regulatory program will differ where appropriate from that of the banking regulators.

When comparing OFHEO's safety and soundness regime to those of the bank regulators, there may be no better yardstick than the principles established by the Basel Committee on Banking Supervision. These are the international standards for the regulation of banking institutions.

In recent years, central bankers from around the world have wrestled with and debated the most effective system of safety and soundness regulation. In 1997, the Basel Committee articulated its core principles for effective banking supervision. Then, earlier this month, the Basel Committee released its proposed new Capital Accord, which is built on the three mutually reinforcing pillars of 1) capital requirements; 2) supervisory review, and 3) market discipline.

The first pillar – capital regulation – is built on the foundation of maintaining minimum capital levels to offset credit, market, and operations risks. Since the early days of its existence, OFHEO has enforced a minimum capital requirement, which is similar to the leverage ratios U.S. banks must meet. The requirement is intended to ensure that capital never falls below a minimum level during good and bad times. Under OFHEO's minimum capital requirement, each Enterprise is required to hold 250 basis points of capital against its on-balance sheet assets. And they are also required to hold 45 basis points of capital against off-balance sheet obligations. However, like banks and thrifts, the Enterprises are subject to more than just this minimum capital requirement.

The 1992 Act establishing OFHEO mandated a risk-based capital requirement using a stress test. The stress test simulates dramatic changes in interest rates and high declines in property values to determine capital requirements.

This approach is consistent with the Basel proposal which is designed to increase the risk-sensitivity of capital requirements. However, due to the homogeneous nature of the Enterprises business – and the fact that there are only two – OFHEO is able to take bank-like risk-based capital regulation to a higher level.

Our risk-based capital regulation will more accurately tie capital to risk than any other current or proposed standard. Once calculated, the statute requires an additional 30 percent capital charge for management and operations risk. This add-on is consistent with the opinion of the Basel Committee, which also calls for a provision for operations risk.

OFHEO is long-overdue on this rule. So when I took office I made finalizing the rule my top priority. We have now finished the text of the rule and are testing the computer code to ensure that the model is completely accurate and operational.

Once the rule is cleared, by the Office of Management and Budget (OMB), Fannie Mae and Freddie Mac will be subject to the most sophisticated capital standard of any financial institution. With that in mind, it is my view that OFHEO has gone further in its capital regulation – both in determining capital levels as well as ensuring capital adequacy through prompt corrective action – than the risk weighted leverage approach employed by the banking regulators.

I don't mean to imply that the banking standard is inappropriate – not at all. Your institutions have certainly asserted that your standard requires greater capital than that which applies to the Enterprises.

But the new Basel Accord, like OFHEO's risk based capital standard, recognizes the need to more closely tie capital to risk. And because these approaches give institutions credit for risk mitigation activities, the institutions that manage risk well will be rewarded with a lower capital requirement. Thus, everyone can benefit if this is done right. As the first agency to implement such a capital standard, I've made sure that we got it right, even under the tight deadlines I've imposed on our staff to finish the job.

The second pillar of the Basel Accord is supervisory review to ensure capital compliance and safe and sound operation. Through a combination of on-site examinations and off-site surveillance and monitoring, OFHEO has built a robust system for ensuring compliance with capital requirements. Our examination program is very well-regarded and I will discuss it in more detail in a moment.

Finally, in describing its third pillar – market discipline – the Basel Accord notes that "market discipline has the potential to reinforce capital regulation and other supervisory efforts to promote safety and soundness in banks and the financial system." Central to the effectiveness of the market as a disciplinarian is the timely and accurate disclosure of appropriate information.

As I noted, OFHEO's examination program is among the best in its field. The effectiveness of our examination program is magnified because we publish a summary of the results and conclusions of our annual examination in the agency's annual report to Congress. No bank regulator that I am aware of provides the public with access to examination findings specific to individual institutions and allows the same level of external scrutiny.

However our efforts to promote disclosure goes much further than an annual summary of our exams. For the market to work, participants must fully comprehend the risks faced by the Enterprises as well as their systems for managing this risk.

We are continuously seeking prudent means to enhance disclosure of the Enterprises' risks and risk mitigation activities. But of course in a way that protects their proprietary interests. For example, in December OFHEO issued a policy guidance on non-mortgage liquidity investments. This guidance lays out our views on prudent non-mortgage liquidity investment policies. The guidance recommends specific types of disclosures related to non-mortgage liquidity investments, which can be an effective deterrent to excessive risk-taking.

In another effort to promote market discipline, the Enterprises will issue subordinated debt on an ongoing basis. Fannie Mae issued its first sub debt last Tuesday. Freddie Mac is expected to follow shortly. The sub debt the Enterprises' will issue has a feature suspending interest payments should their capital drop below a certain point.

The specified trigger is a percentage of their critical capital level, which is defined in OFHEO's statute. In an effort to assist investors in Fannie Mae and Freddie Mac's sub debt, OFHEO will soon begin releasing information on the Enterprises' critical capital levels.

Now I want to return to a brief discussion of the evolution of our examination program. As you likely know, the management of risk is the key challenge for every participant in financial markets.

Management at major institutions like Fannie Mae and Freddie Mac find risk management at the heart of many critical decisions – day-to-day operations, resource allocations, strategic planning, capital structure, legal & political exposure, performance measurement, pricing, and a host of other issues. Increasingly, the Enterprises' success depends on the identification, quantification, and management of a variety of complex and interdependent risks.

Several trends have been driving this increased focus on risk:

- Technological advances that allow market participants to implement decisions with great speed and in large volume;
- Automated tools that provide decision-makers with almost real-time support for decisions about which risks to take, which risks to transfer, and which risks to avoid altogether;
- The use of securitization by an increasing number of participants who tap capital markets to finance business and transactions;
- A movement toward management based on mark-to-market valuation and away from historic cost value (accrual) accounting;
- Greater focus by shareholders, investors, and analysts on the relationship between financial returns and risk;
- Evolution of the regulatory environment that puts greater emphasis on the ability of management to manage and control risk; and
- A competitive environment where superior risk management provides competitive advantages.

Given the forces which are continually reshaping the financial landscape, and the resulting challenges for market participants like Fannie Mae and Freddie Mac, I am committed to ensuring that OFHEO adequately supervises the safety & soundness of these GSEs.

Like the examination programs of the other regulators, ours includes both on-site exams and off-site surveillance and monitoring. It is through the on-site examinations that specialists make hands-on assessments of qualitative factors such as management capabilities, risk management strategies, and internal control processes that cannot be reflected in routine regulatory reporting.

Also, trained examiners verify the quality and integrity of risk management tools, risk measurements, financial and management reports, operational controls, documentation standards and a host of other qualitative and quantitative judgments. In short, I see no substitute for the value provided from going on-site at the Enterprises, looking under the hood and kicking the tires.

OFHEO has assembled an impressive team of examiners possessing a breadth of knowledge and skills that were acquired through their many years of experience at the banking and thrift agencies, as well as from the mortgage banking industry. Frankly, the examination program works well and embodies many best practices in financial regulation and supervision.

Given the high degree of competence in our examination program, there is a slight temptation to leave well enough alone. But leaving the examination program unchanged presents a dilemma. Given the velocity of change in the financial markets and at the Enterprises, maintaining the status quo would render the current examination program obsolete in a few short years.

The key to effectively overseeing the Enterprises in this new millennium is to continuously improve and strengthen our examination program, and to obtain the resources – both human and financial – to make certain the quality of our examination program continues to embody and lead best practices in financial regulation and supervision.

This means that we must continuously adapt and strengthen our risk-focused examinations. I have been working with my Chief Examiner, his examination group, and other financial regulators to ensure we keep our exam program at the vanguard of financial regulation.

Throughout 2001, I will be implementing enhancements to OFHEO's examination program that my Chief Examiner and I have identified and for which we have formalized plans.

For example, we've recently added a new group within the examination area, the Model Exposure examination group which will be dedicated to assessing, testing and validating the automated models and other sophisticated quantitative (mathematical) techniques used by the Enterprises' business units.

We have plans to add an "E-Commerce" examination capability to focus on the new paperless delivery channel that is expanding both the GSEs' business propositions and the financial services landscape. In addition, given the rapid development of convergence technologies spurred by the growth in communications networks, we will strengthen our examination expertise and abilities in these areas. We also plan to strengthen our existing (and future) examination activities by conducting formal benchmarking and best practices efforts.

Of course 2001 does not close the door on further refinements to our examination program. Looking to the future, our examination program must continue to evolve and must become even more tailored to the specific risks of the Enterprises.

Perhaps my view for maintaining a world-class examination program can best be described as a process – not an event. An example for how we will continue to strengthen the examination program, is my recent announcement to form a specialized team of examiners to further test the quality and integrity of how the Enterprises' manage their exposure that results from the use of internal models.

In conclusion, as I have said many times publicly, I am open to and willing to support any real improvements in the oversight of Fannie Mae and Freddie Mac. However, when it comes to ensuring the safety and soundness of the Enterprises, OFHEO's regulatory regime, combined with Congressional oversight and market discipline, is robust and clearly consistent with the opinions of world experts.

Thank you again for this opportunity.

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OFHEO was established as an independent entity within the Department of Housing and Urban Development by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title XIII of P.L. 102-550). OFHEO's primary mission is ensuring the capital adequacy and financial safety and soundness of Fannie Mae and Freddie Mac.