OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

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STATEMENT OF
MARK KINSEY, ACTING DIRECTOR
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND GOVERNMENT-SPONSORED ENTERPRISES
U.S. HOUSE OF REPRESENTATIVES
MAY 12, 1999

Mr. Chairman and members of the Subcommittee, I appreciate the opportunity to appear here today to discuss OFHEO's proposed risk-based capital regulation for Freddie Mac and Fannie Mae. I especially want to thank you personally, Mr. Chairman, for your ongoing support for the regulatory activities of OFHEO. As always, this testimony represents the views of the Office of Federal Housing Enterprise Oversight, which are not necessarily those of the President or the Secretary of Housing and Urban Development.

Regulating the amount of capital that Freddie Mac and Fannie Mae are required to hold is important because the failure of an Enterprise could have serious consequences. The Enterprises are critical to our housing finance system. When Congress created OFHEO back in the fall of 1992, the total obligations of the Enterprises (debt and MBS guarantees of the Enterprises) stood at about $1 trillion. Today, in a little over six years, the obligations of the Enterprises have doubled to nearly $2 trillion. The fastest growing part of their business is their retained portfolio of mortgages and, increasingly, of mortgage-backed securities. These assets have quadrupled. At over $725 billion, the combined retained portfolio of mortgage assets at Freddie Mac and Fannie Mae now exceeds, by well over $100 billion, the combined holdings of mortgage assets by the entire thrift industry.

I am happy to report that, currently, the Enterprises are very healthy and well managed institutions. While we do not see any problems today, we can not take it for granted that current circumstances will prevail indefinitely. Government-sponsored enterprises are not immune to problems. The Farm Credit System experienced severe problems in the late 1980s and required Federal assistance.

And while Fannie Mae did not receive direct Federal assistance, at one point in the early 1980s, when it was a much smaller company, it was losing $1 million a day, and on a mark-to-market basis the value of its liabilities far exceeded the value of its assets.

Another matter of importance to OFHEO is that market forces cannot be relied on to regulate capital because the Enterprises are not subject to the normal market discipline that fully private firms face. What I am referring to here is the disabling of normal market forces resulting from their GSE status. Freddie Mac and Fannie Mae are able to borrow money from the credit markets more cheaply than fully-private triple A rated firms, and at times, nearly as cheaply as the U.S. Treasury. But investors' willingness to lend money to the Enterprises is based primarily on the perception of an implicit government guarantee and not on an evaluation of capital adequacy. Therefore, the Enterprises have the ability to increase their risk-taking, possibly significantly, without much effect on their cost of funds. Even in the extreme case when Fannie Mae had negative economic net worth in the early 1980s, Fannie Mae was still able to borrow money from the capital markets. For a fully private firm in a similar position, the flow of money from the capital markets would have dried up, well before such a condition developed.

The sheer size and importance of the Enterprises to the housing markets together with the distortion of market forces that their GSE status creates makes it critical that a strong risk-based capital standard be put in place. A strong risk-based capital standard will help ensure that the Enterprises remain financially strong even under severe economic stresses.

OFHEO's Proposed Risk-Based Capital Standard

OFHEO's proposed risk-based capital standard represents a new and innovative approach for determining the capital adequacy of Freddie Mac and Fannie Mae. As such, we expect, and welcome, constructive suggestions from a wide range of interested parties. We believe that the basics of the rule are on target, and we are encouraging everybody to take the time to study the proposal and provide us with their insights. Currently, the public comment period ends on August 11. However, several parties have informally expressed a desire to have OFHEO extend the comment period. It may be necessary to provide additional time for all interested parties to fully comment on the proposal. We are evaluating the need for extending the comment period and expect to make a decision on this matter within the next couple of weeks.

In charging OFHEO with the responsibility to develop risk-based capital standards, Congress directed OFHEO to use a stress test for the determination of capital adequacy. Congress also provided OFHEO with many of the parameters for developing the stress test, including the specific credit and interest rate stresses that should be used.

A stress test is the best way to determine the capital adequacy of Freddie Mac and Fannie Mae. It closely links capital to risk by calculating risk exposure holistically. That's my favorite one-word description of how the stress test works. It allows OFHEO to capture the "bottom line" exposure to the Enterprises from both credit and interest rate risk, simultaneously. It not only captures the risks inherent in the Enterprises' assets and off-balance sheet obligations, it also captures the effectiveness of hedges and credit enhancements that the Enterprises put in place. No other regulatory capital standard

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explicitly gives credit for risk management activities.

The beauty of a stress test is that it is an early warning indicator of financial distress. A stress test can expose hidden weaknesses in a system that seems perfectly healthy and sound under normal conditions. This is the same concept used by doctors when they ask individuals to run on a treadmill in order to stress the heart so they can observe how well it functions. This enables the doctor to treat any weaknesses today, while the patient is relatively healthy, rather than after the patient suffers a heart attack, when the treatment may be more difficult or too late. The same can be said for OFHEO's stress test. It assists in the discovery of otherwise hidden financial weaknesses, allowing an Enterprise to fix them today before it becomes too weak financially to do so.

While a stress test based capital standard is a new and innovative approach for determining regulatory capital requirements, the use of a stress test is not new to the Enterprises or to other large financial institutions. In fact, Fannie Mae and Freddie Mac each has been using its own stress test for assessing its capital needs for many years. And as you may recall, Mr. Chairman, both Enterprises played a major role in drafting the specifics of the legislation that created OFHEO and the stress test.

In designing the proposed regulation we had four goals in mind. First, we sought to create a model that measures risk consistently across the two companies. For example, if both Enterprises purchased mortgages with the same risk characteristics and funded them in exactly the same way, they should have the same capital requirement. The use of a single model is important for this goal. Prior to the public release of our proposal, both Enterprises had stated publicly that they had developed their own versions of a stress test that they believed were consistent with the statutory risk-based standard. Not surprisingly, both Enterprises passed their own versions of the stress test. When using OFHEO's proposed standard, it became clear that using a common yardstick to measure risk resulted in quite a different picture.

Second, we needed to meet the statutory requirements for transparency and replicability. The model can't be a black box. It has to be something that the Enterprises can use to anticipate what their capital requirements will be. It also has to be transparent so that everybody else can evaluate it, including investors. So when we say the Enterprises are adequately capitalized, investors will know exactly on what basis we make such decisions.

Our proposed rule is, of necessity, lengthy. Every single equation and parameter in our model that are needed to reproduce our proposed capital standard are detailed in the proposal. In addition, we provided an extensive preamble to explain how the capital standard works and OFHEO's rationale for the choices made in developing the proposal. Actually, the regulation itself is less than a third of the proposal. However, it will take time to understand completely how the proposal works, and OFHEO is committed to working closely with the Enterprises and other interested parties so that they can appropriately comment on the proposal.

Third, we sought to develop a stress test that provided both OFHEO and the Enterprises with flexibility. The stress test allows the Enterprises to manage their own businesses according to their individual strategies. It does not dictate the kinds of activities they should be involved in or how they should manage their risks. It is only a tool to measure overall risk and set capital requirements for that

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risk.

The stress test also needs to be flexible enough to address innovation. The proposal must be able to capture the risk of new products when they are introduced, and just as importantly, capture the reduction in risk from the effective use of new financial instruments. This type of flexibility keeps the stress test from becoming obsolete over time.

The Enterprises' activities are restricted by their charters to those associated with providing a secondary mortgage market. Before an Enterprise can introduce a new program, the company must seek approval from the Secretary of HUD. During the new program review, HUD will have up to 45 days to make its decision. During this time frame, OFHEO will be able to analyze the new program for capital treatment under the risk-based standard.

Any new activity that is not a new program will generally be a variation of an existing activity. In this case, the existing techniques for measuring risk already in the proposal can easily be adjusted on a timely basis to effectively capture the risk impact of the new activity. The proposal allows OFHEO to use our judgement on how to initially treat any new activity for purposes of the risk-based capital standard. We will work with the Enterprises to understand the new activity and our decision will be informed by how they view the relative risk of the activity. We will also encourage the Enterprises to come to us as soon as practicable to engage in these discussions. Once we make a decision, the Enterprises will be informed of the specifics of how we will treat the new activity for capital purposes so that they can plan accordingly.

Fourth and finally, the capital standard needs to recognize and reward appropriate management of risk. The proposed rule would encourage the Enterprises to manage risk effectively because higher risk is associated with higher capital requirements, and vice versa. It also is intended to discourage regulatory capital arbitrage. By tying capital very closely to risk, our proposal should discourage efforts to restructure transactions simply to receive a lower regulatory capital treatment even though the risk has not changed.

The Results

To demonstrate how the risk-based capital standard works, the proposed regulation includes calculations of capital requirements for Freddie Mac and Fannie Mae for two dates – September 30, 1996 and June 30, 1997. Freddie Mac would have comfortably met its risk-based capital requirement on both these dates with a surplus of about $1 ½ billion. Fannie Mae, on the other hand, would have had a capital shortfall of around $3 ½ billion on both dates.

The main reason Freddie Mac met its requirement and Fannie Mae did not is that Fannie Mae had more interest rate risk than its capital base could support. Both Enterprises have relatively low credit risk. Freddie Mac had simply reduced its interest rate risk exposure to a greater extent than Fannie Mae had.

These results should be interpreted with caution. Given that underlying economic conditions and the Enterprises' risk profiles constantly change, these results do not necessarily reflect what an Enterprise's current or future risk-based capital requirement might be. Furthermore, a projected capital

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shortfall, even a large one, does not imply that an Enterprise actually has to raise that amount of capital.

For example, let's focus on Fannie Mae's $3.68 billion capital shortfall on June 30, 1997. The number sounds very large. But because the proposal is so flexible, Fannie Mae could have met its capital requirement by reducing its interest rate risk in a variety of ways at an annual cost of about $70 million. (This estimate is not mine, by the way. It is from Fannie Mae's Chief Financial Officer). Also, Fannie Mae's CFO stated that investors would see no perceptible change in the company's future financial performance as a result of this proposed capital standard.

Impact of Our Capital Proposal

Let me conclude my remarks this morning by talking a little bit about the impact of our proposal on the housing market. Our proposed capital standard is unlikely to cause any change in mortgage rates nor will it curtail the Enterprises' ability to finance affordable housing. The reasons why we believe our rule will have no negative impact on the housing market are straightforward.

The first reason is competition between Fannie Mae and Freddie Mac. Since Freddie Mac comfortably met the capital standard, there would be no incentive for the company to raise the prices it charges lenders. If Fannie Mae attempted to raise its prices to recoup the costs associated with complying with the risk-based capital rule, Fannie Mae would lose profitable business to Freddie Mac. Competition for market share has heightened in recent weeks, following the announcement of the exclusive Freddie Mac/Norwest deal.

Second, the capital costs for credit risk for the two stress periods we looked at are, on average, about the same as they are in the minimum capital requirement – about 45 basis points. Since both companies currently meet their minimum capital requirement (2.5% of balance sheet assets and .45% of off-balance sheet obligations), there would be no incentive for either Enterprise to change the guarantee fees that it charges lenders for accepting credit risk.

As I mentioned previously, credit risk on affordable housing loans was not the reason Fannie Mae did not pass its risk-based capital requirement. We did discover that the credit risk on Fannie Mae loans was on average about 12% higher, on a per dollar basis, than on Freddie Mac loans. However, if we imposed the higher Fannie Mae credit losses on Freddie Mac's loans, Freddie Mac still would have easily met its risk-based capital requirement on both dates. The reason that Fannie Mae failed its risk-based capital requirement and Freddie Mac passed, even with the higher Fannie Mae loss rates, is because Fannie Mae had more interest rate risk. Freddie Mac chose to hedge its interest rate risk more extensively than Fannie Mae did on those selected dates.

Affordable housing loans have been quite profitable for both Enterprises. The credit risk associated with these loans remains relatively low, with loan-to-value ratios that mirror those of their entire portfolios. The far more important variable is the way an Enterprise chooses to fund all of the mortgages it holds in portfolio. It is these funding choices that comprise the interest rate risk that caused Fannie Mae to fall short of its capital requirement.

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We believe our proposed rule will have a long-term positive impact on the housing market. Our proposal will help to ensure that the Enterprises will remain financially strong and able to perform their important public purposes in good as well as bad times, when they will be needed the most. Also, our proposal will provide market participants with additional information concerning the exposure of the Enterprises to credit and interest rate risk.

Mr. Chairman, I appreciate the opportunity to testify before this subcommittee. I will be pleased to respond to any questions.

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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.

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.

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