Testimony of

the Honorable Armando Falcon, Jr.

Director,
the Office of Federal Housing Enterprise Oversight

before the U.S. House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises

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Chairman Baker, Ranking Member Kanjorski, and Members of the Subcommittee, thank you for the opportunity to testify this morning on OFHEO's risk-based capital rule.

Last year I appeared before this Subcommittee and assured you that completing this much-anticipated rule was my highest priority. Today I am pleased to report to the Subcommittee that the job is done. On July 19, we formally submitted a Final Risk-based Capital Rule to the Federal Register for publication. I am proud of the efforts of many talented and dedicated OFHEO employees who worked tirelessly to complete this unprecedented task. I am also grateful for the support of this Subcommittee, particularly yourself Mr. Chairman and the Ranking Member, Mr. Kanjorski. Your input and encouragement certainly kept us focused and motivated.

As you know, this rule is the final component of OFHEO's comprehensive regime to ensure the safety and soundness and capital adequacy of Fannie Mae and Freddie Mac. Once the rule is published in the Federal Register – which is estimated, to occur sometime in September – Fannie Mae and Freddie Mac will be subject to one of the most sophisticated regulatory capital standards in the world.

A great deal has been made of the rule, and I want to be clear on one point. While the rule represents a state-of-the-art approach to tying capital to risk, it in no way makes the other parts of OFHEO's regulatory regime less vital. Rather, it complements our current activities by providing yet another assessment of Enterprise risks. When the results of the test are considered with the other information I have available as Director, I will have the best view of the companies' current and prospective financial health.

This afternoon I will provide the Subcommittee with background on the development of the rule, its contents and rationale, and the process for its implementation. However, because I believe it is important to always consider the test in the broader regulatory context, I will also describe how the test fits into OFHEO's overall regulatory program.

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[1]This testimony represents the views of the OFHEO Director, which are not necessarily those of the President or the Secretary of Housing and Urban Development.

Capital regulation – While the risk-based capital rule has received the bulk of attention in recent years, the 1992 Act establishing OFHEO directed the Office to establish and enforce two major capital tests for the Enterprises – a minimum capital test and risk-based capital stress test.

Minimum capital -- Since its inception, OFHEO has ensured that both Enterprises have maintained a capital base sufficient to meet statutory minimum capital requirements. These requirements utilize a leverage test that is similar to existing capital requirements for banks and thrifts.

The statutory leverage test is simple. Generally, the test applies a 2.5% capital charge to an Enterprise's on-balance-sheet assets and a .45% capital charge to off-balance-sheet obligations, such as guarantees of mortgage-backed securities. Each quarter, OFHEO aggregates the Enterprises' assets and places off-balance sheet obligations into buckets based on their characteristics. Then, each group is multiplied by the capital ratios required in the statute.

This number is then compared to the Enterprise's core capital – or the sum of their (1) common stock, (2) preferred stock, (3) other paid-in capital, and (4) retained earnings. Currently, if core capital exceeds the requirement, the Enterprise is considered adequately capitalized. However, if a core capital shortage exists, the Enterprise is classified as either significantly undercapitalized or critically undercapitalized, based on the size of the deficit, and OFHEO's capital enforcement regime is triggered.

For each quarter the test has been applied to the Enterprises, both companies have exceeded their minimum capital requirement and, thus, have always been classified as adequately capitalized.

Risk-based capital –- As I mentioned a moment ago, the 1992 Act called for a second capital standard to be applied to both Enterprises – one that is a more sophisticated measure of risk. This risk-based requirement uses a stress test to simulate the performance of the Enterprises' balance sheets during a 10-year period of severe economic stress in the nationwide housing and credit markets.

Mr. Chairman, before discussing the RBC test itself, I would like to provide a brief history of the development of the RBC rule as background for the Subcommittee. As I mentioned earlier, the Act mandating the development of the risk-based capital test was signed into law in October of 1992. This Act created OFHEO and required it to issue a risk-based capital regulation within 18 months after the first Director was sworn into office. The first Director was sworn into office in June, 1993.

After staffing the agency and completing initial study of the issues involved, OFHEO published two Notices of Proposed Rulemaking (NPR). The first, published in June of 1996, proposed the methodology for developing a house price index and identifying a benchmark loss experience for use in the stress test. The second NPR was published in April, 1999 and described how the stress test would work. Following six months of comments and an additional month of "comments on comments," OFHEO analyzed the comments and worked on finalizing the RBC test. On March 29 of this year, OFHEO formally submitted the rule to the Office of Management and Budget for clearance. On July 16, OMB completed its review and OFHEO sent the rule to the Federal Register for publication on July 19.

With that short history-providing context on how we got where we are, I would now like to turn to the rule itself.

First, the test factors in large moves in interest rates – mortgage rates, Treasury rates, and Enterprise borrowing costs -- over the course of one year. Congress went so far as to specify that the 10-year Treasury rate changes by as much as 6 percentage points, and other interest rates change in tandem as determined by OFHEO using historical experience as a reference.

Second, the test provides for loan defaults and loss severity on a nationwide basis that are comparable to the largest default and severity rates the Enterprises have experienced in any region in recent history.

Third, the test incorporates no new Enterprise business and no asset sales to raise cash. It simply runs off their existing assets, liabilities and off-balance-sheet activities under the stress conditions. This no-new-business requirement is explicitly mandated in the 1992 Act.

If all of the stress conditions were to occur, the Enterprises would be expected to suffer severe losses as homeowners default (credit losses) or pay off their loans early (loss of fees and interest income) and the Enterprises' assets and liabilities go out of balance. OFHEO's task is essentially to estimate the losses that would occur in the current books of business and determine how much capital each Enterprise would need to maintain positive capital throughout this period. To this amount an additional 30 percent is added to compensate for operations and management risk which is not picked up in the test.

As compared to other contemporary "risk-based" standards, which simply apply haircuts to buckets of assets, OFHEO's standard determines an Enterprise's actual risk exposure as measured by the stress test.

I don't mean to suggest that leverage requirements are inappropriate. But like the proposed new Basel Accord, OFHEO's risk-based capital standard recognizes the need to more closely tie capital to risk and accomplishes this goal years ahead of other regulators. And because both approaches give institutions credit for risk mitigation activities, the institutions that manage risk well will be rewarded with a lower capital requirement.

Every Enterprise business activity, including those that reduce risk, is represented in the stress test. The capital requirement is based much more closely on an Enterprise's actual risk exposure, not just on how big it is. Thus, OFHEO's risk-based capital standard rewards an Enterprise that manages its risks well, and can act as an "early warning system" if an Enterprise's risks are starting to grow.

As noted earlier, the risk-based capital standard will be published in the Federal Register in September. While the rule is "effective" immediately, Congress granted the Enterprises a year to come into compliance before OFHEO can take an enforcement action against the company based on risk-based capital. Thus, the Enterprises will have one year to assess the impact of the rule on their business and take steps to adjust their balance sheets or hedging activity if necessary. Because the rule is effective upon publication, OFHEO will publish in early 2002 how the Enterprises fare under the standard using 4th quarter 2001 data.

To achieve compliance, the Enterprises will have many options. They can raise additional capital, adjust hedging practices, offset more of their risks, retain more of their earnings, or any combination of these. Furthermore, there are several ways to accomplish each of these tasks. With the increasing sophistication of risk management practices and the capital markets increasing ability to provide hedging and reinsurance opportunities, a capital shortfall generally can be eliminated at a fraction of the cost of new equity capital.

While the finalization of the rule is a landmark, it certainly does not close the door on work on RBC. The standard will not be static. The Enterprises will be free to innovate. OFHEO will work with the Enterprises to understand the implications of new activities and appropriately address them within the stress test without the need to amend the rule. This is no burden because the full legal description (which is what OFHEO needs to model) and any financial analysis carried out by the Enterprise (which would certainly expedite OFHEO's task) are available before a new product or policy is announced, or when an innovative transaction closes. In many cases, they may choose to bring OFHEO in at an earlier stage. This is common practice between other financial institutions and their regulators, and an absolute requirement on Wall Street with the SEC and the rating agencies.

As I mentioned earlier, OFHEO's capital regulation is a component of an overall regulatory regime. To assist me in understanding the Enterprises, I will use the stress test results in conjunction with other tools at my disposal, which include examination reports and OFHEO's financial research.

Examinations -- The 1992 Act establishing OFHEO directs the Office to conduct annual on-site examinations to determine the Enterprises' financial safety and soundness and requires OFHEO to report the results and conclusions of these examinations in our annual Report to Congress. This reporting requirement is unique among financial regulators and is a powerful tool in influencing the behavior of the companies we regulate. In our most recent Report to Congress, which was submitted on June 15, 2001, we reported that both Enterprises met or exceeded safety and soundness standards in all examination areas.

It is important to remember that OFHEO regulates just two institutions, but arguably two of the most sophisticated financial institutions in the world. This has allowed us to attract very talented individuals who are experts in their fields. Our examiners, who are OFHEO's front line in ensuring the Enterprises' safety and soundness, possess impressive skills and backgrounds, and bring to OFHEO broad experience from banking and thrift regulatory bodies as well as from many sectors of the financial services and mortgage industries. These experts maintain a physical presence at the Enterprises, and have unlimited access to all levels of management and to highly sensitive corporate records. By staying apprised of the Enterprises' risks and business activities on a timely basis, the examiners are able to evaluate an extensive array of risk-related factors and to assess the Enterprises' financial safety and soundness.

Each quarter, the OFHEO examination staff updates conclusions relating to more than 150 separate components of financial safety and soundness, thereby providing me with a comprehensive picture of the Enterprises' financial condition. These conclusions pertain to such key areas of risk, risk management, and business practices, such as credit risk, interest rate risk, liquidity management, information technology, internal controls, business process controls, internal and external audit, management information and process, and board of director governance and activities.

Our examiners meet frequently with management to discuss and assess business strategies and plans, financial performance results, risk management framework and practices, and each Enterprise's overall risk profile. These discussions include future trends and management's controls and practices to anticipate and prepare for potentially adverse trends in any risk area, or combination of risk areas. Examination teams identify opportunities for improvements in existing Enterprise risk management practices and work directly with management to address identified opportunities to enhance financial safety and soundness. Through our risk-focused examination framework, OFHEO constantly evaluates such critical areas as:

- The Enterprises' overall risk management strategies and practices;
- The composition, risk profile, and significant trends in their retained, and guaranteed, mortgage portfolios;
- The Enterprises' ability to effectively manage interest rate risk and other key financial exposures;
- The Enterprises' ability to efficiently issue debt and hedge financial exposures, and effectively manage liquidity; and
- The quality of financial performance and the quality of information on which the Enterprises' boards and management rely in reaching key business and risk management decisions

Research -- As with all financial regulators, research is an area of great importance to OFHEO's ability to fulfill its mission. Upon taking office, I set out to ensure the Office had sufficient research capacity to provide me with the independent analysis necessary to consider our examination and capital findings in the broader context of the economy and the markets in which the Enterprises operate. I am pleased that this initiative has resulted in OFHEO employing a group of talented researchers with expertise in areas including economics, financial regulation, and policy analysis.

From our periodic research on policy matters impacting the Enterprises and routine internal research on the economic and financial environment in which the Enterprises operate, I find our independent research critical to fully understanding the industry, the marketplace in which the Enterprises operate, and the stresses of economic events in order to meet our Congressional mandate. Without the benefit of economic, policy, and other research, it is clear that decisions I must make would be done in a vacuum. Thus, although much of our research is consumed by an internal audience, it is no less critical to fulfilling our mission.

Regulatory Infrastructure -- Finally, I want to briefly touch on the legal apparatus OFHEO has put in place to deal with any problems, which may occur at either Enterprise. Last summer, I announced that OFHEO would be conducting a regulatory infrastructure project, designed to provide a comprehensive review of and increased transparency into OFHEO's regulatory authorities. The project is designed to fully implement the statutory mandates of OFHEO, to provide greater certainty for the regulated entities and to produce greater transparency for the public in understanding OFHEO's administration of its responsibilities.

This project builds on the existing body of rules and, in many cases, formalizes that which the Office already does. To date, this project has resulted in the issuance of policy guidances on minimum safety and soundness requirements and the management of the Enterprises' non-mortgage liquidity investments, as well as final regulations on enforcement procedures and OFHEO's annual funding assessments. Still pending are rules dealing with prompt supervisory response and corrective action, executive compensation, and updating the Enterprises' minimum capital requirements. I would also note the creation of an internal policy mandating that OFHEO, not less than every five years, review its regulations for inefficiencies and unnecessary burden. The policy sets forth a procedure and even the criteria for internal and external review and comments. Once the project is complete, OFHEO's regulatory infrastructure will be an open book for anyone to comprehend.

In conclusion, OFHEO is meeting the mission Congress gave us. The Enterprises (1) are subject to on-going oversight through our examination program, (2) must meet quarterly minimum capital requirements which are similar to existing capital requirements for banks and thrifts, (3) will be the only entities subject to a risk-based capital stress test which closely ties capital to risk, and (4) can be held accountable if found lacking in any of these stated areas.

Mr. Chairman, you have in OFHEO a very talented group of men and women who are dedicated to fulfilling the agency's mission: ensuring the safety and soundness of Fannie Mae and Freddie Mac. I hope you will consider that the best investment in safety and soundness regulation is an investment in the team and talent we have assembled at OFHEO. Toward that end, I would renew my request that the Congress consider enacting some enhancements to OFHEO statutory authorities. While those enhancements are not essential, they would help ensure that OFHEO has all the tools necessary to respond quickly and effectively to any situation.

Let me again thank you Mr. Chairman, Ranking Minority Member Kanjorski, and the other Members of this Subcommittee for the opportunity to provide my views. I look forward to any questions.