



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

# NEWS RELEASE

**FOR IMMEDIATE RELEASE**  
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**Regulatory Outlook for GSEs**  
**Speech by the Honorable Armando Falcon, Jr. at**  
**the Schwab Washington Research Group Annual Symposium**  
**October 18, 2001**

While we all try to return to “business as usual” following the tragic events of September 11, it is clear from many things, including the revised title of this week’s symposium – “Fallout from the War on Terrorism” – that business is not as usual. As I contemplated my remarks for this event, I considered how the regulation of government-sponsored enterprises was relevant to this new focus. And it was clear. These attacks were not targeted simply at office buildings but at symbols of the nation’s financial strength and prosperity. While the terrorists brought down the offices which housed many successful financial institutions and killed thousands of innocent people, they did not destroy the system that these people built and maintained through hard work. Therefore, I will talk about the strength and resilience of our nation’s housing finance system, particularly Fannie Mae and Freddie Mac, in this war on terrorism.

Immediately following the tragedy of the terrorist attacks, and as events continue to unfold, OFHEO has been gauging the impacts on Fannie Mae and Freddie Mac. I want to assure you that both Enterprises have continued to operate effectively and remain in safe and sound condition throughout this crisis.

As a safety and soundness regulator, it is OFHEO’s responsibility to ensure the Enterprises operate prudently, which includes quality risk management practices and sophisticated contingency plans. The risk management practices and planning employed by Fannie Mae and Freddie Mac paid real dividends throughout this time and have enabled the Enterprises to be a source of strength and liquidity for the U.S. housing finance system.

The terrorist attacks will undoubtedly have real impacts on our economy, both in the short-term and over the longer-term, but there was real and immediate trauma imposed on our financial system by the September 11<sup>th</sup> events. The loss of life, telecommunications and trading capacities by so many major players challenged the capital markets' infrastructure and the payments system. For instance, many

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obligors temporarily lost their technical ability to pay on time, leaving those counting on receiving payments caught short. Another example was the challenge associated with settling financial transactions in the aftermath of the attacks. Fannie Mae and Freddie Mac, while geographically removed from the attacks, were not immune from the market upheavals. OFHEO has been closely monitoring the Enterprises' conditions and operations throughout this period with our examiners on-site assessing the developments and the Enterprises' response to each development.

As you might guess, there were disruptions to the Enterprises' normal operations, but there was nothing that threatened their safety and soundness. In general terms, the problems encountered were solved through alternatives and work-arounds. Let's look more closely at September 11<sup>th</sup> and the following days.

In the first few days following September 11<sup>th</sup>, the Enterprises' pressing concerns were making certain that any settlement and liquidity issues were addressed. Their focus was in three basic areas: First, make certain the market for conforming loans was open-for-business and liquid – this was accomplished by ensuring their automated systems were operating and accessible and that the cash window was open for business as usual; second, address the numerous operational issues that were coming up; and third, manage their liquidity positions effectively to be prepared for normal business operations and any unusual demands that might be presented. The Enterprises were successful in all three areas.

It was important for the Enterprises to address any operational concerns since the monthly settlement for Class A Mortgage-backed securities was scheduled for Monday, September 17<sup>th</sup>, the date for the re-opening of Wall Street. This is the largest category of MBS, and it includes all 30-year conventional securities with coupons of less than 9%. On Wednesday, September 12<sup>th</sup>, there was a call between the dealer community and the Mortgage Backed Securities Clearing Corporation. During that call, it was decided that the settlement date for September should not be moved. In the midst of all the turmoil, imagine what needed to be accomplished for a successful settlement involving market-makers and customers who had been dislocated by the attacks. In the end, an ordinary settlement took place under extraordinary circumstances.

In addition, the Enterprises moved to keep their debt issuance programs as close to normal as possible. During the week of September 11<sup>th</sup>, Fannie Mae continued with its discount note program and announced the resumption of its Benchmark Program for the following week. On Friday, September 14<sup>th</sup>, Freddie Mac successfully auctioned \$5 billion in two-year Reference Notes.

We were concerned about the success of these transactions since the confidence of investors in the secondary mortgage market might have been shaken if there were any significant problems. But through the hard work of many people at the Enterprises and on Wall Street, the settlement and auctions went smoothly. Keeping the secondary mortgage market operating demonstrated that our housing finance system was operating and healthy.

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While the initial attention was on keeping the doors open and money flowing to borrowers, there remained a need to address longer-term issues. The Enterprises and OFHEO are carefully assessing numerous strategic business issues such as the effect of lower interest rates, a steeper yield curve, convexity issues, and changes in counterparty exposures.

Throughout this entire period, OFHEO has been working closely with the Enterprises. Our examiners are on-site and remain in daily contact with managements of the Enterprises. Fortunately, our regulatory program is dynamic and able to immediately adapt and capture concerns introduced unexpectedly. In addition, our group of highly skilled examiners is experienced in dealing with “event risk.” The strengths of OFHEO’s personnel positioned OFHEO to be effective as a safety and soundness regulator in responding to events on and since September 11<sup>th</sup>.

While we are all aware of terrorism’s impact on many industries, notably the travel, and related industries -- what about its impact on the housing industry? Higher consumer uncertainty has been reflected in declines of mortgage applications for home purchases. The recent slowing pace of home price appreciation will almost certainly continue as a result of the attacks. At the same time however, further declines in mortgage interest rates, which are now almost 2 percentage points below their peaks in the Spring of last year, are creating surging refinance volumes.

These effects may be relatively short-lived. A return of consumer confidence, coupled with the stimulative effects of very low interest rates and increased Federal spending, could generate a sharp recovery early next year. If that happens, interest rates could rise substantially later in the year. Alternatively, though, further terrorism or consumer retrenchment could deepen and extend the current downturn in the economy. As Alan Greenspan said yesterday, it is just too soon to tell.

Rapid changes in the economy create challenges, but also sometimes opportunities for the Enterprises. It is our role to ensure the outcome is managed prudently. A decline in interest rates induces mortgage refinancing, which results in the replacement of higher yielding mortgage with lower earning ones in the Enterprises’ asset portfolios. That tests the adequacy of call provisions and options in the Enterprises’ funding structures that permit them to reduce their borrowing costs as yields decline. It also requires that they obtain new hedges to protect against further declines. In doing so, though, they must maintain protection against the possibility that a sudden increase in interest rates could leave them with lower-earning assets and higher funding costs. These risks may be offset if, as is often the case, greater uncertainty increases the spreads between mortgage yields and their own cost of funds.

Another obvious potential problem for the Enterprises is increased loan defaults. In recent years, with a strong economy and rapidly increasing house prices, loan losses have been exceptionally mild. Higher unemployment rates will increase delinquencies and ultimately loan defaults. But the recent increases in house prices mean that borrowers generally have accumulated solid equity in their homes. Unless home values decline, that equity likely will help keep losses from rising to very sizable magnitudes. But a prolonged recession with persistent weakness in house prices could raise credit costs appreciably. Increased volumes in recent years of cash-out refinances, very high loan-to-value loans, subprime loans, and use of new loss mitigation strategies have not been fully tested by cyclically weak

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housing markets. Although the Enterprises have relatively little exposure to the most vulnerable loans — subprime loans and loans with LTVs above 97 percent — diligence is necessary in managing the risk of substantial loan losses.

OFHEO's examinations of Fannie Mae and Freddie Mac require that they maintain and operate quality risk-management programs to deal with those various scenarios. Our examiners are constantly evaluating and testing transactions, systems and business practices to make certain the Enterprises are operating effectively and prudently. Our prudential standards expect quality planning and our examiners carefully evaluate the Enterprises' business continuity plans. Where we find deficiencies, we require remedies. But we also share with the Enterprises situations where they can further strengthen their operations even when there are no safety and soundness concerns. I am pleased that through the efforts of Enterprise management and OFHEO's oversight, Fannie Mae and Freddie Mac employ quality risk management practices and they each conduct state-of-the-art planning.

As we move beyond the events of September 11<sup>th</sup> and we consider their potential longer-term impact on the Enterprises, we have two primary focuses. Our first is on understanding the "lessons learned" from the events. Along with the Enterprises, we will be considering a series of questions surrounding issues that arose from the attacks – for example:

- what went wrong;
- what went right;
- what could have gone wrong but didn't only through good fortune, which may be elusive the next time;
- what lessons can be learned from others about technological and physical security.

Once we have finished analyzing the lessons learned, we will work with the Enterprises in evaluating any resulting recommendations.

The second area of focus will be on the business challenges that may be accentuated as a result of the attacks. Earlier, I mentioned the likelihood of a prolonged period of economic weakness, a possibility that any good regulator has to prepare for. A weak economy clearly has implications for homeowner equity and a borrower's ability to repay. The possibility for structural imbalances in the Enterprises' books of business requires well-conceived and prudently executed asset/liability management, funding strategies, and hedging strategies.

Because our Supervisory Program evaluates the full spectrum of the Enterprises' risks, the problems that may result from the current economic outlook are already being evaluated. For example, we have an examination team dedicated to constantly evaluating and testing changes in the performance of the mortgage portfolio and loss mitigation programs. Further, our credit examiners carefully evaluate risk-sharing strategies, credit hedging strategies, and the quality of counterparties.

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On the market risk side, there are always challenges in appropriately managing the asset and liability portfolios at the Enterprises and their portfolio rebalancing needs. OFHEO has a team of examiners that work full-time, on-site at the Enterprises evaluating interest rate risk, liquidity management tools and activities. We employ a very proactive approach that can't wait upon published results.

While we all remember the events of recent weeks, I want to reassure you that Fannie Mae and Freddie Mac remain safe and sound. As events continue to impact the economy, OFHEO will continue to provide oversight of the Enterprises to ensure they are able to provide liquidity to the nation's housing markets. Thank you for the opportunity to visit with you and I would be glad to answer any questions you might have.

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