



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

# ***NEWS RELEASE***

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**Speech of Jimmy Barton  
Deputy Director  
Office of Federal Housing Enterprise Oversight before the  
National Real Estate Lending Conference and Marketplace  
America's Community Bankers  
Scottsdale, Arizona  
February 11, 2002**

Good afternoon. I'm pleased to be here to speak with you today. Our Director, Armando Falcon, is tending to family business and sends his regrets that he is not able to attend your conference, but I appreciate the opportunity to meet with you and look forward to sharing some of OFHEO's important developments with you today.

As you may all know, during the past year, homeownership in America reached an all-time high -- 68 percent -- and the housing sector turned out to be the safe harbor in our economy. In 2001 the average American home posted a healthy appreciation of 37 percent over the past five years. In fact, since 1980, the average American home appreciated 167 percent -- substantially more than general inflation during that period -- according to OFHEO's third quarter house price index.

As the safety and soundness regulator for Fannie Mae and Freddie Mac, the two major providers of mortgage financing -- with combined portfolio holdings and guarantees of \$2.6 trillion -- I'd like to talk to you about what OFHEO has been doing to ensure the Enterprises' safety and soundness during this period of growth.

OFHEO too, had an exceptional year in 2001. We overcame some major hurdles and have undergone a culture change of sorts -- from creating to implementing. We completed our risk-based capital regulation, which will subject the Enterprises to a state-of-the-art, world-class standard; we have nearly completed our regulatory infrastructure project which, among other

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things, includes a formal process where OFHEO could take action before capital is impaired at either Enterprise; and finally, we are pleased that the President's Budget recommends removing OFHEO from the Congressional appropriations process. This will allow OFHEO the flexibility to keep pace with the Enterprises' changing risk profiles and growth and puts us on par with other financial safety and soundness regulators such as the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS). In Washington, where issues such as Enron and September 11 serve as the backdrop, I want you to know that OFHEO has been diligent in its supervision of the Enterprises.

With the implementation of our risk-based capital regulation, our dedicated examination program and research initiatives, Fannie Mae and Freddie Mac are subject to one of the most sophisticated oversight regimes anywhere. I'd like to provide you with the most recent developments in OFHEO's oversight of the Enterprises.

This past Fall, on September 13, 2001, OFHEO published its final risk-based capital rule in the *Federal Register*. The rule ensures the Enterprises have enough capital on hand to weather extreme financial downturns over a 10-year period. The rule is comprehensive, it is forward-looking and it undertakes what has not been done before. The risk-based capital regime is advanced and involves the most complex financial modeling and risk measurement ever attempted by a government agency. Fannie Mae and Freddie Mac will be subject to what we believe is the most sophisticated and risk-sensitive capital measures of any financial institution.

As you may know, while the rule became *effective* September 13, 2001, OFHEO has a one-year implementation period before the rule becomes *enforceable* in September 2002. The Director stated that we would move quickly to make adjustments if they were needed. In December we published a Notice of Proposed Rulemaking and received 48 comment letters. After careful consideration, we proposed adjustments to the stress test's treatment of counterparty risks on securities held by the Enterprises, mortgage credit enhancements, and derivative contracts; on new Enterprise debt issued when assets outlast liabilities during the stress test; and on multifamily loan losses. These proposed changes were transmitted to the Office of Management and Budget (OMB) February 1. We think these changes will help tie the capital requirement even more closely to risk.

OFHEO's next step is to publish numbers that reflect how the Enterprises fare under the new capital requirements. The Director has stated that he expects to do this sometime in June of this year, not for enforcement purposes but for the sake of transparency. OFHEO will publish an enforceable capital classification of the Enterprises after September 13 of this year.

I'd like to take this opportunity to briefly explain our views on risk-based capital. Congress charged OFHEO with developing this very difficult and complex rule. But that is not the end of the process; it is the beginning. It is imperative that we continue to review and revise where appropriate, the operation of the rule. Over time, new methods of measuring risk may gain acceptance, new types of businesses may evolve that require different measurements and new economic and social changes may affect the business environment in which the Enterprises operate.

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Bank regulators have amended their risk-based capital rules over 35 times in the past 14 years. While we don't envision anything that frequent for risk-based capital, we must maintain a living document, one that undergoes changes when needed after careful and deliberate consideration. Because of the challenge of tying risk to capital, we will constantly keep abreast of risk measurement techniques and the risks attached with evolving products or methods of offering products such as the Internet.

To implement this capital rule, OFHEO created a task force. This group has taken the one-year implementation cycle and broken it into specific tasks to refine and enhance the model to support its ongoing functionality. This task force is working closely with the Enterprises to ensure transparency, to ensure they understand the rule and software, and to ensure their ability to manage risks and ultimately, capital adequacy. We have accomplished much to date with this process. OFHEO staff has been working diligently to resolve all the issues that have arisen.

Safety and soundness examinations are a cornerstone in OFHEO's regulation of the Enterprises. In 1997 OFHEO implemented our annual risk-based examinations of Fannie Mae and Freddie Mac. While our current examination program continues to work well for us today, we continue to identify ways to strengthen the existing program. In fact, we plan to double our examination staff in the next three years to focus on emerging risks and to plan for the next decade.

Just as we have stated our commitment to improving the risk-based capital rule, we also feel strongly about pursuing continuous improvements to our examination program. An important aspect of continuous improvement is the self-assessment process similar to the one suggested by the Basel Committee.

Our examiners continually look at factors such as the changes occurring in the markets and among the participants in the marketplace; the increased complexity of risk-taking and risk management; and the growing importance of the Enterprises to the housing market when assessing the short- and long-term effectiveness of our examination program. While we have concluded that our current examination program is strong, we have identified actions that will further strengthen the existing program and expand the role of examinations in the Agency's other regulatory programs.

First, we are building depth across the current examination teams. We will be adding depth to all the existing areas of expertise, such as credit, interest rate risk, derivatives, information technology, and internal controls, along with others. In particular, we will be adding substantially to the accounting expertise. This additional accounting expertise will allow us to provide even more scrutiny to the accounting practices being employed by the Enterprises.

We currently have cross-disciplinary teams staffed by specialists in the areas of the Enterprises' business activities and conversant in risk management techniques. While the expertise of these seasoned examiners is solid, we are providing more depth to these examination teams to

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keep up with the Enterprises' evolution. This depth will allow us to perform even more testing of transactions and risk management practices. Risk-based examinations require a balance between transaction-testing and the regulator's qualitative assessment for the processes that are necessary to identify, measure, monitor, and control risk exposures.

Second, we are expanding highly-specialized skill areas. Currently, we have solid coverage for the Enterprises' risk exposures. However, because we intend to evolve along with the marketplace and the Enterprises, we will expand our existing skill inventories, particularly in these areas. Consider the rapid developments in communications, computing capability, and information technology, and their roles in the development of ever-more sophisticated financial instruments and techniques. OFHEO's examiners will be able to effectively evaluate and analyze the Enterprises' transactions and their risk management tools and strategies. This evaluation and analysis requires seasoned specialists.

We have already begun this initiative by hiring seasoned econometricians in the examination group who work side-by-side with the other examiners to assist in the evaluation of credit risk models and interest rate risk models. This will provide even more in-depth examination of the models' logical operations. And since these are the models used by the Enterprises to select, price, and manage risks, examiners will be better positioned with prospective views about risk exposures and any potential vulnerabilities. Another example where we are adding specialized expertise is in the area of information technology. A wealth of new technologies and converged technologies are populating the landscape, and the architecture used to host and deliver these technologies is no longer proprietary. We need to add expertise in areas like information security and e-commerce. This expertise in our examination ranks will allow OFHEO to more accurately assess the risk exposures and risk management strategies being employed by the Enterprises.

Another action plan is to formalize the continuous improvement efforts within the examination program. We need to ensure the quality and objectivity of assessments and the integrity of the examination program. Work is currently being performed to enhance the knowledge repository that augments examiner judgments and leads to greater objectivity. In addition, we will expand upon our current benchmarking efforts to identify best practices and best-in-class performance. This knowledge and the regulatory tools being developed will enhance the quality of oversight provided to the Enterprises in determining their safety and soundness. Of course, I fully expect we will continue to streamline and strengthen our examination program well beyond the next couple of years to allow for changes that lie ahead and are unknown today. And I am confident that the culture at OFHEO will allow us to continuously improve our regulatory program.

Let me state clearly that our existing program is strong and state-of-the-art. But we are responsible for supervising two of the largest, non-bank financial institutions in the world and we will keep pace. President Bush's recommendation to remove us from the appropriations process is a solid step in this direction. Instead of planning two years in advance for our budget, OFHEO can now make real-time assessments to ensure our needs match the requirements of the Enterprises.

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Another component of our supervisory regime is our regulatory infrastructure project. Since the Director came to OFHEO in 1999, OFHEO has brought to fruition two very important components of its regulatory structure that strengthen our internal operations and our oversight of the Enterprises.

I know businesspeople feel that regulations are usually burdensome, but I would say that we believe we needed rules to give greater transparency to our operations, to help the public understand what it meant to say that the Enterprises were operating safely and soundly and to permit the Enterprises greater understanding of OFHEO's operations.

I want to talk about one of those rules, but let me summarize that we have issued final rules on assessments, flood insurance, our enforcement process, prompt corrective action, civil money penalties and executive compensation. We have also issued policy guidances on general safety and soundness responsibilities such as non-mortgage investments of the Enterprises and on the special attention that must be paid to information security. We will shortly finalize the project with a rule on corporate governance and on safety and soundness.

In our prompt corrective action rule, finalized last month, OFHEO addressed the operation of the capital-based intervention regime crafted in our statute. This rule set forth procedures and answered some open questions for the system that relates to declines in Enterprise capital. We have enunciated clearly our policies on the operation of prompt corrective action so the Enterprises have an understandable framework for how we would operate. But we also went a bit further. We crafted a new process called prompt supervisory response. As you know, institutions that get into trouble usually do so long before their capital is impaired. Our risk-based capital rule is designed to reflect problems much earlier than other types of capital requirements, but it focuses on only some of the problems that could develop. At OFHEO we have the strongest supervisory staff in the government as far as I'm concerned. They are the key to avoiding problems. By early detection and by working with the Enterprises, they provide the ever-present "eye" of the regulator and the opportunity to avoid problems before they become more serious. The examiners keep a constant information flow going between the Enterprises and OFHEO.

In the course of our strict supervisory program, developments may occur long before losses are encountered by the Enterprises or any loss of capital. It is appropriate that we commit to taking action at those times. We have undertaken a small, but important step in that direction.

The prompt supervisory response system involves two components— triggers, related to marketplace or internal Enterprise developments, and the process to which these triggers lead.

Simply put, OFHEO will look to non-capital events to prompt supervisory action. Among the triggers we have now are significant declines in Enterprise net income or net interest margin or a substantial increase in their delinquency rates. As an external measure, we look to a significant decline in our house price index.

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The triggers lead to a formal letter to the Enterprise seeking a response to the development. If that proves unsatisfactory, the process calls for a special review of the Enterprise and then a plan of action and finally, a “show cause” response of why OFHEO should not proceed to an enforcement action. In short, at an appropriate point, OFHEO is committing to undertake serious investigation, alongside its ongoing monitoring and supervision, that could lead to enforcement actions tied to non-capital measures. I hope we never have to do so, but this rule makes transparent the orderly process we have if we need to act. This should reassure the public that OFHEO is meeting its responsibilities. I believe this is an important step.

Our examination and regulatory activities must be complemented and enhanced by research and analysis. We have established a research program that will not only help us understand the Enterprises’ current risks, but will also broaden our understanding of recent changes and trends in home financing and mortgage-related financial markets. Current topics of interest include the performance of subprime loans, the measurement of house price changes, and a systemic risk study which I expect to release sometime this Spring.

While some of this work is for internal use only, where possible, we will disseminate research products through appropriate channels. One such channel will be a working paper series. Working papers will reflect the preliminary views and conclusions of our individual researchers, and not necessarily those of the Director or OFHEO. It will provide an opportunity to share our results with others on a timely basis and to receive comments from other researchers working in the same areas.

In conclusion, OFHEO is working on a number of initiatives to ensure the Enterprises are managing their risk. We believe strongly that our assessment of the Enterprises’ risk profiles accurately underscore that they are safe and sound and have adequate capital.