Testimony of the Honorable Armando Falcon, Jr.
Director, the Office of Federal Housing Enterprise Oversight
before the U.S. Senate Subcommittee on Housing and Transportation[1]
May 8, 2001

Chairman Allard, Senator Reed, Members of the Subcommittee, my name is Armando Falcon and I am the Director of the Office of Federal Housing Enterprise Oversight, or OFHEO. I commend the Subcommittee for conducting this oversight hearing on the safety and soundness and capital adequacy of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (or Fannie Mae and Freddie Mac) and thank you for the opportunity to testify this morning.

As you know, following the savings and loan crisis and other disruptions which occurred in the nation's financial system in the late 1980s, Congress determined that it was prudent to establish a formal, full-time safety and soundness regulator for Fannie Mae and Freddie Mac to protect against similar events occurring at the Enterprises. To achieve this objective, OFHEO was established as an independent entity within the Department of Housing and Urban Development (HUD). OFHEO was charged with ensuring the safety and soundness and capital adequacy of the Enterprises, while HUD was given responsibility for regulating the Enterprises' activities – so-called "mission" regulation.

As the Director of OFHEO, I am pleased to report that Fannie Mae and Freddie Mac are currently in good financial health, are well-managed, and have exceeded minimum capital requirements every quarter the requirements have been in place. These conclusions are based on the findings of our broad regulatory system which includes a highly-regarded examination program and quarterly minimum capital requirements. While the current situation is good, I want to assure you that OFHEO remains vigilant to ensure that this financial strength and well-being will not be jeopardized by changes in the economy, the markets in which the Enterprises operate, or even the Enterprises themselves.

As you conduct oversight hearings, it is important to do so with an understanding of the responsibilities Congress gave OFHEO. As I mentioned earlier, OFHEO's primary mission is to ensure the capital adequacy and financial safety and soundness of Fannie Mae and Freddie Mac. In fulfilling this mission, OFHEO helps ensure the Enterprises are positioned to fulfill their Congressionally-mandated missions.

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

When considering OFHEO's oversight, it may be useful to compare our program with contemporary global thinking regarding large financial institution risk management and regulation. The Basel Committee on Banking Supervision is an obvious point of reference. The Basel Committee, which is a group of central bankers and international financial regulators, has endorsed "three pillars" of banking supervision, consisting of: 1) supervisory review; 2) capital requirements; and 3) market discipline. While the nature of the institutions OFHEO regulates necessitate some adaptations to Basel's recommendations, our regulatory structure implements contemporary global risk management thinking. Specifically, OFHEO:

- conducts comprehensive annual examinations of both Enterprises;
- ensures compliance with minimum capital requirements and will soon impose a risk-based capital standard;
- conducts financial research on the Enterprises and the markets in which they operate; and
- has developed a formal regulatory infrastructure to ensure transparency and enforceability of its rules and regulations.

I believe it will be useful to expand on these areas and report, where appropriate, on what we have found.

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 annual examinations in our annual Report to Congress. This is unique among financial regulators and is a powerful tool in influencing the behavior of the companies we regulate. While that report is not due until June 15, I am pleased to tell you today that both Enterprises have met or exceeded safety and soundness standards in all examination program areas.

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 risk management areas 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

Quite simply, our examination group provides me with an accurate and timely understanding of the Enterprises' financial condition on an ongoing basis and provides the Congress with an annual report card on how the Enterprises are managing their risk.

Capital

While examinations are an important part of oversight, it is by no means the only area in which Congress provided OFHEO with significant regulatory responsibility. The 1992 Act also directed OFHEO 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 Fannie Mae and Freddie Mac have maintained a capital base sufficient to meet statutory minimum capital requirements. These requirements utilize a leverage test which is similar to existing capital requirements for banks and thrifts.

The statutory leverage test is quite simple. 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. Generally, an Enterprise's assets are multiplied by 2.5% and outstanding guarantees of mortgage-backed securities and other off-balance sheet obligations are multiplied by .45%.

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. If core capital exceeds the requirement, the Enterprise is considered adequately capitalized. However, if a capital shortage exists, the Enterprise is classified as either undercapitalized, significantly undercapitalized, or critically undercapitalized, based on the size of the deficit and OFHEO's enforcement regime is triggered.

I am pleased to report that 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 – The 1992 Act called for a second capital test to be applied to both Enterprises – a sophisticated risk-based capital requirement using a stress test. The stress test simulates dramatic changes in interest rates and the highest historical 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 using the stress test, the statute requires an additional 30 percent capital charge for management and operations risk. This add-on is also consistent with the opinion of the Basel Committee, which also calls for a provision for operations risk.

I recognize that OFHEO is long-overdue on this rule. So when I took office in October 1999, I made finalizing the rule my top priority. Last fall, we finished the text of the rule, continued work on having the computer code, which effectualizes the rule, independently tested and verified by an accounting firm. In addition, we continue to assist Fannie Mae and Freddie Mac in meeting their responsibility to process a vast amount of data in the form needed to run the test.

Early last month, we submitted the rule to the Office of Management and Budget (OMB) for review. Once the rule is cleared by OMB and the rule is published in the Federal Register, Fannie Mae and Freddie Mac will be subject to the most sophisticated regulatory capital standard of any financial institution in the world. 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. Many banks and thrifts have asserted that their standard requires greater capital than that which applies to the Enterprises.

But the proposed 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.

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 understand 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 soon 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. I assure you, OFHEO will remain vigilant in continuing to fulfill our Congressionally-mandated mission.

Let me again thank Chairman Allard, Senator Reed, and the other members of this Subcommittee for the opportunity to provide my views on this important topic.