



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

NEWS RELEASE

FOR IMMEDIATE RELEASE

July 23, 2002

Contact: Stefanie Mullin

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www.ofheo.gov

**ORAL STATEMENT OF
THE HONORABLE ARMANDO FALCON, JR.
DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT
SPONSORED ENTERPRISES
U.S. HOUSE OF REPRESENTATIVES**

JULY 23, 2002

Mr. Chairman, Representative Kanjorski, and Members of the Subcommittee, I am pleased to be here today to report to you on OFHEO's activities and the safety and soundness of Fannie Mae and Freddie Mac.

This is an important time in the short history of the Agency, as OFHEO has just entered its tenth year. OFHEO began operating when its first employee, the first director, took office on June 1, 1993.

The Agency was built from the ground up. It had to acquire staff and address hundreds of administrative issues involved in establishing an agency infrastructure. OFHEO needed to procure office space, equipment, computers, telecommunications, and other logistical support for the lawyers, economists, examiners and administrative personnel who would carry out the duties of the Agency.

In its early years, OFHEO's experienced staff worked to develop an in-depth understanding of the operations of the Enterprises. OFHEO grew from a one-person agency into a strong and well-rounded regulator, fully capable of meeting its regulatory responsibilities.

While the Agency was being built, it was still obligated to fulfill its mission of regulating two extremely large and enormously complex financial institutions.

[WRITTEN TESTIMONY ATTACHED FOLLOWING]

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OFHEO's mandate is to ensure the Enterprises are safe and sound and adequately capitalized. In so doing, OFHEO helps ensure the Enterprises are able to provide liquidity to the mortgage markets and promote home ownership.

I am pleased to report that OFHEO is meeting its mandate. We have found the Enterprises to be safe and sound and adequately capitalized. The Enterprises are providing unprecedented levels of liquidity and stability to the mortgage and housing markets. OFHEO looks forward to its second decade of public service.

OFHEO's regulatory regime consists of three pillars. These are examination, capital standards, and research.

I will refer the Subcommittee to my written testimony for a discussion of these topics and will use the remainder of my time to focus on the risk-based capital rule and disclosure.

OFHEO's risk-based capital standard is unique among financial regulators. Unlike ratio-based capital rules, OFHEO's standard is based on a 10-year stress test. A stress test measures risk in the context of a company's overall portfolio, including the company's risk management activities. An Enterprise can comply with OFHEO's risk-based capital standard by reducing risk or raising capital, or a combination of both.

The risk-based capital rule became effective last September.

At that time I appeared before the Subcommittee and was urged to consider whether refinements to the rule were necessary and, if so, to act quickly. I subsequently determined that modifications were appropriate and the rule was amended after a public rulemaking during the fourth quarter of last year. We will use the rule to classify the Enterprises beginning with the third quarter of this year.

In the interest of public disclosure and regulatory transparency, last month OFHEO released the results of the risk-based capital test using first quarter 2002 Enterprise financial data. Attached to my testimony is the press release announcing the results.

Both Enterprises passed the stress test due to effective risk management, including extensive interest rate hedging, and the first quarter's economic environment. Interest rates are low, home values are rising, and borrower defaults are minimal. An Enterprise's risk-based capital requirement will vary from quarter to quarter, depending on the Enterprise's risk management decisions and market conditions.

I have taken a very open approach to the implementation of the stress test. I decided to release the actual stress test computer model, or source code, to the public. I rejected an interpretation of the one-year implementation period, which would have prohibited the release of any results during that time period. And when I announced stress test results for the first quarter of this year, I didn't just issue a pass-fail notice, I released the full results for both up rate and down rate scenarios.

However, that openness must be balanced with some caution to ensure that no misleading information enters the public domain. That is why OFHEO will not be releasing to the public any stress test results other than the official quarterly announcements. That of course does not override this Subcommittee's

right to information. And so I have promptly, ahead of schedule, supplied the Subcommittee with all the information it has requested. My only request was that the Subcommittee respect the confidentiality of the information.

OFHEO considers the information confidential for a variety of legal reasons, but superior to all those considerations is concern about releasing misleading information about the Enterprises' financial condition that could disrupt the markets. We have developed a strong, rigorous, risk-based capital standard. Now the Enterprises have one year to adapt and be in compliance before we enforce it. Congress wanted us to set up a new capital standard, not a trap. That is why it would be inappropriate to release results before the rule, as amended, was in place.

I will now turn to corporate disclosure. OFHEO's safety and soundness responsibility includes an obligation to ensure that Enterprise financial disclosures are adequate. Our Agency began a comprehensive review of Enterprise disclosure in April 2002.

In May, OMB requested that OFHEO specifically consider a rule that would ensure that Enterprise financial disclosures were comparable to those of other publicly held companies.

In June, I responded to OMB's letter. I agreed that voluntary compliance was inadequate and that given the Enterprises' exemptions from the securities laws, OFHEO needed to promulgate enforceable rules in this area. I am pleased that OFHEO's objective will now be accomplished in a most efficient manner. The Enterprises voluntarily agreed to subject themselves to mandatory regulation by the SEC under the Securities Exchange Act of 1934.

I would like to highlight several key points about the agreement: The Enterprises will become registered companies bound by the '34 Act. Absent the agreement, OFHEO would have adopted its own disclosure regime based on the securities laws.

Second and most significant, the disclosures will be reviewed by the SEC and OFHEO. Currently, it is the Enterprises that determine what corporate information is material and must be disclosed. Once registered, that will change and the ultimate arbiter of what must be disclosed will be the SEC and OFHEO acting in the public interest.

Finally, the disclosure reports will be available from the SEC, the central repository for corporate disclosure reports of all registered companies.

In order to facilitate the application of the '34 Act to the Enterprises, OFHEO will promulgate a rule concerning the filing of all required periodic reports. Registration with the SEC does not in any way limit OFHEO's ability to act in the interest of safety and soundness. In fact, as part of the rule I've mentioned, OFHEO is considering requiring supplemental disclosures beyond those required by the SEC.

In addition, OFHEO, the SEC and Treasury will conduct a review of disclosures relating to the offering of mortgage-backed securities by the Enterprises and other issuers. The review will consider the appropriate manner for creating a more level playing field, and greater comparability of disclosures that will enhance Enterprise safety and soundness.

I would note that OFHEO's goal is disclosure, not registration. After all, disclosure is the rationale underlying registration. Accordingly, OFHEO will not pursue a registration regime at this time. If our disclosure goals can be met without registration, then registration is unnecessary. However, until this review is completed, we should not rule out registration in some form as a possibility. In response to the Subcommittee's request last week, I have conferred with the SEC and Treasury and we have agreed to make every effort to complete the review by year-end.

Mr. Chairman, you have been a strong supporter of our budget requests in the past and have indicated support for permanent funding of OFHEO. OFHEO, as the Agency responsible for the financial health of two companies with combined credit exposure of \$3 trillion dollars, should be permanently funded, as are the other safety and soundness regulators. There is simply too much at stake not to take this prudent step. The Administration supports this in its Fiscal-Year 2003 budget request for OFHEO.

I urge the Subcommittee to support legislation that will bring about this result.

In conclusion, as I stated earlier, Fannie Mae and Freddie Mac are safe and sound and well capitalized. We all concede their financial health at the beginning of any discussion about them. We are all able to have this discussion against such a healthy backdrop, due in part to the hard work of OFHEO's employees.

I don't mean to minimize the efforts of the Enterprises' management, but through our regulatory program, we constantly probe for weaknesses and vulnerabilities, and ensure that the Enterprises maintain the highest standards of sound management.

We have a state-of-the-art risk-based capital rule in place. We are expanding our examination program, building our regulatory infrastructure, and conducting valuable research. The OFHEO of 2002, which I am proud to direct, gets the job done.

Thank you, Mr. Chairman. I look forward to answering any questions the Subcommittee may have.

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OFHEO was established as an independent entity within the Department of Housing and Urban Development by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title XIII of P.L. 102-550). OFHEO's primary mission is ensuring the capital adequacy and financial safety and soundness of Fannie Mae and Freddie Mac.



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SPONSORED ENTERPRISES
U.S. HOUSE OF REPRESENTATIVES¹**

JULY 23, 2002

Mr. Chairman, Representative Kanjorski, and Members of the Subcommittee, I am pleased to testify before the Subcommittee today on the Office of Federal Housing Enterprise Oversight's (OFHEO) safety and soundness oversight of Fannie Mae and Freddie Mac (the Enterprises). In my testimony, I intend to discuss the specifics of the Agency's oversight of the Enterprises but first I would like to speak to the overall condition of the U.S. housing market and the Enterprises.

The U.S. Housing Market Continues to Flourish

The housing market has shown remarkable strength over the past 18 months, despite the September 11th attacks and recession. Low mortgage interest rates, averaging less than 7 percent, are largely responsible. Recent declines to 6.5 percent bode well for continued housing and mortgage market strength in the near term. Last year, housing starts exceeded 1.6 million units, and so far this year they are on pace for nearly 1.7 million units, the most in 16 years. Similarly, home sales in 2001 totaled 6.2 million units, the best year ever, and are running at more than 6.5 million this year.

¹ The views expressed herein are my own and do not necessarily represent the views of the Secretary of Housing and Urban Development or the President. The Office of Federal Housing Enterprise Oversight (OFHEO) is an independent office within the Department of Housing and Urban Development (HUD) charged with ensuring the safety and soundness of Fannie Mae and Freddie Mac (the Enterprises).

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Spurred by heavy refinancing activity, last year's originations of single-family mortgages doubled the previous year's level, topping the \$2.1 trillion mark. This year's total likely will be lower, but second only to 2001. The expansion in home sales has translated into increased homeownership. The homeownership rate reached a record high of 68 percent last year.

Home values, stimulated by heavy demand, have continued their upward trend, albeit at more moderate rates. Single-family home prices, as measured by OFHEO's House Price Index (HPI), increased 6 percent from the first quarter of 2001 to the first quarter of 2002. During the previous 4 quarters, appreciation was 9.3 percent.

The Enterprises' Financial Performance

Against the backdrop of a strong U.S. housing market, the Enterprises also had a very successful year in 2001, and a strong first half this year. Both Enterprises' mortgage purchase volumes and securitizations were at record levels last year. Favorable market conditions also stimulated growth in the Enterprises' mortgage asset portfolios. The combined assets of the Enterprises increased 25 percent in 2001. That portfolio growth, along with widening spreads between asset yields and debt yields, enhanced the Enterprises' operating earnings. This year, asset growth and the flow of new securitizations have moderated, but profits continue to benefit from very low short-term funding costs. Combined operating profits of the Enterprises for the 4 quarters ending March 31 were \$9 billion, 23 percent higher than during the previous 4 quarters. Such income growth has enabled the Enterprises to continue their long histories of high rates of return on equity.

The Enterprises have continued to actively manage their exposure to credit risk. The proportion of single-family mortgages purchased that were evaluated using the Enterprises' automated underwriting systems prior to sale approached or exceeded 60 percent in 2001. The Enterprises have also continued to limit their exposure to mortgage credit risk by obtaining credit enhancements on higher-risk single-family loans. Credit losses – foreclosed property expenses plus net loan loss charge-offs – have remained very low at the Enterprises despite the growth in their owned and guaranteed mortgage portfolios and the generally weak economic conditions. Combined Enterprise credit-related losses were only \$151 million on an exposure in excess of \$3 trillion over the 4 quarters ending March 31.

Despite sizeable changes in interest rates last year and this year, the Enterprises have effectively managed their exposure to interest rate risk. This was accomplished by hedging asset acquisitions - - making substantial use of derivatives, rebalancing those hedges as interest rates changed, and continuing judicious risk management oversight.

Finally, OFHEO -- as required by its statute -- reported to Congress on June 15 the results and conclusions of its ongoing examination of the Enterprises for 2001. Those results and conclusions stated that the Enterprises were operating in a safe and sound manner. OFHEO's examination teams are on-site at the Enterprises continuously, evaluating their operations with assessment factors covering more than 160 features of safety and soundness.

OFHEO's Safety and Soundness Oversight

I'll now turn to the specifics of OFHEO's financial safety and soundness oversight of the Enterprises. Some like to talk about this form of oversight as having three pillars that help ensure the financial safety and soundness of the regulated entities at issue. These pillars, risk-based capital requirements, market discipline, and supervisory review, are used together to ensure the Enterprises operate in a safe and sound manner. I refer to them as legs on a stool and include research and analysis, which in many respects ties the first three together. With risk-based capital requirements complete, the Agency is moving further ahead in other areas - - some of which you have specifically asked me to address today.

Risk-Based Capital Requirements

OFHEO's risk-based capital standard is unique among financial regulators. Unlike ratio-based capital rules, OFHEO's standard is based on a 10-year stress test. A stress test measures risk in the context of a company's overall portfolio, including the company's risk management activities.

OFHEO's stress test simulates an Enterprise's financial performance over a 10-year period under severe economic conditions. Key conditions describing the severe economic conditions used in the Agency's stress test are defined in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the '92 Act) and further specified in OFHEO's risk-based capital regulation. These conditions include high levels of mortgage defaults, with associated losses and large, sustained movements in interest rates. To meet OFHEO's risk-based capital standard, each Enterprise must have sufficient capital to survive the losses under these severe economic conditions plus an additional 30 percent for unspecified management and operations risks.

The stress test aligns the capital requirement for each Enterprise with its specific risk profile. In doing so, it provides Enterprise management with incentives to carefully manage risk. For example, risk reduction activities -- such as the effective use of interest rate derivatives -- work to lower the requirement. Conversely, activities that increase risk -- such as taking on unhedged interest rate exposures -- serve to increase the requirement.

An Enterprise's risk-based capital requirement is also sensitive to changing economic conditions that are beyond the control of management. For example, house price growth influences mortgage credit losses, and thus the requirement. Changes in interest rates also affect the risk-based calculation, e.g., such a change can effect mortgage prepayments and income generated from adjustable rate mortgages.

The dynamic nature of the stress test facilitates OFHEO's understanding of how changes in the economy could impact the Enterprises. It will also help OFHEO uncover changes in capital needs before there could be a significant impact on the Enterprises' balance sheets. In contrast, capital standards based on static ratios are affected only after economic changes impact the balance sheet.

OFHEO's stress test provides the Enterprises with transparency, certainty and flexibility in meeting their regulatory capital requirements. Both Enterprises have copies of OFHEO's stress test and have incorporated the test into their everyday business processes. An Enterprise can comply with OFHEO's risk-based capital standard by reducing risk or raising capital, or a combination of both. Therefore, each Enterprise can follow its own unique strategy to comply with the standard.

The risk-based capital rule became effective last September. At that time, I appeared before the Subcommittee and was urged to consider whether refinements to the rule were necessary and, if so, to act quickly. I subsequently determined that modifications were appropriate and the rule was amended after a public rulemaking during the fourth quarter of last year. We will use the rule to classify the Enterprises beginning with the third quarter of this year.

Per our enabling statute, the rule is not enforceable until September 13, 2002. OFHEO will not use the risk-based capital standard to classify the Enterprises for regulatory purposes until the end of the third quarter 2002. These results will be released in December. Starting then, an Enterprise will need to meet both its risk-based and minimum capital requirements (a more bank-like leverage based requirement) to be classified as adequately capitalized. Until then, it need only meet its minimum requirement.

In the interim, I made a determination -- in the interest of public disclosure and regulatory transparency -- to publicly release first quarter 2002 numbers. These are:

FANNIE MAE

As of March 31, 2002, Fannie Mae's risk-based capital requirement was \$20.228 billion. Fannie Mae's total capital of \$26.290 billion on that date exceeded the risk-based capital requirement by \$6.062 billion. However, Fannie Mae's **higher** minimum capital requirement of \$24.571 billion was binding.

FREDDIE MAC

As of March 31, 2002, Freddie Mac's risk-based capital requirement was \$5.680 billion. Freddie Mac's total capital of \$21.360 billion on that date exceeded the requirement by \$15.680 billion. However, Freddie Mac's **higher** minimum capital requirement of \$19.390 billion was binding.

With the proposal of the rule in 1999, the Enterprises began a program of managing their activities to ensure they would meet the requirements of the rule. Their prudent measures, combined with favorable economic conditions, have resulted in their passing the standard at this stage of the one-year implementation period. These results demonstrate how the test works with respect to the different companies. Freddie Mac's stress test results were especially strong because its hedges enabled it to maintain positive net interest income through nearly the full stress period in both interest rate scenarios. This points to nothing more than the fact that the two companies hedge interest rate risk differently.

Corporate Disclosure

I will now turn to corporate disclosure. OFHEO's safety and soundness responsibility includes an obligation to ensure that Enterprise financial disclosures are adequate. Our Agency began a comprehensive review of Enterprise disclosure in April 2002.

OMB requested that OFHEO specifically consider a rule as part of its action plan in May 2002; such a rule should contemplate the mandatory application by OFHEO of SEC rules to the Enterprises (similar to bank regulatory rules) along with additional disclosures that OFHEO felt would be appropriate. OFHEO has full authority as safety and soundness regulator to review this important topic and to undertake a range of supervisory actions.

In late June, I communicated to OMB the substantial progress the Agency had made in its review and responded to their May letter. Most significantly, I noted that our review had reached a point that it was clear to me that voluntary compliance was inadequate and that given their exemption from the securities laws, OFHEO needed to promulgate enforceable rules in this area. We are prepared to issue a rule requiring disclosures that would be, at a minimum, comparable to those of other publicly traded companies, further strengthen the safety and soundness of the Enterprises, and advance the President's 10-Point Plan for Corporate Responsibility.

I am pleased with recent developments in this area. The Enterprises' voluntary compliance with certain SEC registration act requirements is a significant move toward OFHEO's goal of assuring mandatory conformance with disclosure rules and assuring that the Enterprises maintain a "best practices" approach. OFHEO was pleased to participate in this initiative and will do its part to facilitate its implementation. Specifics of OFHEO's review, and the subsequent agreement, follow.

Specifics of the Disclosure Review Process

OFHEO reviewed Enterprise equivalents of SEC required periodic reports. They appear to have been produced pursuant to the requirements of SEC regulations, but we will defer to the SEC to determine if they officially meet the standards of disclosure demanded by the Commission.

Even if the voluntarily produced periodic report equivalents do meet SEC standards, however, a formal registration of the Enterprises should improve disclosures made to investors. I believe there are three very important reasons for this.

First, it will be **mandatory**. Today, the Enterprises voluntarily attempt to comply with SEC requirements for full and fair disclosure. With this agreement, they will be locked into such a program. Were it not for the voluntary agreement of the Enterprises to register with the SEC, OFHEO would have acted and adopted its own disclosure regime based on the securities acts.

Second, and most significant, the disclosures will be **reviewed** by the SEC for material adequacy. Currently, it is the Enterprises who determine whether and what corporate information is material and must be disclosed. Once registered, that will change and the ultimate arbiter of what must be disclosed will be the SEC and OFHEO. This will be the SEC in its review of the Form 10 registration statement and Enterprise periodic reports and OFHEO will determine if additional disclosures are required. Of course, registration under the Securities and Exchange Act of 1934 (The '34 Act) brings with it the full range of SEC enforcement authority.

Finally, the Enterprises' disclosure **will be available** from the SEC, the central repository for corporate disclosure reports of all registered companies. Today, Enterprise disclosures are provided to shareholders, investors and the public through various means-- paper documents, Internet and web site postings, wire service transmissions, or at their offices. This will be improved by availability in a central location. For example, since the Enterprises could not file insider transaction Forms Three and Four with the SEC, requests for the Enterprise equivalent documents had to be made to the Enterprises. Even though they ultimately were posted on the Enterprises' websites, I believe that it is important that the public have available a regulatory site to access such information for both companies.

The Process the Enterprises will Follow

The process for moving toward compliance with SEC rules will begin with the Enterprises filing a Form 10 Registration Statement. Once reviewed and effective, the entire spectrum of company reporting requirements contained in the '34 Act will apply to them. I believe this will produce many benefits.

1. One of the benefits to be obtained as the result of SEC registration should be a greater degree of uniformity in disclosures. This should facilitate comparison of the disclosures and financial statements of the Enterprises with each other and the comparison of Enterprise reports with those of other 12(g) registered companies. This uniformity will come about, in part, because all of the SEC required forms will have to be produced pursuant to the general rules regarding disclosures that are contained in SEC Regulation S-K.
2. Similarly, uniformity of disclosure should result in the area of financial statements required to be filed as a part of the Registration Statement under Section 12, in the Annual Reports under Section 13, and proxy and information statements under Section 14 that are governed by SEC Regulation S-X.
3. Periodic and other reports to shareholders under Section 13 will be required. This includes annual and quarterly reports (10K and 10Q), as well as special or current reports required because of material developments (8-K). SEC rules like 13a-1 governing the requirements of annual reports will apply for the first time.
4. Forward looking statements made in these reports will enjoy a safe harbor from liability if they comply with the provisions of Section 27A of the '34 Act, and Securities Exchange Act Rule 3b-6, governing liability for certain statements by issuers, provisions of law that until

this registration, did not apply to the Enterprises. Application of these rules will ensure a regulatory discipline is imposed on the Enterprises.

5. Provisions of Section 13 of the '34 Act and Rules 13b2-1 and 13b2-2 governing accounting records and issuer representations will require the Enterprises to keep and maintain books, records and accounts in certain forms and for certain periods of time to ensure compliance with the federal securities laws and other federal statutes as well, such as the Foreign Corrupt Practices Act. Although the Enterprises maintain their own records today, SEC examination and inspection authority will be brought to bear and will supplement OFHEO's examination program to ensure that appropriate record production and retention programs are in place.

6. Enterprise proxy solicitation will become subject to Section 14 and Regulation 14A governing the form of proxies and solicitation materials and the manner in which the solicitation is conducted.

7. Pursuant to Section 16 of the '34 Act governing insider transactions, the officers and directors of the Enterprises will file Form 3 Initial Statements of Beneficial Ownership of Securities in their companies and each transaction will generate a requirement to file a Form 4 Statement of Changes in Beneficial Ownership of Securities. Annually, they will have to file a Form 5 Annual Statement of Beneficial ownership.

8. Should either of the Enterprises choose to make a tender for another company, or be the subject of a voluntary one, their transaction will be subject to Section 14 of the '34 Act and Regulations 14D and 14E will govern the format of materials and the manner in which the offer is conducted.

9. Finally, SEC rules governing interaction of issuers with the financial community of analysts, institutional investors and others will apply for the first time. OFHEO shares the concerns of the SEC that the highest standards of fairness be observed regarding the Enterprises' disclosures of investment relevant information. Now, for the first time, the Enterprises will be formally subject to Regulation FD that requires a public company to release any information, when it chooses to do so, in a way that the general public has access to it at the same time as institutional investors and analysts.

Next Steps

In order to facilitate the application of the '34 Act to the Enterprises, OFHEO will promulgate a rule concerning the filing of all required periodic reports. Registration with the SEC does not in any way limit OFHEO's ability to act in the interest of safety and soundness. Accordingly, as part of the rule I've mentioned, OFHEO is considering requiring supplemental disclosures beyond those required by the SEC.

In addition, OFHEO, the SEC and Treasury will conduct a review of disclosures relating to the offering of mortgage-backed securities by the Enterprises and other issuers. The review will consider the appropriate manner for creating a more level playing field, and greater comparability of disclosures that will enhance Enterprise safety and soundness.

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I would note that OFHEO's goal is disclosure, not registration. Accordingly, OFHEO will not pursue a registration regime at this time. If our disclosure goals can be met without the need for registration, then registration is unnecessary. However, until this review is completed, we should not rule out registration in some form as a possibility. Finally, in response to the Subcommittee's request last week, I have conferred with the SEC and Treasury and we have agreed to make every effort to complete the review by year-end.

Examination Program

I will now turn to OFHEO's examination and supervisory review program. The Agency's examination program is continuous and conducted on-site. Results and conclusions are regularly communicated to the Enterprises' Boards of Directors and reported to Congress annually. The Agency's on-site examination process is augmented by formal surveillance and monitoring to provide context and greater focus for its on-site examination activities. These activities evaluate trends, analyze performance within the broader context of the marketplace and perform sophisticated analysis on features of risk at the Enterprises.

Key to the success of our effective examination program is an ability to keep pace with the speed of change in the financial markets and at the Enterprises. To do so, OFHEO must continuously improve its examination program and augment its examiners' skill expertise. In this connection, the Agency has a three-year plan to further enhance its skill palette and to position its teams of specialists to be prepared for areas of innovation and for emerging potential risks (e.g., E-Commerce, communication networks, augment evaluation of accounting practices). The Administration supports this plan.

Research and Analysis

In order to understand how changes in the market impact the Enterprises and conversely how changes in Enterprise operations impact the market, OFHEO also conducts sound and authoritative research and analysis. Much of our research builds on work already taking place within the other components of our regulatory regime and frequently builds upon work that has already been done.

The information and insights gained from our research and analysis shop helps OFHEO - - and Congress - - become even more proactive in its oversight of the Enterprises. This is critical given today's rapidly changing markets.

Permanent Funding

Mr. Chairman, you have been a strong supporter of OFHEO in terms of its ongoing budget requests and the need to be permanently funded. As you know, this would enable the Agency to have the flexibility to set resources - - on par with its other financial safety and soundness regulators - - in response to any rapid changes in the Enterprises or the markets. The Administration also supports this and has included it as a recommendation in its Fiscal Year 2003 budget request for OFHEO. While the Enterprises are well-run and well-

managed companies today, we must keep pace given the demands of the ever-evolving marketplace. I look forward to working with you on this issue this year.

Conclusion

Mr. Chairman, thank you again for the opportunity to testify. As I stated in my testimony, OFHEO is moving forward with a strong and effective regulatory regime. Risk-based capital requirements are in place and working; our examination program continues to be strong and is perhaps the most highly regarded among financial regulators; and we are moving ahead in pertinent areas such as corporate disclosure, which are critical to the safety and soundness of the Enterprises as well as the overall viability of the markets. I would be pleased to answer any questions you or other Members of the Subcommittee may have.



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

NEWS RELEASE

FOR IMMEDIATE RELEASE

Thursday, June 27, 2002

Contact: Stefanie Mullin

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**OFHEO ISSUES RISK-BASED CAPITAL
STRESS TEST RESULTS FOR
FANNIE MAE AND FREDDIE MAC**

WASHINGTON, D.C. Armando Falcon, Jr., Director of the Office of Federal Housing Enterprise Oversight (OFHEO), safety and soundness regulator for Fannie Mae and Freddie Mac (the Enterprises), announced today that both Enterprises passed the first application of the risk-based capital stress test.

“The risk-based capital stress test is a success,” said Director Falcon. “It is a state-of-the-art capital standard performing the function Congress intended. The risk-based capital stress test requires the Enterprises to safely manage their risks or hold additional capital commensurate with their risk exposures,” said Falcon. “With the proposal of the rule in 1999, the Enterprises began a program of managing their activities to ensure they would meet the requirements of the rule. Their prudent measures combined with favorable economic conditions have resulted in their passing the standard at this stage of the one-year implementation period.”

OFHEO will not use the risk-based capital standard to classify the Enterprises for regulatory purposes until the end of the third quarter 2002. These results will be released in December. Starting then, an Enterprise will need to meet both its risk-based and minimum capital requirements to be classified as adequately capitalized. Until then, it need only meet its minimum requirement. However, OFHEO makes the following information available in the interest of public disclosure and regulatory transparency:

FANNIE MAE

As of March 31, 2002, Fannie Mae’s risk-based capital requirement was \$20.228 billion. Fannie Mae’s total capital of \$26.290 billion on that date exceeded the risk-based capital requirement by \$6.062 billion. However, Fannie Mae’s **higher** minimum capital requirement of \$24.571 billion was binding.

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As of March 31, 2002, Freddie Mac’s risk-based capital requirement was \$5.680 billion. Freddie Mac’s total capital of \$21.360 billion on that date exceeded the requirement by \$15.680 billion. However, Freddie Mac’s **higher** minimum capital requirement of \$19.390 billion was binding.

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An Enterprise's risk-based requirement will vary from quarter to quarter depending on the Enterprise's risk management decisions and market conditions. Accordingly, and especially during this implementation period, it is reasonable for the Enterprises to take appropriate steps to ensure they maintain a comfortable capital cushion.

As of March 31, 2002, both Enterprises passed the stress test due to effective risk management including extensive interest rate hedging. Over the past three years since the risk-based capital rule was proposed, both Enterprises' use of derivatives increased dramatically. Fannie Mae's notional derivatives volumes rose 172 percent while Freddie Mac's volumes jumped 248 percent. The rule gives the Enterprises credit when they engage in effective risk management behavior. Freddie Mac's stress test results were especially strong because its hedges enabled it to maintain positive net interest income through nearly the full stress period in both interest rate scenarios.

The results also reflect the current relatively low-risk environment for the Enterprises. Because interest rates are low, the likelihood of very large changes is less than it would be in higher rate environments. In accordance with the statutory formula, the increase in the 10-year Treasury yield in the stress test as applied for March 31 is 371 basis points, less than the 600 basis point change applicable in higher rate environments. In the low interest rate scenario, the decrease in the 10-year Treasury yield is 247 basis points in the test, as applied for March 31.

The credit risk environment is also quite favorable. Rapidly increasing house prices in recent years have raised the value of the collateral on seasoned loans, which comprise most of the Enterprises' portfolios. Over the past three years, house prices have risen 24 percent, on average. A typical loan made in early 1998 with a loan-to-value ratio of 95 percent amounted to only 72 percent of the property value by March 2002. The risk default is, therefore, fairly low, and the severity in the event of default is also low. By comparison, house prices rose at only a 1.5 percent average annual rate in the early 1990s, and seasoned loans remained subject to much higher risk.

BACKGROUND

The **minimum capital standard** requires each Enterprise to have **core capital** (the sum of the par value of common and preferred stock, additional paid-in capital, and retained earnings) that meets or exceeds its minimum capital requirement (2.5 percent of assets plus 0.45 percent of adjusted off-balance-sheet obligations). Minimum capital represents an essential amount of capital needed to protect an Enterprise against broad categories of business risk.

The **risk-based capital standard** requires each Enterprise to have **total capital** (core capital plus general loss reserves) that meets or exceeds its risk-based capital requirement. Stress test results are calculated for two interest rate scenarios, one in which 10-year Treasury yields rise 75 percent and another in which they fall 50 percent. Changes in both scenarios are generally capped at 600 basis points. The risk-based capital level for an Enterprise is the amount of total capital that would enable it to survive the stress test in whichever scenario is more adverse for that Enterprise, plus 30 percent of that amount to cover management and operations risk.

The risk-based capital rule was proposed in April 1999 and finalized September 13, 2001. The rule was further amended March 15, 2002. The rule will be used for capital classification starting with data for September 30, 2002. That number will be published at the end of this year. Both Enterprises were classified as adequately capitalized on March 31, 2002, and would have achieved that same classification had the risk-based standard been used, as well.

The tables below provide relevant capital data for each Enterprise as of March 31, 2002.

ENTERPRISE RISK-BASED CAPITAL RESULTS FOR MARCH 31, 2002				
<i>(Billions of dollars)</i>				
	FANNIE MAE		FREDDIE MAC	
Risk-Based Capital Requirement:				
High Interest Rate Scenario		18.475	5.680	
Low Interest Rate Scenario	20.228			1.481
Total Capital	26.290		21.360	
Surplus	6.062		15.680	

ENTERPRISE MINIMUM CAPITAL REQUIREMENTS FOR MARCH 31, 2002				
<i>(Billions of dollars)</i>				
	FANNIE MAE		FREDDIE MAC	
Minimum Capital Requirement	24.571		19.390	
Core Capital	25.500		20.558	
Surplus	.929		1.169	