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OFHEO RISK-BASED CAPITAL RULE

HEARING

BEFORE THE

SUBCOMMITTEE ON
CAPITAL MARKETS, INSURANCE, AND
GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON
FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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OFHEO RISK-BASED CAPITAL RULE

WEDNESDAY, AUGUST 1, 2001,

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to call, at 2:05 p.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker, [chairman of the subcommittee], presiding.

Present: Chairman Baker; Representatives Ney, Bachus, Lucas, Hart, Kanjorski, Bentsen, J. Maloney of Connecticut, S. Jones of Ohio, Capuano, Meeks, Inslee, Ford, Hinojosa, Lucas, Israel and Ross.

Chairman BAKER. I would like to call this hearing of the Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises of the Committee on Financial Services to order.

Our hearing today is our continuing oversight of Government Sponsored Enterprises, (GSEs), and specifically the Risk-Based Capital Rule that the Office of Federal Housing Enterprise Oversight, (OFHEO), has recently finalized. And I am looking forward to its initial implementation within the next few weeks.

I am particularly glad to have Armando Falcon, the Director of OFHEO here today to explain the impact, direction and intent of the new standard, and I want to particularly express my appreciation to Mr. Falcon. I have, over the years, made comments concerning OFHEO's performance and my frustration about their inability to produce the document and to give us the tools I feel appropriate to make an appropriate assessment about GSE performance. It has been no easy task, Mr. Falcon, and I want your professional staff to know that I, for one, truly appreciate the commitment made and the intense effort to produce this document.

I will confess to you, I have tried to read it, and admit I cannot understand it, but I am told by those who can that it is a pretty good piece of work. And so I intend to keep mine close by, and as my abilities permit, understand it little pieces at a time, but congratulations to you all.

I do want to read a few lines from the report I think important to have in the record.

Government sponsored enterprises are not immune to failure. For most firms, debt markets provide strong capital discipline, penalizing a firm that is excessively leveraged with higher borrowing costs. That discipline is largely lacking for the enterprises because of their status as Government sponsored enterprises.

"The economic distress of Fannie Mae from 1979 to 1985 was significant. But for fortuitous changes in interest rates, Fannie Mae might have collapsed, costing investors, or the Government, billions of dollars. Because of the growth of the enterprises, a failure today could result in much greater loss. Depending on the response of the Government to such a failure, significant disruption to financial and housing markets, significant burdens on the taxpayers, or both would result. The enterprises have considerably more dollar exposure than the entire savings and loan industry had in 1986."

I find these particular provisions of the rule extremely important, and I think it is the basis on which the subcommittee should begin its understanding of the importance of this work. I believe the regulator of Fannie and Freddie should be a more bank-like regulator in its structure. Specifically, I have looked at moving the regulation of Fannie and Freddie to other sites or to the Treasury. Based on a GAO study, I want to give this new regulator whatever we ultimately decide with regard to regulatory structure, the full set of tools necessary to do this work. OFHEO today, in my opinion, still lacks some of the similar supervisory resources other regulators enjoy. OFHEO has chosen a risk-based capital system that is dependent on its ability to field a large team of financial market experts. I encourage OFHEO to work constructively with GSE management in continuing to improve this oversight ability.

I am particularly interested in exploring how the OFHEO rule differs from bank risk-based capital standards. For example, it is my understanding that bank regulators take a very cautious view of hedging and derivative devices specifically, and requiring banks to hold risk-based capital regardless of how many hedging devices or derivatives may be in place. That is a view which I hope will receive additional consideration from the agency.

I also want to say at the outset today that Fannie Mae and Freddie Mac today are very well managed, very profitable and very important contributors to the housing market of our country, and our actions here today in no way reflect on the current financial conditions of the enterprises, but are, in fact, forward-looking in our effort to ensure that, in the event of a long-term market downturn, we would have in place the necessary tools and abilities to minimize adverse consequences should we face undesirable economic conditions. That is why I am so pleased that OFHEO has come forward with the capital standard today, and very much look forward to Mr. Falcon's remarks in a few moments.

Mr. Kanjorski.

[The prepared statement of Hon. Richard H. Baker can be found on page 28 in the appendix.]

Mr. KANJORSKI. Thank you, Mr. Chairman.

Thank you for the opportunity to comment before we begin our hearing to review the final risk-based capital standard recently released by OFHEO. Because our subcommittee will hear from just one witness, we should probably frame today's hearing instead as a briefing. The briefing will help us to better understand the contents of the Risk-Based Capital Rule, the process of its development and the procedures for implementing it.

OFHEO is the safety and soundness regulator for Fannie Mae and Freddie Mac, the Nation's two largest GSEs and two of the

country's largest financial institutions. Since its creation nearly a decade ago, OFHEO has developed and implemented a robust and continuous examination program that works to protect taxpayers from risk. Each quarter, for example, the regulator examination teams review more than 150 separate components of safety and soundness to develop a comprehensive account for each of the GSEs' financial conditions.

With the release of this stress test, which the agency spent nearly 7 years drafting, OFHEO supplements its existing capital standards and complements its already-tough examination program. Implemented properly, this rule will ensure that the two GSEs remain at the forefront of financial regulation. Furthermore, the implementation of this regulation, in my opinion, enhances the ability of Fannie Mae and Freddie Mac to achieve their mission of helping low- and middle-income families to own homes.

More specifically, this new standard calculates how much capital Fannie Mae and Freddie Mac need to hold to withstand a 10-year period of economic stress. Relying on the parameters contained in the 1992 GSE law, OFHEO's stress test simulates dramatic changes in interest rates and the highest historical declines in property values to determine these capital requirements. Notably, the regulator believes its regulation will, more accurately tie capital to risk than any other current or proposed standard, for any financial institution.

As you know, Mr. Chairman, our subcommittee has closely followed the development and issuance of this innovative rule, holding numerous hearings on the subject, and GSE regulation in general, since 1997. Some have expressed impatience with the amount of time OFHEO has taken to develop this standard, but the relatively quick approval by the Office of Management and Budget of this complicated regulation demonstrates its confidence in OFHEO, its competency, reliability and credibility.

OFHEO's dedicated experts additionally deserve congratulations for their hard work in finalizing this intricate rule. In particular, the Director, Armando Falcon, has demonstrated leadership in successfully guiding this complex standard through the regulatory process. I look forward to learning of his thoughts later today during our briefing. It is also, in my opinion, especially important that the regulator maintain continuity in its leadership in the months and years ahead as it works to implement this rule.

Anticipating the complexity of the GSE stress test, Congress further authorized a 1-year transition period following the final rule's publication in the *Federal Register*. This interlude will allow OFHEO and the affected parties to work through any concerns and address the procedural issues likely to arise as the rule becomes operational. Consistent with the requirements of the 1992 GSE law and the Administrative Procedures Act, our subcommittee should support these consultations and reasonable technical modifications.

As they have done in recent weeks, I also hope that all of the involved parties will work constructively with one another to implement this rule efficiently. I am also confident that the management teams of both Freddie Mac and Fannie Mae will swiftly address any changes required by this regulation.

Finally, I hope that my colleagues will work with me to ensure that OFHEO receives the resources it needs to get the job done and consider removing the agency from the annual appropriations process as we have done with other financial regulators.

In closing, Mr. Chairman, I continue to share with you your desire to conduct effective oversight over the housing GSEs and to ensure that we maintain an appropriate and sufficiently strong supervisory system for them. The implementation of this risk-based capital regulation will provide more immediate protection for taxpayers, investors and homeowners than any legislation that we could pursue in the 107th Congress. I consequently look forward to not only our briefing today, but also to working with you to put this long-awaited rule into practice.

[The prepared statement of Hon. Paul Kanjorski can be found on page 34 in the appendix.]

Chairman BAKER. Thank you, Mr. Kanjorski.

Mr. Ney, do you have an opening statement?

Mr. NEY. Thank you, Mr. Chairman, and thank you for calling another oversight hearing on the safety and soundness of Fannie Mae and Freddie Mac. You are to be commended for your thorough work on these two companies. This afternoon marks the eleventh hearing in 16 months.

Today's hearing is on a long-awaited risk-based capital standard for Fannie Mae and Freddie Mac. In coming weeks, this 567-page regulation will be published in the *Federal Register*. One year after the publish date, the regulation will be enforceable.

Mr. Chairman, I know you have worked long and hard pushing for the standards and pushing for the conclusion of the work on this rule, and today I think the credit is due to both you and also the regulatory agency. I would like to take a moment to commend Director Falcon for his leadership in bringing this risk-based capital stress test to completion. Both he and his staff have worked hard to craft this capital stress test, and they have worked under tremendous pressure. Mr. Falcon took office only 18 months ago, I believe. In that time, he has managed to complete this rule in a fair and balanced manner. We now have in place a vital component for an effective and efficient regulatory program. The new risk-based capital standard puts in place a new sophisticated model that more specifically aligns capital to risk.

Because of the length and complexity of this final rule, and because it will be another year before the rule is enforceable, I would really like to encourage the cooperation and work of Mr. Falcon and the agency to work with Fannie Mae and Freddie Mac to make any necessary technical changes and to ensure the complex regulation conforms to the 1992 Act. This is a very complicated, complex and sophisticated rule which will help ensure that Fannie Mae and Freddie Mac remain safe, well-capitalized and able to continue their housing mission.

However, as with any highly complex Government regulation, it is inevitable, I think we all know that, that the rule mandates will have unintended consequences, potentially, or other problems. So I would encourage Fannie Mae, Freddie Mac and Mr. Falcon and the agency and the subcommittee to work together to solve these problems to ensure that this rule is implemented on time.

Mr. Falcon, your agency has set out to accomplish a very formidable task, creating a sophisticated internal model that closely aligns and ties capital to risk. If you consider the already-existing minimum capital standard, the new risk-based standard and the six voluntary initiatives put forth by Fannie Mae and Freddie Mac last October, these two companies really do stand at the forefront, I think, of financial services, safety and soundness regulation.

And again, Mr. Chairman, thank you for your diligence on the issue.

Chairman BAKER. Thank you very much, Mr. Ney.

Mr. Israel, you are next by time of arrival.

Mr. ISRAEL. Thank you, Mr. Chairman, and thank you for convening this hearing.

I am pleased to welcome the Director and join my colleagues in welcoming the Director this afternoon.

Mr. Chairman, if ever there was any evidence of the critical need for safe and sound GSEs like Fannie and Freddie, it is contained in this morning's edition of *Newsday*, which is my hometown newspaper. The headline is: "Long Island Named Most Expensive Area," and it reports on a study done by the Economic Policy Institute that indicates that Nassau and Suffolk Counties on Long Island are the number one most expensive areas to live, more expensive than Boston, than Washington, DC., than San Francisco, than San Jose, California and others. According to the study, a family of two parents and two children would need to make an after-tax salary of $52,000 a year to afford living in my congressional district. And housing costs are cited as the major reason why Long Island is ranked as the most expensive area in the country.

Because of that situation, as I have said in the past, it is critically important that we support Fannie Mae and Freddie Mac in their mission to provide affordable housing. An article in the *National Mortgage News* states that recent HMDA data suggests that Fannie and Freddie are helping to increase homeownership numbers for all individuals. By improving their underwriting guidelines and adding new loan products, Fannie and Freddie are helping to improve the chances that all borrowers, particularly low- and moderate-income individuals, are approved for a loan and receive affordable housing opportunities.

The new Risk-Based Capital Rule is meant to help the companies remain efficient and operational even in times of severe economic stress. It may be too early to determine how this highly complex rule will affect Fannie and Freddie's ability to continue to fulfill their mission, however I hope that we will be mindful that anytime greater restrictions are placed on the business activities of Fannie and Freddie, it is more difficult for them to continue to work to achieve their mission and close the home ownership gap.

I hope that OFHEO will continue to work with this subcommittee, the Chairman and the Ranking Member, and Fannie and Freddie to ensure that this new risk-based capital standard will achieve its intended purpose of helping the two companies to operate more efficiently. The more efficient those two GSEs are, the more they will be able to continue to fulfill their mission and I hope that we will continue to support them as they work to suc-

cessfully implement this rule in the year ahead. And I thank the Chairman for my time.

Chairman BAKER. Thank you sir.

Mr. Lucas.

Mr. LUCAS. Thank you, Mr. Chairman. And I want to congratulate both you and Director Falcon for finishing this important capital rule. I know it has been certainly your priority, both of you, for that matter, priority for several years.

And Director Falcon, I appreciate your appearance before this subcommittee and certainly commend you on this monumental task. I understand, as the Chairman and a number of my colleagues have pointed out, that this is a very complex rule, 567 pages long in total length, and of course it has not been fully evaluated by the two companies that you regulate, or for that matter, by this subcommittee. Of course, this rule is intended, as has been mentioned, to implement the intent of Congress in the 1992 oversight legislation. And it should be consistent with that Act and should be appropriate in how it aligned capital with risk.

Because the operation of this capital rule may well have an enormous impact on the mortgage markets, on lenders in my district, and ultimately on home buyers, I urge you to work with Fannie and Freddie to identify any needed clarifications. And I also hope that these modifications will be made without delay so that certainly any unintended consequences will be minimized.

With that, Mr. Chairman, I look forward to the Director's comments.

Chairman BAKER. Thank you very much, Mr. Lucas.

Mrs. Jones, you would be next.

Mrs. JONES. Thank you, Mr. Chairman.

Good afternoon, Ranking Member Kanjorski and other Members of the subcommittee.

To Mr. Falcon, welcome back to our subcommittee.

I am pleased and would like to congratulate you and your organization for the completion of this rule. I guess this is about our tenth hearing on safety and soundness. We have a rule now. Hopefully, you as a regulatory agency, and Fannie and Freddie can walk through this and get things going so that we can continue to move on and perhaps have Capital Markets Subcommittee hearings on something else as we go along through the year.

I think it is laudable, however, that as we look at safety and soundness and to assure the strength of the housing market in our communities that we engage in some conversation on the issue. I am confident that Freddie and Fannie, having already agreed to about six commitments or regulations, are prepared to sit with you and make sure that the housing industry is safe and sound.

I have a full statement, Mr. Chairman, that I would seek unanimous consent to have submitted for the record so that we can allow sufficient time to proceed through the hearing.

Thank you very much.

[The prepared statement of Hon. Stephanie Jones can be found on page 31 in the appendix.]

Chairman BAKER. Without objection, your statement and all Members' statements will be included in the record.

Thank you, Mrs. Jones.

Ms. Hart.

Ms. HART. Thank you, Mr. Chairman.

I am pleased that you chose to have this hearing as well. Since I am a freshman and have not been long-awaiting this rule, I will be just very interested in hearing the testimony from Mr. Falcon, and I will reserve the rest of my time for questions.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Ms. Hart.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Let me start by welcoming our former staff member, Mr. Falcon, who was the General Counsel to the Democratic staff for many years on the subcommittee and is also my fellow Texan. And we appreciate you being here and we look forward to your testimony.

Mr. Chairman, I want to commend you for holding this hearing which will examine the Office of Federal Housing Enterprise Oversight's final regulation related to risk-based capital that was released on July 19, 2001. As a Member of this subcommittee, I am pleased that OFHEO has released this long-awaited risk-based capital regulation. As you know, in 1992, Congress approved a new law which established OFHEO and required OFHEO to draft a risk-based capital regulation within 2 years. As we know, it has taken some time to develop this very complex model, but we believe and we hope that this regulation will provide the necessary safeguards to ensure that the Federal housing enterprises of Fannie Mae and Freddie Mac have sufficient capital to sustain themselves during extremely difficult economic conditions, which are described as part of the law.

As you know, this risk-based capital regulation is an extremely complex model which requires extensive data input from the housing enterprises. Because of the complexity of this model, Congress provided additional time before the GSEs must comply with the rule. The effective date will be 1 year after the publication of the final rule in the *Federal Register*. I believe that Congress and this subcommittee should use this time to examine the rule in its entirety to ensure that it is both fair and reasonable. By holding additional oversight hearings on the rule, Congress will have such time to review and make any necessary recommendations for the rule.

In addition, I believe such hearings should bring forward expert witnesses who can discuss this complex model. For instance, I believe it would be appropriate, Mr. Chairman, to invite some of the major rating agencies, such as Moody's and Standard and Poor's, who have familiarity with such complex model and will be reviewing this risk-based rule when they make their own rating determinations for GSE-sponsored debt instruments.

In addition, major market participants should be heard from, and I think we should also hear from witnesses who can provide us more information on other risk-based capital rules, particularly the Basel risk-based capital proposals which are currently under discussion as they related to derivatives instruments.

This is an important hearing that we are having today. I commend the Chairman for calling this hearing. I commend OFHEO and the staff for the work that they have done. But of course, as we all know, this will not be the last word, either on this rule or

the question of the GSEs, and I look forward to additional hearings that I am sure our esteemed Chairman will call.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Ken Bentsen can be found on page 33 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Bentsen for that hearing recommendation. I was not sure whether we would go further, but based on your request, we certainly will.

[Laughter.]

Mr. Lucas.

Mr. Inslee.

Mr. INSLEE. I have nothing to add to the brilliance of my colleagues. Thank you, Mr. Chairman.

[Laughter.]

Chairman BAKER. Mr. Ross.

Mr. Hinojosa.

Mr. HINOJOSA. Yes, thank you, Mr. Chairman.

I am pleased to congratulate my fellow Texan, Armando Falcon, today on finalizing the long-awaited Risk-Based Capital Rule and the complex computer code that implements the rule.

Combined, the rule brings into force any important requirement of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, the risk-based capital stress test, a simulation that determines the amount of capital Fannie Mae and Freddie Mac would need to survive a 10-year period of wild fluctuations in interest rates and large credit losses.

In addition, the 1992 Act requires that the GSEs each maintain an additional 30 percent of capital to protect against management and operations risk in order to meet their risk-based capital standard. My message to you today, Mr. Falcon, is very concise. It is sincere and based on the physicians' credo: "First, do no harm." I congratulate you and OFHEO on this accomplishment.

The new rule, all 567 pages of it, is extremely technical and reflects countless hours of dedicated work by you and your staff. But the rule by its nature is long and complex, and the enterprises it is created to test are dynamic and they are sophisticated. This, combined with the importance of homeownership to our economy and the well-being of our people, require that you take the time, the energy and the resources you need over the next year to get this rule right.

In closing, I want to say that I fully support OFHEO's mission and encourage you to make the corrections necessary to improve the rule and its code so that they conform fully to the 1992 Act and the intent of Congress. The 1992 Act specifically gives you significant sole discretion to decide on many aspects of the risk-based capital test. Use it. Align risk to capital for GSEs in a meaningful, realistic and necessary way.

Chairman BAKER. Thank you, Mr. Hinojosa.

At this time, I would like to introduce to the subcommittee the Director of the Office of Federal Housing Enterprise Oversight, OFHEO, Mr. Armando Falcon.

Welcome sir. I know you have been waiting a long time for this day yourself.

STATEMENT OF HON. ARMANDO FALCON, JR., DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

Mr. FALCON. I have. Thank you very much, Mr. Chairman. It is a pleasure to be back here in the subcommittee's hearing room.

Mr. Chairman, 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 as Director of OFHEO. Today, I am pleased to report to you 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 the 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 Ranking Minority Member Kanjorski. Your input and encouragement certainly kept us, shall we say, focused and motivated.

As you know, this rule is the final major 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 early September, Fannie Mae and Freddie Mac will be subject to one of the most sophisticated regulatory capital standards in the world.

Yet 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 program less vital. Rather, it complements our current activities by providing yet another assessment of the enterprise risk. When the results of the stress test are considered along with other information available to me as the Director, I will have the best possible 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. In addition, I will also describe how the test fits into OFHEO's overall regulatory program.

While the Risk-Based Capital Rule has received the bulk of attention in recent years, the 1992 Act establishing OFHEO directed the agency to establish and enforce two major capital tests for the enterprises, a minimum capital test and the risk-based capital stress test. The minimum capital requirement is a leverage standard that is similar to existing capital requirements for banks and thrifts. The enterprises have satisfied this minimum capital requirement every quarter since its implementation.

To supplement minimum capital, we have a more sophisticated measure of risk. The risk-based capital 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 Nation's housing and credit markets.

Mr. Chairman, allow me to provide a brief history of the development of the Risk-Based Capital Rule as background for the subcommittee.

After staffing and equipping the agency and completing initial study of the issues involved, OFHEO sought public input through an Advance Notice of Proposed Rulemaking and two Notices of Proposed Rulemaking, or NPR as we call them. The first NPR, published in June, 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 these stress tests would work. At the conclusion of the comment period, OFHEO proceeded to analyze and address the comments and finalize the rule. 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* on July 19.

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

First, the stress test factors in large moves in interest rates, mortgage rates, Treasury rates and enterprise borrowing costs. Congress went so far as to specify that the 10-year Treasury rate changes by as much as 6 percentage points. Other interest rate changes are done in tandem as determined by OFHEO using historical experience as a reference point.

Second, the test provides for loan defaults and loss severity on a nationwide basis comparable to the largest default and severity rates 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 these stressful conditions. This no-new-business requirement, or a wind-down scenario, is explicitly mandated in the 1992 Act.

If all of these stress conditions were to occur, the enterprises would be expected to suffer severe losses as homeowners default or pay off the loans early, 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.

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 do not 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 because both approaches give institutions credit for risk mitigation activities, good risk management will be rewarded with a lower capital requirement.

But this is not just a capital standard. It will also serve as a valuable analytical tool. It will help us to identify and understand the strengths, weaknesses and exposures of the enterprises under different scenarios. We will use it to its full capacity for this purpose.

As noted earlier, the risk-based capital standard will be published in the *Federal Register* in September. While the rule is "ef-

fective" immediately, Congress granted the enterprises a year to come into compliance before OFHEO can take an enforcement action based on noncompliance with the standard. However, because the rule is effective upon publication, OFHEO will announce in early 2002 how the enterprises fare under the standard using 4th quarter 2001 data.

To achieve compliance, the enterprises will have many options. For example, they can raise additional capital, adjust hedging practices, offset more of their risk, retain more of their earnings or any combination of these. A capital shortfall generally can be eliminated at a fraction of the cost of new equity capital. Thus, another valuable aspect of this rule is that it will allow the enterprises to choose for themselves the most efficient means to comply with the rule.

So while the finalization of the rule is a landmark, it certainly does not close the door on work on the rule. The standard will not be static. The enterprises will be free to innovate. OFHEO will work with the enterprises to assess the risk of new activities and appropriately address them within the stress test. In addition, the 1992 Act requires us to soon consider whether or not to incorporate new business into the rule.

As I mentioned earlier, OFHEO's capital regulation is a component of an overall regulatory program. We will use the stress test in conjunction with other tools, which include examination reports and OFHEO's research. OFHEO's examiners 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' risk 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.

As with all financial regulators, research is an area of great importance to OFHEO's ability to fulfill its mission. Our research provides 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.

In conclusion, OFHEO is meeting the mission Congress gave us. The enterprises are subject to ongoing oversight through our examination program, must meet quarterly minimum capital requirements, will be the only entities subject to a risk-based capital stress test which closely ties capital to risk, and can be held accountable if found lacking in any of these areas.

Mr. Chairman, Ranking Member Kanjorski, 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's 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 Member Kanjorski and other Members of the subcommittee for your comments and the support you have given this agency.

I would be pleased to answer any questions you may have, Mr. Chairman.

[The prepared statement of Hon. Armando Falcon Jr. can be found on page 36 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Falcon. Again, congratulations.

There is one sort of process question that I would like to start with that I think is very important. You have labored long. We now have a rule approved by OMB, basically back in your area of jurisdiction awaiting final publication. It is also my understanding concurrent that our 60-day congressional review period would commence beginning the date of July 29, I think is correct. And since it has 60 legislative days, that would be to expire sometime in October. I do not have the correct date.

Between now and the time that the rule is promulgated formally, would it be your intent that the modifications to the rule that would be considered would be technical in nature, or to ensure conformity of the rule to the agency's intent, as opposed to a substantive policy alteration that would depart from the original proposal?

Mr. FALCON. Mr. Chairman, I view the process going forward between the time we submitted the rule to the *Federal Register* and the time that it is published as similar to what happens with the House when the enrolling clerk takes a bill that has been enacted by the House and the clerk makes technical corrections to fix punctuation and other things to make sure, as you stated, it is consistent with the intent of the Congress. Any changes that we would make to the rule between now and the date of publication would be consistent with that spirit. And if we recognize a need to make any changes in the rule, we will do so through probably a notice and comment period, perhaps an expedited one, so that we can move quickly to make sure that the rule works properly.

Chairman BAKER. Terrific. Because it would be my interest, and would intend to do so, to make comment to the agency early in the August recess about some areas of concern that, and I have regard for your judgment. Whether I am right or not would be for you to determine. But for example, in the area of hedging, it is my understanding that a financial regulator in looking at interest rate risk and let's say credit risk is two categories, and where we find an excess of hedge with regard to interest rate, but a deficiency on credit risk, that they cannot be averaged. So that if you are over a little bit in one and under a little bit in the other, the aggregate hedge is deemed to be adequate under the risk-based standard, but insufficient under financial standards. I want to make sure I am understanding it properly, but I will forward that at a later date to give you a more detailed explanation.

And then, generally the whole question of the first step being left to the enterprises, let's assume they are modestly deficient, and that a relatively small acquisition of hedging devices would get them into proper balance. I would be a lot more comfortable if rather than having the enterprises manage to maintain minimum cap-

ital, that we—and there are operative reasons for this—minimize the use of hedging devices and instead establish a preference for capital, principally because of the enormity of their hedging portfolio and, frankly, the limited number of counter-parties internationally available for these enterprises to be able to acquire those hedging instruments. So it is against the international capital markets concern that I am worried about the level of their derivatives portfolio. Again, I will forward that in a comment.

And I do not want to get Mr. Bentsen in more trouble with his colleagues, but I shared some of his concerns in his opening statement about having broader formal comment on the applicability of the rule beyond the agencies. So I do not know exactly the process by which I will pursue that, but I do want to have other financial opinions about the applicability and consequences of the rule.

I also want to compliment you, because I think your decision to run the test based on the last quarter of 2001 data is very, very important. Many Members of this subcommittee are concerned about the volatility in the marketplace, and that unanticipated consequence of the rule, either requiring significant capital or reducing risk exposure, could potentially have some impact on interest rate costs to homeowners. I think by taking this step as an early market indicator a year out, should give great confidence to everyone that if in fact there is a deficiency, that the 12 month intervening period can easily be utilized to come into conformity with your requirements without any of the adverse market consequences some are concerned about.

Given that general statement, I am sure I am going to come back. I do not want to run too far over my own time. I will yield my time at this time to Mr. Kanjorski.

Mr. KANJORSKI. Thank you very much, Mr. Chairman, and congratulations to you for taking a very strong leadership role on this entire issue.

Congratulations to you and the employees and staff of the agency, Mr. Falcon. You have only been there 18 months, but it has been a long process, 9 years now, and I am sure the Members of the subcommittee, those even that are not here or do not know about this event can breathe a little easier today to know that we finally do have the regulation ready to go.

One of the things I have been concerned about all along, and intend to support the agency and the GSEs, is that they have given a vitality to our economy at this particular point in time, the real estate transactions in the country. I hope they can maintain that vitality and remain healthy, because I see it as one of the two remaining legs to see the economy afloat, that and consumer confidence, and consumer confidence may start to wane in the latter part now of this year. So it is very important that we stabilize and keep a very vibrant real estate market in the country. And I think your risk-based regulation will help to accomplish that, but also the fact that we attended this briefing, and this entire issue, was the fact that we are providing tremendous stability for 10 years of downturn. There is little worry in the marketplace. We have a very secure financing structure in the United States, and not only in the domestic market, but the international markets should be perfectly

willing to buy the securities of these entities as we proceed through the rest of this year and the following year.

I want to be a little optimistic. I think by next spring we will see a turnaround. We will be turning out of this thing. But if we do not, as I understand, the regulation will have a capacity to support a 10-year downturn, which no one anticipates now, nor should we, since it probably has never occurred other than maybe the Great Depression.

I think it is important that you maintain a relationship with the Chairman of this subcommittee and the Chairman of the full committee, maybe the Ranking Members, and also on the Senate side. If there are technical adjustments or substantive adjustments that may have to be made that we are not presently aware of, I think to speed that process along, communications should be set up between your office and the Congress so that they can be attended to and understood, so that we move through this process without the need for hearings, without the need for even communication by letters of question, but that we are only responding to issues that you or the GSEs raise as they look at the implementation of this role.

I join the Chairman in congratulating you on picking that quarter at the end of the year to be the base which we will gear off of. I hope we do not have a real bad downturn in that quarter, and that could always happen, but maybe that is what the rule is really promulgated to protect against.

Again, this has been a long series of hearings and a lot of skin has been left on the roadway, so to speak, but I congratulate you and the agency for coming to the extent that you have, and wish you well. And I certainly offer my assistance if there is anything we can do, and I am sure the Chairman joins me in that.

Thank you.

Chairman BAKER. Ms. Hart, did you have questions?

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

So to clarify the Chairman's question, the ink is dry on the rule now, and any changes you will make will be purely technical and the rule will be published prior to or within that 60-day legislative period?

Chairman BAKER. It is my expectation that the rule will be, I think, printed before the 60-day legislative day comment period expires. Is that correct, Mr. Falcon?

Mr. FALCON. That is out of our control, Mr. Chairman. It is subject to the ability of the *Federal Register* to get the rule typeset and proofed within that timeframe. But our expectation is that they could do it within 45 days of the day that it was submitted to them. So it would be within that 60-day time period.

Chairman BAKER. Mr. Bentsen, it is my intent to, believe it or not, be the least amount of disruptive element in this process. That is the reason for the hearing today, for Members to be aware of the rule. And as quickly as we return, if there are any issues which we would need to address, do that early in September so the agency would have appropriate time, if warranted, to respond before the final promulgation.

Mr. BENTSEN. Although I think what Mr. Falcon is saying is the final promulgation has occurred, other than really dotting "i's" and crossing "t's." And if that is the case, then once the final rule is published, and I do not want to get into a long drawn-out discussion of the Administrative Procedures Act, as interesting as that would be; but once the rule is published, then we go to, what, an APA-type mechanism, which is Congress or others have issues that they petition OFHEO and OFHEO then takes under advisement can propose a rule or if OFHEO itself determines that something needs to be modified, and then you go under the standard APA?

Mr. FALCON. Right. Once the rule was published, it is a final rule, and if we saw a need to make any changes to the rule, we would utilize the amendatory process of the Administrative Procedures Act. And that allows us flexibility to move at any point in time to make changes that we thought were necessary. We have a wide range of tools from an extended notice and comment period to something as quick as an interim final rule where changes are effective immediately, subject to notice and comment and subject to potential change after that notice and comment period.

So we have the ability to move expeditiously to correct any changes that might need to be made. And Congressman, if we thought that we needed to make any changes, technical or substantive, to get this right as soon as possible, we would do so, I think, in an expeditious manner. If we see a need to make any changes in this to make it fully operational and to correct any problems in it, we could possibly do so very quickly after the rule was published. But we have that ability, and I think we would want to utilize it to make sure we got this right as soon as possible.

Mr. BENTSEN. There has been some concern raised by the GSEs, and I am sure there will be lots of concern raised from time to time, as is the case with any regulated party, but with respect to haircut requirements on hedging instruments, I was just looking at an article from the *Wall Street Journal* from a while back regarding the mortgage insurance companies, that there is concern that the reserve requirements on that may exceed industry standards. Is that an issue that you would see, if you were to agree with them, that you would see taking up in a subsequent rulemaking process?

Mr. FALCON. Yes, I am aware of the issue you are talking about, Congressman, with respect to the counter-party haircuts that are embedded in this rule. Part of the issue there has to do with the distinction we have made between AAA, AA, A and so forth, and how much of a haircut we give to the securities or the counter-parties. Our judgment on the distinctions between those various rating levels and the reflection of those distinctions in the percentages of the haircuts is grounded in a lot of historical analysis and various studies that we looked at to come up with the ultimate resolution in the rule.

However, we are very willing to look at those issues with an open mind and take a fresh look at them. If we did not come up with the optimal resolution of the issue, we will not hesitate to make a correction.

Mr. BENTSEN. If I might, Mr. Chairman, very quickly, given that the rule is not fully effective until a year following the publication date, or whichever date, do you think that you would be able to ad-

dress issues, and again, you may come down and decide that there is no merit in the arguments, in such a way that would allow the companies the ability to deal with this without having to comply with a rule that might otherwise be modified to meet the implementation day?

Mr. FALCON. I think we would definitely want to, if we thought that there were improvements that could be made to the rule, I think we would want to act expeditiously to make those modifications, certainly well before the end of the 1-year transition period, so that it is clear to the enterprises, in fairness to them, what rule they will be expected to meet at the end of that 1-year transition period, and even more so before the end of the quarter when we begin to make public pronouncements about how they fare under this rule.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Chairman BAKER. Mr. Ford.

Mr. FORD. Thank you, Mr. Chairman.

I think my colleague Mr. Bentsen got at much of what I wanted to ask. It is a big thick rule, and I guess it will take a lot of us a long time to get through it all. But just so I can understand, we will have some flexibility to make changes if need be between now and then, Mr. Director?

Mr. FALCON. Yes, Congressman, you will. And if I can just say, I know the Chairman held up a copy of the rule. It is a big thick rule. But I think it is important, if I may, to just state that the 1992 Act which required the promulgation of this rule also required that the agency promulgate a rule which was fully transparent and was specific enough so that any interested party could replicate the regulation and the code, the stress test that implements the rule. So in order to meet that requirement of the 1992 Act, we had to put out a rule which was very specific and lay out all the details about how this model would work. Otherwise, we would not have been in compliance with the rule. I would have loved to have a rule which is maybe 50 pages long, but then I do not think we would have been in compliance with the spirit or the requirements of the 1992 Act.

Mr. FORD. I am not being critical at all.

Mr. FALCON. I know you are not.

Mr. FORD. As a matter of fact, it will make for some good vacation reading during the August recess. But I appreciate you responding to the specificity that, I was not here in the Congress in 1992, you were asked to do.

Mr. Chairman, if it would be appropriate, sir, I know that perhaps this is not an appropriate venue to do this, related to this, there was an issue or two raised in the July 11 hearing on your part, sir, a series of assertions regarding the average loan limit and loan-to-value ratios of loans purchased by Fannie Mae. And I had some numbers that I would love to submit to the record. I certainly do not want to go into those details with the Director here and cloud this hearing, but I did want to, I was curious about that, and asked Chairman Raines at Fannie Mae to respond to some of those issues and have some of that. And if it would be OK without objections.

Chairman BAKER. Sure, without objection. Just for the record, my comments really in the July hearing were with regard to Freddie, but we always welcome Fannie to any fight.

Thank you.

Mr. FORD. Thank you.

Chairman BAKER. I am sorry, Mr. Meeks.

Mr. MEEKS. Timing is everything. I just walked in.

Chairman BAKER. Yes, sir. You took me by surprise.

Mr. MEEKS. I apologize in regard to missing your testimony. I am on roller skates today. We have various hearings and markups going all over the place. And so I only have two quick questions. If you have answered of them already, please I apologize in advance.

But this is something that has come up, and I was just wondering if there were any conflict between the Final Risk-Based Capital Rule and the HUD affordable housing goals of Freddie Mac and Fannie Mae?

Mr. FALCON. There will not be, Congressman. We think this rule, once it is implemented, will allow them to continue their affordable housing activities and remain in compliance and exceed the goals of the affordable housing goals as established by HUD.

Mr. MEEKS. And let me ask another question that I do not know, maybe it is unfair, but I know that there has been a lot of discussion regarding OFHEO's ability to properly regulate the safety and soundness of the GSEs. And so I guess my question is in regards to your capacity, whether there is a lack of capacity in your organization to properly regulate GSEs in general structure, or are you lacking anywhere in legislative authority or resources?

Mr. FALCON. Thank you. I think the agency fully fulfills its mission in supervising the enterprises. I think we could use some additional tools to make sure that we can always respond adequately to any situation that might arise. I would like to have some adjustments to our statutory responsibilities. I do not think they are essential to our ability to fulfill our mission, but items like exemption from the appropriations process that would allow us to adjust our budget to our needs on a real-time basis should any situation arise. That is an authority that every safety and soundness regulator has, and I think OFHEO should be put on par with other agencies. And there are other issues related to enforcement powers, some independence issues, clarifications about our authority. I think those would be nice tools to have, but currently I am comfortable that we do a good job with the staff we have and that we are able to leverage the technology and a very experienced staff to make sure we fulfill our mission on a daily basis.

Mr. MEEKS. Thank you.

That is all from me, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Meeks.

Let me return to process again, because it is apparently a source of concern, and in the brief interim I counseled with staff as to the two processes. One is the current 60-day comment period in which the subcommittee, if it so chose, could only adopt a resolution of disapproval, thereby blocking the implementation of the entire rule. That is not likely to happen. However, after the rule is formally promulgated and published, all changes subsequent to that

date would then be subject to the provisions of the Administrative Procedures Act, which can have an expedited notice and comment period, but would in all substantive cases require notice and public comment period of some sort, so that the subcommittee would then have an opportunity to understand and then again comment on any subsequent change that might be considered at the agency's request.

Is that your understanding of the process?

Mr. FALCON. Yes, that we are subject to all the provisions of the Administrative Procedures Act once this is——

Chairman BAKER. Well, I only mention that because there was some apparent view that we could get together and work this out without going through conformity with the APA. And I think for record purposes, we all ought to acknowledge that that is the law and we will abide by whatever it provides.

Mr. FALCON. Right. We could not do anything inconsistent within the express provision of the regulation absent an amendment to those provisions.

Chairman BAKER. All right.

And the other minor point is that it is actually effective when printed, and it is only enforceable a year later. So that is the reason why the APA becomes effective after it is printed, and that is just again for the record purposes.

And I want to return to the issue raised about modifications. As you know, I have been available for any suggestion by anybody about how to enhance your ability to perform this task. Clearly, getting you out of the appropriations process based on a fee schedule for the regulated enterprises would be something I would strongly support, as all other financial regulators are so funded. And second, giving you more financial regulatory authority is something I have always thought made a great deal of sense wherever the agency may land in some future iterations of congressional legislation. So for the record, I want to acknowledge that you requested funding levels last year in the appropriations process higher than you actually received, although you did receive an increase in budget. And to a great extent, using the OCC model and applying their standards to assessments for regulatory purposes, the two enterprises would have an assessment of approximately $67 million for regulatory compliance, and you are now operating on a $23 million platform.

Now, whether or not the people within the agency are working very hard or not, on its face there is a regulatory mismatch that should be addressed, and for your purposes, I am strongly supportive of adjusting that mismatch.

With regard to the rule, there has been some comment expressed that the effect of the rule is to be procyclical in that in good times that capital assessment may turn out to be excessive, but in bad times the capital assessment may turn out to be too little, which would then result in capital swings that might be excessive within a short-term duration. Further, and this is, I believe, the explanation that OFHEO feels that the capital adjustments that will be required will come from early warning devices that are now within the agency's ability to observe. Don't regular examinations kind of give you leading indications without having to wait on the applica-

tion of the stress test? You know, make us feel more comfortable about how this capital requirement can and will be adjusted?

Mr. FALCON. Absolutely. As I said, the stress test is only part of our comprehensive oversight program with the enterprises. Our examiners are looking at 150 or so different examination areas with respect to the enterprises. They are in there on a daily basis. They are constantly evaluating the risk of the enterprises, how they manage those risks, and certainly they work in concert with other areas in the agency. With respect to whether or not this rule is procyclical, I think what makes this unique from any other capital standard is that it incorporates a downward cycle. In a sense, it anticipates a downward cycle. That is what happens when you apply stressful economic conditions, a 600 basis point swing, whether up or down, in interest rates. The worst historical credit losses in any region apply to their entire portfolio. So this anticipates the worst possible cycle and makes sure that the enterprises can survive such a down cycle over a 10-year period.

And if problems were to occur, the fact is that this rule gives the enterprises the flexibility to decide for themselves the most efficient means for coming into compliance with the capital standard. It would not have, in a true downward cycle, the effect of forcing them to find the most inefficient means of coming to compliance like raising pure equity capital. They would have the flexibility to adjust the risk profile so that they would be in compliance with the rule.

Chairman BAKER. Thank you.

Mr. Bachus has arrived. Mr. Bachus, did you have a comment or question?

Mr. BACHUS. I appreciate it, Mr. Chairman. I commend you for holding this hearing.

I have been on the floor of the House debating the energy bill, and I apologize for missing your testimony, Mr. Falcon. I want to congratulate you. You have only been on the job 18 months, and yet you and your agency have completed the rule, and it is long-awaited, but I appreciate your work.

This is a very long and complex rule. It is over 600 pages. And I would first urge, and I am sort of doing an opening statement here too, but I would also urge you to give the GSEs an opportunity to work with you and for them to work with OFHEO in crafting the final rule. I hope this is not considered a final rule.

Additionally, it is my hope that the final rule will not damage the GSEs' mission to increase homeownership in America, and at the same time protect the taxpayers' interests from any unnecessary exposure from GSEs' debt and mortgage holdings.

Let me ask you, I have two questions in mind. One is, and it goes along with working with the GSEs and their mission of creating home ownership, particularly for the less advantaged. What impact, if any, will the final rule have on GSEs' efforts to finance loans with small down payments? Will these loans become more expensive and harder to get?

Mr. FALCON. Congressman, in order to have a risk-based capital stress test, we do look at historical defaults and prepayment rates and loss severities for mortgages of different types, including various loan-to-value ratios for mortgages. But just because a mort-

gage may have less equity does not necessarily mean that it might require greater capital. The enterprises can take steps to mitigate their potential risk through the use of credit enhancements, offsetting risk, and we would certainly give them full credit for those types of activities in the Risk-Based Capital Rule. So if the data dictates that a certain type of loan has greater risk associated with it, that risk can be mitigated through activities by the enterprises.

Mr. BACHUS. But to a certain extent, HUD, for instance, has asked them to go and make loans in certain areas, and some of these loans as a necessity are going to be higher risk loans than the premium market.

Mr. FALCON. Actually, interestingly, the loans that the enterprises can count toward compliance with HUD's affordable housing goals fall across the spectrum of mortgages. We compared those types of mortgages and their spread across various LTVs and found that the spread across the LTVs for affordable housing mortgages was about the same as it is for non-affordable-housing-goal mortgages. And the affordable-housing-goal mortgage is not quite going to be just a high LTV mortgage. In fact, I think the bulk of them have an LTV which is 80 percent or less.

Mr. BACHUS. Will it make it harder for the GSEs to buy loans from borrowers with poor credit histories? The rule?

Mr. FALCON. The rule? Perhaps. We have not incorporated FICO scores yet through this rule. That is an area of research that we are undertaking, and if it is appropriate we will incorporate things like FICO scores. I think if it is appropriate, we will do it, but as far as what we are now taking into account, I guess you could think of things like borrowers credit history as embedded in the average default rate on that type of mortgage. If it has got a higher default rate, it is probably because it was made to someone with a higher risk profile. And so in that sense, we do incorporate someone with a bad credit history if they receive a mortgage that Fannie and Freddie buy, into the stress test.

Mr. BACHUS. I would simply, again, just stress to you that their mission being to bring home ownership to the less advantaged, and sometimes this requires smaller down payments, things of this nature, which does involve greater risk, but that is part of what Congress has charged them with a mission of doing. And I know that there is probably some tension between some of what HUD asks them to do, and then safety and soundness considerations, but hopefully you can be aware of that. Are you working with HUD in formulating the rule?

Mr. FALCON. Yes, they have been following the progress of this rule. At various points in time, we have discussed it with them, that is over many past years. But I am confident that this rule will not detract from the ability of the enterprises to fulfill their mission, especially with respect to affordable housing.

Mr. BACHUS. OK, including small down payments and things?

Mr. FALCON. Yes. Absolutely.

Mr. BACHUS. All right.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bachus.

Mr. Bentsen.

Oh, I am sorry. Mrs. Jones.

Mrs. JONES. Thank you, Mr. Chairman.

I want to thank my colleagues for asking questions. My questions should not be too lengthy, though, Mr. Chairman.

Mr. Falcon, as a regulator for Fannie and Freddie, part of regulation also is to ensure that these can continue to operate, or you do not really have a job to do if they are not in operation. Fair statement?

Mr. FALCON. Yes, ma'am.

Mrs. JONES. So it is not always an adversarial role. I guess that is what I am trying to ask of you. Is that correct?

Mr. FALCON. Absolutely.

Mrs. JONES. And someone may have asked this question, but in light of the fact that I was not here to hear the answer, I am going to ask it again. On page 68 of the regulation, it says that OFHEO has the authority to make any changes it deems necessary to the code at any time without notice and comment, as long as those changes are not inconsistent with the technical specification of the RBC rule. This authority allows OFHEO to address any technical or other problems that might arise in the operation of the code on a timely basis. Any change to the code will be made available to the public.

As the Director of this regulatory agency, do you believe that this gives you the ability you need to operate or to have oversight over agencies that operate with safety and soundness?

Mr. FALCON. Yes, Congresswoman. The way the rule will work is the rule itself contains various mathematical equations and formulas which make up this stress test. And separate and apart from that, we have this computer code, this model that we constructed using the blueprint of the rule. That code implements the rule. It is that code that we will plug various quarters' worth of data into and that will produce a capital requirement for the enterprises. Now, the code is something that is separate and apart from the rule, but code will always be consistent with any express provisions, all the policy decisions, that are embedded in the rule. If we find ways to make the code operate more efficiently, to make it more operational from the enterprises' standpoint, we made sure that we maintained the discretion to this question to do so.

Mrs. JONES. So you have what you need?

Mr. FALCON. Yes.

Mrs. JONES. But this new program or code will, as you said previously, operate in conjunction with the other means that you have had to have regulation over Freddie and Fannie. Correct?

Mr. FALCON. Yes.

Mrs. JONES. And so it will be, versus two things to judge or assess their safety and soundness, you now have how ever many there are other than this, as well as this new code that came from the law or came from this recent ruling.

Mr. FALCON. Absolutely.

Mrs. JONES. Is that correct?

Mr. FALCON. Absolutely. We have our examination program, various other regulations designed to maintain the safety and soundness. We have our minimum capital regulation. We have this risk-based capital regulation. We have a full array of activities that we do.

Mrs. JONES. Generally, we do not want to allow anyone to toot their own horn, but based on what you had available to you previously and this new rule, do you believe that you are now in a position to help assure the safety and soundness of these two Government Sponsored Enterprises?

Mr. FALCON. Absolutely. And we do a very good job at it, Congresswoman, if I may toot our horn.

Mrs. JONES. Toot, toot, toot, you got the rest of the time.

[Laughter.]

Anything else you want to say?

Mr. FALCON. Yes. I think the 1992 Act which established OFHEO gave us a very solid set of tools to work with, very similar to the tools that any other financial safety and soundness regulator has. We have sought some enhancement to that, but basically I think we have a very talented staff, the tools. We could always use additional resources, but I think we fulfill our mission very thoroughly.

Mrs. JONES. I yield the balance of my time, Mr. Chairman. Thank you very much.

Chairman BAKER. Thank you, Mrs. Jones.

Just to clarify, with reference to page 69 citation that is technical in nature with regard to data and computational matters, so that if you are provided new data or you see an error in the coding, you can modify those in accordance with fairness to reflect an accurate portrayal of the enterprises' condition. But we cannot take the 2.5 percent capital standard and make it 2.0 percent, as distinguished between substantive and technical application. If it is demonstrated by GSEs or other interested parties that an outcome of the computations are not consistent with the agency's intent, then certainly that is viewed, I think, as a technical matter which could be changed not subject to the Administrative Procedures Act.

Mr. FALCON. Right. For instance, if we wanted to change the haircuts, we would move through the Administrative Procedures Act to make those changes in the rule.

Chairman BAKER. I think I am very comfortable with your explanation.

Mrs. JONES. Just so the record is clear, Mr. Chairman, it is page 68 that I was reading from.

Chairman BAKER. Page 68.

Mrs. JONES. Yes.

Chairman BAKER. OK.

Fannie and Freddie will continue to evolve and provide, we hope, creative new products to serve homeowners. Your rule as constructed today, what affect will it have on new product development? Any? None? Any delay for them to proceed? Or how will you assess the risk associated with a new product?

Mr. FALCON. We designed this rule so that it will allow full innovation by the enterprises. There is a section of the rule that deals with new activities. As the enterprises innovate, develop new products that might not be covered by this rule, because they just do not exist today, we will work quickly to incorporate those new products into the stress test as soon as possible. And we will decide whether or not to apply some interim conservative treatment to the new activity until we are able to fully understand the risk and how they manage the risk; decide whether or not we want to incor-

porate a simple application to the stress test; or perhaps do a separate modeling of the performance over time of that particular product.

So we allow them full innovation, but at the same time make sure that the risks of that innovation are incorporated as soon as possible into the stress test.

Chairman BAKER. Thank you.

I am going to yield back my time to enable other Members to ask questions before the break.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Let me say at the outset, I feel a little deficient. I studied the Administrative Procedures Act in graduate school, but I do not think I can quote from various pages what the regs are. But obviously, there is some interest in that.

There has been some discussion and even I guess some criticism in the construct of the rule, both as it relates to whether or not it properly addresses the credit quality of the assets, and then the question of the use of derivatives as hedges. On the first part, and I realize a lot of this came straight out of the 1992 Act, is the treatment with the stress test of the mortgage portfolios, that is similar to what is required in, it is either FIRREA or FDICIA, for the holdings of mortgage instruments by federally insured depository institutions? Is it the same type of model?

Mr. FALCON. It is a different type of risk-based capital requirement. What we currently have in place for banks and thrifts is a risk-based capital requirement that basically places assets into different "buckets," and then assigns haircuts to those "buckets" based on the assessment.

Mr. BENTSEN. No, I understand that. I guess what I am asking is, I thought it was either FIRREA or FDICIA that requires if a thrift or bank is making a purchase of a mortgage-backed security or REMIC or some sort of mortgage portfolio. Aren't they required under one of those acts to engage in certain stress tests? And if so, is that similar to what you do in this rule?

Mr. FALCON. I am not certain.

Mr. BENTSEN. If you could find out for the record, I would just be interested in that.

Mr. FALCON. Sure. I would be glad to.

Mr. BENTSEN. Second of all, how did you all come up with your models for determining risk for the use of derivatives or other types of hedge instruments? The reason I ask is, I am looking at one, on the one hand, I know there is concern that the haircuts are too strict, and on the other, I see where someone says you are using the same model as Long-Term Capital Management. And I find that hard to believe. So I am curious, obviously, this is a new phenomenon in the market used by banks, thrifts and other entities. How did you all come up with your model?

Mr. FALCON. Well, first off, on the issue of derivatives, and Mr. Chairman, we will certainly work to provide what information you would like on the subject that you mentioned previously, but the enterprises use derivatives as hedging instruments to help manage basically their interest rate risk. They do not engage at all in derivative transactions for speculative purposes. We would not allow

that. So the situation with Long-Term Capital Management and the enterprises is vastly different. Long-Term Capital Management used its pricing models to try to anticipate various swings in foreign currency and other types of investments they had. And they lost that bet. So you saw what happened with Long-Term Capital Management. The enterprises do not engage in derivative transactions for speculative purposes. They use them only to hedge their risk. They do not take the naked position in the derivative or trading position. So we are comfortable that they do use derivatives in a prudent manner.

Now, what we did with respect to haircutting for derivatives in the rule, we looked at various studies that had been produced as to whether or not to differentiate between different rating levels, rating agency levels, and what that haircut should be. There were various studies that we looked at which everyone cites, Hickman, Moody's, Standard and Poor's, Duffs and Phelps, everyone has looked at this. We came out with what we thought was a sound judgment, but we are willing to take a fresh look to make sure that we properly balanced a rule which was appropriately stressful, but at the same time was not excessive.

Mr. BENTSEN. Thank you.

Thank you, Mr. Chairman.

Mr. BAKER. Thank you very much.

Mr. Falcon, again, I think every Member has expressed it. We want to again say thank you.

Mrs. JONES. Mr. Chairman, can I just do a quick follow up from the question. I would like one second.

Chairman BAKER. Fine.

Mrs. JONES. Mr. Chairman was talking about the change, or new products. But any financial institution or bank or whatever may come up with new products. And when you come up with a rule or regulation that regulates such a thing, you conceptually would include in that the possibility that there would be new products that would allow you to still withstand the test of time based on your stress test, if I said that right. Did I make any sense? Or can you answer that question?

Mr. FALCON. Yes. If we did not allow for new products in this rule, it would be obsolete from the day that it was published. And so it does appropriately make sure that the enterprises can innovate and put out new products, and we can incorporate them on a timely basis into the stress test.

Chairman BAKER. Again, thank you, Mr. Falcon, for your agency's work. There is a fair certainty that the application of the rule eventually will cause some modification of the enterprise business activity, which will yield, I think, benefit in the long term for the market and for the taxpayer as well. It is my hope that the time available for review, comment and implementation will provide us with sufficient flexibility to ensure that there are not untoward market consequences of the application of the test. That, of course, is everybody's desire. But I just want to assure you of my longstanding, intense interest in seeing the rule implemented on the best of your professional capabilities. And I think the subcommittee stands ready to be of assistance.

We will probably return in the fall for sort of a wrap up after the formal implementation of the rule, and perhaps to receive comment from others as to the advisability of the rule, even the GSEs if they would choose to have some statement on the record as to any concerns about the implementation. This should be an ongoing dialogue that results in the best public policy for all parties concerned.

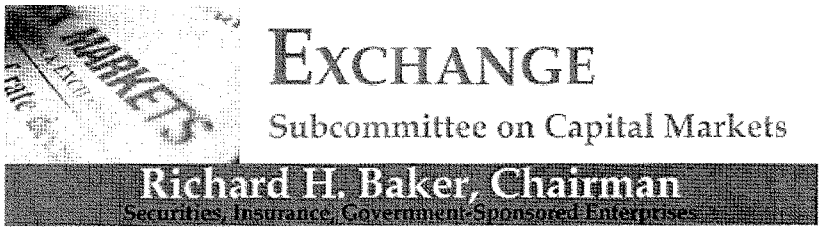
With that, I thank you and our hearing stands adjourned.

Mr. FALCON. Thank you, Mr. Chairman.

[Whereupon, the hearing was adjourned.]

A P P E N D I X

August 1, 2001



The News from U.S. Rep. Richard H. Baker
Sixth District, Louisiana
FOR IMMEDIATE RELEASE: August 1, 2001
CONTACT: Michael DiResto, 225-929-7711

Opening Statement
The Honorable Richard H. Baker, Chairman
House Financial Services Committee Subcommittee on
Capital Markets, Insurance and Government Sponsored Enterprises
Hearing, August 1, 2001
"Office of Federal Housing Enterprise Oversight Risk-Based Capital Rule"

Today, the Subcommittee will conduct oversight of the risk-based capital rule that the Office of Federal Housing Enterprise Oversight has recently finalized and will issue in the near future. This hearing is also being held pursuant to our responsibilities under the Congressional Review Act. I welcome our witness, Armando Falcon, OFHEO's Director.

I congratulate Director Falcon on completing this long overdue task. I have repeatedly urged OFHEO to promulgate this rule, so that OFHEO can better ensure that Fannie Mae and Freddie Mac are adequately capitalized and operating safely. This risk-based capital rule is an important step in the right direction.

In this rule, OFHEO confirms some of my long-standing concerns about market discipline and systemic risk.

To quote from the rule:

"Government sponsored enterprises are not immune to failure."

"For most firms, debt markets provide strong capital discipline, penalizing a firm that is excessively leveraged with higher borrowing costs. That discipline is largely lacking for the Enterprises because of their status as Government sponsored enterprises."

"The economic distress of Fannie Mae in the 1979-1985 period was significant...but for a fortuitous change in interest rates, Fannie Mae might have collapsed, costing investors or the Government billions of dollars. Because of the growth of the Enterprises, a failure today could result in much greater loss. Depending on the response of the Government to such a failure, significant disruption to the financial and housing markets, significant burdens on

taxpayers, or both would result...the Enterprises have considerably more dollar exposure than the entire savings and loan industry had in 1986."

To the extent that market discipline of GSEs is lacking, I have offered legislation for new, stronger regulation. I remain concerned that Congress may not have constructed a regulator fully capable of getting its arms around Fannie and Freddie.

I believe the regulator of Fannie and Freddie should be more bank regulator-like. Specifically, I have looked at moving regulation of Fannie and Freddie to the Fed or the Treasury with a "Comptroller of GSEs." Based on a GAO study, I want to give this new regulator the same supervisory and enforcement powers as federal bank regulators and also comparable financial resources to do the job. In this regard, I look forward to receiving the Administration's views on GSE reform.

OFHEO's risk-based capital rule is highly complex and will be the subject of considerable analysis in coming months. While I commend OFHEO for producing this rule, it is premature to say the rule will remedy all of my concerns about safety and soundness. Today's hearing is the first of what I intend to be periodic oversight hearings on the workability of this rule and, most importantly, its effectiveness.

OFHEO lacks some of the supervisory resources available to the bank regulators for large, complex banks, yet OFHEO has chosen a risk-based capital system that is heavily dependent on its ability to field a large team of financial markets experts. I encourage OFHEO to work constructively with GSE management in this sophisticated arena.

I am particularly interested in exploring how the OFHEO rule differs from bank risk-based capital standards. For example, it is my understanding that bank regulators take a more cautious view of derivatives and limit the use of derivatives, requiring banks to hold risk-based capital regardless of how many derivatives may be in place.

In coming months, I will focus on the implementation of this new capital standard as well as any potential improvements, and, at the same time, work together with all interested parties in pursuit of broader regulatory reform, particularly an effective safety and soundness regime.

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Opening Statement

Chairman Michael G. Oxley

Committee on Financial Services

Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises
August 1, 2001

"Office of Federal Housing Enterprise Oversight Risk-Based Capital Rule"

The Capital Markets Subcommittee meets this afternoon to consider the new risk-based capital rule---I think it's fair to say the long-awaited and much anticipated capital rule---that has recently been finalized by the Office of Federal Housing Enterprise Oversight. This hearing is being conducted as part of our responsibilities under the Congressional Review Act.

OFHEO's risk-based capital rule has a long history. I congratulate Armando Falcon, OFHEO's Director and today's witness, for the role he has played in bringing this rule to completion.

Director Falcon, I encourage you to work with the Committee in the year before the rule is finalized in two ways: first to ensure that members understand the importance of the rule and why it is being issued; and second, to ensure that the rule is consistent with congressional intent.

OFHEO is responsible for ensuring that two government sponsored enterprises -- Fannie Mae and Freddie Mac -- are adequately capitalized and operating safely. The 1992 Act, which created OFHEO, directed the agency to issue a risk-based capital rule tied to an enterprise's risk exposure, as well as the current leverage capital rule that is a percentage of assets. It is important that both these capital requirements are in place and being implemented in tandem, so that the enterprises can continue to perform their public mission in a safe and sound manner.

I look forward to Director Falcon's testimony.

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Rep. Stephanie Tubbs Jones

Good Morning, Chairman Baker, Ranking Member Kanjorski and Members of this Committee. Mr. Chairman, I ask unanimous consent that my full statement be included in the Record.

Mr. Chairman, we are here this morning to consider the Office of Federal Housing Enterprise Oversight (OFHEO) rule that develops a risk-based capital standard for government-sponsored enterprises, Fannie Mae and Freddie Mac. I, along with many of my colleagues, am pleased with the fact that we now have a rule and a better system by which OFHEO can do the job it was created to do. I commend you, Mr. Chairman, for calling this hearing giving this subcommittee the opportunity to hear directly from OFHEO's Director, Armando Falcon.

Safety and soundness, relative to the GSEs, are critical. Thus, the risk capital rule will go a long way in solidifying the stability of these enterprises. I believe it is important, now, more than ever before, to be flexible and allow the regulator to accomplish this complex task. With about 600 pages and a complex housing finance market, I hope this committee encourages OFHEO to make the necessary technical changes to improve the regulation, to ensure this regulation conforms to the 1992 Act and appropriately aligns capital to risk. As a matter of fact, one of my questions to Director Falcon will deal with whether he has ample authority to make such changes.

I believe we are moving in the right direction with this rule. As the safety and soundness regulator, OFHEO, indeed has a tough job. Their work includes evaluations and assessments dealing with over 150 features relative to safety and soundness. Moreover, they evaluate various components of risk, controls, auditing systems, management processes and governance. OFHEO examiners work to complete on-site exams as well as off-site monitoring. This intense analytical work is critical to the proper functioning and monitoring of both Fannie and Freddie.

Director Falcon and OFHEO should be complimented on their completion of the rule. I acknowledge this accomplishment in light of the fact that he has been on the job for only 18 months.

I also encourage Director Falcon to work with Fannie and Freddie. A regulator does not have to become the adversary of the entities it regulates. As important as both Fannie and Freddie are to the secondary mortgage markets and our overall economy, constant review and innovation will be needed to deal with and address changes.

I support the work of both Fannie Mae and Freddie Mac. Thus, I support to work of their regulator in ensuring that these enterprises are safe and can continue to make homeownership and affordable housing available across this nation.

Previously, I have come out against altering the regulatory regimes of these enterprises. Today, OFHEO, with this rule, has come forth with the appropriate tools to work with. I believe they are quite capable of doing the work they are charged to do.

I also want to salute the GSEs. We must remember that the GSEs functioned for about eight years without the benefit of this rule and, by all accounts, have been very successful.

In closing, let the rule work. This rule should be flexible enough so as to not hinder Director Falcon's ability to regulate and the GSEs ability to make homeownership a reality.

This rule serves as the fruit of the labors from our previous meetings in which we examined, with great detail, Fannie Mae and Freddie Mac. From those hearings, we examined safety and soundness and culminated with six Voluntary Commitments by Fannie and Freddie.

Mr. Chairman, I believe in the importance of safety and soundness, disclosure and market discipline. I believe the GSEs have met this challenge. Now, we have a rule and a regulator ready to do its job. We can move forward with OFHEO and be assured that our enterprises, as well as the housing finance market, continues to be the envy of the world.

Thank you, Mr. Chairman, for the opportunity to present my remarks. I look forward to this hearing.

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Congress of the United States
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Washington, DC 20515–4325

Hearing Regarding Risk-Based Capital Regulation
The Honorable Kenneth E. Bentsen, Jr.
of Texas
before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
Wednesday, August 1, 2001

Mr. Chairman, I want to commend you for holding this hearing that will examine the Office of Federal Housing Enterprise Oversight (OFHEO) final regulation related to Risk-Based capital that was released on July 19, 2001. As a member of the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, I am pleased that OFHEO has released this long-awaited risk-based capital regulation. In 1992, Congress approved a new law which required OFHEO to draft a risk-based capital regulation within two years. This regulation will provide necessary safeguards to ensure that the housing enterprises of FannieMae and FreddieMac have sufficient capital to sustain themselves during extremely difficult conditions which are described in this law as part of the stress test.

As you know, this risk-based capital regulation is an extremely complex model which requires extensive data input from the housing enterprises. Because of the complexity of this model, Congress provided additional time before the government sponsored enterprises (GSEs) must comply with this risk-based rule. The effective date of this regulation will be one year after publication of this rule in the Federal Register. I believe we should use this time to examine this rule to ensure that is it fair and reasonable. By holding oversight hearings on this rule, Congress will have sufficient time to review and propose any necessary changes that the Committee and the public would be well served by.

I also believe that additional hearings bringing in other expert witnesses to discuss this complex model are necessary. For instance, I believe it would be appropriate to invite the rating agencies such as Moody's and Standards and Poor who have familiarity with complex models and will be reviewing this risk-based rule when they make their rating determinations for GSE-sponsored debt instruments. Major market participants should also be heard. Additionaly, I believe that we should include witnesses who can provide us with more information about other risk-based capital rules, particularly the Basel risk-based capital proposal, which would provide a comparison to the OFHEO rule.

After all of the years of hard work by OFHEO, we should not expect today's hearing to be the last word on this matter. I look forward to hearing from OFHEO about the specifics in this rule and will continue to carefully monitor this regulation to ensure that it is fair and reasonable.

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OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

BRIEFING ON THE OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT'S FINAL RISK-BASED CAPITAL RULE

WEDNESDAY, AUGUST 1, 2001

Mr. Chairman, thank you for the opportunity to comment before we begin our hearing to review the final risk-based capital standard recently released by the Office of Federal Housing Enterprise Oversight, otherwise known as OFHEO. Because our Committee will hear from just one witness, we should probably frame today's hearing instead as a briefing. This briefing will help us to better understand the contents of the risk-based capital rule, the process of its development, and the procedures for implementing it.

OFHEO is the safety and soundness regulator for Fannie Mae and Freddie Mac, the nation's two largest housing government sponsored enterprises or GSEs, and two of the country's largest financial institutions. Since its creation nearly a decade ago, OFHEO has developed and implemented a robust and continuous examination program that works to protect taxpayers from risk. Each quarter, for example, OFHEO's examination teams review more than 150 separate components of safety and soundness to develop a comprehensive account of each GSE's financial condition.

With the release of this stress test, which the agency spent nearly seven years drafting, OFHEO supplements its existing capital standards and complements its already tough examination program. Implemented properly, this rule will ensure that the two GSEs remain at the forefront of financial regulation. Furthermore, the implementation of this regulation will, in my opinion, enhance the ability of Fannie Mae and Freddie Mac to achieve their mission of helping low- and middle-income families to own homes.

More specifically, this new standard calculates how much capital Fannie Mae and Freddie Mac need to hold to withstand a 10-year period of economic stress. Relying on the parameters contained in the 1992 GSE law, OFHEO's stress test simulates dramatic changes in interest rates and the highest historical declines in property values to determine these capital requirements. Notably, OFHEO believes its regulation "will more accurately tie capital to risk than any other current or proposed standard" for any financial institution.

As you know, Mr. Chairman, our Committee has closely followed the development and issuance of this innovative rule, holding numerous hearings on the subject and GSE regulation in general since 1997. Although some have expressed impatience at the amount of time OFHEO has taken to develop this standard, the relatively quick approval by the Office of Management and Budget of this complicated regulation demonstrates its confidence in OFHEO's competency, reliability, and credibility.

OFHEO's dedicated experts additionally deserve congratulations for their hard work in finalizing this intricate rule. In particular, OFHEO Director Armando Falcon has demonstrated leadership in successfully guiding this complex standard through the regulatory process. I look

forward to learning of his thoughts later today during our briefing. It is also, in my opinion, especially important that OFHEO maintain continuity in its leadership in the months and years ahead as it works to implement this rule.

Anticipating the complexity of the GSE stress test, Congress further authorized a one-year transition period following to the final rule's publication in the *Federal Register*. This interlude will allow OFHEO and the affected parties to work through any concerns and address the procedural issues likely to arise as the rule becomes operational. Consistent with the requirements of the 1992 GSE law and the Administrative Procedures Act, our Committee should support these consultations and reasonable technical modifications.

As they have done in recent weeks, I also hope that all of the involved parties will work constructively with one another to implement this rule efficiently. I am also confident that the management teams of both Freddie Mac and Fannie Mae will swiftly address any changes required by this regulation. Finally, I hope that my colleagues will work with me to ensure that OFHEO receives the resources it needs to get the job done and consider removing the agency from the annual appropriations process as we have done with the other financial regulators.

In closing, Mr. Chairman, I continue to share your desire to conduct effective oversight over the housing GSEs and to ensure that we maintain an appropriate and sufficiently strong supervisory system for them. The implementation of this risk-based capital regulation will provide more immediate protection for taxpayers, investors, and homeowners than any legislation that we could pursue in the 107th Congress. I consequently look forward to not only our briefing today, but also to working with you to put this long-awaited rule into practice.

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

August 1, 2001

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[1]
August 1, 2001

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.

[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.

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