OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE,
AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON THE STATUS OF THE
VOLUNTARY COMMITMENTS
MADE BY FANNIE MAE AND FREDDIE MAC

TUESDAY, MARCH 27, 2001

Mr. Chairman, before commenting further on today's proceeding, I must first commend you for your continued leadership on government-sponsored enterprise, or GSE, issues. In the 106th Congress, in addition to passing legislation to modernize the Federal Home Loan Bank System, we held hearings over five days and a roundtable on legislation designed to reform the regulation of the housing GSEs and eliminate some of their statutory benefits. Although that bill did not become law, it did help lead to the development by Fannie Mae and Freddie Mac of the six voluntary commitments, the subject of today's hearing. You played an important role in raising public awareness about these issues and deserve congratulations.

During our lengthy hearings last year on GSE regulation, I also believe that we reached consensus on several points. First, we agreed that we have the world's most successful housing finance system and gained an appreciation for the important role that the GSEs play in that system. Second, we agreed that Fannie Mae and Freddie Mac have grown significantly in recent years. Finally, we agreed that we must have strong, independent regulators for the housing GSEs. These regulators must also have the resources they need to get the job done.

As one of the few remaining Committee Members who participated in the entire congressional battle to resolve the savings and loan crisis, I am acutely aware of the need to protect taxpayers from risk. It is in the public's interest that we ensure that Fannie Mae and Freddie Mac continue to operate safely and soundly. We can best achieve this goal by pursuing a three-pronged supervisory approach that includes regular congressional oversight of, continued effective government regulation over, and increased market discipline for the two GSEs.

Through our extensive studies last year and our hearing today, we are fulfilling our obligation in Congress to conduct regular oversight of the GSEs. In addition, OFHEO, is, from my perspective, operating increasingly effectively as the safety and soundness regulator for Fannie Mae and Freddie Mac. The agency has, for example, developed and implemented a robust, comprehensive, and continuous examination program that works, and it will soon publish its long-awaited risk-based capital standard to round out its existing capital standards.

The voluntary commitments recently developed by Fannie Mae and Freddie Mac to promote market discipline complete the third leg of my supervisory tripod by strengthening capital adequacy and increasing transparency. The overall package, in my view, constitutes a sound set of measures that supplement OFHEO's formal regulatory regime and augment congressional oversight. The voluntary commitments are also consistent with the prevailing thinking of the leading minds on risk management.

At our press conference last October on the voluntary commitments, I noted that when implemented the initiatives would hopefully become a complement to, and not a substitute for, OFHEO's already strong safety and soundness examination program and capital requirements. In that vein, I asked OFHEO to review the regulatory environment surrounding the voluntary measures in advance of today's hearing. In his response, OFHEO's director notes that "[b]y making these enhanced disclosures, Fannie Mae and Freddie Mac improve the public's awareness about their financial condition and risk management practices." I agree and would ask, Mr. Chairman, unanimous consent to submit this letter into the record.

If we once again decide to pursue legislative action affecting the GSEs in the 107^{th} Congress, we must ensure that we do not diminish their ability to work efficiently. We should also, in my view, explore modernizing their mission. For example, the GSEs could work to improve economic development in our nation's distressed areas. They could also work to create a secondary market for investments made pursuant to the Community Reinvestment Act. These worthy ideas merit our prudent consideration.

Finally, throughout last year's deliberations on GSEs, I consistently noted that we must move forward cautiously in this area so as to ensure that we maintain the delicate balance that has led to more than 67 percent of all American families owning their homes. On at least one occasion last year, however, our Committee's actions discouraged investors and raised homeownership costs. As we proceed today, we must renew our efforts to ensure that we do not repeat that mistake. Mr. Chairman, I therefore look forward once again to carefully, deliberately, and objectively examining the many issues related to the housing GSEs in the 107^{th} Congress.

March 27, 2001

The Honorable Paul Kanjorski
Ranking Member
Subcommittee on Capital Markets, Insurance,
and Government Sponsored Enterprises
U.S. House of Representatives
Washington, DC 20515

Dear Congressman Kanjorski,

I am responding to your office's request that OFHEO provide background on the regulatory environment surrounding the voluntary measures agreed to last October by Fannie Mae and Freddie Mac. I appreciate this opportunity to provide you with my thoughts.

As you know, international financial regulators have been working to enhance the global standards used to regulate large and complex financial firms. The authoritative international body of financial regulators, the Basel Committee on Banking Supervision, has espoused a three-pillar approach to enhancing safety and soundness regulation for large and complex banking firms. Generally, the three pillars are:

- Prudential capital standards – consisting of more standardized measurements of risk and definitions of capital;
- Prudential supervision – consisting of some level of regulatory testing and verification of systems, processes, controls, and reporting; and
- Market discipline – consisting of greater transparency through public disclosure allowing market forces to better differentiate among institutions' risk profiles.

The regulatory program OFHEO has adopted to regulate the safety and soundness of Fannie Mae and Freddie Mac is consistent with the three pillars of the Basle Committee on Banking Supervision and may well be complemented by the heightened market scrutiny evolving from the voluntary agreement.

Consistent with the first pillar, OFHEO enforces a minimum capital standard which is very similar to the risk-based capital standard to which banks are currently subject. Also, OFHEO has completed its risk-based capital test and is in the final administrative stages of implementing the rule. The combination of minimum capital and the risk-based capital stress test will subject Fannie Mae and Freddie Mac to the most sophisticated effort yet to link capital to risk while maintaining a capital floor.

Consistent with the second pillar, OFHEO conducts comprehensive annual risk-based examinations of Fannie Mae and Freddie Mac. Unique to OFHEO is the fact that the process employed in examining the Enterprises' safety and soundness as well as the results and conclusions of the annual examinations are available to the public. In it's January 31, 2001 letter to Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises Chairman Richard Baker (<u>Comparison of Financial Institution Regulator's Enforcement and Prompt Corrective Action Authorities;</u> GAO-01-322R), the General Accounting Office (GAO) stated that,

> "Under the Safety and Soundness Act, the Director of OFHEO is required to provide Congress with an annual report that includes a description of any actions take by the Director, as well as the results of the Enterprises' examinations. These disclosure provisions may encourage early resolution of issues to avoid disclosure of OFHEO's concerns. The bank regulators and FHFB do not have such a disclosure requirement."

In line with Basle's third pillar, on October 19, 2000, Fannie Mae and Freddie Mac (the Enterprises) joined a bi-partisan group of Members of Congress in announcing six commitments covering financial operations and financial disclosures.

As we stated in our 2000 Report to Congress, we believe:

> "Market discipline of Fannie Mae and Freddie Mac is a potentially important complement to safety and soundness regulation of the Enterprises. If creditors have accurate and timely information on the financial risks of Fannie Mae and Freddie Mac and believe that they are exposed to material risk of loss if the Enterprises get into financial trouble, they will take steps to ensure that the Enterprises strike an appropriate balance between risk and return. By enhancing market discipline, greater transparency has the potential to limit the systemic risk that Fannie Mae and Freddie Mac may pose to the financial system."

By making these enhanced disclosures, Fannie Mae and Freddie Mac improve the public's awareness about their financial condition and risk management practices. Increased awareness about Fannie Mae's and Freddie Mac's financial condition and risk management practices allows market forces to better differentiate the credit premium to be attached to each Enterprise's debt instruments and offerings.

With that said, I want to provide you with what OFHEO is already doing on each of the six areas of the agreement.

Commitment #1 – Periodic Issuance of Subordinated Debt

The first area the Enterprises agreed to take action is in the issuance of publicly traded and externally rated subordinated debt on a semi-annual basis. This subordinated debt is to be issued in an amount such that the sum of core capital and outstanding subordinated debt will equal or exceed 4% of on-balance-sheet assets over a three-year phase-in period.

Some proponents advocate that subordinated debt may serve as an effective means of detecting market signals. When considering the Enterprises' sub debt, only time will tell if the markets will treat this debt truly as an investment at risk. If investors are able to treat this debt as if it does not carry an implied government guarantee, it may well be an effective means at providing added market discipline.

Regardless, OFHEO already routinely evaluates the Enterprises' funding composition, the cost of funds and other metrics during its examination of liquidity and liquidity management. Our 2001 examinations are already assessing, through our continuous risk-based activities, the Enterprises' compliance with this commitment and the accuracy of public reporting.

Commitment #2 – Liquidity Management and Contingency Planning

The Enterprises committed to maintain their management practices for liquidity consistent with the principles of sound liquidity management prescribed by the Basel Committee on Banking Supervision. In particular, the Enterprises committed to maintain at least three months worth of liquidity assuming there is no access to public debt markets.

Through its comprehensive examination program, OFHEO has already been assessing the quality of liquidity and liquidity management. Liquidity management and contingency planning are evaluated continuously against the ten assessment factors prescribed in OFHEO's Liquidity Management Program. OFHEO has been engaged in a dialogue with the Enterprises as they have developed the measurement for how they will be reporting under this voluntary commitment, and we will be examining for the accuracy of the reporting they will provide going forward.

Commitment #3 – Interim Implementation of Risk-based Capital Stress Test

Pending final promulgation of OFHEO's risk-based capital standard, the Enterprises will implement their version of a risk-based capital stress test and disclose whether they pass or fail the test on a quarterly basis.

OFHEO's work on the risk-based capital requirement is completed. Pending the publication of a final rule and its effective date (one year later), the Enterprises will operate their independent stress-test versions of the 1992 Act's requirements.

As with the Enterprises' other internal models, OFHEO's examination activities evaluate the quality of these proprietary tools and the validation processes. OFHEO has recognized the growing importance of internal models and automated methodologies by: establishing a dedicated examination group for internal models; hiring examination staff with expertise to conduct the examination work; and publishing OFHEO's methodology for examining the Enterprises' internal models (EG-2001-01).

Commitment #4 – Increased Interest-Rate Risk Disclosure

The Enterprises will publicly disclose on a monthly basis (beginning with first quarter 2001) the expected financial impact of immediate adverse changes in interest rates and the slope of the yield curve.

Through a comprehensive examination program, OFHEO already examines the level of interest rate risk exposure at the Enterprises and the quality of their interest rate risk management tools and practices. Interest rate risk exposure along with the resulting exposure from various changes in the level of interest rates or changes in the yield curve are continuously monitored by a team of qualified and experienced examiners. The Enterprises' exposure to interest rate risk is continuously assessed using a series of safety and soundness standards published in OFHEO's Interest Rate Risk Program within its annual risk-based Examination Program.

OFHEO has been engaged in a dialogue with the Enterprises as they have developed the method for how they will be reporting under this voluntary commitment, and we will examine and assess the accuracy of these reports.

Commitment #5 – Increased Credit Disclosure

The Enterprises will publicly disclose the results of portfolio credit risk sensitivity analyses on a quarterly basis that demonstrates the expected financial impact of an immediate 5% decline in house prices.

Through a comprehensive examination program, OFHEO already evaluates the portfolio sensitivity resulting from sharp and immediate declines in collateral values. The examination analyses covering changes in collateral values are among the various vulnerability analyses that are continuously evaluated throughout the year by OFHEO's examiners. OFHEO has a team of qualified and experienced examiners who are continuously monitoring and testing the Enterprises' credit and counterparty vulnerabilities using a series of safety and soundness standards contained in OFHEO's Credit Risk Program as set forth in the published Handbook that details the processes for OFHEO's annual risk-based Examination Program.

OFHEO remains engaged in a dialogue with the Enterprises as they develop the method for how they report credit risk exposure including the requirements of this voluntary commitment. We have already included an evaluation of the accuracy of the reporting for this commitment into our 2001 (and future) examinations.

Commitment #6 – Public Disclosure of an Annual Rating

The Enterprises have obtained a rating that assesses the risk to the government (and will be continuously updated) from a nationally recognized statistical rating organization and the Enterprises have reported that rating to the public.

OFHEO intends to remain apprised of the developments and pronouncements about the ratings on each Enterprise's risk to the government. However, OFHEO is uniquely positioned as the safety and soundness regulator, and enjoys unfettered access to the information and records of the Enterprises as wells as to management and the directors of these companies. Through our access and routine receipt of reports and data along with frequent interaction with management, directors and staff, OFHEO remains better informed about the financial operations and condition of these companies than the rating agencies. In fact, through OFHEO's examination program, we have teams of examiners continuously on-site at both Enterprises throughout the year. These examiners are routinely conducting discussions with management, employees and directors in addition to monitoring and testing the processes, reports and controls at Fannie Mae and Freddie Mac.

Conclusions

It is clear that the commitments forged between Congress and the Enterprises can complement OFHEO's formal regulatory regime. The market discipline that accrues from increased transparency is only one of the three pillars we support in the safety and soundness regulation of large and complex financial firms. We believe the market transparency pillar is an augmentation of, not a substitute for, OFHEO's strong safety and soundness examination program and capital requirements. In combination, these features achieve a world-class framework for the regulation and oversight provided to Fannie Mae and Freddie Mac.

If I can be any further assistance to you or your colleagues while the Enterprises' safety and soundness and capital adequacy, please do not hesitate to contact me.

Sincerely,

Armando Falcon, Jr.
Director