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FEDERAL HOUSING ENTERPRISES

Operations of the Office of Federal Housing Enterprise Oversight

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Federal Housing Enterprises: Operations of the Office of Federal Housing Enterprise Oversight

In a recently issued report,¹ GAO found that the Office of Federal Housing Enterprise Oversight (OFHEO) has not fully implemented its statutory safety and soundness responsibilities for Fannie Mae and Freddie Mac—the two largest housing government-sponsored enterprises—and faces considerable future challenges in doing so. In particular, OFHEO does not expect to complete a stress test² and risk-based capital standards for the enterprises until 1999 even though it was to have done so by December 1, 1994, under the act. Further, OFHEO has not fully implemented a comprehensive and timely enterprise examination program. As a result, OFHEO has a limited ability to lower the long-term financial risks to U.S. taxpayers associated with the enterprises' activities.

GAO identified a number of reasons for OFHEO's inability to comply with the statutory deadline for completing the stress test and risk-based capital standards. For example, the development process specified in the act presented OFHEO with complex and time-consuming challenges. To meet these challenges, OFHEO, in 1994, decided to develop its own sophisticated stress test rather than adopting existing stress tests. OFHEO officials said that their approach was the most appropriate strategy, but GAO notes that the approach has involved substantial time and resource commitments. GAO also notes that OFHEO faces considerable challenges in completing the stress test by its current target of 1999, such as the need to translate its complex components into proposed and final rules. Given OFHEO's history of underestimating the time necessary to complete the stress test components, GAO believes that strong congressional oversight of the development process is necessary to ensure that OFHEO completes the process as quickly as feasible.

OFHEO has not been able to fully implement an enterprise examination schedule and plan that the organization established in 1994. OFHEO has taken 3 to 4 years to examine the major risks facing the enterprises rather than 2 years as established in the plan, and it reduced the planned coverage of the most recently completed risk examination. GAO's analysis found that, among other factors, limited resources allocated to the examination office and staff attrition contributed to OFHEO's inability to fully implement the 1994 plan. During GAO's audit work, OFHEO officials said that they planned to reassess the examination program and

¹Federal Housing Enterprises: OFHEO Faces Challenges In Implementing a Comprehensive Oversight Program (GAO/GGD-98-6, Oct. 22, 1997).

²The purpose of the stress test is to simulate, in a computer model, situations where the enterprises are exposed to adverse credit and interest rate risks and requiring them to hold sufficient capital to withstand these risks for a period of 10 years.

Summary
Federal Housing Enterprises: Operations of
the Office of Federal Housing Enterprise
Oversight

implement an annual examination cycle by early 1998 to cover all enterprise risks. GAO noted that without a reassessment of resource requirements and potentially a reallocation of resources to the examinations office, OFHEO may not be able to fully implement an annual examination cycle because it has been unable to fully implement a 2-year cycle with existing examination office resources. Thus, GAO recommended that OFHEO include in its reassessment an analysis of the staff resources necessary to adequately carry out alternative examination cycles, such as 1 or 2 years. Through such an analysis, OFHEO could better ensure a fuller consideration of the trade-offs associated with examination coverage provided versus costs involved and thereby engage in a more informed decisionmaking process.

Although Fannie Mae and Freddie Mac have been consistently profitable in recent years, GAO believes it is essential, given the enterprises' outstanding financial commitments of about \$1.5 trillion³ at year-end 1996, that OFHEO implement its safety and soundness responsibilities as quickly as feasible so that any potential long-term financial risks to taxpayers are lowered.

³The \$1.5 trillion consisted of about \$487 billion in combined enterprise debt outstanding and about \$1 trillion in enterprise mortgage-backed securities that were held by investors.

Federal Housing Enterprises: Operations of the Office of Federal Housing Enterprise Oversight

Mr. Chairman and Members of the Committee:

We are pleased to be here today to discuss the operations of the Office of Federal Housing Enterprise Oversight (OFHEO) and the status of OFHEO's efforts to fulfill its mission of helping to ensure the safety and soundness of the two largest housing government-sponsored enterprises: Fannie Mae and Freddie Mac (the enterprises).

Congress has a long-standing concern that the safety and soundness of the enterprises be maintained so that they can continue to fulfill their public purposes while taxpayers are protected from unnecessary financial risks. Consequently, Congress passed the Federal Housing Enterprises Financial Safety and Soundness Act of 1992¹ (the act), which established OFHEO as an independent regulator within the Department of Housing and Urban Development (HUD). Under the act, OFHEO is authorized to help ensure the enterprises' safety and soundness by setting capital standards, conducting examinations, and taking enforcement actions if unsafe and unsound financial or management practices are identified.

As mandated in the Department of Veterans Affairs/HUD Appropriations Act of 1997,² we recently issued a report³ on OFHEO's implementation of its safety and soundness responsibilities since it began operations in June 1993. We concluded that OFHEO has not yet fully implemented its statutory responsibilities and faces considerable future challenges in doing so. In particular, OFHEO currently does not expect to establish final risk-based capital standards for the enterprises until 1999, even though this process was to have been completed under the act by December 1, 1994. Further, OFHEO has not fully implemented a comprehensive and timely safety and soundness enterprise examination program. Although Fannie Mae and Freddie Mac have been consistently profitable in recent years, we believe it is essential, given the enterprises' outstanding financial commitments of about \$1.5 trillion⁴ at year-end 1996, that OFHEO implement its safety and soundness responsibilities as quickly as feasible so that any potential long-term financial risks to taxpayers are lowered.

¹Housing and Community Development Act of 1992, Pub. L. No. 102-550, Title XIII, 12 U.S.C. 4501, et. seq.

²Pub. L. No. 104-204 § 430, 110 Stat. 2784, 2930 (Sept. 26, 1996).

³Federal Housing Enterprises: OFHEO Faces Challenges In Implementing a Comprehensive Oversight Program (GAO/GGD-98-6, Oct. 22, 1997).

⁴The \$1.5 trillion consisted of about \$487 billion in combined enterprise debt outstanding and about \$1 trillion in enterprise mortgage-backed securities that were held by investors.

OFHEO's Mission Is to Help Ensure the Enterprises' Safety and Soundness

The federal government's creation and continued sponsorship of Fannie Mae and Freddie Mac have created the perception in the financial markets that the government may choose to provide financial assistance to them in a financial emergency, even though there is no statutory requirement to do so. Recognizing the potential financial risks the enterprises' activities pose to taxpayers, Congress created OFHEO in 1992 as an independent safety and soundness regulator with wide authority to help ensure that the enterprises' long-term financial security is maintained.

Enterprises' Activities Play a Vital Role in the U.S. Housing Finance System but Also Involve Financial Risks

Congress established and chartered the enterprises as government-sponsored, privately owned and operated corporations to enhance the availability of mortgage credit across the nation during both good and bad economic times. It is widely accepted that the enterprises' activities have generated benefits to home-buyers, such as lower mortgage interest rates. Moreover, the enterprises have reduced regional disparities in mortgage interest rates and spurred the development of new technologies to facilitate the home financing process.

However, the potential also exists that the federal government would choose to rescue the enterprises in a financial emergency. OFHEO officials have stated that, despite the enterprises' consistent profitability in recent years, past financial performance does not guarantee future success. For example, during the 1990s, Fannie Mae and Freddie Mac have rapidly increased the size of their debt-financed mortgage asset portfolios.⁵ According to OFHEO, large holdings of debt-financed mortgage assets potentially expose Fannie Mae and Freddie Mac to increased losses resulting from fluctuations in interest rates.⁶

OFHEO Is Statutorily Mandated to Develop Capital Standards and Conduct Safety and Soundness Examinations

For fiscal year 1998, OFHEO has requested a budget of about \$16 million to carry out its safety and soundness responsibilities and to perform administrative support functions. As of October 27, 1997, OFHEO had a total staff of 96 individuals consisting of full-time and temporary staff, contract employees, and detailees from bank regulatory agencies.

⁵Debt-financed mortgage assets generally consist of whole mortgages and mortgage-backed securities that the enterprises have repurchased from investors. Between year-end 1992 and year-end 1996, the enterprises' combined debt-financed mortgage assets more than doubled from about \$190 billion to \$425 billion.

⁶By repurchasing mortgage-backed securities, the enterprises, rather than investors, assume the risk for losses associated with changes in interest rates.

**OFHEO Is Required to Develop
Capital Standards**

As required by the act, OFHEO is to carry out its oversight function in part by establishing minimum capital standards. Minimum capital is computed on the basis of capital ratios specified in the act that are applied to certain on-balance-sheet and off-balance-sheet obligations. OFHEO has classified Fannie Mae and Freddie Mac as “adequately capitalized” under the minimum standard in each quarter beginning with the quarter that ended on June 30, 1993.⁷

The act also mandated that OFHEO develop a stress test to serve as the basis for more sophisticated risk-based capital standards. The purpose of a stress test is to lower taxpayer risks by simulating, in a computer model, situations where the enterprises are exposed to adverse credit and interest rate scenarios and requiring them to hold sufficient capital to withstand these scenarios for a 10-year period, plus an additional 30 percent of that amount to cover management and operations risk. Under the act, the stress test and risk-based capital standards derived from the test were to have been completed by December 1, 1994. However, as of April 1997, OFHEO’s acting director said the organization expected to issue a proposed rule implementing the stress test and risk-based capital standards by September 1998, with the final rule to be issued in 1999.

**OFHEO Also Has the Authority
to Conduct Annual
Examinations**

The act also gave OFHEO broad authority and responsibility to examine the enterprises and requires annual on-site examinations.⁸ At such examinations, OFHEO staff with the assistance of contractors and bank regulatory detailees are to assess the financial condition of the enterprises and recommend improvements as necessary. OFHEO also has the authority to (1) take enforcement actions, such as cease and desist orders, against the enterprises to stop unsafe practices and (2) place an enterprise into a conservatorship when certain circumstances exist and the enterprise is unable to meet its financial obligations or it is critically undercapitalized.

⁷OFHEO issued the final rule implementing the minimum standard on July 8, 1996, and the final rule was first used to classify the enterprises as adequately capitalized in the third quarter of 1996. Previously, OFHEO classified the enterprises as adequately capitalized under interim procedures.

⁸According to OFHEO, the annual requirement can be and has been met without conducting annual full-scope examinations. Full scope examinations are generally understood to mean thorough assessments of all the management practices and business strategies of a financial institution that could potentially affect its safety and soundness. OFHEO believes it can comply with the annual examination requirement by assessing some, but not necessarily all, enterprise risks each year.

OFHEO's Development of a Stress Test and Risk-Based Capital Standards Has Been Protracted

In OFHEO's planning process and its published documents, the organization has consistently underestimated the time necessary to complete major components of the stress test and risk-based capital standards. For example, in 1995 OFHEO estimated that the final rule would be issued in May 1997, but OFHEO now expects that the process will not be completed until 1999. We identified several reasons why OFHEO did not comply with the statutory deadline and found that OFHEO faces continuing challenges in meeting its current estimate. Thus, we believe that strong congressional oversight of the development process is necessary to help ensure that OFHEO's plan to complete the risk-based capital standards is accomplished as quickly as feasible.

Development Has Been Delayed by the Complexity of the Mandate and OFHEO's Decision to Develop a Comprehensive Stress Test

Our review identified a number of reasons why OFHEO was not able to comply with the December 1, 1994, deadline and for the continuing delays in the development of the stress test and risk-based capital standards. The following reasons are among the more significant:

- OFHEO's statutory mandate to develop a stress test and risk-based capital standards presented complex and time-consuming challenges to the organization. For example, according to OFHEO, the final stress test should be flexible and capable of assessing the effects of different credit and interest-rate scenarios on differing components of the enterprises' mortgage portfolios, such as single-family and multifamily mortgages as well as new financial products. By contrast, the risk-based capital standards developed by federal banking regulators categorize assets into broad categories, which may not account for changes in the institutions' business practices that could affect their risk profiles. For example, banks can hold the same level of capital for loans to corporations with high credit ratings as to those with speculative credit ratings.
- OFHEO decided to develop a new stress test rather than trying to adopt and modify existing stress tests. During OFHEO's start-up phase in 1993 and 1994, there were strategies available that OFHEO could have pursued that might have resulted in the faster completion of a stress test and risk-based capital standards. As the foundation of the stress test, OFHEO could have adopted and modified a stress test under development by HUD in 1992 or the financial models that the enterprises had established to assess the potential impacts of alternative credit and interest rate scenarios. However, OFHEO officials determined that pursuing these strategies would have left the organization with an inadequate basis for assessing the risks facing the enterprises. Consequently, OFHEO concluded that it could establish capital standards that would be more

closely related to enterprise risks by developing its own sophisticated stress test and associated financial modeling capability. We note that OFHEO's approach has, ultimately, involved a substantial development period and commitment of resources.

- OFHEO encountered delays in obtaining accurate financial data from the enterprises. Beginning in 1994, OFHEO officials requested that the enterprises provide large amounts of historical and current financial data so it could do the work necessary to develop the stress test. According to OFHEO officials, the enterprises did not always provide all of the necessary data, or they provided data that may have been inaccurate. These problems persisted into 1996 and impeded development of the stress test, according to OFHEO officials.

In response, Fannie Mae officials said that OFHEO's data requests were burdensome and would have been less extensive if OFHEO had used a simpler approach to develop the stress test. The Fannie Mae officials said that a more simplified approach would have resulted in appropriate risk-based capital standards and could have been completed faster than OFHEO is currently taking to develop its stress test. Freddie Mac officials said they have tried to assist OFHEO in developing the stress test and that inaccurate data submissions have not been responsible for the delays.

- OFHEO experienced significantly greater technical and managerial challenges and associated delays than initially anticipated in developing an integrated financial model. This model—which is referred to as the Financial Simulation Model is to serve as the foundation of the stress test—is designed to simulate the behavior of the enterprises' assets, liabilities, and off-balance-sheet obligations under adverse credit and interest rate scenarios. According to an OFHEO official, OFHEO had largely completed the model by April 1997, although some final testing and software documentation work remained.

OFHEO Faces Continuing Challenges in Completing the Stress Test and Risk-Based Capital Standards by 1999

Our review also found that OFHEO faces several continuing challenges in completing the stress test and risk-based capital standards development process by 1999, as currently planned. These challenges include the need to (1) coordinate an interagency review process in which OFHEO officials are to share the technical components of the stress test with staff from the Office of Management and Budget, HUD, and Treasury; (2) make key policy decisions about the stress test, such as forecasts of future interest rates and the relationship between home prices and interest rates; and (3) translate the complex components of the stress test into proposed and

final rules while protecting proprietary enterprise data from unauthorized disclosure.

Given OFHEO's history of consistently underestimating the time necessary to complete the stress test and risk-based capital standards, we believe congressional oversight appears necessary to ensure that OFHEO completes the process as soon as possible. Accordingly, we recommended that OFHEO report periodically to Congress on the organization's progress towards compliance with the plan. We further recommended that OFHEO inform Congress of any problems that may arise in completing the process by 1999, as well as corrective actions that the organization planned to address such problems.

OFHEO Has Not Fully Implemented a Comprehensive and Timely Enterprise Examination Oversight Program

In the absence of a stress test and risk-based capital standards, OFHEO's primary means of helping to ensure the safety and soundness of the enterprises is its examination program. However, OFHEO has not fully implemented the detailed examination schedule and plan that it established in 1994, which limits the organization's ability to monitor the enterprises' financial condition. We believe that limited resources allocated to the examination office as well as staff attrition contributed to OFHEO's inability to fully implement the 1994 plan. Beginning in 1998, OFHEO plans to restructure its examination program so that it assesses all enterprise core risks annually.

OFHEO Has Not Fully Implemented Its Examination Schedule and Plan

OFHEO established an examination plan in September 1994 that provided for a 2-year cycle for the assessment of six "core" risks, such as interest rate and credit,⁹ facing the enterprises. Although OFHEO identified six core risks, the plan stipulated that examiners were to cover these risks in five examinations—four examinations would each cover one core risk while another examination would cover two risks.¹⁰ OFHEO's examination plan was similar in substance but not in timing to risk-focused examination plans that the Office of the Comptroller of the Currency and the Federal Reserve System have established to monitor the activities of large commercial banks. As required by law, the bank regulators are to conduct full-scope examinations of large commercial banks annually.

⁹The other four core risks are corporate governance, operations, business, and information technology.

¹⁰The plan stipulated that credit and interest rate risks would be covered in one consolidated examination.

As of May 1997, OFHEO had completed or initiated examinations covering five of the six core risks facing the enterprises. However, OFHEO's current 3- to 4-year cycle for assessing the six core risks is considerably longer than the 2-year cycle established in the plan. In addition, OFHEO has scaled back the planned coverage of its most recently completed core risk examination; the examination covered only one of four business areas.¹¹

OFHEO's 3-to 4-year examination cycle and limited examination coverage raise questions about the organization's ability to fully monitor the enterprises' financial activities and risks. In particular, with its current examination schedule, OFHEO may not be able to do another on-site examination of the enterprises' interest rate risks until 1999 or 2000, even though such risks may have increased because of increased holdings of debt-financed mortgage assets, since the previous core risk examination that addressed interest rate risk was completed in 1996.

**Limited Resources
Allocated to the
Examination Office and
Attrition Contributed to
OFHEO's Inability to Fully
Implement the 1994 Plan**

In May 1995, we reported that limited staff resources had impeded OFHEO's initial efforts to implement the 1994 plan.¹² This situation persisted between 1995 and 1997. As of June 1997, OFHEO's examination office had 17 authorized positions, of which 12 were reserved for line examiners directly responsible for conducting examinations.¹³ In its most recently completed core risk examination, which concluded in May 1997, OFHEO assigned 9 of its 12 line examination positions to the examination for approximately 1 year to complete it.¹⁴ Similarly, in the previous core risk examination, which was completed in June 1996, OFHEO assigned eight of the line examiner positions¹⁵ to the examination for about 1 year. In addition, during 1996 and early 1997, OFHEO experienced significant attrition in its examination office which left five vacant positions—a vacancy rate of 30 percent—as of March 31, 1997.¹⁶ Both OFHEO's

¹¹The business core risk examination covered the planned single-family mortgage area but did not cover three other business areas: multifamily mortgages, portfolio, and financial services.

¹²Government-Sponsored Enterprises: Development of the Federal Housing Enterprise Regulator (GAO/GGD-95-123, May 30, 1995).

¹³Of the other five positions, one was for the director, one was for the deputy director, one was for the executive secretary, and two were for financial analysts who are responsible for off-site monitoring.

¹⁴The examiners assigned to each core risk examination are to conduct that examination at both Fannie Mae and Freddie Mac.

¹⁵OFHEO also assigned a financial analyst to this examination even though this position is primarily responsible for off-site monitoring and not examination activities.

¹⁶As of August 1997, an OFHEO official said that the organization had filled three of the five vacant positions while two others were being advertised.

decision to commit virtually its entire staff of line examiners to each core risk examination for 1 year and the significant attrition the examination office has experienced have contributed to OFHEO's inability to fully implement its 2-year examination cycle.

OFHEO officials said that another important factor that has contributed to OFHEO's inability to fully implement the 1994 examination plan was the amount of time that OFHEO examination staff needed to develop an understanding of the enterprises' operations and risk management. Prior to 1993 when OFHEO began operations, the enterprises had not been subjected to an examination oversight program. OFHEO officials said that the first round of examinations has taken longer than initially anticipated in 1994 because of the amount of time necessary to obtain basic information about the enterprises' operations and risk management practices.

OFHEO Plans to Reassess Its Examination Program

During the course of our audit work, OFHEO officials told us that the organization plans to reassess its examination program during 1997 and implement an annual examination cycle for all core risks by early 1998 to ensure that the enterprises' safety and soundness is adequately monitored. The OFHEO officials also said that the reassessment is to include a review of examination office staff resources to ensure that an annual examination cycle can be implemented. OFHEO's acting director also said that OFHEO may have some flexibility to increase its examination staff resources by shifting staff from its research activities as the stress test and risk-based capital standards are completed.

We stated in our report that, without a reassessment of and potential reallocation of resources, OFHEO may not be able to implement an annual examination cycle by early 1998, since it had not fully implemented a 2-year cycle with existing examination office resources. In fact, as of June 1997, OFHEO had not initiated important components of the 1994 plan, such as one of the core risk examinations. Thus, we recommended that OFHEO include in the reassessment an analysis of the staff resources necessary to carry out alternative examination schedules, such as 1 or 2 years. Through such an analysis, OFHEO could help ensure a fuller consideration of the trade-offs associated with examination coverage provided versus costs involved and thereby engage in a more informed decisionmaking process.

Senior OFHEO officials recently told us that they are in the process of reviewing examination office resources, and have decided to reallocate two positions from other offices to the examination office. Thus, the officials said the examinations office will have a total of 14 line examiner positions, rather than 12, and 19 positions overall. In addition, the director of OFHEO's examination office told us that OFHEO plans to make greater use of bank regulatory detailees, than has been the case in the past, to also help ensure the effective implementation of the annual examination cycle by early 1998. Nevertheless, given OFHEO's past difficulties in implementing its enterprise safety and soundness examination responsibilities, we believe that OFHEO's future efforts, including the implementation of its annual examination cycle, should be closely monitored.

Concluding Remarks

I would like to conclude by reiterating that OFHEO has a crucial role in helping to maintain the safety and soundness of Fannie Mae and Freddie Mac and thereby ensuring that the enterprises can continue to meet their housing mission without posing unnecessary risks to taxpayers. As a relatively new federal regulatory organization with complex responsibilities, OFHEO has faced considerable challenges in implementing its statutory safety and soundness requirements. Among its accomplishments, OFHEO has assembled a professional staff that appears to have considerable expertise in housing economics, mortgage finance, computer systems analysis, and financial institution examinations. Although the development process has been slow, OFHEO has developed a working financial model that it believes will serve as the basis of the stress test and OFHEO plans to complete the final risk-based capital rule by 1999. However, given the challenges that remain in meeting this schedule, as well as OFHEO's efforts to implement an annual examination cycle during 1998, we believe that continued strong congressional oversight of OFHEO's progress is essential.

Mr. Chairman, this concludes my statement. My colleagues and I would be pleased to respond to any questions that you may have.

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