S. HRG. 107–303

THE HOUSING MISSION OF THE OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT AND THE FINANCIAL SAFETY AND SOUNDNESS OF FANNIE MAE AND FREDDIE MAC

HEARING

BEFORE THE

SUBCOMMITTEE ON HOUSING AND TRANSPORTATION

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

ON

THE RESOURCES AND EFFECTIVENESS OF OFHEO AS A REGULATOR, THE CAPITAL STANDARDS REQUIRED OF HOUSING GOVERNMENT SPONSORED ENTERPRISES, AND THE STATUS OF RISK-BASED CAPITAL STANDARDS REQUIRED BY CONGRESS IN 1992

MAY 8, 2001

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C O N T E N T S

TUESDAY, MAY 8, 2001

WITNESSES

THE HOUSING MISSION OF THE OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT AND THE FINANCIAL SAFETY AND SOUNDNESS OF FANNIE MAE AND FREDDIE MAC

TUESDAY, MAY 8, 2001

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON HOUSING AND TRANSPORTATION,
Washington, DC.

The Subcommittee met at 9:30 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Wayne Allard (Chairman of the Subcommittee) presiding.

OPENING STATEMENT OF SENATOR WAYNE ALLARD

Senator ALLARD. Let me call the Committee to order.

I like to start my Committee hearings on time. I know many of our witnesses that we call on our panels have very busy schedules. I think out of courtesy to them and, actually, out of courtesy to the other Members on the Committee, that we should get started on time. I always make a point of trying to do that. We are scheduled to start at 9:30 and it is now 9:30 in the morning.

I want to welcome everyone to the Housing and Transportation Subcommittee of the Banking Committee. Today, we will conduct a hearing on oversight of the mission of the Office of Federal Housing Enterprise Oversight—otherwise known as OFHEO—and the financial safety and soundness of Fannie Mae and Freddie Mac.

We have three witnesses. On the first panel we will hear from Mr. Armando Falcon, Director of OFHEO. On the second panel we will hear from Mr. Franklin Raines, Chairman and CEO of Fannie Mae; and also from Mr. Leland Brendsel, Chairman and CEO of Freddie Mac.

The American mortgage finance system is the envy of the world. Fannie Mae and Freddie Mac are a vital part of this system. They are among the largest financial institutions in the world.

While both Fannie Mae and Freddie Mac are New York Stock Exchange-listed companies owned by shareholders, they are also Government Sponsored Enterprises—commonly referred to as GSE's—with the specific mission to increase homeownership. Due to their GSE status, the Congress of the United States has a significant oversight responsibility for Fannie Mae and Freddie Mac.

In 1992, Congress created the OFHEO, an independent regulator within the Department of Housing and Urban Development, to regulate the financial safety and the soundness of Fannie Mae and

Freddie Mac. It has been 5 years since the Senate Banking Committee has conducted oversight of the OFHEO. This is our purpose here today. We will focus on the central question of the effectiveness of the OFHEO as a regulator.

This is a very important question, for together, the housing GSE's hold mortgages and issue mortgage-backed securities that total over $2 trillion. They also have outstanding debt in excess of $1 trillion, much of this held by the U.S. commercial and savings banks. These numbers make it clear how important it is that there be a strong and effective safety and soundness regulator for Fannie Mae and Freddie Mac.

Today, we have asked the OFHEO to submit testimony on the adequacy of its resources, the status of its risk-based capital regulations, and the safety and soundness of the housing GSE's. We will then ask the Chairmen of Fannie Mae and of Freddie Mac to testify to the effectiveness of OFHEO as a regulator, to discuss the financial safety and soundness of their institutions, and to provide an overview of the voluntary commitments made last year to provide greater public disclosure of their own risk assessments, implement a stress test system, increase liquidity, issue subordinate debt, and submit themselves to review by debt-rating agencies.

I look forward to the testimony of our witnesses as we conduct oversight in this important area.

Before I call on Mr. Falcon, I would like to recognize the Members of the Committee that we have here with us this morning. First, I would like to recognize the Ranking Member, Senator Reed from Rhode Island.

I would also mention to the Committee Members, as well as the panel, that we have a vote scheduled at 10:15 this morning. My intention is to go through the first panel by 10:15 a.m., and then we have a series of three votes. We will return as soon as possible after those three votes to hear from the last panel, which will be Fannie Mae and Freddie Mac, if that sounds okay with the Members of the Committee.

I want to recognize Senator Reed and I would ask if we can keep our statements relatively brief so we don't get into trouble with the business outline that I have put forth this morning.

Senator Reed.

OPENING COMMENTS OF SENATOR JACK REED

Senator REED. Thank you, Mr. Chairman. And thank you for holding this hearing on a very important topic. I am pleased that Mr. Falcon, Mr. Raines, and Mr. Brendsel will be here testifying this morning.

We are in the process of a very important review of the Office of Federal Housing Enterprise Oversight and also of the two Government Sponsored Enterprises that it regulates—the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. These are important institutions for our economy. They are institutions that we need to be concerned about in terms of both their safety and soundness and their interaction with the capital markets of our country.

I hope that this hearing will provide perspective as we consider these important issues. I do believe these issues require study. This is the beginning of that study. It might require additional hearings and if that is appropriate, I know, Mr. Chairman, you would invoke such hearings.

But I look forward to having an opportunity to begin today to look carefully at the operation of these institutions and to hear the testimony of our distinguished witnesses.

Thank you, Mr. Chairman.

Senator ALLARD. Senator Reed, we will work closely on follow-up after this hearing with you.

The Senator from New Jersey.

OPENING COMMENTS OF SENATOR JON S. CORZINE

Senator CORZINE. Thank you, Chairman Allard.

I want to personally welcome the witnesses and thank them for taking the time to testify here today. I know a number of them personally and have a very, very high regard for them. I also compliment you, Senator Allard, and Senator Reed for holding this hearing.

I think few would dispute that the mission of the GSE's in seeking to make housing more affordable and accessible is truly one of the important objectives and a very important one for our society.

The results are terrific—68 percent homeownership rate in our country, rising African-American and Latino family ownership. It is really, I think, a terrific result.

Today's hearing about this supervision and oversight by OFHEO I think is an important one which there has been questions and criticism that has arisen mainly from lengthy delays in getting to end results. I understand that Mr. Falcon inherited much of this problem. And so, I just look forward to hearing his comments on the credibility and performance of the effort.

But I want to make very clear that my own experience with both Fannie Mae and Freddie Mac is that they are outstanding institutions performing their roles exceptionally well.

Senator ALLARD. Thank you.

The Senator from Michigan.

OPENING COMMENTS OF SENATOR DEBBIE STABENOW

Senator STABENOW. Thank you, Mr. Chairman.

Mr. Falcon, it is good to see you again and to see Mr. Raines out in the audience in his new and different capacity. It is a pleasure to see both of you here today.

This is a very important topic, Mr. Chairman. I am pleased that you are holding this hearing today. This is an opportunity to discuss the vitally important function that Fannie Mae and Freddie Mac play in our housing market, and it is a chance to review their safety and soundness regulations.

There is no doubt that the role Fannie Mae and Freddie Mac have played in creating a secondary mortgage market—consequently promoting liquidity and mitigating risk—is key to much of the success in the housing market. These two corporations should be proud of the role that they have been playing in promoting homeownership.

Although there is a strong record of achievement, much more needs to be done. There are still too many people for whom the dream of homeownership is out of reach. Good intentions are not enough. We must follow with concrete action, and there is obviously a vital role for the GSE's in achieving our common goal.

One thing I would challenge the GSE's to do is to continue to increase their involvement in the subprime market. As the lending market has grown for consumers whose credit or income currently may prevent them from qualifying for a conventional loan, it has become all the more clear that we need the benefits of reputable actors like Fannie Mae and Freddie Mac. Aggressive GSE involvement in markets would surely help combat some of the outrageous predatory loans that are occurring in too many neighborhoods in Michigan, as well as around the country—by standardizing these loans and promoting competition—they would play a significant role. Indeed, failure to become involved in these markets could almost be considered counter to the GSE's mission for it would deprive too many working families the clear benefits that the GSE's bring to our housing system.

I would submit my full testimony for the record, Mr. Chairman. But I am certainly pleased that you are doing the hearing today. I would simply add that on the issue of regulation of the GSE's, that I don't believe that now is the time to do anything that would disrupt or radically change the regulatory system.

I certainly look forward to ways in which we can strengthen the system and work together.

Thank you.

Senator ALLARD. Thank you.

We will proceed to the first panel. Mr. Falcon, welcome.

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

Mr. FALCON. Thank you, Mr. Chairman.

Chairman Allard, Ranking Member Reed, and Members of the Subcommittee, my name is Armando Falcon and I am the Director of the Office of Federal Housing Enterprise Oversight or OFHEO. Thank you for the opportunity to testify this morning. I commend the Subcommittee for conducting this oversight hearing on the safety and soundness of Fannie Mae and Freddie Mac.

The OFHEO was established as an independent entity within the Department of Housing and Urban Development. The OFHEO was charged with ensuring the safety and soundness and capital adequacy of the Enterprises, while HUD was given the responsibility for regulating the Enterprises' activities—the so-called "mission" regulation.

As the Director of OFHEO, I am pleased to report that Fannie Mae and Freddie Mac are currently in very good financial health. They are well-managed and have exceeded the minimum capital requirements every quarter since 1993, when the capital requirement was first imposed. These conclusions are based on the findings of our broad regulatory system, which includes a highly regarded examination, capital analysis, and research programs. While the current situation is good, I want to assure you that OFHEO remains vigilant. The OFHEO works every day to ensure that this financial strength and well-being will not be jeopardized by the changes in the economy, the markets in which the Enterprises operate, or even the Enterprises themselves.

It may be useful to compare OFHEO's program with contemporary global thinking regarding large financial institution risk management and regulation. The Basel Committee on Banking Supervision is an obvious point of reference. The Basel Committee, which is a group of central bankers and international financial regulators, has endorsed "three pillars" of banking supervision. They consist of supervisory review, capital requirements, and market discipline. Our regulatory structure is consistent with those pillars.

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

Allow me to expand on our regulatory program.

The 1992 Act establishing OFHEO directs the Office to conduct annual on-site examinations to determine the Enterprises' financial condition. OFHEO reports the results and conclusions of these annual examinations in our annual "Report to Congress." This is unique among financial regulators and is a powerful tool in influencing the behavior of the companies we regulate. While that report is not due until June 15, I am pleased to tell you today that both Enterprises have met or exceeded safety and soundness standards in all examination program areas.

OFHEO's examiners maintain a physical presence at the Enterprises and have unlimited access to all levels of management and to highly sensitive corporate records.

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. Our examiners identify the opportunities for improvements in Enterprise risk-management practices and work directly with management to enhance financial safety and soundness.

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

While examinations are an important part of oversight, it is by no means the only area in which Congress provided OFHEO with significant regulatory responsibility. The 1992 Act also directed OFHEO to establish and to enforce two major capital tests for the Enterprises—a minimum capital test and the risk-based capital stress test.

OFHEO implements and enforces a statutory minimum capital requirement. This requirement is a leverage-based test similar to the existing capital requirements for banks and thrifts. If the Enterprise's core capital exceeds the requirement, the Enterprise is considered adequately capitalized. As I stated earlier, both Enterprises continue to exceed their minimum capital requirement.

The 1992 Act also called for a second capital test to be applied to both Enterprises—a sophisticated risk-based capital requirement using a stress test. The stress test simulates dramatic changes in interest rates and the highest historical declines in property values to determine capital requirements.

This approach is consistent with the Basel proposal, which is designed to increase the risk-sensitivity of capital requirements. Our risk-based capital regulation will more accurately tie capital to risk than any other current or proposed standard.

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

Early last month, we formally submitted the rule to the Office of Management and Budget for review. Once the rule is cleared by OMB and the rule is published in the *Federal Register,* Fannie Mae and Freddie Mac will be subject to the most sophisticated regulatory capital standard of any financial institution in the world.

As with all financial regulators, research is an area of great importance to the OFHEO's ability to fulfill its mission. Upon taking office, I set out to ensure that the Office had sufficient research capacity to provide me with an independent analysis of regulatory issues.

Our independent research is critical to the fulfillment of our core mission. We must fully understand the industry, the marketplace in which the Enterprises operate, and the stresses of economic events on the Enterprises.

Finally, OFHEO is undertaking a regulatory infrastructure project 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.

To date, this project has resulted in the issuance of policy guidances on minimum safety and soundness requirements and the management of the Enterprises' nonmortgage liquidity investments, as well as final regulations on enforcement procedures and the 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.

In conclusion, OFHEO is aggressively fulfilling its Congressional mandate. The Enterprises are subject to an ongoing oversight through our examination program, must meet quarterly minimum capital requirements, will soon be subject to a state-of-the-art risk-based capital stress test, and can be held accountable through our enforcement powers if found lacking in any of these areas. I assure you, Mr. Chairman and Members of this Committee, that OFHEO will remain vigilant in continuing to fulfill its mission.

Let me again thank Chairman Allard, Ranking Member Reed, and the other Members of the Subcommittee for the opportunity to be here and testify on this important issue.

Senator ALLARD. Thank you, Mr. Falcon.

In 1996, the Senate Banking Committee held a similar hearing to that which we are having here today. At that time, there was much discussion about OFHEO's progress in the development of risk-based capital stress test for Fannie Mae and Freddie Mac.

Your predecessor, who was the first director of OFHEO, stated that a final stress test was expected to be completed by the end of 1996. Here we are, 5 years later, and still, we do not have those before us. What happened? How is it possible that it has been 5 years later than what was anticipated? How long have the proposed regulations been at OMB?

Mr. FALCON. Mr. Chairman, the agency, OFHEO, has not met Congresses' expectations with respect to the timetable for finishing this rule. I agree with you that that is unacceptable. That is why I made it my first priority when I came to OFHEO to get the rule completed.

The rule is the first of its kind. It will be a state-of-the-art, risk-based capital regulation which more accurately ties capital to risk than any other proposal which is out there.

Now, I would like to say that I don't like to make excuses for the fact that the agency has had this lapse. It is more important just to get the job done. And we have gotten the job done. We are just working closely with OMB to make sure that they understand the rule and so that they can clear it with confidence.

The agency started from scratch. It had administrative issues that had to be dealt with. The agency did not have any other model to work off of. This is the first time any regulatory agency has had to devise a risk-based capital stress test.

So it was not a task that could be done realistically in the 18 months that was laid out in the statute. But then, again, I agree with you that it should not have taken this long. However, we have gotten it done now, Mr. Chairman, and I look forward to OMB clearing it soon so that we can put it in place.

Senator ALLARD. How long has it been at OMB?

Mr. FALCON. It has been at OMB since—I think March 29th is the date when we officially sent it over to OMB, Mr. Chairman.

Senator ALLARD. And apparently, we are expecting some kind of a report back from OMB here shortly?

Mr. FALCON. OMB will just convey to us when they have cleared the rule and then we will be authorized to publish it in the *Federal Register* as a final rule. I don't know whether or not they will be submitting to Congress any formal report with respect to the rule.

Senator ALLARD. After you get that, then that is going to go through administrative procedures. There will be public comment and what not. Is that right?

Mr. FALCON. I think that there will be a 60-day Congressional review period.

We concluded the comment period and what is in the process here is getting the final rule cleared. But we have gone through several rounds of public comment on this rule.

Senator ALLARD. When is your best guess as to when this rule will become fully effective?

Mr. FALCON. I expect this summer that the rule will be published as a final rule. The statute, the 1992 Act, which required this rule, states that there is a one-year delay. It is effective upon publication, but there is a one-year delay before OFHEO can enforce the risk-based capital standard. That was done in order to give the Enterprises a chance to transition into the rule during that one-year period.

Senator ALLARD. I would like to take a moment to compare the OFHEO's resources to those of other regulators.

OFHEO has approximately one hundred employees and a budget of $20 million. By comparison, the Comptroller of the Currency has nearly 3,000 employees to oversee bank assets. Obviously, the Comptroller has many more institutions to regulate, but a recent article in *The American Banker* estimated that the Comptroller of the Currency would assess fees of $71 million to cover the cost of regulating Fannie Mae and Freddie Mac.

Mr. Falcon, does the OFHEO need more resources? Do you have sufficient personnel and resources to do the job?

Mr. FALCON. Thank you for asking the question, Mr. Chairman.

I think it is important that OFHEO have adequate resources to conduct its oversight responsibilities. There are two points that I would like to make here.

The first point is that we have requested additional resources and in fact, this year, the President's budget gave OFHEO a 23 percent increase in its budget. That will be a very useful increase in our budget. And for the last 3 years, Congress has given us an increase in our budget. I think it is important that we continue to receive increases in our budget so that we can continue to oversee the Enterprises with adequate debt.

The lack of more resources at this point has not hindered OFHEO's ability to do its job. We leverage technology in a very experienced and talented staff in order to oversee the Enterprises. So it is important that the trend continue as far as OFHEO obtaining resources. We have to manage our growth properly, so we could not just double overnight in size. But the trend has been positive.

The second point, if I could make it, is I think it is important that OFHEO also have the flexibility to set its resource needs on a real-time basis.

Right now, OFHEO is the only safety and soundness regulator which is subject to the appropriations process. I have asked before that OFHEO be removed from the appropriations process so that we have the flexibility, should the need ever arise, to increase our resources. If we ever needed to hire additional examiners in response to any changes that the Enterprises, I would have to wait until the next appropriations cycle to do that.

I think, like all safety and soundness regulators, OFHEO needs to have the flexibility to adapt its budget needs to the situation that it faces on a quick basis.

Senator ALLARD. Just as a quick follow-up on that—with the tolerance of the Committee, I would like to step over my allotted time a bit with this follow-up question.

Some have proposed a new safety and soundness regulator for Fannie Mae and Freddie Mac and have even suggested the Treasury Department or the Federal Reserve Board or some new entity. In the alternative, what changes would you recommend to strengthen OFHEO as a regulator? You have partially answered that question, but I wanted to get a specific answer from you. Then I will yield to the other Members.

Mr. FALCON. Thank you, Mr. Chairman.

Let me say, first of all, that OFHEO is an effective and strong regulator with or without any changes to its statutory regime. However, like any other regulator, there are always modifications that can be made to enhance our authorities. I mentioned the appropriations issue. I think that is a very appropriate one.

In addition, there are things that could be done to our statute to enhance our independence, such as independent litigating authority, as well as other modifications to our statute to clarify our safety and soundness powers, including our enforcement powers.

Last year, I submitted to the House Banking Committee a package of proposed modifications. I think those modifications would enhance OFHEO's ability to fully do its job. But the lack of those changes has not hindered us from doing our job, Mr. Chairman.

Senator ALLARD. Thank you.

Senator Reed.

Senator REED. Thank you very much, Mr. Chairman. Thank you, Mr. Falcon.

Let me follow up on your testimony where you make reference to the Basel guidelines.

For most banking institutions, they develop their own internal risk-based capital model, subject to supervision by their regulatory authorities. But you have developed your own regulatory models outside of Freddie Mac and Fannie Mae. Can you comment about that approach? Does that give you more confidence? Why did you take that direction?

Mr. FALCON. Thank you, Senator.

I think as a matter of law and as a matter of public policy, we have taken the right approach with respect to the risk-based capital requirement. I think the 1992 Act requires that we implement the risk-based capital requirement with respect to the Enterprises. So if there were to be another approach taken, that would require a change in the 1992 statute.

Second, as a matter of policy, I think if OFHEO did not implement the risk-based capital requirement, you would very likely have two different capital requirements for each Enterprise.

There are hundreds of little decisions which, individually and cumulatively, could have a major impact on the capital requirement of the Enterprises. The statute only identifies a handful of those parameters. And so, the way those hundreds of other issues are resolved could have a huge impact on the capital requirement.

In order for there to be one capital standard that applies to both Enterprises, it is important that OFHEO be the entity that decides how those issues get resolved and ensures that they apply equally to both Enterprises.

Although the Basel Accord leans toward some internal models approach, I think that is in recognition of the reality of the situation banking regulators face. They regulate hundreds and thousands of individual banks. It is not quite practical to devise one stress test that could apply to hundreds and thousands of different banks with different types of portfolios.

Here we regulate two entities and they are virtually homogenous in nature. So, we are able to implement one stress test for both of the entities that we regulate.

Senator REED. Let me just follow up. There are two, among many, but two critical items in terms of safety and soundness. First is the capital adequacy levels; and the second, as you just mentioned, is the stress test.

With respect to the capital adequacy levels, Mr. Raines and Mr. Brendsel will testify later this morning about the very low losses that they have experienced in the last several years. And yet, there is a statutory requirement for a much higher multiple in terms of the capital reserve.

My first question, do you think that that statutory level is adequate? Too high? Should it be reconsidered or relooked at?

My second question, with respect to the stress test, you have taken a regional meltdown, more or less, and applied it nationally as your stress test. Is that, in your view, a valid approach? Can you comment on those two things, Mr. Falcon?

Mr. FALCON. Yes, Senator. The statute required that we take the worst regional historic loss experience and apply it to the entire portfolio of the Enterprises.

Now that is a very stressful economic condition for the Enterprises to have to survive. But I think Congress made the correct judgment in 1992 that, having come out of the savings and loan crisis, Congress wanted to be sure that there was an appropriately conservative stress test that applied to the Enterprises. And this stress test is a very conservative stress test.

You referenced a couple of other items in the 1992 Act.

I think, on balance, what we have done is sufficiently stressful for the Enterprises. And when you look at the capital requirements as part of a broader package of what we do, I think we have a very strong conservative regulatory regime with respect to the Enterprises. It consists not just of risk-based capital, but also of our examination program. It consists of our research agenda. It consists of our regulatory infrastructure and our constant analysis of their capital and their balance sheets.

So, I think, as a whole, we do have a very strong regulatory program and the judgments that Congress made in the 1992 Act are appropriate.

Senator REED. Obviously, from your testimony, you do believe you have very strict and stringent rules for safety and soundness. Do you feel you have adequate staff? And particularly with respect to being able to timely review the institutions.

One of the problems—you might have great standards but if there is an inability to process information on a real-time basis nowadays, you could find yourself suddenly going from a very good situation to a very bad situation.

So assuming, as you say, that you have good standards, do you have the resources to, in a timely way, review the institutions?

Mr. FALCON. I would like additional resources, Senator. That is why it is important that the President's budget, which gives us a 22 percent increase, does get adopted by the Congress. And I think it is very important that the trend continue in the following years.

We want to grow, but we need to manage our growth prudently. But it would be important for us to make sure that we continue to increase the resources so that we can always oversee the Enterprises with adequate depth.

Senator REED. Thank you.

Senator ALLARD. Thank you.

Senator Corzine.

Senator CORZINE. Mr. Falcon, how do you stay current with such a complex risk-based system? I know we just got out a rule, but new instruments are invented. Different elements of them. How do you keep this system that your risk-based assessment, current with the changing conditions and those multiple variables that you are talking about?

One of my fears is that these things are static and not attendant to changing risks that can occur through time.

Mr. FALCON. Senator, the risk-based capital rule has a provision for new activities and new products at the Enterprises. The rule gives us the flexibility to incorporate new activities into the risk-based capital stress test.

I agree with you—if the stress test did not accommodate new activities and new products, it would be obsolete the moment that it became published. So it was very important to us to make sure that it was flexible. At the same time, we have to balance that with the need that the Enterprises have to have predictability in their capital requirement.

So when a new activity or product comes on line, even well before it comes on line, we will be working with the Enterprises to ensure that we understand the nature of the product, the nature of the risk involved, how they manage those risks, and we will decide what the potential risks are and what the capital requirements should be.

If we need additional time to understand the product and the risks involved, we will impose a temporary capital requirement on the activity until we can do the research necessary to decide what the appropriate capital treatment is for the activity.

Senator CORZINE. Have you had some examples of that having occurred as you were building this model in your 18 months?

Mr. FALCON. The proposed rule looked at the balance sheets of the Enterprises as of the second quarter of 1997. And since that time, there are additional products that have come on line, certainly, one of which is Swaptions, which was not on the balance sheet at that time. We have had to look at that derivative in order to make sure that we incorporate it properly into the stress test when it becomes final.

Senator CORZINE. Okay. Now, you said that there are about a hundred people, I think, on staff. How many of those people are market professionals? How many research, quantitative types? Rocket scientists, if you would? How does your staff break out?

Mr. FALCON. I think because OFHEO started in 1993 from scratch, OFHEO did not have the luxury of hiring junior-level people and then training them in what we need to do. We hired very experienced people from other regulatory bodies. We hired people with experience on Wall Street. Our examiner corps has a great deal of experience. About 65 percent are examiners and come from other regulatory agencies and have a great deal of experience in examining institutions, large complex financial institutions. I think the average length of experience for examiners was about, when they came on board, 12 or 13 years. In addition, in order to build this stress test, we hired a great deal of people from Wall Street.

Senator CORZINE. That is dangerous, by the way.

[Laughter.]

Mr. FALCON. They came with a great deal of experience in writing sophisticated financial simulation models to process cash flows for various products.

Senator CORZINE. So, these people had worked with the kind of instruments that you are now assessing the risks of.

Mr. FALCON. Absolutely, Senator.

Senator CORZINE. Who's the accounting firm?

Mr. FALCON. Deloitte & Touche.

Senator CORZINE. They have a specialized practice in mortgage-backed securities?

Mr. FALCON. Yes, Senator.

Senator CORZINE. One final question. The debt of the GSE's is growing fairly significantly and there are some that are critical and others think it is the right strategy to expand housing opportunities. Are you at all concerned about the growing element of debt on the balance sheet of the GSE's? And how do you assess that?

Mr. FALCON. As the safety and soundness regulator, we look at this question from the standpoint of can they manage that growth prudently? We focus on whether or not that growth poses a safety and soundness concern to us. As of today, we are comfortable that they do very prudently manage the risks associated with their growth. And so, we have not taken any steps as the safety and soundness regulator to do anything with respect to their growth.

Now, I understand that their growth raises other issues. And there are other concerns about whether or not it is growing too fast and too large.

We have undertaken a study of the systemic risks that may or may not be posed by the Enterprises and we expect to finish that by the end of the year. So while we focus on the safety and soundness of the Enterprises, we also are cognizant of the bigger picture issues that arise with respect to the Enterprises.

Senator CORZINE. Mr. Chairman, may I ask one follow-up?

Senator ALLARD. You may.

Senator CORZINE. How would you distinguish the difference between systemic, which I understand the definite of, and the safety and soundness considerations as you look at the balance sheet?

Mr. FALCON. Safety and soundness goes to whether or not they can manage the risk inherent in the growth. Systemic risk concerns involve what kind of disruptions to the broader financial markets might occur if there were financial problems at the Enterprises? Or do financial problems external to the Enterprises, can the Enterprises manage any collateral effects from those shocks? I think that is the easiest way that I can think of to distinguish between the two.

Senator CORZINE. Thank you, Mr. Chairman.

Senator ALLARD. Thank you.

I have a brief question. Then if any of the Members have any more questions, I think we can get through this easy enough. I want to go to a question on derivatives.

In the last decade or so, some of the strategies in how Fannie Mae and Freddie Mac manage their secondary market securities has changed, and it involves the use of derivatives. What is the amount of derivatives held by the two companies?

Mr. FALCON. I don't know that figure off the top of my head, Mr. Chairman. I can get it for you.

Senator ALLARD. Okay. The Committee would be interested in having that figure, if you would provide that to the us.

How does the OFHEO regulate the derivatives activities of the GSE's? And what risks might be imposed by those derivatives?

I realize that when we get into derivatives it is a very specialized area. It is something that takes a pretty well-trained individual to work with. So, I am anxious to hear how you regulate the derivative activities of GSE's and those risks.

Mr. FALCON. Let me state that the Enterprises use derivatives in order to manage the risk. They use them in a positive way. They did not use derivatives for speculative purposes. In fact——

Senator ALLARD. For what purposes?

Mr. FALCON. They don't use them for speculative purposes.

Senator ALLARD. Speculative. Okay, yes.

Mr. FALCON. They use them for hedging. They are a very important part of the Enterprises' method of mitigating the interest rate risk that they face.

So, we look to make sure that they always use them as a hedging device and that they are very useful in managing interest rate risks by adding call features to noncallable debt, for instance.

Senator ALLARD. I think that is a very important point because hedging is used by many sound enterprises, in the private sector, particularly, and banks. When properly managed, it is a necessary management system. But if they get into the speculative area, then that is when I think this Committee gets particularly concerned. I am glad to hear your response in that regard.

Senator Reed.

Senator REED. Thank you, Mr. Chairman.

First, let me say that Senator Sarbanes very much wanted to be here for your testimony, Mr. Falcon. He was delayed in Baltimore. He will be here later for the second round.

Let me ask one additional question. One of the human aspects of regulation, particularly with a small organization and two regulated entities, is the potential for relationships to develop between the regulator and the regulated entities that get to be so routine and so comfortable, that you don't challenge assumptions and you don't sometimes realize when the train is going slightly off the track. How do you, in your role as the leader of this organization, guard against that kind of natural inertia or natural tendency to identify?

Mr. FALCON. Thank you for the question, Senator. I think it is a very appropriate question.

I think OFHEO, like any other regulator, has to have a good working relationship with the entities that it regulates. On the other hand, we are very guarded about not allowing any kind of relationship to develop where we cannot take an objective approach to any issue. In fact, I think that has to start from the top down within the organization. And I think OFHEO has a culture within it that wants to have a good relationship, but at the same time, has an arm's-length relationship with the Enterprises.

I tell everyone within OFHEO to just always do the right thing. Do what is the best public policy. I think that is something that I did not just bring to the agency, it was always there. And if we do the right thing, I think we can always defend ourselves in any forum. We do have a good relationship with the Enterprises, a good working relationship. Our examiners are in there day in and day out. They rotate among different offices, so they don't always get too comfortable in one particular area. We do maintain a healthy arm's-length relationship with the Enterprises, but one which is a good working relationship.

Senator REED. Thank you.

Senator ALLARD. Senator Corzine.

Senator CORZINE. I am fine, Mr. Chairman.

Senator ALLARD. Okay. We are right on schedule. We are not sure just exactly when that vote is supposed to come up. Maybe as soon as 3 minutes.

Mr. Falcon, I want to thank you for your testimony. I think it is very helpful for the Committee. I want to thank the Committee Members. I think we will just go ahead and proceed with the next panel. If the bell rings for the vote, then we will stop at that point and go vote.

Thank you, Mr. Falcon.

We will go ahead and bring up the second panel.

[Pause.]

We just started the vote. I cannot believe it is working out this smoothly this morning.

[Laughter.]

It usually doesn't work that way. I think we will go down and vote, get back as quickly as we possibly can after these series of votes, and then we will hear from the panel.

[Recess.]

Senator ALLARD. I call the hearing back to order.

I want to apologize to everybody for the delay in the Committee hearing. We were trying to get votes out of the way on the floor of the Senate.

It gives me pleasure to welcome our next guests on panel two: Mr. Franklin D. Raines, Chairman and CEO of Fannie Mae; and Mr. Leland C. Brendsel, Chairman and CEO of Freddie Mac.

I know you are both very busy and I appreciate your taking the time to show up before our Committee.

I think we will start with you, Mr. Raines.

OPENING STATEMENT OF FRANKLIN D. RAINES CHAIRMAN AND CHIEF EXECUTIVE OFFICER FANNIE MAE

Mr. RAINES. Thank you, Mr. Chairman. I am delighted to be here. We appreciate the opportunity to appear before the Subcommittee and appreciate the oversight that the Subcommittee is providing in this area.

This hearing is happening at a propitious time for housing in America, a time that demonstrates the stunning success of the U.S. housing finance system.

More Americans own their homes than ever before. Home sales in the first quarter of this year set a new all-time record. Housing starts and home values are robust. And the mortgage debt outstanding is growing at a healthy rate of 9 percent per year. This year, mortgage originations are expected to reach an all-time high of over $1.5 trillion.

Millions of homeowners are taking advantage of lower interest rates to refinance their homes and save hundreds of dollars a month. We estimate that mortgage refinancings this year will put $40 billion in the pockets of consumers. The process of financing a home on affordable terms has never been faster, simpler, or more available to more families in more communities.

Quite simply, the U.S. housing finance system is the best in history and certainly the best in the world.

We all know that homeownership strengthens families, communities, and the Nation as a whole. But it also strengthens the economy. A generation ago, when the economy declined, so did housing. Today, the strength of the housing sector and the success of the housing finance system is helping to keep the entire economy on a steady course. A great deal of credit for this goes to the Congress and the work of this Subcommittee for its stewardship of the U.S. housing finance system. In my experience, support for housing has always been strong, deep, and bipartisan.

When I first came to Fannie Mae in 1991, after 11 years on Wall Street, we had a Republican Administration and a Democratic Congress. When I left Fannie Mae to serve as Budget Director, we had a Democratic Administration and a Republican Congress. Today, we have a Republican President and the political margin in the Congress is the closest in recent history. But what continues to unite this Capitol city is what unites our country, and that is a belief in the American dream. And Fannie Mae's mission is to extend the American dream to more Americans.

Mr. Chairman, I have submitted written testimony for the record which describes how we do that and I would like just to summarize that testimony this morning.

Fannie Mae began as a Federal agency in 1938. In 1968, the Congress chartered Fannie Mae as a private company. In 1992, the Congress strengthened our housing mission and our financial oversight.

Last year, Fannie Mae and Freddie Mac announced a series of voluntary initiatives to further bolster our liquidity, capital and market discipline, making our companies a new global model for financial institution safety and soundness.

Today, Fannie Mae is a successful Fortune 50 financial services company with a billion shares trading on the New York Stock Exchange. Fannie Mae is one of the highest credit-rated financial institutions in the country for the strength of our business and risk management.

Indeed, one way to understand Fannie Mae is to compare us with other major financial companies in America of similar asset size. Like major national banks, for example, Fannie Mae operates under a Federal charter that provides for certain benefits, obligations, and limitations.

Unlike banks, Fannie Mae does not offer credit cards, commercial lending, insurance, investment banking, or consumer services. We focus strictly on funding mortgages that lenders originate with homebuying consumers.

Fannie Mae is a private company, but we do have a compact with the Government. We use the benefits of our charter to make sure that consumer-friendly mortgages are available every day in every part of our country under all economic conditions at the lowest rates in the market.

With our charter also comes obligations, especially in the area of affordable housing. We meet and exceed the toughest affordable housing goals in the industry. In fact, Fannie Mae is now the Nation's largest source of mortgage funds for underserved families, including minorities and lower income families.

We achieve our mission by operating two businesses, using 100 percent private capital without a penny of public funding.

First, we operate a mortgage credit guarantee business. To replenish their capital to lend, mortgage lenders bring loans to Fannie Mae, swap them for mortgage-backed securities, and then the lenders sell these into the market. Fannie Mae guarantees the creditworthiness of the loans behind these securities, and for that we receive a guarantee fee. But the mortgage-lender controls and benefits from the sale of the mortgage-backed securities.

Second, we operate a mortgage portfolio business. Fannie Mae buys mortgages and mortgage-backed securities from the market and then manages the interest rate risk in our portfolio. Fannie Mae's portfolio is almost entirely made up of mortgage assets, including hold loans and mortgage-backed securities. To purchase mortgages and mortgage-backed securities for our portfolio, Fannie Mae sells debt securities to investors on Wall Street and around the world.

Let me highlight three points about our businesses.

First, Fannie Mae's expertise is managing the credit risk and the interest-rate risk on mortgages, particularly long-term, fixed-rate mortgages. That is our special role in housing finance. We mitigate and disburse mortgage risk by sharing it with mortgage insurance companies, lenders, and investors. And thus, our credit losses are at historic lows, the lowest in our industry, and we are regarded among the best interest-rate risk managers in the world.

The second point to understand about our businesses is by helping lenders create mortgage-backed securities to sell, and by selling our own debt securities, Fannie Mae gives investors two additional attractive options for investing in housing.

If they don't want the credit risk of mortgages, they can buy our mortgage-backed securities. If they don't want the interest rate risk on mortgage-backed securities, they can invest in Fannie Mae's debt securities. Either way, additional investment comes into housing, lower costs for consumers.

The third point to understand about our business is that Fannie Mae specializes in one particular kind of mortgage—the long-term, fixed-rate loan, with an embedded option to refinance. By financing these loans in large volume, we have created a large, vibrant, and robust market for them. That is, in fact, the reason that Fannie Mae was created in 1938—to ensure the nationwide availability of the self-amortizing, long-term, fixed-rate mortgage, which was then a very bold and new instrument.

Sixty-three years later, Fannie Mae is still doing the very same thing. The long-term, fixed-rate mortgage is still Fannie Mae's bread and butter. It is 95 percent of the single-family mortgages that we finance.

The main thing that has changed in 63 years is that we now use private business practices, international capital markets, information technology, and billions of dollars of private capital to create a more efficient market for these essential mortgages.

It is no wonder that 75 percent of homeowners choose this kind of mortgage. Americans take it for granted that they can get a 30-year, fixed-rate mortgage. But outside of America, you can rarely obtain such a mortgage.

A few weeks ago I was in Europe, meeting with a group of investors in equity in our debt. And at one of these meetings, I asked a group of young analysts—how many of you have 30-year, fixed-rate mortgages? Now most of them in that room owned homes, but none of them raised their hand. None of them had a 30-year, fixed-rate mortgage available to them.

In most of the world, the mortgages that are available are adjustable-rate mortgages and balloon mortgages. With down payments of from 20 to 40 percent. In order to refinance, you have to pay a stiff refinance prepayment penalty. It is simply harder to get a mortgage.

In the United States, you can get a 30-year, fixed-rate mortgage, down payments as low as 3 percent, with an option to refinance any time that rates fall. You can see the benefit that we provide every week in your newspaper. This week, our loans that we buy are up to $21,000 cheaper over the 30-year life of the mortgage than a jumbo mortgage.

To sum up, Mr. Chairman, two questions capture how Fannie Mae's business carries out our compact with the Government. Are long-term, fixed-rate mortgages available every day in all communities? Do the ones we finance have the lowest rate in the market?

The answer to both these questions is demonstrably yes. Fannie Mae brings over $21 billion of private equity capital to the housing market and the results have been spectacular. We have the best housing finance system in the world. Mortgages consumers prefer are widely available. And mortgages cost less.

Mr. Chairman, I am delighted for the opportunity to be able to testify before the Committee. We are delighted that we have been able to be a participant in this growing and effective housing finance system. And we are certain that, as we move forward, particularly with items such as our $2 trillion American Dream commitment to assist an additional $18 million underserved Americans become homeowners, that we will continue to have the kind of success that we have had over the previous decades.

Thank you.

Senator ALLARD. Mr. Brendsel.

OPENING STATEMENT OF LELAND C. BRENDSEL CHAIRMAN AND CHIEF EXECUTIVE OFFICER FREDDIE MAC

Mr. BRENDSEL. Thank you, Mr. Chairman.

Good morning, Chairman Allard, Senator Sarbanes. It is a pleasure to be here. I am Chairman and Chief Executive Officer of Freddie Mac. I certainly appreciate the opportunity to appear here this morning, along with Frank Raines of Fannie Mae, to, in my case, talk about Freddie Mac's financial strength and how it enables us to bring real benefits to America's families.

Freddie Mac is among the strongest, best capitalized, and most transparent financial institutions in the world. We are fiercely committed to maintaining the confidence of Congress, of investors, and of the public in our financial strength. There can be no doubt that Freddie Mac will meet our vital mission for generations to come, which depends on that financial strength.

Freddie Mac is a Congressional success story. We are at the heart of the best housing finance system in the world. Today, I think the mortgage market in many ways works so well, that we take it for granted. Let me summarize some of the key benefits that we bring.

First, there is never a shortage of mortgage money to finance America's homes. That is because Freddie Mac has developed high quality securities that attract global investors throughout the world. As a result, when other markets are rocked by turmoil, there is no disruption in the mortgage market that we serve.

Second, as Chairman Raines has discussed, America's homebuyers enjoy the lowest possible mortgage rates. In the real estate section of the newspaper, two rates are always listed—the low rate for the loans that Freddie Mac buys, and the higher rate for the jumbo loans that we cannot buy. Consumers save real money—currently up to $23 billion a year, according to former OMB Director Jim Miller.

Third, in the market we serve, America's families choose from a broad array of mortgage products. These include the 30-year, fixed-rate mortgage with a low down payment, which is simply not available in most other countries. In addition, even in the jumbo market in the United States, it is far less available.

Fourth, Freddie Mac is at the forefront of innovation. Our technology and our underwriting systems enable lenders to make fast, fair, and accurate decisions to serve the growing diversity of America's homebuyers. Our innovations enable even the smallest lenders, and the newest ones, to compete and to substantially reduce costs to consumers.

Fifth, Freddie Mac protects consumers from predatory lending. The sad stories about abusive lending practices do not come from our segment of the market. We buy loans from reputable lenders and we standardize lending and servicing practices. In addition, we foster competition so that consumers have more choices among reputable lenders. Our goal is to drive responsible lending throughout the mortgage market.

Sixth, Freddie Mac brings strength to housing and the economy. In a downturn, Freddie Mac transmits lower interest rates to the mortgage market. Refinancing puts real money in borrowers' pockets. Plus, the boost to housing is often just the spark that the economy needs. Certainly, low mortgage rates have made housing one of the bright spots on today's economic horizon.

Seventh, by financing homes for millions of families, Freddie Mac has helped the Nation reach the highest homeownership rate ever.

In sum, Freddie Mac brings tremendous benefits to the Nation. These benefits are tangible and they are significant. They far outweigh any value that we derive from our Congressional charter. America's homebuyers can depend on Freddie Mac continuing to meet our vital mission because we are safe, sound, and strong.

We are in a single line of business that is inherently safe—the mortgages on people's homes. Our risk management is disciplined, skilled, and second to none. And we hold enough capital to withstand a severe economic recession that would last for 10 years.

Now Standard & Poor's recently provided an independent view of Freddie Mac's financial strength. They gave us a risk-to-the-government rating of AA−. To put this in perspective, only five bank holding companies have a rating this high on their senior debt, and none has a higher rating.

Freddie Mac operates under the continuous oversight of Congress and our regulators—both the Office of Federal Housing Enterprise Oversight and the Department of Housing and Urban Development. We also operate under the constant scrutiny of the marketplace. Freddie Mac discloses comprehensive information about our exposure to risk—and our effectiveness in managing it.

This high degree of transparency subjects us to the rigor of market discipline every minute of every day. Freddie Mac has long been at the vanguard of world practices in risk and capital management and information disclosure.

Last October, we raised the bar with six voluntary actions or commitments. Fannie Mae joined us in making them. As a result, we will provide more information to the marketplace, to investors than any other financial institution in the world. We implemented all six commitments in just 6 months. The details about each are provided in my written statement.

In developing these commitments, we sought out the best thinking of international regulatory experts, particularly the Basel Committee on Banking Supervision. I believe our six commitments are a model for all financial institutions. In fact, Moody's called them "new standards . . . for the global financial market." They added, and I quote: "The leadership shown by Fannie Mae and Freddie Mac could prove difficult for other firms to ignore and could usher in a wave of enhanced financial risk disclosure."

The importance of all of this is the future. Over the next decade, America's families will need an additional $6 trillion to finance their homes. There are many doors to homeownership to open for families that do not have that opportunity today. Freddie Mac's strength and vitality will enable us to open those doors to the homebuyers of the future.

Mr. Chairman, Members of the Subcommittee, I look forward to working with you to secure the future of America's housing finance system and, with it, the dreams of millions of families.

Thank you very much.

Senator ALLARD. Thank you. I want to start off with a question that is directed to both of you.

We have had an opportunity for the regulator, OFHEO, to comment about you. I want to give you an opportunity to comment about OFHEO. I would like to hear how you rate OFHEO. Do you believe that they have adequate resources to do the job?

Mr. RAINES. Well, Mr. Chairman——

Senator SARBANES. In case you were not here, they said nice things about you.

[Laughter.]

Mr. RAINES. I have some nice things to say about them as well.

It is always treacherous for the regulatee to be rating your regulator. But I think there are a couple of things that I can say that might be of use to the Committee.

First, I think that OFHEO, from its beginning, when it first organized, put a great emphasis on its supervision role, which most safety and soundness regulators do. In fact, with most of them, all you really hear about, is their bank examination and supervision role. They hired very experienced examiners. We currently have 13 examiners dedicated full time to Fannie Mae alone. To put that into perspective, that is the same number of examiners that are dedicated to CitiCorp by their bank examiners, to cover a company that operates in 100 different countries. We operate in one country, and one asset, and all of our records are in one place.

So it is a larger amount of effort they put in and we think that they do a very professional job. I think it can stand up to scrutiny against any other regulator.

With regard to their implementation of the minimum capital standards, again, they have been quite efficient and effective in doing that. I think the market has been very appreciative of their timely assessment of our meeting our minimum capital standards.

With regard to the risk-based capital standard, as the Committee Members have noted, it has taken too long. It has taken too long and it has not been of benefit, either to OFHEO or to the two companies. It would be better for us to have the standard in place and operating because we think it is a world-class approach to managing interest rate and credit risk in an Enterprise.

We wish it had taken less time. If we had any suggestions for how to speed it up, it's to more actively engage with the companies. We think we can be helpful in that process. But when it is done, when there is an effective standard in place, it will be world-class. It is a standard that we would be eager to have other financial institutions subject to. And I think it is one that should give great comfort to the Congress because it does require us to hold capital against one of the most unlikely scenarios you can imagine, interest rates rising or falling up to 600 basis points and staying that way for 10 years.

The largest credit losses in history, not just in one region, but applied nationwide, and those losses go on for 10 years. We have to have 100 percent of the capital to survive that scenario, plus 30 percent in additional capital, to handle what is called management risk. I often say I am not sure what I could do to the company that this risk scenario hadn't already done to it. But we need 130 percent of the capital to survive that scenario.

When that is in place, it will be a world-class risk-based capital standard, giving the correct incentives to the companies to manage risk and hold risk down, and at the same time ensuring that we are able to carry out our mission.

Senator ALLARD. Mr. Brendsel.

Mr. BRENDSEL. Thank you.

I think there are many things that OFHEO has done very well, extremely well. Certainly, as Chairman Raines has said, if I look at the examination staff, the supervision is really excellent. I think they have hired a great group of people. They have a lot of experience coming from banking, regulatory agencies. From my perspective, they do an excellent job of examination and reviewing us. And they are with us every day in doing that.

Certainly, there are many aspects of the regulation that they have implemented on a timely basis. As has already been said here at this hearing, the risk-based capital rule has been tardy. My hopes are that it is finalized soon and that it be a sensible rule and one that meets the requirements of the 1992 Act.

I believe they do have enough resources to perform their regulatory activities today. Particularly, when you consider we are just two Enterprises that they have to focus on in one line of business.

Senator ALLARD. Senator Reed.

Senator REED. Thank you very much, Mr. Chairman. And thank you, Mr. Raines and Mr. Brendsel, for your excellent testimony this morning.

There are two significant issues we are grappling with. First, safety and soundness, and the other issue is one that has been raised, the advantages of GSE's, in general, and to whom these advantages specifically accrue.

First, with respect to safety and soundness, what I have heard from the regulator and what I have heard from you is that the legislation has established very rigorous safety and soundness standards and that your organization is responsive to those standards.

In addition, you are conscious of the potential volatility, as things can change very quickly in this area. But, in general, might you make another summary comment, Mr. Raines and Mr. Brendsel, on the safety and soundness of your institutions.

You feel you are well-positioned, I presume.

Mr. RAINES. I think we are very well-positioned, indeed. As Moody's said, both companies are leading the world in terms of the measures, both those that are mandatory in the statutes and through our regulation, and our voluntary initiatives, which take us far beyond what others have done.

When we looked at this, there was a lot of theory about these things. And we said, well, why don't we just do them all? Let's not debate whether it should be more disclosure or subordinated debt or implementing the risk-based capital standard on our own or liquidity. Let's do them all.

I believe that these two companies are the only companies in the world that are subjected to all of these means of maintaining safety and soundness.

Senator REED. Mr. Brendsel.

Mr. BRENDSEL. I think we are in excellent financial shape. I think the current results show it. Beyond that, though, the information that we are providing to investors and to the marketplace, our standard disclosures, as well as the enhanced disclosures, as well as the additional ratings, all confirm the outstanding financial condition of the company.

Again, to emphasize, we start from a basis that both companies are in essentially one line of business—not many, not spread throughout the world—we are focused on providing mortgage credit secured by American homes. A homeowner makes their mortgage payment among one of the first obligations that they meet beyond, I think, putting food on the table for their families. So when you start from that, it is not surprising that the company should be in such strong financial condition.

Second, we carefully manage the risks that are ever present in the residential mortgage market—very carefully, whether it is credit or default risk or whether it is interest rate risk.

In order to ensure the long-term future of the housing finance system, of the availability of mortgage credit, and indeed, the viability of the Enterprises' ability to meet our public mission must start from the basis and the foundation of running an extremely strong institution.

Senator REED. Mr. Brendsel, you have hit on the public mission, which is important. But you also have obligations to your private shareholders which are equally compelling to any CEO.

In terms of this public mission, first, Mr. Brendsel, and then Mr. Raines, what are you doing to, one, ensure that this public mission benefits consumers and homeowners; and second, continue, and in fact is expanded, with respect to Freddie Mac and Fannie Mae?

Mr. BRENDSEL. First of all, it is our only mission. It is our singular mission. And it is the one that is dictated in our charter. So every one at Freddie Mac, starting with me, is singularly focused on ensuring that we meet the purpose and the mission for which Freddie Mac is chartered and created, and that we are expected to attract private capital from our shareholders and investors around the world to fund housing in the United States.

That is why sometimes people have a sense that there might be a tension between our public mission and our shareholders. I don't believe so. The two have to go hand in hand. You have to serve your mission in order to meet your public purpose. In order to do that, you must have the confidence of your shareholders and continue to attract private capital.

What we are doing is continuing to innovate every day to continue to find new ways to drive down costs, to increase the availability of mortgage money throughout the Nation, and to find new ways to attract capital from throughout the world. There are no boundaries other than the boundaries provided by our charter.

We are using technology to find new ways to qualify homebuyers, to drive down the costs for closing a loan. It is just one example. We are expanding into more parts of the subprime mortgage market, trying to find better ways to finance those mortgages than the ones traditionally that have been available to homebuyers who are in that market today.

Senator REED. Thank you.

Mr. Raines, if you could comment.

Mr. RAINES. Yes. Thank you, Senator.

Just two points that I would make. First, from the standpoint of our shareholders and our mission. There is a very close congruence. By being in the U.S. housing market and the mortgage market, it is an enormous market. It is a market of $5.6 trillion outstanding. It is a market that is growing for the last 3 years at 9 percent.

I have no problems going to my shareholders and saying, where we are chartered to operate is an area where we can do good things for our shareholders while carrying out our mission. They need not worry about there being a conflict.

The second point is Fannie Mae has a tradition of establishing big goals for ourselves when it comes to our mission—to ensure that there is no doubt that we are doing everything we can to achieve that mission.

We just completed last year a trillion-dollar initiative that was begun by my predecessor to focus one trillion dollars on affordable housing for 10 million families.

I announced last year a new American Dream commitment—a $2 trillion commitment over this decade to try to move up the homeownership rate of those people who have not yet broken the 50 percent homeownership rate—minority Americans, young Americans, female-headed families, urban Americans. We want to move up their homeownership rate by investing $2 trillion. And that includes commitments of over $400 billion now aimed on an area-by-area basis, and where our partnership offices are now sponsoring investment plans, focused on individual communities to ensure that we are not simply operating at a very high level out of Washington, but having an impact in local communities.

Senator REED. Thank you very much.

Senator ALLARD. The Senator from Maryland.

OPENING STATEMENT OF SENATOR PAUL S. SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman.

I was not here at the outset and I want to take just a moment or two to make a short statement before I pose a question.

First of all, Mr. Chairman, I want to commend you and Senator Reed for holding this hearing.

I looked at the hearing notice and it said, a hearing on oversight—oversight, I underscore that—of the mission of the Office of Federal Housing Enterprise Oversight and the Financial Safety and Soundness of Fannie Mae and Freddie Mac.

It did not have any bill number with respect to which this hearing was going to be held. And I must say that this is a very welcome, as it were, initiative because I think we don't do enough oversight and we are always gearing everything to a new piece of legislation.

I am frank to say I don't think we need any new legislation in this area. What we need is appropriate oversight. And so, I commend you and Senator Reed for, in a sense, perceiving that and holding this hearing.

Senator ALLARD. Thank you.

Senator SARBANES. It is a very good departure, I have to say.

Fannie Mae and Freddie Mac have been strong engines of homeownership in this country. Homeownership continues to be at the heart of our Nation's housing policy because of the benefits it brings, not just to the homeowners, but to the entire community. We, in effect, perceive it as very important to community stability, and I think there have been studies which will substantiate that.

The GSE's continue to be a crucial link in bringing this important benefit to millions of Americans. Now given their size, and they have been, in my view, very effectively managed, but obviously, they need to be regulated and supervised in a thorough and appropriate manner.

OFHEO has now come forward, or is about to come forward, I gather, with its risk-based regulation. It has been forwarded to OMB for final review and publication and we await its final publication, and then I am sure we will examine it and receive the benefit of comments and so forth.

The other functions that OFHEO is required to perform, it seems to be doing well. It is regarded as having an examination staff that is qualified and experienced. The staff is devoted full time to overseeing the two housing Enterprises that are now at the table.

I am told that if you compare the insured financial institutions and their supervision and examination, that the two GSE's are as closely supervised and examined as any of those insured financial institutions.

OFHEO has invested considerable time and resources. It has developed significant expertise. And I think one of our charges is, of course, to make sure that it has the resources necessary to do the job and it is carrying through on its statutory mandate.

In the meantime, Fannie Mae and Freddie Mac have decided to take a number of steps to increase the transparency of their operations, including their risk management, and to get continuous reviews of their financial conditions by Standard & Poor's.

These are obviously important steps that will allow the market to exercise considerable discipline on these institutions, which should increase our confidence as well.

I look forward to the final regulations publication and its review, and again, redirecting our attention, then, to the goals Fannie and Freddie have been chartered to support, increased homeownership and more affordable rental housing.

I am pleased to welcome these two witnesses before us, to thank them for the leadership they are providing, and for their responsiveness to many of these public policy and public interest concerns. I just have a couple of questions. I think I still have a little bit of time.

As we said, we regard homeownership, affordable rental housing as important to building strong communities, increasing civic engagement, laying the foundation for educational attainment for our children. And these two institutions have played a central role in advancing that cause.

There is, however, still a significant differential in the homeownership rates among whites and minorities. Minority homeownership rates have risen in the past several years, but they continue to lag significantly behind those of white Americans. Maybe you could outline for us what steps you have taken and perhaps even more, what further could be done to try to close this gap.

Mr. RAINES. Well, Senator Sarbanes, thank you for that statement. Thank you for that question.

There is no more important issue facing the housing finance system than how do we bring the benefits of housing ownership to more Americans?

You are correct that about 74 percent of white Americans own their own home. And less than 50 percent of everybody else, including young white Americans own their own homes.

We have established an effort to focus attention on bringing up these homeownership rates, particularly among minority Americans. We have made progress in the last several years. Homeownership has risen faster among both Hispanic Americans and African-Americans than other groups.

We have established a new program, a $400 billion effort over this decade to move up the minority homeownership rate. And we will do that through the creation of new products. We will do that by penetrating markets that have not been adequately served. We will do it by reducing the cost of homeownership. Let me give you just one example.

The subprime lenders have done a phenomenal job in penetrating minority communities. They have brought credit to those communities that did not have credit before. But that credit has come at a cost.

For many people in those communities, they deserve lower-cost mortgages. And so, we have developed products and programs to try to increase competition in those communities to bring lower-cost products, such as our timely payment reward mortgage, which is a mortgage that, if you make your payments on time for 24 months, we will reduce the interest rate. But many of these communities are very suspicious of conventional lenders and have not been served well by them in the past.

And so, we are going to have to work with community groups, with our lenders and with others, to try to convince these communities that mainstream lenders will provide them with service so that they will, in fact, go to those lenders and obtain much more cost-effective products. We are working across the board on each of the problems, whether it is down payment, whether it is credit, whether it is affordability, to try to knock down these barriers and to raise the minority homeownership rate.

Senator SARBANES. Mr. Brendsel.

Mr. BRENDSEL. Thank you, Senator.

Increasing homeownership is a major goal of Freddie Mac and particularly reducing the homeownership gap that confronts African-Americans, Hispanic Americans. We think that there are many things that we can do and we are committed to doing. And I will mention five.

First is improving underwriting qualifying decisions that families face. Certainly, over the course of the last 5 years, Freddie Mac has been an innovator and a leader in developing new underwriting systems that are fair for borrowers.

Second, lowering costs, finding ways to lower costs, particularly costs of qualifying for a mortgage loan and closing on that loan.

Third is the design of new products that are more attractive and better fit the needs of underserved borrowers today. Whether it is products that reduce down payments or allow borrowers to qualify for a mortgage loan, we have instituted many new products—too many to list.

Fourth is education and counseling. This is an important part, I think. We recently completed a couple of studies that demonstrate the importance of financial education and understanding of how to qualify for a mortgage loan, how to improve credit if you have blemishes on your credit today. In addition, another study confirmed the success that homeowner counseling has in improving homeownership opportunities.

Fifth, we are building more alliances with organizations that help us to penetrate minority neighborhoods and communities.

I am really pleased with the results that we are showing and, certainly, as I mentioned before, we are continuing to penetrate more parts of the mortgage market, the subprime market, to drive out practices of predatory lending by bringing in more qualified quality mortgage lenders. I think this is an important activity that Freddie Mac is currently engaged in.

Senator SARBANES. Thank you very much.

Mr. Chairman, I see that my time is up. I was going to ask about predatory lending, but since the time has run out, I won't do that.

Just let me make this observation.

I know you both made constructive contributions in addressing that problem. I would hope that you would continue to try to be as active as possible, including whether there is some way to provide more liquidity to reputable subprime lenders who avoid these predatory practices and products. And thereby, by doing that, strengthen their position and perhaps bring greater quality assurance into the subprime market.

They are all being tainted by the outrageous actions of a few. Most of the lenders in that market should also be interested in finding ways to cut these offenders, as it were, out of the market and the rest of them can go on doing their business in a responsible way.

Thank you very much, Mr. Chairman.

Senator ALLARD. Thank you, Senator.

Senator Carper.

OPENING COMMENTS OF SENATOR THOMAS R. CARPER

Senator CARPER. Thank you, Mr. Chairman.

Welcome, gentlemen. It is especially nice to see our old OMB Director back here wearing his new hat. I was fortunate enough to be able to talk with you earlier this year, Mr. Raines—I don't know if you recall this part of our conversation. We were talking about whether there is some things that we could do within the Congress to help promote not just homeownership, but decent housing, in ways that involve the relationship between Fannie Mae and HUD.

We talked about constraints to partnerships that existed, either through regulation or just through attitudes. We talked a bit about how we might eliminate some of those barriers, either regulatory, through statute, or just through attitudinal changes.

I have thought a good deal about that since. You may not have thought about it at all. But if you have, and if you have any thoughts or examples that you might share with us today, I would be grateful. And if not, I would just ask you to submit something to us in writing.

Mr. RAINES. No, I would be delighted to. I have thought about it quite a bit since our conversation, and I have talked actually to Secretary Martinez about it as well. I think that the key to our success going forward is how do you have effective risk-sharing? Not risk-shedding, but risk-sharing.

Very often, when HUD enters into partnerships, they get the raw end of the deal because people want to simply shift risk from themselves over to HUD. And HUD often is not in a position to adequately measure that risk and to assess it, and then we all get disappointed that yet another program did not work.

And so, my thoughts are, and I have mentioned this to the Secretary and I will be meeting with him again to discuss it, is how can we have a collaboration between the kinds of technology, risk management, risk assessment, product development skills that we bring and the Government's ability to take on risk that perhaps is beyond our ability to do that, but to do it in a way in which there is a fair sharing of the risk and a fair sharing of the revenue.

I think that has to work because we engage in risk-sharing with lots of players today. We engage in risk-sharing with the mortgage insurance companies, where they are our partner in managing credit risk. We engage in interest-rate risk-sharing with counterparties around the world. We have Wall Street every day coming up with new ideas of how we can share risk, mitigate risk, move risk around the system so that there is no systemic problems.

There has to be a way for us to do that with FHA and with HUD if each of us goes into this where the goal is to be able to serve more people. I think if we put our resources together, our private capital together with the Government's capital, we can serve more people and we can do that without shifting risk onto HUD that HUD is not in a position to undertake, or simply take loans that otherwise were going to be made and simply put them into a new guise. I think we can reach out to more people if we put the resources together and work hand-in-hand in a professional manner.

Senator CARPER. My guess is that what you just described here could have been at least begun in the last couple of years, but it wasn't. And I presume that among the reasons why it did not was that people had concerns about this particular course. What are those concerns and how do we address them?

Mr. RAINES. Well, we have had discussions since I have been at Fannie Mae, 1991, we have had discussions with Secretary Kemp along this line, with Secretary Cisneros. Unfortunately, in the last Administration, there was less interest in this sort of partnership.

Senator CARPER. Why do you think that might have been? Any idea?

Mr. RAINES. I don't know. One time, Ginnie Mae and Fannie Mae were part of one organization. And I think from that time on, there has been this sort of silly competition that has gone on, as opposed to looking at a partnership. I think, periodically, that raises its head and gets in the way of really sitting down and trying to figure out how you can work better together. This should not be about who is better than the other one or who is more dedicated than the other. It really ought to be about how can you put resources together and do more than you can if they are separate.

Senator CARPER. Thank you very much. I am glad I was not the only one thinking about that.

And you gave us the name of a person within your team to follow up with. I think we have him. We certainly will after today.

Mr. RAINES. Right. Terrific.

Senator CARPER. I wasn't here earlier for the testimony. Is it Mr. Falcon or Mr. Fal-cone? How does he pronounce it?

Senator ALLARD. Mr. Falcon.

Senator CARPER. Mr. Falcon. I understand that he may have made a comparison between the regulatory regimen established by the statute, the proposed rule and your voluntary commitments, and the Basel Accords that are applied to internationally active financial institutions. I would just ask, and let me address this to Mr. Brendsel—is it Brendsel?

Mr. BRENDSEL. Yes.

Senator CARPER. Mr. Brendsel, in your view, what are the similarities and what are the differences?

Mr. BRENDSEL. Between our capital regime and the regulation and the Basel Accord?

I think the Basel Committee established three basic principles for sound regulation and supervision. First is market discipline. Second is capital related to risk. Third is effective supervision.

If you stack up the legislation of 1992 passed by Congress that OFHEO is charged with implementing, it stacks up extremely well. In fact, in many ways, it goes beyond the principles outlined by the Basel Committee.

Specifically, our risk-based capital rule that is in process now, as directed by Congress, is very innovative, very forward-thinking, and goes beyond anything that banking regulators have developed for banking institutions, or even that the Basel Committee describes.

Second, in terms of market discipline, which contemplates having information out there that allows investors to judge, that allows the public to judge the activities of the Enterprises and whether we are safe and sound. Certainly, with the six commitments, the amount of information that we disclose to the marketplace exceeds anything disclosed by even the largest banking institutions.

Finally, as we have already commented earlier, I think that the examination and supervision staff is professional. They are focused on two Enterprises and do an outstanding job.

Senator CARPER. Good. Thank you very much.

Senator ALLARD. I want to direct the next question to you, Mr. Brendsel. Then, I have one for Mr. Raines.

The main line of business for Fannie Mae and Freddie Mac is to grant pools of mortgage-backed securities. However, in recent years, you have dramatically increased your own investment in mortgages. This is done in two ways, I understand. By the direct purchase of mortgages from lenders and the purchase of mortgage-backed securities that have your guarantee on them. Is this line of business riskier than the guaranteed business? And how do you protect against these risks?

Mr. BRENDSEL. That line of business is not riskier than the guaranteed business.

All risks in mortgage finance, particularly the two principal risks of credit risk and interest rate risk that are involved in the guarantee and the portfolio businesses, are risks that, number one, we understand extremely well, understand better than anyone else. I was going to pay a compliment to Fannie Mae here—they almost understand it as well as we do.

Let's put it that way.

[Laughter.]

In any case, we don't take those risks and just put them on our balance sheet. We intermediate the risks. We use mortgage insurance and reinsurance, for example, on credit risk. In addition, on interest rate risk, we use callable debt options to redistribute that risk to other investors. And so, the fact is that we take very little risk. We are extremely well-capitalized relative to that risk.

Finally, both activities are ways of attracting the broadest range of investors to finance housing in the United States. Some prefer to invest in mortgage-backed securities. Others prefer to invest in debt. We try to provide as broad a range of financing options that we can that are attractive to investors that will provide those funds. And then we manage that in an extremely conservative and sound way.

Senator ALLARD. Thank you.

Mr. Raines, you purchase a significant amount of mortgage-backed securities for your own portfolio. When you purchase these certificates, this is financed with short-term borrowing. Does this increase your risk and how do you guard against the risk of an increase in the short-term interest rates?

Mr. RAINES. Well, Mr. Chairman, first, Fannie Mae has been in the mortgage portfolio business for our entire 63 years. So this is the way Fannie Mae first began doing business. This is not a new business for us. Indeed, the mortgage-backed securities business came much, much later. We have been in the business of managing mortgage risk on our balance sheet for quite some time.

Second, there is no difference, really, in the risk of owning what we call a whole loan or a mortgage-backed security. It is exactly the same risk that is there. Lenders now prefer to put all of their loans into mortgage-backed securities before they sell them into the market because they can get a better price. But that is a decision the lenders make to put them in the mortgage-backed securities.

The third point is, we don't buy long-term mortgages and fund them short. Indeed, we match the funding of the expected duration of the mortgage with our debt. We have a very close match. And that is why in the new disclosures we have made on our interest rate risk, even significant changes in interest rates in the short term have very little effect on our income, because of this very close match.

We don't match it exactly because if we matched it exactly, there would be no way to make any income with running the portfolio. But we have a very, very low level of risk in that business and that is shown by our success over the last 14 years of solid earnings increases as interest rates have risen or fallen, and by very large amounts over time.

The other factor that is important in understanding this is not just what you think the duration of the mortgage will be when you put it on your books, but it is also the option that we provide to the homebuyer to refinance the mortgage. That is an enormous consumer benefit, that if rates go down, they can refinance their mortgage. And that option risk we also manage by putting options into our debt. So, we will sell callable debt or we will structure the equivalent of callable debt.

If we think the mortgage, for example, is going to last 7 years, interest rates fall and the consumer says, I would now like to refinance, we don't say, as they say in other countries, well, you cannot. Or you have to pay us a big fee. What we say is fine, you are going to send us back the mortgage early. We will call back our debt early. And by that way, we can keep this close match of duration, even if the consumer undertakes their option to refinance.

A tremendous benefit to consumers, as I mentioned, is we are going to put as much as $40 billion in the pocket of consumers just this year alone.

Senator ALLARD. Mr. Raines, how do you respond to the criticism that the derivatives are necessary only because of the higher risk associated with your direct purchase of mortgages and mortgage-backed securities?

Mr. RAINES. Again, we have two businesses. One business is to manage credit risk and the other business is to manage business-rate risk. And we have been in the interest-rate risk management business for our entire history.

The reason we have the use of derivatives is that the American people want more long-term, fixed-rate mortgages than any group of investors by themselves are willing to finance.

If investors are willing to finance all the long-term, fixed-rate mortgages that Americans want, then they would all go into mortgage-backed securities. They would all be sold into the market. And there would be no opportunity for us to own any.

We only own mortgages when other investors don't want to own them. In fact, we can only own a mortgage if investors are willing to buy our debt because we sell our debt to investors and use that debt to buy mortgages. If the investors wanted to buy the mortgages themselves, they could just do that.

Clearly, we have more Americans who want long-term, fixed-rate mortgages with an option to refinance than we have investors willing to do that directly. So, we will issue debt so that we will buy those mortgages and the investors can own our debt because they believe that our debt, either our callable debt or our bullet debt, is a better match for them.

But it also turns out that there are people who are in the derivatives market—particularly large financial institutions. It is dominated by banks in the derivatives market—who say, well, we will help you put together debt in a way that will attract even more investors, who may be short-term investors who don't want to provide long-term funds.

We have other investors over here who are willing to extend the maturity of that short-term debt. And we say, great. If we can bring in more investors to help us own these mortgages that consumers want, that is terrific.

Over our lifetime, we have gone from financing just with bullet debt, to then financing with callable debt. Now, we are able to put together debt that uses derivatives. All of which is simply expanding the range of people around the world willing to invest in American mortgages.

Last year, 30 percent of the money we raised to buy mortgages came from outside the United States. Much of that from countries who have homeownership rates lower than ours. But they would rather invest in the U.S. mortgage system than invest in anything else. And so, I believe that this array of products that we offer on the debt side give us the ability to provide Americans with what they want.

Seventy-five percent of Americans have chosen in the marketplace, they want a long-term, fixed-rate mortgage. And it is been our job to go out and scour the world to find the equity, to find the capital, to make that possible.

Senator ALLARD. Now let me understand this. You have provisions on your debt so that, if somebody pays off their loan early, then you can recall the debt in early. Is that right?

Mr. RAINES. That is right. In the first quarter of this year, for example, we called in $80 billion of debt because of the number of refinancings that have happened.

Senator ALLARD. And they all understand that with the contract.

Mr. RAINES. That is the contract we have with them. Of course, they charge us more. They charge us more for that callable debt.

Senator ALLARD. We are familiar with that.

Mr. RAINES. So every feature, there is an expense. But it is worth it because these are the mortgages Americans want. If the American people said, all I want is an adjustable-rate mortgage, which is the mortgage that is available in most of the world, then this would all be a lot simpler because we would simply say, we will borrow short and we will lend to you short.

You take the interest rate risk, consumer.

In England, if interest rates go up, if the short-term rates go up, they simply announce to you that your rate has gone up, with no cap, no limitation. Your interest rate could double.

Well, that is not what Americans have wanted. Americans, since Fannie Mae was created in 1938, for the purpose of buying long-term, fixed-rate mortgages, have said with their actions—we want long-term, fixed-rate mortgages. We want to lock in this.

Somebody else should manage interest-rate risk. But we should not put that burden onto the American family.

Senator ALLARD. Senator Reed.

Senator REED. Thank you, Mr. Chairman.

Mr. Raines, let me follow up on a line of questions that Senator Sarbanes opened up with respect to trying to increase the minority homeownership.

Typically, you find, and my experience in Rhode Island is that they are very hard-working individuals. They want to buy a home and they have stable employment. They just cannot afford an interest rate comparable to what you would find in the market.

When lending institutions try to provide a subsidized interest rate, it runs afoul of your underwriting rules. Is there anything that we can do in Congress or anything you can do to try to identify those worthy credit risks who will pay, but just run afoul of your rules?

Mr. RAINES. Well, certainly, we are constantly modifying our rules in order to ensure that we can penetrate markets and serve more people.

Our research shows that there are a number of reasons why minority homeownership rate is low. The first problem has been information, the lack of knowledge of how the system works. And the Fannie Mae Foundation has led with the largest information campaign ever run. They have been doing it since 1994. Eleven million people have reached out to the foundation for information about homeownership and how do I get through all the hoops and requirements.

The second problem we have found has been lack of money, lack of wealth for down payments. In the 1990's, Fannie Mae led the way in reducing down payment requirements from 20 percent down to 3 percent, and in some cases, down to zero. So that we are able to help people who can make the monthly payments, but who don't have the wealth.

A third problem has been credit. There are many people who have lacked the knowledge of what determines good credit. We have done a lot of research and we found, for example—and this is not just minorities. But a majority of Americans do not know that if they don't pay their bills on time, that that can affect their credit rating.

Many people believe that if I pay it late, but pay the late penalty, then it is okay. And it is only when they apply for a mortgage, that they find that they now have all of these lates on their record.

The Fannie Mae Foundation has launched a campaign to try to improve knowledge of credit. I hope that you have seen some of their commercials, asking people to reach out and to get information before they try to become a homeowner.

The final item as you mentioned that affects minority homeownership has been the ability to afford even the market rate, even after they have gotten over all those hurdles.

We have done a number of things in that regard.

First, to try to hold down all of the ancillary and other costs that drive up that rate. Our technology and other means are making it less expensive for lenders to lend.

Second, we are the largest buyer of mortgage revenue bonds in the country. And through mortgage revenue bonds, your State housing finance agencies are able to make available below-market interest rates.

One of the limitations they have is that there is a cap on the amount of mortgage revenue bonds that they can buy. Indeed, there is a cap on the amount we can buy.

Certainly, in terms of the most efficient way to get lower cost finance available would be to expand the availability of mortgage revenue bonds through the State housing finance agencies. We would be delighted to have an opportunity to invest in more of these. It is an extraordinarily efficient mechanism that has been created.

Another one, the President has a proposal for a new tax credit to provide an incentive for investors to provide funds for rehabilitation, particularly in older communities where the rehabilitation costs are so high. It drives the cost of the house so high, that people who live there cannot afford it.

We are strong supporters of that credit and would be investors in that credit because that would, again, make it possible, particularly in our older areas, for minorities and others who live there to be able to afford to buy the house.

Senator REED. Thank you, Mr. Raines.

My time is running out, Mr. Chairman, would it be appropriate to submit written questions so that we can cover some other areas that have not been addressed?

Senator ALLARD. Absolutely. In fact, I was going to point that out to the Committee. We are going to give a 10-day period of time for them to get questions and then we will submit it to them. Hopefully, they can respond back promptly.

Senator REED. Thank you.

Senator ALLARD. In fact, I am getting ready to adjourn the Subcommittee.

Senator REED. I sensed that when I raised the issue of written questions.

[Laughter.]

Senator ALLARD. I want to apologize for the interruption that we had in the middle because of our series of three votes.

Before we adjourn the hearing, I want to announce that the record will remain open for 10 days for Members to submit statements and for the Committee to receive any written questions for our witnesses.

Finally, I would just like to state that I will be following up with the Office of Management and Budget to determine when the proposed risk-based capital regulations are likely to be released and made final.

Also, you will be asked from time to time to show up before this Committee for no other purpose than we just want to hear from you. We have not decided how frequently that would be, but as I mentioned earlier I am known for oversight. We will probably be spending a good deal of our oversight on agencies such as HUD and those problems, but on occasion, we will want to hear from you.

Thank you very much for showing up.

Mr. RAINES. Thank you.

Mr. BRENDSEL. Thank you.

Senator ALLARD. The hearing is adjourned.

[Whereupon, at 12:37 p.m., the hearing was adjourned.]

[Prepared statements supplied for the record follow:]

PREPARED STATEMENT OF SENATOR JON S. CORZINE

I want to welcome the witnesses and thank them for taking the time to testify before the Committee today. I also thank my colleagues, Senators Allard and Reed, for holding this important hearing on the regulatory oversight and the safety and soundness of Fannie Mae and Freddie Mac.

Few would dispute that the mission of the GSE's—in seeking to make housing more affordable and accessible—is an important one.

One need only look to our Nation's 68 percent homeownership rate—the highest it has ever been—and the increasing number of African-American and Latino families who own their own homes to see that Fannie and Freddie have helped improve the quality of life for American families.

However, this hearing is about the regulatory role of OFHEO and whether our Government Sponsored Enterprises (GSE's) operate in a safe and sound manner. The central role that they play in America's capital, finance and housing markets requires Congress to periodically assess whether they are being well-managed, well-regulated, and held to the highest of standards.

Last fall, Fannie and Freddie reached an agreement with Congressman Baker of the then-House Banking Committee to voluntarily implement six initiatives that would provide additional safety and soundness protections. And it is my understanding that both institutions are well on their way to fully implementing these initiatives. On that note, I applaud the efforts of Mr. Raines and Mr. Brendsel for exercising their leadership and working with Members of Congress.

Regarding OFHEO—well, I think one can safely say that this is an agency that has been subject to a lot of questioning and criticism. There are many questions regarding their proposed risk-based capital requirements, and even more questions about the lengthy delay in their release.

While aware that Mr. Falcon inherited much of this problem, I nonetheless look forward to his testimony and his views on what, if any, measures he believes the Congress could take to enhance his agency's performance and credibility.

Again thank you, Mr. Chairman, for holding this hearing and allowing me to present my opening remarks.

PREPARED STATEMENT OF SENATOR DEBBIE STABENOW

Mr. Chairman, I am pleased we are holding a hearing on this critical topic. This is an opportunity to discuss the vitally important function that Fannie Mae and Freddie Mac play in our housing market and it is a chance to review their safety and soundness regulation.

There is no doubt that the role Fannie Mae and Freddie Mac have played in creating a secondary mortgage market—consequently promoting liquidity risk—is key to much of the success in the housing market. These two corporations should be proud of their role in promoting homeownership.

Although there is a strong record of achievement, much more needs to be done. There are still too many people for whom the dream of homeownership is out of reach. Good intentions are not enough. We must follow with concrete action, and there is obviously a vital role for the GSE's in achieving our common goal.

One thing I would challenge the GSE's to do is to continue to increase their involvement in the subprime market. As the lending market has grown for consumers whose credit or income currently may prevent them qualifying for a conventional loan, it has become all the more clear that we need the benefits of reputable actors like Fannie and Freddie. Aggressive GSE involvement in this mark would surely help combat some of the outrageous predatory loans that are occurring in our neighborhoods, by standardizing these loans and promoting competition. Indeed, failure to become involved in this market could almost be considered counter to the GSE's mission for it would deprive too many working families the clear benefits that the GSE's bring to our housing system.

On the issue of regulation of the GSE's, I do not believe that now is the time to do anything that would disrupt or radically change the regulatory regime. The GSE's and their regulator have the opportunity to serve as a model for how risk-based capital rules can work effectively. Our Committee should follow the implementation of OFHEO's rule carefully. The rule has been 8 years in the making and now is clearly not the time to create undue uncertainty. Instead, we should try to support OFHEO's effort and do what is necessary to ensure that the rule is strong, effective, and well-implemented.

I welcome our witnesses and I look forward to an interesting and informative hearing today.

Thank you.

PREPARED STATEMENT OF SENATOR RICK SANTORUM

Mr. Chairman, thank you for holding this oversight hearing on the Office of Federal Housing Enterprise Oversight (OFHEO) and the two largest housing GSE's, Fannie Mae and Freddie Mac. I appreciate any opportunity to learn more about these companies and their regulator.

This hearing is particularly important because the three institutions we are examining today are major partners in the effort to open the door of homeownership to low- and moderate-income Americans. Congress chartered Fannie Mae and Freddie Mac to purchase U.S. residential mortgages at or below the conforming loan limit. As a result, the secondary mortgage market was born. Although Fannie and Freddie do not originate mortgages, the resources that their mortgage purchases send back into the primary market provide lenders with more money to offer more mortgages. On the other hand, Congress entrusted OFHEO with the task of monitoring the financial safety and soundness of the housing GSE's. Considering the size of the GSE's portfolios, OFHEO has an enormous responsibility. As Members of the oversight committee, it is our job to make sure that these institutions succeed in fulfilling their statutory missions.

Congress and the Administration will continue working to increase homeownership opportunities, particularly for low-income families and minorities. In order to achieve this goal, the continued health of the secondary mortgage market is essential. I am pleased that reports by the OFHEO and other private-sector evaluators indicate Fannie Mae and Freddie Mac are in good financial health. I encourage the GSE's to continue to be mindful of sound management and financial practices as they strive to meet the higher affordable housing goals that HUD, their mission regulator, has set for them.

Mr. Chairman, homeownership rates are at record levels in the United States. These numbers are encouraging, but we can do better. Less than half of African-American and Latino families own their own homes. Secretary Martinez is committed to raising the level of homeownership among minority families. I look forward to working with the Secretary and with the housing GSE's to make the dream of homeownership, and the economic security it provides, a reality for these families.

Again, Mr. Chairman, thank you for holding this important hearing.

PREPARED STATEMENT OF ARMANDO FALCON, JR.

DIRECTOR, OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT [1]

MAY 8, 2001

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

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

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

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

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

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

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

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

Examinations

The 1992 Act establishing OFHEO directs the Office to conduct annual on-site examinations to determine the Enterprises' financial safety and soundness and requires OFHEO to report the results and conclusions of these annual examinations in our annual *Report to Congress.* This is unique among financial regulators and is a powerful tool in influencing the behavior of the companies we regulate. While that report is not due until June 15, I am pleased to tell you today that both Enterprises have met or have exceeded safety and soundness standards in all examination program areas.

OFHEO regulates just two institutions, but arguably two of the most sophisticated financial institutions in the world. This has allowed us to attract very talented individuals who are experts in their fields. Our examiners, who are OFHEO's front line in ensuring the Enterprises' safety and soundness, possess impressive skills and backgrounds, and bring to OFHEO broad experience from banking and thrift regulatory bodies, as well as from many sectors of the financial services and mortgage industries. These experts maintain a physical presence at the Enterprises, and have unlimited access to all levels of management and to highly-sensitive corporate records. By staying apprised of the Enterprises' risks and business activities on a timely basis, the examiners are able to evaluate an extensive array of risk-related factors and to assess the Enterprises' financial safety and soundness.

Each quarter, the OFHEO examination staff updates conclusions relating to more than 150 separate components of financial safety and soundness, thereby providing me with a comprehensive picture of the Enterprises' financial condition. These conclusions pertain to such key risk management areas as credit risk, interest rate risk, liquidity management, information technology, internal controls, business process controls, internal and external audit, management information and process, and board of director governance and activities.

Our examiners meet frequently with management to discuss and assess business strategies and plans, financial performance results, risk management framework and practices, and each Enterprise's overall risk profile. These discussions include future trends and management's controls and practices to anticipate and prepare for potentially adverse trends in any risk area, or combination of risk areas. Examination teams identify opportunities for improvements in existing Enterprise risk management practices and work directly with management to address identified opportunities to enhance financial safety and soundness. Through our risk-focused examination framework, OFHEO constantly evaluates such critical areas as:

- The Enterprises' overall risk management strategies and practices.
- The composition, risk profile, and significant trends in their retained, and guaranteed, mortgage portfolios.
- The Enterprises' ability to effectively manage interest rate risk and other key financial exposures.

- The Enterprises' ability to efficiently issue debt and hedge financial exposures, and effectively manage liquidity.
- The quality of financial performance and the quality of information on which the Enterprises' boards and management rely in reaching key business and risk management decisions.

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

Capital

While examinations are an important part of oversight, it is by no means the only area in which Congress provided OFHEO with significant regulatory responsibility. The 1992 Act also directed OFHEO to establish and enforce two major capital tests for the Enterprises—a minimum capital test and risk-based capital stress test.

Minimum Capital—Since its inception, the OFHEO has ensured that both Fannie Mae and Freddie Mac have maintained a capital base sufficient to meet statutory minimum capital requirements. These requirements utilize a leverage test which is similar to existing capital requirements for banks and thrifts.

The statutory leverage test is quite simple. Each quarter, OFHEO aggregates the Enterprises' assets and places off-balance-sheet obligations into buckets based on their characteristics. Then, each group is multiplied by the capital ratios required in the statute. Generally, an Enterprise's assets are multiplied by 2.5 percent and outstanding guarantees of mortgage-backed securities and other off-balance-sheet obligations are multiplied by .45 percent.

This number is then compared to the Enterprises' core capital—or the sum of their (1) common stock, (2) preferred stock, (3) other paid-in capital, and (4) retained earnings. If core capital exceeds the requirement, the Enterprise is considered adequately capitalized. However, if a capital shortage exists, the Enterprise is classified as either undercapitalized, significantly undercapitalized, or critically undercapitalized, based on the size of the deficit and OFHEO's enforcement regime is triggered.

I am very pleased to report that for each quarter the test has been applied to the Enterprises, both companies have exceeded their minimum capital requirement and thus, have always been classified as adequately capitalized.

Risk-Based Capital—The 1992 Act called for a second capital test to be applied to both Enterprises—a sophisticated risk-based capital requirement using a stress test. The stress test simulates dramatic changes in interest rates and the highest historical declines in property values to determine capital requirements.

This approach is consistent with the Basel proposal, which is designed to increase the risk-sensitivity of capital requirements. However, due to the homogeneous nature of the Enterprises' business—and the fact that there are only two—OFHEO is able to take bank-like, risk-based capital regulation to a higher level.

Our risk-based capital regulation will more accurately tie capital to risk than any other current or proposed standard. Once calculated using the stress test, the statute requires an additional 30 percent capital charge for management and operations risk. This add-on is also consistent with the opinion of the Basel Committee, which also calls for a provision for operations risk.

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

Early last month, we submitted the rule to the Office of Management and Budget (OMB) for review. Once the rule is cleared by OMB and the rule is published in the *Federal Register,* Fannie Mae and Freddie Mac will be subject to the most sophisticated regulatory capital standard of any financial institution in the world. With that in mind, it is my view that OFHEO has gone further in its capital regulation—both in determining capital levels, as well as ensuring capital adequacy through prompt corrective action—than the risk weighted leverage approach employed by the banking regulators.

I don't mean to imply that the banking standard is inappropriate—not at all. Many banks and thrifts have asserted that their standard requires greater capital than that which applies to the Enterprises. But the proposed new Basel Accord, like OFHEO's risk-based capital standard, recognizes the need to more closely tie capital to risk. And because these approaches give institutions credit for risk-mitigation activities, the institutions that manage risk well will be rewarded with a lower capital requirement. Thus, everyone can benefit if this is done right. As the first agency to implement such a capital standard, I have made sure that we got it right, even under the tight deadlines I have imposed on our staff to finish the job.

Research

As with all financial regulators, research is an area of great importance to the 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 very pleased that this initiative has resulted in the 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 the routine internal research on the economic and financial environment in which the Enterprises operate, I find our independent research critical to fully understand the industry, the marketplace in which the Enterprises operate, and the stresses of economic events in order to meet our Congressional mandate. Without the benefit of economic, policy, and other research, it is clear that decisions I must make would be done in a vacuum. Thus, although much of our research is consumed by an internal audience, it is no less critical to fulfilling our mission.

Regulatory Infrastructure

Finally, I want to briefly touch on the legal apparatus OFHEO has put in place to deal with any problems which may occur at either Enterprise. Last summer, I announced that OFHEO would be conducting a regulatory infrastructure project, designed to provide a comprehensive review of and increased transparency into OFHEO's regulatory authorities. The project is designed to fully implement the statutory mandates of OFHEO, to provide greater certainty for the regulated entities and to produce greater transparency for the public in understanding OFHEO's administration of its responsibilities.

This project builds on the existing body of rules and, in many cases, formalizes that which the Office already does. To date, this project has resulted in the issuance of policy guidances on minimum safety and soundness requirements and the management of the Enterprises' nonmortgage 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 5 years, review its regulations for inefficiencies and unnecessary burden. The policy sets forth a procedure and even the criteria for internal and external review and comments. Once the project is complete, OFHEO's regulatory infrastructure will be an open book for anyone to comprehend.

In conclusion, OFHEO is meeting the mission Congress gave us. The Enterprises: (1) are subject to on-going oversight through our examination program, (2) must meet quarterly minimum capital requirements which are similar to existing capital requirements for banks and thrifts, (3) will soon be the only entities subject to a risk-based capital stress test which closely ties capital to risk, and (4) can be held accountable if found lacking in any of these stated areas. I assure you, OFHEO will remain vigilant in continuing to fulfill our Congressionally-mandated mission.

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

PREPARED STATEMENT OF FRANKLIN D. RAINES

CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FANNIE MAE

MAY 8, 2001

Good morning, Chairman Allard, Ranking Member Reed, and Members of the Subcommittee. My name is Franklin D. Raines, and I am the Chairman and Chief Executive Officer of Fannie Mae. I appreciate the opportunity to speak to the Subcommittee about Fannie Mae, our role in the marketplace, and our regulatory structure. I would also like to commend the Subcommittee for the very active role it has played in its stewardship of our housing finance system.

The last time I appeared before the Banking Committee was in March 1996, when as Vice Chairman of Fannie Mae I testified on the implementation of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 ("the Act"). In preparing for today's hearing, I reviewed my testimony from 1996 to see where we are relative to the course we articulated 5 years ago.

In 1996, I reported to the Subcommittee on Fannie Mae's progress in meeting the statutory housing goals, expanding homeownership and affordable rental housing, and strengthening the company's capital reserves and risk management. I told the Subcommittee that Fannie Mae would invest in technology to reduce the costs of buying a home, help lenders provide services to underserved areas of the country, and help small lenders succeed in a competitive market. Interpreted by any measure the 1992 Act was a success because it recognized that American homebuyers, and particularly the first-time homebuyers, are the beneficiaries of the careful balance of obligations and benefits that defines Fannie Mae's unique role in the housing finance system.

Today, I am pleased to report to the Subcommittee that Fannie Mae has made tremendous progress in each of the areas on which I reported to you 5 years ago:

- Since 1996, Fannie Mae has provided $1.45 trillion in home financing for 15 million American families. We have met or exceeded the statutory housing goals every year, and for 2001, HUD has raised the housing goals significantly. In 2000, we met our own 1994 goal to invest $1 trillion in targeted housing finance. We set a new goal to invest $2 trillion to help 18 million families achieve homeownership. As part of this goal, our National Minority Homeownership Initiative aims to invest at least $420 billion to serve more than three million minority households over the next decade.
- We have $21.5 billion of private equity capital, up from $13.5 billion at the end of 1996. Our single-family credit losses have fallen from 5.3 basis points (0.053 percent) in 1996 to 0.7 basis points (0.007 percent) in 2000.
- Last October we announced a set of path breaking voluntary initiatives to further strengthen our safety and soundness. Our liquidity management, market discipline, and disclosure practices are now at the vanguard of such practices globally, and we and Freddie Mac are the only U.S. corporations to commit to creating a deep and liquid market for our subordinated debt.
- Our indisputable safety and soundness means that Fannie Mae serves as a shock absorber for the entire financial system. In the fall of 1998, the commercial credit markets contracted sharply in response to global financial instability. Because Fannie Mae and Freddie Mac stepped up their mortgage purchases, U.S. homebuyers had ready access to fixed-rate financing at some of the lowest rates in a generation.
- Since 1996, technology has revolutionized the mortgage finance industry. Our technology investments have reduced a lender's cost of originating a loan by more than $1,000 and have helped smaller lenders compete and thrive in a business environment of increasing consolidation. Technology has also allowed us to work more efficiently with smaller lenders in rural communities to expand homeownership opportunities. As Senator Ensign said of a partnership we recently formed with Nevada Bank and Trust, "With e-commerce, no bank is too small to help its customers realize the dream of homeownership."

In all, our record over the last 5 years shows that the compact that Congress designed in 1992 between private investors and the Federal Government to achieve the public goal of expanded homeownership using private capital continues to be a spectacular public policy success.

Fannie Mae: A Private Company with a Public Mission

Congress articulated Fannie Mae's specific public mission clearly in the 1992 Act:

- *To provide stability in the secondary market for residential mortgages.*
- *To respond appropriately to the private capital market.*
- *To provide ongoing assistance to the secondary market for residential mortgages (including activities relating to mortgages on housing for low- and moderate-income families involving a reasonable economic return that may be less than the return earned on other activities) by increasing the liquidity of mortgage investments and improving the distribution of investment capital available for residential mortgage financing.*
- *To promote access to mortgage credit throughout the Nation (including central cities, rural areas, and underserved areas) by increasing the liquidity of mortgage*

investments and improving the distribution of investment capital available for residential mortgage financing.[1]

The business defined by our charter is designed to attract private capital to achieve these public purposes. The private individuals and firms that hold 1.038 billion shares of Fannie Mae common and preferred stock invest their capital in a company with a limited, specific public and business mission. In exchange, the Federal Government embraces that mission—through Fannie Mae's Congressional charter—and oversees companies to ensure they operate in a safe and sound manner.

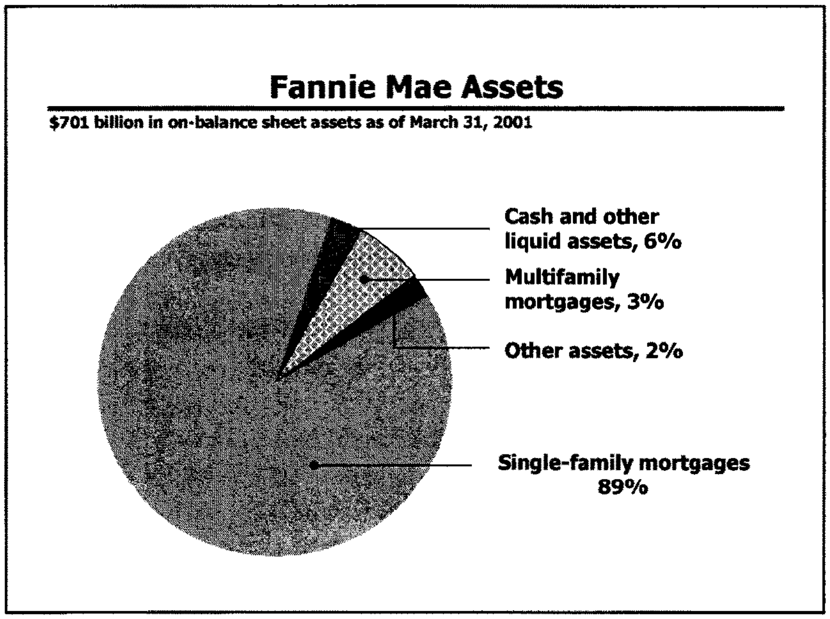
The charter includes certain specific benefits that support the efficiency of the business venture and indicate the Government's commitment to the specific public purposes it has asked Fannie Mae to pursue. These benefits in and of themselves are not sufficient to attract the private capital necessary to achieve the public goals. It is also necessary for Fannie Mae's management to translate the public mission into a profitable and sustainable business proposition. We do that through expert risk management, constant innovation in every part of the business, a tight rein on expenses, and dedication to a strategic business plan aimed at expanding homeownership and affordable rental housing.

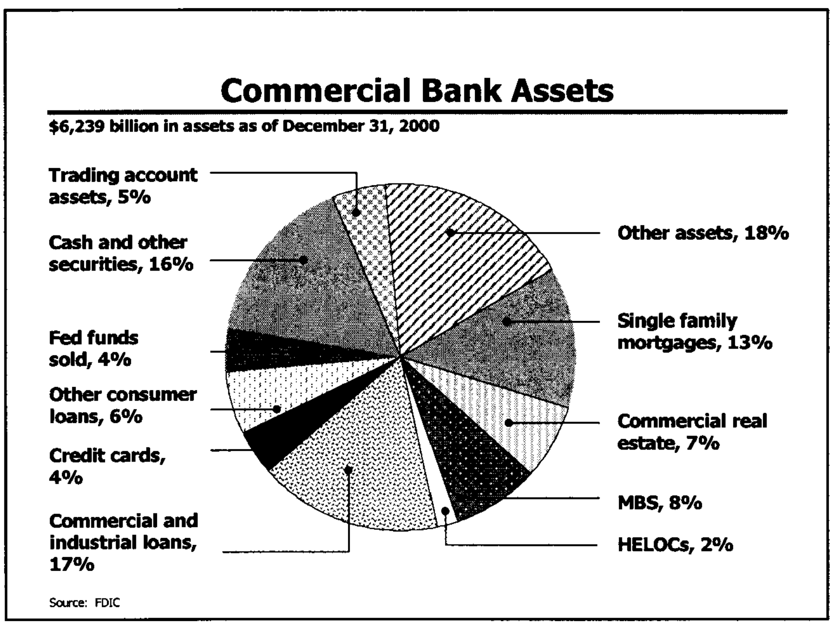
Because Congress wanted to focus Fannie Mae's use of its benefits on reducing costs for low-, moderate-, and middle-income homebuyers and on improving market liquidity, Congress defined how Fannie Mae may use these benefits. We are in a single line of business—U.S. residential mortgages at or below the conforming loan limit (currently $275,000 for single-family homes). Within that business, we participate in the secondary market; we do not originate mortgage loans. We have specific authorizations to deal in Government-insured and conventional single-family mortgages, second mortgages, and energy efficiency loans.[2] We operate under a rigorous risk-based capital standard, one that most banks and thrifts could not meet. We are affirmatively obligated by law to operate in all markets under all economic conditions and to meet three specific percent-of-business affordable housing goals. Congress also requires Fannie Mae to tell investors explicitly that our debt and MBS securities are not guaranteed by the Federal Government.

The focus of Fannie Mae's charter is reflected in the composition of our assets, which are dominated by single-family mortgages. Of our $701 billion in on-balance-sheet assets at the end of the first quarter of 2001, 89 percent were single-family mortgages, 3 percent were multifamily mortgages, 6 percent were cash and other liquid assets, and 2 percent were other assets. In contrast, commercial banks hold a much greater variety of assets.

[1] Title XIII of the Housing and Community Development Act of 1992, Pub. L. No. 102–550, 106 Stat. 3672.

[2] Fannie Mae Charter Act, 12 U.S.C. § 1717(b).





To ensure we pursue our mission and do so in a safe and sound manner, Congress established a comprehensive regulatory regime for Fannie Mae and Freddie Mac. That regime places responsibility for safety and soundness oversight with the Office of Federal Housing Enterprise Oversight (OFHEO) and responsibility for mission oversight with the Department of Housing and Urban Development (HUD).

OFHEO has been conducting a comprehensive, continuous, on-site examination program since 1994, the scope and rigor of which equals or exceeds that to which any other regulated financial institution is subject. OFHEO devotes more staff resources to its examination program of Fannie Mae and Freddie Mac than the OCC and the Federal Reserve devote to large and far more complex banking institutions. In addition, Congress required that the results of OFHEO's examinations be made public in OFHEO's Annual Report to Congress. Other financial regulators issue annual reports to Congress, but only the OFHEO reports on individual companies' exam results.

OFHEO is also responsible for implementing the minimum and risk-based capital standards in the 1992 Act. The 1992 Act requires that Fannie Mae meet a ratio-based minimum capital standard, as well as a stress-test requirement. Under the leverage requirement, we must have capital equal to 2.50 percent of on-balance-sheet assets. We must also hold capital equal to 0.45 percent for off-balance-sheet assets. Fannie Mae must meet this minimum capital requirement using "core capital"—common stock, perpetual noncumulative preferred stock, paid-in capital, and retained earnings.

The 1992 Act also includes a forward-looking capital standard for Fannie Mae and Freddie Mac. The risk-based capital standard requires the two companies to be able to withstand severe economic conditions that are far more catastrophic and persist far longer than those of the thrift crisis in the 1980's. As stated in the statute, the standard requires each company to hold enough capital to withstand a 10-year stress period characterized by unprecedented interest rate movements and credit losses occurring simultaneously, with an additional capital requirement to cover management and operations risk. The standard is truly extraordinary, and Fannie Mae and Freddie Mac are unique in having to meet such a test. Fannie Mae designed its own stress test from the specifications in the statute in 1993 and has complied with that risk-based capital test ever since. OFHEO is in the final stages of promulgating regulations to implement the standard in the 1992 Act. The agency has made a great deal of progress recently on the rule, and we hope to see the final risk-based capital standard in place as soon as possible.

With regard to mission regulation, HUD is responsible for ensuring that Fannie Mae and Freddie Mac carry out their housing missions and comply with their charters. HUD sets the annual percent-of-business housing goals for our service to low- and moderate-income borrowers, to residents of central cities and other underserved areas, and to very low-income borrowers. Regulations promulgated by HUD last year take effect in 2001 and have raised all three goals substantially. HUD also regulates the companies with regard to the fair lending laws, and must give its prior approval to new conventional mortgage programs that are significantly different than those in place before 1992.

Fannie Mae's Business

Fannie Mae achieves the purposes in our Congressional charter through our two primary lines of business. In our credit guaranty business, we create mortgage-backed securities (MBS) from pools of mortgage loans originated and owned by lenders. We guarantee timely payment of principal and interest on the loans in the MBS, which enables lenders to sell the MBS more easily to investors. For taking on this credit risk, Fannie Mae earns a guaranty fee on the MBS from the lenders who originate the loans. As of March 31, 2001, Fannie Mae's outstanding MBS—the MBS on which we provide a credit guarantee but do not hold in the portfolio—totaled $726 billion.

Our second business is our mortgage investment business, in which we buy mortgages from lenders in order to replenish the lender's supply of cash to make new mortgage loans. We fund these mortgage purchases by issuing debt in the global capital markets, and we earn income on the spread between our cost of debt and the yield on the mortgages we buy. As of March 31, 2001, Fannie Mae's mortgage portfolio investments totaled $641 billion.

Fannie Mae's credit guaranty and mortgage investment businesses draw additional investment capital from around the world to the U.S. mortgage market, which increases the funds available for homeownership and reduces mortgage rates for consumers:

- When Fannie Mae guarantees the credit risk on lender-originated MBS, the potential market of investors for mortgages widens substantially. The vast majority of institutional investors do not purchase individual mortgage loans because they are unwilling to take the credit risk on such loans. Instead, they purchase MBS enabling them to avoid the credit risk but still receive compensation (in terms of higher yields) for taking the risk that the loans will prepay if interest rates fall.
- When Fannie Mae purchases mortgages for its investment portfolio, we also greatly expands the range of investors supporting the U.S. mortgage market. We fund those purchases with a mix of four types of debt: short-term debt, and long-

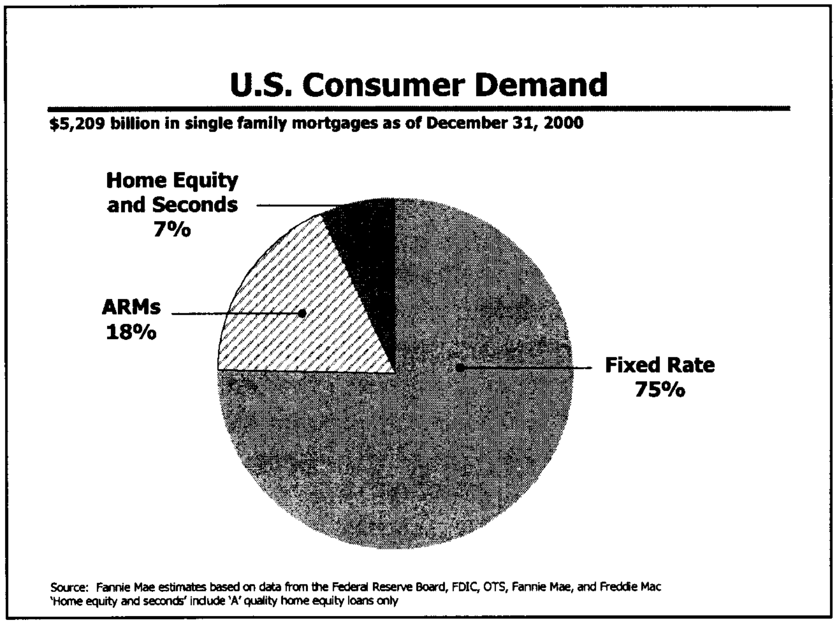
term bullet, callable, and subordinated debt. These debt securities appeal to investors who are unwilling to accept the prepayment risk that comes with MBS, but want a yield higher than that on Treasuries. Our short-term debt is safe, highly-liquid, and has stable prices; investors purchase this debt to match short-term obligations and for cash management purposes. Investors who want long-term investments and are prepared to accept some repayment risk, but less than the prepayment risk of MBS, purchase our callable debt securities. Callable debt is debt that Fannie Mae can redeem earlier than its stated maturity. Long-term investors who want more predictable cash flows and no repayment risk purchase our bullet debt, which Fannie Mae may only redeem at the stated maturity date. Investors who want to avoid repayment risk but who want a higher yield than is available on our bullet debt buy our subordinated debt, and in return accept the risk that interest payments will be deferred under certain circumstances.[3]

It is important to note that Fannie Mae's debt securities draw investors to the U.S. mortgage market who would not otherwise invest in mortgages. Investors who purchase Fannie Mae debt want securities with less prepayment risk than MBS and are willing to accept lower yields to avoid such risk. Without Fannie Mae debt in the market as an available investment, these investors would turn to other instruments. The result would be lower demand for less capital available to the U.S. mortgage market and higher mortgage rates for U.S. homeowners.

A Housing Finance System That Is The Envy Of The World

The unique combination of obligations and benefits in Fannie Mae's charter has given rise to a housing finance system that is the envy of the world—one that is safe, sound, and extraordinarily stable. The system also provides U.S. consumers with the types of mortgages they prefer: long-term, fixed-rate mortgages with a refinancing option. We estimate that, of the $5.2 trillion in U.S. single-family mortgage debt outstanding at the end of 2000, 75 percent was in the form of first-lien, fixed-rate mortgages with terms of at least 5 years. In most of the world, the predominant mortgages available to consumers are adjustable-rate or balloon mortgages.

[3] Prepayment risk is the risk to the investor that the borrower will prepay their mortgage before the mortgage is due, causing a disruption in cash flow to the investor and causing the investor to reinvest their funds in potentially lower yielding investments because of declining interest rates. Repayment risk for callable debt is the risk to the investor that the issuer will repay (call/redeem) the debt before the maturity date, also causing a disruption in cash flow and reinvestment risk to the investor. Both risks typically are associated with declining interest rates.



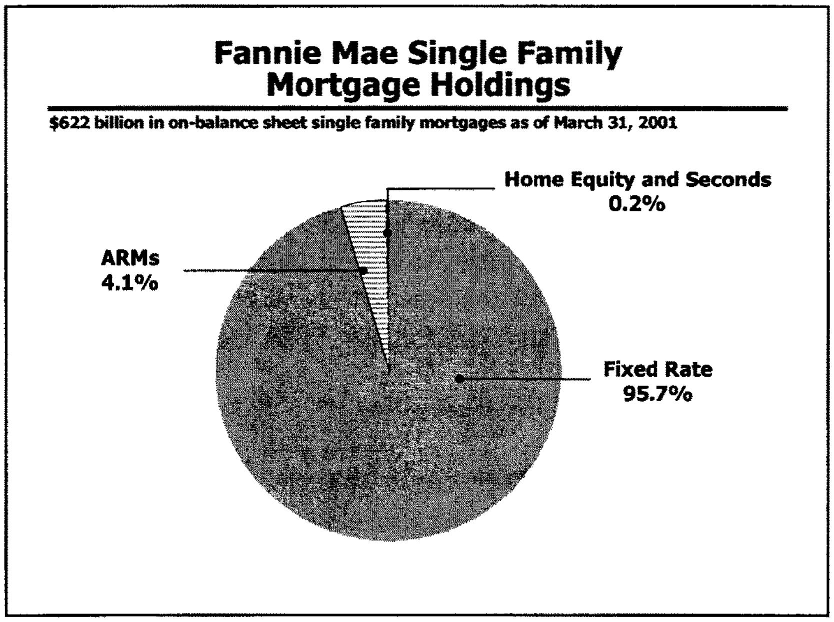
American consumers can obtain mortgages with lower down payments and lower interest rates than their counterparts in the rest of the industrialized world. In the United Kingdom, down payments are generally more than 20 percent, and in Japan and France, they are more than 30 percent. In the United States, homebuyers can put as little as 3 percent down, and increasingly zero-percent down payment mortgages are becoming available. In the United Kingdom, the majority of homebuyers' monthly mortgage payments change as mortgage rates change, and most U.K. homebuyers do not know from 1 month to the next whether they will be paying more or less than the month before. In Spain, approximately 90 percent of mortgages have variable rates. In the Netherlands, where fixed-rate mortgages with low down payments are available (although the rate may be fixed only for an initial period), homebuyers may pay a penalty if they prepay or refinance their mortgages. Prepayment penalties in the U.K. can be as high as 6 percent of the unpaid balance of the loan or 6 months of interest. In the United States, very few mortgages outside of the subprime market carry prepayment penalties. The contrast with our system could not be more stark.

In countries other than the United States, mortgage finance systems developed in different ways to solve the same problem: Who should accept the prepayment, or interest rate, risk? In the United Kingdom, homebuyers take the risk—and see their payments change as rates change—because the financial institutions that fund mortgages have historically not had access to long-term funding. In Germany, the government takes the interest rate risk, and in return requires that homebuyers make down payments of 40 percent on their first liens. In Mexico, homebuyers bear some or all of the interest rate risk because lenders and the government will not accept the rate uncertainty stemming from inflation; if rates rise quickly, the extra interest homebuyers owe as a result is added to their unpaid balances.

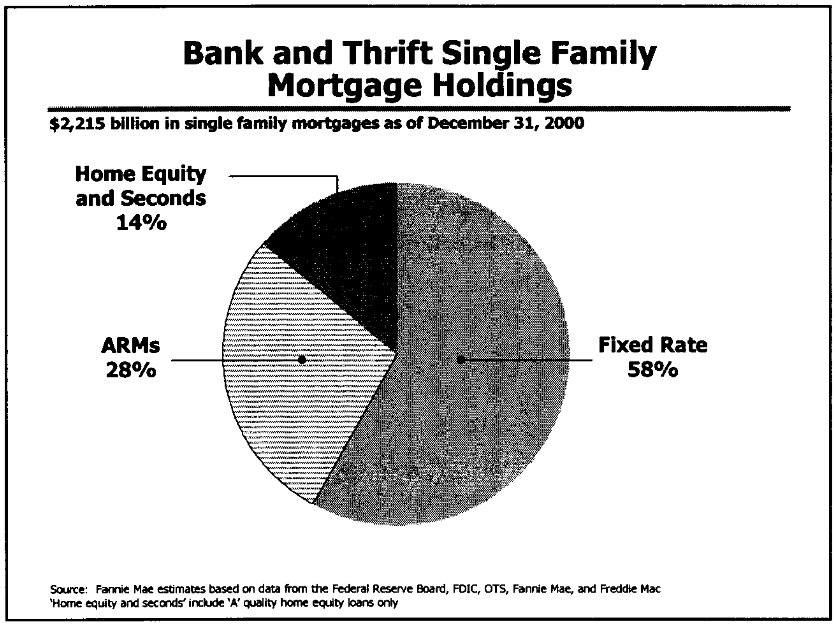
The housing finance system that Congress designed works very differently. Our ability to issue debt across the yield curve, combined with our expertise in matching the durations of our debt liabilities with those of our long-term, fixed-rate mortgage assets, has allowed us to build a specialization in managing the risk on the fixed-rate mortgages U.S. consumers prefer. In contrast, banks and thrifts specialize in the short-term adjustable-rate and home equity loans that match the short-term Federally insured deposits that make up half of their liabilities.

To see this difference in specialization, one only has to contrast the composition of the mortgages held by Fannie Mae and commercial banks. Nearly all—95.7 percent—of the single-family mortgages Fannie Mae holds in its portfolio are fixed-rate.

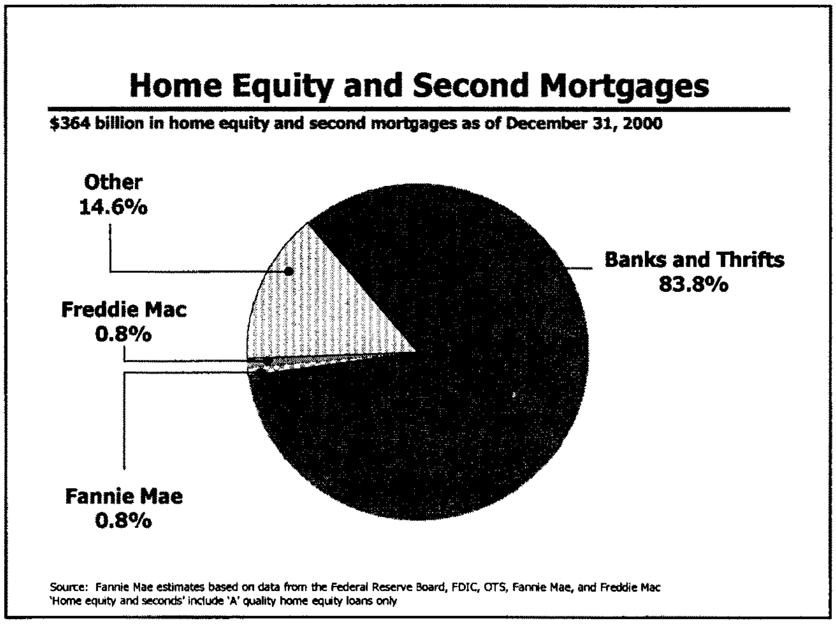
Another 4.1 percent are adjustable-rate, and only a very small amount—0.2 percent—are home equity or second mortgages.

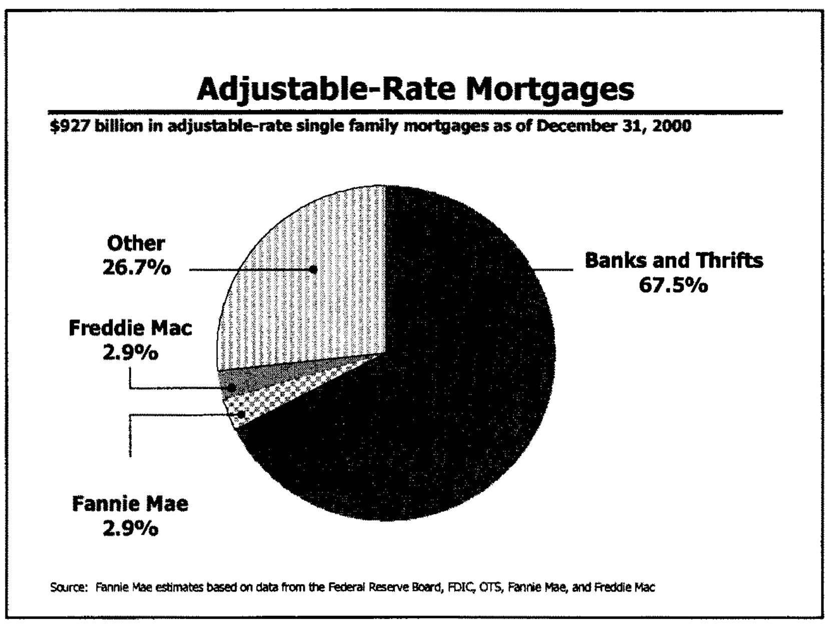


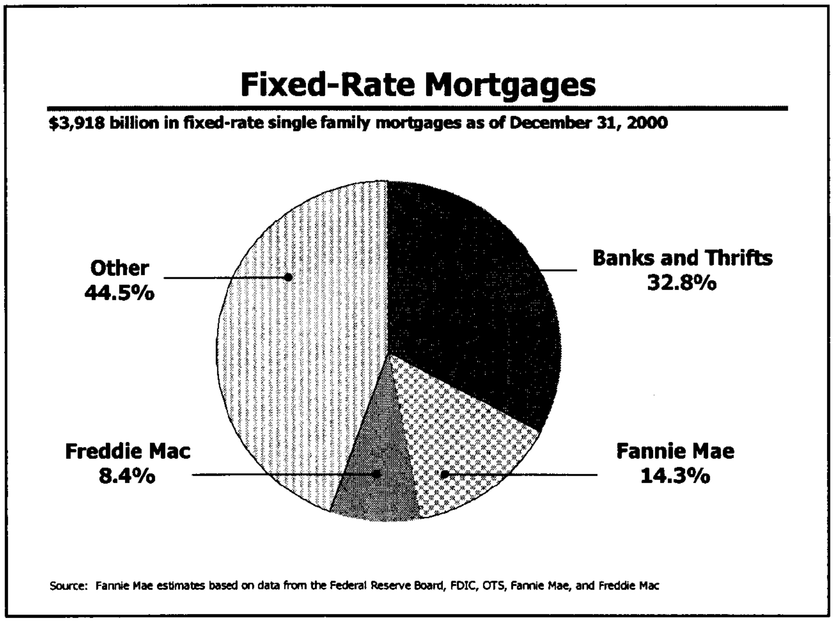
In contrast, our estimates show that commercial banks and thrifts hold a considerably lower percentage of fixed-rate mortgages (58.0 percent) than Fannie Mae, and more adjustable-rate mortgages (28.3 percent) and home equity and second mortgages (13.8 percent). This reflects the advantage in short-term funding that depositories have over Fannie Mae and Freddie Mac by virtue of their access to low-cost deposits insured by the Federal Government and advances from their own Government Sponsored Enterprise, the Federal Home Loan Bank System.



The difference in specialization between Fannie Mae and depositories becomes even more apparent when looked at by mortgage type. Reflecting their short-term funding advantage, depositories have an 83.8 percent share of the market for home equity loans and second mortgages, compared with Fannie Mae's 0.8 percent share. For adjustable-rate mortgages, depositories have a 67.5 percent share compared with Fannie Mae's 2.9 percent share. Only in the fixed-rate segment is Fannie Mae competitive—with a 14.3 percent share compared with depositories' 32.8 percent share.


Home Equity and Second Mortgages
$364 billion in home equity and second mortgages as of December 31, 2000
Other
14.6%
Banks and Thrifts
83.8%
Freddie Mac
0.8%
Fannie Mae
0.8%
Source: Fannie Mae estimates based on data from the Federal Reserve Board, FDIC, OTS, Fannie Mae, and Freddie Mac
'Home equity and seconds' include 'A' quality home equity loans only


Adjustable-Rate Mortgages
$927 billion in adjustable-rate single family mortgages as of December 31, 2000
Other
26.7%
Banks and Thrifts
67.5%
Freddie Mac
2.9%
Fannie Mae
2.9%
Source: Fannie Mae estimates based on data from the Federal Reserve Board, FDIC, OTS, Fannie Mae, and Freddie Mac



Because of our presence in the market, consumers can not only get the mortgage the long-term, fixed-rate mortgage they prefer, but they can also choose among many innovative products to find the fixed-rate mortgage that best fits their financial profile. For example, Fannie Mae's Flexible 97 is a 30-year, fixed-rate mortgage that requires a down payment of as little as 3 percent, and those funds may be in the form of grants, gifts, and secured loans. Likewise, many of the products under our Community Home Buyers Program offer fixed-rate mortgages under more flexible underwriting criteria including lower income requirements, lower cash reserve requirements, and lower closing costs. Timely Payment Rewards is a mortgage option that allows borrowers with slightly impaired credit the chance to finance their home at a mortgage rate as much as 2 percent lower than what credit-impaired borrowers typically pay, with an even lower rate after 24 months of on-time payments.

Safety and Soundness

Because Fannie Mae and Freddie Mac play a critical role in providing consumers access to the long-term, fixed rate financing they prefer, it is essential that the two companies remain at the forefront of global safety and soundness practices.

In 2000, we recognized that there were additional measures we could put in place that would assure policymakers that our safety and soundness protections are at the forefront of evolving world practices. To formulate these measures we turned to the experts: The reports and studies of the Basel Committee on Banking Supervision, OFHEO, the Federal Reserve, and other policymakers and market participants who analyze risk in the financial markets.

After a comprehensive review of these recommendations, Fannie Mae and Freddie Mac, in conjunction with policymakers, crafted a set of initiatives designed to place the two companies at the leading edge of safety and soundness practices. These commitments were announced with Congressman Richard Baker, Congressman Paul Kanjorski, and other Members of the House of Representatives last October. Fannie Mae committed to issue subordinated debt, obtain an annual credit rating, enhance our liquidity planning, disclose more information about interest rate risk and credit risk sensitivity, and implement and disclose the results of an interim risk-based capital standard. Together, these initiatives will give investors and policymakers more information about Fannie Mae's risk exposure—and confidence that Fannie Mae can manage that exposure—than they can get from any other financial institution. I am happy to announce that Fannie Mae has implemented all six of these commitments.

These six new voluntary measures, combined with the regulatory mechanisms Congress enacted in 1992, place Fannie Mae at the vanguard of risk management and disclosure practices worldwide, with cutting-edge regulatory discipline bolstered by cutting-edge market discipline.

Subordinated Debt. In October, we committed to issue publicly traded and externally rated subordinated debt. We included subordinated debt because it offers real benefits to the market and policymakers. First, it is an important way to crystallize the views of thousands of investors into a clear signal to policymakers, as to how investors view the company's financial condition. Second, it provides an incentive for subordinated debt holders to monitor our risk position very carefully. Because subordinated debt interest is suspended in the event of significant capital erosion, large shifts in the yield of Fannie Mae subordinated debt will signal to the OFHEO that the company may have increased its risk position. Last, it serves as an additional cushion of capital on top of Fannie Mae's required equity capital as defined by our statutorily-required minimum levels and our risk-based capital stress test.

In January 2001, Fannie Mae issued $1.5 billion of subordinated debt with a maturity of 10 years, and last week we priced our second issue of $1.5 billion in 5-year subordinated debt. We also signaled our intention, consistent with our commitment in October, to issue subordinated debt quarterly during 2001 and on at least a semiannual basis thereafter. We expect that by 2003 we will have $12 to $15 billion in subordinated debt outstanding, with an average maturity of at least 5 years.

Our first two subordinated debt issues received Aa2 ratings from Moody's Investors Service and AA− ratings from Standard and Poor's (S&P). The rating agencies rated the subordinated debt separate and apart from Fannie Mae's relationship with the Federal Government. In assigning its AA− rating, S&P stressed that they did not regard the Subordinated Notes as being backed by the Government. They wrote:

> *Unlike Standard & Poor's triple 'A' rating on the senior obligations of Fannie Mae, which incorporates implied Government support, the rating on the subordinated debt assumes that the government would not intervene to prevent payment default on the instrument.*[4]

Moody's said that:

> *The debt ratings assigned to the GSE's have the exact same meaning as those assigned to all other firms in the USA and elsewhere. They express Moody's opinion of the ultimate credit risks of a particular debt instrument taking into consideration all relevant factors.*[5]

By the terms of the subordinated debt Fannie Mae issued, interest payments will automatically suspend if certain capital tripwires are activated and, should the company experience difficulties, holders of subordinated debt securities will stand in line behind senior debt creditors and MBS investors to recover their principal. Unlike other subordinated debt issues, the interest deferral cannot be delayed by Fannie Mae or any other party if the defined conditions occur. For these reasons, the consensus of market analysts was that Fannie Mae subordinated debt would be regarded by the market as different from its senior debt and would trade at a discount to our senior debt. This has proven to be the case.

The prices at which our subordinated debt has traded indicate that the market is behaving consistently with analyst expectations. Our first issuance was initially priced at 98 basis points over the 10-year U.S. Treasury and 22 basis points over the November 2010 Fannie Mae Benchmark Note. Since issuance, our 10-year subordinated debt has traded actively in the secondary market, with pricing ranging from 18 to 28 basis points higher in yield than our senior debt.[6] Our second issuance of 5-year subordinated debt was priced on May 2, 2001, at 71 basis points over the 5-year U.S. Treasury and 18 basis points over our February 2006 Fannie Mae Benchmark Note.

Moody's summarized the beneficial results from subordinated debt, emphasizing the difference between it and Fannie Mae's and Freddie Mac's senior securities:

> *The subordinated debt issued by Freddie Mac and Fannie Mae will, in combination with common and preferred equity, improve senior debtholders' position in the highly unlikely event of a liquidation or similar event. This should help to alleviate concerns about the systemic risks from GSE failure and help to provide an early warning signal to the marketplace in times of*

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[4] Standard and Poor's CreditWire, *Rating Assigned to Fannie Mae Subordinated Benchmark Notes,* January 24, 2001.

[5] *Fannie Mae and Freddie Mac Subordinated Debt Rating Rationale,* Moody's Investor Services Special Comment, March 2000, at 3.

[6] More information on Fannie Mae's subordinated debt is available in Fannie Mae's *Funding Notes* publication, *Further Development of Fannie Mae's Subordinated Benchmark Notes Program,* Volume 6, Issue 4 (April 2001), at http://www.fanniemae.com/markets/debt/fundingnotes/pdf/fundingnotes–4–01.pdf.

stress. . . . The GSE's proposed subordinated debt also would not benefit from the same degree of implied support that senior enjoys and could face mandatory interest payment suspension.[7]

Our planned, regular, and large-size issuances of subordinated debt validate the idea of a dynamic and active subordinate debt market as a means of market discipline. Fannie Mae expects that the market will use its collective expertise in measuring our risk profile, capital adequacy, and financial health each time we bring new issues of Subordinated Benchmark Notes to market, as well as in ongoing trading in the secondary market. In doing so, Subordinated Benchmark Notes will truly be the "canary in the coal mine" that is crucial to establishing Fannie Mae at the forefront of financial institutions globally in adhering to the highest standards of market discipline.

As Morgan Stanley wrote recently:

Spreads between the Subordinated Benchmark Notes and its senior Benchmark Notes will provide a real time indicator of investors' perceptions of the adequacy of Fannie Mae's capital relative to the risks it faces. Going forward Fannie Mae will have an additional yardstick with which to gauge the success of its capital policies. In striving to keep these spreads stable, Fannie Mae will have an incentive to communicate more extensively about the risks it faces and how it manages its capital in relation to these risks. This increased transparency to which Fannie Mae is already committed will enable investors to better assess Fannie Mae's risk and the adequacy of its capital.[8]

Annual Rating. We also committed in October to obtain an annual rating from a nationally recognized statistical rating organization of our "risk to the government" or independent financial strength, and that we would disclose this rating to the public.

On February 27, 2001, S&P assigned a AA− "risk to the government" rating to Fannie Mae. Only five commercial bank holding companies, and no thrifts, have a rating this high on their senior debt. This rating, according to S&P, "refers to the inherent default risk of a Federally related entity operating under its authorizing legislation, but without assuming an infusion of cash from the Government." S&P incorporates into the rating such criteria as an evaluation of Fannie Mae's business fundamentals, including the company's competitive position, evaluation of management and its strategies, and examination of relevant financial measures.

At Fannie Mae's request, S&P's "risk to the government" rating will be maintained on a continuous, "surveillance" basis. This goes beyond the annual rating that Fannie Mae committed to obtain last October. Under a surveillance rating, S&P will continuously monitor our financial position and change the rating—with an accompanying press release—if our risk posture changes.

In summarizing its analysis of Fannie Mae's credit strength, S&P wrote:

Fannie Mae has demonstrated consistently good operating performance over a sustained period of time, testifying to its ability to manage the risks inherent in holding a portfolio of mortgage loans and the strength of its franchise as one of two government sponsored mortgage guaranty agencies. It has successfully weathered changing conditions in the demand for mortgage guaranties, several regional housing market declines, and changing interest rate environments. Asset quality is very strong, and the risk profile of its portfolio of mortgages remains very low. Capitalization has been stable, and is expected to remain so given the regulated nature of the company.[9]

With this "risk to the government" rating, Fannie Mae now has outstanding a full range of ratings, including those on senior debt, subordinated debt, and preferred stock. This suite of ratings gives investors a clear, comprehensive, and ongoing assessment of Fannie Mae's credit position. And combined with the daily updates to the prices of our subordinated debt, Fannie Mae now has more signals than any other company of how market professionals view the company's risk posture.

Liquidity. The third initiative from the October package was an enhancement of Fannie Mae's liquidity management. When we looked at the recommendations from the Basel Committee, we noted an emphasis on liquidity management. In its Feb-

[7] *New Freddie Mac and Fannie Mae "Open Book" Policy: A Positive Credit Development,* Moody's Investor Services Special Comment, October 2000, at 4.

[8] Morgan Stanley Product Note on Fannie Mae Subordinated Benchmark Notes, January 2, 2001.

[9] Standard and Poor's, News, *Fannie Mae's Risk to the Government Assigned "AA−" Rating,* February 27, 2001.

ruary 2000 paper recommending enhanced liquidity management for banks, the Basel Committee noted that:

> *Liquidity, or the ability to fund increases in assets and meet obligations as they come due, is crucial to the ongoing viability of any banking organization. . . . Sound liquidity management can reduce the probability of serious problems. Indeed, the importance of liquidity transcends the individual bank, since a liquidity shortfall at a single institution can have system-wide repercussions.*[10]

Based on the discussions of safety and soundness that we had with the House Subcommittee and other policymakers last year, Fannie Mae wanted to ensure that we met the very highest standards of liquidity management. As a result, we committed to:

- Maintain 3 months worth of liquidity, as recommended by the Basel Committee, based on the assumption that the company has no access to the public new-issue debt markets during this period.
- Maintain at least 5 percent of our on-balance-sheet assets in a liquid, marketable portfolio of nonmortgage securities.
- Comply with the 14 principles of sound liquidity management set forth by the Basel Committee in February 2000.[11]

In mid-March 2001, Fannie Mae announced that we had met this commitment. We have a contingency plan in place to ensure that we could meet our funding needs for 3 months without access to the agency debt markets. We are maintaining more than 5 percent of our on-balance-sheet assets in high-quality, liquid, nonmortgage securities. In fact, Fannie Mae's ratio of liquid assets to total assets was 6.3 percent as of March 31, 2001, and we are disclosing this ratio to the public on a quarterly basis. And last, our liquidity plan meets the 14 principles for sound liquidity management set forth by the Basel Committee and satisfies our safety and soundness regulator. We have briefed OFHEO on our liquidity plan, and OFHEO has confirmed that the plan would ensure that Fannie Mae could function for 3 months without access to the new issue debt markets.

These commitments are in addition to a rigorous liquidity program already in place at Fannie Mae. We begin with a close cash-flow match between our assets and liabilities. In addition, we manage our liquid assets under strict investment guidelines approved by our Board of Directors. Under these limits, liquid assets have an explicit goal of zero credit losses. Fannie Mae's typical liquid assets are money market paper and AAA-rated securities. Understandably, the margins on these high quality, liquid investments are much lower than those Fannie Mae earns on our mortgage portfolio, but that is the opportunity cost the company pays to maintain a safe cushion of liquidity.

By virtue of the company's sound liquidity practices and our commitment to maintain more than 3 months worth of liquid assets, Fannie Mae is positioned not only to withstand swings in the markets, but also to provide liquidity to the market when other financial firms withdraw. Thus, for example, during the market turbulence in the second half of 1998, when other investors withdrew from the market, Fannie Mae stepped up our mortgage purchases—largely by drawing down liquid assets—which maintained the stability of the mortgage market and kept mortgage rates at historic lows for homebuyers.

New Risk Disclosures. Our subordinated debt issuance and annual ratings can serve as excellent signals to policymakers and investors, but the company has added additional transparency that puts it at the leading edge of risk disclosures. The fourth and fifth of our October initiatives were our new monthly interest rate risk sensitivity disclosures and new quarterly credit risk disclosures.

Interest Rate Risk Disclosures

We committed to disclose on a monthly basis the impact on Fannie Mae's financial condition of a plus or minus 50 basis point instantaneous change in interest rates and an instantaneous 25 basis point shift in the slope of the yield curve in both directions. On March 26, 2001, we made our first monthly interest rate risk disclosure

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[10] Basel Committee on Banking Supervision, *Sound Practices for Managing Liquidity in Banking Organizations,* Consultative Paper No. 69 (February 2000) at 7.

[11] Basel notes that "[t]he relevant time-frame for active liquidity management is generally quite short. . . . Banks which are reliant on short-term funding will concentrate primarily on managing their liquidity in the very short term (say the period out to 5 days). . . . Other banks (for example, those that are less dependent on the short-term money markets) might actively manage their net funding requirements over a slightly longer period, perhaps 1 to 3 months ahead."

under this commitment to investors and the public. Going beyond the commitment we made in October, Fannie Mae released the two primary measures of interest rate risk that the company uses in managing our interest rate business: Portfolio net interest income at risk and effective asset/liability duration gap.

Fannie Mae's net interest income at risk measure discloses the sensitivity of Fannie Mae's projected net interest income to an immediate 50 basis point increase or decrease in interest rates and a 25 basis point increase or decrease in the slope of yield curve. Net interest income at risk compares projected net interest income under the more adverse of the interest rate and yield curve scenarios with projected net interest income without the interest rate shocks. We are disclosing our net interest income at risk over both a 1- and 4-year period. For the 4-year disclosure, the net interest income at risk calculation reflects the percentage difference in cumulative net interest income over the period.

As of March 31, 2001, the company's net interest income at risk from a 50 basis point change in interest rates was 3.8 percent over the next 1 year, and 3.2 percent over the next 4 years. The company's net interest income at risk from a 25 basis point change in the slope of the yield curve was 3.1 percent over the next 1 year, and 4.7 percent over the next 4 years.

These changes in interest rates and in the slope of the yield curve encompass about 95 percent of the actual changes that are likely to occur over the one-month reporting period. Fannie Mae generally expects our net income at risk measures to range between 1 and 5 percent.

In addition, we are supplementing our net interest income at risk disclosure with monthly disclosure of the company's effective asset/liability duration gap. Effective duration is a measure of the sensitivity of a security's value to changes in interest rates, and is commonly used in fixed-income portfolio management. Fannie Mae has successfully used effective duration gap as an internal risk management tool for a number of years, and we report on duration management to our Board of Directors. We also reported this information as of year-end in our Annual Report to the shareholders.

As of March 31, 2001, the effective duration gap of our mortgage portfolio was a positive 1 month. A positive duration gap indicates that the effective duration of the portfolio's assets exceeds the effective duration of its liabilities by that amount, while a positive duration gap indicates the opposite. Fannie Mae has a target range for our effective duration gap of plus or minus 6 months. When the duration gap moves outside this range—which it can do if interest rates move quickly or by large amounts—we rebalance our assets and liabilities to bring the duration gap within the target band.

Fannie Mae's interest rate risk disclosures follow the recommendations of the New Basel Accord and the report of the Working Group on Public Disclosure, headed by Walter V. Shipley. Both recommend that risk disclosures be consistent with internal risk management practices. Net interest income at risk and duration gap are the primary portfolio risk measures at Fannie Mae. Basel further proposes that disclosures incorporate expected future activity, and that sophisticated disclosures use multiple simulations of interest rates. Fannie Mae's net interest income at risk measure is based on projected future activity over the next one and 4 years, and both net interest income at risk and duration gap are calculated using at least 300 interest rate paths.

Credit Risk Disclosures

We also committed in October to disclose on a quarterly basis the sensitivity of expected credit losses from a 5 percent drop in property values. On March 26, 2001, Fannie Mae released our first quarterly credit risk disclosure under this commitment.

To calculate our credit risk sensitivity, Fannie Mae uses internal credit models, as recommended by Basel, to project the present value of future credit losses. We then calculate the present value of losses assuming an immediate 5 percent decline in the value of all properties securing mortgages owned or guaranteed by Fannie Mae. Following this decline, home prices are assumed to increase at the same long-run rate embedded in the company's credit pricing models. Projected default incidence and loss severity are consistent with the assumed changes in home prices. The sensitivity of future credit losses is the dollar difference between credit losses in the baseline scenario and credit losses assuming the immediate 5 percentage point home price decline.

As of December 31, 2000, the company's net sensitivity of future credit losses, taking into account the effect of credit enhancements, was $295 million. This figure reflects a gross credit loss sensitivity of $1,065 million without the effect of credit enhancements, and is net of projected credit risk sharing proceeds from mortgage insurance companies, lenders, and others of $770 million.

Fannie Mae's current low level of sensitivity to credit losses reflects the quality of our existing book of business, the impact of our loss mitigation techniques, and the effectiveness of our credit enhancement and risk-sharing strategies. While slightly less than 40 percent of Fannie Mae's single-family portfolio as of December 31, 2000, was covered by credit enhancements, we project that our credit enhancement counterparties would absorb $770 million, or 72 percent, of the increase in credit losses that would result from a 5 percent home price shock.

We expect our credit risk sensitivity to vary over time based on a number of factors, including the composition of the company's credit portfolio, recent home price changes, the level of interest rates, and the amount of mortgage insurance and other credit enhancements that reduce Fannie Mae's losses.

Interim Implementation of the Risk-Based Capital Rule. The final component of the October 2000 voluntary initiatives is our commitment to implement on an interim basis the risk-based capital stress test included in the 1992 Act and disclose to the public whether we passed or failed the test. We will run this interim implementation only until the final risk-based capital standard is adopted by OFHEO.

The stress test spelled out in the 1992 Act requires Fannie Mae to hold sufficient capital to withstand an unprecedentedly severe economic and financial shock that extends for 10 years, without defaulting on our obligations. The test includes severe adverse interest-rate movements and nationwide depression-level conditions in residential real estate lasting throughout the decade-long period. The required level of current capital is an amount sufficient for Fannie Mae to remain solvent in every quarter throughout the 10-year span of adverse economic conditions plus, for good measure, an additional 30 percent to account for operations risk.

The possibility of these two credit and interest-rate scenarios happening simultaneously is extremely small, and very few companies could survive for 10 years the type of environment assumed in Fannie Mae's stress test. Indeed, a study commissioned by Fannie Mae found that the thrift industry would have to boost its capital base by 60 to 90 percent to be able to survive the type of scenario envisioned by Fannie Mae's stress test.[12]

Fannie Mae has run our own internal version of the risk-based capital stress test since 1993, and has built capital and managed our business to remain in compliance with that test. For purposes of the voluntary disclosure, Fannie Mae constructed an interim implementation of the risk-based capital test using the OFHEO's Notice of Public Rulemaking 2 (NPR2) as a basis, modified to reflect subsequent changes implemented or suggested both by OFHEO and the company.

OFHEO's NPR2 was published in the *Federal Register* in April 1999, and is extensively documented. Since April 1999, OFHEO has made corrections to NPR2, and the corrections are noted on the OFHEO web site. In constructing our interim stress test, Fannie Mae incorporated OFHEO's NPR2 changes along with the changes we recommended in our March 10, 2000, comment letter to OFHEO and other refinements enumerated on our web site (www.fanniemae.com). Fannie Mae will disclose whether we have passed or failed our interim risk-based capital test as of the end of each quarter, and also give an indication of the amount by which our total capital exceeds or falls short of the calculated risk-based requirement.

In March 2001, we announced that we had sufficient capital to pass our interim version of the OFHEO risk-based capital test as of December 31, 2000, and that our capital cushion on that date was between 10 and 30 percent of total capital. We were able to pass the interim risk-based capital test because of the substantial amount of hedging and loss-sharing arrangements in which we engage. Typically between 45 and 50 percent of Fannie Mae's liabilities consist of callable debt or other option-based instruments. Our reliance on mortgage insurance and credit risk sharing arrangements reduce credit risk exposure and allow the company to withstand the stresses in the risk-based capital test.

Fannie Mae's interest rate risk and credit risk disclosures complement the results of our quarterly stress test. In summarizing the value of the package of disclosures to which Fannie Mae and Freddie Mac committed themselves, Moody's stated:

> *These financial disclosure commitments by Fannie Mae and Freddie Mac set new standards not only for them, but also for the global financial market.*
>
> *The provision by Fannie Mae and Freddie Mac of periodic, detailed risk information to the broad market will permit better independent reviews and*

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[12] Dave Dufresne, *Risk-Based Capital and the Thrift Industry: Implications of Risk-Based Capital Stress Test Requirements* 7 (IPS-Sendero, February 1999).

monitoring of their risk profiles and should substantially reduce the uncertainty about their actual financial health, as well as dampen any systemic risks they present.

The regular disclosure of their interest and credit risk exposure, combined with stress testing of their capital base, should significantly increase market comfort with their risk management disciplines and capital adequacy. The stress test, in particular, will show whether the two GSE's have sufficient capital to withstand very harsh market developments over a long period.[13]

Conclusion

A generation ago, the housing industry was more cyclical than it is today, and when the economy slowed, housing slowed as well. Today, the housing sector—which makes up about 8 percent of annual gross domestic product—is more stable than other sectors of the economy. Indeed, while the manufacturing sector is in a downturn, overall job growth has slowed sharply and orders for high-tech equipment have dropped significantly, housing activity has remained robust. Total home sales in the first quarter of 2001 were at a record level—with new sales in March at an all-time high and existing sales at their second highest level ever.

The strength of the housing industry translates into greater financial stability for American families. Strong home price appreciation in recent years has increased the average net worth of homeowners, and these gains in housing wealth have helped offset declines in equity wealth.[14] With the declining trend in mortgage rates—from 8.62 percent last May to the current rate of slightly over 7 percent—many homeowners have refinanced, allowing them to reduce their monthly mortgage payments. The extra cash from refinancing has enabled households to increase their spending, which has helped cushion the slowing economy. We estimate conservatively that consumer spending may increase by $40 billion this year as a result of refinancing activity.

The financing that Fannie Mae provides through all types of economic circumstances is one reason that housing is so stable. Despite stagnating home prices in California in the first half of the 1990's and in New England in early 1990's, Fannie Mae delivered a steady supply of financing to lenders across the country and consistent earnings to our investors. Our strong financial performance over time is a key factor in drawing investors from around the world to invest their capital in U.S. housing finance.

This financial strength means that we are ready to meet the housing finance challenges ahead. The homeownership rate in America today stands at a record 67.5 percent, but the gap between whites and minorities is huge. Seventy-four percent of white Americans own their homes, but that figure is less than 50 percent for minorities. We have the best housing finance system in the world. Now we must make it work for more American families.

In this context, I would like to propose a straightforward test for examining policy proposals that affect the housing finance system:

- Do they reduce costs for consumers?
- Do they improve the safety and soundness of the housing finance system?
- Do they expand opportunities for homeownership?
- Do they allow innovation in the market without cumbersome regulatory requirements?

I proposed a test similar to this in 1996, when I testified before the Banking Committee, and they remain relevant, particularly in view of the challenges we continue to face in expanding homeownership opportunities for all Americans.

Thanks to Congress' wisdom in understanding the power of private enterprise to meet this critical public purpose—and in crafting a compact with private investors—no single company in America is focusing more capital and commitment to closing the homeownership gap than Fannie Mae. We are in the American Dream business, and our mission is to "tear down barriers, lower costs and increase the opportunities for homeownership and affordable rental housing for all Americans." In partnership with mortgage lenders, elected leaders, housing leaders, community groups, and many others, Fannie Mae will bring more homeownership to more people and places than ever.

Thank you for inviting me to testify before you today. I look forward to working with the Subcommittee on these important issues.

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[13] Moody's Investor Service, *Op. Cit.* at 4.

[14] According to the House Price Index from the Office of Federal Housing Enterprise Oversight, the year-over-year average increases in home prices in 1998, 1999, and 2000 were 5.5 percent, 5.8 percent, and 7.7 percent, respectively.

PREPARED STATEMENT OF LELAND C. BRENDSEL

CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FREDDIE MAC

MAY 8, 2001

Good morning, Chairman Allard, Senator Reed, and Members of the Subcommittee. It is a pleasure to be here. I am Leland C. Brendsel, Chairman and Chief Executive Officer of the Federal Home Loan Mortgage Corporation, known as Freddie Mac.

Executive Summary

Freddie Mac plays a vital role in financing homeownership and rental housing for the Nation's families. Mortgage funds are available whenever and wherever they are needed. Mortgage rates are lower, saving homeowners thousands of dollars in interest payments. Thirty-year fixed-rate mortgages are plentiful, protecting families from unexpected interest-rate increases. In addition, the availability of low down payment loans has helped open the door of homeownership to more low- and moderate-income families.

Freddie Mac's ability to continue to provide these benefits rests on our financial strength. As a result of our superior risk management capabilities, strong capital position and state-of-the-art information disclosure, Freddie Mac is unquestionably a safe and sound financial institution. Freddie Mac is fiercely committed to maintaining the confidence of Congress, investors and the public in our financial strength because that is what we need to meet our mission.

Last October, Freddie Mac made six commitments that keep us at the vanguard of world financial practices. These commitments are significant. They outpace the financial management practices of other institutions; they meet or exceed recommendations of international experts in financial risk and capital management; and they set a new standard for global financial institutions. We made these commitments voluntarily. There can be no doubt that Freddie Mac will be able to serve our vital mission in a safe and sound manner for generations to come.

Freddie Mac Brings Tremendous Benefits To Consumers

Freddie Mac is a shareholder-owned corporation chartered by Congress in 1970 to create a stable flow of funds to mortgage lenders in support of homeownership and rental housing. We bring tremendous benefits to America's families.

Constant Availability. There is never a shortage of mortgage money. Freddie Mac's high-quality, liquid mortgage and debt securities attract global investors to finance America's housing. A diversified investor base makes the housing finance system highly resilient and stable. When other markets face disruption—as they did during the global financial turmoil in the fall of 1998—there is no disruption whatsoever in the mortgage market we serve.

Low Cost. By linking local communities with global investors, Freddie Mac enables homebuyers to compete for funds in the capital markets alongside the largest corporations. As a result, families save thousands of dollars in mortgage interest. In a recent report, former Office of Management and Budget Director Dr. Jim Miller and fellow economist Dr. James Pearce totaled the savings to America's families to between $8 billion and $23 billion each year.[1]

Perhaps the best evidence of how we save consumers money is in the weekly real estate section of major newspapers. For example, in its Saturday Real Estate section, *The Washington Post* provides two sets of mortgage interest rates: Those for conforming mortgages, which are eligible for Freddie Mac purchase (currently up to $275,000 for a single-family home), and those for higher-balance jumbo loans. Invariably, rates on conforming mortgages are lower than those on jumbo loans by as much as 50 basis points. Furthermore, Freddie Mac's activities lower mortgage interest rates on *all* conforming loans, not simply the ones we purchase. Whether a conforming loan is held in portfolio by a bank or a credit union, mortgage rates are lower for all conforming market borrowers.

Uniformity. Freddie Mac purchases mortgages in every community in the country. As a result, a borrower in Denver pays the same for a mortgage as a borrower in

[1] Pearce, James E. and Miller III, James C., "Freddie Mac and Fannie Mae: Their Funding Advantage and Benefits to Consumers," at 29 (2001). Available at *http://www.fhlmc.com/vitalrole/docs/cbo-final-pearcemiller.pdf.* The Freddie Mac commissioned report estimates the funding advantage between $2.3 billion to $7.0 billion. Drs. Pearce and Miller concluded: "Thus, even using the lowest estimate of consumer benefits and the highest estimate of the funding advantage in our range of estimates, the value of consumer interest-cost savings resulting from Freddie Mac and Fannie Mae's activities significantly exceeds the highest estimate of their funding advantage."

Providence. This stands in sharp contrast to 1970 when mortgage interest rates differed by as much as one and a half percentage points across the country.

Product Choice. America's families choose from a broad array of mortgage products, including the 30-year fixed-rate mortgage with a low down payment. In many other countries, this type of mortgage is simply not available.

Innovation. From the development of the mortgage securities market in the 1970's to the development of automated underwriting in the 1990's, Freddie Mac has been at the forefront of innovation in the mortgage market. Borrowers are the direct beneficiaries of Freddie Mac's innovation.

In 1995, Freddie Mac introduced automated underwriting to the market with our Loan Prospector® automated underwriting service. Loan Prospector® has revolutionized the mortgage origination process, reducing the time and expense of getting a loan. Automated underwriting also brings greater objectivity and fairness to lending decisions. Every piece of information is evaluated the same way for every borrower, every time, with an accuracy no human underwriter can match. This high degree of accuracy has led to the development of new products that would have been deemed too risky a few years ago. The Joint Center for Housing Studies at Harvard University concludes that these products enable "more income-constrained and cash-strapped borrowers at the margin to qualify for mortgage loans."[2]

High Standards. By bringing competition, standardization, and accountability to the mortgage market, Freddie Mac promotes responsible lending. We have taken a leadership role in combating predatory lending practices.

Economic Stability. Freddie Mac's activities also play a vital role in stabilizing our Nation's economy. When the economy weakens, we deliver lower interest rates to the mortgage market. This, in turn, boosts housing activity, which is often just the spark the economy needs. According to *Barron's*:

> *If the Fed has staved off a recession, some of the credit should go to Freddie Mac and Fannie Mae. By helping to transmit the benefits of the central bank's rate cuts to the mortgage market, these agencies have done their part in cushioning the impact of the Nasdaq knockdown on the American consumer.*[3]

Lower mortgage rates also enable existing homeowners to refinance their mortgages, putting real money back into their pockets. The easing of mortgage interest costs and the strength of the housing market are among the bright spots on today's economic horizon.

Homeownership. The stability, efficiency, and innovation that Freddie Mac brings to the mortgage market turn homeownership dreams into reality. Since our inception, Freddie Mac has purchased more than $2 trillion in residential mortgages, financing homes for more than 27 million families. In so doing, we have contributed to an all-time high homeownership rate. Today, more than two-thirds of America's families are homeowners, building wealth and brighter prospects for their future.

Freddie Mac brings tremendous benefits to the Nation. They far outweigh any benefits we derive from our Congressional charter. America's homebuyers can depend on Freddie Mac because we are safe, sound, and strong.

Superior Risk Management

Freddie Mac has a 30-year record of successfully managing our business in a rigorous and disciplined way. The tools we have developed to manage both credit and interest-rate risk are second to none, and our exposure to these risks remains at very low levels.

Credit Risk Management: Freddie Mac operates in only one business—residential mortgages. This business has low credit risk, which is the risk that borrowers will default on their loans. Because of the value attached to homeownership, families pay their monthly mortgage payment first and faithfully. More than $500 billion in home equity stands between Freddie Mac and the risk of default on the mortgages we own. We are further protected through the use of third-party credit enhancements on a large share of our mortgage purchases. These enhancements include recourse arrangements with our lenders and mortgage insurance on low down payment loans. Finally, by funding mortgages nationwide, geographic diversity mitigates the risk of local economic downturns.

These extensive loss protections support mortgages that are underwritten and managed using state-of-the-art statistical tools. Loan Prospector® is used by thousands of lenders to originate mortgages that Freddie Mac purchases; in fact, Loan

[2] Joint Center for Housing Studies of Harvard University, *State of the Nation's Housing 1999,* p. 4.

[3] Ablan, Jennifer, "Despite Treasury Selloff, More Fed Easing Ahead?" *Barron's Online* (January 15, 2001).

Prospector® recently processed its 10 millionth loan. Automated underwriting's sophisticated evaluation of risks allows us to purchase mortgages with low down payments in a safe and sound manner. Freddie Mac further mitigates credit losses by actively seeking alternatives to foreclosure. Our loss mitigation techniques reduce credit costs and in many cases enable struggling borrowers to keep their homes.

Our credit risk management techniques have produced extraordinarily low credit losses. Freddie Mac's mortgage delinquency rates are consistently and significantly lower than the overall conventional market, and much lower than those of the Federal Housing Administration. Our loan charge-offs are significantly lower than those of banks and thrifts. We maintain loan loss reserves that are seven times our credit losses, and hold capital against credit losses sufficient to withstand severe losses.

Interest-Rate Risk Management: Freddie Mac also is a leader in managing interest-rate risk. Interest-rate risk is the risk that changes in the level of interest rates could adversely affect the value of a portfolio and could lead to mismatches in the expected cash flows between assets and liabilities. Freddie Mac's interest-rate risk exposure results primarily from the uncertainty as to when borrowers will pay off their mortgages. When mortgage interest rates decline, borrowers tend to prepay their mortgages by refinancing into lower-cost loans. This creates financing challenges for mortgage investors who must find alternative investment instruments in a lower yield environment.

Freddie Mac manages this risk on the mortgages we buy using extremely disciplined standards. We fund our mortgage investments with an appropriate mix of bullet debt, callable debt, and effective callable debt. We closely monitor the sensitivity of our portfolio to changes in the interest-rate environment and rebalance our portfolio as needed. We regularly reassess the accuracy of our prepayment models.

Strong Capital Management And Supervisory Oversight

Not only is Freddie Mac highly skilled at managing risk, we are extremely well-capitalized for the risks we take. We manage our business to hold enough capital to withstand 10 years of economic stress resembling the Great Depression. In addition to our own rigorous capital management, the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the GSE Act) subjects us to both a minimum capital requirement and a stringent risk-based capital standard. The minimum capital requirement applies to both on-balance-sheet and off-balance-sheet assets, unlike bank capital standards. The risk-based capital standard is the industry's toughest, requiring us to withstand 10 years of extremely severe stress.

Our safety and soundness regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), currently assesses our financial strength using the minimum capital standard.[4] Each quarter since OFHEO began assessing Freddie Mac's capital in 1993, our regulator has determined that Freddie Mac is adequately capitalized, which is the highest rating. OFHEO is required to communicate examination results, as well as its determination of our capital strength in an annual report to Congress.

The risk-based stress test required by the GSE Act is innovative, stringent, dynamic, and more responsive to risk than any ratio-based capital regulation.[5] It requires Freddie Mac to maintain sufficient capital to withstand a 10-year period of extreme swings in both credit and interest-rate risks.

The credit risk portion of the stress test is based on the assumption that defaults and losses on mortgages occur throughout the United States at a rate and severity equal to the highest default rates experienced in a regional downturn.[6] In implementing this extremely severe scenario, OFHEO intends to subject Freddie Mac's entire mortgage portfolio to the actual default experience of the collapse of real estate in the oil-belt States in the 1980's. The default rates on mortgages with low down payments during this period were approximately 25 percent; loss rates were approximately 60 percent.

The interest-rate risk portion of the test mandates a stress test in which yields on 10-year Treasury bonds fall or rise by as much as 600 basis points.[7]

Further, the GSE Act requires a 30 percent add-on to required stress test capital to account for management and operations risk.[8]

A pioneer in the use of risk-based stress tests, Freddie Mac believes that a well-implemented regulation would meet four key criteria:

[4] The GSE Act established a minimum capital requirement as the sum of 2.5 percent of on-balance-sheet assets and 0.45 percent of outstanding mortgage-backed securities and other off-balance-sheet obligations. 12 U.S.C. §4612.
[5] 12 U.S.C. §4611.
[6] 12 U.S.C. §4611(a)(1).
[7] 12 U.S.C. §4611(a)(2).
[8] 12 U.S.C. §4611(c)(2).

- The test must be consistent with the GSE Act. For example, the Act calls for the projected stressful conditions to reasonably reflect economic reality and past experience. This means that every assumption from interest rates to prepayment rates to house-price appreciation must be derived from historical data.
- The test must tie capital to the actual risks we face. Assigning too little capital or too much both have negative consequences. Too little capital could jeopardize our ability to withstand an extreme downturn in the economy. On the other hand, requiring too much capital would impose unnecessary costs on the Nation's families. Mortgage rates would rise, and mortgage products attractive to lower income borrowers might become unavailable.
- The test must be operationally workable. For Freddie Mac to purchase mortgages on a daily basis, we must be able to calculate the amount of capital that will be required and incorporate it into our business processes. The test must produce reliable and accurate results.
- The test must foster innovation. Freddie Mac is relentless in our search to wring out every inefficiency and barrier to homeownership. New instruments for managing risk and financing housing are constantly being developed in the markets. The test must encourage Freddie Mac to quickly respond to new opportunities while remaining safe and sound.

Freddie Mac is working with OFHEO toward final risk-based capital regulations that will be a model for the industry.

OFHEO currently carries out a detailed and comprehensive examination program, which includes continuous on-site examinations and quarterly capital determinations. OFHEO's highly regarded examination staff focuses all day, every day on two companies in one line of business. By comparison, examiners of large banks must inspect activities ranging from annuities to foreign currencies to commercial loans to credit cards taking place at hundreds of subsidiaries here and around the world. Despite the monoline nature of Freddie Mac's business, there are roughly the same number of examiners reviewing Freddie Mac as there are reviewing a large bank's dozens of business lines.

Comprehensive Disclosure That Promotes Market Discipline

We disclose more information to the public about the risks we face and our effectiveness at managing them than almost any other financial institution. The annual report and quarterly information statement supplements of Freddie Mac provide comprehensive information related to credit risk. They include extensive discussion, analysis, and quantification of types of credit risk exposures, such as the "at-risk" share of delinquent loans, loan-to-value ratios, and geographic concentrations.

Freddie Mac's interest-rate risk disclosures are similarly comprehensive. Our quantitative methodologies measure the change in portfolio market value that would be caused by immediate upward or downward shifts in interest rates.[9] Freddie Mac provides these disclosures on a regular basis, exceeding the annual disclosure requirements required of financial institutions by the Securities and Exchange Commission (SEC).

Last year, Freddie Mac requested that PriceWaterhouseCoopers (PWC) compare our public risk disclosures to those of selected financial institutions generally recognized to be providing best-in-class risk management disclosures.[10] PWC found that our risk management disclosures "are among the best of the risk management disclosures provided by the recognized best-in-class group included in this study."[11]

Greater transparency through information disclosure exposes an institution to the rigorous discipline of financial markets. If investors perceive that a company's financial condition has deteriorated, they will require higher yields on their investments to assume the higher risk.

Market discipline is not a replacement for strong capital and vigilant oversight, but is a necessary and desirable complement. Recently, Federal Reserve Chairman Alan Greenspan called market discipline the "first line of regulatory defense."[12] In a speech to the American Bankers Association, he stated that:

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[9] Freddie Mac's quantitative disclosures employ sensitivity analysis, one of three methods of quantitative disclosure prescribed by the Securities and Exchange Commission. SEC's rules require SEC registrants to provide quantitative disclosure about market risk sensitive instruments, and permit them to use: (1) a tabular presentation of fair value information and of contractual terms; (2) a sensitivity analysis; or, (3) a value-at-risk methodology.

[10] PriceWaterhouseCoopers, "Freddie Mac: Risk Disclosure Benchmarking Study" (May 15, 2000).

[11] *Id.* p. 4.

[12] Remarks by Federal Reserve Chairman Alan Greenspan in his address "Banking Supervision," before the American Bankers Association, Washington, DC (September 18, 2000).

We are moving toward a system in which . . . public disclosure and market discipline are going to play increasing roles, especially at our large institutions, as a necessity to avoid expansion of invasive and burdensome supervision and regulation. Bank regulators are perforce being pressed to depend increasingly on greater and more sophisticated private market discipline, the still most effective form of regulation.[13]

OFHEO also has endorsed market discipline as an important component of a comprehensive regulatory framework. In its most recent annual report to Congress, OFHEO stated:

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.[14]

Six Commitments Set A New Standard In Financial Management

Freddie Mac is a leader in risk and capital management and information disclosure. Last October, Freddie Mac made six commitments that keep us at the vanguard of evolving worldwide practices. In developing these commitments, we sought out the best practices among financial institutions. We looked at the recommendations of global financial regulators, including the Basel Committee on Banking Supervision. In its first revision to the 10-year-old Basel Accord, the Committee embraced a "Three Pillars" framework for financial regulation.[15] The pillars, are Capital, Supervisory Oversight and Market Discipline. Viewed against these three pillars, Freddie Mac already is among the "best-in-class" for risk and capital management and disclosure practices.

Freddie Mac's Six Commitments

1. Publicly disclose our independent rating.
2. Maintain a high degree of liquidity.
3. Issue subordinated debt on a semiannual basis.
4. Implement a risk-based capital stress test on an interim basis.
5. Publicly disclose a forward-looking measure of credit risk every quarter.
6. Publicly disclose interest-rate risk every month.

Since we announced our six-point plan, other regulatory experts have voiced support for similar principles and best practices:

- In December 2000, the Federal Reserve Board and the Department of Treasury released a joint report to Congress entitled "The Feasibility and Desirability of Mandatory Subordinated Debt."[16] The report concludes that the use of subordinated debt may contribute to market discipline.
- In January 2001, the Working Group on Public Disclosure, also known as the Shipley Commission, issued a report to the Federal Reserve, SEC, and Office of the Comptroller of the Currency (OCC).[17] The report recommends improved and more frequent disclosure of credit and interest-rate risk.
- In March, the Federal Reserve Board and the OCC released supervisory guidance urging large banks to adopt the Shipley Commission recommendations.[18]

These reports and recommendations provide strong affirmation that Freddie Mac's six commitments are aligned with the best and most up-to-date thinking on financial risk management.

Freddie Mac asked William Seidman, the former Chairman of the FDIC, for his assessment of our commitments. He concluded:

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[13] Ibid.

[14] Office of Federal Housing Enterprises Oversight, 2000 Report to Congress, at 33, (June 15, 2000).

[15] *A New Capital Adequacy Framework,* Consultative Paper on Capital Adequacy No. 50, Basel Committee on Banking Supervision (June 1999); *The New Basel Capital Accord,* Consultative Document, Basel Committee on Banking Supervision (January 2001).

[16] *The Feasibility and Desirability of Mandatory Subordinated Debt,* Report to Congress by the Board of Governors of the Federal Reserve System and the Department of the Treasury, December 2000.

[17] Letter of the Working Group on Public Disclosure (January 11, 2001).

[18] Board of Governors of the Federal Reserve System, Supervisory Staff Report SR 01–6 (March 23, 2001). See Appendix A.

Your package of disclosures and standards puts [Freddie Mac] in a position of providing more and better public information than any other financial institution, both regulated and nonregulated, of which I am aware.[19]

Our six commitments set the pace for other institutions to adopt similar practices and to enhance their public disclosures. In fact, Moody's Investors Service said that the commitments "set new standards not only for themselves [Freddie Mac and Fannie Mae], but for the global financial market."[20] They added:

The leadership shown by Freddie Mac and Fannie Mae could prove difficult for other firms to ignore, and could usher in a wave of enhanced financial risk disclosure. This may prove to be one of the most important ramifications of the GSE's initiatives.[21]

Freddie Mac met all six commitments in just 6 months. I will briefly describe each commitment and how it sets a new standard in financial practices and disclosure.

Commitment 1: Public Disclosure of Independent Rating

What we accomplished. On February 27, 2001, we released our "AA−" risk-to-the-government rating from Standard & Poor's (S&P). We originally pledged to obtain a rating once a year. Now Freddie Mac is going beyond that. We have asked S&P for a continuous "surveillance" rating. This means that the S&P will be obligated to notify the public if there is ever a change in our financial position that affects the rating.

Why it is important. Independent ratings are crucial to our financial system. Every day, millions of securities change hands on the basis of rating agency opinions of financial quality. Freddie Mac's commitment to seek an annual independent rating provides a readily discernible measure of capital strength that promotes market discipline. Ratings provide an independent early warning signal to the public, Congress and investors regarding our financial condition.

In the preamble of the joint agency proposed rulemaking on risk-based capital standards for recourse and direct credit substitute transactions,[22] the Federal bank and thrift regulatory agencies stated:

In the opinion of the agencies, ratings have the advantages of being relatively objective, widely used and relied upon by investors and other participants in the financial markets. Ratings provide a flexible, efficient, market-oriented way to measure credit risk.[23]

How we measure up. A risk-to-the-government rating of AA− places Freddie Mac in the top tier of financial institutions. To put this in perspective, of the 10 largest bank holding companies, only two have earned a rating this high on their senior debt—and none has a higher rating.

Commitment 2: Liquidity Management and Contingency Planning

What we accomplished. On March 8, 2001, we announced that we met our liquidity commitment. Freddie Mac holds enough liquid, high-quality assets so that we can meet all of our financial obligations, even in the event of a market disruption so severe that we are unable to issue debt for 3 months. With this commitment, we also are meeting the Basel Committee's 14 principles of sound liquidity management for large banks.[24]

Why it is important. Liquidity is the lifeblood of any financial institution and of any financial market. We take it for granted until it is gone. Freddie Mac's liquidity commitment, together with public disclosure, will provide strong assurances to investors about Freddie Mac's financial strength. Regardless of disruptions in the capital markets that may make it impossible to borrow, Freddie Mac has the means to meet our financial obligations for at least 3 months.

Summary of Principles
Basel Sound Practices for Managing Liquidity

1. Strategy for day-to-day management of liquidity.
2. Approval of liquidity strategy by bank's Board of Directors.
3. Effective management structure for implementing liquidity strategy.

[19] Memorandum of L. William Seidman to Freddie Mac (December 13, 2000).
[20] *New Freddie Mac & Fannie Mae 'Open Book' Policy: A Positive Credit Development,* Moody's Investors Service (October 2000).
[21] Ibid.
[22] 65 *Fed. Reg.,* at 12320, 12321 (March 8, 2000).
[23] 65 *Fed. Reg.,* at 12321.
[24] "Sound Practices for Managing Liquidity in Banking Organizations," Consultative Paper No. 69, Basel Committee on Banking Supervision (February 2000).

4. Adequate information systems to measure and monitor liquidity risk.
5. Process for measuring and monitoring net funding requirements.
6. Use of scenario analysis to analyze liquidity needs.
7. Frequent review of underlying assumptions.
8. Periodic review of relationships with liability holders.
9. Contingency plans for handling liquidity crisis.
10. Control system for managing currency risk.
11. Limits on possible cash flow mismatches arising from currency risk.
12. Effective internal control systems, including independent review.
13. Mechanism to ensure adequate public disclosure.
14. Supervisory oversight.

How we measure up. Freddie Mac's ability to withstand 3 months without access to debt markets and still meet our financial commitments is an extraordinary indication of our financial strength and liquidity. It is unlikely that many other financial institutions can meet this standard. In its 1999 liquidity paper, the Basel Committee suggested that large institutions be prepared to weather a liquidity crisis of between 1 and 3 months.[25] We chose the more stringent 3 months.

Our liquidity commitment also exceeds current market practices and represents a new best practice for financial institutions. For example, the Federal Housing Finance Board recently adopted a minimum liquidity requirement for the Federal Home Loan Banks.[26] The rule requires the FHLB's to withstand only 5 days without access to the debt markets.

Commitment 3: Periodic Issuance of Subordinated Debt

What we accomplished. On March 21, 2001, we met our subordinated debt commitment with the issuance of $2 billion of 10-year subordinated debt securities, known as Freddie SUBS℠. This will create a supplement to our already strong capital position. The amount of subordinated debt we issue, when combined with our core capital, will equal at least 4 percent of on-balance-sheet assets. We expect that within 3 years, there will be an additional $8 billion to $10 billion of investor funds standing in front of our senior debt holders.

Why it is important. Subordinated debt is a tool for market discipline. Subordinated debt is paid to the holders only after all other debt instruments are paid. Interest payments on Freddie Mac SUBS will be suspended and allowed to accumulate for up to 5 years if Freddie Mac's core capital deteriorates materially. As a result, the yield at which our subordinated debt trades will provide a market-based indication of our financial strength.

Chairman Greenspan has likened the use of subordinated debt to a "canary in the mine," alerting investors and the public of potential financial weakness well before any regulatory or other governmental intervention would be needed.[27] Similarly, the December 2000 joint report by the Federal Reserve and the Treasury concluded that issuing subordinated debt contributes to market discipline. While the report stopped short of recommending mandatory issuance by banks, Freddie Mac stepped up to the challenge of frequent, large issues.

How we measure up. Freddie Mac's subordinated debt commitment exceeds practices of other financial institutions. According to the joint report and a 1999 Federal Reserve study, typically only the largest banks and bank holding companies issue subordinated debt, and most banks' subordinated debt is not publicly traded.[28] Moreover, no bank has voluntarily committed to issue publicly traded subordinated debt on a regular basis to enhance its transparency and market discipline.

Commitment 4: Interim Implementation of Risk-Based Capital Stress Test

What we accomplished. We met this commitment on March 26, 2001, when we announced that we passed the risk-based capital stress test envisioned in GSE Act. Our interim disclosure will not substitute for OFHEO's regulatory process. We are working with OFHEO toward final risk-based capital regulations that will be a model for the industry.

Why it is important. Adequate capital is critical to an institution's ability to weather adverse circumstances. Freddie Mac's commitment to implement the risk-based stress test and disclose the outcome ensures that we are adequately capitalized for the risks we take.

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[25] Basel Liquidity Paper, at 7, par. 28.
[26] FHLB Final Rule, 66 *Fed. Reg.* at 8261–321 (January 30, 2001).
[27] Testimony of Federal Reserve Board Chairman Alan Greenspan in his renomination hearing before the Senate Banking Committee (January 26, 2000).
[28] *"Using Subordinated Debt as an Instrument of Market Discipline,"* Federal Reserve Study Group on Subordinated Debt and Debentures, Staff Study 172 (December 1999).

How we measure up. Freddie Mac's statutory risk-based capital stress test is the toughest test in the financial industry and is entirely consistent with the 2001 New Basel Capital Accord. A 1999 study conducted by the economic consulting firm IPS-Sendero concluded that the thrift industry would run out of capital after 5 years of this stress test and would need to triple its capital to survive.[29]

Commitment 5: New Quarterly Credit Risk Disclosures

What we accomplished. We met this commitment on March 26, 2001, when we disclosed the impact on Freddie Mac of a 5 percent decline in house prices everywhere around the country. Since we began keeping track of house-price changes in 1975, there has not been a nationwide decline of this magnitude. Our new disclosure demonstrates the outstanding credit quality of Freddie Mac's portfolio.

Why it is important. Freddie Mac's commitment to disclose quarterly our exposure to credit risk represents a new best practice for financial institutions. Most credit risk disclosure is backward looking, focusing on charge-offs and loans that are already delinquent and in default. This type of information is useful, and Freddie Mac will continue to report it. The addition of our new credit-risk disclosure, which predicts exposure to a worsening economy, provides forward-looking insights into our business.

How we measure up. By subjecting ourselves to this test, Freddie Mac has set a new standard in the measurement and reporting of mortgage credit risk. The Basel Committee issued a paper in July 1999 regarding best practices for credit risk disclosure[30] stating the Committee's expectation that banks disclose sufficient, timely, and detailed information to allow market participants to perform meaningful evaluations of the bank's credit risk profile.[31] Our commitment is consistent with the Basel approach.

Commitment 6: New Monthly Interest-Rate Risk Disclosures

What we accomplished. On April 18, 2001, we began the monthly disclosure of interest-rate risk. We disclosed the impact on Freddie Mac of an abrupt change in our funding costs—both a 50 basis-point shift in interest rates and a 25 basis-point shift in the slope of the Treasury yield curve. The disclosure demonstrates Freddie Mac's disciplined and skilled risk management, as our interest-rate risk exposure remained at very low levels in a volatile environment.

Why it is important. In modern financial markets, interest-rate and other market risks can expand and contract at great speed. To understand the impact of rapidly changing interest-rate environments and manage their investment positions, investors need current information about their risk exposure.

How we measure up. Freddie Mac's commitment to monthly disclosure of interest-rate risk significantly raises the bar; no banking institution reports interest-rate risk as frequently. Our commitment also exceeds the recommendation of the Shipley Commission. In its January report to the Federal Reserve, the SEC, and the OCC, the Commission recommended quarterly disclosure of interest-rate risk. In supervisory guidance released on March 23, 2001, the Federal Reserve and the OCC urged large banking organizations to adopt Shipley recommendations to improve both their quantitative and qualitative disclosures.[32] Institutions also were encouraged to seek new avenues, such as company web sites, for disseminating financial information more frequently than regular annual or quarterly disclosures.[33] Freddie Mac is using our web site at *freddiemac.com* to give the public and our investors financial information about our six commitments.

Taken together, our six commitments represent a watershed in financial practices and disclosure.

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[29] *Thrift Industry Analysis: Implications of Risk-Based Capital Stress Test Requirements* IPS-Sendero (August 19, 1999).

[30] *"Best Practices for Credit Risk Disclosure,"* Basel Committee on Banking Supervision, Basel, July 1999 ("Basel Credit Paper").

[31] These best practice recommendations are consistent with the recommendations concerning hedge fund disclosures in *"Hedge Funds, Leverage and the Lessons of Long-Term Capital Management"* a report of the President's Working Group on Financial Markets (April 1999). The President's Working Group (comprised of representatives from the Department of Treasury, Federal Reserve Board, Securities and Exchange Commission, and Commodities Futures Exchange Commission) concluded that the current scope and timeliness of information about hedge funds was limited and recommended that "more frequent and meaningful information on hedge funds should be made public."

[32] Board of Governors of the Federal Reserve System, Supervisory Staff Report SR 01–6 (March 23, 2001).

[33] Federal Reserve Advisory Letter (March 23, 2001).

The Commitments Support Our Vital Mission

Freddie Mac is safe, sound, and strong. We are committed to the highest standards in financial management and disclosure, because we are committed to opening doors to housing for more of America's families.

Because of the high level of support provided by Freddie Mac and the secondary market, America enjoys the world's best housing finance system. By attracting global capital to finance homeownership in America, we reduce mortgage costs, saving families billions of dollars. The extraordinary liquidity we bring to the Nation's mortgage markets also helps stabilize our Nation's economy.

To meet our mission, Freddie Mac is relentlessly wringing out every unnecessary cost and barrier to homeownership; we are pushing the limits of technology; and we are searching the globe to find the lowest costs funds for housing. As a result of our activities, more families than ever before can afford to buy a home. In addition, they compete on an equal footing with the largest corporations for low-cost funds in the world's capital markets.

America is projected to grow by 30 million people over the next 10 years. The country is expected to form 1 million new households yearly. All told, America's families will need an additional $6 trillion to finance their homes over the next decade. Freddie Mac will open doors of opportunity for the homebuyer of the future, who is more likely to be a low-income, minority or immigrant family, eager to realize the American Dream.

Recently, HUD Secretary Martinez captured the essence of why housing holds a special place in the Nation. He said:

> *We believe that if you help a man or a woman buy a home, you are helping to make a better citizen. Homeownership is vital in creating strong communities. It helps average Americans build equity and increase their household wealth.*[34]

Freddie Mac's strength and vitality ensure that we are able to meet the housing finance needs of the future. Our superior risk management capabilities, strong capital position and state-of-the-art information disclosure make Freddie Mac unquestionably a safe and sound financial institution. The six commitments demonstrate our determination to stay that way, so that we can finance housing for generations to come.

Thank you for the opportunity to appear today. Freddie Mac is a great Congressional success story. I look forward to working closely with Chairman Allard, Senator Reed, and the Members of this Subcommittee to ensure that Congress is confident that Freddie Mac is meeting our very important mission in a safe and sound manner. Together we will secure the future of our housing finance system and, with it, the dreams of millions of families.

[34] Remarks by HUD Secretary Mel Martinez to the National Association of Counties' Legislative Conference (March 5, 2001).