



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

NEWS RELEASE

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OFHEO DIRECTOR ADDRESSES BOND MARKET ASSOCIATION, RELEASES OFHEO STUDY ON SYSTEMIC RISK

**Attached: Executive Summary of Systemic Risk Report and
Remarks Before the Bond Market Association**

For Systemic Risk Report go to www.ofheo.gov at 4 p.m. ET

WASHINGTON, D.C. — Armando Falcon, Jr., Director of the Office of Federal Housing Enterprise Oversight (OFHEO), safety and soundness regulator for Fannie Mae and Freddie Mac (the Enterprises), today addressed the Bond Market Association and discussed an OFHEO report on systemic risk, among other topics.

“Fannie Mae and Freddie Mac are very strong financial institutions today, and the possibility of either Enterprise failing or contributing to a financial crisis is remote. OFHEO employs examinations, a strong risk-based capital test and other tools to reduce the possibility of systemic risk,” said Director Falcon. “However, in the unlikely situation that an Enterprise experienced severe financial difficulties, there could be disruptions to the housing market and financial system given their size and central role in the housing and financial markets.”

The OFHEO Director released the report titled: “Systemic Risk: Fannie Mae, Freddie Mac and the Role of OFHEO.” The report analyzes how the Enterprises operate in the housing finance system and the financial sector, how their activities affect economic activity and how they can affect systemic risk in different circumstances. It also discusses how safety and soundness regulation and market discipline of Fannie Mae and Freddie Mac can reduce their risk of serious loss or failure, thereby limiting the potential of systemic risk. The report includes several recommendations detailed in the following Executive Summary.

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I. EXECUTIVE SUMMARY FROM SYSTEMIC RISK REPORT

Fannie Mae and Freddie Mac—the two government-sponsored enterprises (GSEs) chartered by the federal government to support the secondary market for residential mortgages—provide considerable benefits to the housing sector of the U.S. economy. The Enterprises boost housing activity by supplying ample, low-cost liquidity to the primary mortgage market. Fannie Mae and Freddie Mac are very strong financial institutions today, and the possibility of either Enterprise failing or contributing to a financial crisis is remote. The risk of either company causing a systemic disruption is highly unlikely under the comprehensive safety and soundness regulation of the Office of Federal Housing Enterprise Oversight (OFHEO). OFHEO employs examinations, a stringent risk-based capital stress test, and other tools to meet its responsibility and reduce systemic risk.

Nevertheless, it is useful to consider, hypothetically, what systemic impact an Enterprise could have on the housing market and financial system in two very different situations. In the first case, the Enterprises are strong and other parts of the financial system are destabilized. In the second, either Enterprise is itself experiencing financial difficulties.

If the Enterprises are financially strong during a stressful economic period in which many other financial institutions experience solvency and liquidity problems, the Enterprises are a source of stability. Their activities can protect mortgage lending and the housing sector. In addition, in those circumstances, the liquidity of Fannie Mae and Freddie Mac debt and mortgage-backed securities (MBS) can enhance the liquidity of institutions that hold those obligations and overall liquidity in financial markets. In both ways, the Enterprises mitigate systemic risk.

If Fannie Mae or Freddie Mac experienced financial difficulties the systemic implications might vary depending upon the circumstances. Any systemic disruption would likely be minimal as OFHEO took prompt corrective action and other market participants filled the short-term market void. Alternatively, in the highly unlikely event that unforeseen events occurred, there could be disruptions to the housing market and financial system.

This report consists of six chapters:

Chapter One presents the concepts used in the report and surveys the literature on financial crises and systemic risk.

Chapter Two summarizes the relationship of the government to the Enterprises, and examines their operations and activities. The Enterprises support the housing sector and assist refinance activity by ensuring that residential mortgage lenders in all regions of the country have continual access to funds on comparable terms. Fannie Mae and Freddie Mac do so by purchasing single- and multifamily mortgages underwritten according to their standards and by guaranteeing MBS collateralized by such loans.

Chapter Three discusses the fact that the activities of Fannie Mae and Freddie Mac have had several economic effects: local and regional markets for single-family mortgages that carry no federal guarantee or insurance—so-called conventional loans—are fully integrated into the capital markets; interest rates on conventional fixed-rate loans the Enterprises are eligible to purchase are lower than they otherwise would

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be; and the supply of credit to the housing sector is more stable than the supply of credit to most other sectors of the economy.

Chapter Four analyzes hypothetical scenarios in which, under adverse financial conditions, the activities and financial health of Fannie Mae and Freddie Mac affect the rest of the financial sector. The scenarios illustrate how under some circumstances the Enterprises can be a source of strength for the U.S. housing finance system and the financial sector as a whole, and present other circumstances where Fannie Mae and Freddie Mac might or might not increase the risk of financial disruptions that could lead to large losses in aggregate economic activity.

Chapter Five discusses how the safety and soundness regulation of Fannie Mae and Freddie Mac by OFHEO limits the systemic risk posed by the Enterprises by ensuring their safe and sound operation.

Chapter Six describes the regulatory actions that OFHEO will undertake to enhance its supervision and offers two legislative recommendations, as follows:

Regulatory Actions

A. Continue the Planned Enhancements to OFHEO's Supervisory Tools

OFHEO is engaged in an ongoing process to enhance its ability to perform its safety and soundness mission by, among other things, significantly expanding its examination program, enhancing its data and analytical capabilities and its early warning systems, fully utilizing the risk-based capital stress test as an analytical tool, and completing its regulatory infrastructure project.

B. Conduct Additional Research

Research will help secure a better understanding of the economic effects of Enterprise activities at both a regional and national level and, building upon that, the implications of the operations of the Enterprises for systemic risk. Furthermore, more research needs to be done on the complex networks of interdependencies between Fannie Mae and Freddie Mac, mortgage borrowers, and lenders and other firms in the primary mortgage market, and between the Enterprises and other participants in securities and derivatives markets. Further research and analysis of the benefits and costs of alternative approaches to mitigating systemic risk would also be desirable.

C. Enhance Enterprise Transparency to Improve Market Discipline

The relationship of Fannie Mae and Freddie Mac to financial markets is critical to their viability, and they must have access to capital markets to accomplish their mission. The Enterprises access domestic and global financing sources and offer a variety of issuances demanded by these markets. They are significant participants in the MBS and agency debt markets, and in related hedging activities, and as issuers and guarantors of securities.

Enterprise access to the markets and the price of that access are directly affected by investor perceptions of the transparency of the Enterprises and the safety and soundness of their operations. All financial regulators recognize transparency as a fundamental component of safety and soundness. Disclosure strengthens market understanding, market discipline and market stability. OFHEO will continue to review ways to increase financial disclosures by Fannie Mae and Freddie Mac.

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Clarify Conservatorship Authority Through Regulation

OFHEO will issue a regulation to implement the agency's conservatorship authority. A regulation would support OFHEO's ability to use that authority to manage the affairs of an Enterprise that experienced severe solvency problems.

Legislative Recommendations

A. Permanently Fund OFHEO to Insure That It Has Adequate Resources and Budget Flexibility

OFHEO recommends that the agency be permanently funded and exempt from the appropriations process. Currently, OFHEO's assessments of Fannie Mae and Freddie Mac are subject to the annual Congressional appropriations process, whereas other regulators' assessments are exempt. Permanent funding would permit OFHEO to adapt more easily to changes in the Enterprises' activities and to act quickly should serious problems develop or a financial crisis become much more likely. OFHEO's funding mechanism should be identical to that of all other federal safety and soundness regulators.

B. Congress Should Grant Receivership Authority to OFHEO

OFHEO recommends that the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 be amended to allow the agency to close and appoint a receiver to manage the affairs of an insolvent Enterprise. If the condition of an Enterprise is such that it is not viable, then OFHEO should have authority to place it in receivership and wind down the business of the company. Financial markets, the housing sector and creditors all would benefit from the final resolution of a non-viable Enterprise.

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