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**ANNUAL REPORT  
TO CONGRESS**

JUNE 15, 1994





**OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT**  
1700 G STREET NW WASHINGTON, DC 20552 (202) 414-3800

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June 15, 1994

Honorable Donald W. Riegle, Jr.  
Chairman, Committee on Banking,  
Housing, and Urban Affairs  
United States Senate  
Washington, D.C. 20510-6075

Dear Mr. Chairman:

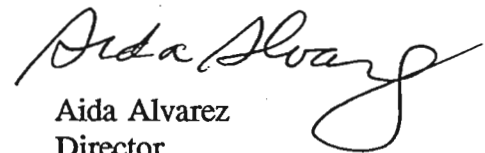
I am pleased to transmit the Annual Report to Congress of the Office of Federal Housing Enterprise Oversight (OFHEO). This report has been prepared to meet the statutory requirements in section 1319B of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title XIII of Pub. L. No. 102-550).

The statute requires the OFHEO Director to submit to the Committee on Banking, Finance and Urban Affairs of the House of Representatives, and the Committee on Banking, Housing, and Urban Affairs of the Senate, an annual report not later than June 15 which shall include:

- (1) A description of the actions taken, and being undertaken, by the Director to carry out the title;
- (2) A description of the financial safety and soundness of the Enterprises, i.e. the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac), including the results and conclusions of the annual examinations of the Enterprises; and
- (3) Any recommendations for legislation to enhance the financial safety and soundness of the Enterprises.

OFHEO began operating June 1, 1993. This first annual report includes an analysis of the financial condition of the Enterprises, as well as a description of economic conditions in the secondary mortgage market. It also describes the organizational activities of the Office leading to the fulfillment of its mission as an independent financial regulator.

Sincerely,

A handwritten signature in cursive script, appearing to read "Aida Alvarez".  
Aida Alvarez  
Director



**OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT**  
1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800

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June 15, 1994

Honorable Alfonse D'Amato  
Ranking Minority Member  
Committee on Banking  
Housing, and Urban Affairs  
United States Senate  
Washington, D.C. 20510-6075

Dear Senator D'Amato:

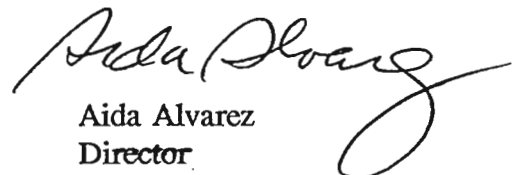
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Director



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June 15, 1994

Honorable Henry B. Gonzalez  
Chairman, Committee on Banking,  
Finance and Urban Affairs  
House of Representatives  
Washington, D.C. 20515-6050

Dear Mr. Chairman:

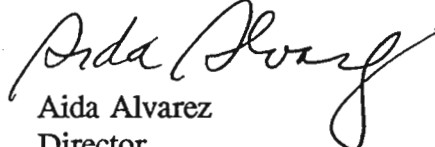
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Aida Alvarez  
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June 15, 1994

Honorable Jim Leach  
Ranking Minority Member  
Committee on Banking, Finance,  
and Urban Affairs  
House of Representatives  
Washington, D.C. 20510-6075

Dear Mr. Leach:

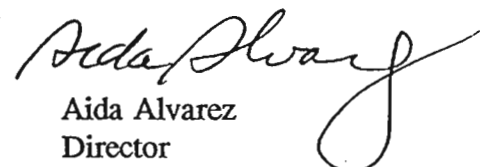
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*Federal Housing Enterprises  
Financial Safety and Soundness Act of 1992  
(Title XIII of Public Law No. 102-550)*

**Section 1313. DUTY AND AUTHORITY OF DIRECTOR.**

(a) **DUTY.** - The duty of the Director shall be to ensure that the enterprises are adequately capitalized and operating safely, in accordance with this title.

(b) **AUTHORITY EXCLUSIVE OF SECRETARY.** - The Director is authorized, without the review or approval of the Secretary, to make such determinations, take such actions, and perform such functions as the Director determines necessary regarding -

- (1) the issuance of regulations to carry out this part, subtitle B, and subtitle C (including the establishment of capital standards pursuant to subtitle B);
- (2) examinations of the enterprises under section 1317;
- (3) determining the capital levels of the enterprises and classification of the enterprises within capital classifications established under subtitle B;
- (4) decisions to appoint conservators for the enterprises;
- (5) administrative and enforcement actions under subtitle B, action taken under subtitle C with respect to enforcement of subtitle B, and other matters relating to safety and soundness;
- (6) approval of payments of capital distributions by the enterprises under section 303(c)(2) of the Federal National Mortgage Association Charter Act and section 303(b)(2) of the Federal Home Loan Mortgage Corporation Act;
- (7) requiring the enterprises to submit reports under sections 1314 of this title, section 309(k) of the Federal National Mortgage Association Charter Act, and section 307(c) of the Federal Home Loan Mortgage Corporation Act;
- (8) prohibiting the payment of excessive compensation by the enterprises to any executive officer of the enterprises under section 1318;
- (9) the management of the Office, including the establishment and implementation of annual budgets, the hiring of, and compensation levels for, personnel of the Office, and annual assessments for the costs of the Office;
- (10) conducting research and financial analysis; and
- (11) the submission of reports required by the Director under this title.

(c) **AUTHORITY SUBJECT TO APPROVAL OF SECRETARY.** - Any determinations, actions, and functions of the Director not referred to in subsection (b) shall be subject to the review and approval of the Secretary.

(d) **DELEGATION OF AUTHORITY.** - The Director may delegate to officers and employees of the Office any of the functions, powers, and duties of the Director, as the Director considers appropriate.

(e) **INDEPENDENCE IN PROVIDING INFORMATION TO CONGRESS.** - The Director shall not be required to obtain the prior approval, comment, or review of any officer or agency of the United States before submitting to the Congress, or any committee or subcommittee thereof, any reports, recommendations, testimony, or comments if such submissions include a statement indicating that the views expressed therein are those of the Director and do not necessarily represent the views of the Secretary or the President.

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## *MESSAGE FROM THE DIRECTOR*

The Office of Federal Housing Enterprise Oversight was created on June 1, 1993, the day I was sworn in as the Office's first Director. I am pleased to report on OFHEO's accomplishments in this, our first Annual Report to Congress. This critical regulatory effort has obvious important consequences for Fannie Mae and Freddie Mac, the two large, government-sponsored enterprises that OFHEO oversees. But the stakes are also high for the process of federal financial regulation, for the vital housing sector of the economy and potentially for the American taxpayer.

Congress created OFHEO in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992. The Act attempts to deal with a persistent concern: The implied government guarantee associated with the obligations of Fannie Mae and Freddie Mac, and the exposure faced by the taxpayer should either or both of these Enterprises be faced with adverse financial circumstances. (The combined assets and off-balance sheet obligations of Fannie Mae and Freddie Mac on March 31, 1994 totaled nearly \$1.3 trillion.) Congress ultimately decided to promote taxpayer protection by authorizing an independent regulator with broad supervisory and enforcement authority in the area of financial safety and soundness. OFHEO is the result of that action.

OFHEO is an office of the Department of Housing and Urban Development, much as the Office of Thrift Supervision and the Office of the Comptroller of the Currency are a part of Treasury. But OFHEO, with a direct reporting relationship to Congress, is more independent of HUD than OTS and OCC are of Treasury. The legislative mandate called for OFHEO to steer an independent course, and I have done so.

The Act separates OFHEO's responsibility for financial safety and soundness from the programmatic and policy regulatory responsibility accorded to the Secretary. Notwithstanding this separation, there is no inconsistency between affordable housing and safety and soundness.



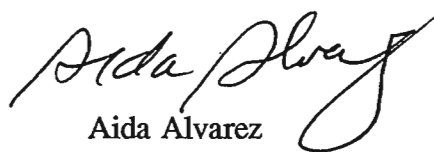
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The views in this report are those of the Director and do not necessarily represent those of the President or the Secretary. In this first Annual Report to Congress, I am pleased to report several significant accomplishments:

- OFHEO has recruited a corps of senior professionals with the expertise and experience to analyze the operations of two very large and complex Enterprises.
- OFHEO has determined the Enterprises to be adequately capitalized for the second, third and fourth quarters of 1993, and for the first quarter of 1994, according to minimum capital standards for an 18-month transition period specified in the statute.
- OFHEO's Research, Analysis and Capital Standards group is currently developing a financial simulation model to perform risk-based capital tests. These Congressionally-mandated tests will determine the Enterprises' ability to maintain positive capital in the face of severe credit and interest rate stresses. The tests are the basis for risk-based capital standards, which will be implemented through regulations.
- OFHEO has evaluated Fannie Mae's proposed energy efficiency loan programs under its authority to review the financial impact of the Enterprises' new programs.
- OFHEO's Examinations and Regulatory Oversight group began on-site examination of Fannie Mae and Freddie Mac last month. The initial focus is an analysis of the use of derivatives by the Enterprises, and the effectiveness of their internal controls in managing types and amounts of derivatives. In its examination process, OFHEO is using a "top down" approach to identify the overall risks inherent in the business activities of the Enterprises, and to determine whether or not those risks are prudently managed and controlled.

It is important to note that while the savings and loan crisis was the catalyst for the Act, OFHEO is launching its comprehensive regulatory mission in a non-crisis atmosphere, giving the Office a chance to build a structure that will be effective in the short and long term. OFHEO's mission is forward-looking oversight. We want to ensure that the Enterprises are adequately capitalized should interest rates shift significantly or credit conditions deteriorate. The Office is developing a stress-test to determine risk-based capital requirements that will be the most comprehensive of its kind. Also, OFHEO's examinations of the Enterprises will focus on the effectiveness of policies and internal controls, and the actions of management and directors.

The creation of a new regulatory entity is not accomplished without the advice and support of many individuals. The generous support of Secretary Henry G. Cisneros, as well as his Assistant Secretaries and senior staff, has been essential to OFHEO's development. The advice and wisdom shared by Members of Congress, their senior staff and my fellow regulators, have been indispensable. Finally, this Office is most fortunate to have attracted a team of talented and hard-working professionals, dedicated to upholding the interests of the American taxpayer.



Aida Alvarez

Director

# STATUS OF FANNIE MAE AND FREDDIE MAC

## *The Secondary Mortgage Market*

The year 1993 was a record-setting period for both the primary and secondary mortgage markets. Originations (new purchases and refinancings) of one-to-four family mortgages reached \$1 trillion, an all-time high.

Refinancings accounted for an unusually large 55 percent of this activity. The explosive mortgage growth resulted largely from a continued decline in interest rates to the lowest levels in more than two decades. (See Figure 1.)

The bullish conditions in 1993 were good news for the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Each purchased or securitized a larger share of mortgage originations than in the past. In the process, the two government-sponsored enterprises set records for both mortgage purchases and issuance of mortgage-backed securities.

### RECORD YEAR FOR FANNIE MAE AND FREDDIE MAC

In 1993, Fannie Mae and Freddie Mac (the Enterprises) enhanced their roles as the dominant players in the secondary mortgage market. The two Enterprises purchased 52 percent of all residential mortgages originated in 1993, up from 50 percent a year earlier. (See Figure 2.)

In dollar terms, combined 1993 mortgage purchases by Fannie Mae and Freddie Mac totaled \$543.2 billion, up 18 percent from \$461 billion the previous year. Freddie Mac's purchase volume rose 20 percent in 1993 to \$229.7 billion. Fannie Mae's purchases increased 16 percent to \$313.5 billion.<sup>1</sup>

Although Fannie Mae held a distinct market share advantage last year in terms of absolute mortgage purchases, the two Enterprises were much closer in volume with respect to issuance of single-class mortgage-backed securities.<sup>2</sup> Collectively, the Enterprises issued a record-high volume of

\$430.2 billion of single-class mortgage-backed securities in 1993. This was 15 percent above the 1992 level of \$373.2 billion. Fannie Mae's total volume was \$221.4 billion, and Freddie Mac's, \$208.7 billion.

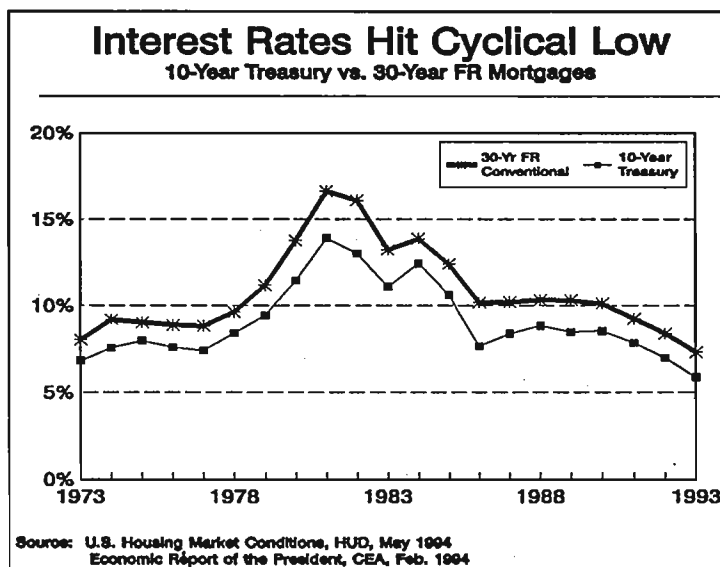


Figure 1

1. Fannie Mae and Freddie Mac are required by their charters to purchase mortgages that are of such quality, type, and class as to meet, generally, the purchase standards imposed by private institutional mortgage investors. In addition, mortgage purchases are subject to a maximum loan amount that is tied to a house price index published by the Federal Housing Finance Board. Currently, the maximum loan amount for single-family mortgages is \$203,150. Mortgages that meet these purchase criteria are known as "conforming mortgages."

2. Freddie Mac uses the term Participation Certificates when referring to mortgage-backed securities. The generic term, or the abbreviation MBS, is used in the text of this report.

Outstanding mortgage-backed securities issued by the two Enterprises totaled a combined \$935 billion at the end of 1993. Outstandings are expected to top \$1 trillion by mid-1994. (See Figure 3.)

In issuing mortgage-backed securities, Fannie Mae and Freddie Mac assume the credit risk of individual mortgages that back these securities. The risk results from Fannie Mae's and Freddie Mac's guarantees that investors holding these securities will receive timely payment of principal and interest from the underlying mortgages. But the securitization process shifts interest rate risk to the investors who now own the assets.

REMICs (Real Estate Mortgage Investment Conduits) are an increasingly important product derived from mortgage-backed securities. Fannie Mae and Freddie Mac issued a combined \$311 billion of REMICs in 1993, up nearly 9 percent from a year earlier. REMICs are securities created by pooling mortgage-backed securities and dividing them into a number of classes, or tranches, that meet different investment needs. Tranches have varying cash flow characteristics. By issuing REMICs, the Enterprises broaden demand for their mortgage-backed securities, and also generate additional fee

income. REMIC volume equalled 76 percent of Fannie Mae's MBS production in 1993, and 69 percent for Freddie Mac.

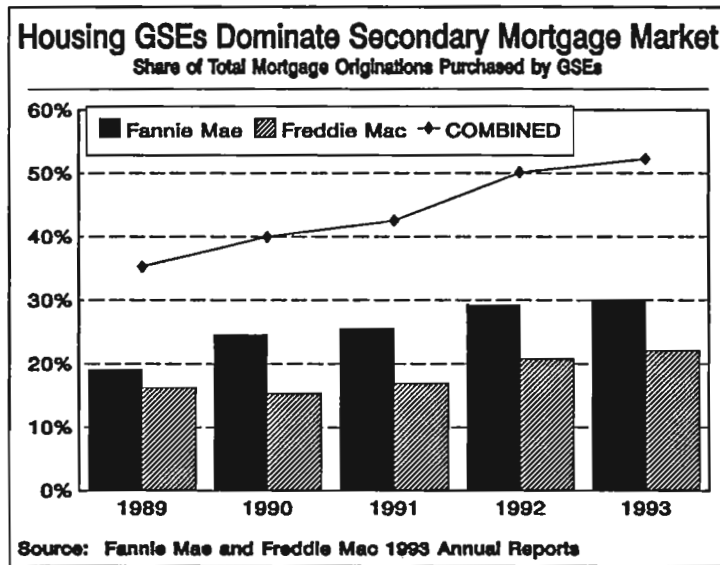


Figure 2

widening spread between mortgage yields and their cost of funds provided an advantageous environment to purchase and retain mortgages rather than securitize them. Overall in 1993, Fannie Mae retained the same relative proportion of retained and securitized assets as in

previous years. In addition to MBS growth (which is not reflected on the balance sheet), Fannie Mae and Freddie Mac have aggressively increased their retained mortgage portfolios. Fannie Mae's retained portfolio has grown at an annual rate of 17 percent during the past three years, to \$189.9 billion at the end of 1993. In its annual report, Fannie Mae said that the decline in interest rates and the

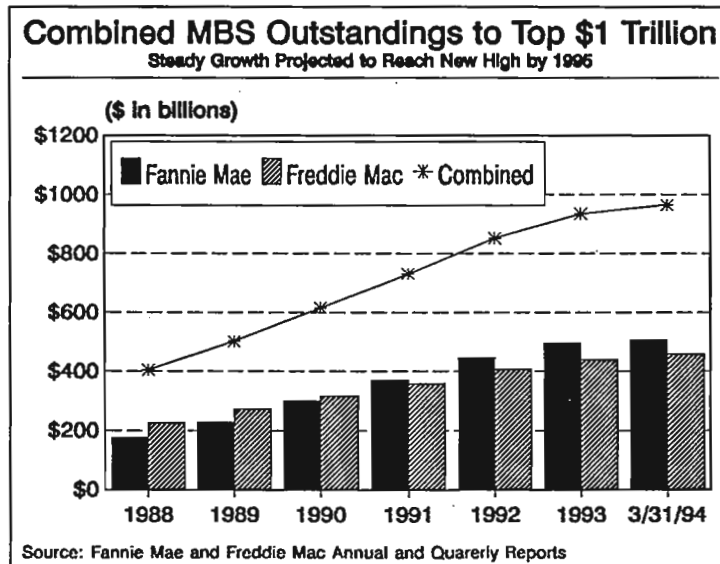


Figure 3

reduce risk, enhance MBS liquidity and manage its earnings stream.

Freddie Mac's portfolio has increased at a 32 percent annual rate over the same three-year period to \$55.7 billion. Freddie Mac's sharply higher growth rate stems from a strategic decision in 1993 to increase its retained portfolio from 5 percent to about 10 percent of its overall mortgage portfolio. Freddie Mac says it has increased its retained portfolio to

Unlike MBS, retained mortgages expose the Enterprises to both credit risk and interest rate risk. OFHEO will be monitoring this portfolio growth and

### RISING IMPORTANCE OF MORTGAGE BANKERS

The rapid growth of the Enterprises in recent years has been accompanied by a change in the mix of mortgage originators. Portfolio lenders, essentially banks and thrift institutions, dominated the market in the mid-1980s. But thrifts lost a large share of their originations as that industry went through a major restructuring that included four years of losses, a major shrinkage of industry assets, and the closing, merger or conversion of hundreds of insolvent thrifts. Mortgage bankers took up much of this slack, effectively doubling their share of the origination market in six years to 52 percent in 1993. (See Figure 5.) The refinancing boom of the early 1990s gave mortgage bankers an added boost.

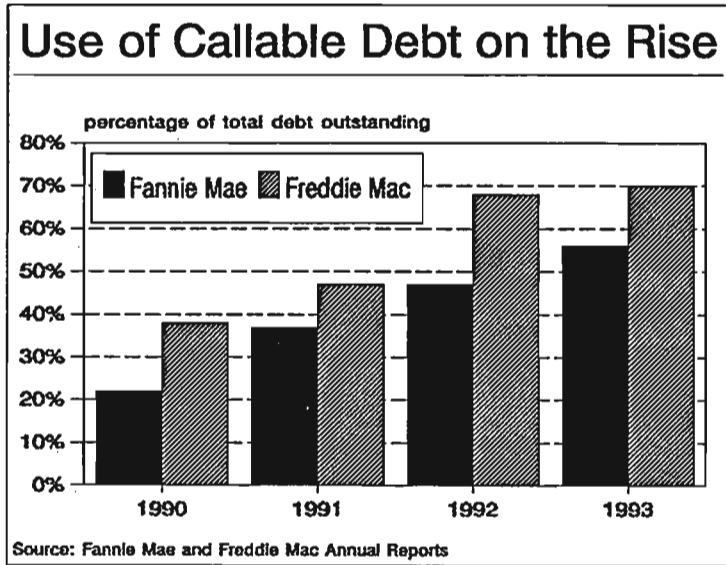


Figure 4

its impact on the Enterprises closely in the course of its normal examination and financial monitoring activities.

To help manage interest rate risk exposure associated with their retained portfolios, both firms have increased the use of callable debt to finance their retained portfolios. Callable debt helps to hedge interest rate risk resulting from the impact of mortgage prepayments when rates decline. At year-end 1993, Fannie Mae's proportion of callable debt to total debt outstanding was 58 percent, up from 22 percent in 1990. Freddie Mac's share of callable debt rose to 70 percent from 38 percent three years earlier. (See Figure 4.)

Mortgage bankers' increasing share of originations has important consequences for Fannie Mae and Freddie Mac. Unlike banks and thrifts, mortgage banks generally do not have the capacity to hold mortgage loans in portfolio, and rely heavily on Fannie Mae and Freddie Mac to purchase the loans they originate. This tends to increase the Enterprises' overall market share.

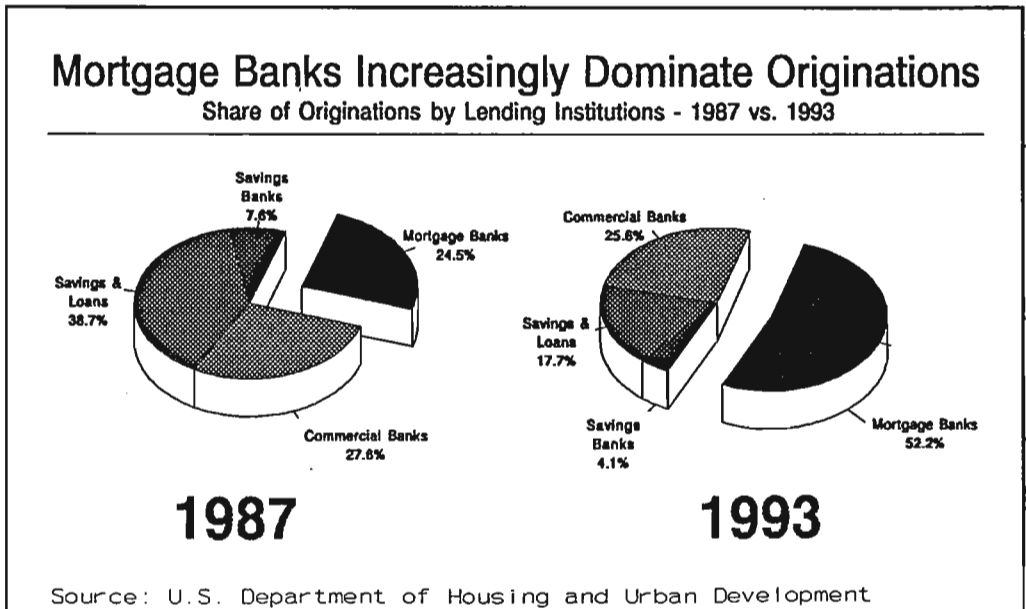


Figure 5

As interest rates rise and the use of adjustable-rate mortgages increases, mortgage bankers' share of total originations may decline. With the recent rise in interest rates, signs of this trend are already beginning to emerge.

### ECONOMIC IMPACT OF DECLINING INTEREST RATES

An unprecedented wave of refinancings dominated the mortgage industry during the early 1990s. Stimulated by a five-year decline in interest rates beginning in

1989, refinancings exploded from 13 percent (\$59.5 billion out of \$458 billion) of all one-to-four unit mortgage originations in 1990, to 55 percent (\$555 billion out of \$1.08 trillion) in 1993. (See Figure 6.)

In 1993, 64 percent of the \$289.6 billion of mortgages bought by Fannie Mae were refinanced loans. For Freddie Mac, the refinancing share was 72 percent of the \$229.1 billion total purchases.

A key characteristic of the refinancing wave was the propensity of borrowers to refinance their homes with shorter-term obligations. According to Fannie Mae, 31 percent of homeowners with 30-year fixed-rate mortgages refinanced into intermediate-term loans during 1993. Of those that had intermediate-term mortgages, 85

percent refinanced into the same product. Homeowners who stayed with fixed-rate loans were able to reduce their mortgage obligations by an average 44 months. With the sharp decreases in interest rates, these borrowers were also able to lower their monthly payments by \$28, an average reduction of 3 percent.

These trends tend to lower the risk profile of the Enterprises' mortgage portfolios. Shorter-term mortgages are generally less risky than longer-term mortgages, because shorter amorti-

zation schedules build up equity faster. Also, with lower monthly mortgage payments, borrowers are less likely to default on their obligations when their income streams are disrupted.

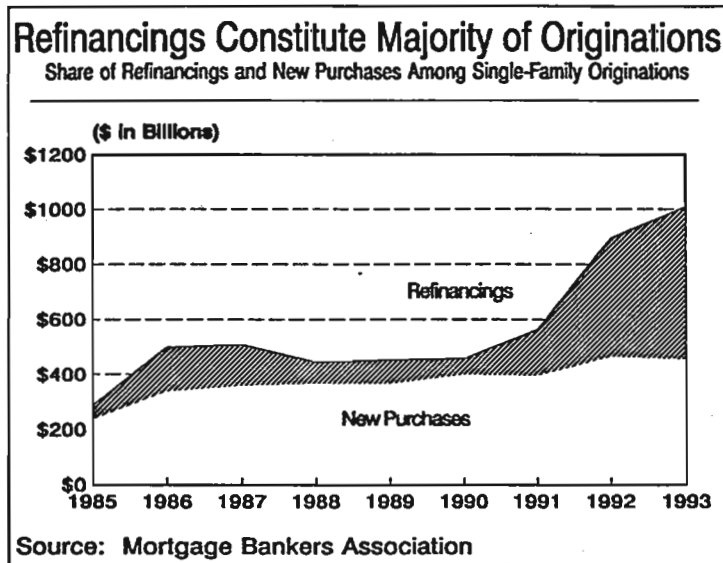


Figure 6

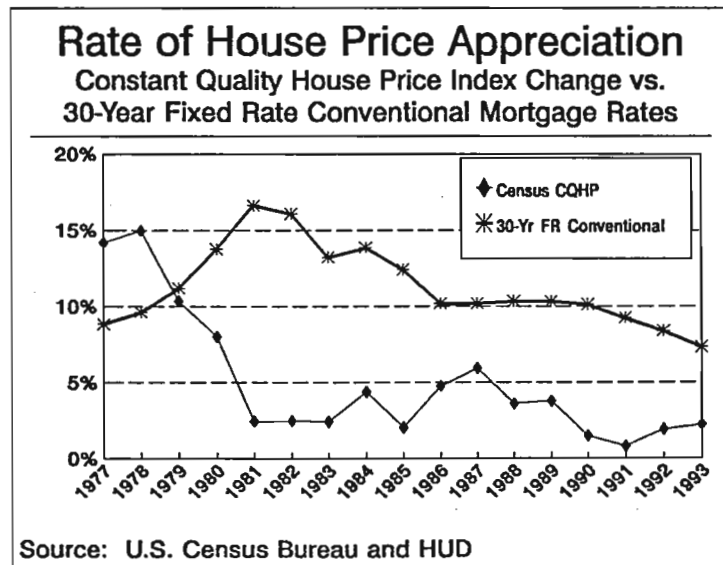


Figure 7

The fall in rates that precipitated the refinancing boom is generally associated with low rates of housing inflation. (See Figure 7.) Lower housing inflation slows equity buildup. This increases risk because borrowers with lower equity tend to default more frequently. The impact of these trends will be addressed by OFHEO in its risk-based capital test (discussed later in this report).

# Fannie Mae and Freddie Mac in 1993-94

## DERIVATIVES

### FINANCIAL CONDITION

The economic environment of low interest rates and high business volume has enabled the Enterprises to flourish. Both Fannie Mae and Freddie Mac have posted record profits. Combined, the two Enterprises generated \$2.7 billion in net earnings in 1993, a threefold increase from the \$888 million earned in 1988. (See Tables 1 and 2 for selected financial highlights.)

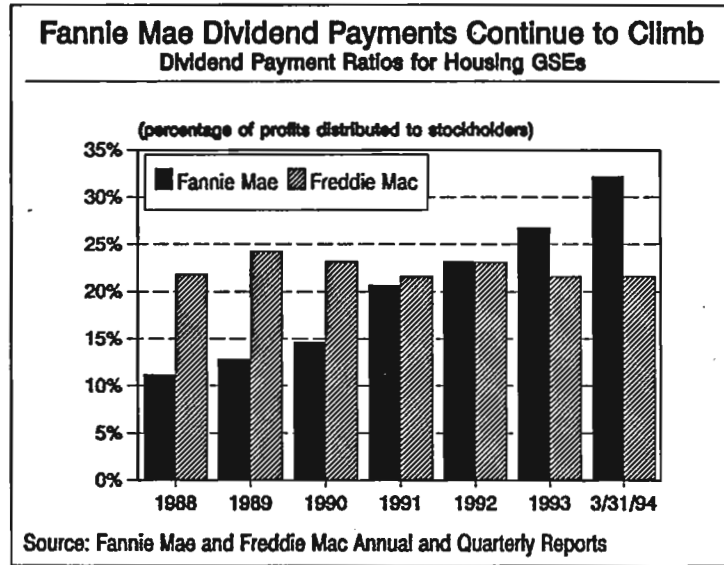


Figure 8

Record profits and greater financial leverage have enabled the Enterprises to maintain returns to equity holders in excess of most banks and thrifts. Return on total equity in 1993 for Fannie Mae and Freddie Mac was 25.3 percent and 19.6 percent, respectively. This compares with a return on equity of 15.5 percent for the banking industry, an historic high, and 9.5 percent for the thrift industry. While still significantly higher than banks and thrifts, increasing capital has decreased leverage, reducing slightly the Enterprises' return on equity.

The portion of profits paid out to stockholders in dividends has increased substantially over time for Fannie Mae, from 14.7 percent in 1990 to 26.8 percent for 1993.

Freddie Mac's payout ratio has remained relatively constant, 21.6 percent for 1993. (See Figure 8.)

Fannie Mae and Freddie Mac are major end-users of derivative instruments. The Enterprises use different types of non-mortgage derivatives including interest rate swaps, interest rate caps and floors, and short sales of Treasury securities. Fannie Mae uses foreign currency swaps to hedge its exposure to the risk of currency fluctuations on non-dollar denominated debt issues. The goals are to hedge interest rate risk, and to reduce funding costs and

increase investment yields in the context of an overall risk management strategy.

The Enterprises' use of derivatives has grown sharply in recent years. (See Figure 9.) Freddie Mac, in particular, experienced substantial growth in derivatives usage in 1993. The notional amount of Freddie Mac's derivative positions grew to nearly \$20 billion at year-end 1993 from virtually zero a year earlier. Fannie Mae's derivatives activities continued on a fast growth track in 1993 with the notional amount outstanding increasing to \$51.2 billion.

In light of recent legislative and regulatory concern over rapid growth in the use of derivatives, and the Enterprises' status as large end-users, OFHEO has commenced an examination

initially targeting the derivative activities of both Fannie Mae and Freddie Mac.

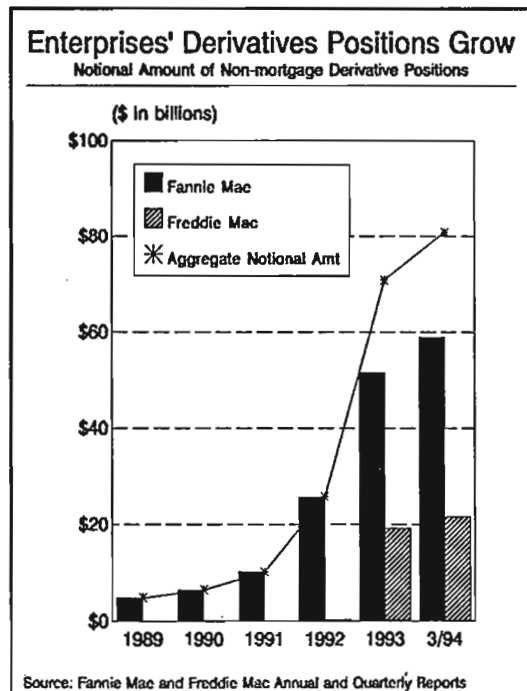


Figure 9

Table 1

**SELECTED FINANCIAL HIGHLIGHTS**  
**FEDERAL NATIONAL MORTGAGE ASSOCIATION**  
**(\$ BILLIONS)**

	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994Q1</u>
<b>EARNINGS PERFORMANCE:</b>				
Earnings	\$1.363	\$1.623	\$1.873	\$0.511
Return on Equity	27.7%	26.5%	25.3%	24.8%
Return on Assets	1.00%	1.00%	1.30%	0.93%
Dividend Payout Ratio	20.7%	23.2%	26.8%	32.2%
 <b>BALANCE SHEET POSITION:</b>				
Total Assets	\$147.1	\$181.0	\$217.0	\$227.0
Outstanding Debt	\$133.9	\$166.3	\$201.1	\$216.4
 Mortgages:				
Retained Mtge. Portfolio	\$126.5	\$156.0	\$189.9	\$197.0
MBS	\$372.0	\$445.0	\$495.5	\$507.0
Retained as % of Total Mtgs. in Portfolio and MBS	25.4%	26.0%	27.7%	28.0%
 Capital:				
Equity/Assets & MBS	1.07%	1.08%	1.13%	1.15%
Equity & Reserves/ Assets & MBS	1.20%	1.21%	1.25%	1.27%

Source: 1993 Annual Report and First Quarter 1994 Fannie Mae Financial Information



Table 2

**SELECTED FINANCIAL HIGHLIGHTS  
FEDERAL HOME LOAN MORTGAGE CORPORATION  
(\$ BILLIONS)**

	<u>1991</u>	<u>1992</u>	<u>1993</u>	<u>1994Q1</u>
<b>EARNINGS PERFORMANCE:</b>				
Earnings	\$0.555	\$0.622	\$0.786	\$0.233
Return on Equity	23.6%	20.3%	19.6%	20.6%
Return on Assets	1.26%	1.11%	0.99%	1.10%
Dividend Payout Ratio	21.6%	23.1%	21.6%	21.6%
 <b>BALANCE SHEET POSITION:</b>				
Total Assets	\$46.9	\$59.5	\$83.9	\$85.3
Outstanding Debt	\$28.3	\$28.2	\$48.5	\$61.5
 Mortgages:				
Retained Mtge. Portfolio	\$26.5	\$33.5	\$55.7	\$58.7
MBS	\$359.2	\$407.5	\$439.0	\$457.6
Retained as % of Total Mtgs. in Portfolio and MBS	6.9%	7.6%	11.3%	11.4%
 Capital:				
Equity/Assets & MBS	0.63%	0.76%	0.85%	0.85%
Equity & Reserves/ Assets & MBS	0.81%	0.93%	0.99%	0.99%

Source: 1993 Annual Report and Freddie Mac First Quarter 1994 Highlights

The examination with respect to derivatives has two goals. First, OFHEO will become familiar with the types and uses of derivative instruments utilized by the Enterprises, within the context of asset and liability management and individual transactions or strategies. Second, the Office will also determine if internal controls have been established and implemented to ensure derivative operations are conducted in a safe and sound manner.

In addition to its examination of derivatives, OFHEO is developing the

capability to model individual derivatives in its risk-based capital stress test model. This model will not only help the Office determine the adequacy of capital by incorporating derivatives, it will help OFHEO judge if the net effect of the derivative positions is non-speculative. OFHEO has already addressed derivatives issues in the context of its quarterly capital determination and classification. In determining minimum capital requirements for the Enterprises, the Director has discretion to set capital requirements for certain off-balance sheet items, including non-mortgage derivatives.

In developing its interim capital approach to these off-balance sheet items, OFHEO sought advice from derivatives experts in bank regulatory agencies, law and accounting firms, and

commercial banks. The Office requested and received pertinent data from the Enterprises on their derivatives contracts (by counterparty), computed

credit equivalent amounts (equating the contracts to balance sheet assets), and determined appropriate risk weightings and capital ratios.

### CAPITAL TRENDS

Both Fannie Mae and Freddie Mac have improved their capital positions in recent years. One commonly used capital adequacy measure is shareholder equity as a percentage of total assets and

MBS. These measures demonstrate an overall improvement in the capital positions of Fannie Mae and Freddie Mac, but do not necessarily measure capital adequacy. In the five years ending in 1993, Fannie Mae has increased its ratio from 0.85 percent

to 1.13 percent. Freddie Mac's ratio has grown from 0.62 percent to 0.85 percent over the same period. (See Figures 10 and 11.)

It is important to note that these simple capital ratios equate less risky securitized mortgage assets with mortgage assets on the balance sheet. Therefore, it is inappropriate to compare the Enterprises based on these measures.

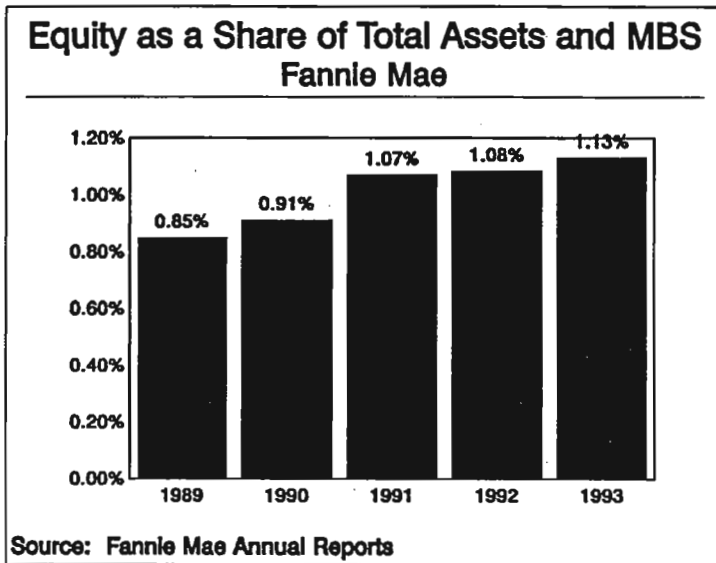


Figure 10

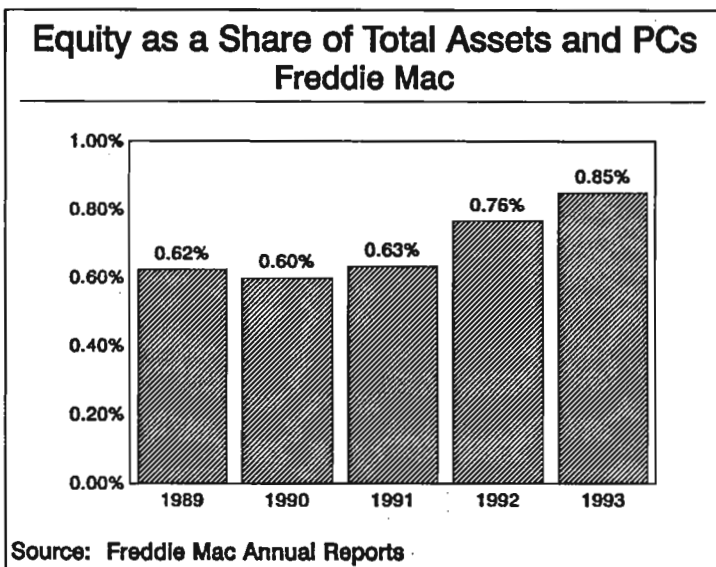


Figure 11

The Enterprises have taken advantage of their rapid growth over the past few years and attractive interest

rate spreads on their retained mortgage portfolios to generate consistently high levels of retained earnings. Freddie Mac's capital position has also improved due to two offerings of preferred stock, in 1992 and 1993, which raised \$837 million.

One explanation for this capital growth is that the Enterprises' rapid business growth occurred during a period of low home price appreciation. Management has been increasing capital because rapid growth may have increased the overall risk profile of the Enterprises. Recently purchased mortgages are potentially riskier than mortgages purchased during the mid to late 1980s, when home price inflation tended to build up homeowners equity at a much faster pace.

Another reason the Enterprises have been increasing their capital levels is their obligation to meet their statutory requirements. With the introduction of minimum capital standards, including the lower transitional minimum standard for the first 18 months after enactment of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the Act), and the prospect of future risk-based capital standards, both Enterprises will likely want to operate with a capital cushion to ensure safe and sound operation in compliance with the new statutory requirements.

### AFFORDABLE HOUSING

The Act, which established OFHEO, also requires Fannie Mae and Freddie Mac to meet certain affordable housing goals. Specifically, the Act requires the Secretary of Housing and Urban Development to establish goals and ensure compliance for the number of units financed by mortgages purchased by the Enterprises. The targets relate to the responsibility of the Enterprises to finance low- and moderate-income mortgages, central-city mortgages, and special affordable housing loans.

In their first report to the Secretary, the Enterprises said that the percentage of low-income and moderate-income mortgage purchases equaled 35.6 percent for Fannie Mae and 29.2 percent for Freddie Mac. These figures exceeded the Secretary's goals. But the

companies each failed to meet the 1993 goals for central-city and other underserved areas. Fannie Mae's figure was 26.3 percent, short of the Secretary's 28 percent goal. Freddie Mac's 24 percent figure was below the official 26 percent target.

In the special affordable housing loan category, both Fannie Mae and Freddie Mac made progress toward meeting their targets. In the 1993-1994 single-family subgoal, a part of the larger special affordable loan category, each company achieved more than 50 percent of their targets. In the multifamily area, Fannie Mae achieved 56 percent of its two-year goal in 1993, while Freddie Mac hit just 3 percent of its two-year target. In December, Freddie Mac ended a three-year absence from the multifamily market, and began purchasing multifamily mortgages.

The Enterprises have undertaken various programs to help low-income and underserved families. Fannie Mae recently announced a broad-based campaign targeting \$1 trillion of affordable housing financing by the year 2000. This represents an increase of over \$140 billion of new activity. Freddie Mac said it planned to purchase \$700 billion in affordable housing mortgages by the end of the decade.

While OFHEO does not play a statutory role in setting and monitoring housing goals, its statutory mission of ensuring that the Enterprises are adequately capitalized and operating safely increases the likelihood that the Enterprises will be able to achieve their affordable housing goals. A secure financial condition enables Fannie Mae and Freddie Mac to effectively fulfill their critical affordable housing role.

This role is fundamental to the public mission of the Enterprises. The charters of the two companies state that one of their purposes is to provide mortgage credit to assist low- and moderate-income families while maintaining a reasonable economic return, which may be less than the return earned on other activities.

In assessing the operations of Fannie Mae and Freddie Mac, OFHEO reviews the safety and soundness of affordable housing activities in the broad context of their overall mortgage purchase

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activities. OFHEO's authorities include the power to terminate, reduce or modify any activity that creates excessive risk to the Enterprises in the event of significant undercapitalization. In addition, prior to establishment and enforcement of risk-based capital standards, the Secretary cannot approve a new program for Fannie Mae or Freddie Mac if OFHEO determines that the program would risk significant deterioration of the financial condition of the Enterprise.

### **PRIVATIZATION STUDIES**

The 1992 legislation creating OFHEO also required the Secretary of the Treasury, the Secretary of Housing and Urban Development, the Comptroller General of the United States, and the Director of the Congressional Budget Office, to conduct studies on the desirability and feasibility of repealing the federal charters of Fannie Mae and Freddie Mac, eliminating any federal sponsorship of the Enterprises, and allowing them to continue operating as fully private entities. The reports must be sent to Congress by Oct. 28, 1994.

These studies will refocus attention on the role of Fannie Mae and Freddie Mac in the housing finance market. Specifically, the statute requires the studies to address questions of 1) capital adequacy and cost of capital; 2) housing affordability and availability and the cost of home-ownership; 3) the level of secondary mortgage market competition subsequently available in the private sector; and 4) the secondary market for residential loans and liquidity of such loans.

The statute requires the agencies to consider the views of Fannie Mae and Freddie Mac. Also, the Enterprises are given the option of preparing their own privatization studies. OFHEO has no statutory role in the studies.

# STATUS OF OFHEO

## *Examination of Fannie Mae and Freddie Mac*

In May 1994, OFHEO's Examinations and Regulatory Oversight unit began its first on-site examination of the Enterprises. The initial focus of this examination is derivatives.

The Act requires OFHEO to conduct annual, on-site examinations to determine the financial safety and soundness of Fannie Mae and Freddie Mac. OFHEO also examines for compliance with applicable law. The Act states that in OFHEO's annual report: "The Director shall submit to the Committee on Banking, Finance and Urban Affairs of the House of Representatives and the Committee on Banking, Housing, and Urban Affairs of the Senate...the results and conclusions of the annual examinations of the enterprises...." Special examinations may be conducted at the Director's discretion.

OFHEO recognizes that there is inherent risk in the operation of any financial institution. OFHEO's examination is designed to identify the overall risks in the business activities of the Enterprises, and to determine if those risks are prudently managed and controlled.

The examination is process-oriented, and complements OFHEO's data-oriented, risk-based

capital standards. The capital adequacy model, for example, uses data supplied by the Enterprises to assess their ability to maintain sufficient capital levels under extreme market conditions. The examination verifies the integrity of the data, and the policies, procedures and internal controls that underlie the behavioral assumptions of the test. The business of the Enterprises is dynamic and not static, therefore risk-based capital standards alone are not a sufficient measure of safety and soundness. New products,

strategies, and significant on- and off-balance sheet growth, can change an Enterprise's risk profile. (See Figure 12.)

OFHEO's examination is not comparable to an audit, a rating agency analysis, or research by equity analysts. Instead, the objective is to determine the safety and soundness of a business. Essentially, "safe" means that risks are prudently

undertaken, and "sound" means in good condition, financially secure. Therefore, an examination is a process that identifies the overall risks inherent in a business, including:

- Managerial strengths and weaknesses.
- Adequacy of analytical systems, such as capital adequacy and pricing models.
- Adequacy of internal controls, management information systems, and policies and procedures.
- Emerging financial and operational problems.

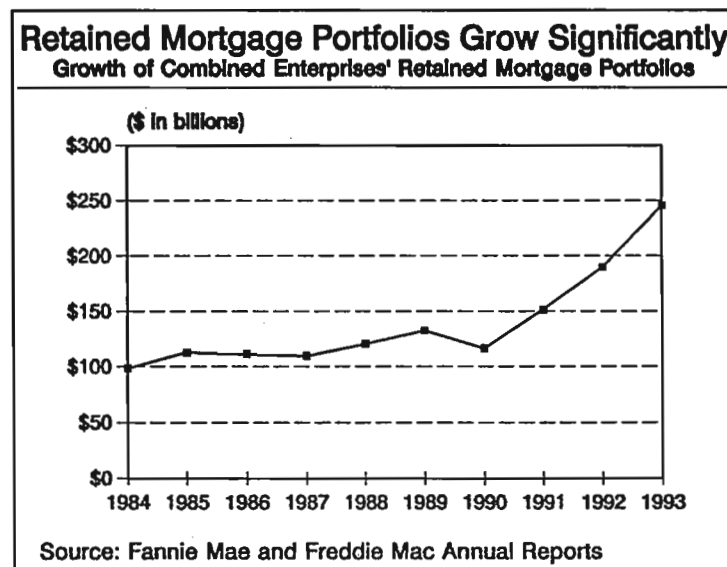


Figure 12

OFHEO takes a "top down" approach (See Figure 13) that minimizes detailed transaction and loan review. A more traditional methodology requires a large number of examiners who focus solely on assets held, or transactions executed at a point in time, rather than assessing the effectiveness of systems and controls for managing and controlling the various risks associated with conducting a given business.

The examination starts with a big-picture approach.

The scope is expanded when anomalies are found. (See Figure 13.) The examination in a specific functional area of the Enterprise starts with a Level I review. Examiners in this phase evaluate senior management and its planning strategy, analyze internal and external audits, and verify records and control systems. Level II is broadened to include testing, statistical sampling and additional analysis. Level III includes detailed review of an entire area by an examining team.

While most of the examination work will be done on-site at the headquarters of the Enterprises in the Washington, DC area, some examination functions will be carried out in their regional offices. These offices are responsible for marketing and dealing with each Enterprise's network of seller-servicers, the companies that sell mortgages to, and service mortgages for, the Enterprises. Fannie Mae has regional offices in Atlanta, Chicago, Dallas, Pasadena, Calif., and Philadelphia. Freddie Mac's offices are in Atlanta, Chicago, McLean, Va., and Woodland Hills, Calif.

OFHEO's examination will not impede the normal business of Fannie Mae and Freddie Mac, nor will it

hamper the ability of the Enterprises to develop new mortgage products, or to seek the lowest cost of funds. The examination is designed to be flexible and

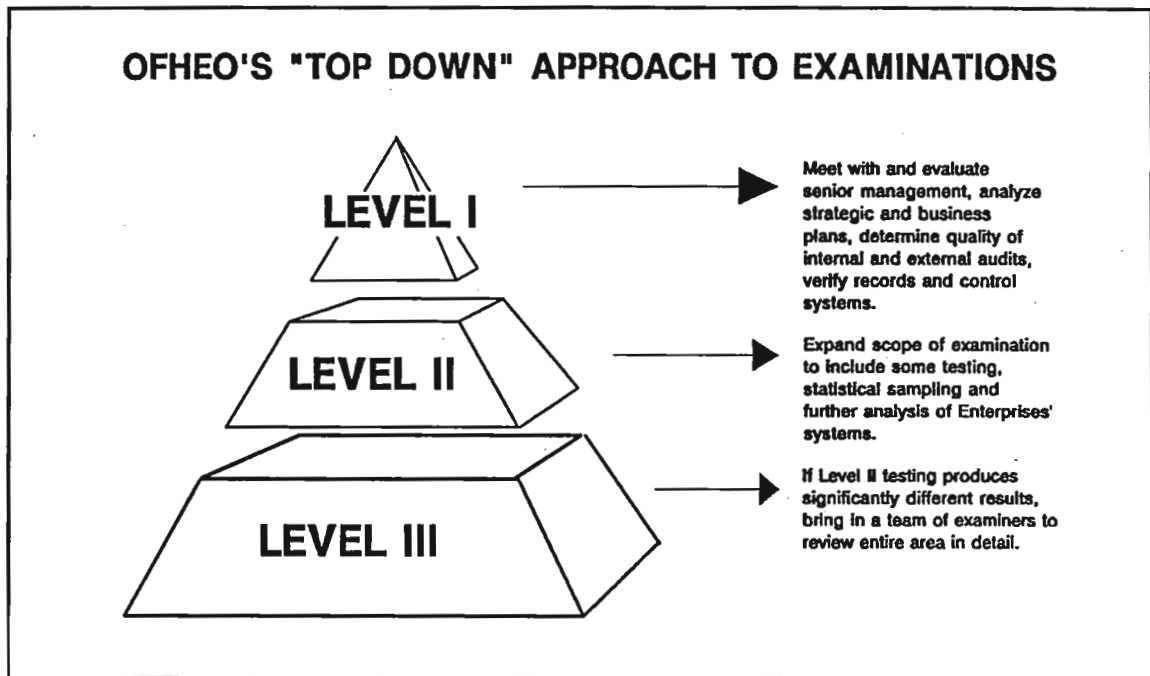


Figure 13

risk-focused. Where appropriate, examiners will leverage off the work of internal and external auditors. Moreover, OFHEO's examiners will take a prospective approach, attempting as much to prevent future problems as to fix current ones.

## *Capital Adequacy of Fannie Mae and Freddie Mac*

### MINIMUM CAPITAL STANDARDS

#### Statutory Requirements

OFHEO's enabling Act states that the Director shall determine the capital classification of Fannie Mae and Freddie Mac not less than quarterly. The classification levels are: adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized.

By definition, an Enterprise is classified as adequately capitalized if it: (a) maintains an amount of core capital equal to, or greater than, its minimum

capital level, and (b) maintains an amount of total capital equal to, or greater than, its risk-based capital level.

The Act specifies one set of capital levels during a transition period ending in the second quarter of 1994. Under the transition standards, core capital must equal: (a) 2.25 percent of on-balance sheet assets; (b) 0.40 percent of outstanding mortgage-backed securities; and (c) 0.40 percent of other off-balance sheet obligations except as adjusted by the

Director. Starting with the capital classification for the second quarter of 1994, the percentages used to determine compliance with the minimum capital requirement rise to 2.50 percent, 0.45 percent, and 0.45 percent respectively.

### Capital Classification

In the capital classification process, the Director has discretion to determine appropriate capital requirements with respect to certain off-balance sheet obligations. In determining an appropriate interim methodology to apply to these obligations, OFHEO met with Congressional staff, and with officials of the Treasury Department and the General Accounting Office.

On Dec. 23, 1993, OFHEO issued notices of proposed action declaring its intention to classify Fannie Mae and Freddie Mac "adequately capitalized" as of June 30, 1993. Final action was taken Jan. 31, 1994. Subsequently, on April 15, 1994, OFHEO declared the two Enterprises "adequately capitalized" for the quarters ending Sept. 30, 1993, and Dec. 31, 1993. And on June 14, 1994, the Office declared the Enterprises "adequately capitalized" for the quarter ended March 31, 1994.

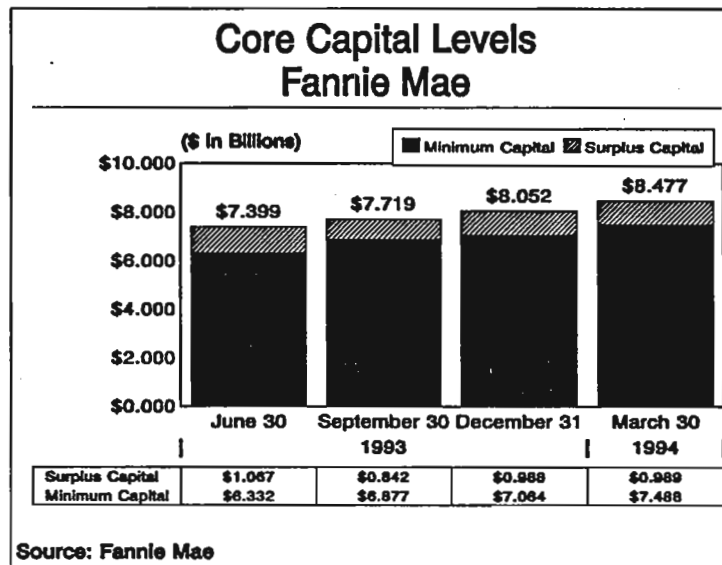


Figure 14

Since the application of the transitional minimum capital standards, (See Figures 14 and 15), Fannie Mae's surplus capital has fluctuated between \$842 million and \$1.067 billion. Freddie Mac's surplus capital has grown

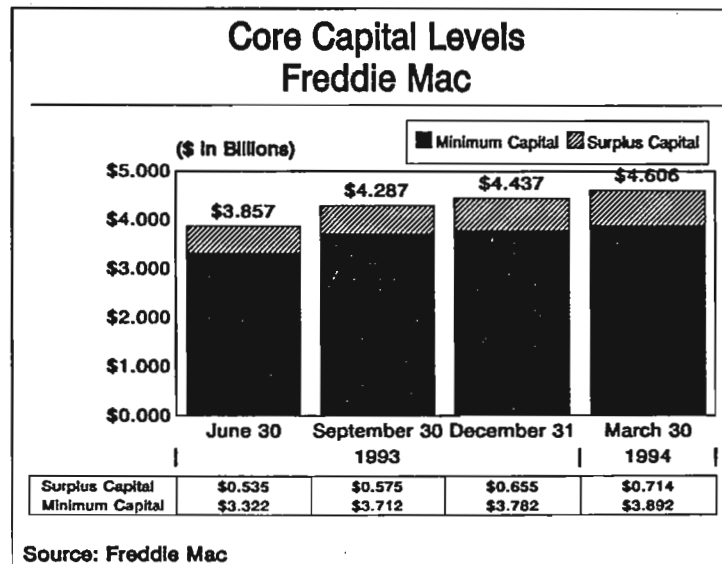


Figure 15

from \$535 million at June 30, 1993 to \$714 million on March 30, 1994. On March 30, 1994, Fannie Mae held core capital of \$8.477 billion to back \$227 billion of on-balance sheet assets, and \$507 billion of MBS obligations. Freddie Mac held \$4.606 billion to back \$85 billion of on-balance sheet assets and \$458 billion of MBS obligations.

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## RISK-BASED CAPITAL STANDARDS

The Act requires OFHEO to establish a risk-based capital test, often called a "stress test," for Fannie Mae and Freddie Mac, and to issue final risk-based capital regulations. The stress test is designed to measure the performance of the Enterprises' mortgage portfolios under severe interest rate and credit stresses stretching 10 years into the future, and to determine adequate capital levels under these scenarios.

The credit risk scenario outlined in the Act requires OFHEO to determine the highest rates of default and loss severity occurring during a two-year (or longer) period in a contiguous area containing at least 5 percent of the total U.S. population. Those default rates and losses are then applied on a nationwide basis to the Enterprises' current books of business over 10 years.

The interest rate stress test requires both high and low rate scenarios. The high rate case assumes that the 10-year Treasury rate increases in the first year and remains constant thereafter at the greater of: a) 600 basis points above the average yield during the preceding nine months; or b) 160 percent of the average during the past three years. However, the rate cannot be lower than 175 percent of the average yield in the past nine months.

The low rate case assumes that the 10-year Treasury rate decreases during the first year, and then remains stable at the lesser of: a) 600 basis points below the average yield during the preceding nine months; or b) 60 percent of the average during the past three years. However, the rate cannot be lower than 50 percent of the average yield in the past nine months.

The statute requires OFHEO to determine the combination of scenarios for each Enterprise that results in the highest capital requirement. The resulting requirement must then be increased 30 percent to cover management and operations risk.

The stress test approach to risk-based capital standards with regard to credit risk is a departure from bank and thrift capital requirements, which do not differentiate among assets in a given category, even when those assets may have different risk

profiles. OFHEO's stress test requires consideration of the risk specific to each of the many mortgage products in the Enterprises' portfolios, and other factors such as accumulated home equity.

In order to establish a financial simulation modeling capability to run the interest rate and credit stress scenarios in the risk-based capital stress test, OFHEO is developing a Research Systems Environment (RSE). The RSE will allow OFHEO to develop financial simulation models to address a wide range of economic scenarios, new products, and alternative Enterprise business strategies as well as enhancing the Office's ability to conduct credit and interest-rate risk research. While the Act outlines some parameters of the risk-based capital stress test, other assumptions are made by the Director. Exploration is underway on a number of complex issues and approaches critical to the development of the stress test.

## *Creating a New Federal Regulatory Office*

OFHEO has made significant progress during its start-up year in establishing itself as an independent financial regulator.

In tackling the unprecedented task of ensuring the financial safety and soundness of Fannie Mae and Freddie Mac, OFHEO has adopted the blueprint laid out in the Vice President's National Performance Review. As a consequence, OFHEO has built an office that is lean in numbers and long on talent; an organization that has undertaken a complex regulatory task in a smart, efficient, cost-conscious, and entrepreneurial fashion.

OFHEO's staff has been recruited from government, academia, and the private sector and is augmented by cross-servicing from other federal agencies. This helps ensure that OFHEO achieves productivity at lower costs, without building a large and inefficient bureaucracy.

## **Recruiting Senior Staff**

In its first 12 months, much of OFHEO's efforts have been focused on the time-intensive task of recruiting and hiring senior staff. The Director sought talented



and experienced personnel with backgrounds in mortgage finance, economics, regulation, law, policy, systems development, accounting and administration. By April 1994, all members of the OFHEO management team had been hired.

#### **Creating a Diverse Workforce**

OFHEO has focused on recruiting and hiring a diverse workforce. On June 1, 1994, 61 percent of OFHEO's permanent professional staff were women and minorities. The staff will grow to 45 permanent positions during FY 1994, as authorized by Congress.

#### **Establishing Offices at OTS Building**

Working with HUD and the General Services Administration, OFHEO found office space in the Office of Thrift Supervision (OTS) building at 1700 G St. NW. OFHEO negotiated and signed a lease with OTS on Nov. 4, 1993 and moved into the building on December 6. The OTS space is both cost effective and appropriate to OFHEO's needs as an independent financial institution regulator.

#### **Assessing the Enterprises**

OFHEO is funded by semi-annual assessments on the Enterprises rather than tax dollars. On March 1, 1994, OFHEO levied its first assessment.

OFHEO is requesting a legislative change in the timing of the assessments. The proposed date changes will permit OFHEO to coordinate the timing of its assessment of the Enterprises with the Congressional appropriations process.

#### **Determining FY 95 Resource Requirements**

In April 1994, OFHEO amended its original FY 95 budget request from \$17.5 million and 56 full-time equivalent (FTE) employees to \$15.5 million and 65 FTEs, a savings of nearly 12 percent in budget dollars. As OFHEO moves from start-up to operational mode in the second half of FY 94, the Office will again reevaluate its budget and staffing needs.

#### **Instituting Internal Management Controls**

OFHEO has installed an internal management control program to help the Office coordinate its strategic planning, program delivery, program performance and resource allocation. This internal control program complies with the requirements of the Federal Managers' Financial Integrity Act, the Chief Financial Officers Act and the Government Performance and Results Act.

#### **ORGANIZING TO FULFILL THE MISSION**

OFHEO's organizational structure is designed to maximize its effectiveness in addressing its statutory mandate. There are six functional areas, all reporting to the Director and Deputy Director.

Three line functions are directly responsible for carrying out the Office's mission:

**Examination and Regulatory Oversight** designs and conducts examinations of Fannie Mae and Freddie Mac. This unit has expertise in capital markets, portfolio management, financial and regulatory accounting, and mortgage credit analysis. It conducts an annual on-site examination of each Enterprise, as required by the law, and performs additional examinations as determined by the Director.

**Research, Analysis and Capital Standards** develops and implements a financial "stress test," using interest rate and credit risk scenarios prescribed in the statute to determine risk-based capital requirements of Fannie Mae and Freddie Mac. This unit is responsible for conducting research and financial analysis on issues related to the activities of the Enterprises.

The **General Counsel** has responsibility for preparing the regulations required by the Act and advising the Director on legal issues, including financial institution regulatory issues, applicable securities and corporate law principles, and administrative and general legal matters.

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Three staff functions support OFHEO's mission:

**Finance and Administration** ensures the Office has the infrastructure to function independently. This unit provides support services in human resources management, budget formulation and execution, financial and strategic planning, contracting and purchasing, office automation, travel, records and document security and related administrative support services. Finally, this unit develops annual budgets, and serves as the liaison with the Office of Management and Budget.

**Communications and Public Affairs** is responsible for public and press inquiries. The Senior Director, Communications and Public Affairs is OFHEO's spokesperson.

OFHEO is required by statute to report to Congress. The **Congressional Affairs** unit, headed by the Senior Director, Congressional Affairs, briefs Members of Congress and staff on matters relating to OFHEO, monitors legislative developments, and brings Members' concerns to the attention of the Director.

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## APPENDICES

- OFHEO Senior Officials
  - OFHEO Milestones
  - Letter from Vice President Al Gore
  - Letters to Fannie Mae and Freddie Mac on Capital Classification at March 31, 1994
  - Letter on Fannie Mae's New Program Approval.
  - OFHEO Statement on Fair Lending
-

## OFHEO SENIOR OFFICIALS

**Aida Alvarez**  
Director

**Mark Kinsey**  
Deputy Director

**Michael J. Burch**  
Principal Director,  
Finance and Administration

**Eugene Carlson**  
Senior Director,  
Communications and Public Affairs

**Anne E. Dewey**  
General Counsel

**Wynn E. McClenahan**  
Executive Assistant to the Director

**David J. Pearl**  
Principal Director,  
Research, Analysis and Capital Standards

**Mary Ellen Taylor**  
Senior Director,  
Congressional Affairs

**Marianne D. Wright**  
Principal Director,  
Examination and Regulatory Oversight

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## OFHEO MILESTONES

**Oct. 28, 1992**

Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Title XIII of Pub. L. No. 102-550) signed into law by President George Bush.

**May 28, 1993**

Aida Alvarez confirmed by the Senate as OFHEO's first Director.

**June 1, 1993**

Aida Alvarez sworn in as Director; OFHEO officially begins operations.

**July 22, 1993**

Office of Personnel Management approves Schedule A excepted service hiring authority for all OFHEO staff positions to permit a prompt start-up of the Office.

**Oct. 29, 1993**

Aida Alvarez testifies before the House Committee on Banking, Housing and Urban Affairs.

**Nov. 4, 1993**

OFHEO signs lease for headquarters space with the Office of Thrift Supervision at 1700 G St. NW, Washington, DC.

**Dec. 6, 1993**

OFHEO moves its headquarters from HUD to OTS building at 1700 G St. NW, Washington, DC

**Jan 31, 1994**

OFHEO issues final notice of determination that Fannie Mae and Freddie Mac are "adequately capitalized" at June 30, 1993.

Mark Kinsey joins OFHEO as Deputy Director.

**March 8, 1994**

Administration designates OFHEO as a participant in announcement by Interagency Task Force on Fair Lending. OFHEO releases statement regarding its enforcement authority over non-discrimination violations.

**April 15, 1994**

OFHEO issues final notice of determination that Fannie Mae and Freddie Mac are "adequately capitalized" at Sept. 30, 1993 and Dec. 31, 1993.

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**May 20, 1994**

OFHEO notifies Fannie Mae and Freddie Mac of commencement of on-site examinations.

**June 14, 1994**

OFHEO issues final notice of determination that Fannie Mae and Freddie Mac are "adequately capitalized" at March 31, 1994.

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THE VICE PRESIDENT  
WASHINGTON

June 8, 1994

Ms. Aida Alvarez  
Office of Federal Housing  
Enterprise Oversight  
1700 G Street, N.W.  
Washington, D.C. 20552

Dear Aida:

I am pleased to have this opportunity to send my personal greetings to everyone associated with the Office of Federal Housing Enterprise Oversight as you observe the first anniversary celebration of its operations. While I regret that I cannot offer my best wishes in person, I want to congratulate and thank you for your efforts in tackling a difficult, but very important, task.

As a result of the work of the National Performance Review, we have found ways to make government more effective, more efficient, and more responsive to the citizens we all serve. I am greatly encouraged by the underlying management philosophy you have adopted at OFHEO. Your commitment to the principles of reinvention is especially important for America's housing industry; every dollar saved through better management is a dollar that can help another family capture the American dream of home ownership.

Please be assured of my support for your efforts. I am confident that the success you have enjoyed in your first year will continue in the future, and I look forward to working with you on behalf of the American people.

Sincerely,



Al Gore

AG/wem



*OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT*  
*1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800*

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June 14, 1994

Mr. James A. Johnson  
Chairman of the Board and  
Chief Executive Officer  
Federal National Mortgage Association  
3900 Wisconsin Ave., N.W.  
Washington, D.C. 20016

Re: Capital Classification at March 31, 1994

Dear Mr. Johnson:

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the "Act") requires that the Office of Federal Housing Enterprise Oversight (OFHEO) determine the capital level and classification of the Federal National Mortgage Association (Fannie Mae) not less than quarterly.

On May 20, 1994, OFHEO issued a notice of proposed action indicating its intention to classify Fannie Mae as adequately capitalized at March 31, 1994. In making this capital classification, OFHEO relied upon information supplied by Fannie Mae in its April 29, 1994 letter to OFHEO. OFHEO received a letter on June 9, 1994 from Fannie Mae stating that it was satisfied with the methodology and calculations used to make this classification. As stated in the May 20, 1994 letter to Fannie Mae, OFHEO will apply the permanent minimum capital requirements in future classifications as required by the Act.

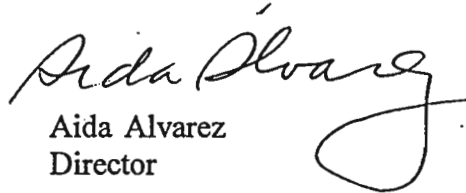
This letter, therefore, constitutes the required written notice and statutory action classifying Fannie Mae as adequately capitalized at March 31, 1994. As indicated in the attachment, Fannie Mae's transition minimum capital requirement was \$7,488 million at March 31, 1994. Thus, Fannie Mae's core capital of \$8,477 million on that date exceeded the transition minimum by \$989 million.



Mr. James A. Johnson  
Capital Classification - March 31, 1994 (FNMA)  
Page 2

OFHEO is continuing to apply the interim methodology used in the June 30, 1993 capital classification with respect to certain categories of off-balance sheet obligations. This methodology does not establish any precedent with respect to future determinations, and OFHEO will continue to evaluate the methodology and suggested approaches as they relate to future capital requirements and classifications.

Sincerely,

  
Aida Alvarez  
Director

Attachment

FEDERAL NATIONAL MORTGAGE ASSOCIATION  
Transition Minimum Capital Levels  
March 31, 1994

SUMMARY

(Dollars in millions)

<b>ON-BALANCE SHEET ASSETS</b>	<b>5,218</b>
<b>OFF-BALANCE SHEET OBLIGATIONS</b>	
MBS and Equivalents	1,928
Commitments	289
<b>OTHER OFF-BALANCE SHEET OBLIGATIONS</b>	
Interest Rate Contracts	46
Multifamily Credit Enhancements	8
<b>TOTAL CAPITAL REQUIREMENTS</b>	<b>7,488</b>
<b>CORE CAPITAL</b>	<b>8,477</b>
<b>SURPLUS/(DEFICIENCY)</b>	<b>989</b>

Note: Totals may not add due to rounding.



*OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT*

*1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800*

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June 14, 1994

Mr. Leland C. Brendsel  
Chairman of the Board and  
Chief Executive Officer  
Federal Home Loan Mortgage Corporation  
8200 Jones Branch Dr.  
McLean, VA 22102

Re: Capital Classification at March 31, 1994

Dear Mr. Brendsel:

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the "Act") requires that the Office of Federal Housing Enterprise Oversight (OFHEO) determine the capital level and classification of the Federal Home Loan Mortgage Corporation (Freddie Mac) not less than quarterly.

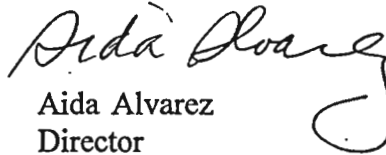
On May 20, 1994, OFHEO issued a notice of proposed action indicating its intention to classify Freddie Mac as adequately capitalized at March 31, 1994. In making this capital classification, OFHEO relied upon the information supplied by Freddie Mac in its May 2, 1994 letter to OFHEO. OFHEO received a letter on June 6, 1994 from Freddie Mac stating that it was satisfied with the methodology and calculations used to make this classification. As stated in the May 20, 1994 letter to Freddie Mac, OFHEO will apply the permanent minimum capital requirements in future classifications as required by the Act.

This letter, therefore, constitutes the required written notice and statutory action classifying Freddie Mac as adequately capitalized at March 31, 1994. As indicated in the attachment, Freddie Mac's transition minimum capital requirement was \$3,892 million at March 31, 1994. Thus, Freddie Mac's core capital of \$4,606 million on that date exceeded the transition minimum by \$714 million.

Mr. Leland C. Brendsel  
Capital Classification - March 31, 1994 (FHLMC)  
Page 2

OFHEO is continuing to apply the interim methodology used in the June 30, 1993 capital classification with respect to certain categories of off-balance sheet obligations. This methodology does not establish any precedent with respect to future determinations, and OFHEO will continue to evaluate the methodology and suggested approaches as they relate to future capital requirements and classifications.

Sincerely,

  
Aida Alvarez  
Director

Attachment

FEDERAL HOME LOAN MORTGAGE CORPORATION  
Transition Minimum Capital Levels  
March 31, 1994

SUMMARY

(Dollars in millions)

<b>ON-BALANCE SHEET ASSETS</b>	<b>1,919</b>
<b>OFF-BALANCE SHEET OBLIGATIONS</b>	
PCs and Equivalents	1,830
Commitments	121
<b>OTHER OFF-BALANCE SHEET OBLIGATIONS</b>	
Interest Rate Contracts	14
Sold Portfolio Remittances Pending	9
<b>TOTAL CAPITAL REQUIREMENTS</b>	<b>3,892</b>
<b>CORE CAPITAL</b>	<b>4,606</b>
<b>SURPLUS/(DEFICIENCY)</b>	<b>714</b>

Note: Totals may not add due to rounding.



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT  
1700 G STREET NW WASHINGTON, DC 20552 (202) 414-3800

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March 24, 1994

Honorable Henry G. Cisneros  
Secretary  
Department of Housing and Urban  
Development  
451 Seventh Street, N.W.  
Washington, D.C. 20410

Re: Fannie Mae New Program Approval

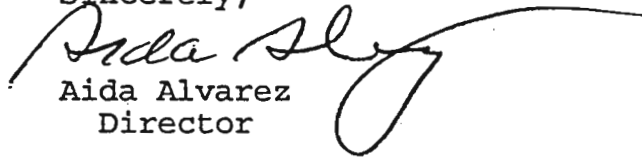
Dear Mr. Secretary:

As you know, Fannie Mae has requested your approval of a new program, the energy efficiency loan program, by letter to you from Chairman Johnson dated March 4, 1994.

Section 1322 (b) (2) (B) of the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 provides a transition standard for your review and prior approval of a new program requested by an enterprise. Under the section, the Director determines whether the new program would risk significant deterioration of the financial condition of the enterprise. If the Director were to make such a determination, then the Director's action becomes a basis upon which the Secretary must not approve the request.

As Director of this Office, I have reviewed the program as represented to us by Fannie Mae, and I have determined that the program would not risk significant deterioration of the financial condition of Fannie Mae. This completes my review.

Sincerely,

A handwritten signature in cursive script, appearing to read "Aida Alvarez". The signature is written in black ink and is positioned above the typed name and title.

Aida Alvarez  
Director

cc: James Johnson  
Chairman and  
Chief Executive Officer  
Fannie Mae



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

# PRESS RELEASE

FOR IMMEDIATE RELEASE

CONTACT: EUGENE CARLSON  
JILL WEIDE (202) 414-3800  
March 8, 1994

## OFHEO STATEMENT ON FAIR LENDING

The Office of Federal Housing Enterprise Oversight (OFHEO), the federal government's newest financial regulator, is responsible for overseeing the safety and soundness of the nation's two largest housing finance organizations -- the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac).

The legislation creating OFHEO -- the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (P.L. 102-550) -- also gives the Office enforcement authority over violations by Fannie Mae and Freddie Mac in the area of fair lending.

OFHEO's enforcement authority relates to regulations issued by the HUD Secretary that prohibit discrimination by Fannie Mae or Freddie Mac in the purchase of any mortgage, as spelled out in Sec. 1325 of the Act. The remedies available to OFHEO include cease-and-desist orders, and the imposition of civil money penalties.

"There is no inconsistency between fair lending and financial safety and soundness," said OFHEO Director Aida Alvarez. "Pulling the government's fair lending rules into one coherent policy is an intelligent and long-overdue action that will help lending institutions make the decisions that are right for America," said Ms. Alvarez.

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OFHEO is an independent office of the Department of Housing and Urban Development. OFHEO reports to Congress, but receives no government funds; it is funded through assessments of Fannie Mae and Freddie Mac. In its safety and soundness mission, OFHEO is analogous to such other federal financial regulators as the Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Federal Deposit Insurance Corporation, and the Federal Reserve Board.

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