OFHEO

Title: Risk Based Capital Report Materiality Guideline

Approved By: Armando Falcon, Jr. Date: May 19, 2003

The Risk Based Capital (RBC) Report provides OFHEO with input data for the RBC stress test, which determines an Enterprise's RBC Requirement. An Enterprise prepares the RBC Report according to the RBC Report Instructions. OFHEO requires that an Enterprise submit its RBC Report no more than 30 days following a Report Date (ordinarily the last day of a calendar quarter), and the Report contains a declaration by a senior officer of the Enterprise that the Report is true and correct, to the best of such officer's knowledge and belief. OFHEO may ask an Enterprise to resubmit an RBC Report that contains material inaccuracies.

The RBC Rule provides for Proxy Treatments when the RBC Report and stress test can accommodate a modified treatment of an instrument without materially misrepresenting its performance and thus inaccurately reflecting its risk. In addition, OFHEO recognizes that it may not be cost effective for an Enterprise to identify and correct every small misstatement, data error, or anomaly in an RBC Report, and accepts Reports containing errors and omissions to the extent that they neither materially misrepresent the performance in the stress test of affected financial instruments, nor the related incremental RBC Requirement. Such acceptance is predicated upon sound, controlled, and documented Enterprise processes that strive to enhance, improve, and correct data integrity issues on an ongoing basis.

I. Purpose:

This guideline sets forth criteria for the acceptability of data reported by an Enterprise in its RBC Report, to ensure that the Reports are materially accurate and complete.

II. Scope:

This guideline applies to data submitted to OFHEO by an Enterprise in its RBC Reports and the processes and controls involved in the preparation of such Reports.

The Director of OFHEO may amend this guideline at his/her discretion.

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III. Authority And References:

12 U. S. C. §§ 4513(b); 4514; 4611; 12 C.F.R. Part 1750, Subpart B, § 12 Appendix A (the Technical Appendix) , § 3.1.

IV. Effective Date:

This guideline is effective for Reports for dates submitted more than 90 days following its approval by the Director.

V. Definitions:

Materiality Materiality is a matter of judgment and is influenced by the needs of a reasonable person who will rely on the data to make judgments. An issue is material if the judgment, perception, or decision of a reasonable person using the data for its intended purpose (stress test, capital determination, and/or safety and soundness decision) would have been changed or influenced by the missing data, data error, or misstatement.

VI. Policy

Predicated on the existence of Enterprise documentation and control processes acceptable to OFHEO, OFHEO shall accept (and not require resubmission of) RBC Reports containing Proxy Treatments or minor misstatements, errors or omissions when such Proxy Treatments or errors or omissions do not materially misrepresent the behavior of a Financial Instrument, nor its incremental impact on the resulting RBC Requirement. In judging materiality, the Enterprises and OFHEO shall rely on accounting industry, judicial, and regulatory standards of materiality summarized in Appendix A to this guideline.

Documentation and Controls

Enterprise preparation of RBC Reports shall be subject to rigorous documentation and internal controls, including:

A. Documenting all exceptions, decisions, and judgments made in the preparation of an RBC Report, including any standards or rules of thumb that are applied.
B. Applying OFHEO's data validation rules, as required in the guideline "Procedures for Managing Risk-Based Capital Data Validation Rules."

C. Providing full documentation to OFHEO of Proxy Treatments and New Activities as an addendum to the RBC Report, as required in the guideline "Risk-Based Capital Reporting of New Activities and Proxy Treatments."

D. Following a systematic process that supports the reconciliation of all data included in the RBC Report to published financial information.

E. Following a systematic process that ensures that the Enterprise officer who provides the declaration included in the RBC Report is appropriately informed regarding exceptions, decisions, judgments, data validation rule violations, Proxy Treatments, New Activities, and reconciliation issues affecting the RBC Report.

OFHEO Authority and Oversight

Both Enterprise decisions concerning materiality and the documentation and control processes an Enterprise uses to prepare RBC Reports are subject to OFHEO review, examination, and approval.

If OFHEO detects material misstatements, errors, or omissions in an RBC Report, OFHEO may choose to require a resubmission of the Report. Alternatively OFHEO may highlight the material errors as a qualification to an RBC classification until such time as these errors are corrected.

OFHEO may require an Enterprise to change or enhance its controls and processes for RBC Report preparation. Examination or other supervisory action may also be warranted based upon specific circumstances.

OFHEO shall periodically reevaluate this guideline and amend it as necessary to ensure the level of data integrity required to accurately compute the RBC requirement.

VII. Responsibilities:

The Office of General Counsel (OGC). OGC provides guidance to appropriate OFHEO offices and/or the Enterprises regarding materiality, consistent with the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (the 1992 Act), OFHEO's regulations, other applicable law, and OFHEO guidelines. OGC will respond to the request for guidance within approximately 14 calendar days of the request.

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The Office of Risk Analysis and Model Development (ORAMD). ORAMD prioritizes and evaluates Proxy Treatments and prepares related analyses, recommendations, and required supporting documentation, as described in the guideline "Risk-Based Capital Reporting of New Activities and Proxy Treatments." ORAMD also establishes and monitors the RBC Report Validation Rules and recommends changes as needed to the Change Management Control Board. Based on its analysis of Validation Rule program outputs, Enterprise documentation, and as appropriate, input from other OFHEO offices, ORAMD determines when materiality thresholds have been violated, and communicates such determinations to an Enterprise within 14 calendar days of receiving results of Validation Rule programs from OIT.

The Office of Information Technology (OIT). OIT loads Enterprise RBC Report data, designing and maintaining validation programs used to determine compliance with Validation Rules, and providing results of the validation runs or other potential data concerns to ORAMD.

The Office of Examination and Oversight (OEO). OEO examines and validates Enterprise processes for generating the RBC Report, including documentation and control processes for Proxy Treatments and materiality decisions.

The Office of Policy Analysis and Research (OPAR). OPAR comments validation issues, as requested.

The Change Management Control Board (CMCB). The CMCB ensures the adequacy of controls surrounding the development and implementation of Validation Rules and corresponding validation programs. The CMCB also determines the timing for implementation of changes to ensure linkage with data and code changes.

VIII. Types of Records Created or Received:

- Risk Based Capital Report, including Enterprise officer declaration
- Risk Based Capital Report Instructions
- Validation Rules
- Validation Rule Reports (i.e., Exception Reports)

Appendix A
Materiality Standards

A summary of select industry guidance on materiality standards is provided below. These summaries provide the basis for the determination of materiality with respect to RBC Report data.

Financial Accounting Standards Board

The Financial Accounting Standards Board (FASB) recognizes the importance of materiality in financial disclosures and reporting. The FASB's memorandum *Criteria for Determining Materiality* states:

> If presentations of financial information are to be prepared economically on a timely basis and presented in a concise intelligible form, the concept of materiality is crucial.

In applying the concept of materiality, judgment must be used. Materiality concerns the significance of an item to users of the information. A matter is "material" if there is a substantial likelihood that a reasonable person would consider it important. In its Statement of Financial Accounting Concepts No.2, the FASB stated the essence of the concept of materiality as follows:

> The omission or misstatement of an item in a financial report is material if, in the light of surrounding circumstances, the magnitude of the item is such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

The FASB has long emphasized that Materiality cannot be reduced to a numerical formula. In its Concepts Statement No.2, the FASB noted that:

> The predominant view is that materiality judgments can properly be made only by those who have all the facts. The Board's present position is that no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment.

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Supreme Court

The Supreme Court in Basic, Inc. v. Levinson, 485 U.S. 224 (1988) has held that a fact is material if there is:

> A substantial likelihood that the ... fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

Thus an assessment of materiality requires that one views the facts in the context of the "surrounding circumstances, " as the accounting literature puts it, or the "total mix" of information in the words of the Supreme Court. Some matters, either individually or in the aggregate, are important for fair presentation of financial information while other matters are not important. Likewise, some matters, either individually or in the aggregate, are important for computation of an accurate capital classification while others are not important. The notion of materiality is not a constant. It varies between two entities of different size and varies between the types and uses of the data.

SEC

The SEC in *Staff Accounting Bulletin No. 99 "Materiality"* says that it has no objection to a "rule of thumb" threshold, such as 5%, as an initial step in assessing materiality. But quantifying, in percentage terms, the magnitude of a misstatement or omission is only the beginning of an analysis of materiality; it cannot appropriately be used as a substitute of a full analysis of all relevant considerations.

Evaluation of materiality requires consideration of all the relevant circumstances, and the SEC staff believes that there are numerous circumstances in which misstatements below 5% could well be material. Qualitative factors may cause misstatements of quantitatively small amounts to be material. See *Staff Accounting Bulletin No. 99 "Materiality"* for examples of considerations that may well render material a quantitatively small misstatement.