OFHEO

SUPERVISION GUIDANCE

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Subject: Standards for Enterprise Capital Management Practices

To: Director of Supervision
Associate Director for Capital Supervision
Examiners in Charge

I. Purpose and Scope

Using the safety and soundness standards discussed in this guidance, OFHEO's supervisory personnel assess the effectiveness of the capital management practices of Fannie Mae and Freddie Mac (the Enterprises) through examination activities. Examination principles for supervisory personnel to assess capital are outlined separately in the *Office of Supervision Handbook*.

This guidance sets forth expected standards for capital planning and management processes at the Enterprises. Each Enterprise is expected to maintain effective and prudent management of its capital position. The Enterprises are expected to meet all statutory and regulatory capital standards to ensure sufficient capital is available to remain safe and sound. In addition, internally developed management metrics for meeting and maintaining adequate capital standards should be a normal part of all Enterprise activities.

II. References

A. 12 U.S.C. 4611 – Risk-based Capital Levels

B. 12 U.S.C. 4612 – Minimum Capital Levels

C. 12 U.S.C. 4614 – Capital Classifications

D. 12 C.F.R. 1710 – Corporate Governance

E. 12 C.F.R. 1750 – Capital

F. 12 CFR 1777 – Prompt Supervisory Response & Corrective Action

G. OFHEO Examination Guidance PG-06-001: Examination Corporate Governance

H. OFHEO's *Office of Supervision Handbook (January 22, 2007)*

III. Standards

A. Capital Planning

A well developed capital plan is the foundation for effective capital management practices. An effective capital plan:

- Is an integral component of the overall strategic plan as approved by the Board of Directors;
- Clearly describes capital strategies, capital measurements, and key assumptions over a rolling, four quarter time horizon;
- Is dynamic and is updated as strategies and operating assumptions change;
- Articulates and provides for the assessment of the impact of potential future actions on the Enterprise's capital before they are approved by the Board of Directors for implementation; and
- Is integrated with operating and business plans throughout the company.

At a minimum, each Enterprise should have a written capital plan that encompasses the following:

- The primary strategies that will be followed and implemented over a rolling, four quarter time horizon to ensure capital meets statutory, regulatory, and internal capital limits. Longer-term strategies covering projections for at least an additional year should be discussed in broader, more general terms.
- A discussion and analysis of various alternative capital measures and projections that reflect proactive management of capital versus a focus solely on regulatory and statutory capital measures.
- An analysis of risks, including potential credit risk events and alternative interest rate scenarios, as they may affect the balance sheet and income projections. Specifically, the capital plan should provide quarterly projections at least one year forward and annual projections for at least an additional year forward that encompass both

baseline projections and under alternative interest rate and credit event scenarios. The projections should be detailed sufficiently to identify risks inherent in asset types, liabilities, and off-balance sheet or guaranteed activities.
- Contingency plans that identify alternative methods to enhance capital should the primary strategies prove insufficient to ensure maintenance of an adequate capital surplus.
- Analysis and discussion of potential corporate actions (e.g., payment of common stock or preferred stock dividends, redemption of preferred stock, share repurchase program, and stock issuance, etc.). The analysis should include an assessment of the impact of the proposals on the capital surplus and any scenario analysis needed to determine alternative actions or trigger points.

B. Capital Management Practices

OFHEO expects the Enterprises to maintain robust capital management practices. Capital management practices should encompass the following:

- Active capital planning that ties with corporate strategic plans and articulates potential actions and strategies at least a quarter before they are executed under normal circumstances. When situations arise unexpectedly, appropriate parties including the Board or a committee thereof are informed as soon as practical.
- A capital management culture and strategy that ensures maintenance of capital that meets regulatory, statutory, and internally mandated standards.
- An Economic Capital model that is used to determine an internal risk-based capital requirement and to allocate capital among business lines to better inform management and enhance the business decision process. The Economic Capital model should be a key component of an overall Enterprise Risk framework.
- A capital management strategy that accommodates various measures of available capital to compensate for inaccuracies, deficiencies, and volatility in each of the various measures.
- Well-controlled and dynamic models that appropriately reflect stress assumptions to support the measurement tools.
- Effective communication and linkage with business lines, as well as senior corporate management, ensuring all parties operate consistently with the capital plan. Specifically, earnings and business growth projections used for capital planning should be consistent with forecasts and projections used to manage business lines and the Enterprise.
- Ongoing and active dialogue with the Board of Directors, including appropriate detail regarding planned or potential actions and reports.

- Prudential dividend payout strategies.
- Other capital deployment strategies such as share repurchase programs, stock swaps, and calling of preferred issuances.

C. Measurement of Available Capital

Effective capital management practices ensure capital is appropriately measured and monitored. Specifically, available capital should be measured against all applicable statutory, regulatory and internally defined standards, and valued according to GAAP, as implemented for financial reporting and as applied to any fair value reporting requirements. Management should appropriately compensate for deficiencies and volatility in each of these standards and valuation methods by managing to achieve a surplus over each required standard, thus ensuring capital adequacy is maintained. The measures, internal or regulatory, should be reviewed and evaluated, with enhancements to measurement tools or refinements to modeling approaches made when warranted. It is expected that each Enterprise will utilize internally developed and maintained models that measure risks in relation to capital standards to manage surpluses. However these models should be well-controlled, appropriately documented, and independently tested to ensure their integrity.

D. Management Information Systems

Management information systems for capital monitoring should be subject to effective internal controls and have adequate documentation. Sufficient detail should be presented to ensure the information is understood by various management levels and the Board of Directors.

E. Communication

Capital management practices should be integrated into the planning and decision-making processes throughout the company. Regardless of the organizational responsibility for capital or corporate management structure that exists at the Enterprise, it is essential that capital implications are considered by all areas of the organization.

F. Capital Deployment Strategies

The dividend policy and dividend payout methodology applicable to both common and preferred stock should be integrated into the capital plan. Additionally, the Board of Directors should receive sufficient detail regarding the amount of proposed dividends, rationale for payments, industry comparisons, and the impact of the payouts on the capital levels. Effective internal controls and processes should also exist to ensure the correctness of dividend calculations prior to approval and distribution. As a matter of good regulatory communications, the Enterprises are encouraged to share capital deployment strategies with OFHEO to supplement the capital plan presentations, regardless of the capital position and/or whether a legal requirement for pre-approval exists.

Plans for other capital deployment activities, including share repurchases, should also be appropriately articulated and integrated into the plan. These proposed strategies should be incorporated in advance of Board of Director approval to ensure the impact of the proposed strategies can be evaluated by the Board. Various scenarios, conditions for the action to occur, and other factors impacting the execution of the strategy should be detailed in the plan.

IV. Additional Matters

A. Submission of Capital Plans to OFHEO

As a matter of effective ongoing communication with OFHEO, and to enable OFHEO to properly assess the adequacy and effectiveness of the capital planning and management process as part of its normal examination and supervisory oversight, the Enterprises should submit capital plans to OFHEO on a regular basis, including quarterly updates to those plans. Should changes occur to the Capital Plan between submissions to OFHEO, discussions should occur to ensure OFHEO is fully briefed on capital management actions. Any material departures from the Capital Plan should be promptly incorporated into a written update.

B. Submission of Regulatory Capital Reports

As described in regulation, capital reports should be submitted to OFHEO in a timely manner. These reports should be submitted in accordance with the Risk-based Capital Report Instructions, the Minimum Capital Report Instructions, and any other instructions for capital-related reports as required by the Director or provided for in statute or regulation. Deviations from these standards and instructions for reports should be appropriately detailed in disclosures to OFHEO. Resubmissions of capital reports are required within three business days of publication of financial statement adjustments, 12 CFR 1750.3(d) (minimum capital) or errors or omissions, 12 CFR 1750.12(d) (risk-based capital). All capital submissions are required, per regulation, to be certified by an officer designated by the Board of Directors, as true and correct to the best of his or her knowledge. 12 C.F.R. 1750.3(3); 12 CFR 1750.12(f).

C. Ongoing Monitoring of Capital Position

Effective supervision requires ongoing communication of capital management actions between OFHEO and the Enterprises. At OFHEO's request, all internal management information systems used to measure, monitor, or support capital management practices should be made available for access and review by OFHEO in a timely manner.

D. Corporate Governance Practices

Management should provide adequate information to the Board of Directors, or a delegated committee of the full Board, regarding capital positions, capital actions, and capital plans to ensure that the Board has sufficient detail to fulfill its fiduciary duties and obligations. The information regarding capital positions and capital plans should be provided in a manner that allows the board adequate time for reflection and consideration of all relevant issues. The Board of Directors should actively oversee the sufficiency of capital positions and appropriately discuss plans with senior management. Communication with the board regarding capital should occur on a regular and frequent basis. 12 C.F.R. 1710.11 (b)(4) and PG-06-001, III.a.5.

V. Compliance

Failure by an Enterprise to comply with 12 U.S.C. 4611, 12 U.S.C. 4612, 12 U.S.C. 4614, 12 C.F.R. 1710, 12 C.F.R. 1750, and 12 C.F.R. 1777 may subject the Enterprise or members of the Board of Directors, officers or employees thereof to supervisory action by OFHEO under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, including but not limited to, cease-and-desist proceedings and civil money penalties. OFHEO will utilize this guidance to assist in determining compliance with these statutes and regulations.

VI. Preservation of Existing Authority

Nothing in this Supervision Guidance in any way limits the authority of OFHEO to otherwise address unsafe or unsound conditions or practices or violations of applicable law, regulation or supervisory order. Action in accordance with this Supervision Guidance may be taken separate from, in conjunction with or in addition to any other enforcement action available to OFHEO. Compliance with the standards identified in this Supervision Guidance in general would not preclude a finding by OFHEO that an Enterprise is otherwise engaged in a specific unsafe or unsound practice or is in an unsafe or unsound condition, or requiring corrective or remedial action with regard to such practice or condition. That is, supervisory action is not precluded against an Enterprise that has not been cited for a deficiency under the standards cited in this Supervision Guidance. Conversely, an Enterprise's failure to comply with one of the supervisory requirements set forth in the Supervision Guidance may not warrant a formal supervisory response from OFHEO, if OFHEO determines the matter may be otherwise addressed in a satisfactory manner. For example, OFHEO may require the submission of a plan to achieve compliance with the particular requirement or standard.