OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

NEWS RELEASE

FOR IMMEDIATE RELEASE **Contact: Stefanie Mullin**
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OFHEO ISSUES RISK-BASED CAPITAL STRESS TEST RESULTS FOR FANNIE MAE AND FREDDIE MAC

WASHINGTON, D.C. — Armando Falcon, Jr., Director of the Office of Federal Housing Enterprise Oversight (OFHEO), safety and soundness regulator for Fannie Mae and Freddie Mac (the Enterprises), announced today that both Enterprises passed the first application of the risk-based capital stress test.

"The risk-based capital stress test is a success," said Director Falcon. "It is a state-of-the-art capital standard performing the function Congress intended. The risk-based capital stress test requires the Enterprises to safely manage their risks or hold additional capital commensurate with their risk exposures," said Falcon. "With the proposal of the rule in 1999, the Enterprises began a program of managing their activities to ensure they would meet the requirements of the rule. Their prudent measures combined with favorable economic conditions have resulted in their passing the standard at this stage of the one-year implementation period."

OFHEO will not use the risk-based capital standard to classify the Enterprises for regulatory purposes until the end of the third quarter 2002. These results will be released in December. Starting then, an Enterprise will need to meet both its risk-based and minimum capital requirements to be classified as adequately capitalized. Until then, it need only meet its minimum requirement. However, OFHEO makes the following information available in the interest of public disclosure and regulatory transparency:

FANNIE MAE

As of March 31, 2002, Fannie Mae's risk-based capital requirement was \$20.228 billion. Fannie Mae's total capital of \$26.290 billion on that date exceeded the risk-based capital requirement by \$6.062 billion. However, Fannie Mae's **higher** minimum capital requirement of \$24.571 billion was binding.

FREDDIE MAC

As of March 31, 2002, Freddie Mac's risk-based capital requirement was \$5.680 billion. Freddie Mac's total capital of \$21.360 billion on that date exceeded the requirement by \$15.680 billion. However, Freddie Mac's **higher** minimum capital requirement of \$19.390 billion was binding.

ANALYSIS

An Enterprise's risk-based requirement will vary from quarter to quarter depending on the Enterprise's risk management decisions and market conditions. Accordingly, and especially during this implementation period, it is reasonable for the Enterprises to take appropriate steps to ensure they maintain a comfortable capital cushion.

As of March 31, 2002, both Enterprises passed the stress test due to effective risk management including extensive interest rate hedging. Over the past three years since the risk-based capital rule was proposed, both Enterprises' use of derivatives increased dramatically. Fannie Mae's notional derivatives volumes rose 172 percent while Freddie Mac's volumes jumped 248 percent. The rule gives the Enterprises credit when they engage in effective risk management behavior. Freddie Mac's stress test results were especially strong because its hedges enabled it to maintain positive net interest income through nearly the full stress period in both interest rate scenarios.

The results also reflect the current relatively low-risk environment for the Enterprises. Because interest rates are low, the likelihood of very large changes is less than it would be in higher rate environments. In accordance with the statutory formula, the increase in the 10-year Treasury yield in the stress test as applied for March 31 is 371 basis points, less than the 600 basis point change applicable in higher rate environments. In the low interest rate scenario, the decrease in the 10-year Treasury yield is 247 basis points in the test, as applied for March 31.

The credit risk environment is also quite favorable. Rapidly increasing house prices in recent years have raised the value of the collateral on seasoned loans, which comprise most of the Enterprises' portfolios. Over the past three years, house prices have risen 24 percent, on average. A typical loan made in early 1998 with a loan-to-value ratio of 95 percent amounted to only 72 percent of the property value by March 2002. The risk default is, therefore, fairly low, and the severity in the event of default is also low. By comparison, house prices rose at only a 1.5 percent average annual rate in the early 1990s, and seasoned loans remained subject to much higher risk.

BACKGROUND

The **minimum capital standard** requires each Enterprise to have **core capital** (the sum of the par value of common and preferred stock, additional paid-in capital, and retained earnings) that meets or exceeds its minimum capital requirement (2.5 percent of assets plus 0.45 percent of adjusted off-balance-sheet obligations). Minimum capital represents an essential amount of capital needed to protect an Enterprise against broad categories of business risk.

The **risk-based capital standard** requires each Enterprise to have **total capital** (core capital plus general loss reserves) that meets or exceeds its risk-based capital requirement. Stress test results are calculated for two interest rate scenarios, one in which 10-year Treasury yields rise 75 percent and another in which they fall 50 percent. Changes in both scenarios are generally capped at 600 basis points. The risk-based capital level for an Enterprise is the amount of total capital that would enable it to survive the stress test in whichever scenario is more adverse for that Enterprise, plus 30 percent of that amount to cover management and operations risk.

The risk-based capital rule was proposed in April 1999 and finalized September 13, 2001. The rule was further amended March 15, 2002. The rule will be used for capital classification starting with data for September 30, 2002. That number will be published at the end of this year. Both Enterprises were classified as adequately capitalized on March 31, 2002, and would have achieved that same classification had the risk-based standard been used, as well.

The tables below provide relevant capital data for each Enterprise as of March 31, 2002.

ENTERPRISE RISK-BASED CAPITAL RESULTS FOR MARCH 31, 2002 (Billions of dollars)				
	FANNIE MAE		FREDDIE MAC	
Risk-Based Capital Requirement:				
High Interest Rate Scenario		18.475	5.680	
Low Interest Rate Scenario	20.228			1.481
Total Capital	26.290		21.360	
Surplus	6.062		15.680	

ENTERPRISE MINIMUM CAPITAL REQUIREMENTS FOR MARCH 31, 2002 (Billions of dollars)				
	FANNIE MAE		FREDDIE MAC	
Minimum Capital Requirement	24.571		19.390	
Core Capital	25.500		20.558	
Surplus	.929		1.169	

1700 G STREET, NW WASHINGTON, DC (202)414-6922 FAX (202)414-3823

SUMMARY OF OFHEO'S RISK-BASED CAPITAL REGULATION FOR FANNIE MAE AND FREDDIE MAC

OFHEO's Mission

OFHEO was required by the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (1992 Act) to establish minimum and risk-based capital standards as part of its role as safety and soundness regulator. These capital requirements are intended to ensure both Enterprises continue to operate and perform their crucial roles in the secondary mortgage market, keeping constant the flow of funds to mortgage lenders and prospective American homeowners. By ensuring the Enterprises are adequately capitalized, OFHEO minimizes the risk that American taxpayers will ever be asked to pay for losses at these complex financial institutions.

OFHEO evaluates capital adequacy from other perspectives as well. OFHEO's **examination program** conducts continuous, comprehensive examinations of the Enterprises to ensure they are operating under standards of financial safety and soundness. OFHEO's examination of the Enterprises provides a qualitative assessment of capital adequacy. The more direct and quantitative tools are OFHEO's **minimum** and **risk-based capital** standards, which are supplemented with other tests and analyses. OFHEO's minimum capital standard is calculated based on specific percentages for assets and off-balance sheet guarantees. The minimum capital level is therefore determined more by the size of the Enterprise than its specific risks. The risk-based standard, in contrast, requires that Fannie Mae and Freddie Mac each have enough capital to survive prolonged, severe problems in financial and economic markets, as well as management or operational failures. It is directly related to the risks the Enterprises are exposed to in their current business.

The Risk-Based Capital Rule

The risk-based capital regulation meets the specific requirements of the 1992 Act. The rule utilizes a stress test to determine the amount of capital needed to protect against credit and interest rate risks, and requires an additional 30 percent more capital to protect against unspecified management and operations risk. The regulation itself is the blueprint needed to construct the stress test and calculate the risk-based capital requirement for Freddie Mac and Fannie Mae. It is a detailed description of the stress test to allow the Enterprises and others to essentially replicate the stress test, as required by law.

What is the Stress Test?

OFHEO's risk-based capital standard is based on a 10-year stress test. A stress test measures risk in the context of a company's overall portfolio, including the effectiveness of a company's risk management positions. While companies often use stress tests for internal risk management, and rating agencies use stress tests to rate companies and securities, OFHEO is among the first financial institution regulators to use its own stress test to determine capital adequacy.

OFHEO's stress test simulates an Enterprise's financial performance over a 10-year period under severe economic conditions. Key aspects of the severe economic conditions used in OFHEO's stress test are defined in the 1992 Act and further specified in OFHEO's risk-based capital regulation. These conditions include high levels of mortgage defaults, with associated losses and large, sustained movements in interest rates, both increasing (up-rate scenario) and decreasing (down-rate scenario).

OFHEO uses a detailed computer model to simulate each Enterprise's cash flows associated with mortgages and other financial assets and obligations under the severe economic conditions of the stress test. The modeling of incoming and outgoing cash flows captures the risks embedded in those financial assets and obligations and the benefits of the hedges each Enterprise has set in place. To meet OFHEO's risk-based capital standard, each Enterprise must have sufficient capital to survive the losses under these severe economic conditions plus an additional 30 percent for unspecified management and operations risks. The result is a stringent test of the capital adequacy of each Enterprise.

Results of the Stress Test

Results for 1Q02		Fannie Mae	Freddie Mac
Actual Total Capital		$26.290 B	$21.360 B
RBC	**Down-rate Scenario Requirement**	**$20.228 B**	$1.481 B
	Up-rate Scenario Requirement	$18.475 B	**$5.680 B**
Minimum Capital Requirement*		$24.571 B	$19.390 B

*the minimum capital requirement is compared to Enterprise core capital.

What do the Results Mean?

For the quarter ending March 31, 2002, both Fannie Mae and Freddie Mac had enough capital to survive the 10-year stress test plus 30 percent, as specified in OFHEO's regulation. Both Enterprises would be considered "adequately capitalized" if OFHEO had used the risk-based standard to make a capital classification. In addition, for both Enterprises the minimum capital requirement was higher than the risk-based capital requirement for the first quarter.

These results only apply to the first quarter, 2002. Future quarters results will be dependent on current economic conditions, and the risks associated with each Enterprise's book of business as of the last date of that quarter.

A projected capital shortfall does not imply that an Enterprise actually has to raise that amount of capital. The risk-based capital standard captures the "bottom line" risk exposure of the Enterprises, taking into account all of their risk-taking and risk-management activities, in light of current economic conditions. Therefore, an Enterprise can meet any potential capital shortfall by reducing risk, raising capital, or a combination of the two. The regulation does not prescribe any particular approach to capital compliance.

In many cases, relatively inexpensive hedging strategies can substantially reduce required capital by reducing interest rate risk. Alternatively, an Enterprise might choose to reduce credit risk either through innovative hedging transactions (such as credit derivatives) or by increasing mortgage credit enhancements. Conversely, a projected capital surplus does not necessarily mean that an Enterprise has too much capital. Each Enterprise still must meet its minimum capital requirement, which is more a function of size than specific risks.

Benefits of the Risk-Based Capital Regulation

The stress test provides Enterprise management with incentives to carefully manage risk. OFHEO's stress test aligns the capital requirement for each Enterprise with its specific risk profile. For example, risk reduction activities such as the effective use of interest rate derivatives, the use of private mortgage insurance (PMI) for high loan-to-value (LTV) mortgages, and the use of callable long-term debt all work to lower the risk-based capital requirement. Conversely, activities that increase risk, such as taking on unhedged interest rate exposures, serve to increase the risk-based capital requirement.

The stress test provides an early warning signal of potential future problems. The dynamic nature of a stress test facilitates OFHEO's understanding of how changes in the economy could impact the Enterprises. It will also help OFHEO uncover changes in capital needs **before** there could be a significant impact on the Enterprises' balance sheets. In contrast, capital standards based on static ratios are affected only **after** economic changes impact the balance sheet.

The risk-based capital standard encourages safe and sound innovations. Provisions in the regulation allow OFHEO to reflect the risk characteristics of new products and risk management techniques as soon as they are implemented by the Enterprises, applying the same risk-sensitive principles embodied in the stress test. These provisions allow OFHEO to treat innovative products and risk management techniques fairly and incorporate their impact on the Enterprises' capital requirements on a timely basis.

OFHEO's stress test provides the Enterprises with transparency, certainty, and flexibility in meeting their regulatory capital requirements. Both Enterprises have copies of OFHEO's stress test and have incorporated the test into their business processes. An Enterprise can comply with OFHEO's risk-based capital standard by reducing risk or raising capital, or a combination of both. Therefore, each Enterprise can follow its own unique strategy to comply with OFHEO's risk-based capital standard.

OFHEO's Risk-Based Capital Standard is Vital for Effective Regulatory Oversight

The risk-based capital standard is a key measure of Enterprise financial safety and soundness. With our comprehensive examination program, it provides OFHEO with the necessary tools for effective regulatory oversight. The examination program ensures the integrity of Enterprise policies and processes in all risk management areas, and informs the qualitative evaluation presented in OFHEO's annual report to Congress. The risk-based capital standard ensures that the quantity of risk undertaken by an Enterprise never exceeds what can be supported by its capital base. At the same time, the risk-based capital standard provides assurance that the Enterprises' capital, as compared to other financial institutions, properly reflects the lower relative risk of most of the mortgages they guarantee.

Implications for the Housing Market

OFHEO's risk-based capital standard will help ensure that Freddie Mac and Fannie Mae will be able to fulfill their important public purposes, both in good times and in bad times, when they will be needed most.

The risk-based capital standard contributes to OFHEO's ability to monitor the safety and soundness of Freddie Mac and Fannie Mae. Through this mechanism, OFHEO is able to support the availability of affordable housing and protect the nation's housing markets.

(more)

Q & A ON THE RISK-BASED CAPITAL STRESS TEST

RELATIONSHIP BETWEEN MINIMUM AND RISK-BASED CAPITAL REQUIREMENTS

Question: Does OFHEO require the Enterprises to meet more than one measure of capital adequacy?

Answer: The 1992 Act that established OFHEO specified two types of capital requirements for the Enterprises. The first, a minimum capital requirement, is a simple ratio-based calculation, which specifies a "minimum" and a "critical" level of capital. The Enterprises are required to maintain a minimum level of capital equal to the sum of 2.5% of their on-balance sheet assets plus .45% of their outstanding off-balance sheet guarantees. The critical capital levels are 1.25% and .25%, respectively. Minimum capital represents an essential amount of capital needed to protect an Enterprise against broad categories of business risk.

Question: What does risk-based capital comprise, and how did OFHEO determine the conditions in its stress test?

Answer: OFHEO's risk-based capital requirement is the amount of total capital – core capital plus a general allowance for foreclosure losses – that an Enterprise must hold to absorb projected losses flowing from future severe interest rate and credit risk conditions, plus 30% to cover management and operations risk. In the 1992 Act, Congress specified the broad parameters of the stressful conditions underpinning the stress test that determines an Enterprise's risk-based capital requirement. The final RBC regulation published in September 2001, as amended in March 2002, fleshed out in detail these economically stressful scenarios.

Question: Now that OFHEO has a final RBC rule, do the Enterprises need to meet both a minimum and risk-based capital requirement?

Answer: Yes, however, the 1992 Act requires that until the third quarter of 2002, OFHEO's quarterly classification of an Enterprise's capital adequacy is determined by whether the Enterprise met its minimum capital requirement. Thereafter, an Enterprise must meet both the minimum and risk-based requirements in order to be classified as adequately capitalized each quarter.

Question: What is the relationship between the minimum and risk-based capital requirements?

Answer: The minimum and risk-based capital requirements are complementary. The first sets an absolute floor, related to the level of Enterprise assets and obligations, below which capital should not dip. It ensures there is capital available to protect against risks not modeled in the OFHEO stress test. The second requirement ensures a healthy relationship between the level of risk undertaken at a particular time by an Enterprise, and the level of capital it must hold. As a far more risk-sensitive measure, the risk-based requirement is designed to expose hidden weaknesses in an Enterprise that seems financially sound under normal conditions using more traditional capital measures.

CAPITAL CLASSIFICATION PROCESS

Question: What are the statutory requirements for classifying the adequacy of capital held by an Enterprise? What capital requirements are used to determine the capital classifications?

Answer: OFHEO is required by the 1992 Act to classify the adequacy of the capital held by each Enterprise based upon risk-based and minimum capital requirements. The minimum capital requirement (which includes both a "minimum" and a lower "critical" level) is a traditional ratio-based standard calculated by applying percentage factors to all on-balance-sheet assets and various specified off-balance-sheet items such as loan guarantees, loan purchase commitments, and derivatives. The risk-based capital requirement is based on the sum of two capital amounts: (1) the amount of capital an Enterprise needs to survive a ten-year period of credit and interest rate stress, as determined by OFHEO's stress test, and an additional 30 percent of that amount to cover management and operations risk.

Question: What are the capital classifications for an Enterprise? What criteria are used to determine the capital classifications?

Answer: An Enterprise that meets or exceeds both the minimum and risk-based capital requirements will be classified as "adequately capitalized." An Enterprise that meets the minimum capital requirements, but does not meet the risk-based capital requirements would be classified as "undercapitalized." An Enterprise that does not meet the minimum capital requirements would be classified as "significantly undercapitalized." An Enterprise that holds less than the critical capital requirement would be classified as "critically undercapitalized."

Question: How frequently will the capital classification process be conducted?

Answer: In most cases, the Director will issue a regular quarterly capital classification within 90 days of a quarter's close. The Director has discretion, however, to modify the period for submission of data by the Enterprises. The Director may also make capital classifications more frequently than quarterly and may compress or extend the period that an Enterprise has to comment on the proposed classification.

Question: Will the capital classification process be public?

Answer: The capital classification process will be non-public until the Director makes a final determination. This policy serves to prevent the release of confidential information or the premature release of the proposed capital classification.

Question: How will the capital classification process be implemented during the initial year after the risk-based capital rule takes effect?

Answer: For quarters ending prior to September 13, 2002, an Enterprise's capital classification will be based solely on its minimum and critical capital requirements. An Enterprise will be classified as "adequately capitalized" if it maintains an amount of core capital that is equal to or greater than the minimum capital level. Starting with the third quarter, 2002, an Enterprise's capital classification will also be based on its risk-based capital requirement. An Enterprise will be classified as “adequately capitalized” if it meets the risk-based capital requirement and maintains an amount of core capital that is equal to or greater than the minimum capital level.

HOW RBC CONTRIBUTES TO LONG-RUN SAFETY AND SOUNDNESS – ONE TOOL AMONG MANY

Question: Is OFHEO’s RBC regime different in any important respects from the existing RBC requirements for depository institutions?

Answer: OFHEO’s risk-based capital standard is a unique financial regulatory tool. Unlike other, ratio-based capital requirements, this standard is based on the risk of the entire book of business for each Enterprise. Instead of instrument buckets or categories associated with different percentage capital requirements, OFHEO’s RBC standard is based on a 10-year stress test. While companies often use stress tests for internal risk management, and rating agencies use stress tests to rate companies and securities, OFHEO is the first financial regulator to run its own stress test to determine capital adequacy, as directed by Congress in 1992. The test simulates each Enterprise’s financial performance under extreme economic conditions, and can expose weaknesses in a firm that may appear sound using other capital measures.

Question: Does OFHEO rely solely on the RBC standard to ensure the Enterprises’ financial health and the integrity of their operations?

Answer: The stress test is not, of course, the only tool OFHEO has to determine whether the Enterprises are operating safely and soundly. OFHEO’s examination staff conducts ongoing, comprehensive examinations of all facets of the Enterprises’ operations and brings crucial, qualitative judgment to bear in supervising the Enterprises. OFHEO’s regulatory framework includes measures on “Prompt Supervisory Response and Prompt Corrective Action.” These specify how OFHEO may respond to safety and soundness concerns other than a decline in capital at the Enterprises. Similarly, OFHEO has proposed a rule that sets forth minimum requirements with respect to Enterprise Corporate Governance practices and procedures, and a comprehensive review of Enterprise financial disclosures is underway.

Question: How will OFHEO ensure that its new RBC rule does not become outdated?

Answer: OFHEO’s risk-based capital rule will evolve in order to accommodate market innovations as well as developments in risk-measurement techniques. Changes to the rule can be expected from time to time as improved measurements and methodologies are incorporated into the stress test. A great deal has been learned in the process of completing the current RBC rule. OFHEO will pursue specific research projects and consider alternative or supplementary ways of assessing Enterprise risk as more is understood about the potential for these to improve OFHEO’s supervisory capacity. More sensitivity analysis (“what if…scenarios”), close scrutiny of the Enterprises’ own assessment of their risks, and a consideration of the relative probability of capital impairment under particular circumstances beyond those specified in the rule, are all subject areas to be pursued. OFHEO’s upcoming report on Systemic Risk, and a project that takes a closer look at the role and position of the Enterprises in the derivatives market, are two examples of current OFHEO efforts to improve understanding of how the Enterprises function in the broader economy.

OFHEO's risk-based capital requirement is designed to help ensure the long-term financial health of the Enterprises, and the dynamic nature of both the stress test and related means of supervisory oversight actively contribute to that goal.

BUSINESS DEVELOPMENTS & INNOVATION

Question: How does the RBC rule address changing business practices and innovation?

Answer: In recognition of the dynamic business environment in which the Enterprises operate, OFHEO built flexibility into the RBC rule. For example, the rule will accommodate innovations in:

- Mortgage products and mortgage-backed securities;
- REMICs and other structured transaction practices;
- The use of derivative instruments and other risk management instruments and techniques, and
- Debt instruments and issuance practices.

Question: How do the RBC rule and OFHEO accommodate every new development and innovation?

Answer: Once notified of a new activity such as those described above, OFHEO will devise stress test treatments for most new instruments by using combinations or adaptations of existing treatments described in the RBC rule, amendments to the rule, or in OFHEO pronouncements adopted in accordance with applicable OFHEO regulatory procedures.

In the event OFHEO determines that it cannot find a reasonable way to combine or adapt existing stress test treatments to address a new activity, OFHEO will adopt an appropriately conservative treatment, based on the risk characteristics displayed by the new activity. In doing so, OFHEO will rely on available data and information, including any provided by the Enterprise, and exercise its expertise and judgment to ensure that the stress test treatment is commensurate with the actual risk posed to the enterprise by the new activity.

Question: How does OFHEO incorporate new capital treatments into the RBC rule?

Answer: OFHEO may apply a conservative, interim, treatment until such time as supplemental performance or other data and information are available to derive a long-term stress test treatment appropriate for the particular activity. In adopting this long-term stress test treatment, OFHEO will follow procedural requirements in the rule and applicable regulations. These procedural requirements provide the Enterprise(s) the opportunity to comment on the proposed treatment, and, if the treatment involves a material change in the RBC Rule, allow public comment as well. If necessary, after completing the prescribed procedural steps, OFHEO will formally incorporate the stress test treatment by amending the RBC rule at the appropriate time.

TREATMENT OF SUBPRIME LOANS

Question: How does the rule treat subprime loans?

Answer: The model effectively treats all Enterprise mortgages as prime. This is a priority area for future improvements, but subprime loans are still only a very small component of overall Enterprise loans.

CAPITAL CUSHION

Question: Should an Enterprise maintain a significant cushion above its risk-based capital requirement?

Answer: That depends on the Enterprise's minimum capital requirement and its business strategy. When an Enterprise maintains a low risk profile, its risk-based requirement may be lower than its minimum requirement, and the cushion may simply reflect this differential.

Because risk is dynamic, and the risk-based capital requirement is a functioning of both Enterprise business choices and external economic conditions, OFHEO expects that requirement to be more volatile than the minimum requirement. Specifically, in good times the risk-based requirement is more likely to be lower relative to the minimum requirement, and in more difficult times, more likely to be higher relative to that requirement.

Enterprise may not want to raise capital during an economic downturn, but under such conditions might find it difficult and expensive to lower its risk-based requirement through hedging. Thus during good times an Enterprise may choose to maintain a significant capital cushion over its risk-based requirement.

Question: What will happen if an Enterprise has a large capital cushion based on RBC?

Answer: OFHEO's stress test determines the amount of capital needed to prevent failure under the terms specified in the RBC rule. One or both Enterprises may well choose to maintain more capital than this 'floor' RBC amount. That choice would reflect an individual business strategy rather than the risk-based capital requirement. Additionally, the Enterprises must meet their minimum capital requirement each quarter. The minimum capital requirement may be higher or lower than the RBC requirement, depending on the individual Enterprise's specific risks.

Recent economic circumstances have been quite favorable, so the risks undertaken by the Enterprises in the normal course of business have not been unusually large. Maintaining some capital cushion in benign environments would likely mean that an Enterprise would not face the immediate need to raise capital as these circumstances become less favorable.

DERIVATIVES

Question: How does the Risk-Based Capital stress test treat derivatives and what aspects of derivatives does the stress test take into account?

Answer: Derivative contracts are important tools the Enterprises use to manage their principal source of risk, interest rate risk, as well as their exposure to foreign currencies. They also use derivative contracts to create synthetic debt structures to achieve savings over the cost of equivalent securities.

An effective risk-based capital standard must take into account the risk mitigating effects of derivatives, as well as any additional risks they pose. There are three potential additional risks. First, to the extent an Enterprise enters into speculative derivative contracts, such contracts would introduce new interest rate or foreign currency risks. Second, when an Enterprise uses derivative contracts that pay interest at LIBOR-based rates to pay interest on its short-term debt obligations, the derivatives create basis risk—the risk of a changing relationship between LIBOR and rates on Enterprise securities. Finally, derivatives introduce counterparty credit risk—the risk of loss in the event of counterparty default.

Question: How does the stress test take derivatives into account?

Answer: OFHEO's stress test takes into account derivatives' risk mitigating features, as well as their risk factors. The test generates cash flows for each derivative contract, including contracts that hedge basis risk, just as it does for on-balance sheet assets and liabilities. To reflect the creditworthiness of counterparties, the stress test "haircuts" cash flows due to an Enterprise from its counterparties, just as it haircuts cash flows due from investment securities, with the size of the haircut proportional to the creditworthiness of the counterparty. In consideration of the high level of protection afforded by agreements that require the Enterprise's counterparties to post collateral to offset the credit risk of derivatives positions, haircut percentages for derivatives counterparties are lower than those applied to the cash flows of assets with the same rating.

Question: How does the risk-based capital requirement supplement public disclosure about derivatives?

Answer: Enterprise public disclosure asserts derivatives are used only for risk management, provides information about how derivatives are used in various hedging strategies, and characterizes counterparty risk exposures. The stress test, by dynamically simulating both the cash flow and credit behavior of derivatives within the context of a comprehensive stress test, helps validate that derivatives do not pose undisclosed risks.

THE RBC RULE AND “HAIRCUTS” TO COUNTERPARTY OBLIGATIONS

Question: What are “counterparties”?

Answer: The Enterprises maintain contractual relationships with a variety of companies during the course of their business activities. The most important of these relationships, for purposes of the risk-based capital test, are the relationships with seller/servicers, mortgage insurers, and counterparties to derivatives contracts. The RBC rule classifies each counterparty as either a derivative contract counterparty or a non-derivative contract counterparty, depending on the nature of the contractual relationship with the Enterprise.

These contractual relationships give rise to obligations between the Enterprises and their counterparties that involve, for example, a series of payments, an exchange of payments, and/or the posting of collateral. To calculate an appropriate risk-based capital requirement, the RBC rule must address the impact on these payments of the stressful conditions prescribed by the 1992 Act.

Question: What is a “haircut”?

Answer: In keeping with the overall nature of the statutory “stress period” on which the risk-based capital test is based, the RBC rule presumes that companies with whom the Enterprises do business will experience some impairment to their operations, and to their ability to meet their payment obligations to the Enterprises. In practical terms, the RBC rule presumes that the stronger the counterparty, the more likely it is to meet its financial obligations to the Enterprises. The rule applies a “haircut,” or discount, to the payments due from each counterparty, and thereby reduces the amount of funds received by the Enterprise from that counterparty for purposes of the capital calculation. The size of the haircut is determined by the financial strength of the counterparty.

Question: How are “haircuts” applied?

Answer: Consistent with common business practice, the RBC rule uses ratings provided by the major rating agencies—Standard & Poor’s, Moody’s, and Fitch Ratings—to reflect the relative financial strength of each counterparty. Generally speaking, the higher a counterparty’s rating, the smaller the haircut applied to the cash flows due from that counterparty. For counterparties that are unrated, or are rated below investment grade, the rule presumes that their ability to make payment to the Enterprise is completely impaired, and that they fail to meet their payment obligations.

Question: How did OFHEO determine the haircut levels?

Answer: To determine the size of the haircuts, OFHEO conducted research to evaluate how companies with different financial ratings fared during observed periods of severe economic stress. After evaluating studies into historical default rates, and considering an extensive set of public comments on this issue, OFHEO adopted haircut rates that are commensurate with the counterparty’s rating, or reflect the fact that the counterparty is unrated.

With regard to derivatives counterparties, the RBC rule gives effect to standard contractual netting arrangements, which allow offsetting cash flow calculations to address multiple exposures between the same counterparties, and simplify the exchange of funds between them.

Question: Are the haircuts immediate, or are they imposed over time?

Answer: In an effort to reflect the gradual impairment of a counterparty's ability to make payments to the Enterprises that is expected to occur during the stress period, the RBC rule phases-in the haircut levels over the 10-year period. Thus, the rule recognizes that a counterparty's failure becomes more likely the longer the stressful period continues.

IMPLEMENTATION PERIOD

Question: Why is there a one-year period between when the rule was published and when it is enforceable?

Answer: When OFHEO published the final risk-based capital regulation on September 13, 2001, it became effective immediately. However, Congress mandated a one-year implementation period between the effective date of the regulation and the date upon which OFHEO can use risk-based capital to determine the Enterprises' capital adequacy. Congress wanted to ensure that the Enterprises had ample time to understand and manage to the requirements of the regulation. During the implementation period, the Enterprises continue to be subject to a quarterly, minimum capital requirement.

Question: When will the rule be enforceable?

Answer: The risk-based capital rule will be used to classify the Enterprises' capital starting with the third quarter, 2002, which is the first quarter ending after the rule becomes enforceable on September 13, 2002. Including risk-based capital in the classification process at that point ensures that the Enterprises have the full one-year period anticipated by Congress in which to implement the rule. OFHEO has worked closely with the Enterprises this year to ensure a smooth transition to the risk-based capital standard.

REGULATORY PROCESS AND CONTINUED PUBLIC INPUT Q&A

Question: How was the rule developed?

Answer: The Risk-Based Capital rule has been the subject of an extensive notice and comment rulemaking under the Administrative Procedure Act including:

An Advanced Notice of Proposed Rulemaking (ANPR) 1995;

Two Notices of Proposed Rulemaking, (NPR 1) and (NPR 2), between 1996 and 1999;

A Final Rule issued in September 2001;

A Notice of Proposed Rulemaking to amend the Final Rule in December 2001; and,

An Amendment to the Final Risk-Based Capital Rule issued in February 2002.

Question: Once the rule becomes enforceable will OFHEO remain open to input regarding the rule?

Answer: OFHEO remains committed to receiving input about the RBC rule from the public, including the Enterprises, market participants, public interest groups and other interested persons.

Opportunities for additional input and interaction are available:

At any time during a non-rulemaking period;

During future RBC related rulemakings, subject only to the requirements of the Administrative Procedure Act;

When OFHEO releases revised versions of the code used to run the stress test;

Upon publication (when implemented) of the results of the stress test; and,

During meetings, forums, conferences and other events open to the public where OFHEO has the opportunity to explain the RBC rule to the public.

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