



OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT  
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## NEWS RELEASE

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### **OFHEO ANNOUNCES SECOND QUARTER 2004 MINIMUM AND RISK-BASED CAPITAL CLASSIFICATIONS FOR FANNIE MAE AND FREDDIE MAC MONTHLY CLASSIFICATION FOR FANNIE MAE TO BEGIN**

**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), has classified both Enterprises as adequately capitalized under OFHEO's capital standards as of June 30, 2004.

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 requires the OFHEO Director to determine the capital level and classification of the Enterprises not less than quarterly, and to report the results to Congress. OFHEO classifies the Enterprises as adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized. The Enterprises are required by Federal statute to meet both minimum and risk-based capital standards to be classified as adequately capitalized.

Freddie Mac's capital classification is based on financial information and the application of accounting policies currently involved in the ongoing financial review process. The publication of Freddie Mac financial statements for 2004 will impact both minimum capital surpluses and, to a lesser degree, risk-based capital surpluses as reported and relied upon for classifications by OFHEO. OFHEO will continue to monitor and analyze 2004 capital resubmissions once the financial results for these periods are issued by Freddie Mac.

OFHEO imposed a capital surcharge for Freddie Mac in January 2004 due to increased operational risk. Freddie Mac has maintained their minimum capital surplus in excess of the surcharge during the second quarter 2004.

Separately, Freddie Mac has submitted, and OFHEO has analyzed quarterly 2003 minimum capital resubmissions, including recent revisions for three quarters of 2003 due to establishment of special reserves. OFHEO has determined Freddie Mac remained adequately capitalized during all periods in 2003. OFHEO also determined, based upon analysis of information submitted by Freddie Mac, that Freddie Mac was not required to resubmit risk-based capital for the four quarters in 2003. Results of the restated minimum and critical capital calculations can be found on OFHEO's website.

Fannie Mae's capital classification is based on financial information and the application of accounting policies currently under review by OFHEO. The outcome of the review may result in a restatement of prior period results and a revision of the respective capital calculations. Based on the September 17, 2004 "Report of Findings to Date", OFHEO has directed a recalculation of historic accounting treatments under SFAS 91 (beginning 1998) and SFAS 133 (beginning 2001) for previously reported financial statements. Fannie Mae has agreed to increase minimum capital surpluses over a nine-month time period to 30% of the minimum capital requirement due to the uncertainties in the financial statements and operational weaknesses.

As an additional safeguard against those uncertainties and weaknesses, OFHEO will determine and publish Fannie Mae's capital classification on a monthly basis. This monthly determination will take effect based on their capital position as of September 30, 2004, and will continue until such time as all safety and soundness concerns are fully addressed.

## **SECOND QUARTER RESULTS:**

### **FANNIE MAE**

As of June 30, 2004, Fannie Mae's **risk-based capital** requirement was \$24.391 billion. Fannie Mae's total capital of \$36.862 billion on that date exceeded the risk-based capital requirement by \$12.471 billion.

Fannie Mae's **minimum capital** requirement was \$31.188 billion. Fannie Mae's core capital of \$36.115 billion exceeded the minimum capital requirement by \$4.927 billion.

### **FREDDIE MAC**

As of June 30, 2004, Freddie Mac's **risk-based capital** requirement was \$3.858 billion. Freddie Mac's total capital of \$33.081 billion on that date exceeded the requirement by \$29.224 billion.

Freddie Mac's **minimum capital** requirement was \$24.266 billion. Freddie Mac's core capital of \$32.884 billion exceeded the minimum capital requirement by \$8.619 billion.

*Capital data for each Enterprise as of March 31, 2004 and June 30, 2004:*

Enterprise Risk-Based Capital Requirement (Billions of Dollars) (1)								
	Fannie Mae (2)				Freddie Mac(3)			
	30-June-04		31-Mar-04		30-June-04		31-Mar-04	
	Up	Down	Up	Down	Up	Down	Up	Down
Interest Rate Scenario								
Risk-Based Capital Requirement	7.074	24.391	25.961	16.587	1.322	3.858	7.047	7.131
Total Capital		36.862	36.481			33.081		34.898
Surplus (Deficit)		12.471	10.520			29.224		27.767

Enterprise Minimum Capital Requirement (Billions of Dollars) (1)				
	Fannie Mae (2)		Freddie Mac(3)	
	30-June-04	31-Mar-04	30-June-04	31-Mar-04
	Minimum Capital Requirement	31.188	31.354	24.266
Core Capital	36.115	35.701	32.884	34.781
Surplus (Deficit)	4.927	4.347	8.619	10.309

Enterprise Critical Capital Requirement (Billions of Dollars) (1)				
	Fannie Mae (2)		Freddie Mac(3)	
	30-June-04	31-Mar-04	30-June-04	31-Mar-04
	Critical Capital Level	15.957	16.041	12.362
Core Capital	36.115	35.701	32.884	34.781
Surplus (Deficit)	20.157	19.660	20.523	22.327

- (1) Numbers may not add due to rounding.
- (2) Fannie Mae's capital calculation is based on financial information and the application of accounting policies currently under review by OFHEO. The outcome of the review may result in a restatement of prior period results and a revision of the respective capital calculations.
- (3) Freddie Mac's 03/31/2004 and 6/30/2004 capital numbers are based on financial information and application of accounting policies currently involved in the restatement process. These numbers are subject to change.

*Technical questions regarding these results should be directed to:*  
[rbcquestions@ofheo.gov](mailto:rbcquestions@ofheo.gov).

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## **GENERAL ANALYSIS OF THE RISK-BASED CAPITAL RESULTS**

By statute, stress test interest rate levels are a function of the average 10-year Constant Maturity Treasury (CMT) over the most recent nine months. During the second quarter of 2004, the nine month average increased by 12 basis points to 4.30%. As a result, the stress test interest rate levels increased to 7.53% in the up-rate stress test and 2.15% in the down-rate stress test.

In contrast to modest increases in the moving average rate level, spot market interest rates rose substantially during the second quarter. Consequently, the duration of existing mortgage assets increased as the economic incentives attached to prepayment declined. In addition, the spread between mortgage rates and borrowing rates remained historically narrow during the second quarter, reducing the attractiveness of mortgage portfolio investment opportunities for both Enterprises. As a result, Fannie Mae's net mortgage portfolio grew by a minimal 0.6% while Freddie Mac's shrank by 0.7%.

As of June 30, 2004, Fannie Mae's minimum capital surplus increased by \$0.6 billion to \$4.9 billion. The increase in surplus reflected a \$0.4 billion increase in core capital and a decrease in the minimum capital requirement of \$0.2 billion. The decrease in the minimum capital requirement was the result of a decline in outstanding mortgage commitments and total on-balance sheet assets.

Freddie Mac's minimum capital surplus, as of June 30, 2004, declined \$1.7 billion to \$8.6 billion. The primary driver in the reduction in the surplus was a \$1.9 billion decline in core capital that was partially offset by a \$0.2 billion decline in the minimum capital requirement. The decrease in the minimum capital requirement was the result of a decline in on-balance sheet assets.

In addition to longer mortgage durations associated with higher interest rates, both Enterprises experienced an increase in the weighted average maturity of their mortgage portfolios. Consistent with longer assets and a rising interest rate environment, the Enterprises moved to lengthen liability durations during the second quarter as part of their risk management operations.

Unlike in the prior quarter, the down-rate stress test scenario produced the higher capital requirement for Fannie Mae. Fannie Mae's risk-based capital level increased by \$7.8 billion in the down-rate stress test to \$24.4 billion and fell in the up-rate stress test to a level of \$7.1 billion. Fannie Mae's capital surplus increased from \$10.5 billion in the prior quarter to \$12.5 billion due to a lower binding risk-based capital requirement and higher starting total capital.

Compared to last quarter, Fannie Mae's net interest margin decreased in the down-rate stress test and increased in the up-rate scenario. Longer-term initial liabilities resulted in higher debt yields and lower net interest margin in the down-rate stress test. Conversely, net interest margin in the up-rate stress test was driven by lower overall funding costs that stemmed from less short-term debt refunding at higher debt yields.

Similar to last quarter, Freddie Mac's results were binding in the down-rate stress test. Freddie Mac's risk-based capital level decreased in both stress test scenarios primarily due to a decrease in cumulative portfolio mark-to-market gains during the second quarter. Risk-based capital levels decreased to \$3.9 billion in the down-rate stress test and to \$1.3 billion in the up-rate stress test. Freddie Mac's risk-based capital surplus increased to \$29.2 billion.

The net interest margin of Freddie Mac decreased in the down-rate stress test and increased in the up-rate test compared to last quarter. The results of the down-rate stress test environment were driven by higher funding costs stemming from longer-term liabilities. The converse occurred in the up-rate environment where longer-term liabilities led to lower funding costs and, subsequently, higher net interest margin.

### **DEFINITION OF CAPITAL STANDARDS**

**Minimum** capital represents an essential amount of capital needed to protect an Enterprise against broad categories of business risk. For purposes of minimum capital, an Enterprise is considered adequately capitalized if core capital — common stock; perpetual noncumulative preferred stock; paid in capital; and retained earnings — equals or exceeds minimum capital. The minimum capital standard is 2.5 percent of assets plus 0.45 percent of adjusted off-balance-sheet obligations.

OFHEO's **risk-based** capital requirement is the amount of total capital — core capital plus a general allowance for loan losses less specific reserves — that an Enterprise must hold to absorb projected losses flowing from future adverse interest-rate and credit-risk conditions specified by statute, plus 30 percent mandated by statute to cover management and operations risk. The risk-based capital standard is based on stress test results calculated for the two statutorily prescribed interest rate scenarios, one in which 10-year Treasury yields rise 75 percent (up-rate scenario) and another in which they fall 50 percent (down-rate scenario). 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 **critical** capital level is the amount of core capital below which an Enterprise must be classified as critically undercapitalized and generally must be placed in conservatorship. Critical capital levels are computed consistent with the Federal Housing Enterprises' Safety and Soundness Act of 1992 as follows: One-half of the portion of minimum capital requirement associated with on-balance-sheet assets plus five-ninths of the portion of the minimum capital requirement associated with off-balance-sheet obligations.

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