MORTGAGE MARKET NOTE 08-2

Introduction

Discussions about the capital of Fannie Mae and Freddie Mac are sometimes confusing because of the various alternative types of capital and capital requirements. This note is intended to provide a quick reference for the different measures of capital, the capital requirements, the capital classifications, and data for recent years and the first quarter of this year.

Types of Capital

Statutory

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 defines two measures of capital.

- *Core Capital* is the sum of outstanding common stock, perpetual noncumulative preferred stock, paid-in capital, and retained earnings. It is similar to tier 1 capital for banks and thrifts.

- *Total Capital* is core capital plus general allowances for loan losses.

Accounting

- *Shareholder's Equity* is generally defined as the amount by which the book value of assets exceeds the book value of liabilities. For Fannie Mae and Freddie Mac, that is the same as core capital plus accumulated other comprehensive income (AOCI). AOCI reflects the differences between the current market value and the amortized cost of available-for-sale assets, as well as gains or losses on certain types of hedge instruments. The exclusion of AOCI from core capital mirrors its exclusion from tier 1 capital for banks and thrifts.

- _Fair Value of Equity_ is the difference between the fair value of assets and the fair value of liabilities. Depending on what types of data are available, fair values are market values or best estimates.

Capital Requirements

Statutory

- _The Minimum Capital_ requirement equals 2.5 percent of assets plus 0.45 percent of adjusted off-balance-sheet obligations, including guaranteed mortgage-backed securities. Core capital must equal or exceed the requirement.

- _The Risk-Based Capital_ requirement equals the amount just sufficient to survive a 10-year stress test involving statutorily mandated modeling of mortgage credit losses and adverse changes in interest rates, plus an additional 30 percent of that amount to protect against management and operations risk. Total capital must equal or exceed the requirement.

OFHEO-Directed

- OFHEO, by supervisory action, has required both Fannie Mae and Freddie Mac to hold additional amounts of core capital because of their accounting systems, internal control, and risk management deficiencies. OFHEO directed Freddie Mac to hold 30 percent more than the minimum capital requirement in January 2004. In September 2004, Fannie Mae became subject to the same requirement. By March 2008, both GSEs were finally able to release timely, accurate financial statements and had otherwise cured many of their past problems. OFHEO reduced the OFHEO-directed capital requirements to 20 percent above the normal regulatory minimum requirement in return for commitments by both to raise significant capital and maintain overall capital levels well in excess of requirements. Finally, in May 2008, OFHEO determined that Fannie Mae had substantially completed its remediation, recognized that it had issued $7.4 billion in new capital, and therefore lowered the OFHEO-directed capital requirement to 15 percent above the statutory level.

Classification

By statute, the Enterprise is classified as –

- *Adequately Capitalized* if it meets both the statutory minimum capital requirement and the risk-based requirement.

- *Undercapitalized* if it meets the minimum requirement, but not the risk-based requirement.

- *Significantly Undercapitalized* if it does not meet the minimum capital requirement but exceeds its critical capital level, which is 1.25 percent of assets plus 0.25 percent of adjusted off-balance-sheet obligations, roughly half the minimum requirement.

- *Critically Undercapitalized* if its core capital is less than its critical capital level.

The lower the classification, the broader the array of enforcement authorities that OFHEO may apply.

Statutory Language:

12 USC 46: GOVERNMENT SPONSORED ENTERPRISES is at:
http://uscode.house.gov/browse/prelim@title12/chapter46&edition=prelim

See sections 4602 and 4611 - 23.

Regulation:

12 CFR 1750 – CAPITAL
http://www.access.gpo.gov/nara/cfr/waisidx_08/12cfr1750_08.html

Loss Severity Amendments:

RISK-BASED CAPITAL REGULATION - LOSS SEVERITY AMENDMENTS; FINAL RULE (6/10/2008)

RISK-BASED CAPITAL REGULATION - LOSS SEVERITY AMENDMENTS; FINAL RULE - CORRECTION OF FOOTNOTES (7/15/2008)

($ billions)

Fannie Mae Capital

Types of Capital	2005	2006	2007	1Q08
Core Capital	$39.4	$42.0	$45.4	$42.7
Total Capital	39.2	43.0	48.7	47.7
Shareholders' Equity	39.3	41.5	44.0	38.8
Net Fair Value of Assets	42.2	43.7	35.8	12.2

Capital Requirements	2005	2006	2007	1Q08
Core Capital	$39.4	$42.0	$45.4	$42.7
Minimum Capital Requirement	28.2	29.4	31.9	31.3
Surplus - $	**11.2**	**12.6**	**13.5**	**11.4**
Surplus - %	40%	43%	42%	36%
Core Capital	$39.4	$42.0	$45.4	$42.7
OFHEO-Directed Requirement	36.7	38.2	41.5	37.6
Surplus - $	**2.7**	**3.8**	**3.9**	**5.1**
Surplus - %	7%	10%	9%	14%
Total Capital	$39.2	$43.0	$48.7	$47.7
Risk Based Capital Requirement	12.6	26.9	24.7	23.1
Surplus - $	**26.6**	**16.1**	**24.0**	**24.6**
Surplus - %	211%	60%	97%	106%
Classification	←	Adequate	→	

Freddie Mac Capital

Types of Capital	2005	2006	2007	1Q08
Core Capital	$36.0	$36.2	$37.9	$38.3
Total Capital	36.8	36.7	40.9	42.2
Shareholders' Equity	27.2	28.3	26.7	16.0
Net Fair Value of Assets	30.9	31.8	12.6	(5.2)

Capital Requirements	2005	2006	2007	1Q08
Core Capital	$36.0	$36.2	$37.9	$38.3
Minimum Capital Requirement	24.8	25.6	26.5	26.9
Surplus - $	**11.2**	**10.6**	**11.4**	**11.4**
Surplus - %	45%	41%	43%	42%
Core Capital	$36.0	$36.2	$37.9	$38.3
OFHEO-Directed Requirement	32.5	33.6	34.4	32.3
Surplus - $	**3.5**	**2.6**	**3.5**	**6.0**
Surplus - %	11%	8%	10%	19%
Total Capital	$36.8	$36.7	$40.9	$42.2
Risk Based Capital Requirement	11.3	15.3	14.1	26.1
Surplus - $	**25.5**	**21.4**	**26.8**	**16.1**
Surplus - %	226%	140%	190%	62%
Classification	←	Adequate	→	

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