OFHEO

OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT

1700 G STREET NW WASHINGTON DC 20552 (202) 414-3800

September 20, 2002

The Honorable Richard H. Baker
Chairman
Subcommittee on Capital Markets, Insurance and
Government Sponsored Enterprises
U.S. House of Representatives
341 Cannon House Office Building
Washington, DC 20515

Dear Chairman Baker:

I am writing in response to your September 12, 2002 letter regarding OFHEO's recently published amendments to our risk-based capital rule for Fannie Mae and Freddie Mac (the Enterprises). The concerns raised in your letter focus on one change, which implements a revision related to Financial Accounting Standard 133 (FAS 133). I believe this change is necessary and appropriate.

As you note, the proposed FAS 133 revision addresses a critical element of the risk-based capital rule. It ensures that the risk-based requirement for total capital is measured in a way that is fully consistent with the way total capital is measured under FAS 133. For this reason, I've proposed to implement this change in time for the first capital classification utilizing the risk-based capital rule.

The proposed change would not have impacted either Enterprise's capital classification at the end of first quarter 2002 had the rule been in force and the change in effect. Both institutions met the risk-based capital requirement with substantial surpluses. Freddie Mac had a surplus of $14 billion and Fannie Mae had a surplus of $6 billion. The higher minimum capital requirements, which were binding, would have been unchanged. As you know, the binding capital requirement for an Enterprise in a particular quarter is whatever is higher, the minimum or risk-based capital requirement.

While FAS 133's mark to market requirement will obviously impact total capital and the risk-based capital requirement, it will not consistently raise or consistently lower capital requirements for the Enterprises over time. That impact in any given quarter will depend on the Enterprises' portfolios and market conditions. Therefore, I agree that the change is substantive, but it should not be viewed as either a benefit or detriment to the Enterprises. It is simply an improvement in the accuracy of the stress test.

You also express concern that a ten-day comment period is too short. In setting this time frame for public comment, I determined that it provided adequate time to receive comment and would ensure the capital measure was correct prior to the first classification. I believe this is the best and most appropriate way to do it. However, I will certainly give careful consideration to any commenters request for an extension, should any be submitted.

Congress created a one-year implementation period for the risk-based capital rule. The purpose of this implementation period was, in part, to provide the Agency an opportunity to fine-tune the rule prior to enforcement. The FAS proposed revision is an example of an area requiring such refinement.

The following provides more background on the legal and accounting issues in connection with the FAS 133 change. The 1992 Act requires that "total capital" be computed in accordance with GAAP and also specifies that the risk-based capital requirement should be an "amount of total capital." As of January 2001, FAS 133 changed GAAP to require that derivatives be marked to market, a process that discounts anticipated future cash flows to estimate a current market value. Some of the GAAP changes affect the measurement of total capital. The stress test, on the other hand, is not based upon market values, but uses a cash flow model to project the performance of financial instruments based upon fixed economic assumptions (loss rates and interest rates). After FAS 133 was implemented, it would have been an error to use total capital as the starting capital for the stress test, because the derivatives values would have already been adjusted to account for future cash flows and the subsequent modeling of the derivatives' cash flows would have amounted to double counting. Therefore, as the first step in the stress test, the mark-to-market adjustments required by FAS 133 are backed out to create the starting capital positions for the Enterprises. The risk-based capital rule promulgated last September includes this adjustment.

As we worked through the implementation issues earlier this year, we found that the 1992 Act and FAS 133 presented an additional issue for resolution. Although the rule correctly computed the amount of capital required by an Enterprise during the stress test, that "stress test capital" is not GAAP capital and, therefore, not "total capital" as required by the Act. For this reason, to comply strictly with the terms of the statute it is necessary to put back into the stress test capital at the end of the stress test the FAS 133 adjustment that had been backed out from the total capital at the start. Once our experience in the implementation period demonstrated that this conflict should be resolved, I moved quickly to propose the necessary revisions. Also, in response to your question on the relationship between FAS 133 and the statutory management add-on, the amendment's adjustment to capital requirements is made after the 30% add-on for management and operations risk.

Finally, let me assure you that we are on target to use third quarter 2002 data to make the first capital classifications based on both the leverage and risk-based capital requirements. OFHEO intends to publish these classifications by year-end 2002. In addition, we will comply with your request for how both Enterprises fare under the risk-based capital rule with and without the proposed amendment. In the interim, should you have any additional questions about this matter, please do not hesitate to contact me.

Sincerely,

Armando Falcon, Jr.
Director

cc: Honorable Paul E. Kanjorski