

Capital Regulation of Fannie Mae and Freddie Mac

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This memorandum discusses the regulatory capital regulations applicable to Fannie Mae and Freddie Mac (F&F). F&F are subject to two separate capital requirements -- a leverage ratio or "minimum capital level" test and a risk-based capital test. Both capital requirements are calculated as of every quarter-end date; in effect, snapshots of the GSEs' capital position are taken four times per year. What their capital levels are between the quarter-end dates is not known.

This memorandum, citing relevant sections of the U.S. Code dealing with F&F's capital requirements, also discusses the supervisory implications of not meeting those requirements. OFHEO, as F&F's safety-and-soundness regulator, is responsible for enforcing the sanctions that must be applied if Fannie or Freddie fails to meet a capital requirement.

The first capital definition, in 12 U.S.C. Sec. 4502(4), defines "core capital" as follows (**Bolding** is as it appears in the United States Code Annotated):

(4) Core capital

The term "core capital" means, with respect to an enterprise, the sum of the following (as determined in accordance with generally accepted accounting principles):

- (A)** The par or stated value of outstanding common stock.
- (B)** The par or stated value of outstanding perpetual, noncumulative preferred stock.
- (C)** Paid-in capital.
- (D)** Retained earnings.

The core capital of an enterprise shall not include any amounts that the enterprise could be required to pay, at the option of investors, to retire capital instruments.

This definition is used in the leverage ratio or "minimum capital level" test that F&F must meet on a quarterly basis. Note that this definition excludes "accumulated other comprehensive income" (AOCI), which in case of Fannie in recent years has been an "accumulated other comprehensive loss." On June 30, 2004, Fannie had "total stockholders' equity" of \$26.121 billion, as measured on a GAAP basis. That amount is net of a \$9.994 billion AOCI loss. Adding back the AOCI loss gave Fannie a total of \$36.115 billion of core capital, as defined above.

The other definition of capital used to regulate the adequacy of F&F's capital is "total capital," which is used in F&F's risk-based capital test. This measure of capital is defined in 12 U.S.C. Sec. 4502(18) as follows:

(18) Total capital

The term "total capital" means, with respect to an enterprise, the sum of the following:

- (A) The core capital of the enterprise.
- (B) A general allowance for foreclosure losses, which -
 - (i) shall include an allowance for portfolio mortgage losses, an allowance for nonreimbursable foreclosure costs on government claims, and an allowance for liabilities reflected on the balance sheet for the enterprise for estimated foreclosure losses on mortgage-backed securities; and
 - (ii) shall not include any reserves of the enterprise made or held against specific assets.
- (C) Any other amounts from sources of funds available to absorb losses incurred by the enterprise, that the Director by regulation determines are appropriate to include in determining total capital.

On June 30, 2004, Fannie reported total capital of \$36.862 billion, which consisted of \$36.115 billion of core capital plus \$80 million of "allowance for loan losses" on "loans held-for-investment" and \$677 million of "guarantee liability for MBS" minus \$10 million of "specific loss allowances." It is appropriate to add the allowance for loan loss and the guarantee liability for MBS to this calculation of "total capital" since risk-adjusting assets and contingent liabilities accomplishes the same purpose. Not adding back the loss allowance and the guarantee liability would effectively double-count this reduction in a GSE's net asset value. Apparently no amounts were added into capital under Subparagraph (C) above.

In order to be deemed to be "adequately capitalized" (the highest or toughest of the capital tests F&F face), a GSE must hold at least as much capital as required under both of the two capital tests. These tests are defined in 12 U.S.C. 4614(a)(1) as follows:

(1) Adequately capitalized

An enterprise shall be classified as adequately capitalized if the enterprise -

- (A) maintains an amount of total capital that is equal to or exceeds the risk-based capital level established for the enterprise under section 4611 of this title; and
- (B) maintains an amount of core capital that is equal to or exceeds the minimum capital level established for the enterprise under section 4612 of this title.

The required amount of capital needed in order to be deemed "adequately capitalized" under the risk-based capital test is determined under a very complex set of regulations formulated under the requirements spelled out in 12 U.S.C. Sec. 4611, as cited in Subparagraph (A) above.

Rather than copy that lengthy section into this memorandum, here is the link to it: <http://uscode.house.gov/uscode-cgi/fastweb.exe?getdoc+uscview+t09t12+5979+0++%28%29%20%20AND%20%28%2812%29%20ADJ%20USC%29%3ACITE%20AND%20%28USC%20w%2F10%20%284611%29%29%3ACITE%20%20%20%20%20%20%20%20%20>
The risk-based capital regulations formulated under Section 4611 can be found at 12 C.F.R. 1750, Subpart B, Appendix A.

The required amount of capital a GSE must hold in order to be deemed "adequately capitalized" under the leverage ratio or "minimum capital level" test (Subparagraph (B) above) is spelled out in 12 U.S.C. Sec. 4612(a); that section of the U.S. Code reads as follows:

(a) In general

For purposes of this subchapter, the minimum capital level for each enterprise shall be the sum of -

- (1) 2.50 percent of the aggregate on-balance sheet assets of the enterprise, as determined in accordance with generally accepted accounting principles;
- (2) 0.45 percent of the unpaid principal balance of outstanding mortgage-backed securities and substantially equivalent instruments issued or guaranteed by the enterprise that are not included in paragraph (1); and
- (3) 0.45 percent of other off-balance sheet obligations of the enterprise not included in paragraph (2) (excluding commitments in excess of 50 percent of the average dollar amount of the commitments outstanding each quarter over the preceding 4 quarters), except that the Director shall adjust such percentage to reflect differences in the credit risk of such obligations in relation to the instruments included in paragraph (2).

At June 30, 2004, Fannie's minimum capital level was \$31.118 billion, per its June 30, 2004, 10-Q (page 41, second line from the top of the page), \$4.927 billion less than its reported core capital. The components of Fannie's minimum capital level as follows:

On-balance-sheet assets (Paragraph (1) above): \$24.734 billion (\$989.341 billion x .025).

Guarantees on MBS owned by third-parties (Paragraph (2) above): \$6.120 billion (\$1,360.045 billion x .0045)

Other off-balance-sheet obligations (Paragraph (3) above): \$264 million. These other off-balance-sheet obligations were imputed to total to \$58.667 billion (\$264 million/.0045).

Fannie did not report its required risk-based capital at June 30, 2004, because that number had not yet been calculated when Fannie filed its 10-Q for that date. However, that number has not been relevant for either Fannie or Freddie since their required minimum capital has been their binding capital constraint; that is, they have held much less capital in excess of their required capital level than has been required under the risk-based capital test. This has been especially true at Freddie.

F&F are subject to a third capital test, "required critical capital," which is a lower capital level requirement that becomes relevant only if the GSE flunks one or both of the other capital tests. "Critical capital level" is defined in 12 U.S.C. Sec. 4613 as follows:

Sec. 4613. Critical capital levels

For purposes of this subchapter, the critical capital level for each enterprise shall be the sum of -

- (1) 1.25 percent of the aggregate on-balance sheet assets of the enterprise, as determined in accordance with generally accepted accounting principles;
- (2) 0.25 percent of the unpaid principal balance of outstanding mortgage-backed securities and substantially equivalent instruments issued or guaranteed by the enterprise that are not included in paragraph (1); and
- (3) 0.25 percent of other off-balance sheet obligations of the enterprise not included in paragraph (2) (excluding commitments in excess of 50 percent of the average dollar amount of the commitments outstanding each quarter over the preceding 4 quarters), except that the Director shall adjust such percentage to reflect differences in the credit risk of such obligations in relation to the instruments included in paragraph (2).

At June 30, 2004, Fannie reported that its core capital exceeded its required critical capital level by \$20.157 billion, an amount more than double its AOCI loss on June 30 of \$9.994 billion. Hence, Fannie would still be above its required critical capital level even if, under an earnings restatement, all of its AOCI had to be taken into earnings, thereby reducing its retained earnings and therefore both its core capital and its total capital, as measured for statutory purposes. However, Fannie might then be found to be either "undercapitalized" or "significantly undercapitalized," as determined under 12 U.S.C. Sec. 4614(a)(2) and (3), which read as follows:

(2) Undercapitalized

An enterprise shall be classified as undercapitalized if -

(A) the enterprise -

(i) does not maintain an amount of total capital that is equal to or exceeds the risk-based capital level established for the enterprise; and

(ii) maintains an amount of core capital that is equal to or exceeds the minimum capital level established for the enterprise; or

(B) the enterprise is otherwise classified as undercapitalized under subsection (b)(1) of this section.

(3) Significantly undercapitalized

An enterprise shall be classified as significantly undercapitalized if -

(A) the enterprise -

(i) does not maintain an amount of total capital that is equal to or exceeds the risk-based capital level established for the enterprise;

(ii) does not maintain an amount of core capital that is equal to or exceeds the minimum capital level established for the enterprise; and

(iii) maintains an amount of core capital that is equal to or exceeds the critical capital level established for the enterprise under section 4613 of this title; or

(B) the enterprise is otherwise classified as significantly undercapitalized under subsection (b)(2) of this section or section 4615(b) of this title.

If Fannie is found to be either undercapitalized or significantly undercapitalized, then it becomes subject to supervisory actions spelled out under 12 U.S.C. Sec. 4615, which reads as follows:

Sec. 4615. Supervisory actions applicable to undercapitalized enterprises

(a) Mandatory actions

(1) Capital restoration plan

An enterprise that is classified as undercapitalized shall, within the time period provided in section 4622(b) and (d) of this title, submit to the Director a capital restoration plan that complies with section 4622 of this title and carry out the plan after approval.

(2) Restriction on capital distributions

An enterprise that is classified as undercapitalized may not make any capital distribution that would result in the enterprise being reclassified as significantly undercapitalized or critically undercapitalized.

(b) Discretionary reclassification from undercapitalized to significantly undercapitalized

The Director may reclassify as significantly undercapitalized an enterprise that is classified as undercapitalized (and the enterprise shall be subject to the provisions of section 4616 of this title) if -

(1) the enterprise does not submit a capital restoration plan that is substantially in compliance with section 4622 of this title within the applicable period or the Director does not approve the capital restoration plan submitted by the enterprise; or

(2) the Director determines that the enterprise has failed to make, in good faith, reasonable efforts necessary to comply with the capital restoration plan and fulfill the schedule for the plan approved by the Director.

It is not clear what OFHEO would do, if anything, if Fannie was found, after an earnings restatement, to have been undercapitalized or significantly undercapitalized as of one or more quarter-end dates, but had since returned to an adequately capitalized condition.

The regulations implementing F&F's capital requirements will be found at 12 C.F.R. Part 1750 (Capital) while the regulations implementing supervisory actions by OFHEO will be found at 12 C.F.R. Part 1777 (Prompt Corrective Action).