



## REGULATORY INTERPRETATION 2010-RI-05

**Subject:** Investments in Unsecured Debt Issued by Fannie Mae and Freddie Mac

**Issue:** Whether a Federal Home Loan Bank (Bank) may consider the financial support to be provided by the Department of the Treasury to Fannie Mae and Freddie Mac (Enterprises) under the Senior Preferred Stock Purchase Agreements when calculating the maximum amount that it may invest in unsecured debt instruments issued by the Enterprises.

**Conclusion:** The applicable regulations would allow a Bank to deem the financial support provided by the Department of the Treasury to constitute a “similar comparable measure” that could be used in lieu of the total capital of the Enterprises in calculating the maximum amount of unsecured credit that a Bank may extend to an Enterprise. Under such an approach, the unsecured credit limit would be equal to the total capital of the investing Bank.

**Background:**

The regulations of the Federal Housing Finance Board (FHFB), which continue to apply to the Banks, generally limit the amount of unsecured credit that a Bank may have outstanding to any one counterparty. 12 C.F.R. § 932.9(a). Those regulations impose a separate limit on the amount of unsecured credit that a Bank may have outstanding to a government-sponsored enterprise, which limit applies to the Enterprises. 12 C.F.R. § 932.9(c). Under that provision, a Bank may extend unsecured credit to an Enterprise in an amount not to exceed the lesser of: (a) the total capital of the Bank, or (b) the total capital of the Enterprise, or “some similar comparable measure identified by the Bank.”<sup>1</sup> If a rating agency were to assign a credit rating of less than the highest investment grade, or were to downgrade, the senior debt of an Enterprise, the unsecured credit limit would be determined under the general provisions of § 932.9(a).

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<sup>1</sup> For purposes of this regulatory interpretation, references to an Enterprise’s “total capital” mean the measure of capital that is used to determine its compliance with its risk-based capital requirement. See 12 C.F.R. §§ 1750.2 (definition of core capital), 1750.11(n) (definition of total capital), 1750.13 (risk-based capital computation). That measure differs from total capital as determined under generally accepted accounting principles (GAAP), which generally is referred to as “equity” or “net worth” and represents the difference between total assets and total liabilities reported in the GAAP financial statements. Total GAAP capital includes, among other things, accumulated other comprehensive income, perpetual cumulative preferred stock (e.g., senior preferred stock) and minority interests that are not included in “total capital” for regulatory purposes. Total capital for regulatory purposes includes items, such as general loan loss allowances and mandatorily redeemable capital stock, that are not included in GAAP capital. Those differences do not affect this regulatory interpretation.

On September 6, 2008, the Federal Housing Finance Agency (FHFA) placed the Enterprises into conservatorship. In conjunction with that action, each Enterprise entered into a separate Senior Preferred Stock Purchase Agreement (SPSPA) with the United States Department of the Treasury (Treasury Department). Under the SPSPA, as amended, if an Enterprise's liabilities were to exceed its assets the Treasury Department has committed to provide the Enterprise with sufficient cash to eliminate that deficit, in exchange for senior preferred stock issued by the Enterprise.<sup>2</sup> The SPSPA effectively guarantees each Enterprise's senior and subordinated debt by ensuring the solvency of the Enterprise.<sup>3</sup>

Historically, the "total capital" of each Enterprise (determined under the regulations of the Office of Federal Housing Enterprise Oversight (OFHEO)) has been greater than the "total capital" of each of the Banks (determined under the FHFHB regulations), which has meant that each Bank could invest in an Enterprise's unsecured debt up to the amount of the Bank's total capital. Since the conservatorships, however, the "total capital" of both Enterprises has diminished considerably, with each Enterprise currently having negative amounts of "total capital". Those deficits, and the prospect for future deficits, have introduced uncertainty about how the Banks are to apply the unsecured credit limit of § 932.9(c) to the Enterprises. If the Enterprises' regulatory "total capital" were to remain negative, that would reduce the Banks' unsecured credit limit to zero, precluding further investments in Enterprise debt. That possibility has prompted inquiries about whether the financial commitment provided by the Treasury Department could be considered in determining a Bank's unsecured credit limit.

### ***Analysis:***

The regulatory limits on extensions of unsecured credit to an Enterprise contemplate that a Bank may use a "similar comparable measure" in lieu of an Enterprise's total capital in order to calculate the maximum amount of unsecured credit that the Bank may have outstanding to that Enterprise. 12 C.F.R. 932.9(c)(1)(ii).

The Treasury Department has committed to provide to each Enterprise periodic infusions of cash in return for the senior preferred stock, as necessary to eliminate any deficits that may result if the Enterprise's liabilities exceed its assets. As described above, the SPSPA establishes a minimum commitment of \$200 billion and allows the Treasury Department to increase its commitment as necessary to accommodate any cumulative reduction in the Enterprises' net worth over the next three years. The United States Department of Justice has determined that the Treasury Department's commitments under the SPSPAs constitute binding obligations on the United States that would be enforceable in a federal court.<sup>4</sup>

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<sup>2</sup> For purposes of the SPSPA, whether an Enterprise has a capital deficit is generally determined in accordance with GAAP.

<sup>3</sup> The Treasury Department commitment to each Enterprise under the SPSPA is the greater of (a) \$200,000,000,000 or (b) \$200,000,000,000 plus the cumulative total of the Enterprise's quarterly net worth deficits in calendar years 2010, 2011, and 2012, less any positive net worth determined as of December 31, 2012. Senior Preferred Stock Purchase Agreements, section 2.1 as amended Dec. 31, 2009. Thus, the total commitment against which each Enterprise may draw funds to eliminate net worth deficits always is at least \$200 billion.

<sup>4</sup> See Letter from Steven G. Bradbury, Principal Deputy Assistant Attorney General, to Henry M. Paulson, Jr., Secretary of the Treasury, dated September 26, 2008.

Although the commitment by the Treasury Department under the SPSPAs does not qualify as “total capital” under the OFHEO capital regulations applicable to the Enterprises, *see* 12 C.F.R. § 1750.11(n), it does serve the same purpose as total capital, in that it is available to absorb losses incurred by the Enterprises. More specifically, it absorbs losses that otherwise would cause the Enterprises to have negative net worth. Because the Treasury Department’s commitment is functionally comparable to the total capital measure that otherwise would be used in calculating the limit on extensions of unsecured credit, FHFA has determined that the Treasury Department’s commitment constitutes a “similar comparable measure,” as that term is used in 12 C.F.R. § 932.9(c)(1). Thus, a Bank may elect to substitute the Treasury Department’s commitment under the SPSPA for the total capital of an Enterprise when calculating its limit on extensions of unsecured credit to that Enterprise.

At present, the minimum amount of the Treasury Department’s commitments under the SPSPAs, \$200 billion, significantly exceeds the amount of “total capital” for each of the Banks. So long as that remains the case, a Bank could elect to use the Treasury Department’s commitment under the SPSPA as an alternative to an Enterprise’s total capital for purposes of calculating the unsecured credit limit under § 932.9(c)(1). In that event, the total capital of the Bank would in all cases be the lesser amount and thus would constitute the limit of unsecured credit that the Bank could have outstanding to that Enterprise.

Date: November 9, 2010 By:   
Alfred M. Pollard  
General Counsel

This Regulatory Interpretation is issued pursuant to 12 C.F.R. § 907.5 and is subject to modification or rescission by the Director of the Federal Housing Finance Agency.