

March 21, 2000

BY HAND DELIVERY

Alfred M. Pollard, Esq.
General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, N.W.
Washington, DC 20552

Dear Mr. Pollard:

Enclosed are our views on the question of whether the 1992 Act provides for a risk based capital regime that has the companies compute the capital requirements using OFHEO's model.

Please contact me if you have any questions or would like to discuss this analysis further.

Sincerely,

[signed: Thomas E. Donilon]

Thomas E. Donilon

cc: Eric Bruskin

THE LEGAL REQUIREMENTS FOR A RISK-BASED CAPITAL TEST

Question Presented:

Can OFHEO issue a risk-based capital test under the 1992 Act that allows Fannie Mae and Freddie Mac to compute capital requirements using OFHEO's model?

Short Answer:

Yes. The 1992 Act requires OFHEO to establish a risk-based capital test for the companies consistent with the parameters set forth in the law, but is silent on the method by which the actual calculation of the capital number is achieved. OFHEO thus would be entitled to substantial judicial deference under the *Chevron* doctrine in interpreting its implementing statute. Both the statute and the legislative history of the 1992 Act emphasize the flexibility available to the Director of OFHEO in making decisions with regard to the test that are not otherwise prescribed by Congress. In fact, this approach is consistent with the approach OFHEO currently takes to calculation of minimum capital. Additional support for this view is confirmed by the proposed risk-based capital test for Farmer Mac, under which Farmer Mac will calculate its capital using the specified test and report results to the regulator. The statute governing Farmer Mac's risk-based capital test is virtually identical to the 1992 Act and the Farm Credit Administration found its approach fully consistent with the statute.

Legal Discussion:

- **Statute is Silent.** Section 1361(a) of the 1992 Act simply states that “the Director shall, by regulation, establish a risk-based capital test ...” that “when applied to an enterprise shall determine the amount of total capital ... to maintain positive capital during a ten-year [stress] period.” The legal requirement is only that the test adopted by OFHEO be applied. The statute is silent as to where the calculation will take place. No other provision of the 1992 Act could be interpreted to preclude adoption of the suggested approach. OFHEO is entitled to substantial judicial deference under the *Chevron* doctrine in interpreting its implementing statute on a matter on which the statute is silent.
- **In contrast to the 1992 Act's silence on this point, the statute is very specific about the aspects of the test that OFHEO must specify by regulation.** For example, OFHEO's regulation must address the following major factors:
 - The historical period and region of the U.S. on which the credit losses should be based.
 - The yields on Treasury securities during the stress period relative to the 10-year Treasury yield.
 - The amount of a credit loss reduction in stress environments in which the 10-year Treasury yield increases by more than 50 percent over the average yield over the preceding 9 months.
 - The characteristics of mortgage purchases, securitizations, and financing conducted in connection with outstanding commitments.
 - Losses or gains on other activities including interest rate and foreign exchange hedging activities.

- Appropriate distinctions among types of mortgage products and mortgage seasoning.
 - Mortgage prepayment experience and dividend policies.
 - The statute also requires that the final risk-based capital regulations contain specific requirements, definitions, methods, variables, and parameters used under the risk-based capital test such as loan loss severity, float income, loan-to-value ratios, taxes, yield curve slopes, default experience, and prepayment rates.
- **OFHEO currently requires Fannie Mae and Freddie Mac to calculate minimum capital numbers and report them to OFHEO.** The suggested approach thus is consistent with current OFHEO practice with respect to capital calculation.
 - **Outside of these statutory requirements, the legislative history to the 1992 Act strongly emphasizes the discretion available to the Director of OFHEO in adopting a test methodology that is reasonable.** For example, the House Report to the Act states that in developing the risk-based capital test, “the Director will have to make many decisions concerning methodology and assumptions,” and provides that the Director should use “any methodology . . . generally recognized by experts as valid.”^{1/} Similarly, the Senate Report, while noting the “fairly detailed framework for capital regulation” states that the Director may to use “orders or guidelines” to implement the risk-based capital test. The Senate Report further explicitly states that the “provisions of this title...leave the Director with considerable flexibility in setting many key parameters...”² The House Report states that OFHEO’s risk-based capital regulatory emphasis should involve “examination and monitoring” with company cooperation, and be “conducted in a manner which does not unreasonably interfere with the normal decision-making and business activities of the enterprises.”^{3/} These statements clearly demonstrate that Congress left open the issue of methodology in implementing the risk-based capital test. Because the statute does not contain any provision relating to final capital calculation, the Director has discretion to prescribe the method by which this is accomplished. Calculation of capital numbers by the companies using OFHEO's model accomplishes this objective.
 - **OFHEO staff have recognized the legal flexibility that the 1992 Act grants to the Director.** Despite its legal analysis rejecting use of an "internal models" approach to implementing the risk-based capital test, OFHEO counsel noted that the Director has considerable discretion under the 1992 Act.⁴ According to OFHEO, this flexibility was used in developing section 3.11 of the proposed regulation addressing capital for innovative products. Calculation of capital numbers using company infrastructure is merely another way in which the Director may permissibly use his discretion. Using infrastructure to calculate capital numbers is not an "internal models" approach, since the calculation would be performed using

^{1/} H.R. Rep. No. 102-206, at 65 (1991).

² Sen. Rep. 102-282, at 19.

^{3/} H.R. Rep. No. 102-206, at 64-65.

⁴ Memorandum from A. Dewey, General Counsel, OFHEO to Mark Kinsey, Acting Director, OFHEO, December 10, 1998 at 3.

OFHEO's model -- therefore this legal position is not inconsistent with any prior OFHEO legal analysis.

- **Calculation of capital by the companies is not contrary to any other requirement of the 1992 Act.** The APA requirement of public notice and comment on the OFHEO specified model would be preserved. The OFHEO model would be available to the public and transparent as required by the 1992 Act.
- **Farmer Mac Precedent.** The Farmer Mac risk-based capital statutory framework is virtually identical to the statutory risk-based capital framework established by the 1992 Act. The Farm Credit Administration (FCA), under this construct, made a legal finding that its approach, including calculation of the final capital numbers, is consistent with the statute. Subject to verification and oversight (which would be emphasized in any risk-based capital test applied to Fannie Mae and Freddie Mac), the Farm Credit Administration proposes to combine regulator specification of model elements with substantial reliance on Farmer Mac to report test results. There has been no challenge to the FCA's legal authority to implement the risk-based capital mandate in the way it has proposed.