REGULATORY INTERPRETATION 2010-RI-1

Subject: Effect of SFAS 166/167 on Enterprise Statutory Minimum Capital Requirement

Issue: Whether an accounting change to require loans backing MBS that an Enterprise has guaranteed and sold to be consolidated onto the Enterprise balance sheet requires the Enterprise to hold the same level of capital against those MBS as against MBS they hold in portfolio?

Conclusion: No, the Safety and Soundness Act establishes a higher capital ratio for retained MBS than for MBS that are guaranteed and sold, and the Act did not contemplate that the accounting requirement to consolidate loans backing MBS guaranteed by the Enterprise onto the balance sheet might eliminate that distinction.

Summary and Background:

On June 12, 2009, the Financial Accounting Standards Board (FASB) issued FAS 167 which addresses the reporting effects of eliminating the rules covering Qualified Special Purpose Entities (QSPE) in effect under FAS 140 and FIN 46(R).[1] The effect of the new accounting standards is that the Enterprises will, for the first time, report as on-balance sheet assets mortgage-backed securities issued by trusts that the Enterprises control and guarantee. For the Enterprises, which report on a calendar year basis, FAS 167 is effective as of January 1, 2010.

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[1] FASB issued FAS 166 simultaneously with FAS 167. FAS 166 addresses requirements for assets which have been transferred to a separate entity to be derecognized from the balance sheet of the reporting company.

Previous accounting literature under FAS 140 and FIN 46(R) allowed assets contained in trusts that were formerly categorized as QSPEs to remain unconsolidated from the balance sheet of the sponsor of the trusts even though the sponsor may have retained a controlling financial interest in the economic performance, and power to direct the activities, of the trusts. FAS 167 heightens the reporting standards, requiring consolidation of trust assets where an Enterprise holds a controlling financial interest and "variable interest" in a "variable interest entity," and where the Enterprise holds the power to direct activities that would significantly affect the economic performance of the entity, and retains the obligation to absorb losses of, or the right to receive benefits from, the entity, either of which could potentially be significant to the variable interest entity. "Variable interest" is any "... contractual, ownership, or other pecuniary interests in an entity that change with changes in the fair value of the entity's net assets..." FIN 46(R), as amended by FAS 167. "Variable interest entity" is an entity that has one of these three characteristics: 1) total equity investment at risk is insufficient for the entity to self finance without additional support; 2) as a group, the equity holders lack (a) the power to direct activities that most significantly affect the entity's economic performance, (b) the obligation to absorb losses, or (c) the right to receive expected residuals of the entity; and 3) voting rights of some of the equity holders are not proportional to the obligation to absorb losses or receive returns, or substantially all the entity's activities are conducted on behalf of an investor with disproportionately few voting rights. FAS 167, para. 5.

The Federal Housing Enterprises Financial Safety and Soundness Act, as amended, (Safety and Soundness Act or Act) references "on-balance sheet assets" prescribing the Enterprises' minimum capital level. Sec. 1362(a)(1); 12 U.S.C. 4612(a)(1). And, the Safety and Soundness Act requires that the Enterprises' capital generally be calculated by reference to generally accepted accounting principles (GAAP). *Id.*; 12 U.S.C. 4613(a) (critical capital level). The Enterprises are required to report their financial condition in accordance with GAAP. *See* Federal National Mortgage Association Charter Act, sec. 309(k)(2)(A), 12 U.S.C. 1723a(k)(2)(A) (financial statements in accordance with GAAP); Federal Home Loan Mortgage Corporation Act, sec. 307(c)(2)(A), 12 U.S.C. 1456(c)(2)(A) (same). The new reporting standards under FAS 167, which change GAAP to require the consolidation of assets contained in securitized trusts onto the Enterprises' balance sheets without regard to whether the securities were sold or retained, raise the question of whether those changed standards automatically affect the required level of minimum capital for the Enterprises.

Staff concludes that the Safety and Soundness Act distinguishes, for purposes of minimum capital, mortgage assets that are retained "on-balance sheet" from "outstanding" mortgage assets guaranteed by the Enterprises that are not retained. As a result, the Enterprises' minimum capital requirements are not automatically affected by FAS 166 and 167.[2]

While the Enterprises are in conservatorship, the FHFA has suspended the capital requirements applicable to them. However, the Enterprises continue to be required to report the difference between their actual capital position and the required minimum, so the question posed by the change in accounting rules is a live one.

Analysis:

A. Impact of HERA on FHFA's minimum capital authority

On July 30, 2008, the President signed the Housing and Economic Recovery Act of 2008 ("HERA") into law. HERA established the Federal Housing Finance Agency ("FHFA") as the successor to Office of Federal Housing Enterprise Oversight (OFHEO). P.L. 110-289, 122 Stat. 2654. HERA maintains the Enterprises' existing minimum capital requirements. Pub. L. 110-289, Sec. 1111; Safety and Soundness Act, sec. 1362(a). In addition, HERA authorizes FHFA to establish, by regulation, new permanent minimum capital requirements that are higher than the requirements under existing statutory authority; to establish, by order, temporary minimum capital requirements for a particular regulated entity that are higher than either the statutory or

[2] Currently, FHFA requires the Enterprises to report data according to asset buckets corresponding to on-balance sheet assets and off-balance sheet assets in several categories to avoid double-counting. These data serve as the basis for determining the minimum capital requirement and the critical capital requirement, and any surplus or deficiency for those capital requirements. 12 U.S.C. 4612(a) and 4613(a). Because the language and structure of the critical capital provision mirror those of the minimum capital provision, the rationale supporting the statute's distinction of "on-balance sheet" assets from "outstanding" mortgage assets guaranteed but not retained by the Enterprise discussed in this Regulatory Interpretation applies equally to both the minimum capital and critical capital provisions.

regulatory minimum capital requirements; and to establish additional capital requirements for particular products or activities. *Id.*; Safety and Soundness Act, sec. 1362(c), (d), and (e).

B. The Safety and Soundness Act's minimum capital requirement sets different capital ratios for "outstanding" Enterprise-guaranteed MBS that are not retained, versus retained "on-balance sheet" MBS.

The Act establishes two capital requirements for the Enterprises – a minimum capital requirement and a risk-based capital requirement. In order for an Enterprise to be considered "adequately capitalized," its core capital must equal or exceed its minimum capital requirement, and its total capital must equal or exceed its risk-based capital requirement.[3] The minimum capital requirement is the sum of three components – 2.50 percent of the Enterprise's "on-balance sheet assets," 0.45% of the "unpaid principal balance of outstanding" MBS not already included in the on-balance sheet assets, and 0.45% of "other off-balance sheet obligations" not already included in the outstanding Enterprise-guaranteed MBS. 12 U.S.C. 4612(a).[4]

The Act's minimum capital requirement distinguishes between two groups of assets: (1) assets owned by the Enterprises, which the Act describes as "on-balance sheet," and (2) assets that are guaranteed but not owned by the Enterprises, which obligations are represented by the unpaid principal balance on "outstanding" MBS guaranteed by the Enterprises, which the Act describes as those "not included in" group (1), *i.e.*, not held in portfolio. The Act requires a capital ratio of 2.50 percent to support the assets in group (1). The Act requires a lower capital ratio (0.45 percent) to be applied to the principal balance of MBS in group (2).

C. The 0.45 percent requirement for "outstanding" MBS "not included in paragraph (1)" applies to Enterprise guarantee obligations for Enterprise-guaranteed MBS not retained in portfolio.

The Act established 0.45 percent as the benchmark capital ratio to cover the credit risk of MBS issued or guaranteed by the Enterprises. Specifically, the Act established the category of obligations consisting of the "unpaid principal balance of outstanding mortgage-backed

[3] 12 U.S.C. § 4614(a).

[4] The Act's minimum capital provision at 12 U.S.C. § 4612(a) states:

(a) . . . 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;
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> (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
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> (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).

securities and substantially equivalent instruments issued or guaranteed by the enterprise…." 12 U.S.C. § 4612. To avoid double-counting the MBS that the Enterprises purchase for their portfolios, the Act only applied this capital charge to MBS "that are not included in paragraph (1)," that is, to MBS that are not held in portfolio and thus receive the separate 2.5 percent charge. *Id.* In other words, Congress was using the on- and off-balance sheet accounting categories at the time of the Act's enactment to distinguish MBS held in portfolio versus MBS guaranteed and sold. Therefore, the most logical reading of the reference to the accounting treatments is that they are descriptive rather than prescriptive. Accordingly, it is reasonable for FHFA to interpret the Safety and Soundness Act to require that the capital ratios should apply to the MBS based on whether they are owned by the Enterprises or instead sold to investors, a distinction that Congress recognized, rather than the accounting treatment for the instrument, changes to which do not enhance the reporting of risks already known and associated with the MBS.

D. Congress understood the differences between assets held in portfolio and the obligations associated with securitized assets guaranteed by the Enterprises – and set different capital requirements for those categories of assets.

Throughout the lengthy legislative process, Congress discussed extensively the appropriate capital charge associated with MBS. Congress deliberately distinguished between mortgage-backed securities owned by the Enterprises in portfolio (referred to as "on-balance sheet assets") and mortgage-backed securities they do not own but as to which they guarantee timely payment of principal and interest from the underlying mortgages (referred to as "unpaid principal balance of outstanding mortgage-backed securities . . . issued or guaranteed by the enterprise"). For example, in the first version of the bill reported by the House in 1991, the minimum capital provision states:

> (a) In General – For purpose of this title, the minimum capital level for each enterprise shall be an amount of core capital equal to 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, and
>
> (2) 0.45 percent of the unpaid principal balance of outstanding mortgage backed securities and substantially equivalent instruments issued or guaranteed by the enterprise and other off-balance sheet obligations of the enterprise, excluding commitments to purchase mortgages or issue securities, as determined in accordance with generally accepted accounting principles.

H.R. Rept. No. 102-206 (Sept. 17, 1991), 18, sec. 202(a).

As described by a leading legislator, Congress determined that the 2.50 percent capital ratio would apply to "held assets" and the 0.45 percent capital ratio to "passed through assets." Cong. Rec., Sept. 25, 1991, H6833 (statement of Rep. Leach).

In 1992, the Senate reported its version of the legislation, adopting language different from, but similar to, that used in the House bill. The language of the 1992 Senate bill states:

> (a) In General – The minimum capital level for each enterprise shall be the sum of –
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> (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
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> (3) those percentages of off-balance-sheet obligations not included in paragraph (2) (excluding commitments with remaining terms of no more than 6 months to purchase mortgages or issue securities), that the Director determines best reflect the credit risk of such obligations or guarantees in relation to those included in paragraph (2).

S. Rept. 102-282 (May 15, 1992), 114, sec. 202(a). The Senate report explained that the provision "establishes a minimum capital level for each enterprise equal to the sum of 2.50 percent of GAAP assets, 0.45 percent of outstanding mortgage-backed securities not held by the enterprise, and percentages (as determined by the Director) to best reflect the relative credit risk of other off balance sheet obligations." *Id.* at 55. This statement affirms that Congress was differentiating the capital ratios based on whether the securities were held by the Enterprise in its portfolio.

The Senate report contemplated that OFHEO promulgate regulations to establish capital standards for category 3 obligations which are "off-balance sheet obligations" that are not included in category 2 obligations. The report defined category 2 obligations as those "outstanding mortgage-backed securities" (and similar securities) that are issued or guaranteed by the Enterprise and not included in category 1 assets. The report cautioned that "GSE securities . . . held directly by the GSEs should not be double-counted." *Id.* at 24. This structure indicates the intent to apply one capital ratio to the mortgage-backed securities held directly by the Enterprises, and a different capital ratio to the Enterprise-guaranteed mortgage-backed securities not held in portfolio.

While the House version referenced GAAP in describing the category of off-balance sheet obligations, the Senate version did not. This distinction suggests that GAAP is not the critical reference for setting the minimum capital requirements for Enterprise guarantee commitments stemming from Enterprise-guaranteed MBS that are not held in Enterprise portfolio.[5]

The final enacted version retained the language and structure of the Senate version with the exception that the enacted statute establishes a capital standard of 0.45 percent for "other off-balance sheet obligations" not already included in the category 2 guarantee obligations.

E. Congress premised "on-balance sheet" language on GAAP as it existed at the time, and intended for OFHEO to determine, as appropriate, the effects on capital requirements of any changes in GAAP.

The interpretation that the statutory term "on-balance sheet assets" excludes any Enterprise-guaranteed MBS not in portfolio is consistent with GAAP in effect at the time that the applicable provisions were enacted. At that time, GAAP did not require that mortgage loans underlying Enterprise-guaranteed mortgage-backed securities be included as assets on the Enterprise balance sheet. Therefore, the term "on-balance sheet assets" in the Act included only the category of mortgage-backed securities held in portfolio and specifically excluded Enterprise guarantee obligations on MBS not held in portfolio. There is no evidence that the reference to GAAP in § 4612(a) was intended to override a fundamental distinction drawn by Congress between assets held in the Enterprises' retained portfolios versus those sold to investors.

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FHFA's predecessor agency previously expressed dissatisfaction with the low level of the Enterprises' statutory capital requirements.[6] This Regulatory Interpretation does not opine on the correct capital level for purposes of sound prudential supervision, *i.e.*, whether the percentage established by statute is appropriate; only on what is the statutory requirement for minimum capital. Indeed, FHFA is implementing its risk-based capital authority by developing a new risk-based capital model for the Enterprises.[7] This Regulatory Interpretation does not make any

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[5] In contrast, the Sarbanes-Oxley Act, Pub. L. 107-204, authorized the SEC to recognize as generally accepted for purposes of securities laws which include public reporting and disclosure requirements, but not capital adequacy determination, any accounting principles established by a private standards setting body with certain characteristics such as those found in FASB. 15 USC 77s(b).

[6] *E.g.*, Statement of The Honorable James B. Lockhart III, Director, Office of Federal Housing Enterprise Oversight, on "Reforming the Regulation of the Government Sponsored Enterprises" before the Senate Banking, Housing and Urban Affairs Committee (February 7, 2008), p. 5 (required minimum capital level is low compared to other financial institutions); Statement of The Honorable James B. Lockhart III, Director, Office Of Federal Housing Enterprise Oversight, on "Legislative Proposals On GSE Reform" before the House Committee on Financial Services, U.S. House of Representatives (March 15, 2007), p. 6 (same).

[7] Existing risk-based capital regulations issued by FHFA's predecessor agency, Office of Federal Housing Enterprises Oversight (OFHEO), also bear on the question of adequate capital. 12 C.F.R. 1750, Subpt. B. The Safety and Soundness Act authorizes FHFA to "adjust" the minimum capital percentages for "outstanding commitments" not already included in determining the minimum capital for retained and unretained guaranteed assets. 12 U.S.C. 4612(a)(3). In addition, HERA amended the Safety and Soundness Act to authorize FHFA to increase the statutory minimum capital to the extent needed to ensure the safe and sound operation of the

prediction as to the effect of the risk-based capital model on the required capital levels of the Enterprises, other than that such risk-based capital levels will not necessarily have any relation to the leverage ratios of 2.5 percent of retained mortgage assets or 0.45 percent of "outstanding" guaranteed mortgage assets.[8] In addition, as part of the ongoing legislative work to address the country's current financial difficulties, Congress may address the subject of the Enterprises' capital levels in future legislation restructuring the Enterprises. This Regulatory Interpretation construes the existing statute.

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This Regulatory Interpretation is a staff interpretation and is subject to modification or rescission by the Director of the Federal Housing Finance Agency.

Enterprises. 12 U.S.C. 4612(c). FHFA reserves the authority to adjust the capital ratios for such commitments in the event that the Enterprises emerge from conservatorship still subject to the current statutory framework.

8 GAAP may not fully reflect the economic capital of an Enterprise. FHFA made this point in a recent letter to Chairman Barney Frank of the House Financial Services Committee dated Aug. 25, 2009, in which FHFA noted that "the statute's inclusion of GAAP assets into capital requirements may not appropriately measure economic risk, and yet nevertheless factor them into the calculations of an institution's regulatory capital and/or capital requirements." Examples include loan loss reserves which, because of the incurred loss methodology under GAAP, may overstate an Enterprise's capacity to absorb losses from any new shocks. Therefore, where GAAP requires the recognition of previously unrecognized assets on an Enterprise's balance sheet, the statutory minimum capital – to the extent it is pegged to GAAP -- may not fully reflect the economic risk to the Enterprise.