Mortgage-Backed Securities<sup>8</sup>

For MBS, the interim procedures apply the minimum capital ratio specified in section 1362(a)(2) of the Act. That section establishes a minimum capital ratio of 0.45 percent of the unpaid principal balance of outstanding MBS and substantially equivalent off-balance sheet instruments <sup>10</sup> that the Enterprises issue or guarantee. It only applies to MBS and substantially equivalent instruments that are not included among the onbalance sheet items of the Enterprises.

## Other Off-Balance Sheet Obligations

Section 1362(a)(3) of the Act 11 requires OFHEO to adjust the minimum capital ratios for off-balance sheet obligations other than MBS. That adjustment must reflect the differences between the credit risk of such obligations and the credit risk of MBS. That section further provides that commitments in excess of 50 percent of the average dollar amount of the commitments outstanding each quarter over the preceding four quarters are to be excluded from minimum capital level computations. The following discussion describes the interim procedures for determining minimum capital requirements for off-balance sheet obligations other than MBS.

## Commitments 12

OFHEO determined that there is no significant difference between the credit risk of commitments and the credit risk of MBS. Therefore, the interim procedures set a minimum capital ratio for commitments of 0.45 percent, which is applied to 50 percent of the average of the dollar amounts of commitments outstanding on the date for which the minimum capital level is being computed and the dates of the three preceding quarter-ends.

**Multifamily Credit Enhancements** 

Multifamily credit enhancements (MFCEs) are guarantees by an Enterprise of payments on multifamily mortgage revenue bonds issued by state and local housing finance agencies. The guarantees permit state and local agencies to obtain a lower cost of funds. The bonds are collateralized by multifamily mortgages to which the Enterprise has recourse in the event of a default. OFHEO concluded that the risk of MFCEs is most analogous to the risk of multifamily MBS. Therefore, the interim procedures apply the minimum capital ratio for MBS (0.45 percent) to the outstanding principal amount of bonds with MFCEs.

## Sold Portfolio Remittances Pending

Sold portfolio remittances pending are funds held in custodial accounts awaiting collection by one of the Enterprises for disbursement to the holders of MBS. The obligations associated with these funds arise from the MBS accounting cycle in the accounting system of one of the Enterprises. Once payments of mortgage principal are received by a sellerservicer and placed in custodial accounts, the Enterprise reduces the reported amount of the MBS, or sold portfolio. The Enterprise eventually passes the mortgage principal payments to MBS investors.

OFHEO concluded that the sold portfolio remittances pending are essentially part of MBS. Sold portfolio remittances pending are reflected separately only as a result of the accounting treatment used by one Enterprise. Therefore, the interim procedures apply the same minimum capital ratio for MBS (0.45 percent) to the dollar amount of sold portfolio remittances pending.

Interest Rate and Foreign Exchange Rate Contracts

The Enterprises use interest rate contracts <sup>13</sup> to obtain more desirable financing terms and hedge interest rate risk exposure. Fannie Mae uses foreign exchange rate contracts <sup>14</sup> to fix the United States dollar costs of debt issued in foreign currencies. The credit risk associated with interest rate and foreign

exchange rate contracts is the risk of loss that may result when a counterparty defaults.

Because the credit risk of interest rate and foreign exchange rate contracts is not fundamentally different than the risk of those contracts to banks and bank holding companies, the interim procedures apply substantially the same requirements as the risk-based requirements that are applicable to banks and bank holding companies. Those bank-related requirements are contained in guidelines that have been adopted by the Board of Governors of the Federal Reserve System at 12 C.F.R. Part 208, Appendix A, for state member banks, and at 12 C.F.R. Part 225, Appendix A, for bank holding companies; by the Comptroller of the Currency at 12 C.F.R. Part 3, Appendix A, for national banks; and by the Federal Deposit Insurance Corporation at 12 C.F.R. Part 325, Appendix A, for federally insured state nonmember banks (hereinafter referred to as the Guidelines).15

The Guidelines convert off-balance sheet items into balance sheet equivalents by determining a credit equivalent amount (CEA) for each item. Risk-weights are applied to the CEA based on the type of counterparty and on the extent to which qualifying collateral has been posted.

The CEA for interest rate and foreign exchange rate contracts is an estimate of the overall credit exposure associated with such contracts. Under the Guidelines, the CEA is the sum of two components: (1) the current exposure and (2) the potential future exposure. The current exposure (often referred to as "replacement cost") of a contract is equal to the contract's market value or zero, if its market value is negative. The potential future exposure of an interest rate or foreign exchange rate contract (often referred to as the "add-on") is calculated for each contract, regardless of its current market value. 16 Potential future exposure is calculated by multiplying the notional amount of the contract by a credit conversion factor, which is determined by the remaining maturity and by the type of the contract (0.0 percent for interest rate contracts expiring in less than one year and 0.5 percent for those expiring in more than

<sup>\*</sup>Mortgage-backed securities are defined in the proposed regulation as securities, investments, or substantially equivalent instruments that represent an interest in a pool of loans secured by mortgages or deeds of trust where the principal or interest payments to the investor in the security or substantially equivalent instrument are guaranteed or effectively guaranteed by an Enterprise.

<sup>912</sup> U.S.C. 4612(a)(2).

<sup>&</sup>lt;sup>10</sup> An off-balance sheet obligation is defined in the proposed regulation to mean a binding agreement, contract, or similar arrangement that requires or may require future payment(s) in money or kind by another party to an Enterprise or that effectively guarantees all or part of such payment(s) to third parties, where such agreement or contract is a source of credit risk for an Enterprise not included on its balance sheet.

<sup>11 12</sup> U.S.C. 4612(a)(3).

<sup>&</sup>lt;sup>12</sup> A commitment is defined in the proposed regulation to mean any contractual, legally binding arrangement that obligates an Enterprise to purchase mortgages for portfolio or securitization.

<sup>&</sup>lt;sup>13</sup> Interest rate contracts include single currency interest rate swaps, basis swaps, forward rate agreements, interest rate options purchased (including caps, collars, and floors), and other instruments that give rise to similar credit risks (including when-issued securities and forward deposits accepted).

<sup>&</sup>lt;sup>14</sup> Foreign exchange rate contracts include crosscurrency interest rate swaps, forward foreign exchange contracts, currency options purchased, and other instruments that give rise to similar credit

<sup>&</sup>lt;sup>15</sup> The Guidelines are based upon a framework developed jointly by supervisory authorities from the countries that are represented on the Basle Committee on Banking Regulations and Supervisory Practices.

<sup>&</sup>lt;sup>16</sup> Because the floating rates associated with basis swaps are highly correlated, potential future exposure is not material; the credit exposure for these contracts is evaluated solely on the basis of the mark-to-market values.