

comparatively new; therefore, the functioning of this market is less predictable in terms of operational and legal risk.

- Interest rate and foreign exchange rate contract exposures are not as fully-collateralized as are the mortgages underlying the Enterprises' MBS.

- There is no current stream of fee income to offset losses on interest rate and foreign exchange rate contracts associated with counterparty failures.

The effect of these differences is difficult to quantify. Derivative markets are relatively new. While the Enterprises have not experienced any losses on interest rate or foreign exchange rate contracts, recent losses by major participants make clear that the unexpected, sudden failure of a financial firm that is a counterparty is a risk that must be seriously considered.

Based on a weighing of these factors, the proposed regulation applies a higher ratio to the CEAs of interest rate and foreign exchange rate contracts than to MBS. The proposed regulation applies a ratio of 3.00 percent to uncollateralized exposure and a ratio of 1.50 percent to collateralized exposure. OFHEO believes that the proposed regulation will encourage prudent management of counterparty risk by reducing the capital requirement by half to the extent a counterparty posts collateral that qualifies under the Guidelines. This approach is consistent with a minimum capital level that focuses on the general risk characteristics of instruments rather than the credit quality of third parties.

The proposed regulation continues to allow the Enterprises to recognize the risk-reducing benefits of qualifying bilateral netting contracts. As under the interim procedures, the Enterprises are allowed to net positive and negative mark-to-market values of interest rate and foreign exchange rate contracts in the determination of the current exposure portion of the CEA.¹⁹

¹⁹ Proposals by the Comptroller of the Currency (59 FR 45243, Sept. 1, 1994) and the Board of Governors of the Federal Reserve System (59 FR 43508, Aug. 24, 1994) would make other changes to the Guidelines. First, they would increase the number of credit conversion factors that are used to measure the potential future exposure, subjecting contracts with longer maturities to higher factors. Second, they would set new credit conversion factors for contracts related to equities, precious metals, and other commodities. (These are not currently relevant to the Enterprises.) Finally, they would change the way that potential future exposure is calculated when the contracts are subject to a qualifying bilateral netting agreement, resulting in a reduction in the amount of capital required for the netted interest rate and foreign exchange rate contracts.

OFHEO will continue to review the progress of the banking agency proposals which permit similar risk-reducing benefits of netting in the calculation of potential future exposure and which address

In developing this proposal, OFHEO compared the results of the application of the interim procedures and the proposed regulation with respect to interest rate and foreign exchange rate contracts. For each of the past five quarters, OFHEO determined the weighted average capital ratio that resulted from the application of the interim procedures for all interest rate and foreign exchange rate contracts. The weighted average capital ratio for each Enterprise over this period ranged between 2.24 percent and 3.41 percent. Had the ratios in the proposed regulation been used, the average ratio for each Enterprise would have ranged from 2.32 percent to 3.00 percent. Thus, the application of the ratios in the proposed regulation will result in a minimum capital level roughly consistent with the minimum capital level under the interim procedures.

OFHEO considered the argument that because MBS are accorded a much lower capital ratio by the Act than MBS under the Guidelines, consistency requires that interest rate and foreign exchange rate contracts be accorded a similarly lower ratio. Unlike the Enterprises, institutions subject to the Guidelines do not issue MBS that are fully guaranteed by the institutions. The Guidelines would apply the same capital ratio to MBS backed by the issuers' guarantees as is applied to mortgages held in portfolio. Banks' mortgage loans held in portfolio are considerably more risky than the mortgages underlying the Enterprises' MBS because they are not as well-diversified, on average have experienced higher loss rates, are not required to be as well-collateralized, and are not protected by a stream of guarantee fee income.

OFHEO has also considered the argument that OFHEO should establish a low minimum capital ratio for interest rate and foreign exchange rate contracts in recognition of the steps the Enterprises take to manage that risk. Further, OFHEO has considered the argument that OFHEO should apply different minimum capital ratios for interest rate and foreign exchange rate contracts based on the specific counterparty risk of the contract. OFHEO believes that these arguments are inconsistent with the purpose of minimum capital requirements. The proposed minimum capital regulation is designed to establish an essential amount of capital that an Enterprise,

other issues identified in this proposal. OFHEO will make a determination of the appropriateness of the inclusion of these changes in the minimum capital regulation if and when these banking agency proposals become effective.

with given levels of outstanding business, must hold to address broad categories of risks. The minimum capital ratios should reflect risk inherent in types of instruments, not the Enterprises' current practices.

IV. Proposed Minimum Capital Regulation: Section-by-Section Summary

The proposed regulation sets forth the minimum capital requirements that will replace the interim procedures currently in use. The proposed minimum capital regulation also establishes procedures for the filing of minimum capital reports by the Enterprises each quarter, or at other times as required by the Director. The proposed minimum capital regulation also requires OFHEO to provide each Enterprise with notice and opportunity to comment on its capital classification. A summary of the treatment of the on- and off-balance sheet items, the filing procedures, and the notice of capital classification follows.

On-Balance Sheet Assets

The minimum capital ratio for on-balance sheet assets is specified in section 1362(a)(1) of the Act.²⁰ That section establishes a minimum capital ratio equal to 2.50 percent of the aggregate on-balance sheet assets of the Enterprises determined in accordance with GAAP. The proposed regulation adopts that ratio.

Mortgage-Backed Securities

Section 1362(a)(2) of the Act²¹ establishes a minimum capital ratio of 0.45 percent of the unpaid principal balance of outstanding MBS and substantially equivalent instruments issued or guaranteed by the Enterprises that are not included in the on-balance sheet assets of the Enterprises. The proposed regulation adopts that ratio.

Other Off-Balance Sheet Obligations

Section 1362(a)(3) of the Act²² also establishes a minimum capital ratio of 0.45 percent for all other off-balance sheet obligations, except as adjusted by the Director to reflect the differences in the credit risk of those off-balance sheet obligations in relation to MBS and substantially equivalent instruments. The proposed regulation continues the interim treatment for three of the four major categories of off-balance sheet obligations: (1) commitments will require capital equal to 0.45 percent of 50 percent of the average dollar amount

²⁰ 12 U.S.C. 4612(a)(1).

²¹ 12 U.S.C. 4612(a)(2).

²² 12 U.S.C. 4612(a)(3).