

# Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

## DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

### Office of Federal Housing Enterprise Oversight

#### 12 CFR Part 1750

RIN 2550-AA03

#### Minimum Capital

**AGENCY:** Office of Federal Housing Enterprise Oversight, HUD.

**ACTION:** Proposed rule.

**SUMMARY:** The Office of Federal Housing Enterprise Oversight (OFHEO) proposes to issue a regulation for determining the minimum capital requirement for the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation (collectively, the Enterprises). The proposed regulation defines the necessary terms and sets forth the methodology for computing the minimum capital level. The proposed regulation also establishes procedures for the filing of quarterly minimum capital reports by each Enterprise. In addition, the proposed regulation establishes procedures under which OFHEO will determine the capital classification of each Enterprise on a quarterly basis.

**DATES:** Written comments on the proposed regulation must be received by August 7, 1995.

**ADDRESSES:** All comments concerning the proposed regulation should be addressed to Anne E. Dewey, General Counsel, Office of Federal Housing Enterprise Oversight, 1700 G Street NW., 4th Floor, Washington, D.C. 20552. Copies of all communications received will be available for examination by interested parties at the Office of Federal Housing Enterprise Oversight.

**FOR FURTHER INFORMATION CONTACT:** Gary L. Norton, Deputy General Counsel (202/414-3800); or Michael P. Scott, Assistant Director, Office of Research, Analysis and Capital Standards (202/

414-3800), 1700 G Street NW., 4th Floor, Washington, D.C. 20552.

#### SUPPLEMENTARY INFORMATION:

##### I. Background

Title XIII of the Housing and Community Development Act of 1992, Pub. L. No. 102-550, known as the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, 12 U.S.C. 4501 *et seq.* (Act), established the Office of Federal Housing Enterprise Oversight (OFHEO). OFHEO is an independent office within the Department of Housing and Urban Development with responsibility for ensuring that the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) (collectively, the Enterprises) are adequately capitalized and operating in a safe and sound manner. Included among the express statutory authorities of the Director of OFHEO is the authority to issue regulations establishing the capital level requirements.<sup>1</sup>

On February 8, 1995, OFHEO published an Advance Notice of Proposed Rulemaking<sup>2</sup> as the first step toward developing the risk-based capital regulation required by section 1361 of the Act.<sup>3</sup> The risk-based capital requirements will be based on a stress test to be developed by OFHEO. The stress test will determine the amount of capital that an Enterprise must hold to absorb the projected losses associated with credit and interest rate risks during a ten-year period of economic stress. That amount plus an additional 30 percent to cover management and operations risks will constitute the risk-based capital level of the Enterprise.

Separate from the risk-based capital requirements, section 1362 of the Act prescribes the minimum capital requirement for the Enterprises.<sup>4</sup> Unlike the risk-based capital requirements, which are based on the stress test, the minimum capital level is computed largely on the basis of statutorily established ratios that are applied to certain defined on- and off-balance sheet items of the Enterprises.

An Enterprise's capital serves as a cushion to absorb financial losses, thereby reducing the risk of failure. As

specified by the Act, the minimum capital level of an Enterprise represents an essential amount of capital needed as protection against the broad categories of risk in its businesses. The minimum capital level is not designed to address the risks of specific exposures within these categories. In addition, none of the capital levels specified in the Act represents the amount needed by an Enterprise to operate safely and soundly under all circumstances.

Section 1364 of the Act<sup>5</sup> requires the Director of OFHEO to determine the capital classification of each Enterprise not less than quarterly. The proposed minimum capital regulation provides procedures for each Enterprise to file a minimum capital level report each quarter and at other times, as required by the Director. In addition, it implements the provisions of section 1368 of the Act,<sup>6</sup> which require OFHEO to provide each Enterprise with notice and an opportunity to comment on its capital classification.

##### II. Interim Procedures

As discussed below, the Act specifies the minimum capital ratios applicable to on-balance sheet assets and to certain off-balance sheet obligations, *e.g.*, mortgage-backed securities (MBS), but requires adjustment of the minimum capital ratio applicable to other off-balance sheet obligations. Following the appointment of the Director of OFHEO, OFHEO implemented the statutory minimum capital and capital classification provisions by establishing, through administrative action, interim procedures for computing the minimum capital level. These interim procedures will continue to be used until the effective date of the final minimum capital regulation.

##### *On-Balance Sheet Assets*

The interim procedures apply the minimum capital ratio applicable to on-balance sheet assets as specified in section 1362(a)(1) of the Act.<sup>7</sup> That section establishes a minimum capital ratio of 2.50 percent of the aggregate on-balance sheet assets of the Enterprises determined in accordance with generally accepted accounting principles (GAAP).

<sup>1</sup> Act, section 1313(b)(1) (12 U.S.C. 4513(b)(1)).

<sup>2</sup> 60 FR 7468, Feb. 8, 1995.

<sup>3</sup> 12 U.S.C. 4611.

<sup>4</sup> 12 U.S.C. 4612.

<sup>5</sup> 12 U.S.C. 4614.

<sup>6</sup> 12 U.S.C. 4618.

<sup>7</sup> 12 U.S.C. 4612(a)(1).

### *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.<sup>9</sup> 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 on-balance sheet items of the Enterprises.

### *Other Off-Balance Sheet Obligations*

Section 1362(a)(3) of the Act<sup>11</sup> 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*<sup>12</sup>

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.

<sup>8</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>9</sup> 12 U.S.C. 4612(a)(2).

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

<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.

### *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 seller-servicer 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

<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>14</sup> Foreign exchange rate contracts include cross-currency interest rate swaps, forward foreign exchange contracts, currency options purchased, and other instruments that give rise to similar credit risks.

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).<sup>15</sup>

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.<sup>16</sup> 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>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>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.

one year; 1.0 percent for foreign exchange contracts expiring in less than one year and 5.0 percent for those expiring in more than a year).

Once the CEA of an interest rate or foreign exchange rate contract has been determined, the amount of the contract is assigned a risk-weight (20 or 50 percent) appropriate to the counterparty or, if relevant, the nature of any collateral or guarantees. Total risk-weighted assets are then multiplied by 8.0 percent<sup>17</sup> to determine the amounts included in the Enterprise's minimum capital level.

The interim procedures allow the Enterprises to recognize the risk-reducing benefits of qualifying bilateral netting contracts as outlined in the Federal Reserve Board's final rule amending the risk-based capital guidelines (59 FR 62987, Dec. 7, 1994). Thus, the Enterprises may 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.

The interim procedures supplement the Guidelines in the area of foreign exchange rate contracts. Fannie Mae includes items associated with foreign exchange rate contracts on its balance sheet. With respect to such contracts, OFHEO determines the amount that would be required under the Guidelines and compares it to the amount that would result from applying the 2.50 percent ratio for on-balance sheet assets contained in the Act, and applies the higher amount.

### III. Basis for the Proposed Minimum Capital Regulation<sup>18</sup>

The proposed regulation continues the interim approach with respect to on-

<sup>17</sup> Eight percent represents the required ratio of total capital to risk-weighted assets contained in the Guidelines.

<sup>18</sup> In the course of developing this proposed regulation, OFHEO solicited and received comments and recommendations from the Enterprises regarding alternative approaches. One Enterprise asserted that a low minimum capital ratio for interest rate and foreign exchange rate contracts is justified because these contracts are not used for speculative purposes; credit losses on these contracts have not been experienced; the contracts are mostly executed under master netting agreements with counterparties that are investment-grade; and, depending on counterparty credit quality, require the posting of collateral or other credit enhancements. The Enterprise suggested that OFHEO continue to apply the Guidelines to calculate the CEA to measure the credit exposure of interest rate and foreign exchange rate contracts, but that OFHEO apply a fixed ratio of 0.45 percent to the CEA, rather than apply the 8.00 percent ratio and various risk-weights, as required by the Guidelines. The Enterprise suggested the elimination of risk-weights because it believes they do not measure credit quality. The Enterprise suggested that the enforcement of strict credit and performance standards for its counterparties,

balance sheet items, MBS, commitments, multifamily credit enhancements, and sold portfolio remittances pending. However, the proposed regulation modifies the interim approach with respect to interest rate and foreign exchange rate contracts. A discussion of how OFHEO arrived at the approach adopted by the proposed regulation follows.

The Act requires OFHEO to adjust the statutory minimum capital ratio applicable to any class of off-balance sheet obligations if the credit risk of that class of obligations differs from the credit risk of MBS. OFHEO believes that the credit risk of interest rate and foreign exchange rate contracts, as measured by their CEAs, is significantly greater than that of MBS. Accordingly, the proposed regulation contains a minimum capital ratio for interest rate and foreign exchange rate contracts that is higher than the ratio applicable to MBS. Under the proposed regulation, this ratio will be applied to the CEAs of these contracts. The proposed regulation provides a relatively lower ratio for exposures that are collateralized than for those that are not collateralized. However, the proposed regulation does not distinguish between different types of counterparties. The minimum capital amount associated with interest rate and foreign exchange rate contracts under the proposed regulation is not expected to be substantially different than it is under the interim procedures.

coupled with aggressive collateral requirements for credit exposure, eliminates the need for credit differentiation among counterparties and the corresponding risk-weights. The Enterprise also recommended that OFHEO's regulations reflect, without amendment, the proposed and final changes to the Guidelines related to the calculation of current and potential future exposure. These changes would incorporate the impact of bilateral netting in the calculation of credit exposure, extend the capital treatment under the Guidelines to activities other than interest rate and currency contracts, and add higher credit conversion factors for longer-term contracts.

The other Enterprise supported the application of the Guidelines to calculate the CEA and recommended that OFHEO apply, as a starting point, a capital ratio of 0.45 percent to that amount. It made further recommendations that would collectively have the effect of lowering the capital requirements, namely, that OFHEO consider: (1) easing the requirements under which bilateral netting contracts become "qualifying," enabling an institution to "net" and thus reduce its current and potential future exposure; (2) increasing the benefit of netting over what proposed amendments to the Guidelines provide by applying the "net-to-gross ratio" (the current net positive market value of swaps divided by their current gross positive market value) on a portfolio-wide basis rather than counterparty-by-counterparty, and applying it to 100 percent of the notional amount rather than 50 percent; and (3) adjusting the 0.45 percent capital ratio applied to the CEA of interest rate and foreign exchange rate contracts downward based on the credit ratings of the counterparties, collateral arrangements, and other credit enhancements.

### Risk of MBS

In developing the proposed regulation, OFHEO analyzed the relative risk of interest rate and foreign exchange rate contracts as compared with MBS. The source of credit risk of MBS to the Enterprises is the risk of defaults and losses on the underlying mortgages. Guarantee fees provide a continuing source of income to offset these losses.

The aggregate risk associated with the Enterprises' underlying mortgages is low because the Enterprises have—

- Very broad geographic diversification;
- Strict and consistent mortgage underwriting standards; and
- Requirements for minimum initial collateralization of 125 percent (*i.e.*, maximum 80 percent loan-to-value ratio) or supplemental mortgage insurance, as well as increasing levels of collateralization as loans amortize and property values increase.

Neither Enterprise has experienced a net credit loss on its MBS. Annual losses to date have ranged from two basis points to ten basis points (expressed as a percentage of the outstanding portfolio) and have been easily covered by guarantee fee income, which has ranged from 20 to 25 basis points.

### Risks of Interest Rate and Foreign Exchange Rate Contracts

The Enterprises limit the credit risk of interest rate and foreign exchange rate contracts by restricting their business to high quality counterparties and adjusting collateral requirements on the basis of the current replacement cost and counterparty credit quality of interest rate and foreign exchange rate contracts. Notwithstanding these limitations of risk, interest rate and foreign exchange rate contracts entail the following risks beyond those of MBS:

- Large swings in market rates, on which interest rate and foreign exchange rate contracts are based, may simultaneously increase exposure to, and risk of default by, one or more counterparties, which are typically financial firms.

- While losses may be infrequent, systemic problems could cause disproportionately high losses when they do occur.

- Counterparty risk is concentrated. The loss resulting from the default of a single counterparty could be many times larger than the amount of capital that would be associated with the application of a 0.45 percent capital ratio.

- The interest rate and foreign exchange rate contracts market is

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.<sup>19</sup>

<sup>19</sup> 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.<sup>20</sup> 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 Act<sup>21</sup> 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 Act<sup>22</sup> 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

<sup>20</sup> 12 U.S.C. 4612(a)(1).

<sup>21</sup> 12 U.S.C. 4612(a)(2).

<sup>22</sup> 12 U.S.C. 4612(a)(3).

of commitments outstanding each quarter over the preceding four quarters, (2) multifamily credit enhancements will require capital equal to 0.45 percent of the unpaid principal balance, and (3) sold portfolio remittances pending will require capital equal to 0.45 percent of the dollar amount.<sup>23</sup> Any individual interest rate and foreign exchange rate contract or group of contracts subject to a recognized netting agreement will require capital equal to 3.00 percent of the CEA, except to the extent that the Enterprises hold qualifying collateral. The portion of the CEA equal to the market value of the collateral for that contract or group of contracts will equal 1.50 percent.

#### *Minimum Capital Report*

The proposed regulation requires that each Enterprise file with the Director of OFHEO a minimum capital report each quarter or at other times, as required by the Director. The report will contain the information required by OFHEO in written instructions to the Enterprise, including, but not limited to, an estimate of the minimum capital level and an estimate of core capital overage or shortfall relative to the estimated minimum capital level. The proposed regulation provides the Director flexibility to determine the specific items to be included in the minimum capital report. The proposed regulation also addresses the timing, certification, and amendment of the report. The information provided by each Enterprise in the minimum capital report will be used by OFHEO in determining the capital classification of the Enterprise.

#### *Notice of Capital Classification*

Section 1368 of the Act<sup>24</sup> requires OFHEO to provide the Enterprises with notice of, and an opportunity to comment on, the proposed minimum capital classification. This proposed regulation provides that before OFHEO determines the capital classification of an Enterprise, OFHEO will provide the Enterprise with written notice of the proposed classification and a 30-day period during which each Enterprise may submit its views regarding the classification. The proposed regulation provides that OFHEO may extend the period for up to 30 days and may shorten the period to less than 30 days if the Director determines that the condition of an Enterprise so warrants. Following the expiration of the response

period, OFHEO will take into consideration any comments received from an Enterprise prior to issuing the final notice of capital classification.

#### *Regulatory Impact*

##### Executive Order 12606, The Family

This proposed regulation does not have potential for significant impact on family formulation, maintenance, and general well-being, and thus, is not subject to review under Executive Order 12606.

##### Executive Order 12612, Federalism

This proposed regulation has no federalism implications that warrant the preparation of a Federalism Assessment in accordance with Executive Order 12612.

##### Executive Order 12866, Regulatory Planning and Review

This proposed regulation has been reviewed by the Office of Management and Budget pursuant to Executive Order 12866.

##### Unfunded Mandates Reform Act of 1995

This proposed regulation does not include a federal mandate that may result in the expenditure by State, local, and tribal governments, in the aggregate, or by the private sector, of \$100,000,000 or more (adjusted annually for inflation) in any one year. As a result, this proposed regulation does not warrant the preparation of an assessment statement in accordance with the Unfunded Mandates Reform Act of 1995.

##### Regulatory Flexibility Act

This proposed regulation will not have significant economic impact on a substantial number of small entities.

##### Paperwork Reduction Act

This proposed regulation contains no information collection requirements that require the approval of the Office of Management and Budget pursuant to the Paperwork Reduction Act of 1980, 44 U.S.C. 3501 *et seq.*

#### **List of Subjects in 12 CFR Part 1750**

Minimum capital, capital classifications.

Accordingly, for the reasons set forth in the preamble, OFHEO proposes to amend Chapter XVII of Title 12 of the Code of Federal Regulations by adding Part 1750 to read as follows:

## **PART 1750—CAPITAL**

### **Subpart A—Minimum Capital**

#### Sec.

- 1750.1 General.
- 1750.2 Definition.
- 1750.3 Procedure and timing.
- 1750.4 Minimum capital level computation.
- 1750.5 Notice of capital classification.

### **Appendix A to Subpart A of Part 1750—Minimum Capital Level Components for Interest Rate and Foreign Exchange Rate Contracts**

### **Subpart B—[Reserved]**

**Authority:** 12 U.S.C. 4513, 4514, 4612, 4614, 4618.

### **Subpart A—Minimum Capital**

#### **§ 1750.1 General.**

The regulation contained in this Subpart A establishes the minimum capital requirements for each Enterprise. The board of directors of each Enterprise is responsible for ensuring that the Enterprise maintains capital at a level that is sufficient to ensure the continued financial viability of the Enterprise and in excess of the minimum capital level contained in this Subpart A.

#### **§ 1750.2 Definitions.**

For purposes of this Subpart A, the following definitions shall apply.

*Act* means the Federal Housing Enterprises Financial Safety and Soundness Act of 1992, found at Title XIII of the Housing and Community Development Act of 1992, Pub. L. No. 102-550, 12 U.S.C. 4501 *et seq.*

*Affiliate* means any entity that controls, is controlled by, or is under common control with, an Enterprise, except as otherwise provided by the Director.

*Commitment* means any contractual, legally binding arrangement that obligates an Enterprise to purchase mortgages for portfolio or securitization.

*Core Capital* (1) means the sum of—

- (i) the par or stated value of outstanding common stock,
- (ii) the par or stated value of perpetual, noncumulative preferred stock,
- (iii) paid-in capital, and
- (iv) retained earnings; and

(2) Does not include any amounts the Enterprise could be required to pay at the option of an investor to retire capital or debt instruments.

*Director* means the Director of OFHEO.

*Enterprise* means the Federal National Mortgage Association and any affiliate thereof or the Federal Home Loan

<sup>23</sup> Freddie Mac accounts for these funds held by seller-servicers in custodial accounts separately from MBS until principal payments are passed on to MBS investors. Fannie Mae includes these custodial accounts in its MBS accounts.

<sup>24</sup> 12 U.S.C. 4618.

Mortgage Corporation and any affiliate thereof.

*Foreign exchange rate contracts* means cross-currency interest rate swaps, forward foreign exchange contracts, currency options purchased, and any other instruments that give rise to similar credit risks.

*Interest rate contracts* means single currency interest rate swaps, basis swaps, forward rate agreements, interest rate options purchased (including caps, collars and floors purchased), and any other instruments that give rise to similar credit risks (including when-issued securities and forward deposits accepted).

*Mortgage-backed security* means a security, investment, or substantially equivalent instrument that represents 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.

*Multifamily credit enhancement* means a guarantee by an Enterprise of the payments on a multifamily mortgage revenue bond issued by a state or local housing finance agency.

*Notional amount* means the face value of the underlying financial instrument(s) on which an interest rate or foreign exchange rate contract is based.

*Off-balance sheet obligation* means 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 that is not included on its balance sheet.

*OFHEO* means the Office of Federal Housing Enterprise Oversight.

*Other off-balance sheet obligations* means all off-balance sheet obligations of an Enterprise that are not mortgage-backed securities or substantially equivalent instruments.

*Perpetual, noncumulative preferred stock* means preferred stock that (1) does not have a maturity date, (2) provides the issuer the ability and the legal right to eliminate dividends and does not permit the accruing or payment of impaired dividends, (3) cannot be redeemed at the option of the holder, and (4) has no other provisions that will require future redemption of the issue, in whole or in part, or that will reset the dividend periodically based, in whole or in part, on the Enterprise's current credit standing, such as auction rate, money market, or remarketable preferred stock, or that may cause the

dividend to increase to a level that could create an incentive for the issuer to redeem the instrument, such as exploding rate stock.

*Qualifying collateral* means cash on deposit, securities issued or guaranteed by the central governments of the OECD-based group of countries,<sup>1</sup> United States Government agencies, or United States Government-sponsored agencies, and securities issued or guaranteed by multilateral lending institutions or regional development banks.

#### § 1750.3 Procedures and timing.

(a) Each Enterprise shall file with the Director a minimum capital report each quarter or at such other times as the Director requires, in his or her sole discretion. The report shall contain the information that responds to all of the items required by OFHEO in written instructions to the Enterprise, including, but not limited to:

(1) estimate of the minimum capital level;

(2) estimate of core capital coverage or shortfall relative to the estimated minimum capital level;

(3) such other information as may be required by the Director.

(b) The quarterly minimum capital report shall be submitted not later than April 30, July 30, October 30, and January 30 of each year.

(c) Each minimum capital report shall be submitted in writing and in such other format as may be required by the Director.

(d) In the event an Enterprise makes an adjustment to its financial statements for a quarter or a date for which the information was requested, which would cause an adjustment to a minimum capital report, the Enterprise shall file with the Director an amended minimum capital report not later than 3 business days after the date of such adjustment.

(e) Each minimum capital report or any amended minimum capital report shall contain a declaration by an officer authorized by the board of directors of the Enterprise to make such a declaration, including, but not limited

<sup>1</sup> The OECD-based group of countries is comprised of all full members of the Organization for Economic Cooperation and Development (OECD), as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the Fund's General Arrangements to Borrow. The OECD includes the following countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Saudi Arabia has concluded special lending arrangements with the IMF associated with the IMF's General Arrangements to Borrow.

to a president, vice president, or treasurer, that the report is true and correct to the best of such officer's knowledge and belief.

#### § 1750.4 Minimum capital level computation.

(a) The minimum capital level for each Enterprise shall be computed by adding the following amounts:

(1) 2.50 percent times the aggregate on-balance sheet assets of the Enterprise;

(2) 0.45 percent times the unpaid principal balance of mortgage-backed securities and substantially equivalent instruments that were issued or guaranteed by the Enterprise;

(3) 0.45 percent of 50 percent of the average dollar amount of commitments outstanding each quarter over the preceding four quarters;

(4) 0.45 percent of the outstanding principal amount of bonds with multifamily credit enhancements;

(5) 0.45 percent of the dollar amount of sold portfolio remittances pending;

(6) (i) 3.00 percent of the credit equivalent amount of interest rate and foreign exchange rate contracts except to the extent of the current market value of posted qualifying collateral, computed in accordance with Appendix A to this subpart;

(ii) 1.50 percent of the credit equivalent amount of interest rate and foreign exchange rate contracts equal to the market value of posted qualifying collateral, computed in accordance with Appendix A to this subpart; and

(7) 0.45 percent of the outstanding amount of other off-balance sheet obligations, excluding commitments, multifamily credit enhancements, sold portfolio remittances pending, and interest rate contracts and foreign exchange rate contracts, except as adjusted by the Director to reflect differences in the credit risk of such obligations in relation to mortgage-backed securities.

(b) Any asset or financial obligation that can be properly classified in more than one of the categories enumerated in paragraphs (a)(1) through (7) of this section shall be classified in the category that yields the highest minimum capital level.

(c) As used in this section, the term "preceding four quarters" means the last day of the quarter just ended (or the date for which the minimum capital report is filed, if different), and the three preceding quarter-ends.

#### § 1750.5 Notice of capital classification.

(a) Pursuant to section 1364 of the Act (12 U.S.C. 4614), OFHEO is required to determine the capital classification of

each Enterprise on a not less than quarterly basis.

(b) The determination of the capital classification shall be made following a notice to, and opportunity to respond by, the Enterprise.

(1) Not later than 60 calendar days after the date for which the minimum capital report is filed, OFHEO will provide each Enterprise with a proposed notice of classification in accordance with section 1368 of the Act (12 U.S.C. 4618). The proposed notice shall contain the following information:

(i) the proposed classification;  
(ii) the proposed minimum capital level; and  
(iii) the summary computation of the proposed minimum capital level.

(2) Each Enterprise shall have a period of 30 calendar days following receipt of a proposed notice of classification to submit a response regarding the proposed classification. The response period may be extended for up to 30 additional calendar days at the sole discretion of the Director. The Director may shorten the response period with the consent of the Enterprise or without such consent if the Director determines that the condition of the Enterprise requires a shorter period.

(3) The Director shall take into consideration any response to the proposed notice received from the Enterprise and shall issue a final notice of capital classification for each Enterprise not later than 30 calendar days following the end of the response period in accordance with section 1368 of the Act (12 U.S.C. 4618).

#### **Appendix A to Subpart A of Part 1750—Minimum Capital Level Components for Interest Rate and Foreign Exchange Rate Contracts**

The minimum capital level components for interest rate and foreign exchange rate contracts are computed on the basis of the credit equivalent amounts of such contracts. Credit equivalent amounts are computed for each of the following off-balance sheet interest rate and foreign exchange rate instruments:

##### **1. Interest Rate Contracts**

- a. Single currency interest rate swaps.
- b. Basis swaps.
- c. Forward rate agreements.
- d. Interest rate options purchased (including caps, collars, and floors).
- e. Any other instrument that gives rise to similar credit risks (including when-issued securities and forward deposits accepted).

##### **2. Foreign Exchange Rate Contracts**

- a. Cross-currency interest rate swaps.
- b. Forward foreign exchange rate contracts.
- c. Currency options purchased.
- d. Any other instrument that gives rise to similar credit risks.

Foreign exchange rate contracts with an original maturity of 14 calendar days or less and instruments traded on exchanges that require daily payment of variation margins are excluded from the minimum capital level computation. Over-the-counter options purchased, however, are included and treated in the same way as the other interest rate and foreign exchange rate contracts.

##### **3. Calculation of Credit Equivalent Amounts**

a. The credit equivalent amount of an off-balance sheet rate contract that is not subject to a qualifying bilateral netting contract in accordance with this Appendix A is equal to the sum of the current exposure (sometimes referred to as the replacement cost) of the contract and an estimate of the potential future credit exposure over the remaining life of the contract.

b. The current exposure is determined by the mark-to-market value of the contract. If the mark-to-market value is positive, then the current exposure is the mark-to-market value. If the mark-to-market value is zero or negative, then the current exposure is zero. Mark-to-market values are measured in United States dollars, regardless of the currency or currencies specified in the contract, and should reflect changes in the relevant rates, as well as counterparty credit quality.

c. The potential future credit exposure of a contract, including a contract with a negative mark-to-market value, is estimated by multiplying the notional principal amount of the contract by a credit conversion factor. The Enterprises shall use the effective rather than the apparent or stated notional amount in this calculation. The credit conversion factors are:

Remaining maturity	Interest rate contracts (percent)	Foreign exchange rate contracts (percent)
One year or less .....	0.0	1.0
Over one year .....	0.5	5.0

d. Because foreign exchange rate contracts involve an exchange of principal upon maturity, and foreign exchange rates are generally more volatile than interest rates, higher conversion factors have been established for foreign exchange rate contracts than for interest rate contracts.

e. No potential future credit exposure is calculated for single currency interest rate swaps in which payments are made based upon two floating rate indexes, so-called floating/floating or basis swaps. The credit exposure on these contracts is evaluated solely on the basis of their mark-to-market values.

##### **4. Avoidance of Double Counting**

In certain cases, credit exposures arising from the interest rate and foreign exchange instruments covered by this Appendix A may already be reflected, in part, on the balance sheet. To avoid double counting such exposures in the assessment of capital adequacy, counterparty credit exposures

arising from the types of instruments covered by this Appendix A may need to be excluded from balance sheet assets in calculating the minimum capital level.

##### **5. Collateral**

The sufficiency of collateral and guarantees for off-balance sheet items is determined by the market value of the collateral in relation to the credit equivalent amount. Collateral held against a netting contract is not recognized for minimum capital level purposes unless it is legally available to support the single legal obligation credit by the netting contract. The only forms of collateral that are formally recognized by the minimum capital level framework are cash on deposit in the bank; securities issued or guaranteed by the central governments of the OECD-based group of countries,<sup>1</sup> United States Government agencies, or United States Government-sponsored agencies; and securities issued by multilateral lending institutions or regional development banks. Excess collateral held against one contract or a group of contracts for which a recognized netting agreement exists may not be considered.

##### **6. Netting**

a. For purposes of this Appendix A, netting refers to the offsetting of positive and negative mark-to-market values in the determination of a current exposure to be used in the calculation of a credit equivalent amount. Any legally enforceable form of bilateral netting (that is, netting with a single counterparty) of interest rate contracts and foreign exchange rate contracts is recognized for purposes of calculating the credit equivalent amount provided that:

i. The netting is accomplished under a written netting contract that creates a single legal obligation, covering all included individual contracts, with the effect that the Enterprise would have a claim to receive, or obligation to pay, only the net amount of the sum of the positive and negative mark-to-market values on included individual contracts in the event that a counterparty, or a counterparty to whom the contract has been validly assigned, fails to perform due to default, insolvency, liquidation, or similar circumstances.

ii. The Enterprise obtains a written and reasoned legal opinion(s) representing that in the event of a legal challenge—including one resulting from default, insolvency, liquidation, or similar circumstances—the relevant court and administrative authorities would find the Enterprise's exposure to be such a net amount under:

<sup>1</sup> The OECD-based group of countries is comprised of all full members of the Organization for Economic Cooperation and Development (OECD), as well as countries that have concluded special lending arrangements with the International Monetary Fund (IMF) associated with the Fund's General Arrangements to Borrow. The OECD includes the following countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, the Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States. Saudi Arabia has concluded special lending arrangements with the IMF associated with the IMF's General Arrangements to Borrow.

—The law of the jurisdiction in which the counterparty is chartered or the equivalent location in the case of noncorporate entities, and if a branch of the counterparty is involved, then also under the law of the jurisdiction in which the branch is located;

—The law that governs the individual contracts covered by the netting contract; and

—The law that governs the netting contract.

iii. The Enterprise establishes and maintains procedures to ensure that the legal characteristics of netting contracts are kept under review in the event of possible changes in relevant law.

iv. The Enterprise maintains in its files documentation adequate to support the netting of rate contracts, including a copy of the bilateral netting contract and necessary legal opinions.

b. A contract containing a walkaway clause is not eligible for netting for purposes of calculating the credit equivalent amount.<sup>2</sup>

c. By netting individual contracts for the purpose of calculating its credit equivalent amount, the Enterprise represents that it has met the requirements of this Appendix A and all the appropriate documents are in the Enterprise's files and available for inspection by OFHEO. OFHEO may determine that an Enterprise's files are inadequate or that a netting contract, or any of its underlying individual contracts, may not be legally enforceable under any one of the bodies of law described in this Appendix A. If such a determination is made, the netting contract may be disqualified from recognition for minimum capital level purposes or underlying individual contracts may be treated as though they are not subject to the netting contract.

d. The credit equivalent amount of rate contracts that are subject to a qualifying bilateral netting contract is calculated by adding the current exposure of the netting contract and the sum of the estimates of the potential future credit exposures on all individual contracts subject to the netting contract, estimated in accordance with section 3 of this Appendix A. Offsetting contracts in the same currency maturing on the same date will have lower potential future exposure as well as lower current exposure. Therefore, for purposes of calculating potential future credit exposure to a netting counterparty for foreign exchange rate contracts and other similar contracts in which notional principal is equivalent to cash flows, total notional principal is defined as the net receipts falling due on each value date in each currency.

e. The current exposure of the netting contract is determined by summing all positive and negative mark-to-market values of the individual contracts included in the netting contract. If the net sum of the mark-to-market values is positive, then the current exposure of the netting contract is equal to that sum. If the net sum of the mark-to-

market values is zero or negative, then the current exposure of the netting contract is zero. OFHEO may determine that a netting contract qualifies for minimum capital level netting treatment even though certain individual contracts may not qualify. In such instances, the nonqualifying contracts should be treated as individual contracts that are not subject to the netting contract.

f. In the event a netting contract covers contracts that are normally excluded from the minimum capital level computation—for example, foreign exchange rate contracts with an original maturity of fourteen calendar days or less, or instruments traded on exchanges that require daily payment of variation margin—an Enterprise may elect consistently either to include or exclude all mark-to-market values of such contracts when determining net current exposure.

#### Subpart B—[Reserved]

Dated: June 1, 1995.

**Aida Alvarez,**

*Director, Office of Federal Housing Enterprise Oversight.*

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## DEPARTMENT OF TRANSPORTATION

### Federal Aviation Administration

#### 14 CFR Part 39

[Docket No. 94-NM-72-AD]

#### **Airworthiness Directives; Boeing Model 757 Series Airplanes Equipped With Pratt & Whitney Engines**

**AGENCY:** Federal Aviation Administration, DOT.

**ACTION:** Supplemental notice of proposed rulemaking; reopening of comment period.

**SUMMARY:** This document revises an earlier proposed airworthiness directive (AD), applicable to certain Boeing Model 757 series airplanes, that would have required inspection of certain fuse pins, and replacement of certain fuse pins with certain other fuse pins. That proposal was prompted by the development of new corrosion-resistant steel fuse pins. This action revises the proposed rule by including a requirement for inspections of refinished straight fuse pins and replacement of cracked refinished straight fuse pins with certain other straight fuse pins. The actions specified by this proposed AD are intended to prevent cracking of the midspar fuse pins, which may lead to separation of the strut and engine from the wing of the airplane.

**DATES:** Comments must be received by June 29, 1995.

**ADDRESSES:** Submit comments in triplicate to the Federal Aviation Administration (FAA), Transport Airplane Directorate, ANM-103, Attention: Rules Docket No. 94-NM-72-AD, 1601 Lind Avenue, SW., Renton, Washington 98055-4056. Comments may be inspected at this location between 9:00 a.m. and 3:00 p.m., Monday through Friday, except Federal holidays.

The service information referenced in the proposed rule may be obtained from Boeing Commercial Airplane Group, P.O. Box 3707, Seattle, Washington 98124-2207. This information may be examined at the FAA, Transport Airplane Directorate, 1601 Lind Avenue, SW., Renton, Washington.

**FOR FURTHER INFORMATION CONTACT:** Carrie Sumner, Aerospace Engineer, Airframe Branch, ANM-120S, FAA, Transport Airplane Directorate, Seattle Aircraft Certification Office, 1601 Lind Avenue, SW., Renton, Washington 98055-4056; telephone (206) 227-2778; fax (206) 227-1181.

#### SUPPLEMENTARY INFORMATION:

#### **Comments Invited**

Interested persons are invited to participate in the making of the proposed rule by submitting such written data, views, or arguments as they may desire. Communications shall identify the Rules Docket number and be submitted in triplicate to the address specified above. All communications received on or before the closing date for comments, specified above, will be considered before taking action on the proposed rule. The proposals contained in this notice may be changed in light of the comments received.

Comments are specifically invited on the overall regulatory, economic, environmental, and energy aspects of the proposed rule. All comments submitted will be available, both before and after the closing date for comments, in the Rules Docket for examination by interested persons. A report summarizing each FAA-public contact concerned with the substance of this proposal will be filed in the Rules Docket.

Commenters wishing the FAA to acknowledge receipt of their comments submitted in response to this notice must submit a self-addressed, stamped postcard on which the following statement is made: "Comments to Docket Number 94-NM-72-AD." The postcard will be date stamped and returned to the commenter.

<sup>2</sup> A walkaway clause is a provision in a netting contract that permits a non-defaulting counterparty to make lower payments than it would make otherwise under the contract, or no payment at all, to a defaulter or to the estate of a defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the contract.