Existing Statutory Capital Requirements for Fannie Mae and Freddie Mac
Executive Summary

The Federal Housing Enterprises Financial Safety and Soundness Act of 1992 (Safety and Soundness Act) established the “minimum capital” required of Fannie Mae and Freddie Mac (the Enterprises). In July 2008, the Housing and Economic Recovery Act of 2008 (HERA), which amended the Safety and Soundness Act, maintained the existing minimum capital requirements in the Safety and Soundness Act, and authorized the Enterprises’ newly created regulator, the Federal Housing Finance Agency (FHFA or Agency), to “establish, by regulation, new permanent minimum capital requirements that are higher than the requirements under existing statutory authority.”

When FHFA placed Fannie Mae and Freddie Mac into conservatorships on September 6, 2008, the then-FHFA Director announced that the Enterprises’ ability to fulfill their mission had deteriorated due, in part, to deterioration in their earnings and capital. He stated, “[i]n particular, the capacity of their capital to absorb further losses while supporting new business activity is in doubt.” The following day, the U.S. Department of the Treasury (Treasury) and FHFA, as conservator for the Enterprises, executed Senior Preferred Stock Purchase Agreements (PSPAs) which have been subsequently amended. The PSPAs, as amended, contain two critical provisions:

- First, in any quarter in which an Enterprise’s net worth becomes negative, the Treasury is obligated to provide funds (subject to specified limits) to that Enterprise to restore it to positive net worth. For the period from July 2008 through December 31, 2011, the Enterprises incurred combined losses of $247 billion and required $187.5 billion in investment from Treasury. The Enterprises returned to profitability in 2012 and have not needed to draw on additional federal funds since then. As of June 30, 2017, $258 billion of Treasury funding remains available under the PSPAs.

- Second, in exchange for this investment, each Enterprise issued senior preferred stock to the Treasury that provides for cumulative quarterly dividends. Currently, quarterly dividends accrue on the senior preferred stock in an amount equal to the positive net worth reported on each Enterprise’s balance sheets minus a specified capital reserve amount (set to decline to zero in 2018). For the period 2008 through June 30, 2017, the Enterprises have paid approximately $270.9 billion in dividends to the Treasury. Pursuant to the PSPAs, quarterly dividend payments do not reduce the outstanding liquidation preference of the stock held by the Treasury.
Shortly after FHFA placed the Enterprises into conservatorships, it suspended their existing statutory and regulatory capital requirements. Pursuant to the third amendments to the PSPAs, the capital reserve of each Enterprise will be eliminated as of January 1, 2018. According to the Congressional Budget Office, the Enterprises’ “debt and mortgage-backed securities are now effectively guaranteed by the federal government, and that backing substitutes for the capital that the [Enterprises] would otherwise have needed to hold in order to back their guarantees.”

The Treasury Secretary and Chairman for the U.S. Senate Committee on Banking, Housing and Urban Affairs, have publicly stated that reform of the housing finance system is a key priority and that perpetual conservatorship of the Enterprises is not sustainable. While the Obama administration put forth a plan in 2011 to wind down the Enterprises, different proposals -- from Congress, lenders, think tanks, former policy makers and others -- have emerged since that time to reform the housing finance system and resolve the conservatorships. These proposals run the gamut from turning the Enterprises into shareholder-owned utilities to merging them into a single government-owned corporation. The FHFA Office of Inspector General (OIG) takes no position on the structure a reformed housing finance system should take or whether Fannie Mae or Freddie Mac, in any form, should emerge from that reform effort.

We recognize that some of the discussion over reform of the housing finance system has focused on recapitalizing the Enterprises and releasing them from conservatorship. FHFA-OIG defers to Congress and to the Trump administration to determine the merits of any proposal to recapitalize the Enterprises in the short or long term. Because of heightened public interest in the role of the Enterprises, if any, in the future structure of the housing finance system, FHFA-OIG prepared this white paper to explain the current statutory and regulatory capital requirements for the Enterprises under the 1992 Safety and Soundness Act (suspended since the Enterprises entered conservatorship in September 2008), the Enterprises’ reported capital shortfalls, and enhancements to capital requirements adopted by other financial regulators since 2008. FHFA-OIG takes no position on the merits of any such proposal and is issuing this white paper only to inform the discussion.

This report was prepared by Jacob Kennedy, Senior Investigative Evaluator. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this report.
This report has been distributed to Congress, the Office of Management and Budget, and others and will be posted on our website, www.fhfaoig.gov.

Kyle D. Roberts  
Deputy Inspector General for Evaluations
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<td>CCAR</td>
<td>Comprehensive Capital Analysis and Review</td>
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<td>Enterprises</td>
<td>Fannie Mae and Freddie Mac</td>
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<td>Federal Reserve</td>
<td>Board of Governors of the Federal Reserve System</td>
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<td>FHFA or Agency</td>
<td>Federal Housing Finance Agency</td>
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<td>GAAP</td>
<td>Generally Accepted Accounting Principles</td>
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<td>GSIB</td>
<td>Global Systemically Important Bank</td>
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<td>HERA</td>
<td>Housing and Economic Recovery Act of 2008</td>
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<td>LTV</td>
<td>Loan-to-Value</td>
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<td>MBS</td>
<td>Mortgage-backed securities</td>
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<td>OFHEO</td>
<td>Office of Federal Housing Enterprise Oversight</td>
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<td>PSPA</td>
<td>(Senior) Preferred Stock Purchase Agreement</td>
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<tr>
<td>Safety and Soundness Act</td>
<td>Federal Housing Enterprises Financial Safety and Soundness Act of 1992</td>
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<td>Treasury</td>
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Current Statutory and Regulatory Capital Requirements for the Enterprises

The purpose of capital is to provide a financial cushion to absorb unexpected losses and to support a business’ operations. Capital is commonly understood to amount to the difference between estimates of what the business owns (its assets) and what it owes (its liabilities). It is therefore available as a cushion in the event of losses. Consistent with this concept, FHFA has recognized that in the case of the Enterprises, capital provides a measure of assurance that the Enterprises will continue to operate, honor their obligations, and fulfill their statutory mission, without the need for a draw from the Treasury.

Congress, in enacting the Safety and Soundness Act in 1992, established minimum capital requirements for the Enterprises and those standards have been in place for the past 25 years. That Act requires the Enterprises to maintain minimum capital that is greater than or equal to:

- 2.5 percent of on-balance sheet assets, which include mortgage-backed securities (MBS), mortgage loans, and other investments the Enterprises hold in their respective investment portfolios;¹
- 0.45 percent of the unpaid principal balance of outstanding MBS not included in on-balance sheet assets, which include MBS the Enterprises issue and guarantee, but do not own and hold in their investment portfolios;² and
- 0.45 percent of “other off-balance sheet obligations.”³

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¹ The Enterprises own securities investments in their retained portfolios, such as Fannie Mae, Freddie Mac, and Ginnie Mae MBS; private-label securities; and commercial MBS. The PSPA mandates that the Enterprises continue to reduce this portfolio to $250 billion by December 31, 2018. See FHFA, Third Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement (Aug. 17, 2012) (online at www.fhfa.gov/Conservatorship/Documents/Senior-Preferred-Stock-Agree/2012-8-17_SPSPA_FannieMae Amendment3_508.pdf).

² The off-balance sheet MBS are assets issued and guaranteed, but not owned, by the Enterprises, represented by the unpaid principal balance of the underlying mortgages. FHFA Office of General Counsel’s (OGC) Regulatory Interpretation 2010-R1-1 (Jan. 12, 2010) at page 5, explains that “[t]he Senate report explained that the provision ‘establishes a minimum capital level for each [E]nterprise equal to the sum of 2.50 percent of [generally accepted accounting principles (GAAP)] assets, 0.45 percent of outstanding mortgage-backed securities not held by the [E]nterprise, and percentages (as determined by the Director) to best reflect the relative credit risk of other off balance sheet obligations.’”

³ The statutory language defining “minimum capital” appears at 12 U.S.C. § 4612(a). On January 12, 2010, FHFA’s OGC issued Regulatory Interpretation 2010-R1-1 that described several key terms defined in the Safety and Soundness Act (the OGC Interpretation). In this white paper, we adopt the description of the key terms in the OGC Interpretation.
HERA, passed in 2008, did not change the leverage ratios in the Safety and Soundness Act to calculate statutory minimum capital requirements for the Enterprises.

**Risk-Based Capital Requirements Imposed by Regulation**

The Safety and Soundness Act requires the regulator of the Enterprises to issue one of four statutorily defined capital classifications—Adequately Capitalized, Undercapitalized, Significantly Undercapitalized, or Critically Undercapitalized—for each Enterprise on a quarterly basis.\(^4\) Pursuant to the Safety and Soundness Act, an Enterprise can only be categorized as Adequately Capitalized for any quarter where its core capital equals or exceeds its minimum capital requirement and its total capital equals or exceeds its risk-based capital requirement.\(^5\)

The Safety and Soundness Act also directs the regulator of the Enterprises to set risk-based capital requirements for each Enterprise, taking into consideration the overall portfolio, a stressed market environment, and the effectiveness of its risk management practices. Pursuant to that statutory directive, OFHEO promulgated in September 2001 a stress test regulation by which the amount of risk-based capital would be determined. The risk-based stress test simulates the effects of ten years of adverse economic conditions on the existing assets, liabilities, and off-balance sheet obligations of the Enterprises to determine, as of a fixed point in time, how much capital each Enterprise would require to survive the economically stressful conditions of the test.

**Surplus Capital Requirements Imposed on Enterprises by Regulator**

The Safety and Soundness Act, as amended by HERA, authorized the regulator of the Enterprises to increase minimum capital requirements.\(^6\) FHFA’s predecessor regulatory agency for the Enterprises, the Office of Federal Housing Enterprise Oversight (OFHEO), relied on its authority under the Safety and Soundness Act to increase the Enterprises’ capital requirements. In 2004, OFHEO required the Enterprises to maintain a capital surplus over the minimum capital requirements to address shortcomings that it identified in the Enterprises’ risk management practices.\(^7\) OFHEO directed each Enterprise to maintain an additional 30% surplus over its minimum capital requirement.

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\(^4\) *See Appendix A for an explanation of each classification.*

\(^5\) *See 12 U.S.C. § 4614(a).*

\(^6\) The Safety and Soundness Act authorized OFHEO to take mandatory supervisory actions applicable to significantly undercapitalized Enterprises, including requiring the Enterprise to submit a “capital restoration plan.” The capital restoration plan “shall specify the level of capital the enterprise will achieve and maintain.” *See Safety and Soundness Act, at § 1366(a)(1) and § 1369C(a)(1).*

\(^7\) According to the 2007 Committee on Financial Services Report (May 9, 2007), “OFHEO concluded that Fannie Mae was ‘significantly undercapitalized’ in the third quarter of 2004, and required that the [E]nterprise’s minimum capital requirement be increased by 30% to strengthen its financial position.” On
capital in excess of the statutory minimum capital requirement.\(^8\) OFHEO reduced this surplus capital requirement from 30% to 20% in March 2008 to “increase mortgage market liquidity and market confidence.”\(^9\)

**Status of Enterprises’ Capitalization Immediately Prior and Subsequent to Conservatorship**

As of June 30, 2008, each Enterprise’s capital calculations reflected that they met the statutory requirements to be classified as Adequately Capitalized. Fannie Mae reported a surplus of core capital over statutory minimum capital of $14.3 billion and Freddie Mac reported a surplus of $8.4 billion. The following month, HERA was enacted into law. Among other things, HERA created the FHFA and charged it with supervision of the Enterprises. On September 6, 2008, FHFA used its authorities under HERA to place the Enterprises into conservatorship. At that time, the then-FHFA Director announced that the Enterprises’ ability to fulfill their mission had deteriorated due, in part, to deterioration in their earnings and capital. He stated, “[i]n particular, the capacity of their capital to absorb further losses while supporting new business activity is in doubt.”\(^10\) In Congressional testimony, the then-FHFA Director explained that the Enterprises were placed into conservatorship in part because of accelerating safety and soundness weaknesses, continued deterioration in market conditions, and the Enterprises’ inability to raise capital or to issue debt.\(^11\)

Shortly after placing the Enterprises into the conservatorship of FHFA in September 2008, the then-FHFA Director classified each Enterprise as undercapitalized, retroactive to June 30, January 28, 2004, OFHEO directed Freddie Mac to maintain a mandatory target capital surplus of 30 percent over its minimum capital requirement. Freddie Mac agreed to implement corrective measures as part of a consent order entered into with OFHEO on December 9, 2003.

\(^8\) OFHEO imposed the excess capital requirement on Freddie Mac on January 28, 2004, and on Fannie Mae on September 30, 2005.


2008, citing “significant questions about the sufficiency of [the Enterprises’] capital.” As of September 30, 2008, the Enterprises reported a combined $32.7 billion deficit of their core capital to the minimum capital requirements.12

**Suspension of Statutory Capital Requirements During Conservatorships**

In October 2008, the then-FHFA Director announced that, for the duration of the conservatorships, FHFA: (1) had suspended the capital classifications of the Enterprises; (2) did not intend to publish critical or risk-based capital levels; and (3) had determined that the existing statutory and regulatory capital requirements would not be binding.13 FHFA last published the minimum and risk-based capital levels for the Enterprises on October 9, 2008.14

At that time, FHFA directed each Enterprise to calculate and report quarterly (1) the difference between its capital reserve and the minimum statutory capital requirement and (2) the difference between the statutory minimum capital requirements and core capital. Some of the discussion over reform of the housing finance system has focused on recapitalizing the Enterprises and releasing them from conservatorship. FHFA-OIG defers to Congress and to the Trump administration to determine the merits of any proposal to recapitalize the Enterprises in the short or long term. Should a recapitalization proposal be pursued, the Safety and Soundness Act would require each Enterprise to have core capital that equals or exceeds its minimum capital requirement and total capital that equals or exceeds its risk-based capital requirement.15

**Current Capital Shortfalls of Each Enterprise**

Since October 2008, the capital classifications of the Enterprises have been suspended and the existing statutory and regulatory capital requirements have not been binding on the

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12 See Fannie Mae, SEC Filing (Form 10-Q), (as of Sept. 30, 2008) at 106; Freddie Mac, SEC Filing (Form 10-Q), (as of Sept. 30, 2008) at 138.


14 According to FHFA’s Examination Module for Capital, “[t]he Enterprises were subject to a risk-based capital test prior to Conservatorship. It was published in 2001, implemented in 2002, and suspended in 2011. FHFA does not currently use this model.” See FHFA, Examination Module –Capital, at 17 (online at www.fhfa.gov/SupervisionRegulation/Documents/Capital-Module.pdf).

15 See 12 U.S.C. § 4614(a); see also the OGC Interpretation (Jan. 12, 2010).
Enterprises. Pursuant to the third amendments to the PSPAs, the capital reserve amount of each Enterprise must decline by $600 million annually until the capital reserve reaches zero on January 1, 2018. According to the FHFA Director, “[the] most serious risk and the one that has the most potential for escalating in the future is the Enterprises’ lack of capital” because the dwindling reserves hamper the Enterprises’ ability “to weather quarterly losses...without making a draw against the remaining Treasury commitments under the PSPAs.”

While FHFA has suspended capital classifications during the conservatorship, it requires each Enterprise to report the minimum capital required by the Safety and Soundness Act and its shortfall from this statutory requirement. Fannie Mae reported that, as of December 31, 2016, it calculated the statutory minimum capital requirement to be $24.4 billion. Because Fannie Mae’s 2016 capital reserve pursuant to the PSPAs stood at $1.2 billion, its capital was $23.2 billion below its minimum statutory capital requirement. FHFA also requires each Enterprise to report the difference between the statutory minimum capital requirements and its core capital. As of December 31, 2016, Fannie Mae reported its core capital as negative $111.8 billion. It also reported the difference between the minimum statutory requirement and core capital, its “minimum capital deficiency,” of $136.2 billion. Put differently, Fannie Mae


17 Since August 2012, the Enterprises have been operating under the terms of the third amendment to the PSPA. The 2012 amendment modified the structure of dividend payments owed to Treasury and implemented a “positive net worth” model, in which Treasury takes the Enterprises’ entire positive net worth as dividends each quarter. The PSPA defines “net worth amount” as the total assets (excluding the PSPA Commitment and any unfunded amounts thereof) less total liabilities (excluding any obligation in respect of any capital stock of [the Enterprise], including [the PSPA]) as reflected on the Enterprise’s balance sheet, prepared in accordance with GAAP. See FHFA, Third Amendment to Amended and Restated Senior Preferred Stock Purchase Agreement (Aug. 17, 2012) (online at www.fhfa.gov/Conservatorship/Documents/Senior-Preferred-Stock-Agree/2012-8-17_SPSPA_FannieMae_Amendment3_508.pdf; see also www.fhfa.gov/Conservatorship/Documents/Senior-Preferred-Stock-Agree/2012-8-17_SPSPA_FreddieMac_Amendment3_N508.pdf).

18 Melvin L. Watt, Director of FHFA, Prepared Remarks at the Bipartisan Policy Center (Feb. 18, 2016).

19 The Enterprises last reported the OFHEO capital surcharge in their June 30, 2008, SEC form 10-Q filing. As of the September 30, 2008, SEC annual and quarterly filings, the Enterprises only report core capital to the statutory capital requirement.

20 The stated value of outstanding common stock is typically an element of core capital. According to the Enterprises’ SEC 10-K filings, Treasury’s senior preferred stock is not included in their calculation of core capital. FHFA maintains that Treasury’s senior preferred stock holdings comprise all, or almost all, of the difference between the statutory minimum capital requirements and core capital.

21 See Fannie Mae, SEC Filing (Form 10-K), at F-57 (as of Dec. 31, 2016).
would require $136.2 billion in capital in order to meet the minimum capital requirement for the Adequately Capitalized standard under the Safety and Soundness Act.\(^\text{22}\)

Freddie Mac calculated and reported the same information as of December 31, 2016. Freddie Mac calculated the minimum capital required by statute to be $18.9 billion. Because Freddie Mac’s 2016 capital reserve pursuant to the PSPAs stood at $1.2 billion, its capital was $17.7 billion below its statutory minimum capital requirement. As of December 31, 2016, Freddie Mac reported its core capital as negative $67.7 billion and the difference between the minimum statutory requirement and core capital to be negative $86.7 billion.\(^\text{23}\) Freddie Mac reported a “minimum capital deficit” of $86.7 billion, the capital it would require in order to meet the minimum capital requirement for the Adequately Capitalized standard under the Safety and Soundness Act.\(^\text{24}\) To meet the minimum capital requirement and achieve the Adequately Capitalized standard under the Safety and Soundness Act, the Enterprises would require $222.9 billion in capital as of December 31, 2016.

**Adequacy of the Capital Requirements in the Safety and Soundness Act and Actions by Other Federal Regulators to Increase Statutory Capital Requirements of Entities They Regulate**

In 2007 and 2008, the OFHEO Director testified before Congress that the statutory minimum capital requirements for the Enterprises, set in 1992 by the Safety and Soundness Act, were lower than requirements for other regulated financial institutions.\(^\text{25}\) He noted that, as of 2007, the Federal Home Loan Banks were required to hold 4 percent in minimum capital and major banks were required to hold over 6 percent in capital. He observed that the differential “may be an indication that the present requirement [for the Enterprises was] too low.”

Ten years after his testimony, the statutory minimum capital requirements remain unchanged, although these requirements have been suspended since October 2008. FHFA officials with whom we spoke voiced the opinion that the minimum capital requirements established in the

\(^\text{22}\) Because FHFA announced on October 9, 2008, that the Enterprises are only required to report minimum capital, core capital, and GAAP net worth figures in the Enterprises’ quarterly SEC form 10-Q and 10-K filings, this white paper only discusses the Enterprises’ deficits of minimum capital, not risk-based capital.

\(^\text{23}\) See Freddie Mac, *SEC Filing (Form 10-K)*, at 332 (as of Dec. 31, 2016).

\(^\text{24}\) Apart from the PSPAs, the significant shortfall in the capital reserves by both Enterprises is driven, in large measure, by their negative retained earnings caused by their losses from 2008-2012.

\(^\text{25}\) See Statement of The Honorable James B. Lockhart III, Director, OFHEO, on “Legislative Proposals on GSE Reform” before the House Committee on Financial Services, U.S. House of Representatives (Mar. 15, 2007), at page 6; and Statement of The Honorable James B. Lockhart III, Director, OFHEO, on “Reforming the Regulation of the Government-Sponsored Enterprises” before the Senate Banking, Housing and Urban Affairs Committee (Feb. 7, 2008), at page 5 (the minimum capital requirement set in the statute is low compared to other financial institutions).
Safety and Soundness Act of 1992—45 basis points for the Enterprises’ MBS guarantees—is inadequate and not realistic. A FHFA senior official characterized the statutory leverage requirements as “unconscionably low” in a 2013 white paper he co-authored prior to joining FHFA. In May 2017, the Chief Executive Officer of Freddie Mac remarked that the 45 basis point capital requirement on guarantees was implicitly a subsidy in that it was lower than normal market requirements, and currently the right level is estimated to be five to ten times the 1992 level.26

The Board of Governors of the Federal Reserve System (Federal Reserve) adopted new capital rules (including leverage capital requirements) that require large banking organizations to hold “substantially larger amounts of high-quality capital” than they held prior to the crisis.27 (Similar to the FHFA, the Federal Reserve recognizes that “the primary function of capital is to support the bank’s operations, act as a cushion to absorb unanticipated losses and declines in asset values that could otherwise cause a bank to fail, and provide protection to uninsured depositors and debt holders in the event of liquidation.”28) In addition, the new capital rules impose risk-based and leverage capital surcharges for global systemically important banks (GSIBs),29 mandating that such firms “hold larger amounts of loss-absorbing capital than other firms.”30

26 Freddie Mac CEO Donald Layton made this comment during his keynote address at the Credit Risk Transfer Symposium (hosted by the Information Management Network and Andrew Davidson & Co.) on May 15, 2017.


28 See Board of Governors of the Federal Reserve System, Capital Guidelines and Adequacy (online at www.federalreserve.gov/supervisionreg/topics/capital.htm).

29 The Financial Stability Board (FSB), established in April 2009 as successor to the Financial Stability Forum, is an international body that monitors and makes recommendations about the global financial system. In 2011, FSB launched an effort to determine the additional capital buffers required by the initial group of GSIBs based on the relative threat that GSIB poses to the financial system. Since 2011, the FSB identifies GSIBs, which are subject to up to 3.5 percent additional capital buffer requirements, by their national authorities (such as the Federal Reserve). For 2016, the FSB assigned thirty GSIBs to buckets that required 1.0 percent to 2.5 percent capital surcharges in addition to the capital required by the firm’s prudential regulator. No GSIB was placed into the 3.5 percent additional capital buffer bucket. See FSB, 2016 List of Global Systemically Important Banks (Nov. 21, 2016) (online at www.fsb.org/wp-content/uploads/2016-list-of-global-systemically-important-banks-G-SIBs.pdf).

In 2013, the Federal Reserve finalized several risk-based capital requirements that included raising the minimum tier 1 capital ratio\textsuperscript{31} from 4 percent to 6 percent and a new “capital conservation buffer” of 2.5 percent for all banks.\textsuperscript{32} In 2015, the Federal Reserve finalized its capital rule for U.S. GSIBs, to be implemented starting in 2016 and fully effective on January 1, 2019. Under that new capital rule, the estimated surcharges for the eight U.S. GSIBs will range from 1.0 to 4.5 percent of each firm’s total risk-weighted assets.\textsuperscript{33} Finally, in 2016, the Federal Reserve implemented yet another capital requirement, the countercyclical capital buffer, to apply to large banks “during periods of rising vulnerabilities in the financial system.”\textsuperscript{34}

Beyond setting capital rules, the Federal Reserve also recognized the importance of supervisory stress testing as part of its post-crisis prudential regulation. In 2010, the Federal Reserve implemented a “forward-looking assessment” to evaluate the capital adequacy and capital planning processes of U.S. bank holding companies.\textsuperscript{35} Through its Comprehensive Capital Analysis and Review (CCAR) program, the Federal Reserve sets capital ratios and assesses the bank holding company’s overall capital adequacy and whether the capital provides an adequate buffer for losses during stress scenarios.

The impact of these enhanced capital requirements and additional buffers becomes evident when compared to the capital requirements in place prior to the financial crisis. For example, in 2007, the Federal Reserve required large financial institutions like JPMorgan Chase to

\textsuperscript{31} Tier 1 capital is equity capital and disclosed reserves.

\textsuperscript{32} The new rules contain several components “[c]onsistent with the international Basel framework”: (1) a new minimum ratio of common equity tier 1 capital to risk-weighted assets of 4.5 percent; (2) a common equity tier 1 capital conservation buffer of 2.5 percent of risk-weighted assets that will apply to all supervised financial institutions; (3) increase in the minimum ratio of tier 1 capital to risk-weighted assets from 4 percent to 6 percent; (4) a minimum leverage ratio of 4 percent for all banking organizations; and (5) for the largest, most internationally active banking organizations, a new minimum supplementary leverage ratio that takes into account off-balance sheet exposures. See Press Release, Federal Reserve Board Approves Final Rule to Help Ensure Banks Maintain Strong Capital Positions (July 2, 2013) (online at www.federalreserve.gov/newsevents/pressreleases/bcreg20130702a.htm).

\textsuperscript{33} The eight U.S. firms currently identified as GSIBs are: Bank of America Corporation, The Bank of New York Mellon Corporation, Citigroup, Inc., The Goldman Sachs Group, Inc., JPMorgan Chase & Co, Morgan Stanley, State Street Corporation, and Wells Fargo & Company. There is no firm in FSB’s 3.5 percent bucket.

\textsuperscript{34} The countercyclical capital buffer supplements the Federal Reserve’s minimum capital requirements and other capital buffers. This buffer applies to banking organizations with more than $250 billion in assets or $10 billion in on-balance sheet foreign exposures and to any depository institution subsidiary of such organizations.

\textsuperscript{35} In what the Federal Reserve considers a “cornerstone of its supervision” of these financial institutions, the Federal Reserve annually assess whether the largest U.S. bank holding companies have “sufficient capital to continue operations throughout times of economic and financial stress and that they have robust, forward looking capital-planning processes that account for their unique risks.” Results of the annual assessments are published on the Federal Reserve website. See Federal Reserve, CCAR by Year (online at www.federalreserve.gov/supervisionreg/ccar-by-year.htm).
maintain a 4 percent minimum tier 1 capital ratio on its risk-weighted assets. For JPMorgan Chase, with over $1.0 trillion in assets in 2007, it needed to maintain a minimum tier 1 capital of $42.1 billion to meet the minimum capital requirement. In 2016, JPMorgan Chase, designated as a GSIB, was required to maintain a minimum tier 1 capital ratio of 6 percent plus capital surcharges of at least 1.75 percent on its total risk-weighted assets of nearly $1.5 trillion. As a consequence, JPMorgan Chase must hold tier 1 capital of almost $113.5 billion to meet the minimum and capital surcharge requirements.

As the chair of the Federal Reserve Board of Governors has testified, the Federal Reserve increased capital requirements so that GSIBs and large banks will be more resilient to stress. Through stress testing, the Federal Reserve assesses whether the GSIBs and large banks maintain a capital buffer to incur losses during stress scenarios. A review by the Federal Reserve in 2016 of its CCAR program, which is intended in part to set capital ratios and assess the GSIBs capital adequacy, noted it expects their capital requirements to rise. At this juncture, it remains to be seen whether the increased capital requirements will enable GSIBs and large banks to tolerate significant stress.

CONCLUSIONS

For the past few years, different proposals have emerged to reform the housing finance system and resolve the conservatorship. While the Obama administration put forth a plan in 2011 to wind down the Enterprises, different proposals -- from Congress, lenders, think tanks, former policy makers and others -- have emerged since that time to reform the housing finance system and resolve the conservatorship. These proposals run the gamut from turning the Enterprises into shareholder-owned utilities to merging them into a single government-owned corporation.

FHFA-OIG takes no position on the form that housing finance system should take, or whether Fannie Mae or Freddie Mac, in any form, will emerge from that reform effort. We recognize that some of the discussion over reform of the housing finance system has focused on recapitalizing the Enterprises and releasing them from conservatorship. FHFA-OIG defers to Congress and to the Trump administration to determine the merits of any proposal to recapitalize the Enterprises in the short or long term. Because of heightened public interest in the role of the Enterprises, if any, in the future structure of the housing finance system, FHFA-OIG prepared this white paper to explain the current statutory and regulatory capital requirements for the Enterprises under the 1992 Safety and Soundness Act (suspended since the Enterprises entered conservatorship in September 2008), the Enterprises’ reported capital shortfalls, and enhancements to capital requirements adopted by other financial regulators since 2008. FHFA-OIG takes no position on the merits of any such proposal and is issuing this white paper only to inform the discussion.
OBJECTIVE, SCOPE, AND METHODOLOGY ........................................

The objective of this white paper was to explain the current statutory and regulatory capital requirements for the Enterprises (suspended since the Enterprises entered conservatorship in September 2008), the Enterprises’ reported capital shortfalls, and enhancements to capital requirements adopted by other financial regulators since 2008.

To achieve these objectives, we met with FHFA officials, reviewed statutory and regulatory capital requirements and levels for the Enterprises, reviewed capital requirements for the Federal Reserve, and reviewed capital standards set by the Financial Stability Board. The performance period for this whitepaper was February 2017 to June 2017.

This white paper was conducted under the authority of the Inspector General Act and in accordance with the Council of the Inspectors General on Integrity and Efficiency’s Quality Standards for Inspection and Evaluation (January 2012). These standards require us to plan and perform an evaluation based on evidence sufficient to provide reasonable bases to support its conclusions. We believe that this white paper meets these standards.
APPENDIX A: STATUTORY CAPITAL CLASSIFICATIONS ............

Adequately Capitalized

The Enterprise maintains an amount of total capital that is equal to or exceeds the risk-based capital level established for the Enterprise and an amount of core capital that is equal to or exceeds the minimum capital level established for the Enterprise.

Undercapitalized

The Enterprise does not maintain an amount of total capital\(^{37}\) that is equal to or exceeds the risk-based capital level established for the Enterprise but maintains an amount of core capital that is equal to or exceeds the minimum capital level. When classified as undercapitalized, FHFA will impose certain mandatory supervisory actions such as required monitoring, capital restoration plans, restricting capital distributions and asset growth, and requesting prior approval of acquisitions and new activities.

Significantly Undercapitalized

The Enterprise does not maintain an amount of total capital that is equal to or exceeds the risk-based capital level established for the Enterprise, does not maintain an amount of core capital that is equal to or exceeds the minimum capital level established for the Enterprise, but maintains an amount of core capital that is equal to or exceeds the critical capital level. If significantly undercapitalized, the Enterprise is subject to certain mandatory actions including: the submission of a capital restoration plan, restrictions of capital distribution and compensation of executive officers, and limitation of certain business activities.

Critically Undercapitalized

The Enterprise does not maintain an amount of total capital that is equal to or exceeds the statutory risk-based capital level and does not maintain an amount of core capital that is equal to or exceeds the statutory critical capital level. If critically undercapitalized, the Director then has the authority over the Enterprise to appoint the Agency as conservator or receiver. As conservator or receiver, the Agency is granted powers and duties related to operating the Enterprise, collecting outstanding obligations, and preserving the assets of the Enterprise.

\(^{37}\)“Total capital” is the sum of core capital, a general allowance for foreclosure losses, and other amounts from sources of funds available to absorb losses incurred by the Enterprise, that the Director by regulation determines are appropriate to include in determining total capital. 12 U.S.C. § 4502(23).
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