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Congress of the United States

House of Representatives
Washington, D.C. 20515-1806

September 12, 2002

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The Honorable Armando Falcon, Jr.
Director
Office Of Federal Housing Enterprise Oversight
1700 G Street, NW
Washington, DC 20552



Dear Director Falcon:

I am writing regarding OFHEO's proposed rule, published in today's Federal Register, making technical and correcting amendments to the risk-based capital rule for Fannie Mae and Freddie Mac.

Specifically, OFHEO's proposed rule makes 11 technical corrections to the risk-based capital rule and updates the treatment of Financial Accounting Standard 133 (FAS 133) in the rule. I have no concerns with the technical corrections, since they should enhance the accuracy of the risk-based capital calculations. However, the need for urgency to modify the rule is not clear.

OFHEO's proposed FAS 133 change addresses a critical element of the risk-based capital rule. FAS 133 adjustments affect retained earnings under GAAP and therefore have a material impact on the bottom-line risk-based capital calculations. The proposal states: "The change to the calculation of the risk-based capital requirement to account for the effect of FAS 133 on Total Capital will impact the risk-based capital requirement in any particular quarter, but will not consistently raise or consistently lower capital requirements for the Enterprises." To be classified "adequately capitalized," the enterprises must maintain total capital equal to or exceeding the risk-based capital requirement, as determined by OFHEO on a quarterly basis.

Any rule change that impacts the risk-based capital requirement "in any particular quarter" is a substantive change. In fact, your figures show that the proposed FAS 133 change, if applied in the first quarter 2002, would have increased Freddie Mac's risk-based capital requirement by \$1.652 billion and Fannie Mae's requirement by \$121 million, if the adjustments had been made at that time. A 29% increase in Freddie Mac's risk-based capital requirement is a significant impact.

OFHEO's proposal also states: "FAS 133 requires that many previously off-balance sheet derivative positions be reflected on the balance sheet at their fair values." OFHEO's risk-based capital rule encourages Fannie Mae and Freddie Mac to purchase large volumes of

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financial derivatives, in order to hedge interest rate risk exposure and minimize risk-based capital requirements. Given the extensive use of derivatives by the enterprises, changing the treatment of FAS 133 in the risk-based capital rule is a substantive, if not fundamental, change.

In addition, the 1992 Act requires a 30% add-on to the stress test calculations, in order to cover management and operations risk. This results in each enterprise having 130% of the total capital necessary to maintain positive net worth throughout the stress period. Under OFHEO's proposal, will FAS 133 adjustments occur before or after the 30% amount is added?

From a timing standpoint, OFHEO's risk-based capital rule becomes effective September 13, 2002, and you will use third quarter 2002 financial data to make the first capital classifications based on both the leverage and risk-based capital standards. By year-end 2002, you will publish the calculations showing how the enterprises fared. I expect you to utilize this timetable for implementation.

OFHEO is providing a ten-day comment period because "this proposal is not expected to generate significant commentary." This seems appropriate for the 11 technical corrections. However, because the proposed FAS 133 change is not technical and the third quarter 2002 ends shortly, I believe OFHEO should provide a longer period of time for public comment on the proposed FAS 133 change, so that the effect of this substantive change may be openly and fully considered. To determine, at this late date, that the risk-based capital rule would result in capital calculations that are not consistent with total capital as required under the 1992 Act raises serious questions.

Further, in order to better assess the impact of FAS 133, I request that OFHEO provide me the risk-based capital calculations for the enterprises based on September 30, 2002, financial data, calculated with and without the proposed FAS 133 change.

I would appreciate having your response to this letter by no later than September 20, 2002.

Sincerely,



Richard H. Baker
Member of Congress

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Cc: Rep. Paul E. Kanjorski
Hon. Peter R. Fisher