FREDDIE MAC AND FANNIE MAE ENHANCEMENTS TO CAPITAL STRENGTH, DISCLOSURE AND MARKET DISCIPLINE

October 19, 2000

Fannie Mae and Freddie Mac announced today that they are implementing a series of commitments regarding financial operations and controls that will strengthen the capital adequacy, transparency and market discipline of the companies. These commitments include enhancements to the companies' periodic public disclosures that will enhance the timeliness and quality of the financial information available to the public about the companies. Taken together, these operational and disclosure commitments will ensure that Freddie Mac and Fannie Mae's risk management and disclosure standards are at the vanguard of evolving worldwide practices.

Summary of Components of the Package

The components of Freddie Mac and Fannie Mae's commitments are as follows:

- ***Component 1—Periodic Issuance of Subordinated Debt***: Freddie Mac and Fannie Mae will issue publicly traded and externally rated subordinated debt on a semi-annual basis.
    - Subordinated debt will be issued in an amount such that, for each company, the sum of core capital and outstanding subordinated debt will equal or exceed 4 percent of on-balance-sheet assets following a three-year phase-in period.
    - This amount of subordinated debt will be in addition to, and not a substitute for, required equity capital and will strengthen the companies' safety and soundness.
    - Congress and many in the financial regulatory community have identified periodic issuance of subordinated debt as a mechanism for promoting market discipline for financial institutions.
    - The terms of the subordinated debt will provide for interest payments to be suspended for up to five years under defined conditions of financial stress.

- ***Component 2—Liquidity Management and Contingency Planning***: Fannie Mae and Freddie Mac will comply with principles of sound liquidity management set forth by the Basel Committee on Banking Supervision and will maintain more than three months' worth of liquidity assuming they have no access to public debt markets.
    - Maintaining this liquidity will keep low the risk that the companies' operations could be disrupted during a significant financial crisis

- ***Component 3—Interim Implementation of Risk-based Capital Stress Test***: Pending final promulgation of a risk-based capital standard by the Office of Federal Housing Enterprise Oversight, Freddie Mac and Fannie Mae will implement a risk-based capital stress test and disclose the test outcome on a quarterly basis.

- Parameters, such as the interest-rate shocks used in the test, will be based on those contained in the Federal Housing Enterprises Financial Safety and Soundness Act of 1992.
- The parameters, including the default and prepayment models, as well as the quarterly stress test outcome, will be publicly disclosed.
- Interim implementation of the risk-based capital stress test will provide a near-term “bridge” of stress testing and public accountability pending completion of final risk-based capital regulations.
- Basel Committee members strongly endorse stress test capital requirements
- Interim implementation in no way substitutes for OFHEO’s promulgation of a final risk-based capital rule

- ***Component 4—New Interest-Rate Risk Disclosures***: Fannie Mae and Freddie Mac will initiate public disclosure of interest-rate risk sensitivity analyses and results on a monthly basis.
  - Monthly disclosure of interest-rate risk exceeds current best practices of financial institutions
  - Provides investors with this essential information on a more frequent basis than is provided by any other financial institution
  - Shows the expected financial impact of immediate adverse changes in interest rates and the slope of the yield curve

- ***Component 5—New Credit Risk Disclosures***: Freddie Mac and Fannie Mae will initiate public disclosure of credit risk sensitivity analyses and results on a quarterly basis.
  - Forward-looking sensitivity analysis provides investors with information on credit risk that no other financial institution provides
  - Exceeds the best practices of financial institutions
  - Shows the expected financial impact of an immediate 5 percent decline in house prices

- ***Component 6—Public Disclosure of Annual Rating***: Fannie Mae and Freddie Mac will commit to obtain an annual rating from a nationally recognized statistical rating organization and to disclose this rating to the public.
  - Provides an independent early warning signal to the public and Congress regarding each company’s financial condition
  - Ratings will assess the risk to the government, or the independent financial strength, of each of the companies

Each component will be self-executing through implementation and disclosure. Congress, the public and investors will be able to independently evaluate Fannie Mae’s and Freddie Mac’s performance against the commitments. These components also will be subject to continuous supervisory examination by the Office of Federal Housing

Enterprise Oversight, the companies' safety and soundness regulator, under their existing examination program.

The Package Will Place Freddie Mac and Fannie Mae at the Forefront of Best Practices for Financial Institutions

The commitments of Fannie Mae and Freddie Mac will create a new standard for financial institution regulation. The package is drawn from principles and standards embraced by leading financial institution regulators and follows the capital framework set forth by the international Basel Committee on Banking Supervision in its most recent proposed framework for financial institution risk management and oversight, *A New Capital Adequacy Framework,* Consultative Paper on Capital Adequacy No. 50, Basel Committee on Banking Supervision (June 1999) (the "1999 Basel Consultative Paper").

The commitments embody principles and enhancements endorsed by Freddie Mac's and Fannie Mae's safety and soundness regulator. In its most recent annual report to Congress, OFHEO stated:

> *Market discipline of Fannie Mae and Freddie Mac is a potentially important complement to safety and soundness regulation of the Enterprises. If creditors have accurate and timely information on the financial risks of Fannie Mae and Freddie Mac and believe that they are exposed to material risk of loss if the Enterprises get into financial trouble, they will take steps to ensure that the Enterprises strike an appropriate balance between risk and return. By enhancing market discipline, greater transparency has the potential to limit the systemic risk that Fannie Mae and Freddie Mac may pose to the financial system.*

The package of enhancements derives from and strongly adheres to the most recent comprehensive risk and capital management framework set forth by the Basel Committee on Banking Supervision in the 1999 Basel Consultative Paper. The 1999 Basel Consultative Paper proposes a new capital adequacy framework to replace the 1988 Capital Accord on which current U.S. bank capital standards are based. Members of the Basel Committee on Banking Supervision have rejected much of the framework in the 1988 Accord, including reliance on simple ratios to set capital standards, because the framework does not accurately align capital requirements to the actual risks incurred by regulated institutions. Currently, most financial institution regulation relies on simple capital ratios.

The 1999 Basel Consultative Paper capital framework consists of "three pillars": The First Pillar – Capital requirements – consists of a definition of regulatory capital, measures of risk exposure, and rules specifying the level of capital in relation to those risks. The Second Pillar – Supervisory review of capital adequacy – explicitly recognizes supervisory review as an integral and critical component of the capital framework and a complement to both the capital requirement and market discipline pillars. The Third Pillar – Market discipline – consists of greater transparency through public disclosure, imposing strong incentives on institutions to conduct their business in a safe, sound and efficient manner and maintain a strong capital base as a cushion against potential future losses arising from risk exposures.

Serving Public Interests through Private-Sector Disciplines

Taken together, the commitments exceed best practices and standards for financial institutions, ensuring that Fannie Mae and Freddie Mac maintain extremely strong risk-management practices. Implementation of these components will ensure that the companies' risk management and disclosure activities are at the forefront of financial institution management practices worldwide.

The attached chart compares Freddie Mac's and Fannie Mae's commitments to Basel Committee recommendations and current financial institution practices.

Comparison of Components

The following summarizes the components of the enhancements:

Component	Companies' New Standard	Current Company Standards	Current Depository Institution Standards	Result
Component 1—Periodic Subordinated Debt Issuance	• Issued in an amount such that the sum of core capital and outstanding subordinated debt equals or exceeds 4 percent of on-balance-sheet assets following a three-year phase-in period • Periodic issuance (semi-annual) with public trading and external ratings • Average maturity of at least five years • Sub debt terms provide that interest payments would be suspended and will accumulate for up to five years if (a) core capital falls below 125 percent of critical capital levels; or (b) core capital falls below minimum capital levels and, pursuant to a company's request, the Secretary of the Treasury exercises his or her discretionary authority under the company's charter to purchase the company's obligations • Subordinated debt will be in addition to, but not a substitute for, equity capital	• Neither Company currently issues subordinated debt on a periodic basis.	• Banks and bank holding companies are not required to issue subordinated debt. Typically only the largest banks and bank holding companies issue subordinated debt and most banks' subordinated debt is not publicly traded. • No bank or bank holding company has committed to enhance its disclosures and market discipline through periodic issuance of subordinated debt.	• Externally rated subordinated debt will serve as a market barometer of the companies' financial strength • The subordinated debt commitment will enhance market discipline and transparency, and goes beyond current banking standards and practices. • The terms of the subordinated debt will contractually suspend interest payments on a company's subordinated debt well before insolvency.

Component	Companies' New Standard	Current Company Standards	Current Depository Institution Standards	Result
Component 2—Liquidity Management and Contingency Planning	• The companies will enhance existing qualitative controls and procedures to ensure compliance with Basel Committee's principles for managing liquidity • The companies will commit to maintain contingency plans for handling a liquidity crisis based on the assumption that they are unable to access the new issue debt markets for a period exceeding three months. • The companies will commit to maintain at least five percent of on-balance sheet assets in a liquid, marketable portfolio of non-mortgage securities and to maintain additional, highly liquid securities in unencumbered form in order to facilitate liquidity. • Subject to continual OFHEO supervisory examination	• Each company currently maintains asset-liability management policies establishing policies and procedures designed to satisfy day-to-day corporate funding requirements and to ensure the availability of sufficient funds at all times. • The companies maintain high-quality liquid investment and contingency portfolios and have diverse sources of liquidity needed to provide stability under a broad range of market conditions.	• The Basel Committee has established 14 "best practices" principles for liquidity management at large banks. None of these recommendations are required to be implemented. Financial institution regulators assess liquidity issues as part of their overall examination process • The Committee considers four elements of liquidity management to be "crucial" for banks of any size and scope of operations: 1. good management information systems; 2. analysis of net funding requirements under alternative scenarios 3. diversification of funding sources; and 4. contingency planning. .	• This will enhance market discipline and increase the ability of the Companies to survive an economic downturn without fostering any perception that governmental intervention will safeguard debt holders against loss.

Component	Companies' New Standard	Current Company Standards	Current Depository Institution Standards	Result
Component 3—Interim Implementation of Risk-based Capital Stress Test	• The companies will voluntarily implement a stress test tying capital to risk pursuant to assumptions based on the 1992 Act • The companies will disclose the parameters used in their risk models and stress test outcomes on a quarterly basis • Interim implementation in no way substitutes for OFHEO's promulgation of a final risk-based capital rule. • Subject to continual OFHEO supervisory examination under existing examination program.	• The assumptions and scenarios currently used by the companies in their internal capital stress tests are not uniform. • The companies do no currently disclose the results of their internal stress tests on a quarterly basis.	• Stress tests do not generally form the basis for setting overall capital levels, although individual banks may perform stress tests on specific lines of business (*e.g.*, those banks subject to market risk requirements must apply stress tests on their trading portfolios). • Federal bank regulators strongly encourage internal stress testing by large banks to assess capital adequacy and to evaluate the effect of high-stress scenarios that could jeopardize the health of a financial institution.	• Self-implementation and public disclosure of an interim risk-based capital stress test will increase confidence in, and transparency of, the Companies' safety and soundness and risk management. • The stress test incorporates best practices for a high quality stress test. Unlike current bank standards, the stress test is dynamic and intended to reflect evolving risk management techniques. • The stress test will serve as an industry model for other large financial institutions and will lead the industry in adoption of the Basel Committee recommendations relating to risk- based capital stress tests.

Component	Companies' New Standard	Current Company Standards	Current Depository Institution Standards	Result
Component 4—New Best Practice Interest-Rate Risk Disclosure Standard	• The companies will provide public disclosure of quantitative interest-rate analyses on a monthly basis, exceeding best practice standards for frequency of disclosure • Quantitative disclosure will include the impact on financial condition of both a 50-basis-point shift in interest rates and a 25-basis point change in the slope of the yield curve • Disclosure to include qualitative discussion of quantitative results and any material changes in risk modeling and assumptions • Subject to continual OFHEO supervisory examination under existing examination program	• Current company practices meet SEC requirements and compare favorably with leading banks • Frequency is on an annual or quarterly basis • The companies provide substantively comparable quantitative disclosures measuring the change in portfolio market value or net asset value or projected net interest income that would be caused by immediate parallel shifts (upward or downward) in interest rates across the entire yield curve • The companies' qualitative disclosure discusses methodology underlying the quantitative disclosure; also discusses other interest rate and market risks (such as basis risk and volatility risk) and various operational risks (such as financial modeling risk)	• Currently, there are no financial institutions that commit to disclose interest-rate risk on a monthly basis	• Freddie Mac and Fannie Mae's enhanced disclosures will set new best practices standard for quantitative and qualitative disclosures for financial institutions • Frequency of disclosure – on a monthly basis – will exceed any other financial institution's disclosure practices or commitments

Component	Companies' New Standard	Current Company Standards	Current Depository Institution Standards	Result
Component 5—New Best Practice Credit Risk Disclosure Standard	• The companies will provide public disclosure of quantitative credit risk sensitivity on a quarterly basis, establishing a new "forward-looking" best practice standard • Quantitative disclosure to include a sensitivity analysis of expected loss in net fair value of assets and liabilities from immediate decline in property values of five percent • Disclosure to include discussion of results and any material changes in risk modeling and assumptions • Subject to continual OFHEO supervisory examination under existing examination program	• Current company quantitative disclosures meet SEC requirements and compare favorably with leading money center banks • The companies' disclosure includes portfolio UPB by year of origination, original and estimated current LTV ratios and geographic concentrations	• Required disclosure shows point-in- time, historical views of credit risk exposures • Some financial institution provide slightly more information that is historical, not forward-looking	• New forward-looking sensitivity analysis showing the expected financial impact from an immediate five percent decline in property values will enhance current historical, point-in-time credit risk disclosure • Freddie Mac and Fannie Mae's enhanced disclosure exceeds Basel Committee best practices and sets a new standard for best practices for financial institutions

Component	Companies' New Standard	Current Company Standards	Current Depository Institution Standards	Result
Component 6—Public Disclosure of Annual Rating	• The companies will commit to obtain an annual rating from a nationally recognized statistical rating organization and to disclose this rating to the public • The rating will assess the risk to the Government, or, independent financial strength, of each of the companies	• Each company currently has outstanding preferred stock that is rated by both Standard & Poor's and Moody's Investors Service. Since 1996, the companies have maintained a rating of AA-/aa3 on preferred stock issuances. • In 1996, the Director of OFHEO contracted for a risk to the Government rating on the companies. The rating process resulted in a AA- rating for each Company.	• There is no requirement for banks or bank holding companies to obtain and disclose external credit ratings, either on issued securities or on a stand-alone basis. Only six U.S. bank holding companies currently maintain a rating of AA-/aa3 or better on long-term senior debt.	• This component provides a readily discernible measure of capital strength that promotes market discipline.