

information, to be consistent with the stress period.³⁶

Question 49: How should OFHEO simulate gains and losses (other than those associated with counterparty failures) on derivative activities in the stress test?

G. Investment of Excess Cash

Under certain circumstances, simulation of the stress scenarios may require decision rules concerning the investment of excess cash. For example, in the stress test scenario where the ten year CMT yield falls, mortgage prepayments will increase. The proceeds from prepayments of mortgages in the retained portfolio may exceed the cost of retiring associated debt. Likewise, in the rising rate stress test scenario, mortgages will prepay more slowly than in other scenarios. Slower prepayments may lead to the receipt of more guarantee fee income than initially anticipated on the Enterprises sold portfolio because the mortgages remain outstanding longer than originally anticipated.

Since the Act does not permit the simulation of new business in the initial stress test model, any excess cash generated during the stress test period must be assumed to either be retained as cash or reinvested in an interest-bearing asset.

Question 50: What decision rules should govern the investment of excess cash during the stress period?

Question 51: What rate of interest should excess cash be assumed to earn?

Question 52: Should excess cash be assumed to earn a single rate or a weighted average rate, representing a range of possible investment choices?

H. Other Indexes and Yields

Values must be created for other indexes and yields, *e.g.*, the Federal Home Loan Bank Eleventh District Cost of Funds Index and the London Interbank Offer Rate, over the stress period in order to reasonably project liability costs, as well as amortization, prepayment, and default rates on affected adjustable rate mortgages. One reasonable approach might be for OFHEO to create equations that project these indexes based on their relationship to points on the Treasury yield curve and assumed market conditions consistent with the circumstances of the stress test.

Question 53: What techniques should be used to simulate the behavior of these indexes and yields?

III. New Business and Other Considerations

OFHEO's risk-based capital test must incorporate a number of decision rules to reflect management actions that would significantly affect the financial performance of the Enterprises during the stress period. Initially, the Act requires that OFHEO's stress test incorporate no new business for the Enterprises during the stress period other than the fulfillment of contractual commitments to purchase mortgages or issue securities.³⁷ The Act specifically states that:

The characteristics of resulting mortgage purchases [and] securities issued * * * will be consistent with the contractual terms of such commitments, recent experience, and the economic characteristics of the stress period.³⁸

The Act also requires that characteristics of the stress period other than those discussed above in the "Credit Risk" and "Interest Rate Risk" sections (such as, for example, dividend policies and operating expenses) be determined by the Director, on the basis of available information, to be most consistent with the stress period.³⁹

A. Commitments

At this time, the only "new business" OFHEO can assume during the stress period is the fulfillment of contractual commitments to purchase mortgages or issue new securities. As a regular business practice, the Enterprises enter into commitments to purchase mortgages for periods that may extend from a few weeks up to a year. The commitments specify underwriting and pricing criteria for the mortgages to be delivered. If the Enterprise intends to securitize the mortgages listed in the commitment, then the Enterprise will hedge the commitment at the time it is executed by selling the mortgages forward.

Often the seller/servicer that has agreed to sell to an Enterprise under a commitment has not yet originated the mortgages at the time the commitment is executed. When the seller/servicer actually delivers mortgages, their characteristics may differ from those specified in the original commitment.

Question 54: How should OFHEO define the term "commitments"?

Question 55: On what basis, if any, should OFHEO simulate the fulfillment of outstanding commitments?

Question 56: What mix of product types and underwriting qualities should be assumed?

³⁷ Section 1361(a)(3) (12 U.S.C. 4611(a)(3)).

³⁸ *Id.*

³⁹ Section 1361(b)(2) (12 U.S.C. 4611(b)(2)).

Question 57: What delivery timing should be assumed?

Question 58: What assumptions should be made with regard to securitization versus retention in portfolio?

B. Dividend Policies

During the stress period, net income will fall, reducing cash available for distribution to shareholders. In such circumstances, Enterprise management might be expected to suspend dividends or reduce the dividend rate. However, Enterprise management may be reluctant to take such actions, because dividend reductions send a negative signal to investors and would be expected to depress the market price of Enterprise shares.

Question 59: Should OFHEO assume continuation of the present dividend policies of each Enterprise for the entire stress period?

Question 60: If OFHEO simulates a reduction in the dividend payout rate, at what point in the scenario should it take place?

Question 61: By how much should dividends be reduced if they are reduced?

C. Operating Expenses

The Act is silent on how operating expenses should be treated in the stress test, but OFHEO interprets the Act to require that OFHEO model operating expenses in a manner most consistent with the stress period. Operating expenses lower the Enterprises' earnings or increase their losses, and thereby reduce their capital. The major portion of operating expenses at each of the Enterprises consists of costs related to personnel, occupancy, and equipment. Each Enterprise is divided by business function, such as purchase of mortgages, credit analysis, and investment management. Each Enterprise has regional offices. The cessation of additional business at the commencement of the stress period (beyond the fulfillment of contractual obligations) creates conditions that would quickly eliminate some operations and gradually reduce others.

Question 63: How should OFHEO appropriately model operating expenses in the stress test?

Question 64: To what extent, if any, should operating expenses be disaggregated and treated in distinct categories?

Question 65: How, if at all, should the stress test distinguish between the Enterprises in their management of operating expenses during the stress period?

³⁶ Section 1361(a)(4) (12 U.S.C. 4611(a)(4)).