

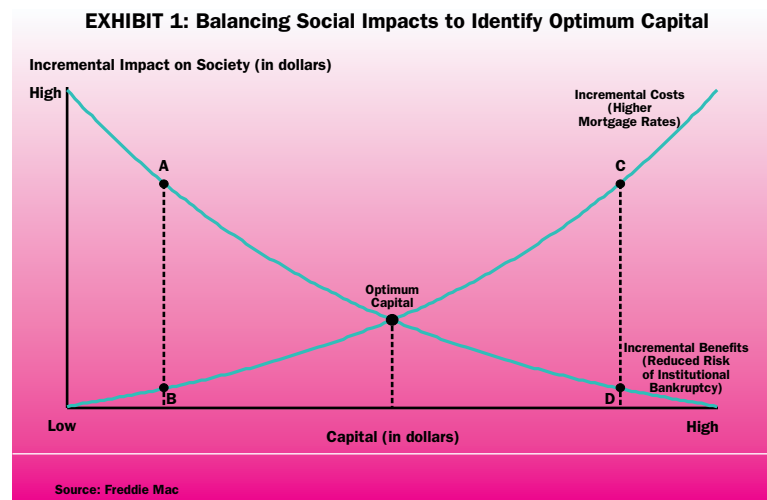
# Why Care About Capital, Anyway?

Stakes Are High for Mortgage Borrowers and Taxpayers in Capital Debate

WHAT INTEREST RATE WILL YOU pay on your next home mortgage? How readily will lenders provide money the next time you purchase a home? How high will your taxes be in the future?

The answers to these questions may be different in a year or two, altered by the latest round in an important but relatively abstract debate now going on in Washington, DC. The deliberations, which began a few years ago, focus on the amount of funds that regulated organizations involved in the housing-finance system must set aside—and keep readily available—to minimize the possibility of insolvency. At the federal level, at least a half-dozen agencies are rewriting rules covering what are known generically as **risk-based capital standards**. Regulators use these requirements to identify the amount of capital needed by an institution to weather stormy economic conditions.

The debate over risk-based capital rules initially concentrated on thrifts and banks. The focus, though, has broadened. State regulators now are looking at the capital requirements for mortgage insurers and life-insurance companies. In addition, the Office of Federal Housing Enterprise Oversight (OFHEO), which regulates Freddie Mac and Fannie Mae, is well into the process of establishing new



by Frank E. Nothaft

**Increasing a housing-finance firm's capital that is low advances the common good when the lower societal costs associated with the institution's bankruptcy (Point A) exceed the larger societal costs of higher mortgage rates (Point B). Conversely, when a firm holds too much capital, the price paid in higher mortgage rates (Point C) outweighs the benefits of lower bankruptcy risk (Point D). In that case, society benefits from a reduction in capital. An optimal capital level occurs at the point where reduced bankruptcy-risk benefits balance out higher mortgage-rate costs.**

capital-adequacy requirements for the two companies (see “Stressing Performance: Evaluating the Capital Adequacy of Freddie Mac and Fannie Mae, page 47).

No matter which financial institutions are considered in this debate, it is important for their respective regulators to arrive at well-thought-out decisions, for any mistakes could prove potentially costly to the public as taxpayers or as homeowners and renters. The challenge requires a judicious balance between capital standards that are:

- high enough to guard

against the prospect of institutional defaults sufficiently massive to prompt a Congressionally authorized and taxpayer-funded rescue and;

- low enough to avoid unnecessarily high mortgage-interest rates and a corresponding decrease in homeownership rates for families nationwide.

Reconciling both priorities is no easy task, but reaching the point of **optimum capital** (see *Exhibit 1*) is a worthy goal.

Frank E. Nothaft is Freddie Mac's deputy chief economist.

The housing-finance regulatory community can pursue the goal of optimum capital in a number of ways. Regulators traditionally have set and enforced rule-oriented capital standards for the companies they oversee. Currently, a very different approach to safety-and-soundness regulation is picking up momentum. This shift involves harnessing the financial institutions' own policies, technologies and responses to market incentives in an effort to promote self-imposed capital requirements (see "Wanted: Bank Regulators Who Act More Like the Market," page 6).

In fact, bank regulators already are moving in this direction, relying on the banks themselves to determine capital charges for certain activities using their own internal risk-evaluation models. The regulators' role then becomes one of validation rather than rule-making (see "Regulators Trust but Time Verifies Under Experimental Capital Plan," page 38). Consequently, who determines a company's capital charge becomes less significant. What is more important is whether the firm is accurately measuring its risks and holding enough capital so that taxpayers are protected from financial harm without distorting sound business judgments.

*Bank regulators are relying on banks themselves to determine capital charges for certain activities using their own internal risk-evaluation models.*

#### **Aiming Too Low**

Regulators potentially put the American public at risk financially if they settle for capital requirements that are too low—at a level insufficient to cover the risks taken by a financial institution.

For example, deteriorating banks and thrifts can put taxpayers on the spot to honor the federal government's explicit obligation to stand behind insured deposits in the event the Federal Deposit Insurance Corp. runs out of money to pay off depositor claims. Mortgages insured against lender losses by the Federal Housing Administration (FHA) or guaranteed by the Department of Veterans Affairs (VA) also carry the full faith and credit backing of the federal government. If a rash of mortgage defaults

overwhelms the ability of FHA and VA to reimburse lenders for foreclosed-property losses, then taxpayers must fill the financial void.

Society has a stake in insisting that these and other financial institutions maintain sufficient capital reserves to fulfill their financial obligations under a variety of economic conditions, lest their failures ignite a crisis in a critical business market. There is a choice to make: protect companies from insolvency by paying off some or all of their creditor obligations, *or* risk subjecting the economy to damaging and costly aftershocks triggered by the collective demise of the firms. By regulating the capital of these institutions, the nation reduces its chances of facing a repeat of the costly savings-and-loan rescue or the New England credit crunch that hobbled the markets for residential-construction loans and income-property loans during the late 1980s and early 1990s.

#### **Overshooting the Mark**

If some amount of capital is good protection for taxpayers, then more must be better, right? Not for taxpayers buying or refinancing homes. If regulators embrace capital requirements that are too high for housing-finance institutions, then interest rates on fixed-rate mortgages will rise and stay there permanently, setting off a chain of events that would work to the detriment of

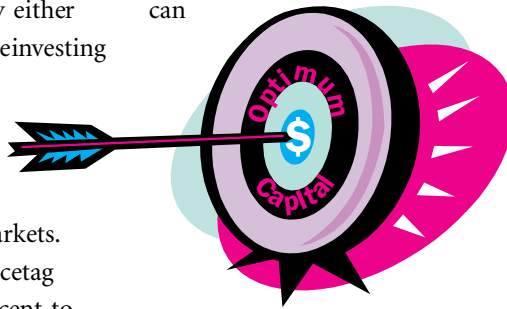
homebuyers, homeowners and renters.

When the amount of a firm's mandatory capital rises relative to liabilities, its cost of doing business increases, too. Capital supplied by a company's stockholders—raised by either issuing more stock or reinvesting corporate profits in the firm—is two to four times more expensive than debt raised in the capital markets. Much of the higher pricetag results from the 10-percent to 20-percent after-tax return that stock investors typically require on their money. The greater the proportion of capital relative to debt in a firm's funding mix, the more expensive it becomes for the company to support its business activities. In particular, higher capital requirements for mortgage-finance firms would undercut the market's ability to keep mortgage rates as affordable as otherwise possible. Even slightly higher capital costs can undermine the market's effectiveness in a major way. For example, if excess capital requirements push up mortgage rates by as little as 1/100th of a percentage point, then, over the long run, America's families needlessly would pay \$200 million per year in extra interest on a home purchase or a refinanced mortgage, according to Freddie Mac estimates.

Even some renters would feel the pinch of higher mortgage-

interest rates as landlords raise rents to cover the higher financing costs imposed by lenders trying to maintain their investment returns.

Paradoxically, high capital requirements can



give company officials more incentive to take hidden risks. Opportunities always exist for institutions to undertake substantial **interest-rate, management or operational risks**, but unrealistically high capital requirements may encourage even greater risk taking by depressing corporate profits, thereby putting company managers under pressure to boost earnings. This type of go-for-broke strategy is not captured by **capital-to-assets ratios**, but detection of the maneuver is much more likely when an institution is bound by a business-performance measure of capital such as a **stress test**.

### Zeroing In on Optimum Capital

Regulators may feel tempted to spare society from bearing the brunt of any business insolvency by erring on the side of higher capital levels. A tilt too far toward higher capital requirements, however, could destroy the ability of the market to continue delivering a cost-effective mortgage-lending system.

At some point lies an optimum amount of capital that would both lower the risk of insolvency and preserve affordable mortgage rates. Reaching the equilibrium illustrated in Exhibit 1 requires finding an approach to capital standards that balances the benefit of reduced bankruptcy risk with the costs of higher mortgage rates and a lower frequency of homeownership. **SMM**