

August 17, 1999

Mr. Kenneth Koranda  
President  
Mid America Bank, FSB  
1823 Centre Point Circle  
Naperville, IL 60566

Dear Ken:

It was a pleasure meeting you in Washington last week.

Due to my hasty departure, and poor attendance record at prior meetings, Countrywide's views have not been well represented in the Task Force sessions. Thus, I would like to take this opportunity to share with you our views on the OFHEO rule.

1. **Objective**

Countrywide's objective is to maximize the availability of liquidity for the mortgage market. We believe this should be the objective of the MBA as well. Toward this end, we support the lowest capital requirements for the mortgage sector consistent with safety and soundness. This applies to banks and thrifts as well as the GSEs.

2. **Stress Test Methodology**

A stress test methodology is valid and useful, but the results can be very sensitive to assumptions made in implementation. Ongoing dialog about reasonableness of assumptions is critical. In turn, this requires that the OFHEO model be transparent and replicable. The model has proven to be difficult to replicate. Given this difficulty, the comment period should be extended and OFHEO strongly urged to make all efforts to facilitate replication by all interested parties.

3. ***Are the Stress Scenarios Harsh Enough?***

The outlines of the stress scenarios are prescribed in the statute. They are quite extreme. In implementing the statute, OFHEO has made a series of additional assumptions which have the general tendency of making the statutory prescribed scenarios yet more extreme. Since the statutory assumptions are not on the table, the focus of our response to the OFHEO proposed rule should be on these additional OFHEO assumptions, including the yield curve assumptions, rate spread assumptions, housing price assumptions, and the like. We should direct our consultant to comment on the reasonableness of these assumptions.

Of course, the relevance and importance of any individual assumption cannot be accurately determined until the model is made available for experimental runs. Thus, the core of intelligent comment awaits resolution of the replication issue.

In any event, we take issue with the thrust of the Barents Group ("BG") analysis suggesting that the interest rate risk component of the OFHEO test is not adequately severe. Their conclusion seems to be drawn from an admittedly "back of the envelope calculation" of the likelihood of interest rate changes of a given magnitude over a given horizon. Our "back of the envelope" calculation is that the probability of an interest rate increase of 600 basis points or more in one year is very small, less than one in ten thousand.

4. ***Comparison with Bank and Thrift Capital Requirements***

The BG report indicates that the GSEs would not satisfy current bank and thrift capital requirements, and refers to a Sendero study which concludes that the thrift industry as a whole would not satisfy the OFHEO test (the statutory test as interpreted by Sendero, which is probably considerably less onerous than the test as proposed by OFHEO).

Countrywide supports the notion that capital requirements on the mortgage asset class ought to be consistent across institutions. And we believe these requirements should be as low as possible consistent with safety and soundness. We note with approval that the Basle Standards imply a Tier 1 equity requirement of 2.0% on owner-occupied mortgage loans (the Tier 1 requirement is 4.0% of risk weighted assets and owner-occupied loans carry a 50% risk weight), less than but close to the GSE minimum capital requirement of 2.5%.

It is appropriate to supplement the minimum capital requirement with a risk based requirement like the OFHEO test. This requirement should be applied to bank and thrift mortgage portfolios just as it is to the GSE portfolios. We believe it likely that regulatory capital standards on the mortgage asset class will converge over time.

Although straightforward application of the statutory stress tests is reasonable in our view, the MBA should be aware of the significant risk to the mortgage market inherent in supporting or encouraging a harsh interpretation of the OFHEO test. This is not only because it may adversely affect the GSEs' ability to fulfill their mandate to provide liquidity, but also because the same or similar rule may one day be applied to banks and thrifts. In our opinion, the Sendero analysis of the capital shortfall of the thrift industry under the stress test is probably understated (that is, the thrift capital requirements under the test would probably be greater than estimated by Sendero). The effect of promoting a harsh interpretation of the OFHEO rule, combined with its eventual application to banks and thrifts, will be to induce banks and thrifts to exit the mortgage business, leaving the GSEs as an even more predominant participant.

5. ***OFHEO Role in Test Implementation***

The OFHEO role should be supervisory in nature not prescriptive. The clear trend in regulatory practice is to move in the direction of OFHEO directing the GSEs to perform specific scenarios on their internal models, and then reviewing the assumptions and results of these analyses. This procedure would tend to create and support the type of continuing dialog about assumptions that was referred to above. It would also lever the considerable risk management expertise and resources that have been developed inside the GSEs.

6. ***Hedging is a Dynamic Process***

One weakness with the OFHEO stress test methodology is that it ignores hedging dynamics. In practice, managing an economic hedge means managing the net sensitivities to changes in the key economic risks, including changes in the level, slope and curvature of the yield curve, changes in spreads, changes in default rates and prepayments, and so on. If these net sensitivities are well managed, then the hedging process is likely to be successful. However, there is no reason to assume that the appropriate hedge position will not need to be adjusted over time.

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We have made this point to OFHEO and their response is that no credit can be given in a capital test to possible future actions. They reason that they have no way of knowing how management will respond to conditions in the future. We believe that through the regulatory examination process OFHEO will have a great deal of information about how the GSEs manage their hedge positions and should be able to seek comfort in the observed process and in the track record, provided that the process is adequate and the track record continues to be superb.

We believe, however, that the only practical way to capture such dynamics in a simulation or stress test environment is to charge the GSEs themselves with the task of carrying out the stress test. Each GSE could imbed into the stress test its own rebalancing strategy. Subsequent OFHEO examination would reveal whether the rebalancing 'predictions' were consistent with observed GSE hedging behavior.

7. ***Specific Comments on Barents Group Report***

We do not see support in the statute for the BG assertion on page 2 that "The goal was to raise the Enterprises' capital requirements." This reference should be deleted.

The argument on pages 105-112 that the OFHEO interest rate scenarios are not sufficiently extreme is not well supported. The calculations are highly speculative but not labeled as such. BG should be urged to redraft their report and focus on the reasonableness of the yield curve, spread and other rate assumptions.

On page 106, BG maintains that the OFHEO model, while capturing duration, maturity and cash flows, fails to address convexity. We don't agree with this criticism. By looking at both the rising and falling rate scenarios, the OFHEO analysis will tend to identify both the direction of greatest exposure and the degree of positive or negative convexity.

On the other hand, we concur with the BG analysis on pages 94-100, in which specific issues and concerns are raised relating to the measurement of credit risk.

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8. **Summary**

Countrywide's position is that the Task Force should focus its comment on suggestions that affect and improve the application of the risk based capital rule, not on criticisms of the OFHEO approach.

Ken, I hope you find these comments useful. In general, we support the OFHEO effort to ensure safety and soundness of the Federal Housing Enterprise system. Our sense, however, is that the proposed OFHEO rule is more harsh than intended by Congress or required in the statute. We would like to see a dialog commence between OFHEO, the GSEs, and other interested parties including the MBA, as to the reasonableness of the various key assumptions to be made in carrying out the risk based capital test.

Regards,

[signed: Jeffrey K. Speakes]

Jeffrey K. Speakes  
Managing Director  
Risk Management

JKS:mam

cc: Angelo Mozilo