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Alfred M. Pollard
Office of the General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, NW, Fourth Floor
Washington, DC 20552

RE: Second Notice of Proposed Rulemaking for Risk-Based Capital Regulation

Dear Mr. Pollard:

Merrill Lynch appreciates the opportunity to comment on OFHEO's proposed rulemaking for risk-based capital regulations. Merrill Lynch is one of the world's leading financial management and advisory companies and is the top global underwriter of debt and equity securities. We believe that effective capital adequacy testing for Fannie Mae and Freddie Mac (the "Enterprises") is essential to maintaining the confidence of the secondary mortgage markets given the important role that the Enterprises play in housing finance. The 1992 Act itself declared the need for OFHEO to promote the capital adequacy of the Enterprises because of the important public purpose that they provide to the secondary market for residential mortgages and the important role that they play in providing access to mortgage credit.

A risk-based capital standard that simulates the flow of business in a stress test is a significant improvement from ratio-based capital tests that cannot capture the various business risks that the Enterprises face. We believe, however, that some elements of the proposed regulations should be reexamined to ensure that there are no unintended consequences on the market activities of the Enterprises.

The starting point for the proposed rulemaking is the 1992 legislation that defines a stress test to analyze capital adequacy. We believe that the implementation of the stress test should be easily reproducible by the Enterprises (and others subject to availability of data inputs) so that capital requirements for both new and existing business lines can be calculated in a timely manner. We believe that the current formulation for the stress test is overly complex, and requires too fine a level of data aggregation relative to the benefits received. In addition, new products and new hedging techniques cannot be evaluated under the stress test without revisions to the test by OFHEO, which limits innovation.

We also believe that the implementation of the stress test should match capital requirements to the business risks faced by the Enterprises. The areas that we believe are inconsistent with this goal include:

- Counterparty credit risk. The severity of the haircut for assuming counterparty risk is many times the historical average. In the case of BBB-rated counterparties, the additional 30% capital charge for management and operations risk results in more than $1 of capital needed to assume $1 of BBB counterparty risk. In the case of derivative counterparties, although the haircuts are much lower, they are still very high given that collateral is posted.

- Home price inflation. In rising interest rate environments, projected losses from defaults are higher because housing prices are not allowed to rise for five years. This result is inconsistent with historical experience.

- High LTV loans. The methodology for modeling the volatility and dispersion of housing prices results in significant capital requirements for high LTV loans. In addition, the default specification does not take into account the credit scoring of the borrower.

- Non-Treasury interest rates. The proposed spread models for non-treasury interest rates can lead to widely varying results depending on the recent interest rate environment. In addition, the conventional mortgage rate does not lend itself to being modeled as a percentage of the 10-year CMT. The non-treasury rates in turn affect the prepayment results and projected cash flow.

Merrill Lynch would like to commend OFHEO on the framework for implementing the risk-based capital regulations. We believe that the proposed rulemaking can serve as an effective standard for achieving OFHEO's goal of ensuring the capital adequacy of Fannie Mae and Freddie Mac if modifications are made to simplify the construction of the stress test and to ensure that capital requirements are matched to business risks.

Sincerely,

[signed: Jeffrey W. Kronthal]

Jeffrey W. Kronthal
Managing Director

[signed: Daniel B. Markaity]

Daniel B. Markaity
Managing Director