Comments of Bear, Stearns & Co. Inc.
Risk-Based Capital Rules
for Fannie Mae and Freddie Mac

March 8, 2000

Bear, Stearns & Co. Inc. is providing comments pursuant to the Notice of Proposed Rulemaking describing the risk-based capital rules that OFHEO proposes to apply to the government-sponsored enterprises under its jurisdiction. Bear Stearns has been one of the largest participants in the secondary markets for all types of residential, multifamily, and commercial mortgage-backed securities and related derivatives throughout the past two decades. Our daily trading activity in mortgage securities averages significantly in excess of $10 billion.. We are a market-maker and principal in mortgage-backed securities issued and guaranteed by Fannie Mae or Freddie Mac (the "Enterprises") and by hundreds of other financial institutions. Through our wholly-owned subsidiary EMC Mortgage, we purchase and service residential mortgage loans, focusing primarily on loans with impaired credit histories. We provide investment banking services, including capital-raising and strategic advice, to a wide array of regulated financial institutions in the United States and internationally. We are commenting on the proposed rule because of the direct correlation that exists between the proposed capital standards and the market behavior of the Enterprises in purchasing and issuing various securities and mortgage loans that are an important element of our business with the Enterprises and with other financial institutions

We are especially concerned about the impact of the proposed regulation on our ability to conduct business with the Enterprises in two important (and often closely related) areas: the guaranteeing and purchasing of private-label REMIC securities and the creation of new financial products to allocate the credit and interest rate risks associated with mortgage loans. A major source of the impact of the regulation on our business is that the proposed capital standards do not appropriately reflect the economic risk of instruments subject to the "haircut" requirements. The derivative counter party haircut is excessive at all levels when compared to the capital market's perceived risk levels as reflected in the pricing behavior of global market participants. OFHEO appears to have imposed a requirement that is arguably nearly ten times what would be indicated by the use of the rating agency methodologies and private credit evaluation such as we routinely employ in our business. Of even greater concern to us is the impact of the "haircut" for "other instruments". The proposed scale appears arbitrary in how it steps up the "haircut" by a factor of two as the rating on the instrument declines. This does not reflect historical loss experience and will discourage the use of structures that may become increasingly important tools for transferring credit risk from the Enterprises to third parties.

A related concern centers on the specific assumptions employed in the model for single-family loan defaults and severity, especially for what are traditionally viewed as weaker credit loans. The default and severity assumptions appear to penalize such loans. The problem is exacerbated because of the failure to incorporate credit scoring and related techniques for measuring risk in loans with high loan to value ratios. We encourage OFHEO to elicit specific proposals from the Enterprises to incorporate credit scoring in the risk calculation.

We note that the financial products that will be affected by the "haircut" requirements and the single-family default model factors have been a key element of the Enterprises' programs to create efficient markets for mortgage loans that service lower-income and first-time homebuyers. The public benefits associated with these efforts are magnified by greater certainty of execution for banks in meeting their lending obligations under the Community Reinvestment Act. We would also note that the direct impact on the Enterprises is a small fraction of the impact on the public as a whole because of the leadership role they play in the market. Their instruments are the primary pricing reference for all residential mortgage securities, including those backed by loans ineligible for their programs. Excessive capital requirements on these elements of the Enterprises' business will produce lower prices and higher yields across the entire residential mortgage lending market, which in turn will lead to higher borrowing costs for all home owners.

We believe that OFHEO should modify its proposed rules to stipulate that the frequency with which it may change the regulations in the future will be severely limited in order to create a stable planning environment for the Enterprises. This concern is linked to our belief that OFHEO should reconsider its rejection of the use of internal models under all circumstances. OFHEO must find a mechanism such as permitting the use of internal models that will increase the flexibility available to the Enterprises in responding to the rapid pace of change in the mortgage markets. Bear Stearns' ability to continue to provide creative interest rate and credit risk products to the Enterprises will be impaired if, as it appears, they are unable to fully replicate the OFEHO analysis and must seek specific guidance on the application of the model to new products. Both Fannie Mae and Freddie Mac have commented that they are unable to replicate the results that OFHEO itself has produced when applying the model to their capital structures. Without the ability to duplicate and predict the results of the capital adequacy analysis that OFHEO will conduct periodically, the enterprises will not be able to deploy the OFHEO model in their internal planning processes. In order to discharge their primary mission of lowering the cost of financing for homeowners by sustaining an efficient and liquid secondary market for residential mortgage loans, the government-sponsored enterprises must be able to deploy capital structures that utilize the entire range of interest rate and credit risk management products.

The importance of flexibility and planning has never been greater. We are likely to see more change in the markets over the next three years than the previous thirty. The fundamental option and risk characteristics of residential mortgages will change dramatically over the next few years. Improved information and communications technology will lead to a restructuring of the origination process and the secondary market. At the same time, the market will see major change in the structure of the financial sector itself brought about by the Financial Modernization Act. This rapid rate of change has become much more evident even in the period since the publication of the Notice. When the rule-making process for the risk-based capital standards began, there were no mortgages originated over the Internet. At last count, there were a dozen Internet-only lenders and dozens more traditional lenders that accept and process mortgage applications over the Internet. Some analysts predict that within five years, over half of all new loans will be originated and processed through the Internet. In the past six months, two well-financed start-up companies have deployed Internet-based secondary trading platforms for mortgage loans and mortgage-related securities, including those that are eligible for purchase by Fannie Mae and Freddie Mac. Markets for important risk-management tools such as swaps and options are migrating rapidly to Internet-based platforms. OFHEO must not impair the Enterprises ability to adapt to such changes.

In reviewing comments such as ours that may in certain instances reduce the capital required to engage in specific businesses and purchase or issue certain securities, we would note that OFHEO appears to have adopted the view that it is the only check on the propensity of the Enterprises to assume risk and thus must adopt a particularly cautious approach when dealing with the risks associated with products at the margin. The preamble to the proposed rule makes this point in several places, noting for example that "the Enterprises are largely insulated from private market discipline."

From our vantage point as a major investment banking concern active in all segments of the debt and equity markets, we would disagree profoundly with this assumption. We believe that in determining how to exercise its regulatory discretion, OFHEO should assign far greater weight to the "first line of defense" that the private market provides in severely penalizing the Enterprises for assuming excessive risk. The compensation structures of both companies give management strong incentives to maintain stock price performance and ensure that investors have confidence in the soundness of their risk management practices.

As of the date of these comments, the total market capitalization of the Enterprises exceeds $77 billion. Their common stock is among the most widely held of any companies in the world. Their institutional investor base includes virtually every single large and sophisticated fund management company in the United States. These managers employ sizeable research staffs that are constantly reviewing the Enterprises' business results. The quarterly information reports provided to investors by the Enterprises are extremely thorough by any standard and facilitate the work of investors in monitoring the Enterprises' business.