

March 10, 2000

Mr. Alfred M. Pollard
General Counsel
Office of General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, NW
Fourth Floor
Washington, DC 20052

Dear Mr. Pollard:

J.P. Morgan appreciates the opportunity to comment on the Office of Federal Housing Enterprise Oversight's proposed risk-based capital rules. As a global banking institution subject to capital regulation by a variety of authorities worldwide, we have long been involved in the evolution, development and implementation of capital standards as applied to banks and other financial institutions. This process is nowhere near complete. Nevertheless, we believe our international experience and that of the banking industry might help to provide some insights that might prove useful to Fannie Mae, Freddie Mac and OFHEO.

Why discourage the flow of capital into the GSEs?

We applaud OFHEO and the GSEs for pursuing an alternative to the traditional capital ratio approach that has increasingly proven itself to be ill-suited to banking institutions. But at the same time, we are struck by the divergence between the direction taken by the OFHEO proposal and that taken by the banking regulators. We recognize that the OFHEO approach is mandated by the Federal Housing Enterprise Safety and Soundness Act of 1992, which allows limited flexibility even compared with our law, the Federal Deposit Insurance Corporation Improvement Act of 1991. Yet even within the constraints of the 1992 law, it appears that OFHEO has gone beyond the law's mandate to produce something even less flexible. Our objective in this letter is, first, to step back from the implementation details of the proposed rule, and to consider instead the objectives of capital standards and how regulation can best achieve those objectives. We then evaluate the OFHEO proposal in light of the current evolution of bank capital standards. Finally, we propose a reorientation of the implementation of the law in a direction more consistent with what we believe to be the law's objectives.

For purposes of this discussion, the most concise statement of the objective of capital regulation appears in the Congressional Findings section:

“(2) because the continued ability of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation to accomplish their public missions is important to providing housing in the United States and the health of the nation's economy, more effective Federal regulation is needed to reduce the risk of failure of the enterprises...”

The passage makes clear that Congress believes it is important that the GSEs survive because they perform an important mission. But we believe the mission of assuring the enterprises' survival means more than simply reducing the risk of insolvency of the enterprises. We believe, in addition, that assuring survival also means avoiding measures that will discourage the flow of capital into the GSEs. The banking industry's experience over the past decade might be relevant to considering how best to pursue this dual objective.

The 1990s taught bankers and their regulators the importance of getting capital rules right. At the beginning of the decade, policy makers were primarily concerned with ensuring that capital levels were not too low; few imagined that capital requirements could be too high. But over the course of the decade, we realized that such a perspective is essentially a short-run view. Over the long run, overly stringent capital requirements could be equally dangerous because they could discourage the commitment of capital to banks in favor of financial intermediaries subject to less burdensome rules.

The conventional wisdom that more capital is always better is turned even more on its head when we consider that, if capital standards were set too low, we would still have the option to capitalize ourselves correctly. But if capital standards were set too high we would not have that option. The result of this realization is that bankers and bank regulators are now searching for capital rules that avoid both extremes. The following section describes how bank capital adequacy regulation has evolved during the past decade and where we expect it to go over the next few years.

The evolution of bank capital regulation

Banks are still subject to the risk-based capital standards described in the 1988 Basel Accord. The Accord applied mainly to credit risk, and the supervisors declared their intention to address market risk at a later date.

In 1993, Basel supervisors proposed a standardized risk-based capital approach to market risk, which bore strong resemblance to the OFHEO proposal. The industry's criticisms included the following:

- The proposed model bore no resemblance to risk management models used at banks and provided little if any useful risk management information. The model would be used only for regulatory compliance, so banks would run two parallel risk measurement systems, only one of which would be useful for risk management purposes.
- Banks do not manage risks on product-by-product basis, but by risk categories.
- Bank models are much more accurate than Basel model, which necessarily incorporated simplifying assumptions in the interest of general applicability.
- The Basel model was based on existing risk categories and product types, and could not easily incorporate new risk categories or product types.

- The model recognized that only exact offsets of risks of most hedging would be penalized with higher capital even though economic risk would be reduced.

Regulators took the criticisms seriously, and set to work on an alternative approach. The result of the regulators' efforts has been a substantial reorientation of how we think about capital.

The new rules, known as the Internal Models Approach, appeared in 1995. According to the rules, banks use their own risk measurement models to calculate capital necessary to cover risk in the trading book, subject to parameter restrictions specified by the regulatory agencies. But in order to use the approach, banks must meet qualitative standards set by the regulators. These standards emphasize the quality of control environment as well as the accuracy of models.

The Internal Models Approach provided two important benefits. One was to eliminate the necessity to maintain a parallel capital model that is useful only for compliance, but not for risk management. More fundamentally, the Approach marked the first effort to reduce inconsistencies between regulatory capital requirements and internal economic capital measurements (which are based on actual risks taken). The latter has helped to focus more recent efforts to reform capital treatment of credit risk.

In 1999, the Basel supervisors proposed reforms of 1988 Basel Accord that would address the issue of credit risk in the Banking Book. The Proposal divides policy between three 'pillars' of capital adequacy:

- Minimum capital requirements
- Supervisory review of capital adequacy
- Market discipline through enhanced disclosure

Notable aspects of the proposal include the following:

- The proposal recognizes the distinction between regulatory minimum capital and a bank's economic capital. So long as regulatory capital requirements are met, banks are likely to retain some freedom to determine their optimal economic capital level.
- The proposal seeks to give increased recognition to the benefits of credit risk mitigation measures such as collateral.
- The proposal contains an increased emphasis on a supervisory approach to internal calculation of economic capital. The new emphasis reflects a more general move from traditional prescriptive regulation to a supervisory approach that places more responsibility on the regulated entity.

The proposal has not escaped criticism from the industry. For example, the proposal that risk-weighted assets be based on external ratings, still lacks the necessary granularity to ensure consistency between regulatory and economic

capital, and the ability to deal with diversification. In addition, there is substantial agreement in the industry that capital charges for operational risk as suggested in the proposal will discourage improvements in how banks manage such risks.

Some changes in the proposal are possible. For example, it is likely that new rules will allow banks to use their internal credit ratings (subject to agency approval) to determine risk-weights for calculating minimum capital. It is also conceivable that the proposed capital charge will be replaced with supervisory treatment of operational risk. And finally, longer-term reforms might include allowing banks to use internal credit risk models to calculate minimum capital. Whatever the outcome, we expect future capital standards to reflect more accurately the risks taken by banks and to reduce the distortions of the current rules.

Evaluating the OFHEO approach

As noted above, bank capital regulation seeks increasingly to accommodate concerns about bank insolvency caused by undercapitalization as well as exit of capital caused by forced overcapitalization. In contrast, the OFHEO approach strongly resembles the asymmetric regulatory approach as reflected in the 1988 Accord because it imposes an external model on the enterprises. There are several reasons why the proposed risk-based capital rules might not be an appropriate means to attain the Congressionally mandated public policy objectives of assuring Fannie's and Freddie's long-term survival.

Inconsistency. Under the OFHEO model, regulatory capital requirements might not correspond to actual risks incurred (i.e., economic capital); bank regulatory experience suggests that this is an inevitable characteristic of 'one size fits all' models. A potential result is that the rules could discourage hedging or other activities that reduce risk but are not recognized by the OFHEO model. Yet even when regulatory and economic capital are somewhat consistent, the OFHEO approach excessively penalizes risk-taking regardless of how well-managed it is; haircuts on credit enhancements and derivatives counterparty risk, for example, are excessive by any reasonable standard. The long-run result could be an exit of capital from the Federal housing enterprises.

Unworkability. The OFHEO model is simply too complex to be of use in management of risks in a going concern because it could not produce timely and accurate capital calculations. Why use a complex, costly model when more efficient and accurate alternatives are available? Further, the OFHEO approach uses what appears to be an unworkable approach to stress testing by going well beyond the level of severity mandated by law. When conducting a stress test, it is tempting to construct scenarios in which the worst conceivable events occur. But stress testing consumes substantial resources, and focusing on dire and highly complex scenarios necessarily diverts resources from less severe but more likely scenarios. Consequently, we believe the objectives of the 1992 law would be better served by using the law's standards as a minimum standard and by allowing the enterprises to supplement the required scenarios with those they deem appropriate to current market practices and conditions.

Inflexibility. As was true of the 1993 standardized market risk model for banks, it does not appear that the OFHEO model easily accommodates the development of new products or the assumption of risks previously not considered. In contrast, standard financial industry practice is, to the extent feasible, to manage risks instead of products that are in essence bundles of risks; the result is to facilitate the incorporation of new products and risks into existing risk management systems.

We would like to comment further on why we believe an external models approach is not appropriate.

- Risk management models are subject to constant revision and improvement in response to changing technology, business objectives, and market conditions. We believe that developing, applying, and improving models should remain the responsibility of the enterprises for three reasons. First, the enterprises themselves have better access to the detailed local knowledge relevant to modeling. Second, there are stronger incentives within the enterprises to revise the models to avoid unanticipated losses than there are in an oversight agency that does not directly bear the losses. If OFHEO believes nonetheless that the enterprises have underestimated capital, problems can be addressed through the supervisory process. Finally, imposing a detailed model by regulation will discourage further development and improvement of risk management models that comes from a diversity of approaches. Other financial regulatory agencies have acknowledged this in recent years by avoiding overly detailed 'checklist' approaches to supervision.
- OFHEO argues in its proposal that 'business risks and risk management techniques are very similar at the two Enterprises' but that at the same time 'capital models are likely to differ significantly.' It further asserts that an internal models approach would lead to unequal treatment of the two enterprises. We suggest that the opposite is true. By its nature, a 'one size fits all' model will fail to take account of differences in the business practices as well as risk preferences of the two enterprises. Consequently, an external model could end up overcapitalizing one enterprise while undercapitalizing another.
- Even though OFHEO proposes to perform risk-based capital calculation using its own model, each of the two enterprises will need to run parallel versions of the same model internally in order to anticipate regulatory capital requirements resulting from various business decisions. The result will be that three entities will incur the costs of maintaining a model that serves no risk management function other than to determine regulatory requirements.

Proposed solutions

As emphasized above, capital regulation involves balancing the short-run problems caused by undercapitalization against the long-run problems caused by overcapitalization. Given the constraints and conditions embodied in the 1992 statute, we propose that the Federal housing enterprises be given the following choice:

- Use the OFHEO model to calculate required risk-based capital, or
- Each enterprise uses its own internal model to calculate required risk-based capital that meets the standards outlined in the law

If an enterprise chooses the first option, we believe it would be more efficient for the enterprise to run the model. If an enterprise chooses the second option, OFHEO would undertake the task of examining and verifying that each enterprise is using a reasonable model that complies with the requirements of the law.

Over the long term, however, it is likely that the inflexibility arising from the highly specific nature of the 1992 law coupled with the evolution of markets will make capital computation and compliance increasingly complex and costly but of decreasing relevance to actual economic risks. Accordingly, should Congress undertake an effort to address these issues, particular attention should be paid to amendments that accomplish the following:

- *Clarify objectives of OFHEO regulation of GSE capital adequacy.* For example, the law could clarify the purpose of minimum capital standards versus risk-based capital standards. The performance objectives in the law could form the basis for a supervisory approach to capital adequacy as is likely to evolve among other GSEs and banks in the United States. As Fed Chairman Alan Greenspan has noted, 'the most cost-effective approach to prudential oversight would have supervisors tap into that bank's internal risk assessments and other management information.'
- *Replace specific requirements with general guidance for OFHEO.* Subject to Congressional oversight, OFHEO should have responsibility for developing regulations that accomplish the objectives of the law. The less specific the requirements in the law, the greater the ability to adapt regulations to changing market conditions and changing risk management practices.

Laws are by their nature more difficult to change than regulations. But it is conceivable that OFHEO and the enterprises could find common ground to head off future problems resulting from requirements that diverge from the realities of markets and business practices.

We greatly appreciate the opportunity to comment on this complex but important issue. Please feel free to contact us should you have any questions.

Sincerely,

[signed: T. Timothy Ryan]

[signed: Mark Brickell]

T. Timothy Ryan
Managing Director

Mark Brickell
Managing Director