January 16, 2002

Alfred Pollard
General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, NW
Washington, DC 20552

Dear Mr. Pollard:

On behalf of J.P. Morgan Chase & Co., I am writing to comment on the Office of Federal Housing Enterprise Oversight's proposed modifications to the final risk based capital rule which were published in the *Federal Register* on December 18, 2001.

We greatly appreciate the consideration Director Falcon and the OFHEO staff have given to the concerns J.P. Morgan Chase and other dealers expressed about the final rule's haircuts for derivatives counterparties. The proposed modification is a significant improvement and better reflects the relative counterparty credit risk of the interest rate derivative contracts used by Fannie Mae and Freddie Mac to manage their interest rate risk. We commend OFHEO for modifying the rule to better reflect the risk mitigating impact of collateral and netting and for changing the haircut's phase-in period so it is more consistent with the structure of the overall stress test.

We believe it is important to point out, however, that the derivatives counterparty haircuts contained in the proposed modification will still result in capital charges for interest rate derivatives that are well in excess of what J.P. Morgan Chase and other dealers/market participants would calculate for the same type of collateralized derivatives counterparty credit risk. OFHEO has expressed the view that as the Enterprise regulator, it is inclined to be more conservative in its approach than the dealer community as a whole. However, we believe that OFHEO needs to strike the proper balance between excessive capital requirements and regulatory laxity. We ask OFHEO to continue to consider the potential impact on Enterprise safety and soundness, the derivatives market and homeownership costs of imposing overly severe haircuts. As you know well, the Enterprises are two of the largest (if not the largest) end-users of interest rate derivatives in the market. A change in how they use derivatives to manage risk, which might result from well-meaning but inappropriate regulatory measures, could have serious unintended consequences on market liquidity, the Enterprises' risk management practices and ultimately the cost of homeownership. We urge OFHEO to carefully monitor the impact of the final derivatives counterparty haircuts to ensure that serious unintended consequences do not result.

We would also like to express our concern about the related provision of the proposed modification that imposes new haircuts for foreign currency swaps utilized by the Enterprises. We view this as an important issue but are uncertain about the rationale for this apparently new and significant change. According to the December 18, 2001 *Federal Register* notice, OFHEO is proposing to "eliminate the simplifying assumption" of no haircut for currency swaps contained in the final rule, "in furtherance of its commitment to refine the stress test…". Rather than trying to project foreign currency values in order to apply the haircut to the net cash flow of both the pay and the receive sides of the swap, OFHEO has apparently decided to ignore the receive side of the swap and simply adjust upward the pay side by the amount of the haircut. While we would welcome a more detailed explanation from OFHEO on the justification for this approach, it seems that a more precise reflection of the real relative risk of currency swaps would be more suitable and than this proxy OFHEO proposes. In addition, OFHEO's methodology will likely result in capital charges that are significantly in excess of the relative foreign currency and credit risk incurred, particularly for the collateralized transactions used by the Enterprises. For a ten-year foreign currency deal that is swapped with a AA counterparty, 75 basis would be added to the payments on the debt under the stress test model.

We acknowledge that currency swaps may create market and credit risks for the Enterprises that should be factored into their capital requirements. We do not challenge the need "to eliminate the simplifying assumption" of applying no haircut to foreign currency swaps. However, at this late stage in the process, the proposed solution appears more problematic than the "simplifying assumption" and should be carefully reviewed. Overly conservative haircuts that result in significant additional non-dollar funding costs could impede the Enterprises' ability to develop new markets for their debt. As you know, issuing debt denominated in foreign currencies has given both Fannie Mae and Freddie Mac greater flexibility in funding their business activities, sometimes at lower all-in costs than dollar funding. Maintaining and increasing access to foreign markets is a critically important strategic objective for Fannie Mae and Freddie Mac as their balance sheets grow. The two Enterprises have taken different approaches to foreign currency debt issuance. However, for both of them, having the option to issue non-dollar debt securities cost effectively is critical to their overall objective of expanding their international investor base and maintaining their growth. This objective is likely to increase in importance as foreign capital markets expand and non-US investors become more sophisticated and seek greater diversification.

On one final topic, in changing the blend of short-term and long-term securities used to refund the Enterprises' on-balance sheet portfolios during the stress test, OFHEO has adopted a more realistic approach. However, using 100% par callable debt to represent the long-term security component is not consistent with their actual practice. Published data indicates the Enterprises fund their portfolio with a mix of callable debt and bullet debt. In addition, par callable debt issued in the stress test is mismatched as a hedge of a mortgage portfolio that will be either at a discount or at a premium during the stress test.

In conclusion, we urge OFHEO to carefully consider and monitor the impact of its derivatives counterparty haircuts on the Enterprises and the derivatives markets. The proposed haircuts for interest rate derivatives counterparties, though a marked improvement from the final rule, are still very conservative relative to the credit risk they are intended to reflect. The proposed haircuts for foreign currency swaps should be carefully reconsidered by OFHEO after more detailed input from risk management and currency market participants. OFHEO should ensure they are analytically sound and won't impede important strategic objectives of the Enterprises.

In addition, OFHEO should revisit its assumptions about the mix of long-term debt during issued by the Enterprises during the stress period.

We would be happy to discuss our views with you in greater detail and we greatly appreciate your willingness to again consider our concerns.

Sincerely,

Timothy Ryan
Managing Director
Global Government Institutions Group
J.P. Morgan Chase & Co.