January 16, 2002

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

Dear Mr. Pollard,

Thank you for providing the opportunity to submit comments on the risk-based capital rule being proposed by OFHEO.

Fannie Mae and Freddie Mac (the GSEs) have provided a significant stimulus to our economic growth over the past decade by facilitating trillions of dollars of mortgage loans. Today it is difficult to imagine how the mortgage and housing markets might function without the presence of these two entities. Indeed, a long-term impairment of the activity of the GSEs would have significant negative consequences on the economy and housing market.

I believe it is the government's responsibility to provide the necessary assurances to its citizens that the GSEs can continue stable operations for years to come. I applaud OFHEO's efforts to fulfil this responsibility.

I offer two broad comments to OFHEO's proposed legislation:

(a) In determining a risk-based capital rule I believe we must consider not just the survival of the GSEs through a time of economic hardship, but also their ability to continue to operate at reasonable levels of business through difficult times. Significant forced curtailment of the activity of the GSEs during a period of economic weakness would create an additional destabilizing shock to the housing sector at a time when the economy was already struggling.

(b) The proposed 10 basis point (bps) change to yields on enterprise debt in the stress test is inadequate and does not realistically reflect the changes in debt financing costs the GSEs would realize if their business were stressed. If the GSEs were perceived to be in trouble, liquidity premiums and default premiums would both increase. There is strong evidence to suggest that this increase would be much more than the 10 bps proposed. The sheer volume of the debt issued by the GSEs and the potential costs associated with increased yield spreads warrants that this issue be given careful attention.

Details of both comments follow.

Policy Objective Should Be Sustainable and Stable Operations, Not Survival

The GSEs help facilitate over 50% of all home loans. If the GSEs were to halt their activities, there are currently no other financial intermediaries that could perform their function. While some of the business volume of the GSEs would be replaced if the GSEs were restriced from making new loans, I believe it is realistic to expect that overall home loan volume would decline by no less than 30% in this scenario.

Today, borrowers in the housing market may be purchasing new homes, refinancing existing mortgages, or taking out home equity loans. Removing 30% of these borrowers would have significant negative economic impacts. During a time of economic distress, reduced access to loanable funds in the housing market would be a destabilizing force in our economy (i.e., act to further depress economic activity). As a result, I submit that beyond just survival the proposed rules should ensure the stable and sustained operation of the GSEs during times of economic distress.

A sharp decline in loan volume by the GSEs would have several negative economic effects. First, demand for homes would be forcibly reduced as aspiring homeowners would have reduced access to funds for homebuying. This would cause a decline in home prices, all else being equal. Second, existing homeowners would have a reduced capacity to use home equity lines of credit to finance purchases of home improvements and other big-ticket items. This would impair consumption and negatively impact overall economic activity.

A readily accessible mortgage market supports demand in the housing market by providing access to funds for would-be purchasers. In part, the increased activity of the GSEs over the past decade has helped increase demand for homes by making funds more accessible to homebuyers. If the GSEs had to curtail their activity, access to mortgage loans would be reduced as the supply of loanable funds provided by the GSEs would removed. The reduced access to mortgage loans would forcibly reduce demand in the housing market. Assuming no change in supply, prices and unit volumes in the housing market would decline. This would further strain the GSEs and American homeowners during hard times.

Recent advances in the mortgage market allow homeowners to easily use their home equity to finance consumption. The advanced home equity loan products offered by many financial institutions are made possible by the combined liquidity of the mortgage and housing markets. An economic downturn that placed the GSEs under stress would reduce the liquidity of the housing and mortgage markets. A sharp reduction in the liquidity of either the housing market or the mortgage market would at best increase the cost of accessing home equity and at worst remove the option of accessing home equity altogether. As a result, an economic downturn could be worsened by making home equity credit less accessible to consumers than during times of prosperity.

The inability of GSEs to provide stable operation through times of economic difficulty will provide a destabilizing force in the economy at the worst possible time. Capital

requirements that would ensure only the survival of the GSEs during econmic downturns do not adequately serve the needs of citizens. I feel American citizens would be best served if the GSEs continued to operate at reasonable business volumes during times of economic hardship. Therefore, I believe any new capital requirements should be designed to ensure sustained and stable operation of the GSEs through times of economic hardship.

10 bps Change to Yields on Enterprise Debt in the Stress Test Is Inadequate

As noted by OFHEO in the December 18th Federal Register, it is appropriate to assume that the GSEs will realize a higher cost of debt if they get into financial difficulty. There appeared to be insufficient data to help make a sound judgement on the magnitude of the borrowing premium: "OFHEO conceded that data upon which to base such a premium may be too sparse…" The latest decision was to apply a "10 bp borrowing premium to incorporate these risks in a modest way," even while OFHEO recognized that "Firms in very stressful circumstances frequently face premiums of several hundred basis points, if they are able to borrow at all."

I find the 10 bps borrowing premium and the supporting evidence to justify such a small premium during the stress test woefully inadequate. I believe that if the GSEs found themselves in financial trouble the combination of changes in risk and liquidity premiums would cause GSE debt costs to increase by far more than the 10 bps assumed. In addition, the 10 bps assumption is so small that I think it could be achieved simply by a rise in overall interest rates. Although some may find a debate over a 10 bps figure trivial, the large volume of GSE debt that is issued each year implies that the borrowing premium is an important source of risk for the GSEs.

GSE debt is rated AA- by Standard & Poor's. After both the Asian Currency Devaluations of 1997 and the Long-Term Capital/Russian Debt Crisis of 1998, spreads between LIBOR and AA rated instruments increased 5 to 10 bps. After 1997, the spreads remained 5 bps wider than normal for nearly 6 months. While neither one of these two events directly impacted the default risk of the GSEs, the flight away from risky assets alone was enough to move risk premiums for comparable instruments by 5-10 bps. It is reasonable to conclude an economic event that directly impacted the GSEs would cause the spread between their debt and LIBOR/COFI to increase by far more than 10 bps.

The recent rash of downgrades in the energy trading sector provides further insight into the process whereby risk premiums can suddenly increase. After Enron's collapse, many of debt rating agencies reviewed and subsequently downgraded the ratings of other energy related firms (e.g., Mirant). The downgrades increased costs of capital and also triggered increased capital (margin) requirements for many of the energy trading firms. In many cases, they were forced to slash budgets and access capital markets to shore up their balance sheets.

Similarly, if the GSEs were to get into trouble, it would be reasonable to conclude that their debt ratings would also be cut and that they would also have an increased need to

access capital markets to repair their balance sheets. Capital markets always require compensation to assist in such repair, and the recent experience of the energy trading sector indicates the magnitude of the compensation is far greater than 10 bps.

By OFHEO's own admission, "Firms in very stressful circumstances frequently face premiums of several hundred basis points, if they are able to borrow at all." From this statement and the factors discussed above, I feel there is ample evidence for a reasonable person to conclude that the GSEs would face borrowing cost premiums far in excess of 10 bps if they were to encounter some financial difficulty. While there may be a question as to how long the increased premiums would persist, we should expect them to persist at least as long as the GSEs remain in a questionable financial position.

Leaving aside the issue of risk premiums, a 10 bps change in borrowing costs may occur from a change in liquidity premiums. GSE debt securities are second only to US Treasuries in terms of liquidity. Realizing that improved liquidity reduces their borrowing cost, the GSEs have active trading operations that help improve liquidity in their own securities. While it may be impossible to quantify the exact liquidity premium embedded in the GSE debt securities, it is reasonable to assume that any decline in the liquidity of the GSE debt market would result in higher borrowing costs. Any event which significantly impaired the ability of the GSEs to issue new debt and trade existing debt should cause an increase in the liquidity premium and therefore result in higher borrowing costs. 10 bps is such a small borrowing premium that a change in the liquidity premium alone could account for the full amount.

Finally, we should also remember that many interest rate spreads correlate with the level of interest rates. While interest rates have been generally very low recently, even a gradual increase of several hundred basis points across the entire yield curve should cause various risk spreads to widen. I believe it is well within the realm of possibility that an overall increase in the level of interest rates alone would cause the spreads between GSE debt and other benchmarks to increase by 10 bps.

Due to the large volume of debt issued each year by the GSEs, a significant capital requirement would be imposed by working with realistic borrowing cost premiums. Even the proposed 10 bps increase in borrowing cost results in an additional 500 million dollar annual expense during the test period when 500 billion dollars of debt is rolled over each year. Accumulated over a 10 year period, this could cause an individual GSE's capital requirements to increase by several billion dollars – something the GSEs would not want.

As a result, the GSEs have a significant incentive to reduce or eliminate the borrowing cost premium imposed by the stress test. In an early draft of the proposed rule, the GSEs had somehow convinced OFHEO that no borrowing premium was required. While OFHEO strives to come up with an adequate borrowing cost premium, I would hope that they keep in mind the long-term interests of taxpaying Americans who would be forced to deal with a probable untimely bailout of an inadequately capitalized GSE. I feel the

currently proposed 10 bps figure is an unrealistic borrowing premium for the stress test. It unfairly and unnecessarily rewards GSEs at the future expense of American taxpayers.

Thank you for providing the opportunity to share my comments with you.

Sincerely,

Mahesh Johari
4314 Linden Hills Blvd. #105
Minneapolis, MN 55410