May 31, 2001

Basel Committee Secretariat
Basel Committee on Banking Supervision
Bank for International Settlement
CH-4002
Basel, Switzerland

Dear Sir or Madam:

This comment reflects the views of FM Watch on the proposed revisions to the capital regime for internationally-active banks (so-called Basle 2). FM Watch is an association of U.S. financial trade associations concerned that two housing public-sector entities (PSEs) operate within the boundaries of their public charters and on competitive terms with other financial services firms. Specifically, FM Watch is dedicated to ensuring that Fannie Mae and Freddie Mac, shareholder-owned companies known as government-sponsored enterprises in the U.S., use their government-granted benefits solely to promote the liquidity of the market for conventional conforming mortgages.

FM Watch generally commends the Committee for its effort to make the risk-based capital (RBC) framework more risk-sensitive. The current accord, we believe, gives PSEs an unwarranted preferential risk weighting based solely on their agency status without regard to the actual risk such entities may pose. However, we are concerned that the ratings-based approach in the standardized model could well have the same adverse effect. This is because the ratings provided to the housing PSEs in the U.S. reflect their government status and as such are not a fair representation of their actual financial risk. To prevent continuation of the current capital arbitrage with respect to debt and MBS issued by Fannie Mae and Freddie Mac, FM Watch urges the Committee to:

- make it clear in the standardized and internal ratings-based models that any PSE that operates as a corporate enterprise under applicable law in its country of domicile should be treated as corporate, not PSE, risk for purposes of risk weighting; and

- revise the risk weightings for PSEs deemed by home-country regulators to be corporate risk so that only true stand-alone ratings determine the risk weighting used to set the capital requirement. Failure to use a true stand-alone rating will render moot the Committee's intent to have the capital weightings based on real risk, not agency status.

1. PSE Status

On page 5 in the detailed discussion of the standardized model, the Basle 2 proposal states that PSEs that operate as "normal" corporate enterprises will be treated as corporates for purposes of the risk weightings. However, the recent "Quantitative Impact Survey 1" request for data suggests that all PSEs are to be treated as sovereign or bank risk for purposes of the survey, with PSEs treated as corporates only under the IRB calculations.

FM Watch urges the Committee to make it clear in both the standardized and IRB models that PSEs that operate as corporate ventures should be treated as corporate risk. Failing to do so would mean that Fannie Mae and Freddie Mac would continue to enjoy a privileged risk weighting as government agencies, even though they do not have an explicit government guarantee like most PSEs. Federal Reserve Board Chairman Alan Greenspan has cited the market distorting implications of the housing GSEs in the U.S. financial markets, and it is vital that the Basle rules do not exacerbate this problem by providing an inappropriate capital weighting that alters investor decisions and capital flows.

Treatment of these shareholder-owned firms as PSEs in the capital regime would further increase investor expectations (see below) that these companies enjoy an implicit government guarantee. This will increase the moral hazard associated with their activities, since investors will not exercise due diligence with regard to analyzing Fannie Mae or Freddie Mac obligations. Given the huge size of these ventures — they now have $2.4 trillion in consolidated obligations — systemic risk will also increase if these firms enjoy favored PSE status under the international RBC rules.

2. These PSEs Pose Real Risks

Further, FM Watch urges the Committee not only to treat PSEs that are chartered as corporations as corporate risk for purposes of the risk weightings, but also to use only true stand-alone ratings to determine the actual risk weighting that will apply.

Currently, both Fannie Mae and Freddie Mac enjoy a AAA rating from Standard & Poors for their senior debt and a AA- one for recent issues of subordinated debentures. Ratings from the other nationally-recognized statistical ratings organizations are comparable. However, both of these ratings reflect the implicit guarantee investors assume when evaluating the financial condition of these two enterprises. As such, they are a distortion and are not comparable to the ratings given by the agencies to other corporate enterprises.

FM Watch refers the Committee to the March 19, 2001 report by S&P on Fannie Mae. It states that, "The rating on the senior debt of Fannie Mae reflects the company's status as a government-sponsored enterprise (GSE). While there is no U.S. government obligation to support Fannie Mae's obligations, the Secretary of the Treasury has authority to purchase up to $2.25 billion of Fannie Mae obligations, and the approval of the Secretary of the Treasury is necessary for the corporation's issuance of debt obligations and MBS."

The ratings agency analyzes Freddie Mac in the same fashion. In a February 8, 2001 report, S&P said, "the ratings on the global senior debt program of the Federal Home Loan Mortgage Corporation (Freddie Mac) reflects the company's fundamental strength and its status as a government-sponsored enterprise (GSE). While there is no U.S. government guarantee on Freddie Mac's obligations, the company, like all GSEs, benefits from the ability to issue debt obligations that are agency securities, pursuant to its GSE charter. This is one of several links to the federal government that Freddie Mac maintains, and all of its debt obligations are exempt from SEC registration. Also, the Secretary of the Treasury has authority to purchase up to $2.25 billion of Freddie Mac obligations…".

As noted, the ratings agencies similarly take account of Fannie Mae and Freddie Mac's government ties in rating their subordinated debt. The agencies agreed with the U.S. Congress last year to obtain a "risk-to-the-government" rating for these instruments. However, the AA- rating does not in fact represent the financial condition of these PSEs as stand-alone ventures. In an April 30, 2001 report, S&P said that, "…Management of interest-rate risk is facilitated by the company's status as a government-sponsored enterprise, which allows it to fund at an economical cost over a wide array of maturities and terms on a global basis."

The Basel Committee will quickly recognize how important the PSE status is to the rating of these government-sponsored enterprises from even a quick overview of their financial condition. Both Fannie Mae and Freddie Mac have debt-to-equity ratios over 30:1. As the Committee knows, this is far in excess of the leverage allowed for banks, and it is far above the leverage ratios the ratings agencies also regard as prudent for purposes of assigning AAA and comparable ratings. FM Watch believes that, analyzed on a true stand-alone basis, Fannie Mae and Freddie Mac would be, at best, A-rated institutions because of their leverage, their risk concentrations and their reliance on complex derivatives to hedge almost $800 billion in interest-rate risk.

It is clear that Fannie Mae and Freddie Mac cannot be treated simply as corporates without adjusting their rating to a true-stand alone basis. We urge the Committee to permit domestic regulators to make such adjustments in their implementing capital rules to avoid a continuation of the capital arbitrage that already provides these PSEs with an undue market advantage in terms of their actual risk.

FM Watch would be pleased to provide the Committee with additional data on the U.S. PSEs and on how their current ratings have been granted. We believe it is essential for the Committee to require that true stand-alone ratings be used for PSEs to prevent an exacerbation of the market distortions that such subsidized ventures already create.

Sincerely,

Mike House
Executive Director

cc: Federal Reserve Board
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