March 26, 2007

Ms. Jennifer J. Johnson, Secretary
Board of Governors
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Docket Numbers R-1261 and R-1238

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 1-5
Washington, DC 20219

Re: Docket Numbers 06-09 and 06-15

Mr. Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Re: RIN 3064-AC73 and RIN 3064-AC96

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552

Attention: Nos. 2006-33 and 2006-49

Dear Sir or Madam:

Fannie Mae welcomes this opportunity to comment on the Basel IA and Basel II Notices of Proposed Rulemaking (NPR).

We typically do not comment on rules proposed by the banking agencies. However, in the current instance, the agencies specifically request comment, particularly in the Basel IA NPR, on the risk weights to be assigned to our securities:

> "Question 5: The Agencies are considering whether to use financial strength ratings to determine risk weights for exposures to GSEs, where this type of rating is available, and are seeking comment on how a financial strength rating might be applied."[1]

We confine our comment letter to a discussion of this issue.

[1] 71 Fed. Reg. 77446, 77454 (December 26, 2006)

Executive Summary

Fannie Mae believes that the securities of the Government Sponsored Enterprises should be treated similarly to those of other federally regulated financial institutions for purposes of risk weighting. In the Basel IA NPR, the banking agencies appropriately adopt this approach,[2] proposing to continue assigning the securities of GSEs and banks located in OECD countries to the same 20 percent risk basket as in Basel I.

In contrast to the language in the proposed regulation, however, the preamble to the Basel IA NPR suggests a possible alternative of targeting GSE securities for special scrutiny.[3] As indicated by Question 5 in the NPR, one option under consideration is the use of financial strength ratings to determine risk weights.

Such an approach would require the 8,000-plus non-Basel II banks and thrifts to subject GSE securities to a new and special level of scrutiny and would introduce a distinction between the co-existing Basel I and Basel IA rules, between which non-Basel II banks will be allowed to choose.

We believe this distinction is unnecessary and unjustified given that:

- The GSEs are rated more highly than many OECD banks – even on the basis of financial strength ratings that seek to discount any implied government support for either the GSEs or banks;
- The GSEs are subject to U.S. regulation and Congress is in the process of adopting reform legislation to strengthen regulation of the housing GSEs – with the watchword that the regulatory structure should be more bank-like; and
- The housing GSEs invest primarily in low-risk U.S. residential mortgages or in assets secured by such mortgages.

In addition, the suggested use of financial strength ratings as a mechanism for assigning risk weights to GSE securities presents several practical obstacles and concerns:

- These ratings are relatively recent in origin, are potentially confusing and have not been tested in an economic downturn;
- Financial strength ratings are not widely used – for instance, less than 2 percent of banks and thrifts in the U.S. carry a Moody's Bank Financial Strength Rating;
- S&P's Risk to the Government Rating is only used for Fannie Mae and Freddie Mac; and

[2] For instance, *id.* at 77502.
[3] I*d.* at 77454.

- Most GSEs (e.g., the Federal Home Loan Banks and the Farm Credit Banks) do not have a financial strength rating.

GSE securities are important investments for banks – community banks, in particular. There is a distinct inverse relationship between the size of a bank and its propensity to invest in GSE debt rather than mortgage-backed securities (MBS). Evidently there is a preference among community banks for the lower option risk in GSE debt securities as opposed to that of MBS.

At the same time, banking industry statistics do not indicate that holdings of GSE securities should give rise to systemic concerns that would warrant separate-track treatment of such securities.

The combination of these two factors – the importance of GSE debt securities to community banks coupled with the low risk of their causing a systemic problem – argues against the introduction of an unnecessary difference between the two options (Basel I and Basel IA) available to non-Basel II banks.

In summary, under the proposed Basel IA, GSE securities would still be weighted at the same 20 percent risk weight as OECD banks. The alternative suggested method of using financial strength ratings would create the possibility of treating GSE securities differently from those of banks using untested and narrowly-used ratings systems. It would introduce the further possibility of assigning GSE securities to higher-risk categories than those of lower-rated banks including lower-rated banks that are not subject to regulation by U.S. banking authorities.

Thus, if financial strength ratings are reliable, it would lead to a situation where 88 percent of rated U.S. banks and 94 percent of other OECD banks are reliably rated as weaker than the GSEs, but get preferable treatment over them (see Exhibit 3 on page 8 below).

If, on the other hand, financial strength ratings are unreliable, they obviously should not be used as the basis for regulatory determinations.

It is our belief that the banking agencies, in their proposed Basel IA and Basel II regulations, take the correct approach in assigning risk weights to GSE securities. We urge the agencies to reject proposals to single out GSE securities for discriminatory treatment.

Fannie Mae's Detailed Comments

I. Current and proposed risk-based capital rules covering GSE and bank securities

Under current Basel I rules, the securities of banks and GSEs (MBS and debt securities) are assigned a 20 percent risk weight without regard to ratings. The banking institutions covered are "U.S. depository institutions and OECD banks."[4,5]

In the Basel IA NPR, the agencies appropriately propose continuing to assign the securities of OECD banks and GSEs to the same 20 percent risk category as in Basel I.

However, the preamble to the NPR contemplates a possible different approach under which the securities of GSEs would be singled out for special scrutiny. "Bank Financial Strength Ratings" or "Risk to the Government Ratings" are suggested as risk measuring devices instead of assigning GSE securities an automatic 20 percent risk weight as is done for banks.[6]

In contrast, the Basel II NPR would direct that: "In estimating relevant risk parameters [to determine the capital charge], banks should not rely on the possibility of U.S. government financial assistance, except for the financial assistance that the government has legally committed to provide."[7] This Basel II guidance does not single out GSE securities for discriminatory treatment, thereby meeting the principle of handling the securities of all institutions evenhandedly.

II. Impact of a change in the risk-weight determination for the GSEs

Based on current ratings, introduction of a financial strength rating in Basel IA would have no impact on the risk weights assigned to Fannie Mae and Freddie Mac securities while the impact on those of the FHLBanks and Farm Credit Banks is uncertain.

Fannie Mae and Freddie Mac have financial strength ratings (FSRs) that map to a double-A S&P senior rating (and a resulting 20 percent risk weight).[8] FSRs present a particular challenge for the FHLBanks and the Farm Credit Banks because they do not have FSRs — which has led the banking agencies to ask a question applicable to the Bank System and the Farm Credit System: "How should exposures to a GSE that lacks a financial strength rating be risk weighted?"[9,10]

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[4] See, for instance, for the FDIC, 12 CFR Part 325, App. A(II)(C).

[5] The OECD is the Organization for Economic Co-operation and Development, a group of 30 countries that are signatories to the Convention on the Organization for Economic Co-operation and Development. The countries are Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom and the United States. (http://www.oecd.org/document/58/0,2340,en_2649_201185_1889402_1_1_1_1,00.html)

[6] Both ratings are collectively known as Financial Strength Ratings and will be referred to by the acronym FSRs in this letter.

[7] 71 Fed. Reg. 55830, 55850 (September 25, 2006).

[8] Both Fannie Mae and Freddie Mac have a Risk to the Government Rating from S&P of AA-. Freddie Mac has a Moody's Bank Financial Strength Rating of A-, Fannie Mae of B+. The Moody's BFSR uses a different scale, running from A to E, for its BFSR than for its senior debt ratings (see Exhibit 1 below).

[9] 71 Fed. Reg. 77446 *id.*

Thus, the suggested use of financial strength ratings in Basel IA would not have any immediate effect on the risk weights for the securities of Fannie Mae and Freddie Mac. It apparently would, however:

- Cause operational problems for the Federal Home Loan Bank System and the Farm Credit System;
- Introduce another difference between Basel I and Basel IA; and
- Involve the use of untested financial strength ratings in official government regulations.

III. Reasons for leaving the risk-weight system for GSE securities unchanged in the final Basel IA regulation

A. Consistency between Basel I and Basel IA

It is contemplated that those banks that are not required to adopt Basel II will have a choice between Basel I and Basel IA.[11] Both Basel I and Basel IA use the same method for determining the risk weight for the securities issued by banking institutions in the U.S. and in other OECD countries.

Making a unique distinction for the securities of the GSEs between Basel I and Basel IA introduces a measure of inconsistency and confusion between the two that is not necessary.

B. Financial Strength Ratings are inappropriate measures to be used for determining risk weights

Financial strength ratings are relatively new and untested. For instance, Moody's Bank Financial Strength Rating (BFSR) system was only introduced in 1995.[12] There is no experience with these systems over an extended period of time and, in particular, during a serious economic downturn.

Moody's is currently conducting a massive re-evaluation of its bank ratings. In March 2007, it changed 60 out of 99 (or 60 percent) BFSRs of U.S. banks that it has examined – upgrading 59 of the 60 banks.[13] This suggests a system that is not yet fully stable.[14]

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[10] Both the Federal Home Loan Banks and the Farm Credit Banks presumably could get financial strength ratings but it would be expensive for them to do so since each of the 12 Federal Home Loan Banks and the several Farm Credit Institutions would have to get, and pay for, their own rating.

[11] According to the Government Accountability Office, nine U.S. banks and two foreign banks operating in the U.S. meet the criteria for mandatory adoption of Basel II. They are Bank of America, JP Morgan Chase, Citibank, Wachovia, Wells Fargo, Washington Mutual, HSBC, State Street Bank, Bank of New York, Northern Trust and Deutsche Bank. These banks hold 42 percent of industry assets with the other 58 percent held by the remaining banks and thrifts. *Risk-Based Capital: Bank Regulators Need to Improve Transparency and Overcome Impediments to Finalizing the Proposed Basel II Framework*, GAO 07-25-253, February 2007 at 24.

[12] Moody's Investor Service, *Bank Financial Strength Ratings: Global Methodology, February 2007* at 3. The data and discussion on FSRs in this letter refer generally to Moody's Bank Financial Strength Rating rather than to S&P's Risk to the Government Rating. This is because statistics and other information on Moody's rating are more readily accessible. Similar observations to the BFSRs in this letter apply also to Risk to the Government Ratings.

[13] Moody's Investors Service, Rollout of Finalized BFSR Rating Methodology & Incorporation of JDA, Bermuda, Canada and the United States, March 4th and 5th 2007.

[14] Further indications of instability in the ratings were evident from widespread criticism of Moody's upgrades (e.g., *Moody's Retracement On Bank Ratings Draws More Harsh Words*, Dow Jones Newswires, March 12, 2007) and

As well as being of relatively recent origin, FSRs are also narrowly used. S&P issues its risk to the government rating only for Fannie Mae and Freddie Mac. There are no other financial institutions subject to these ratings.[15]

As of January 2007,[16] Moody's had issued BFSRs on only 142 banks and thrifts in the United States – a mere 1.6 percent, approximately, of the total of 8,700-plus U.S. banks and thrifts. In the 29 other countries belonging to the OECD, an additional 453 BFSRs were issued.[17]

Of particular relevance to the suggested alternative in the Basel IA NPR, neither the Federal Home Loan Banks,[18] nor institutions belonging to the Farm Credit System,[19] had FSRs.

The FSRs are potentially confusing. This is particularly true of Moody's Bank Financial Strength Rating which uses a different scale from the agency's senior debt rating.

For instance, Fannie Mae has a BFSR of B+. According to a mapping supplied by Moody's and as shown in Exhibit 1, a B+ BFSR is equivalent to an Aa2 senior debt rating (which corresponds to double-A on S&P's scale).[20]

Exhibit 1

Mapping of Moody's BFSRs to Moody's Baseline Credit Ratings		
Grade	Moody's Bank Financial Strength Rating	Baseline Credit Assessment
Investment Grade	A	Aaa
	A-	Aa1
	B+	Aa2
	B	Aa3
	B-	A1
	C+	A2
	C	A3
	C-	Baa1 or Baa2
	D+	Baa3
Speculative Grade	D+	Ba1
	D	Ba2
	D-	Ba3
	E+	B1, B2 or B3
	E	Caa1, Caa2, Caa3

Moody's consequent announcement on March 16, 2007 that it would further refine its new system (*Moody's announces plan for refinement of "joint default analysis" methodology for bank ratings*, Moody's Investor Service Announcement, March 16, 2007).

[15] Communication from S&P staff to Fannie Mae, February 21, 2007.

[16] Moody's Investor Service, Bank Credit Research, *Monthly Ratings List, January 2007*.

[17] Even these numbers significantly overstate the number of separate banking organizations rated. BFSRs are generally assigned to individual banks, including those that are subsidiaries or affiliates of another bank or bank holding company. Therefore, there are banking groups that have a number of banks with different BFSRs. For instance, in the OECD countries, there are ratings assigned to 14 recognizable JP Morgan Chase companies, 13 Citigroup companies, 12 HSBCs, eight Barclays Banks and to each of seven ABN AMRO and UBS companies. *Thus, these six companies account for at least 10% of all the BFSRs issued in the 30 OECD countries.*

[18] As of September 2006, the Federal Home Loan Banks had $939 billion in consolidated debt obligations outstanding.

[19] At the end of January 2007, the Farm Credit System Funding Corporation, the fiscal agent for the Farm Credit System Banks, had $137 billion in notes and bonds outstanding on behalf of Farm Credit Banks.

[20] *Frequently Asked Questions on Proposals to Revise Methodology for Assigning Bank Financial Strength Ratings (BFSRs) and to Incorporate Joint-Default Analysis (JDA) into Bank Rating Methodology*, Moody's Investor Service, November 2006 at 3.

C. Having financial strength ratings that are lower than institutions' senior rating is not unusual and, therefore, not a reason for their unique application to the GSEs

The FSRs given to Fannie Mae and Freddie Mac by Moody's and S&P map to the equivalent of a double-A on S&P's senior debt rating scale. This is one letter grade below the companies' triple-A rating on their senior debt.

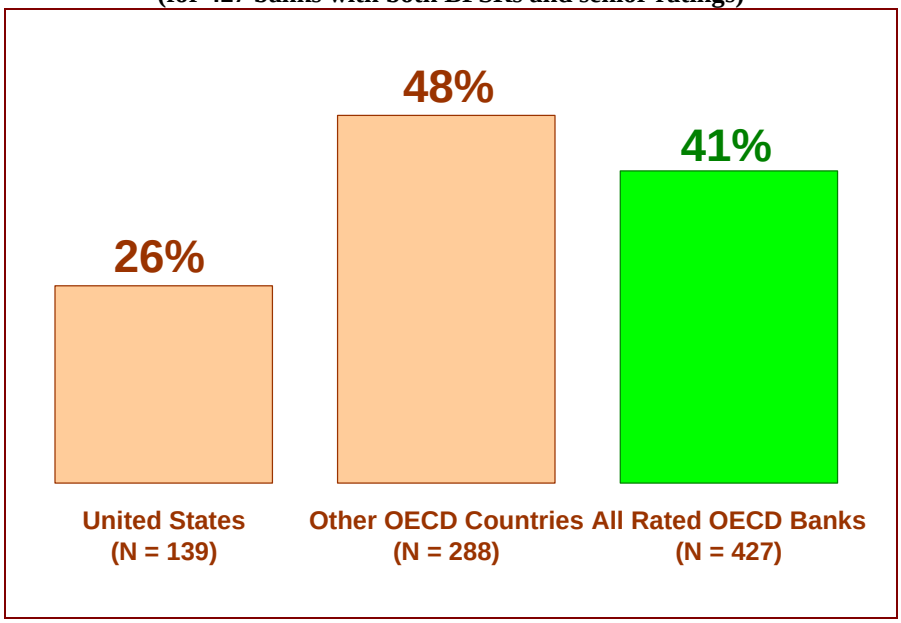
That a financial institution would have a BFSR that maps to a lower senior rating is not unusual as seen from Exhibit 2 where:

- In the United States, 26 percent of rated banks have a BFSR that maps to a lower senior rating;
- In other OECD countries, the percentage with a lower senior rating than BFSR is 48 percent of cases;
- All told, 41 percent of all rated OECD banks have a BFSR that maps to a lower senior rating; and
- Of the 14 banks throughout the OECD with a triple-A senior debt rating, only 6 (or 43 percent) have the equivalent of a triple-A bank financial strength rating.

In other words, Fannie Mae and Freddie Mac are rather typical of AAA-rated banks in having a lower Bank Financial Strength Rating, one grade lower in their case.

In summary, a BFSR that maps to a lower rating than a company's senior rating is not a reason for subjecting GSE securities to a more stringent level of scrutiny than those of OECD banks.

Exhibit 2: Percent of banks in OECD countries with BFSRs that map to a lower level than the issuer or senior unsecured long-term debt rating (for 427 banks with both BFSRs and senior ratings)

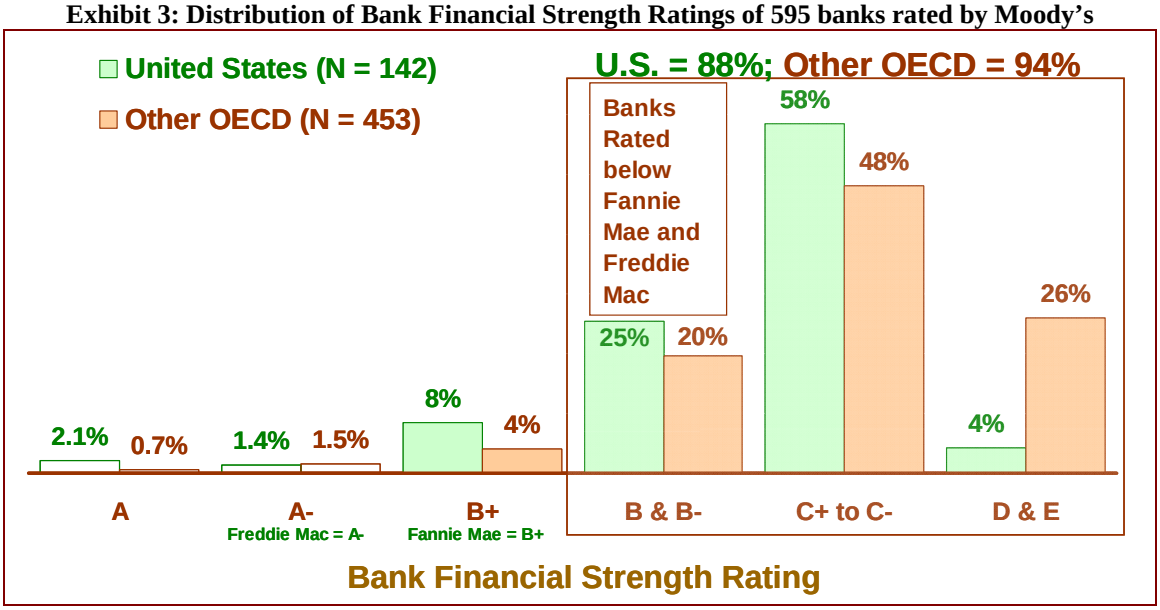


Source: Fannie Mae analysis of Moody's data – "Bank Credit Research, Monthly Rating List," Jan. 2007

D. The preamble to the NPR contemplates subjecting GSE securities to a higher standard than those of even weak banks

This is contemplated even though the GSEs have a higher rating (including Bank Financial Strength Rating) than most rated banks. Thus, 88 percent of rated U.S. banks and 94 percent of rated banks in other OECD countries had BFSRs that were lower than Fannie Mae's or Freddie Mac's (Exhibit 3).

Exhibit 3: Distribution of Bank Financial Strength Ratings of 595 banks rated by Moody's



Source: Fannie Mae analysis of Moody's data – "Bank Credit Research, Monthly Rating List," January 2007

Yet the GSEs would be subject to a higher standard than these banks even though Freddie Mac and Fannie Mae carry a high BFSR of A- and B+ respectively (equivalent to an S&P AA+ and AA long-term senior debt rating). Furthermore, they are subject to strict U.S. regulation, which the Congress is in the process of strengthening even further.

Finally, the securities of the two GSEs are familiar domestic assets that are generally low risk:

- *GSE MBS:* Securities that are guaranteed by the GSEs and further backed by investors' undivided interests in pools of mortgage loans originated in the United States.

- *GSE debt securities:* GSE corporate obligations that finance portfolios of mostly high-quality mortgages or advances secured by such mortgages, also originated in the United States.

Indicators of the low risk of the GSEs' portfolios include:

- The single-family mortgages backing Fannie Mae's portfolio had an estimated market loan-to-value ratio (LTV) of 55 percent at year-end 2006 and Freddie Mac's equaled a similar 55 percent at year-end 2005.[21]

- Fannie Mae and Freddie Mac are required by statute to obtain credit enhancement on non-government loans with loan-to-value ratios in excess of 80 percent.

- In the Basel IA proposed regulation, the banking agencies are contemplating lowering the current 50 percent risk weight for loans with LTVs of 60 percent or less to 20 percent and for loans with LTVs between 60 percent and 80 percent to 35 percent.

- Under Basel II, the risk weights would be even lower. According to data from the Government Accountability Office, the risk weight for a loan with an LTV of 80 percent and a FICO score of 720 would fall from the current 50 percent to an estimated risk weight of just 6 percent under Basel II.[22]

E. Implicit government support of banks

Moody's bank financial strength ratings are mentioned in the Basel IA NPR as a possible tool for deciding on the risk weight for GSE securities. In light of this officially-contemplated centrality for the ratings agency in bank risk-based requirements, Moody's recent actions and statements regarding the rating process for banks are instructive and do not support the case for differential treatment of GSE securities.

In recent months, Moody's radically overhauled its system of rating banks. Specifically, it incorporated what it calls Joint Default Analysis (JDA) into its ratings process. JDA formally and systematically recognizes that banks may receive support from a hierarchy of sources:

a. Parental support (from a parent operating company or family group),
b. Support from a cooperative or mutualist group or association,
c. Support from a regional or local government, and
d. Systemic support (i.e. national government and/or central bank support).[23]

In an announcement on March 2, 2007, Moody's assigned a 98 percent probability that the government would support JP Morgan Chase in the event that the bank got into trouble.[24] Moody's assigned "this virtually certain support assumption" based on the bank's strong deposit shares, extensive derivatives operations, and role as a major government securities clearer.

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[21] Fannie Mae's Form 12b-25 filed with the SEC on February 27, 2007 at 8; Freddie Mac's 2005 Annual Report at 67.

[22] As of year-end 2006, the weighted average FICO score for Fannie Mae's portfolio was an estimated 721 (Fannie Mae, *id.* at 141) and 722 for Freddie Mac's at year-end 2005 (Freddie Mac, *id.* at 67). The 6 percent risk weight for an 80 percent LTV loan with a FICO score of 720 was derived from feeding interpolated GAO data into the mortgage RBC Basel II formula (see GAO *op. cit.* at 50).

[23] Moody's Investor Service, *Frequently Asked Questions on Moody's JDA and BFSR Methodologies, Special Comment, March 2007* at 4-5.

[24] Moody's Investor Service, *Rating Action: JP Morgan Chase & CO., Moody's Announces Bank Rating Actions Resulting From Implementation Of JDA Methodology* – United States, March 2, 2007.

Moody's also factored in "the potential disruption to the financial markets from any failure or default by such an institution would be massive."

This presumed level of government support earned the bank Moody's highest rating of Aaa for its senior debt, two notches above where Moody's assesses the bank on a stand-alone basis. As summarized in Exhibit 4, the ratings profile of JP Morgan Chase and Fannie Mae are exactly the same.

Exhibit 4: Ratings Comparison of JP Morgan Chase Bank NA and Fannie Mae

Company	Senior Unsecured Rating	Bank Financial Strength Rating
JP Morgan Chase	Aaa	B+
Fannie Mae	Aaa	B+

According to the *Economist* magazine: "This safety net extends to nine others in America."[25] Citigroup was thought to be the beneficiary of government support to a 98 percent confidence level. For other banks, such as Bank of America and Bank of New York, Moody's assigned a probability of support that was "only modestly lower, at 95 percent." The ratings agency assigned a 70 percent probability of government support to banks such as Wachovia, Wells Fargo and State Street.

Note that these assessments relate to subsidiary banks rather than to their holding companies and that banks raise more of their non-deposit funding at the holding company rather than the bank level. In September of last year, the 28 *banks* with more than $50 billion in assets had $396 billion in "other borrowings" besides FHLBank advances (which totaled $95 billion). The 33 *holding companies* with more than $50 billion in assets had issued $1,527 billion in other borrowings (with an unknown amount of that figure consisting of FHLBank advances – unknown because holding companies do not file data on FHLBank advances in their FR Y-9C call reports).

But even with bank holding companies, Moody's assesses a non-negligible probability for government support at large parents as well as the subsidiary banks. Thus, with regard to JP Morgan Chase, Moody's stated that:

> "Moody's views the 98% government support level to only cover deposits and senior debt at the bank, consequently they are rated Aaa. Moody's assigns a lower likelihood of support (50%) for the sub debt of the bank as well as the senior debt obligations of the holding company. Consequently the bank subordinated debt rating and the holding company senior debt rating are Aa2, reflecting both the lower likelihood of support and the subordination of these instruments."[26]

These assumptions about government support are made despite the fact that "Moody's views the U.S. as a low-government-support system."[27]

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[25] *No support here - Credit ratings*, The Economist, Mar 10, 2007
[26] Moody's Investor Services *Credit Opinion: JP Morgan Chase & Co.*, March 7, 2007.
[27] Moody's Investor Services *Credit Opinion: Wachovia Corporation*, March 6, 2007.

> "The law dictates that regulators must seize a bank if it fails certain capital tests or that the regulators view the bank as being under capitalized. The law, however, allows regulators and the government to provide systemic support so as not to undermine the economy."[28]

One could argue that Moody's assessments of the likelihood of government support are subjective. Moody's itself concedes as much:

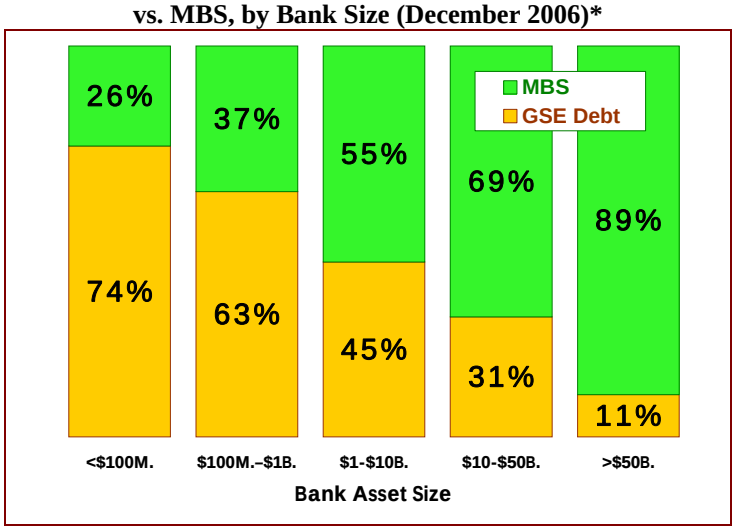
> "Moody's has long incorporated assumptions about support into its ratings. This is necessarily a subjective process, but it is one that Moody's analysts have done for many years, having observed numerous bank failures and bailouts."[29]

But, of course, a similar evaluation of government support for the GSEs and the BFSR assessments of the GSEs are also just as subjective. The conclusion is that there is no justification for treating the GSEs separately from large banks as far as considering the possibility of government support for purposes of bank risk-based capital requirements.

IV. <u>The importance of GSE debt securities to community banks</u>

There is a striking difference in the pattern of bank investment in mortgage-related securities. Large banks tend to invest more heavily in MBS than in GSE debt; smaller ones more heavily in GSE debt. For instance, of the total amount they have invested in GSE debt and mortgage-backed securities, the smallest banks have allocated 74 percent of their investment to GSE debt compared to only 11 percent for the largest banks (Exhibit 5).

Exhibit 5: Investment by Commercial Banks in GSE Debt vs. MBS, by Bank Size (December 2006)*



* For each group, the column shows how banks in that group allocate their investment between GSE debt and MBS. For instance, for small banks, of the total investment in GSE debt plus MBS, 26 percent is allocated to MBS and 74 percent to GSE debt. MBS include both agency and private-label securities.
Source: Fannie Mae analysis of bank call reports

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[28] *Id.*

[29] Moody's Investor Services, *Frequently Asked Questions on Proposals to Revise Methodology for Assigning Bank Financial Strength* at 7.

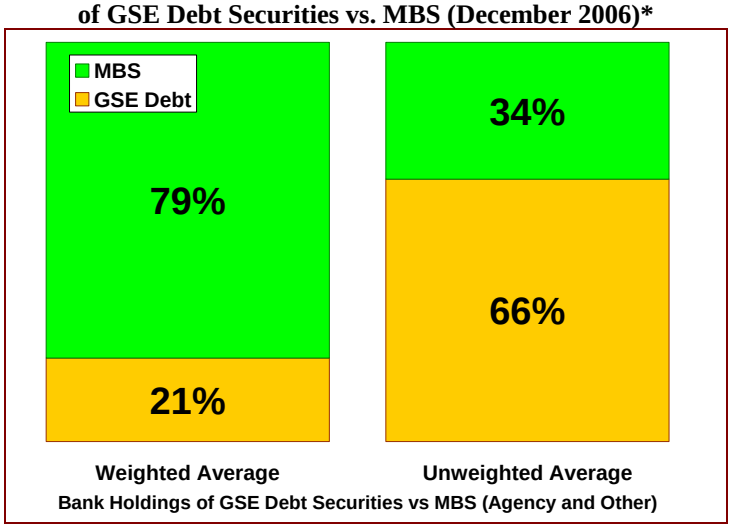
Ratings (BFSRs) and to Incorporate Joint-Default Analysis (JDA) into Bank Rating Methodology at 7.

Thus, as shown in Exhibit 6, although MBS make up 79 percent of total bank holdings of GSE debt securities plus GSE and private-label MBS, they only make up 34 percent on an unweighted basis (where each individual small bank carries the same weight as a large bank).

The implication of these data is that small banks manage prepayment risk by their purchase of GSE debt securities while large banks feel confident in actually managing prepayment risk themselves.

With regard to community bank holdings of agency debt, Michael Brosnan, the former deputy comptroller for risk evaluation at the OCC, offered the following observation: "There's not too much out there that's less risky" than GSE debt. As for alternatives to GSE securities, Brosnan said that: "Almost for sure, they'll have to expand into something that either has more credit risk or more optionality."[30]

Exhibit 6: Weighted vs. Unweighted Average Bank Holdings of GSE Debt Securities vs. MBS (December 2006)*



* See note to Exhibit 5

V. The risk of bank investment in GSE securities

It has been said that bank investment in GSE debt securities raises the concern that the failure of one of the GSEs would systemically cause problems throughout the banking industry. In fact, it is most unlikely that bank holdings of GSE debt would cause such systemic problems since *banks with large portions of their capital invested in agency debt tend to be small and have a small aggregate total of GSE debt*.

Large banks, which hold most of the assets of the banking industry and thereby harbor the biggest potential for systemic risk, have a small amount of their balance sheets invested in Fannie Mae debt (Exhibit 7):[31]

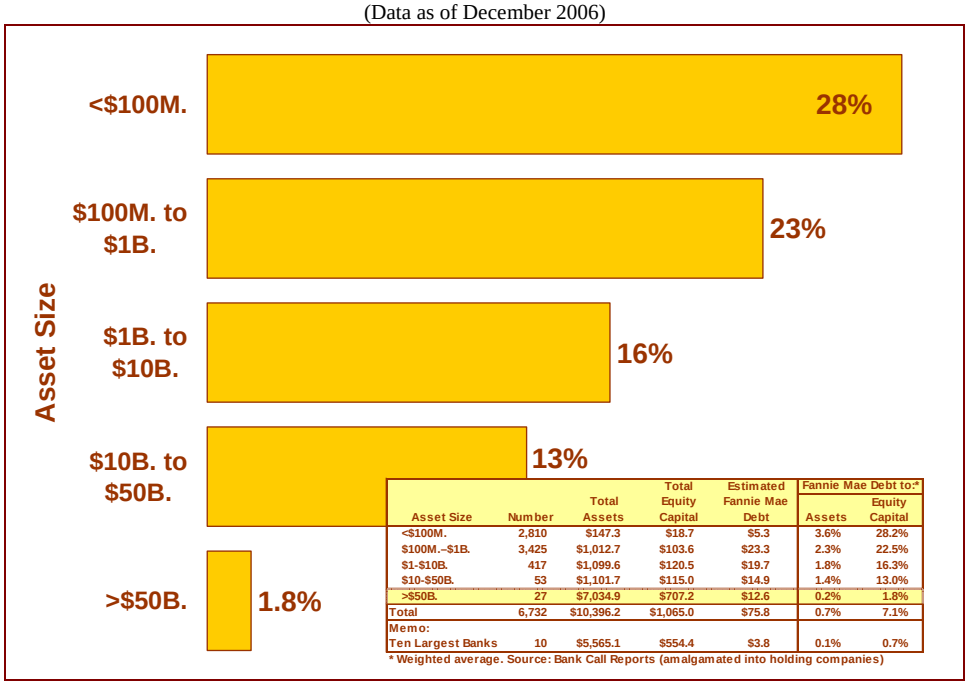
[30] *OCC Official: GSE Cap Would Turn Banks to Riskier Assets*, Jonathan Nicholson, Dow Jones Newswire, June 30, 2000.

[31] The numbers in Exhibit 7 are estimates because bank call reports do not collect data on bank holdings of the debt of individual GSEs. The exhibit assumes that those banks hold the debt of each GSE in the same proportion as the

- Large banks, those with over $50 billion in assets, hold just 1.8 percent of their capital, on average, in Fannie Mae debt; and

- The ten largest banking companies have an average of only 0.7 percent of their capital invested in Fannie Mae debt.

Exhibit 7: Estimated Fannie Mae Debt as a Percent of Capital, by Bank Size
(Data as of December 2006)



Asset Size	Number	Total Assets	Total Equity Capital	Estimated Fannie Mae Debt	Fannie Mae Debt to:* Assets	Fannie Mae Debt to:* Equity Capital
<$100M.	2,810	$147.3	$18.7	$5.3	3.6%	28.2%
$100M.–$1B.	3,425	$1,012.7	$103.6	$23.3	2.3%	22.5%
$1-$10B.	417	$1,099.6	$120.5	$19.7	1.8%	16.3%
$10-$50B.	53	$1,101.7	$115.0	$14.9	1.4%	13.0%
>$50B.	27	$7,034.9	$707.2	$12.6	0.2%	1.8%
Total	6,732	$10,396.2	$1,065.0	$75.8	0.7%	7.1%
Memo:						
Ten Largest Banks	10	$5,565.1	$554.4	$3.8	0.1%	0.7%

* Weighted average. Source: Bank Call Reports (amalgamated into holding companies)

Banks with a relatively large investment in Fannie Mae debt tend to be smaller and hold small amounts of the assets of the industry and of Fannie Mae debt:

- Banks holding 91 percent of industry assets hold less than 25 percent of their capital in Fannie Mae debt (Exhibit 8);

- The 2.9 percent of banks with an amount of assets invested in Fannie Mae debt that is greater than their capital (192 banks) hold less than 1 percent of industry assets; and

- Approximately two-thirds of the banks with assets invested in Fannie Mae debt securities equal to more than 100 percent of their capital have less than $100 million in assets each (Exhibit 9). These banks held an estimated average of just $5 million in Fannie Mae debt securities.

total amount of GSE debt outstanding. Thus, at the end of 2006, Fannie Mae's debt equaled 28.3% of total GSE debt outstanding. It was assumed that 28.3% of the GSE debt holdings of each bank consisted of Fannie Mae debt instruments.

Exhibit 8: Over 90 percent of Banks have less than 25 percent of Capital Invested in Fannie Mae debt while banks with over 100 percent of Capital in Fannie Mae debt hold less than 1 percent of industry assets

December 2006							
				Percent Distribution			
				Number of Banks		Assets	
Fannie Mae Debt to Equity	Number of Banks	Assets	Fannie Mae Debt	Percent	Cumulative Percent	Percent	Cumulative Percent
Less than 10%	2,014	$8,263.5	$11.3	29.9%	29.9%	79.5%	79.5%
10% to 25%	1,864	$1,187.0	$19.9	27.7%	57.6%	11.4%	90.9%
25% to 50%	1,707	$504.5	$17.1	25.4%	83.0%	4.9%	95.8%
50% to 100%	955	$367.4	$19.7	14.2%	97.1%	3.5%	99.3%
Over 100%	192	$73.9	$7.8	2.9%	100.0%	0.7%	100.0%
Total Count of Total assets	6,732	$10,396.2	$75.8	100.0%		100.0%	

Source: Bank Call Reports (with data amalgamated in holding companies)

Exhibit 9: Almost Two-Thirds of the Banks With over 100% of Capital In Fannie Mae Debt are Small and Hold Little Fannie Mae Debt

December 2006						
	Banks		Amount ($Bill.)		Average ($Mill.)	
Asset Size	Number	Percent	Total Assets	Fannie Mae Debt	Assets	Fannie Mae Debt
>$50B.	None					
$10-$50B.	2	1.0%	$32.5	$2.7	$16,255	$1,342
$1-$10B.	5	2.6%	$19.1	$2.7	$3,826	$530
$100M.–$1B.	66	34.4%	$16.6	$1.8	$252	$27
<$100M.	119	62.0%	$5.6	$0.6	$47	$5
Total	192	100.0%	$73.9	$7.8	$385	$40

Source: Bank Call Reports (with data amalgamated in holding companies)

VI. Conclusion

We support the adoption of the proposed language in the Basel IA NPR that provides continuity with Basel I in the risk weighting for GSE assets – just as there is continuity contemplated for the securities of OECD banks. It is appropriate because it is proposed that in the NPR that Basel I and Basel IA continue as options for all but a handful of the largest banks in the country. Given that there is no basis for uniquely changing the risk weighting regime for GSE securities, the banking agencies are correct in the approach they have proposed in the regulatory language of the NPR. We believe the suggested alternative discriminatory approach for evaluating GSE securities is unwarranted and should be rejected.

Sincerely

Beth A Wilkinson
Executive Vice President and General Counsel