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Mr. Alfred Pollard
General Counsel, Office of the General Counsel
Office of Federal Housing Enterprise Oversight
1700 G Street, NW, 4th Floor
Washington, DC 20552
RegComments@OFHEO.gov

RE: Notice of Proposed Rulemaking on Risk-Based Capital

Dear Mr. Pollard:

Morgan Stanley Dean Witter welcomes this opportunity to provide further comments in the matter of OFHEO's proposal for risk-based regulatory capital requirements for Fannie Mae and Freddie Mac. In this letter we would like to comment on:

- the value of using internal systems in the calculation of regulatory requirements and
- the recognition in regulatory capital requirements of the benefits of credit risk mitigation.

It is important, in our view, that OFHEO ensure that all risk capital calculations are done using the systems and data of Fannie Mae and Freddie Mac. Indeed, financial regulators generally require that risk-based capital systems be integrated into a financial firm's internal risk management systems and risk monitoring. Consistent with this approach, we would suggest that OFHEO's role is to establish appropriate quantitative and qualitative standards for the regulatory risk capital calculations. The agencies would then implement these calculations using their internal systems and data. Regulatory and audit review would ensure that the risk capital calculation and the risk management process satisfy regulatory standards on an ongoing basis. This approach has two principal advantages relative to the alternative of OFHEO attempting to implement the regulatory capital calculations itself.

First, it ensures that the risk capital is based on data subject to rigorous internal control, as well as internal and external audit review. Risk capital computations based on data subject to such controls would be significantly more reliable than computations performed by external systems. Our experience with the challenges in verifying risk position data transmitted among multiple systems suggests that establishing and maintaining a process of passing to OFHEO data on the portfolios of Fannie Mae and Freddie Mac would be time consuming, costly, and prone to error.

Second, using the agencies' systems and data would help to better align internal management and external regulatory views of risk. Fannie Mae and Freddie Mac must run the stress tests themselves to understand fully their actual and potential regulatory capital requirements. Once the agencies begin carrying out the regulatory capital calculations on their systems, they and their regulators will benefit from joint review and discussion of the principal risk exposures. In addition, the risk management and regulatory capital process can be enhanced via a dialogue between OFHEO and the agencies on the regulatory capital calculation process. Having OFHEO perform the calculations would, on the other hand, result in longer time lags between data availability and risk analysis and would hinder the ability of the banks to use the stress-testing tools in their management processes.

Finally, we would like to encourage OFHEO to ensure that its regulatory capital regime provides suitable encouragement for the agencies to utilize credit risk mitigation tools. Such tools include credit default swaps, reinsurance, and credit linked notes. Credit default swaps are privately negotiated transactions in which the agencies enter into an agreement to transfer pre-agreed levels of loss exposure on a specified pool of risk. Credit default swaps are generally structured using standard ISDA documentation and should be subject to similar counterparty credit requirements as interest rate swaps. Credit default swaps with insurance company counterparties may be documented as reinsurance or insurance policy agreements. Credit linked notes have the added benefit of being fully collateralized and are not subject to counterparty default risk, so should be given full capital benefit. As a general principle, the degree to which a credit risk mitigation arrangement reduces regulatory capital requirements should be graduated and based on a number of factors: the credit quality of the counterparty; the level of legal/operational risk based on the standardization of the contract; and the degree to which the maturity of the derivative matches the maturity of the underlying exposure.

By ensuring that credit risk mitigation arrangements yield an appropriate reduction in regulatory capital requirements, OFHEO would reinforce market incentives to engage in such practices. By contrast, a failure to recognize the benefits of such arrangements would depress the expected return on regulatory capital and provide a disincentive for risk mitigation activities.

In closing, Morgan Stanley Dean Witter very much appreciates the opportunity to share our views on these matters. Please contact Tim Wilson at 212-762-9140 with any questions on these comments.

Respectfully submitted,

Morgan Stanley Dean Witter

By: /s/ Charles Vadala

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