August 24, 2000

The Honorable Richard Baker
Chairman, Subcommittee on Capital Markets
Committee on Banking and Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Chairman Baker:

I am writing to express the views of Bear, Stearns & Co. Inc. on the potential impact of H.R. 3703 on the liquidity and depth of the U.S. fixed income markets. Our firm is a major underwriter and secondary market-maker in fixed income securities of all types. We work with a wide range of institutional and individual clients and customers, including virtually all of the largest public and private pension funds, banks, insurance companies, and mutual funds. We are particularly active in the market for mortgage-backed securities and debt instruments issued by or guaranteed by the government-sponsored enterprises.

We have two major concerns about the consequences of enacting H.R. 3703. Our first concern is that the structural changes in the role of the government-sponsored enterprises mandated in the legislation may permanently reduce the liquidity and efficiency that are the hallmarks of the modern U.S. debt markets. The second concern is that as a means of effecting the broad policy goal of ensuring sound and prudent oversight of the government-sponsored enterprises, a legislative solution will lead to a substantially longer period of uncertainty than an approach based on more effective utilization of existing law. An extended period of uncertainty associated with implementation of H.R. 3703 would impose substantial costs on investors and homeowners. These costs, which will be real and immediate, may ultimately far outweigh the incremental reduction in the potential risks to the government, which can be more quickly addressed through aggressive use of existing authority.

The market's response to uncertainty in this area has already been apparent. Over the past year, we have seen public comments from major policy-makers produce huge short-term changes in the price of the outstanding Fannie Mae and Freddie Mac debt securities.

Some of the largest pension funds and other major institutional investors have seen the value of their holdings change by millions of dollars over the course of a day due to uncertainty about potential policy changes. This in turn leads investors to demand higher yields to compensate for volatility, which in turn ultimately produces higher mortgage rates.

The United States has the most robust fixed-rate market in the world, in no small measure due to the roles played by the secondary mortgage market participants. Americans benefit greatly from this highly efficient and complex market. Though the benefit is most apparent in our housing finance system, which has allowed us to achieve a level of middle and working class home ownership and access to housing finance that far exceeds that of other industrialized countries, it is also evident in the broader market for debt securities. We believe it is important for policy makers to promote policies that maintain and enhance the position of the U.S. financial markets in the global marketplace. The regulatory reforms enacted in 1992 created tools to further this goal and put in place broad regulatory authority to address the risks inherent in the operations of the government-sponsored enterprises. Those tools may not have been deployed rapidly enough or with sufficient vigor. We are concerned that in addressing the perceived inadequacies of the regulatory framework in which the government-sponsored enterprises operate, H.R. 3703 risks creating costs from disruptions in the market that will not be offset by incremental offsetting benefits from improved safety and soundness, better functioning markets, better products or more efficient flow of capital..

The cost of even temporary episodes of illiquidity are enormous, as the events surrounding the Russian debt crisis and the collapse of Long Term Capital Management demonstrated. The cost of financing rose for all participants in the market. Policymakers responded quickly to those episodes by organizing a series of measures designed to restore liquidity. The response was rapid because the responsible officials knew that had the market disruptions and inefficiency persisted, millions of Americans would have suffered the consequences of lower returns from their pensions and investments. Corporations would have had reduced access to capital and productivity gains and overall economic growth would have slowed. The risk we face from H.R. 3703 is that a structural solution imposed to address perceptions of ineffective or inadequate regulatory oversight of Fannie Mae and Freddie Mac produces a permanent and irreversible reduction in the liquidity upon which our fixed income markets depend for their efficient operation.

We would also like to provide the Committee with our perspective on the impact of the purchase of mortgage-backed securities by Fannie Mae and Freddie Mac. We have an outstanding vantage point to observe the effect of their actions since we are routinely among the top three secondary market makers and trade billions of dollars of such securities each day First, virtually all conforming balance mortgages are offered for sale in the marketplace in the form of Fannie Mae MBS or Freddie Mac Gold PCs, even in many cases those loans that are eventually retained in bank and thrift portfolios. Second, Fannie Mae's and Freddie Mac's bid for these securities in the secondary market is a key underpinning for the relative price of all mortgage-backed securities, which in turn governs the rate that lenders offer to borrowers. In short, when the price of mortgage securities drops, banks and other mortgage lenders raise their rates on newly-originated mortgages. The stable demand from Fannie Mae and Freddie Mac for MBS and PCs provides an important counterweight to the trading activities of money managers and other market participants whose demand is linked to complex arbitrage strategies, the performance of non-mortgage securities, and other factors that can bring about dramatic supply and demand changes in short periods of time. The portfolio demand from Fannie Mae and Freddie Mac is a major source of liquidity, which in turn also enhances the value of mortgages and ultimately lowers rates for borrowers. Thus we believe that these market purchases are consistent with the basic mission of the companies as set forth in their charters.

Finally, we would like to comment on the relative degree of risk associated with holding MBS and PC securities compared to unsecuritized whole loans. Some participants in the debate over the status of the government-sponsored enterprises have asserted incorrectly that it is somehow riskier for them to purchase and hold securities than to purchase and hold whole loans. In fact, Fannie Mae and Freddie Mac have precisely the same interest rate and prepayment option related risks when they own whole loans as when they own the MBS and PCs they guarantee. When Fannie Mae and Freddie Mac own MBS or PCs, they hold both the credit risk and the interest rate risk – this risk has simply been divided into two somewhat more visible component parts for reporting and regulatory purposes (credit risk and the interest rate risk). Indeed, by securitizing the whole loans and repurchasing out of the market, Fannie Mae and Freddie Mac create the liquidity needed to support the efficient production of a huge variety of mortgage-related swaps, options and other derivatives that all market participants – banks, thrifts, pension funds, broker-dealers, and Fannie Mae and Freddie Mac themselves -- depend upon to manage interest rate and prepayment risks. Without the huge volumes of securities flowing through the secondary market, these hedging instruments could not be created at low cost, which in turn would increase the risk to all holders of mortgage securities and whole loans.

I hope that this information helps your subcommittee resolve quickly the recent questions that have been raised on these topics in Washington.

Yours very truly,

Frederick N. Khedouri
Senior Managing Director