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From: Craig C Thomas [mailto:Craig_Thomas@freddiemac.com]
Sent: Wednesday, June 07, 2000 3:46 PM
To: regs.comments@occ.treas.gov; comments@fdic.gov;
public.info@ots.treas.gov
Subject: comments on recourse/DCS proposed rule

Attached in PDF format are Freddie Mac's comments on the interagency
proposed
rulemaking on recourse and direct credit substitutes.

Please contact me either by e-mail or by phone at 202-434-8635 if you
experience
any problems with accessing the document.

June 7, 2000

Freddie Mac

Communications Division
Third Floor
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Attention: Docket No. 00-06

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Attention: Docket No. R-1055

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Attention: Comments/OES

Manager, Dissemination Branch
Records Management and Information Policy
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

Attention: Docket No. 2000-15

RE: Risk-Based Capital Standards; Recourse and Direct Credit Substitutes; Proposed Rule; 65 Fed. Reg. 12320, March 8, 2000

The Federal Home Loan Mortgage Corporation ("Freddie Mac") appreciates this opportunity to submit comments on the interagency notice of proposed rulemaking on revisions to their risk-based capital standards to revise the regulatory capital treatment of recourse obligations and direct credit substitutes ("the Proposed Rule").[1]

Freddie Mac is a shareholder-owned corporation chartered by Congress in 1970 to support homeownership and rental housing. Freddie Mac does this principally by purchasing mortgages from lenders and attracting funds from the capital markets by issuing mortgage-backed securities and long-term debentures. In this way, Freddie Mac facilitates the flow of mortgage funds from investors to borrowers. Over the years, we have helped finance 25 million home mortgages, or one in six American homes. A substantial portion of the mortgages Freddie Mac purchases are originated by institutions regulated by the Agencies.

Summary of comments

[1] The Proposed Rule was issued jointly by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation (collectively, "the Agencies").

Freddie Mac strongly supports the expressed objective of the Proposed Rule to better align regulatory capital with the risk of a transaction or instrument. Accordingly, we endorse the proposal to make consistent the regulatory capital treatment of recourse and direct credit substitutes.

However, the proposed capital treatment of credit-rated asset securitizations could encourage depository institutions to structure securitizations that reduce their capital requirements to a fraction of what they would otherwise be required to hold, even though the risk exposure remains the same. The result could be a net reduction in the amount of capital in the banking system to protect against credit risk.

Freddie Mac supports the proposed treatment of representations and warranties. We recommend the Agencies clarify that a warranty concerning value at the time of loan transfer would not be regarded as a recourse obligation or direct credit substitute.

Freddie Mac recommends that the Agencies move forward with a final rule incorporating the Proposed Rule except for the provision relating to capital treatment of credit-rated recourse obligations, direct credit substitutes and asset securitizations, which we believe should be reconsidered and further evaluated by the Agencies. Freddie Mac would be pleased to assist the Agencies by making available our expertise in mortgages and mortgage-backed securities. In the interim, we recommend that the Agencies assign to direct credit substitutes the capital treatment currently given to recourse obligations.

Proposed treatment of direct credit substitutes

We endorse the Agencies' proposal to extend the current risk-based capital treatment of asset transfers with recourse to direct credit substitutes. As the Agencies note in the preamble, under the current standard, the risk-based capital requirement for a direct credit substitute, such as a standby letter of credit, may be substantially lower than the requirement for a recourse obligation with an identical risk exposure. Making more consistent the regulatory capital treatment by tying it to the risk of the transaction or position would much more closely align capital with risk.

Proposed capital treatment of credit-rated positions

Under the Proposed Rule, the capital requirement for a securitized structure, direct credit substitute, or recourse exposure can be determined using a proposed credit ratings-based schedule. Positions rated with the highest or second highest investment grade (*e.g.*, AAA

and AA) will receive a capital charge of 1.6 percent. Positions with the third highest investment grade (A) would receive a capital charge of 4 percent. Positions with the lowest investment grade (BBB) would be charged 8 percent, while those rated at one category below investment grade (BB) would receive a charge of 16 percent. Positions that either are more than one category below investment grade or are unrated would receive "gross-up" treatment, which involves combining the position with all more senior positions in the transaction and then risk-weighting it based on the underlying assets.

Freddie Mac believes this provision is contrary to the expressed objective of the Proposed Rule to more closely align capital requirements with risk exposure. This provision is likely to diminish rather than enhance the alignment of capital with risk by encouraging depository institutions to structure securitizations that reduce their capital requirements to a fraction of what they would otherwise be required to hold, even though the risk exposure remains the same. The result could be a net reduction in the amount of capital in the banking system to protect against credit risk.

Ratings and capital for securitized transactions

Freddie Mac fully supports reducing risk-based capital requirements on asset securitizations that reduce credit risk through diversification. Indeed, a depository institution could face overly stringent capital requirements under a risk-weighting system that does not recognize diversification benefits.

The Proposed Rule would reduce risk-based capital requirements on asset securitizations through a credit ratings-based risk-weighting structure that does not recognize or directly measure the benefits of diversification. In our view, this could have the effect of significantly reducing capital levels in the banking system without a commensurate reduction in credit risk exposures. This clearly would not achieve the Agencies' goal of aligning capital with risk.

An example is shown in the table below. It shows the approximate capital requirements under the Proposed Rule for a $100 million dollar mortgage pool structured into the typical tranches with support levels that are representative of those found on newly issued rated mortgage-backed securities. These levels are roughly representative of a structured finance on an average quality mortgage pool. The capital required for this structure, $2.276 million, would be only slightly more than one-half of the $4 million that otherwise would be required, even though the overall risk remains the same.

Mortgage tranche rating and representative support level		Proposed Rule's capital requirements
AAA	$94 million	$1.504 million (1.6%)
AA	$ 2 million	$0.032 million (1.6%)
A	$ 2 million	$0.080 million (4%)
BBB	$ 1 million	$0.080 million (8%)
BB	$0.5 million	$0.080 million (16%)
Unrated	$0.5 million	$0.500 million (gross-up)
TOTAL	**$100 million**	**$2.276 million**

Furthermore, the required capital for the subordinate positions is unlikely to provide sufficient protection for the risk exposures. In our experience, there is roughly a one in four chance that credit losses will completely exhaust the BB position and a one in ten chance that credit losses will completely exhaust the BBB position. We strongly recommend the Agencies consider whether the 16 percent capital requirement for the BB position provides adequate protection.

This example demonstrates that the risk weightings in the Proposed Rule are not appropriately aligned with actual credit risk exposures. They would result in a net reduction in the amount of capital within the banking system while the overall risk exposure remains the same. We believe a far better approach is to introduce credit risk models that measure the benefits of diversification more directly. Such models would determine regulatory capital requirements that are far more aligned with risk.

Interest Rate Risk

The Agencies' credit risk capital requirements are designed to ensure appropriate capital for both credit risk and the "normal" risks associated with interest rate exposures. However, because credit ratings do not measure interest rate risk, the rating-based approach fails to recognize any potential difference in the interest rate risk exposures of securitized structures. Unless and until separate interest rate risk capital requirements are implemented for held-to-maturity assets, at a minimum, it would be prudent to develop separate ratings-based schedules for fixed and floating rate securitized obligations.

Ambiguity on ratings criteria

The regulatory language in the Proposed Rule for obtaining external credit ratings of any credit enhancements and positions within an asset securitization is ambiguous regarding how the credit rating agency arrives at a rating. We believe the regulatory language can be interpreted to allow the rating to be based on the credit quality of the issuer, instead of on the credit enhancement or credit enhanced position itself. Our understanding is that the Agencies intend that the external credit rating of any credit enhancement or credit enhanced positions be exclusive of the credit quality of the issuer if the credit rating is to be used to determine the capital requirement of the issuer of the credit enhancement. We recommend the regulatory language be revised to make this intent clear.

Proposed treatment of representations and warranties

In their 1997 notice of proposed rulemaking on recourse,[2] the Agencies proposed that "standard representations and warranties" – defined as those referring to an existing state of affairs that sellers or servicers can verify with reasonable due diligence at the time of asset sale or transfer – would not be treated as recourse or direct credit substitutes.

In the Proposed Rule the Agencies instead would treat as recourse or a direct credit substitute any representations and warranties that "function as credit enhancements to protect asset purchasers or investors from credit risk by obligating the [seller] to protect [the purchasers or investors] from losses due to credit risk in the transferred assets."[3] The Proposed Rule also distinguishes "operational risk" from "credit risk" and indicates that warranties creating operational risk, such as "warranties that assets have been underwritten in conformity with identified standards" and warranties around "incomplete documentation or fraud," will not give rise to recourse treatment, as long as the financial institution can demonstrate to examiners that such operational risks are being managed.[4] Certain representations and warranties commonly used by Freddie Mac and other secondary market purchasers of mortgages may impose on sellers some operational risk but no credit risk. Therefore, Freddie Mac supports the Agencies' approach, particularly the differentiation between credit and operational risks, as sensible and workable.

However, one of the examples provided in the Proposed Rule to illustrate the Agencies' approach suggests that some representations and warranties may be viewed as imposing

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[2] *62 Fed. Reg. 59943.*

[3] Proposed Rule at 12325.

[4] *Id.* at 12326.

operational risk instead of credit risk on sellers. The proposed changes to the regulations of the Office of the Comptroller of the Currency (OCC) cite "promises to protect a party from losses resulting from the default or non-performance of another party or from an insufficiency in the value of the collateral" as an example of representations and warranties imposing credit risk retention.[5]

Certainly, the first part of this example – guarantees against default losses – would constitute credit risk retention and should be treated as a recourse obligation. But the second part of the example, dealing with "insufficiency" of collateral value, does not in all cases impose credit risk retention on sellers. If the insufficiency exists at the time of default and foreclosure (*i.e.*, due to a decrease in value since the loan was transferred), the seller would retain credit risk. However, if the insufficiency exists as of the loan transfer date, the seller would face operational risk, not credit risk. The seller is operationally capable of determining and accurately representing value as of that time through re-appraisal, re-certification, statistical analysis, knowledge of market conditions, and other means. This distinction should be made in the final rule. We recommend the Agencies clarify that a warranty concerning value at the time of loan transfer imposes operational risk on the seller and thus would not be regarded as a recourse obligation or a direct credit substitute, provided that the Seller actually has operational processes in place to form a basis for the warranty.

Proposed treatment of servicer cash advances

The Agencies would exclude from the definitions of recourse and direct credit substitute cash advances made by residential mortgage servicers to ensure an uninterrupted flow of payments to investors. These advances are temporary and do not expose parties to additional risk. Conversely, loan servicing arrangements in which the servicer is responsible for credit losses from the serviced assets would be considered recourse obligations. We believe this proposed treatment is appropriate.

Proposed treatment of implicit recourse

The preamble to the Proposed Rule states that the Agencies intend to continue to address implicit on a case-by-case basis considering the variety of circumstances under which implicit recourse may be provided, and will issue additional guidance if needed to clarify the circumstances which would constitute implicit recourse. Freddie Mac believes that regulatory text defining the myriad of circumstances under which implicit recourse could

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[5] *Id.* at 12333.

be provided is neither needed nor workable. We support the Agencies' case-by-case approach with the possibility of further guidance as needed.

Recommendations

With the exception of the proposed capital treatment of credit-rated recourse obligations, direct credit substitutes and asset securitizations, Freddie Mac endorses the Proposed Rule. Accordingly, we recommend that the Agencies move forward with a final rule incorporating all of the proposed provisions except the capital treatment provision. We recommend that the Agencies reconsider and further evaluate their proposed capital treatment of externally credit rated recourse obligations, direct credit substitutes and asset securitizations. Freddie Mac would be pleased to assist the Agencies by making available our expertise in mortgages and mortgage-backed securities. In the interim, we recommend that the Agencies assign to direct credit substitutes the capital treatment currently given to recourse obligations.

Thank you for this opportunity to comment on the Proposed Rule. Please do not hesitate to contact me if you have any questions regarding our comments.

Sincerely,

Edward Golding
Senior Vice President
Housing Economics and Financial Research