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December 22, 2000

Freddie Mac

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

Attention: Docket No. 00-17

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-1080

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

Attention: Comments/OES

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

Attention: Docket No. 2000-70

RE: Residual Interests in Asset Securitizations or Other Transfers of Financial Assets, Notice of Proposed Rulemaking, 65 FR at 57993 (September 27, 2000).

The Federal Home Loan Mortgage Corporation ("Freddie Mac") is pleased to have the opportunity to submit comments to the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("Federal Reserve"), Federal Deposit Insurance Corporation ("FDIC") and the Office of Thrift Supervision ("OTS") (collectively, "the agencies") on their proposed rule to amend risk-based capital standards for residual interests in asset securitizations ("the proposed rule").

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.

In summary, Freddie Mac recognizes the agencies' supervisory concerns about residual interests and supports their efforts to improve the alignment of risk with regulatory capital requirements. We believe that the proposed risk-based capital treatment of residual interests would be applied too broadly to a class of assets with substantially varying degrees of risk. A residual interest with a AA credit rating should not have the same capital requirement as a residual interest with a BB rating. We also believe the distinction the agencies propose to draw between retained and purchased residual interests is artificial and would establish substantially different capital standards for essentially identical business activities. We recommend that the agencies focus their efforts on improving the valuation of residual interests, promulgate equal risk-based capital standards for retained and purchased residuals and develop capital requirements that more accurately reflect risk.

Summary of proposed rule

The agencies propose to require that regulatory capital be maintained in an amount equal to the amount of residual interests retained on a depository institution's balance sheet and to include residual interests in the 25 percent of Tier 1 capital sublimit that applies to nonmortgage servicing assets and purchased credit card relationships. Residual interests subject to the proposed rule are those serving as credit enhancements in an asset securitization or other transfer of assets and which are structured through subordination provisions or other techniques to absorb more than a pro rata share of credit losses from the assets. Residual interests that do not serve as credit enhancements or which are purchased from another party are excluded from the scope of the proposed rule.

The agencies state that "[t]his proposed rule is intended to better align regulatory capital requirements with the risk exposure of these types of residual interests, encourage conservative valuation methods, and restrict excessive concentrations in these assets."[1] Thus, the proposal addresses supervisory concerns about overvaluation of residual interests, the limited liquidity and marketability of many residual interests, inadequate capital and risk management and high concentrations of residual interests in relation to capital.

Dollar-for-dollar capital requirement would not align capital with risk

We believe the agencies' supervisory concerns about depository institution investments in residual interests are generally valid, and we agree that in certain securitization structures the current risk-based capital requirement may not sufficiently cover the risk exposure presented by the residual interests covered in the proposed rule. Accordingly, we would agree that in such cases the agencies should require depository institutions to hold whatever additional capital is necessary to protect against losses.

[1] Proposed Rule at 57993.

However, we believe that requiring dollar-for-dollar capital to be held against *all* residual interests serving as credit enhancements would not align capital with risk. It would treat all residual interests in the same manner, when the risk of loss can vary greatly. While dollar-for-dollar might be appropriate for most non-investment grade (*i.e.*, BB or below) or unrated securities, it would almost always require capital far in excess of the risk posed by a highly rated (*i.e.*, AA or A) investment grade position.

We thus recommend that instead of applying a single risk-based capital treatment to all residual interests, the agencies align the capital requirement to the actual risk of loss. A financial stress test provides the most reliable and accurate method for distinguishing risks. Alternatively, the agencies at least should apply a less stringent standard to highly rated investment grade residuals than it does to non-investment grade or unrated residuals.

Valuation of residual interests should be improved

The proposed risk-based capital treatment of residual interests appears based to a large degree on concerns about the overvaluation of such interests by depository institutions. Under Statement of Financial Accounting Standards No. 125 ("FAS 125"), when a transfer of assets is treated as a sale, the seller carries any retained residual interests on its balance sheet at an estimate of fair value. The fair value reflects the expected future cash flows of the residual interest. The agencies express particular concern about "fair value estimates that are based on unwarranted assumptions of expected cash flows"[2]

We recognize that for both depository institutions and regulators alike, the process of establishing reasonable values for many residual interests is complicated by the lack of an active market and reliable price information. Nevertheless, we believe the most appropriate response to this problem is for the agencies to focus their efforts on making the valuation of residual interests more accurate and reliable. In their December 1999 Interagency Guidance on Asset Securitization the agencies provided depository institutions with some guidance in this regard. The agencies should provide further guidance as needed either on the supervisory level or through additional documentation.

Purchased and retained residual interests should be treated equally

The proposed treatment of residual interests applies only to those retained by a depository institution as a result of a securitization or other asset transfer and does not cover residual interests purchased from another party. The agencies believe that purchased interests could pose less liquidity risk and, by virtue of being purchased at a fair market price, are less likely to be overvalued by the institution. At the same time, the agencies express

[2] Proposed Rule at 57995.

concern that purchased interests pose the same degree of concentrated credit risk as retained interests and that differing capital treatment could encourage "swapping" of residual interests as a way to artificially reduce capital requirements.

We believe any regulatory distinction between retained and purchased residual interests would be artificial. In principle, residual interests sold in the marketplace are more liquid and more likely to be accurately valued. But, as the agencies recognize, given the substantially higher capital requirements proposed for retained interests, depository institutions would most likely own only those residual interests that they purchase. It thus would be almost impossible to distinguish residual interests that truly are purchased at a fair market price from those "purchased" at accommodation valuations in swaps or other transactions designed solely to avoid the capital treatment of retained interests. In that case, the agencies would fail to achieve their purpose of improving the alignment of capital with risk and probably also compound the supervisory difficulties they now face.

Moreover, the distinction between purchased and retained residual interests would require substantially different risk-based capital levels for essentially identical business activities. A prime example may be seen in the likely risk-based capital treatment of residual interests created under the two mortgage purchase programs of the Federal Home Loan Bank ("FHLB") System: the Mortgage Partnership Finance ("MPF") program offered by the FHLB of Chicago; and the Mortgage Purchase Program ("MPP") offered by the FHLBs of Cincinnati, Indianapolis and Seattle. In both programs, depository institutions retain credit risk through spread accounts used as credit enhancements in first loss positions and structured to absorb more than a pro rata share of any credit losses. However, in the MPP lenders sell mortgages to the FHLBs, while in the MPF mortgages are closed in the name of the FHLB of Chicago, with the lender as agent. The MPP's spread account would be considered a retained residual and would receive dollar-for-dollar capital treatment. On the other hand, because the MPF program does not involve a transfer of assets, the spread account may not be considered by some as a "retained" residual; instead, it may be viewed as effectively a "purchased" residual and thus exempt from the proposed rule's capital requirement. We believe such an outcome is not intended by the agencies.

Accordingly, we recommend that the agencies treat retained and purchased residual interests equally for risk-based capital purposes.

Exclusion of non-credit enhancement residual interests

In the preamble the agencies state that the proposed rule would exclude from coverage both purchased residual interests and residual interests that do not serve as credit enhancements. However, in the proposed changes to the rules for each of the agencies, only purchased residual interests are cited as being excluded from coverage. To ensure clarity, we recommend including the exemption for non-credit enhancement residual interests in the rules.

In conclusion

We appreciate the opportunity to offer our comments on this issue. Please contact us if we may be of further assistance.

Sincerely,

Edward L. Golding
Senior Vice President
Housing Economics and Financial Research