

## **Appendix A**

### **Observations Concerning Proposed PSR Triggers**

Freddie Mac offers the following specific observations about the triggers proposed by OFHEO in the PSR portion of its Prompt Corrective Action proposed rulemaking. We note that our comments should not be interpreted as a specification of all items that must be adjusted in order to make the triggers workable. Rather, we believe that a trigger-based system is a fundamentally flawed approach to regulatory supervision and that individual triggers cannot provide meaningful insight into the future financial condition of the Enterprises.<sup>1</sup>

- (a) OFHEO's national House Price Index (HPI) for the most recent quarter is more than two percent less than the national HPI four quarters previously, or for any Census Division or Division in which are located properties securing more than 25 percent of single-family owned or securing securities guaranteed by an Enterprise, the HPI of the most recent quarter for such Division or Divisions is more than five percent less than the HPI for that Division or Divisions four quarters previously.

A national HPI decline of 2% or more would probably be associated with a catastrophic economic event, and it is a virtual certainty that the Enterprises and OFHEO would be aware of the crisis and taken appropriate steps long before the proposed trigger would be hit. In contrast, a Census Division HPI decline of the proposed magnitude does occur on occasion, although our analysis reveals no correlation between such local declines and subsequent financial difficulties for Freddie Mac.

Credit losses are only one component of the Enterprises' complex financial structure, and analysis of the HPI alone is a crude method to assess even the limited issue of potential future credit risk to the Enterprises. High homeowner equity levels and available credit enhancements, as well as prepayment rates and other factors, can effectively mitigate any threat presented by modest declines in house prices (including all such declines witnessed during the past 30 years).

In order to operate as even a moderately useful indicator, a house price measure should be tied to an Enterprise's collateral at risk. Absent consideration of such additional information, this measure would have little value as an early warning of a safety-and-soundness issue.

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<sup>1</sup> OFHEO specifically requests comments on whether there are additional marketplace or internal indicators that should be included in its list of triggers. 66 Fed. Reg. 18695. As is demonstrated by our comments on the existing proposed triggers, Freddie Mac believes that the exercise of defining in advance specific events that are reliable indicators of safety-and-soundness issues is extremely difficult. Furthermore, OFHEO could double or triple the number of triggers on its list and still not come close to covering all possible advance warning indications. Accordingly, we believe that expansion of the list of triggering events would simply compound the problems associated with this supervisory approach.

(b) An Enterprise's interest rate risk, as assessed by any internal measure, exceeds the limit at which the Enterprise's policies and procedures require a report of such exception to its board of directors.

The term "assessed by any internal measure" is quite vague; in the case of Freddie Mac, we measure Portfolio Market Value Sensitivity ("PMVS") and exposures to individual risk factors such as duration, convexity, yield curve, basis, and volatility, among other interest-rate risk related measures. Many of these interest rate risk measures are routinely reported to our Board – not just when limits are hit. (Presumably, OFHEO does not intend to commence its PSR process after every Freddie Mac Board meeting.)

Furthermore, our "limits" tend to be thresholds for discussion between the Board and management rather than absolute expressions of the Board's maximum acceptable risk tolerance. In other words, we purposefully set limits well below our maximum risk tolerance, increasing the probability of hitting the limit but substantially decreasing the likelihood that crossing a limit will be associated with any adverse consequences. The limits thus exist primarily as devices to permit management and our Board to monitor our positions and market trends and to make appropriate adjustments, precisely for the purpose of avoiding future financial difficulties.

Ironically, OFHEO's inclusion of self-defined measures and limits as a triggering event creates disincentives for the Enterprises to monitor relevant measures and to keep their respective boards apprised of meaningful developments. By effectively penalizing proactive internal management, the proposed interest rate risk trigger could decrease an Enterprise's safety-and-soundness.

(c) An Enterprise's net income for the most recent calendar quarter is less than one-half of its average quarterly net income for any four-quarter period during the prior eight quarters.

In order to evaluate the appropriateness of this trigger, we would need to know how OFHEO defines "net income" or whether it proposes that each Enterprise define the term according to its own criterion. Assuming that OFHEO intends to rely on a standardized definition, it must specify details. To cite some initial questions, should an Enterprise include extraordinary items in net income? Should it mark its derivatives positions to market? Absent specific guidance on these and other subjective accounting decisions, neither OFHEO nor the Enterprises would be able to determine if such a trigger had been tripped.

(d) An Enterprise's net interest margin (NIM) for the most recent quarter is less than one-half of its average NIM for any four-quarter period during the prior eight quarters.

NIM has no formal definition and instead is defined subjectively by many factors. Adding or removing components from the NIM calculation could easily determine whether this trigger is tripped or not. (Notably, the two Enterprises calculate NIM

differently.) In order to give meaning to this trigger, OFHEO must specify a definition for NIM.

- (e) For single-family mortgage loans owned or securitized by an Enterprise that are delinquent ninety days or more or in foreclosure, the proportion of such loans in the most recent quarter has increased more than one-half of a percentage point compared to the lowest proportion of such loans in any of the prior four quarters.

We note that delinquency rates provide a crude assessment of credit risk because they do not consider credit enhancements as well as other relevant factors. It is certainly possible for credit losses to decline even as delinquency rates increase, and correlations between these rates and financial risk to an Enterprise is likely to be quite low. To add greater meaning to this trigger, OFHEO should instead consider an Enterprise's actual collateral at risk.

- (f) An Enterprise's equity, as measure on its Consolidated Fair Value Balance Sheet as of the end of a calendar year, is ten percent less than the Enterprise's equity so measured as of the end of the previous calendar year, and is ten percent or more below the amount of its core capital.

With respect to this trigger, we note that our calculation of fair value balance sheet ("FMBS") equity incorporates several risks that we manage, although not through the use of specific offsetting financial hedges. Despite resulting volatility in our FMBS equity, we are aware of no historic correlation between such volatility (including measured changes sufficient to trip the designated trigger) and any financial distress. In fact, it is easy to postulate a situation in which positive financial developments, such as an increase in prices of our outstanding debt securities, would result in a decline of our FMBS equity.

Apart from the lack of a clear relationship between this proposed trigger and actual financial risk, "Enterprise equity" must be defined clearly for this trigger to be meaningful. For example, it is not clear whether equity includes estimated taxes on the difference between book value and fair value or if equity includes preferred stock. OFHEO would have to enhance the precision of the terms used in this trigger before it could provide guidance.

- (g) An Enterprise experiences material and sustained disruptions to its data processing or operational systems.

All of the operative terms in this trigger are too vague to set any meaningful standards. Specifically, OFHEO must define what it considers to be: (i) a "material and sustained disruption"; (ii) an Enterprise's "data processing" system; and (iii) its "operational" system.

(h) An Enterprise changes its external auditor without cause.

It is difficult to imagine how such a change could occur “without cause”; presumably any switch of auditors would be for a reason. We believe that OFHEO is attempting to address a situation in which an Enterprise’s external auditors is changed for a reason that implicates a safety-and-soundness concern. However, it is not clear how OFHEO would be able to incorporate sufficient specificity into a definition of cause to make this predictor a meaningful predictor of financial stress.

(i) The board of directors of an Enterprise fails to hold a schedule meeting without cause.

Again, the “without cause” provision raises a question of how such an event could possibly occur. OFHEO presumably would want to develop a definition of “cause” that could cover any situation in which the cause for canceling a board meeting potentially implicates safety-and-soundness issues. We question whether it is possible to develop such a definition. In addition, we note that most possible reasons for canceling a board meeting are unrelated to safety-and-soundness issues, and it is unlikely that a single cancelled meeting would itself constitute a significant financial event for an Enterprise.

(j) Any other development, including conduct of an activity by an Enterprise, that OFHEO determines in its discretion presents a risk to the safety and soundness of the Enterprise or a possible violation of applicable law, regulation or order.

OFHEO’s final proposed PSR trigger is a discretionary catch-all. Significantly, all of the other triggers (to the extent that they are adequately specified and are reasonably related to potential risks) could be addressed by this trigger. This catch-all most closely approximates OFHEO’s current oversight powers because it incorporates discretionary elements and implicitly requires OFHEO to consider context and actual risk before automatically moving forward with a mandatory process.