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Financial Accounting Standards Board
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Re: File Reference 1200-001

Dear Ms. Bielstein:

The Federal Home Loan Mortgage Corporation ("Freddie Mac" or "the Company") appreciates this opportunity to comment on the FASB's exposure draft *Qualifying Special-Purpose Entities and Isolation of Transferred Assets* ("the ED"). Freddie Mac has previously sent you an e-mail requesting the opportunity to participate in the public roundtable on this project scheduled for August 28, 2003 and we look forward to that discussion.

Congress created Freddie Mac by establishing its charter in 1970. The Company's mission is to stabilize the nation's mortgage markets and expand opportunities for homeownership and affordable rental housing. Within the constraints of its charter, Freddie Mac has been a significant participant in the market for mortgage backed securities ("MBS") since 1974. While the market for MBS has grown to include some $2.8 trillion of outstanding securities, the basic MBS securitization transaction is essentially unchanged since the 1970s. The MBS securitization structures are passive, as contemplated by the Board's original discussions of these transactions as part of FAS 125. The securities issued are freely traded and are often repurchased and resold by Freddie Mac. There are no changes (such as substitutions or new additions) to the mortgages in the pool. The cash flows of the MBS are the cash flows of the original mortgages. In a very real sense, MBS are the original "plain vanilla" securitizations.

MBS Programs

Freddie Mac's securitization transactions were originally derived from and are structured as loan participations in which an *undivided interest* in the pool of loans is transferred to the holders of the MBS. The holder of that undivided interest is free to sell or pledge it without restriction. Freddie Mac issues these MBS in the form of Mortgage Participation Certificates, or "PCs." This securitization process does not involve the use of a special purpose entity ("SPE"). This PC securitization has a long-standing consistent treatment beginning with FAS 65 and continuing through FAS 125 and finally FAS 140. More recently, FAS 140 addresses loan participations in paragraphs 104-106, concluding that if the transferee of the participation (undivided interest) can transfer that interest, the transaction is a sale for accounting purposes. FAS 140 defines an *undivided interest* as a "Partial legal or beneficial ownership of an asset as a tenant in common with others. The proportion owned may be pro rata, for example, the right to receive 50 percent of all cash flows from a security, or non-pro rata, for example, the right to receive the interest from a security while another has the right to the principal." FAS 140 also suggests that an undivided interest in an asset may be transferred in a transaction not involving use of an SPE. For example, paragraph 10 states:

> Upon completion of any transfer of financial assets, the transferor shall: (a) continue to carry in its statement of financial position any retained interest in the transferred assets, including, if applicable, servicing assets (paragraphs 61-67), beneficial interests in assets transferred to a qualifying SPE in a securitization (paragraphs 73-84), and retained **undivided interests** (paragraphs 58 and 59); (b) allocate the previous carrying amount between the assets sold, if any, and the retained interests, if any, based on their relative fair values at the date of transfer (paragraphs 56-60).

Paragraph 58 also differentiates between undivided interests and SPE transactions: "Examples of retained interests include securities backed by the transferred assets, **undivided interests**, servicing assets, and cash reserve accounts and residual interests in securitization trusts."

Freddie Mac creates PCs and supplies them to the capital markets primarily through two programs: the *guarantor* program and the *cash window* program.

Under the *guarantor* program, Freddie Mac typically contracts with a lender who originates a pool of conforming mortgage loans and desires to convert them to PCs which are guaranteed by Freddie Mac. These PCs are more liquid than unsecuritized mortgage loans priority due to standardized underwriting terms, parameters governing the "pooling" of loans into securities and the principal and interest guarantee. To effect this conversion, the lender transfers the mortgages to Freddie Mac in exchange for PCs that are undivided interests in those mortgages. This securitization process does not involve the use of a special purpose entity ("SPE"). The transfer of the mortgages takes the legal form of a sale (and that form is required by Freddie Mac's charter), but because Freddie Mac as the "transferee" cannot sell or pledge the loans and must convey the undivided interests (PCs) representing substantially all of the cash flows on those loans back to the transferor, the transfer does not qualify as a sale from the lender's perspective for accounting purposes.[1] That is, the lender/seller does not give up control and Freddie Mac does not obtain control of the assets. Freddie Mac receives a fee for providing its guarantee and for its services in managing the program. This fee is received over the life of the mortgages.

[1] For example, if the mortgages have a coupon yield of 5.5%, the lender might retain a servicing fee of 0.25% (25 basis points) and Freddie Mac might receive 0.25% (25 basis points) as its guarantee fee, so that the MBS would pay 5.0%. The servicing fee, guarantee fee, and coupon yield of the MBS are all set at inception and do not change subsequently.

Under the *cash window* program, Freddie Mac purchases conforming mortgages from lenders or other holders for cash. Some mortgages are held as loans in Freddie Mac's portfolio, but many are gathered in pools and converted to PCs guaranteed by Freddie Mac in much the same way as under the guarantor program. These PCs are frequently sold to investors. In the hands of an investor, a security originated in the cash window program is indistinguishable from one originated in the guarantor program. Similarly, Freddie Mac's rights and obligations under the guarantee arrangement are the same for both programs. The holder of the securities owns the original pool of mortgages in the form of an undivided interest. The cash flows on the mortgages (less servicing fees and guarantee fees) will go to the holders. The arrangement is passive.

Other government agencies and government sponsored enterprises, specifically Ginnie Mae and Fannie Mae (collectively "GSEs"), have programs to create MBS that are essentially the same with respect to the characteristics of the securities issued, but that differ in form. Like Freddie Mac, the other GSEs have federal charters that constrain their operations. However, it is our understanding that, unlike Freddie Mac, Fannie Mae uses SPEs in its securitizations. Ginnie Mae, however, does not use SPEs and does not create a legal transaction to purchase the mortgage loans. Ginnie Mae simply issues its guarantee to the lender, and the lender is legally the issuer of the securities.

All of the GSEs securitizations are similar in the result. In all cases the investor holds a security which is entitled to receive the cash flows on the underlying mortgage loans and the GSEs provides a guarantee of timely payment of amounts due. GSEs charters established by legislation constrain the form of these transactions. In particular, Freddie Mac could not adopt a transaction structure like that used by Ginnie Mae without a legislative change in its charter.

Accounting

We believe that GSEs accounting for all MBS should be based on one model and that the current accounting for GSEs MBS is appropriate. FAS 65, FAS 125 and FAS 140 all recognized the existence of MBS and, we believe reaffirmed the accounting models that are in use and widely understood. FAS 65 defined "mortgage backed securities" by reference to GSEs as follows:

> Securities issued by a governmental agency or corporation (for example, GNMA or FHLMC) or by private issuers (for example, FNMA, banks, and mortgage banking enterprises). Mortgage-backed securities generally are referred to as *mortgage participation certificates or pass-through certificates* (PCs). A PC represents an undivided interest in a pool of specific mortgage loans. Periodic payments on GNMA PCs are backed by the U.S. government. Periodic payments on FHLMC and FNMA PCs are guaranteed by those corporations, but are not backed by the U.S. government.

SFAS 140 defines a specific treatment for MBS in recognition of the long history of specialized accounting for those transactions. Paragraph 182 of FAS 140 describes the Board's process as follows:

182. In connection with its discussion of minimum outside beneficial interest, the Board was asked whether a guarantee, if it is the only outside beneficial interest and worth less than 10 percent of the total value of the securitization, was sufficient to demonstrate that an SPE was distinct from the transferor. Some commentators mentioned "swap-and-hold" securitizations, in which the transferor takes back and retains all the mortgage-backed securities. The Board decided to make an exception to the 10 percent minimum for what this Statement refers to as a *guaranteed mortgage securitization*, a securitization of mortgage loans that is within the scope of FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,* as amended, and includes a substantive guarantee by a third party. While a substantive guarantee by a third party clearly can have significant impact on the value and liquidity of the interests retained in guaranteed mortgage securitizations, which is consistent with the conclusion that the SPE is demonstrably distinct from the transferor, that impact is not the primary reason for this exception. Instead, the Board made that exception primarily in view of the long history of specialized accounting for mortgage banking activities, including its recent reconsideration of the measurement of retained mortgage-backed securities in FASB Statement No. 134, *Accounting for Mortgage-Backed Securities Retained after the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise.*

The transactions that originate MBS today are the same as those the Board has considered in the past. Changes that would bring some or all of the mortgage loan collateral and the MBS outstanding onto the balance sheets of the guarantor GSEs would not, in our opinion, be an improvement in financial reporting; such a change would impair, not enhance, the understandability of financial statements. Within the last year, we and the other GSEs have devoted considerable efforts to implementing FASB Interpretation 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, including Indirect Guarantees of Indebtedness of Others*. FIN 45 results in recognition of a liability for the fair value of our guarantee obligation and recognition of the guarantee fee receivable. These represent the full extent of the expected economic benefits controlled by the Company and obligations of the Company to sacrifice assets. Inflating the balance sheets of the GSEs beyond what we understand FAS 140 and FIN 45 already require by including mortgage loan collateral they do not control[2] and liabilities for beneficial interests in those loans does not seem to us to be an improvement.

The Exposure Draft

Paragraphs A5 – A7 of the ED note that the Board initially believed that "the legal structures used in securitizations were passive passthrough arrangements", and since such a structure effectively gave holders of beneficial interests an undivided interest in the pool of assets, derecognition was appropriate. Subsequently, it became apparent to the Board that some securitization structures were not passive passthrough arrangements. Freddie Mac's PC structures are different from most in that they do not use an SPE but legally transfer an undivided interest in the mortgage loans to the holder. They are the passive passthrough arrangements the Board initially understood. Paragraph A7 states,

[2] Specifically in the case of Freddie Mac's *guarantor* Program, as discussed above, the Company not only does not currently control the assets, but it never had such control at any time in the past. The same is true of Ginnie Mae transactions.

"Identification of a controlling interest in a passive passthrough structure that effectively creates undivided interests in assets is unnecessary because control is not pertinent to such a structure." We believe that conclusion appropriately applies to the MBS structures described above. Accordingly, those transactions are not part of the problem the ED set out to remedy.

We do not understand how the Board intended the ED to apply to GSE MBS transactions. Much of the ED addresses qualifications for a QSPE. That would suggest that transactions that do not involve an SPE would be unaffected. If, however, it is the Board's intent to require different accounting for MBS issuers that use an SPE and provide a guarantee, the result would be an unfortunate mixed model, with some traditional MBS transactions achieving derecognition and others failing. As noted above, we do not believe that would contribute to the goal of understandable financial statements. Further, we do not understand why the existence of a guarantee should preclude the current accounting approach, with or without an SPE. FAS 140 clearly indicates that a transfer with recourse is not an obstacle to derecognition. (See, for example paragraphs 11b, 146d, and 270.)

Other parts of the ED suggest the Board might be thinking of shifting away from the control and components approach that is the basis for FAS 125 and FAS 140, and replacing it with a risks and rewards approach. If that is the Board's intent, however, we do not believe the ED adequately explains either the need for such a significant change, or the scope of which transactions would be required to change their accounting. We believe the Board had good reasons for moving away from the risks and rewards approach in FAS 125. Paragraph 136 of FAS 140 summarizes those reasons:

> 136. In developing Statement 125, the Board noted that application of a risks-and-rewards approach for derecognizing financial assets would be highly dependent on the sequence of transactions leading to their acquisition. For example, if Entity A initially acquired an undivided subordinated interest in a pool of financial assets, it would recognize that subordinated interest as a single asset. If, on the other hand, Entity B initially acquired a pool of financial assets identical to the pool in which Entity A participates, then sold a senior interest in the pool and continued to hold a subordinated interest identical to the undivided interest held by Entity A, Entity B might be judged under a risks-and-rewards approach to have retained substantially all the risks of the entire pool. Thus, Entity B would carry in its statement of financial position the entire pool of financial assets as well as an obligation equal to the proceeds from the sale of the undivided senior interest, while Entity A would report its identical position quite differently. Those accounting results would disregard one of the fundamental tenets of the Board's conceptual framework; that is, " . . . accountants must not disguise real differences nor create false differences."

We do not understand what the Board intended by the changes proposed to paragraphs 80-84 regarding isolation of transferred assets in securitizations, and how those paragraphs relate to the discussion of effectively creating undivided interests in paragraphs A5-A7. It is unclear whether it was the intent of the Board to eliminate the distinction between an undivided interest and a beneficial interest with the subtle parenthetical change in paragraph 80. If so, that change would seem to be inconsistent with the distinction the Board has drawn in FAS 125, FAS 140 and in the basis for conclusions in the ED. More specifically, we do not understand the scope of the sentence proposed to be added to the end of the proposed amendment to paragraph 83 by paragraph 11 of the ED, which would suggest that beneficial interests (including undivided interests) can only be issued from a QSPE to achieve derecognition. If it addresses only two step securitizations, as suggested by the reference to paragraph 83(b), it does not present any specific problems for us. We believe our PC transactions achieve legal isolation as described in paragraph 80. We hope the Board can make clear that paragraph 83 does not somehow override that conclusion.

Recommendations

If the ED is intended to be narrow, the Board could make it clear and avoid creating problems for MBS transactions by limiting the scope to situations where there are perceived abuses, such as where beneficial interests can be reissued by the SPE (or other structure) or where there is discretion to shorten the life of the structure. Alternatively, the Board could clarify that accounting for GSE MBS transactions is addressed elsewhere and is not affected by this document.

If it is the Board's intent to pursue a major revision of the FAS 125 model, which might require Freddie Mac, for example, to record as its assets all or some portion of the mortgages that underlie MBS, we believe exposure of a successor document that would make clear the scope of such change and the reasons for it would be appropriate. We note that such a change would eliminate the information previously required by FAS 140 and generated by the recently implemented FIN 45.

We appreciate the opportunity to participate in the Board's due process and look forward to the public roundtable. If the Board or staff would like to discuss any of the issues raised in this letter or further developments in the Board's project as they relate to GSEs and MBS, please feel free to call Ken Evola at (703) 714-4900. We would also be happy to schedule a meeting at your convenience or participate in a working group to further explore these issues.

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