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Financial Accounting Standards Board 401 Merritt 7 Norwalk, Connecticut 06856-5116

RE: FAS 155 Implementation Concerns

Ladies and Gentlemen:

We would like take this opportunity to make you aware of some issues related to the application of Statement of Financial Accounting Standards No. 155 "Accounting for Certain Hybrid Financial Instruments" ("SFAS 155"). These issues, which we previously raised with the FASB staff, are creating uncertainty among practitioners and relate to the application of SFAS 155 to securitization markets in general and more specifically to mortgage backed securities. In particular, we have concerns regarding the interaction of FAS 155 with DIG Issue B39, Application of Paragraph 13(b) to Call Options That Are Exercisable Only by the Debtor (DIG B39), and the impact this authoritative literature will have on our accounting and ultimately the transparency of our financial statements.

Our overriding concern is that inconsistencies will be introduced into the financial reporting of companies with significant investments in asset backed securities, which will confuse financial statement users and diminish comparability generally. We believe an accounting model that requires different accounting treatment for economically identical instruments is not an improvement to financial reporting. In addition, we have the following practical concerns:

- The amendment to DIG B39 and its impact on the scope of SFAS 155 is not clear. Differing interpretations exist in the marketplace.
- The use of the "double double" test for mortgage backed securities can result in inconsistent financial reporting for identical securities.

Different Accounting for Identical Financial Instruments

Purchases of these financial instruments will likely be required to apply different accounting to identical securities based on the timing of when the securities were purchased. This will likely be confusing to investors and impair the transparency and comparability of results.

The paragraph 13(b) test prescribed in SFAS 133 "Accounting for Derivative Instruments and Hedging Activities" (commonly referred to as the "double double" test) could be failed by purchasing any security that contains an underlying prepayment option at a discount. For example, if a mortgage-backed security is purchased for a dollar price of 99 and all of the underlying mortgages prepay immediately, the purchaser would receive 100 (par) back within one month (next payment date). This would be a 12% annualized return, which may be more than double the initial yield as well as the then current yield for a similar instrument, failing paragraph 13(b) and requiring



bifurcation of the embedded prepayment option. Immediate prepayment of the same security purchased at par would not result in an increase in yield.

As a result, a security purchased one day at a price of 99 would have different accounting from the exact same security purchased two days later at a price of 100. Applying SFAS 155, as currently drafted, companies would mark to market the security purchased at 99 through the income statement while the security purchased at 100 could be classified as an available for sale security and marked to market through other comprehensive income.

Another example of different accounting for similar securities is the discrepancy in accounting for individual mortgage loans underlying a mortgage-backed security versus the security itself. A mortgage-backed security, purchased at a discount, would likely contain an embedded derivative not considered clearly and closely related whereas a similar purchase of just the underlying collateral at a discount would not. This results from the fact that mortgage loans are specifically scoped out of SFAS 133.

The only difference between the mortgage-backed security and the mortgage loan is that the mortgage-backed security no longer has credit risk based on the guarantee provided in the security. The underlying prepayment option is identical in every way, regardless of whether the loan is securitized or not. We believe an accounting model that does not require fair value accounting with changes in the income statement for a mortgage loan should not require such accounting for a virtually identical financial instrument whose variability and risk is only lessened.

DIG B39 interpretation confusion

DIG B39 considered the question of when the embedded derivative "double double" test should be applied to embedded options that allowed for the prepayment of a hybrid instrument. It concluded that the "double double" test in paragraph 13(b) of SFAS 133 was not to be applied by investors who own instruments in which only the issuer had the ability to exercise this option. Included in the scope of DIG B39 (as amended by SFAS 155), by way of Example 6, were mortgage-backed securities. Specifically, mortgage backed securities in which the cash flows related to the prepayment option are proportionally passed through to the investors are not subject to the paragraph 13(b) test. The prepayment option in mortgage backed securities in which these cash flows are **not** proportionally passed through are subject to the 13(b) test despite the fact that the investor cannot exercise an option to obtain the double return.

This has created uncertainty among practitioners, specifically when considered in the context of how proportional pass throughs of cash flows are defined in paragraph 14 of SFAS 155 for interest only and principal only securities. Proportional cash flows are defined in paragraph 14 as a straight pass through of underlying cash flows except for "reasonable compensation for stripping the instrument or to provide adequate compensation to a servicer". Excess servicing, guarantees fees or any other fees would not meet the definition of proportional.

If it is appropriate to apply the paragraph 14 definition of proportional cash flows to the revised language of DIG B39, it is unclear what mortgage backed securities this would be apply to. Those who interpret that the paragraph 14 definition is not applicable to DIG B39 believe that agency single class pass throughs are eligible for this



treatment while those who believe that the paragraph 14 definition is relevant to DIG B39 believe that no mortgage backed securities would be eligible for this treatment.

It is our understanding, based upon discussions with staff members during the drafting of SFAS 155 as well as our reading of the related meeting minutes, that the amendment to DIG B39 contained in FAS 155 was intended to clarify that the "double double" test should not be applied to agency single class mortgage backed securities. This also appears to be the impression of other constituents who had similar expectations regarding the intention of the revision. We know of no securities, other than agency single class mortgage backed securities, issued with any regularity that could possibly be the target of this language. Securitizations where the resulting security is simply a 100% proportional pass through of the underlying security lack economic substance, and, therefore, they do not exist on a meaningful scale.

To illustrate this concern, consider a single class agency mortgage backed security. These instruments are beneficial interests in a pool of mortgage loans that are guaranteed by a Government Sponsored Enterprise ("GSE") as required by their federally mandated charters. The investor has purchased a security that is a pass through of the cash flows from the pool of mortgage loans except that the credit risk is removed through a guarantee. The guarantee provider is compensated by a guarantee fee, which is taken from the cash flows of the mortgage pool. Additionally, a servicing fee to compensate the servicer is removed for handling the administration of the loans. This fee will likely be considered "more than adequate" for accounting purposes. A typical coupon cash flow is as follows:

Average rate on loans in the pool	6.50%
Servicing Fee (including adequate plus excess)	(.25%)
Guarantee fee	(.25%)
Coupon on security	6.00%

All of the cash flows of the mortgage loans are not proportionately passed through as paragraph 14 of FAS 133 (as amended by FAS 155) requires. As previously stated, many in practice are interpreting the guarantee fee and excess servicing fee as disqualifying a single class agency pass through mortgage backed security from the application of DIG B39 exemption from the "double double" test.

We have concluded, based upon our knowledge of the deliberations around FAS 155, that the use of the words "cash flows associated with the embedded call feature" does not apply to the stripping of the guarantee and servicing fees as those fees can be viewed as a cash flow not related to the embedded call feature. However, we understand that many practitioners do not hold this same interpretation.

We believe that a guaranteed mortgage backed security should not be considered to have an embedded derivative if the underlying mortgage loan does not. This accounting model lacks representational faithfulness because it



provides different accounting answers based on form for what is the economically identical transaction. This topic was raised in the December 14, 2005 Board Meeting, Issue 7, where the FASB staff recommended that prepayment options in securitizations be considered clearly and closely related to the debt host as established in DIG B39.

We are concerned that different interpretations could lead to different accounting treatments amongst different companies based on individual interpretations, i.e. some may interpret single class pass throughs as out of scope of the "double double" test, while others may interpret them as in scope. This would create financial statements that are not comparable within industries and, significant confusion amongst analysts and investors.

Application of Paragraph 13 (b) "double double" test to mortgage backed securities

The "double double" test is only required of embedded derivative instruments where the underlying is an interest rate or an interest rate index that alters net interest payments that would be paid or received. In a mortgage-backed security that can be prepaid, the underlying is not an interest rate or an interest rate index. In fact, paragraph 7 of SFAS 133 identifies underlyings "...or other variable (including the occurrence or nonoccurrence of specified event such as the payment under a contract)." It further states that the settlement of a derivative is dependent on the interaction of the underlying with the notional. We believe that the underlying in the potential prepayment related derivative embedded within a mortgage-backed security to be whether or not the underlying mortgages actually prepay. Prepayment on a mortgage may be interest related, however if interest rates decline, mortgage may not prepay. In fact, when considering a pool of mortgage loans, prepayments often result from noneconomic events, such as death, divorce and relocation. Conversely, many mortgages will prepay even when interest rates increase. We believe the substance of the "double double" test is to capture instruments that contractually are required to pay the double return in an interest rate scenario, not those that would double if a certain contingency occurred, even if the likelihood of the contingency is primarily driven by interest rates.

The determination as to whether an embedded derivative requiring bifurcation exists requires estimates about prepayment behavior in extreme interest rate scenarios[mph1]. Such predictions would be model driven, given the extreme nature of the interest rate scenarios and not based on empirical information. In other words, the discount that creates an embedded derivative requiring bifurcation would vary from practitioner to practitioner based upon whose prepayment model was used. It should be noted that while these models may be highly accurate at predicting prepayment speeds over large samples, they are not designed to predict accurately what would happen in the extreme interest environments required to be considered under paragraph 13 (b).

Conclusions

The application of paragraph 13 (b) to prepayment options in mortgage backed securities is highly problematic and not an improvement in financial reporting. That is not to say that we believe mortgage backed securities do not have embedded derivatives related to prepayment optionality. Application of the "double double" test for prepayment options seems to be the wrong standard.

Given the confusion over how to apply the revised DIG B39 and the points discussed above, we ask that you reconsider DIG B39. We think that prepayment risk should be treated similarly to credit risk and not require



consideration under the "double double" test. SFAS 133 was intended to subject interest rate related items to the "double-double" test, and although prepayment risk is associated with interest rate risk, it is not directly linked.

In addition, we ask you to reconsider Example 6 in DIG B39. This example includes MBS in the scope of the "double double" test primarily as a result of a trust not having an option to pass through cash flows. This creates different accounting for similar securities merely through the introduction of a trust. By clarifying Example 6 to state that the prepayment option is in the control of the underlying mortgage holders in an MBS security, regardless of the existence of the trust, and are therefore exempt from the "double double test", the discrepancy in accounting models would be eliminated.

If it is concluded that clarifications regarding prepayment risk or Example 6 of DIG B39 are not required, we believe that clarification of the current wording in Example 6 of DIG B39 (as amended by SFAS 155) would be required to solve current interpretational issues and the differences in accounting treatment between companies with identical transactions.

Similarly, we believe that a delay of the removal of the DIG D1 scope exception would allow the time necessary to further vet the issues and resolve the contradiction in the application of this guidance.

Thank you for your attention to the matters raised in this letter. If you have any questions regarding our letter please call me at (703) 903-3410 or Tim Armstrong at (571) 382-3738.

Sincerely

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