October 24, 2005

Technical Director – File Reference 1201-001
Financial Accounting Standards Board
401 Merritt 7
Norwalk, CT 06856-5116
VIA E-MAIL

Re: Proposed Statements of Financial Accounting Standards, Accounting for Certain Financial Instruments – An Amendment of FASB Statements No. 133 and 140

Ladies and Gentlemen:

Freddie Mac appreciates this opportunity to offer the following comments on the FASB’s Proposed Statements of Financial Accounting Standards, Accounting for Certain Financial Instruments – An Amendment of FASB Statements No. 133 and 140.

In principle, we support the direction of this proposed Statement, which is an important step towards the Fair Value Option for all financial instruments. However, as discussed below, we do have concerns regarding certain aspects of the Exposure Draft.

Beneficial Interests In Securitized Financial Assets That Are Prepayable

We are concerned that the proposed guidance will result in permanent differences in the accounting for a wide range of similar instruments merely based on the form of the instrument. This concern is predominately around securitized financial assets that are prepayable (e.g., mortgage-backed securities). Currently, assets such as mortgage loans are exempt from performing the testing in paragraph 13(h) of Statement 133 based on the guidance in Statement 133 Implementation Issue B39. This exemption is not available to beneficial interests in securitized mortgage loans. We recommend that the exemption provided for in Statement 133 Implementation Issue B39 be afforded to beneficial interests in securitized financial assets.

To help illustrate this point, consider a mortgage-backed security issued by a GSE (see Example 1 in the Attachment). Credit risk is significantly reduced in the BI through the guarantee provided by the GSE. Therefore, the primary remaining risk in the BI is interest rate risk, specifically prepayment risk. This prepayment risk is unchanged from that contained in the original mortgage loans, which would not require bifurcation of that prepayment risk. However, an investor holding the BI may be required to bifurcate the embedded prepayment derivative, especially if the BI is acquired at a discount. Acquiring this security at a discount is problematic since when performing the Statement 133 paragraph 13(b) testing, we must consider the remote interest rate...
scenario where interest rates immediately fall to 0%. Under such a scenario, the homeowners would elect their prepayment option and the BI holder would quickly receive back par for their security, resulting in a rate of return that is more than double the initial rate and the then current rate of return on the host contract. We question why the form of the holding and not its economic characteristics should determine whether bifurcation of the embedded prepayment option is required.

Furthermore, given the FASB’s basis for conclusions around the proposed exemption for concentrations of credit risk in subordinated beneficial interests, we believe that it would be consistent to also provide an exemption for concentrations of prepayment risk in subordinated beneficial interests.

Consider a securitization of mortgage loans that issues two beneficial interests: a planned amortization class (“PAC”) and a companion class (“companion”). The PAC is designed to reduce investors’ prepayment risk by establishing a sinking-fund structure. PAC bonds assure to varying degrees that their investors will receive payments over a predetermined time period under various prepayment scenarios. The companion bond absorbs the variability of the collateral cash flows, and as such, generally pays a higher yield. This concentration of prepayment risk is very similar to the concentration of credit risk, which is receiving an exemption by the Board. If it is the intention of the Board to require a different accounting result for similar structuring of risks simply because this risks are different, then this point should be clarified.

Need for Implementation Guidance

Given the relative complexity of beneficial interests in securitized financial assets, we are strongly concerned that:

- It will be immensely challenging in practice to identify the embedded derivative(s) and the host contract due to the complexity of the cash flow allocations and interdependencies of the assets and other arrangements within a securitization vehicle, specifically since such instruments often do not exist on a freestanding basis.
- It is likely that beneficial interest holders will identify the host and embedded derivative for a particular beneficial interest differently since each investor will have a different view of the implied stated terms.
- The valuation of identified embedded derivative(s), as required under Implementation Issue B6, will involve lower level valuation techniques than used for the actual hybrid instruments, and in many cases will be highly dependent upon an entity’s identification of the terms of the embedded derivative and an entity’s estimate of the prepayment profile of the assets backing the beneficial interest.

We, therefore, are recommending that the proposed Statement provide implementation guidance on defining the host contract and evaluating whether a hybrid instrument contains an embedded derivative that would require bifurcation. Such guidance could be in the form of common marketplace examples that address (i) beneficial interests that do/do not qualify for the credit risk exemption, (ii) beneficial interests that do/do not qualify for the IO/PO exemption, (iii) beneficial interests that are backed by prepayable assets, including those acquired at a discount, and (iv) beneficial interests that contain financial guarantee contracts. We believe that the Board could provide this guidance and still achieve its goal of issuing clarifying principles rather than writing...
rules. We have provided a few examples in an attachment to this document which help to illustrate our confusion in applying the guidance in the proposed Statement.

**Effective Date**

We would also recommend that the implementation of this proposed Statement be delayed to allow sufficient time after its issuance for entities to develop and implement new processes and internal controls over (i) embedded derivative testing of beneficial interests, (ii) valuation models for embedded derivatives requiring bifurcation, and (iii) electing to account for hybrid instruments at fair value. We believe that this process could be simplified if the proposed Statement was delayed until the issuance of a Fair Value Option standard, as the Fair Value Option standard would provide an alternative that would allow companies to account for all instruments at fair value.

**Exemption for Interest-Only and Principal-Only Strips**

It is not clear what the Board means when it describes the “portions” of contractual cash flows that would qualify for the paragraph 14 exemption. We understand that the Board’s amendment to Statement 133’s paragraph 14 was meant to narrow the set of instruments that would qualify for this exemption. We also recognize that beneficial interest that share similar economic characteristics to interest-only and principal-only are not intended to qualify for this exemption solely due to the form of those instruments. However, we are not certain which instruments qualify for the former and which fall into the latter. We, therefore, feel that examples should be provided to help in understanding this subtle distinction.

An example that we would recommend discussing involves the PAC discussed in the example on the prior page. If that PAC were used as collateral for a second securitization where beneficial interests were issued in the form of an interest-only strip and a principal-only strip, would the strips qualify for the proposed exemption. We believe that the strips should qualify for the proposed paragraph 14 exemption. If this is the intention of the Board, then this intention should be made clear.

**Fair Value Election**

We are concerned about the deletion of the paragraph 16 phrase, “If an entity cannot reliably identity and measure the embedded derivative instrument that paragraph 12 requires be separated from the host contract, the entire contract shall be measured at fair value with gain or loss recognized in earnings, but it may not be designated as a hedging instrument pursuant to this Statement.” Given the reasons stated above concerning the reliable identification and measurement of embedded derivatives in beneficial interests, we believe that retaining this phrase is necessary. An alternative solution would be to consider the model used in International Accounting Standard No. 39, which would permit the fair value election for any hybrid instrument with an embedded derivative unless it is clear “with little or no analysis” that the embedded derivative would not require bifurcation.
Interaction with Statement 140

We do not believe that the guidance for evaluating how the existence of embedded derivatives would affect whether an entity is a qualifying SPE is clear and understandable. Specifically, it is not clear to us whether requirements established in paragraph 40 of Statement 140 would apply to derivatives that are embedded in financial assets that are transferred to a QSPE that, pursuant to Statement 133, require bifurcation. Our interpretation of paragraph 40 is that it is only directed at freestanding derivative instruments to which the QSPE would be a legally-named counterparty, as opposed to embedded economic components that become freestanding derivatives for accounting purposes. Our view in this case is based upon paragraph 187 of Statement 140, which essentially indicates that paragraph 40 was developed in response to concerns about "...whether a large derivative instrument could be put into or entered into by a qualifying SPE ..." Further to such thinking, paragraph 173 of Statement 140 indicates that "...the effect of establishing the qualifying SPE is to merge the contractual rights in the transferred assets and to allocate undivided interests in them—the beneficial interests", thereby suggesting any and all rights that are embedded in financial assets that are transferred to a QSPE should be respected as having been allocated to and, thus, held by investors in beneficial interests (as opposed to being held by a QSPE). If our interpretation in this case is correct, we would advise the Board to amend Statement 140 to clarify that paragraph 40 does not apply to embedded derivative components of financial assets that are transferred to a QSPE.

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We appreciate the opportunity to participate in the Board’s due process on this issue. If the Board or its staff would like to discuss any of the issues raised in this letter, please feel free to call Tim Armstrong at (571) 382-3738. We would also be happy to meet with you at your convenience or participate in a working group to further explore this issue.

Sincerely,

/s/ Kenneth J. Evola

Kenneth J. Evola
Vice President
Accounting Policy
ATTACHMENT

EXAMPLE 1

Description of transaction:

- Originator transfers a pool of 30-year, 1-4 family residential, amortizing, fixed-rate mortgage loans to Freddie Mac ($100 million par, $99 million fair value)
- A single-class pass-through security is issued by Freddie Mac to Investor ($100 million par, $99 million fair value)
- All cash flows from the fixed rate loans are passed through to the investor in the single-class security, except for cash flows used to pay fees related to servicing
- Freddie Mac provides a guarantee of the timely payment of principal and interest to the investor

The borrowers of the single-family mortgage loans have the ability to prepay their loans without penalty at any time.

QUESTION 1: Can the guidance in Statement 133 Implementation Issue B39 be analogized to?

OBSERVATION: This implementation guidance in B39 was focused on whether embedded call options (including prepayment options) that can accelerate the settlement of a hybrid instrument containing a debt host contract would be subject to the conditions in paragraph 13(b). We understand that the FASB believes that this guidance is not applicable given their views that the MBS itself does not contain an embedded call option and is therefore outside the scope of B39. We believe that market participants do not distinguish between a prepayment option in a loan and in a MBS given they have identical prepayment risk to the investor. Furthermore, our understanding of the objective of this literature was to require the testing in paragraph 13(b) of Statement 133 when the investor has the unilateral ability to exercise the option. This is not the case with the example MBS above.

QUESTION 2: How should the host contract be defined?

OBSERVATION: Statement 133 Implementation Issue B19 states, “The characteristics of a debt host contract generally should be based on the stated or implied substantive terms of the hybrid instrument. Those terms may include a fixed-rate, floating-rate, zero-coupon, discount or premium, or some combination thereof.” We believe that there are many options with how to define the host contract for this security. We considered one of the most obvious for purposes of discussion. This would be where the host was defined as a non-prepayable, amortizing security based on the scheduled principal and interest cash.
flows of the underlying collateral. The embedded derivative would therefore be defined as a series of prepayment options spanning the 30-year life of the mortgage collateral.

Below is a chart that depicts the valuation of that embedded option in a Freddie Mac 5% Coupon Participation Certificate utilizing a simple valuation methodology.

Intuitively, we would expect that the value of the embedded written prepayment option would be a negative value to the investor, since the investor has effectively written a prepayment option through to the fixed rate loan borrowers. However, using our simple valuation methodology, the value of the embedded option was positive for many periods. This illustrates that the use of this definition of the host contract, coupled with a simple valuation model will not be appropriate. Therefore, we are concerned that entities that invest in relatively generic mortgage-backed securities will need to develop sophisticated models in order to comply with the accounting requirements of this new exposure draft. These sophisticated models would necessarily be different (driven by the definition of the host contract and prepayment model assumptions), and sometimes drastically so, from one market participant to another.

QUESTION 3: How should the testing in paragraph 13(b) of Statement 133 be applied?

OBSERVATION: This testing focuses on whether there is a possible future interest rate scenario (even though it may be remote) under which the embedded derivative would at least double the investor's initial rate and then current rate of return on the host contract. If such a scenario exists, then the embedded derivative is not considered to be clearly and closely related to the host contract. Under a remote interest rate scenario where interest rates go to 0% immediately after acquiring the MBS, most of the collateral underlying MBS would prepay and the investor would receive back par on the security. The rate of return earned by an investor over this very short holding period would easily be double the investor's initial rate of return on the host contract, since economically the investor put in $99 and would immediately receive back $100. This rate of return would also clearly more than double the then current rate of 0%.
For example, consider the example given above where the host contract is defined as a non-prepayable, amortizing security based on the scheduled principal and interest cash flows of the underlying collateral with par of $100, coupon of 5%, term of 360 months, and initial fair value of $99. If you assume that interest rates go to 0%, the valuation of those cash flows on the host would increase to a fair value of $193.26. However, the hybrid instrument would only have a fair value of $100, since with 0% interest rates, the mortgage-backed security is expected to immediately prepay at par. Therefore, one could assume that the embedded derivative has increased to a value of $93.26. The gain calculated on the host contract’s cash flows would more than offset the loss on the embedded written option’s cash flows by exactly $1.

QUESTION 4: Would bifurcation still be required if the price of the security above was 101?

OBSERVATION: We do not think that bifurcation would be required for a security that has a slight premium. Therefore, we are concerned that the proposed guidance will result in differences in accounting for similar instruments merely based on whether the security trades at a premium versus a discount.
EXAMPLE 2

Multiclass securitizations can take many forms. One such form is that of a planned amortization class ("PAC") and a companion class ("companion"). The PAC is designed to reduce investors' prepayment risk by establishing a sinking-fund structure. PAC bonds assure to varying degrees that their investors will receive payments over a predetermined time period under various prepayment scenarios. The companion bond absorbs the variability of the collateral cash flows, and as such, generally pays a higher yield.

The market values of IOs and POs are very sensitive to fluctuations in prepayment rates and interest rates, making them individually more volatile than standard pass-throughs. However, through a multiclass securitization utilizing a PAC and a companion class, the sensitivity of the PAC class can be greatly reduced.

Description of transaction:

- Originator transfers a fixed rate security that is backed by 30-year, 1-4 family residential, amortizing, fixed-rate mortgage loans to Freddie Mac ($100 million notional, $99 million fair value)
- A Planned Amortization Class Principal Only security is issued by Freddie Mac to Investor, which receives principal cash flows according to a schedule until the support PO security is fully amortized (at which point it receives 100% of the principal cash flows)
- A support (companion) Principal Only security is issued by Freddie Mac to Investor, which receives the remainder of the principal cash flows
- An PAC Interest Only security is issued by Freddie Mac to Investor, which receives interest cash flows according to a schedule until the support PO security is fully amortized (at which point it receives 100% of the interest cash flows)
- An support (companion) Interest Only security issued by Freddie Mac to Investor, which receives the remainder of the interest cash flows
- Freddie Mac provides a guarantee of the timely payment of principal and interest to the investor
- Investor pays $99 for the IO and PO securities

QUESTION 1: Would any of these classes be eligible for the §14 of Statement 133 exemption?

QUESTION 2: If not, how should the host contract be defined for each class and what would be the embedded derivative?