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Alfred M. Pollard, Esq.
General Counsel
Federal Housing Finance Agency
1700 G Street, NW
Fourth Floor
Washington, D.C. 20052

Re: Advance Notice of Proposed Rulemaking: Alternatives to the Use of Credit Ratings in Regulations Governing the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal Home Loan Banks; RIN 2590-AA40

Dear Mr. Pollard:

Freddie Mac is pleased to submit these comments in response to the Advance Notice of Proposed Rulemaking (the ANPR) regarding Alternatives to the Use of Credit Ratings, published by the Federal Housing Finance Agency (FHFA) on January 31, 2011.[1]

Under Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), certain federal agencies, including FHFA, must review and modify existing regulations to remove any reference to, or requirements based on, the use of credit ratings. These federal agencies are required to substitute alternative standards of credit-worthiness appropriate for such regulations. The ANPR describes relevant FHFA regulations affected by Section 939A and requests comments on alternatives to the use of credit ratings in these regulations.

Freddie Mac was chartered by Congress in 1970 with a public mission to stabilize the nation's residential mortgage markets and expand opportunities for homeownership and affordable rental housing. Our statutory mission is to provide liquidity, stability and affordability to the U.S. housing market. Freddie Mac currently operates under the direction of FHFA as our Conservator.

<u>Summary</u>

In the ANPR, FHFA identifies instances in which its existing standards related to regulatory oversight of Freddie Mac and Fannie Mae (the Enterprises) and the Federal Home Loan Banks (the FHLBs) currently rely upon, or reference, credit ratings issued by Nationally Recognized Statistical Rating Organizations (NRSROs). Our comments principally address those requirements contained in regulations identified by FHFA that relate to oversight of the Enterprises: the risk-based capital (RBC) regulations[2] and the prudential guidance relating to non-mortgage investments.[3]

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[1] 76 Fed. Reg. 5292 (Jan. 31, 2011).
[2] 12 CFR Part 1750.10 *et seq.*
[3] 12 CFR Part 1720, App. B. FHFA also identified in the ANPR six regulations related to the FHLBs that contain credit ratings: Capital (12 CFR Part 932); Acquired Member Assets (12 CFR Part 955); Investments (12 CFR Part 956), Consolidated Obligations (12 CFR Part 966); Letters of Credit (12 CFR Part 1269); and Office of Finance (12 CFR Part 1273). 76 Fed. Reg. at 5294.

As we discuss in greater detail below, our preferred recommendation with respect to the existing regulations applicable to the Enterprises is that FHFA delete and not replace references to NRSRO ratings in such regulations. With respect to RBC submissions, we believe that this recommendation is appropriate because RBC data submitted to FHFA is not currently used to compute binding capital requirements.[4] With respect to the prudential guidance, we believe that this recommendation is appropriate because the current guidance, while referencing NRSRO ratings, does not mandate any specific actions based on such ratings or use such ratings for specific purposes. Accordingly, we believe that such references could be removed without compromising safety and soundness and without requiring any significant modifications to the Enterprises' current practices or to FHFA's supervisory oversight.[5] In addition to describing our preferred recommendations, we offer comments on other approaches presented in the ANPR.

Discussion

The ANPR includes nine questions, each with multiple sub-questions. The questions are organized into three broad categories: (1) Principles for a New Approach; (2) Alternative Approaches for Risk-Based Capital Requirements; and (3) Alternative Approaches to Prudential Regulations. Rather than responding to each question and sub-question individually, we have organized our comments to follow the three broad categories of questions in the ANPR.

Principles for a New Approach

The ANPR initially presents several questions concerning the "core principles" that FHFA should use to guide its development of new standards of credit-worthiness. FHFA suggests that standards of credit-worthiness: (i) should distinguish between different levels of credit risk in an accurate and meaningful manner; (ii) be transparent; (iii) be able to be applied consistently across regulated entities to the extent they are subject to the same regulatory requirements; (iv) be straightforward and not unduly burdensome to apply; and (v) not be readily subject to manipulation.[6] In addition to inquiring about the appropriateness of these core principles, FHFA asks what additional principles should be considered.

We agree that the "core principles" identified in the ANPR should guide FHFA's development of new standards of credit-worthiness. In particular, we believe that FHFA should strive to ensure that any new standards permit drawing of accurate and meaningful distinctions between levels of risk and are as transparent as possible in design and application. Beyond the core principles listed in the ANPR, we believe that FHFA should consider the following additional principles:

1. Standards of credit-worthiness should be consistent, to the extent reasonably possible, with standards applicable to other regulated financial companies;

2. Standards of credit-worthiness should facilitate understanding of the material risks that a regulated entity is adopting;

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[4] *See* FHFA News Release, *FHFA Announces Suspension of Capital Classifications During Conservatorship and Discloses Minimum and Risk-Based Capital Classifications as Undercapitalized for the Second Quarter 2008 for Fannie Mae and Freddie Mac* (Oct. 9, 2008).
[5] In the ANPR, FHFA suggests that the prudential provisions applicable to the Enterprises may be outside of the scope of Section 939A of the Dodd-Frank Act. *See* 76 Fed. Reg. at 5294. While we agree that this view may be correct, we see no harm in modifying the existing prudential guidance to delete references to NRSRO ratings.
[6] *See* 76 Fed. Reg. at 5295.

3. Standards of credit-worthiness should consider and appropriately balance benefits against operational costs and burdens; and

4. Standards of credit-worthiness should not preclude regulated entities from using third-party credit ratings for internal purposes, and should not preclude regulated entities from using third-party credit ratings in public disclosures.

We briefly discuss each of our recommended additional principles below.

1. Standards of credit-worthiness should be consistent, to the extent reasonably possible, with standards applicable to other regulated financial companies

Our first recommended additional principle relates to regulatory consistency. As a general proposition, we believe that it is desirable for replacement standards of credit-worthiness to be as similar as is reasonably possible to the approaches used by other financial regulators.[7] Consistency in approach increases transparency and comparability among regulated entities and minimizes competitive disparities resulting from dissimilar regulatory requirements. We believe that consistency is particularly important for any future requirements that may become binding on the Enterprises through regulatory or legislative action.

Notwithstanding our general support for regulatory consistency, we believe that an exception is warranted with respect to replacement of *current* references to NRSRO ratings in regulations and guidance that are applicable to the Enterprises. As we have described, RBC submissions are not currently binding, and references to NRSRO ratings in the prudential guidance applicable to the Enterprises do not necessarily compel specific actions. Given the relatively insignificant role of references to NRSRO ratings in existing Enterprise regulations, we believe that the best approach to replace these existing references may be to focus on simplicity and reducing operational costs and burdens, even if different standards are necessary for other financial institutions.

2. Standards of credit-worthiness should facilitate understanding of the material risks that a regulated entity is adopting

Our second additional recommended principle is intended to focus development of new standards on what we believe to be the fundamental purpose of such standards: tools for understanding material risks. We think it is important that standards of credit-worthiness focus on material risks and not be diluted through efforts to address risks that do not represent significant exposures.

3. Standards of credit-worthiness should consider and appropriately balance benefits against operational costs and burdens

We are recommending our third additional principle because we believe that it is particularly important to evaluate thoroughly the benefits and costs associated with implementing new standards of credit-worthiness. At the present time, we believe that the benefits of developing new standards with respect to the Enterprises are small. RBC submissions currently are not used to determine Enterprise capital requirements, and references to NRSRO ratings in FHFA's

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[7] Section 939A of the Dodd-Frank Act instructs that agencies, in modifying regulations that refer to credit ratings, "shall seek to establish, to the extent feasible, uniform standards of credit-worthiness for use by each such agency, taking into account the entities regulated by each such agency and the purposes for which such entities would rely on such standards of credit-worthiness." Public Law 111-203, 124 Stat. 1887 (July 21, 2010).

prudential guidance do not necessarily compel any specific actions and serve little purpose that cannot be accomplished through supervisory oversight. Accordingly, we believe that FHFA should accord substantial weight to operational costs and burdens associated with any new credit assessment standards applicable to the Enterprises.

4. *Standards of credit-worthiness should not preclude regulated entities from using third-party credit ratings for internal purposes, and should not preclude regulated entities from using third-party credit ratings in public disclosures*

We are recommending our final additional principle to mitigate any possible misinterpretation of the scope of any new standards. Our understanding is that Section 939A of the Dodd-Frank Act only requires that references to NRSRO ratings be replaced in regulations, and that the law does not restrict the use of such ratings by regulated entities either in internal processes or in public disclosures. Notwithstanding their limitations, NRSRO ratings continue to have significant value as indicia of credit-worthiness of issuers, as well as the riskiness of securities. Third-party ratings are well-understood and permit consideration of a range of investment alternatives while providing independent, easy-to-use measurements of relative credit risk.

While we believe it is important that regulated entities have internal processes that permit assessment of credit risk and that such entities have responsibility for making their own risk assessments, we also think that those processes may be supplemented and validated by NRSRO ratings, especially in cases where the NRSROs are in a unique position in the industry with access to information and insights that individual companies cannot obtain.[8] We therefore believe that FHFA should clearly indicate in any new standards for assessing credit-worthiness that such standards do not restrict a regulated entity from considering NRSRO ratings in evaluating credit risk or making business decisions. Further, FHFA should clarify that any new standards do not preclude a regulated entity from making public disclosures that reference NRSRO ratings.

Risk-Based Capital Requirements

Questions 2 through 4 in the ANPR relate to the development of replacements for requirements based on NRSRO ratings in FHFA's RBC regulations. The Counterparty Default component of the RBC regulations relies upon NRSRO credit ratings to populate the Ratings Categories in Table 3-30, which accounts for the risk of default by credit enhancement and derivative contract counterparties, and by corporate, municipal and mortgage-related securities.[9]

As we have indicated, the RBC requirements are not currently binding on the Enterprises and FHFA does not currently use RBC stress test results to assess Enterprise capital adequacy. Given the minimal role of the RBC requirements in Enterprise oversight at this time, we believe that a principal consideration in the development of alternate standards of credit-worthiness should be that such standards impose minimal additional operational costs and burdens. We discuss below our specific recommendations concerning new standards of credit-worthiness.

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[8] Use of external ratings is particularly appropriate for certain securities (for example, mortgage revenue bonds (MRB) and private label securities (mortgage and non-mortgage asset-backed securities)) where development of an internal rating process for such instruments would be highly resource intensive and likely not desirable from a benefit-cost perspective.
[9] *See* 12 CFR Part 1750, subpart B, Appendix A, § 3.5.

Deleting (and not replacing) references to NRSROs

Our preferred recommendation with respect to current RBC requirements is that FHFA delete submission requirements based on NRSRO ratings and not substitute any replacement standards of credit-worthiness at this time. This approach could be implemented relatively easily by the Enterprises at minimal cost and should not have any impact on FHFA's ability to ensure Enterprise safety and soundness. We believe that this approach is appropriate until such time as it becomes necessary to reinstate capital requirements or institute new RBC rules.

Risk buckets

As an alternative to deleting and not replacing existing NRSRO-based RBC requirements, FHFA could substitute a "risk-bucket" approach, in which counterparties and instruments are assigned to broad categories based on readily discernable characteristics (*e.g.*, Treasury obligations, corporate debt, *etc.*). We understand Question 4 in the ANPR to be inquiring about such an approach.[10] This approach would provide a rough proxy for credit-worthiness, and implementation into current RBC submissions would not necessarily involve significant operational costs and burdens, depending upon the level of detail required. Accordingly, we believe that such an approach could replace NRSRO references in the current RBC regulations if our preferred recommendation is not adopted.

Significantly, we do not recommend a risk-bucket approach in connection with any *future* requirements that are binding on the Enterprises. Risk buckets have proven difficult to define so as to permit accurate and meaningful differentiation of risks, and risk buckets are substantially less useful as determinants of credit-worthiness than are other approaches. However, we do consider the use of risk buckets to be an acceptable alternative for *current* RBC requirements only because the information being submitted under such requirements is not being used to assess capital adequacy, and any inherent limitations to a risk-bucket approach are not applicable.

Internal standards of credit-worthiness

If FHFA adopts neither of our recommendations discussed above, we would recommend an approach that relies on the internal credit review processes of each regulated entity.[11] We believe that the operational costs and burdens associated with implementation of this approach could be reasonable, provided that FHFA clarifies that the regulated entities may consider NRSRO ratings in their internal processes. We believe that an internal standards approach is promising as a long-term alternative for assessment of credit-worthiness in future requirements, although, as we discuss above, less burdensome alternatives may be preferable for purposes of current RBC requirements.

Question 3 in the ANPR includes an inquiry concerning qualitative and quantitative standards that FHFA should set to implement an approach that relies on internal estimates of credit risk.[12] We believe that establishing comprehensive standards for such an approach is a substantial undertaking and that FHFA should promulgate standards only following careful consideration of qualitative and quantitative standards that have been developed by other financial regulators. Consistent with our core principle regarding regulatory consistency that we discuss above, we

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[10] Question 4 asks, "Could an approach be developed that estimates a meaningful risk-based capital charge that avoids requiring a specific credit risk charge or specifying criteria to estimate credit risk?" 76 Fed. Reg. at 5296.
[11] Question 3 in the ANPR includes inquiries related to internal estimates of credit risk by regulated entities. *Id.*
[12] 76 Fed. Reg. at 5296.

believe that any qualitative and quantitative standards developed by FHFA should adhere to other regulatory standards as closely as is reasonably possible. During the development of such standards, FHFA would be able to monitor and assess a regulated entity's internal assessment processes through subjective evaluations as part of FHFA's supervisory oversight.

FHFA risk estimates

In the final sub-question to Question 3, the ANPR inquires about the strengths and weaknesses of FHFA setting credit risk capital charges based on its own estimates of risk.[13] We do not recommend that FHFA pursue such an approach. We believe that it would be difficult for FHFA to implement its own assessments of credit risk successfully because it would require extensive data, models and experienced staff to generate reliable indicators of credit-worthiness. Further, charges established by FHFA under such an approach would not be comparable to those charges set for other regulated financial institutions.

Prudential Requirements

Questions 5 through 9 in the ANPR relate to the development of replacements for requirements based on NRSRO ratings in FHFA's prudential guidance. In the case of the Enterprises, FHFA identifies two references to ratings in its Policy Guidance on Non-Mortgage Liquidity Investments (the Guidance).[14] The first is in connection with instruction in the Guidance that the Enterprises "should establish thresholds identifying the minimum credit standards for any security eligible for purchase."[15] This Guidance indicates, "Where these standards involve credit ratings, the ratings should come from a nationally recognized rating organization."[16] The second reference to ratings occurs where the Guidance is discussing the essential elements of sound disclosure practices regarding non-mortgage liquidity investments. The Guidance lists disclosure of "credit quality or rating" as one of the three essential elements.[17] Notably, disclosure of credit ratings is not a requirement, but merely a possible avenue for disclosure of "credit quality."

As we have indicated, FHFA's prudential guidance applicable to the Enterprises does not necessarily compel any specific actions based on NRSRO ratings. FHFA itself observes in the ANPR that the provisions "do not necessarily require the Enterprises to take or refrain from specific actions based on NRSRO ratings or to use NRSRO ratings for specific purposes and therefore may be outside the scope of section 939A of the Dodd-Frank Act."[18] In consideration of the non-obligatory nature of the references to NRSRO ratings in the Guidance, we believe that these references could be removed without limiting FHFA's ability to monitor safety and soundness. We discuss this alternative below, as well as provide our comments on other approaches discussed in the ANPR.

Removing references to NRSRO ratings

Our preferred recommendation to address references to NRSRO ratings in the Guidance is simply to remove these references. Thus, with respect to minimum credit standards for securities eligible for purchase, the provision relating to the establishment of thresholds would

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[13] *Id.*
[14] 12 CFR Part 1720, Appendix B.
[15] *Id.* at § C(3)(c)(i).
[16] *Id.*
[17] *Id.* at § D(1).
[18] 76 Fed. Reg. at 5294.

remain, but the supplemental instruction (applicable only *if* the thresholds refer to ratings) would be deleted. Similarly, for the provision in the Guidance relating to the essential elements of sound disclosure practices, FHFA could simply replace "credit quality or rating" with "credit quality," in order to remove any suggestion that an Enterprise is required to disclose NRSRO ratings. The Enterprises would not, of course, be prohibited from including NRSRO ratings in their minimum credit standards. Nor would they be prohibited from including NRSRO ratings in their disclosure about the credit quality of non-mortgage liquidity investments, if consistent with industry practice and market expectations.

We believe the approach of removing references to NRSRO ratings in the Guidance is desirable for several reasons. First, the approach will likely have little impact on current practices, as current requirements do not compel use of NRSRO ratings by the Enterprises. Second, the approach should have no impact on FHFA's ability to ensure the safety and soundness of the Enterprises because FHFA will still be able to monitor and direct the Enterprises' minimum credit thresholds and disclosure practices through its supervisory oversight. Finally, the approach should impose no additional operational costs and burdens.

Internal standards of credit-worthiness

In discussing alternative approaches to prudential regulations, the ANPR suggests that "FHFA could also rely on the regulated entity's internal credit assessment process and let the regulated entities decide on what specific investments or exposures may be appropriate."[19] In general, we support an approach that would allow the Enterprises to rely on internal standards, provided that consideration of NRSRO credit ratings is not proscribed. Under this approach, the Enterprises would take internal responsibility for assessing credit-worthiness, but would be able to leverage external information as benchmarks as appropriate. Through supervisory oversight, FHFA could ensure the adequacy of the internal systems and processes used to generate the internal standards.[20] Adoption of this approach should not have a material impact on current Enterprise practices or FHFA oversight.[21] Further, the approach should impose minimal additional operational costs and burdens.

FHFA specified standards and/or restrictions

The ANPR mentions two other possible approaches to replace prudential guidance that references NRSRO credit ratings. Under one approach, regulated entities would "analyze and document compliance with certain specific credit-worthiness standards or metrics set forth by FHFA."[22] Under the other approach, FHFA would implement "a prohibition on investment in broad categories of instruments or on assumption of particular types of exposure to replace the ratings based requirements."[23]

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[19] 76 Fed. Reg. at 5296.

[20] This approach is effectively the same as our recommendation to simply remove references to NRSRO ratings in prudential guidance applicable to the Enterprises. If FHFA were to remove any references to NRSRO ratings, it implicitly would be instructing the Enterprises to use their internal credit assessment processes to make decisions related to non-mortgage liquidity investments.

[21] The ANPR also suggests that under an internal credit assessment approach, "FHFA would likely need to provide regulatory and policy guidance on how any internal credit assessment process is to be structured and to rely heavily on the supervisory process to make sure that the regulated entities are strictly following their own guidelines and are not assuming high levels of credit risk." 76 Fed. Reg. at 5296. Such additional guidance may be unnecessary with respect to requirements applicable to the Enterprises, as FHFA already has comprehensive policy guidance concerning Enterprise investments in non-mortgage liquidity investments. *See* 12 CFR Part 1720, App. B.

[22] 76 Fed. Reg. at 5296.

[23] *Id.*

In general, we would not support approaches to assessing credit-worthiness that are based on standards set by FHFA. Our view is that such approaches would require FHFA to commit significant resources to ensure that the methodologies and processes used to assess credit risks are reliable and credible, and would duplicate credit-worthiness assessments that the Enterprises already are conducting as part of their internal processes. Absent such a resource commitment, standards or metrics developed by FHFA could prove over- or under-restrictive. Absolute prohibitions regarding particular categories of instruments or types of exposures, while less resource intensive, are also likely to result in over- or under-restrictive standards. We prefer, instead, a more comprehensive and nuanced analysis of credit-worthiness that could result from reliance on internal standards of credit-worthiness. Of course, under an internal standards approach, there remains a significant role for FHFA to ensure that the internal systems and processes used to generate the internal standards are sufficient and are being followed.

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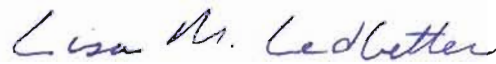
Freddie Mac appreciates the opportunity to provide our views in response to the ANPR. Please contact me if you have any questions or would like further information.

Sincerely,



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