Freddie Mac

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Submitted via email to RegComments@fhfa.gov

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Mr. Alfred Pollard
General Counsel
Federal Housing Finance Agency
Fourth Floor
1700 G Street, NW
Washington, DC 20552

Re: Notice of Proposed Rulemaking: Credit Risk Retention; RIN 2590-AA43

Dear Mr. Pollard:

Freddie Mac is pleased to submit these comments in response to the Notice of Proposed Rulemaking published by the Federal Housing Finance Agency ("FHFA"), Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Securities and Exchange Commission and Department of Housing and Urban Development (together, the "Agencies") on April 29, 2011, 76 Fed. Reg. 24090 (the "Proposal"). The Proposal implements the credit risk retention requirements of Section 15G of the Securities and Exchange Act of 1934 ("Section 15G"), as added by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Section 15G generally requires securitizers of asset-backed securities ("ABS") to retain not less than five percent of the credit risk of the assets collateralizing the ABS.

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.

Summary

Freddie Mac supports the Agencies' goal of aligning the economic interests of securitizers with those of investors. We agree that the appropriate alignment of incentives will bring added discipline to the origination process and help maximize the substantial benefits that securitizations provide to the financial markets. Notably, Freddie Mac's securitization model features significant "skin in the game," as we provide a full guarantee against the credit losses of securities that we issue.

In general, Freddie Mac supports the principles and approaches included in the Proposal. However, we believe that the Agencies should modify certain provisions of the Proposal to provide greater flexibility and clarity, as we describe in greater detail below.

I. The Agencies should modify the Proposal to provide greater flexibility regarding risk retention by securitizers of CMBS

The Proposal includes a provision in Section 10 that provides an alternative for a CMBS sponsor to meet risk retention requirements (the "CMBS Alternative"). We are supportive of the inclusion of the CMBS Alternative in the Proposal, as we believe it will facilitate the use of CMBS structures and support the growth of a vibrant multifamily securitization market.[1] We recommend, however, that the Agencies modify the Proposal as we describe below to provide greater access to the use of the CMBS Alternative.

Background

CMBS are an established securitization structure for multifamily properties.[2] In a CMBS transaction, an unrated subordinate tranche, or "B-piece," is created and typically is sold to an independent third-party investor who has performed substantial due diligence on the underlying properties. Because the B-piece buyer is taking a first-loss position, this buyer has significant motivation to ensure that the pool assets are prudently underwritten. The CMBS structure provides an effective check on unreasonable credit risks and we believe the Agencies should encourage the use of this structure.

Section 15G implicitly recognizes the significant value of the CMBS structure, expressly stating that the risk retention regulations prescribed by the Agencies may provide for retention of the first-loss position by a third-party purchaser in lieu of the sponsor.[3] The CMBS Alternative would implement this provision by permitting a sponsor of CMBS to satisfy its risk retention requirement if a B-piece buyer retains the necessary exposure to the credit risk of the underlying assets and meets several conditions. The conditions include requirements that the B-piece purchaser pay cash at the closing of the securitization, perform extensive due diligence on the interests being acquired, be subject to the hedging, transfer and other restrictions applicable to the interest as if it were the sponsor, and not have control rights in the securitization that are not collectively shared by all other investors. We are concerned, however, that certain components of the CMBS Alternative may prove overly burdensome without appreciably reducing risks, making it less likely that CMBS transactions can be structured in an economically viable form. In particular, we are concerned about restrictions on the transferability of the B-piece and about requirements related to the "premium capture cash reserve account" that is described in Section 12 of the Proposal.

Transferability of the B-Piece

Among the conditions required to be met in order to utilize the CMBS Alternative, the transfer restrictions in the Proposal would effectively require the purchaser of the B-piece to hold its

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[1] The preamble to the Proposal indicates that the Agencies proposed the various acceptable forms of risk retention to take into account the diversity of securitization markets and practices and "to reduce the potential for the proposed rules to negatively affect the availability and costs of credit to consumers and businesses." *See,* 76 Fed. Reg. 24090, 24101.

[2] Freddie Mac's multifamily "K-deals" are designed to follow the conventions of existing CMBS. In a Freddie Mac sponsored K-deal, an underlying private label trust sells senior classes, which are guaranteed and securitized by Freddie Mac, and mezzanine and subordinate classes, which are not purchased or guaranteed by Freddie Mac.

[3] Section 15G(c)(1)(E).

interest for the duration of the securitization.[4] While we appreciate the Agencies' concern that the B-piece investor have a long-term interest in the securitization, we believe that such an extensive mandatory holding period requirement will reduce the desirability of the B-piece for certain investors and require that B-pieces be sold at significantly greater discounts than would be necessary without the transfer restriction.

Freddie Mac believes that there are less restrictive alternatives that would still address the Agencies' concerns. Instead of an absolute prohibition on the transfer of the B-piece, we suggest that the Agencies consider requiring a minimum holding period of one year, after which the B-piece could be sold to a qualified purchaser. If the initial B-piece investor were required to hold its interest for a year, and were further restricted in its ability to sell its interest to a purchaser that itself would qualify as a B-piece investor, we believe that there would be no reasonable basis for concern that the third-party purchaser was acting simply as a conduit and not performing its role as gatekeeper with respect to CMBS underwriting.

Premium Capture Cash Reserve Account

In addition to risk retention requirements associated with securitizations, the Proposal also includes a requirement that a securitization sponsor establish and fund a "premium capture cash reserve account" if interest-only tranches or premium bonds are issued in the securitization.[5] Amounts in the premium capture cash reserve account would be used to cover credit losses on underlying assets before losses would be allocated to any of the securities issued, including any securities retained by the sponsor, or by the B-piece investor in the case of the CMBS Alternative. The Agencies included the premium capture cash reserve account requirement in order to prevent sponsors from monetizing excess spread at the start of a transaction and thereby reducing the impact of the risk retention requirements.[6] We are concerned, however, that the premium capture requirements as currently proposed would prove overly burdensome when applied to CMBS structures, will increase costs without appreciable benefit, and may reduce liquidity for multifamily financing. Accordingly, we believe that the Agencies should modify these requirements for CMBS transactions.

As applied to CMBS structures, our understanding is that the Agencies intended that the premium capture cash reserve account requirements would ensure that the combination of sponsors and B-piece investors together hold five percent of total proceeds for a transaction, rather than five percent of the par value. Because the B-piece investor's interest typically sells for a substantial discount, its interest generally would not constitute close to five percent of total deal proceeds. CMBS transactions could be restructured, such as by directing more excess spread to the third-party purchaser's interest to increase yields and move prices to par value, or by directing additional bonds to the third-party purchaser; however, it is not clear that these alternatives are economically feasible. In any event, efforts to structure CMBS transactions to meet requirements related to both risk retention and the premium capture cash reserve account are likely to decrease the efficiency of these transactions.

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[4] 76 Fed. Reg. 24090, 24110.

[5] Proposed Section 12.

[6] See, *e.g.*, 76 Fed. Reg. 24090, 24113 ("By monetizing excess spread before the performance of the securitized assets could be observed and unexpected losses realized, sponsors were able to reduce the impact of any economic interest they may have retained in the outcome of the transaction and in the credit quality of the assets they securitized.")

We recommend that the Agencies modify the requirements of the Proposal such that the B-piece investor's interest and the premium capture cash reserve account (held by the sponsor) would combine to equal five percent of the market value of the transaction. Because both the B-piece investor and the sponsor would be conducting significant due diligence on the underlying properties, there would be a sufficient alignment of incentives to ensure that underwriting is appropriate. This approach would also be less likely to undermine the fundamental economics of the CMBS market amid efforts to bring private capital back to that market.[7]

II. The Agencies should clarify that customary contractual agreements with sellers and originators are not considered prohibited hedging

Section 15G requires that regulations implementing the credit risk retention requirements must prohibit a securitizer from directly or indirectly hedging or otherwise transferring the credit risk that the securitizer is required to retain. The Proposal would implement this requirement by generally prohibiting a securitization sponsor and its consolidated affiliates from entering into an agreement with any other person if payments under the agreement are materially related to the credit risk the sponsor is required to retain and the agreement in any way reduces or limits the sponsor's financial exposure.[8] The Proposal also generally exempts Freddie Mac and Fannie Mae (each an "Enterprise" and together, the "Enterprises") securitizations from the hedging prohibitions.[9] As we describe in greater detail below, we believe that the proposed Enterprise exemption from hedging prohibitions is appropriate. In addition, we believe the Agencies should clarify that they do not intend that the hedging prohibition operate to prevent securitizers from entering into customary and prudent contractual arrangements.

Enterprise Hedging

Question 80 of the Proposal requests comments on whether the Enterprises should be prohibited from all hedging. Applying to the Enterprises an absolute prohibition on hedging would be unduly burdensome and inequitable as we generally retain 100 percent of the credit risk on our securitizations and have substantially more exposure than sponsors of private label securitizations who are only prohibited from hedging the five percent credit risk interest they are required to retain. Further, to the extent that we are prohibited from hedging, opportunities to reduce risk to the U.S. government while we are in conservatorship would be reduced. Any missed opportunity to mitigate loss would ultimately be born by the U.S. taxpayer. Accordingly, we believe that the Enterprise exemption from the hedging prohibitions is appropriate as proposed.

Question 81 of the Proposal requests comments on whether the hedging prohibition should apply to five percent of the total credit risk of any securitization that we sponsor. We believe that

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[7] *See* Lingling Wei, *CMBS Revival Marks Step Toward Recovery*, WALL ST. J., Sept. 22, 2010, *at* http://online.wsj.com/article_email/SB10001424052748703399404575506110648952530-lMyQjAxMTAxMDAwNjEwNDYyWj.html (last visited June 6, 2011).

[8] Proposed Section 14.

[9] Proposed Section 11(b).

the full exemption as proposed is appropriate and, for the reasons noted above, would suggest that the application of a hedging prohibition to even five percent of the credit risk on our securitization would work to the detriment of the U.S. government and, ultimately, the U.S. taxpayer.

Hedging Generally

The Preamble to the Proposal indicates that the Agencies' intention in proposing the hedging prohibitions in Section 14 was to prevent sponsors from effectively reducing their exposure to the credit risk they are required to retain.[10] However, a literal reading of the proposed regulatory language would suggest that recourse and indemnification agreements fall within the broad scope of the Section 14 prohibition. Similarly, reliance upon representations and warranties providing for repurchase by the seller upon the occurrence of various credit-related events would also appear to be prohibited. We request that the Agencies clarify that customary representations and warranties, as well as recourse and indemnification agreements, are permissible forms of hedging under Section 14.

We do not believe that the Section 14 prohibitions were intended to prohibit customary and prudent contracts or contractual provisions between a sponsor and an originator that could offset losses incurred with respect to retained credit risk. The preamble to the Proposal indicates that Rule 15G was adopted, at least in part, to properly incent securitizers and originators to ensure the quality of underlying assets. In other respects, the Proposal recognizes that originators are appropriate holders of credit risk, permitting a sponsor to allocate a portion of the retained interest to an originator in certain situations.[11] While recourse and indemnification agreements, and representations and warranties, may mitigate a sponsor's financial exposure, these agreements and provisions also operate to promote responsible underwriting practices by sellers and originators. Moreover, such representations and warranties are so pervasively relied upon that limitations on their use would have considerable adverse consequences for the secondary mortgage market. The market would necessarily slow as securitizers adjusted their practices, which would freeze liquidity during this crucial recovery period. Prices likely would rise to absorb the up-front costs to sponsors and the additional risk inherent in securitizations that lack such representations and warranties. We therefore request that the Agencies clarify that customary agreements and contractual provisions with sellers and originators remain permissible.

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

Sincerely,

Lisa M. Ledbetter

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[10] 76 Fed. Reg. 24090, 24116.

[11] Proposed Section 13.