



U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT  
WASHINGTON, DC 20410-8000

ASSISTANT SECRETARY FOR HOUSING-  
FEDERAL HOUSING COMMISSIONER

DEC 20 2007

Mr. Richard F. Syron  
Chairman and Chief Executive Officer  
Freddie Mac  
8200 Jones Branch Drive  
McLean, VA 22102-3110

Dear Mr. Syron:

This letter responds to Freddie Mac's proposal to enter into credit default swap transactions as a seller of credit protection where the reference obligation is an index composed of identified mortgage-backed securities (the ABX.HE Index). Freddie Mac initially submitted information regarding its proposal during a briefing on August 16, 2007, and subsequently submitted additional information by letters dated September 19, 2007 and October 25, 2007. In conducting its review of the proposed credit default swap (CDS) transactions, the Department reviewed the information provided by Freddie Mac, including Freddie Mac's legal authority to engage in such transactions as a seller of credit protection.

The Department has completed its review, and for the reasons described below, the Department has concluded that Freddie Mac does not have the legal authority under the Federal Home Loan Mortgage Corporation Act (Freddie Mac Act) to enter into CDS transactions as a seller.

The Department has determined that Freddie Mac's role as a seller of credit protection does not qualify as an "investment" within the meaning of § 303(d) of the Freddie Mac Act, which provides in relevant part that "[f]unds of the Corporation may be invested in such investments as the Board of Directors may prescribe."

Although the Corporation contends that "Freddie Mac will dedicate economic capital against the risk of default losses," the Department finds that setting aside capital against the risk of loss is inconsistent with the common or ordinary meaning of the term "investment." As underscored in Freddie Mac's October 25, 2007 letter, investments require: 1) an outlay of money or capital, and 2) the expectation of earning a return. By the Corporation's own admission, "[t]he economic or 'risk' capital that Freddie Mac will dedicate and set aside . . . will be equivalent to the economic capital Freddie Mac will invest in the future," and does not differ from the capital it will dedicate against the risk of mortgage default in the future.

The CDS transactions are negotiated agreements where the seller (i.e., Freddie Mac) receives periodic payments in exchange for providing a risk management service to the buyer. In these arrangements, capital set-asides offset the risk that, under certain circumstances, Freddie Mac may be required to make payments to the buyer. The Department also notes that Freddie Mac has no interest in any of the mortgage assets protected under the CDS agreements, and Freddie Mac is

not putting money into any security vehicle or other asset with an expectation of generating a favorable return. Therefore, the Department does not agree with Freddie Mac's assertion that its proposed participation in CDS transactions meets the definition of an "investment" for purposes of § 303(d) of the Freddie Mac Act.

Even if Freddie Mac were able to restructure the proposed CDS transactions to meet the commonly accepted meaning of "investment," the Department concludes that Freddie Mac's proposed participation extends beyond the range of routine, ordinary course investments permissible under § 303(d) of the Freddie Mac Act, as it, in fact, initiates a new line of business for the Corporation. As a Government Sponsored Enterprise, Freddie Mac must operate within the confines of the powers expressly granted under §§ 305 and 306 of the Freddie Act to carry out its limited purposes. Freddie Mac's investment and other general corporate powers may not be used by Freddie Mac as a means to engage in activities beyond its limited purposes and express powers. Freddie Mac has not demonstrated and the Department is not persuaded that (a) the CDS transactions are authorized by or directly related to §§ 305 and 306 of the Freddie Mac Act and (b) that the CDS transactions further one or more of the purposes set out in § 301 of the Freddie Mac Act.

Section 305(a)(1) authorizes Freddie Mac "to purchase, and make commitments to purchase, residential mortgages." Freddie Mac may also "hold and deal with, and sell, or otherwise dispose of, pursuant to commitments or otherwise, any such mortgage or interest therein." Section 306(a) authorizes Freddie Mac "to borrow, to give security to pay interest or other return, and to issue notes, debentures, bonds or other obligations, or other securities," including mortgage-backed securities.

Although Freddie Mac contends in its September 19, 2007 submission that selling credit protection may permit it to "lock in" prices for accepting credit risk for mortgages it may purchase in the future, the Enterprise has acknowledged that the proposed activity does not involve the purchase of any mortgages. The Freddie Mac submission also makes clear that "Freddie Mac does not bear any interest rate risk with respect to the mortgages, nor does Freddie Mac obtain any rights of the mortgagee to enforce the mortgagor's debt or to direct foreclosure and liquidation of the real property security." Further, Freddie Mac declares that it obtains "no ownership interest of any kind – legal, beneficial or otherwise – in the mortgage securities referenced in the ABX.HE Index." Therefore the Department finds that Freddie Mac's participation in the CDS transactions is not authorized under Freddie Mac's express powers.

The proposed activity is equally unauthorized under § 303(c) of the Freddie Mac Act. Freddie Mac's incidental powers under § 303(c) do not authorize Freddie Mac to sell credit protection. The incidental powers were intended to facilitate Freddie Mac's express authorities only and do not confer separate authorities to engage in the type of activity proposed.

Finally, Freddie Mac contends that the "only way" it can fulfill its statutory mission to provide stability and liquidity in the market is through participation in the market for credit risk using the ABX.HE Index. The Department disagrees. The proposed CDS transactions do not further the purposes of the Corporation described in § 301(b) of the Freddie Mac Act. The relationship between the derivatives market price of credit risk and the price of credit risk in the

actual subprime mortgage market is highly speculative. Freddie Mac's contention that its participation will cause other investors to become comfortable purchasing securities that are referenced on the index has no factual basis, and the Department discerns no correlation between selling credit protection and Freddie Mac's ability in the future to buy mortgage-backed securities at more favorable rates.

Please do not hesitate to contact me should you have any questions concerning the Department's determinations described herein.

Sincerely,

A handwritten signature in black ink, appearing to read 'BDM', with a stylized flourish at the end.

Brian D. Montgomery  
Assistant Secretary for Housing-  
Federal Housing Commissioner

cc: James Lockhart  
Director  
Office of Federal Housing Enterprise Oversight

cc: Wendell Chambliss  
Managing Associate General Counsel  
Freddie Mac