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**VIA ELECTRONIC SUBMISSION**

January 12, 2024

Benjamin W. McDonough
Senior Deputy Comptroller and Chief Counsel
Attention: Comment Processing
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
Washington, DC 20219

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

James P. Sheesley
Assistant Executive Secretary
Attention: Comments/Legal OES
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

RE: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity: OCC Docket ID OCC-2023-0008; RIN 1557-AE78; Federal Reserve System Docket No. R-1813; RIN 7100-AG64; Federal Deposit Insurance Corporation RIN 3064-AF29

Dear Mr. McDonough, Ms. Misback and Mr. Sheesley:

Freddie Mac appreciates the opportunity to provide comments in response to the recently proposed amendments related to the Regulatory Capital Rule (the "Proposal") by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (together, the "Agencies").[1]

## I. Introduction

Freddie Mac generally supports the Agencies' efforts to enhance and improve the calculation of risk-based capital requirements to better reflect risk, reduce complexity of the capital framework, and enhance consistency across banking organizations and other financial entities. To this end, our comments are specifically targeted toward two components of the Proposal related to the treatment of debt issued by Freddie Mac and Fannie Mae (the "government-sponsored enterprises" or "GSEs"). If finalized as proposed, these components would reduce liquidity in the US mortgage market.

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[1] Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity, 88 Fed. Reg. 64028 (Sept. 18, 2023) and 88 Fed. Reg. 73770 (Oct. 27, 2023) (extension of comment period to Jan. 16, 2024).

- The first item of note is the proposed treatment of Uniform Mortgage-Backed Securities ("UMBS") under the market risk section of the Proposal, which would require Freddie Mac and Fannie Mae to be treated as separate names for the purposes of calculating credit spread risk.[2] Our overall understanding is that the Agencies' original intent is to continue their support of the single security initiative,[3] which has homogenized the mortgage pool and security characteristics of UMBS. Therefore, Freddie Mac recommends that the Agencies further enhance the current drafting of the rules in order to clarify and reaffirm their support for the single security initiative in the final rule. We recommend the Agencies modify any language within the preamble or elsewhere of the Proposal pertaining to the UMBS securities, in particular by revising the language in the Proposal so that it explicitly treats the GSEs as the same name for calculating credit spread risk without the possibility of deterring investors' demand for such securities.

- The second item of note is the proposed treatment of GSE-issued debt securities (UMBS and Senior Unsecured Debt, together "GSE debt"), which would be subject to higher collateral haircuts under the proposed "Market Price Volatility Haircuts."[4] To this end, Freddie Mac recommends that the Agencies retain a separate categorization for GSE debt (separate and distinct from any investment-grade corporates), consistent with the current bank capital rules, recognizing the different risk profile and market treatment of GSE debt relative to investment grade corporate securities.

We believe that the adoption of a final rule without these two above-mentioned changes would result in reduced liquidity in the secondary mortgage market, which risks reducing affordability for US mortgage borrowers.

## II. Credit Spread Risk Treatment of UMBS

The Proposal would require separate treatment of UMBS issued by Freddie Mac and Fannie Mae under the market risk capital requirements' credit spread risk calculation[5] despite acknowledgment of the homogenization of the GSE securities under the single security initiative. For credit spread risk calculations, the Proposal states that "[a]s part of the single security initiative, UMBS allows for either Fannie Mae or Freddie Mac to deliver, thus creating the basis risk between the GSEs for such securities."[6] In contrast, under the default risk calculation specifications, the Proposal notes that the covered banking organizations can fully offset UMBS issued by either GSE.[7] The Agencies state that "[a]s the single security initiative led by Fannie Mae and Freddie Mac has homogenized the mortgage pool and security characteristics for

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[2] 88 Fed. Reg. at 64123-24.
[3] The single security initiative was established in 2019 as a joint initiative of Freddie Mac and Fannie Mae, under the direction of FHFA. The initiative significantly changed the structure of the agency MBS market and greatly reduced fragmentation by making Freddie Mac and Fannie Mae MBS fungible with one another in the to-be-announced (TBA) market. Under this new structure, both GSEs' MBS are issued using a standardized, uniform design called "Uniform MBS" (UMBS). TBA sellers can deliver UMBS issued by either GSE, or a combination, when a trade is settled. *See* Uniform Mortgage-Backed Securities, 12 CFR Part 1248; FHFA, Uniform Mortgage-Backed Security, 84 Fed. Reg. 7793 (March 5, 2019).
[4] 88 Fed. Reg. at 64062-63 (including Proposed Table 1 to § __.121).
[5] 88 Fed. Reg. at 64123; Proposed §__.209(b)(3)(iii) at 88 Fed. Reg. at 64247-62.
[6] 88 Fed. Reg. at 64123 n. 355.
[7] 88 Fed. Reg. at 64125.

[UMBS], the proposal would allow the banking organization to fully offset [UMBS] that are issued by two different obligors."[8]

The proposed credit spread risk calculation would reduce liquidity in the fungible TBA market by increasing capital requirements for banks hedging with UMBS. Bank-owned dealers would be required to hold additional capital under the Proposal when a UMBS TBA position is used to hedge pools issued by either of the GSEs. For example, bank-owned dealers often sell forward UMBS TBA contracts to hedge their inventory of UMBS securities. This could include newly issued pools from the GSEs that were issued as part of a guarantor swap transaction and pools that were acquired on the secondary market. For the dealer, the forward UMBS TBA contract would be considered a hedge against a Freddie Mac or Fannie Mae UMBS position. In the Proposal, a bank-owned dealer would have to hold capital against both the long pool position and the short TBA position. In this scenario, dealers may look for an alternative hedging strategy such as forward sale of the pool outside of the UMBS TBA market. This would remove an important source of market liquidity to the fungible TBA market.

These elements of the Proposal would cause uncertainty and potentially disparate interpretations among bank-owned dealers. At worst, they would incentivize bank-owned dealers to bifurcate their TBA pools by GSE name, potentially reducing the market liquidity that the single security initiative produced.

As described below, both the regulatory establishment of the UMBS and current market expectations support the similar treatment of UMBS under the credit spread risk calculation, regardless of whether the UMBS is issued by Freddie Mac or Fannie Mae. As previously described, our general understanding is that the Agencies' collective intention is for the Proposal to support the single security and not to create any unintended consequences of decreased market demand as a result of the proposed changes to the Market Risk Rule. Therefore, we recommend that the rule, when finalized, should further clarify the language related to both the Preamble as well as subsequent rule specifications and treat the GSEs similarly under the final credit spread risk calculation within the market risk capital framework. Specifically, we recommend that the text of the final rule indicate that the correlation parameter for UMBS should be such that the two securities are regarded as the same – consistent with the overarching UMBS single security initiative and current market treatment.

The fungibility of UMBS is supported by the following:

**a. The UMBS Rule requires the GSEs to align programs, policies, and practices that affect TBA-eligible securities to support fungibility of these securities.**

In 2019, the GSEs' regulator, the Federal Housing Finance Agency (FHFA), promulgated a final rule on UMBS ("UMBS Rule"), which requires both Freddie Mac and Fannie Mae to maintain policies that promote aligned investor cashflows for UMBS, supporting fungibility and liquidity of TBA-eligible mortgage-backed securities.[9] FHFA stated that its "goal for the proposed Single Security structure is for legacy Fannie Mae MBS and legacy Freddie Mac PCs (legacy securities) to be fungible with the Single Security for purposes of fulfilling 'to-be-announced' (TBA) contracts."[10]

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[8] 88 Fed. Reg. at 64125.
[9] See 12 CFR Part 1248.
[10] FHFA, Request for Input: Proposed Single Security Structure at 3 (Aug. 12, 2014), cited in FHFA, Uniform Mortgage-Backed Security, 83 Fed. Reg. 46889, 46890 (Sept. 17, 2018).

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A prerequisite for the fungibility of UMBS securities is that the underlying fundamental value of the securities maintain general alignment. Because UMBS securities are guaranteed by the GSEs, there is essentially no credit risk to investors, so the main driver of fundamental valuation differences is differences in prepayment rates. However, the UMBS Rule established structural guardrails for the GSEs and the market to actively monitor and maintain alignment of prepayment rates. FHFA requires that the GSEs submit monthly reports on any misalignments in prepayment rates, provide plans to address any material misalignments that arise, and secure FHFA's approval before changing policies, programs, or practices that could cause future misalignment.

**b. The market currently does not differentiate between the GSEs in fulfillment of UMBS contracts.**

The Proposal's credit spread risk treatment is also at odds with market practice since the implementation of the single security. Chapter 8 of The Securities Industry and Financial Markets Association (SIFMA) Uniform Practices guidelines state that all UMBS and Supers[11] will be good delivery for a UMBS TBA trade, regardless of issuer.[12] Because pools delivered by either issuer can satisfy a UMBS TBA contract, there has been no pricing differential based on issuer since the introduction of the single security initiative. As such, the credit spread risk based on issuer should be zero. Further, there has been no notable increase in the stipulation of TBA trades based on issuer name since the introduction of the single security initiative (see Figure 1 in Appendix A).

## III. Market Price Volatility Haircuts for GSE Debt

The Proposal also addresses the amount of capital banks must hold against exposures related to eligible margin loans and repurchase (repo) transactions.[13] The combined exposure is based on the collateral underlying the transactions, where the haircut for each type of collateral is set by the rule.

The Proposal is a departure from the prevailing capital regime under which haircuts are determined based on the risk of the underlying collateral and are categorized into: (1) sovereign; (2) non-sovereign; and (3) investment grade securities. The current regime includes GSE securities in the non-sovereign entity category, leading them to receive lower haircuts than investment grade securities.[14] The Proposal eliminates the non-sovereign issuer category, thereby shifting GSE securities into the investment grade corporate securities category. If adopted as proposed, this re-classification would increase haircuts on repo transactions secured by our securities across the board, resulting in a 1% increase for securities with less than one year to maturity and an increase of up to 12% for a 30-year agency MBS. Such a change would lower liquidity and demand for our securities due to higher capital charges for banks providing liquidity in the repo market and margin loan market against our bonds, and likely also pass any higher costs to borrowers posting MBS and agency debt.

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[11] "Supers" are single class, pass-through, TBA-eligible securities. Their collateral may be mixed Freddie Mac and Fannie Mae UMBS and/or Supers, or a single issuer's securities. A Super may be issued by either GSE, regardless of whether its own collateral is contained in the security.
[12] SIFMA: Uniform Practices for the Clearance and Settlement of Mortgage-Backed Securities and Other Related Securities. Section 8.
[13] Proposed Table 1 to §__.121, at 88 Fed. Reg. at 64062-64063 ("Market Price Volatility Haircuts").
[14] Other non-sovereign issuers such as municipals and some banks fall in the same category as Freddie Mac. For full eligibility, see 12 CFR § 217.32.

We therefore recommend that the Agencies retain the non-sovereign category present in the existing capital rules. We believe that the proposed change is inconsistent with the treatment of GSE debt elsewhere in the Proposal and among other market regulations and overlooks the fact that GSE securities have a different, lower risk profile than investment grade corporates, as described below.

**a. Other sections of the Proposal treat GSE debt exposures differently from investment grade corporate securities.**

Other sections of the Proposal recognize the singular nature of GSE debt. For instance, Section III.2, which discusses proposed risk weights for credit risk, groups exposures to GSEs separately from exposure to corporate securities.[15] Section III on general risk weights devotes a separate subsection to GSEs, distinguishing GSE exposure from that of depository institutions, corporates, and other types of institutions.[16] In a similar manner, we believe that GSE debt should maintain its separate treatment and be distinct from any private label MBS for purposes of market price volatility haircuts.

**b. Current regulations recognize the lower risk of UMBS relative to corporate debt.**

The Federal Reserve and other market institutions currently recognize the difference in quality between agency MBS and corporate debt and account for this difference in collateral eligibility and liquidity rules. The Federal Reserve treats agency debt as Level 2A High Quality Liquid Assets ("HQLA") while relegating investment-grade corporates to the tier below, Level 2B HQLA.[17] As a result, agency debt is subject to lower Liquidity Coverage Ratio haircuts for HQLA portfolio requirements than corporate debt.

In addition, the collateral eligibility rules of Federal Home Loan Banks ("FHLBs") and the Federal Reserve's Bank Term Funding Program ("BTFP"), which are designed to support their market stabilizing missions, allow only securities that are widely recognized as secure to be received in exchange for lending cash. The fact that agency MBS, but not corporate bonds, can be pledged to FHLBs[18] and the BTFP[19] further demonstrates the recognized difference between these securities in the market.

**c. Markets for GSE debt are more developed and deeper than investment grade corporate debt markets, resulting in relatively easier conditions to liquidate or protect security value in times of stress.**

GSE debt benefits from several factors that are relatively underdeveloped in corporate debt markets and that are especially helpful in differentiating between the two in times of stress. Acquiring cash for agency MBS is less costly than doing so for a corporate debt security as MBS secondary and repo markets have higher trading volumes on average. As a result of the relative higher trading volume of agency MBS, liquidating a security in the agency MBS secondary market will result in a smaller price impact and more

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[15] 88 Fed. Reg. at 64038 (Section III.C.2).
[16] 88 Fed. Reg. at 64188-89 (Section III.F).
[17] For a list of Level 2A and 2B HQLA, see 12 CFR § 249.20.
[18] See 12 CFR § 1266.7.
[19] The Federal Reserve's Bank Term Funding Program specifies that eligible collateral includes any collateral eligible for purchase by the Federal Reserve Banks in open market operations (see collateral specifications at Bank Term Funding Program (federalreserve.gov)). For a list of collateral eligible for purchase by the Federal Reserve Banks in open market operations, see 12 CFR § 201.108(b).

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cash availability than when conducting a comparable liquidation in the corporate debt market. In 2023, TBA/MBS secondary trading volume was five times that of corporates,[20] and MBS repo has been five to ten times the amount of volume relative to corporate debt.[21] See Appendix A Figure 2 for more details on agency MBS trading volume relative to corporate debt.

Furthermore, if liquidation is not an option, MBS benefit from a liquid forward market that corporate debt securities do not have. This provides an avenue for investors to hedge interest rate risk and preserve securities' value if they possess MBS of defaulted counterparties.

Given both the depth and liquidity of the agency MBS market and the agency MBS forward market, the price volatility due to forced selling of positions should be smaller for MBS relative to corporate debt.

It is also important to note that the GSEs benefit both from extensive regulations and capital and liquidity oversight by FHFA. At present, Freddie Mac has grown over $45 billion in GAAP Net Worth to withstand the impact of any financial losses as it aims to reach its capital requirements under FHFA's Enterprise Regulatory Capital Framework (ERCF) capital requirements, which is at a level consistent with its minimum Common Equity Tier 1 capital requirements under ERCF as of 2023.

## IV. Additional Comments

Additionally, we would like to note that the Proposal's treatment of mortgages, mortgage servicing rights (MSRs), and Accumulated Other Comprehensive Income (AOCI) for banking organizations subject to Category III or IV standards may have unintended consequences on the overall mortgage market. In particular, the Proposal may incentivize those banking organizations to limit their mortgage activities and thereby increase the cost of mortgages to borrowers.

Specific to mortgage loans, the proposed changes to risk-weights will be raised higher than current capital standards and also introduce a sliding scale based on loan-to-value ratios for such assets. In turn, greater risk-weights have the potential to disincentivize impacted banking organizations from holding mortgage loans, particularly those with high loan-to-value ratios within their respective portfolios. This could further reduce credit availability and market liquidity to consumers and homebuyers. Lastly, the proposed capital threshold limits on MSRs and AOCI filters for those Category III and Category IV banking organizations may result in further migration of mortgage servicing and mortgage investment from the banking sector. All of the above factors could have long-term negative implications on borrowers' costs.

## V. Conclusion

For the foregoing reasons, we recommend that the Agencies revise the Proposal so that it treats UMBS issued either by Freddie Mac or Fannie Mae as the same name under the credit spread risk calculations. We also recommend that the Agencies revise the Proposal's section on market volatility haircuts so that it maintains the non-sovereign category present in the existing capital rules. Finally, we ask that the Agencies consider the impact that the Proposal may have overall on the US mortgage market as outlined within Section IV, in particular as such impact relates to the migration of activity from the banking

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[20] Data source is FINRA, TRACE Monthly Volume Files, (TRACE Monthly Volume Files | FINRA.org).
[21] Data source is the Federal Reserve Bank of New York, Tri-Party/GCF Repo, (Tri-Party GCF Repo - FEDERAL RESERVE BANK of NEW YORK (newyorkfed.org)).

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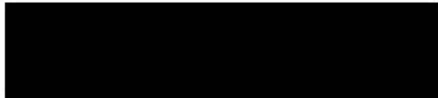
sector to elsewhere, thereby creating potentially negative implications to mortgage markets, its liquidity and homebuyer/consumer affordability.

Freddie Mac appreciates the Agencies' review of our concerns regarding the GSE's debt securities and would be pleased to respond to any questions or requests for further information.

Sincerely,



Ravi Shankar
Senior Vice President
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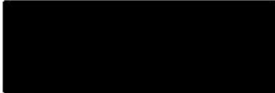

John Glessner
Senior Vice President
Investment & Capital Markets

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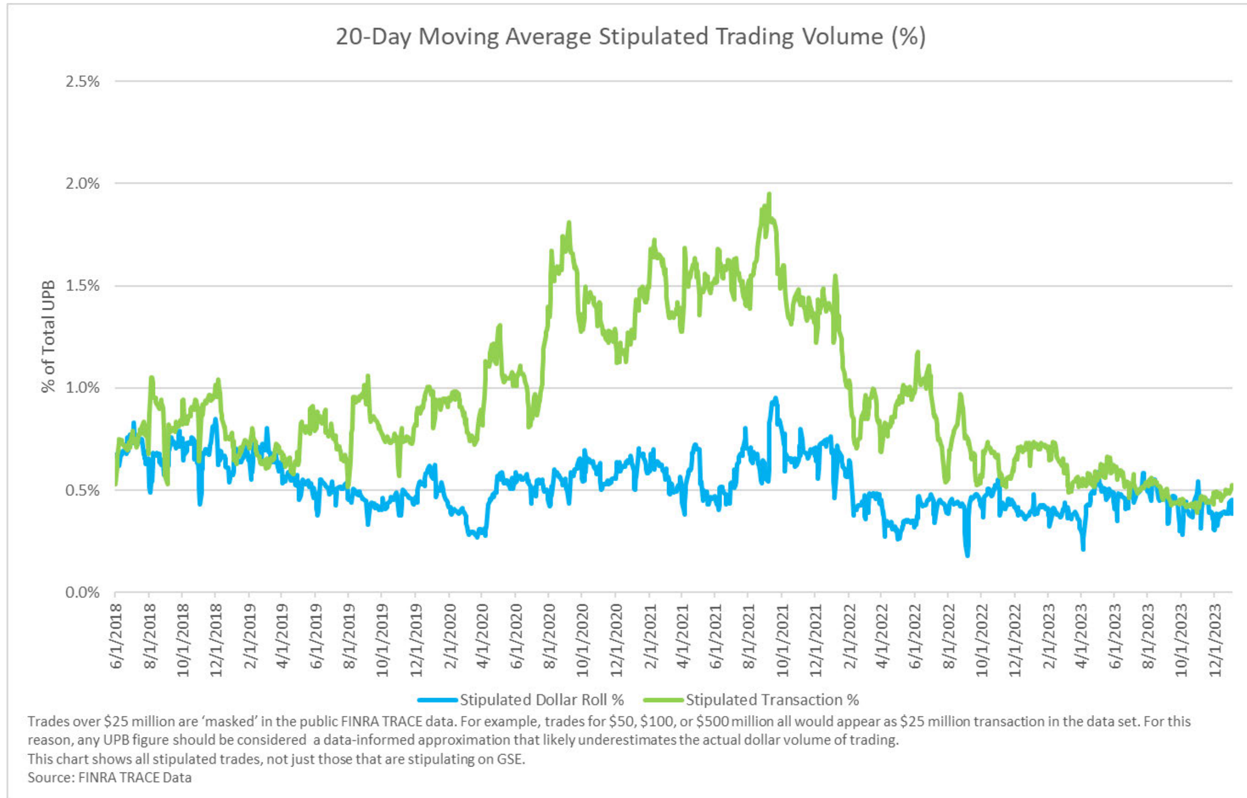
**Appendix A**

**Figure 1: 20-Day Moving Average Stipulated Trading Volumes**[22]




[22] Stipulated trades ('stips') increased during the 2020-2021 period due to the high prepayment environment prevailing at the time. The stipulated trading volume can also reflect stips based on other loan characteristics such as seasoning and geographic concentration, not just issuer, and investors stipulated trades during this time to obtain some level of prepayment protections. Stips have since settled into levels below that of the period prior to the introduction of the single security initiative.

**Figure 2: Agency MBS versus Corporates Trading Volume**

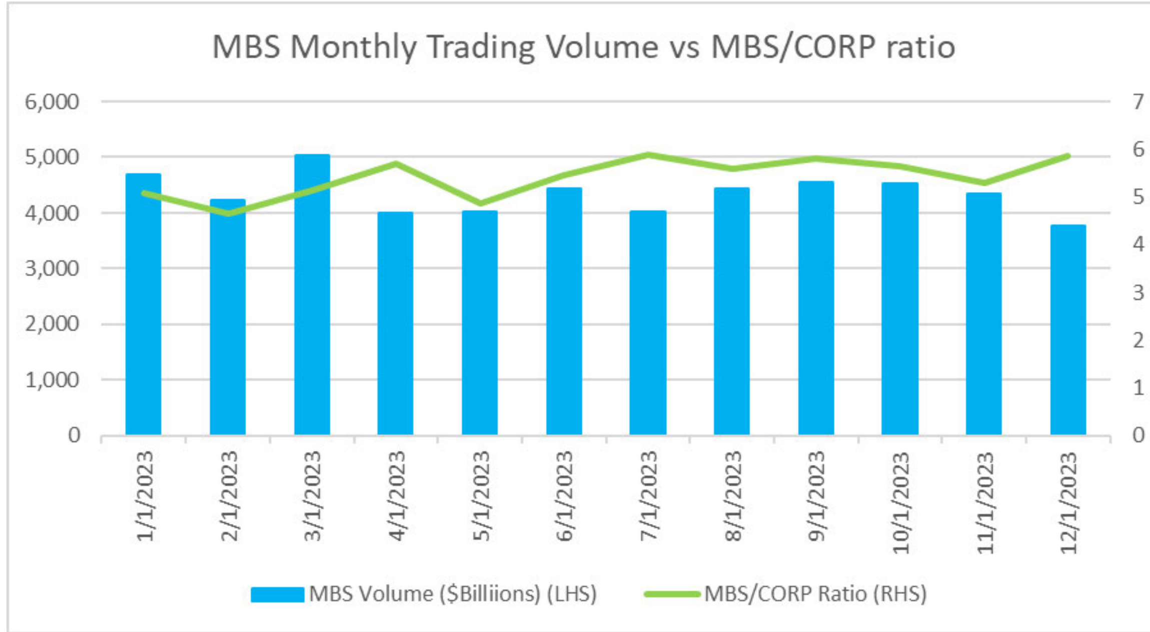



Figure 2 Source: [Tri-Party GCF Repo - FEDERAL RESERVE BANK of NEW YORK (newyorkfed.org)]