

Appendix E: Exchange Option for Investors in Legacy Freddie Mac Participation Certificates

Freddie Mac will offer investors in legacy Participation Certificates (PCs) backed by fixed-rate mortgage loans the option to exchange such a PC for a comparable Single Security issued by Freddie Mac backed by the same pool of mortgage loans. This document provides information about the exchange program, which will commence on or before the first day of trading of the new Single Security and be open for the foreseeable future. The first section below outlines the exchange process. The second section discusses how Freddie Mac will calculate the compensation to be paid to investors to compensate for the change in the payment date. The third section defines key program terms.

Overview of the Exchange Process

At their option, investors in an outstanding Freddie Mac PC that is backed by fixed-rate mortgages and eligible to be delivered into “to-be-announced” (TBA) contracts and is not already 100 percent committed to re-securitizations will have the option to exchange the PC for a Single Security issued by Freddie Mac that is backed by the same pool of mortgage loans.¹ As part of that exchange, investors will receive compensation from Freddie Mac for the additional ten days of payment delay, from the 45th day to the 55th day from the date monthly interest begins accruing.

Each new Single Security issued through the exchange program will have the same characteristics as the corresponding PC for which it was exchanged, such as unpaid principal balance, pool factor, and weighted average coupon. However, the structure of the new securities will be similar to current Giant PCs (Giants) in that each security will be backed by the original PC, instead of being backed by the loans directly. Thus, Single Securities issued through the exchange program will have the same disclosures as single-class Single Security re-securitizations, and investors will have to refer to the underlying PC for loan-level disclosures.

When an investor exchanges a PC, they will receive an equal par amount of the corresponding Single Security. If another holder of the same PC exchanges their bond at a later date, they will receive a corresponding piece of the Single Security with the same pool number and CUSIP.

¹ Freddie Mac refers to PCs backed by fixed-rate mortgage loans as “Gold PCs” and Giant PCs backed by Gold PCs as “Gold Giant PCs”. For simplicity, this appendix refers to those securities as PCs and Giants, respectively.



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Investors should seek appropriate legal and accounting guidance on the potential tax and accounting implications of transactions conducted under the exchange program.

Investors desiring to exchange PCs will be required to do so through a member of a pre-determined dealer group that will be authorized to submit exchange transactions to Freddie Mac. The use of a dealer group will increase the efficiency and capacity of the exchange process. Freddie Mac currently uses a dealer group to conduct Giant transactions.

Dealers conducting exchanges will submit exchange transactions through an online exchange portal that Freddie Mac will create to process the exchange transactions. The portal will link the dealers with Freddie Mac's back-end infrastructure, including the exchange account, the wire room, and operations support personnel. The portal will also keep track of the progress of the exchange and will be the main system responsible for producing the "exchanged par," a new disclosure element that will describe the amount of each PC that has been exchanged.

The date a dealer submits an exchange request will be considered the "trade date" for the new Single Security. The dealer will enter into the portal the CUSIP, pool number, and par amount of the security to be exchanged. The portal will validate the trade and display a float compensation value and the CUSIP of the corresponding new Single Security that the investor can expect to receive in return. The dealer will be required to confirm those trade details. On the settlement date, which will generally be at least two days after the trade date, the dealer will wire the PCs to Freddie Mac's Federal Reserve Bank account. The Freddie Mac wire room will validate the collateral and send the corresponding new security and float compensation to the dealer.

Methodology for Calculating Float Compensation

Freddie Mac intends to compensate investors, when 45-day PCs are exchanged for 55-day Single Securities, for the approximate fair value of the additional ten days from the mortgage payment due date to the receipt of payments on the new securities ("the float"). That practice will follow the precedent established by the exchange Freddie Mac initiated in 1990, when investors were required to pay Freddie Mac for the value of the delay in payments when they exchanged 75-day PCs for 45-day PCs. The respondents to the *Request for Input: Proposed Single Security Structure* (RFI) published by FHFA in August 2014 stated that compensation for the change in the payment date would be warranted.

The approach that will be used to determine the approximate fair value of the float is guided by two complementary but sometimes competing principles: (1) the level of precision of the calculation and (2) a desire to use a simple and durable calculation mechanism. Investors and



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Freddie Mac will want assurance that when there is an exchange, the fair value of the exchanged Single Security plus the cash compensation is equal to that of the current PC. The more precise the approach used to determine the fair value of the float, the more likely it is to produce a non-biased exchange. The effort to be precise could, however, undermine the exchange process because of the range of fair value assumptions and methodologies. Also, the exchange should remain open for the foreseeable future, which implies that the methodology selected should be highly durable and not require an inordinate infrastructure for Freddie Mac to support over the coming years.

The valuation methodologies Freddie Mac could use range from a flat fee based on the current unpaid principal balance (UPB) exchanged to a constant yield or constant option-adjusted spread (OAS) approach. The flat fee would be the simplest to administer but would not be as precise, whereas an OAS approach would be more precise but would embed a number of assumptions which could be disputed and would require more infrastructure. In short, determining the best way to value the float requires a judgment call.

Given the range of available methodologies and the desire to balance the competing principles of precision versus simplicity and durability, Freddie Mac plans to use a schedule of flat fees that will be informed by fair value methodologies. One or more flat fees for each product type (15-year mortgages, 30-year mortgages, etc.) will be offered. The fee schedule will be informed by various fair value methodologies, including a constant yield calculator, the Freddie Mac internal OAS model, and third-party OAS models. Those models will not be used to directly determine the float compensation but will provide a range of fair values to guide the compensation determination. The compensation schedule may also be affected by other considerations, such as the goal of increasing early liquidity in the new Single Security market. Thus, the final compensation offered by Freddie Mac may differ from the fair values produced by the models. Investors will see one transaction price per cohort (product, term, and coupon), as they do now with Giant and Real Estate Mortgage Investment Conduit (REMIC) fees. To provide general information about the level of compensation, Freddie Mac will publish an illustrative fee schedule prior to commencement of trading of the Single Security.

The expectation is that the compensation schedule will be relatively consistent over time. However, Freddie Mac will reserve the right to revise the compensation schedule at any time as market conditions warrant or in response to potential selection biases observed over time.



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Definitions of Key Terms

Scope of Exchange – The Freddie Mac exchange program will be open to holders of 15-, 20- and 30-year TBA-eligible PCs and Giants. However, PCs and Giants that are 100 percent allocated to resecuritizations will not be mirrored or exchanged. Freddie Mac may choose to offer an exchange mechanism for holders of non-TBA PCs backed by fixed-rate mortgage loans, if it is decided that would be advantageous from a business perspective. Freddie Mac is not planning to offer an exchange for REMICs or securities backed by adjustable-rate mortgage loans.

Timing of Exchange – The exchange will be open on or before the first day of Single Security trading and will stay open for the foreseeable future.

Float Compensation – As discussed above, in order to facilitate investor exchange and fairly compensate investors for the time value of money lost by receiving payments ten days later, Freddie Mac will compensate investors for the approximate value of the foregone float.

Trading Window – A trade can be submitted on any day of the month; however, trade settlement may be restricted on certain blackout dates. For example, trades will be unable to settle during the first four business days of the month, because collateral factors are not yet available for the month. That reflects current practice with the issuance of Giants.

Dealer Group - The group will be based on Freddie Mac's existing dealer networks for Giants and REMICs. Up to ten users from each dealer may be authorized to use the exchange portal.

Exchanged Par – Freddie Mac will disclose a new data element for each exchanged Single Security that will enable market participants to determine the outstanding balances of PCs and Single Securities. The exchanged par will represent the dollar amount of the UPB of each PC that has been exchanged.

Exchange Support – Support for the exchange process will be provided by the Security Operations Team at Freddie Mac. That team will provide support if users encounter difficulties using the portal. The team will also assist dealers in conducting special transactions, such as any transactions that need to be fulfilled on the next day or transactions where the collateral delivered to Freddie Mac does not match that which was entered into the portal on the trade date.

