

Bulletin

TO: All Freddie Mac Sellers and Servicers

July 13, 2007

SUBJECT: Underwriting Requirements for Nontraditional Mortgages Consistent with the *Interagency Guidance on Nontraditional Mortgage Product Risks*

As directed by Freddie Mac's regulator, the Office of Federal Housing Enterprise Oversight (OFHEO), we are implementing changes to our underwriting requirements consistent with the practices referenced in the *Interagency Guidance on Nontraditional Mortgage Product Risks* ("the Guidance"). The Guidance was issued to address risks associated with Mortgage products that allow Borrowers to defer payment of principal or interest and/or that could result in negative amortization ("nontraditional Mortgages").

Freddie Mac shares the views of OFHEO and the financial institution regulatory agencies that, because nontraditional Mortgages are complex and entail the possibility of payment shock, it is important that underwriting standards for nontraditional Mortgages are consistent with prudent lending practices and that prospective Borrowers have clear and balanced information prior to choosing a Mortgage product. We also believe it is important that Borrower repayment capacity is adequately assessed when underwriting Mortgages that have a potential for payment shock. The principles expressed in the Guidance and the requirements announced in this Bulletin address these concerns. It is our expectation that Sellers will comply with the provisions of the Guidance.

The Guidance was proposed by the federal regulatory agencies in December 2005 and was issued in final form in October 2006. According to OFHEO, based on discussions it has had with the federal banking regulatory agencies, regulated financial institutions should have already implemented the Guidance. OFHEO has directed that the changes announced in this Bulletin will take effect for nontraditional Mortgages that have loan application dates on or after September 13, 2007. This effective date, which was determined through discussions between OFHEO and Freddie Mac, reconciles OFHEO's desire for rapid implementation of the Guidance with the need for advance notice to enable Sellers to adjust their underwriting processes, train their personnel and manage their Mortgage origination pipelines.

Changes for nontraditional Mortgages

For purposes of this Bulletin, nontraditional Mortgages are Initial InterestSM Mortgages and other adjustable-rate Mortgages (ARMs) and fixed-rate Mortgages that have an interest-only feature, as well as ARMs with the potential for negative amortization (such as payment option ARMs) that are purchased on a negotiated basis.

With this Bulletin, we are making the following changes to our requirements for nontraditional Mortgages in order to be consistent with the practices referenced in the Guidance:

- The Borrower must be qualified using a monthly housing expense that includes, but is not limited to, the principal and interest payment on the Mortgage that is calculated in accordance with Guide Section 37.15
- For the purpose of qualifying the Borrower, the principal and interest payment must be based on a fully amortizing payment schedule for the term of the Mortgage. For example, the amortizing payment for an ARM with a 5-year interest only period and a 30-year term, would be based on a 30-year amortization schedule.

- For nontraditional fixed-rate Mortgages, the Borrower must be qualified using payments calculated using the Note Rate
- For nontraditional ARMs, the Borrower must be qualified using payments calculated at the higher of the Note Rate or the fully indexed rate as defined in Section 30.16(a)
- For nontraditional ARMs, the initial Note Rate must not be more than three percentage points below the fully indexed rate
- For nontraditional Mortgages originated with stated income or other forms of reduced documentation and verification of income and/or assets (such as Accept Plus documentation level Mortgages originated using stated income) the Mortgage file taken as a whole must demonstrate the reasonableness of the stated income. If the Mortgage file contains documentation that raises questions about the reasonableness of the stated income, further review of the information must be undertaken.
- The Seller must represent and warrant that the Seller has implemented processes and controls to ensure that Borrowers with nontraditional Mortgages receive written disclosure addressing payment shock, negative amortization (if any), prepayment penalties and the cost of reduced documentation loans, as appropriate, and that such disclosure is provided in a timely manner, all as discussed in the Guidance

As is the case with all Mortgages sold to Freddie Mac, Sellers must comply with the requirements in Guide Section 37.1, which states that a Seller's conclusion that a Mortgage is acceptable must be based on a determination that the Borrower is creditworthy (acceptable credit reputation and capacity) and the Mortgaged Premises (collateral) is adequate for the transaction. Credit reputation, capacity and collateral are often called the "three Cs" of underwriting. If one of these components is not acceptable or if there is excessive layering of risk across components, the Mortgage is not eligible for sale to Freddie Mac.

As part of the normal quality review process, Freddie Mac will assess compliance with the Guidance.

At this time, there are no changes to our delivery requirements.

Special requirements for federally- or State-regulated Sellers

We expect that Sellers that are regulated by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision or the National Credit Union Administration, or any State regulator of mortgage origination practices that has adopted the Guidance (the regulating agency) will comply with the Guidance in the manner and time frame required by the regulating agency.

Regulated Sellers either must comply with the requirements of the Guide changes announced in this Bulletin or must contact their Freddie Mac representative to discuss the need for an alternative approach to the requirements in this Bulletin. Freddie Mac will accommodate such an alternative approach subject to its normal credit policy evaluation processes, provided the Seller represents and warrants that:

- The Seller intends to use or is using the same alternative approach to originate Mortgages it will hold in its own portfolio, and
- The alternative approach is consistent with the Guidance as interpreted and applied to the Seller by the Seller's regulating agency.

OFHEO has requested that Freddie Mac provide it with reports from time to time about such alternative approaches.

Effective dates

As mentioned previously, the changes will be effective for all nontraditional Mortgages that have loan application dates on or after September 13, 2007; however, we strongly encourage Sellers to adopt the changes sooner wherever possible.

The Guide changes described in this Bulletin will be effective for all Master Agreements and Master Commitment Contracts issued without a Master Agreement (collectively, Master Contracts), which are entered into after the date of this Bulletin and which permit the sale of nontraditional Mortgages with loan application dates on or after September 13, 2007. For Master Contracts that were entered into before the date of this Bulletin and that include language requiring a Seller to adopt modifications to Freddie Mac's purchase requirements consistent with the Guidance within a specified time frame, the Seller must comply with the requirements of this Bulletin (and any amendments to the Master Contract incorporating such requirement) within the time frame specified in a written notice from Freddie Mac.

Freddie Mac will work with Sellers that have negotiated terms of business for the purchase of nontraditional Mortgages covered by the Guidance to effect any necessary contract changes if and to the extent such changes are permitted by the Seller's negotiated terms of business.

Revisions to the Guide

Applicable Guide chapters will be revised and announced in a future Bulletin. Until the Guide text is updated, Sellers must retain this Bulletin for requirements changes regarding the purchase of nontraditional Mortgages.

Loan Prospector[®] assessments

Loan Prospector will be enhanced between August 12 and August 26, 2007, to reflect changes to assessments and feedback messages for all applicable nontraditional Mortgages submitted. Sellers will be notified when those changes are implemented.

Conclusion

The changes announced in this Bulletin reflect Freddie Mac's continued commitment to its statutory responsibility to provide stability to the mortgage market. We will continue to work with Sellers on our shared goal of promoting responsible lending practices to put Borrowers into homes they can afford and keep. If you have questions, please contact your Freddie Mac representative or call (800) FREDDIE.

Sincerely,



Patricia J. McClung
Vice President
Customer Outreach and Offerings Deployment