BANKING ISSUANCE

Comptroller of the Currency
Administrator of National Banks

Type:	Banking Circular	Subject:	Federal Home Loan Mortgage Corporation (FHLMC) Swap Program

TO: Chief Executive Officer of All National Banks, Regional Administrators, and Examining Personnel

PURPOSE

This circular presents the policy of the Comptroller of the Currency regarding the accounting treatment for the exchange of mortgages for participation certificates by National Banks involved in the Federal Home Loan Mortgage Corporation's (FHLMC) Guarantor Phase I and II mortgage swap programs.

BACKGROUND AND DEFINITIONS

Banks which are not members of the Federal Home Loan Bank System (FHLBS) may participate in the FHLMC Guarantor mortgage swap programs which began on October 5, 1981. Under these programs the FHLMC buys participations (up to 100%) in conventional mortgage loans at par from a seller and concurrently sells a guaranteed participation certificate (PC) at par to the seller. These PC's may then be used as collateral for repurchase agreements or other borrowings or may be sold in the secondary market.

FHLMC acquires its participations through an auction from bidders who swap a minimum of $5,000,000 in mortgages. These bidders offer their mortgages through either competitive or noncompetitive offers. For competitive bids, the bidders offer a yield to FHLMC of at least 25 basis points over the interest rate on the PC to be received in exchange. FHLMC accepts bids in descending order from the highest yield offered.

The non-competitive bid offer is based upon the weighted average spread of the offers.

Upon notification of FHLMC's acceptance, successful bidders must remit a nonrefundable commitment fee. Institutions which are not members of the FHLBS must also pay a nonmember fee computed on the dollar amount of mortgages sold which are less than one year old, if any.

Successful bidders then elect to engage in either a "single seller" or "multiple seller" (not currently offered) mortgage swap.

A single seller swap is one in which the mortgages sold by the bank comprise one PC mortgage pool backed solely by the mortgages it has sold. In such swaps, the seller effectively retains its own mortgage loans while foregoing a portion of the interest income on them. This portion represents FHLMC's fee (generally less than .4 percent) for its guarantee of principal and interest on the mortgages underlying the PC. Thus, the FHLMC single seller swap would generally qualify as an exchange of substantially identical assets and no loss (or gain) would be recognized on the transaction.

A multiple seller swap is one in which the bank's mortgages and mortgages of other program participants are combined into one PC mortgage pool backed by a fractional undivided interest in all of the mortgages comprising the pool. This PC represents an interest in the seller's mortgages and those of others. Consequently, such PC would generally not satisfy the substantially identical test and a loss (or gain) would be recognized on the sale of the mortgages.

ACCOUNTING

National banks participating in the FHLMC Guarantor Phase I and II mortgage swap programs should account for the exchanges in conformity with generally accepted accounting principles. Program participants electing the single seller option will generally not recognize a loss (or gain) on the exchange of their mortgages.

However, equivalent interest rates are necessary for an exchange of assets to qualify as substantially identical. When the spread between the interest rate on such PC's and the yield to FHLMC at which a seller's auction bid was accepted exceeds one percent, the substantially identical test is not considered met. Therefore, a loss (or gain) will be recognized on such transactions.

Banks electing the multiple seller option would normally be required to recognize a loss (or gain) since the substantially identical requirement is not met. While this may be the normal presumption, there may be occasions when the mortgages each party has sold were substantially identical. In such a situation the bank should fully document the circumstances surrounding the transaction.

Commitment and nonmember fees are deemed period costs and must be expensed immediately.

Application of this substantially identical test will not necessarily be appropriate for other transactions. Hence, banks that engage in other loan or bond swaps should have complete documentation to support any contention that the assets involved are substantially identical.

OTHER CONSIDERATIONS

Participation in this mortgage swap program entails a cost to the selling bank in the form of the loss of interest caused by the rate spread (FHLMC's fee). Additionally, multiple seller option election requires accounting recognition of a sale upon exchange. Consequently, a bank would generally not undertake an exchange of seasoned, basically risk-free mortgages for a FHLMC PC when there is no offsetting benefit to be gained from the transaction. Often, however, this type of an exchange can be consistent with a bank's needs and objectives.

The exchange transaction itself provides the bank with no new funds. However, the PC may be better suited as a funding vehicle than the mortgages in which participations are sold. For example, the PC can be used to secure deposits. Since it carries FHLMC's full guarantee as to principal and interest, it is also acceptable collateral for securities sold under repurchase agreements. And the PC (because of its form as a security and the FHLMC guarantee) can be expected to bring a higher sales price than the underlying mortgages.

Therefore, a bank should carefully analyze the benefits and costs of investing in PC's to assure that participation in such a program is in its own best interest.

PROGRAM INFORMATION

Additional information on the swap program can be obtained by contacting the appropriate regional office of Federal Home Loan Mortgage Corporation. Offices are located in the following cites:

Northeast - Arlington, Virginia

EXAMINING ISSUANCE

Southeast - Atlanta, Georgia
North Central - Chicago, Illinois
Southwest - Dallas, Texas
Western - Los Angeles, California

ORIGINATING OFFICE

Questions regarding this banking circular may be directed to the Chief National Bank Examiner's Office, Bank Accounting (202) 874-4660.

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