

SINGLE SECURITY

What is the Single Security?¹

The “Single Security” will be a single form of MBS which will be issued by the Fannie Mae and Freddie Mac (“the Enterprises”) and is intended to be deliverable into the same TBA contract. The Enterprises refer to this type of security as UMBS, or Uniform Mortgage Backed Security. It will be issued in the form of a “first level” pass through and will be able to be re-securitized into a “second level” resecuritization (similar to current Mega and Giant pools) as well as CMOs. One of the Enterprises will be the issuer, trustee and guarantor of each first-level UMBS, as with current Fannie Mae and Freddie Mac MBS. The stated goal of this initiative is to bring additional liquidity and depth to the TBA market and to reduce or eliminate the trading disparities that exist today between the Enterprises’ TBA-eligible securities.²

Fannie Mae and Freddie Mac plan to operate certain back office functions relating to issuance, disclosure and bond administration of UMBS through the Common Securitization Platform (CSP).³ The CSP is owned and operated by Common Securitization Solutions (CSS). CSS has been incorporated, staffed and is developing the CSP’s infrastructure. In December 2018, Freddie Mac announced it had transitioned onto the CSP.⁴ In 2q2019, with the utilization of CSP by both Enterprises, FHFA’s goal is that TBA trading would become unified with a delivery into a single TBA contract that accepts the UMBS for good delivery, regardless of whether it was issued by Fannie Mae or Freddie Mac. On March 7, 2019, SIFMA announced that its TBA Guidelines Advisory Council voted to approve revisions to the Good Delivery Guidelines that establish a definition of good delivery for a UMBS TBA contract.

The components of the single security initiative include aligning (1) key features, which will mainly follow those of Fannie Mae’s current MBS (e.g., a 55-day delay, nomenclature); (2) investor disclosures, which will generally follow those for current Freddie Mac PCs; and (3) certain policies and practices which impact security performance, including, for example, those related to the removal of loans from securities. In addition, Freddie Mac will allow investors to exchange their existing 45-day PCs for new 55-day UMBS issued by Freddie Mac, with compensation to investors for the loss of 10 days’ float.⁵ Because the structure of the single security follows the features of the current Fannie Mae MBS, exchange of existing Fannie MBS for new UMBS will not be necessary.

FHFA proposed a rule⁶ to codify some alignment requirements in late 2018, and SIFMA responded⁷ with its views. This rule was finalized on February 28, 2019.⁸

Single Security Exchange Process for Freddie Mac Gold PCs

Holders of Gold PCs will be offered the option to exchange their PCs for UMBS, with compensation for the later payment date. Freddie Mac has created a website with more information on the exchange process.⁹ It is important to note that availability of settlement dates will be on a first come, first serve basis. Freddie Mac will not charge a fee for the transactions.

Freddie Mac began issuance of mirror securities, which will be used for the exchange process, on August 7th, 2018 and will continue through the launch of the exchange offer as required. The exchange offer is expected to open in May 2019. The exchange will be open for an indefinite period of time; there is no planned end date at this time. Existing Freddie Mac PCs will have to be exchanged in order to be eligible for good delivery into the UMBS TBA. Existing Fannie Mae MBS would not need to be exchanged for UMBS to be TBA eligible.

There will be two paths to exchange:

Broker-dealer facilitated exchange path: Broker-dealers are already utilizing the web-based portal for Giant transactions today. The trade instruction that will be sent from the Investor to the Custodian will be DVP/RVP.

¹ Please note that nothing in this document should be construed as accounting, legal, or tax advice, and readers should consult their own experts on these issues. This document is intended to summarize a variety of issues related to the Single Security Initiative.

² <http://www.fhfa.gov/PolicyProgramsResearch/Policy/Pages/Single-Security.aspx>

³ More information on the common securitization platform is available here: <http://www.fhfa.gov/PolicyProgramsResearch/Policy/Pages/Securitization-Infrastructure.aspx>

⁴ <https://freddiemac.gcs-web.com/news-releases/news-release-details/freddie-mac-implements-common-securitization-platform-single>

⁵ http://www.freddiemac.com/mbs/html/single_security_csp.html

⁶ <https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Issues-Notice-of-Proposed-Rulemaking-on-Uniform-Mortgage-Backed-Security.aspx>

⁷ <https://www.sifma.org/wp-content/uploads/2018/11/SIFMA-Response-to-FHFA-UMBS-NPR-FINAL.pdf>

⁸ <https://www.fhfa.gov/SupervisionRegulation/Rules/RuleDocuments/UMBS%20Final%20Rule%20for%20Web.pdf>

⁹ <http://www.freddiemac.com/mbs/exchange/>

- Brokers will execute the exchange trades at the CUSIP and entity level and provide an Exchange identifier for each exchange.
- In order to isolate the transaction for purposes of accounting and tax reporting, it's critical that Investors clearly instruct the exchange trade to the custodian following ISITC recommended standards in populating tags 20c and 22f.
- If the exchange fails, the broker-dealer will automatically re-instruct, which will result in cancel/rebook instructions from the Investor to custodian.
- The float compensation is expected to typically be provided within the DVP proceeds.

Direct to Freddie Mac exchange path: This path will leverage Tradeweb and will require Investors to obtain access to the Tradeweb portal. The trade instruction that will be sent from the Investor to the Custodian will be Free Del/Free Rec. This path will only be available to Investors for 3 – 5 years.

- In order to isolate the transaction for purposes of accounting and tax reporting, it is critical that the Investor instruct the exchange trade to the custodian including the Exchange identifier within tag 20c.
- Custodians will settle trades at newly created Freddie Mac dedicated accounts at the Federal Reserve.
- If the exchange fails, the Investor will be required to re-instruct via Tradeweb, obtain a new Exchange identifier, and provide a cancel/rebook instruction to the custodian.
- There have been some questions raised by 40 Act Fund Managers in relation to Free Delivery transactions and the Custody Rule. Freddie has published a letter from a law firm that reaches a conclusion that eligible securities delivered to Freddie Mac's holding account in connection with the exchange offer will be presumptively beyond the reach of Freddie Mac until returned or exchanged. The letter is available [here](#).¹⁰ It will be the ultimate responsibility of each fund manager to evaluate this letter, its conclusions, and their own or their counsel's views on the requirements of the 40 Act as they relate to the exchange process.
- Float compensation payments will be provided by Freddie on the Settlement Date of the exchange via wire payment made to the custodian bank.

Recommended ISITC Trade and Wire Instructions: The SIFMA Asset Management Group's Custodian Forum has recommended the following ISITC formatted trade and wire instruction for both Paths. (Link to ISITC market practice [here](#)).

Instructional requirements

SWIFT

Primary Considerations	Dealer-Facilitated Path	Direct-to-Freddie Mac Path
Message Type	Deliver vs Payment - MT543 Receive vs Payment - MT541	Free of Payment Deliver - MT542 Free of Payment Receive - MT540
Universal Exchange Reference Identifier *	:20C::COMM//UMBS00345678 – 12 characters	:20C::COMM//UMBS00345678 – 12 characters
Exchange Code Words **	:22F::STCO/FHMC/UMBS	:22F::STCO/FHMC/UMBS
Counterparty details	Dealer counterparty instructions	ABA#: 021033205 Beneficial account: 2BD5 (REC) & 2BD7 (DEL) Buyer/Seller: FMACUS33
Float Compensation	Float compensation included in DVP net settlement amount	MT210 to highlight expected float compensation

* The Universal Exchange Reference Identifier should be a unique 12-character ID and exclude '/' in the data field when combining the UMBS prefix and the 8-digit reservation number.

** Exchange Code Words will allow custodian to identify the trades as exchanges for purposes of accounting and tax reporting.

¹⁰ http://www.freddie.com/mbs/docs/cwt_memo_free_delivery_securities_exchange.pdf

Re-securitizations

An investor that owns a UMBS issued by one of the Enterprises, for example Freddie Mac, will be able to request that the second Enterprise (in this example, Fannie Mae) re-securitize the first level Single Security into a new second level security either by itself or commingled with other Freddie Mac or Fannie Mae securities. The re-securitizing Enterprise will also guarantee the re-securitization. FHFA clarified that *“the timely payment of principal and interest on the resulting second-level security will be guaranteed by the second Enterprise, and that guarantee will be supported by the first Enterprise’s guarantee of timely payment of principal and interest on the first-level security. As a result, the investor in the second-level security will benefit from effectively the same protection that would have existed if both Enterprises had directly guaranteed the first-level security. Further, the issuer/guarantor of a single security is material information that will be included in the disclosure.”*¹¹

Accordingly, a Fannie Mae or Freddie Mac second-level security could contain only Fannie Mae-issued pools, a mix of Fannie Mae and Freddie Mac-issued pools, or be entirely collateralized by Freddie Mac-issued pools. Details were published on the GSEs’ websites.¹²

Accounting and Tax Treatment of Exchange Transactions and UMBS

Accounting Treatment of Exchange - Regarding exchanges of Gold PCs for UMBS, Fannie Mae sought and received guidance from the SEC that “accounting for the exchange by analogizing to the accounting guidance for modifications of receivables in FASB ASC 310-20-35.¹³ This is expected to result in the conclusion that the transaction is a “minor modification of the existing security”, and “by concluding the transaction is a minor modification, Fannie Mae would carry over the basis of its 45-day PCs and would recognize the cash payment received as compensation for the 10-day delay in payment cycle as a basis adjustment on the 55-day Supers.

Tax Treatment of Exchange – On August 17, 2018, the Treasury Department published guidance¹⁴ on the treatment of the Gold PC exchange. The conclusion of the guidance is that the conversion will not constitute a taxable exchange of property for the purposes of Section 1001, so long as the total of float compensation and any exchange inducement does not exceed 25bp. The float compensation and inducement may be considered income, and the tax consequences of that should be considered by holders. For its part, Freddie Mac indicated that it *“will treat the float compensation payment as a tax-free adjustment to the security basis. As such, for those investors that execute their exchange through the direct-to-Freddie path, Freddie Mac does not intend to report the payment as taxable income to the investor”*.¹⁵

Application of IRS Rule 817-H – On October 16, 2018, the IRS issued Revenue Procedure 2018-54 (RP).¹⁶ The RP applies to “generic GSE securities” which *“means a TBA-eligible GSE security that a buyer acquires by taking delivery pursuant to a TBA trade in which, at the time that the buyer entered into the TBA contract, the buyer had no way of knowing the actual issuer(s) of the securities to be delivered under the contract”*. The RP allows for a taxpayer to elect a deemed issuance approach to these Generic GSE Securities, where a taxpayer could elect to treat their issuers, for the purposes of 817(h) compliance tests, according to a ratio that will be set forth by FHFA for each year (e.g., an MBS could be treated as 60% Fannie Mae and 40% Freddie Mac). It notes that a *“deemed-issuance-ratio election is applicable to all of the electing taxpayer’s generic GSE securities acquired under TBA contracts that were entered into for quarters ending in the year specified in the election and for quarters ending in all subsequent taxable years for which the election is effective.”* FHFA announced the deemed issuance ratio for 2019 to be 60% Fannie Mae / 40% Freddie Mac.¹⁷

The RP does not address open TBA positions. It is unclear if this guidance will be further clarified, modified, or amended. SIFMA is pursuing further discussions with the IRS and Treasury.

GSE Policy and Program Alignment

Fannie Mae and Freddie Mac will continue to maintain their own seller/servicer guides and trust agreements but have indicated they will work to maintain alignment in key areas. This has been a key area of market focus, and the primary focus of SIFMA’s advocacy, and we expect more details to be released over time. FHFA’s final rule, previously mentioned, is centered on this issue.

¹¹ <http://www.fhfa.gov/AboutUs/Reports/ReportDocuments/Single%20Security%20Update%20final.pdf>

¹² http://www.freddiemac.com/mbs/docs/post_single_security_collateral_eligibility_super_giant_mega_remic.pdf?elqTrackId=bd5124e95e4a456eb041ca62e31f9ce0&elq=472a15e5dca04c37b9bbd715599cbf2e&elqaid=6037&elqat=1&elqCampaignId=5251

¹³ http://www.freddiemac.com/mbs/docs/Fannie_Mae_Confirming_Letter_to_SEC_Regarding_Accounting_Treatment_for_Gold_PC_Exchanges_and_Co_mpanion_Document.pdf

¹⁴ <https://www.irs.gov/pub/irs-drop/rr-18-24.pdf>

¹⁵ http://www.freddiemac.com/mbs/docs/float_compensation.pdf

¹⁶ <https://www.irs.gov/pub/irs-drop/rp-18-54.pdf>

¹⁷ <https://www.fhfa.gov/PolicyProgramsResearch/Policy/Pages/Deemed-Issuance-Ratio.aspx>

TBA Good-Delivery

On March 7, 2019, SIFMA announced that a significant majority of SIFMA's TBA Guidelines Advisory Council members voted to approve the changes to the Uniform Practices Manual relating to good delivery guidelines for UMBS TBA transactions that would be effective for trades with (1) trade date on or after March 12, 2019 and (2) settlement dates on or after June 3, 2019.

Things Industry Participants Should Consider Today

- Vendor and key counterparty readiness (e.g., technology providers, custodians)
- How a single security, and conversions of legacy securities, might impact accounting or tax treatment of existing or new positions, including exchanges and dollar rolls; including:
 - Impact to systems and workflow processes; including how Fund Administrators will be instructed for accounting and financial reporting purposes
 - Approach & workflow specific to security exchanges with consideration to the accounting and tax reporting impact
 - Clarity on how to process "float compensation" from an accounting perspective
- Operational impact and requirements; including:
 - That Freddie Mac will only provide one Universal Exchange Reference ID by exchange and not by tranche of 50 Mio (FED limit) for all exchange bigger than 50 Mio
- Amendments to transaction documentation (e.g., MSFTA collateral annexes, investment management agreements, and other agreements)
- Client communication, required approvals for changes to agreements, necessary documentation changes

Important Links

FHFA

<http://www.fhfa.gov/PolicyProgramsResearch/Policy/Pages/Single-Security.aspx>

Fannie Mae

<http://www.fanniemae.com/portal/funding-the-market/single-security/index.html>

Freddie Mac

http://www.freddiemac.com/mbs/html/single_security_csp.html

SIFMA's TBA Market Page

<http://www.SIFMA.org/TBA>

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