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Invested in America

August 21, 2015

Federal Housing Finance Agency
Office of Strategic Initiatives
400 7th Street, S.W.,
Washington, DC 20024

Re: An Update on the Structure of the Single Security (May 15, 2015)

Dear Sir or Madam,

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates this opportunity to provide additional feedback to the Federal Housing Finance Agency ("FHFA") on its Update on the Structure of the Single Security ("Update") as it considers how to continue the alignment of the operations of the Fannie Mae and Freddie Mac (together, "GSEs") and direction of the two GSEs to issue a single form of mortgage-backed security ("MBS").

We commend the FHFA for soliciting feedback from the industry on this proposal, given its importance to all of our members as well as the housing markets and mortgage borrowers. We also appreciate the opportunity for SIFMA members to meet with representatives of FHFA, the GSEs, and the Common Securitization Platform to discuss these issues.

Since FHFA has indicated that there are no plans to align GSE selling guides (we maintain that this would be the preferred and most efficient approach), alignment of prepayment speeds must be ensured by establishing a concrete vetting and review process for new lending, underwriting, servicing, securitization, or other programs and policies or changes to existing programs and policies, when these changes are expected to have a material impact on MBS performance or be of significant size.

Below we briefly summarize our members' views on a limited set of important issues that we believe FHFA and the GSEs should consider.

Policy, Practice, and Performance Alignment Must Be Top Priority

We appreciate the further clarification from FHFA in the recent discussion paper, including that regarding buyout policies, counterparty risk, and security disclosure. Market participants sought further details on these questions, and upon an initial reading, we believe the responses provided in the update satisfy current demands. However, further iteration and detail may be required as participants explore implementation of the common TBA in more detail.

However, we believe the new paper does not indicate a strong enough role for FHFA in maintaining the policy and practice alignment of the GSEs, and does not offer enough detail regarding the process to create and maintain such alignment. This causes significant concern about the potential outcome of the initiative.

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

The Update notes:

> *"As each Enterprise develops and considers changes in its programs, policies, or practices, the Enterprise's process includes an analysis of the likely effect of such potential changes on the prepayment speeds of its mortgage-backed securities. For each change the Enterprise finds likely to have a significant effect on prepayment speeds, the Enterprise reports such finding and any related analysis to FHFA and requests FHFA's prior approval for the change."*
>
> *"FHFA assesses the effects on the prepayment speeds of an Enterprise's mortgage-backed securities of any potential change in that Enterprise's programs, policies, or practices that the Enterprise has proposed for FHFA's approval or that is otherwise considered by FHFA. If FHFA finds that such a change will likely have a significant effect on such speeds, FHFA identifies and assesses potential actions before approving, disapproving, or directing the Enterprise to implement the change."*

We appreciate the intention of this statement. By itself and especially when coupled with a later statement:

> *"In considering and making decisions about potential changes to the Enterprises' loan removal policies and practices, the Director of FHFA will have the discretion to balance policy objectives that he believes to be appropriate, given FHFA's statutory obligations."*

One is left with a concern of the unknown -- while "potential actions" may be considered, it is not clear what those actions are; further, what "policy objectives" may exist at any given time? How are any of these factors weighted in the decision making process? Could a political goal override the need for fungibility between the GSEs? Could one GSE influence a policy change that creates a divergence in performance?

Promotion of maximum liquidity in the TBA market serves all borrowers – both those in the TBA market, and those whose rates are set by reference to the TBA market. The key to the success of the TBA market is fungibility. SIFMA believes that if the goal of the single security project is to increase the overall liquidity of the TBA market by combining the float of the GSEs' MBS into a single TBA deliverable, then the most effective (and only true) means to achieve this end is to ensure that there is a concrete, comprehensive, and sustained process by which alignment of performance, and therefore fungibility, will be maintained. The great majority of mortgage borrowers served by the GSEs and the TBA market will only benefit from such alignment. We submit that alignment of MBS performance and GSE credit exposure[2] should be priority number one, now and in the future.

As we have stated in our previous submissions, we believe that effective alignment of policies and practices, so as to achieve a continuing alignment of security performance, is the single most important factor in the success, or lack thereof, of this initiative. Any policy or practice of the GSEs that could impact prepayment speeds in a material way must be effectively aligned. This includes, but is not limited to: buyout policies, streamlined refinancing program policies (e.g. HARP and any future programs like it), implementation of new underwriting and servicing initiatives, servicing compensation, and loan level price adjustments/adverse market delivery fees.

If performance and credit risk are not aligned, then the securities will not be fungible and the market will not trade them as if they are. If Fannie and Freddie speeds meaningfully diverge in the future, the market will find a way to deal with that, and it will involve lower liquidity and more fragmentation. Lower liquidity and market fragmentation is an unacceptable outcome of this initiative.

Investors will not be able to price differences in performance in the same manner they are today (e.g., by avoiding the issuer they don't like), therefore misalignment would likely result in harm to the entire market at once. In a single security market, investors will not be able to enforce market discipline without

[2] To avoid a situation where one GSE takes on excess credit risk in a manner that leads to concerns of insolvency, which would likely have a negative impact on the perceived fungibility of MBS.

stipping or moving to the spec pool market. These concerns would magnify in a future multi-guarantor system where it will be even more complicated to deal with multiple issuers. If FHFA believes it is laying the groundwork for the future, this is a legitimate concern today.

We agree that in recent years the performance of the MBS has been closely aligned. That small sample size, though, does not provide comfort to market participants that this alignment will continue given the much wider lens through which we observe the GSEs. But the market will not operate on a “trust me” basis. Market participants remain well aware that the GSEs are still publicly traded, independent companies. They each have motivations to maximize their profit and maximize their market share. We fully expect they will do so. Accordingly, there need to be risk mechanisms in place, guard rails, to head off bad outcomes before they can take root.

As we have previously noted, aspects of the GSEs’ operations that can have a material impact on prepayments need to be aligned for the single security initiative to be a success. The goal of our suggestions is to limit differences in convexity between the two MBS programs and also prevent a competitive race to the bottom that creates a parallel worsening of MBS performance.

There are two elements to this alignment:

1. The actual alignment of specific policies and procedures; and
2. The oversight and monitoring of this alignment to ensure a sustained alignment.

We address each below.

Specific Areas of Alignment

Certain aspects of operation should be exactly aligned. When perfect alignment is not practical, misalignments should be explicitly recognized, publicized, and addressed, with the goal of achieving the *maximum practical alignment*. Priority features that will allow for a successful and interchangeable single security should center around the policies that affect prepayment risk and credit risk, including these below:

1. Changes to buyout policies must be implemented in the same manner for each GSE. There is no room for variation. This is addressed in the Update, but we stress the importance of this given the recent history of major (and dislocating) differences in buyout activity.
2. Servicer compensation should be identical. We recognize that this issue is not currently on the active agenda of FHFA, but if and when it reappears, there will not be any room for variation between the GSEs in the TBA-deliverable universe.
3. New lending programs or other expansions of the credit box should be implemented in the same manner. The rollout of the 97 LTV program, though de-minimis in nature, sent the wrong signals to the market. Especially in this time where market participants are still coming to grips with what a single TBA delivery would mean and look like, it is important that every effort is made to promote conformity of operations.
4. The GSEs each currently have policies in place requiring delivery of a representative mix in terms of collateral characteristics (not necessarily a specific percentage split) of their production. FHFA should make this requirement explicit in the context of the single security. This should minimize the risk of originators adversely selecting a GSE in a single security regime, which would harm the fungibility of the security.
5. There are other issues that also warrant attention but are less pressing at the current time – these include changes to guarantee fee pricing and material changes to servicing policies/requirements.

Formal Review and Comment Process

Accordingly, we propose a framework whereby new policies and changes to existing policies are vetted in a regular, formal, and continuous process.

1. Formal review should be required for any change that could impact either (1) prepays by 5% or (2) 1% of borrowers served by the GSEs or (3) materially change the credit risk, in the short or long term, taken on by the GSEs.
2. The review will explore –in detail and in multiple scenarios—expected prepayment outcomes and impact to the GSEs' credit risk profile.
3. To the extent a program or policy change is expected to have a material impact on prepayments – 5% or greater – the policy or program must be implemented identically. A similar standard should exist for material changes to credit risk profile.[3]
4. Market participants should have insight into this process, and FHFA should seek comment from them.

Along with this review process, FHFA should implement performance monitoring and should include in the annual scorecard an enhanced oversight of the GSEs' MBS programs. The scorecard enhancement should cover both issuance and prepayment performance. This will offer the FHFA and market participants transparency and metrics on the effectiveness of alignment on an ongoing basis.

1. FHFA would publish a quarterly "Alignment Report on Fannie/Freddie MBS issuance trends with a detailed breakdown of collateral characteristics (averages and quartiles).
   a. GSEs will be required to provide explanations for meaningful deviations; these would be published with FHFA's report.
2. FHFA will seek remedial steps to bring about closer alignment if significant differences arise.
3. FHFA should publish a quarterly report on prepayment rates on Fannie/Freddie MBS at the cohort level and quartiles within a cohort.
4. Differences in speeds between Fannie and Freddie exceeding 5% of the slower speed would require a detailed explanation. If differences persist for more than one quarter, FHFA would seek remedial steps.

Implementation, Milestones, and Timeline

The marketplace remains unclear regarding the intended implementation date and transition plans for the single security and CSP. All that has been publicly expressed is that "this is a multi-year initiative". We believe that CSS and the GSEs should issue an implementation plan that includes benchmark goals, a timeline, and a target date for completion. This would require more regular and frequent industry consultation, but we believe the outcome of such efforts would be beneficial to the development and success of this initiative. Seller/servicers, the investor base, and service providers would benefit from consistent communications about progress towards the Single Security and quarterly updates on the targeted completion date, for example that the CSS expects to be ready to issue (but won't necessarily issue) its first MBS on MM/YYYY. More frequent communication will be of high value even if it focuses on soft targets that are adjusted as necessary – we believe more clarity is important.

This would be a pivotal market signal that CSS has set a path with a date in mind and that it intends to assist market participants in their transition to the single security regime by issuing a transparently managed transition plan. There are a number of issues that individual market participants will need to explore prior to transacting in the new securities. Participants will need to examine accounting treatments, make changes to client investment guidelines, update delivery systems, adjust prepayment models and more. Without at least a general sense of when the new market would go live, it is difficult to

[3] We would expect changes that materially impact credit risk would generally have an associated impact on prepayments, but this may not always be the case so we include it here.

prioritize resources. That being said, a primary prerequisite for this work will be the finalization of the structure of the security.

We believe the recently-formed advisory committee can be helpful in developing these scorecards and milestones and encourage the GSEs to make active use of this group.

In any case, we do not believe it is workable to begin issuance of the new form of securities in any shorter period than 1 year from the time that the structure of the single security, and any related changes to CMO issuance or other related policies and procedures, is complete.

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We hope these comments are useful and we appreciate the continued dialog with FHFA and the GSEs. Please contact me (212-313-1126 or ckillian@sifma.org) to discuss any of these comments or if we may be of further assistance.

Sincerely,

Christopher B. Killian
Managing Director
Securitization