



October 10, 2014

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

Re: Request for Input: Proposed Single Security Structure

Dear Sir or Madam,

The Securities Industry and Financial Markets Association (“SIFMA”)¹ appreciates this opportunity to provide feedback to the Federal Housing Finance Agency (“FHFA”) on its Request for Input (“RFI”) as it considers whether or not to continue the alignment of the operations of the Fannie Mae and Freddie Mac (together, “GSEs”) to the point of directing 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.

Based on the publication by FHFA and public statements from its Director and others it appears that FHFA is moving with appropriate caution, which we also commend. It is important for FHFA to move at a measured pace and not create surprises for market participants. We believe implementation of any initiatives related to this RFI should be done in stages, beginning with items that serve as pre-requisites to the goal of a unified TBA market (e.g., aligning disclosure, streamlined refinancing programs, etc), and avoiding a “big bang” approach, as this carries much more risk.

SIFMA has previously supported FHFA’s efforts to align the operations of the GSEs based upon the belief that the GSEs serve similar functions in the market. Aligning the operations of the GSEs would serve to increase efficiencies for market participants and enhance the functioning and liquidity of the markets for their MBS.² The step of aligning the GSEs functionally and operationally is a necessary pre-requisite to the penultimate stage of alignment, which is the unification of the markets for the MBS they issue.³ A key question presented by this RFI is whether or not the GSEs are now functionally aligned enough to support a belief by market participants securities would be fungible.

SIFMA formed a working group consisting of broker-dealers, originators, and investors, and over the last two years we have discussed various options for combining the MBS markets of the GSEs. We have received input from our members (and non-members) regarding the costs, benefits, risks and rewards of various paths forward. While there may be views for or against any particular aspect of the idea, we

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.

² See, e.g., our letters of June 12, 2012 and December 3, 2012, available at <http://www.sifma.org/issues/item.aspx?id=8589939012> and <http://www.sifma.org/issues/item.aspx?id=8589941112>, respectively.

³ The ultimate stage of alignment would be the unification or consolidation of the operations of the two GSEs into one, which is an issue that may be worthy of discussion but beyond the scope of this letter.

believe it is essential that the FHFA and the GSEs have a broad base of support and buy-in from market participants before any steps are taken that have the potential to disrupt the liquidity of the TBA market. Buy-in is needed not just from originators, broker-dealers, or investors independently, but from all of the differently situated participants in the MBS markets together.

We recognize that FHFA has the authority to direct the GSEs to implement the plan in the RFI. However, we believe it is important that more work be done to obtain broader industry support and create a full understanding of many granular details of this proposal. In the following comments, we will address some of the critical aspects of this proposal that warrant further consideration and dialog. This consideration and dialog will take time, but the negative impact of a rushed or poorly-planned process would be tremendous and is something that all participants want to avoid.

What follows in the Annex are a number of considerations and constructive suggestions that our members believe should be explored and addressed in FHFA's process. They are presented in a general ordering of priority.

SIFMA's key conclusions on the RFI include:

1. FHFA should continue to seek out and address industry feedback to ensure a very broad-based level of support for the proposal laid out in the RFI.
2. FHFA should be highly confident that any changes to market pricing and liquidity would be net-positive before implementing any proposal similar to that described in the RFI. *(See section 1)*
3. FHFA should examine and clarify issues related to the identity of the guarantor faced by investors and other issues that create legal certainty. Any changes to the system must be durable. *(See sections 2 and 6)*
4. The performance of the GSEs' MBS must remain fungible for this initiative to succeed. FHFA must be prepared to take an active role to ensure the improved and continued alignment of the performance of the GSE's MBS, take steps to preclude policy implementation and competition for market share that could impair such alignment, and should involve the industry in discussions on this topic. *(See sections 3,4,and 5)*
5. In addition to creation of a fungible MBS environment, another prerequisite for success will be to reduce frictions in any transition to a new MBS issuance framework, including ensuring appropriate compensation to holders of legacy MBS for changes in payment delay upon exchange, and minimizing the costs of these exchanges. *(See section 8)*

Please do not hesitate to contact me at 212-313-1126 or ckillian@sifma.org with questions or for further discussion.

Sincerely,



Christopher B. Killian
Managing Director
Head of Securitization

Annex

1) Goals and Range of Outcomes

It is a fact that Freddie Mac MBS have for some time traded at a discount to Fannie Mae MBS due to liquidity differences and fundamental performance factors. Historically the prepayment performance of the GSEs MBS was not aligned – in many instances Freddie Mac MBS had higher prepayment speeds. This distinction has been generally eliminated, at least for now, so the prevailing view today is that the current distinctions in pricing are primarily due to liquidity. Data published by FINRA shows the vast difference in trading volumes between the GSEs' MBS.⁴ We also understand that Freddie Mac compensates originators through reductions in guarantee fees or otherwise, and that this foregone revenue is viewed by some as a cost to taxpayers. Those who view the GSEs as currently aligned on prepayment speeds, with liquidity being the only difference between their securities, argue that through a combination of the MBS markets these liquidity distinctions will be eliminated. Accordingly, the need for pricing adjustments by Freddie Mac will be reduced, revenue to Freddie Mac will increase, and overall TBA market liquidity will improve to the benefit of the GSEs, taxpayers, MBS market participants and mortgage borrowers.

Our view is more nuanced and less definitive. Our primary goal with regard to this issue is to ensure that no harm is done to the TBA market -- given that the consequences of disruptions to liquidity in the TBA market would be extremely costly to borrowers, the GSEs, MBS investors, and the housing market as a whole. One can see the potential benefits of the ideal unified and homogeneous market, including that concerns regarding liquidity that exist today due to a lack of tradable float in particular coupons could be lessened or eliminated. On the other hand, the ideal case is just that – ideal – and there are a number of practical considerations that would need to be addressed to get there.

The risks to implementing this concept are not de minimis. In the proposed plan, the ability of the GSEs to re-securitize MBS issued by one another should serve to lessen or eliminate the spread between MBS issued by the GSEs and cause prices to converge (depending on conversion frictions). However, it would be a bad outcome were the pricing of the securities to converge and remain below the level of pricing enjoyed by Fannie Mae today. That result would increase costs for many mortgage borrowers whose loans would be delivered into a market with worse pricing. Views on the level where pricing would converge are not uniform across our membership. It is incumbent upon FHFA to be highly confident that any changes to the structure of the market would result in a neutral or positive change to this equilibrium level before moving forward.

The main issue that drives the concern that TBA prices would converge and remain below the current Fannie Mae price is a view that the cheapest-to-deliver option would be expanded in a unified market, because for any given trade the seller will have an increased pool of cheapest to deliver securities to deliver.⁵ This is not a controversial point – the different views held by market participants as to at what level will TBA pricing converge reflect of whether or not they believe that the negative pressures from expansion of the cheapest-to-deliver option will be overcome by positive benefits to liquidity from the increase in the tradable float brought about by the combination of the two markets.

⁴ See data here: <https://vantage.interactivedata.com/aggregate>

⁵ The total number of such securities will not increase but optionality on allocation with respect to any specific trade will.

We believe the outcome of a unification of the TBA markets will be driven in large part by how many MBS investors believe the GSEs' MBS are fungible, their level of support for the concept of a combined market, how many or how few trades are stipulated as "Fannie Mae only" or "Freddie Mac only", and how many trades are shifted into the specified pool market. In the best case, relatively few trades will be stipulated or specified and the result would be a market that is indeed larger and more liquid than today. In a suboptimal case, a higher number of trades would be stipulated and more trading would move into the specified pool market, decreasing TBA trading volume and diminishing the benefits from combined liquidity. In the worst case, so many trades are stipulated or moved to the specified pool market that there is a significant impairment of TBA market liquidity, harming borrowers, originators, and investors. The goal of this exercise should be for trading to remain in a liquid, unstipulated TBA market where liquidity is not fractured into smaller sub-markets.

This is why we stated in the beginning of this letter that achieving broad industry buy-in for this effort is critical to its success. In particular, to the extent that MBS market participants have concerns that are not addressed, they will speak with how they direct their investments and activities in the future, which may result in a lack of convergence of prices or an overall lowering of prices. The outcome of that will be negative for all market participants; most importantly it will be costly to mortgage borrowers.

2) Clarification of Guarantor for Cross-GSE Resecuritization

FHFA should issue explicit written legal confirmation that investors in a resecuritization will face the credit of the top-level guarantor, whose guarantee will be supported by the underlying guarantee of the other guarantor, and that ultimately (e.g., in a bankruptcy scenario) investors would have recourse to the loans that underlie the securities. In essence, this would be confirmation that the investor benefits from two guarantees and recourse to the collateral. While we have heard questions and received requests related to this from our members, we also understand it to be a particular concern of foreign investors in the GSEs' MBS. We believe a concise and definitive clarification on the nature of the guarantee is necessary to aid in investor analysis of this initiative.⁶

3) Alignment of GSE Security Performance – Policy Implementation

For this initiative to succeed, the GSEs would need to be aligned in all aspects of their operations that materially affect investor perception of the credit profiles of the GSEs as guarantors and prepayment performance of their MBS. A sizable majority of firms on our working group believe that the performance of the GSEs' MBS is aligned enough today to support a combined market going forward (assuming speeds remain aligned – see below). On the other hand, the same majority does not believe that the GSEs are aligned enough operationally and in terms of underwriting and servicing to support a unified market, with a majority of members being unsure or believing they are not. We understand that FHFA does not propose to unify the GSE seller/servicer guides, buyup/buydown grids and other pricing adjustments. We note that these items can have a material impact on which GSE an originator chooses to use to securitize its loans, and the mix of originators in one security versus another can create differences in prepayment speeds since some originators tend to create faster-paying pools than others.

SIFMA members believe FHFA should provide details on exactly which aspects of the operations of the GSEs have been aligned, which are in progress, which will be aligned in the future, and which will not be

⁶ We also discuss further clarifications needed related to the guarantee in section 6 below.

aligned (e.g., exactly which documents and agreements will be aligned). While FHFA has indicated that servicing guide alignment is not within scope, we believe this decision should be reconsidered.

SIFMA would be pleased to convene an industry working group that would meet on a regular basis to work jointly with FHFA to discuss exactly what aspects of documentation and operations should be aligned.

In any case, our members agree that the GSEs must be completely and unequivocally aligned in the following areas that directly affect prepayment characteristics of MBS:

1. Buyout policies;
2. Streamlined refinancing program policies (e.g. HARP and any future programs like it);
3. Implementation of new underwriting and servicing initiatives;
4. Servicing compensation;
5. Loan level price adjustments/adverse market delivery fees.

4) Alignment of GSE Security Performance – Competition for Market Share

Competition for market share between the GSEs could impair the homogeneity of their MBS relative to one another and increase stipulated or specified pool trading due to significant shifts in originator mix or for other reasons. While there are beneficial aspects to the GSEs competing -- related to issues such as customer service, responsiveness to seller/servicer/borrower needs, and similar areas -- competition may also be a source of misalignment between the prepayment characteristics of MBS issued by the GSEs. Competition for market share will be detrimental if it leads to a lowering of standards, especially if it occurs in an uncoordinated fashion. Of course, a mutual and coordinated lowering of standards is not a good outcome either.

5) Alignment of GSE Security Performance – FHFA's Ongoing Role

Our members believe that the success of a single MBS program will be dependent on the continued alignment of the operations of the GSEs, and this continued alignment will require FHFA's active engagement. If this initiative moves forward FHFA will need to serve in a role of an alignment monitor for the GSEs, actively ensuring that any new initiatives or changes to the operations of the GSEs are done in an identical manner. For example, it would be extraordinarily disruptive in a unified market if the GSEs were to implement a key initiative differently, such as when the GSEs implemented large-scale buyouts differently in 2010 and implemented HARP in somewhat different ways. Similarly, if one GSE were to materially expand its credit box, it would likely create misalignment with the performance of the other GSE's MBS. We recognize that in recent years the GSEs have been implementing new policies and procedures in a similar manner, but the importance of this would be greatly heightened in a unified environment. FHFA should provide commitments and assurances to market participants that it will serve in this role of enforcing alignment. Likewise, FHFA needs to ensure that competition between the GSEs for market share does not negatively or differentially impact security performance.

As a part of this initiative FHFA should implement a mechanism to track GSE performance on a variety of measures related to security performance (e.g., prepayment speeds and indicators of market liquidity such as trading volumes, levels of stipulated or specified trading, etc) and develop and implement a system of corrective measures to ensure incentives exist that drive the GSEs towards homogeneity as

opposed to differentiation. The goal of security performance alignment should be included on the GSEs annual scorecards, and could include financial penalties for failure to meet goals.

6) Legal Certainty

The move to a single form of MBS needs to be strenuously examined under a variety of different scenarios -- including low probability/high impact scenarios. FHFA should take all necessary steps to ensure the durability and legal certainty of any changes made to the current system since the risks of failure are profound. The current litigation related to the PSPAs places these issues at front-of-mind for many market participants, and it is clear that negative outcomes could upend carefully laid plans related to this initiative.

There are two scenarios related to legal issues that we believe warrant discussion. First, the RFI is silent on what kind of consideration would be paid to the GSE that provides the guarantee on a resecuritization of the other GSE's guaranteed MBS. Our members believe it is worth FHFA considering whether and to what extent consideration should be paid between the GSEs for the guarantee provided by the resecuritization. It seems plausible that a shareholder or group of shareholders (or post-conservatorship, a GSE) could challenge the risk that is being taken on by the resecuritization issuer/guarantor without adequate compensation, potentially upending the framework that this RFI envisions and destabilizing the MBS market if their challenge were successful.

The second scenario is a loss or settlement by the government in litigation related to the Preferred Stock Purchase Agreements ("PSPA") that unwinds or materially changes the final amendment to the PSPAs. This could restore the need for the GSEs to pay dividends to the Treasury, and would place in more stark relief the credit differences between the two GSEs. This could create an undesirable interruption to the development of this program and FHFA should consider developing a contingency plan.

Finally, to the extent the GSEs exit conservatorship without a government guarantee, the ability of market participants to treat the entities' MBS as fungible will be called into significant question. We recognize this is outside of FHFA's control, but we believe all policymakers should keep this in mind as we move into the future.

Related to this, some of our members are concerned that GSE reform will result in another momentous change in market structure or dynamics that will entail another adaptation period relatively shortly after a move to a single form of MBS. Again, while this is outside of FHFA's control, we believe that FHFA and other policymakers should be conscious of this concern.

7) Investment Guidelines

The GSEs remain separate legal entities, and neither they nor their MBS have a full-faith and credit guarantee of the U.S. government.⁷ Accordingly, investors still view each GSEs as requiring a distinct credit analysis, and in some cases subject them individually to specific credit or concentration limits.

⁷ See, e.g., Fannie Mae's October 1, 2014 *Single Family MBS Prospectus* at 1 "We alone are responsible for making payments under our guaranty. The certificates and payments of principal and interest on the certificates are not guaranteed by the United States and do not constitute a debt or obligation of the United States or any of its agencies or instrumentalities other than Fannie Mae." Available here: http://www.fanniemae.com/syndicated/documents/mbs/mbspros/SF_October_1_2014.pdf

Our investor members believe that in the short term a high percentage (>25%) of their accounts will stipulate trades for one GSE or the other, or trade in the specified pool market. This will be a negative factor for TBA market liquidity. The key question is how enduring the stipulations and specified pool trading will be – will they be limited, due to technical issues such as the time needed to amend investment guidelines; or will they endure because they are the result of a fundamental view that Fannie Mae and Freddie Mac securities are not equally valuable, where investment guidelines will not be amended? This will also be dependent on the lead time market participants have to implement changes prior to the new form of MBS being issued by the GSEs. For accounts with guidelines that will be amended, some proportion of these guideline changes may be executed before the new market “goes live”, but exactly how many will depend on lead time and other factors. We reiterate the point made earlier that having broad-based support for the changes proposed in the RFI is critical to its long-term success.

Some underlying guidelines may not be within the control of an investment manager to change, and in some cases the underlying clients may not want them to change. For example, guidelines of mutual fund accounts would likely be easier to amend (and more likely to be amended sooner) than those of insurance, separate accounts, and foreign investors. In any case, our investor members believe that it will generally take 1-2 years for a meaningful share of underlying guidelines to be amended to remove restrictions that impact this effort. Over the long run, members expect the proportion of funds stipulating their trades or trading specified pools due to guideline limitations to decline, but there is significant uncertainty as to the scale of the reduction.

Related to this, investments of variable annuity, endowment, and life insurance contracts are subject to specific diversification requirements promulgated by the IRS.⁸ Our members are still looking into the application of these regulations to their accounts. To the extent guidance or relief is necessary, FHFA should work with Treasury and the IRS to ensure that appropriate relief is granted that would allow for free investment by these accounts in MBS.

Investment managers may have self-imposed diversification tests or concentration limits with respect to Fannie Mae or Freddie Mac. While it is possible that a TBA position in the new unified security may be able to be considered either a Fannie Mae or a Freddie Mac position (due to easy convertibility between the two securities) and applied against either limit (instead of both), it is not clear at this time whether most investment managers will be able to take this position. This will be a firm-by-firm discussion. Frictions, including the costs of conversion from one guarantor to the other, will impact this analysis. If TBA positions are not able to be applied against either limit, the positions may need to be applied against both GSE concentration limits. This would reduce TBA liquidity by requiring stipulated or specified trades.

8) Exchange Pricing and Frictions

As noted above, frictions in the conversion process may impact an investment manager’s analysis of the application of concentration limits to TBA positions. More broadly, frictions in the conversion process will result in disincentives to convert and increase the risk of adverse selection of poorly performing

⁸ IR Code §817(h); Treasury regulations § 1.817-5(b)), including e.g.:

“(A) No more than 55% of the value of the total assets of the account is represented by any one investment;
(B) No more than 70% of the value of the total assets of the account is represented by any two investments;
(C) No more than 80% of the value of the total assets of the account is represented by any three investments; and
(D) No more than 90% of the value of the total assets of the account is represented by any four investments.”

Freddie Mac securities into the new form of MBS. The cost hurdle will result in investors holding on to the best legacy Freddie Mac bonds. Accordingly, our members believe that the conversion from one issuer to another should be as low-cost as reasonably possible. This should not be a profit center for the GSEs.

Holders of legacy Freddie Mac Gold PCs who exchange securities for the new form of MBS should be compensated for the change in payment delay. This will require further discussion.

In no circumstance should one GSE be allowed to refuse to resecuritize the other GSEs securities (assuming they meet TBA eligibility standards). This would defeat the purpose of this initiative and cause significant disruption.

9) Accounting Implications to be Explored Further by Market Participants

Market participants are still exploring the accounting implications of the conversion of legacy securities into the new form. All of our investor working group members expect some accounting or regulatory issues to arise related to the exchange of legacy for new securities, but the scale and scope is not clear yet. As a general matter, if the conversion causes a P&L event for the holder it may make that holder less inclined to convert their holdings. This may be an area where specific accounting or regulatory guidance will be needed, but it is too soon to tell at this point.

Another question that may be important for certain holders of MBS is whether or not a holder will be able to obtain financing accounting treatment for securities it rolls if it does not receive securities from the same issuer upon completion of the trade. E.g., a holder rolls a Fannie-Mae issued MBS and receives back a Freddie-Mac issued MBS. The key question is whether or not the returned security would be substantially the same as the rolled Fannie Mae bond.⁹ This is a question that members who currently rely on financing treatment will need to explore. If the view is that financing treatment is necessary for holders, they will likely need to stipulate trades to ensure securities returned are substantially the same. Rolling an unstipulated TBA may create unwanted P&L events for these participants.

10) Timing of Resecuritization Issuance and the Need for Stipulated/Specified Pool Trading

As discussed above, in the short term our members expect an increase in the number of stipulated and specified pool trades from investors and a corresponding increase in the need for stipulated and specified pool trades by market makers. Stipulated and specified pool trading by their nature will reduce the liquidity of the TBA market. One mechanism to address this issue would be for the GSEs to enhance the speed with which they create resecuritizations. Currently, GSE resecuritizations are created with a two-day turnaround standard. If the GSEs were able to reduce this standard to a single day (or shorter – same day) it could be possible for a market maker to create a resecuritization on the settlement date to change the name of the guarantor if that would satisfy the needs of its counterparty. This could reduce the need for stipulated or specified pool trades and reduce fail risk.

Related to the above, it is currently cumbersome and costly to break up a GSE resecuritization into its constituent parts. The GSEs should lower the costs of such transactions and implement a fixed-fee structure (as opposed to one that varies by size), and if possible should relax the requirement that a

⁹ See, e.g. UPDATE NO. 2014-11—TRANSFERS AND SERVICING (TOPIC 860): REPURCHASE-TO-MATURITY TRANSACTIONS, REPURCHASE FINANCINGS, AND DISCLOSURES available here: http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176164126488&acceptedDisclaimer=true at 45.

whole pool be presented for deconstruction. We believe each of these initiatives would improve TBA market liquidity and should be included in the scope of this effort.