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December 19, 2017

Robert Ryan
Acting Deputy Director
Division of Conservatorship
Federal Housing Finance Agency
Office of Strategic Initiatives
400 7th Street, S.W.,
Washington, DC 20024

Re: SIFMA Comments on December 4, 2017 Update on the Single Security

Dear Mr. Ryan,

SIFMA[1] is pleased to see FHFA publish additional discussion of the progress towards the development of the Common Securitization Platform and work to create a single form of MBS to be issued by the two GSEs. As you know this issue is a central focus for SIFMA's members active in the Agency MBS market, and they have devoted significant time and energy over the last 5 or so years discussing and providing feedback to FHFA, the GSEs, and Treasury on various aspects of it.

The message we would like to convey in this letter is as follows: while we observe and appreciate the efforts that have been made to provide comfort to market participants that the introduction of a common TBA contract would be a net positive to the market, we do not believe that enough has been done, and also believe that time is running short to provide this comfort to the market if FHFA intends this effort to launch in mid-2019. This is particularly an issue around alignment of GSE activities and monitoring of performance, given how important it is to ensure that misalignment of performance does not occur in the first place, as opposed to trying to remedy it after it happens.

It is also imperative that the market, including investors, is ready to trade the product at launch. This implicates issues (discussed further below) related to changes to investment management

[1] SIFMA is the voice of the U.S. securities industry. We represent the broker-dealers, banks and asset managers whose nearly 1 million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the U.S., serving clients with over $18.5 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. 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 http://www.sifma.org.

agreements (IMAs) and vendor/system/IT work. Today there are uncertainties around tax and other regulatory treatment which need to be addressed for some of this work to move forward. In some cases these changes take significant time, and may be on a schedule outside of a fund manager's control (e.g., a mutual fund board that meets once per year). We believe this merits action to move regulatory issues forward as expeditiously as possible, and a continuation of the focus on market readiness.

This effort represents a fundamental change to a $5 trillion market, where the consequences of a non-optimal implementation will have broad impact. In our view, there are no more important factors in the success or failure of single security than creating a durable and effective alignment of the GSEs' activities, policies, and programs, and therefore the performance of their MBS, and ensuring that the market is prepared to trade that product. We do not believe market participants have a sufficient level of comfort with or belief in the durability of the current relatively equal prepayment performance of the GSEs' MBS, and believe more work needs to be done to ensure readiness.

Below we address a few sections of the document published by FHFA on December 4th.[2]

1. Engagement of Consultants

> *"The Enterprises have also engaged Ernst & Young (E&Y) to assist in those activities and to help align readiness activities between Fannie Mae, Freddie Mac, FHFA, and market participants. In the coming months, E&Y will be designing a survey of groups of market participants and "impact assessment templates" based on the Playbook. The "impact assessment templates" are intended to help market participants estimate the level of effort that may be required to effect systems and process changes in preparation for implementing the SSI"* (p6)

We believe this is a positive step and support this conceptually. Given that this is a project driven and controlled by the GSEs, it is important that they make every effort, and spare no expense, in ensuring market readiness.

It is important that timelines for implementation be continually reassessed in light of market participants' ability to adapt to the changes required, in particular the ability of investors to transition their activities from the Fannie/Freddie TBA markets into a UMBS TBA market. For this effort to succeed, investors must be ready. As discussed further below, there are impediments to this at the time, including regulatory ones which impede the renegotiation of IMAs, which need to be resolved. Additionally, work to adapt systems and processes for UMBS TBA trading will need to be prioritized and slotted among the many other competing priorities that investors and other market participants face from various other regulatory initiatives. As you probably are aware, firms have long lists of competing priorities.

[2] Available here: https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Updates-Progress-on-the-Single-Security-Initiative-and-Common-Securitization-Platform.aspx

The shared goal is that of a smooth transition into the new world. That will require all parties to be ready to transact in similar volume and in similar ways that they do today. The proposed work with E&Y can help here, but we believe that is only part of the picture.

2. Vendor Readiness

> *"We are therefore requesting market participants to ensure that the vendors they work with are identified, informed, and prepared for SSI implementation. Upon request, the Enterprises and FHFA can provide support for these efforts."* (p8)

We agree that this is important, and SIFMA has worked with members to identify key vendors and service providers and will continue to do so.

3. Regulatory Certainty

> *"Freddie Mac and Fannie Mae have requested the Internal Revenue Service (IRS) to issue public guidance concerning the application of tax rules to the exchange itself and to the accompanying payment from Freddie Mac to investors. Both Enterprises have also requested Securities and Exchange Commission (SEC) guidance concerning the application of accounting rules to these transactions."* (p9).

> *"Market participants have identified a number of regulatory issues related to the introduction of UMBS and the new TBA contracts, including possible changes to the exemption of TBA trades from security-based swap (SBS) rules imposed by the Dodd-Frank Act or institution-specific capital, liquidity, and diversification requirements. FHFA has facilitated a request for SEC guidance on the application of SBS rules."* (p8)

> *"The Enterprises, in close collaboration with industry representatives, are also requesting the IRS to resolve uncertainty about how the new TBA contracts will interact with the diversification requirement imposed on certain variable contracts under Section 817(h) of the IRS Code."* (p8)

Obtaining regulatory clarity is critical to implementation of this effort. If an investment manager cannot describe the tax or accounting treatment of a change to a client, that manager will likely not be able to recommend to that client that they invest in UMBS. This stalls renegotiation of IMAs, and market progress toward implementation more generally. This is critical.

Regarding 817-H, we have been working with Freddie Mac and a smaller group of our members, and we hope that resolution of this issue, once final requests are put forward, will occur more expeditiously than the tax and accounting treatment discussed above. While this is a narrower issue than the one above, we still view it as very significant.

We recognize that the timing of the issuance of guidance by the SEC or IRS/Treasury is not under GSE or FHFA control, but we hope that all policymakers recognize the importance of it. IMAs can take a very long time to be amended – it may be the case that a mutual fund board only meets once per year, or a foreign central bank has a very long change management process. If IMAs are not amended, managers may be forced to stipulate their TBA trades or trade specified pools. If this happens in material volume, it will be a tremendous negative for TBA market liquidity.

4. Alignment

While positive progress has been made, the market is being asked to place too much trust in private-sector, competitive entities and the efforts of a regulator for which there is no guarantee that there will be a continuity of prioritization, perspectives, or action in the future. **Accordingly, the market needs more concrete, written, and durable regulation of the activities and interaction of the GSEs.** Otherwise, market participants will not have confidence that the current alignment will be durable, and a highly liquid single-TBA-contract market may not be broadly supported.

Policy and Practice Alignment

> *"Both Enterprises have well-established, internal processes that require all internal stakeholders to notify their Securitization teams to evaluate any proposed new or modified programs, policies, or practices."* (p12)
>
> *"Each Enterprise has augmented its process to include a Single Security Initiative Impact Assessment. Through those processes, the Enterprises notify FHFA of any measurable effects on prepayment speeds and the performance of TBA-eligible securities that may result from a new or modified program, policy, or practice."* (p12)
>
> *"For any changes to a program, policy, or practice that an Enterprise's analysis indicates may have a significant impact on prepayment speeds, FHFA works with the Enterprises to determine the dimensions on which the Enterprises should align… When circumstances arise that cause divergences in prepayment speeds for some cohorts notwithstanding the above efforts, each Enterprise has used other strategies, with FHFA oversight, to address misalignment of prepayment speeds"* (p12)

In 2015 SIFMA requested that FHFA establish firm guidelines around alignment of activities and monitoring of performance.[3] Our recommendation was as follows:

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 – <u>the policy or program must be implemented identically</u>. A similar standard should exist for material changes to credit risk profile.*[4]
4. *Market participants should have insight into this process, and FHFA should seek comment from them.*

What has been set out in this update, and previous updates, falls short of these minimum standards. While we are not wedded to the specific numbers set forth above, we do believe

[3] Available here: https://www.sifma.org/resources/submissions/sifma-submits-comment-to-the-fhfa-on-the-structure-of-the-single-security-update/

[4] 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.

strongly that there need to be formal triggers established, with transparency to the market, that will result in a mandate for alignment of GSE programs, policies, and activities. Market participants are not comfortable trusting an internal black-box practice such as that described in the FHFA update. While we understand that the GSEs may resist having their flexibility to act as they desire being curtailed, we believe that this is a necessary and justified cost of asking investors and other market participants to reduce their freedom to act (for example, by removing their ability to easily avoid an issuer that is less preferred, or performing poorly).

It is not enough to say that there will be consultation among FHFA and the GSEs about which aspects of a new program or policy change that has “significant” impacts on prepayments will be aligned**. Indeed, if a program, action, or policy change has a potentially “significant” impact on prepayments, then it follows that every material aspect of that program needs to be aligned between the GSEs. Otherwise, “significant” differences in prepayments may occur.** This would harm liquidity in a single TBA contract by causing participants to stipulate trades, arbitrage the performance differential, etc.

We also note that more recently market participants have considered and questioned how the GSEs will compete in the future in a single security world. Previous discussions with FHFA and the GSEs indicated that the competition between the GSEs would shift to that of competition in service – who provides the more efficient experience for lenders, who has the best APIs and interfaces, who is most responsive, etc. Given that MBS pricing is expected to converge, logic follows that the GSEs should not be competing on the price of a loan. In other words, the same loan should receive the same bid. The alternative, GSEs competing with adjustments to pricing grids or other actions that are not transparent to the market, has the potential to introduce variability into the performance of the MBS in an unpredictable manner. E.g., if one GSE ends up creating MBS with a significantly different weighted average coupon than the other, it is likely to perform differently in the future, which will harm the homogeneity that is so important to TBA trading.

We believe FHFA, in a future release, should address in more detail how it sees competition in the future and how it plans to ensure it is competition that promotes both benefit to customers as well as liquidity of the capital markets that provide the funds for lending.

Finally, we stress again that it is critical that this process of alignment is not a black box that requires market participants to simply trust the GSEs and the FHFA. **Alignment needs to be dealt with in a formal, durable, and structured manner**. The reasons for this include:

- **Competitive forces drive differentiation.** While the GSEs are in conservatorship, they are private companies and they still compete fiercely. Those facts do not drive alignment – they drive differentiation which is only partially controlled in conservatorship. Differentiation needs to be managed in a single-TBA contract environment to maintain liquidity.
- **Planning for future regime change.** While FHFA will exist for the foreseeable future, its leadership and staff will change over time. This means that the trust market participants

place in today's regime will not necessarily be carried into a future regime, as a new regime may have different priorities, or less focus on this issue. The TBA market, however, will still be just as important as it is today.

- **Articulate in a more permanent manner how alignment will be maintained.** As FHFA has previously stated, this effort is being done with the prospect of GSE reform in mind – that it is setting the table for the future state. Accordingly, today's FHFA needs to write down, in regulation or otherwise, the specifics of how alignment will be enforced tomorrow, including thresholds for action and for alignment. This will create a durable blueprint for a new world which could involve even more guarantors, which will drive the need for even more careful focus on alignment.
- **Prevent bad bonds from being created.** Finally, it is very important to always keep in mind that TBA is a cheapest-to-deliver market. The worst securities drive pricing. Once bad bonds are in the marketplace it is too late -- it is very difficult to get them out of it. Accordingly, the primary focus must be on not allowing problems to occur in the first place.

Monitoring of Performance

> *FHFA has set a minimum standard to trigger a review of the differences in prepayment speeds of any given cohort. In general, FHFA investigates differences between actual Fannie Mae and Freddie Mac prepayment speeds when the divergence for a cohort exceeds a conditional prepayment rate (CPR) of 2 percentage points. For a divergence in CPR in excess of 3 percentage points, FHFA will require that the cause of the divergence be reported to FHFA's internal Single Security Governance Committee. The percentage triggers are based on the current interest rate environment and mortgage rates and are subject to change over time."* (p11)

Regarding monitoring of speeds, SIFMA's 2015 recommendations were as follows:

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.*

From the latest update, we are pleased to see that FHFA has established a 2 CPR threshold where review would be required of elevated prepayment speeds. This is positive.
The report does not, however, include any provisions for disclosure of the details or results of this process to the market. This is important information to help the market understand why speeds have changed, and should be disclosed. We believe FHFA should establish a process

more in line with our 2015 recommendation. It would also be beneficial for FHFA to communicate timeframes in which they would expect issues to be remedied.

Similar to our points above, asking market participants to simply trust that everything is under control is not supportive of a successful implementation of single security.

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We hope these comments are helpful and would be pleased to discuss them in further detail. Please do not hesitate to contact me at 212-313-1126 or ckillian@sifma.org.

Sincerely,

Christopher B. Killian
Managing Director
Business Policy and Practices