



July 10, 2018

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Re: Single Security – Priority Issues to be resolved before launch

SIFMA's Goals

The preservation and enhancement of the strong liquidity of the TBA market that has developed over the past 40 years is a shared and paramount goal that is embraced by all stakeholders including lenders, investors, and regulators. Given the importance of the TBA market, the successful launch of the Uniform Mortgage-Backed Security ("UMBS") requires a communal effort that must be owned by all mortgage market participants. SIFMA¹ wants to ensure that there is a successful outcome for the TBA market when the UMBS is introduced. Various official sector policymakers and stakeholders have suggested that it would be useful understand the most important "open issues" related to the implementation of the single security. Accordingly, we have set forth in this letter the most significant open issues and recommendations to address them.²

Many market participants have expressed concerns regarding the level of uncertainty surrounding many key issues that need to be addressed prior to the successful launch of the UMBS. In order to ensure the successful launch, there are a number of open issues that need to be resolved regarding alignment, tax/regulatory treatment and the orderly exchange process. Satisfactorily addressing these issues in a timely manner will help to ensure a successful "on time" launch.

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).

² Please note that while this letter addresses some of the most significant issues, it does not address all of the issues related to the launch of the UMBS.



Two of the primary metrics of success for the new UMBS will be relatively consistent prepayment performance across Fannie Mae and Freddie Mac issued UMBS and improved overall liquidity in the new TBA contract. Achieving these metrics is critical in garnering and maintaining confidence in the UMBS dealer and investor community that liquidity will be sufficient to facilitate large scale trading activity in a single TBA contract. An implementation of the UMBS which results in excessive stipulation, where one GSE issuer trades with a pay up, is contrary to the stated policy objectives and something that all parties want to avoid.

Moreover, the interests of investors and homeowners are fully aligned. A liquid market with consistent security performance helps provide stability for mortgage lending and access to credit for homeowners. The recent example of GNMA's efforts to mitigate performance issues in some of its securities illustrates how homeowners' and investors' interests can be aligned in a successful outcome. Security performance improved, liquidity improved, and the rates to homeowners declined.

In order to insure the successful implementation and operation of the UMBS, the following open issues need to be addressed and resolved:

- 1. Alignment Process and Transparency:** The concerns raised about the framework for monitoring activity that can affect prepayments, and transparency into the process for fostering alignment and promptly remediating divergent behavior, undermine market confidence.
- 2. Roadblocks for Investor Readiness:** A number of critical tax and regulatory issues remain in flux, which impedes discussions with end investors and custodian readiness for the UMBS.
- 3. Finalization of the Exchange Process:** The exchange process also remains in flux. Exploration of alternatives to the proposed approach must be considered.
- 4. Gold PC Exchange liquidity and conversion issues:** Holders of Golds should be provided a perpetual free and frictionless process to convert to UMBS. Additional measures should be considered to maximize liquidity post-launch.
- 5. Investor Awareness:** More needs to be done to ensure there is a clear articulation of the new policies and practices to insure a broad global understanding of the proposed changes to the market.

These issues should be addressed in a timely manner to ensure that the timeline specified by FHFA is readily achievable.

1) Alignment Process and Transparency

Issue: Absent the uniform standardization and alignment of the seller-servicer guides, concerns raised about the framework for and transparency into the alignment process and monitoring of activity have not been adequately addressed. Referral to internal committees without clear guard rails, insight into the membership, and clarity into the decision-making process are headwinds to building the desired level of market confidence in the new UMBS TBA contract.

SIFMA Proposal: SIFMA has requested a transparent process that will be durable. SIFMA views a rules-based process with specified triggers as optimal. It would provide greater transparency for market participants into how decisions are made, would be easy to understand, and would allow for proper setting of expectations. As for durability, much good work has been done, and steps should be taken to make it as lasting as possible. Accordingly, FHFA should seek public comment and enshrine as many of the parameters of the management of these issues in some sort of publicly-available format, e.g. guidance memos, white papers, regulations, or otherwise.

Discussion: SIFMA has repeatedly expressed the view that the process of referral of alignment concerns related to new products or changes to existing products to FHFA internal committees is not transparent and does not promote market confidence that issues will be prevented or quickly remediated in order to avoid a deterioration of UMBS performance. This view is largely informed by a number of issues in recent years, e.g. (1) The rollout of different 97 LTV programs; (2) Pricing changes in the fall of 2017 that significantly impacted market share without explanation to the market of what happened and why; and (3) Funding of MSRs by one GSE but not the other, which could impact originator mix and stickiness of that mix.

While it is understood and expected that performance will not be identical between the GSEs – indeed there are significant differences in speeds today within a single GSE’s production, these examples give rise to concerns. Each of these is an example of actions that, while not necessarily of consequential scale in and of themselves, created a sense of confusion and concern in the MBS markets that the GSEs were taking actions in an uncoordinated manner.

The key here is to remove uncertainty regarding a variable – that of differing programs or of the differential implementation of similar programs or competition for market share that impairs the value of the UMBS – understanding that differences will remain due to originator mix and other factors that are present today. Importantly, it is essential that the market, in general and investors, in particular have a clear understanding of the process by which this is managed.

SIFMA has previously suggested a transparent trigger-based process through which FHFA could help ensure GSE actions serve to maintain overall liquidity and the impacts of efforts to gain market share at the expense of the other GSE are fully evaluated through that lens. We have suggested, as an example, a framework which is laid out below.

We do not believe this is the only framework that would work, or that these numbers are the only thresholds that could work. The larger point is that a framework along these lines, implemented by FHFA, would be transparent, promote understanding, and provide confidence to market participants that a process for both preventing and remediating potential issues exists. The process should entail two prongs with the first addressing new programs or products, and the second defining an ongoing monitoring framework for the actual prepayments on the two underlying GSE securities.

Part I: New Product Implementation

- a) Formal review should be required for any change that is projected to impact cohort level prepayments (year of origination and coupon) by creating a difference of more than 3% CPR between the two GSEs. It is important that this analysis include projected speed differences across a range of interest rate scenarios such as plus/minus 100bp shocks, unchanged interest rates, and rates tracking the forward curve. Additionally, if the program is anticipated to either increase/decrease the population of borrowers by more than 2% it should be deemed significant. Special consideration should also be required for any program that could materially impact CTD down to the decile level. Lastly, any program that materially changes the credit risk, in the short or long term, taken on by the GSEs should also be reviewed and potential issues assessed.
- b) To the extent a program or policy change is expected to have a material impact on prepayments, a plan must be developed for consistent implementation by both GSEs of the policy or program. A similar standard should exist for material changes to credit risk profile, the population of borrowers, or if cheapest-to-deliver (“CTD”) is expected to be disproportionately impacted.
- c) Prescriptive implementation guidelines should be created for such programs or policies with the goal of aligning prepayment speeds between the GSEs, but absolute prepayment performance must also be considered. Balancing the convexity costs, and well as the benefits of new activities that will materially impact prepayments, is important as an accelerated “race to the bottom” in terms of prepayment performance will damage liquidity and increase the cost of homeownership for borrowers.
- d) Market participants should have insight into this process, and FHFA should seek feedback from them as appropriate. This could be facilitated by public disclosure with notice and comment of “new programs” and their implementation. For cases where the impact is expected to be significant, this would preferably be done before implementation. In any case it should be done within a few months of implementation at the latest if specific reasons prevent advanced disclosure. For programs that were evaluated to have minimal, below threshold impacts and were implemented, disclosure can be made subsequent to execution and in regularly scheduled releases, such as a quarterly release. Sample disclosures would define the program or product, the implementation timeframe, the anticipated impact on prepayments and credit, and the number of borrowers that could be affected.

Part II: Ongoing Monitoring Framework

A formal steering committee should be established to review ongoing prepayment behavior of both GSE securities.

The steering committee could meet either quarterly or semi-annually and should be chaired by FHFA and have an established membership consisting of senior management and research personnel from both GSEs as well as FHFA. The committee should also develop an outreach plan that would engage industry stakeholders and seek their input and comment. We believe the following points would provide for market transparency and confidence in the process:

- a) Standard reports should be defined and publicly disclosed along with the meeting agenda. The standard reports should include typical cohort level prepayments and loan level characteristics. However, because cohort level impact could be minimal due to the large size and diversification of annual coupon issuance, there should be special consideration paid to deviations more narrow breakouts such as cheapest to deliver quartiles, deciles, loan balance breakouts, geographic concentrations, and otherwise.
- b) Any differences outside of predefined thresholds should be documented and an appropriate remediation process should be triggered along with disclosure of an expected for remediation.
- c) The issue should then be evaluated on an ongoing basis at subsequent meetings and in cases where remediation has not been successful, an escalation of the remediation process should occur with new steps being implemented.
- d) In extreme cases where large differences have occurred and should have been anticipated, remedial action including penalties, should be considered for a GSE to serve as a deterrent to future misalignment.
- e) SIFMA looks to the recent efforts of Ginnie Mae to deter poor performance in certain GNMA securities as exemplary of action by a policymaker that produced a positive outcome for investors and homeowners alike. However, with UMBS, SIFMA believes that the establishment of a well-defined, durable, and transparent process will help prevent material issues like that from developing in the first place.
- f) FHFA should also consider developing a menu of potential actions that it might be willing to take to the extent that significant differences occur. This menu of potential actions should consider, without limitation, both speed alignment and the absolute impact on prepayments and could include either:
 - temporarily halting a GSE program,
 - requiring the other GSE to implement it in short order,
 - modifying a program, or
 - discontinuing something altogether.
- g) Minutes from the steering committee should be disclosed publicly.

Note re: Super Securities: A specific alignment issue that should be addressed is the pricing structure for the proposed Super securities where one GSE will wrap the other's MBS. SIFMA's view is that the ability to cross-wrap should be as frictionless and balanced as possible. However, the market does not have clarity on how this will work at this time.

2) Roadblocks for Investor Readiness

Issue: A number of critical tax and regulatory issues are in flux, which stalls investor discussions with clients and custodian readiness for single security. In many cases, investors will have to discuss and negotiate amendments to investment management agreements ("IMA") related to concentration limits, investing in a new product, or otherwise. This is a time-consuming process, and a number of critical pieces of information are still not known.

SIFMA Proposal: FHFA, Treasury, and the IRS should continue to prioritize and resolve the tax treatment of the Gold exchange, the tax treatment of float compensation payments, and 817-H concentration limits. These issues are roadblocks to IMA amendment, custodian readiness for the exchange, and market acceptance of a single TBA contract. With these issues out of the way, the market will be able to accelerate its internal systems development and client outreach. We understand that the Treasury, IRS, FHFA, and the GSEs are working on these issues, and we urge the most expeditious resolution possible.

Discussion: In many cases, investors cannot simply begin trading UMBS without permission or approval from the clients whose money they manage. UMBS is a new product and may be impacted by concentration limit questions, specific reference to Fannie or Freddie TBA, or otherwise. Permission or approval may be required from mutual fund boards, separate accounts, foreign sovereigns, or otherwise.

Tax Treatment: Currently, the tax treatment of the Gold PC exchange is not known, the tax treatment of float compensation payments is not known, and if/how guidance will be provided to relax Internal Revenue Code section 817(h) restrictions is not known. The first two items are core issues that need an appropriate resolution for work to precede. For example, custodians cannot build their workflows until they know how exchanges will be taxed.

817-H Impact: As for IRC 817(h), a proposal has been submitted to provide relief from diversification requirements which are incompatible with active involvement in the TBA market for funds which are subject to these rules. We estimate the size of affected funds to be in the range of \$150-200BN, but we do not have a reliable data source to precisely size the market. UMBS should not be launched without appropriate guidance here. If the UMBS initiative goes live without 817(h) guidance, then variable insurance funds investing in UMBS will likely need to specify issuers, at additional expense, and contrary to the intent of the UMBS initiative. We further note that many funds have client-driven diversification

limits that can impair liquid trading of UMBS. How the government addresses 817-H is likely to serve as a guide, in some cases, for how client-driven limits can be addressed. In other words, guidance on 817-H will have impacts beyond its strict jurisdiction.

We are pleased to understand that the Treasury, IRS, FHFA, and the GSEs are working on these issues. We urge the most expeditious resolution possible.

Note on IMA Change Process: As a general matter, managers prefer to avoid engaging in client documentation discussions without fairly complete information, and further feel like they cannot provide a reasonable recommendation to clients that they should invest in the product when, for example, the tax treatment is unknown, or it is not clear how existing MBS could be exchanged. There is also a concern that going to clients with key facts unknown could be counterproductive. SIFMA has developed a draft cover letter for managers to use with clients, but key sections remain listed as “TBD”. Accordingly, a large share of investor members has done only limited client outreach pending receipt of further information.

Note on Investor Fiduciary Duty: In terms of investor acceptance of single security, it is important to note that an investment manager’s fiduciary duty is an individual relationship with each client – it is not to their clients as a whole. In other words, an investment manager cannot view harm to one client or set of clients as being mitigated by benefit to other clients.

Note on Investor Infrastructure: In addition to the client outreach items we describe, there is also the IT work required. Example: Bloomberg is creating new fields to store allocation between FNMA & FHLMC in Supers post UMBS. Those specs aren’t developed yet, but all parties that need to consume that data require it so that loaders can be built and database structures developed. Once the data is in-house, firms then need to expose that data to other systems (e.g. – a guideline monitoring application) and build rules to test the data and reflect it appropriately in front-end tools.

3) The Exchange Process Has Not Been Finalized

Issue: It has become clear from recent discussions that the previously planned approach to the Gold PC exchange is sub optimal for any of the affected parties – investors, custodians, or dealers.

SIFMA Proposal: Industry/Freddie Mac discussions should continue and a solution responsive to the concerns of all participants should be implemented as soon as practical. While these discussions have been positive and appear headed in the right direction, it is important to note that changes to this process may be consequential to participants in terms of development or other resource demands, and there is scant time before the proposed implementation date.

Discussion: A smooth exchange process will be critical to investor confidence in UMBS and to the smooth transfer of liquidity to the UMBS market. This needs to be resolved as soon as possible (we note that tax guidance is key to resolving these discussions).

4) Gold PC Exchange Conversion and Liquidity Issues

Issue: It is likely that many investors who currently hold Golds will not convert for a variety of reasons. They may want to wait to see how the market evolves, prefer to wait until they want to sell or roll a position, or they may not want to deal with the operational costs or risks of conversion. During periods such as the current environment and potentially going forward where prepayments are low and new MBS will not be originated at a strong pace, incenting early conversion at a sufficient rate could supplement liquidity and help develop a successful UMBS market. We recognize through Freddie’s activity and extensive industry dialog over recent months that it places a priority on creating an easy and active exchange process.

SIFMA Proposal: Holders of Golds should be provided a perpetual **free and frictionless** process to convert to UMBS. This will enable efficient conversions and will minimize opportunities to arbitrage any exchange-induced market asymmetries. We note that there are a variety of costs associated with the Gold PC exchange – first and most obvious is the extension from a 45 to a 55-day delay, which Freddie already plans to cover with its float compensation arrangement. However there are additional operational and other costs associated with a conversion – from payments to custodians for additional securities movements, the actual costs of an exchange (e.g., if a process such as a corporate action is taken, which we understand will explicitly not be costless), costs that some holders may encounter to engage accounting or tax consultants, manual overrides or system changes to accommodate conversions, etc. Freddie Mac should discuss with holders of Gold PCs what their expected costs to convert will be, and what would be needed to incent conversion.

Discussion: We believe it is in the market’s best interest to ensure that the vast majority of investors are comfortable that the Gold conversion process is costless in aggregate terms. Additionally, a liquid dollar roll market, a more active TBA market, and demand for unstipped UMBS TBAs is critical to the success of the program especially in the months after launch. In light of this, dollar roll inducements, creation of better-than-TBA, large UMBS supers, and other initiatives are all things that could be considered to incent early, active, and unstipped investor participation in UMBS.

5) Investor Awareness

Issue: Many members have expressed a view that market awareness, in general, and end investor awareness, in particular, needs to improve. Members have noted that overseas investors need further education. We believe that most major US-based investors have at least a broad understanding of the issues, but the status of smaller and non-US investors is less clear. In previous experiences, non-US investors have simply shifted away from conventional MBS when uncertainty arose (e.g., imposition of the conservatorships). We note, importantly, that awareness necessarily comes before preparation.

SIFMA Proposal: FHFA and the GSEs should focus efforts and campaigns on ensuring that important global investors have an understanding of the changes that would occur with single security to ensure continued sponsorship and appetite for a single TBA contract. This could include visits with key investors, additional conferences or events for them, and advertising/marketing plans involving Bloomberg, TradeWeb, and/or other gathering places for market participants. Similarly, GSEs should work to ensure smaller investors in their securities are aware of these changes.

Discussion: As mentioned above many SIFMA members have indicated to SIFMA their view that investor awareness of single security and what it means could be improved. In particular, members have noted that overseas investors have been quieter than they would have expected, as changes typically draw out many questions. The GSEs should focus efforts on ensuring that their global investors are informed, so as to ensure their continued sponsorship of the conventional markets, to ensure that the idea of a single TBA contract is accepted, in order to preserve their contribution to the liquidity of the market. The GSEs could also consider developing a guide for dealers and investors working with Bloomberg, TradeWeb and other popular platforms and consider advertising forthcoming changes there.

Conclusion

SIFMA supports the goals of the establishment of the UMBS which preserves and enhances the strong liquidity of the TBA market. There remain a host of open items which need to be addressed in a manner that supports the goals of the UMBS. SIFMA looks forward to continuing to work with FHFA to ensure that the issues are addressed in a timely manner that facilitates a successful implementation and operation of the UMBS. We look forward to discussing these and other issues at your convenience.

Sincerely,



Christopher B. Killian
Managing Director