January 21, 2020

Federal Housing Finance Agency
Division of Conservatorship
400 7th Street SW, 8th floor, Washington, D.C., 20219

Re: Request for Input on Enterprise Pooling Practices

Dear Madam or Sir,

SIFMA[1] is pleased to respond to FHFA's Request for Information (RFI) on UMBS pooling. SIFMA also appreciates the extension of the comment period through January 2020 to provide more time for a thoughtful response to the proposals in the RFI. This was important because the RFI contains proposals that could fundamentally change how investors, market makers, and originators are able to access conventional MBS markets. Accordingly, we thank FHFA for seeking input from market participants on these issues. Our response is primarily focused on the views of our members active in the MBS trading markets.

The UMBS structure has been in place for less than one year, and while our members broadly agree that the operational transition was fairly smooth, we have heard a variety of views on the impacts of UMBS. What is clear is that TBA liquidity has not been optimal over the last year or more and could be improved. SIFMA members agree that volumes of issuance and trading in specified pools have increased and many believe that TBA liquidity has decreased. There are varying views, however, on how much of this is related to UMBS itself (through worsening the deliverable among other things), how much is related to high-WAC pools that were produced in 2018/2019, how much is related to a rally in rates or other factors, and how much is related to a combination of these factors. In any case, we appreciate that FHFA has a focus on liquidity in this essential market that drives mortgage finance.

The most important of the RFI's proposals regards enhancement of multi-lending pooling volumes and is described as follows:

- *"All sellers/servicers would be incentivized or required by Enterprise policy to deliver the vast majority of production into generic multi-lender pools formed by either Enterprise; potentially 70 to 80 percent of each month's TBA-eligible MBS issuance would be in these very large, well-diversified multi-lender pools."*
- *"Specified pools and potentially other pools with market pay-ups (such as certain single lender pools that have particularly desirable characteristics) would continue to be allowed under prescribed circumstances, and the loans underlying these pools would not be directed into the*

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. 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.

generic multi-lender pools. The expectation is that a modest share (potentially 20 to 30 percent) of each month's TBA-eligible MBS issuance would be comprised of these pools."

- *"On a case-by-case basis, to address anomalies in prepayment speeds, certain seller/servicers would be directed to deliver all or part of their production into non-TBA eligible, single-lender pools; the criteria for these cases would be aligned across the Enterprises and would consider overall lender performance and the effects of such a pooling requirement on the performance and liquidity of UMBS and other market impacts."*[2]

The RFI indicates that this would be done to "*reap the advantages of forming much larger, multi-lender pools that stem from more consistency in prepayment behavior*".[3] The RFI posits that this would enhance TBA liquidity and its ability to serve lenders, investors, and borrowers.

Summary of SIFMA's position

SIFMA believes that the multi-lender pooling proposal in the RFI, while well-intentioned, would not have its intended effect. We believe that it would be significantly harmful to liquidity in each of the conventional MBS markets - TBA, specified pool, and CMO - and to their investor, originator, and market maker participants, and consequently to mortgage borrowers. SIFMA members believe very strongly that FHFA should abandon the multi-lender pooling proposal to avoid this disruption and harm, and instead pursue more appropriate and effective avenues to enhance liquidity in these important markets.

The concerns we will address below are as follows:

A. GNMA's market structure is not an appropriate model for the conventional MBS markets
B. The RFI does not address the actual problem the markets face.
C. The RFI would have a negative impact for all GSE MBS markets, and by extension consumers.
D. It is unclear how a multi-lender pool share requirement would be operationalized.
E. The idea behind the RFI's proposal to exclude egregious performers from TBA pools has conceptual merits, but lacks details and implementation seems challenging on a programmatic level.
F. An effective solution includes abandoning the proposal to mandate multi-lender pools and fixing the underlying problems that have caused liquidity issues.

In Section F at the end of this letter, we provide a number of suggestions for alternative areas where FHFA should focus its and the GSEs' efforts. Some are related to pooling, some are related to disclosure, and others relate to interaction with the market. We welcome further discussion with FHFA and the GSEs on these suggestions, and believe they represent more fruitful avenues to pursue that could bring greater rewards and present far less risk than the multi-lending pooling proposal in the RFI.

[2] RFI at 12.
[3] RFI at 12.

A. ***GNMA's Market Structure is Not an Appropriate Model for the Conventional MBS Markets*** *(this and the following sections address questions 1, 2, 3, 4, 6)*

The proposal posits that it would be beneficial to make the conventional market look more like the GNMA market, where (in the GNMA II program) one large TBA-eligible pool is issued per month per coupon.[4] Our members do not agree that the structure of the GNMA MBS market should be the model for the conventional MBS markets and believe the conventional MBS markets to be more liquid than the GNMA markets.

For example, dealer research has shown that market depth of the conventional markets far exceeds that of the GNMA markets, and GNMA trading volumes trail their outstanding market share.[5] This is despite the explicit government guarantee and regulatory advantages associated with GNMA securities.[6] Further, our dealer members indicate that they typically carry a greater amount of conventional inventory, which is another indicator of liquidity. Additionally, there is much greater liquidity available in financing and dollar roll markets in the conventional space. A market that is deep enough to produce and separately price all the various payup stories versus the TBA only underscores the liquidity of the latter. To make the conventional markets look more like GNMA would be a step backwards - the conventional model has been proven superior.

Second, it is not the case that making singular large pools that have more predictable performance necessarily fosters more liquidity than more numerous pools that have somewhat less predictable performance. This is a nuanced point that could be discussed further; while the TBA market requires a level of homogeneity to operate efficiently, it does not require absolute homogeneity and indeed that is not desirable. At the risk of oversimplification, this is because a single large pool with predictable bad performance will drive the TBA deliverable – there is no escape from it. On the other hand, in an environment where there are a number of pools that could constitute the deliverable, and there is some limited variation in those pools, an investor will not necessarily expect the worst possible outcome and liquidity should be improved given the broader range of trading strategies available. In other words, homogeneity is needed to a point – but beyond that markets prefer some amount of variability that provides an opportunity to express views. This nuance is supportive of greater liquidity than the alternative of a monolithic deliverable, and we believe experience in the GNMA II market bears this out.

Furthermore, the RFI's proposal would increase the GSEs' control of the mortgage markets – they would get to decide what is an allowable spec pool, how much it will cost to issue one, how pools would be produced for REITs, and which lenders should be allowed in TBA or not. While they have many of these powers today, this proposal would consolidate and make more entrenched this control. Furthermore, if and when the GSEs exit the strict controls they face in conservatorship, it is not clear how these processes will be managed and aligned.

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[4] "FHFA believes this proposal would result in pooling practices similar to those under the Ginnie Mae II program". RFI at 13.

[5] See, e.g., *JPMorgan MBS Market Commentary*, November 15, 2019, which found that GNMA bid/offers in 3% coupon MBS were more than double that of conventional 3s. Further, GNMA market share is approximately 34%, but only represents 24% of trading activity.

[6] Our members have also pointed out that demand in the GNMA markets is at least somewhat driven by non-market factors. For example, GNMA MBS have lower risk weights, better treatment in the LCR, and other prudential advantages. On the supply side, some portion of the subprime market has shifted to GNMA collateral, which has not happened in the conventional space to the same degree.

B. The RFI Does Not Address the Actual Problems the Conventional MBS Markets Face

The RFI's proposal is intended to make pools more homogeneous and predictable in order to enhance liquidity, which has decreased due to certain previous pooling practices, the worsening of the deliverable, and other reasons mentioned above. However, the reality is that many of these problems have been caused by fundamental misalignments of the MBS produced by the GSEs, and have not been addressed in the process outlined by FHFA's UMBS rule or otherwise, and will not be addressed by the multi-lender pooling proposal.

The proposal in the RFI would simply push more loans into bigger securities without doing anything to improve their fundamentals and could be seen as form of the race to the bottom that some feared would come with UMBS. It would hide the problems without fixing them. The lack of alignment is exemplified by the fact that bonds issued by Fannie Mae and Freddie Mac may trade with different payups, and that the Freddie multi and Fannie Major pools do not have the same value. Members have reported to SIFMA that it is common for Freddie Mac bonds to be cheapest to deliver and comprise a large proportion of delivery to fulfill a TBA. These issues would not be present if fundamental performance were aligned as market participants expected it would be in the lead up to UMBS. Further, the RFI does not at all address the potential for market share competition degrading MBS performance.

C. The RFI Would Have a Negative Impact on GSE MBS Markets as a Whole, and By Extension Consumers and All Other Classes of Market Participants

We believe that this proposal represents a significantly negative risk to each of the main components of the MBS markets, and therefore the liquidity of the markets as a whole. We expect MBS issuance impacts would be along these lines if the proposal were implemented:

- Larger multi-issuer pools would be created.
- Fewer specified/single issuer pools would be created.
- Fewer specified pools would be available for CMOs, and those that were would be more expensive, making CMO creation less dynamic and economic.

This kind of market structure would offer less value to MBS investors and we expect it would see declines in sponsorship from various investor types – money managers, REITS, hedge funds, and others. At the same time, the conventional MBS market would be a less economical business line for market makers, and we expect that their capital and staffing allocations to TBA, specified pool, and CMO desks would decline. Originators would see best execution worsen. The liquidity picture for the conventional MBS markets would look more like the GNMA situation – that is, less liquid, with fewer trading opportunities, less trading, and less financing available. Loans that receive a payup today and possibly offer better pricing or availability to borrowers would not be available at the same price. This outcome would be negative for investors, originators, dealers, and mortgage borrowers.

- *Negative Impact on Investors*

If the RFI's proposal were implemented, investors would see their investment choices significantly reduced. Fewer specified pools would be produced, which would likely make those that are issued more expensive than they are today. The RFI is not clear on this, but it appears that the types of specified pools available would also be reduced by the GSEs to a subset of the current pool types available in the market. There is concern that this means that many types of specified pools sought by investors today at various

payup levels (low and high) may not be available at all. In any case, specified pool selection would be reduced and investment opportunities will decline. CMO issuance would also be expected to decline as buyers would be less able to pursue particular prepayment stories and a lack of supply of pools would make transactions less economic to create. Overall, the MBS market will become a less valuable place for investment dollars to be allocated versus corporates or other asset classes, and investors may adjust their allocations away from MBS. Our view is that a broad selection of specified pool types will translate to the widest possible investor base, contribute to a vibrant CMO market, and allow originators to differentiate themselves on product selection and service.

The RFI indicates that "*whole loan pools to address the needs of certain investors (such as REITs) would continue to be issued by the Enterprises*."[7] This does not address the concerns of our REIT or other investor members and leaves a number of important topics unaddressed. For example, the RFI does not indicate what kind of pools would be created. Would REITs have to place an order? What volume of pools will be produced? What collateral will underlie the MBS? How responsive would the GSEs be to sudden changes in demand? Would these pools be similar to TBA multi pools? Would they be story pools with payups? What would the mix of those be? Even if all of these questions were answered, the RFI raises a question of fundamental fairness to other investors – why would REITs receive special treatment whereas money managers and bank portfolios would not? How would equity be ensured?

- ***Negative Impact on Originators***

Originators today strive for best execution, which may involve creating single-issuer pools to receive payups that are available from the market. The level of this activity varies with market conditions. The RFI would greatly impair an originator's ability to do this, would reduce profitability of origination, and could result in increased costs or lower product availability for some consumers. The RFI would also impair originator risk hedging strategies (e.g., it would be more difficult to hedge geographic risk if geography-based specified pools were not available).

Importantly, the RFI's proposal would turn incentives to produce loans investors desire on their head. The proposal would force originators who make more desirable loans to subsidize originators who make less desirable loans and/or churn their customers - reducing originator incentives to produce desirable loans. We believe this would disadvantage bank issuers in particular. The opposite is what should happen – originators should be incentivized to produce loans that are superior to their competitors.

- ***Negative Impact on Market Makers***

While the proposal is focused on TBA markets, we believe it would have far-reaching negative impacts on all conventional MBS markets. It is important to note that MBS business lines are typically viewed as a whole from a corporate level. Our understanding from members is that a TBA trading desk is generally thought of as being engaged in a commoditized business that performs a client service-type of operation rather than being a core revenue driver, but requires significant amounts of capital and balance sheet. On the other hand, particularly recently, specified pool and CMO businesses have generated significant revenue and typically require less capital.

The effect of the proposal would be to shrink specified pool and CMO businesses, simply by virtue that issuance of pools would be significantly reduced and there would be fewer bonds to trade or place in

[7] RFI at 13.

CMOs. In particular for CMOs, investor choice would be reduced as fewer numbers and fewer varieties of story bonds would be produced. This overall revenue reduction would likely result in a shrinkage of the affiliated TBA trading business. If business lines see revenues decrease, less capital and balance sheet will be allocated to them from management. If less capital and balance sheet are allocated to them, trading activity will shrink. If trading activity shrinks, markets will become less liquid. If markets become less liquid, they become less attractive to investors who may look elsewhere, which reinforces the problem. All of this is bad for originators and their mortgage borrower customers, and investors that the market makers serve.

- ***Negative Impact on Mortgage Borrowers***

To the extent that TBA liquidity worsens, TBA pricing will degrade and mortgage borrowers will suffer through higher rates. To the extent borrowers enjoyed lower rates or better availability of credit due to their mortgage fitting a spec pool profile that was no longer available, that would also put upward pressure on rates. Lenders that issue greater shares of single-issuer pools will see their execution worsen and may need to pass on these increased costs to customers.

D. It is Unclear How a Multi-Lender Pool Share Requirement Would Be Operationalized

The RFI lacks several important details regarding the multi-lender pooling proposal's operationalization and raises a number of questions. For example, how would the GSEs manage to a specific multi pool issuance share? Given that sellers come to the GSEs daily as their needs demand, how would the GSEs manage to a specific threshold on a forward basis? Would such a limit drive larger sellers to issue pools early in a month (or otherwise distort normal issuance patterns) if they desired single-issuer pools out of concern that capacity would be used up later in the month? How would sellers be "incentivized"? Would single issuer pools have higher G-fees or other costs? What would be the second order effects of this? What would the consequence be if a GSE breached a limit? Which types of specified pools would be issued? What is the process for requesting additions to the list of allowable specified pools? Which servicers would be allowed to issue single-issuer pools and what is the process to become approved or rejected from doing so? How would this be managed and enforced post-conservatorship?

In any case, beyond the complications and uncertainties shown by the questions above, we note that this type of control goes against free market principles that have served the TBA market so well over the last 40 years. The TBA market did not come to be because of fiat or a regulatory instruction – it developed over time as market practices became accepted and standardized, were compiled and documented, and it has changed over time in line with the demands of the market. Driven by the needs of the participants in the market, it will continue to change and adapt into the future in the interest of preserving and enhancing its liquidity. The market should continue to be flexible and adapt to the needs of its users.

E. The idea behind the RFI's proposal to exclude egregious performers from TBA pools has conceptual merits, but lacks details and implementation seems challenging on a programmatic level (question 5)

The RFI includes the proposal that the GSEs would exclude certain originators from TBA-eligible pools based on their prepayment performance. This makes sense because given the cheapest-to-deliver nature of the TBA market, a bad actor can have an outsize effect on an entire TBA coupon, repricing rates on all mortgages sold into that MBS coupon. As a general matter, we agree that bad actors should not have the

privilege of issuing TBA-eligible pools and that the GSEs should carefully police their MBS programs and enforce strict performance standards.

However, the GSEs should be doing the work today to identify and deal with bad actors and we see room for improvement and alignment of how GSEs deal with problematic seller/servicers. Tying this back to the multi-lender pool proposal in the RFI, the key outcome of this exercise should be an aligned approach to how the GSEs deal with unjustifiably fast paying seller/servicers - not simply hiding the fast-paying sellers in larger pools.

It is not always easy for market participants to identify, based on the data available to them today, bad actors vs. more efficient refinancers vs. sellers who see loans refinanced by third parties. We note that as a general matter, higher prepayment speeds in premium MBS coupons will translate into lower prices for those MBS and higher costs for borrowers whose loans would be securitized in them. Therefore, FHFA should be cognizant of the public policy balance between refinancing efficiency, on one hand, and maintaining robust pricing on loans and MBS, on the other. In any case, this issue points to the need for greater disclosure around the identity of loans being refinanced – with better disclosure market participants would be better able to properly price MBS.

SIFMA members recognize that over the long term, enhancements to technology will make more loans refinanceable at a lower rate incentive than today and do not desire to stand in the way of technological advancement that benefits borrowers. That said, SIFMA believes originators should own their economics, be compensated for strong performance, and pay the price for bad performance. Forcing most loans into large pools will not achieve this goal, as the good will subsidize the bad to the detriment of the market and its participants.

In terms of the need for a coordinated and proactive GSE approach to this issue, we note that blocking a seller from TBA pools at only one GSE is not likely to be effective in the UMBS construct. Servicing may be transferred from one servicer to another, and while FHFA has the power to block a servicing transfer (while the GSEs are in conservatorship), we do not recall seeing this power frequently used. Further, mortgage brokers may attempt to direct their loan production to other sellers, so if one party is blocked the loan can be originated through a party who remains eligible. Alternately, a seller blocked by one GSE could simply go to the other. The GSEs need a comprehensive and aligned strategy to prevent evasion of individual GSE efforts to control performance to avoid forcing the Enterprises to play whack-a-mole, which is not an effective long-term strategy. The only effective way deter bad behavior, remediate poor performance, and stop evasion is a unified approach by the GSEs.

F. An Effective Solution Includes Abandoning the Proposal to Mandate Multi-Lender Pools and Fixing the Underlying Problems that have Caused Liquidity Issues

As mentioned above we strongly believe FHFA should abandon the proposal in the RFI.

FHFA should address the underlying problems that we discuss above, and we suggest a number of potential initiatives below. While the UMBS rule was a positive development, we believe that alignment efforts to this point have not been effective and need to be revisited. Indeed, the process though which alignment issues are remediated (as required by the UMBS rule) is unclear. We understand that various reports are produced, and discussions may be held among the FHFA and GSEs, but the market does not know what happens after that. Market participants are concerned that too much responsibility and/or

trust is put on the GSEs to maintain alignment, when reality is that the GSEs are (and always will be) fierce competitors.

Our views are driven at the conceptual level by a strong belief that FHFA should allow the market to drive pooling. We assume one root of this RFI is that the GSEs' large pools price differently even though there should be theoretical (but not actual) alignment under UMBS. We suggest that the fact that the Fannie Major prices better than the Freddie multi-lender pool is evidence of at least two things: (1) a more monolithic, kitchen sink approach to pooling is not necessarily better, and (2) that markets work. If investors desire larger pools, they will pay for them. Alternately, if investors desire smaller pools or pools with particular characteristics, they will pay for them, or ask dealers to create Supers from a number of smaller pools. In any case, single issuer pooling allows the market to reward issuers who create desirable products and provides signals to those who do not – originators are able to own their own economics and have skin in the game. If a seller wants payups, they need to originate loans and MBS that receive payups. This is the correct direction of incentives and should not be disturbed.

In the list below we set forth a number of suggestions that FHFA should explore further as an alternative to the pooling proposal in the RFI that we hope will be abandoned. While these are not fully fleshed out, they are suggestions that our members have put forward as potentially liquidity-enhancing. We will continue to discuss these ideas within our membership and would welcome a meeting with FHFA to discuss them further.

Suggestions for further discussion:

1. **GSE pool creation practices should be aligned.** As discussed above, an approach that retains the ability for single-servicer and other specified pool types will benefit the liquidity of the TBA market and the borrowers and other parties it serves.
    a. In terms of designing standards for major/multi pools, FHFA should consider and discuss with market participants and the GSEs a simple approach whereby seller/servicers of a certain size (based on issuance shares) would be directed into single lender pools, keeping the focus of the multi/major pools on smaller lenders who cannot support single-lender MBS issuance on their own (which we believe to be the original intent of those programs).
2. **Aligning cash window processes, as mentioned in the RFI's question seven, would be beneficial.** It would be useful for the Enterprises to publish advance schedules of planned security issuances with information on security type, security size, and loan purchase bids. These notices should be aligned between the GSEs.
    a. Some members have suggested that FHFA could also explore whether diversification of cash window pooling practices, e.g., the issuance of pools containing loans sold across multiple months to help smooth spikes in prepayments that tend to occur at a certain WALA, would be beneficial to liquidity.
3. **FHFA should direct the GSEs to align seller/servicer loan performance requirements and remediation steps to prevent forum shopping by bad actors.** These standards could include monetary penalties or increased costs (e.g. g-fees or retained servicing requirements), servicing transfer restrictions, and other consequences for seller/servicers that violate them. The ultimate penalty should be exclusion from TBA-eligible pools. Any standards, and any actions taken pursuant to them, should be clear and transparent to market participants.
4. **Some members have suggested that FHFA should consider whether the standardization of a net tangible benefit test between the GSEs would be useful in helping to stem instances of**

suspected churning. Any standards underlying such a test should be transparent to market participants.

5. **FHFA and the GSEs should organize and/or participate in regular discussions with market participants about prepayment performance, for example on a quarterly basis following the release of prepayment monitoring reports.** SIFMA would be pleased to assist with organizing such a forum, or FHFA could organize an advisory committee. This would heighten the understanding market participants have with regard to the activities of the GSEs and allow participants to share comments or concerns in an organized setting.
6. **FHFA should provide more clarity into directives it provides to the GSEs related to loan or MBS alignment, performance, or other issues.** This would be in the spirit of greater transparency and allow for a better understanding of how the GSEs are managing their businesses.
7. **FHFA should consider enhancements to existing GSE disclosures** regarding the following GSE practices which could create misalignment:
    a. Digital programs such as automated appraisals and underwriting elements;
    b. Buy up and buy down pricing; and
    c. Information on loans that are refinanced.
8. **FHFA should review elements of the current UMBS Final Rule for effectiveness**:
    a. Whether further downward revision of the 112.5bp WAC cap is warranted to promote MBS liquidity; and
    b. Whether the 50bps servicing cap which puts the GSE's in greater control of the IO is promoting MBS liquidity
9. **FHFA should work with the GSE's to advance internal communication and coordination within each GSE regarding MBS performance.** For example, the interests a GSE has with respect to growing seller/servicer market share might conflict with the interests a GSE has regarding managing its MBS program. In the past, a Gold/Fannie swap could provide immediate signaling as to how the market perceived the performance of a GSE's MBS. However, with UMBS, there is no Gold/Fannie swap and therefore less of an immediate signal to a given GSE regarding its MBS performance in relation to front-end activities.

G. Conclusion

We thank FHFA for seeking market participant input through this RFI. As outlined in this letter, we have significant concerns with the proposal in the RFI. On the other hand, we are pleased that FHFA is concerned about the maintenance and enhancement of liquidity in these markets and have provided several suggestions designed to help achieve this. We look forward to discussing these issues further at your convenience.

Please contact me with any questions or for further discussion at ckillian@sifma.org.

Sincerely,

Christopher B. Killian
Managing Director
Securitization and Credit Markets