HOUSING POLICY COUNCIL

January 21, 2020

Honorable Mark Calabria
Director
Federal Housing Finance Agency
Constitution Center
400 7th Street, NW

Re. Enterprise Pooling Practices Request for Input

Dear Director Calabria,

Thank you for the opportunity to comment on the Federal Housing Finance Agency (FHFA) proposal to alter the pooling practices of Fannie Mae and Freddie Mac (the GSEs). We appreciate FHFA's interest in addressing the divergence in the performance of agency securities, which has persisted despite the successful deployment of Uniform Mortgage Backed Securities (UMBS). The enduring disparity between Fannie Mae and Freddie Mac UMBS is not unexpected, given the differences in the company's policies as well as the distinct set of sellers and composition of assets that those sellers deliver to each GSE. That said, the Housing Policy Council (HPC)[1] and our member firms are concerned that the proposal to direct the "vast majority of production" from both GSEs into large multi-lender pools and limit the use of specified pools will be detrimental for the industry and consumers alike.

We welcome the intent of the proposal, to improve liquidity in the "to-be-announced" (TBA) market, but believe that the problems that FHFA is seeking to address along with alternative solutions to those problems are worthy of additional deliberation. Therefore, we request that FHFA withdraw the proposal altogether and instead initiate an industry-wide policy dialogue to identify alternative approaches that FHFA could consider.

This letter highlights our primary concerns, all of which address the set of questions posed in the RFI. These concerns include:

- *Detrimental Impact on Market Participants and Consumers:* Delivery optionality is beneficial for market participants and consumers, enabling originators to pursue "best execution" for each mortgage, investors to request tailoring of pools by asset

[1] The Housing Policy Council is a trade association comprised of the leading national mortgage lenders and servicers, mortgage and title insurers, and technology and data companies. HPC advocates for the mortgage and housing marketplace interests of its members in legislative, regulatory, and judicial forums. Our interest is in the safety and soundness of the housing finance system, the equitable and consistent regulatory treatment of all market participants, and the promotion of lending practices that create sustainable homeownership opportunities in support of vibrant communities and long-term wealth-building for families.

characteristics, and consumers to access the lowest-cost financing. Large multi lender pools provide investors a choice for originator/servicer diversification and allow smaller sellers to realize benefits of larger pool sizes. In the TBA market, originators and investors can commit to a buy and sell arrangement for a security that will be delivered at a future date, which creates liquidity and lowers mortgage rates for consumers, but does so with a "worst-to-deliver" expectation. In contrast, market participants can also engage in the complementary practice of specified pool trades, where buyers agree to purchase a security that will be backed by assets with specific characteristics that are known in advance of settlement/delivery. Specified pool trades appeal to a wide array of participants in the mortgage market such as central banks, large regional banks, insurance companies, and consumers of "structured product" that make use of collateralized mortgage obligations (CMOs), all of which are essential to a well-functioning, liquid marketplace that has minimal supply/demand imbalances. Many originators and investors rely on and prefer the specified pool framework to the TBA market, as a means to match the supply and demand of home mortgage funding. Forcing loans into large multi-lender pools and constraining the use of specified pools disrupts this optionality and undercuts the commercial, competitive, market-based decisions that generate better pricing and cash flow across the system, a framework that ultimately advantages borrowers.

- *Failure to Address Prepayment Problem*: The proposal – to rely on an increased use of the multi-lender/major pooling structure to securitize a larger volume of mortgage assets as the primary mechanism to moderate the impact of prepayment performance disparities – does not actually resolve the problem at-hand. It merely blends the idiosyncratic disparities of various borrowers (e.g., state-by-state) and the origination community into an amalgam that is not accretive to the mortgage market. The investment community that supplies the funding is well-versed in these deviations and the proposed approach would serve to increase opacity in a market that makes productive use of current levels of transparency. Lastly, this approach disenfranchises originators that produce mortgages with slower prepay speeds by breaking the linkage to the sources of funding that are willing to provide compensation for what the market terms "call protection." Adjunct to this, originators with faster prepayment speeds would benefit from the lack of opportunity for the market to more effectively price the "call risk" associated with MBS formed by firms that have a greater propensity to "churn" the loans backing pools that were previously formed.

- *Distinction between Ginnie Mae and GSE Models*: The GSEs serve as issuers (as well as guarantors), while Ginnie Mae performs a more narrowly defined set of securitization and guarantee functions. The distinction in the two models means that imposition of the Ginnie Mae pooling approach will not produce the same effect in the GSE conventional market. In fact, the limited set of Ginnie Mae pooling options, the statutorily set fees, and the narrow role of Ginnie Mae create an entirely distinct set of business considerations for Ginnie Mae and issuers alike. Ginnie Mae, because it is NOT the issuer, has fewer tools available, yet more incentive to normalize performance of

Ginnie Mae MBS. The GSEs are not in this position. As the issuers, they have complete control and influence to direct the activities and performance of GSE sellers as well as to facilitate construction of various pool types that benefit investors, lenders, consumers, and themselves. *Private issuers* who participate in Ginnie MBS can capitalize their production quickly and efficiently with the limited pool types, but Ginnie MBS does not achieve the level of liquidity that UMBS commands.[2] In contrast, with the GSEs serving as issuers, *loan originators* need and benefit from delivery optionality. This proposal, by applying a Ginnie Mae-appropriate practice in the GSE context, eliminates this valuable feature from GSE UMBS. In other words, this proposal removes variability and delivery optionality that enables an originator to optimize the pricing and profitability of each mortgage asset, based on an erroneous assumption that the GSEs and Ginnie Mae are comparable.

- *Expansion of GSE Control*: The proposal reinforces and frankly expands the dominant role of the GSEs as duopoly issuers. Large scale originators deliver virtually all of their monthly UMBS production as specified pool trades, a practice that appears to be all-but eliminated under the proposal. As a result, restrictions on single-lender pools and other types of specified pools allow the GSEs to further constrain and control critical business interests of originators, who today work diligently to net their buy and sell activities and optimize cash flow, profits, and pricing. Large-scale originators are constantly evaluating their production and the risk characteristics of their hedge positions, in pursuit of best execution as well as to satisfy demand from investors for specialized pools. The ability to tailor pools for such investor demand helps lenders lower the mortgage rates they charge customers. The FHFA proposal restricts, or likely eliminates, these delivery decisions, undercutting one of the few remaining competitive aspects of agency business.

- *Lack of Details*: The general concepts of the proposal concern HPC members, but the lack of detail makes it difficult to understand precisely how the new pooling practices will be executed and, therefore, difficult to anticipate the full impact of the potential changes. For example, what are the “prescribed circumstances” under which single issuer pools would be permitted and which seller-servicers might be allowed to produce these pools? What is the impact of monthly pooling on high-volume originators and therefore consumer pricing? Who would direct these pooling decisions post-conservatorship?

Negative Impact on Market Participants and Consumers

Today, mortgage originators approach their MBS pooling on the basis of “best execution” rather than on simple pooling policies. These execution decisions are complex and critical, requiring originators to consider a variety of factors including, but not limited to:

[2] J.P.Morgan MBS Market Commentary, Exhibit 6, North America Securitized Products Research, November 15, 2019.

- guarantee fee (g-fee) adjustments offered by the agencies (e.g., buy-up/down);
- market pricing of the eligible MBS coupon into which the loan may be delivered;
- excess servicing that the originator is comfortable generating;
- the market determined spread to TBA pricing of a specified pool trade into which loans could be pooled based on their characteristics; and
- the volume and profile of non-eligible product (e.g., super-conforming Jumbo, relocation, and temporary buy-down) that can be practically blended under "de minimus" pooling tolerances.

Large-scale originators employ sophisticated modeling techniques involving iterative optimization routines to "fit" the portion of their pipeline into pre-defined classes of specified pools for the next delivery cycle or retain for future delivery. The value of these considerations adjusts in accordance with fluctuating interest rate scenarios and therefore affects hedging needs as well. Elimination of the originator's ability and flexibility to pursue best execution delivery decisions will affect the market value of the assets in the pipeline, which ultimately translates into higher mortgage rates for consumers. Furthermore, originators will suffer immediate and substantial mark-to-market losses in their "held-for-sale" pipelines if they are forced to adopt the use of multi-lender pooling mandates. This is because the best execution routines need to consider the unrealized gains resulting from the additional compensation that may be obtained from the aforementioned 100% issuance of specified pools strategy. Imposing the use of multi-lender pooling requirements would eliminate these unrealized gains and, by extension, generate losses on existing positions.

Fails to Address Prepayment Speed Disparities

The RFI acknowledges that the GSEs monitor the prepayment performance of sellers and could influence behavior by mandating remedial action or by imposing financial penalties, likely in the form of reimbursement of premiums. Yet, the proposal itself is designed to generally permit the disparities and instead dilute the impact of faster-paying mortgages produced by certain counterparties by blending them with slower-paying loans produced by other counterparties. At its core, this approach bypasses a direct resolution of the problem.

Most problematic, however, is the fact that the originators that produce slower-paying mortgages are expected to abandon single-lender and specified pooling to participate in the multi-lender pools. In this arrangement, these originators are cross-subsidizing the enormous multi-lender pools while also losing the profit and pricing benefits associated with the creation of single-lender pooling, which includes the ability to compete for customers by offering better pricing, thereby reducing the likelihood for refinance.

While the GSEs could compensate originators for this loss, which the use of the term "incentivize"[3] in the proposal suggests, this new GSE expense would have no ability to be recovered through better TBA pricing. The TBA market would receive an inefficient transfer of

[3] Enterprise UMBS Pooling Practices Request for Input, November 2019, page 12, "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 . . ."

capital from the GSEs that bears no direct linkage to its source – which in a post-conservator framework ensures that shareholders are subjected to this with no discernable benefit. Furthermore, this structure raises more questions for housing finance reform, such as whether new entrants to the UMBS or CSP platform would have to participate in such regimens and whether this is a barrier to entry. Finally, absent a clear, objective, equitable approach to determining the subsidy that is market-determined, the approach will create more problems than it will solve. For these reasons, we are left to presume that the implementation of this concept would manifest itself into an actual mandate from the GSEs (without compensation), which would push the losses to the originators and ultimately borrowers in the form of higher lending costs.

The consequences of the approach – the dilution or "masking" of the problem by creating larger pools that contain slower-paying mortgages at a loss to large-scale originators - is predictable. Incentives and/or capability to improve customer pricing would greatly diminish. Motivation and/or ability for originators to construct tailored pools becomes severely limited, which erodes the attractiveness of the mortgage market as an investment sector which, in turn, affects product choice to the consumer. Originators might choose to pursue the additional incentive to "churn" borrowers to preserve profitability, further harming the sector and pushing the demand for yield higher which would ultimately be passed along to the consumer in the form of higher rates and fees.

Further, the actual impact of introducing slower-paying mortgages into the pools may not result in a significant improvement in the overall payoff speed, according to analysis performed by JPMorgan Chase.[4] The negative unintended consequences of the proposal must be weighed carefully against this potentially negligible benefit.

GSE and Ginnie Mae Models are Not Equivalent

Unlike the seller relationship with the GSEs, in the Ginnie Mae model, large-scale originators are the issuers of Ginnie Mae securities. In this arrangement, there are few mechanisms to curb adverse issuer behavior. For example, Ginnie Mae cannot permit buy-up/down of the guarantee fee, which would create a punitive cost that would influence issuer performance.

Further, Ginnie Mae operates only three major classes of pools for conforming balance loans for originators/issuers to construct MBS pools. First, there are single-Issuer pools that are denominated in fifty (50) basis point (bps) intervals, where the underlying note rates are all homogenous and are 50 bps above the MBS coupon rate issued under the GNMA I program. Although the use of single-issuer pools has declined considerably, the GNMA I program has enjoyed sufficient liquidity in the MBS market, but not as deep as UMBS.[5] Second is the multi-

[4] J.P.Morgan MBS Market Commentary, North America Securitized Products Research, November 15, 2019.
[5]Ginnie Mae liquidity is inferior to that of GSE UMBS. "Ginnie Mae's market share is . . . roughly 34% of all 30-years outstanding. Ginnie trading volume, as seen on TRACE, is only 24% of all 30yr MBA volume, lagging behind its market share," J.P.Morgan MBS Market Commentary, North America Securitized Products Research, November 15, 2019.

issuer pool class that is also denominated in 50 bps intervals, but unlike the GNMA I program, is issued under the GNMA II program and allows for the underlying loan to vary, but in no instance can the note rate be greater than 75 bps above the MBS coupon. The multi-issuer pool is the only type that is eligible to meet Good Delivery requirements to satisfy a GNMA II TBA trade. Finally, the third class is a single-issuer pool under the GNMA II program and has the same pooling limitations as the multi-issuer. However, it is not eligible for delivery into a GNMA II TBA trade. The inability to deliver single-issuer GNMA II securities into TBA contracts reduces Ginnie market depth and worsens Ginnie consumer pricing. For this reason, single-issuer, Ginnie II pools are rather illiquid and trade at a severe discount unless an investor requests a pool composed of mortgages with unique features. Absent investor demand, no originator would create a single-issuer Ginnie II pool with otherwise multi-issuer eligible loans unless forced to do so.

This is the essence of GNMA's approach to dealing with undesirable behavior from problem issuers – prohibiting them from participating in the multi-issuer program, thereby forcing them to accept lower market pricing for illiquid pools. Ginnie Mae does not set nor influence this illiquid pricing; the "penalty" is paid *to* market participants in exchange for the risks posed by these issuers, rather than to Ginnie Mae, an arrangement that makes this a good market-oriented solution for Ginnie Mae.

It is unnecessary for the GSEs to replicate the Ginnie Mae approach to moderate disparities in the individual GSE's UMBS. The GSEs, unlike Ginnie Mae, are capable of deploying other remedies that are more market-oriented and that would not contaminate the liquidity of the UMBS landscape. Imposing market-based discipline – such as pricing adjustments for performance or identification of originators in securities disclosures to allow investors to project and price for the prepay speeds associated with distinct originators and therefore influence behavior – would be superior mechanisms to address the problem.

We recommend market-based approaches that would better align GSE perspective regarding their counterparties with that of the investor community. Replacing today's zealous competition for market share with a focus on quality counterparty performance would be a welcome change. In other words, market-oriented methods to influence performance should drive the GSEs' competition for new business as well as decisions around the delivery of production from current seller-servicer customers. This approach would likely have a more immediate impact on behavior – all reinforced by a broader set of market participants.

Expansion of GSE Control

As mentioned already, the shift to predominantly multi-lender securities would undermine the best execution decisioning activities and benefits for large-scale originators. Restricting the types of eligible specified pools removes the natural, dynamic market forces that today shape pooling decisions, be it through dealers who can create large pools for investors with an interest in larger MBS or investors who communicate their desire for pools of assets with particular features and characteristics. In other words, the proposal would disrupt commercial relationships that exist today between private companies, originators and investors and dealers who trade in the single-lender specified pools. The proposal would transfer from the originators to the GSEs a key market-based role. The GSEs would now be empowered to determine the profile for the specified pools they may or may not be willing to construct, undoubtedly in accordance with their own business interests. The transfer of this function expands the control of the GSEs over both the originators and investors.

Further, in cases where the GSEs may attempt to exclude a seller-servicer from the multi-lender pools, the GSEs will have full authority to differentiate between originators with unjustifiably fast pre-payment speeds and those with technology capabilities or innovative practices that drive efficient refinancing. Without transparent, market-driven industry influence over that decision – aided by more comprehensive securities disclosures – the GSEs have the power to independently ban some originators from the TBA market. Aligned standards for monitoring originator performance, supported by market participants, would better ensure that bad actors are naturally sorted out of the market.

Finally, the proposal indicates that the GSEs would now perform another private market function, the development of whole pools for REITs to purchase. Because REITs can be both buyers and sellers and their market appetite fluctuates with changes in market condition, it is untenable to position the GSEs to have complete control over this function. An exclusive right to create pools for REITS would not only limit choice for REITS, but also constrain private capital. [6] REITS provide one of the means for private cash flow into the mortgage market, so additional GSE control furthers their duopoly dominance of the mortgage market.

Again, HPC recommends that FHFA consider market-oriented solutions to address the disparity in GSE UMBS. In general, we think these could include:

- Enhancements to the GSE UMBS disclosures to provide additional transparency regarding factors that could affect prepay speeds;
- Added transparency on cash window business, as suggested in the RFI;
- Reconsideration of the cap on servicing fees, which put the GSEs in greater control, at the expense of market forces.

We would be happy to expand on these general ideas, but we assert that more transparency and market driven pricing mechanisms are the path to a more robust TBA market.

Lack of Details

HPC recognizes that the Request for Information was intended to serve as a vehicle to collect industry input on a general concept, but the lack of specific detail regarding several aspects of the proposal make it difficult to envision how this significant change could benefit the broader housing finance system. Of particular concern for HPC members, the requirement to deliver loans into the multi-lender pools and restrictions on single-lender pools represents a fundamental change in the nature of GSE securitization that appears to provide no upside and

[6] Wells Fargo Structured Products Research, Wells Fargo Securities, November 8, 2019.

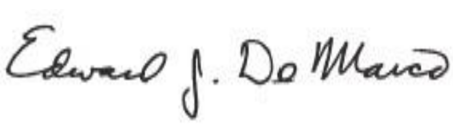
significant downside without actually addressing the underlying problem. Of note, more information regarding the opportunities for continued single-lender or other types of specified pooling would assist HPC members in evaluating the impact of the proposal.

In addition, while we request withdrawal of the proposal, if FHFA were to proceed, a proper notice period to implement any changes of this nature is 120 days at a minimum. This gives the market time to price in any impact in an orderly fashion and originators time to liquidate pipelines under the market at which they were locked.

Conclusion

We appreciate the opportunity to comment on the proposals presented in the RFI and the FHFA's interest in receiving such input. In view of the issues raised in this letter, we respectfully request that FHFA reconsider the expansion of multi-lender pooling at the expense of single-issuer and other specified securities. As FHFA prepares a revised framework, we urge that the agency consider market-based solutions that preserve the variability and optionality necessary for the GSE guarantee to facilitate and enhance liquidity in the marketplace. We look forward to future dialogue on these critical issues. Please do not hesitate to contact Meg Burns, SVP for Mortgage Policy, at 202-589-1926 should you have questions or need additional information.

Yours Truly,



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