PIMCO

Via Electronic Submission

January 21, 2020

The Honorable Mark Calabria, Ph.D.
Director
Federal Housing Finance Agency
Division of Conservatorship
400 7th Street SW, 8th Floor
Washington, D.C. 20219

Re: Enterprise UMBS Pooling Practices

Dear Director Calabria,

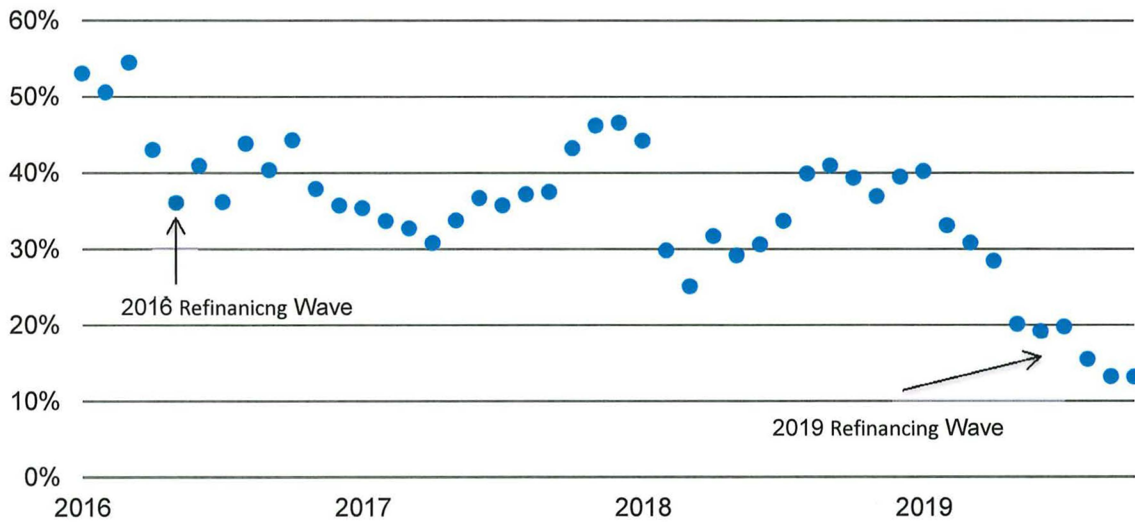
Thank you for inviting public comment on the Federal Housing Finance Agency ("FHFA") *Enterprise UMBS Pooling Practices* Request for Input ("RFI"). We appreciate the opportunity to provide our thoughts, and we do so in the capacity as one of the largest investors in Fannie Mae ("Fannie") and Freddie Mac ("Freddie") (collectively, the "Enterprises" or "GSEs") mortgage backed-securities ("MBS") and non-Agency mortgage whole loans and securities ("RMBS") globally. Pacific Investment Management Company LLC ("PIMCO") is the largest active fixed income manager globally, and as of December 31, 2019, manages $1.9 trillion of assets on behalf of millions of individuals and thousands of institutions globally; in all cases, we function in a fiduciary capacity and are legally obligated to act in the best interests of our clients.

PIMCO is encouraged by FHFA's examination into the Enterprises' current pooling practices of Uniform Mortgage Backed Securities ("UMBS"). We believe that a reevaluation of this market is especially important now, given that trading in the to-be-announced ("TBA") UMBS market has undergone a significant decline in both volume and liquidity over the past year, while at the same time, demand for specified pools has greatly increased. Although it is true that the decrease in U.S. Treasury rates and the corresponding wave of refinancing that took place in the summer and fall of 2019 are partially responsible for this phenomenon (as investors prefer to buy mortgage pools with specified characteristics, particularly those with more stable prepayments during a refinancing wave), it does not explain the significant magnitude of the shortfall in demand for TBA and the similar preference for specified pools. Indeed, the change in specified pool trading relative to other refinancing waves is materially larger as illustrated in the first chart.

In other words, investors continue to avoid the TBA market and prefer to buy specified pools largely because of the advent of UMBS – and in particular, the degradation of the securities being delivered into UMBS. This is because investors can no longer differentiate between Fannie pools of loans and Freddie pools of loans in the UMBS and can only do so by buying specified pools. Because there is less demand for pools trading TBA, mortgage rates, which are set by the TBA price, have increased, leading to higher relative borrowing costs for the homeowner (less demand

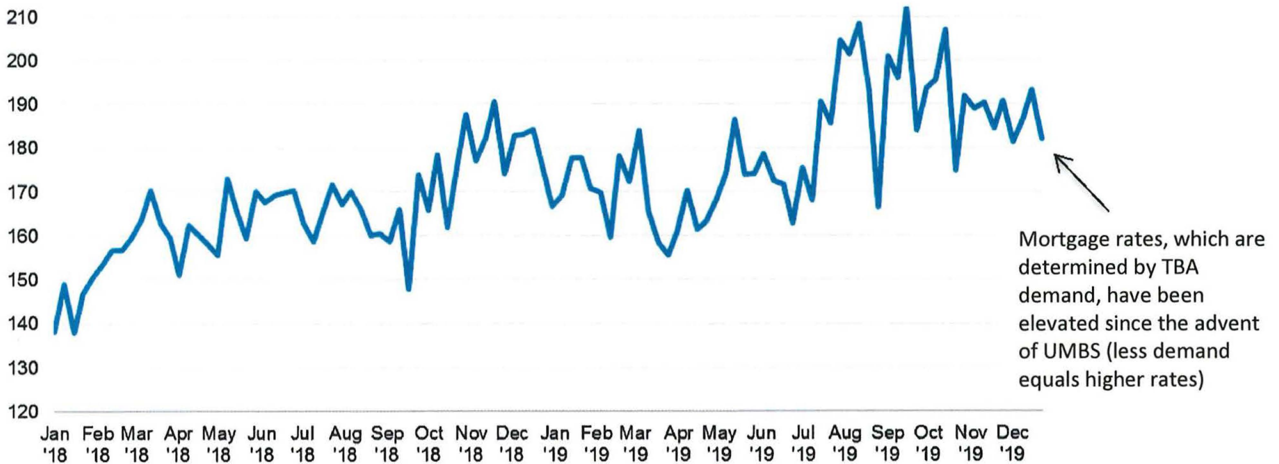
leads to lower prices leads to higher borrowing rates). These two phenomena – significantly lower demand for TBA and higher relative mortgage rates are illustrated in the charts below. As we elaborate below, we do not believe the FHFA's multi-lender pooling proposal, as currently proposed, will help this dynamic and could actually make it worse.

Share of Pools Trading at TBA Price is at Record Low and is Only Partially Explained by Refi Activity



Source: Wells Fargo

Less Demand for TBAs have Put Upward Pressure on Mortgage Rates



Source: Bloomberg, PIMCO

While we very much welcome the RFI's consideration of potential modifications to the current pooling practices, we respectfully disagree with the proposed approach to restore liquidity and value to the UMBS TBA market by creating large multi-lender pools, as we believe that doing so fails to address the fundamental issues contributing to current market dynamics as previously described and could further exacerbate some of the liquidity issues that have arisen since the launch of UMBS. Indeed, we worry that the creation of large multi-lender pools and the regulation of specified pools as proposed could:

- Unintentionally increase moral hazard, by masking the behavior of "bad" or fast seller/servicers and depriving the market of the ability to penalize these bad actors, thereby polluting broader TBA pools and causing or exacerbating a race to the bottom dynamic;

- Reduce market forces by allowing FHFA – not the market – to determine what should constitute "pay-up" specified pools; and

- Ironically, lead to even *less* demand for TBA and *more* demand for specified pools, which could decrease TBA liquidity even further and lead to higher mortgage rates for borrowers.

Overall, the proposal, in our view, could create more – not less – uncertainty for investors and would do little to address the structural headwinds facing the MBS market today.

As we outline below, instead of moving forward with the creation of large multi-lender pools, we believe it would behoove FHFA to pursue the following:

- **Standardize, align and improve pooling practices across the GSEs.** We believe FHFA should require uniform – and improved – pooling criteria across the GSEs, which would help to avoid the race-to-the-bottom dynamic that PIMCO and others have discussed[1] and would increase true fungibility *and* liquidity. We elaborate on this further below, but broadly, we encourage a tighter range for the allowable weighted average coupon ("WAC") and the establishment of identical buy-up and buy-down policies and prices across the GSEs.

- **Increase transparency.** As detailed below, we believe that providing more disclosure as it relates to loan characteristics, buy-ups and buy-downs, as well as the original loan ID that a loan is refinanced from, would provide investors valuable information about the repayment profile of the loan as well as better enable the market to help identify and curb abusive seller/servicer practices. Additionally, we support the adoption of a practice common in both the whole loan and Ginnie Mae GNMA markets that would require disclosure of the net tangible benefit to borrowers from refinancing. This, too, would help the marketplace identify and curb abusive practices of servicers/sellers through the pricing mechanism.

[1] *See* Comment Letter from Pacific Investment Management Company LLC to Melvin Watt, Director, FHFA on RIN 2590-AA94, Uniform Mortgage-Backed Security Proposed Rule Single security letter; single security viewpoint (Nov. 16, 2018) [hereinafter PIMCO Single-Security Comment Letter].

- **Increase enforcement and accountability.** We are encouraged that FHFA recognizes the deleterious impact that some seller/servicer practices have on the TBA market[2] and are strongly supportive of FHFA using the tools at its disposal to identify and rectify such behavior. Similarly, we support the "penalty box" concept as outlined in the RFI. However, in order to be effective, clear, tangible thresholds need to be established about what is – and what is not – acceptable in terms of performance as well as clear penalties need to be both outlined and enforced. Such penalties include depriving servicers/sellers access to the TBA market as well as requiring servicers/sellers to forfeit any premium paid for a loan if refinanced within a specific time period. These are all consistent with ideas proffered by FHFA, but to be truly effective, we contend that they need to be consistently enforced across the GSEs and need to include more explicit thresholds that are transparent to the marketplace.

Broadly speaking, we applaud FHFA for soliciting feedback and are encouraged by its willingness to reevaluate its current pooling practices, and we look forward to engaging with FHFA further on this important topic.

Responses to RFI Questions

1) What are the benefits, costs, and implications of the pooling concepts proposed in this RFI?

We maintain that bigger pools do not necessarily lead to better pools either in terms of liquidity or performance. Specifically, we worry that FHFA's pooling proposal in its RFI may unintentionally create moral hazard risks whereby sellers delivering loans with more valuable performance characteristics ultimately subsidize sellers delivering loans with less valuable characteristics, masking bad actors and creating further incentive for the "race to the bottom" dynamic. Indeed, larger pools are likely to beget less transparency and less accountability for bad behavior, meaning that seller/servicers will likely only have more incentive to mimic and expand on such behavior. This is likely to lead to a further degradation of the cheapest-to-deliver loans and less – not more – liquidity in the TBA market. Of course, worse performance and lower prices in the TBA market will ultimately be borne by the borrower in the form of higher mortgage rates.

We recognize and applaud FHFA for acknowledging this risk in its RFI and suggesting that "[o]n 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 in non-TBA-eligible, single-lender pools. . . ."[3] Although we believe that the price mechanism should be utilized to police performance outliers, in certain circumstances, more explicit remedial measures are appropriate. Consequently, we very much support this idea of a "penalty box;" however, we are concerned that without specific, transparent performance thresholds determining what is and what is not TBA eligible, investors will not be able to count on or model such differentiation, and TBA pricing and liquidity would fail to improve.

[2] FHFA Enterprise UMBS Pooling Practices Request for Input, at 10 (Nov. 2019).

[3] *Id.* at 12.

a) What type of loans or pools would be best suited for the multi-lender pooling approach?

We will address loan pooling directly in our response to a separate question, although we maintain that there is little necessity for the existence of multi-lender pools aside for those sellers/servicers that have insufficient production to create single-lender pools. In other words, multi-lender pools should be reserved for loans from small lenders unable to meet the single-lender pooling requirements. Again, we believe that outside of this context, sellers/originators of loans, to the greatest extent possible, should be held accountable and subject to the price mechanism – a mechanism that investors do not have in a multi-lender pool context. In other words, if originators deliver valuable characteristics, they should be rewarded by receiving a premium for their product; if they deliver less valuable characteristics, they should not be. Under a scenario in which most loans become part of multi-lender pools, this dynamic – and accountability – fail to exist.

2) Which approaches to pooling (i.e. the Enterprises' current approaches, FHFA's proposed approach, or other approaches) are preferable and why?

While we understand and are sympathetic to FHFA's proposed approach, we believe it is more likely than not to further deteriorate UMBS liquidity and does little to address the lack of alignment and performance degradation that has occurred in the TBA market over the past year.

Instead, we advocate for a different approach – for FHFA to standardize and improve pooling criteria across issuers and require that each GSE issuing UMBS utilize identical pooling criteria. (This is consistent with what PIMCO advocated in the PIMCO Single Security Comment Letter in 2018, in which we supported identical servicing and selling guides for both Fannie Mae and Freddie Mac.[4]) Indeed, we believe the utilization of identical pooling criteria would foster both fungibility *and* increased liquidity. Notably, fungibility is not necessarily liquidity-maximizing: worse pool characteristics, though fungible, remain worse and *reduce* liquidity. Accordingly, to maximize both fungibility *and* liquidity, it is important that pooling criteria for TBA UMBS be both improved and uniform across GSEs and that investor reporting be enhanced. Given Fannie Mae's historical relative liquidity, we believe it is most sensible to use its pooling parameters as the foundation upon which to improve.

We propose the new identical pooling parameters should include:

i. A narrower weighted average coupon ("WAC") range should be used: we suggest a minimum of 25 basis points to a maximum of 75 basis points over the UMBS coupon rate.
ii. Guaranty fee buy-ups and buy-downs should be disclosed (measured in basis points).
iii. Guaranty fee buy-ups and buy-down prices should be disclosed across issuers.
iv. Pools including loans with buy-ups that prepay within 120 days should be required to reimburse the entire proceeds to the guarantor, with 50% of the reimbursement being paid back to investors.
v. Pool disclosures should be improved, such that net tangible benefits to borrowers from refinancing are readily identifiable by investors.

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[4] *See* PIMCO Single-Security Comment Letter, at 9.

vi. Non-standard loans should not be allowed to be included in TBAs indefinitely.
vii. Non-standard loans should be limited to 10% of the pool, and high balance loans should be excluded entirely from TBA eligibility.

The first three items address the eligible WAC for TBA UMBS. In our view, no discernible economic reason exists for the current range of WACs in UMBS TBA pooling. A tighter allowable WAC range will create less heterogeneity, more certainty, and go far to improve TBA liquidity. Moreover, more transparency around buy-ups and buy-downs will provide more insight to the market regarding pricing. As of now, while it is acceptable for the Enterprises and the market to have different bid-ask prices for interest payments, the Enterprises enjoy a significant informational pricing asymmetry relative to the marketplace.

The last four recommendations would increase originator accountability for the loans they produce by creating mechanisms that ensure that sellers would eat their own cooking so-to-speak. The notion of premium recapture as recommended above– i.e., forfeiting the proceeds above par paid for loans that prepay within a prescribed timeframe – is a standard feature of the whole-loan market (and Ginnie Mae) and is included in mortgage loan purchase agreements as a disincentive to churning loans. This is desirable as both a protection to borrowers, as oftentimes there is no net tangible benefit of refinancing to borrowers, and to investors. Currently, buy-up recapture is optional in the current Fannie Mae pooling requirements, but we believe it should be made mandatory for both GSEs. Buy-up recapture and increased disclosure are also aligned with many of the environmental, social and governance ("ESG") considerations that investors – and their clients -- are increasingly focused on.

Finally, as suggested above, non-standard loans should not be allowed to be TBA-eligible indefinitely; instead, we suggest an 18 month timeframe for non-standard loans to be included until they are deemed to be TBA eligible (or not). Moreover, non-standard loans in aggregate should be capped at 10% of a TBA pool, and high balance loans should be excluded entirely.

4) Should the Enterprises require or otherwise incentivize production of multi-lender pools?

No, they should not, for all of the reasons previously enumerated.

5) Should seller/servicers that have extraordinarily high prepayment rate performance be barred from inclusion in multi-lender pools and required to form non-TBA-eligible single-lender pools? If so, for what reasons or under what conditions? Should there be any instances where the single-lender, high-prepaying pools be TBA-eligible? If such action is taken, should it be aligned across the Enterprises? Please explain your reasoning and the ramifications of your position.

Yes, we are very supportive of the idea of a "penalty box" for sellers/servicers that have high prepayment rate performance, although we believe that if the aforementioned pooling requirements were adopted, such remediation would be less necessary. We also believe that as with the pooling criteria, any sort of penalty box has to be aligned across the Enterprises.

To begin with, we suggest that prepayment performance should be measured by using a relative concept measured in terms of single-monthly mortality ("SMM") as opposed to constant prepayment rate ("CPR"). SMM is the cleanest measure of the monthly prepayment performance of a security, an observation accepted across the industry.

The table below illustrates historical SMM performance by refinance incentive. For example, the SMM across loans when the refinance incentive was "in-the-money" at 150 bps was 2.44% post-conservatorship vs. 3.90% post-introduction of UMBS, which illustrates the higher prepayment activity and the commensurate deterioration of performance in non-specified pools recently.

Single Monthly Mortality (SMM) Rate for Loans < 2 Years

	Refinancing incentive "in-the-money"		
Period	**@ 150bps**	**@ 100bps**	**@ 50bps**
Back to 1994 Average	3.63%	2.83%	1.78%
Since 2000	3.73%	3.03%	1.99%
Post Conservatorship	2.44%	2.17%	1.57%
Post UMBS	**3.90%**	**3.58%**	**1.92%**

Source: Bloomberg, PIMCO

We believe the performance threshold for exclusion from TBA access should be once a lender's non specified pools* exceeds the median SMM by a **20% threshold** as measured over the past 6 months. For instance, if the median SMM for the in-the-money incentive at 50bps over the past 6 months is 1.92%, then any lender whose SMM has averaged 2.30% (120% x 1.92%) for that period would be excluded from delivering TBA pools for the following 6 months.

This prohibition should also extend to the cash window or any other lender buying loans from the violating seller for the purposes of surreptitious TBA delivery. To the extent another lender is wittingly or unwittingly complicit of contributing loans from a suspended lender, it should also be subject to the same exclusion with no exceptions and no appeal.

6) Should FHFA prescribe limits to the issuance of specified pools through or by the Enterprises? If so, how should a specified pool be defined and how might FHFA apply limits? How might FHFA update any such limits over time to ensure that specified pooling does not unduly impair performance of the TBA market?

No, we do not believe there should be limits, as we strongly believe that originators should own their economics for both good *and* bad; in other words, if originators make attractive bonds that investors want to pay a premium for, they should have the flexibility to do so, and likewise, if they make bonds that are not attractive to investors, they should be penalized. This is a market-based mechanism, which we believe aligns with the Administration's objectives more broadly. Instead of restricting specified pay-up pools, we believe FHFA should focus on the performance of the bonds that are being delivered into the TBA market. Specifically, FHFA should focus on measuring and improving the performance of negative outliers, which both drag down the price of the TBA market and raise mortgage rates for all current and future borrowers.

7) How might the Enterprises add value to the process of pool formation from whole loan/cash window purchases that are ultimately securitized?

We believe FHFA should consider limiting access to the cash window to those sellers who really need it – those with limited market share – and not allow the cash window to function as a dumping-ground for originators who cannot get good bids on their own collateral by themselves. We would suggest market share of 1% or less.

For example, would it be useful for the Enterprises to publish advance schedules of planned security issuances with information on security type, security size, and loan purchase bids? If so, what type of advance communications and schedule would you recommend?

We think such disclosure is a good idea, and as we assert above, we would also like to see the following disclosed:

i. Net tangible benefit tests to ensure borrowers are benefiting from the refinancing: pool disclosures should be improved such that net tangible benefits to borrowers from refinancing are readily identifiable by investors.

ii. Clear transparency of disclosed pricing of buy up and buy down pricing paid by GSEs: uniform pricing between each enterprise, including zero differentiation of guarantee fee, or buy up/buy down pricing.

8) If changes are to be made to pooling practices, how should such changes be implemented to ensure a successful transition and minimize market disruption? How should the Enterprises or FHFA communicate to the markets to both maintain liquidity and facilitate a transition?

We believe that simultaneous and prompt disclosure to all investors and market participants is essential. Currently, announcement dates with a delay are common, but we believe improvements in timing could and should be made; we suggest the smallest lag possible to allow originators to adjust their pipelines and processes to accommodate the new delivery requirements (2-3 months).

Sincerely,

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