January 21, 2020

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

RE: Request for Input on Enterprise UMBS Pooling Practices

Dear Director Calabria:

Thank you for the opportunity to comment on the Federal Housing Finance Agency's ("FHFA") request for input ("RFI")[1] on the proposed approach to align the pooling policies and practices of Fannie Mae and Freddie Mac (the "Enterprises") as well as other actions FHFA may take to align cash flows across Uniform Mortgage-Backed Securities ("UMBS") issued by either Enterprise. As the third largest issuer of single-family Agency mortgage-backed securities[2] ("MBS"), PennyMac[3] recognizes the vital role that UMBS plays in the secondary mortgage markets and ensuring the liquidity of the housing finance markets in the United States. We also understand that the success of the Single Security Initiative relies on the aligned performance of Fannie Mae and Freddie Mac MBS pools and commend the FHFA for taking the initiative to develop an approach that attempts to limit the divergence in prepayment speeds across the Enterprises' To-Be-Announced ("TBA")-eligible pools, and soliciting feedback on other potential options to accomplish this goal.

While we agree with the underlying objective of the RFI, namely to ensure fungibility of UMBS, we are concerned that the FHFA proposal is a significant structural change for the well-functioning and liquid TBA-eligible MBS market, relative to its objective. The proposal would materially change the way UMBS are pooled and cause disruption in the mortgage markets, with potential negative implications for investors, lenders, and borrowers.

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[1] FHFA, "Request for Input: Enterprise UMBS Pooling Practices," November 4, 2019. Available at: https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/Pooling_RFI.pdf

[2] According to Inside Mortgage Finance for 2019. Agency refers to Ginnie Mae, Fannie Mae, and Freddie Mac.

[3] PennyMac refers to PennyMac Financial Services, Inc. (NYSE: PFSI) and PennyMac Mortgage Investment Trust (NYSE: PMT)

We believe that using the current market-based, investor-driven approach coupled with existing Enterprise policies and practices, FHFA's authority under the UMBS Final Rule ("Final Rule")[4], and an option for the Enterprises to force certain seller/servicers to pool into non-TBA-eligible UMBS would be a better and less risky approach to aligning prepayment speeds.

Today, there is an active, thriving, and liquid market for TBA-eligible, single-lender UMBS pools that is driven by robust investor demand. Seller/servicers who have collateral with desirable prepayment characteristics can receive a pay-up over TBA pricing based upon an investor's view of the relative value of such collateral versus TBA. Generally, the more desirable the prepayment characteristics, the larger the pay-up. This market-based approach provides those seller/servicers with better pricing which can, in turn, lower the interest rates offered to the borrowers they serve. Additionally, the existence of the investor-driven pay-ups provide seller/servicers with an economic incentive to keep their prepayment speeds in check. A seller/servicer's ability to pool desirable loan collateral into single-lender pools allows them to satisfy the diverse demands of a large variety of investors with different views and strategies, including REITs. Single-lender pools also provide transparency to market participants with respect to a particular seller/servicer's prepayment performance, which can provide insight as to their origination and marketing behaviors. Seller/servicers who pool loans that exhibit less desirable prepayment speeds receive little to no pay-up over TBA, and generally try to pool their collateral into multi-lender securities to receive a blended price; which is based on the average prepayment expectations of all the seller/servicers who contribute to the multi-lender pool.

As noted in the RFI, the Enterprises have "a number of options to address these types of idiosyncratic seller/servicer prepayment behavior." These include:

- Monitoring seller/servicer prepayment performance with thresholds to trigger review;

- Requiring that seller/servicers analyze prepayment performance associated with the activity of individual loan officers, investigate outliers, and take appropriate corrective action;

- Require repayment of any premium paid for the loan if it is repaid within a specified timeframe;

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[4] 84 FR 7793, "Uniform Mortgage-Backed Security Final Rule," March 5, 2019. See: https://www.federalregister.gov/documents/2019/03/05/2019-03934/uniform-mortgage-backed-security

- Ask seller/servicers to agree to refrain from refinance solicitations for the first few months of a loan's life; and,

- Require seller/servicers to form individual pools or adjust the seller/servicers share of Enterprise loan purchases.

We believe these can be effective tools to address undesirable prepayment behavior if used correctly and consistently across both Enterprises. As previously discussed, seller/servicers who have less or undesirable prepayment speeds may wish to pool into the multi-issuer to get a blended price, subsidized by other slower contributors to the pool. If such seller/servicers were forced to issue single-issuer UMBS pools, those pools would likely be priced worse than the multi-issuer pool, reflecting its less desirable characteristics. It should also be noted that newly-issued multi-issuer pools can and do trade at a pay-up to TBA. Such sellers/servicers would forgo much or all of the new issue multi-issuer pay-up and get priced to the TBA. If such seller/servicer prepayment speeds are adverse enough, the Enterprises could limit the amount of volume purchased or securitized by such seller/servicer, effectively rendering a portion of the subject seller/servicer's business ineligible for UMBS.

One potential downside of forcing sellers/servicers with undesirable prepayment speeds into single-issuer pools is that those pools are still TBA eligible and can worsen the TBA price for all issuers (e.g. they may become the cheapest-to-deliver pools). Accordingly, we support FHFA's recommendation to allow the Enterprises to require certain seller/servicers who exhibit exceptionally undesirable prepayment speeds to pool all or a portion of their production into non-TBA eligible UMBS, provided the requirements discussed below are met. We believe this option provides seller/servicers with a very strong market-based incentive to manage their prepayment speeds. This option is less punitive than an outright refusal to purchase/securitize some or all of such seller/servicer's production, allows investors to determine the appropriate price for such seller/servicer's pools, and keeps these undesirable UMBS from adversely impacting the TBA market. Additionally, it provides the market with transparency into the performance of such loan collateral and the marketing and origination practices of seller/servicers.

Any proposal to provide the Enterprises with a non-TBA option for seller/servicers that exhibit exceptionally undesirable prepayment speeds should be governed by rules and criteria that are clear and transparent to seller/servicers and other market participants. The policy should ensure that a seller/servicer's performance is measured against a benchmark of like loan collateral (e.g., seller/servicers who originate in areas with higher

balances should be benchmarked against other seller/servicers' loans of similar size). The policy should also allow for faster than average prepayment speeds that are the result of technical innovation that drives origination efficiency and are beneficial to borrowers. We believe seller/servicers should be given advance notice of an action that would require pooling all or a portion of their loan volume into non-TBA UMBS, and such sellers/servicers should be allowed sufficient time to address the non-compliance, or rebut the claim. A seller/servicer should be given an opportunity to rebut such a notice by providing evidence that the loan collateral wasn't benchmarked against like loan collateral, or their activities were the result of technical innovation that benefited the borrower. Seller/servicers should also receive clear guidance on what criteria will be used to determine if and when they can resume issuing into TBA deliverable pools, and how long the assessment period will be. For repeat offenders, we would also support increasingly shorter periods to cure the non-compliance, and increasingly long non-TBA only periods.

As noted previously, the Enterprises' use of these policies and practices to address seller/servicers with less desirable or undesirable prepayment speeds must be aligned. Accordingly, we note that the final rule implementing UMBS[5] gave FHFA authority to enforce such alignment, as well as authority to force an Enterprise to add, modify, or terminate "a program, policy, or practice."

We also note that if and when the Enterprises exit conservatorship, shareholders will provide another market-based incentive to align the cash flows of UMBS as an Enterprise with faster overall prepayment speeds will have to subsidize its pricing to remain competitive, which would reduce shareholder returns.

The following comments and recommendations are additional thoughts that we have on specific parts of the proposal.

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The proposal would require the Enterprises to incentivize or require all seller/servicers to deliver a majority of their production into larger, multi-lender pools and limit the issuance of specified pools through or by the Enterprises.

While we acknowledge that larger multi-lender pool sizes behave more consistently and reduce the variability in cash flows to investors, we believe that this approach does not

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[5] 84 FR 7793, "Uniform Mortgage-Backed Security Final Rule," March 5, 2019. See: https://www.federalregister.gov/documents/2019/03/05/2019-03934/uniform-mortgage-backed-security

address the misalignment of prepayment speeds between Fannie Mae and Freddie Mac MBS pools. Today, the Enterprises compete for volume from multiple seller/servicers with varying business models, production mix, and origination practices. The prepayment speeds of Fannie Mae and Freddie Mac pools are influenced by seller/servicer concentrations, and the behavior of those seller/servicers. Mandating that seller/servicers with the slowest prepayment speeds be forced to pool into multi-lender pools may slow down prepayment speeds of multi-lender pools, but this will do little to change the average prepayment speed differential between Fannie Mae and Freddie Mac.

In addition to a continued misalignment, we are concerned that the elimination of market-based incentives may dampen the natural feedback mechanisms and accelerate overall UMBS prepayment speeds. Forcing seller/servicers to deliver into multi-lender pools would eliminate the market-based incentive for seller/servicers to keep prepayment speeds in check. This has the potential to create a race to the bottom, since individual seller/servicer pay-ups would no longer exist and the slower paying seller/servicers would inherently be subsidizing the faster ones. Without this market-based check on prepayment speeds, individual seller/servicers may allow their prepayment speeds to increase, thereby increasing the overall average prepayment speeds, lowering TBA prices, and ultimately increasing mortgage rates.

Specified pooling and other pooling with pay-ups would be restricted to certain guidelines, as determined by the FHFA, or subject to undefined FHFA approval processes and timelines.

The specified pool market today is driven by investor demand, and the diverse set of views and strategies of those investors. Investors pass through value to seller/servicers, in the form of a pay-up over TBA, for pools with collateral characteristics that they specify. PennyMac has a long history of passing these pay-ups through to its borrowers, thereby lowering borrowing costs for our customers. This has benefited a wide range of borrowers, including low-to-moderate income borrowers, with lower interest rates.

Requiring FHFA to approve the issuance of all specified pools and other pools with pay-ups would hinder market innovation by limiting trading strategies and reduce the liquidity of the specified/pay-up market. Under the proposal, seller/servicers would be unable to serve the diverse range of investor preferences since they would not be able to create MBS pools with specific requirements outside of the ones FHFA has approved. This may lead to reduced investor demand, including demand from REITs, and lower liquidity for Agency specified pools since certain desirable cohorts may no longer be available in the UMBS market, and those that remain may not satisfy certain investors' strategies, or the

needs of certain REITs. This, in turn, may increase borrowing costs for certain borrowers with loan characteristics which FHFA deems ineligible for specified pooling, which otherwise may have received a specified pay-up if market forces were driving the pooling decision. We believe that the proposal may also reduce the availability of whole pools for REITs and other investors, without specifying how those needs of REITs and other investors would be met.

The FHFA proposal also creates uncertainty for seller/servicers by not specifying a clear timeline or criteria for approving new specified pool-eligible characteristics, and modifying or eliminating existing ones. This could harm both borrowers and seller/servicers. Given FHFA's goal to keep specified market to a "modest share (potentially 20 to 30 percent)," any new approval could come at the expense of one or more existing ones. Hence, seller/servicers would have less certainty as to which specified pay-ups will remain eligible over time, reducing the likelihood that the economics will be passed along to their borrowers.

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We appreciate the opportunity to provide input on this important matter for our industry and welcome other opportunities to provide more specific feedback as FHFA publishes additional information on its efforts to enhance the alignment of Enterprise pooling practices and fungibility of UMBS. Should you have any questions or wish to discuss further, please contact me or Oliver Rubinstein, SVP of Product Strategy & External Relations, at (818) 746-2055 or oliver.rubinstein@pnmac.com.

Sincerely,

David Spector
President and Chief Executive Officer
PennyMac Financial Services, Inc.
PennyMac Mortgage Investment Trust