MILKEN INSTITUTE
CENTER FOR FINANCIAL MARKETS

January 27, 2020

Mr. Robert Fishman
Deputy Director
Division of Conservatorship
Federal Housing Finance Agency (FHFA)
400 7th Street SW, 8th Floor
Washington, DC 20219

Re: Request for Input–Fannie Mae and Freddie Mac UMBS Pooling Practices

Dear Deputy Director Fishman:

The Milken Institute Center for Financial Markets appreciates the opportunity to provide input on FHFA's Request for Input (RFI) on Fannie Mae and Freddie Mac Uniform Mortgage-Backed Security (UMBS) Pooling Practices.[1]

The Milken Institute[2] is a nonprofit, nonpartisan tank catalyzing practical solutions to global challenges by connecting resources to those who need them. The Milken Institute Center for Financial Markets (CFM)[3] conducts research and constructs programs designed to facilitate the smooth and efficient operation of financial markets—to help ensure that they are fair and available to those who need them when they need them.

The Fannie Mae and Freddie Mac (each an Agency or GSE[4]) "To Be Announced" (TBA) securities market is the backbone of conventional mortgage lending, allowing efficient origination and investment in 30-year fixed-rate conventional mortgage loans. FHFA should move carefully in making changes to the UMBS that might have unintended negative consequences on the TBA market.

In the RFI, you ask what types of loans should be included in multi-lender pools. The current multi-lender pooling program offered by Fannie Mae and Freddie Mac should be carried forward as is. FHFA should let UMBS investors determine the value of buying a multi-lender

[1] Enterprise UMBS Pooling Practices – Request for Input, November 2019 (RFI), https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/Pooling_RFI.pdf.
[2] "About Milken Institute," https://milkeninstitute.org/.
[3] "About Us: Center for Financial Markets," https://milkeninstitute.org/centers/center-for-financial-markets.
[4] Government-sponsored enterprise.

UMBS relative to a single-lender pool. In an efficient market, investors will pay-up for multi-lender pools if they see value in such pools in the same way they pay-up for low balance pools.

SIFMA, a trade group that represents UMBS investors, has successfully set "good delivery" rules for the TBA market for nearly 50 years and should continue doing so without FHFA interference. Any incremental value that FHFA might create by tightening pooling requirements could be more than offset by disrupting this well-established market. FHFA should be reluctant to restrain market forces from driving pooling mechanisms and relative market values. We do not believe it is FHFA's job to effectively maximize the absolute value of the UMBS. Rather, FHFA should enable UMBS investors to fairly value UMBS pools by creating guard rails that result in pools of the same vintage and pass-through interest rate having consistent prepayment profiles.

We believe that FHFA should mandate three pool types:

1. Multi-lender pools that include loans from sellers in good standing with Fannie Mae and/or Freddie Mac. These pools would be TBA-eligible.
2. Single-lender pools that include loans from sellers in good standing with Fannie Mae and/or Freddie Mac. These pools would also be TBA-eligible.
3. Single-lender pools that include loans from sellers that are subject to either Fannie Mae or Freddie Mae sanctions for actions that FHFA prescribes as detrimental to UMBS trading. These pools would be TBA-ineligible.

Single-lender pools are an important component of Agency lending. Such pools allow the GSEs to continue to do business with lenders whose profiles do not fit their standard seller or prepay profiles. Preventing or artificially limiting this type of pooling (apart from sanctioning lenders who engage in prohibited practices, which we discuss below) would prevent lenders from originating loans and holding them in portfolio in the most cost-effective way.

Lenders might want to hold on their balance sheet UMBS that only contain their own loans to help meet CRA requirements at a cheaper cost in the form of TBA-eligible UMBS, to better manage their interest rate risk. Lenders may also only want to invest in UMBS containing their own loans because they know the loan quality and can better predict their prepayment profile. In both cases, the MBS must be TBA-eligible to allow the lender access to a more liquid market if they are required to sell them to manage interest rate risk.

Rather than incentivizing issuing pools in the multi-lender program, FHFA and the GSEs should consult UMBS investors to better understand why they are not paying up for delivery of multi-lender pools versus single-lender pools, as well as to solicit suggestions for program improvements that would increase multi-lender pools' value. In an efficient market, the incentive for lenders to use the multi-lender program should come from UMBS investors in the form of pay-ups. Having the market pay the incentive creates value, rather than having Fannie Mae or Freddie Mac cut its profit margins in order to adhere to the proposed multi-lender pool mandate suggested in the RFI. FHFA must work with UMBS investors to identify the dynamics that support a premium for multi-lender pools and mitigate the issuance of custom pools unless there is a meaningful pay-up.

Additionally, cordoning off sellers whose loans prepay faster than a designated threshold due to FHFA-proscribed conduct[5] into TBA-ineligible single-lender pools would help FHFA instill appropriate governance of prepay speeds into the Agency MBS market without unduly disrupting market-driven pooling preferences and pricing. Any sanctioned seller would have to demonstrate to UMBS investors the value of the UMBS that are backed by its loans, effectively constraining the seller's behavior in order to regain market confidence and earn relief from TBA suspension.

A lender whose loans have a prepayment rate that exceeds a specified relative threshold should be evaluated through a formal multistep process. The first step would be to evaluate the seller/servicer at a pool- rather than portfolio-level against pools from other lenders having the same pass-through interest rate and vintage. If a lender's prepayment speeds at the pool level are substantially greater than its peers, it is important to look for inappropriate conduct such as churning or, conversely, the presence of mitigating factors.

Key questions include:

1. Did the servicer refinance the loan?
2. If the servicer did not originate the loan, did the original lender refinance the loan?
3. Was the weighted average coupon of the pool substantially higher than pools of peer seller/servicers having the same pass-through interest rate and vintage?

FHFA should then evaluate Fannie Mae and Freddie Mac's underwriting guidelines and servicing requirements for any material divergence that might cause markedly higher prepayment speeds. Additionally, to prevent churning, FHFA should consistently enforce an appropriate borrower-focused tangible benefit test, and sanction failing lenders by restricting their issuance to single-lender, TBA-ineligible pools.

FHFA should also work with Ginnie Mae to explore the feasibility of creating a multi-issuer UMBS off of the Ginnie Mae securitization platform rather than the multi-lender security off of the GSE's Common Securitization Platform (CSP). The Ginnie Mae platform would allow loans guaranteed by either GSE to be included in one national monthly pass-through MBS, with the GSE guarantee at the loan-level rather than the pool-level. This structure would allow the applicable GSE to be responsible solely for the performance of its own loans.

Under this structure, the CSP would perform master servicing and loan aggregation responsibilities, while Ginnie Mae would perform all UMBS bond administration functions off of

[5] For example, loan churning, or the accelerated refinancing of loans that are not in the borrowers' best interest and generally designed to generate fees for the lender.

the Ginnie Mae platform. Ginnie Mae has evolved this structure with over 400 issuers over the last 35 years. Notably, investors do not make issuer-based distinctions among Ginnie Mae MBS.

Fannie Mae and Freddie Mac should deliver UMBS within 48 hours of their loan acquisition from seller/servicers. By keeping a nominal amount of loans held for sale on their respective balance sheets, the GSEs would be unable to use their low cost of funding to squeeze out competitors in the private market. There are a number of Fannie Mae and Freddie Mac seller/servicers that offer their own cash window to acquire loans to be pooled into UMBS. FHFA should ensure there is a level playing field between the GSEs and the private sector to acquire loans for pooling into UMBS.

To reiterate, FHFA should avoid needlessly disrupting the Agency TBA market that SIFMA developed and maintains, and that has been one of the great success stories of modern market making. FHFA should work with SIFMA to evolve and continually monitor the health of the multi-lender pool market. If there is value in multi-lender pools, lenders will use the multi-lender program, and single-lender pools will constitute a niche market segment or phase out over time. FHFA must assure UMBS investors that the GSEs will use the same criteria to evaluate the prepayment performance of their seller/servicers. FHFA must also ensure that GSE-guaranteed loans yield similar prepayment profiles.

Furthermore, FHFA should consult with Ginnie Mae regarding the possibility of using Ginnie Mae's bond administration platform for the issuance of Agency UMBS to minimize the impact of possible variance between Fannie Mae and Freddie Mac's respective underwriting and servicing guidelines.

The Milken Institute appreciates the opportunity to comment on the FHFA's Request for Input on GSE UMBS Pooling Practices. We look forward to engaging further with you on this letter and on these issues.

Sincerely,

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