COMMENT ON FHFA'S REQUEST FOR INPUT ON A PROPOSED SINGLE SECURITY STRUCTURE

Submitted by:

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FHFA is to be commended for engaging on this issue that has been of critical importance to the mortgage industry for a number of years. The lack of a fungible trade in the TBA market has been an impediment to the relative competiveness of the two GSEs for some time, causing a tremendous and unnecessary expense for taxpayers. If done correctly, FHFA's efforts will reduce this cost and promote an equal playing field in the current environment. More importantly, it will establish the framework for the securities that will be traded in the secondary market structure that eventually replaces Fannie Mae and Freddie Mac. If done incorrectly, FHFA could saddle the housing finance system an uncompetitive structure that enshrines Fannie Mae MBS as the de facto secondary mortgage market instrument for years to come.

While an admirable step toward finding a solution to the problem, the proposal as outlined falls short in several significant areas. These areas are summarized below and will be discussed in detail. Finally the four questions specifically listed in the Request for Input will be addressed:

- While the proposal calls for a single security, it in fact proposes the creation of a third security with no guarantee that this new security will be fungible with either of the two existing GSE TBA markets. The issue is not really the need for a single security. Instead it is the need for a single TBA market. The creation of a third Agency security in and of itself will not create fungibility of delivery of agency securities into the TBA market and liquidity disparities could easily persist or get worse.

- The fundamental issue is SIFMA's stewardship of the TBA market. SIFMA could solve the problem in short order without the multi-year process discussed in this Request for Input. The lack of responsiveness by the SIFMA TBA committee to the changes that have taken place with Agency mortgage-backed securities over the last several years does not provide confidence that the committee will embrace this new security in such a way as to eliminate the liquidity differentials. This lack of responsiveness has cost the taxpayers billions of dollars. For this proposed structure to succeed, FHFA must address the role of this trade association in unilaterally setting the rules for a multi-trillion dollar market with no oversight or accountability. Specifically, FHFA should use its authority, and seek to employ the authority of the Financial Stability Oversight Council, to determine why SIFMA is not required to comply with OMB Circular A-119 that clearly spells out the responsibilities and requirements for a trade association engaged in standards-setting practices. Finally, because the MAP payments are a major expense to taxpayers, FHFA should use the investigative authority of its Office of the Inspector General to evaluate the history of how SIFMA's TBA Committee has dealt with this issue.

- The proposal has two fatal flaws. The first is how it would break down market discipline in controlling prepayment speeds. If Fannie and Freddie know that their securities will go into a single pool without direct accountability back to either firm, the incentive will be to pay up for the worst loans in terms of prepay speeds, dump them into the new single security and cheapen overall TBA prices. The second flaw is that one of the principal concerns of investors on the SIFMA TBA committee is that going to a single TBA contract with fungible Agency delivery would leave investors exposed to credit concentration risk. For example, if they or one of their clients were near investment policy limits for exposure to Freddie Mac, that firm could not safely purchase a generic Agency TBA for fear that it would have to take delivery of an amount of Freddies that would push it over its investment policy limits. The FHFA single security proposal does not solve this problem and actually appears to make it worse by combining two different credit exposures in a single security. Investors would need to parse out the exposure in each security and compare that with their guideline limits, or pay for an additional credit wrap that, under the current structure, would mean paying twice for the same taxpayer-provided credit guarantee.

- The Request for Input clearly ties the issuance of the proposed new security with the development of the Common Securitization Platform. The development of the platform is neither a necessary nor sufficient condition for fungible TBA delivery. It may not even be necessary for bringing to market the proposed single security, although it might make the administration of that security more efficient. Given the huge cost to the taxpayers of the current liquidity differential, the timetable for taking steps to eliminate the liquidity/pricing differential should not be tied to the timetable for the CSP.
- While it is clear that in the technical specifications FHFA sought to mimic to the greatest degree possible the current structure of the Fannie Mae MBS, it is neither wise nor necessary to maintain the 55 day delay between mortgage payments and when cash is received by the investors. The 55 day delay is an artifact of processing and

accounting systems that existed decades ago and can be significantly reduced with current technology. Freddie Mac has demonstrated for years that it is possible to operate with only a 45 day delay. Apart from making the securities more attractive by putting cash into the hands of investors earlier, going to a shorter delay reduces the systemic risk of large amounts of cash being held in the payments system for unnecessarily long periods of time. As a member of the Financial Stability Oversight Council, FHFA should seek to reduce this payments system risk by reducing the payment delay, not lock it in as a standard for many more decades. FHFA should not saddle investors and the payments system with a 55 day delay just because that is the current Fannie Mae structure.

What follows is a detailed explanation of the points given above.

1) <u>The problem is not the need for a single security but rather the need for a single TBA market. The FHFA proposal would accomplish neither.</u>

The guidelines for what constitutes good delivery for trading agency securities in the TBA market were set by the old Bond Market Association years ago and that responsibility was inherited by SIFMA when the BMA was merged with another group to form SIFMA. SIFMA sets a number of trading guidelines for things like what the holidays will be for trading Treasury securities or at what time the fixed-income market will close on Christmas Eve. In these cases the rules are market neutral in that they do not help or hurt one market player over another. The TBA guidelines started out as essentially the same sort of thing. There was a need for forward trading of mortgage-backed securities as a way to hedge interest rate exposure on mortgage rate locks, as well as to have indications of future demand and supply of MBS from month to month. The rules essentially dealt with issues like delivery dates, the allowable characteristics of the underlying mortgages and the payments made to the servicers. Of particular importance is that separate TBA markets were established for Fannie, Freddie, and Ginnie securities. The justification was that Fannie and Freddie were private companies and the value of their corporate guarantees of their MBS could vary over time. In addition, they had different business practices that impacted the prepayment speeds for their MBS and thus the value of their MBS. For example, Freddie securities had a history of prepaying faster due to the loan production channels and customer bases of the lenders that were major Freddie sellers.

Over time, the Fannie security became the standard for the MBS market. The much higher liquidity of the Fannie security enabled it to sell for better prices than those of Freddie Mac, even after the prepayment differences were taken into account. Freddie had a serious problem. If a lender could deliver a loan into a Fannie security and be paid, for example $103 per $100 of face value, why would that lender deliver the same loan into a Freddie security and only be paid $102.50? Freddie responded in two ways. First, it used its large investment portfolio to buy a very large percentage of its own securities. It could bid up the price paid to lenders, thus keeping them as Freddie customers, but still earn a nice profit by holding the securities in portfolio and funding them with subsidized debt. Second, Freddie instituted Market Adjusted Pricing (MAP) payments whereby Freddie would pay lenders something approximating the difference in the Fannie and Freddie MBS prices, essentially a reduction in the g-fee paid by the lenders.

With the conservatorship in 2008, three things happened. First, the source of the support for the guarantee on MBS securities became the US Treasury, not the individual companies. The companies hold only *de minimis* levels of capital against their guarantees so all of the risk is held by the taxpayers. Therefore, the credit risk of Fannie and Freddie mortgage-backed securities was equalized. Second, the GSEs were directed to shrink their portfolios, limiting Freddie Mac's ability to support the price of its MBS with its portfolio. Third, while the MAP payments to lenders continued, these payments now represented an expense to the taxpayers rather than a cost to Freddie's shareholders. While FHFA has available more detailed information on the actual MAP payments, the approximate amounts of the MAP payments since conservatorship are as follows:

Year	Estimated MAP Payment
2009	$860 million
2010	$475 million
2011	$425 million
2012	$430 million
2013	$650 million
2014	$375 million
Total	$3.2 billion

While the MAP payments are made to lenders, it is the investors who benefit. If Fannies are selling at 103 and Freddies are selling at 102.5, Freddie has to make up the difference in price with the MAP payment, otherwise no lender would sell loans into a Freddie Mac security. From the lender's perspective, all the MAP payment does is to make the lender indifferent between selling to Fannie or Freddie, all other things being equal. In contrast, the investor is able to buy a Freddie security that would not exist without the price subsidy. As long as the performance of the securities is essentially the same, investors get a better yield on the Freddies because they pay a lower price for the exact same performance and same credit guarantee from the government.

They even get their money ten days earlier. Therefore, the MAP price subsidy paid by the taxpayers ultimately flows into the pockets of the investors, although given the size of the Federal Reserve portfolio holdings of MBS, a portion of the taxpayer-paid MAP subsidy flows back to the taxpayers in the form of the yield on the Federal Reserve holdings.

The problem is that as long as Fannie's MBS have a liquidity advantage, they will always price better than Freddie's PCs, and MAP payments amounting to hundreds of millions of dollars every year will need to continue if Freddie is to remain in business. Hence FHFA's single security Request for Input. Fannie's liquidity price advantage is due solely to the fact that the market has chosen it to be the liquid trading instrument, not because of any remaining differences in the intrinsic values of the securities. Unless an investor is buying a security to hold it long-term, that investor needs to be sure that a sufficiently liquid market exists such that the investor can get a fair price in the event of a sale. Without a liquid market, an investor could have difficulty finding potential buyers at the perceived market price on any given day and could move the market down simply because that investor wanted to sell. The daily trading volume in the Fannie market can run as much as ten times that of the Freddie market, even though there is roughly a 60-40 split in the Fannie and Freddie outstandings. A potential buyer or seller of Fannie MBS knows that there will be a buyer or seller on the other side of the trade whenever they want to act, and that prices will be driven by fundamentals, not by a thin number of buyers or sellers on any one day. In contrast, an investor selling even a modest position in Freddie's risks moving the bid price lower if the pool of active buyers is small. That is why investors have been willing to pay approximately half a point more for Fannie MBS even though the intrinsic characteristics of the Fannie and Freddie securities did not justify such a spread. Many lenders who ultimately sell to Freddie use the Fannie TBA market to hedge their interest rate risk.

This highlights the fundamental problem with the direction FHFA appears to be taking. FHFA is not proposing steps to eliminate this liquidity differential between the securities but instead to create a third hybrid security that it is hoped will be accepted by the market on equal terms with Fannies, and, perhaps, replace Fannies as the preferred TBA instrument. As long as the Fannie security continues as a separate instrument, the idea that the new hybrid instrument would trade on an equal basis with it is only a hope. This proposal does not contain an imperative that either the market or SIFMA accept it has fungible with a standalone Fannie. The one outcome that is fairly clear is that whatever liquidity the Freddie security now has will be quickly subsumed into the new hybrid and standalone Freddies will be even worse off.

The benefits of the fungibility approach are clear. First, it is an easy, low-cost step toward the market structure that would be needed in the secondary market reform proposals being advocated by the MBA, other trade associations and public interest groups, and numerous members of Congress. Under the proposed reform, multiple guarantors would issue into the same security. Making the Fannie and Freddie securities deliverable into a single TBA structure would be a major step toward demonstrating the feasibility of this approach. Second, market reaction could be quickly ascertained and any market disruptions minimized without a multiyear effort. Third, volumes have already fallen significantly in the TBA market. Liquidity for both Fannie and Freddie securities is already under pressure. Combining the Fannie and Freddie issuance into a single TBA delivery would provide liquidity that would benefit all participants, except those who are currently able to profitability exploit illiquid positions. Fourth, as stated previously, there is a significant cost to taxpayers for inaction due to the Freddie MAP payment. A long, multi-year effort that involves a new single security and the successful launch of the Common Security Platform means hundreds of millions of dollars more in MAP payments.

Fifth, Freddie is at a competitive disadvantage. If the situation is allowed to continue, Fannie will essentially have monopoly control over the market. Given the uncertain timeline for moving to a new secondary market structure, the housing finance market is best served by maintaining some sort of competition between Fannie and Freddie in the interim. Indeed, FHFA's role as the conservator of Freddie Mac would appear to require that FHFA act to enhance Freddie's competitive position.

2) <u>The fundamental issue is SIFMA's stewardship of the TBA market. FHFA needs to address SIFMA's practices and responsibilities, and bring if in the authority of the FSOC if needed, even if it decides to proceed with the single security proposal.</u>

The biggest shortcoming of the Request for Input is that SIFMA is mentioned only once in a footnote to the rules for what can be included in a security eligible for TBA delivery. FHFA needs to address directly SIFMA's ongoing role in and responsibility for the TBA market if the market is to be anything more than a Fannie Mae dominated market for years to come. It is SIFMA's failure to respond to the changes since 2008 that has led to the current problems and that has cost taxpayers billions of dollars. SIFMA could argue, however, that it was the decision to keep Freddie Mac alive that has cost billions, not the TBA rules, and that investors would be happy with just one guarantor and one security, Fannie Mae MBS. The issue of maintaining some degree of competition in the secondary market is an important policy and FHFA has come out firmly in favor of competition and retaining Freddie Mac while eliminating the MAP expense by issuing this Request for Input. Maintaining competition is why the Mortgage Bankers Association and others have proposed for some time that the SIFMA TBA committee move to a single TBA market for Fannie and Freddie securities. Given that Fannie and Freddie securities are nearly identical in their prepayment speeds and their credit support from Treasury, the current separate TBA markets are no longer appropriate. The only significant difference is the 45-day versus 55-day delay in remitting payments to investors, and that actually works in favor of the Freddie security.

While a number of market participants have pushed for the change in the TBA rules, it was been blocked by some members of the SIFMA committee responsible for the TBA market rules. While different market observers can have different views of how any particular market should be structured or operate, it appears that some of the investor firms on the SIFMA committee have opposed any change for reasons associated their perception of the potential impact on their positions. It particular, the apparent concern is their perception of their exposure as fiduciaries. They have fiduciary responsibilities to their investors and have large holdings of Fannies (or dollar rolls in Fannies) that might be adversely impacted by a combination with Freddie TBA market. They reportedly see their vote on the SIFMA TBA committee as an extension of their fiduciary responsibility to protect their investors against potential negative impacts, particularly since they appear to be overweight Fannies relative to Freddies.

Yet the SIFMA committee is a quasi-regulatory group that sets market rules. Should participants be expected to vote based on their own firms' portfolio positions or based on the overall good of the market? What investment manager would want to risk potential legal liability and reduced profitability by voting in favor a market change that might advantage the market as a whole but specifically disadvantage them? While the most likely outcome of combining the TBA markets is that the Freddie prices would rise to match Fannie prices, and that any potential drop in Fannie prices would be within the range of normal daily fluctuations, the investors' concern is that they could be held liable for not blocking the change on the SIFMA committee if there is an unexpected price drop for Fannies or if they are no longer able to deliver to their investors Fannie-type performance at discounted Freddie prices. All of these possible motivations are perfectly understandable.

Despite not having a majority on the TBA committee, the investment firms are able to block any changes due to SIFMA's eligibility and admission requirements to serve on the TBA committee, and a somewhat ill-defined voting structure. Simply joining SIFMA is no guarantee that a firm will be allowed on the TBA committee. SIFMA's June 2013 document (http://sifma.org/committees/) on committee participation states:

> "Each standing Committee has different standards for participation. A Committee may be open to all members who wish to joins as participants; a Committee may restrict active participants but have distributions for interested parties; or, new participants may require an affirmative vote by the existing Committee members. Specific ground rules for each individual Committee may be obtained by contacting the designated staff advisor listed in this guide." (SIFMA-Committee-Guide.pdf, Page 4)

In addition, it appears from conversations with SIFMA that the voting structure is not explicitly established. A change to the TBA guidelines cannot pass by a simple majority or even a supermajority. A successful change apparently needs to be by consensus, and that consensus is determined by how strongly opposing opinions are held rather than how many members hold those opinions.

The conundrum for the investment firms on the committee, for SIFMA, for FHFA, for the mortgage finance industry, and for taxpayers is to find a way to reform the SIFMA TBA committee structure to separate rule-making authority from the need for participating firms to act as fiduciaries for their clients and therefore block, through the ambiguous SIFMA voting structure, any change that might negatively impact that firm's current book of business. Fortunately the guidance for how to deal with such a conundrum was laid out years ago by the Office of Management and Budget in the form of Circular No. A-119, issued February 10, 1998. In this announcement, OMB spelled out how trade associations should operate when they have responsibility for setting industry standards. OMB Circular No. A-119 spells out these best practices and makes adherence to these standards a condition for government participation:

> 4.a.(1) "Voluntary consensus standards bodies" are domestic or international organizations which plan, develop, establish, or coordinate voluntary consensus standards using agreed-upon procedures. For purposes of this Circular, "voluntary, private sector, consensus standards bodies" as cited in [the National Technology Transfer and Advancement] Act, is an equivalent term. The Act and the Circular encourage the participation of federal representatives in these bodies to increase the likelihood that the standards they develop will meet both public and private sector needs. A voluntary consensus standards body is defined by the following attributes:
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> i. Openness
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> ii. Balance of interest
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> iii. Due process
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> iv. An appeals process
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> v. Consensus, which is defined as general agreement, but not necessarily unanimity, and includes a process for attempting to resolve objections by interested parties, as long as all comments have been fairly considered, each

> objector is advised of the disposition of his or her objection(s) and the reasons why, and the consensus body members are given an opportunity to change their votes after reviewing the comments."

SIFMA's rule-making through its committee fails all five of these tests. The meetings are not generally open to outside parties. The membership is limited to select SIFMA members rather than a balance of all interested and affected participants in the industry. There is no clear process for resolving issues that are brought to the committee. Since the decision on the TBA fungibility question has really been to stick with the status quo through no decision, there is no way to appeal inaction. Finally, there is a difference between consensus and giving certain members what amounts to veto power.

What should FHFA do? The most important step is to codify the applicability of OMB Circular No. A-119 to SIFMA's TBA committee. Rather than attempt to create a new security that may or may not be accepted by the SIFMA TBA committee, FHFA should directly address the problems with the TBA governance structure. The TBA market is too large and important for the SIFMA committee to operate without oversight or explicit due process procedures, particularly since that committee will likely be called upon to decide on future, more drastic changes as the new secondary market structure evolves. If structural changes in the SIFMA TBA committee are needed, those changes should be made now while the substantive TBA changes are small. Otherwise, any changes to the secondary market could be blocked by a relatively small group of firms who are acting in what they believe are the best interests of their investors.

FHFA should call upon the authority of FSOC to facilitate greater regulation of the TBA governance process. The health and structure of the multi-trillion dollar TBA market is too important to the domestic and international financial systems to be allowed to continue to operate in a regulatory vacuum and an absence of oversight. In addition, FHFA should keep in mind that leaving the current regulatory vacuum invites in other potential regulators. Given the large disparity between the volumes of TBA trades versus the actual securities delivered, the CFTC could logically argue that a TBA trade is more of an interest rate derivative than a forward sale and we could see the CFTC step in similar to the way it took over regulation of the interest rate swaps market under Dodd-Frank.

Another step that FHFA could take is to bring more openness to the SIFMA process through FHFA's Office of Inspector General. FHFA's OIG has a history of being involved in issues that were seen to cost taxpayers money, such as agency repurchase and indemnification demands to lenders. Given the billions of dollars that the taxpayers have spent on MAP payments, it would be appropriate for the OIG to use its wide-ranging investigative authority to look into the structure and process of the TBA committee.

3) <u>The proposal has two fatal flaws. The first is the elimination of market discipline to control prepayment speeds. The second is the problematic appetite of investors for a single security that combines two different credit exposures, particularly if those investors have investment policy concentration limits that might be violated if they are delivered a security that has more loans from one GSE than anticipated.</u>

Investors in mortgage-backed securities are most concerned about prepayment speeds. Faster prepayments generally mean they lose money. Fannie and Freddie, therefore pay close attention to the prepayment speeds of their securities, monitoring prepayment speeds at the lender level and reflecting those speeds in the guarantee fees charged to different lenders. For example, lenders with a heavy mix of loans originated by brokers and/or a heavy mix of high balance, high credit quality loans tend to have faster prepay speeds. Freddie's PCs have historically had faster prepay speeds than Fannie MBS largely due to the mix of Freddie customers, and this is one of the factors that have led to Freddies being priced lower than Fannies over the years. Freddie has worked hard to bring down its prepay speeds and many market observers believe that the speeds on Freddie's current production match up favorably with those of Fannie.

The discipline shown by Freddie Mac in reducing its prepayment speeds was due to its need to gain an equal liquidity footing with Fannie and to reduce the billions of dollars it has had to spend on Market Adjusted Pricing (MAP) payments to compensate lenders for the price disparity between Fannie MBA and Freddie PCs. Without the MAP payments, the only lenders doing business with Freddie would have been the ones that Fannie refused to have as customers. The problem with the single security as outlined in the FHFA proposal is that the motivation for the discipline that Freddie has demonstrated goes away. Once Freddie can deliver its securities into a combined single security and get the same TBA price as Fannie, it has no incentive to limit its prepayment speeds because any negative price impacts on the cheapest-to-deliver TBAs will hit Fannie as well. Perhaps more importantly, Fannie would no longer have an incentive to price up or no-bid lenders with historically fast speeds. This is an important point. To the extent current Fannie TBA prices represent the worst to deliver Fannie loans, Fannie has an incentive to protect its TBA price by limiting just how bad the worst to deliver will truly get. With the single security that is no longer the case. Fannie can dump its worst to deliver into blended single security pools with Freddies, thereby increasing the quality and pricing of Fannie-only TBAs.

The result would be a race to the bottom as neither lender has an incentive to limit speeds since the single security TBA price would impact both lenders equally for those loans delivered into it. The single security TBA prices would be lower relative to current Fannie TBA prices and we would see an even greater growth in the specified pool market. While Fannie's standalone TBA prices could improve, but the best that Freddie could get is the single security price. Since stipping only Freddies would still have the liquidity problem, nothing has been gained. Lenders who are forced to sell at TBA prices, or who sell to the Agency cash windows or to other aggregators at near TBA pricing would suffer as they would be less able to offer competitive rates to their customers.

The answer is to seek the solution of fungible delivery of GSE securities into the TBA trades that was already discussed. The fungibility option would maintain market discipline in that it would equalize the liquidity price differences between the two securities while maintaining the option of price differences for any prepay speed differences. Investors could stip their TBA bids to exclude whichever GSE was perceived to have the faster prepay speeds at any particular time, but the price of the stip would reflect just the prepay differentials, not the liquidity differential.

The second fatal flaw with the proposal deals with the impact of investor guidelines on limiting credit concentration. One of the objections raised by members of SIFMA's TBA committee to the idea of making Fannie and Freddie securities fungible for TBA delivery is that investors could be put in the position of violating concentration limits depending on what securities got delivered to them in a TBA trade. If an investor has a regulatory or investment policy limit of X for Fannie Mae and Y for Freddie Mac, it could find itself suddenly in violation of one of those limits were it to receive all Fannies or Freddies in a TBA trade with fungible delivery. Regardless of whether those limits are meaningful in a world where the credit support comes from the federal government, the limits exist and the need to comply with those limits has been raised as argument against a fungible TBA market. The FHFA proposal does not solve the problem, and in some ways makes it worse. Combining Fannie and Freddies into a single large security does not change the underlying credit support and investors would face the same potential violation of credit limits with the intermingled large securities as they would with the individual securities being delivered into fungible TBA trades. The difference, however, is that it would be much more difficult to sell off pieces of the proposed single security to get into compliance than it would be to swap a Fannie for a Freddie or vice versa. Regardless of the merits of the credit concentration argument, it has been used to block the fungible TBA solution. If credit concentration limits for GSE securities are truly an insurmountable issue, then the FHFA single security proposal will fail. In the more likely event that they are not an issue that would block acceptance of the proposed single security then they are not an issue for the much easier route of going to fungible TBA delivery.

Finally, the FHFA proposal for dealing with this problem is to allow some sort of credit wrap by one company or the other to cover this concentration risk. The price of this additional credit wrap is not specified but if it is not free then the price is too much. The sole source for the credit support at this point is the US taxpayer. Why should anyone have to pay twice for the exact same credit support?

4) <u>The Common Securitization Platform is neither a necessary nor sufficient condition for the solution to the liquidity problems of the Freddie Mac security.</u>

Every discussion of the multi-year effort to build the FHFA-sponsored Common Securitization Platform should begin with the words "Call me Ishmael," largely because a private sector, industry-managed approach had a greater chance of ultimate success. Nevertheless, making the solution to the liquidity problems of the Freddie Mac TBA market contingent on the successful completion of the CSP is a mistake. Reliance on the CSP is certainly not an issue if FHFA pursues the approach of dealing directly with SIFMA on the fungibility approach. It is not even clear that the existing systems of Freddie Mac, and perhaps even Fannie Mae, could not handle the interim administration of the third security outlined in the in the Request for Input. If not, FHFA should then explore whether an outside vendor such as Bank of New York could handle the administration until such time as the CSP is finished. Keeping in mind that every month of delay is costing taxpayers something on the order of $30 million, FHFA should sever whatever solution it decides to pursue from the development of the CSP and instead put it on the quickest path to implementation.

5) <u>Continued use of a 55-day delay in remitting mortgage payments to investors maintains an unnecessary level of counterparty risk in the payments system.</u>

It is clear that FHFA sought to mimic as closely as possible the specifications of the Fannie Mae MBS in the outline for the proposed new security. This is understandable given the huge liquidity advantage Fannie MBS enjoy over Freddie PCs. Since only a small portion of the Fannie TBA trades ever go to delivery, the 45 day versus 55 day delay is immaterial to the majority of Fannie TBA traders. If one looks instead at the actual amount of securities in the hands of investors, Freddie has roughly a 40 percent share of the market. Therefore investors holding roughly 40 percent of the securities outstanding are accustomed to receiving their cash 10 days earlier, and may have purchased Freddies to get alignment with required cash outflows.

Telling traditional investors in Freddies that they will now have to wait and extra 10 days for their cash for any new securities they buy needs a better explanation than that is what Fannie Mae does.

The 55 day delay is an artifact of accounting and remittance systems that are decades old. Technology and reporting have moved well beyond what was available when the 55 day delay was standard. If 21st century accounting and remittance systems no longer require a 55 day delay, FHFA needs to examine whether there are important motivations for reducing that delay. The most important motivation is reduction of counterparty risk in the payments system. Billions of dollars in mortgage payments flow through the GSEs and other market participants to investors every month. Other regulators have focused on payments systems risk as a significant safety and soundness issue due to the cascading effects of the failure of even one counterparty in the system. The issue is not the risk of the ability of the current two GSEs to make payments while they are explicitly supported by Treasury, but the risk in the structure that follows the GSEs if FHFA standardizes the 55 day delay. It can be understood why, under the current structure of FHFA conservatorship and Treasury support, FHFA would not see the need to reduce payments system risk by shrinking the Fannie delay from 55 days to 45 days, but it not understandable why FHFA would seek to increase that risk by adding on 10 days to the Freddie delay.

Before FHFA makes any efforts toward standardizing the 55 day delay, it should consult with its fellow FSOC members and team with them to do a detailed analysis of the risks posed by the standardizing a 55 day delay versus a 45 day delay. This analysis should cover the incremental risks of the 55 day delay now and in potential future secondary market structures.

Only then can it be determined whether the markets and the public are best served by moving to a longer delay for Freddie Mac, or adopting a shorter delay for Fannie Mae.

Summary

In summary, as FHFA attempts to deal with the current liquidity and price differential problems of the Freddie PC, it should look for a solution that maintains market discipline while encouraging maximum liquidity. If should determine whether the problem is the current structures of the Fannie and Freddie securities or whether the problem is with the stewardship of the market by the SIFMA TBA committee. Creating a third, single security in an attempt to fit within the SIFMA rules is not the answer to the problem. The answer is to address head-on the process, oversight and disparate motivations of a trade association that is the de facto regulator of an important part of a multi-trillion market. It is crucial that FHFA look not only at the impact on the current trading and pricing of Fannie and Freddie securities, but at what precedents will be set for whatever secondary mortgage market structure is eventually adopted.

Specific Responses to FHFA's four questions:

In its Request for Input, FHFA requested responses to four specific questions. Those responses are below and are based on the comments already offered.

1. *What key factors regarding TBA eligibility status should be considered in the design of and transition to a single security?*

The most important issue here is that security characteristics are not the biggest impediments to a fully liquid TBA market but the operation of SIFMA's TBA committee. It can be argued that there is already more heterogeneity within existing TBA pools than would be added by moving to multi-issuer fungibility. Therefore, FHFA should deal with the operation and accountability of SIFMA's TBA committee before it invests a lot of time on specific security characteristics.

2. *What issues should be considered in seeking to ensure broad market liquidity for the legacy securities?*

Legacy securities are priced off the current coupon TBA trades. Therefore whatever steps are taken to improve liquidity and pricing will help legacy securities. In theory, holders of Freddie securities would stand to gain the most from a liquidity gain. Conversely, they stand to lose the most if their securities are orphaned, meaning that there are no current trades of similar securities against which to price older instruments. This is a particular problem for investors who need to mark their portfolios to market. Moving to fungible TBA delivery for the two GSEs would prevent a problem from developing for the legacy securities without a major and expensive exchange program.

3. *As discussed above, this is a multi-year initiative with many stakeholders. What operational system (e.g. investment guidelines), or other effects on the industry should be considered?*

FHFA has already done significant work in standardizing operating policies of the two GSEs and that work should continue. A number of items listed in Exhibit A are worth putting place if they are not already, with or without a single security. It is not correct, however, that perfect alignment needs to be achieved before the TBA markets can be combined, or that this needs to be a multi-year initiative. While more work can be done, the securities are already close enough to pursue the steps presented earlier. FHFA needs to sit down with the SIFMA TBA committee, ask them what exactly needs to be done to makes the two securities fungible, determine if their list makes sense, and then agree on action steps and a timetable. This approach would shrink the timeline to something less than a year.

4. *What can be done to ensure a smooth implementation of a Single Security with minimal risk of market disruption?*

Market disruptions can take many forms, including operational, tax and legal disruptions. This point will be limited to price disruptions. The price disruptions would likely fall into one of three general categories:

a. Fannie prices fall by ½ point for a day or two until the market figures out relative values and Fannie prices recover.

b. Prices on Fannies and Freddies converge with Freddie prices rising considerably and Fannie prices falling by a few ticks on a permanent basis relative to where they would have been.

c. Fannie prices fall by ½ point and spreads remain that wide.

Of the three potential market disruptions, FHFA should only be concerned with the last one. It would come about only if investors were chased away from the TBA and dollar roll markets because they truly questioned the quality of the loans that might be offered to them in the new security. Investors hate uncertainty and price it into any bid. The problem is that once the new security is in place, it will be very difficult to unwind or abandon. In contrast, the fungible TBA approach will give almost instant feedback on market acceptance and would be relatively easy to unwind in the event of a serious disruption.