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By electronic delivery to: www.fhfa.gov

The Federal Housing Finance Agency
Office of Strategic Initiatives
400 7th Street, S.W.
Attn: Proposed Single Security Structure

Dear Ladies and Gentlemen:

Wells Fargo is pleased to submit this letter in response to the Request for Input (RFI) on a Proposed Single Security Structure that was issued by the Federal Housing Finance Agency (FHFA). FHFA is seeking input on additional steps that it should take to improve the likelihood of success of its initiative and reduce the risks involved in materially reconstituting a $4.5 trillion agency market.[1]

We recognize that many constituents will be weighing in with their own perspectives. Since the success of this effort will require broad support, it is important to listen to their views and address as many of the issues as possible. While this letter does not attempt to identify all the steps that might ultimately be required, we are using this opportunity to comment on two issues that Wells Fargo views as particularly important.

Wells Fargo believes that a single, federally-guaranteed security is a fundamental element of long-term housing finance reform. A single security will encourage competition by reducing barriers to entry. It will reduce concerns over too-big-to-fail by allowing an issuer to fail without jeopardizing the market's ability to function. And it will minimize the moral hazard that would otherwise be associated with a government guarantee by separating the guarantee on the *security* from any implicit guarantee that might otherwise be attached to the security's *issuer*. However, none of these benefits can be achieved without an explicit government guarantee, and this requires legislation.

Today, FHFA wants to move in this direction in the absence of reform and without an explicit guarantee. Whether this is possible or even desirable is an open question. If executed well, creating a single security for Fannie Mae and Freddie Mac could foster a competitive and liquid market going forward. If executed poorly, it could lead to market disruptions that reduce liquidity. While FHFA's proposal seeks to address many of the industry's major concerns, in our view, there are at least two fundamental issues that still need to be resolved.

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[1] http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm

First, in order for the securities to be seen as fungible, trust agreements, disclosure requirements and certain other policies (e.g., buy-out policies, refinancing programs) will need to be aligned. While this is a complex undertaking, it is within FHFA's existing authorities. Second, and perhaps more challenging, the credit risk associated with the two security issuers must be the same. While FHFA has attempted to address this issue by allowing for the securities of one GSE to be "wrapped" by the other, additional steps may be required to ensure that investors are largely indifferent between Fannie Mae and Freddie Mac credit—including steps that are outside of FHFA's control. In our view, unless this credit issue is resolved, any move to a common security at this point in time would be premature.

1.0 Reasons for Proceeding with the Development of a Single Security

Given the risks involved, a threshold question relates to what FHFA is attempting to achieve by moving to a single security while the GSEs are still in conservatorship and while the ultimate structure of the secondary market is unknown.

A variety of reasons have been given for developing a single security before the eventual structure of the secondary market has been resolved. Some relate to the dividends foregone by the US Treasury due to the underperformance of Freddie Mac PCs (or "Golds"). Others reflect the desire to maintain and enhance market liquidity. As described in the Appendix to this letter, these objectives are related, but not the same, and the solutions are potentially different. While each objective has merit, we agree with the FHFA[2] that concerns over market liquidity should be the principal driver of the initiative.

Assuming that improved liquidity is the principal objective, it is important to clarify the specific liquidity problem(s) that need to be addressed and whether there are easier ways to address these problem(s). GSE securities are traded in different markets—the TBA market is dominated by Fannie Mae MBS, while Freddie Mac Golds are more likely to be traded through specified pools and re-securitization structures. However, despite these differences, most would agree that today's secondary mortgage market is both efficient and highly liquid. As a result, the primary reason for taking action prior to long-term financial reform would appear to relate *less* to current market conditions and *more* to potential threats to market liquidity in the next few years.

The main concern relates to the impact that Federal Reserve purchases have had on the amount of agency MBS available for trading and hedging purchase. Many believe that the Federal Reserve purchases of agency MBS under the Large Scale Asset Purchase are largely responsible for recent improvements in the pricing of Freddie Mac Golds, which have historically traded at a significant discount compared to Fannie Mae MBS. The Federal Reserve's MBS holdings now account for about 35%

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[2] FHFA has indicated through the RFI itself, as well as through subsequent public comments, that the primary driver for moving to a single security while the GSEs are still in conservatorship is to improve and sustain market liquidity.

of outstanding GSE securities.[3] After accounting for Federal Reserve holdings and CMOs, the amount of tradable "float" today is estimated to be about $750 billion in combined Freddie Mac and Fannie Mae securities. By increasing the amount of comparable securities available for hedging and trading purposes, moving to a single security could help to ensure that investors continue to have the ability to buy and sell large volumes of agency securities without moving the market—one aspect of market liquidity.

In our view, liquidity should be the key consideration when deciding to develop a single security while the GSEs are still in conservatorship. It is a reasonable policy decision as long as the FHFA proceeds in a way that minimizes the risk of market disruption and increases the probability of market acceptance.

2.0 The Importance of Addressing Credit Risk

There are numerous issues that may need to be resolved to develop a fungible security, including how to prevent prepayment rates from diverging at a future date. However, in our view, the threshold issue is whether FHFA has done enough to ensure that the credit quality of the two issuers will be the same. If the securities of each issuer are largely seen as interchangeable, moving to a single security while the GSEs are still in conservatorship makes sense. If they are not, we believe that the potential benefits of proceeding at this point in time will probably not be worth the risks involved.

Most discussions of a single security are predicated on a post-reform structure in which the government provides an explicit guarantee on the credit risk of the underlying security. However, no such guarantee exists today, despite the fact that the federal government holds the majority of both GSEs' outstanding equity and both GSEs have the ability to draw on the US Treasury.

Many investors believe that the GSEs will have the implicit backing of the federal government for as long as they remain in conservatorship. However, the GSEs are separate companies with different financial profiles. Freddie Mac's remaining commitment from the US Treasury is about $140 billion, compared to $116 billion for Fannie Mae. Fannie Mae's 2013 10-K included an expectation that they will remain profitable for the foreseeable future, while Freddie Mac's disclosure provided no such assurance. It is only reasonable that investors will consider these and other factors such as stress tests in assessing the credit risk associated with each GSE's issuances. While significant Treasury commitments remain, a draw by one of the GSEs could trigger investor concerns about their underlying credit risk. If this occurs, the result would be less liquidity in the TBA market as investors deliver the MBS of the weaker GSE into TBA trades.

FHFA has attempted to address credit risk through providing for second-level securitizations in which one GSE can provide a wrap guarantee for the issuances of the other. While investor reaction to this

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[3] http://www.federalreserve.gov/releases/h41/current/, and http://www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm as of September 24, 2014

solution has been guardedly positive, questions remain about the specific layers of protection in the event of default, as well as the cost of obtaining the wrap. We understand that the GSEs have reported that the waterfall of investor protection will begin with the top-level guarantor, then flow to the original issuer, and then finally to the underlying collateral. While this structure may provide ample protection to investors, the terms of the wrap must be codified. It is also reasonable to expect the top-level guarantor (e.g., Fannie Mae) to charge an appropriate fee for re-insuring the obligations of the original issuer (e.g., Freddie Mac). If this fee is too high, incentives to obtain this cross-guarantee would diminish. If the fee is too low, there may be legal risk associated with a "sham" transaction. Finally, accounting issues regarding the treatment of the wrap may need to be resolved. The extent to which the wrap will allow investors to manage both credit risk and concentration limits will depend on FHFA's clarification of the terms, price and accounting treatment of this execution.

To be successful, any change should be structured in such a way that the value of the security is able to withstand the failure of one of the GSEs. To do otherwise would ultimately threaten the ability to deliver Fannie Mae or Freddie Mac securities through the TBA market since investors would not be indifferent to the financial strength of the two entities. At a minimum, this requires that mega securities be structured in a way that protects investors in the event that the entity providing the wrap is unable to meet its obligations, for example, by triggering the obligation of the remaining GSE. However, since financial difficulties at one GSE are likely to affect the other—both in fact and in market perceptions—this might ultimately require the Treasury to amend the terms of the PSPAs to provide what would be tantamount to an explicit guarantee.

We recognize that FHFA does not have the ability to provide investors with the assurances that they may require to satisfy concerns over credit risk. But unless this issue is resolved, moving to a single security at this point in time may be less likely to be successful in enhancing market liquidity. We therefore urge the FHFA to collaborate with the US Treasury to determine how greater certainty regarding credit risk might be achieved in the absence of legislation.

Wells Fargo would like to thank the FHFA for giving us the opportunity to provide comments on its plans to move to a single security.

Sincerely,

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Wells Fargo Bank, N.A.

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Senior EVP, Wholesale Banking
Wells Fargo Bank, N.A.

Appendix

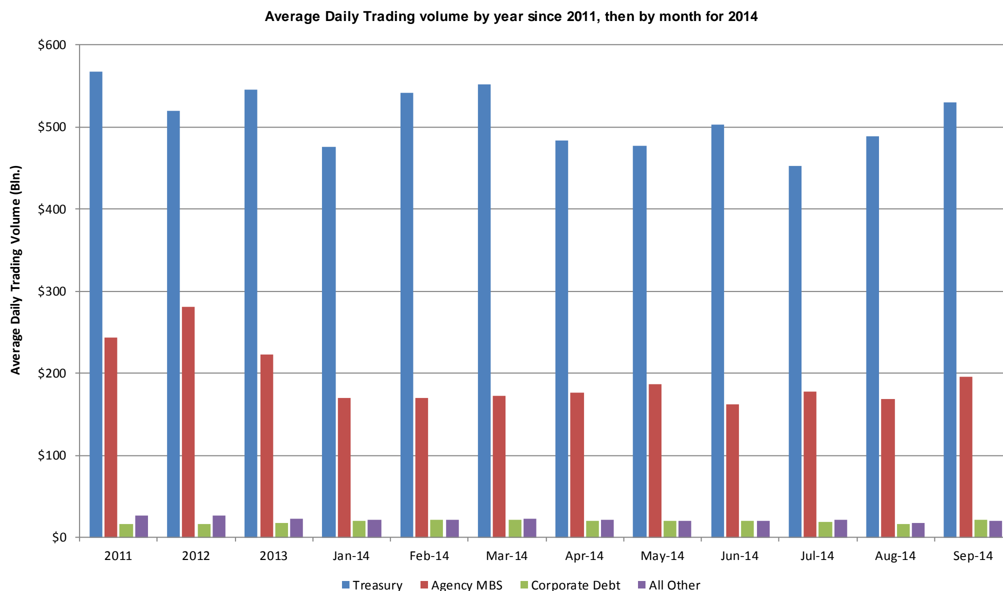
This Appendix discusses two objectives that are frequently used to support the development of a single security while the GSEs are still in conservatorship: increased market liquidity; and foregone dividends to the US Treasury due to the underperformance of Freddie Mac Golds.

A.1 Impact on Market Liquidity

A stated goal of FHFA's proposed Single Security effort is to improve the overall liquidity of the TBA market by combining Fannie Mae MBS and Freddie Mac PC's into a single TBA contract.

Defining liquidity is a challenging endeavor, and while it may be difficult to agree on a universal definition, there are several defining market trading characteristics that exist in a liquid market. Liquidity is sometimes evaluated based on both security trading volume and bid-ask spreads. By either measure, the TBA mortgage market today is highly liquid. From 2011 onwards, the average daily trading volume in the TBA market was about 10 times higher than that of corporate bonds and other fixed income securities, and almost 40% of the trading activity of US Treasuries (Exhibit 1).

Exhibit 1



Sources: SIFMA, Wells Fargo Securities, LLC | "All Other" includes: Muni's, Non-Agency MBS, ABS, Federal Agency Securities

In addition, average bid-ask spreads on MBS were only a fraction of those observed on corporate bonds and relatively close to those enjoyed by Treasuries. Between May 2011 and January 2014, for example,

weekly bid-ask spreads on agency MBS averaged around 5.5 bps, compared to over 109 bps on corporate debt and 1.7 bps on US Treasuries[4]

Given that the TBA market demonstrates a high degree of liquidity by these measures, it is important to understand what specific liquidity problem the FHFA is trying to address. In our view, the issue is not liquidity in general, but rather, a specific problem associated with liquidity in the Freddie Mac Security. This is reflected in how Freddie Mac enters into pricing contracts with its lenders.

Timing of Guarantee Fees

To minimize the costs associated with the poor performance of its security, Freddie Mac does not provide pricing terms to lenders until immediately prior to delivery of the loans. In contrast, Fannie Mae allows lenders to secure pricing terms for longer periods. While Freddie Mac's approach may be a reasonable way for the agency to manage its costs, it does not fit very well with the lender's pricing and delivery risks. This simple timing difference both reflects and contributes to the liquidity issues FHFA is hoping to solve with the introduction of a single security.

In order to serve borrowers and earn a reasonable return, lenders will guarantee a mortgage rate to a borrower well in advance of the closing date ("rate lock"). Normally, the rate lock period is about 60 days in order to cover the time required for borrowers to complete the purchase transaction and for lenders to obtain the necessary documentation to close the loan. To construct a rate for a borrower, a lender must estimate both the revenues and costs that will arise from producing the loan. In particular, aside from its unique internal costs, a lender will need to know the guarantee fee it will be required to pay when it delivers a loan into a Fannie Mae or Freddie Mac security. The lender will also need to know the forward price of the security into which it will deliver the loan after closing.

Security prices are easily available to lenders via broker/dealers ("dealers") who make markets in the GSE securities. However, as noted above, while lenders have the ability to know the guarantee fee with Fannie Mae at the time of rate lock, Freddie Mac provides only one-month contracts for many lenders and final pricing (which may or may not include MAP adjustments for any particular mortgage rate) is not established until the lender is ready to pool their loans. In general, pricing from Freddie Mac is not made available to lenders until much closer to the delivery of the loans.

When lenders make a commitment to a borrower via a rate lock, a lender is exposed to future market movements in the price of the underlying security. To manage this risk, a lender will sell forward the projected volume of closed loans to a dealer. Given the link between the guarantee provider and the securitization vehicle, the lender must decide to sell a Freddie Mac Gold or a Fannie Mae MBS. Since

[4]http://www.federalreserve.gov/econresdata/notes/feds-notes/2014/measuring-agency-mbs-market-liquidity-with-transaction-data-accessible-20140131.html#fig2

lenders do not have pricing from Freddie Mac and do with Fannie Mae, lenders overwhelmingly decide to sell forward a Fannie Mae MBS (Exhibits 2 and 3).

Selling securities two-months forward is a standard activity through which lenders hedge pricing and delivery exposure. The implication of this activity is that lenders create a "first step of liquidity" by selling Fannie Mae MBS. Again, this liquidity is built overwhelmingly upon Fannie Mae's security, both in terms of volume and share. In fact, since 2011, more than 90% of the two-month forward sale activity has been done via the Fannie Mae MBS.

Exhibit 2

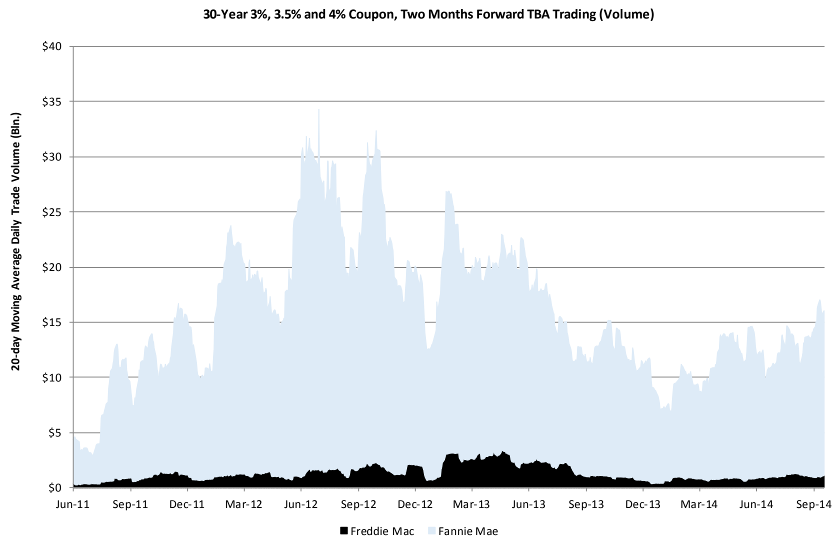
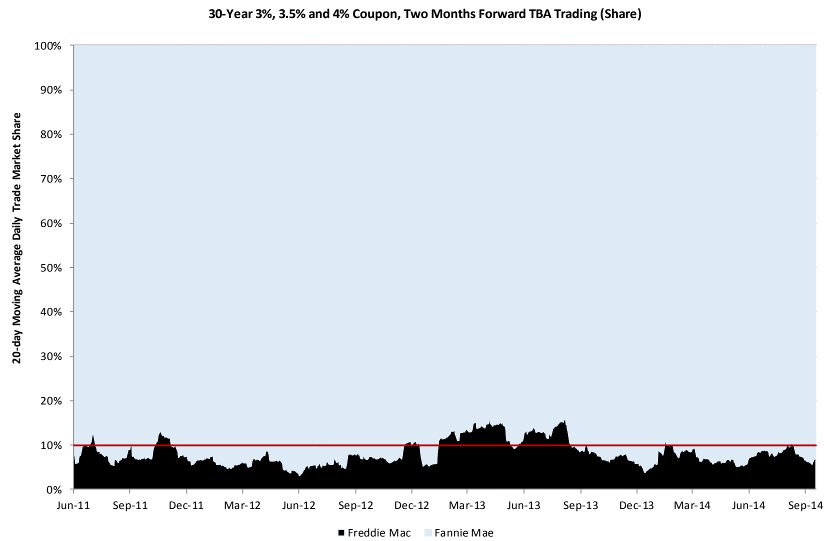


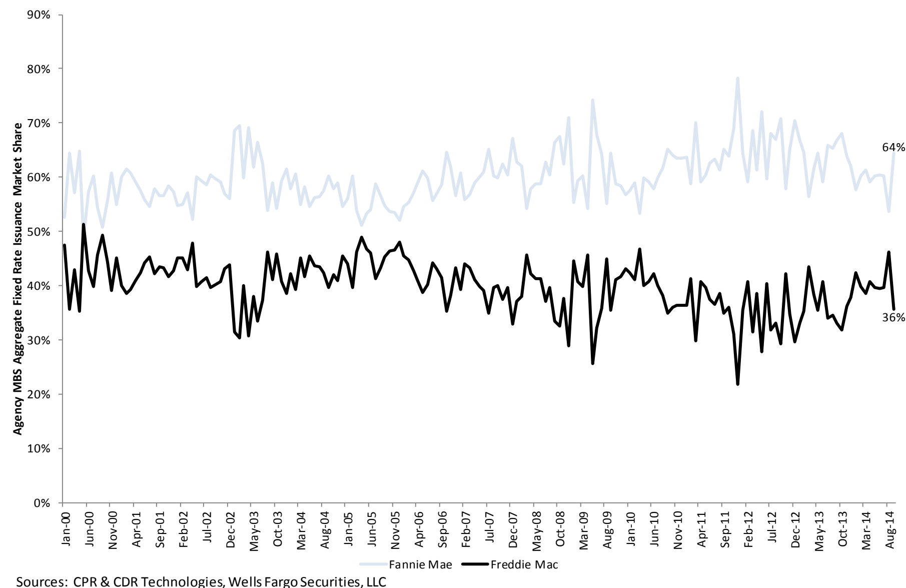
Exhibit 3



Sources: FINRA Trace, CPR & CDR Technologies, Wells Fargo Securities, LLC

Obviously, this forward selling activity does not reflect actual issuance volumes of MBS by Fannie Mae and Freddie Mac. Recent trends show Fannie Mae makes up around 60% of the gross issuance and Freddie Mac around 40% (Exhibit 4). Freddie Mac's pricing approach helps explain this dynamic. In the month prior to delivery, Freddie Mac provides their guarantee fee and pricing adjustment needed to cover the difference to between Fannie Mae MBS and Freddie Mac Golds to lenders. If the pricing terms from Freddie Mac make lenders economically indifferent between issuing Fannie Mae versus Freddie Mac securities, then lenders will accept the pricing from Freddie Mac and issue Freddie Mac Golds.

Exhibit 4



It is at this point that lenders will swap their prior Fannie Mae MBS sales for Freddie Mac Golds (i.e., buy Fannie Mae MBS and simultaneously sell Freddie Mac Golds). This activity is illustrated by the fact that Freddie Mac's volume and share in front month forward TBA trading (Exhibits 5 and 6) is approximately twice as high as it is for two month forward trading (Exhibits 2 and 3). It's important to note that this concentrated level of selling each month in Freddie Mac's securities does not necessarily enhance the liquidity of Golds. Since lenders who agree to Freddie Mac's pricing terms are simultaneously "covering" their original sale of the Fannie Mae MBS, this act is supportive of Fannie Mae liquidity, but puts pressure on Freddie Mac's relative pricing.

Exhibit 5

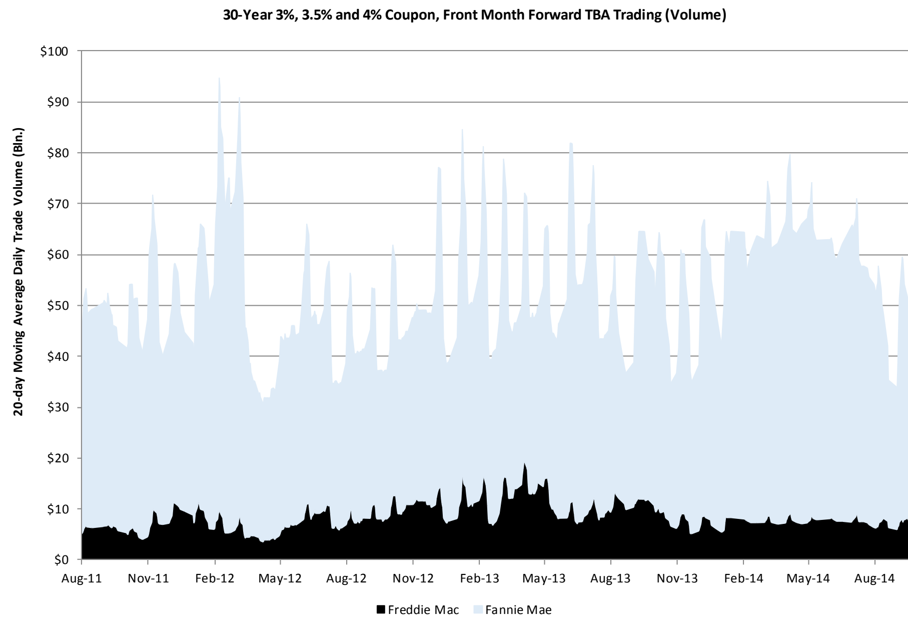
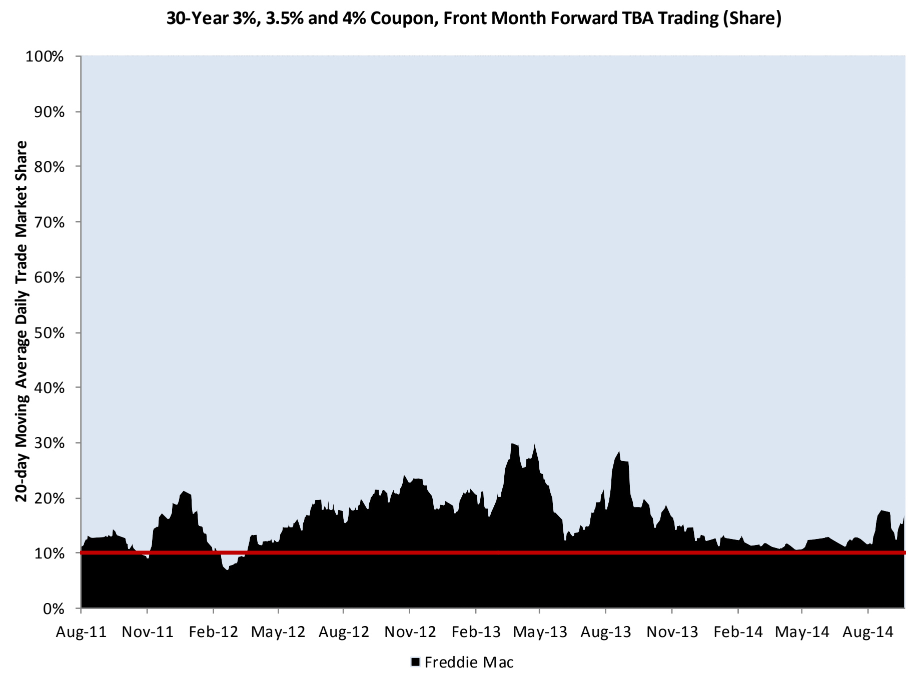


Exhibit 6



Sources: FINRA Trace, CPR & CDR Technologies, Wells Fargo Securities, LLC

Will the FHFA Proposal Help Liquidity?

Assuming that the new security is viewed as truly fungible, its adoption should eliminate the need to engage in swaps to manage the pricing risk that is now associated with delivery into Freddie Mac Golds. This, in turn, should lower costs and improve the efficiency of the TBA market. It will also increase the overall liquidity of the TBA market by creating a larger pool of securities that participants can actively trade.

However, as noted in the body of this letter, there are a number of questions that will ultimately impact how investors will receive this new TBA security - most importantly, how they view their credit exposures and future prepayment rates. How the single security is ultimately received will have major implications not only to Freddie Mac and its lenders as described in this appendix, but to the proper functioning of the entire mortgage market.

FHFA's request for information is a good first step towards creating a single security and addressing the problem of liquidity caused by the Freddie Mac security. However, failure to holistically address the credit exposure and future prepayment topics will counteract the benefits of combining the security platforms. Furthermore, it could negatively impact Freddie Mac as well as Fannie Mae since the market will price the new TBA security to the "weaker" platform or Freddie Mac, while investors and lenders will trade Fannie Mae backed loans as a "specified" security. If done correctly, however, both Freddie Mac and Fannie Mae will be in a better position to help lenders and investors efficiently facilitate less expensive funding to borrowers.

A.2 Impact on Dividends Paid to the US Treasury

Another reason that is often mentioned for moving to a single security while the GSEs are still in conservatorship relates to the impact that a single security could have on the dividend payments received by the US Treasury under the terms of its Preferred Stock Purchase Agreements (PSPAs) with the GSEs.

Freddie Mac securities have traded at a discount relative to Fannie Mae MBS since the conversion to the Gold PC in the early 1990s. While spreads have improved recently due to the convergence of repayment rates on Gold PCs and Fannie MBS, Golds continue to be priced roughly 7/32nd below the pricing of Fannie Mae MBS. Since lenders will receive a lower price from investors for Gold PCs, Freddie Mac has to lower its guarantee fees by an equivalent amount (~5 bps in yield) in order to remain competitive with Fannie Mae. This has led some to conclude that Freddie Mac earnings--and thus, dividend payments to the US Treasury--would rise if pricing disparities were eliminated.

Both the Urban Institute[5] and Deutsche Bank[6] have estimated that moving to a single security would increase Freddie Mac's dividend payments to the Treasury (and hence the taxpayer) by between $400

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[5] http://www.urban.org/UploadedPDF/413218-Charting-the-Course-to-a-Single-Security.pdf

and $600 million a year.[7] However, we believe that this estimate greatly overstates the increase in Treasury revenues that would actually occur. To begin with, the estimate reflects the *lifetime* value of the subsidy of each year's purchases, and is based on loan origination volumes that are typical of a high refinancing environment. In addition, the estimates fail to consider other revenues that would be lost to the US Treasury if a single security were adopted.

While no methodology for calculating the potential Treasury costs of the current and future security pricing is infallible, one approach would be to look at guarantee fees. Simply put, if the Fannie Mae MBS and Freddie Golds traded at the same price, the GSEs should charge the same guarantee fee. A successful move to a single security would presumably remove the current 5 bps subsidy[8] on new production. Assuming Freddie Mac's guarantee book remains roughly stable in size[9] and re-prices at a rate of 10% per year, this would be worth about a $53 million dividend to Treasury in the first year. In the second year, the annual value would grow to just over $100 million[10] as 10% of the remaining portfolio re-priced. This process would continue until the entire guarantee book is re-priced, the PSPAs changes, or the conservatorship ends, whichever comes first. Thus, while a single security would result in increased revenues to the US Treasury, the increase would occur over time and the annual impact would be considerably smaller than the $400 to $600 million estimates would appear to suggest.

It is also important to recognize that some of the revenues received by the US Treasury would be offset by reduced earnings to the Federal Reserve on its holdings of agency securities (which it also remits to the US Treasury). According to analysts' forecasts, the Fed is expected to purchase $20 billion of MBS each month as it replaces runoff on its current $1.7 trillion portfolio over the next year—28% of which should be re-invested in Freddie Golds.[11] If the single security succeeds in increasing prices of Freddie Golds, the Fed will pay more (earn less) to buy and hold these securities to maturity.

Finally, it is useful to consider other aspects of future changes to Freddie Mac revenue streams under a single security. To begin with, legacy security holders may require compensation for moving the payment date back by 10 days. If they do, Freddie Mac will presumably pay the present value of the payment delay to investors upfront, while only receiving the current-period value of the delay—a cash-flow negative operation for at least several years. In addition, Freddie Mac currently earns higher

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[6] Deutsche Bank Markets Research, September 17, 2014

[7] Based on Freddie Mac average 2009-2013 purchase volume of $400 billion, a subsidy of .25%, an estimate that subsidy applies to 80% of volume and that the subsidy is equal to 75% of its economic value ($400B X.25% X 80% X 75% = $600 million). Purchase volume of roughly $265 billion would result in a subsidy of $400 million.

[8] 5 basis point subsidy is implied from the most recent Fannie Mae and Freddie Mac 10-Q SEC filings; disparity on guarantee fee pricing for new book of business

[9] $1.65 trillion, Freddie Mac 10-Q 2Q 2014

[10] First year revenue of 5 bp X 165 Billion, adjusted for taxes ($165B X .0005) X (1-.35) = $53.6 million in the first year, and $48.3 million in the second year (after 10% runoff). Second year purchase volume of $165B would add an additional $53.6 million, making second year revenues $101.9 M ($48.3 M + $53.6 M). After tax income is the basis on which dividends are paid.

[11] As of September, 2014; The Federal Reserve holds approximately $485 billion in Freddie Mac securities

REMIC spreads since it benefits from being able to use cheaper securities to structure the security. As a result, Freddie Mac's REMIC spreads will decline if the underlying MBS are similarly priced. While it is difficult to estimate the magnitude of these effects, they should further reduce any increase in dividend payments that would otherwise accrue to the US Treasury.

In summary, given the other considerations note above, we believe that increased Treasury revenue in the first year will be less than $50 million—and considerably less than $400 to $600 million estimates that are often used. In the end, if the primary objective is to increase the dividend payments that flow to the US Treasury, a much simpler approach would be to require the two GSEs to raise their guarantee fees by 3 to 5 bps.