October 13, 2014

Federal Housing Finance Agency
Office of Strategic Initiatives
400 7th Street SW, Ninth Floor
Washington, DC 20024

FHFA Proposed Single Security Structure: Request for Input

Dear Sir or Madam:

The Structured Finance Industry Group[1] (SFIG) appreciates the opportunity to respond to the Federal Housing Finance Agency's ("FHFA") request for input on the FHFA's Proposed Single Security Structure ("Single Security Proposal"). SFIG's comments are based on the views of the members of SFIG's GSE Reform Task Force ("Task Force"). The Task Force is comprised of constituencies from all areas of the residential securities market, including investors, issuers, servicers, due diligence firms, law firms, trustees, accounting firms, rating agencies and other market participants.

Background

With respect to the mortgage markets, SFIG's primary focus is on the re-invigoration of the private label securities ("PLS") market for residential mortgage-backed securities ("RMBS"), *i.e.*, the "credit" side of the market and not on the "rates" side of the market as represented by Fannie Mae MBS and Freddie Mac PCs (Fannie Mae and Freddie Mac are together referred to as the "GSEs").[2]

However, even though the structural specifics of the single security relate to a side of the mortgage market that is not *per se* the primary focus of SFIG, our membership nevertheless has a heavy stake in the development of the single security and of the Common Securitization Platform ("CSP"), as well as in the reform of the GSEs and of the housing finance system generally. Our

[1] SFIG is a member-based, trade industry advocacy group focused on improving and strengthening the broader structured finance and securitization market, with over 260 members including at present 47 investors. SFIG provides an inclusive network for securitization professionals to collaborate and, as industry leaders, drive necessary changes, be advocates for the securitization community, share best practices and innovative ideas, and educate industry members through conferences and other programs. Members of SFIG represent all sectors of the securitization market including issuers, investors, financial intermediaries, law firms, accounting firms, technology firms, rating agencies, servicers, and trustees. Further information can be found at www.sfindustry.org.

[2] SFIG's investor members tend to be "credit" investors as opposed to "rates" investors.

membership's interest is driven principally by two factors; first, the current size of the "GSE footprint" in the nation's mortgage markets and the uncertainty as to GSE reform efforts makes it difficult for the PLS market to gain traction, and second, regardless of the role of the PLS market, it will almost certainly be the "agency MBS" side of the market that will provide the benchmark pricing, both at the consumer-facing mortgage level as well as at the capital markets-facing securities level. In light of these factors, SFIG remains supportive of efforts to reform the GSEs provided that any transition to a future state includes a gradual transition process to preserve the To Be Announced ("TBA") market and does not create a bifurcated market between newly issued and legacy securities.

In connection with the U.S. Senate Committee on Banking, Housing and Urban Development's hearings in September 2013 on S.1217 and related housing reform issues, SFIG previously authored a memorandum ("Senate Banking Memo") and testimony ("Senate Banking Testimony") regarding a number of the issues presented in the Single Security Proposal.[3] Most importantly, SFIG emphasized the preservation of the TBA market in its current form, particularly during any transition to a single security. In our Senate Banking Testimony, we outlined three **sequential** steps that any reform effort should follow in order to preserve the TBA market:

- First, a conversion into a common TBA should be adopted, making Fannie and Freddie MBS fungible and therefore deliverable into a single TBA market, eliminating current pricing and liquidity inefficiencies in GSE securities.

- Second, any reform legislation should provide for the creation of a single agency security that not only would facilitate the conversion and continued liquidity of legacy securities but also would promote a deep and liquid new-issue MBS market.

- Third, a common securitization platform should be established for the purpose of overseeing and maintaining the standardization of the market for government-guaranteed MBS.

We reiterate our positions as expressed in our prior Senate Banking Testimony, and offer specific observations below as regards to the Single Security Proposal.

[3] The Senate Banking Memo and a transcript of the Senate Banking Testimony can be found under the "GSE Reform" section of our website, www.sfindustry.org.

Discussion

In response to FHFA's Single Security Proposal, we have created an aggregated response to the four questions raised since the questions are, in our view, interrelated.

The TBA Market and the Single Security

As noted above, it has been historically, and is likely to remain the case, that the GSEs' securities will provide the benchmark pricing on which all parts of the U.S. mortgage market are based. This is true at both the consumer level and the capital markets level and is most clearly demonstrated in the pricing of "jumbo" mortgages, the rates (at the consumer level) which generally move in lockstep to conforming loan rates. Similarly, "jumbo" backed PLS RMBS prices are typically based on TBA pricing for pools of conforming loans.

This benchmark pricing aspect is in large part due to the existence of the TBA market. The TBA market (at least with respect to Fannie Mae MBS produces, among other things, the rarest of all financial products – the perfect hedge (or, at least as close to a perfect hedge as can reasonably exist). As FHFA is aware, it is the TBA market that allows mortgage originators to "lock in" rates at the consumer level, especially for the 30-year fixed rate mortgage – the predominant financing option sought by consumers.

To the extent that the TBA market at present deviates from being the perfect hedge, that deviation is due in large part to the *absence* of a single security. The present system of two distinct issuers and guarantors, issuing securities with different payment features and containing loans originated and serviced under different guides has resulted in pricing differentials between the two GSEs' securities.

In addition to their function in the primary market, TBAs are also the mechanism, through dollar rolls, by which the secondary market in agency MBS maintains its liquidity ("dollar rolls" being the combination of one TBA trade with a simultaneous and offsetting TBA trade settling on a different date). This secondary market liquidity has a feedback into the primary market, and the overall effect is to create one of the most efficient securities markets in the world and to bring that efficiency "from Wall Street to Main Street" at the consumer level.

Since the TBA market is a near perfect hedge, it will, by definition, be difficult if not impossible to improve upon. The flip-side of that observation, unfortunately, is that any actions that tend to disrupt the TBA market are likely to have a negative impact on the liquidity of the GSE market and on the pricing of the mortgage products generally. As perfect as the TBA hedge has proven to be, and as robust and deep as the TBA market is, FHFA should not underestimate either how brittle that hedge may become if the GSE securities market were to fragment, or how quickly investors may abandon a market in which they have lost confidence (as of course happened to the PLS market in 2007).

Other commenters have noted that FHFA's proposed single security may be more accurately described as the "synchronized" or "harmonized", rather than "single" security, given

the fact that Fannie Mae and Freddie Mac will remain as separate and distinct issuers and guarantors of securities that will have identical payment terms. Thus, even following the implementation of a single security, there will still remain several categories of "first-level" securities: two separate new issue securities, as well as two sets of legacy securities and a potential new category of legacy securities that have been converted into new single securities. So, in the first instance, the single security initiative may, counterintuitively, result in a larger rather than smaller number of categories of GSE securities.[4] This potential fragmentation may play out most importantly in the new issue market, which is the market most tightly connected with the consumer-facing loan pricing benchmarks.[5]

Some of our members have noted that many investors may have separate name limits for each of Fannie Mae and Freddie Mac, and that without the single security's guaranty being backed by a single source of credit, that approach is likely to continue to be reflected in those investors' investment guidelines. However, since the Single Security Proposal contemplates the re-securitization of Fannie Mae MBS into Freddie Mac Giants and of Freddie Mac PCs into Fannie Mae Megas, there may be an argument to re-assess the application of name limits in respect of those Giants and Megas, since in these structures Fannie Mae credit would be wrapped by Freddie Mac and *vice versa*. How this will play out in practice is far from clear, as counterparty concerns regarding the first-level credit may remain.

To the extent that each GSE is (for lack of a better phrase) inclined to "compete" against the other (e.g., by widening its credit box)– or is affirmatively encouraged to compete against the other, or is given an opportunity to compete against the other through investor-driven "reverse inquires" – new issuances of GSE MBS may fall out of the TBA market altogether and rather trade as "specified or "stipped" pools, on a bespoke basis, if investors discriminate between the two entities.[6] This tendency to differentiate, were it to occur on a large enough scale, may disrupt the perfect hedge aspects of the TBA market, by reducing rather than increasing liquidity and perhaps by fragmenting the benchmark pricing currently derived from the TBA market.

---

[4] The potential for the proliferation of categories of GSE securities may occur even without taking into account that GSE reform efforts have the potential to result in the issuance of an entirely new set of GSE securities that are likely to be issued by newly-created entities with differing credit profiles. We view this "double transition" risk to be one of the major pitfalls to be avoided in the implementation of the single security. We address this point in more detail later in this letter.

[5] Ideally, a true "single security" would have, among other features, a single source of credit backing the guaranty. In this regard, even though the issuers are all distinct, it is probably fair to say that Ginnie Mae securities are in fact closer to actualizing a single security than will Fannie Mae and Freddie Mac securities following the full implementation of the Single Security Proposal. We concede, however, that instituting a single guaranty credit is beyond FHFA's statutory powers, and would need to await statutory GSE reform.

[6] Although the terms are sometimes used interchangeably, "specified pools" are those where the buyer and seller identify the specific pool to be traded by pool number or cusip, and "stipulated pools" are pools of newly-originated loans having specified loan characteristics, particularly characteristics suggesting an expected repayment pattern. Defined markets have also developed for a variety of loan and borrower attributes, such as maximum loan balances, low-FICO, high LTVs, etc.

We are by no means predicting such an outcome. However, the GSEs will (unless Congress eventually mandates a different result) remain separate and distinct, with different personnel, management teams and different buy-side and sell-side relationships. It may be contrary to human nature to expect that each GSE will not seek to distinguish itself from the other, or be asked to, or be presented with the opportunity to, so distinguish itself. How that may play out in relation to the TBA market is unknown.

Similarly, in the secondary market (where over $3 trillion in Fannie Mae MBS and over $1.6 trillion in Freddie Mac PCs are outstanding) the potential for benchmark pricing fragmentation also exists. Among the damaging effects the secondary market may suffer may be the drying up of the dollar roll float, which is likely to occur if the new issuance market moves towards more "stipped" or "specified" executions. A further bad result would be the potential for "orphaning" legacy securities that, for whatever reason, are not exchanged into new single securities. This result would drain liquidity from those legacy securities, leading to much more pricing uncertainty for these off the run securities, and could be further exacerbated post GSE reform, when all GSE securities may become "legacy".[7]

Finally and perhaps most importantly, FHFA should not discount the risk that the combination of single security implementation coupled with the potential for an entirely new issuance regime following GSE reform could cause investors simply to sit out, or at least scale back, GSE security purchases while that process unfolds. In this regard, foreign investors who may be less familiar than domestic investors with the U.S. regulatory framework and political system may be of particular concern. These investors could conceivably and reasonably conclude that it may be better to wait and see what happens, rather than risk being whipsawed by volatility originating from sources they find difficult to understand or even perceive.

Accordingly, to lessen the impact of maintaining multiple securities, SFIG emphasizes the approach set forth in our Senate Banking Testimony—a staged, sequential approach—including the creation of a common TBA prior to the creation of a single security.

[7] Another example of how the design and transition to the single security may impact the TBA market relates to the securities law exemption for agency MBS. Under current law, agency MBS is exempt from registration under the Securities Act of 1933, as amended. Consequently, the prospectus delivery requirements and Regulation AB do not apply to agency MBS and the TBA market has developed without regard to these requirements.

To the extent that each GSE remains as the issuer and guarantor of each issuance of the single security, as is proposed at least initially, then there is no concern under the securities laws. However, the result may be very different if the facts were to change – if the entity that is the CSP were to be the issuer, if a "joint venture" of the two GSEs were to be the issuer – or some other variant. It would not take much of a tweaking of the facts to create an unworkable legal result.

We raise this not because it is an issue under the Single Security Proposal as it is presented in the August 12, 2014 request for input, but because of what may be a natural evolution of the single security into some sort of a unified "agency security" at some point, as the CSP becomes more fully realized.

Questions Related to Implementation of a Single Security Remain

In addition to the specific considerations just described, we note that there are many further details of the single security and of the CSP that will need to be addressed prior to implementation to ensure that as few as possible unintended consequences arise. Among these considerations are:

- other elements of the remittance cycle for seller/servicers, beyond just the distribution date to investors, including the remittance of prepayments, particularly when prepayments in full will be received by investors;

- the status of legacy Fannie Mae securities if Freddie Mac's disclosure regime is adopted;

- to what extent, in addition to the "common features" referenced in the Single Security Proposal, will the selling/servicing guides of the GSEs be conformed; we note that the failure to conform them may exacerbate the tendency to differentiate noted above, that may in turn lead to increased use of specified pool rather than TBA execution;

- to the extent that any mortgage product currently deliverable into TBA securities loses that status as a result of the single security initiative would, in our view, be a step backwards; it is important that all products currently deliverable into TBA securities continue to be available for delivery into TBA securities.

Timing of implementation

It may be difficult in practice to separate the implementation of the single security from the implementation of the CSP. As we expressed in our Senate Banking Memo and in our Senate Banking Testimony, we would recommend proceeding with the implementation of the single security even before the CSP is operational—an approach consistent with our sequential recommendation. As we noted in our Senate Banking Testimony:

> SFIG believes that the best way to facilitate this transition [to a reformed system of housing finance] would be to create a single agency security to which legacy securities would be converted and which Fannie and Freddie could begin issuing even before a single securitization platform is fully functional. This would allow for cost savings as well as greater liquidity in the TBA market. Failure to take such steps not only would discourage investors from participating in both the leftover and post-reform TBA market, but it also would create substantial mortgage funding issues.

More broadly, both the single security and the CSP initiative are being undertaken in advance of Congressional action on GSE reform. Although obviously this is not an ideal way to proceed, we recognize, as FHFA itself manifestly has, that administrative reform of GSE policies and procedures is at present the only viable route to get anything accomplished. As a national consensus on GSE reform remains elusive, only FHFA is currently in a position to bring enhanced efficiencies to GSE operations. Therefore, our recommendation is that neither the single security nor the CSP initiatives should wait for GSE reform by Congress.

This recommendation is, however, tempered by the "double transition" risk noted above – the potential for either or both operational issues or investor confusion/skittishness to arise as a result of single security implementation preceding GSE reform. Obviously, the results of statutory GSE reform would trump FHFA-initiated actions. It may not be overstatement to say that GSE reform is among the most politically-charged issues of our times (as evidenced by the different approaches taken by the House Financial Services Committee and by the Senate Banking Committee during the current Congress). It further may not be overstatement to characterize the outcome of GSE reform as "unpredictable". This of course increases the risk that the single security initiative may find itself wrong-footed, and headed in a different direction than GSE reform. It is essential that FHFA appreciate that the *risk alone* of the single security being caught wrong-footed is enough to cause investor skittishness, even if ultimately everything works out fine. Consequently, it is essential that FHFA manage the risk of investors' legitimate concern that GSE reform could upend the single security initiative.

The best risk mitigant in our view is for FHFA to adopt the sequential approach referenced above: proceed with the required changes only in small increments announced in advance, assess market reaction to the steps taken both individually and cumulatively before taking the next step, and keep one eye trained to detect any movement on GSE reform that would affect the single security.[8] We acknowledge that this progress of continuous re-assessment may give a "start and stop" appearance to the single security implementation process, but we also think it will go a long way towards providing investors with needed comfort as the political aspects play out.[9]

---

[8] At all stages during the reform process – including both FHFA-initiated reforms as well as statutory reforms – care must be taken to avoid any risk of market fragmentation, particularly regarding the critical importance of maintaining a similar guaranty. Looking ahead, we note that there will be yet more work to do post GSE reform. To avoid in the future the issues we have raised in this letter, legacy securities (which at that future time may include all GSE securities) will be at risk of "orphaning" unless the guarantees (including the credit source) and payment terms are harmonized with the post-GSE securities.

[9] We also believe that it would be useful to phase in any required changes to the GSEs' securities and the guides by beginning with easier, less controversial items and then moving on to the harder items. For example, FHFA could begin the process by harmonizing reporting requirements at the security level, moving on to refinancing programs, then buyout policies and so on, working up to the payment features (such as payment delay) of the securities at the end of the process.

Smooth Implementation of the Single Security with Minimal Risk of Market Disruption

SFIG strongly believes that a public and transparent process by which FHFA and the GSEs work with stakeholders representing all aspects of the mortgage finance industry is the surest way to achieve smooth implementation with minimal market disruption.

We are of the view that a process of active engagement among FHFA, the GSEs and the Securities Industry Financial Markets Association ("SIFMA") is required. The policies and procedures of the TBA market are not under FHFA's (or, generally, the government's) purview, but rather are established by SIFMA. To have FHFA finalize the details of the single security without the input of and buy in from SIFMA would in our view be a mistake. It could lead to substantial unintended and negative consequences at both the consumer and capital markets levels. We want to re-emphasize that to the extent the TBA market represents a near-perfect hedge, tampering with it is more likely to make things worse rather than better.

Although we consider SIFMA's participation in the process necessary, we would further recommend that FHFA actively engage with other industry participants as well, in a formal and transparent way. As we said in our introductory remarks, although SFIG's primary focus is on the PLS market, whatever happens with respect to the single security will clearly impact that market. Consequently, we would welcome being part of any "working group" to assist in the development of a single security and the CSP.

We further ask FHFA to consider having one or more organizations representing the following groups of stakeholders be part of any working group or other mechanism that may be established, and that periodic, publicly-announced formal meetings of that group be held:

- Mortgage investors;
- Mortgage bankers;
- Community banks; and
- Clearing corporations.

The process that we have in mind in terms of active, transparent, periodic and formal engagement can be illustrated by several approaches the Securities and Exchange Commission has recently undertaken in the area of asset-backed securities such as the "credit rating agencies roundtable" and the upcoming "pilot program" for Regulation ABII.

In the event that FHFA determines that it is not in a position itself to sponsor and co-ordinate such a process, due to legal impediments or otherwise, then we would hope that FHFA would support, and of course participate in, such a process were it to be coordinated by another entity. Our view is that SIFMA, perhaps in conjunction with the Fixed Income Clearing Corporation, would be in the best position to serve in that role if FHFA cannot. To be clear, our

preference is that FHFA itself take the lead in any such process. But we believe following such a process of active, transparent, periodic and formal engagement is ultimately more important than which entity co-ordinates it.

Finally, we urge FHFA to release its final single security proposal for further comment prior to implementation. This will allow stakeholders which are important, but not necessarily involved in the development of the single security (for example, foreign investors) to focus on the proposed outcome at the appropriate time.

The risks of getting the single security initiative wrong, or just off-track, are high, and the negative consequence may be great. At best, achieving a broad consensus on implementing the single security initiative may demonstrate that achieving a similar consensus on GSE Reform more broadly is not an unreachable goal.

We greatly appreciate the opportunity to provide input on the Single Security Proposal. Please contact the undersigned at Richard.Johns@sfindustry.org or 202.524.6301 with any questions or comments.

Sincerely,

Richard Johns
Executive Director