



Submitted via email to: RegComments@fhfa.gov

November 16, 2018

Robert Ryan
Acting Deputy Director, Division of Conservatorship
Federal Housing Finance Agency
400 7th Street, S.W.,
Washington, DC 20024

Re: RIN 2590-AA94, Uniform Mortgage-Backed Security Proposed Rule

SIFMA¹ is pleased to respond to FHFA's Notice of Proposed Rulemaking (NPR) regarding the implementation of the Uniform Mortgage-Backed Security (UMBS). We appreciate the continuation of the dialog between the FHFA and the MBS market. As FHFA knows, SIFMA has been an active and highly engaged participant in this dialog over the last five years, and shares FHFA's goal of a well-functioning and liquid secondary market.

The NPR mentions the effect on competition and suggests that boosting competition between Fannie Mae and Freddie Mac would have "potential benefits to mortgage rates and the availability of mortgage credit". We agree but also believe that we must strive to prevent competition from degrading the value of MBS which in turn will lead to higher costs to borrowers.

We have identified three aspects of the NPR that should be strengthened so as to reduce risks that the launch of single security fails to achieve our shared goals of the enhancement of liquidity and the continuation of the benefits to borrowers that the TBA market currently provides. We believe that these issues can be addressed without significant burden, in a manner consistent with the practical constraints previously outlined by FHFA and the GSEs, and describe our suggested approaches below.

We understand the timetable for the proposed launch of UMBS; however we think it is critical that these outstanding issues be addressed before the launch. They are that critical to the success of single security initiative.

In this letter we will address three key points:

1. We support the issuance of a regulation including our suggestions contained herein to codify the extensive alignment activities that have taken place over the past few years.

¹ SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly 1 million employees, we advocate on legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit <http://www.sifma.org>.

2. The definition of “alignment” should be revised in two ways to focus more granularly on what actually drives TBA market pricing.
 - a. First, “alignment” in prepayment behavior should be tracked versus the cheapest to deliver quartile, or at a minimum, the proposed cohorts with specified pools stripped out.
 - b. Next, the definition of “alignment” should include within its scope mortgage pool-level characteristics that drive future prepayment activity. Of these, the gross WAC is the most important characteristic that can and should be aligned between the GSEs’ production.
3. FHFA should outline a wide menu of remedies that reflect the breadth of its existing authority regarding misalignment, in order to provide confidence to investors that not only will misalignment be corrected, but that the GSEs will have little incentive to take actions that cause misalignment.

We appreciate the opportunity to submit these comments on this important initiative, and we look forward to discussing them further. By understanding what frictions and obstacles they may present, we can work toward solutions that are mutually beneficial. Our shared goal is the continuation of the ability of the TBA market to provide the significant benefits to mortgage borrowers that it has provided over the past 40 years. Our suggestions on the following pages will help the industry, FHFA, and the GSEs achieve this shared goal.

Please do not hesitate to contact me at 212-313-1126 or ckillian@sifma.org if you would like to discuss these comments further.

Regards,



Christopher B. Killian
Managing Director
Securitization and Credit Markets

1. We support the codification of alignment initiatives as it will instill confidence in the TBA market that the progress achieved to date will not be capriciously undone.

SIFMA recommends that:

- *FHFA finalize a regulation incorporating our suggested modifications to the NPR.*
-

We are pleased that the FHFA has taken steps to make more permanent the changes that have been made at the GSEs in order to try to ensure that the performance of their MBS is similar. The success or failure of UMBS will be determined by how well GSE MBS performance is aligned, and how strongly the market believes it will remain aligned. While any action taken by one administration can be reversed by the next, formal rulemakings are more likely to remain in place, and in any case, changes to them will require further discussion with the public regarding the merits of the changes, costs and benefits, etc. Accordingly, SIFMA supports the issuance of this regulation (with our suggested changes noted below), and we believe that the regulations should be periodically reviewed to ensure that they appropriately promote alignment.

2. The definition of “alignment” should be enhanced along two distinct lines:

- ***First, to be effective in protecting the UMBS TBA market, the definition of “alignment” must focus on the subset of MBS that impacts TBA pricing. Alignment should be measured at the cheapest-to-deliver quartile.***
- ***Second, “alignment” must also prevent material deviations in the key pool characteristics that drive future prepayment activity. Of these, the gross WAC (within a given production coupon) is the most important characteristic that can and should be aligned between the two GSEs.***

Prepayment Alignment Recommendations:

1. *FHFA should redefine the “cohorts” that are compared to be based on the worst quartile of each GSEs production on a rolling three-month basis, excluding specified pools which are typically not delivered into TBA (“CTD cohorts”). This will provide a more meaningful view into performance differences that drive TBA pricing and liquidity.*
2. *FHFA can define a somewhat larger allowable deviation between the two GSEs for these narrower CTD cohorts in faster prepayment environments, such that in stages the threshold can expand to 5 CPR.*

Production Alignment Recommendations:

1. *FHFA should evaluate and monitor all important loan attributes that impact future prepayment behavior on a quarterly basis between the two GSEs as it is highly unlikely that future prepayment behavior will be similar if the initial pool characteristics are materially different. Characteristics that should be evaluated include but are not limited to WAC, WAM, geographic concentration, FICO, LTV, loan balance, and loan purpose.*
2. *FHFA should instruct the GSEs to take appropriate and proactive steps to address material deviations in cohort characteristics in a timely manner, irrespective of actual prepayment behavior, early in the life of a mortgage.*
3. *FHFA should include in the regulation that CTD cohort WACs for both GSEs be within a 10bp tolerance and should expect that total production level cohort WACs be within 5bp.*

4. FHFA should also limit aggregate WACs for a total production cohort to 75 bps over the passthrough coupon unless there is a material increase in aggregate G-fees
 5. FHFA's monitoring process should look beyond the hard thresholds for early warning signs of prepayment differences such as significant differences in individual seller/servicer prepayment or pooling behavior between the two GSEs, as this may be a signal of GSE policy and program misalignment.
-

Cohort Specification

Section 1248.1 of the proposed rules provides that: “**Align or alignment** means to be sufficiently similar or sufficient similarity as to produce a conditional prepayment rate (CPR) divergence of less than two percentage points (or less than the prevailing threshold for alignment set by FHFA, per § 1248.5(c)), in the one-month CPR for a cohort”. The preamble notes that: “For this purpose, FHFA would define a cohort as TBA-eligible securities with the same coupon, maturity, and issuance year”.

We note that certain cohorts (e.g. current or recent production) may be quite large. Additionally, this proposed cohort would include pools which are not typically delivered into TBA trades – for example, low loan balance pools which typically trade specified with a payup. Therefore, the current selection of the total production coupon is inconsistent with the practical reality of how the TBA market actually functions and would allow for substantial differentiation between the two GSE's with respect to their true TBA deliverable universes. For example, it would require a very significant amount of poorly-performing collateral issued by one GSE to shift a prepayment speed of a large cohort by 2 CPR. On the other hand, a materially smaller amount of poorly-performing issuance may be sufficient to disrupt the TBA market and cause significant changes in market pricing, the exact scenario all market participants including FHFA are trying to avoid.

FHFA summarized this point, made in our July letter, aptly: “However, because cohort-level impact could be minimal due to the large size and diversification of annual coupon issuance, the July SIFMA letter suggests that special consideration should be paid to deviations in more narrow breakouts such as cheapest to deliver quartiles, deciles, loan balance breakouts, geographic concentrations, and otherwise”.

We continue to believe that this is a critical measure of alignment and suggest that it should not only be a measure used in reporting on performance, it should also be used in the determination of alignment and should therefore have a predetermined, albeit wider threshold in faster prepayment environments. A year/issuer/coupon cohort is too broad – we believe FHFA should, at a minimum, implement a year/issuer/coupon standard that excludes specified pools (e.g., LLB, MLB, GEO pools, which could be defined as pools that trade at a premium to the Bloomberg/Barclays MBS index) for the definition of alignment. That said, our recommendation is to use the worst quartile of production for each GSE on a rolling three-month basis (comparing three 1-month CPR measures).

With this narrower definition for the “cohort”, we believe FHFA could define the base threshold for misalignment at 2% in slower prepayment environments, but the threshold could be variable and expand in steps to a 5 CPR differential in faster prepayment environments. When the entire cohort is prepaying less than 15CPR, the threshold could be 2 CPR. For 15-20 CPR, the threshold could be 3 CPR, 20-25 the threshold could be 4 CPR, and above 25CPR a threshold of 5 CPR (in each case, accounting for whether there is an offsetting benefit provided to the upper quartiles).

Proactive Measures to Prevent Misalignment – Alignment of Loan and Pool Characteristics

As all seasoned mortgage market participants are aware, it often takes several or more years for many production cohorts to become refinable. This mortgage market reality is a function of the fact that a meaningful decline in interest rates is required to create sufficient incentive for borrowers to refinance their mortgage. Additionally, other non-rate driven types of prepayments such as housing turnover, cash-out refis, defaults, or other life events generally require a mortgage to season at least a couple of years. That said, loan characteristics are very strong predictors of future prepayment performance and are available at the time of issuance. FHFA and the GSE's must pay special attention to ensuring that the key underlying loan attributes between the two GSE's are also within a reasonable tolerance or the reality is that there will be misalignment. It will only be a matter of time before the prepayment differences materialize.

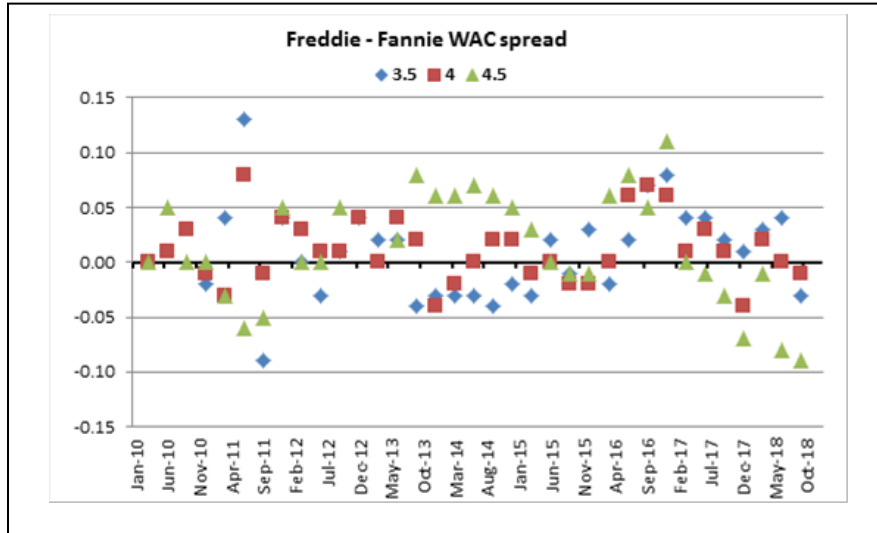
WAC Alignment

Of the loan level characteristics, the gross WAC is the most important characteristic that must be aligned between the GSEs' production. The first and most important input into any mortgage prepayment model is the difference between the current mortgage rate and the gross WAC of the pool. Therefore, if gross WACs differ materially, then significant prepayment deviations are almost a certainty at some point in the future.

Other characteristics that should be monitored over time include WAM, age, FICO, LTV, loan balance, loan purpose, originator mix, and geographic distribution.

We note that in the definition of "covered programs, policies, or practices" that weighted-average coupons of MBS are not included. On the other hand, G-fees, LLPAs, sale agreements and other items are included. We believe that FHFA needs to make it clear that they are committed to ensuring the general alignment of WACs between the two GSE's as part of the alignment analysis. Pool WAC is a variable that the GSEs are able to materially influence via buy-up/buy down ratios, pooling decisions on their conduit production, and via discussions with seller/servicers. This does not mean that all factors that go into a pool's WAC (e.g., buyup/buydown grids) must be aligned, but in the end the GSEs need to manage to a similar WAC result. Maintaining alignment on WACs may turn out to be an iterative process when material deviations are identified, but can be rectified within one or two months with proactive efforts on the part of the GSE's.

We strongly believe WAC alignment is absolutely critical to any effort to ensure consistent prepayments. To this end, we propose that differences in WACs (at the cohort level we defined above) between the GSEs should not exceed 10bp, and when they do, FHFA should mandate remedial action to bring them in line. Realistically, we would expect the GSE's to monitor these statistics on a monthly basis and to start to address differences before an actual breach of the threshold occurs. Based on historical data we've reviewed, WACs have been generally less than 10bp different between the GSEs (see chart below), which means this provision would be protective to investors and enhance their confidence in alignment, and not be burdensome to the GSEs.



Source: SIFMA member analysis

We also recommend a cap of 75 bp on the difference between the gross WAC less the passthrough coupon for all annual production coupons comprising at least 10% of total production. We believe this cap is substantially above where gross WACs have been for almost all such coupons dating back years. If gross WACs were to increase in an uncontrolled manner (even with alignment), TBA pricing would be materially negatively impacted and mortgage rates will rise. Based on data we have reviewed covering 2010 through 2018, gross WACs have averaged 56bp above the passthrough coupon for Fannie Mae and Freddie Mac. The largest difference between gross WAC and the passthrough coupon for any material annual cohort since 2010 was 78 bp, which happened in 2015 FN 3s; one other period saw a gap of 75. As with the comparison between the GSEs in the paragraph above, based on historical data we've reviewed, we believe this policy would be protective to investors, enhance their confidence in alignment, and not burdensome to the GSEs.

FN WAC - coupon spread (bp)

	3	3.5	4	4.5	5
2010	59	64	50	44	35
2011	65	53	47	43	37
2012	59	51	47	46	49
2013	59	54	59	55	43
2014	87	74	59	53	39
2015	78	62	58	49	57
2016	66	59	52	42	44
2017	66	56	47	48	49
H1:2018	92	58	53	55	62

FH WAC - coupon spread (bp)

	3	3.5	4	4.5	5
2010	57	59	49	45	36
2011	73	56	48	39	34
2012	62	50	49	47	38
2013	58	53	58	63	59
2014	80	72	59	59	53
2015	75	62	57	48	
2016	71	62	56	49	31
2017	74	58	48	45	52
H1:2018	86	65	55	49	52

Source: SIFMA member analysis. Shaded cohorts were <10% of total production during that period.

Gaps In Servicer Performance Between the GSEs Need to be Monitored and Investigated

In addition to monitoring the differences in loan characteristics between the GSE's, there are other things FHFA and the GSE's should evaluate as leading indicators of misalignment as we believe they are equally important. Differences in a given originator's and/or seller/servicer's behavior between the two GSE's may be important indicators of misaligned policies or programs. As FHFA stated in its NPR,

“programs, policies, and practices can influence origination patterns as well”. If originators are consistently selling one type of product to one GSE and other types of loans to another, this could lead to different prepayment patterns. Conversely, if a particular originator’s production is prepaying differently between the two GSE’s, this is also worth investigating. FHFA and the GSEs should be proactive in the monitoring process and not wait until prepayment differences exceed thresholds before acting. Lastly, FHFA should monitor any *sudden* shift in origination patterns, in either enterprise, including loan characteristics and market share.

Alignment Can Mask Problems - FHFA should also monitor overall performance metrics to ensure liquidity

SIFMA members remain concerned about the scenario whereby there is a gradual disintegration of the quality of the TBA as each GSE attempts to match the other’s efforts to roll out new programs in an attempt to gain market share. A cohort level threshold, even amended to focus on cheapest-to-deliver as we describe above, will not expose this type of behavior, given that the deterioration will be aligned. In a single security regime, any action a GSE takes that accelerates prepayment behavior or incentivizes churning will also harm the value of their competitor’s MBS. Accordingly, the check on a GSE’s actions previously provided by the need to protect their own MBS market is removed, and an action that a GSE may not have taken in an attempt to gain market share in the past (because of concern for a relative cheapening of their MBS) may now be more palatable (because MBS should be harmed equally given a common delivery). FHFA should monitor overall MBS performance metrics in order to identify and remediate, e.g., instances of prepayment speed increases that don’t correspond to a significant decrease in interest rates or some other typical driver of speeds. We recognize that this is a more complex exercise than the relative performance monitoring discussed above. Additionally, we have no intention of stifling innovation or preventing the adaptation of new programs that are clearly beneficial to borrowers. However, we are concerned that competitive dynamics between the two GSE’s could lead to programs that may not provide material benefits to borrowers while devaluing the TBA market. A cheapening of the TBA market would in turn harm borrowers, originators, and holders of MBS.

Alignment of Servicing Policies and Practices

We recognize that the GSEs have undertaken an extensive Servicing Alignment Initiative which has aligned many policies and practices. We agree that all “management decisions or actions” that may reasonably foreseeably affect MBS performance should be aligned and clearly include all GSE policies, products, and servicing requirements that may have such effects. Our seller/servicer members have indicated that additional clarifications are needed, for the purposes of creating a comprehensive regulation, that the definition of “Covered Programs, Policies, or Practices” explicitly includes other servicing requirements that affect efficiency and servicing costs, including servicing guidelines, foreclosure requirements and timelines, advancing and remittance, and obligations to remit payments.

- 3. SIFMA recognizes that FHFA’s regulatory powers are broad and go beyond the few remedies laid out in the NPR. Accordingly, the final rule should reference stronger practical remedies for misalignment that FHFA may implement to provide market participants with greater comfort that alignment will be maintained over time, and that any instances of misalignment will be short-lived and appropriately addressed. By highlighting more completely the menu of remedies available to FHFA, investor confidence in UMBS will be enhanced, improving the program’s probability of success.**

The remedies set forth in the NPR do not reflect the full breadth of FHFA’s authority, do not address issues that can no longer be impacted by changes to new business activities, and are unlikely to serve as a significant disincentive to prevent misalignment.

Importantly, SIFMA fully understands that it would be both impossible and inadvisable for FHFA to attempt to codify its specific reaction to every type of “misalignment” that might occur. Our request is simply to expand the enumerated menu of potential remedies that the FHFA may consider in the event of a material issue.

SIFMA Recommends that:

1. FHFA should explicitly clarify that it may require a GSE to stop a program.
2. FHFA should explicitly clarify that it may require a GSE to implement a program similar to one currently in effect at another GSE.
3. FHFA should explicitly acknowledge that some instances of misalignment cannot be addressed by changing future origination or pooling behavior as the cohort may have been originated more than a year ago or the coupon may not be in the current production window.
4. For instances of misalignment where changes in current origination or pooling activities at a GSE cannot address the problem, FHFA should clarify that it will still evaluate alternatives to limit the consequences of the problem. Potential actions could include directing a GSE to repurchase loans at market levels in instances where their inclusion in TBA pools significantly harmed the market. FHFA should also direct the GSEs to clarify their investor claim policies, which have been used in the past in instances where GSE actions harmed investors.
5. FHFA should clarify that a potential remedy could include penalties for a GSE that caused misalignment in extreme cases where the impact of a new program or policy should have been predictable.

FHFA proposes the following remedies for misalignment:

- *“Require an Enterprise to undertake additional analysis, monitoring, or reporting to further the purposes of this part.”*
- *“Require an Enterprise to change covered programs, policies, and practices that FHFA determines may conflict with the purposes of this part.”*
- *“To address material misalignment, FHFA may require additional and expedient Enterprise actions based on:*
 - o *Consultation with the Enterprises regarding the cause of the material misalignment;*
 - o *Review of Enterprise compliance with previously agreed upon or FHFA required actions;*
 - o *Review of the effectiveness of such actions to determine whether they are achieving the purpose of this part.”*

These measures have not provided comfort to our members that the GSEs will be appropriately disincentivized from taking actions that harm the TBA market. More importantly, these measures do not even attempt to address the likely scenario where an instance of “misalignment” occurs that cannot be addressed via changes to current origination related activities. For example, if a large rally in interest rates occurs in the middle of 2020 (and the main production coupon is now 3.5s), what will FHFA do to address material prepayment differences in FH and FN UMBS 2019 4.5s? Changing current origination activities can help mitigate the issue in 2020 UMBS 3.5s but those actions will have no impact on UMBS 4.5s. If the issue was caused by 5% of the Fannie cohort that was originated under a

specific new program that was forecasted to have no impact, we would hope that FHFA and the GSE's would not just ignore the issue, given that TBA pricing, and therefore mortgage loan pricing, will be worsened. While market participants fully understand it is their responsibility to take on reasonable prepayment risks, it seems logical that there may be some instances similar to the above example where the best course of action would be for a GSE to remove the loans at issue and repool them outside of TBA.

For issues that can be addressed by changes in current activities, the strongest remedy currently defined is requiring a GSE to change a program. We assume this includes requiring a GSE to stop a program – but that is not specified in the rule, and it should be. That being said, this may not be a complete remedy. A GSE may have an incentive to undertake a program that is financially attractive but may not be in the best interests of MBS investors or the borrowers whose mortgage rates are set by TBA prices. Under UMBS, the consequences will be borne by future borrowers in the form of higher mortgage rates and a GSE does not have to worry about their “currency” being tarnished by the behavior as the other GSE will suffer the same pricing hit. As such, stopping a program will address the issue in arrears but it still gives a GSE incentive to undertake the program.

For this reason, we believe FHFA should specify more clearly that it may order remedies that are stronger and provide financial or other disincentives to engaging in activities that harm the TBA market and the borrowers who are supported by it. We note in this regard that the recent proactive actions by GNMA should serve as a precedent of how such actions can provide strong deterrents to prevent bad behavior and lead to lower mortgage rates for borrowers. The final remedy, “[FHFA] *may require additional...Enterprise actions*”, may be intended to include the full breadth of FHFA's regulatory powers, but this is not clear. The market and the GSEs will be best served by a transparent understanding of the options that will at least be considered and possibly implemented.

Accordingly, the menu of options detailed in the regulation should be expanded to include potential remedies for these more egregious situations, including the following:

- That the FHFA may levy fines or other penalties on the GSEs for policies or programs that create significant misalignment that should have been foreseeable;
- That the FHFA may require a GSE to activate their claims process to compensate holders of securities which exhibit the consequences of egregious misalignment.
 - o There is precedent for this type of action. In the past, GSEs have compensated holders for issues which caused harm – for example system errors which resulted in the unplanned repurchase of loans from MBS.² However, if and how these compensation policies would work for UMBS is unclear to the market. FHFA should clarify, or direct the GSEs to clarify, what their compensation or claim policies and mechanisms are.
- That the FHFA may require a GSE to take actions to remove problematic loans from MBS at market levels, and repool those loans in non-TBA-eligible securities.

We reiterate that this detail of an expanded menu of remedies is not intended to suggest any particular action in response to any particular problem, and we believe FHFA is already empowered to compel any of these actions. Rather, listing a broader yet practical set of remedies that will be considered in the final rule will go a long way in enhancing the confidence of investors that alignment will be maintained over time and that GSEs will not have incentive to take actions that create misalignment. These

² See, e.g.: <http://www.fanniemae.com/resources/file/mbs/pdf/faqs-removal-loans-mbs-pools.pdf>

enhanced remedies will therefore significantly improve the odds of a successful UMBS program thus enhance TBA market liquidity and maintaining or lowering mortgage rates for borrowers.