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ASSOCIATION

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Director Sandra Thompson
Federal Housing Finance Agency
Office of the Director
400 7th St SW, Washington, DC 20024

Re: 50 bps fee on commingled UMBS securities under Enterprise Regulatory Capital Framework

Dear Director Thompson,

We are writing regarding the 50 basis point fee that Fannie Mae and Freddie Mac (the "GSEs" or "Enterprises") added to commingled Uniform Mortgage Backed Securities ("UMBS") pursuant to the 2021 Enterprise Regulatory Capital Framework ("ERCF")("Commingling Free"). We appreciate FHFA's strong affirmation and support for the UMBS initiative, as well as your willingness to engage with the industry on alternative options that will mitigate or avoid the adverse impact that these fees will have on the liquidity of the UMBS market, which would ultimately flow through to borrowers in the form of higher mortgage rates. At the same time, we recognize your responsibility as regulator and conservator to uphold the provisions of the ERCF, including the current requirement for each GSEs to cross-guarantee the collateral of the other Enterprise.

Having consulted with our members, we would like to take this opportunity to share some of their views, including alternative ways for the Enterprises to fulfill their regulatory capital obligations to maintain the overall safety and soundness of the GSEs, while limiting the adverse impact to the market, ultimately, any harm to consumers. At the outset, we'd like to note that while these views are derived from SFA's members, they should not be construed as consensus view from among SFA's membership. Indeed, given the breadth of SFA's membership, it is likely that some of our members would prefer one option over another. That said, we hope these suggestions are helpful in thinking about alternative ways to implement provisions of the ERCF.

I. Guiding Principles

We would first like to enumerate three guiding principles that provide support for the various options set forth below. In a complex task such as setting the appropriate capital levels of the GSEs, we recognize that there are competing priorities which can at times conflict with each other. While we understand the 50 bps fee was implemented pursuant to overarching principle #3 (Safety and Soundness), we believe it runs afoul of Principle #1 (Liquidity and Fungibility) and #2 (Market Certainty). However, we believe that there are alternative means whereby all three guiding principles can work in harmony, and our proposals seek to harmonize the three guiding principles discussed below.

a. Liquidity and Fungibility

Alongside the GSEs Credit Risk Transfer Programs, the UMBS is one of the two most important and critical innovations to arise from the GSEs during the Conservatorship. In a May 2021 Report, the Federal Reserve of New York published a study titled "Defragmenting Markets: Evidence from Agency MBS", which looked at the effects of the combined UMBS, and stated:

> We find that consolidation ***increased the liquidity and prices of Freddie Mac MBS without measurably reducing liquidity for Fannie Mae***; this was in part achieved by aligning characteristics of the underlying MBS pools issued by the two agencies. Prices partially converged prior to the consolidation event, in anticipation of future liquidity. ***Consolidation increased Freddie Mac's fee income by enabling it to remove discounts*** that previously compensated loan sellers for lower liquidity (emphasis added).[1]

Any change in the fungibility of MBS from either Enterprise or from blended pools would be detrimental to the success of the UMBS, as it would adversely impact liquidity. Importantly, the liquidity benefits owing to the Single Security Initiative (i.e., improved pricing due to enhanced liquidity) apply across the board to all securities—including single-issuer pools—and not just to blended securities. Given that the benefits apply to all Agency MBS, and not just commingled securities, it follows that the costs should apply more widely, and not just to the blended UMBS pools.

It is essential to recognize that investors have already "paid up" for UMBS in the pricing that resulted from the Single Security Initiative. Investors were willing to accept lower interest coupons in exchange for the increased fungibility that resulted from the UMBS. The lower-interest TBA coupons—along with the removal of discounts previously paid by Freddie Mac—underscored the purpose of the UMBS and represent a policy victory for the entire market.

b. Market Certainty

Market participants need to have certainty that the policies enacted today will be in place over a long-time horizon. Changing the rules of the road presents a significant source of uncertainty this will not only negatively impact the liquidity and pricing of UMBS but also the confidence of future regulatory decisions.

The success of the Single Security Initiative is predicated upon the implicit and explicit understandings that were formulated in the years leading up the creation of the UMBS. This includes the understanding that lower UMBS bond yields would be offset by an increase in fungibility, a point which investors continue to rely upon today. Any abrogation of that understanding—including increasing the costs paid by investors by adding a 50 bps fee to commingled Supers—risks the ongoing viability of the Single Security initiative. This is true not only for the present 50 bps fee, but also because implementation of the fee signals to market participants that additional fees may be added at any time in the future.

[1] See: https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr965.pdf

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c. *Safety and Soundness*

SFA strongly supports the need for the Enterprises to operate in a safe and sound manner, and we understand that the cross-guarantee fee was pursuant to provisions in the ERCF that ostensibly sought to increase the safety and soundness of the GSEs. We also believe capital requirements should not be punitive or duplicative, and should reflect risk mitigations such as collateral, risk-sharing, and third-party guarantees. As detailed below, we believe that the Treasury's backing under the terms of the Preferred Stock Purchase Agreements ("PSPAs") are among the mitigating elements that FHFA could consider when implementing the ERCF. Therefore, the alternatives we outline below are mindful of the statutory requirement for GSEs safe and sound operation, as well as FHFA's regulatory mandate, and believe that the options set forth below represent ways to harmonize the guiding principles of Liquidity and Fungibility, Market Certainty, and Safety and Soundness.

II. Alternative Implementations of the ERCF

SFA believes that there are alternative ways to implement the requirements of the ERCF that would not adversely impact liquidity, but that still allow the GSEs to operate in a safe and sound manner. In presenting these options, it is important to distinguish the imposition of the 50 bps fee from the ERCF's requirement of a cross-guarantee itself. Thus, while we recommend suspension of the 50 bps fee in the short term, it is with a medium- and long-term view of additional steps that should be taken to achieve the same policy goals of operating the Enterprises in a safe and sound manner. As noted above, neither the options themselves nor the order in which they are presented represent consensus views from SFA members as to which, if any, of these are the best option.

a. *Suspend 50 BPS Fee, Impose a Lower, Broad-based Alternative Fee*

The first option is to suspend the 50 bps fee that applies only to commingled securities, and instead impose a much smaller fee (i.e., 1 or 2 bps) on all UMBS securities. As noted above, SFA believes that the benefits of increased fungibility apply to all UMBS, not just those which commingle collateral. Thus, it may follow that the imposition of the fee should be more broadly based across all securities which benefit from increased liquidity. While this would mitigate some of the adverse impacts of the 50 bps fee—including investors stipping pools, which could lead to TBA market fragmentations—it would also introduce additional costs across all securities, which costs would be ultimately borne by borrowers.

A similar idea would be to have a more targeted fee that applies across all Giants. This approach represents a middle ground, as its applicability is narrower than all UMBS, but broader than just commingled Supers. However, because there would be other UMBS that would not be subject to the fee, this approach may also be seen as a “double-charge” to investors who previously paid up for the enhanced liquidity across all UMBS.

A final note on any approach that would broaden the applicability of a fee would be the appropriate level at which to set the fee. Our understanding is that the 50 bps fee does not fully cover the 20% assigned risk weighting as mandated by the ERCF. Given that precedent, when looking at broadening the UMBS subject to an additional fee, it may be appropriate to impose a fee that does not cover the 20% risk weighting.

b. Specifically Designate Portion of PSPA Backstop as Covering UMBS Cross Guarantee

Another option would be for FHFA, in coordination with Treasury, to specifically designate a portion of the PSPAs as covering the cross-guarantee capital charge of the ERCF. This approach would likely involve bilateral cooperation between FHFA and Treasury, which could entail an amendment to the PSPAs, a Letter Agreement between FHFA and Treasury, or some other mechanism[2]. Regardless of the path taken, this approach recognizes that it may be appropriate to require the Enterprises to guarantee the securities of the other within the UMBS for the benefit of the overall mortgage market and its liquidity.

Given the GSEs’ current state in Conservatorship, the PSPAs could be interpreted to implicitly cover the cross-guarantee charge. FHFA and Treasury could choose to make that interpretation explicit. A benefit of this approach is that it does not undermine the need for the cross-guarantee capital charge and retains the option that it be imposed at a future point when the PSPAs are no longer in effect.

c. Suspend 50 BPS Fee, Re-Issue NPR Focusing on Cross-Guarantee

The final option is more related to process than policy outcome. Whereas the first two options could be undertaken unilaterally by FHFA and/or in coordination with Treasury, this option entails suspending the fee while issuing a Notice of Proposed Rulemaking to seek industry and stakeholder feedback on amending the cross-guarantee provisions of the ERCF. While the first two options could be accomplished under the ERCF as it exists today, this approach would codify into regulation any changes made to the Enterprise capital rules. While such a process would take additional time and resources, it would also serve as a signal to the market about the importance of the UMBS, as well as the safety and soundness of the GSEs.

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[2] Note that there is an outstanding question related to the Letter Agreements dated January 14, 2021, which purport to govern future amendments or modifications to the ERCF. Section 5.15 *Capital Covenant* states “Seller shall comply with the Enterprise Regulatory Capital Framework disregarding any subsequent amendment or modification to that rule”. (see https://home.treasury.gov/system/files/136/Executed-Letter-Agreement-for-Fannie-Mae.pdf and https://home.treasury.gov/system/files/136/Executed-Letter-Agreement-for-Freddie%20Mac.pdf) We raise this point and defer to FHFA and/or Treasury to determine the efficacy of Section 5.15 and whether any modification in the PSPAs and/or the Letter Agreement would be appropriate.

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One critique of the ERCF is that (in some instances), it was designed to effectuate an end-state of the GSEs that was materially different than the one the markets have evolved around since 2008. While conservatorship is not intended to be a permanent end state, revisions to the Final ERCF might better reflect the actual current state of the GSEs, which would include the ongoing support from Treasury in the form the of PSPAs. A capital rule that requires MBS investors to pay a cross guarantee would be a capital rule that would likely lead to higher funding costs for one of the GSEs versus the other and, certainly, the end of the UMBS. Appropriate revisions that are narrowly targeted at the cross-guarantee and that more closely align to the reality of today's mortgage market would provide both Congress and the Administration with additional flexibility to determine how to resolve the ongoing Conservatorship of the Enterprises without damaging market liquidity that FHFA is tasked with protecting.

III. Conclusion

SFA members have observed that the imposition of the 50 bps fee has led to some instances of the negative outcomes identified above, including stipping pools. While currently limited in nature, there is a risk that if left unchecked, such instances will become more widespread, and cause permanent damage to the viability of the UMBS and the single security initiative. Therefore, it is imperative that FHFA act in the near-term so that these problems do not create irreparable UMBS market fragmentation.

At the same time, it is also important that any near-term action(s) be coupled with a long-term path forward so as not to undermine market expectations for how regulators will respond to future market disruptions. A focused, limited response that does not foreclose the possibility of additional steps (and indeed, even makes clear what such steps might be) will help restore confidence in the short-term while making clear to industry stakeholders that long-term factors will require additional time and action to adequately resolve.

We again thank you for thoughtful attention to this issue and look forward to continuing our dialogue on this important topic. Please reach out at any time if you have further questions or if we can be of any assistance.

Best,

Michael Bright,
CEO, Structured Finance Association