April 30, 2013

A Progress Report on the Common Securitization Infrastructure

Introduction

This progress report provides an update on the Federal Housing Finance Agency's (FHFA's) proposal for Fannie Mae and Freddie Mac (the Enterprises) to establish a "common securitization infrastructure" (CSI) for residential mortgage-backed securities (RMBS). CSI updates are discussed in two component parts: (1) building a "common securitization platform" (CSP), largely a technology project; and (2) creating a "contractual and disclosure framework" (CDF) to enhance transparency and investor protections in RMBS. FHFA plans to provide periodic updates to the public on the CSI as well as other strategic priorities.

I. Background

In February 2012, FHFA issued its *Strategic Plan for Enterprise Conservatorships* (Strategic Plan). The plan sets forth three strategic goals for the next phase of the conservatorships:

1. *Build*. Build a new infrastructure for the secondary mortgage market.
2. *Contract*. Gradually contract the Enterprises' dominant presence in the marketplace while simplifying and shrinking their operations.
3. *Maintain*. Maintain foreclosure prevention activities and credit availability for new and refinanced mortgages.

The effort to create a new infrastructure for the secondary mortgage market will further all three goals. To maintain the efficient flow of mortgage credit, the existing outmoded Enterprise infrastructures must be upgraded. In addition, a transition to a future securitization framework would require a more flexible infrastructure than currently available to accommodate future policy decisions. Given that the expenditures for the upgrades are necessary, it makes sense to direct them toward the development of a common flexible infrastructure for the two Enterprises to accommodate various securitization structures and policy goals. The new infrastructure will also enable the contraction of the Enterprises by facilitating programmatic transactions by which the Enterprises will transfer credit risk to the private sector and increase entry of private capital into the business of taking mortgage credit risk.

In October 2012, FHFA issued a white paper entitled, "Building a New Infrastructure for the Secondary Mortgage Market." The white paper set forth a proposal for both a new securitization platform and a model contractual and disclosure framework, as described in the Strategic Plan. The proposal reflected key principles that are critical to the success of a functional secondary mortgage market. These principles include promoting liquidity, attracting private capital, benefiting borrowers, and operating flexibly and efficiently, while minimizing market disruption during the transition. The white paper focused on functions that are repeated across the industry and for which greater standardization would benefit the overall market. The goal of the proposal is to offer benefits to the broader housing finance market while not limiting market choices or valuable independent innovations.

II. Common Securitization Platform (CSP)

CSP Design Principles

As outlined in the white paper, the CSP will adhere to clearly defined design principles in order to provide a sound foundation on which to rebuild the country's secondary mortgage market, and will maintain flexibility on several levels. Specifically, it is being developed so as to be adaptable to policy change, provide standardized interfaces with market participants, and remain configurable in light of future standards and emerging technologies. Other aspects of the CSP's design include:

- Straight-through processing and event automation – Event-driven system architecture is being incorporated in order to minimize manual intervention, facilitate efficient operations and performance, and allow for capture of operational and market metrics.

- Data transparency – Data architecture is being developed that provides data traceability and accessibility via common data infrastructure and data standards.

- Open architecture – Standard external interfaces are being established for efficient interoperability with multiple Issuers/Enterprises. The CSP will leverage existing industry data standards (*e.g.*, MISMO, Uniform Mortgage Data Program).

- Functional modularity – CSP's internal components will communicate via standard interfaces to ensure that modifying, configuring, replacing, or adding new functional modules can be accomplished with minimal impact across the CSP.

- Scalability – Integration architecture is being employed based on standard technologies with proven scale in financial services and other industries, to ensure accommodation of growth demands and increased throughput.

CSP Functions

Specific functions highlighted in the white paper that will be accommodated by the CSP are outlined below. These descriptions have been updated based on the feedback on the white paper provided by the public and additional detailed reviews undertaken by the Enterprises and FHFA to further define the scope of these functions. As part of their on-going maintenance and upgrading of systems, the Enterprises were engaged in various systems projects prior to the consolidation of these resources into this joint initiative. This joint work has resulted in the on-going build of a prototype to perform the securitization functions listed here. The scope described represents FHFA's current view; the agency will continue to solicit input from key stakeholders, including the industry, and adjust the CSP scope as appropriate.

- **Data Validation**
  - The CSP data validation service will verify that the request (*e.g.*, to issue a security) as submitted conforms to agreed-upon standards and the data format for both loans and securities is valid and complete. Notification will be provided back to the requestor of

the acceptance or rejection of the request, along with details on specific rule violations so that deficiencies can be efficiently corrected and requests resubmitted.

- **Issuance**
  - Acting as agent for the issuer, the CSP issuance service will accept the validated request and register the security with the appropriate agent, either the Federal Reserve (FED) or the Depository Trust and Clearing Corporation (DTCC). On the security settlement date, the CSP will transfer the security to its initial owner (and remit cash proceeds to the issuer for cash transactions) according to the instructions provided with the issuance request. The CSP will validate that settlement occurred and provide confirmation back to the issuer. The underlying loan information will be transferred to the Master Servicing function to initiate the master servicing process. The security data will also be transferred to the Disclosure function. The CSP will not be delivering previously-issued securities for the purpose of settling post-issuance trades.

- **Disclosures**
  - Disclosure covers the process whereby attributes describing a security and underlying loans or pools are published to the marketplace in a timely manner. The CSP will be acting as the issuer's agent; the accuracy of the disclosures will be the issuer's responsibility. Preliminary disclosure occurs before the security settles in order to alert the market to a pending security's fundamental characteristics. On settlement date, the CSP will publish the final disclosure, which includes detailed information describing the final loan pool and security structure. On-going disclosure occurs monthly or when relevant changes occur to the pool or underlying loans. Disclosure documents proposed to be published include the prospectus supplements and supplemental oversight documents. Disclosure information will be published by the CSP on the Internet and possibly in other forms.

- **Master Servicing**
  - The Master Servicing functions performed by the CSP include asset and cash management activities as directed by the issuer, its master servicer, a trust, or governing security documents. These functions include collecting and processing data on primary servicer loan activity and verifying that principal and interest payments are correct for each reporting cycle. Master Servicing in the CSP will handle different cycles and reporting/remitting cut-off dates to support multiple security programs while interacting with servicers, sub-servicers, interim servicers, and special servicers. Primary servicers could provide investor reporting and cash directly to the CSP or via other parties, with standardized reporting and remitting dates.

    It is important to note a distinction between "master servicing" activities that the CSP will undertake – those functions that can leverage straight-through processing and the execution of decisions that are rules-based – and those activities typically undertaken by an issuer through its master servicer role, such as making decisions about individual loan work-outs, *etc*., which involve "high touch," case-by-case activities that the CSP will not undertake.

- **Bond Administration**
  - Bond Administration will be responsible for establishing the security, security administration and reporting, and making data available to the Disclosure function for on-going investor reporting for each payment cycle. Bond Administration will support both first-level securitizations (securities backed directly by loans) and second-level re-securitizations (securities backed by existing securities). Bond Administration will also ensure that payments to investors and other parties are managed in a timely manner. The CSP will collect funds due to investors generated by the collateral (loans or existing securities) and provide such funds to the issuer for investment in eligible investments. Payment instructions will be provided to the paying agent (FED, DTCC, or physical certificates) for appropriate fund distribution. The CSP will be able to perform these and any other required activities as directed by the Trust or other governing security documents.

    Similar to the Master Servicing functions, the Bond Administration module will focus on those functions that can leverage straight-through processing and that are rules-based. Thus, for example, while the CSP will collect funds due to investors, it will not make any fund investment decisions necessary prior to disbursement of collected funds to investors; such decisions will be the responsibility of the issuer.

Feedback on the White Paper Regarding the CSP

FHFA received public responses from a broad cross-section of industry participants and other stakeholders in the securitization process. In general, the respondents supported the technological upgrade aspects of the CSP proposal and agreed with the specific functions proposed.

Many respondents offered suggestions related to the scope of functionality. The most significant responses were related to the five areas discussed here. FHFA and the Enterprises have been developing the design, scope, and functional requirements for the CSP and have developed a CSP prototype. The CSP design will be incorporating the responses discussed below.

- Ownership/Governance – Many respondents asked for greater clarity on ownership and governance of the CSP. The current plan is to initially structure the CSP as co-owned by the Enterprises, particularly in the near term as we await Congressional resolution of the conservatorships, during which time key CSP components will be designed, built, and tested. As FHFA recently announced, the new venture will be headed by a Chief Executive Officer and Chairman of the Board that are independent from Fannie Mae and Freddie Mac. It will also be physically located separately from Fannie Mae and Freddie Mac and will be overseen by FHFA. The design is deliberately flexible so that the long-term ownership structure may be adjusted to meet the goals and direction that policymakers may set forth for housing finance reform. Importantly, FHFA plans on instituting a formal structure to allow for ongoing input from industry participants.

- Build – Several respondents focused on the mechanics of how the CSP would be built, urging the use of industry-standard data definitions and protocols and industry-standard technologies and that FHFA leverage the private sector to the extent feasible. The Enterprises and FHFA are using industry-standard data definitions, protocols, and technology, for example by leveraging MISMO initiatives and the Enterprises' Uniform Mortgage Data Program. In terms of the development, coding, and testing of the software necessary for the CSP, the Enterprises and FHFA are leveraging existing industry software to the extent feasible. The project team charged with undertaking this work is a combination of subject matter experts and project leads from the Enterprises and third-party contract staff (to perform the coding, testing, and validation).

- Access – Several respondents either requested clarity on or specifically recommended that certain mortgage market participants have access to the CSP, including lenders, mortgage insurers, servicers, security issuers, custodians, and independent trustees. Some of these market participants (servicers and the Enterprises) will have immediate access to the CSP; others will have access as the CSP evolves over time. Broad, open access remains the long-term goal.

- Disclosures – Several respondents provided feedback on the disclosure functionality of the CSP. Respondents supported standardized, loan-level disclosures, and several suggested that in addition to loan balance and performance information, the CSP provide updates on borrower- or property-level information such as credit scores and loan-to-value ratios. The CSP functionality does include both initial and on-going loan-level disclosures. Disclosure of updated borrower- or property-level information is not in scope for the initial phase of the CSP. FHFA and the Enterprises will, however, ensure that the design of the CSP is flexible to incorporate these data in a future release.

- Functionality – Several respondents focused on the specific functions that the CSP could perform. Most respondents supported the proposed functional scope described above. The most significant suggested revisions to the CSP's functions were to add: (a) a "life-of-loan" database or data warehouse; (b) loan acquisition data; and (c) collateral management and custodial functions.

    a. "Life-of-loan" Database or Data Warehouse – Respondents recommended that the CSP track activity over the life of a loan. A database or data warehouse with this information would be extremely valuable for market participants and regulators. FHFA and the Enterprises agree and plan to include this functionality in the CSP.

    b. Loan Acquisition Data – Several respondents recommended that the CSP receive initial loan purchase data, so that lenders only need to submit one data file and be subject to uniform data editing and validation procedures. FHFA and the Enterprises concur that there are important benefits to having the CSP undertake uniform validation of loan acquisition data. FHFA and the Enterprises are assessing the scope of this activity and how and when to incorporate it into the CSP. This functionality can be seen as an expansion of the scope of the Data Validation module.

c. Collateral Management Activities and Custodial Functions – Several responses recommended that the CSP perform several collateral management activities (i.e., tracking, verifying, and reporting on collateral values) and custodial functions (i.e., document custody, assignment, etc.). FHFA agrees there could be substantial benefits to the secondary mortgage market from incorporating these features. For the initial phase of the CSP, the plan is to include the data necessary for collateral management, but not to have the CSP perform these other functions. FHFA and the Enterprises will, however, ensure that the design of the CSP is flexible to incorporate such functionality in the future. For the initial phase of the CSP, it will not include custodial functionality, though it will track who the custodian is for each loan.

Given the foregoing discussion, the current scope for the CSP is comprised of the following modules and infrastructure components:

- Modules
  - Data Validation
  - Security Issuance
  - Disclosures
  - Master Servicing
  - Bond Administration

- Infrastructure components:
  - Operational data store
  - Industry standard data interfaces
  - Life of loan data warehouse

CSP Next Steps

In light of the importance of this initiative to the housing finance system, and reinforced by the comments received from the public, FHFA has directed the Enterprises to move forward on the development of the CSP. On March 4, 2013, FHFA issued the 2013 Conservatorship Scorecard (2013 Scorecard) for Fannie Mae and Freddie Mac, which states that the Enterprises shall undertake the following in 2013:

In conjunction with FHFA, continue foundational development of the CSP:

- Establish initial ownership and governance structure for the CSP. Assign dedicated resources and establish independent location site for the CSP Team.

- Develop the design, scope and functional requirements for the CSP's modules and develop the initial business operational process model.

- Develop multi-year plan, inclusive of CSP build, test and deployment phases and the Enterprises' related system and operational changes.

- Develop and begin testing the CSP.

- Support FHFA progress reports to the public on the design, scope and functional requirements. Update documents based on feedback received.

FHFA and the Enterprises are currently working on each of these objectives.

As noted above, the combination of the two components of the common securitization infrastructure – the Common Securitization Platform (CSP) and the Contractual and Disclosure Framework (CDF) – will enable the Enterprises to engage in programmatic transactions to share mortgage credit risk with the private sector and allow the contraction of the Enterprises' footprint in the market.

III. Contractual and Disclosure Framework (CDF)

This portion of the progress report includes an update on the proposed CDF and invites additional input from interested market participants. This section considers the feedback received on the framework proposed in the white paper and reviews planned next steps.

FHFA will continue to direct the Enterprises to align contracts and standards so as to benefit investors, lenders, borrowers, and taxpayers. As highlighted in the 2013 Scorecard, FHFA is also directing the Enterprises to explore alternative approaches to transferring mortgage credit risk in order to reduce their overall credit risk exposure. Through these risk transfer activities, there are opportunities to create efficiencies and standards that have the potential to benefit a broader group of stakeholders.

Feedback on the White Paper Regarding the CDF

FHFA received feedback from a broad cross-section of stakeholders that play a variety of roles in the secondary mortgage market. The feedback is summarized in two parts below, each of which also discusses next steps FHFA is considering: (1) Enterprise Alignment Activities; and (2) Non- or Partially Guaranteed RMBS Transactions.

Enterprise Alignment Activities: FHFA proposed that the Enterprises continue their on-going alignment improvements not only to achieve efficiencies but also to support the future securitization platform and the broader private market through the development of common standards. Most respondents indicated that Enterprise alignment activities were generally favorably viewed as an opportunity to create potentially valuable efficiencies for the market. There was broad support for continuing to align Enterprise policies and an overall favorable response to efforts already undertaken through the Uniform Mortgage Data Program; the Servicing Alignment Initiative; Contract Harmonization efforts, including Representation and Warranty alignment; and efforts to enhance Enterprise Loan-Level Disclosures.

FHFA will continue the Enterprises' alignment efforts that are underway with the goal of developing standards and efficiencies that may be useful to the broader market. As part of this effort, FHFA will explore additional incremental alignment activity that could be useful for interest rate investors. The goals are to create more consistency and transparency in activities in an effort to create more common features and standards in current Enterprise securitization transactions, create more commonality and certainty for investors, and provide more liquidity for securities issued through a common platform.

The following describes specific areas that will be explored for potential Enterprise alignment during 2013:

Solicitation of Borrower Refinances of Loans in a Pool: FHFA will review Enterprise practices and determine the feasibility of aligning their borrower refinance solicitation guidelines. This may include guidelines for borrowers who are current on their mortgages, borrowers beginning to show an increased potential for default, and borrowers in imminent risk of default. As a result of this work, investors may be able to better gauge the timing of cash flows and the prepayment risk of securities issued through the common securitization infrastructure. Borrowers, in turn, will benefit from more effective, deliberate, and structured contact from servicers.

Repurchases and Substitutions of Loans from a Pool: FHFA will explore the development of a common Enterprise strategy for mortgage repurchase and mortgage substitution. This work may include the conditions under which repurchases/substitutions are allowed, who is responsible for the repurchase/substitution, and the timing of the collection of proceeds related to repurchases. The increased clarity and transparency from an aligned Enterprise policy will help investors better understand the propensity for loans to exit pools and affect the prepayment risk of securities issued through the common infrastructure.

Representations and Warranties: In 2012, FHFA directed the Enterprises to adopt a single selling representations and warranties framework in order to achieve greater efficiency and to provide relief as early as 36 months into the life of loans that meet qualifying eligibility criteria. FHFA will continue to evaluate the representation and warranty needs of investors that assume credit risk from credit risk transfer transactions that occur in accordance with FHFA scorecard goals for 2013.

Pooling Practices: FHFA will review potential opportunities to create more standard parameters for creating loan pools. This work may include aligning the mechanics and methodology behind pooling transactions. Under this initiative, the Enterprises will explore the potential value to investors and borrowers in creating more standard pooling parameters.

Other Areas: In addition, FHFA will explore the feasibility of potential alignment in document custody policies, features of securities trust documents, and servicer performance monitoring.

Non- or Partially Guaranteed RMBS Transactions: With regard to standardization and contracts for securitization beyond the current Enterprise guarantee model, industry feedback suggested that any new credit structures, for example senior-subordinated bond structures, will have some of their own unique contractual needs and differences, especially when considering the roles of Issuers, Trustees, Investors (senior and subordinated), Master Servicers, and other key stakeholders. Critical issues for investors include concerns about weaknesses in contractual representation and warranty terms, contract enforcement, dispute resolution, due diligence, disclosures, data needs, and servicing terms.

Taking into account the broader private market challenges and the issues highlighted by this industry feedback, in 2013 FHFA and the Enterprises will evaluate opportunities to develop standards for credit risk transfer activities that address some of the issues raised. Specific concerns and needs raised, especially from a non-guaranteed perspective, include:

- Broader Market Regulatory Requirements and Uncertainties: There was concern and recognition of broader market uncertainties that may have policy and contract ramifications. For example, the efforts by federal regulators to implement the risk retention requirements of the Dodd-Frank Act and to define a "Qualified Residential Mortgage" standard (QRM), as opposed to the recently promulgated "Qualified Mortgage" (QM) standard, were cited as a factor that will affect securitization markets and practices. In addition, private-label RMBS must adhere to the disclosure requirements of the Securities and Exchange Commission's Regulation AB, which the Commission has proposed to change through a rulemaking initiated in 2010. In addition, market uncertainty arising from the implementation of new capital requirements for banks (Basel III) will impact investment decisions.

- Representation and Warranty Framework: Most respondents expressed significant concerns that the representation and warranty framework used in the private-label MBS market had weaknesses that caused problems with accountabilities, contract enforcement, and investors' ability to fully direct servicing activities. Concern was also expressed about the need for clarity in enforcement and for more specific requirements for engaging in fair and timely arbitration for dispute resolution.

- Due Diligence: Many stakeholders expressed the need for more robust and timely due diligence that would require up-front and on-going full file (or statistically valid) reviews by independent third party firms.

- Conflicts of Interest: Various potential conflicts of interest were raised, particularly between senior and subordinate bond holders. Many respondents also mentioned the need to better align Trustee, Servicer, Investor, and Issuer interests. In addition, respondents stated that conflicts in servicing, such as servicer relationships with vendors, should be fully disclosed.

- Data and Disclosures: Many advocated for fuller disclosures, including ongoing servicing disclosures, and a need for credit investors (*i.e.*, in subordinated bonds) to have robust access to data so that credit risk can be fully understood and priced. In addition, concerns were expressed about potential ramifications for the "to-be-announced" (TBA) market, in that any expansion of data disclosure at a pool level could unintentionally create market bifurcation in the formation of pools.

- Flexibility of Guides: There were concerns expressed that the Enterprises' Guides, particularly the Servicing Guides, would be subject to change and could potentially put investors at risk from policy changes, particularly with regard to loss mitigation or foreclosure policies. Some feedback highlighted a need to separate critical from non-critical changes so that there could be more control(s) over changes with potentially significant impacts.

As the Enterprises develop the contractual framework for credit risk transfer to the private sector, they will leverage the experience gained from the private-label RMBS market. The American Securitization Forum (ASF) models and standards initiative, known as Project RESTART, suggested some of the groundwork for establishing standards for data, disclosures, and more.

As noted above, there are key issues of concern to private investors, including representations and warranties, enforcement, loan-level disclosures, due diligence, and conflicts of interest. FHFA will explore opportunities to address these issues as part of credit risk transfer initiatives, with the intent of developing standards.

The items enumerated above summarize the key themes raised in the feedback to FHFA on the contractual and disclosure framework proposed in the white paper, insofar as they relate to transactions other than standard Enterprise RMBS transactions. Many of the items in this list will need to be considered in RMBS contracts and disclosures going forward, including certain potential Enterprise risk sharing transactions. As envisioned in the 2013 scorecard, each of the Enterprises is expected to pursue multiple types of risk sharing options. The response to these transactions will provide an opportunity to develop contractual standards and receive feedback from market participants.

CDF Next Steps

As stated in the 2013 Conservatorship Scorecard, FHFA's plan is for the Enterprises to undertake the following in 2013 related to the Contractual and Disclosure Framework (CDF):

> Continue the development of the CDF to meet the requirements for investors in mortgage securities and credit risk:

- Identify and develop standards in data (i.e., leveraging work underway in the Uniform Mortgage Data Program), disclosure and Seller/Servicer contracts.

- Develop and execute work plans for alignment activities between the Enterprises with regard to common standards and creation of legal/contractual documents to facilitate varied credit risk transfer transactions

- Engage with the public in a variety of forums to seek feedback and incorporate revisions and support FHFA progress reports to the public.

Conclusion

As stated at the outset of this progress report, a key objective of the 2013 Scorecard is to execute various risk transfer transactions aimed at reducing the Enterprises' footprint in housing finance. The design of the common securitization infrastructure will, in the future, facilitate increases in the scale and ease of execution of such transactions. The infrastructure will be designed to be flexible so as to enable policy makers to have a choice about the role of the federal government in a future housing finance system, including a choice about the degree of mortgage credit risk directly assumed by the government.

FHFA invites interested parties to provide written input on this progress report. While this effort is not a notice and comment rulemaking subject to the requirements of the Administrative Procedures Act, the purpose is to provide a mechanism for industry input – a critical factor in the acceptance and ultimate success of the CSI. Input must be received by June 30, 2013, and may be submitted via email to SecuritizationInfrastructure@fhfa.gov or addressed to: *Federal Housing Finance Agency, Office of Strategic Initiatives, 400 7th Street, S.W., Washington, DC 20024.* After June 30^{th}, FHFA plans to post the input on FHFA's website for public review.