**Response to FHFA’s Request for Input on Proposed Pooling Practices Changes by *Mortgage Capital Trading, Inc.***

The managers of Mortgage Capital Trading, Inc. (MCT) would like to thank the Federal Housing Finance Agency (FHFA) for the opportunity to provide input and comments on “Enterprise UMBS Pooling Practices: Request For Input,” which in November 2019 proposed changes to pooling practices for mortgage-backed securities issued by Fannie Mae and Freddie Mac (collectively, the Enterprises). MCT is a capital markets advisory firm based in San Diego, California that provides hedging, loan sale and software services to mortgage originators throughout the United States.

MCT believes that significant changes to policies and practices for the mortgage and MBS markets should be taken with abundant caution, given both the complexity of the mortgage sector and its importance to the housing market and the economy. MCT’s management supports the FHFA’s stated desire to minimize differences in the pricing and performance of the two Enterprises’ securities, but will describe potential issues associated with the proposal that we believe could have negative implications for the mortgage and MBS markets. In our view, any changes to the policies and operating procedures of the Enterprises should serve to increase and improve the liquidity and fungibility of the mortgage-backed securities market while also fostering competition between Fannie Mae and Freddie Mac and encouraging the creation of innovative new products and programs that benefit consumers.

**Summary of Proposals**

Before commenting on the proposed changes, we believe it will be helpful to outline our understanding of the FHFA’s proposal and request for input (“the RFI”)[[1]](#footnote-1), which contains three major provisions.

* All seller servicers would be either “incentivized or required” to deliver the bulk of their production into “generic, multi-issuer pools formed by either Enterprise.”
* Both “specified pools” and other pools “with market pay-ups” could be created “under prescribed circumstances.”
* Loans by seller/servicers whose production is deemed to exhibit anomalous prepayment behavior would be forced to “deliver all or part of their production” into single lender pools that are not deliverable into TBAs.

The proposal would apply to all loans pooled into securities issued under the “Single Security Initiative” (SSI) as “Universal Mortgage-Backed Securities” (UMBS)[[2]](#footnote-2) irrespective of whether they are comprised of loans sold directly to the Enterprises through their “cash windows” or are securitized through “guarantor swap transactions,” i.e., by essentially swapping loans to Fannie Mae or Freddie Mac in exchange for UMBS.

The proposal is intended to further implement the FHFA’s “Final Rule,” which outlined policies and procedures designed to improve the fungibility of securities issued under the UMBS framework, as well as “align” the cash flows and prepayment speeds of UMBS pools issued by Fannie and Freddie. In the FHFA’s view, a critical component to the long-term success of the SSI is that there should not be any systematic differences between the prepayment speeds and behavior of UMBS issued by Fannie Mae and Freddie Mac. This is why the Final Rule emphasized the “alignment” of the prepayment performance of pools issued by the two Enterprises. The Final Rule outlines both procedures to compare the prepayment speeds of pools issued by the different enterprises, as well as aligning the “programs, policies and practices” of the two enterprises in order to minimize variations in the prepayments of the two Enterprises’ securities.

**Comments on the Proposal**

Despite our support for the above-stated objectives, we have identified issues with the proposal that make it problematic for the mortgage lending community, along with market-makers and dealers in MBS products. Our concerns are outlined below for each element of the proposed changes.

Delivering the “Vast Majority” of Production into Multi-Issuer Pools

It’s not clear to us that this core aspect of the proposal is necessary, as we note that current issuance trends and data suggest that that the proposed changes to issuance composition have already been achieved. For example, data and analysis published by Refinitiv indicates that the share of loans securitized in multi-lender pools by Fannie Mae and Freddie Mac grew from 58% in 2014 to 75% (year-to-date) in 2019. If this trend holds, the percentage of loans in multi-issuer pools will be well within the 70-80% target outlined in the proposal. The growth in the share of multi-issuer pools is, we suspect, attributable to a number of factors, including:

* improvements to generic loan prices offered by the Enterprises through their “cash windows;”
* the Enterprises’ willingness to offer improved pricing for loans with “specified attributes” such as smaller balances that command pay-ups in the MBS markets; and
* industry consolidation.

We also believe that, while the proposal would serve to improve the “fungibility” of UMBS pools within the population of pools issued by each Enterprise, it would not necessarily improve the consistency of prepayment speeds *between* Fannie Mae and Freddie Mac pools, the clear intent of the FHFA’s Final Rule. We agree that forcing the issuance of larger pools would make it less likely that an investor would be delivered pools against TBA purchases that exhibit unfavorable and anomalous prepayment behavior, and that there are potential differences between pools that might be mitigated through the creation of larger multi-lender pools. (For example, there may be originators whose production might be concentrated within a limited geographic footprint and thus exhibit atypical prepayment speeds if securitized as single-issuer pools; the impact of their prepayment speeds on the performance of larger multi-lender pools would be muted.) With respect to the alignment of Fannie and Freddie speeds, however, the proposal does not address key factors that might result in materially different prepayment performance by the two Enterprises’ pools, including different policies and practices of lenders distributing their production through the two Enterprises; it also does not consider changes that would better align prepayment performance, such as cross-guarantees or co-mingling of Fannie and Freddie loans within “first level” pools. (On page 8, the proposal notes that, with respect to pooling practices, “the Enterprises may take different approaches, which may lead to divergences in prepayment behavior despite overall alignment across the broader cohorts.”) In this context, we don’t believe that the proposed solution of directing production into larger pools will, on its own, result in further alignment of Fannie and Freddie speeds. Put differently, the proposal conflates the “fungibility” of MBS with the “alignment” of prepayment speeds across the two enterprises, which in our view are related but separate considerations.[[3]](#footnote-3)

Creating Single-Issuer Specified Pools for Approved Categories

The proposal indicates that single-issuer specified pools would continue to be created for designated categories and characteristics. The wording in the proposal reads that “[S]pecified pools and potentially other pools with market pay-ups (such as certain single-lender pools that have particularly desirable characteristics) would continue to be allowed under prescribed circumstances…” We read this to mean that single-issuer specified pools will only be created and traded subject to regulatory approval.

We note several issues associated with attempting to codify the specified pool market in this fashion. First, we believe that allowing specified pools to be traded only for pre-approved categories would seriously inhibit innovation and creativity in the MBS market. Take, for example, so-called balance pools, i.e., pools comprised of loans with a range of maximum original loan balances. Currently, specified balance categories traded in the MBS market include pools with maximum loan balances of $85,000, $110,000, $125,000, $150,000, and $175,000. At some point, it may make sense to begin creating pools with other cutoffs (e.g., $200,000 maximum balances), especially in light of recent increases to the conforming loan limits. (Consider that the current market structure evolved when the conforming limits were much lower; the 2020 limit of $510,400 is 22% higher than the $417,000 limit that prevailed as recently as 2016.) Other balance cutoffs might also develop, especially if the conforming limit continues to increase at the current pace. Market conditions may also favor the development of entirely new categories, such as pools with low Gross WACs relative to their coupon rate. (Current pooling practices have pushed the spreads between pools’ GWACs and coupon rates to as much as 100 basis points or more, much greater than the historical norms of 40-60 basis points.)

However, under the proposal it appears that new categories could not be developed without the approval of a regulator or regulators. In our view, the requirement that new specified pool characteristics be created only with regulatory approval would create additional barriers to the already complex process of developing and marketing new categories. While the proposal does allow for pooling criteria to change over time, it is silent on how such changes would be proposed and approved. The proposal also overlooks the regulatory overlap in this sector of the market; while the FHFA governs pool issuance by the Enterprises, SIFMA regulates trading and delivery practices and rules. Requiring the consent of multiple regulators in order to alter the structure of the specified pool market would, we expect, stifle innovation and make the market resistant to changes in issuance and trading practices. (We also note that the benefits of specified pool trading are not limited to seller/servicers and trading desks; for example, the pay-ups received by originators for their smaller-balance loans are often passed on to consumers, a practice which supports low- and moderate-income housing.)

Forcing Some Seller/Servicers to Pool Production into Non-Deliverable Single-Issuer Pools

This clause would force certain unfortunate seller-servicers to securitize “all or part of their production” into single-issuer pools that would not be deliverable into TBAs. Action would be taken “to address anomalies in prepayment speeds,” and, as we see it, might be based simply on the prepayment history of lenders’ loans, although lenders “whose policies encourage borrowers to prepay significantly faster than average” may also be singled out for sanction. Depending on how much of their production is directed to non-deliverable pools, lenders subject to these actions would be at a major competitive disadvantage, to the point where their viability and solvency could ultimately be threatened.

This element of the proposal is, on its face, similar to punishments handed out by Ginnie Mae over the past few years for improper behaviors associated with the VA’s Interest Rate Reduction Refinance Loans (IRRRLs). Ginnie Mae’s actions meant that a number of lenders were temporarily prohibited from including their VA loans into pools deliverable into Ginnie Mae TBAs. However, the proposal to force offending lenders to securitize potentially all their conventional production into non-deliverable pools is much harsher; while Ginnie Mae’s punishment only extended to VA loans (which comprise at most about half of the loans securitized into Ginnie Mae pools), this proposal could effectively force all of some lenders’ production into non-deliverable pools that would trade at significant concessions to TBA prices. (We believe that such non-deliverable pools would trade at a concession greater than those prevailing for “high-balance pools,” i.e., non-deliverable pools backed by loans made in high-cost areas that have a maximum balance of 150% of the national conforming limit. Due to their history of fast prepayment speeds, such pools currently trade at concessions of at least three-quarters of a point to TBAs. Given the relatively small pool balances of the proposed non-deliverable cohort, the actual concession could be much larger—potentially, they could trade points behind TBAs.) We also worry that these potentially crippling penalties would be directed disproportionately against small- and mid-size originators, in part because their prepayment anomalies would be easier to identify.

Moreover, we don’t believe that the creation of a new non-deliverable category is beneficial to the housing finance system. In addition to operational and logistical issues[[4]](#footnote-4), there is no natural home for a class of small orphan pools that prepay inordinately fast. We fear that these pools would ultimately be marketed by unscrupulous operators to small unsophisticated investors enticed by ostensibly “cheap” prices that in fact offer little or no actual value.

**Additional Comments and Conclusions**

We believe that the current structure of the conventional MBS market is preferable to that proposed by the FHFA in the RFI. It is interesting, in fact, that the RFI explicitly states that adopting it “would result in pooling practices similar to those under the Ginnie Mae II program.” In our view, the UMBS market is inherently superior to the market for Ginnie IIs. This is because single-issuer Ginnie II pools, including specified pools, are issued as “custom” pools, and as such are not deliverable into Ginnie II TBAs. By contrast, most specified pool categories in the conventional market are deliverable into UMBS TBAs. This means that, unlike UMBS specified pools that should never trade at a concession to TBAs (since traders can simply deliver them into TBAs), single-issuer Ginnie II pools can trade significantly behind TBAs. This could occur in higher-rate regimes where much of the market is trading at a discount, and the perceived slower prepayments of specified pools is disadvantageous. (In fact, this occurs in the conventional markets for non-deliverable products such as pools backed by loans with 105-125% LTVs, which normally trade at a discount to similar-coupon TBAs when the TBA prices are below 101.)

We also don’t believe that it is productive for the FHFA, or any other regulator, to ascribe limits to the specified pool markets. Historically, these markets have evolved and adapted on their own, and we see no reason that they won’t continue to do so. In fact, the Enterprises need to be cognizant of developments in the specified pool markets in order to maintain the trend favoring multiple-issuer pool production. We previously noted that the changes instituted a few years ago to cash window pricing that saw Fannie and Freddie offer improved levels for loans with “specified” characteristics was a major factor in pushing more issuance into multi-lender “cash” pools. To continue this trend, the Enterprises will need to add additional loan categories (such as new balance limits) as they develop.[[5]](#footnote-5)

We reiterate our earlier conclusion that the proposal would not materially improve the alignment of prepayment speeds across the two Enterprises. While the goal of creating more consistent prepayments is certainly desirable and achievable through the issuance of larger multi-issuer pools, the proposed changes will not cause the speeds of the different Enterprises’ pools to converge. The only aspect of the proposal that might impact the Enterprises’ relative prepayment performance would be to force fast lenders’ production out of the TBA population and into non-deliverable pools. However, we see the impact of this proposition on prepayment alignment as marginal at best; for example, it’s unlikely that “bad” prepayment performance due to excess solicitation and other policies is skewed toward one or the other Enterprise.

Finally, we note that the fear of a multi-tiered UMBS market is the preeminent concern behind the FHFA’s focus on prepayment and cash flow alignment. The underlying issue is that, if investors think that the securities of one or the other Enterprise are “better,” they might begin to stipulate Fannie- or Freddie-only requirements in TBA trades, resulting in a fragmented market with seriously diminished liquidity. In addition to the FHFA’s focus on prepayment and cash flow alignment, we believe that the issues of MBS liquidity and market integrity need to be considered by the FHFA as part of any initiative to remove the Enterprises from conservatorship. In addition to the obvious issues associated with privatizing Fannie Mae and Freddie Mac and potentially eliminating their securities’ implied government backing, we believe that removing the Enterprises from conservatorship without instituting some form of government guarantee could inadvertently lead to an illiquid multi-tiered MBS market if the two Enterprises are perceived as having different degrees of creditworthiness. Without any government guarantee, pools issued by Fannie and Freddie would trade differently if investors view them (and thus their pools) as representing different credit risks, resulting in the fragmentation of the conventional MBS market and significantly impaired liquidity for the sector.

While we acknowledge that the issue of government guarantees for conventional MBS is highly complex and contentious, it’s important for regulators to recognize the implications of removing the Enterprises from conservatorship on UMBS market liquidity and, in turn, how it might ultimately impact the housing finance system. In addition, solving the puzzle of how to create private entities whose securities are nonetheless perceived to be free of credit risk will be a key element of any initiative to allow new market participants to issue securities through the SSI framework.

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1. Available at https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/Pooling\_RFI.pdf . [↑](#footnote-ref-1)
2. A description of the Single Security Initiative, which was fully implemented in June of 2019, can be found at https://www.fanniemae.com/resources/file/single-security/pdf/single-security-faqs.pdf . [↑](#footnote-ref-2)
3. As an aside, we disagree with the proposal’s statement on page 9 regarding changes to the cheapest-to-deliver (CTD) cohorts resulting from placing “fast” loans in large versus small pools. As long as the pools containing the loans in question are deliverable into TBAs, the performance of the CTD population will not change based on how the loans are pooled. What will change, however, is the likelihood that an investor will receive fast pools in their TBA deliveries. Certainly, more consistent prepayment performance within each Enterprises’ production is a worthy goal, but that is not the objective of the Final Rule and thus is not germane to the success of the SSI. [↑](#footnote-ref-3)
4. It’s also unclear how this element of the proposal would work in practice. If a lender whose production consistently exhibits abnormally prepayment speeds has agency approvals but is not approved for securitization, would they then automatically be approved for securitization? [↑](#footnote-ref-4)
5. In fairness, we note that at least one Enterprise offers pricing for loans with maximum balances of $200,000, a category not quoted by many specified pool dealers. [↑](#footnote-ref-5)