**Response to FHFA’ Pooling RFI**

The concerns raised by FHFA on differing pooling practices across the GSEs adversely impacting the fungibility of UMBS, are well founded given that there are more than a hundred seller/servicers. As shown in the charts below, pre-crisis the top four seller/servicer accounted for around 80% of the GSE market while recently the same 80% is split across more than a dozen seller/servicers.





The fragmented universe of seller/servicers could result in idiosyncratic prepayment risks for the TBA market. These risks could be mitigated by creating large multi-lender pools. However, one must ensure that all lenders pooling their loans into a multi-lender pool receive equitable compensation so that they can continue to offer comparable and competitive mortgage rates.

Although we are in favor of creating large multi-lender pools to mitigate idiosyncratic risks, we would recommend a more thoughtful pooling strategy than the current FHFA’s proposal of pooling 70-80% of every lender’s non-specified collateral into a large multi-lender pool each month. Ginnies are a perfect example of how creating one large multi-lender pool can result in lenders with prepayments comparable to or slower than cohort subsidizing the secondary market execution for those with higher than cohort prepays.

**Differentiated Secondary Market Execution for Seller/Servicers with Outlier Prepays**

Typically, lenders with higher than cohort prepays have higher than average recapture rates (i.e. *churners*). *Churners* are incentivized to efficiently refinance their portfolios because of both the premium secondary market execution and the improvement in the value of the MSR asset.

In the short-term, *churners* in multi-lender pools are likely to adversely impact the secondary market execution for the *non-churners*. In the long-term, allowing *churners* to grow at the expense of *non-churners* will adversely impact mortgage rates being offered to the borrower. An unchecked increase in share of *churners* in a multi-lender pool would increase the convexity cost of the asset, thereby increasing mortgage rates for all borrowers.

Consequently, we would recommend differentiated secondary market execution for lenders with anomalously high prepayment rates (i.e. *outliers*) in multi-lender pools.  Differentiated secondary market execution for *outliers* can be achieved by forcing these lenders to pool their non-specified originations separately so that the market can appropriately price the inherent prepayment risk. In addition, making these pools non-TBA deliverable (as recommended by FHFA’s proposal) will impose more severe penalties on the lenders with *outlier* prepays, help persevere fungibility and protect against any adverse impact on mortgage rates.

We would also recommend that multi-lender pools have less lender concentration risk. In other words, no one lender can skew the execution for all other lenders by establishing de-minimis criteria for lender concentrations.

Given that UMBS and multi-issuer pools have reduced the capability of differentiated secondary market execution for lenders with outlier prepayment speeds, we would recommend that FHFA adopt a simple, robust and transparent lender prepayment scoring methodology that dictates a lender’s pooling privileges. We would recommend that FHFA award TBA eligible multi- and single-lender pooling privileges based on the prepayment response of loans originated by a specific lender. To be effective, the framework of determining pooling privileges must be automatic and objective.

**Lender Prepayment Scoring Methodology to Dictate Lender Pooling Privileges**

While we have detailed one possible prepayment scoring methodology in the appendix attached, the main elements of such a scoring methodology would be as follows:

* Keep the lender prepayment scoring methodology simple by awarding lenders a *pass* or a *fail* score each month across GSEs.
* Given that specified pools are rarely delivered into the TBA, the lender prepay scoring methodology should focus on relative lender prepays for cheapest-to-deliver cohorts (as defined in FHFA’s Uniform Mortgage-Backed Security Final Rule). Besides the well-known collateral attributes such as loan balance, high-LTV, low FICO, NY, etc.; seasoning is another attribute that commands a significant pay-up and hence should be excluded from the cheapest-to-deliver cohorts.
* To ensure that each lender is less likely to receive any worse an execution than the large multi-lender execution if they were to pool their cheapest to deliver loans separately each month, we compare prepays on loans originated by the lender each month with those originated by others. While doing so we adjust for the most important attributes like net coupon and possibly loan size.
* Use 3-month refinance SMMs (i.e. single monthly mortality) to account for possible delay differences across lenders resulting in anomalies in monthly prepayment rates.
* We would recommend a thoughtful grid of absolute and relative refinance SMM metrics to identify *outliers*.
* A lender with *outlier* prepays only receives a *fail* score if those prepays adversely impact the TBA execution.
* We would recommend that FHFA publish the lender prepay score card to the market. A transparent score card will help lenders correct their prepayment behavior before it is too late and help a lender’s non-deliverable pools trade better as their score improves.

**Lender Pooling Privileges Awarded based on History of Lender Prepayment Scores**

The lender’s monthly prepayment scores should be used to dictate pooling privileges. Only lenders with a history of good prepayment scores should be able to pool their non-specified loans in TBA eligible pools. While the others are restricted to TBA in-eligible pools for a period. The period for which a lender is excluded from the TBA market should be determined by the number of times a lender receives a poor prepayment score. This would ensure that repeat offenders are identified and penalized more severely.

The importance of a sliding scale of penalties is very evident in Ginnies. For example, Freedom was identified having outlier prepays and hence was restricted from pooling their loans in the TBA eligible pools for a period of six months. However, when they were allowed back in the multi-lender TBA program, prepayments on their loans spiked again.

**Other Factors to Align Conventional and Ginnie Prepays**

In addition, to align prepays across conventionals and Ginnies we would also recommend a net-tangible benefit test (i.e. NTB) for conventional rate refinance loans. Also, to ensure that WAC difference between Ginnies and conventionals do not vary widely as they have in the past, we would suggest doing away with the buy-up/buy-down

**Appendix (Sample Lender Prepayment Scoring Methodology)**

Given that specified and seasoned pools are rarely delivered into the TBA, the lender prepay scoring methodology should focus on relative lender prepays for cheapest-to-deliver cohorts. Consequently, we would define the cheapest-to-deliver cohorts for a given coupon as 0-24 WALA non-specified pools.

The prepayment scoring methodology will award a lender a *pass* or a *fail* score each month across GSEs. A lender will receive a *fail* if their loans exhibit significantly higher (i.e. *outlier*) prepays and the prepays fall in the worst quintile of the cohort prepays.

To assess *outlier* prepays we begin by computing a lender’s 3-month refinance prepays (i.e. SMM) for non-specified loans originated each month for a given coupon. We only focus on the past 24-months of issuance. We then compare the lenders prepays with the 3-month refinance prepays for all non-specified loans issued in the same month and coupon. We recommend that lenders with *outlier* prepays for a given issue month and coupon are identified as follows: lenders with a 3-month refinance SMM that is multiples of 3-month refinance SMM of the cohort and the refinance SMM of the cohort is above a threshold of 0.5 SMM (i.e. ~6CPR).

While there maybe many lenders with *outlier* prepays we would recommend only penalizing those that are also likely to be in the worst quintile of a given coupon. Hence for a given coupon we bucket the lender prepays for each issue month across quintile buckets and pick the top 10 *outlier* lenders by balance in the worst quintile and give them a *fail* score for the month. While the others will receive a *pass* score for the month. We would recommend that FHFA publish the lender prepay score card each month.

Pooling privileges for a lender are determined by their history of prepayment scores. Only lenders who satisfy the following two monthly prepayment score requirements (i.e. in good standing) can pool their loans in multi- or single-issuer non-specified pools that are TBA deliverable:

1) has no *fail* scores in the past 12-months; and

2) at the most two *fail* scores in the past 36-months.

The two sets of criteria mentioned above will ensure repeat offenders are locked-out of the TBA market for a period of three years instead of one year for first time offenders.

The lenders who do not satisfy the above-mentioned criteria can only issue specified pools that are TBA deliverable and non-specified pools that are not TBA deliverable.

In multi-issuer non-specified pools that are TBA deliverable, no one lender can be more than 10% of the pool and each lender must contribute a minimum of the lower of 1% or their entire monthly non-specified production.

Seller/servicers with non-specified originations more than the minimum 1% limit and in good standing can issue single-issuer non-specified pools that are TBA deliverable.