Bond Dealers of America

"Main Street" Principles for Reforming the GSEs

On September 7, 2008, at the height of the global financial crisis, the Federal Housing Finance Agency (FHFA), the federal government agency that oversees Fannie Mae and Freddie Mac, took control of the two mortgage agencies under conservatorship authority enacted under the Housing and Economic Recovery Act of 2008. The agencies have been operating under conservatorship ever since. On March 27, 2019, President Trump announced that he had directed relevant federal agencies to develop plans to reform Fannie and Freddie. The reform plan has the goals of ending the conservatorship of Fannie Mae and Freddie Mac, improving regulatory oversight over them, promoting competition in the housing finance market, and creating a system that encourages sustainable homeownership and protects taxpayers against bailouts.

The Bond Dealers of America (BDA) believes that several key principles are necessary for a successful reform initiative to ensure the soundness and efficiency of our mortgage finance system. BDA is the only DC-based group exclusively representing the interests of securities dealers and banks focused on the U.S. fixed income markets.

Preserve the "TBA" mortgage securities market

At the end of 2018, Fannie Mae and Freddie Mac together held or guaranteed $5.5 trillion of home mortgage assets on their balance sheets or in mortgage pools backing agency mortgage-backed securities (MBS), nearly 55 percent of total US home mortgage assets.[1] Agency MBS, securities that are issued or guaranteed by Fannie Mae, Freddie Mac, or Ginnie Mae, are created, issued and traded differently from other kinds of securities.

In general, the cash flow used to pay principal and interest to MBS holders comes from monthly mortgage payments made by homeowners whose mortgages are in the underlying pool of loans dedicated to back a certain security. However, there is typically a delay of some weeks between when mortgage originators begin to assemble the mortgage pools and when the securities backed by those pools are ready to be issued. The "To Be Announced" - or TBA - market is the mechanism by which investors commit to buy new mortgage securities when they are issued in the future without knowing all the details of the pool at the time of the trade commitment. The TBA market provides a means for mortgage originators to know with certainty that their mortgage pool will be securitized and sold. It is an important way for originators to hedge risk and lock in interest rates for homebuying customers.

In a TBA trade an investor agrees to buy an agency MBS in the future—say, one month—based on just a basic description of the security to be issued, including the issuer, maturity, coupon, face value, price and the settlement date. Forty-eight hours before the settlement date, the seller specifies to the buyer all additional details about the security, and on the settlement date securities and cash are exchanged.

The TBA market is extremely liquid and efficient. In terms of trading volume, only the US Treasury securities market has more activity than the TBA market. TBAs are the principal way that mortgage lenders can know that the loans they originate will be sold to institutional investors at an agreed

[1] Federal Housing Finance Agency (FHFA), "Report to Congress 2018," page 4, and Board of Governors of the Federal Reserve, *Financial Accounts of the United States*, First Quarter 2019, page 127.

upon price. The existence of an active and healthy TBA market helps ensure that mortgage capital continues to flow readily to homebuying families. Whatever changes Congress makes to the mortgage agencies, it is vital that this important funding pipeline be maintained.

UMBS is a welcome advancement

On June 3, 2019, Fannie Mae and Freddie Mac implemented a new Uniform MBS ("UMBS or "single security"). Under this initiative, Fannie Mae and Freddie Mac have begun issuing MBS with identical characteristics that are effectively interchangeable. One goal of the program is to further enhance liquidity in the TBA market by increasing the volume of identical securities being traded.

The "single security" initiative was undertaken by the two mortgage GSEs beginning in 2014. Now fully implemented, UMBS can be issued by either agency. Under TBA "good delivery" guidelines, a UMBS issued by either agency can be delivered against a TBA trade as long as the underlying mortgage pool meets the criteria agreed to when the trade was initiated. UMBS have identical features in terms of cash flow timing and other characteristics regardless of whether they are issued and guaranteed by Fannie Mae or Freddie Mac.

UMBS are designed to enhance liquidity by concentrating trading in identical, interchangeable securities. Before the development of the UMBS, there were sometimes discrepancies in pricing and liquidity between Fannie and Freddie MBS. Under the UMBS initiative, these discrepancies have disappeared. Enhanced liquidity in the TBA market means less risk and more efficient pricing for originators, which translates into lower mortgage rates for homebuyers.

Market reception for the UMBS has been positive. The product appears to have achieved its desired effects based on the first few months of experience. In restructuring the GSEs, we urge policymakers to maintain the single security UMBS structure for the issuance of eligible agency-guaranteed MBS.

Capital-building

One of the goals of restructuring the GSEs is to transition them from conservatorship. In order for a move out of conservatorship to be successful, the agencies will need to build significantly larger capital cushions than they have now. We urge policymakers to begin that transition now by allowing the agencies to retain profits as a way to build capital.

When the GSEs became financially troubled during the financial crisis, the Treasury Department recapitalized both agencies under Senior Preferred Stock Purchase Agreements ("PSPA") whereby Treasury committed to providing up to $100 billion (later increased to $200 billion) to each agency in exchange for certain dividend-bearing senior preferred stock in the two companies.[2] As of December 31 2018, Fannie Mae and Freddie Mac have drawn a combined $191 billion of taxpayer support under the PSPAs.[3] By current agreement of Treasury and FHFA, each agency maintains a capital buffer of $3 billion. Any profits earned that would increase their capital above $3 billion are paid to the Treasury as a dividend, known as a "profit sweep." Since the execution of the PSPAs,

[2] FHFA, "Senior Preferred Stock Purchase Agreements," www.fhfa.gov/Conservatorship/Pages/Senior-Preferred-Stock-Purchase-Agreements.aspx.
[3] FHFA, "Report to Congress 2018," page 5.

Fannie Mae and Freddie Mac have paid the US Treasury more than $292 billion in dividends.[4] In addition, the Temporary Payroll Tax Cut Continuation Act of 2011 (P.L. 112-78) required Fannie and Freddie to raise their guarantee fees by 10 basis points each with the revenue derived from the increase paid to the Treasury Department. Between 2013 and 2018 Fannie and Freddie have paid a combined $16.5 billion to the Treasury under this mandate.[5]

While it is not inappropriate for the Treasury to earn dividends from the preferred capital it has paid into the GSEs, the "profit sweep" is an impediment to recapitalizing the GSEs and transitioning them from conservatorship. We urge the Treasury to revise the PSPAs to allow the agencies to keep a portion of their net profits, which would become a capital cushion for the companies. Once the GSEs are appropriately recapitalized, some form of privatization or release from conservatorship would be possible. Allowing Fannie Mae and Freddie Mac to retain profits to build capital means a quicker transition from conservatorship. If the reform plans do not materialize and the GSEs remain in conservatorship, Treasury could require the accumulated profit to be transferred to Treasury at that time.

State and local governments

State and local governments are big purchasers of GSE debt securities. Many states and localities have very strict policies that limit the investment of public funds to federally backed debt securities such as US Treasuries or debt issued by Fannie Mae and Freddie Mac. Agency debt is an attractive investment for state and local governments because it is effectively federally guaranteed but it offers a slightly better yield than Treasury securities.

However, the supply of outstanding agency debt securities has been falling fast. At the end of 2008, Fannie Mae and Freddie Mac had a combined total of $1.8 trillion of debt outstanding.[8] By the end of 2018 that figure had fallen to $482 billion.[9] We encourage federal policymakers to remain sensitive to the needs of state and local governments and other investors who are already limited in their investment choices.

Preserve local lending models

One of the strengths of the country's mortgage finance system is the diversity of originators that compete in the market. Mortgage brokers, mortgage originators, community banks, credit unions. regional banks and money center banks all compete in the same market, giving homebuyers extraordinary choice in selecting a lender. This diversity and competition helps keep costs low and quality of service high. We urge policymakers to maintain the diversity of mortgage lenders and especially the ability of local and regional originators to service their customers effectively and to ensure that the playing field for competitors in the mortgage origination business remains level.

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[4] Congressional Research Service, "Fannie Mae and Freddie Mac in Conservatorship: Frequently Asked Questions," updated May 31, 2019.
[5] Fannie Mae, "2018 Form 10-K," page 51; Fannie Mae, "2015 Form 10-K," page 86; Freddie Mac, "2015 Form 10-K," page 14; and Freddie Mac, "2018 Form 10-K," page 15.
[8] Fannie Mae, "Funding Summary Report," as of December 31, 2008, and Freddie Mac, "Annual Funding Summary (2001-2008)," www.freddiemac.com/debt/funding/annual_summary.xls
[9] Fannie Mae, "Funding Summary Report," as of December 31, 2018, and Freddie Mac, "2018 Quarterly Funding Summary," www.freddiemac.com/debt/funding/2018_Quarterly_Funding_Summary.xls.