Charting the Course to a Single Security

BY LAURIE GOODMAN AND LEWIS RANIERI*

On August 12, 2014, the Federal Housing Finance Agency (FHFA) issued a request for input on the proposed structure of a single security for the Government-Sponsored Enterprises (Fannie Mae and Freddie Mac, the GSEs). This request is an important development, as it opens the door to a robust discussion of the importance of moving to a single security and greatly increases the likelihood that we will ultimately achieve it.

It is important to realize that the FHFA alone cannot dictate a single security outcome; SIFMA (Securities Industry and Financial Markets Association), the bond market trade association, must endorse it in order to make this single security "good delivery" in substitution for or in addition to Fannie Mae and Freddie Mac securities. However, this proposal is structured so that to prevent a single security outcome, SIFMA would have to change existing rules explicitly for the purpose of blocking this initiative. Given the benefits of achieving a Single Security and the logical paths the FHFA has laid out to get there, we think it unlikely that SIFMA will do this in the end. In short, the FHFA's structuring of the proposal means that a Single Security has moved closer to becoming a "when" rather than an "if." We believe the market has underestimated the importance of this development.

The FHFA first announced in The 2012 Strategic Plan for Enterprise Conservatorships that the development of a single security should be an intermediate-term goal. In the release of The 2014 Strategic Plan for the Conservatorships of Fannie Mae and Freddie Mac, the first strategic plan under Director Watt, this item was moved up in the priority queue. One of the three goals it laid out in the plan was to build a new single family securitization infrastructure for use by the GSEs that can be adapted for use by other participants in the secondary market in the future. The first subgoal is to develop a common securitization platform (CSP) that improves secondary market liquidity, of which the common security is to be a key component. There was little market reaction to the May release, likely because the FHFA provided few details on how or when it would address the challenge.

The August 12 request for comment finally provides those details.

In this commentary, we first discuss the problem the FHFA is trying to solve and the importance of solving it. Then we discuss the proposal in some detail, addressing some of the objections that have been raised already. Finally, we evaluate the actions SIFMA can take, making the case that if this proposal is adopted as written, price convergence is very likely to happen.

We conclude that the effort is a valuable and important one. If successful, a single security will enhance the overall liquidity of the market, remove a considerable if underappreciated burden to the taxpayer, and level the playing field between Fannie Mae and Freddie Mac. Moreover, it will make transition to a new system considerably easier if and when Congress is ever able to move on GSE reform, lowering the barriers to entry for new market participants, as the platform and the security structure becomes accessible to all entrants.

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The Issue That They Are Trying to Solve

Freddie Mac's securities trade at a considerable discount to those of Fannie Mae, compromising the housing finance system's liquidity and increasing risk to taxpayers. The issue is complicated, so bear with us as we wade through it.

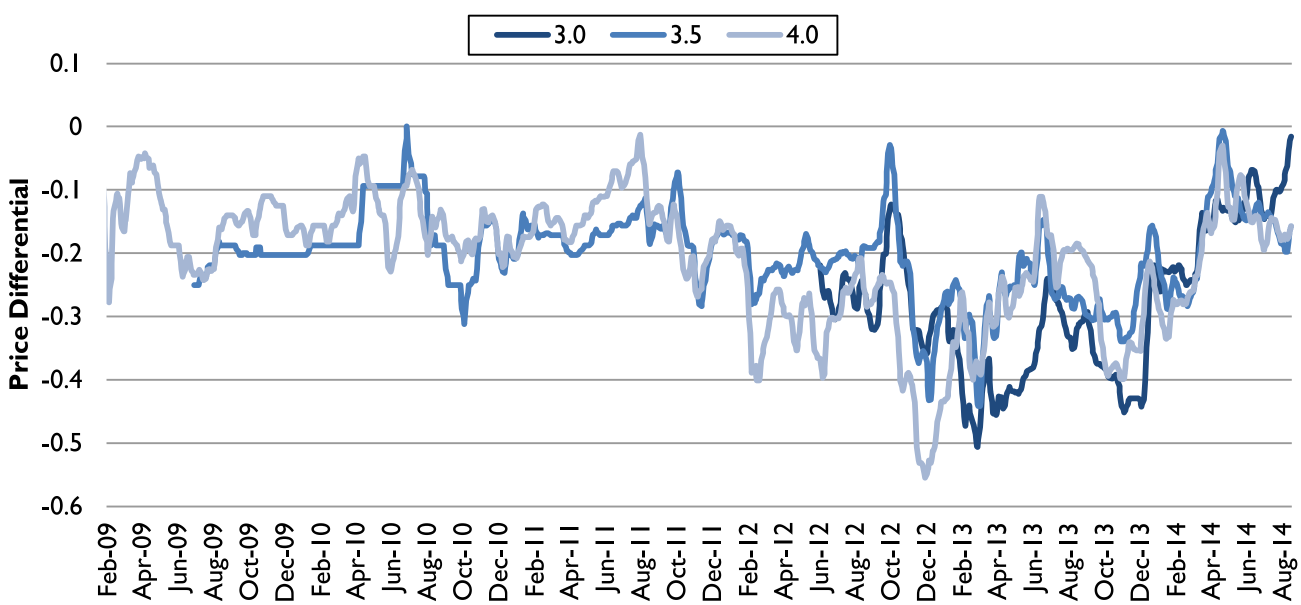
The delay of payment for Freddie Mac securities is 10 days shorter than that for Fannie securities. So, all things being equal, Freddie Mac securities *should* trade at a premium to Fannie Mae securities—that is, Freddie Mac investors receive their cash flows 14 days after the end of the month, rather than 24 days. This is approximately equivalent to the investor getting 10 days' extra interest on a security. If the mortgage interest rate is 3.5 percent, this extra interest is worth just under $0.10. So, if Freddie Mac securities are priced $0.15 cheaper than Fannie Mae's (which is the case at the time of this writing) and should be trading $0.10 higher, they are cheaper by $0.25.

Nonetheless, Freddie Mac securities have historically traded at a significant discount to Fannie Mae securities, as shown in figures 1 and 2. The spreads in the most frequently traded coupons, the 3.5s and 4.0s, have ranged anywhere from half a point behind to even, averaging $0.21 cheaper since 2009, and recently falling on the tighter end of the scale. The price discount on the higher-coupon Freddies (4.5s, 5,0s, 5.5s) is greater than on the lower coupons, averaging $0.33 cheaper over the period. These securities are also trading at the tighter end of their historical range.

There are two reasons Freddie's trade at a discount despite their shorter payment delays: prepayment rates and liquidity. Historically, prepayment rates on Freddie Mac mortgages were faster when the mortgages were in the money (i.e., the coupon on the security was at or below the current mortgage rate). This reflected differences in the composition of the originators delivering the mortgages, and in the implementation of various streamlined refinancing programs. Today, Freddie and Fannie prepayment rates have substantially converged; last month, Freddie's speeds were marginally slower than Fannie's in the lower coupons and marginally faster in the higher coupons. This convergence has, in turn, narrowed the spread between the securities (as shown in figures 1 and 2).

The second reason Freddie Mac securities trade at a discount is lack of liquidity. FINRA (Financial

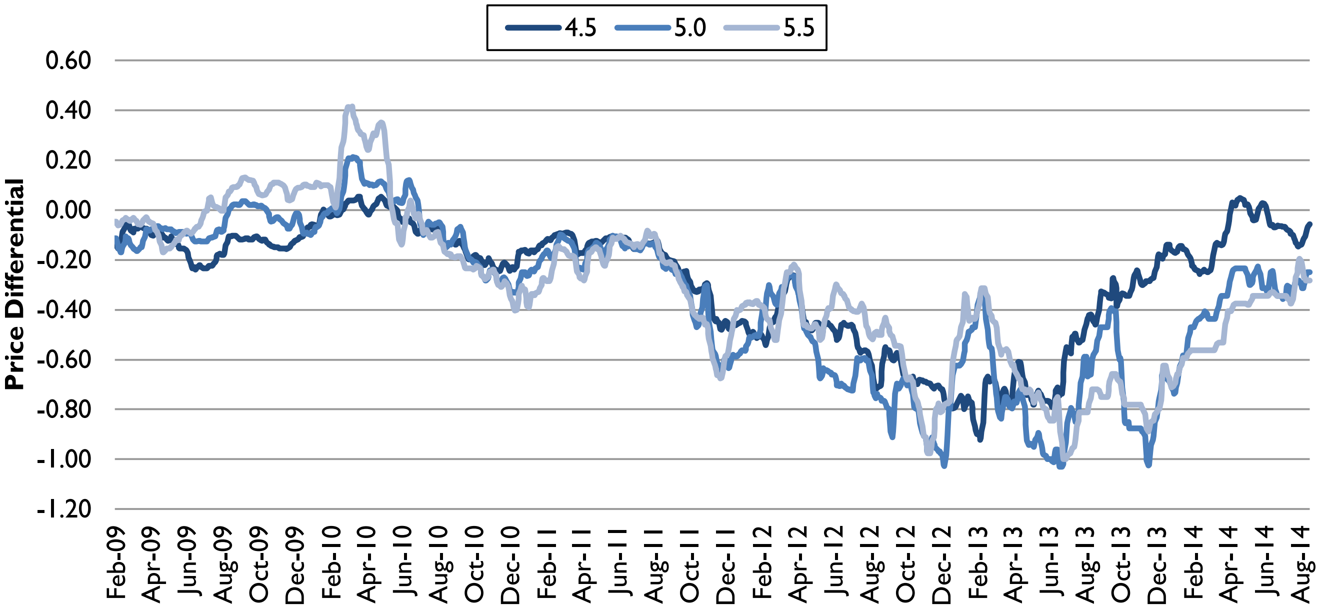
Figure 1: Price Spreads: 3.0, 3.5, and 4.0 Percent Coupons (Freddie Mac Less Fannie Mae Prices)



Sources: Credit Suisse and Urban Institute.

Note: Spreads calculated as five-day moving average.

Figure 2: Price Spreads: 4.5, 5.0, and 5.5 Percent Coupons (Freddie Mac Less Fannie Mae Prices)



Sources: Credit Suisse and Urban Institute.

Note: Spreads calculated as five-day moving average.

Industry Regulatory Authority) numbers show that for recent months, Freddie Mac securities comprise 9 percent of total TBA (to be announced) GSE trading and 9 percent of total TBA 30-year GSE trading.[1] Freddie Mac accounts for roughly 38 percent of total GSE securities outstanding and a similar share of new origination. Not only are there fewer Freddie Mac securities, but also a greater proportion of Freddie Mac than Fannie Mae securities are locked up in collateralized mortgage obligations (CMOs). This combination of factors makes them much less liquid than Fannie Mae securities.

Because Freddie securities are less liquid, most trades involving them are priced as Fannie Mae securities plus the Fannie–Freddie price spread. Thus, with Freddie securities trading more cheaply than their Fannie Mae counterparts, originators seeking the most economic execution would always go to Fannie Mae. However, figure 3 demonstrates that Freddie 30-year production has represented almost 38 percent of total 30-year GSE production over the past 5 years, and closer to 40 percent for the entire period since 1999.

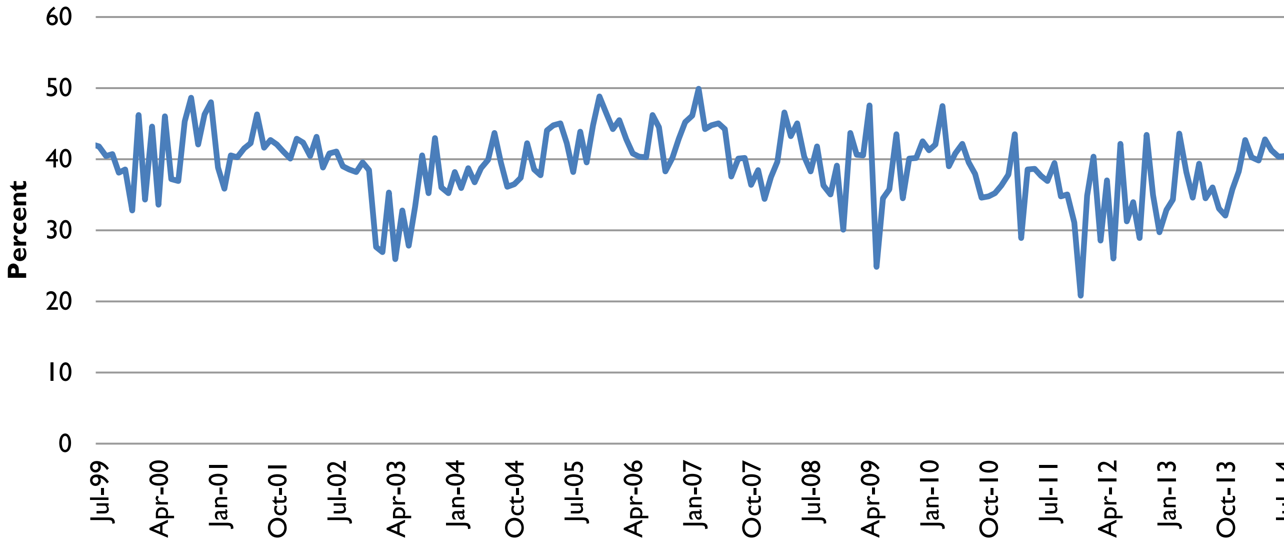
Why has Freddie Mac been able to hold onto that market share? It subsidizes its guarantee fees—that is, it reduces the guarantee fee to make up for the market price differential. The cost of this subsidy falls on taxpayers.

There are many ways to calculate how much this subsidy costs, none of them simple or without controversy. But for a sense of the scale involved, assume that the entirety of the current subsidy of $0.25 per $100 of securities issued (the value of the price discount plus the delay) is passed through to the lender. Given Freddie Mac's average annual production from 2009 to 2013 of $400 billion, this would suggest *that there is an annual subsidy of $1 billion* ($400 billion × 0.25 percent).

In reality, this figure is high, as not all loans receive a subsidy, and the subsidy is often less than 100 percent of the economic value. If we assume that only 80 percent of the production receives some subsidy—and that subsidy averages 75 percent of the economic value—the subsidy would be $600 million. With production expected to be lighter this year, on the order of $250 billion, the annual subsidy would come down to the $400 million area. This is still a very hefty subsidy.

Another way of seeing the impact of the subsidy is to compare effective guarantee fees. Figure 4 shows the spread between Freddie and Fannie's effective

Figure 3: Freddie Mac Share of 30-Year GSE Production



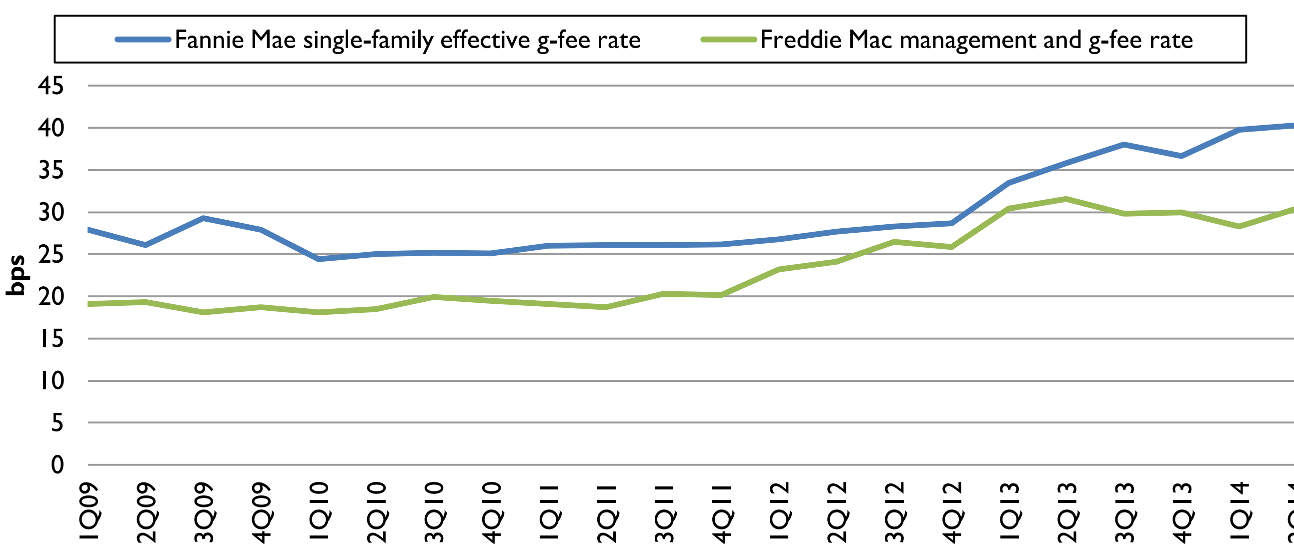
Sources: eMBS and Urban Institute.

guarantee fees; Freddie's fees have averaged about 10 basis points (bps) per annum lower than Fannie's fees. While some of this differential is due to the fact that Freddie Mac has historically held a slightly less risky guarantee book of business, most of the differential is due to Freddie's lower execution price versus Fannie's, a result of both historically higher prepayments (which have now converged) and inferior liquidity.

So, in essence, Freddie is being forced to accept lower guarantee fees than Fannie in order to maintain market share. This trend will continue to act as a significant drag on Freddie's return to economic health, reducing the return to the taxpayer and increasing the chance of further draws from the Treasury.

And recall that we have based our calculation off of a period of relatively tight spreads. As these spreads expand, so too does the subsidy.

Figure 4: Fannie Mae and Freddie Mac Guarantee Fees (bps)



Sources: Fannie Mae, Freddie Mac, and Urban Institute.

The current tightness in spreads is driven largely by three factors: the convergence of prepayment speeds; low volatility in pricing, making it less costly to hold less liquid assets; and the Federal Reserve's (Fed's) unprecedented purchase of agency securities, which has muted the Freddie liquidity shortfall. Spreads between Fannie and Freddie securities could push out substantially if the cost of liquidity rises, particularly as the Fed continues to ease its involvement in this market. At some point, we would expect that as volatility picks up and the Fed is less active, the size of the subsidy will almost surely get worse, perhaps substantially.

How Does This Proposal Solve the Problem?

The FHFA is proposing to eliminate this spread by unifying Fannie and Freddie securities into a single security. The single security structure that they are proposing would align the current Fannie Mae Mortgage Backed Security (MBS) and the current Freddie Mac Participation Certificate (PC) by combining the best features of each security. Thus, the single security would have the superior pooling features of the current Fannie Mae MBS and the superior disclosure features of the Freddie Mac PCs. After a certain date, both entities would issue only securities with these features, using the infrastructure of the CSP.

To ensure maximum liquidity for both the new and legacy securities, the legacy securities would be fungible with the newly issued single security. The proposal suggests that the new single security would share enough features with legacy Fannie Mae securities that conversion with these may not be necessary. For more distinct legacy Freddie Mac securities, the proposal states:

> Investors … would be offered the option to exchange a Freddie Mac PC for a comparable Single Security backed by the same mortgage loans. The option would be available for the life of the legacy PC starting from the introduction of the Single Security.

Discussions with Freddie Mac indicate that their intent is to pay fair value for the extra 10-day delay. Each entity would continue to issue its own securities. Initial securitizations (currently referred to as Fannie Mae MBS and Freddie Mac PCs), must be backed by mortgage loans that represented either 100 percent Freddie Mac or 100 percent Fannie Mae purchases. There would be no comingling of the loans in first-level securitizations. Resecuritizations—currently referred to as Fannie Mae Megas (securities in which the underlying collateral is existing Fannie Mae securities, not loans), Freddie Mac Giants (securities in which the underlying collateral is existing Freddie Mac securities, not loans), and multiclass Fannie Mae and Freddie Mac Stripped MBS and Real Estate Mortgage Investment Conduits (REMICs)—would allow comingling. In other words, resecuritizations issued and guaranteed by either enterprise could be backed by

- Single Securities issued by both enterprises or just one of them;
- Legacy securities issued by both enterprises or just one of them; or
- A combination of Single Securities and legacy securities, which could be issued by both enterprises or just one of them.

Critically, either new or legacy Freddie Mac PCs could be placed into Fannie Mae Megas, and either new or legacy Fannie Mae MBS could be placed into Freddie Giants.

Additional Benefits of the Move

While we believe removing the subsidy that Freddie is forced to pay to investors to be sufficient to warrant the move to a single security, it is not the only benefit. First, it would benefit consumers with lower pricing for products in which Freddie faces little competition. In HARP, for instance, borrowers with Freddie-owned loans often pay higher rates than those with Fannie-owned loans because Freddie faces little competition for these borrowers; they don't need to subsidize their guarantee fees to retain the business, so they don't. In essence, borrowers rather than Freddie pay the illiquidity premium on these loans.

Second, moving to a single security would remove the considerable market advantage that Fannie has on the basis of its security alone. Fannie's price advantage has undermined potential competition with Freddie, rendering the market much less responsive to the needs of borrowers and lenders. Moving to a single security would remove that advantage, boosting competition between Fannie and Freddie, with potential benefits to mortgage rates and the availability of mortgage credit.

Third, moving to a single security will help pave the way for longer-term reform. Virtually every politically and substantively viable plan for longer-term reform—including bills passed out of the Senate Banking Committee and out of the House Financial Services Committee—envisions a single security issued through a single platform, and rightfully so. As described, it makes it easier for more market participants to take on first-loss risk in the system, as they need not provide their own securitization infrastructure as do Fannie and Freddie today.

Addressing Concerns

Since the release of the proposal, there have been several concerns raised, though none appear to us to have merit.

Liquidity

Some fear that the move will actually compromise liquidity rather than improve it. The claim is that the less-desirable Freddie securities will trade in the TBA market and all Fannie securities will trade as specified pools, compromising liquidity.

We view this scenario as unlikely. As discussed earlier, in most coupons the only difference between Freddie and Fannie securities is liquidity. If Freddies were fungible with Fannies, then the liquidity issue would be removed and Freddie and Fannie securities should trade at the same level that Fannies do now. And while there are small differences in prepayment speeds for some higher-coupon mortgages, these do not trade on a TBA basis to begin with, so there should be minimal effect on their liquidity.

Position Limits

Many money managers have separate position limits for Freddie and Fannie. Allowing for either to be deliverable into the TBA market would increase uncertainty for those entities close to the limit because they would not know what securities they would be getting.

As the securities become fungible, there is no reason for firms to operate with these largely internally imposed limits, as the credit risk and terms of payment will be identical. Even with the limits, however, the interests and options of the money managers would not be compromised: they are under no obligation to convert legacy Freddie PCs and investors could still specify whether they want Fannie or Freddie delivery for what is likely to be a very small pay-up. A final option is to make use of Mega/Giant resecuritization to achieve the desired deliverable; allowing those close to their limit in Fannies to deliver some of these Fannies into Freddie Giants and those close to their limit in Freddie's to deliver some of these Freddies into Fannie Megas.

Why Waste the Resources?

Many don't see the need for a single security, believing the resources spent on it could be better dedicated to other activities. Some investors actually prefer the cheaper Freddie Mac securities, particularly for CMOs. Because Freddie Mac PCs are cheaper than their Fannie Mae counterparts, but there is no difference in CMO pricing, Freddie's are used disproportionately to create CMOs.

The problem is that this subsidy is coming at the expense of the taxpayers and adds absolutely no benefit to the mortgage or housing market.

Why Does This Proposal Make Price Convergence More Certain?

As Fannie and Freddie securities are synched up through this process, the next logical step would appear to be allowing them to be delivered into a single security—call it "agency MBS." This will be SIFMA's call, however, and to date SIFMA has declined to make such a move. As recently as 2010 and 2011, SIFMA would have been right to be reticent: prepayment speeds on Freddies were considerably higher than on Fannies, providing an economic reason Freddies should trade cheaper. Making these economically distinct securities deliverable into an "agency MBS" TBA would have thus compromised Fannie's liquidity.

The prepayment speed differences were due to several factors—first, program differences. When the Home Affordable Refinancing Program (HARP) was introduced in 2009, Fannie Mae eliminated its existing streamlined modification program, allowing all pre-March 2009 loans to use the HARP refinance documentation; there was no streamlined program for loans extended after this point. Freddie, on the other hand, kept its existing streamlined program in place until 2012, allowing more non-HARP borrowers to use the streamlined option and producing faster speeds than did Fannie on many coupons. This situation was exacerbated because Freddie's HARP implementation was initially more streamlined and the eligibility window for HARP borrowers was longer. The programs were aligned in early 2012.

Second, Freddie has historically had a narrower mix of originators, who, on average, delivered faster pools to Freddie. Over the past few years, Freddie has taken steps to resolve these issues by seeking a more representative seller mix and requiring those sellers to deliver a more representative mix of their pools. They have reduced their reliance on the top 10 originators from 70 percent in the first half of 2011 to 30 percent in the second half of 2013 and the first quarter of 2014.

Together, these steps have eliminated the prepay speed differences, and with them any economic reason to be concerned about allowing the securities to be deliverable into an "agency MBS." While it is difficult to anticipate how SIFMA will decide with any certainty, we believe that once the payment terms and the economics of the securities have been synched up, it will be difficult for SIFMA not to support the move to a single security.

It is important to realize that by the way FHFA has structured the proposal, to stop the march to a single security, SIFMA would have to do more than simply fail to support the effort— it would have to actively oppose it, altering its existing rules to ensure that the market continued to treat the securities differently despite their economic convergence. It is quite difficult to see on what grounds SIFMA would choose to do this. To see why, one need only walk through the options.

Table 1 considers SIFMA's alternatives in the face of the FHFA proposal:

- SIFMA could allow both Fannie and Freddie single securities to be good delivery into an "agency MBS" TBA. This would be the best outcome, supporting the single security effort and explicitly recognizing that the securities would be issued off the same CSP and with identical characteristics. Legacy Freddie PCs would have to be converted to be identical, but the conversion could take place at any time. Those who want to trade these securities could convert quickly, but buy and hold investors would not have to rush to do so.
- SIFMA could keep the status quo, with Freddie securities deliverable into Freddie pools (both single pools and Giants) and Fannie securities deliverable into Fannie pools (both single pools and Megas). Under the proposed single security, Freddie PCs are deliverable into Fannie Megas, which are, in turn, good delivery into TBA contracts. Current SIFMA rules will lead to price convergence between Freddie and Fannie Single Securities, albeit less cleanly than would an "agency MBS."
- SIFMA could vote to block the FHFA move by ruling that resecuritizations are not good delivery wherever the issue name on the resecuritization does not match the issuer name on 100 percent of the loans. Thus, a Fannie Mega that contains some or all Freddie loans would not be good delivery into a TBA pool.

The third option would require elaborate monitoring and make mortgage pool management

Table 1: SIFMA Actions and Their Consequences

SIFMA Action	Result
Advance the single security agenda: allow for Freddie Mac and Fannie Mae securities to both be good delivery in an "agency MBS" TBA.	Price convergence clearly achieved.
Preserve the existing structure: Freddie Mac and Fannie Mae securities not good delivery into the other.	Price convergence achieved because Freddies have the option to be delivered into Fannie Megapools, which are good delivery.
Take the existing structure one step backward: Freddie Mac and Fannie Mae securities not good delivery into the other; Fannie resecuritizations that contain Freddie securities or Freddie resecuritizations that contain Fannie securities no longer TBA deliverable.	Price convergence not achieved.

extremely difficult. Investors often bundle smaller pools into Megas so that they could manage fewer securities and maintain efficiencies of scale, an important consideration for mortgage investors as pools pay down over time.

It is, thus, very difficult to imagine why SIFMA would step in and block the FHFA's path to a single security, because doing so would create significant economic and practical inefficiencies for the market and its own members.

Two Lingering Concerns

We have two concerns from reviewing the proposal and request for comment. The first is that it is unclear how the FHFA and enterprises will synch up the range of policies and document practices at Fannie and Freddie that will need to be normalized in order to render them economically fungible. Although synching up the timing of payments and the disclosure is clearly important, it alone will not close the gap. The agency and enterprises appreciate this issue, but because they are relatively silent on it, we believe it important to note here.[2]

And the second concern is about timing. The proposal is also silent on this point, except to mention that it is a "multi-year" project. We do not believe that waiting several years to resolve this concern is wise, because the size of the problem could well get much bigger in the meantime—that is, the spreads between Freddie and Fannie are at the narrow end of their historical ranges and, in any sort of liquidity crisis, are likely to push out closer to historical averages. As those spreads widen, the subsidy required of Freddie will get larger, as will the cost to the taxpayer.

Conclusion

We believe that the FHFA has charted a very well-thought-out course to a single security and that the way they have charted it makes it highly likely that it will ultimately succeed. As the FHFA makes its timeline a bit clearer—particularly if that timeline is not too protracted—we would expect the market to begin to price it into their trades, bringing the bulk of the convergence forward well before the birth of the single security. And when they do, it will be none too soon.

Endnotes

[1] TBA is a term used to describe a mortgage-backed securities trade for forward settlement; Fannie Mae, Freddie Mac, and Ginnie Mae securities generally trade in this manner. The term "TBA" is used because the actual mortgage-backed security that will be delivered to fulfill a TBA trade is not designated at the time the trade is done. The designation is made 48 hours prior to the established settlement date for the trade.

[2] The GSEs have shown they appreciate the importance of standardized policies, going to considerable lengths to align both credit policies (maximum loan-to-value (LTV) ratios, minimum credit (FICO) scores, etc.) and servicing requirements (Servicer Alignment Initiative).

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