A Progress Report on Fannie Mae and Freddie Mac's Move to a Single Security

Laurie Goodman and Jim Parrott

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In 2012, Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs) began working with their regulator, the Federal Housing Finance Agency (FHFA), to create a common securitization platform (CSP) to manage much of the GSEs' securitization activities, including, eventually, the issuance by both of a single mortgage-backed security (FHFA 2012).[1]

Together, they developed a plan to migrate Fannie Mae and Freddie Mac's securitization functions over to the CSP in two phases. In the first, the CSP would begin handling functions related to data acceptance, issuance support, and bond administration for the issuance of Freddie Mac's legacy fixed-rate, single-class securities. In the second, the CSP would expand to handle these functions and several others for issuance by both enterprises of a single mortgage-backed security, including commingled resecuritizations of mortgage-backed securities already issued by Fannie Mae and Freddie Mac.

They completed the first phase in 2016 without an apparent hitch and are scheduled to complete the second in June 2019. It is a monumental lift, amounting to synchronizing, migrating, and upgrading a significant share of the infrastructure of two of the world's largest financial institutions, all without disrupting a housing finance system that relies on their functioning smoothly.

Given the difficulty and the stakes involved, it is important to understand why they are going through the trouble before walking through how the transition is to work.

The Problem the FHFA and GSEs Are Solving

Fannie Mae issues considerably more securities each year than Freddie Mac, which has historically made their securities more valuable. To hold market share in the face of this value difference, Freddie Mac has had to offer lenders a discount on the fee it charges for its guarantee, costing Freddie Mac close to $500 million a year in lost revenue.[2] This continued subsidization has made it difficult if not impossible for it to compete with Fannie Mae on equal footing, undermining what little competition we have in a system already compromised by the dominance of a duopoly.

Unifying Fannie Mae and Freddie Mac's issuance into a single security removes that advantage and one of the primary impediments to competition between the two enterprises. It will also make it easier to transition to a system in which new entrants create still more competition. Without a single, commingled security, it is difficult to see how new entrants could overcome the prohibitive advantage Fannie Mae would have with its dominance of the mortgage-backed securities market. Although a single security is not a sufficient condition for evolving the system beyond Fannie Mae and Freddie Mac, it might be a necessary one.

The very prospect of a single security has already begun to solve the problem. As the FHFA and GSEs' effort has progressed, investors have come to value the two securities more equally in anticipation of their success, reducing the need for Freddie Mac to subsidize its guarantee fees. But if the effort falters, the difference will arise again, and Fannie Mae will retain the same competitive advantage.

How the Single Security Is to Work

Under the single security framework, Fannie Mae and Freddie Mac will continue to issue their own securities. Fannie Mae will continue to issue securities backed entirely by loans it purchases, and Freddie Mac will continue to issue securities backed entirely by loans it purchases. The enterprises will be able to use these *first-level securities* as collateral for resecuritizations, or securities backed by other securities. These *second-level securities* can be collateralized by the first-level securities, other second-level securities, or some combination of both. They can be collateralized by new securities, legacy Fannie Mae securities, or some combination of both (legacy Freddie Mac securities will need to be converted into the new single security before backing second-level securities). And they can be collateralized by Fannie Mae securities, Freddie Mac securities, or some combination of both.[3]

Both enterprises will issue and guarantee a new single security collateralized by some combination of these first- and second-level securities. This single security will be called the Uniform Mortgage-Backed Security, or UMBS.

The UMBS payment cycle will follow Fannie Mae's current payment schedule, with payments going to the bondholder on the 25th day of each month. This is 10 days later than Freddie Mac's payment schedule, so holders of eligible legacy Freddie Mac securities will be paid a fee to make up the for the difference if they exchange their securities for the UMBS.

Timeline

The FHFA has published a useful timeline of the transition to the UMBS (figure 1).

FIGURE 1

Single Security Initiative and Common Securitization Platform Timeline

2012

February 21, 2012
FHFA issues "*A Strategic Plan for Enterprise Conservatorships*," announcing the goal of building a new securitization platform.

October 4, 2012
FHFA issues "*Building a New Infrastructure for the Secondary Mortgage Market*," a white paper providing a detailed description of the new securitization platform (including scope, functionality, and design principles) and seeking industry input.

2013

April 30, 2013
FHFA issues "*A Progress Report on the Common Securitization Infrastructure*," reflecting feedback received from the October 2012 white paper.

October 7, 2013
Fannie Mae and Freddie Mac establish *Common Securitization Solutions, LLC* (CSS), the joint venture to build and operate the Common Securitization Platform (CSP).

November 25, 2013
FHFA issues "*A Progress Report on the Implementation of FHFA's Strategic Plan for Enterprise Conservatorships*," indicating that CSP development and testing had begun.

2014

May 13, 2014
FHFA issues "*The 2014 Strategic Plan for the Conservatorship of Fannie Mae and Freddie Mac*," affirming ongoing development of the CSP and announcing development of the Single Security.

August 12, 2014
FHFA issues "*Request for Input: Proposed Single Security Structure*," outlining the proposed structure for the Single Security and seeking industry feedback.

November 3, 2014
Fannie Mae and Freddie Mac announce revisions to the governance structure and operating agreement of CSS and appointment of the first CEO of CSS.

2015

March 16, 2015
FHFA issues a *Progress Report* detailing continued CSP development and testing.

May 15, 2015
FHFA issues "*An Update on the Structure of the Single Security*," detailing changes to the structure of the Single Security in response to feedback received from the August 2014 Request for Input.

September 15, 2015
FHFA issues "*An Update on the Common Securitization Platform*," providing descriptions of the CSP functions, modules, development and testing; the status of the CSS; and announcing that Fannie Mae and Freddie Mac are planning for two releases of the CSP software.

2016

February 19, 2016
Freddie Mac and CSS complete system-to-system testing for Release 1 (first use of CSP software).

March 3, 2016
FHFA issues the "*2015 Scorecard Progress Report*," detailing continued CSP development and testing.

July 7, 2016
FHFA issues "*An Update on Implementation of the Single Security and the Common Securitization Platform*," detailing the progress made and expected milestones.

July 11, 2016
Fannie Mae and *Freddie Mac* publish final Single Security features and disclosures for Release 2.

July 26, 2016
Freddie Mac and CSS complete end-to-end testing for Release 1.

November 18, 2016
Freddie Mac and CSS complete operational and production readiness for Release 1.

Freddie Mac and CSS complete parallel activities for Release 1.

December 8, 2016
FHFA *Announces* Successful Implementation of Release 1 of the Common Securitization Platform.

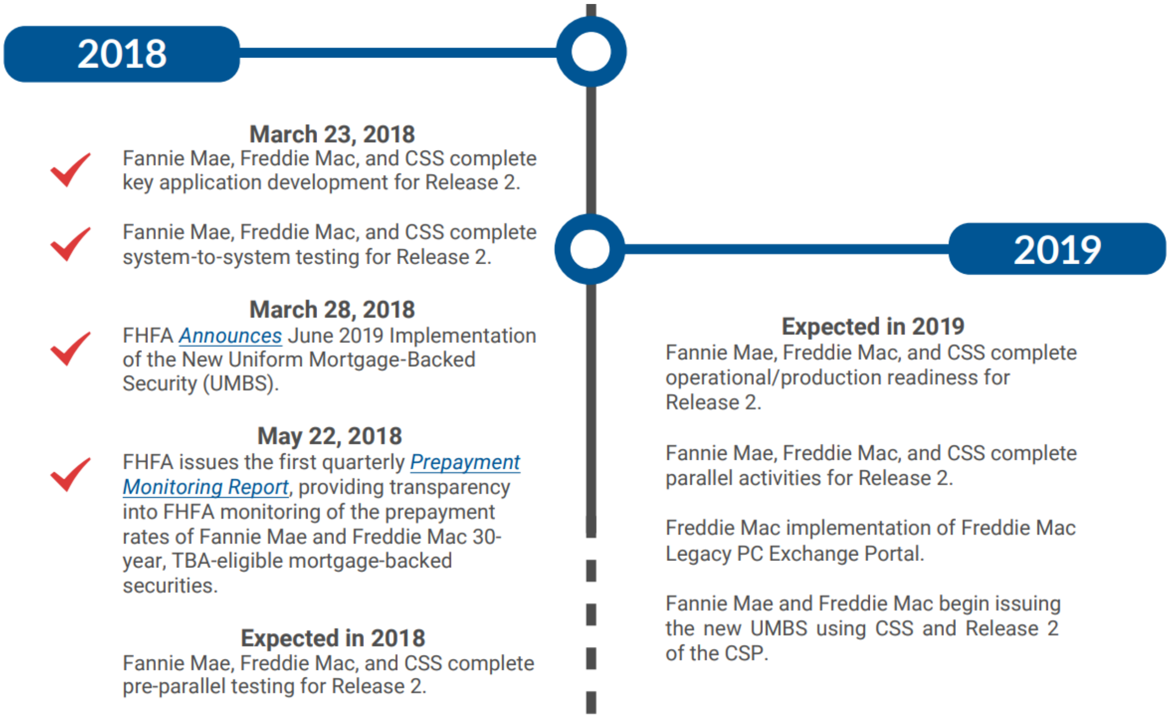
2017

March 23, 2017
FHFA issues "*An Update on the Implementation of the Single Security and the Common Securitization Platform*," providing details of the successful implementation of Release 1 of the CSP, the timeframe for Release 2, costs related to the CSP and CSS, and steps to ensure alignment between the Enterprises to facilitate the Single Security Initiative.

August 28, 2017
Freddie Mac implements aligned investor disclosures in support of the Single Security Initiative.

September 6, 2017
Fannie Mae and Freddie Mac publish the *Market Adoption Playbook* (updated May 2018) identifying possible actions that market participants should consider taking to ensure a smooth transition to the issuance of, and TBA trading in, the new Uniform Mortgage-Backed Securities.

December 4, 2017
FHFA issues "*An Update on the Single Security Initiative and the Common Securitization Platform*" detailing activity and progress on the development of the CSP and implementation of the Single Security Initiative (SSI). This Update also describes outreach by the Enterprises and FHFA to inform and engage market participants as they prepare for SSI implementation.



Source: Federal Housing Finance Agency (used with permission).

What Has to Be Done

Several hurdles must be cleared for the transition to the UMBS to work effectively.

Making Fannie Mae and Freddie Mac's Securities Fungible

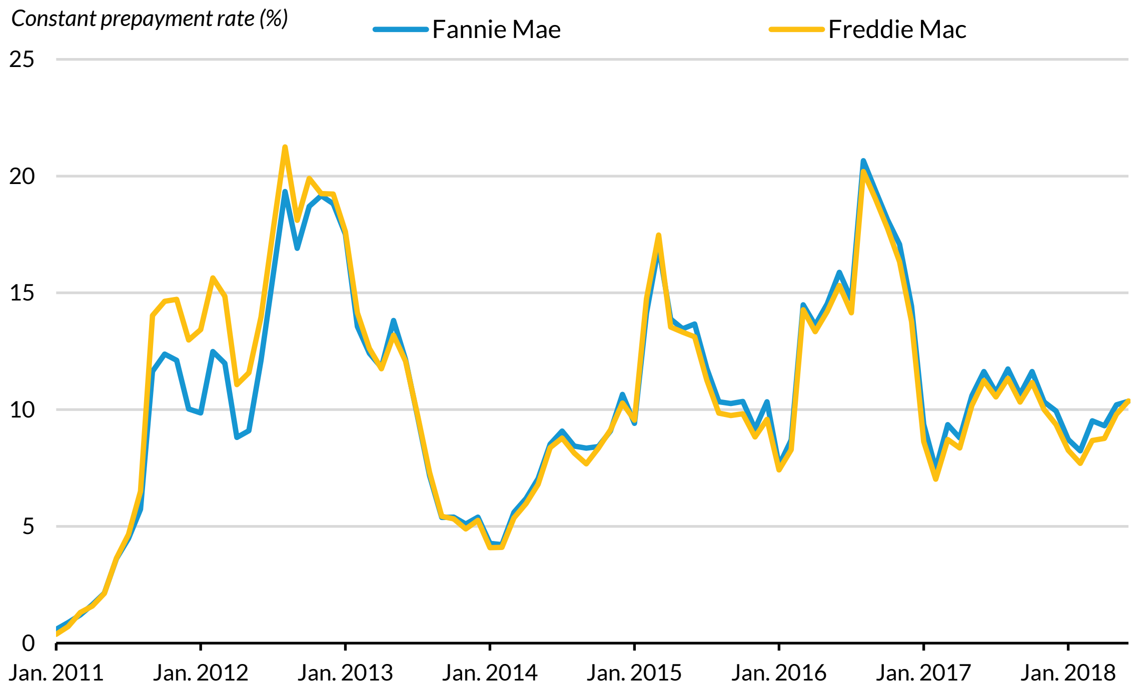
For a single security to be collateralized by the securities of either or both Fannie Mae and Freddie Mac, investors must view them as fungible. If investors do not, they will value each issuance of the UMBS according to which enterprise's securities back them, leading to a breakdown of the new security.

Historically, investors have viewed the enterprises' securities very differently because of differences in their payment schedules, prepayment speeds, and liquidity. If the GSEs and FHFA address payment schedules and prepayment speeds, they will render the securities economically indistinct, allowing them to address liquidity difference by simply moving to a single security. Removing the difference in payment schedules is a straightforward matter—as mentioned, they are simply moving Freddie Mac to Fannie Mae's schedule—but removing the difference in prepayment speeds is more complicated.

The difference in prepayment speeds is driven in part by a difference in how easy it is to refinance loans backed by the two enterprises and in part by the different mix of counterparties, which often originate loans that tend to prepay at different rates. The FHFA has worked to align the relevant refinancing and other policies of Fannie Mae and Freddie Mac, and the GSEs have pushed to develop a mix of counterparties that more accurately reflects the market and thus mirrors one another. As Fannie Mae and Freddie Mac move closer to alignment (figure 2), the FHFA is requiring each enterprise to submit any proposed policy changes going forward that could have an effect on prepayment speeds and is monitoring policies that were initially determined to have no effect on speeds. It has committed to working with Fannie Mae and Freddie Mac to address unexpected differences as they arise.

FIGURE 2

Fannie Mae and Freddie Mac Prepayment Speeds



Sources: Credit Suisse and the Urban Institute.

When pushed to explain how it would track prepayment differences, the FHFA indicated it would investigate any prepayment speed differential exceeding 2 percentage points for any coupon, maturity, or issuance year cohort in a single month (FHFA 2017). Thus, if the prepayment differential between Fannie Mae and Freddie Mac in the 2015-issued 30-year 4.0 coupon exceeded 2 percentage points in June, it would be investigated. Some market participants are pushing for more and stronger assurances, including rules for which policies have to be identical and commitments on what the FHFA will do if divergences arise.[4]

Completing the CSP

For the UMBS to be issued, the CSP will need to support core functions related to data acceptance, issuance, bond administration, and disclosure in the issuance of the new single security by Fannie Mae and Freddie Mac and related resecuritizations. Since the completion of the first phase in November 2016, it has been supporting each of these functions, except those related to disclosure, for the issuance of Freddie Mac's fixed-rate, single-class securities. To be fully functional, then, the CSP will need to expand to support disclosure and to cover issuance of the UMBS, related resecuritizations by both Fannie Mae and Freddie Mac, and real estate mortgage investment conduit (REMIC) bond administration.

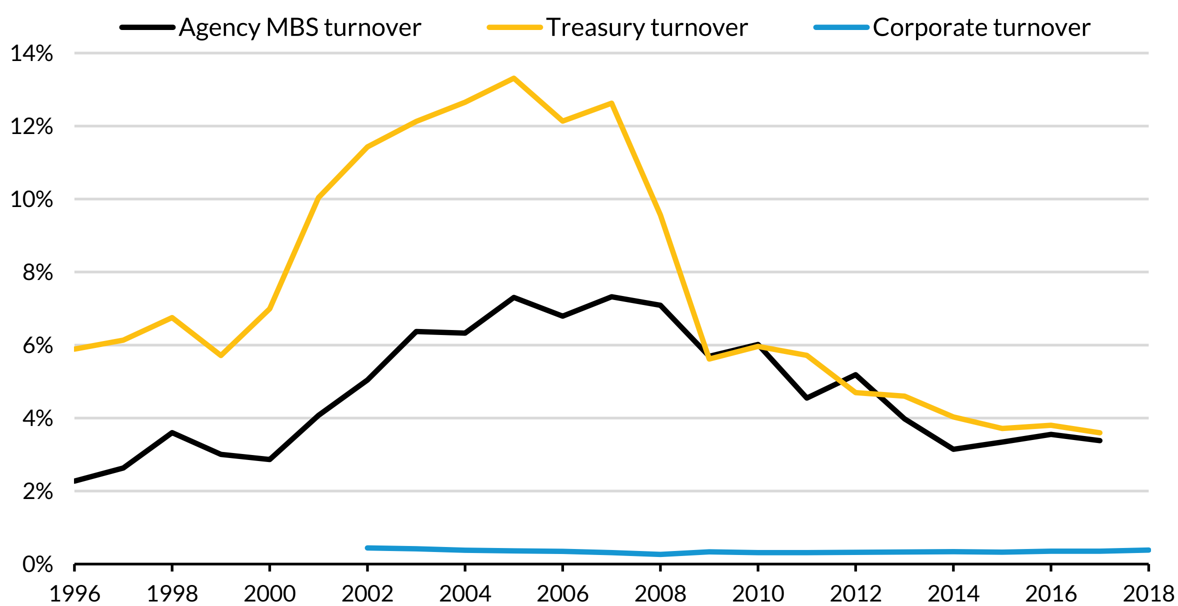
As they did in bringing Freddie Mac's fixed-rate, single-class securitization online, this means running the remaining processes in parallel at Fannie Mae, Freddie Mac, and the CSP to make sure they sync up before migrating them over to the CSP.

Getting the Third Parties Ready

Trading volume in the agency mortgage-backed securities (MBS) market is enormous—$223 billion a day in June 2018. As a share of outstanding MBS, that is only marginally lower than daily turnover of outstanding Treasuries and much higher than levels in the corporate market (figure 3).

FIGURE 3

Average Daily Turnover for Agency MBS (as a Share of Outstanding Volume)



Sources: The Securities Industry and Financial Markets Association and the Urban Institute.
Note: MBS = mortgage-backed securities.

A market of this size requires dozens of third parties to manage the vast infrastructure. The Fixed Income Clearing Corporation nets and clears trades in Fannie Mae and Freddie Mac MBS, the Federal Reserve Bank of New York is the fiscal agency for the GSEs, and several large custodial banks safekeep the assets of most of the money managers (in this role, they are responsible for settlement and delivery of securities). Several major trading platforms handle the bulk of the trading of these securities. There are also data and analytics providers that do pool valuation, allocation and settlement by Committee on Uniform Security Identification Procedures number, MBS index computation, and prepayment reports and projections. The list goes on and on.

All these parties must change their systems to adapt to the UMBS. This means adapting to new processes introduced by the CSP and adapting to changes from other market participants preparing for the same.

To help coordinate this enormous effort, Fannie Mae, Freddie Mac, and the FHFA have undertaken extensive industry outreach efforts. They have developed detailed guidance for each industry sector on what they need to do to be ready (Fannie Mae and Freddie Mac 2018), hosted industry events to allow for interaction and feedback, and are planning an exercise in fall 2018 to simulate how the market will work under the UMBS (FHFA 2017).

Mechanics of the Legacy Freddie Mac Exchange

Legacy Freddie Mac securities will have to be exchanged for the UMBS before they can be resecuritized into second-level securities or traded in the UMBS market. The dealers and custodians that will have to handle this exchange have raised two concerns: that they are not getting paid for the exchange, despite having to dedicate time and resources to the effort, and that they do not know what volumes to expect, leaving them unable to prepare adequately.

To address these issues, Freddie Mac will allow but will not require investors to exchange their securities either through dealers or directly with Freddie Mac, which Freddie Mac may administer through a third party.

Regulatory Clarity

Several regulatory issues will need to be clarified as well.

The Internal Revenue Service (IRS) must rule on the tax treatment of the conversion of legacy Freddie Mac MBS into the UMBS. In particular, it must decide whether the conversion is a taxable event and whether compensation received for the 10-day delay will be taxable income.

The IRS must also decide how to apply the requirement that investments in securities made from segregated accounts must be adequately diversified to get favorable tax treatment. Under the tax code, no more than 55 percent of the total assets in one of these accounts can be the securities of a single issuer, no more than 70 percent can be the securities of any two issuers, no more than 80 percent can be the securities of any three issuers, and no more than 90 percent can be the securities of any four issuers. Fannie Mae and Freddie Mac are currently considered separate issuers, allowing investors to manage their Fannie Mae–Freddie Mac distribution to stay within these rules.

Under the new regime, however, investors will not know at the time they enter a trade for the UMBS what the ultimate mix of Fannie Mae and Freddie Mac securities will be. The IRS thus needs to rule on how investors in UMBS will be expected to remain in compliance with the diversification requirements when they cannot easily control the distribution of issuers in their agency investments.

And then the Securities and Exchange Commission must confirm that the UMBS will be exempt from regulations concerning security-based swaps, as Fannie Mae and Freddie Mac's securities are today.

Although this is a formidable list, the FHFA appears confident that each of the rulings will provide the clarity needed well in advance of the UMBS launch date. Timing will be important, as many key market participants will not begin to prepare until they see clarity on these questions. For example, to be in a position to invest in the UMBS, many money managers will have to go back to their clients to amend the plan guidelines and diversification requirements in their investment management agreements. These amendments often need the approval of the client and the board of directors of either the money manager or the fund, which many money managers are reluctant to seek until the regulatory rulings are in place.

SIFMA's TBA Eligibility Ruling

Finally, for the transition to the UMBS to work, the new security will need to be considered good delivery into the to-be-announced (TBA) market, the market through which investors can commit to purchasing mortgage-backed securities that have yet to be delivered. What is considered good delivery into the TBA market is up to the Securities Industry and Financial Markets Association (SIFMA), the trade association for the dealer community.

When faced with this decision, SIFMA will have three options:

1. SIFMA can decide that all Fannie Mae and Freddie Mac securitizations and single-class resecuritizations are good delivery into the UMBS TBA contract. This is the most direct path to accepting the single security.
2. SIFMA can maintain the status quo, with all Fannie Mae securitizations and single-class resecuritizations considered good delivery into the Fannie Mae TBA market and all Freddie Mac securitizations and single-class resecuritizations considered good delivery into the Freddie Mac TBA market. This, too, would pave the way for fungibility and amount to accepting the single security, though in a less straightforward manner. If Freddie Mac securities begin to sell at a discount, they could be delivered into Fannie Mae resecuritizations, which are deliverable into Fannie Mae TBA contracts.
3. SIFMA could request a delay in implementation until the dealer and investor community's residual concerns are addressed. If the FHFA and GSEs decline, SIFMA would have to either approve in one of the two ways described above or decide that Fannie Mae resecuritizations that contain any amount of Freddie Mac securities and Freddie Mac resecuritizations that

contain any amount of Fannie Mae securities are no longer TBA eligible. This would effectively block the move to a single security. If the hurdles described above are cleared, however, it is difficult to see why SIFMA would block the move to a single security.

Conclusion

In 2012, when then acting FHFA director Ed DeMarco introduced the idea of migrating the securitization infrastructure of Fannie Mae and Freddie Mac to a common platform through which they could issue a single security (FHFA 2012), few outside the enterprises understood how heavy a lift it would be. Six years later, the FHFA and GSEs have mapped out the complex economic, technical, and regulatory path from policy idea to market reality and have navigated through enough of that path that the end is in sight. The most significant challenge now is not completing their own work, or even getting regulators to complete theirs, but convincing the industry that the move to a single security is going to happen and that it needs to be ready. Assuming they clear this last hurdle—and the odds are high that they will—come June 2019, the FHFA and GSEs will have taken one of the most important steps of housing finance reform in decades, resolving a costly inefficiency in today's system and laying the foundation on which Congress might build a healthier system for tomorrow.

Notes

1 The single security was not fully integrated into the CSP's planning until 2014, when Mel Watt became FHFA director. The new FHFA leadership shifted the focus of the effort from developing a market utility open to a wide range of issuers (which was the vision of Watt's predecessor, acting director Ed DeMarco) to the development of a platform to support only Fannie Mae and Freddie Mac. As the FHFA narrowed the focus to Fannie Mae and Freddie Mac, it began to plan the steps needed to move from these two securities to one.

2 Goodman and Ranieri (2014) note that Freddie Mac securities sold, on average, about $0.25 less per $100 of securities issued. Based on Freddie Mac's production from 2015 to 2017, averaging $362 billion a year, this would mean lost revenue of roughly $900 million a year. But not all loans received a discounted fee, and the discounted fee was often less than the full economic value. And loans that go through the cash window are not eligible for the discount in this form. If we assume that only 70 percent of the production receives the discounted fee, and this discount is 75 percent of the economic value, the revenue loss is close to $500 million.

3 The major difference from resecuritization in the current framework is that the second-level securities can be collateralized by securities issued by either GSE. Under the current system, Fannie Mae Mega pools and real estate mortgage investment conduits (REMICS) are composed entirely of Fannie Mae–issued securities, and Freddie Mac Giant pools and REMICs are composed entirely of Freddie Mac–issued securities.

4 Christopher B. Killian, "Single Security—Priority Issues to Be Resolved before Launch," letter to acting deputy director of the Federal Housing Finance Agency's Division of Conservatorship Robert Ryan, July 10, 2018, https://www.sifma.org/wp-content/uploads/2018/07/Single-Security-%E2%80%93-Priority-Issues-to-be-resolved-before-launch.pdf.

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About the Authors

Laurie Goodman is a vice president at the Urban Institute and codirector of its Housing Finance Policy Center, which provides policymakers with data-driven analyses of housing finance policy issues that they can depend on for relevance, accuracy, and independence. Goodman spent 30 years as an analyst and research department manager on Wall Street. From 2008 to 2013, she was a senior managing director at Amherst Securities Group LP, a boutique broker-dealer specializing in securitized products, where her strategy effort became known for its analysis of housing policy issues. From 1993 to 2008, Goodman was head of global fixed income research and manager of US securitized products research at UBS and predecessor firms, which were ranked first by *Institutional Investor* for 11 straight years. Before that, she held research and portfolio management positions at several Wall Street firms. She began her career as a senior economist at the Federal Reserve Bank of New York. Goodman was inducted into the Fixed Income Analysts Hall of Fame in 2009. Goodman serves on the board of directors of MFA Financial and Arch Capital Group and is an adviser to Amherst Capital Management, a member of Morningstar Credit Ratings Regulatory Governance Board, and a member of the Federal Reserve Bank of New York's Financial Advisory Roundtable. She has published more than 200 journal articles and has coauthored and coedited five books. Goodman has a BA in mathematics from the University of Pennsylvania and an AM and PhD in economics from Stanford University.

Jim Parrott is a nonresident fellow at the Urban Institute and owner of Falling Creek Advisors, which provides strategic advice on housing finance issues to national bank and nonbank lenders, a mortgage finance technology start-up that helps smaller lenders sell loans into the secondary market, and a consumer finance technology start-up that uses advanced data science to lend to households not well served by the rest of the market. Before joining Urban in 2013, Parrott spent several years in the Obama White House as a senior adviser at the National Economic Council, where he led the team of advisers charged with counseling the cabinet and president on housing issues. He was on point for developing the administration's major housing policy positions;

articulating and defending those positions with Congress, the press, and public; and counseling White House leadership on related communications and legislative strategy. Before his time in the White House, Parrott was counsel to Secretary Donovan at the US Department of Housing and Urban Development. Before that, he was a litigator, first in New York with Sullivan and Cromwell, and later in North Carolina with Smith Anderson. Parrott serves on the advisory board of the J. Ronald Terwilliger Foundation for Housing America's Families and the Ackland Museum of Art. He also served in Sri Lanka with the Peace Corps. Parrott has a BA in philosophy from the University of North Carolina, an MA in philosophy from the University of Washington, and a JD from Columbia Law School.

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2100 M Street NW
Washington, DC 20037

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