Federal Housing Finance Agency
Office of Inspector General

Fannie Mae and Freddie Mac Uniform Mortgage-Backed Securities

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Executive Summary

Historically, Fannie Mae and Freddie Mac (the Enterprises) each issued its own unique security, backed by that Enterprise's mortgages. According to the Federal Housing Finance Agency (FHFA or Agency), the market for Fannie Mae securities was more liquid than the market for Freddie Mac securities, and Fannie Mae securities tended to trade at higher prices. To compete for mortgage purchases, Freddie Mac subsidized the guarantee fees paid by lenders. According to FHFA, the costs to Freddie Mac ultimately were borne by taxpayers because they reduced the funds available for the Enterprise to make dividend payments to Treasury under the Senior Preferred Stock Purchase Agreement.

In 2014, FHFA directed the Enterprises to build an infrastructure through which a single mortgage-backed security (also called a common security) could be issued. FHFA's principal objectives for the common security were to establish a single, liquid market for Enterprise-issued mortgage-backed securities and to maintain the liquidity of that market over time. FHFA also expected that a common security would reduce or eliminate the cost to Freddie Mac (and, ultimately, the taxpayers) from the historical difference in the liquidity of Fannie Mae and Freddie Mac securities.

In 2019, the Enterprises launched the Uniform Mortgage-Backed Security (UMBS), a mortgage-backed security with the same structure issued either by Fannie Mae or Freddie Mac and backed only by that Enterprise's single-family fixed-rate mortgages.

Most trades of Enterprise mortgage-backed securities are made on a to-be-announced (TBA) basis. With TBA trades, only general features of the security are identified at the time of the trade. The specific security that will be delivered typically is not identified until two days before settlement. Before the UMBS, for example, a TBA trade might have been an agreement to buy $1 million of 30-year Fannie Mae securities with a 4% coupon for settlement in 60 days at a stated price. By contrast, when the UMBS is traded on a TBA basis, which Enterprise will issue the security is not specified at the time of the trade, and a security issued by either Fannie Mae or Freddie Mac can be delivered at settlement. According to FHFA, this interchangeability was intended to merge the formerly separate TBA markets for Enterprise mortgage-backed securities and was key to achieving the Agency's purposes for the UMBS.

As of December 31, 2019, UMBS trading volume exceeded $26 trillion, which surpassed expectations, according to Freddie Mac. FHFA has recognized that the rates at which the mortgages backing Fannie Mae and

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Freddie Mac UMBS prepay might diverge, which could lead to misalignment between the Enterprises' UMBS, and a material divergence in prepayments could lead investors to prefer one security over the other. Fannie Mae and Freddie Mac each identified this risk as a key risk to the success of UMBS.

There have been instances of prepayment differences in UMBS since the Enterprises began to issue the UMBS in 2019. FHFA reported that industry stakeholders have expressed concern that, in the event the rates at which the mortgages backing Fannie Mae and Freddie Mac securities prepay diverged, the interchangeabiliy of the UMBS might be undermined. Should material differences in prepayment speeds develop, the securities could be priced differently and more trades could specify either the Fannie Mae- or Freddie Mac-issued UMBS, eroding the broad market liquidity the UMBS seeks to foster.

FHFA has taken steps to mitigate this risk and maintain alignment of the UMBS. In the long term, divergent prepayment speeds may pose a risk to the interchangeability of the Fannie Mae and Freddie Mac UMBS.

FHFA Director Calabria has observed that success of the UMBS is a critical component of a liquid housing finance market. In light of the potential risks identified with future potential for misalignment, we are issuing this white paper, which discusses the development of UMBS, the risks identified by FHFA and the Enterprises, and efforts by FHFA to mitigate that risk.

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ABBREVIATIONS

CSP	Common Securitization Platform
Enterprises	Fannie Mae and Freddie Mac
FHFA or Agency	Federal Housing Finance Agency
OIG	Federal Housing Finance Agency Office of Inspector General
TBA	To Be Announced
UMBS	Uniform Mortgage-Backed Security

BACKGROUND

Historically, each Enterprise issued its own unique security, backed by that Enterprise's single-family fixed-rate mortgages.[1] According to FHFA, the market for Fannie Mae securities was more liquid than the market for Freddie Mac securities. For example, Fannie Mae securities were traded in much greater volume than Freddie Mac securities and tended to trade at higher prices than similar Freddie Mac securities. Higher security prices made selling mortgages to Fannie Mae more attractive to lenders. To compete for mortgage purchases, Freddie Mac effectively reduced the guarantee fees paid by lenders to offset the weaker performance of its securities, amounting to a subsidy for lenders. In some years, Freddie Mac spent as much as $500 million to subsidize its guarantee fees. According to FHFA, the costs to Freddie Mac ultimately were borne by taxpayers because the costs reduced the funds available for the Enterprise to make dividend payments to Treasury under the Senior Preferred Stock Purchase Agreement.

As conservator, FHFA set a goal for the Enterprises in 2012 to build a new infrastructure for the secondary mortgage market. At the outset, the focus was on development of a common securitization platform (CSP) to be used by each Enterprise to issue its separate mortgage-backed securities. In 2014, FHFA amended the goal: it tasked the Enterprises to construct a CSP through which a single mortgage-backed security (also called a common security) could be issued.

FHFA's principal objectives for the common security were to establish a single, liquid market for Enterprise-issued mortgage-backed securities and maintain the liquidity of that market over time to further its statutory obligation and the Enterprises' charter obligations of ensuring the liquidity of U.S. housing finance markets. In 2018, FHFA estimated that approximately $2.3 trillion of tradeable TBA-eligible Fannie Mae mortgage-backed securities and another $1.3 trillion for Freddie Mac were outstanding in the market.[2] FHFA believed combining the separate TBA markets into one even larger TBA market would increase liquidity. FHFA also expected that a common security would reduce or eliminate the cost to Freddie Mac (and, ultimately, the taxpayers) from the historical difference in the liquidity of Fannie Mae and Freddie Mac securities. The Agency speculated that use of a common security would facilitate the entry of future market participants, should Congress adopt housing finance reform legislation.

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[1] The Enterprises also issue single-family adjustable-rate securities, which do not have a common security.

[2] FHFA considered 15-, 20-, and 30-year Enterprise mortgage-backed securities that had not been resecuritized as collateralized mortgage obligations to be tradeable.

In 2019, the Enterprises launched the UMBS, a common mortgage-backed security.[3] Although FHFA called the effort the Single Security Initiative, Fannie Mae and Freddie Mac mortgages are not commingled in the UMBS. Instead, the UMBS is issued either by Fannie Mae or Freddie Mac and is backed only by that Enterprise's single-family fixed-rate mortgages.[4] The securities have the same structure regardless of which Enterprise is the issuer, including the same number of days from when the borrower's interest accrues on the mortgage to when the investor gets paid.[5]

Most UMBS are traded on a TBA basis: at the time of the trade, the specific security to be delivered is not specified but the maturity date and coupon are. In a TBA trade of the UMBS, a security issued by either Fannie Mae or Freddie Mac can be delivered at settlement.[6] According to FHFA, this interchangeability effectively merged the formerly separate markets for Enterprise mortgage-backed securities and is key to achieving the Agency's purposes for the UMBS.[7]

As of December 31, 2019, UMBS trading volume exceeded $26 trillion, which surpassed expectations, according to Freddie Mac. Both the Enterprises and FHFA considered the launch and initial trading of UMBS to be a success. Fannie Mae reported publicly that the UMBS eliminated the trading advantage of its securities. An FHFA official told us that Freddie Mac is no longer subsidizing lenders by reducing guarantee fees and that the costs to Freddie Mac started falling in January 2019, leading up to the launch of the UMBS. In addition, holders of prior Freddie Mac securities have been able to readily exchange such securities for the UMBS.[8]

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[3] Forward trading of the UMBS for future settlement began on March 12, 2019. The Enterprises first issued the securities and trade settlements began on June 3, 2019.

[4] The UMBS can be resecuritized to create what are known as "Supers"—single-class securities that can be backed by Fannie Mae-issued UMBS, Freddie Mac-issued UMBS, other Supers, or a combination of them.

[5] Prior Fannie Mae securities had a 55-day payment delay, and most prior Freddie Mac securities had a 45-day payment delay. The UMBS has a 55-day delay.

[6] Previously, Enterprise securities also were traded on a TBA basis, but whether the security was issued by Fannie Mae or Freddie Mac was specified at the time of the trade.

[7] A liquid TBA market provides benefits beyond those of trading specific mortgages, according to a 2013 report published by the Federal Reserve Bank of New York. For example, the report observed that lenders often offer borrowers the option to lock in the rate during the origination process, and the TBA market provides lenders with a way to manage the associated risk by selling mortgages forward before origination.

[8] The Securities Industry and Financial Markets Association, which sets delivery guidelines for mortgage-backed securities, determined that prior Fannie Mae securities (which had the same structure as the UMBS) met its delivery guidelines for the UMBS, but prior Freddie Mac securities did not. As a result of the Single Security Initiative, Freddie Mac no longer issues new securities using its prior structure (45-day payment delay) and allows the exchange of previously issued Freddie Mac securities for the UMBS. Currently, more than $200 billion of legacy Freddie Mac securities have been exchanged.

RISK SHOULD THE MARKET DIFFERENTIATE BETWEEN THE FANNIE MAE AND FREDDIE MAC UMBS..................................

In 2019 remarks, FHFA Director Calabria observed that continued success of the UMBS is a critical component of a liquid housing finance market. FHFA has recognized that the rates at which the mortgages backing Fannie Mae and Freddie Mac securities prepay might diverge, and a material divergence in prepayment could lead investors to prefer one security over the other. Fannie Mae and Freddie Mac each identified this risk as a key risk to the success of UMBS.

Prepayment refers to the repayment of mortgage principal, either in part or in full, prior to the agreed-upon maturity date of the mortgage. Borrowers often prepay their mortgages because they can refinance at a lower interest rate. According to FHFA, faster prepayments are undesirable to investors in a falling interest-rate environment; investors would receive a lower return on subsequent investments made with the proceeds of their UMBS investment. In the event that the magnitude of the divergent prepayments were significant, the Enterprise UMBS with the slower prepayment rate would likely be preferred by investors.

FHFA officials explained to us that FHFA recognizes that there will be differences in the prepayment speeds between the Enterprises' UMBS and that its objective is not perfect alignment. They reported that many factors affect prepayment speeds of Enterprise UMBS. These factors include which lenders sell mortgages to each Enterprise, the geographic distribution of the loans, and the credit characteristics of the borrowers.[9] Other key factors are the policies the Enterprises establish for which mortgages will be combined into the pools backing mortgage securities. The Enterprises create three types of pools—single-lender, multi-lender, and specified.[10] A policy of creating larger, multi-lender pools, for example, would offset some effects of different lenders having different prepayment speeds.[11] Additionally, practices such as the range of mortgage interest rates permitted in a pool will affect prepayment speeds.

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[9] Because the Enterprises guarantee payment on the securities, in the event of default the investor receives principal before the stated maturity similar to a prepayment. However, borrowers with weaker credit may prepay slower than borrowers with higher credit scores.

[10] Specified pools are designed to have prepayment characteristics attractive to investors. In recent years, they have accounted for 30% to 40% or more of Enterprise 30-year security issuance, depending on how specified pools are defined, according to FHFA.

[11] The use of multi-lender pools has increased in recent years and currently accounts for approximately 70% to 80% of Enterprise issuance of non-specified securities, according to FHFA.

FHFA recognizes that, in the event that material differences in prepayment speeds were to develop, the securities could be priced differently and investors could select either Fannie Mae- or Freddie Mac-issued UMBS. Such a consequence could erode the broad market liquidity the UMBS seeks to foster.

Recently, there have been instances of prepayment differences in Enterprise UMBS. According to a November 2019 analyst report, investors faced faster prepayments on 2018 and 2019 originations with Freddie Mac-issued UMBS than Fannie Mae-issued UMBS. A Freddie Mac official sought to explain this differential to us by stating that the Enterprise had purchased more mortgages from some larger lenders with faster prepayment speeds than projected. To correct this misalignment, this official reported that Freddie Mac was purchasing fewer mortgages from such lenders.

FHFA'S RISK MITIGATION EFFORTS ....

As conservator, FHFA has authority to address material misalignment, misalignment, or the risk of misalignment in the prepayment speeds of different Enterprises.[12] Depending on the severity, the Agency could require an Enterprise to change or end a program, policy, or practice.

FHFA has established an internal committee to mitigate the risk of a material differential in prepayment rates. That committee monitors the issuance, prepayments, and liquidity of the Enterprise UMBS; reviews attributes of the mortgages underlying the securities and the mix of loan originators; and monitors new Enterprise programs, policies, and practices. Should the committee identify any significant divergence in prepayment speeds, it is authorized to research the causes of that divergence and recommend that the Director take action to address the differential in UMBS price. FHFA has published quarterly prepayment monitoring reports since 2018 that provide information about how the Agency monitors the consistency of prepayment rates for Enterprise UMBS.

FHFA's Regulation

FHFA issued a regulation, effective May 6, 2019, intended to enhance liquidity of the UMBS by achieving sufficiently similar cash flows to continue to incent investors to accept the UMBS from either Enterprise for TBA trades, and to provide transparency and durability into

[12] As conservator, FHFA has broad authority over the Enterprises, with the powers of the directors, officers, and shareholders transferred to the conservator. For information about what authority FHFA has chosen to delegate to the Enterprises and what authority it retains, see OIG, *FHFA Letters of Instruction to the Enterprises* (July 23, 2018) (WPR-2018-004) (online at www.fhfaoig.gov/sites/default/files/WPR-2018-004.pdf).

the process for creating alignment. The regulation codifies alignment requirements that FHFA implemented as conservator.[13] In the event FHFA finds material misalignment, misalignment, or the risk of misalignment, the regulation authorizes it to take remedial actions.[14]

The regulation purportedly authorizes the Agency to require an Enterprise to change or end a program, policy, or practice, depending on the severity of the misalignment. According to the Agency, these authorities, including the enforceability of the alignment requirements, stem from the Director's regulatory authority and duty under the Housing and Economic Recovery Act to ensure that the Enterprises' operations and activities foster liquid, efficient, competitive, and resilient national housing finance markets, as well as the Director's duty to ensure that the Enterprises fulfill the Charter Act and Corporation Act, which includes increasing the liquidity of mortgage investments. It is unknown whether the Agency could have the supervisory authority to enforce these provisions if the Enterprises exit conservatorship.

Alignment of Enterprise Programs, Policies, and Practices Under FHFA's Regulation

Under the regulation:

- The Enterprises' covered programs, policies, and practices must be aligned;[15]
- Each Enterprise must have a governance process to ensure that proposed changes to covered programs, policies, and practices that may cause misalignment of prepayment speeds are submitted for FHFA approval; and

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[13] As conservator, FHFA directed the Enterprises to work with the Agency in 2016 to develop and implement a process to assess new or revised Enterprise programs, policies, and practices for their effects on the cash flows of TBA mortgage-backed securities; monitor purchases, security issuances, and prepayments; and provide related information to the Agency.

[14] The regulation defines misalignment and material misalignment for cohorts of securities. Cohorts are groups of TBA-eligible Enterprise securities with the same coupon, maturity, and year of mortgage origination, where combined Enterprise issuance exceeds $10 billion. Whether prepayments are misaligned or materially misaligned is based on (1) the difference in the prepayment speeds of cohorts of Fannie Mae and Freddie Mac securities or (2) the difference in the prepayment speeds of the fastest paying quartiles of cohorts of Fannie Mae and Freddie Mac securities. The regulation includes a process for FHFA to adjust the definitions if needed. Because measurement is based on the prepayment rate of securities, not the underlying mortgages, how the loans are pooled into securities will affect the prepayment speed for each Enterprise and the difference between them.

[15] Covered programs, policies, or practices are defined in the regulation to mean management actions with reasonably foreseeable effects on cash flows of TBA-eligible securities. For example, actions regarding guarantee fees, the spread between the mortgage rate and the coupon on the security, eligibility standards for sellers and servicers, and loan modifications would be included.

- Changes that likely caused an unanticipated divergence in prepayment speeds must be reported to FHFA.

Alignment of Prepayment Speeds Under FHFA's Regulation

The regulation also sets actions the Enterprises must take in the event of misalignment or material misalignment of prepayment speeds.

- The Enterprises must report any misalignment to FHFA; and
- For material misalignment, they must submit a written report describing the likely cause and plan to address it.[16]

It is unknown whether FHFA's regulation requiring alignment would be enforceable if the Enterprises exit conservatorship.[17]

FHFA's Request for Input

In September 2019, the Agency determined that the market would benefit from further alignment with respect to multi-lender, specified, and single-lender pooling policies. The Enterprises told us that FHFA instructed them to work together on further approaches to align their practices. The Enterprises were unsuccessful in agreeing on an approach. FHFA sought public input on whether further action was needed to ensure reasonably consistent cash flows and continued fungibility of the UMBS. In November 2019, six months after its regulation went into effect, the Agency issued a request for input on Enterprise UMBS practices.

FHFA asked, among other things, for input on which approaches to pooling were preferable and what benefits and costs should be considered. FHFA also requested input on a specific proposal to pool most mortgages sold to the Enterprises into large multi-lender pools.[18] (A modest amount of mortgages with features attractive to investors could be pooled separately.) A number of industry trade associations and other market participants expressed opposition to

[16] In addition to Freddie Mac's faster prepayments noted above resulting in misalignment of recent cohorts, there have been instances of material misalignment of the fastest paying quartiles for older cohorts, with Fannie Mae securities having faster prepayments. Fannie Mae explained to FHFA that the prepayment difference reflected the small remaining principal balance of those securities and the larger average size for Freddie Mac pools.

[17] FHFA took other actions to align pooling practices as conservator. For example, FHFA instructed the Enterprises to pool fixed-rate mortgages so that the mortgage rate is no more than 112.5 basis points greater than the security coupon.

[18] FHFA received a suggestion similar to its proposal in response to a 2014 request for input. At that time, the Agency did not believe it was necessary. FHFA noted that re-securitizations could be used to create large multi-lender pools if there were investor demand. FHFA added that the Enterprises could encourage sellers to create multi-lender pools without requiring it.

FHFA's specific proposal, with some saying that it could have negative consequences for liquidity and for borrowers.[19] Some commenters explained that creating large multi-lender pools does not address underlying misalignment and could mask faster prepaying mortgages. The Enterprises advised us that each has its own views on the best approach to large multi-lender pools. They agree, however, on the importance of maintaining alignment of the UMBS.

CONCLUSION...

FHFA's main objective for the UMBS was to establish and maintain a single liquid market for Fannie Mae and Freddie Mac mortgage-backed securities. The Agency also expected the common security to reduce or eliminate the cost to Freddie Mac and ultimately to taxpayers from the historical difference in the liquidity of Fannie Mae and Freddie Mac securities. The Enterprises launched the UMBS in 2019. FHFA and both Enterprises considered the launch and initial trading to be a success. They also have recognized the potential risk that investors may stop treating the Fannie Mae- and Freddie Mac-issued UMBS as interchangeable, particularly if their prepayment speeds diverge, which could undermine the Agency's purposes for the securities. In the short term, FHFA has taken actions intended to mitigate this risk and plans to continue to monitor the issuance, prepayments, and liquidity of the UMBS. Nevertheless, in the long term, divergent prepayment speeds may pose a risk to the interchangeability of the Fannie Mae and Freddie Mac UMBS.

[19] An industry trade association commented that issuance and trading of specified pools had increased since the introduction of the UMBS, and many of its members believed that TBA liquidity had decreased. There were varying views about how much of the change was related to the UMBS versus interest rates and other factors.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this white paper was to provide information about the UMBS, discuss the risk that the market could differentiate between Fannie Mae- and Freddie Mac-issued securities, and describe actions that have been taken to mitigate this risk. To achieve this objective, we reviewed internal FHFA and Enterprise documents as well as publicly available documents. We also interviewed FHFA and Enterprise officials.

We provided FHFA with the opportunity to respond to a draft of this white paper. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this white paper.

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