

Single Security and CSP Industry Advisory Group

June 9, 2016 – Meeting Summary

Members of the Single Security and Common Securitization Platform (CSP) Industry Advisory Group (IAG) convened at Freddie Mac for the third meeting of the group since it began last year.

Market Focus Groups

Over the past several months, representatives from Fannie Mae, Freddie Mac and the Federal Housing Finance Agency (FHFA) have had several focus group discussions about Single Security impacts with market trade groups and their members. Representatives of the trade groups – including the Mortgage Bankers Association (MBA), the American Bankers Association (ABA), SIFMA, and SFIG shared updates from these meetings and the questions their members raised.

Among those who work in operations and policy roles there is concern about the Single Security timeline – the 12 months’ advance notice of the Single Security launch that FHFA has promised will be important. Lenders and other front-end market participants have “change exhaustion” from the intensive schedule of changes required by a variety of consumer-oriented and safety and soundness regulatory requirements. They want the transition to the Single Security to be more seamless than that to the recent TILA-RESPA Integrated Disclosure Rule. Some larger regional institutions have questions about the impact of the CSP and Single Security on pricing – including guarantee fees, buyups and buydowns, and securitization pricing. The Enterprises reiterated that they intend to continue pricing separately, and acknowledged that the Single Security may have some impact on prices. Lenders also want to understand Freddie Mac’s plans for the Market Adjusted Pricing (MAP) program and how it will be phased out.

On the investment side of the business, asset managers and their operations teams will need time to absorb needed changes in investment guidelines. Asset managers also have questions about the accounting and tax implications of the planned Freddie Mac Gold PC exchange. IAG members believe the lead time of a year –or more– will be helpful for Single Security implementation. But, they also raised the fact that there are a number of other market initiatives, including FICC’s Novation project and FINRA margining changes, that are planned for roughly the same time period as the Single Security. SIFMA has been documenting all the known market initiative timelines and will publish a master schedule soon. IAG participants agreed that there needs to be more outreach on the Single Security to the buy-side of the business, particularly operations and trading. FHFA said they are looking for more market feedback on the timing of the Single Security and what the market needs to get ready – especially since they are scheduled to share a more specific launch timeline with the market later in 2016.

Single Security Go-Live Calendar

Members turned to a discussion of the launch of the Single Security and what “go-live” means. Freddie Mac stated that the project team needs market stakeholder feedback on how they believe trading will

work, including dollar rolls, hedges, open trades and fails across the go-live date, and exchanges of Gold PCs. FHFA, Fannie Mae, and Freddie Mac all emphasized that the goal is to minimize market disruption.

The Enterprises and FHFA shared a draft calendar that they have developed illustrating several months' market activity before and after go-live day. In the calendar, go-live coincides with the ability to issue and settle the first Uniform Mortgage Backed Securities (UMBS). That will mean enabling contracting and forward trading of Single Securities, ahead of having an outlet for their sale. Similarly, if Freddie Mac offers exchanges for UMBS before go-live, there could be forward trading, but investors wouldn't be able to settle for cash. It was also pointed out that with forward trading before a real market, the ability of holders to price and settle collateral in their pledged accounts could be difficult. IAG members agreed that UMBS go-live could be on the first day of a given month. They believe that the Single Security TBA market should get started and might be cheapest-to-deliver – of all outstanding trading – for the first month of the launch. The roll markets would start 1 or 2 months in advance of the Single Security go-live day. IAG members seemed to concur that the Single Security TBA and current Freddie Mac and Fannie Mae TBA markets should not settle in the same month.

Instead, the Enterprises could pick a final settlement month of their current TBA securities markets. For example, if the Single Security were to go live on March 1, the February/March roll should be in Fannie Mae UMBS. TBA trades in Fannie Mae MBS and Freddie Mac PCs would end in February. Then, the current Fannie Mae TBA MBS market will become the initial TBA UMBS market. In March TBA issuance and settlement of the Single Security would begin. The day after February settlement day, investors would be able to begin exchanges of Gold PCs for UMBS. For their financing strategies as the market transitions, investors would still need to see Gold/MBS price spreads for the period from February settlement to March 1. UMBS securities prices could be calculated based off of Fannie Mae MBS. The TBA markets in legacy MBS and PCs would cease, with Fannie Mae securities becoming UMBS, and Freddie Mac TBA Golds becoming a specified market. How to handle trade fails between the preceding month and the month of go-live – particularly for 45-day Gold PCs – needs to be explored further. The Freddie Mac Gold roll will need to have exchange factored in for the March 1 go-live.

SIFMA, as owner of the mortgage securities market good delivery guidelines, noted that while no decisions have been made, it is actively considering what approach to trading a single TBA market will result in the smoothest transition and active trading.

Leading up to the go-live day, lenders may want to do a lot more Cash settlements than Guarantors, and they may opt for early settlements. The Enterprises will need to be prepared for this likelihood.

Freddie Mac Gold PC Exchange

There were some questions about how the Freddie Mac exchange will work. One misconception – which both Enterprises were quick to dispel – is that Freddie Mac would charge for exchanges. There will be no charge for exchange transactions – and Freddie Mac will pay investors for the float because of the longer payment delay for the Single Security. IAG members asked about other exchange parameters – including if there are any transaction volume constraints, whether a single Supers security could be delivered in exchange for multiple PCs (many-to-one exchange), and whether investors have to work

through dealers to execute their exchanges. Freddie Mac is still analyzing whether they have limits on volume, and would like to have a better understanding of how dealers expect to request exchanges. Will there be multiple pieces of a single PC CUSIP – from multiple customer accounts – delivered for exchange into one UMBS that the dealer can parse back out to their accounts? Or will there be pieces of different CUSIPS delivered for multiple UMBS exchanges? More market discussions on this are warranted.

IAG members pointed out that there can be difficulties today with Giants and Megs when multiple bonds are delivered for one Giant. If one bond meant for that transaction can't be located timely in a custodian's account, the entire transaction can fail. Given the goal of a smooth transition and encouraging as many eligible bonds be exchanged as possible, IAG members said Freddie Mac may want to consider encouraging more one-for-one exchanges rather than many bonds being delivered for a single Supers security to limit possible fails. Freddie Mac may also need to allow longer settlement timelines for many-to-one exchanges.

The question of whether investors would have to work through dealers for exchanges was discussed at length. On the one hand, allowing investors to transact directly with Freddie Mac could make exchanges faster, and take some of the administrative burden off of the dealers for managing exchanges for their customers. On the other hand, Freddie Mac has existing transactional and counterparty relationships established with their Giant dealer group. Freddie Mac has no such contractual relationship established with investors, and it could be a lot of work to establish counterparty and banking relationships if the investor only comes in rarely or once to execute their exchanges. Freddie Mac will continue the conversations on this with dealers and investors.

Returning to the topic of accounting and tax implications of exchanges, the Enterprises reported that they are working together to get outside opinions from the SEC for accounting, and a third party tax counsel, and perhaps the IRS, for tax. Both Enterprises stated that their internal experts agree that exchanges are not a buy-sell transaction for the issuer (Freddie Mac) or for an investor (Fannie Mae portfolio). However, while the Enterprises are actively pursuing giving the market additional comfort on exchanges, each investor will still need to consult their own accounting and tax experts.

FHFA Single Security Update

FHFA plans to publish their next update on the Single Security project by the end of the second quarter. The Update will include more specifics on development and testing phases of the Freddie Mac CSP implementation in 2016 as well as the Single Security implementation in 2018. FHFA will also share their approach for monitoring and managing alignment between the Enterprises, a topic that has been of great interest to the market. FHFA shared that the Single Security features published in last May's 2015 Update are considered final. FHFA also told IAG members that the Enterprises will publish their joint Single Security disclosure specification in the next few weeks, following the Update.

CSP Update

Development of the CSP was discussed. Common Securitization Solutions' (CSS) immediate focus is the implementation of Freddie Mac's current Single Class securities on the CSP later this year. Application development and system-to-system testing for R1 is completed. CSS and Freddie Mac are currently engaged in end-to-end testing, which tests each party's systems and operational processes. CSS has completed one "dress rehearsal" moving Freddie Mac loans, PCs, and Giants to the platform. Another rehearsal will happen later this summer. CSS is completing the buildout of all R1 operating controls.

The team at CSS is also actively focused on the Single Security release in 2018, when the Single Security goes live on the platform, along with multiclass securities and Fannie Mae ARMs. Application development and system-to-system testing is in progress. Extensive testing, including tri-party testing is planned for next year. The CSP has been built using a modular, event-driven architecture. The system's design allows for the integration of additional participants in the future.

Another milestone CSS recently achieved was the transition of all former Enterprise employees to CSS employment status. CSS currently has 500 employees and contractors building the platform. At this point, CSS has in-sourced most corporate administrative functions. CSS also has completed the build out of its west coast site.

Disclosure Update

As reported by FHFA, the Enterprises will publish their joint Single Security disclosure specification – in flat file format – later in June. Vendors can begin analyzing the specification to determine their impacts and needed development time. Sample output files will be available later this year, and test files will be published next year for the disclosure vendors. Freddie Mac shared that because we need to prepare for exchange and the issuance of mirror securities prior to the Single Security launch, we will adopt the Single Security disclosure spec for our current securities in mid-2017. Vendors will need to be prepared to support that implementation schedule.

Final Discussion and Adjournment

There were a few more points raised about the market transition to Single Security. Some investors track to the mortgage market indices. Members of the IAG believe that the aggregate indices need to look the same before and after Single Security go-live – both Fannie Mae MBS and eligible-to-exchange Freddie Mac Gold PCs should be counted the same way. Freddie Mac will make exchange as simple as possible, pay float compensation, and show what is available for exchange and what has been exchanged – so the transparency will be there. The Enterprises reported that they have had several discussions with the index providers, but we don't have final decisions from them on their plans.

The Enterprises and FHFA asked IAG members to continue sharing their feedback on the Single Security timeline and market transition issues. They requested members provide vendor outreach contacts as well, to ensure that all potential stakeholder impacts are considered. The transition timeline that was shared in the meeting will be distributed to members following the meeting and posted to the Enterprises' Single Security and CSP web pages.

The IAG meeting was then adjourned.