Mortgage-Backed Security Fails

Much has changed since messengers on bicycles physically delivered Government National Mortgage Association (GNMA) certificates around lower Manhattan on GNMA delivery day. The settlement of mortgage-backed securities (MBS) is now almost completely electronic, yet current market conditions have recently resulted in increased MBS trade settlement failures, or "fails." It is important to understand how and why an MBS fail occurs and what costs it poses to investors.

Current market conditions

- Low overnight rates make it inexpensive for dealers to fail. When a dealer fails to make delivery on a security owed to an investor, the dealer does not have the right to the coupon that the security pays, but neither does the dealer have the money for selling the security. With overnight rates so low, the cost of failing is as low as 9 basis points (bps) per month, and dealers have little incentive to avoid fails or to cure fails immediately.
- The advantage of owning slower prepaying pools has increased as prepayment rates have skyrocketed. Dealers will sort through the pools they receive and look for those pools that pay—or could potentially pay—significantly slower than the average. For instance, many Federal National Mortgage Association (FNMA) 5% pools paid as fast as 60% constant prepayment rate (CPR)[1]. If through sorting, a dealer can find pools that pay as slow as 40% CPR, the value of that slower prepaying pool is 20 bps per month. Compared with the low cost of failing, dealers have found it advantageous to spend time sorting pools.

How do MBS settle?

Virtually all of the trades that Western Asset enters into for our clients will involve one of two settlement methodologies.

1. Pair-Off Trades

These are settlements that are buys and sells that involve only one dealer. These trades settle by netting the difference between the purchase and sale price and wiring that difference to the appropriate custodian bank. Pair-off trades do not fail, but as with any balances wired via the US Federal Reserve's (Fed) wire system, there is the potential for infrequent discrepancies between what one party is wiring and what the other party is expecting.

2. MBS Turns

These are settlements that are buys and sells that involve more than one dealer. On pool allocation day[2], pool information is entered by the selling dealer into the Electronic Pool Notification (EPN) system at the Mortgage-Backed Securities Division (MBSD)[3] and is received by Western Asset. Western Asset then "turns" this pool information to the dealer or dealers to which Western Asset has sold these MBS.

The timeframe for turning allocations is 3 p.m. EST on allocation day. The possibility of receiving and not turning the relevant pool information can be considerable on allocation days, when the whole market is working toward the same deadline.

Why do fails occur?

- **Pool information fails.** Pool information can be past the cutoff time or can be incorrect. These types of fails involve only two parties (a buyer and a seller) and can usually be cleared up within a day.

- "**Round robin" fails.** These are fails that involve multiple parties, both buyers and sellers. Party A is failing to deliver pool information to party B, who is failing to deliver pool information to party C. To complete the chain, C owes pool information to A. These types of fails, often involving many dealers and investors, can take several days to resolve, and they require cooperation among all the participants in the chain for everything to be ultimately worked out. There have been several conference calls among market participants recently that have cleared up many of the recent "round robin" fails.

- **Actual "short" fails.** From time to time, either mortgage originators (lenders) or dealers may sell an MBS security that they do not own, assuming that they will either originate or purchase that security. When this does not occur, the dealer or originator will be "short" and will not be able to deliver pool information. This "short" fail can cause several other participants who have traded in this coupon to also fail. This type of fail can be more difficult to clear up because the dealer or originator who is short may not want other market participants to be aware of the "short" fail.

Cost of fails

A market participant that has sold a security and is failing to deliver will incur the cost of that fail. This cost is generally considered to be the money that could be earned by investing the proceeds of the sale at the overnight rate while the fail is outstanding. Only the original party that fails to settle the trade bears that cost. The party that bought the "failing" security actually benefits by possessing the right to receive the coupon on the security while retaining the cash that had been earmarked to pay for the security. The party can invest this cash overnight and enjoy the right to the interest earned. A participant that serves as an intermediary in a "fail" transaction—both suffering from fails and therefore subsequently failing others—has a net cost of zero. This is the position in which Western Asset usually finds itself.

In summary

MBS now comprise 34% of the market value of the Barclays Capital Index, and as such, can be a significant component of any fixed-income allocation. While Western Asset does not sell MBS that it does not own, we and our clients can be caught up in MBS fails when market-trading volume is high and market conditions are ripe. This is a situation that affects all MBS market participants. If Western Asset and our clients are at the receiving end of the fails, our clients will earn the coupon on the underlying security and have use of their funds until the fail is settled. As a result, there should be no adverse economic impact of these fails on our clients' performance. Western Asset works diligently with dealers, custodian banks and other market participants to ensure that fails for our clients' accounts are cleared up in as timely a fashion as possible.

Footnotes

[1] CPR is the annualized prepayment rate for a mortgage pool.

[2] Allocation day occurs monthly for MBS, and is two days prior to actual settlement day.

[3] The Mortgage-Backed Securities Division, a subsidiary of the Depository Trust and Clearing Corporation. Virtually all MBS settle with the MBSD.