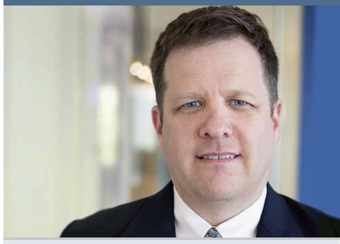

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UMBS: A Single Security Solution for Fannie Mae and Freddie Mac

Executive Summary

- A new "single security"—called the Uniform MBS or UMBS—will be issued jointly by Fannie Mae and Freddie Mac that seeks to simplify investment by standardizing the MBS issues currently offered by each entity.
- Western Asset advises investors to consider aggregating their mortgage concentration and exposure limits (formerly separately designated for Fannie Mae and Freddie Mac) for the combined UMBS investments.
- UMBS issues will be available beginning June 3, 2019.

Give me six hours to chop down a tree and I will spend the first four sharpening the axe.
~Abraham Lincoln

Fannie Mae and Freddie Mac will be making important changes to how their mortgage-backed securities (MBS) are issued, effective June 2019. As these changes may affect investors' related MBS investments, this note describes the rationale for the change, how UMBS investments will work after the effective date and Western Asset's view regarding the new securities. While June 2019 may sound fairly far in the future, getting a good handle on the new UMBS issues now will help investors prepare for what's ahead and maintain the continuity of their investment portfolios.

Background

As it works now, Fannie Mae and Freddie Mac each issue and guarantee mortgage-backed securities, backed by pools of single-family mortgage loans. The securities issued by Fannie Mae are simply known as MBS; the securities issued by Freddie Mac are called Participation Certificates (PCs). Most trading of Fannie Mae MBS and Freddie Mac PCs occurs in the "to be announced" (TBA) market, which is a type of forward market in MBS. The process generally works like this:

1. Counterparties agree on the issuing agency (i.e., Fannie or Freddie), term (e.g., 15-year, 30-year) and coupon (e.g., 3.5%, 4.0%) for a specific settlement month, but not specific pool numbers.
2. The seller retains the option to deliver any pool that satisfies the agreed terms described previously, with additional rules set by the Securities Industry and Financial Markets Association (SIFMA).
3. Two days before the settlement date, the buyer learns which pools she or he will receive.

Why the Change?

The objectives in developing a single security are to establish a single, liquid market for the securities issued by both entities that are backed by fixed-rate loans, and to maintain the liquidity of this market over time. Another goal is to improve the overall liquidity of Fannie Mae and Freddie Mac securities, which currently are not interchangeable with one another. Achievement of these objectives would enhance the liquidity of the TBA market and further the statutory obligations of the Federal Housing Finance Agency (FHFA) to ensure the liquidity of the nation's housing finance markets.

The FHFA is the regulator and conservator of Fannie Mae and Freddie Mac. In its "2014 Conservator Strategic Plan," it included a goal to build a new single-family securitization infrastructure for use by Fannie and Freddie, and adaptable for use by other participants in the secondary market in the future. A result of this was the creation of Common Securitization Solutions—a company jointly owned by Fannie and Freddie—to build a Common Securitization Platform (CSP) that will allow Fannie and Freddie mortgages to be deliverable into a single, fungible security.

This was done because Freddie Mac's mortgage pools commanded a price concession to Fannie Mae's despite both issuers being backed by the same guarantee (Treasury line of credit) and despite the fact that their credit performance and prepayment experience were nearly identical. In fact, much of the FHFA's efforts as conservator was to align both entities to be similar in many ways, including underwriting, borrower eligibility, guarantee pricing, etc. The smaller size, and thus lower liquidity, of Freddie Mac issuance was the primary remaining difference with Fannie Mae. A market where Freddie Mac's bonds were exchangeable with Fannie Mae's would eliminate the liquidity difference and, it was hoped, the pricing difference as well.

Historically, TBA-eligible Fannie Mae MBS have been much more liquid than comparable Freddie Mac PCs. By dollar volume, annual issuance of Fannie Mae MBS has exceeded issuance of Freddie Mac PCs by about 70% in recent years, whereas the trading volume of Fannie Mae MBS has been about nine times that of Freddie Mac PCs. Also, Fannie Mae MBS generally trade at higher prices than Freddie Mac PCs that pay the same coupon rate and are backed by comparable loans. Further, the movement of individual large investors in and out of the market has a greater impact on the prices of Freddie Mac PCs and results in those prices being more volatile. Another goal of developing a single security is to reduce the costs to Freddie Mac and taxpayers that result from the persistent difference in the liquidity of Fannie Mae MBS and Freddie Mac PCs.

The Common Securitization Platform (CSP)

The CSP, in concert with Fannie Mae, Freddie Mac, FHFA, the U.S. Department of the Treasury and other market participants (including SIFMA), has decided that creating a TBA that allows delivery of either Fannie Mae or Freddie Mac is the best shot for the Freddie Mac concession to go away. The newly created Uniform Mortgage-Backed Security or UMBS will replace FNMA as an "issuing agency" in TBA.

The UMBS is identical to a Fannie Mae pool, and all fixed-rate Fannie Mae pools will automatically be considered UMBS. All fixed-rate Freddie Mac pools (issued after implementation of UMBS) will have their payment delay match that of Fannie Mae (55 days) and will be considered UMBS as well. The majority of Freddie Mac pools issued before the implementation date of UMBS are 45-day delay, fixed-rate Freddie Mac pools, which can be converted into UMBS securities by exchanging the 45-day delay Freddie pool for the new 55-day delay UMBS pool plus some cash for the value of the 10-day delay difference. The exchange is optional, and can be done directly with Fannie Mae via TradeWeb or through a dealer intermediary. While much of the legacy Freddie Mac issuance will not be converted to UMBS, because it is locked up in collateralized mortgage obligations (CMOs) or held by investors that choose not to convert, the owner's option to convert creates the liquidity envisioned by the program creators. The universe of pools available to deliver into UMBS TBA will be, in theory, the combination of Fannie Mae and Freddie Mac TBA deliverables.

Adapting to TBA UMBS and Adjusting Concentration Limits

The TBA UMBS is the first potential problem for clients' existing guidelines that have specific issuer limits. For clients who set separate Fannie Mae and Freddie Mac concentration limits, the UMBS TBA will pose a conundrum as we don't know which agency's issues will be delivered. It could be all Fannie Mae, all Freddie Mac or a combination.

Furthermore, one can take a Fannie Mae UMBS pool and have Freddie Mac convert it to a Freddie Mac UMBS pool, effectively reissuing the pool and providing a Freddie Mac credit wrap. One can also take some Fannie Mae pools and combine them with some Freddie Mac pools in a "super" pool, thus having a UMBS "super" pool with some portion issued by Fannie Mae and some by Freddie Mac, but wrapped by one or the other. This complicates the issuer question as well, which is why Western Asset advocates for clients to aggregate their mortgage concentration and exposure limits.

Western Asset's View

Fannie Mae and Freddie Mac pools that are eligible for UMBS can be considered fungible given the conversion options described earlier. Further, the ultimate guarantor for Fannie Mae and Freddie Mac, at least as long as they are in conservatorship, is the US government. We believe the correct way to view Fannie Mae and Freddie Mac is to combine the agency mortgage concentration limits and exposures for both. For example, a 10% limit for Fannie Mae and a 10% limit for Freddie Mac should be combined to a 20% limit on the sum of Fannie Mae, Freddie Mac and UMBS. Even though there may still be small liquidity differences between Fannie Mae and Freddie Mac for non-fungible (non-fixed rate) pools, we believe the conservatorship and Treasury backstop make the issuer a distinction without a difference.

Next Steps

In advance of the June 3, 2019 effective date, Western Asset will be working with affected clients to discuss the new UMBS single security and its treatment with respect to client specific restrictions. Certain clients may need to amend their guidelines to ensure the continuity of their investments.

Western Asset client service contacts will be reaching out to discuss the single security development and suggested guidelines for clients impacted by the single security initiative.

If you have any questions in the meantime, please inquire with your Western Asset Client Service Executive.