

# Viewpoint

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## Proposed New MBS Security Set for Mid-2019 Rollout, but Questions Remain

By Paul Norris, Head of Structured Products

The agency mortgage-backed securities (MBS) market is preparing to introduce a new security, known as the Uniform MBS (UMBS), in June 2019. The security will be the first offered in an effort to unite issuance from the Federal National Mortgage Association (Fannie Mae or Fannie) and the Federal Home Loan Mortgage Corp. (Freddie Mac or Freddie).

While a number of basic facts about UMBS have been established, there are still some remaining issues to be resolved and there is no consensus yet about the market impact once it goes live. Conning is happy to share the information we have at this point and we note that market participants continue to seek better understanding of the pros and cons of UMBS versus traditional Fannie and Freddie MBS.

### Building a Common Platform

The Federal Housing Finance Agency (FHFA), which oversees Fannie and Freddie, is sponsoring the development of a “Single Security Initiative” in a larger push for a Common Securitization Platform (CSP). The CSP is intended to support the FHFA’s primary goal of helping maintain stability and a high level of liquidity in the MBS market.

The single security has been under consideration for years, but the financial crisis helped push the idea to the forefront. While the GSEs were started in different eras (Fannie in 1938, Freddie in 1970), both are intended to provide liquidity and stability to the housing market through the purchase of residential mortgages and issuance of MBS. Consolidation would seem to be logical, but differences related to Fannie and Freddie prepayment speeds and underwriting, for example, make that more complex.

Beginning June 3, 2019, both Fannie and Freddie will issue securities via the UMBS platform in the MBS To Be Announced (TBA) market. In this market, the actual securities to be delivered to fulfill a trade are not designated until settlement, and fulfillment can be either a Fannie or Freddie bond. In June, fulfillment will be via a UMBS security but Fannie or Freddie will be identified as the underlying issuer and guarantor. A common security offers the benefit of simplicity: the UMBS will be structured with a 55-day payment delay, the same as Fannie securities (Freddie securities feature a 45-day delay). It also offers another potential benefit: in the TBA market, Freddie securities, which generally trade at a discount to Fannie’s, have had to be subsidized so they can be valued the same and used interchangeably with Fannie’s. With the introduction

of UMBS, Freddie’s pay-up cost – borne by taxpayers – should go away.

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UMBS securities will apply to 30-, 20-, 15- and 10-year fixed-rate mortgages from Fannie and Freddie. Legacy securities, i.e., any

Fannie or Freddie pools issued prior to June 3, do not have to be converted to UMBS, but Freddie will offer investors the option to convert legacy bonds and the exchange will open for booking on May 7, 2019.

## Tax and Accounting Hurdles

Several steps have been taken to ease the exchange of MBS for UMBS.

The Securities and Exchange Commission has stated that it would not object to treatment of an exchange as a minor modification of the existing security.<sup>1</sup>

This allows the holders of the exchanged security to carry over the basis of their 45-day Freddie securities and recognize the cash payment received as compensation for the 10-day delay in payment cycle as a basis adjustment on the 55-day UMBS security they received.

The Internal Revenue Service published Revenue Ruling 2018-24 regarding certain tax treatment of the Gold PC exchange offer that Freddie plans to make as part of the Single Security Initiative. According to the ruling, the exchange of 45-day Freddie Gold PC securities for 55-day UMBS will not be taxable.<sup>2</sup>

On October 16, 2018, the IRS also published Revenue Procedure 2018-54, which provides guidance for issuer diversification requirements. The TBA market's fulfillment delay and the interchangeable use of Fannie and Freddie securities could leave UMBS TBA investors overexposed to Fannie or Freddie issuance. The FHFA will develop a ratio, updated annually, reflecting the actual market-share balance of Fannie and Freddie, and UMBS investors can use this market ratio for issuer diversification reporting rather than their actual portfolio Fannie/Freddie ratio.<sup>3</sup>

### Investor interest in UMBS: TBD

The complicated nature of exchanging PCs for UMBS may not make investors any more keen on making exchanges; in fact, investors' willingness to exchange is key.

Investors have little economic incentive to exchange legacy Freddie MBS into new UMBS, especially given the administrative work. One possible fallout from this is a three-way market featuring old Fannie Mae MBS, old Freddie Mac MBS and the new UMBS. Conning can envision a future in which older securities would trade at a pay-up to the new UMBS.

Other issues will also likely take more time to resolve, and investors, dealers, vendors and others will need to update contracts, marketing materials, investment documents, systems, and procedures to reflect the new UMBS securities.

Otherwise, progress continues toward the UMBS launch as

planned. The FHFA is awaiting for its newly nominated director, Mark Calabria, to be approved by the U.S. Senate, as Mel Watt's five-year term as director ended in January. Calabria, who is Vice President Mike Pence's chief economist, is not expected to alter the UMBS effort.

### UMBS At A Glance<sup>4</sup>

First Issuance	June 3, 2019
Market	MBS TBA Issuance
Securities Collateral	30-, 20-, 15-, and 10-year fixed-rate mortgages
Guarantor	Fannie Mae or Freddie Mac (identified within the UMBS security)
Pre-payment delay	55 days (same as Frannie Mae)
MBS-UMBS Exchange	Open for booking on May 7, 2019

Prepared by Conning, Inc.

### Contact Conning with Questions

The new UMBS securities will bring change to the investment landscape and will require most market participants to adjust to new conditions, but Conning believes change also brings its share of new opportunities.

A portfolio to meet your specific needs is essential to your business, and Conning has the experience and expertise in insurance asset management to help you navigate the world of MBS, UMBS and many other portfolio and business concerns. We will share more about UMBS when we have information, but please let us know in the meantime if we can be of further assistance.

You can also learn more about the Single Security Initiative on the Freddie Mac website: <http://www.freddiemac.com/mbs/single-security/>.



**Paul Norris** is a Managing Director and Head of Structured Products, and oversees the team involved in the research and trading of structured securities. Prior to joining Conning in 2017, he was a hedge fund portfolio manager focused on mortgage derivatives. Previously, Mr. Norris was head of securitized products at Dwight Asset Management, where he led a team of portfolio managers, traders and analysts, and also has served as director of mortgage and non-mortgage investments at Fannie Mae. Mr. Norris earned a BS in finance from Towson University and an MBA from the University of Maryland.

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## Footnotes

1. Federal Housing Finance Authority (FHFA) (2018), "An Update On the Single Securitization Initiative and Common Securitization Platform," ([https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/Update-on-Implementation-of-the-Single-Security-and-CSP\\_November-2018.pdf](https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/Update-on-Implementation-of-the-Single-Security-and-CSP_November-2018.pdf), page 8).
2. *ibid*
3. *ibid*, page 9
4. "Single Security and the Common Securitization Platform (CSP)," <http://www.freddiemac.com/mbs/single-security/>.