FIVE BRIDGES

December 3, 2012

Mr. Edward DeMarco
Acting Director
Federal Housing Finance Agency
400 7th Street, S.W.
Washington, DC 20024
Edward.demarco@fhfa.gov

Submission to: SecuritizationInfrastructure@fhfa.gov

Re: Building a New Infrastructure for the Secondary Mortgage Market

Dear Mr. DeMarco:

Five Bridges Advisors, LLC a Washington, D.C.-based mortgage analytics and advisory firm with broad expertise in the U.S. mortgage, housing and real estate markets appreciates the opportunity to comment of the FHFA's *Building a New Infrastructure for the Secondary Mortgage Market* (White Paper). Below please find Five Bridges' general comments on the White Paper[1].

Background Information

As a result of the greatest housing crisis in nearly 100 years, the FHFA was forced to take Fannie Mae and Freddie Mac into conservatorship in September 2008.

On February 21st, 2012, the FHFA sent to Congress their *Strategic Plan for Enterprise Conservatorship: The Next Chapter in a Story that Needs an Ending* (Strategic Plan). On March 9th, 2012, the FHFA released a *2012 Conservation Scorecard* which was offered as a roadmap for the implementation of the FHFA Strategic Plan announced in February 2012. The Scorecard includes specific objectives and timetables for the Enterprises in support of the Strategic Plan. One of the Scorecard requirements was for a new template for enhanced loan-level disclosure to be delivered by June 30th, 2012.

On October 4th, 2012 the FHFA released *Building a New Infrastructure for the Secondary Mortgage Market* (White Paper) and asked for the industry to comment. The purpose of this White Paper was to describe a proposed framework for both a new securitization platform and a model Pooling and Servicing Agreement. While the Strategic Plan

[1] Five Bridges wishes to thank our many advisors and affiliates who have shared their perspectives and insights into the Strategic Plan. In particular, we would like to thank W. Scott Frame and Thomas Stanton for their contributions to our thoughts. The views and opinions presented hear reflect those of Five Bridges only.

established a vision for housing finance that leverages the development of a new infrastructure of the Enterprises, it also envisions the possibility that this platform could have broader application to the private sector. Finally, later in October the FHFA released its longer term framework for conservatorship (FHFA Strategic Plan: FY 2013 – 2017; *Preparing a Foundation for a More Efficient and Effective Housing Finance System*).

Five Bridges' role in the mortgage markets is as the developer of modern, advanced mortgage analytics and the provider of independent, expert, advisory solutions related to many of the complex data and analytical questions of housing and mortgage finance. We advise clients including regulators, federal agencies, central banks, broker/dealers, institutional investors, originators, servicers, law firms and other market participants. Having decades of collective experience with every participant in the housing finance system, both public and private, our firm is well positioned to understand the complexities of both the challenges and the potential solutions.

One of the hallmarks of value provided by the Enterprises over the years has been their ability to impart standards on the real estate, housing and secondary markets. Unfortunately, as competitors, this often resulted in not one, but two sets of standards. The Enterprise duopoly was "arbitraged" by their customers who determined which entity provided the set of standards that best suit their business needs at any given moment.

The FHFA should be commended for taking the needed initiative of eliminating costly and confusing differences in areas of the platforms that did not require competition. Since Conservatorship in 2008, the FHFA has mandated that the Enterprises eliminate many of the differences which previously discouraged smaller lenders and other market participants from active participation. These efforts have begun to re-level the origination and servicing playing fields and encourage ethical behavior by all participants.

However, the work done to date, as difficult as it may appear, represents the obvious and easiest changes. With this low hanging fruit picked, the FHFA now embarks on decisions that will impact the delivery of US housing policy for many years to come. While the FHFA recognizes that ultimate decisions on housing policy are the purview of the US Congress, it has acted aggressively to ensure more transparency in housing finance.

While the White Paper presents a more exhaustive discussion of platform elements, our comments are intentionally limited to the White Paper's discussion on data and data disclosure from the securitization platform.

Five Bridges' General Comments

Five Bridges' principals, members, and employees have been active participants in the U.S. housing market for more than 30 years. Our principals and partners have collectively spent more than 20 years working at the GSEs, and an even longer tenure in the private sector.

The White Paper provided a very high level view of a proposed platform for securitization. While we agree with many of the broad points, many of the items are left for broad interpretation.

Our comments herein are predicated on the assumption that the FHFA is looking to develop a platform that is expected to become a market standard and designed to be utilized by the private sector as well. This is a serious concern as it is not clear that the FHFA wishes for a platform that "could" versus "will" be that standard. One takes luck and the other determination. There is great distinction that should not be lost in usage.

It would be easier on some levels for the FHFA to simply "modernize" one or both of the existing Enterprises and hope that on the margin these efforts create some economies of scale that attract others to it. It would be far more challenging (but also more beneficial to the apparent "Contract" goals of the Strategic Plan) to develop a platform that the industry expects to be the future securitization platform. Industry participation from the onset is the only path to such an outcome.

Broad disclosure transparency is a prerequisite to future housing success. The US is seven years past peak housing prices, and six years from the onset of the largest economic downturn in nearly a century. We believe strongly that bad collateral hurt the performance of Agency and private label MBS, not bad securitization structures. Whether a pass-through security with an agency wrap, or a private label senior-subordinated structure with multiple tranches, the legal structure was not the cause of poor performance by mortgage borrowers underlying RMBS deals.[2] The same structures and vehicles, by and large, continued to be used in other structured finance sectors without the same outcome. The difference was in the level of transparency provided on the underlying collateral pool.

As owners and managers of one of the most comprehensive mortgage, consumer, property securities and economic data repositories in the world, we would offer that transparency is good for markets. We like to say that "transparency only kills things that needed to be killed". If a marketplace cannot survive the scrutiny of all participants without the

---

[2] It should be noted that many issues existed in PLS PSAs due to the lack of investor access to accurate and credible collateral information. Misalignments of interest between issuer/sponsor and investors related to the origination representations and warranties were commonplace but did not, themselves, cause individual loan defaults.

censorship of the opportunity for open and complete flow of information then what is the long-term benefit of that market?

While the Enterprises (and other guarantors), ratings agencies and the broker-dealer community have all argued to protect information asymmetry to their individual benefits, a lesson learned through the current crisis is that *all* investors share in the risk of poor MBS performance and therefore should have equal insights into collateral performance. Overreliance on the "disclosures" of others and the "ratings" of conflicted independent corporations must be replaced with access to the level of investor disclosure necessary for investors to develop their own independent conclusions on risk and reward.

Data disclosure on assets and trading has fueled the expansion of numerous US markets over the last 20 years. FINRA's Trade Reporting and Compliance Engine (TRACE) created growth and expansion of the corporate bond market as a result of transparency in over-the-counter trade pricing. The TBA market created real-time price transparency in residential mortgages. The CMBS market provides updated information on the debt service and vacancy of many of the underlying pieces of collateral allowing for more accurate on-going assessments of risk. Investors need information to make accurate decisions.

While the quantity of information helps, far more important is the quality of information. In the proposed platform diagrams, the White Paper envisions a centralized data repository with vendors providing data management and other services. We believe that this approach will only attract private capital if the quality of the information and its timeliness are different than what has been offered in the past. Neither the Agency nor the PLS market provided investors with the quality or quantity of information on borrowers, property or loans that would be needed to accurately assess risk dynamically and over time.

We believe that the key to efficient execution in the transfer of interest rate and credit risk lies in the expansion of quality disclosure and transparency. We encourage the FHFA to work towards a platform that encourages private sector participants as opposed to developing one or more separate platforms and returning us to a fragmented market like that found pre-crisis.

1) Separate the Credit Enhancement (risk guarantor) from role as controller of operational functions. The data repository as outlined in the White Paper is a sound concept. Creating a centralized data structure to aggregate, store, and verify data on the platform with create economies of scale and increase investor confidence if properly executed.

The FHFA would be well served, in our opinion, to recognize the inherent conflicts of interest in having the guarantor of risk as the guardian of data supporting the operations of the platform. Historically, the Enterprises controlled every aspect of data; origination, servicing, payment, tax, investor reporting. As a result, investors in Agency MBS were constantly suspicious of the Enterprises access to or use of loan level data as a competitive advantage. For example, investors always assumed that the Enterprises used their loan level data as a means to improve assets selection and manage purchases by their retained portfolios.

Just as many servicers (and their parent companies) have been criticized during the crisis for the conflicts arising from a dual role as servicer and investor, the Enterprises need to be removed from the day-to-day management of the operational components of any new platform. The Enterprises have used their power to standardize the markets, often for the good, but arguably in ways that limited access to needed information by regulators, investors and customers. Investor disclosures for instance, are not provided at a level of granularity that would allow investors to make any future decision on credit risk at the loan or pool level.

One of the most important lessons learned from the last six years has been that *all* investors have exposure to changing borrower dynamics that affect performance. Every investor is exposed to credit risk, not just the guarantors. Whether payment, liquidity or market related, these credit risks need to be understood through thoughtful analysis by investors. Detailed analysis by investors should be the determinate of whether a loan pool provides the enhancements needed to make reasonable investment decisions.

Providing just enough information to execute a transaction versus providing enough detail to monitor and value on-going risk represent two very different levels of data aggregation and disclosure. The Enterprises over the years have provided only a guarantors level of disclosure of limit utility and cloaked it with the label of "investor disclosure". The FHFA White Paper describes a platform that tries to balance standardization and competition. Investors drive markets and best execution. More complete and accurate collateral data matched[3] to individual pools and managed by independent, third parties is needed to ensure that the private sector has confidence in the platform.

2) Increase confidence through historical and on-going disclosures. If broad distribution of risk is desired, the FHFA must encourage and support a platform that ensures that all data, not limited or unmatched data is made available to investors in a timely and cost effective process. The market should bear the burden of this expense. Going forward, if credit risk is to be distributed it needs to be modeled and forecast.

[3] Historically, neither the PLS or Agency markets have provided enough detail to match loans to pools in monitoring on-going performance.

Access to empirical and on-going disclosure of data relevant to informed modeling techniques is the only way that investors can develop clear views of the cost and benefit of accepting residential credit risk.

Recall, that the GSEs tried to share or transfer credit risk with the private sector previously, with limited success. In 1997, Freddie Mac evaluated the potential to issue credit derivatives to sell off mortgage default risk. In spring of 1998, Freddie issued a $243-million dollar Mortgage Default Recourse Notes (MODERNs), the first attempt by an Enterprise to manage mortgage default risk through the capital markets. This was supposed to be the first step in developing an "efficient derivatives market for mortgage credit risk"[4]. But even this transaction never saw offspring by the Enterprises. Lack of public disclosure on the prior or on-going performance of the underlying loans made it nearly impossible for investors to accurately value the risk being transferred. The result was a substantial investment in time and resources that led to a platform of limited utility.

If the FHFA wishes to develop a market that encourages risk sharing it will require that information asymmetry is limited such that the initial guarantors of risk are not the only ones that have access to modeling or costing information.

3) Markets will evolve, utilities often don't. Historically, the credit risk of residential US mortgages has been largely a "buy and hold" asset with the Enterprises the primary investor. The FHFA needs to develop a platform that anticipates that the secondary transfer of prepayment or default risk in the future will be a necessary option for investors. The Strategic Plan envisions a marketplace for credit risk where the original guarantor may not be the only or ultimate guarantor. This is important as no participant today can accurately envision or model all of the potential issues facing housing finance in the coming decades. Whether for economic, regulatory, or market reasons, today's interested investors may not be around in the future. Therefore best execution is attained when the market for a product is deep and plentiful and where the pool of buyers is dynamic.

The FHFA has used the term "utility" in the White Paper and previous documents to describe how it could envision the provision of some services by the new securitization platform. The concept of utilities is flawed as history tells us that utilities often become highly inefficient in delivering their services. While public utilities are often private corporations, the extensive regulation stymies the ability (or desire) to invest in the systems and operations that would be most interested by the private investment community.

[4] Credit Derivatives: Hedging Closer to Happiness; Secondary Mortgage Markets; A Freddie Mac Publication, Freddie Mac (December 1999) Vol. 16, No. 2

The only way to ensure that a marketplace is ready for changing investor demand is to ensure that the quality and quantity of information disclosed prior to, during and after securitization is available to all potential guarantors. We see this as a data repository governance issue.

Governance of the data repository and the "adaptors" to the repository should be led by an advisory board comprised heavily by the private sector from platform initiation, including representatives from all functional operations with access to or engagement with the repository. The FHFA or some other governmental body should chair the board and provide for a consistent and open dialogue.

Evolution in the residential mortgage market is inevitable and the FHFA's focus on interoperability and flexibility is noble. Keeping the data repository and other operations is the control of governmental entities will diminish the private sector's confidence. Governance of the data repository and operational roles of the platform needs to be an industry solution.

4) A TBA market may not be for everyone so don't to support it alone. The to-be-announced (TBA) market has served US homeowners well for decades as a useful mechanism to link borrowers of mortgage capital to those investors willing to supply it to them. And the Enterprises have done a great service to the marketplace as the overseer of this innovation. The TBA market has distributed risk across numerous types of investors and expanded the reach around the globe. Critical to the success of the TBA market has been the investor acceptance of homogenous product delivery. This homogeneity is the link to the liquidity that TBA provides investors. However, the market has evolved to include very active specified pool trading which has devolved the TBA market into a true cheapest to deliver marketplace.

The FHFA would be well suited to develop the platform in a way that is built for both a world that values liquidity over transparency but also for one that does not. Foreign investors provided a deep pocket of capital during the bubble-years. There is no guarantee, that barring the explicit guarantee of the US taxpayer, that foreign capital will ever return to the US housing finance system. In fact, foreign investors currently fall well behind domestic banks, pension funds, mutual funds, savings institutions, and the Federal Reserve in their current holdings of Agency MBS. Estimated at $600-billion dollars[5], this balance is little changed in the last year and net flows are estimated to be flat to declining. In fact the Enterprises are responsible for little of this supply as the majority of these holdings have been GNMAs.

[5] Freddie Mac Investor Presentation; October 2012

Building a system that requires or relies upon government guarantees for participation and liquidity is contrary to the stated mission of the Strategic Plan. While it may seem to be the least painful solution to simply "modernize" the existing Enterprises, it is by no means the best. A return the past ignores the important new role for private capital. Investors drive markets and market innovation. While the TBA market is an important risk distribution mechanism, the FHFA platform should establish operational principles that do not require governmental activity for success.

Conclusion

It is certainly possible that the four (4) core functions described in the White Paper could provide the foundation for the future of housing finance. If the goal of the platform is truly to expand the distribution of both prepayment and credit risk beyond government, then we believe that these operational functions must be independent of the Enterprises.

However, it is not clear to us why the private sector would participate or use an FHFA platform for all securitization unless it had the confidence that participation would represent industry best practices that were free of governmental influence (perceived or real), created legal safe harbors or offered economies of scale on costs. Without such confidence, the private sector will seek one or more alternative platforms that serve similar purposes but provide more flexibility.

We believe that the markets are best served where the risk guarantors, like all debt holders are customers of a central data repository, not its operator. The data repository should be governed by an industry advisory board led by the FHFA which controls the flow of information into and out of the repository and oversees the platform contracting of services.

Practically speaking, modernization of the Enterprise platform is the most likely short term outcome, however we believe that the FHFA is on the right path and should continue to focus on a platform that:

- Establishes practices and principals benefit all investors equally
- Provides for quality data disclosure before, during and after securitization
- Leverages the technology and resources of the private sector from inception
- Encourages broad constituency involvement from external stakeholders and private sector in all phases of development

Five Bridges respects the challenges facing the FHFA at this critical moment in US history, understands the limitations on the FHFA, is knowledgeable of the Enterprises and appreciates the opportunity to respond. Any questions about Five Bridges' comments should be directed to Steve Gaenzler at 301-841-6444 or sgaenzler@fivebridgesllc.com.

Yours truly,

Stephen Gaenzler, CFA
Co-Founder and Principal
Five Bridges Advisors, LLC

Michael Youngblood, PhD
Co-Founder and Principal
Five Bridges Advisors, LLC