FannieMae

Timothy J. Mayopoulos

Executive Vice President,
Chief Administrative Officer, General Counsel and
Corporate Secretary

3900 Wisconsin Avenue, NW
Washington, DC 20016-2892
202 752 7144
202 752 6952 (fax)
timothy_mayopoulos@fanniemae.com

April 30, 2012

Ms. Jennifer J. Johnson, Secretary
Board of Governors
Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Submitted by email to regs.comments@federalreserve.gov

Re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies. Regulation YY; Docket No. 1438, RIN 7100–AD-86

Dear Ms. Johnson:

Fannie Mae appreciates the opportunity to comment on the notice of proposed rulemaking implementing the standards required by Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). We will confine our comments to section V of the proposal – Single Counterparty Exposure Limits. We want to address this section, in particular, since it has profound implications for the secondary mortgage market in which we operate. We understand that the Board's proposal exempts the securities of Fannie Mae as long as it is operating under conservatorship.[1] However, the proposal has significant implications for the secondary mortgage market at large that extend beyond this exemption.

Our comment letter will address three aspects of the proposed Single Counterparty Exposure Limit rule:

I. Counterparty Exposure to Corporate-Guaranteed MBS and Covered Bonds;
II. Transactions-related Exposures in Secondary Market Operations; and
III. Definition of Eligible Collateral.

I. Counterparty Exposure to Corporate-Guaranteed MBS and Covered Bonds

We presume that mortgage-backed securities or covered bonds issued by and/or guaranteed by a covered company would be subject to the single counterparty exposure limits.[2] However, the mortgages securing those obligations or owned by the investors

[1] Proposed rule §252.97(a)(2) at 77 Fed. Reg. 594, 654 (January 5, 2012)(Proposed Rule).
[2] Proposed Rule §252.92(n)(5) at 650.

in such obligations are not included in the list of collateral that is eligible to be counted as a reduction in such exposures.[3]

Several considerations support the inclusion of those mortgages as backing or collateral (with appropriate conditions, standards or haircuts as specified by the Board) that reduces the single-counterparty exposure from holding such securities:

1. *Look-through to the Underlying Borrowers*
   Mortgages backing single-family MBS represent the obligations of many individual borrowers rather than a single entity. If the guaranteeing issuer failed, the investor would still own on a pro-rata basis, or have a call on, the mortgages of a diverse group of obligors. If, say, five percent of the borrowers default, the investor is still left with the performing loans of the remaining 95 percent of the borrowers. This is the antithesis of the concentrated exposure of lending a large amount of funds to a single borrower.

   The risk of loss that exists from a default of *both* the issuer/guarantor and a number of the underlying borrowers can be taken into account by appropriate standards for the loans to count as collateral, by loss allowances for expected losses and by other such prudential standards and/or haircuts as the Board deems appropriate.

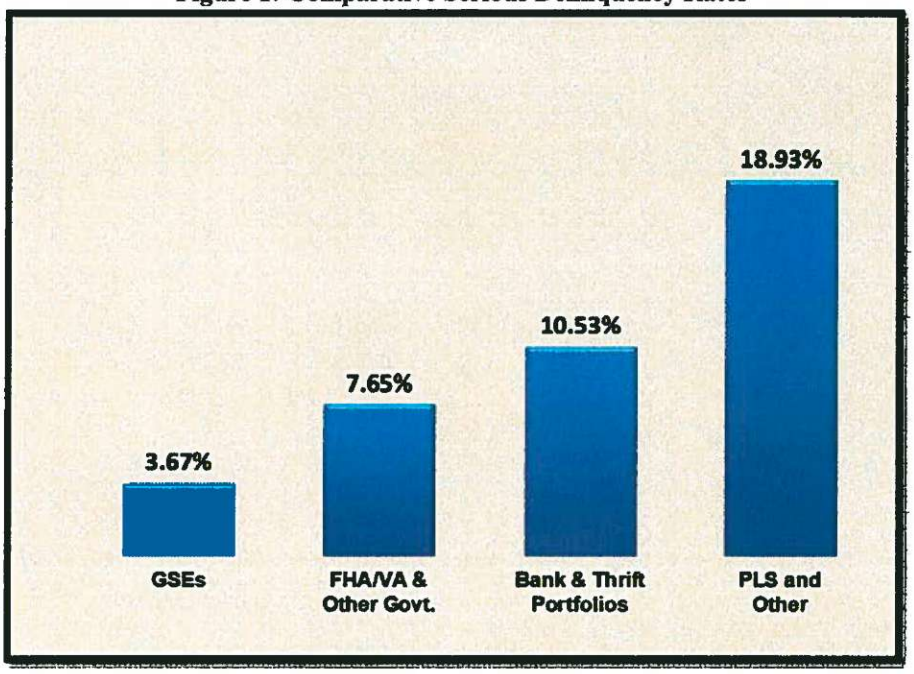
2. *Advantageous Treatment of Structured MBS relative to Corporate-Guaranteed MBS or Covered Mortgage-Backed Bonds*
   Our reading of the proposed rule suggests that structured MBS (discrete trusts or entities with the credit enhancement internalized in the structure) would get preferential treatment as compared to corporate-guaranteed MBS. Each structured transaction would stand alone and would not be aggregated with other obligations of the sponsor or any other discrete structured transactions sponsored by it.

   This would be a counterintuitive outcome for several reasons:

   i. *The Comparative Loss Experience of Securitized Loans:*
   Structured MBS were characteristic of the private-label security (PLS) market that flourished during the housing boom. During the subsequent financial crisis, loans backing PLS were more troubled than either loans guaranteed by the GSEs or the unsecuritized loans that banking institutions held on their balance sheets. The difference is shown clearly in Figure 1, as the serious delinquency rates on mortgages backing PLS were, for example, *over five times* the delinquency rates on loans that backed the corporate-guaranteed MBS issued by Fannie Mae and Freddie Mac.

[3] Proposed Rule §252.92(q). *Id.*

Figure 1: Comparative Serious Delinquency Rates[4]



If structured MBS are exempt from aggregation under the exposure limits because of their discreteness, the reason this happens is that that the underlying loans are, in fact, being counted as *de facto* collateral against the securities, a status that is denied to loans that back corporate-guaranteed mortgage-backed pass-throughs or bonds.

Given the empirical record summarized in Figure 1, this would seem to be a counterintuitive unintended consequence of the workings of the proposed rule.

ii. *Risk Retention:*

Section 941 of the Dodd-Frank Act evidenced a desire on the part of Congress that sponsors of asset-backed securities, in general, and mortgage-backed securities, in particular, retain an exposure to risk in securitizations unless they are backed by "qualified residential mortgages." This requirement is often referred to as having "skin in the game."

One of the reasons advanced for the worse-than-average credit performance of PLS was the fact that the sponsors were isolated from losses in the securitizations. The guarantee operations of GSEs and FHA/VA and the banking institutions' holdings of unsecuritized loans in

[4] Source: Fannie Mae compilation of data from *OCC Mortgage Metrics Report*, Fourth Quarter 2011 at http://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/mortgage-metrics-2011/mortgage-metrics-q4-2011.pdf. The rates in Figure 1 are for the number of loans 90 days or more delinquent or in foreclosure as a percent of the total number of loans serviced by large commercial bank servicers either on their own behalf or on behalf of MBS trusts.

portfolio, in contrast, were characterized by their having skin in the game by reason of their exposure to losses. The comparative performance of loans in these different sectors shown in Figure 1 tends to support the prudential benefits of risk retention.

By its intrinsic nature, the proposed rule operates at cross purposes with the will of Congress expressed in the skin-in-the-game requirement:

- The very act of retaining risk on the part of guarantors/sponsors makes them subject to the exposure limits; while

- The act of shedding all exposure to risk exempts the securitizations from aggregation into the overall credit exposure profile of the sponsors.

One way to right this imbalance is to grant the same collateral status to the underlying mortgages in corporate-guaranteed MBS that they enjoy *de facto* in standalone structured transactions.

iii. *Attracting Private Capital to the Secondary Mortgage Market:*
The first goal that HUD and the Treasury Department outlined in their joint report on *Reforming America's Housing Finance Market* was, in part, to: "Pave the way for a robust private mortgage market by reducing government support for housing finance."[5]

As will be shown below, any such market is likely to be dominated by a handful of large players to the extent that it seeks to raise mortgage funds in the fixed-income capital markets.

The proposed counterparty risk limits is likely to be a hindrance to those efforts. Corporate securities issued by such secondary market players would be aggregated into the exposure pool of the issuing company and be subject to the exposure limits unless there is a federal government guarantee backing the securities issued.

Again, one way to avoid conflict with the Administration's announced goal is to grant collateral status to the underlying mortgages.

[5] http://portal.hud.gov/hudportal/documents/huddoc?id=housingfinmarketreform.pdf at page 11.

II. Cash Flows in Servicing Mortgage-Backed Securities

The secondary mortgage market is characterized by large monthly cash flows representing borrower principal and interest payments in a two-stage process (1) from intermediate depositories[6] to MBS trustees[7] and (2) from the trustees to MBS investors.

Given the relative concentration of large servicers in the secondary mortgage market and the fact that non-GNMA outstanding mortgage-related securities total the enormous sum of approximately $6 trillion, large temporary exposures build up in the system each month. It may be almost impossible to handle these short-term exposures within the system if they are subject to the type of limits contemplated in the proposed rule.

The fact that the proposed rule contemplates exposure being measured, and limited, on a daily basis means that the peak amounts of exposure each month, however temporary they may be, would be the level against which the exposure limits are calculated. In short, since these cash flows are part of the infrastructure that make the secondary mortgage market work, the proposed rule could wreak havoc with it.

Even a replacement secondary market without GSEs or where the GSEs are no longer the dominant presence in the market that they are today would be unlikely to experience reduced problems from the exposure limits. We can get a preview of likely concentration in a successor secondary market to the current one by examining current concentration in the GNMA versus the FHA markets, as is shown in Figure 2.

Figure 2: Market Concentrations among FHA Lenders and Issuers of GNMA MBS

FHA Loans Originated, 2011			Ginnie Mae Issuers, 2011		
Lender	**Amount**	**Market Share**	**Lender**	**Amount**	**Market Share**
Wells Fargo	**$24,844**	**13.1%**	**Wells Fargo**	**$108,547**	**38.5%**
Bank of America	**$10,226**	**5.4%**	**Bank of America**	**$65,408**	**23.2%**
Top 2	$35,069	18.4%	Top 2	$173,955	61.7%
Quicken Loans	**$6,216**	**3.3%**	**Chase Home Financial**	**$26,090**	**9.3%**
Flagstar Bank	**$4,015**	**2.1%**	**PHH Mortgage**	**$10,382**	**3.7%**
Metlife Bank	**$2,952**	**1.6%**	**U.S. Bank**	**$10,103**	**3.6%**
JP Morgan Chase	**$2,898**	**1.5%**	**GMAC/Ally Bank**	**$8,082**	**2.9%**
US Bank	**$2,672**	**1.4%**	**Flagstar Bank**	**$6,905**	**2.5%**
PrimLending	**$2,291**	**1.2%**	**Quicken Loans**	**$5,803**	**2.1%**
PHH Mortgage	**$2,240**	**1.2%**	**Mortgage Investors Corp.**	**$5,241**	**1.9%**
Fifth Third	**$2,226**	**1.2%**	**MetLife Home Loans**	**$3,966**	**1.4%**
Remainder of Top 10	**$25,510**	**13.4%**	**Remainder of Top 10**	**$76,572**	**27.2%**
Top 10	$60,579	31.8%	Top 10 Issuers	$250,527	88.9%
11-50	**$38,255**	**20.1%**	**Issures 11-50**	**$28,860**	**10.2%**
Top 50	$98,834	51.9%	Top 50 Issuers	$279,387	99.1%
Remainder of Industry	**$91,489**	**48.1%**	**Remainder of Industry**	**$2,440**	**0.9%**
Total All Lenders	**$190,323**	**100.0%**	**Total All Issuers**	**$281,827**	**100.0%**

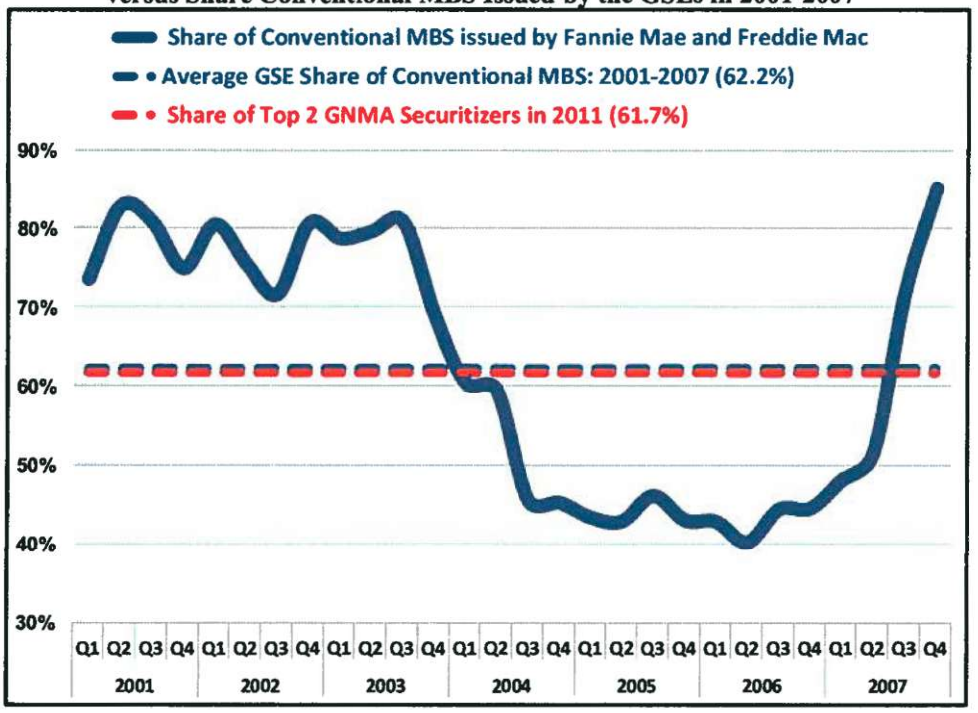
Source: Inside FHA Lending

[6] Servicers typically can hold borrower payments for up to two days prior to deposit into an account at a trustee bank held in the name of the MBS trust. Thus, the guarantor of an MBS has sequential exposure to the servicer and to the trustee depository.

[7] Fannie Mae and Freddie Mac being the trustees in the case of GSE MBS.

The data show that securitization, as compared to lending, is a business that is particularly responsive to economies of scale and subject to concentration. The top two FHA lenders had a market share of 18.5% last year. The top two GNMA securitizers, on the other hand, had a market share of 61.7%.[8] This market share of the GNMA securitization market is almost the same as the share of the conventional MBS market that Fannie Mae and Freddie Mac averaged during the 2000s before the PLS market collapsed in the financial crisis of 2008 (Figure 3).

Figure 3: Share of GNMA Securitization by Top 2 Securitizers in 2011 versus Share Conventional MBS Issued by the GSEs in 2001-2007[9]



Thus, whatever form the mortgage-related securities market takes in the future, one would expect it to be characterized by a few institutions controlling a large share of the market. As a consequence, the large amounts of cash that flow through the system each month are likely to continue to create concentrated exposures and the proposed rule will make it difficult to operate the machinery that keeps the system going.

Figure 4 depicts a simplified stylized example of how borrowers' payment cash flows build up each month until they are remitted to the MBS trustee. A maximum amount is reached for a few days during the month.

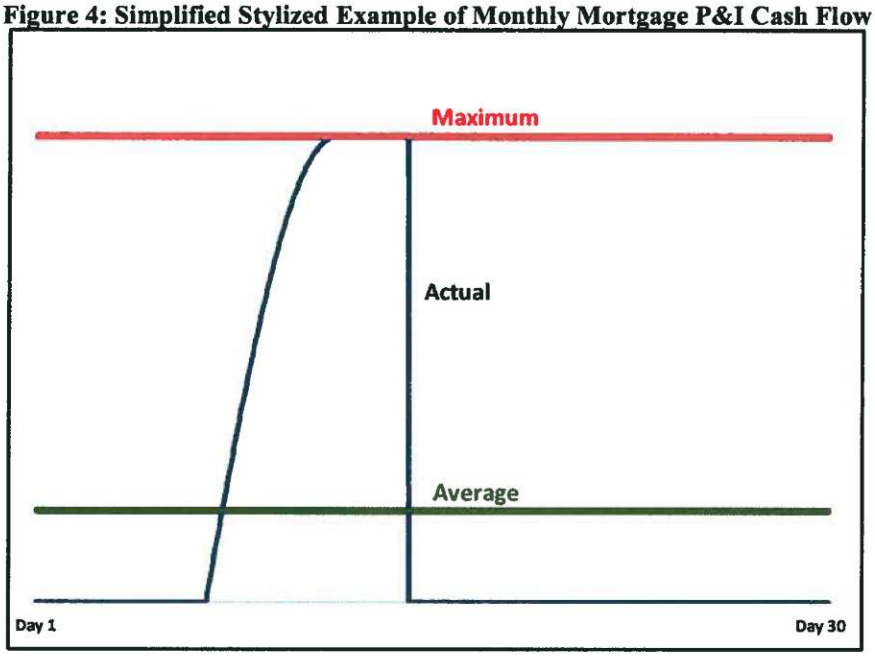
Given the amplitude of the swings over short periods of time, it would be impractical to live with the actual daily exposure as a fluctuating exposure limit since it would be unworkable to change the exposure limits to mirror the extreme daily intra-month movements of the actual exposure. Given the regularity of this peak each month, the

[8] Unlike GSE MBS which are issued by Fannie Mae and Freddie Mac, GNMA MBS are issued by lenders/aggregators.

[9] Sources: Bond buyer, Bloomberg, Inside MBS & ABS and company reports.

monthly maximum would become the practical prudential exposure limit that the MBS trustee would have to live by, for the full month, every month. Stated simply, the short-term maximum exposure limit each month would become the *de facto* long-term permanent limit.

Figure 4: Simplified Stylized Example of Monthly Mortgage P&I Cash Flow



Additionally, given the amounts involved for the largest servicers, it is conceivable that the exposure from unremitted borrower P&I payments on their own would be sufficient to exceed the MBS trustees' exposure limits without taking any other exposures into account.

We might describe the exposures that arise from these cash flows as transaction-related exposures rather than the investment exposures that arise from making loans or investing in securities.

Two possible approaches suggest themselves as ways to deal with these problems:

1. Exempt such transaction-related exposures from the proposed limits.

2. Lessen the likelihood of the monthly maximum being the practical daily exposure limit by setting the limit at the average exposure over the course of a month. In terms of the diagram in Figure 4, the exposure limit under such a system would be the green average line rather than the red maximum line.

III. Definition of Eligible Collateral

The definition of eligible collateral does not include GSE mortgage-backed securities or mortgage servicing rights which are two common forms of collateral that used to offset counterparty exposures. Mortgage-backed/asset-backed securities are expressly

excluded from debt securities that qualify as eligible collateral – which would arguably exclude even GNMA MBS.[10]

Agency MBS are accepted at the Federal Reserve "to secure discount window advances and may be used to offset risk associated with extensions of daylight credit or master account activity" with a 2% to 5% haircut.[11] Thus, it would seem reasonable to accept agency MBS as collateral to mitigate counterparty exposures.

Further bolstering this position are the following considerations:

1. The rationale for the general exemption for Ginnie Mae and the GSEs while under conservatorship from the limits on credit exposure provided under the proposed rule[12] would equally argue for the inclusion of their MBS in eligible collateral;
2. The proposed definition of eligible collateral includes publicly traded equity securities and convertible bonds.[13] Collateral in the form of agency MBS would seem to provide at least as much security as these instruments; and
3. The Notice of Proposed Rulemaking states that the "list of eligible collateral is similar to the list of eligible collateral in the Basel II standardized capital rules."[14] However, the Basel II final rule issued by the FFIEC in 2007 not only does not seem to exclude MBS from financial collateral, but the agencies:

> ". . . have included conforming residential mortgages in the definition of financial collateral and as acceptable underlying instruments in the definitions of repo-style transaction and eligible margin loan based on the liquidity of such mortgages and their widespread use as collateral in repo-style transactions."[15]

The fact that the agencies have included conforming mortgages[16] in a list deemed to be similar suggests *a fortiori* that agency MBS should be included in the definition of eligible collateral for the current proposed rule.

---

[10] "Eligible collateral means collateral …in the form of: (1) Cash …; (2) Debt securities (other than mortgage- or asset-backed securities) that are bank eligible investments; …" Proposed Rule §252.92(q) at 650.

[11] http://www.frbdiscountwindow.org/FRcollguidelines.pdf?hdrID=21&dtlID=81 and Excel file at http://www.frbdiscountwindow.org/discountmargins.cfm?hdrID=21&dtlID=83.

[12] Proposed Rule §252.97 at 654.

[13] Proposed Rule §§252.92(q)(3) and (4) at 650.

[14] *Id.*

[15] 72 Fed. Reg. 69,288, 69,342 (December 7, 2007).

[16] The agencies have mandated a 25 percent haircut against conforming mortgages but their reasoning for this is: "However, because this inclusion goes beyond the New [Basel] Accord's recognition of financial collateral, the agencies decided to take a conservative approach and require banks to use the standard supervisory haircut approach, with a 25 percent haircut." *Id.*

Thank you for your attention in this matter. If you have any questions, please contact Noel Fahey at 202-752-8877 or j_noel_fahey@fanniemae.com.

Sincerely,

Timothy J. Mayopoulos
Executive Vice President, Chief Administrative Officer, General Counsel and Corporate Secretary