Single Security and CSP Industry Advisory Group

December 14, 2016

Meeting location: New York

Attendees: ~ 52 (including those in the room and on the phone)

CSS Release 1 and Release 2

FHFA reviewed Release 1 and timing for the Release 2 announcement (Q1 2017). CSS reported they had already processed about $50B in securities for Freddie Mac, and it was reiterated that this was a long, intensive effort, and a big accomplishment, as well as a key milestone for the Single Security implementation. Fannie Mae, Freddie Mac, and CSS are all taking into account the lessons learned from Release 1 and going through a replanning process for Release 2. FHFA stated they want to be highly confident of the Release 2 date and will take a look at everything learned in Release 1. One thing that took longer than expected were the testing and control reviews, as well as following the governance processes, as multiple entities need to sign off before the release goes live.

FHFA gave an update on the Enterprise alignment efforts, which the industry has been very interested in. One component of alignment monitoring will be quarterly meetings with interested stakeholders to review GSE security cohorts and prepayment speeds and the effect of initiatives. FHFA suggested that the group could be constituted from members of the IAG – those interested in joining can reach out to Rick Sorkin at Fannie Mae or Steve Clinton at Freddie Mac.

Electronic Pool Notification

Fannie Mae provided an overview of the industry outreach that has taken place since the last IAG meeting. SIFMA has been actively involved with helping reach certain facets of the industry in addition to helping brainstorm potential solutions (i.e., best approach to identifying issuer). Electronic Pool Notification (EPN) users will need to be able to identify who the issuer of the security is once the Single Security is implemented. There are two possible existing data elements that could be used – the Security CUSIP and the Pool number. Some IAG members were strongly in favor of the Security CUSIP – which would need to be made a mandatory field by the FICC, while others thought the pool number would be better. There were two follow-ups on the discussion: FICC, SIFMA, BlackRock and some EPN users will get together to hash out the best approach; and Freddie Mac, Fannie Mae and FHFA will research some questions about pool number overlap so that the group has more complete information to make their decision.

Market Preparation

Fannie Mae provided a first look at the market checklist and asked the group for feedback. Fannie Mae explained that the document is still a working draft and the Enterprises are looking for help from the various industry associations and IAG members to help flesh it out. The group reviewed the trading scenarios document. In the scenarios, Month 4 is the month of implementation, while Months 1-3 are forward trading months. A straight buy of Fannie Mae TBA securities in month 3 would settle as UMBS in Month 4, with no price differential.

The group discussed the Freddie Mac TBA market and what would happen once the Single Security is implemented in Month 4. There were several IAG members who expressed a strong preference for the Freddie Mac 45-day Gold PC TBA market to end after implementation. In their view, there would be no separate Freddie Mac or Fannie Mae TBA markets, but one unified Single Security TBA market. So a Freddie Mac Gold roll position in Month 3 could either be closed out that month, and the investor could take delivery of their Gold PCs, or they could roll forward to Month 4, and do a "roll/swap" to take the Golds and exchange them for 55-day UMBS.

Freddie Mac pointed out that some investors use finance accounting for dollar rolls – and if they take delivery of their roll position they would have to recognize a gain or loss. Ultimately, it will be up to SIFMA and the market makers to determine whether 45-day securities continue to trade TBA or transition to specified trading.

Legacy PC Exchange

Freddie Mac then reviewed the exchange process and some recent discussions with the market. Freddie Mac discussed their plan for float compensation, the settlement process that could be used to avoid fails, and the plan to allow investors to begin exchanging early – before the implementation date. Generally, Freddie Mac has been thinking this early exchange would be allowed only one month before the launch, since the exchanged bonds will not be tradable until the following month.

Fannie Mae asked if it was possible for Freddie Mac to allow exchanges well in advance of implementation, and if Freddie Mac could switch to 55-day issuance before the Single Security implementation, providing an outlet for trading. IAG members expressed the concern that this may result in a scenario where bonds are being removed from the 45-day TBA market well before launch, and that that would not be desirable. A participant suggested that SIFMA could provide sellers an explicit right of substitution in which UMBS securities may be used after the Single Security implementation date to satisfy open 45-day Gold PC sales, therefore eliminating possible technical squeezes.

There was a question about what the Federal Reserve Bank of New York (Fed) will do over the transition month. The Fed staff present at the meeting stated that the Open Market Desk is aware of their role in the market and that they will be mindful of the effects of any actions they choose to take. As the sponsor of the Treasury Market Practices Group, the Fed can ask the TMPG whether any specific best practices around the transition and implementation of single security would be appropriate.

Accounting and Tax Update

The discussion turned to accounting and tax treatment for the exchange. There was also discussion of the potential issues that may arise under the asset diversification requirements of Internal Revenue Code Section 817(h) and the corresponding regulation. Specifically, this relates to the how the proposed UMBS TBA market will impact diversification compliance for segregated assets held by insurance companies.

Freddie Mac reported that they have had preliminary conversations with the IRS. Freddie Mac has submitted a technical analysis to the IRS that provides support for the proposition that the conversion will not be a taxable transaction. As part of that submission Freddie also provided a technical basis for alternative tax treatments for any incentive and float payments. Although it is not definitive, we believe the IRS will ultimately view the float compensation as well as any incentive payment that is paid as part of the exchanges as taxable income when received. Freddie Mac is pursuing a published ruling from the IRS. The IRS indicated they are open to providing published guidance on the tax treatment of the conversion transaction, the float payments and the incentive payments. However, it is uncertain as to when the IRS might issue such guidance.

Freddie Mac reported that they have had preliminary conversations with the SEC about the accounting for the exchange. Freddie Mac, along with Fannie Mae, is planning to engage in formal discussion with the SEC on the accounting for the exchange. The Enterprises believe that the exchange should be accounted for as a modification of the original security with no gain or loss recognized on the exchange, and any compensation for float should be treated as a basis adjustment to the security that will be amortized into income over the life of the security. The SEC does not publish or make available the conclusions reached in these formal discussions; however, the Enterprises believe that one potential method of communicating the SEC's conclusions would be for FHFA to share the results of these discussions with interested parties.

Questions were brought up about accounting treatment for commingled securities (Supers). Currently most investors recognize a gain or loss when they take Gold PCs and MBS and create Giants and Megas, though there is a minority that do not recognize a gain or loss, as they view the resecuritization as an administrative transaction. There has been some discussion with market participants that there might be an advantage – in terms of risk-weighted capital requirements -- to "double wrapping" all their UMBS holdings. However, if there are tax consequences to this practice it may outweigh the advantages. There was also a question about held-to-maturity portfolios and how they would need to treat both exchanges and commingled Supers.

Returning to Internal Revenue Code 817(h), Freddie Mac reported that they had multiple conversations with representatives from the American Council of Life Insurers and SIFMA. Freddie Mac provided the organizations with a write-up outlining the issues and possible approaches to address the asset diversification challenges that may be created by the new UMBS TBA market. There will be another draft of the write-up later this month incorporating SIFMA and ACLI comments that offers up proposed treatment for UMBS securities. The proposal will be shared with the IRS once it is final.

Good Delivery

SIFMA provided a quick update on their Good Delivery guidelines. They have been examining the guidelines to determine needed changes for the Single Security and getting feedback from members of their guidelines committee. SIFMA will have a public solicitation of feedback before making final changes to the guidelines. They know they will need to update securities names as well as making sure exchanged securities can be looked through to the original maturity dates rather than the mirror creation date. SIFMA does not believe MSFTA agreements will need to be updated for the Single Security.

Repo agreements and the eligibility of TBA securities were mentioned. This has also come up in recent investor meetings. A liquid TBA market is required for tri-party repos. Because TBA eligible Gold PCs are easily exchangeable to UMBS, it is desirable to have repo lenders treat them as TBA in their repo agreements post-launch. Members of the group agreed more research is needed both on securities' eligibility for repos – particularly for Gold PCs over the transition -- as well as if repo agreements will need to be updated.

There was a brief discussion of how the market will transition to the Single Security and whether there will be an immediate large volume of PC exchanges. Some thought exchanges might happen as Gold PCs are traded, making the transition to the Single Security more incremental -- rather than an investor exchanging their whole portfolio all at once. Investors have expressed concerns about exposing their whole securities holdings to the dealers who will perform exchanges on their behalf.

Vendor Updates

The final part of the meeting was devoted to presentations from both Tradeweb and Bloomberg about how they will need to change their systems to accommodate the Single Security and the unified trading of the TBA market, as well as exchanges of 45-day for 55-day securities. Freddie Mac will be adopting Fannie Mae identifiers, so that both can trade together as "UMBS."

Both vendors showed screen shots of how their systems might look in a post-Single Security implementation environment. Tradeweb stated it will take them about 6 months to change their screens and their electronic feeds. Downstream systems will need to be able to read what comes from Tradeweb, so there is also work to be done with Tradeweb's vendor partners.

Freddie Mac mentioned that the Enterprises had jointly released the disclosure specification for Single Security REMICs (Level 3 securities), as well as sample files for exchanges, UMBS and Supers (Level 1 and Level 2) in late November. Freddie Mac reminded the attendees that they may need to do some systems work in 2017 if they are consumers of securities disclosures. Freddie Mac will be adopting the Single Security disclosure format for its current securities in the Summer of 2017.

Bloomberg will be reaching out to the industry to have broader discussions about possible changes to their screens and what will work for their users.

Fannie Mae closed the meeting, reminding members to provide feedback on the market checklist and the trading scenarios. We expect to hold the next meeting in early Q2 2017, following FHFA's planned Q1 announcement of the Single Security implementation date.