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White Paper on proposed New Infrastructure for Secondary Mortgage Market



Piyush Sinha
piyush@vinodkothari.com
Vinod Kothari & Company
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Note

The Federal Housing Finance Agency (FHFA) released a white paper on “*Building a New Infrastructure for the Secondary Mortgage Market*” on October 4, 2012. The paper incorporates a proposed framework for a common securitisation platform and a model Pooling and Servicing Agreement. FHFA released the paper with a motive of inviting suggestions and expert advice from the industrial experts and from the common knowledgeable public at large. The dual objectives were set forth in the Strategic Plan for Enterprise Conservatorship (Strategic Plan) in the month of February, 2012 by the FHFA. Developing a new securitisation infrastructure is one of the key goals of the FHFA which will be in line with the existing guidelines maintaining the same standards and practices of the Enterprises. It will be built on the business practices of Fannie Mae and Freddie Mac which are already underway and forms the base platform for this new securitisation infrastructure plan. The white paper mainly deals with identifying the core components of mortgage securitisation that are essential for the evolution of the Housing Finance System.

The proposed structure has the following two key objectives:

- Replacement of the outmoded existing proprietary infrastructure of the Enterprises with a new efficient model, and
- Establishing a new framework which will be consistent with multiple states of housing finance reform, actively including the participation of private capital for assuming and countering credit risk.

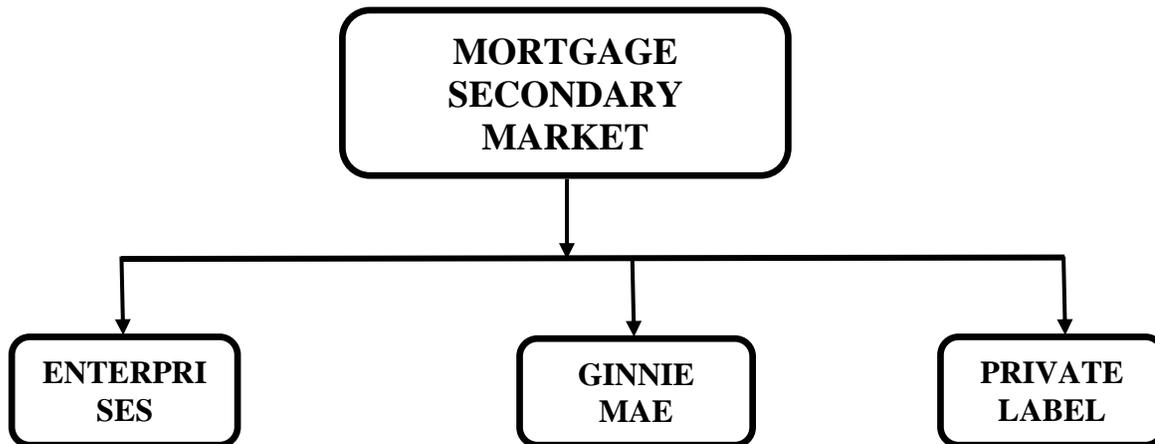
Success in the above areas will enable the establishment of a sound, efficient and a flexible environment for mortgage securitisation and will help the policy makers to design and build a proper mortgage finance system. Efforts should be made to curb out the drawbacks of the existing system and emphasis should definitely be laid on working without government involvement at various levels.

Existing State of Securitisation Infrastructures

The current state of the secondary mortgage securitisation market is constituted by three models which can be demonstrated with the help of a figure below:



Note



After the 2008 global financial crisis the activities of Private Label model shrank drastically due to the crunch of the environment. The vacuum was filled up by the other two models; Ginnie Mae and the Enterprises who turned out to be the market dominators. This in turn increased government participation in the newly originated mortgages. The characteristics of the existing models are summarized below.

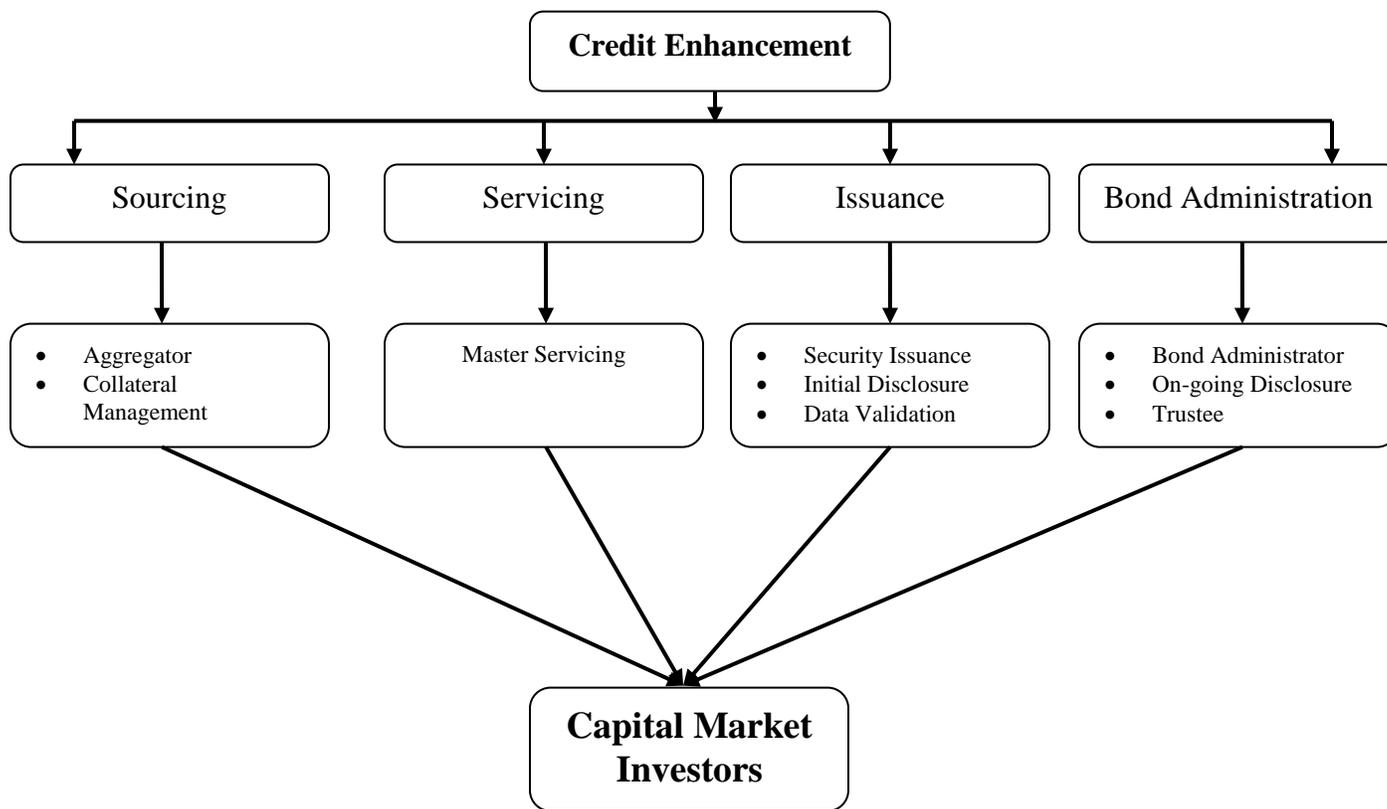
Enterprise Platforms

Enterprises perform diversified activities in the current market. These include issuances, providing guarantee, credit underwriting and pricing, credit loss management, master servicing, etc. The recent joint initiatives require the Enterprises to perform other monitoring activities such as servicing standards, delivery data requirements, representations and warranty requirements and securities disclosures. The infrastructure requires active involvement of the market participants to manage different processes. In addition to this each enterprise invests separately to maintain its guidelines and contractual framework. Two separate platforms are being maintained by the Enterprises to support their high volumes of securitisation. Channelizing the resources into a common securitisation platform under the new framework will prevent duplicate investment practices.



Note

The functions of the Housing Finance System under the Enterprises in the current market scenario may be demonstrated with the help of the figure below:



Brief Description of the Functions in the Housing Finance System:

- Credit Enhancement – providing guarantee against credit-related loss.
- Sourcing – aggregating loans; manages and tracks assignment of mortgage notes.
- Servicing – involves performing master servicing; managing asset and cash activities; interfaces to servicers, guarantors, and aggregators.
- Issuance – preparing and issuing securities in accordance with standard security, pooling and trust contracts.
- Bond administration – involves producing investor and third party disclosures; distributes principal and interest; monitoring securities; addresses servicer shortfall; produces portfolio reporting.
- Capital Markets – it provides capital to fund securitization process.



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Ginnie Mae Platform

The main function which this platform performs is the administration of mortgage backed securities program under which federally insured residential mortgage loans are securitized. Under this program, the market participants (lenders and servicers) pool their loans that have been insured or guaranteed under various programs sponsored by the Federal Housing Administration (FHA), US Department of Veterans Affairs (VA) and the US Department of Agriculture (USDA). The pooled loans are issued as securities by the issuers. The responsibility of remittance of the contractual amount to the entitled security holders lies with the issuers and not with Ginnie Mae.

Private Label Securities Platform

The Private Label Securities (PLS) market is dependent on investment of private capital to support their market activities with private participants performing all the market functions. The Credit Risk is either retained by the aggregator of the investor and is guaranteed by a third party or is re-packaged into a new securitisation structure. Here the market participants define their own rules for underwriting, pooling and servicing. This market slowed down and eventually became stagnant post the 2008 global financial crisis. One of the main reasons for such stagnation is that the common public started avoiding mortgage credit risk as it involved private participant with flexible guidelines which were at the disposal of such private participants. Another important fact of consideration is PLSs sole dependence on private capital without any government security which led to its fall.

Relationship between these three models can be jotted down in the following table:

Fannie Mae MBS/ Freddie Mac PC	Ginnie Mae	Private Label
MSSC, Selling Guide, Servicing Guide, DU/LP Guide, Master Agreement and Pool Purchase Contract	Ginnie Mae MBS Guide	Pooling and Servicing Agreement, Mortgage Loan Purchase Agreement
MBS/PC Master Trust Agreement together with Issue Supplement	Guarantee Agreement	Pooling and Servicing Agreement
MBS/PC Offering Circular	Prospectus	Prospectus



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together with Offering Circular Supplement		
Master Custodial Agreement	Custodial Agreement	Custodial Agreement

Source: White Paper Released by FHFA

The New Proposed Securitisation Structure

The proposed framework involves key principles which will effectively determine the implementation of a functional secondary mortgage market. It aims at promoting liquidity, attracting private capital, benefiting borrowers and facilitates operating flexibility and efficiency. It tries to minimize market disruption during transition.

The framework focuses on better standardization that would benefit the industry as a whole. The aim is to offer advantages to the housing finance market while providing market choice alternative and promoting valuable independent innovations. The functions can be enumerated as follows:

- Collateral management with a centralized note tracking system.
- Master servicing including assets and cash management, standardized interfaces for the servicers, guarantors and aggregators, servicing metrics, data validation and reporting.
- Issuance which includes other functions as isolating eligibility rules, establishing data quality standards, pool delivery, settlement and disclosures.
- Data validation with the standardized platforms involving the storage of loan level, pool level data and bond level data. Improving data integrity, promoting advance transparency and efficiency in the market.
- Bond administration involving authentic disclosures, bond processing, determination of principle and interest amounts, securities monitoring and portfolio reporting.

In addition to the above functions greater consistency in the key contractual functions will facilitate an efficient secondary market.



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Key Features

The following are the key features of the proposed new structure:

Credit Risk Distribution

Proper distribution of the credit risk has been emphasized in the new model which stipulates the distribution of the credit risk between the conservatorship and the private sector. Much of the risk absorbing function has been assigned to the private sector. The framework has been designed to be more flexible and inculcate much more participation from the future states of housing finance. This will give the policy makers a chance to choose from the various alternative housing finance systems that are less dependent on the government involvement for the absorption of the credit risk.

Under the proposed structure a platform is provided that would enable bundling of the mortgages into an array of securities structure. This will allow providing all the operational support required for the process and a procedure to track the payments until the ultimate payoff is made. The platform should utilize the existing secondary market liquidity and also promote the active participation of private capital.

Proposed Scope and Functionality of the New Structure

The following figure depicts the housing finance life cycle and demarcated the advantages the new structure will provide to the industry.

BORROWER	PRIMARY MARKET	SECONDARY MARKET	INVESTOR
<ul style="list-style-type: none"> • Select Lender • Select Product • Acquire Loan 	<ul style="list-style-type: none"> • Underwrite Loan • Originate Loans • Service Loans 	<ul style="list-style-type: none"> • Acquire Loans & securities • Structure Securities • Credit Enhance Securities • Issue & Administer Securities 	<ul style="list-style-type: none"> • Purchase & Sell Securities • Receive Cash Flows • Access Disclosures • Influence Structures





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Secondary Market

ACQUIRE	STRUCTURE	CREDIT ENHANCEMENT	ISSUE & ADMINISTER
<ul style="list-style-type: none"> • Purchase Loans & Securities • On-board Collateral 	<ul style="list-style-type: none"> • Define New Securities • Sell Securities 	<ul style="list-style-type: none"> • Define Eligibility • Price the Credit Enhancement • Manage Credit Risk 	<ul style="list-style-type: none"> • Validate Data Against Rules • Issue Securities • Master Service • Disclose • Distribute Payments



SECURITISATION PLATFORM

The proposed platform has the following initial core services:

- I. The identified services are standard services that lend themselves to straight-through, highly automated processing of large volumes with limited manual intervention.
- II. As an integrated offering, the identified services accommodate setting and adjusting market standards, and assists market and data transparency.
- III. The identified services are rules-driven and can readily adapt to changes in market standards and policy – consistent with the imperative that the platform must be able to accommodate and implement future policy decisions about the Enterprises.
- IV. The identified services have the flexibility to serve many industry models.
- V. The identified services enable the private sector to continue to drive security selection, loan pooling, loan underwriting and other functions not currently performed by the Enterprises.



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Data Validation

The data validation system verifies the submitted requests and compares them to the predetermined standards fixed mutually. It also checks the data format for both loans and securities. Acknowledgement will be provided to the requestor if the proposal is accepted. In case of rejection of the proposal, details of violations made will be communicated back to the requestor for further re-submission.

Issuance

The issuance service of the platform will accept the validated requests and register the security with the appropriate agent, Federal Reserve (FED) or Depository Trust and Clearing Corporation (DTCC). On the date of settlement the security will be transferred to the initial owner and consideration will be remitted as per the instructions provided with the issuance request. The settlement will be validated by the platform and confirmation will be sent to the issuer. The underlying loan information will be transferred to the Master Servicing Service for the master servicing process.

Disclosures

Disclosure covers the process whereby attributes describing a security and underlying loans or pools are published to the marketplace in a timely manner. Preliminary disclosure occurs before the security settles in order to alert the market to a pending security's fundamental characteristics. On settlement date, the platform would publish the final disclosure, which includes detailed information describing the final loan pool and security structure.

On-going disclosures are done on a monthly basis or when changes surface for the pools or underlying loans. Disclosure documents proposed to be published would include the prospectus supplements and supplemental oversight documents. Disclosure information would be published by the platform on the Internet and possibly in other forms.

Master Servicing

It involves asset and cash management activities as directed by a trust or other governing security documents. This includes collecting and processing primary servicer loan activity and verifying that principal and interest payments are correct for each reporting cycle. The platform could monitor and direct document custody, and monitor primary servicer performance for adherence to standards as well as all other compliance directives



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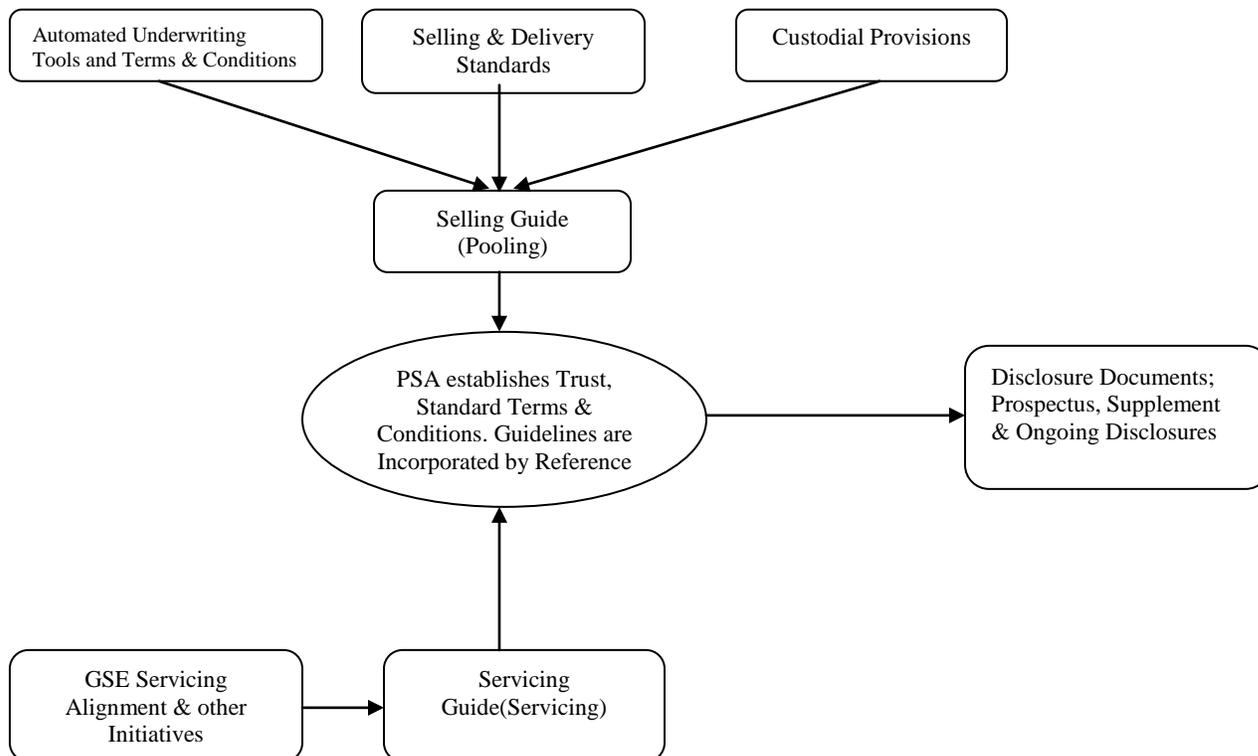
requested by the trustee or other governing documents. It could have the ability to provide updated loan and security positions.

Bond Administration

Bond administration will calculate investor payment factors and make data available to the disclosure function for ongoing investor reporting for each payment cycle. Bond administration would support both first level securitizations (securities backed directly by loans) and second level re-securitizations (securities backed by existing securities). Bond administration would also ensure payments to investors and other parties are managed in a timely manner. The platform would collect funds due from investors on the collateral (loans from master servicing or existing securities) and invest the funds in eligible investments. Payment instructions would be provided to the paying agent (FED, DTCC or physical certificates) for appropriate fund distribution.

Proposed PSA Framework

The proposed integrated infrastructure cannot function without the appropriate legal agreements, rules and allocations of responsibilities, including a framework for an effective contractual PSA. A model framework for the PSA could enhance the efficiency of the housing finance market by incorporating standardized provisions and best practices. The proposed PSA framework can be represented with the help of the following diagram:





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Inference

The Strategic Plan aims to replace the existing models with a new and better platform for securitisation infrastructure. The new structure facilitates useful advantages to the secondary mortgage market and offers involvement of private capital to absorb the credit risks involved in the process of securitisation. The paper defines the scope of the proposed changes and demarcates the functions that FHFA proposes to be included in the new securitization infrastructure that can support the mortgage finance system. It also describes the steps required to be taken by FHFA and the Enterprises to further standardize the system. Building a new securitization infrastructure is likely to be a long-term effort. The various aspects involved in the new structure will enhance the efficiency of the industry in times to come.

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ⁱ The write-up is based on the White Paper released by FHFA. It can be viewed [here..](#)