March 28, 2014

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, D.C. 20006-1506

Re: Regulatory Notice 14-02 – Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market

Dear Ms. Asquith:

On January 27, 2014, the Financial Industry Regulatory Authority (FINRA) published for comment proposed changes to its rules governing margin requirements on transactions in the To Be Announced (TBA) market (the Proposal). Specifically, the Proposal would require broker-dealers to impose margin requirements on their counterparties and force the liquidation of positions in the event that counterparties do not exchange margin within five days of incurring an exposure. The Proposal would apply to TBA transactions as well as certain forward-settling transactions in specified pools and collateralized mortgage obligations.¹ The Mortgage Bankers Association² (MBA) appreciates the opportunity to comment on the Proposal’s impact on borrowers and the broader housing market.

At the outset, MBA thanks FINRA for formalizing mortgage bankers’ status as exempt accounts, and thus removing the initial margin requirement. Mortgage bankers utilize TBAs almost exclusively as a mechanism to hedge risks associated with originating loans eligible for TBA securities. As the “creators” of the assets underlying TBA-eligible securities, mortgage bankers present a vastly different counterparty profile from other participants in the TBA market. With this in mind, MBA believes the Proposal should be revised to recognize this unique relationship between mortgage banker and the TBA market generally. FINRA should exempt verified hedge positions from the Proposal’s variation margin requirements.

¹ FINRA Regulatory Notice 14-02
² The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 260,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation’s residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA’s Web site: www.mortgagebankers.org.
If an exemption is not granted, MBA recommends FINRA impose a threshold of 2% of total position size for mortgage bankers who engage in hedge transactions. MBA also recommends that the minimum transfer amount be subject to negotiation between the parties, in recognition of the robust risk management practices currently used by broker-dealers when trading with mortgage bankers.

BACKGROUND

Mortgage bankers provide mortgage applicants with the ability to lock-in an interest rate on their mortgage loan while the mortgage bank underwrites and processes the loan application. This process allows consumers to secure a rate that will be used to underwrite their mortgage application, ensuring that if market rates increase the lender will still be able to close the loan at the rate for which the borrower was initially qualified. If this “rate lock” is not hedged, originators would be at risk of closing a loan that is “underwater” from a market standpoint if rates rise. Therefore, originators enter into TBA trades to both mitigate this interest-rate risk and to provide the benefit of certainty to the consumer.

Mortgage bankers generally enter into forward TBA contracts whereby the originator agrees to deliver the loans expected to close into a future Ginnie Mae, Fannie Mae or Freddie Mac mortgage-backed security (MBS) at a specified price, to be settled generally within 30-90 days from the date the TBA is entered into. This process creates a hedge for the mortgage banker which puts the originator into a “risk neutral” position that preserves the revenue margin needed to cover the bank’s loan origination and operating expenses, plus the target return on capital. Once the loan is closed, the originator continues using those same forward TBA contracts to hedge the loans held for sale until the pool is created and the TBA is settled.

As a matter of course, many if not most mortgage bankers provide their broker-dealers with access to the information necessary to ensure that the mortgage bankers are sufficiently capitalized and are using the TBAs to prudently hedge their exposures rather than speculate. This information is ordinarily exchanged both at the time a trading relationship is established and on an on-going basis to ensure there have not been material changes in the strength of the counterparty. Additionally, as the trading relationship develops, the broker-dealer begins to gain an intimate understanding of the flow of their counterparties’ business – allowing the broker-dealer to spot behavior that is out of the ordinary.

The financial system benefits from TBA trades because the ability to reliably hedge interest rate risk allows for a diverse, competitive market of mortgage bankers to efficiently access the secondary market and operate nationwide, including in rural and underserved areas. This competitive landscape significantly reduces the concentration of risk which threatens other areas of the financial system.
Indeed, it is important to note that despite the failure of individual mortgage bankers, the broader TBA market remained active through the worst financial crisis since the Great Depression. Moreover, counterparties such as broker-dealers subject mortgage bankers of all sizes to rigorous credit and capital checks before initiating a counterparty relationship and will extend or contract credit lines accordingly.

**MBA's COMMENTS**

**Agency TBA Securities**

MBA strongly recommends that FINRA exempt mortgage bankers' hedge transactions from the final rule, thus allowing broker-dealers and mortgage bankers themselves to manage this critical risk management tool. The summer of 2013 saw substantial interest rate volatility, with rates rising then abruptly falling, before rising again for much of the remainder of the year. Despite this significant volatility, mortgage bankers remained sound TBA counterparties, and the market continued to function unimpeded. This is a testament to risk management practices that are prevalent among broker-dealers who offer trading lines to mortgage bankers.

It should be noted that the Proposal takes away from broker-dealers the ability to manage counterparty credit risk through their balance sheet and the bid-ask spread. Instead, the Proposal all but dictates the terms under which a broker-dealer's counterparty (but not the broker-dealer itself) must post margin. The Proposal does this in a "one-size fits all" manner that will make pipeline and inventory hedging more expensive for mortgage lenders and ultimately consumers. Moreover, the Proposal will confer a sizable competitive advantage to Fannie Mae and Freddie Mac at the same time policy-makers are indicating a desire to reduce the GSEs' footprint in the secondary mortgage market. All of this will reduce borrower's access to housing finance capital, while concentrating the TBA market among the nation's largest financial institutions and speculative traders.

**Borrowers Will Have Less Access to Credit**

Put simply, the Proposal will harm borrowers by limiting their access to credit. Mortgage bankers who hedge their locked loan pipeline and warehouse of mortgages sell their loans predominantly on a mandatory execution basis. Mandatory execution means that the mortgage banker takes the risk that they will be able to deliver the agreed upon quantity of loans by a certain date. The alternative is best efforts execution, whereby the investor assumes the risk of a mortgage banker's failure to deliver the agreed upon volume of loans.

Not surprisingly, mortgage bankers who are able to utilize mandatory execution are compensated for this risk through better pricing for their loans, which translates into

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3 This cost will be felt by larger lenders as well because the size of their positions will increase the frequency with which they would be required to exchange margin under the Proposal — driving up the operational and compliance costs even further.
more competitive rates for borrowers.\(^4\) MBA members have indicated that this premium ranges from 18 to 50 basis points relative to the size of the loan in the current market, imposing a significant opportunity cost on best efforts execution.

Additionally, best efforts execution relies more heavily on aggregators as the investors in the loan, who often require loans to exceed the minimum credit requirements imposed by the Fannie Mae or Freddie Mac (the GSEs). These additional requirements, called credit overlays, effectively make it harder for a consumer to qualify for a loan. For example, many aggregators will not purchase a loan with a credit score below 640 or will impose additional cash reserve requirements on borrowers for loans approaching or exceeding this limit, regardless of compensating factors. Some aggregators also refuse to purchase mortgages made to finance the purchase of a condo. Each of these overlays impose a limit on some borrowers’ ability to obtain competitively priced loans.

*Mortgage Capital Will Become More Expensive if the Proposal is Not Amended*

Moreover, implementing margin monitoring and posting systems represents a significant cost for many mortgage bankers. This cost includes not only the cash to support any margin calls, but also wire transfer, processing, and operational costs. Under the Proposal, these additional costs would need to be recouped through higher interest rates charged to consumers—either to pay for the additional overhead or to compensate for the lower return on best efforts execution.

The expense of establishing the controls and procedures to comply with the Proposal may, in many cases, exceed the value of the counterparty risk against which the margin is intended to protect. These costs will be a dead-weight loss for the duration of the trade and would likely contribute to further consolidation in the mortgage banking industry as companies find themselves too small to comply. Some originators may even be driven to the less profitable best efforts execution, resulting in a significant competitive disadvantage. In fact, these costs could become large enough to drive the mortgage banking industry to consolidate further. Originators may withdraw from certain markets or merge with other companies, limiting consumer choice. This issue is particularly acute for rural and underserved areas where access to credit is limited.

*The Proposal's Terms Will Harm Competition*

Recently, primary dealers began implementing the Treasury Market Practices Group's (TMPG) recommendation that market participants exchange variation margin while waiting for their TBA transactions to settle.\(^5\) While FINRA's Proposal operationalizes much of TMPG's recommendation, it discards a core theme underlying the

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\(^4\) As a rule of thumb, the pricing needs to be about a quarter of a point better per loan in order for mandatory execution to be worthwhile. Each point in price is worth about 25 basis points in interest rate paid by a borrower.

recommendation. The TMPG relied on standard market practices to guide the final terms of each trading relationship, allowing market participants the flexibility necessary (within reason) to meet their own capital needs as well as those of their counterparties.

The Proposal, however, allows no such flexibility. Parties trading TBAs with a broker-dealer, whether as part of a hedging strategy or speculation, would be required to post margin once the exposure exceeds the Proposal’s minimum transfer amount of $250,000 – regardless of the size of the position. Broker-dealers, on the other hand, must take a regulatory capital charge for the entire unmargined exposure, leaving no opportunity for the parties to negotiate.

It is important to note that most, if not all, Master Securities Forward Transaction Agreements (MSFTA) to which mortgage bankers are a party require margin to be posted under certain circumstances. The parties themselves negotiate the terms of these agreements, and take into account counterparty credit strength, the experience of the management team of the mortgage banker, and the length and experience of the relationship between the mortgage banker and the broker-dealer. In many cases, the broker-dealer will require audited financial statements, pipeline reports and, in some cases, the use of a third-party hedge advisory firm to ensure that the trading line is being used prudently.

One of the Proposal’s unintended consequences will be the further expansion of Fannie Mae’s footprint in the secondary mortgage market. Fannie Mae’s cash window provides competitive funding terms that are in many cases superior to other best efforts execution channels in either price, funding speed, or both.6 Moreover, Fannie Mae’s capital markets desk is not subject to FINRA regulations. While Fannie Mae has indicated that it will follow TMPG’s recommendation, it has set its margin threshold at $3,000,000, with a $50,000 minimum transfer amount.7 These terms dwarf what the Proposal would allow a FINRA-regulated broker-dealer to offer even its safest counterparty. At a time when comprehensive reform of Fannie Mae and Freddie Mac is a top priority of both Congress and the Obama Administration, FINRA should not promulgate rules which hamper the private market’s ability to compete in the secondary mortgage market.

**Agency Multifamily Mortgage-Backed Securities**

MBA is concerned that the inclusion of the Multifamily Agency Mortgage-Backed Securities (Agency MF MBS) in the Proposal would have unwarranted and detrimental consequences for the Agency MF MBS market.

**Background**

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6 Fannie Mae’s cash window promises to fund the loan as soon as two business days after delivery. See Selling Whole Loans to Fannie Mae at 43 (available at: https://www.fanniemae.com/content/job_aid/selling-whole-loans.pdf)
Agency MF MBS typically involve loans secured by either multifamily or healthcare loans. These include residential property that contains five or more dwelling units, including apartment buildings, residential facilities for seniors or disabled persons (such as independent living, assisted living, skilled nursing facilities, memory care, and similar facilities on the healthcare loan spectrum), cooperative housing projects, manufactured housing communities, student housing, rural housing, military housing, and hospitals.\(^8\)

Agency MF MBS are a type of securitized product for which the timely payment of principal and interest is guaranteed by an Agency or a GSE, where the Agency MF MBS represents an ownership interest in one or more multifamily housing or healthcare loans. Agency MF MBS are issued in conformity with a program of an Agency as defined in 6710 - Definitions of FINRA Rule 6700 - Trade Reporting and Compliance Engine (TRACE), where Agency is defined in paragraphs (k) and (p)\(^9\) and Government-Sponsored Enterprise (GSE) is defined in paragraph (n).\(^10\)

As drafted, the Proposal applies to Covered Agency Securities, which include CMOs, and it may appear that Agency MF MBS are included in the definition of CMOs by reference to endnote 13, where it states, "includes a real estate mortgage investment conduit (REMIC) and an Agency-Backed Commercial Mortgage Backed Security as defined in FINRA Rule 6710(ee)."\(^11\) It should be noted that the definition in 6710(ee) was deleted by Amendment 1 to the Rule change proposed in SR-FINRA-2013-046.\(^12\)

\(^8\) Hospitals are part of Agency MF MBS because Ginnie Mae securitizes FHA insured Multifamily Housing and Healthcare loans.

\(^9\) "Agency" means a U.S. "executive agency" as defined in 5 U.S.C. 105 that is authorized to issue debt directly or through a related entity, such as a government corporation, or to guarantee the repayment of principal and/or interest of a debt security issued by another entity. The term excludes the U.S. Department of the Treasury ("Treasury") in the exercise of its authority to issue U.S. Treasury Securities as defined in paragraph (p). (p) "U.S. Treasury Security" means a security issued by the U.S. Department of the Treasury to fund the operations of the federal government or to retire such outstanding securities.

\(^10\) "Government-Sponsored Enterprise" ("GSE") has the same meaning as defined in 2 U.S.C. 622(8).

\(^11\) In proposed FINRA Rule 6710(ee), Agency-Backed Commercial Mortgage-Backed Security is defined as: a type of Securitized Product that is classified as a Collateralized Mortgage Obligation for purposes of the Rule 6700 Series and Rule 7730 and is issued in conformity with a program of an Agency as defined in paragraph (k) or a Government-Sponsored Enterprise ("GSE") as defined in paragraph (n), for which the timely payment of principal and interest is guaranteed by the Agency or GSE, representing ownership interest in a pool (or pools) of mortgage loans on commercial property.

\(^12\) In addition, FINRA proposes to clarify the definition of Collateralized Mortgage Obligation ("CMO") in proposed FINRA Rule 6710(dd) to mean: "a type of Securitized Product backed by Agency Pass-Through Mortgage-Backed Securities as defined in paragraph (v), mortgage loans, certificates backed by project loans or construction loans, other types of mortgage-backed securities or assets derivative of mortgage-backed securities, structured in multiple classes or tranches with each class or tranche entitled to receive distributions of principal and/or interest according to the requirements adopted for the specific class or tranche, and includes a real estate mortgage investment conduit ("REMIC")."

The proposed revised definition of CMO makes minor technical changes and eliminates the reference to "Agency-Backed Commercial Mortgage-Backed Security." FINRA originally proposed to include Agency-Backed Commercial Mortgage-Backed Security as a type of CMO as a way to provide additional clarity for classification purposes. In light of the elimination of a Non-Agency-Backed Commercial Mortgage-Backed Security from classification as an Asset-Backed Security above, FINRA proposes to streamline the definition.
Agency MF MBS typically involve periods between the trade date and the contractual settlement date of greater than three business days, and they are subject to the following market practices:

- **Interest Rates are Locked** - Commercial mortgage bankers (Seller) sell Agency MF MBS to institutional investors and broker-dealers to lock in interest rates to the borrower while the underlying mortgage loan is being processed, closed and funded and prior to the time that the Agency MF MBS is issued.

- **Mortgage Loan is Known at Time of the Trade** - The trade is project specific where the terms of the security and the related mortgage loan, as well as the identity of the project collateral are known at the time of trade (typically with +/- 5% loan amount variance).

- **Document Signed by Both Parties with Specific Terms** - The Agency MF MBS trade is documented through a Trade Confirmation Letter (not by a SIFMA Master Securities Forward Transaction Agreement) that is signed by both parties upon execution of the trade. The Trade Confirmation Letter specifies the terms of the underlying mortgage loan and identifies the security. It also includes specified terms for purchase price, good faith deposit, delivery, extensions, settlement, and other miscellaneous representations and warranties.

- **Trade is Ex-clearing** - The trade is ex-clearing, meaning it is not cleared through a registered clearing agency (i.e., FICC).

- **Security is Delivered to Investor** - The security is issued in book-entry form using the book-entry system of the U.S. Federal Reserve Banks and delivered to the investor delivery versus payment.

- **Good Faith Deposit Collected by the Seller** - A good faith deposit is collected by the Seller from the borrower to ensure the borrower closes the mortgage loan and is either retained or passed to the investor until such time that the security is delivered. The good faith deposit is typically 0.50 percent to 1.00 percent of the security amount and, in many cases, represents liquidated damages payable to the investor in the event that the Seller fails to deliver the security if the mortgage loan is not closed due to circumstances beyond the Seller’s control or there has been a material change involving Fannie Mae, Freddie Mac, or Ginnie Mae or the rules and regulation related to the relevant Agency MF MBS such that the security cannot be issued and delivered.

- **No Interest Rate Risk** - Due to the forward sale of the project specific loan at the time of rate lock, the Seller is not taking interest rate risk or mark-to-market risk from the time of rate lock until the time the security is delivered to the investor.

The above definitional amendments eliminate the need for the defined terms “Agency-Backed Commercial Mortgage-Backed Security” and “Non-Agency-Backed Commercial Mortgage-Backed Security” since these securities would not be subject to dissemination. FINRA may propose new definitions for such securities at such time as they may be proposed to be disseminated in the future. Finally, FINRA proposes to amend FINRA Rule 6750 to clarify that Asset-Backed Securities, as proposed to be redefined, would be subject to dissemination.
Trade is Specific to the Mortgage - There is not a market mechanism to replace the security as a result of a failed trade as the trade is for a specific security backed by an identified mortgage loan.

As is clear from the foregoing, the risks that the Proposal seeks to address are not evident in Agency MF MBS transactions. Consequently, it is neither necessary nor advisable to apply the Proposal's margin requirements to Agency MF MBS. As proposed, the margin requirement will almost certainly have a negative impact on Agency MF MBS market participants due to the posting of additional margin for the mark-to-market requirement, which would require significant additional liquidity on the part of market participants. This need for increased liquidity would result in a higher cost of capital for lenders, and therefore increase pricing of Multifamily and Healthcare Loans to borrowers.

Consequently, we strongly recommend that the definition of Agency MF MBS be added to the FINRA Rule 6700 definitions to clarify reporting and dissemination requirements for TRACE and to explicitly exclude these securities from the margin requirements in the Proposal.

CONCLUSION

Mortgage bankers provide critical services to communities throughout the country, and smaller lenders are particularly important in those areas left underserved by the broader market. The TBA trade remains unparalleled in its ability to allow mortgage bankers of all sizes to access the secondary market on competitive terms, allowing these entities to develop innovative ways to best serve their community's borrowers. FINRA's Proposal would reduce both competition among lenders and affordable access to credit for consumers, and may merely replace a broadly distributed risk with one more concentrated among larger participants – including an even larger presence for Fannie Mae and Freddie Mac.

FINRA's Proposal will also unnecessarily increase costs to Agency MF MBS issuers who already have extensive market conventions in place to guard against counterparty risk.

MBA appreciates the opportunity to comment on the Proposal. Any questions should be directed to Dan McPheeters at (202) 557-2780 or dmcpheeters@mortgagebankers.org; or Eileen Grey at (202) 557-2747, or egrey@mortgagebankers.org.

Sincerely,

David H. Stevens
President and Chief Executive Officer