



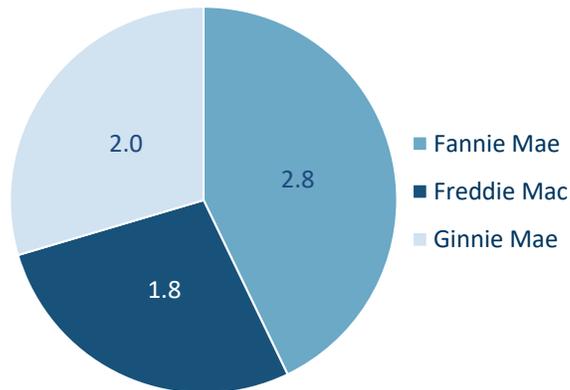
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UMBS – The Next Generation of Agency Mortgage Securities

In 2019, the FHFA will roll out a unified MBS security that will combine Fannie Mae and Freddie Mac and introduce a framework for others to enter the market while not disrupting a market that consumers use and understand.

The Federal Housing Finance Authority (FHFA) announced that on June 3, 2019 a common security for the Government Sponsored Entities (GSEs, Freddie Mac and Fannie Mae) called Uniform Mortgage Backed Security (UMBS) will be introduced. Since the financial crisis, there has been discussion surrounding what level of government involvement there should be in the US housing market. There have been some radical changes proposed, but ultimately the desire to continue providing affordable 30-year mortgages to Americans seeking home ownership prevented any major changes. The current proposal suggests that Fannie Mae and Freddie Mac will remain integral parts in the market but will provide uniform standards for other participants to enter the market.

Exhibit 1: RMBS is a \$6.6 trillion market



Source: Fannie Mae, Freddie Mac, Ginnie Mae, eMBS, AP Securities

Currently, the agency Residential Mortgage-Backed Security (RMBS) market is a ~\$6.6 trillion market, split between ~\$2.8 trillion Fannie and ~\$1.8 trillion Freddie, with the remainder being Ginnie Mae, which will be unaffected by this initiative. The agency RMBS market is often described as having the same or more liquidity than the US Treasury market. The creation of UMBS is expected to enhance that liquidity while creating a framework for the evolution of the US housing market.

The following factors are being assessed:

Standardized payments

In general, the new UMBS securities will adopt most current Fannie Mae conventions. Fannie Mae pays interest to investors with a 55-day payment delay from the original payment made by the homeowner, while Freddie Mac pays on a 45-day delay. UMBS will follow the Fannie Mae payment convention. On June 3, 2019 all holders will be able to exchange legacy Freddie securities into UMBS (for free) and will be compensated for the 10-day differential based on an option-adjusted spread (OAS) model. The details of these exchanges are available on the Freddie Mac website and the company began rolling out the new UMBS security details in 3Q18 for information purposes. The compensation for each individual exchange will vary but it generally is expected to be around 3 “ticks” (\$0.09 per \$1,000 par). This exchange is optional at the choice of the holders. The SEC and IRS have both opined that conversion is an exchange and is therefore not a taxable event.

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Index

Bloomberg Barclays, a fixed income index provider, has opined that they will include legacy Freddie 45-day securities as well as new or exchanged 55-day Freddie securities and 55-day Fannie securities. In addition, legacy and exchanged Freddie securities of the same original issue will be linked for purposes of determining index inclusion. For calculation of returns, the exchange compensation will not be included.

Systems/back office process

Much of the burden of this exchange will fall on systems and back office processes. Freddie Mac has said it has capacity to exchange 50,000 line items per day. Discussions within Opus have been on-going for months to prepare and the investment accounting team is verifying the process to handle the exchanges. At this time, we believe the process is similar to other exchanges that frequently happen in the course of fixed income investing and should not prove difficult to execute.

Investment process implications

At the highest level, this should enhance overall liquidity in the To Be Announced (TBA) market. We will continue to evaluate the characteristics and pricing of various coupons, pools, and collateralized mortgage obligations (CMOs) to achieve favorable risk-adjusted returns. There will be some tactical thinking required to determine when and if to exchange from legacy Freddie securities to new 55-day UMBS securities. Specified mortgage pools and CMOs will continue to have separate Fannie and Freddie pools.

Overall this should have minimal impact on our investment process and our clients. Opus will remain current on any future changes as the implementation date nears.

The move to UMBS is a very manageable evolution in the RMBS market. Currently, Opus does not have any positions in TBAs so our focus for current holdings will largely be on the exchange of existing Freddie Mac specified pools into the new 55-day securities. Our back office is aware of the changes and has been preparing for months to continue to provide our clients with the signature performance that they have come to expect.

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