American University Business Law Review

Volume 10 | Issue 1 Article 5

2021

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Recommended Citation

Elizabeth Ashlee Kuan "Uniform Mortgage-Backed Securities: An Analysis of the Regulatory Hurdles Caused by the Federal Housing Finance Agency's Standardization of the TBA Market," American University Business Law Review, Vol. 10, No. 1 (2021) .
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UNIFORM MORTGAGE-BACKED SECURITIES: AN ANALYSIS OF THE REGULATORY HURDLES CAUSED BY THE FEDERAL HOUSING FINANCE AGENCY'S STANDARDIZATION OF THE TBA MARKET

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I. INTRODUCTION

After the financial crisis of 2008, Congress enacted legislation establishing a new agency, the Federal Housing Finance Agency ("FHFA"), to act as conservator of the Federal National Mortgage Association ("Fannie Mae") and the Federal National Home Mortgage Corporation ("Freddie Mac").[1] Fannie Mae and Freddie Mac are both government-sponsored enterprises ("Enterprises") that function as servicers for loans that are secured by mortgage bonds.[2] Though the government regulates the Enterprises, they used to be "privately owned, publicly traded companies."[3] Under the goals of conservatorship, the FHFA announced its plans in 2012 to create a single securitization platform for Fannie Mae and Freddie Mac to trade to-be-announced ("TBA") eligible securities.[4] In 2019, the FHFA issued a final rule establishing a single mortgage-backed security ("MBS") for Fannie Mae and Freddie Mac to issue in the TBA market, which would be known as the Uniform Mortgage-Backed Security ("UMBS").[5] This

1. Housing and Economic Recovery Act (HERA) of 2008 § 1101, 12 U.S.C. § 4511 (establishing the FHFA and granting it authority over Fannie Mae and Freddie Mac); *see id.* § 4617 (enumerating the reasons to appoint the FHFA as the conservator or receiver of Fannie Mae and Freddie Mac ("Enterprises"), such as substantial dissipation and assets insufficient for obligations).

2. *About Fannie Mae and Freddie Mac*, FED. HOUS. FIN. AGENCY, https://www.fhfa.gov/SupervisionRegulation/FannieMaeandFreddieMac/Pages/About-Fannie-Mae---Freddie-Mac.aspx (last visited Mar. 27, 2021); *see* Allan Lopez & Christopher Maloney, *Why the Big Change in Agency MBS Is a Big Deal*, BLOOMBERG (June 6, 2019), https://www.bloomberg.com/professional/blog/big-change-agency-mbs-big-deal/.

3. Janice Kay McClendon, *The Perfect Storm: How Mortgage-Backed Securities, Federal Deregulation, and Corporate Greed Provide a Wake-Up Call for Reforming Executive Compensation*, 12 U. PA. J. BUS. L. 131, 141 (2009).

4. *See* FED. HOUS. FIN. AGENCY, A STRATEGIC PLAN FOR ENTERPRISE CONSERVATORSHIPS: THE NEXT CHAPTER IN A STORY THAT NEEDS AN ENDING 13 (2012) [hereinafter FHFA, A STRATEGIC PLAN], https://www.fhfa.gov/AboutUs/Reports/Report Documents/20120221_StrategicPlanConservatorships_508.pdf (explaining that the securitization platform is necessary because Fannie Mae and Freddie Mac's infrastructures were incapable of becoming market utilities without significant investment and technological resources).

5. Uniform Mortgage-Backed Security, 84 Fed. Reg. 7793, 7793 (Mar. 5, 2019) (to

Comment will discuss what led to the creation of the UMBS and compare the effect of UMBS prepayment speeds on the loan originator pool with the effect of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") on small and medium-sized enterprises ("SMEs") and community banks. This Comment will argue: (1) the UMBS fungibility is dependent upon whether the Enterprises' regulatory and disclosure processes effectively align the prepayment speeds; and (2) the current Enterprise governance model will likely restrict loan originator participation by consolidating specified loan pools into one, large multi-lender pool.[6]

II. WHAT LED THE FHFA TO CREATE THE UNIFORM MORTGAGE-BACKED SECURITY?

A. Fannie Mae and Freddie Mac: Foundation and Purpose

During the twentieth century, Congress created Fannie Mae, the Governmental National Mortgage Association ("Ginnie Mae"), and Freddie Mac to stabilize the mortgage market. Though the primary and secondary mortgage markets are separate and distinct platforms, they are connected through lenders.[7] Lenders use the primary mortgage market to supply funds to borrowers seeking to take out mortgages.[8] However, lenders use the secondary mortgage market to sell those mortgages to investors and continue providing loans to borrowers in the primary mortgage market.[9]

Congress created Fannie Mae in 1938 to help provide stability in the secondary mortgage market and promote access to mortgage credit.[10] To

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be codified at 12 C.F.R. pt. 1248).

6. *See* FED. HOUS. FIN. AGENCY, AN UPDATE ON THE STRUCTURE OF THE SINGLE SECURITY 5 (2015) [hereinafter FHFA, UPDATE ON THE STRUCTURE], https://www.fhfa.gov/AboutUs/Reports/ReportDocuments/Single%20Security%20Update%20final.pdf (using "fungible" and "interchangeable" to denote the same meaning); *see also Regulatory Burdens: The Impact of Dodd-Frank on Community Banking: Hearing Before the Subcomm. on Econ. Growth, Job Creation, & Regul. Affs. of the H. Comm. on Oversight & Gov't Reform*, 113th Congress 1, 2, 5 (2013) (statement of Hester Peirce, Senior Research Fellow, Mercatus Center at George Mason University), https://www.mercatus.org/system/files/Peirce_RegBurden_testimony_071713.pdf (discussing the regulatory burdens on community banks).

7. *See* THOMAS P. LEMKE ET AL., MORTGAGE-BACKED SECURITIES § 5.1 (database updated Oct. 2020) (noting that lenders obtain funds by selling mortgages in the secondary market).

8. *Id.* § 1:2.

9. *Id.* (adding that the sale of loans in the secondary mortgage market offers the borrower "the benefits of lower costs").

10. Federal National Mortgage Association Charter Act § 302, 12 U.S.C. § 1717.

move Fannie Mae's debt, which was traditionally held in Fannie Mae's portfolio, Congress converted Fannie Mae into a quasi-governmental private company in 1968.[11] Fannie Mae purchases mortgages from lenders, including banks and credit unions, and then sells its interest in the bundles of mortgages to investors in the market as MBS, distinguishing Fannie Mae from Ginne Mae.[12]

Created by Congress in the same year, Ginnie Mae was intended to expand the mortgage loan investment market by providing lenders with liquidity secured by the government.[13] Prior to the MBS, banks were the primary source of mortgage investment because of mortgage rate and sourcing disparities amongst differing localities.[14] In 1970, Ginnie Mae created the first MBS,[15] a security comprised of multiple residential mortgage loans used as collateral for the security.[16]

In 1970, Congress created Freddie Mac to help maintain market stability and "increase[] the liquidity of mortgage investments."[17] Unlike Fannie Mae, Freddie Mac packages mortgages into trusts and sells its interests in the trusts as "participation certificates" or "PCs."[18] "Agency MBS" is a term referring to an MBS guaranteed by Fannie Mae, Ginnie Mae, or Freddie Mac.[19] An MBS issued by the Enterprises is distinguishable from a private-label MBS because the government secures an Enterprise MBS.[20]

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11. 12 U.S.C. § 1716(b); *see* LEMKE ET AL., *supra* note 7, § 1:7 (explaining that having a quasi-governmental private company status means that Fannie Mae could now purchase mortgages that were not insured by the FHFA).

12. *See About Us*, GINNIE MAE, https://www.ginniemae.gov/about_us/who_we_are/Pages/our_history.aspx (last modified Dec. 2, 2020, 9:47 AM) (stressing that Ginnie Mae securitizes only certain government-backed mortgages, and "Fannie Mae's role was to buy FHA insured loans from lenders").

13. *See id.*

14. *Id*.

15. *Id*.

16. *See id.*

17. Federal Home Loan Mortgage Corporation Act, Pub. L. No. 91–351, § 301, 84 Stat. 450, 450 (1970) (codified as amended at 12 U.S.C. §§ 1451–1459).

18. Rev. Proc. 18-54, 2018-45 I.R.B. 769; *see* Mark Leeds & Steven Garden, *IRS Ruling on MBS Restructuring Should Encourage Investors*, LAW360 (Sept. 13, 2018, 9:29 PM), https://www.law360.com/articles/1082765/print?section=assetmanagement.

19. James Vickery & Joshua Wright, *TBA Trading and Liquidity in the Agency MBS Market*, FED. RSRV. BANK N.Y. ECON. POL'Y REV., May 2013, at 1, 1, https://www.newyorkfed.org/medialibrary/media/research/epr/2013/1212vick.pdf.

20. *See id*. at 2 (explaining that the government-backed guarantee protects "[i]nvestors from credit losses in case of defaults on the underlying mortgages").

B. Fannie Mae and Freddie Mac in the TBA Security Market

A TBA security represents a forward agreement that allows the execution of trades before the required delivery of the securities.[21] The TBA market enables investors to manage their risk because the forward agreement allows for the parties to agree on the price before the underlying mortgages are delivered or even created.[22] In the TBA market, the exact mortgage pool characteristics or number of mortgage pools are unknown at the time of the trade because a security issued or guaranteed by a government-sponsored entity is exempt from certain federal securities registration requirements.[23]

The basic structure of a TBA trade is divided into three parts: the purchase and sale of the securities, the disclosure of the underlying loan identities of the securities, and the delivery of the purchased securities.[24] Because participants are unaware as to the identity of the actual mortgages underlying the security, there are six basic parameters agreed upon before delivery of the MBS on the day of the trade: "the issuers, maturity, coupon, paramount, settlement, and price."[25] The settlement date for agency MBS depends on the associated class of the MBS.[26] Trading behavior in the MBS market is primarily driven by the "average life" for each underlying loan; that is, how long it will take the borrower to repay the principal balance.[27] However, two days before the trade is settled, the seller is required to disclose to the purchaser the identity of the underlying mortgages, what is known as the "forty-eight-hour" rule.[28]

Under the "forty-eight-hour" rule, the seller chooses the MBS it will deliver to the buyer on the day of the trade and will often choose the lesser-valued securities, referred to as "cheapest-to-deliver."[29] Because the

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21. LEMKE ET AL., *supra* note 7, § 5:3.

22. Vickery & Wright, *supra* note 19, at 2 (emphasizing that trading in the TBA market allows investors to trade "agency MBS, out to a horizon of several months").

23. 12 U.S.C. § 1723c; *id.* § 1455(g); *see* Michael E. Murphy, *Fannie Mae and Freddie Mac: Legal Implications of a Successor Cooperative*, 10 DEPAUL BUS. & COM. L.J. 171, 178 (2012) (distinguishing TBA security disclosure requirements from that of registered MBS, which includes disclosure regarding the underlying pools of mortgages).

24. Vickery & Wright, *supra* note 19, at 5.

25. Murphy, *supra* note 23, at 178.

26. *See* LEMKE ET AL., *supra* note 7, § 5:4 (listing the associated product classes such as Class A, which includes thirty-year Fannie Mae and Freddie Mac MBS).

27. *Id.* § 5:2.

28. *See* Vickery & Wright, *supra* note 19, at 6 (detailing that this disclosure occurs approximately forty-eight hours — also known as the "forty-eight-hour-day" — before the trade).

29. Vickery & Wright, *supra* note 19, at 6.

identities of the underlying mortgages do not have to be disclosed before the trade occurs, there is an incentive for the seller to choose the lowest-value securities that satisfy the six basic parameters the buyer and seller agreed upon prior.[30] However, the buyer is not necessarily disadvantaged because the buyer, who is aware of the incentive, will lower the price they are willing to pay at the time of the trade.[31]

Once the trade has been made, a mortgage borrower typically has a set schedule to make monthly payments that include the principal and interest, but the borrower also has the option to make extra payments or pay off the mortgage completely, options known as prepayments.[32] An MBS investor can calculate their future return on investment based on these prepayments.[33] Investors rely on benchmark standards to measure prepayment speeds, such as the Conditional Prepayment Rate ("CPR") and Public Securities Association Rate ("PSA"), to calculate their future return on investment.[34] The key to calculating the rate of prepayment depends on the prevailing mortgage interest rate compared with the interest rates of the underlying mortgages.[35] Investments in MBS can expose investors to risk because the prepayment schedule is not predefined, rather providing flexibility to the mortgagor.[36] The mortgagee's ability to make prepayments or pay off the mortgage entirely at any time makes investing in MBS riskier than other investments.[37]

Securities issued by the Enterprises enable the operation of the TBA market because Enterprise-issued securities are not subject to the same

30. *See id.*; Murphy, *supra* note 23, at 178.

31. Vickery & Wright, *supra* note 19, at 6 (defining this process as a market phenomenon called "adverse selection").

32. FED. HOUS. FIN. AGENCY, A FINANCIAL CONCEPTS TUTORIAL app. at 22, 25, Westlaw FHFA-BEM 18.6 (2013) [hereinafter FHFA, FINANCIAL CONCEPTS TUTORIAL] (explaining that prepayment speeds are just one of the many interest rate environments that investors monitor through cash flows).

33. *Id.* app. at 23–24.

34. LEMKE ET AL., *supra* note 7, § 5:14 (defining CPR as a "rate [that] assumes . . . some fraction of the remaining principal in a mortgage pool is prepaid each month," and PSA as a rate comprised of "a monthly series of CPRs and assumes that prepayment rates are low for newly originated mortgages and then accelerate over the life of the mortgages").

35. FED. HOUS. FIN. AGENCY, A FINANCIAL CONCEPTS TUTORIAL, *supra* note 32, app. at 26 ("The most important factor in determining the likelihood of prepayments is the difference between the interest rates on pooled mortgages and the prevailing mortgage interest rate.").

36. *See id.* app. at 25.

37. *Id.*

registration requirements as publicly-traded MBS. The TBA market operates in a unique way because Fannie Mae and Freddie Mac are exempt from certain requirements of the Securities Act of 1933.[38] This exemption distinguishes Fannie Mae and Freddie Mac MBS from those sold publicly[39] and allows traders to execute forward trades without the existence of the securities to be delivered on the settlement day.[40] The exemption from U.S. Securities and Exchange Commission ("SEC") registration requirements does not necessitate the existence of the securities because the seller may withhold disclosure of the actual identities of underlying mortgages.[41] The exemption from SEC registration requirements is a key component of the TBA market, but it is a primary reason why investment in the residential mortgage market is so risky and the change to UMBS prepayment speeds is significant.[42]

In the early 2000s, the United States experienced a substantial increase in home financing because the loosening of borrowing restrictions made it easier for people to take out mortgages.[43] During that time, the Federal Reserve also drastically reduced federal interest rates.[44] Because the federal rates were so low, financial institutions could offer their current and potential customers options to purchase inexpensive mortgages while still earning a profit.[45]

Prior to the Enterprises' dominance of the secondary mortgage market, Fannie Mae and Freddie Mac had "conservative underwriting standards" for lenders to trade government guaranteed loans.[46] Due to pressure from Congress to achieve affordable housing goals and pressure from shareholders to invest in the subprime mortgage market to boost profitability,

38. 12 U.S.C. §§ 1455(g), 1723c; *see* Vickery & Wright, *supra* note 19, at 9.

39. Vickery & Wright, *supra* note 19, at 9; *see also* 12 U.S.C. §§ 1455(g), 1723c (explaining that Fannie Mae and Freddie Mac, along with the other federal home loan banks, are not considered agencies).

40. Vickery & Wright, *supra* note 19, at 9.

41. *Id.*

42. *Id*. at 9, 10.

43. *See* Alexander S. Bonander, Note, *Fannie Mae, Freddie Mac, and Due-Diligence Failures: Should Comparative Responsibility Be Imposed on a Government-Sponsored Entity's Claims Brought Under Sections 11(a) and 12(a)(2) of the Securities Act of 1933?*, 98 IOWA L. REV. 835, 839 (2013) (quoting *In re* Fannie Mae 2008 Sec. Litig., 742 F. Supp. 2d 382, 391 (S.D.N.Y. 2010)).

44. *Id.*

45. *Id.*

46. *See id*. at 843 (demonstrating the Enterprises' conservative underwriting standards consisted of a "loan-to-value ratio of 80% and a single-family residential mortgage maximum-principal-indebtedness amount of $417,000").

the Enterprises abandoned their stringent underwriting standards and began guaranteeing subprime mortgages and investing in sub-prime MBS.[47]

C. Dodd-Frank Wall Street Reform and Consumer Protection Act: A Byproduct of the 2008 Financial Crisis

At the time of the crisis, Fannie Mae and Freddie Mac were sitting on millions of dollars' worth of "junk" MBS and PCs.[48] Between 2004 and 2006, the Enterprises "purchased over $434 billion in subprime mortgages."[49] The Treasury lent the Enterprises nearly $150 billion.[50] In February of 2008, Congress passed the Emergency Economic Stabilization Act, which allowed the Federal Reserve to purchase $700 billion in mortgages for the market to maintain liquidity.[51] Later that year, Congress also passed the Housing and Economic Recovery Act ("HERA"), which created the Federal Housing Finance Agency ("FHFA").[52] The FHFA's purpose was to act as conservator of Fannie Mae and Freddie Mac in governing the acceptance and issuance of agency securities.[53] Although the conservator role does not equate to micromanaging the Enterprises' operations, it does require the FHFA's approval over changes in regulations and other laws.[54]

The other major legislation resulting from the financial crisis of 2008 was the Dodd-Frank Act.[55] The Dodd-Frank Act was one of the most

47. *Id.* at 850–51.

48. *See id.* at 853; Eamonn K. Moran, *Wall Street Meets Main Street: Understanding the Financial Crisis*, 13 N.C. BANKING INST. 5, 60 (2009) (quoting Michael S. Barr & Gene Sperling, *Poor Homeowners, Good Loans*, N.Y. TIMES (Oct. 17, 2008), https://www.nytimes.com/2008/10/18/opinion/18barr.html) (specifying that Fannie Mae and Freddie Mac had either guaranteed or purchased $270 billion in loans from 2005 to 2008); *see also* Milan Markovic, *Subprime Scriveners*, 103 KY. L.J. 1, 8 (2015) (explaining that towards the end of 2008, the "credit rating agencies downgraded most MBS investments to junk status").

49. Bonander, *supra* note 43, at 844.

50. *Id.* (acknowledging that the amount of money the Enterprises received from the government was "the largest bailout of the [2008] financial crisis").

51. Emergency Economic Stabilization Act of 2008 §§ 2–301, 12 U.S.C. §§ 5201–5261; *see* Moran, *supra* note 48, at 11.

52. Housing and Economic Recovery Act (HERA) of 2008 § 1145(a), 12 U.S.C. § 4617; *see About FHFA*, FED. HOUS. FIN. AGENCY, https://www.fhfa.gov/AboutUs#:~:text=The%20Federal%20Housing%20Finance%20Agency,%E2%80%8B%20and%20the%20Federal%20Home (last updated Oct. 5, 2020).

53. *See Conservatorship*, FED. HOUS. FIN. AGENCY, https://www.fhfa.gov/Conservatorship (last visited Mar. 27, 2021).

54. *Id.*

55. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-

comprehensive securities regulation reforms since the Securities Exchange Act of 1934.[56] The primary purpose of the Dodd-Frank Act was to use transparency as the primary mechanism to stabilize the markets and to prohibit large financial institutions from engaging in proprietary trading practices that contributed to the financial collapse of 2008.[57] By promoting accountability and transparency, the legislation would protect taxpayers from bearing the financial burden of "Wall Street's mistakes."[58]

The Dodd-Frank Act created two new regulatory agencies: the Financial Stability Oversight Council ("FSOC") and the Consumer Financial Protection Bureau ("CFPB").[59] Due to the role of the residential mortgage market that led to the 2008 financial crisis, the Dodd-Frank Act granted the CFPB the authority to regulate all non-bank residential mortgage loan originators, brokers, and servicers.[60] The Dodd-Frank Act also granted the CFPB the authority to create rules to require disclosure of loan terms.[61] Thus, by implementing credit risk retention minimums for securitizers, the Dodd-Frank Act aims to eliminate high-risk trading of qualified residential mortgages ("QRM").[62] The Dodd-Frank Act also created the FSOC, which is tasked with identifying potential risks to the U.S. economy.[63] In response to the 2008 financial collapse, due in large part to risky trading of MBS backed by high-risk residential mortgages, the Dodd-Frank Act included strict and specific provisions to prevent lenders from allowing retail

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203, 124 Stat. 1376 (2010) (codified at 12 U.S.C. §§ 5301–5641).

56. Cody Vitello, *The Wall Street Reform Act of 2010 and What It Means for Joe & Jane Consumer*, 23 LOY. CONSUMER L. REV. 99, 99 (2010).

57. Brynne Krause, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: How Increased Regulation Has Given Large Banks an Artificial Competitive Edge*, 83 UMKC L. REV. 1045, 1049 (2015) (quoting Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010)).

58. *Id*. (quoting President Barack Obama pledging that "[t]he American people [would] never again be asked to foot the bill for Wall Street's mistakes").

59. Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 111, 1002, 12 U.S.C. §§ 5321, 5481.

60. *See* 12 U.S.C. § 5107(f)(2) ("[T]he Bureau shall take into account the need to provide originators adequate incentives to originate affordable and sustainable mortgage loans . . . .").

61. *Id.* § 5531(a); *see* Jason Scott Johnston, *Do Product Bans Help Consumers? Questioning the Economic Foundations of Dodd-Frank Mortgage Regulation*, 23 GEO. MASON L. REV. 617, 638 (2016).

62. *See* 15 U.S.C. § 78o-11; Emre Carr, Commentary, *An Economic Analysis of the SEC's ABS Risk-Retention Rule Re-Proposal*, 20 NO. 1 WESTLAW J. DERIVATIVES 1, 1–2 (2013).

63. 12 U.S.C. § 5321; *see also* Vitello, *supra* note 56, at 102–03 (listing specific responsibilities of the FSOC).

consumers to take out mortgage loans that they could not repay.[64]

However, beginning in 2013, the Dodd-Frank Act was modified in response to criticisms from financial industry participants arguing that complex disclosure and compliance requirements limited participation to large financial institutions with capital.[65] Named after Paul Volcker, former chairman of the Federal Reserve, the Volcker Rule was integrated into the Dodd-Frank Act to apply to all banking entities regardless of size.[66] The Volcker Rule places broad prohibitions on banks from engaging in proprietary trading and other risky sponsoring of alternative asset classes.[67] In response to criticism of the Volcker Rule's restrictive impact on SMEs, the Volcker Rule was subsequently amended in 2018 to allow increased participation.[68] The Volcker Rule modifications provided small banks engaging in limited trading activity an exemption from certain compliance disclosure requirements.[69]

D. Regulatory Outcomes of the FHFA Rulemaking Session: Alignment of Prepayment Speeds

Since September 6, 2008, Fannie Mae and Freddie Mac have functioned under the conservatorship of the FHFA.[70] HERA grants the FHFA the

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64. *See* Johnston, *supra* note 61, at 619 (identifying the Dodd-Frank Act as the regulatory response to predatory lending practices and convoluted mortgages resulting in thousands taking on mortgages far outside of their financial reach).

65. *See* OCC Issues Annual Report to Congress, Fed. Banking L. Rep. (CCH) ¶ 156-564, 2020 WL 1323401 (Jan. 9, 2020) (stating that financial industry participants voiced concerns over the Dodd-Frank Act's effects around 2013).

66. 12 U.S.C. § 1851(a)(1); *see* Krause, *supra* note 57, at 1067–68.

67. 12 U.S.C. § 1851(a)(1); *see* Shay Raoofi, Note, *The Volcker Rule: A Regulatory Vice Under the Guise of Consumer Protection*, 26 LOY. CONSUMER L. REV. 301, 303–04 (2014) (specifying that the Volcker Rule prohibits financial institutions from "(1) engaging in proprietary trading; (2) acquiring or retaining any equity, partnership, or other ownership interest in a hedge fund or private equity fund; and (3) sponsoring a hedge fund or a private equity fund").

68. *See* Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33,432, 33,546–47 (July 17, 2018) (proposing to allow for more diverse participation by allowing a banking entity to take on an ownership interest in a covered fund in addition to that permitted under the 2013 Volcker Rule provisions).

69. *See* Sydney Sachs, *Proposed Volcker Rule Revisions and Expected Impact*, 38 REV. BANKING & FIN. L. 98, 105 (2018) (stating that the new disclosure requirements create three distinct categories: banks with assets over $10 billion, banks with assets between $1 billion and $10 billion, and banks with fewer than $1 billion in assets, for which the banks with the most assets are subject to the strictest compliance requirements).

70. *See* Housing and Economic Recovery Act (HERA) of 2008 § 1145(a), 12 U.S.C.

authority to oversee Fannie Mae and Freddie Mac so that the entities do not fall into a position that causes destabilization in the market.[71] The statutory rulemaking authority allows the FHFA to initiate the common security platform and to request Fannie Mae and Freddie Mac to create a single security.[72]

In February 2012, the FHFA published a report announcing its goal to create a new securitization platform for Fannie Mae and Freddie Mac to issue securities in the secondary mortgage market.[73] In response to feedback on the new securitization platform in 2013, the FHFA stated it would review alignment policies pertaining to borrower refinancing, as borrower refinancing affects the prepayment risk investors must weigh.[74] In October 2013, Fannie Mae and Freddie Mac established Common Securitization Solutions, LLC to build and operate the Common Securitization Platform ("CSP").[75] In May 2014, the FHFA announced the development of a single security to boost market liquidity by attempting to decrease the trading gap between the Enterprises' securities, leading toward a more balanced market.[76] The goal of the single security would not only be to build a new infrastructure for Fannie Mae and Freddie Mac, but also a system more conducive for future market participation.[77]

In August 2014, the FHFA issued a publication detailing the structure for

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§ 4617(b)(2)(A).

71. *See* 12 U.S.C. § 4617(b)(2)(A), (D).

72. *See id.* § 4617(b)(2)(D) (allowing the FHFA to make decisions that enable the entities to operate soundly); *id.* § 4513(a)(1)(B) (listing the FHFA's regulatory responsibilities as conservator); FED. HOUS. FIN. AGENCY, UPDATE ON THE STRUCTURE, *supra* note 6, at 5.

73. FHFA, A STRATEGIC PLAN, *supra* note 4, at 13.

74. FED. HOUS. FIN. AGENCY, A PROGRESS REPORT ON THE COMMON SECURITIZATION INFRASTRUCTURE 8 (2013), https://www.fhfa.gov/PolicyProgramsResearch/Policy/Documents/WhitePaperProgressReport43013.pdf.

75. Press Release, Fed. Hous. Fin. Agency, FHFA Announces Significant Steps in Organization of Joint Venture to Establish Common Securitization Platform (Oct. 7, 2013), https://www.fhfa.gov/Media/PublicAffairs/Pages/FHFA-Announces-Significant-Steps-in-Organization-of-Joint-Venture-to-Establish-Common-Securitization-Platform.aspx.

76. *See* FED. HOUS. FIN. AGENCY, THE 2014 STRATEGIC PLAN FOR THE CONSERVATORSHIPS OF FANNIE MAE AND FREDDIE MAC 17 (2014) [hereinafter FHFA, 2014 STRATEGIC PLAN], https://www.fhfa.gov/aboutus/reports/reportdocuments/2014strategicplan05132014final.pdf (acknowledging that Freddie Mac securities traded less favorably to those of Fannie Mae).

77. LAURIE GOODMAN & LEWIS RANIERI, URB. INST., HOUS. FIN. POL'Y CTR., CHARTING THE COURSE TO A SINGLE SECURITY 1 (2014), https://www.urban.org/sites/default/files/publication/22916/413218-Charting-the-Course-to-a-Single-Security.PDF.

the new single security.[78] In an update on the Single Security Initiative in 2015, the FHFA stated that the majority of the feedback from the proposed single security structure in 2014 reflected concern over divergence of prepayment speeds.[79] Though financial institutions and government agencies suggested that the FHFA make further adjustments to align the Enterprises' securities regulations affecting prepayment rates, the FHFA expressed its belief that complete alignment of the Enterprises' regulations would be unnecessary because innovation in the issuance of loans from both Enterprises enhances the entire secondary mortgage market.[80] Feedback from commentators also showed concern over the Enterprises' differing remittance policies.[81] The remittance policies pertain to two key components: the remittance cycle and the remittance type.[82] At that time, the FHFA did not find it necessary to align Fannie Mae and Freddie Mac's remittance cycles because the agency projected little impact on prepayment speeds.[83]

On September 17, 2018, the FHFA requested public comment on a Notice of Proposed Rulemaking in the Federal Register regarding the FHFA requiring the Enterprises to adopt and maintain new regulations that would "promote aligned investor cash flows."[84] The proposed rule shifted the conservatorship responsibilities from the FHFA to the Enterprises by requiring the Enterprises: (1) create regulations with regard to alignment of prepayment speeds; and (2) adopt regulations that were aligned with one another.[85] In March 2019, the FHFA issued a final rule establishing the

78. FED. HOUS. FIN. AGENCY, REQUEST FOR INPUT: PROPOSED SINGLE SECURITY STRUCTURE 3 (2014), https://www.fhfa.gov/policyprogramsresearch/policy/documents/rfi-single-security-final-8-11-2014.pdf.

79. FHFA, UPDATE ON THE STRUCTURE, *supra* note 6, at 15.

80. *Id*.

81. *Id*. at 16, 17 (explaining that feedback in response to the request for public input reflected concerns that new programs and policies are similarly implemented to prevent divergence in prepayment speeds).

82. *Id.* at 17 (defining remittance cycle as "the collection period for payments from borrowers and the date on which servicers must remit funds to the Enterprises," and the remittance type as "whether the payments servicers make should reflect funds actually received from borrowers or what borrowers were scheduled to pay").

83. *Id.*

84. Uniform Mortgage-Backed Security, 83 Fed. Reg. 46,889, 46,889 (Sept. 17, 2018) (to be codified at 12 C.F.R. pt. 1248).

85. *Id.* at 46,893 (requiring the Enterprises to maintain alignment for current TBA-eligible MBS and future UMBS); *id.* at 46,895 (detailing the final rule requirements for alignment between the Enterprises).

UMBS, which Fannie Mae and Freddie Mac would issue on June 3, 2019.[86]

Historically, agency MBS issued by Fannie Mae traded at a far higher volume than agency PCs issued by Freddie Mac because MBS are known to be more liquid, which translates into safer and more stable investments.[87] Because Freddie Mac PCs were known to lack liquidity, its bonds traditionally traded at a discount in comparison to Fannie Mae MBS.[88] Moreover, Fannie Mae provided better service and issues bonds with better performance characteristics.[89] This allowed Fannie Mae to continually maintain "a larger market share with originators" in comparison to Freddie Mac.[90]

UMBS is the new common security issued by Fannie Mae and Freddie Mac, available on the TBA securities market, "backed by one-to-four unit (single family) properties."[91] The new securities should improve both Enterprises' liquidity and maintain the UMBS fungibility, meaning maintaining an equal exchange in value.[92] In November 2019, the FHFA submitted a Request for Input ("RFI") regarding the Enterprise UMBS pooling practices.[93] Comments from entities like Securities Industry and Financial Markets Association ("SIFMA") and the American Bankers Association ("ABA") reflected increasing concern over the expanded governance role of the Enterprises and the new regulations governing the UMBS under the single securitization platform.[94]

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86. *Id.* at 46,891; Uniform Mortgage-Backed Security, 84 Fed. Reg. 7793, 7793 (Mar. 5, 2019) (to be codified at 12 C.F.R. pt. 1248).

87. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7795–96.

88. *See* GOODMAN & RANIERI, *supra* note 77, at 3 ("[A] greater proportion of Freddie Mac loans are locked up in collateralized mortgage obligations (CMOs).").

89. Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7795–96.

90. *Id.*

91. *Id.* at 7793 (explaining the properties are used as collateral for the security).

92. *Id.*

93. FED. HOUS. FIN. AGENCY, ENTERPRISE UMBS POOLING PRACTICES REQUEST FOR INPUT 1 (2019) [hereinafter FHFA, ENTERPRISE UMBS POOLING PRACTICES], https://www.fhfa.gov/Media/PublicAffairs/PublicAffairsDocuments/Pooling_RFI.pdf.

94. *See* Am. Bankers Ass'n et al., Comment Letter on Request for Input on Enterprise Pooling Practices (Jan. 21, 2020), https://www.aba.com/advocacy/policy-analysis/letter-to-fhfa-on-the-uniform-mortgage-backed-securities (concluding that FHFA needs to specifically address misalignment issues between the Enterprises' securities); Secs. Indus. & Fin. Mkts. Ass'n, Comment Letter on Request for Input on Enterprise Pooling Practices (Jan. 21, 2020), https://www.sifma.org/wp-content/uploads/2020/01/FHFA-RFI-RESPONSE-FINAL-SIFMA-2020-01-21.pdf ("TBA liquidity has not been optimal . . . .").

III. ENTERPRISE ENFORCEMENT: LEGAL IMPLICATIONS AND GOVERNANCE OF THE UMBS LOAN POOL IN A POST-CONSERVATORSHIP MARKET

A. Examining the Dodd-Frank Act Disclosure Requirements for Qualified Residential Mortgages

The "risk retention rule" enacted by Dodd-Frank, makes it less likely that securitizers will take undue risks by requiring that they retain "five percent of the credit risk of any securitized asset."[95] In other words, securitizers will have "skin in the game."[96] The Dodd-Frank Act requires that the securitizer retain, at minimum, "five percent of the credit risk of any securitized asset," but the regulators retain the power to decide "how to calculate the five percent minimum credit risk."[97] Through this legislation, Congress gave six regulating agencies the power to create exemptions and define "underwriting standards that indicate low-credit risk in any asset class."[98] A major component of the Dodd-Frank Act is the exemption that applies to QRMs.[99] For QRMs, securitizers are not required to "retain any risk associated with the creditworthiness of [QRMs] backing their asset pools."[100] In 2011, the six regulating agencies conducted a notice and comment rulemaking to implement a final rule that complied with the Dodd-Frank Act credit risk retention requirements.[101]

The original rule, published in 2011, provided sponsors with multiple means of calculating the five percent credit risk minimum.[102] Initially, the

95. Carr, *supra* note 62, at 1; Credit Risk Retention, 79 Fed. Reg. 77,602, 77,603 (Dec. 24, 2014) (to be codified at 17 C.F.R. pt. 246).

96. Carr, *supra* note 62, at 1.

97. *Id*.

98. *Id*. at 1, 1 n.1 (denoting the six regulating agencies as the Office of the Comptroller of the Currency ("OCC"), Federal Reserve, Federal Deposit Insurance Corporation ("FDIC"), SEC, FHFA, and Department of Housing and Urban Development ("HUD")).

99. 15 U.S.C. 1639(c); *see Regulatory Burdens: The Impact of Dodd-Frank on Community Banking: Hearing Before the Subcomm. on Econ. Growth, Job Creation, & Regul. Affs. of the H. Comm. on Oversight & Gov't Reform*, 113th Congress 6 (2013) (statement of Hester Peirce, Senior Research Fellow, Mercatus Center at George Mason University), https://www.mercatus.org/system/files/Peirce_RegBurden_testimony_071713.pdf (noting that the new QRM rule conflicts with underwriting tailored to consumers).

100. Carr, *supra* note 62, at 2.

101. Credit Risk Retention, 76 Fed. Reg. 24,090, 24,090 (Apr. 29, 2011) (to be codified at 17 C.F.R. pt. 246).

102. *See* Credit Risk Retention, 79 Fed. Reg. 77,602, 77,605 (Dec. 24, 2014) (to be codified at 17 C.F.R. pt. 246) (indicating retention could include "a 5 percent 'vertical' interest in each class of ABS interests . . . or a 5 percent 'horizontal' first-loss

transactions the Enterprises sponsored would be deemed to satisfy the risk retention requirements because of their conservatorship with the FHFA.[103] However, the proposed rule was adjusted in response to major concerns over ways to satisfy the credit risk retention requirements.[104] In 2013, the agencies broadened the definition of QRM to provide more flexibility in determining how sponsors could retain the minimum credit risk retention.[105] The exemption specifically covers QRMs that are "asset-backed securities that are collateralized exclusively by residential mortgages . . . ."[106]

In 2014, the six regulating agencies stated that Fannie Mae and Freddie Mac satisfied the credit risk retention requirements of Section 15G of the Securities Exchange Act of 1934, which was added by Section 941 of the Dodd-Frank Act, because of the Enterprises' government backed guarantee.[107] The final rule emphasized that as long as the Enterprises continued to operate with the FHFA as conservator, the risk retention requirements under the final rule would be satisfied with respect to the Enterprise-issued MBS.[108]

In contrast, the rulemaking process governing the UMBS reflects a marked change in the FHFA's role as conservator of the Enterprises.[109] Comments from the ABA indicate that the Enterprises' striking control over programs and policies could continue even after the conservatorship with the FHFA ends because the agency remains ambiguous as to what limitations can or will be put on the Enterprises.[110] Under the FHFA's direction, the Enterprises have gained more control over whom may participate in the TBA

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interest . . . .").

103. *See id.*

104. *See id.* (elaborating on how the rules were adjusted in the revised proposal for "eligible vertical interest" and "eligible horizontal residual interest" to satisfy credit risk retention requirements).

105. *See id.* (explaining how satisfying the final credit risk retention requirements included an option to retain "any combination of an 'eligible vertical interest' with a pro rata interest in all ABS interests issued and a first-loss 'eligible horizontal residual interest' . . . .").

106. *Id.* at 77,602.

107. *Id.* at 77,602, 77,649; *see* 15 U.S.C. § 78o-11(E)(3)(B).

108. *See* Credit Risk Retention, 79 Fed. Reg. at 77,649 (explaining that the Enterprises provide a full guarantee on the timely principal and interest payments on the MBS that they issue because of capital support provided by the Treasury).

109. *See* Am. Bankers Ass'n et al., *supra* note 94 (noting the FHFA's approval of moving the conventional markets to a multi-lender pool would yield the opposite of progress).

110. *Id.*

market and what types of loans will be pooled to create Enterprise UMBS.[111] Despite being in a conservatorship with the FHFA, the Enterprises gaining this type of control is a source of concern because the Enterprises remain loan issuance competitors.[112]

Misalignment is concerning because the Enterprises are competitors, and misalignment, meaning "[t]o diverge by, or a divergence of, 2 percentage points or more, in the three-month CPR for a cohort or 5 percentage points or more, in the three-month CPR for a fastest paying quartile of a cohort . . ." could lead investors to favor one Enterprise over the other, which is exactly what the FHFA aimed to eliminate with the implementation of the UMBS.[113] Should misalignment of cash flows occur, the Enterprises are required to report the misalignment to the FHFA.[114] The report must provide a detailed explanation of the issue including the cause of misalignment and a plan to rectify it.[115] Once the FHFA has reviewed the report, it may elect to temporarily change definitions of misalignment to adjust to market conditions.[116] Despite the FHFA's conservator role to oversee the Enterprises' alignment policies, the Enterprises are still focused on issuing the most desirable loans to investors.[117] This competitive relationship between the Enterprises causes concern amongst market participants that the Enterprises retain too much responsibility for ensuring that each entity is in alignment with the other.[118]

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111. *Id.*

112. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (emphasizing concern that there needs to be effective measures implemented to prevent one Enterprise from exerting efforts to control performance).

113. Uniform Mortgage-Backed Security, 84 Fed. Reg. 7793, 7800 (Mar. 5, 2019) (to be codified at 12 C.F.R. pt. 1248).

114. *Id.*

115. *Id.*

116. *Id.* at 7800–01.

117. *See id.* at 7796.

118. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (reiterating market participants' concerns that the Enterprises' current responsibilities with regard to alignment may suffer because the Enterprises will remain "fierce competitors").

B. Potential Consequences for Loan Originators

The Volcker Rule enacted compliance requirements on investment banks that regulated trading activity in order to mitigate risk.[119] Banks in particular were concerned that the overbroad scope and intricate ramifications of the Volcker Rule would make compliance for boutique banks extremely difficult.[120] The Volcker Rule also imposed high-cost compliance requirements that favored large financial institutions.[121] Reporting requirements imposed by the Dodd-Frank Act are beneficial to investors of large banks and simultaneously burdensome on SMEs and community banks.[122] Moreover, banks with fewer than $10 billion in assets are already subject to certain public disclosure requirements, such as liability quality and capitalization.[123] Repeating this disclosure information in compliance with the SEC's mandated disclosures creates even more burdens on small banks.[124]

SMEs and community banking industries have a capital disadvantage to large financial institutions because the industry focus is on core banking services as opposed to revenue streams generated from proprietary trading.[125] This is particularly significant for the small banks that are already absorbing additional compliance costs.[126] Because the banks have to absorb more fixed costs, there is an increased likelihood that they will offset their costs and push them onto consumers through methods such as higher transaction fees.[127] Fewer institutional costs could lead to more inefficient

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119. *See* 12 U.S.C. § 1851(a)(1) (prohibiting banks from engaging in proprietary trading or owning or investing in a hedge fund or private equity fund); Krause, *supra* note 57, at 1068.

120. Halah Touryalai, *Volcker Rule Is Out, How Much Will It Hurt?*, FORBES (Oct. 12, 2011, 5:25 PM), https://www.forbes.com/sites/halahtouryalai/2011/10/12/volcker-rule-is-out-how-much-will-it-hurt/#1b71cf023bd8.

121. Krause, *supra* note 57, at 1069.

122. *See Community Banks in Comment Letter Urge Relief From Disclosure Guide Requirements*, 11 ACCT. & COMPLIANCE ALERT — COMPLETE EDITION, May 22, 2017 (stating that certain SEC statistical disclosure requirements are more useful for large banks with "diversified operations and . . . complex balance sheets").

123. *See id.*

124. *See id.*

125. *See* Raoofi, *supra* note 67, at 307; *see also* Katherine Reynolds Lewis, *Volcker Rule: Why It Matters to Consumers*, BANKRATE (Nov. 11, 2011), https://www.bankrate.com/finance/banking/volcker-rule-1.aspx (explaining that the Volcker Rule forces banks to focus on making profits from core banking services as opposed to the kinds of activities that large investment banks primarily use as methods for earning profits).

126. *See* Raoofi, *supra* note 67, at 314.

127. *Id.* at 313.

markets because higher stock trading could lead to the market losing liquidity, which produces inefficiency.[128]

In January 2020, five federal agencies invited public comment on proposed modifications to the Volcker Rule in connection with "covered funds."[129] Pursuant to the Dodd-Frank Act, banking entities cannot acquire "ownership interest in or sponsor a covered fund."[130] The proposed modifications to covered funds were finalized in June, to become effective in October 2020.[131]

The costs of conforming to the Dodd-Frank Act regulations have caused small bank acquisitions and effectuated consolidation among banking institutions.[132] Large financial institutions absorbed smaller banks to relax their own regulatory burdens and the largest financial institutions continue to expand.[133] Though the costs of conforming to Dodd-Frank Act regulations impact all banks, SMEs and community banks have a more difficult time absorbing the costs of regulations.[134] Unlike large financial institutions, small banks are not always equipped with the capacity to quickly comply with the new, intricate regulations, and the cost of hiring compliance

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128. *Id.*

129. Press Release, SEC, Agencies Propose Changes to Modify "Covered Funds" Restrictions of Volcker Rule (Jan. 30, 2020), https://www.sec.gov/news/press-release/2020-24 (listing the five federal agencies as the Federal Reserve, Commodity Futures Trading Commission ("CFTC"), FDIC, OCC, and SEC); *see* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 Fed. Reg. 46,422, 46,422–23 (July 31, 2020); *see also* Richard L. Fried, *Volcker Rule's Impact on Securitization*, 15 DERIVATIVES: FIN. PRODUCTS REP., Mar. 2014, at 1 (defining covered funds as those resulting from engaging in activity and "transactions with, certain hedge funds and private equity funds").

130. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 619, 124 Stat. 1376, 1620–21 (2010) (codified at 12 U.S.C. § 1851); *see* Fried, *supra* note 129, at 1.

131. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 Fed. Reg. at 46,422; *see also* Press Release, SEC, Financial Regulators Modify Volcker Rule (June 25, 2020), https://www.sec.gov/news/press-release/2020-143.

132. *See* Krause, *supra* note 57, at 1050, 1065 (stressing that though there is not one specific cause of the decrease in small banks, critics have pointed to the extensive, incomprehensive, and complex nature of the Dodd-Frank Act itself).

133. *See id.* at 1050.

134. *See* Hester Peirce et al., *How Are Small Banks Faring Under Dodd-Frank?*, 12 (Mercatus Ctr. Geo. Mason, Working Paper, No. 14-05, 2014), https://www.mercatus.org/system/files/Peirce_SmallBankSurvey_v1.pdf (comparing the compliance staff at JPMorgan, containing more than 5,000 staff members, to a small bank compliance staff, which may have five members).

personnel can easily cause a small bank to lose profitability.[135] Mandatory costs of compliance for small banks limit profitability.[136] The effect of the Dodd-Frank Act on small banks results in more burdensome compliance costs because small banks are forced to shift regulatory costs to customers.[137]

Like the Dodd-Frank Act's blanket attempt to standardize the banking industry with increased compliance costs, the RFI's proposal affecting Enterprise UMBS similarly attempts to make pools increasingly homogenized and predictable to improve liquidity and prevent misalignment through competition within lender pools.[138] The proposal seeks to bundle more loans into larger multi-lender pools instead of the previous model allowing market-driven smaller loan pools.[139] Rather than preventing misalignments in prepayment speeds, this regulatory environment will reduce incentives for loan originators to participate in the multi-lender pool.[140]

A "'race to the bottom' in asset quality" could occur if the Enterprises begin issuing securities consisting of loans with undesirable prepayment characteristics.[141] Because the price of the UMBS will be the same for both Enterprises, investors will not be able to adequately monitor prepayment speed differentials of the Enterprises.[142] Instead of boosting market liquidity, implementation of the Enterprise UMBS could lead to an increased amount of large, multi-lender pools consisting of loans with reduced quality.[143]

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135. *See Regulatory Burdens: The Impact of Dodd-Frank on Community Banking: Hearing Before the Subcomm. on Econ. Growth, Job Creation, & Regul. Affs. of the H. Comm. on Oversight & Gov't Reform*, 113th Congress 3 (2013) (statement of Hester Peirce, Senior Research Fellow, Mercatus Center at George Mason University), https://www.mercatus.org/system/files/Peirce_RegBurden_testimony_071713.pdf (emphasizing that "hiring just two additional compliance personnel could reverse" a small bank's profitability).

136. *See* Peirce et al., *supra* note 134, at 13.

137. *Id.*

138. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (stating that the RFI's proposal regarding multi-lender pools for Enterprise UMBS will not adequately address persistent, fundamental misalignment issues).

139. *See* FHFA, ENTERPRISE UMBS POOLING PRACTICES, *supra* note 93, at 2.

140. *See* Am. Bankers Ass'n, *supra* note 94 (emphasizing that the RFI's multi-lender pool proposal will only mask problems impacting liquidity and simultaneously reduce incentives for originators).

141. Lopez & Maloney, *supra* note 2.

142. *See id.* (stating that this could result in "higher interest rates for borrowers" because it would "likely lead to lower prices for UMBS").

143. *See* Am. Bankers Ass'n, *supra* note 94 (emphasizing that the RFI proposal has the potential to create a "race to the bottom" in the quality of loan pools); *see also* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 ("[T]he RFI would simply push more loans

The Dodd-Frank Act's "one-size-fits-all" approach makes it very difficult for small banks to operate with constant compliance costs.[144] In turn, the competition pool decreases, leaving the larger financial institutions to make up larger portions of the financial system.[145] However, despite being relatively low-risk, community banks must comply with the same regulatory and examination requirements as larger banks.[146] While large banks generally utilize electronic models to determine loan risk, community banks utilize actual knowledge from customers to assess loan risk.[147] Thus, community banks, an essential component of the U.S. economy and economic growth, [148] are hit the hardest.[149] Based on data provided by the Federal Reserve and the Federal Deposit Insurance Corporation ("FDIC"), community banks seem to be on the decline, and large banks are steadily increasing in size.[150] In 2015, the FDIC reported an increase in operating banks with over $1 billion in assets.[151]

Similarly, the FHFA's proposal to further standardize the Enterprises' pooling practices could create a similar "one-size-fits-all" effect on loan originators because loan originators "strive for best price execution."[152] In

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into bigger securities without doing anything to improve their fundamentals and could be seen as form [sic] of the race to the bottom that some feared would come with UMBS.").

144. *See* Daniel Wilson, *Small Banks Slam 'One Size Fits All' Dodd-Frank Regs*, LAW360, (Sept. 16, 2014, 5:47 PM), https://www.law360.com/articles/577496/small-banks-slam-one-size-fits-all-dodd-frank-regs (stating that the one-size-fits-all approach is unfair to banks because it reduces product availability).

145. *See* Krause, *supra* note 57, at 1066–67.

146. Wilson, *supra* note 144.

147. *See* Bryce W. Newell, *The Centralization of the Banking Industry: Dodd-Frank's Impact on Community Banks and the Need for Both Regulatory Relief and an Overhaul of the Current Framework*, 15 DEPAUL BUS. & COM. L.J. 1, 8 (2016) (noting that the types of interactions community banks have with their customers contribute to a better understanding of relationship banking).

148. *See id.*

149. *See* Wilson, *supra* note 144.

150. *Standard Industry Reports — Statistics on Depository Institutions (SDI): Standard Report #1*, FDIC, https://www5.fdic.gov/sdi/main.asp?formname=standard (last visited Mar. 11, 2021); *see* Newell, *supra* note 147, at 3–4, 10–11.

151. *See* Newell, *supra* note 147, at 9–10 (citing FDIC, *supra* note 150) (stating that although this increase in banks operating with over $1 billion in assets represents only "10.8% of all commercial banks," this percentage controls the majority of banking assets in the United States, amounting to 92.6%).

152. Am. Bankers Ass'n, *supra* note 94 (stating that best price execution would "be best served by issuing single-issuer pools or other specified pools depending upon investor appetite"); Secs. Indus. & Fin. Mkts. Ass'n., *supra* note 94 ("Originators today strive for best execution, which may involve creating single-issuer pools to receive

order to promote alignment, the FHFA proposed that the Enterprises standardize their policies with regard to TBA eligible MBS.[153] Despite one argument that standardization equates to simplified risk management and analytical process because market participants need only to assess risk relative to the six basic parameters associated with the TBA eligible security, the FHFA argued that standardization will reduce costs and complexities.[154] The simplified process increases market participation and competition because it appeals to a broader pool of investors, including mutual funds and foreign central banks.[155] The FHFA expressed its belief that instituting regulations promoting increased standardization would not only eliminate barriers to entry for future market participants but also reduce additional burdens such as the cost of producing data.[156]

However, standardization could significantly harm loan originators, including community and large banks, participating in the TBA market.[157] Because loan originator activity varies with conditions of the market, the proposed multi-lender pool practice in relation to Enterprise UMBS could reduce originators' profitability and result in increased costs for borrowers.[158] Standardization leads to increased generic multi-lender pools, which increases the difficulty in identifying bad actors.[159] Moreover, the RFI proposal would drastically alter the types of loans that loan originators create.[160] In subsidizing loan originators, the proposed multi-lender pooling practice for Enterprise UMBS will reduce "originator incentives to produce

payups that are available from the market.").

153. Uniform Mortgage-Backed Security, 83 Fed. Reg. 46,889, 46,893 (Sept. 17, 2018) (to be codified at 12 C.F.R. pt. 1248).

154. *See id.*

155. *See* Vickery & Wright, *supra* note 19, at 7 (explaining that TBA trading encourages a variety of investors because the forward enables them to project value based on the six characteristics used to identify the security versus evaluating every single security).

156. Uniform Mortgage-Backed Security, 83 Fed. Reg. at 46,893.

157. *See* Am. Bankers Ass'n, *supra* note 94 (listing credit unions and independent mortgage bankers as other types of loan originators).

158. *See id.* (noting that the proposed practice will reduce loan originators' profitability because it requires that the majority of originations be "delivered into large, multi-lender pools").

159. *See id.* (recommending the Enterprises adopt transparent standards to identify bad actors in large loan pools).

160. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (explaining that "[t]he proposal [will] force [loan] originators who make more desirable loans to subsidize originators who make less desirable loans . . . .").

desirable loans."[161] If loan originators choose to produce less desirable loans, the subsidization will help mask those bad actors, making it even more difficult to distinguish the quality of Enterprise UMBS.[162]

C. UMBS Uniform Prepayment Speeds: Legal Complications for Fannie Mae and Freddie Mac

One of the biggest changes resulting from implementation of the common UMBS is that both Fannie Mae and Freddie Mac will have fifty-five day delays on payments to investors.[163] This is significant for Freddie Mac because its remittance cycle was forty-five days.[164] This change comes in response to comments from other agencies and stakeholders in the residential mortgage lending market that advocated for alignment in Fannie Mae and Freddie Mac's policies with regard to prepayments.[165] Although the FHFA expressed satisfaction with the expected prepayment speeds resulting from the change to UMBS, the change in the law will prove inefficient if investors do not view Fannie Mae and Freddie Mac UMBS as interchangeable.[166]

With the new ability granted to Fannie Mae and Freddie Mac in the rulemaking process, the Enterprises have the power to regulate the issuance and participation in the TBA market for Enterprise UMBS.[167] The Enterprises already have the power to decide what an allowable specified pool is, its issuance price, and which lenders are eligible to participate in trading Enterprise UMBS.[168] Although the governing law requires that the UMBS align prepayment speeds, the Enterprises are still in competition with each other to issue the most desirable loans packed into the UMBS.[169] If the Enterprises act unilaterally in issuing these loans on the CSP, then the Enterprises, versus the market, could drive prepayment speeds based on the loans they accept from loan originators and how the investors will favor the

161. *Id.* (noting that this effect could be particularly harmful on bank issuers).

162. *See* Am. Bankers Ass'n, *supra* note 94.

163. Lopez & Maloney, *supra* note 2.

164. *See* Leeds & Garden, *supra* note 18.

165. *See* FHFA, 2014 STRATEGIC PLAN, *supra* note 76, at 7.

166. *See* Lopez & Maloney, *supra* note 2.

167. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (emphasizing that the Enterprises assert control over the mortgage markets in a variety of ways).

168. *See id.*

169. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. 7793, 7796 (Mar. 5, 2019) (to be codified at 12 C.F.R. pt. 1248) (acknowledging concerns from commenters like SIFMA and PIMCO that indicated the Enterprises could take actions to undermine one another because they are competitors).

Fannie Mae traded UMBS versus the Freddie Mac traded UMBS.[170] Even though Fannie Mae traded UMBS and Freddie Mac traded UMBS are supposedly identical, the Enterprises will be able to control this because they govern together and ensure they follow their own guidelines.[171]

Though the purpose behind the uniform prepayment speeds is to boost overall liquidity in the loan pool, there is concern that eliminating the difference in prepayment speeds also eliminates the associated price differentials traders use to value their investment.[172] One of the main components mortgage traders use to value investments is the rate at which underlying loans within an MBS will be paid off.[173] Historically, the CPR between Fannie Mae and Freddie Mac has been substantially different.[174] If the gap between Fannie Mae CPR and Freddie Mac CPR widens, meaning the prepayment speeds continue to be dissimilar, traders may not treat the Fannie Mae and Freddie Mac UMBS as interchangeable.[175] Because mortgages in the TBA market are not identified until after the trade, the investors cannot factor prepayment speed differentials into the price.[176] With the UMBS, Fannie Mae and Freddie Mac will issue identical securities.[177] This could serve as a potential source of anxiety for investors because there is one less significant factor for them to use in valuing an investment.[178]

There are also concerns about the implementation of the UMBS as it relates to stipulated trading "because investors do not [currently] view Fannie and Freddie MBS as interchangeable" investments.[179] Stipulated trades are TBA trades where the buyer requires the seller to include additional stipulated characteristics.[180] Though the FHFA stated the change in prepayment speeds should account for the issues with interchangeability

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170. *See id.* (stating that if one of the Enterprises decides to take adverse actions against the other that impacts the quality of their UMBS, the quality of the entire Enterprise UMBS market will suffer because both Fannie Mae UMBS and Freddie Mac UMBS can be delivered into the same contracts).

171. *See id.* at 7800 (stating that the Enterprises are responsible for reporting misalignment to the FHFA in the event it occurs).

172. *See id.* at 7795 (elaborating on FHFA's response to price differences between quartiles).

173. *See id*. at 7799.

174. *See* Lopez & Maloney, *supra* note 2.

175. *Id*.

176. *Id.*

177. *See id.*

178. *See id*. (explaining the basic premise behind how investors valuate price).

179. Uniform Mortgage-Backed Security, 84 Fed. Reg. 7793, 7793 (Mar. 5, 2019) (to be codified at 12 C.F.R. pt. 1248).

180. LEMKE ET AL., *supra* note 7, § 5:3.

and the potential for investors to move to stipulated trading, aligned prepayment speeds will prove insufficient to promote Enterprise UMBS liquidity unless the FHFA adjusts the standardization of large, multi-lender pools.[181]

D. Repeating the Mistakes of the Dodd-Frank Act on Small Banks with Uniform Prepayment Speeds Imposed by the UMBS

The final rule governing the UMBS prepayment speeds will restrict smaller banks from participating as loan originators in a similar manner that the Dodd-Frank Act, specifically the Volcker Rule, permitted for more market competition prior to the adjustments made in 2018.[182] Implementing uniform prepayment speeds effectively eliminates an option for investors when determining which Enterprise UMBS to invest in.[183] Eliminating this option will lead to a homogenized loan originator pool if smaller originators with less capital cannot afford the costs of complying with the UMBS regulations.[184] Though the Enterprise UMBS prepayment cycle mirrors that of Fannie Mae UMBS, the UMBS disclosure requirements mirror Freddie Mac PCs, another compliance change that will disadvantage SMEs and community banks.[185] Like the Dodd-Frank Act's effect on community banks in reducing competition, aligned prepayment speeds are burdensome on small banks struggling to maintain capital.[186] Similar to the burdensome regulatory impact on SMEs and community banks after implementation of

181. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7793 (reiterating concern that implementing policies to align prepayment speeds is insufficient so maintain Fannie Mae and Freddie Mac UMBS fungibility); *see also* Am. Bankers Ass'n, *supra* note 94 (indicating that investors could look to other markets for returns on their investment, which would reduce TBA market liquidity).

182. *See Regulatory Burdens: The Impact of Dodd-Frank on Community Banking: Hearing Before the Subcomm. on Econ. Growth, Job Creation, & Regul. Affs. of the H. Comm. on Oversight & Gov't Reform*, 113th Congress 4–5 (2013) (statement of Hester Peirce, Senior Research Fellow, Mercatus Center at George Mason University), https://www.mercatus.org/system/files/Peirce_RegBurden_testimony_071713.pdf.

183. Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7794.

184. *See id.* at 7796 (quoting the National Association of Federally-Insured Credit Unions ("NAFCU") that the UMBS equalized pricing will increase market competition).

185. *See* Uniform Mortgage-Backed Security, 83 Fed. Reg. 46,889, 46,890 (Sept. 17, 2018) (to be codified at 12 C.F.R. pt. 1248).

186. *See* Merric R. Kaufman, Note, *Too Small to Succeed?: An Analysis of the Minimal Undue Regulatory Burdens Facing Community Banks in the Post Dodd-Frank Regulatory Environment, and How to Further Minimize Their Burden*, 37 REV. BANKING & FIN. L. 445, 463 (2017) (emphasizing that the effect of Dodd-Frank Act compliance costs on community banks has led to numerous failed banks, mergers of banks, and increased consolidation).

the Dodd-Frank Act, the UMBS aligned prepayment speeds could produce the same effect in creating a loan pool mainly consisting of large financial players.[187] If smaller loan originators cannot afford to invest in Enterprise UMBS, then there could be potential for the entire secondary residential mortgage market to lose liquidity.[188]

IV. PROTECTING/GUARDING THE PURPOSE OF THE UMBS: THE ROLE OF THE FHFA

This Comment recommends that the FHFA create stricter rules to ensure that the Enterprises develop regulations governing the acceptance and issuance of loans that align with one another.[189] Moreover, the FHFA should ensure that the Enterprises report when there is a divergence in prepayment speeds so the FHFA may adjust definitions of "fastest paying" and "cheapest to deliver" quartiles of cohorts to compensate for the misalignment.[190] This Comment also recommends that the FHFA, in its conservator role of the Enterprises, promote loan diversification for the loans that were issued in specified pools under the former governance model.[191] Because the Enterprises are already exempt from certain registration requirements with the SEC, it is even more important that the FHFA take steps to preserve the quality of the loans being put into large multi-lender pools.[192]

Although this Comment does not recommend complete alignment of all of the Enterprises' policies that would affect prepayment speeds, as this would also cause a change in Fannie Mae and Freddie Mac selling guides, the FHFA should institute stricter regulations for the possibility of divergence in prepayment speeds.[193] This Comment also recommends that

187. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7796 ("[T]he reduced barriers to entry will encourage private financial institutions to again enter the market as they were prior to the financial recession.").

188. *See id.* (noting that competition leads to more effective markets).

189. *See id.* at 7800 (stating that each Enterprise must institute policies that align with the other Enterprise programs).

190. *See id.* (explaining that the FHFA retains the authority to adjust definitions of the final rule governing the UMBS).

191. *See* Am. Bankers Ass'n, *supra* note 94 (stating that the RFI proposal will not only reduce profitability and product availability for loan originators but also will result in more standardized loans).

192. *See* Vickery & Wright, *supra* note 19, at 9–10 (acknowledging that although the Enterprises publicly disclose summaries about each loan pool, the buyer still lacks this information at the time of a trade because it is unknown which securities will be delivered, which is enabled by the Enterprises' SEC registration exemption).

193. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7800 (defining material misalignment as the divergence of three or more "percentage points in the three-month

the FHFA establish stricter rules with respect to competition.[194] Like SIFMA's reasoning, this Comment argues that stricter rules affecting competition should be instituted to prevent a decrease in the value of Enterprise UMBS.[195] Because competition between the Enterprises in accepting desirable loans remains a significant source of concern with the issuance of the UMBS, the FHFA should provide a clear process relating to remedial actions in response to misalignment.[196]

Similar to the Volcker Rule's effect on small banks, the introduction of the large multi-lender pool could reduce the participation of small financial institutions as loan originators.[197] If such a reduction occurs, the loan originator pool for agency UMBS will become homogenized and dominated by large financial institutions that are forced to subsidize potential hidden bad actors.[198] A market structure consisting of fewer specified pools will be unattractive for investors, which could lead to a decline in sponsorship of Enterprise products and significantly reduce liquidity.[199]

As the FHFA acknowledged in the final rule regarding UMBS, there must be sufficient incentives to invest in Enterprise UMBS, especially for smaller financial institutions.[200] The FHFA should directly address concerns regarding the issuance of single-issuer pools as it affects loan originators because the proposal could lead to a deterioration in loan quality because the loan originator pool will become even more subsidized.[201] Because loan originators' activity varies with respect to conditions of the market, the FHFA could require that the Enterprises provide more transparency relating

CPR for a cohort or at least 8 percentage points in the three-month CPR for a fastest paying quartile of a cohort").

194. *See* Uniform Mortgage-Backed Security, 83 Fed. Reg. 46,889, 46,893 (Sept. 17, 2018) (to be codified at 12 C.F.R. pt. 1248) (acknowledging that the potential improvements in liquidity of Enterprise UMBS are dependent on market participants accepting UMBS fungibility, regardless of the FHFA's role as conservator).

195. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7796 (reasoning that one Enterprise may take efforts to harm investors, which would harm the value of both Enterprises' UMBS because they are "deliverable into the same contracts").

196. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (acknowledging that reports may be published and discussions held between the Enterprises and the FHFA, "but the market does not know what happens after that").

197. *See* Krause, *supra* note 57, at 1069.

198. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (predicting that specified pools will become more expensive because the RFI proposes the creation of larger multi-issuer pools).

199. *See id.* (detailing that the proposed market structure could lead to a decrease in sponsorship from investors, including hedge funds and money managers).

200. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7796.

201. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94.

to alignment policies.[202] To mitigate competition between the Enterprises when it comes to acceptance of loans, the FHFA could also require the Enterprises to report regularly on their loan requirements and how they are working together in ensuring that the loan requirements are met before they accept them to package as a UMBS.[203] This form of regulation by the FHFA would require that the Enterprises provide sufficient evidence that they are not competing for loans against each other and actively enforcing their loan requirements in order to avoid a potential price differentiation caused by two different factors: (1) easier entry into the market by potential bad actors due to the larger multi-lender pool; and (2) both Enterprises enforcing the maintenance of standardized loan requirements and acceptance regulations that encourage diverse loan originator participation.[204] The FHFA, in its capacity as conservator of Fannie Mae and Freddie Mac, should provide specific disclosure requirement exemptions for small financial institutions if prepayment speeds prove to decrease competition in squeezing small banks out of the market.[205]

V. CONCLUSION

Like the Dodd-Frank Act's original effect on SMEs and community banks, uniform prepayment speeds in relation to UMBS could cause the residential mortgage market to lose liquidity because such an environment will prove too burdensome for smaller banks to participate as loan originators. Moreover, the FHFA should institute stricter reporting requirements to mitigate Enterprise competition in accepting loans. In order to ensure that the legal framework governing the UMBS is protected in practice, the Enterprises must adhere to standardized loan requirements and work together to enforce compliance and bar entry of potential bad actors.

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202. *See id.*

203. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7796 (reiterating concerns from commenters, such as SIFMA and PIMCO, that the Enterprises could choose to align policies and programs that may adversely affect consumers, lenders, and investors).

204. *See* Secs. Indus. & Fin. Mkts. Ass'n, *supra* note 94 (recommending that FHFA provide more clarity as to the Enterprises' handling of alignment and performance, which would be indicative of the increased transparency that the FHFA claimed it would provide to market participants upon implementation of Enterprise UMBS).

205. *See* Uniform Mortgage-Backed Security, 84 Fed. Reg. at 7797.