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Fannie Mae, Freddie Mac Single Security Initiative

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In a move to enhance liquidity in mortgage markets, Fannie Mae and Freddie Mac will issue a new uniform mortgage-backed security.

Applicability

Investors in Fannie Mae and Freddie Mac securities.

Key impacts

It is expected that beginning June 3, 2019, Fannie Mae and Freddie Mac, under the direction of the Federal Housing Finance Agency (FHFA), will begin issuing a new, single mortgage-backed security (MBS) through their respective securitization trusts, known as the uniform mortgage-backed security or UMBS. Currently, Fannie Mae and Freddie Mac each issue their own securities in separate 'to-be-announced' (TBA) markets.

The introduction of the UMBS will create a uniform security, issued and guaranteed by either Fannie Mae or Freddie Mac, and backed by the same types of fixed-rate 30-, 20-, 15-, or 10-year single-family mortgage loans in use today. This joint initiative to create a common securitization platform, under which UMBS will be issued, is known as the Single Security Initiative (SSI).

Features of the UMBS

The features and characteristics of the UMBS will generally be based on the legacy Fannie Mae MBS. For example, the UMBS will retain the Fannie Mae MBS feature that provides for a 55-day payment delay in the remittance of cash flows to investors. The securities issued by Fannie Mae are referred to as MBS and the securities issued by Freddie Mac are referred to as Participation Certificates (PCs).

Similar to current Fannie Mae and Freddie Mac securitization programs, the SSI would include three types of securitizations.

Type	Description
Single-class agency Level 1 MBS (UMBS)	Will be similar to current single-class PCs/MBS. These securities are referred to as pools or pass-through securities and can be traded in the TBA (forward) market.
Single-class re-securitization program Level 2 MBS (Supers)	Will be similar to the current single-class re-securitization program (Megas/Giants). These securities are used to combine multiple small pools, and can also be delivered in the TBA market.

Type	Description
Multi-class Level 3 re-securitization program	Will direct the principal and interest cash flows to different classes. Legally they are Real Estate Mortgage Investment Conduits (REMICs), but are commonly called Collateralized Mortgage Obligations (CMOs) and will be similar to the current multi-class re-securitization program (REMICs).

Exchange of Freddie Mac 45-day securities

Unlike the Fannie Mae MBS, current Freddie Mac PCs have a 45-day payment delay. Beginning May 7, 2019, Freddie Mac provided holders of 45-day securities the option to exchange securities for newly issued 55-day payment delay securities, backed by the same underlying mortgage loans as the original securities. While the exchange is not mandatory, Freddie Mac will stop issuing PCs after SSI goes live, and the market for legacy PCs is expected to diminish thereafter.

As part of the exchange of 45-day securities for 55-day securities, Freddie Mac will provide investors with a one-time cash payment for the approximate fair value of the 10 days' delay in the payment for the rest of the life of the security.

Accounting considerations

The exchange of Freddie Mac 45-day securities involves a transfer by the investor of previously issued beneficial interests (45-day securities) to a newly created securitization entity in exchange for cash and a newly issued beneficial interest (55-day securities) in the new entity.

With the exception of the shortened remittance cycle, the economic substance of the new beneficial interest will be the same as the securities being exchanged. Each new 55-day security will have a new CUSIP, pool number and issuance date. However, the cash flows of the 55-day security will ultimately be backed by the same underlying mortgage loans as the original 45-day security, and the unpaid principal balance, pool factor, and weighted average coupon will also be the same.

ASC 860 includes guidance on the accounting for transfers of financial assets. However, as it relates to SSI, the substance of the exchange is a modification of the security's remittance cycle. Fannie Mae and Freddie Mac's SSI Market Adoption Playbook[1] includes a letter to the SEC staff that confirms that the SEC staff would not object to accounting for the exchange of 45-day Freddie Mac PCs as a minor modification of the existing security.[2]

The Playbook points out that by concluding that the exchange is a minor modification, holders of the security would (1) carry over the cost basis of their 45-day security, (2) recognize the one-time cash compensation received for the 10-day payment delay as a basis adjustment to the 55-day Freddie Mac security, and (3) subsequently amortize the basis adjustment related to the compensation payment over the remaining life of the security.

Similar to the confirming letter provided to the SEC, we believe it would be appropriate to apply the guidance in ASC 310-20 related to modifications of receivables in assessing the accounting for the exchange of MBS securities.[3]

Excerpt from ASC 310-20
> Loan Refinancing or Restructuring **35-11** A modification of a debt instrument shall be considered more than minor under the preceding paragraph if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument. If the difference between the present value of the cash flows under the terms of the new debt

1 Freddie Mac and Fannie Mae Single Security Initiative Market Adoption Playbook: SSI Market Adoption Playbook

2 See page 33 of the SSI Market Adoption Playbook

3 ASC 310-20-20 clarifies that the term 'loan' includes loans accounted for as debt securities

Excerpt from ASC 310-20
instrument and the present value of the remaining cash flows under the terms of the original debt instrument is less than 10 percent, a creditor shall evaluate whether the modification is more than minor based on the specific facts and circumstances (and other relevant considerations) surrounding the modification. The guidance in Topic 470 shall be used to calculate the present value of the cash flows for purposes of applying the 10 percent test.

Accordingly, if the MBS exchange is not deemed 'more than minor', the new security received would not be recognized at fair value. Instead, the new security would continue to be recognized under the amortized cost basis of the previous security, with adjustment to the security's basis to reflect cash compensation received from Freddie Mac for the 10-day delay in payment. With this treatment, there would be no gain or loss recognized from the exchange.

Notwithstanding the forgoing, companies engaging in the MBS exchange need to clearly document the basis for the accounting treatment of the exchange, including references to the accounting literature considered in arriving at the conclusion.

Other considerations

In addition to the SEC, the Playbook indicates that Fannie Mae and Freddie Mac consulted with other stakeholders on certain effects of the exchange.

— **The IRS** ruled that the exchange of 45-day Freddie Mac PCs for 55-day Fannie Mae MBS does not constitute a taxable exchange of property, but declined to rule on the taxability of the compensation for the 10-day payment delay. Freddie Mac announced that it will treat that payment as a tax-free adjustment to the security basis, but encouraged investors to consult with tax advisors.[4]

— **FINRA** believes the facilitation of an exchange of a 45-day security for a 55-day security is not reportable under Rule 6730 (transaction reporting), provided that the prices of the securities used to facilitate the exchange only reflect and pass through the compensation provided by Freddie Mac.[5]

4 See page 33 of the SSI Market Adoption Playbook

5 See FINRA FAQ related to Rule 6730 on page 34 of the SSI Market Adoption Playbook

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KPMG's Financial Reporting View

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