

TMPG Encourages Market Attention to Best Practice Recommendations During the Transition to Uniform Mortgage-Backed Security (UMBS)

The FHFA issued a [Uniform Mortgage-Backed Security \(UMBS\) Final Rule](#) on February 28. This rule requires that Fannie Mae and Freddie Mac align programs, policies, and practices that affect the cash flows of “To-Be-Announced” (TBA)-eligible Mortgage-Backed Securities (MBS) beginning in June 2019. The new securities issued by both Fannie Mae and Freddie Mac starting in June would be called UMBS. SIFMA [announced](#) in March that UMBS issued by both Fannie Mae and Freddie Mac would be good delivery for a single UMBS TBA contract starting in June. In addition, SIFMA noted that all previously TBA- eligible Fannie Mae securities, as well as previously TBA-eligible Freddie Mac securities that are [exchanged](#) for UMBS, would be good delivery for the UMBS TBA.

The Treasury Market Practices Group (TMPG) is committed to supporting the integrity and efficiency of the U.S. government securities (Treasury), agency debt, and agency mortgage-backed-securities (MBS) markets, and reviewed its [Best Practices for Treasury, Agency Debt and Agency Mortgaged-Backed Securities Markets](#) (Best Practices) in light of the developments described above. These Best Practice recommendations are intended for any market participants active in the covered markets including dealers, banks, buy-side firms, investors, investment advisors, market utilities, custodians, the Government Sponsored Enterprises and others to help encourage a smooth transition to UMBS. The implementation of these best practices will help reduce market disruptions—including, but not limited to, episodes of protracted settlement failure—and buttress overall market integrity, resulting in important benefits for Treasury, agency debt, and agency MBS market participants as well as the public. While market participants should review all of the best practice recommendations on a regular basis and especially when there are significant changes to markets or market liquidity, the TMPG believes that market participants should be particularly mindful of the specific recommendations described below in light of the transition to UMBS and exercise due vigilance and oversight.

Selected Best Practice #1

I. PROMOTING LIQUIDITY AND TRANSPARENCY

All market participants should behave in a manner that supports market liquidity and integrity. Market participants should avoid trading strategies that hinder market clearance or compromise market integrity. Examples of strategies to avoid include those that cause or exacerbate settlement fails, those that inhibit the provision of liquidity by others, those that restrict the floating supply of a particular issue in order to generate price movements in that security or related markets, and those that give a false impression of market price, depth or liquidity.

UMBS Implication: The expected replacement of both the existing Fannie Mae and Freddie Mac TBA contract with a UMBS TBA contract may make it more difficult to define a large position in the TBA market and available float for particular TBA contracts across the transition period. Because of this, market participants should be particularly sensitive to behave in a manner that supports

TMPG NOTE

market liquidity and integrity. Additionally, investors should be more vigilant in assessing the impact of their trading behavior during the transition with respect to clearing, settlement, or market liquidity.

Selected Best Practice #2

Market participants should not plan or make sudden changes to trading strategies with the intention to disrupt market liquidity or functioning.

UMBS Implication: With the introduction of a new market structure, market participants should be sensitive to this best practice recommendation and not plan or make sudden changes to trading strategies with the intention to disrupt market liquidity and market functioning.

Selected Best Practice #3

Market participants should ensure adequate oversight of their Treasury, agency debt, and agency MBS trading activity. The nature of the oversight may vary depending on the role that each market participant plays in the marketplace and the organizational structure of the firm. However, all firms should develop a mechanism for measuring and scrutinizing the market participant's overall trading activity in the Treasury, agency debt, and agency MBS markets to ensure that trading behavior in the aggregate, as well as along individual business lines, is understood by senior business managers. Oversight coverage should include, at a minimum, the organization's activities in the Treasury, agency debt, and agency MBS cash markets (including primary and secondary trading), related financing activity, and related derivatives or structured products activity.

UMBS Implication: Heightened oversight of agency MBS trading should be prioritized throughout the UMBS transition period, and senior business managers should ensure adequate levels of understanding of the changes in market structure in order to continue measuring and scrutinizing trading activity through the transition period.

Selected Best Practice #4

III. MAINTAINING A ROBUST CONTROL ENVIRONMENT

Market participants that are active in financial markets are familiar with the importance of establishing and maintaining a rigorous internal control environment. Indeed, the variety of legal and reputational risks that a market participant's Treasury, agency debt, and agency MBS trading and settlement operations are subject to suggests that a vigorous, well-informed, and assertive internal control program is essential. An internal control program should include the active engagement of the business, audit, legal, risk, operations, finance, and compliance functions.

Internal control policies should further the firm's ability to detect and prevent potentially disruptive trading activity by identifying the specific trading trends, positions, strategies, or behaviors within the trading operation that constitute triggers for mandatory business and compliance review. Mandatory review does not in itself automatically suggest that a trading

TMPG NOTE

position, strategy, or behavior must be altered; that will depend on the results of the review and consultations between management and compliance.

UMBS Implication: Given the significant change in market structure, firms should conduct business and compliance reviews to ensure that trading behaviors are appropriate through the transition period.

Selected Best Practice #5

Market participants and trading venues should ensure that they employ a robust change control process for designing, testing, and introducing new trading technologies, algorithms, order types, or other potentially impactful system features or capabilities. Changes to trading venue processes and procedures should promote market integrity and should take into account, prior to implementation, behavior and market alterations that these changes may foster. Market participants and trading venues should adopt written policies and procedures identifying the types of changes that must be vetted and ensuring that such changes are vetted with appropriate representatives from key support areas such as compliance, risk, and operations. Such processes should be reviewed on a regular basis for ongoing compliance.

UMBS Implication: Market participants should ensure that all critical systems required for trading, processing, risk management, and settlement are appropriately prepared for the change in market structure. Further, market participants who plan to transact in UMBS should ensure the appropriate level of technological development, training and operational readiness ahead of executing UMBS transactions.

Selected Best Practice #6

Consistent with prudent management of counterparty exposures, forward-settling transactions, such as agency MBS transactions, should be margined. To help both parties mitigate counterparty risk owing to market value changes, two-way variation margin should be exchanged on a regular basis. Written master agreements should describe the parties' agreement on all aspects of the margining regime, including collateral eligibility, timing and frequency of margin calls and exchanges, thresholds, valuation of exposures and collateral, and liquidation. (Please refer to the TMPG Agency MBS Margining Recommendation for detailed best practice guidance.)

UMBS Implication: Consistent with existing forward-settling agency MBS transactions, forward-settling UMBS transactions should be margined to mitigate counterparty risk.

Selected Best Practice #7

IV. MANAGING LARGE POSITIONS WITH CARE

Although large long or short positions are not necessarily problematic, these positions should be managed responsibly to avoid market disruptions. From time to time, a market participant may amass a particularly large long or short position in a specific Treasury, agency debt, or agency MBS issue or product. A market participant should manage that position with heightened vigilance,

TMPG NOTE

mindful of the need to support market liquidity. Particularly, large short or long positions in the floating supply of an issue should be given close scrutiny because of the uncertainty of the tradable float. Market participants with large short positions or active shorting strategies have similar responsibilities to support the liquidity and smooth functioning of the market to those with large long positions.

Market participants should avoid any strategies that create or exacerbate settlement fails. Such vigilance should be intensified when a large position predominantly or entirely results from non-market-making activity since the market participant has more control over that position's size and growth.

- In the agency MBS market, when a participant holds a large position or controls a significant percentage of the deliverable supply of a TBA issue that is trading deeply special, it should not finance the position with the intent to adversely affect the liquidity of the TBA issue. One example of this type of behavior would be financing a large position in a more expensive manner through the repo market, rather than through the dollar roll market, in order to limit the deliverable supply of the TBA issue.

UMBS Implication: During the transition, what should be considered “large positions” or the size of the “tradeable float” are likely more uncertain. Given this increased level of uncertainty, market participants should exercise a heightened level of diligence and caution and avoid any strategies that create or exacerbate settlement fails. Transactions that were not problematic in the past may have a more significant impact on market liquidity or settlement integrity during the transition.

Selected Best Practice #8

V. PROMOTING EFFICIENT MARKET CLEARING

Practices that cause settlement fails should warrant high scrutiny from trading management, settlement staff, and compliance staff. Intentionally failing to deliver on settlement date in order to “hold the box,” “sort the box,” or substitute TBA pools should be avoided. Repeated or systematic practices that cause settlement fails should not be permissible under a market participant's operating procedures.

UMBS Implication: Consistent with the Best Practices for Fannie Mae and Freddie Mac forward-settling transactions, UMBS transactions that cause settlement fails should warrant prompt and high scrutiny from trading management, settlement staff, and compliance staff.