



FEDERAL RESERVE BANK *of* NEW YORK

# GSE reform and secondary market liquidity

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# Disclaimer

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The views expressed in this presentation are my own and do not necessarily represent the opinions of the Federal Reserve Bank of New York or the Federal Reserve System.



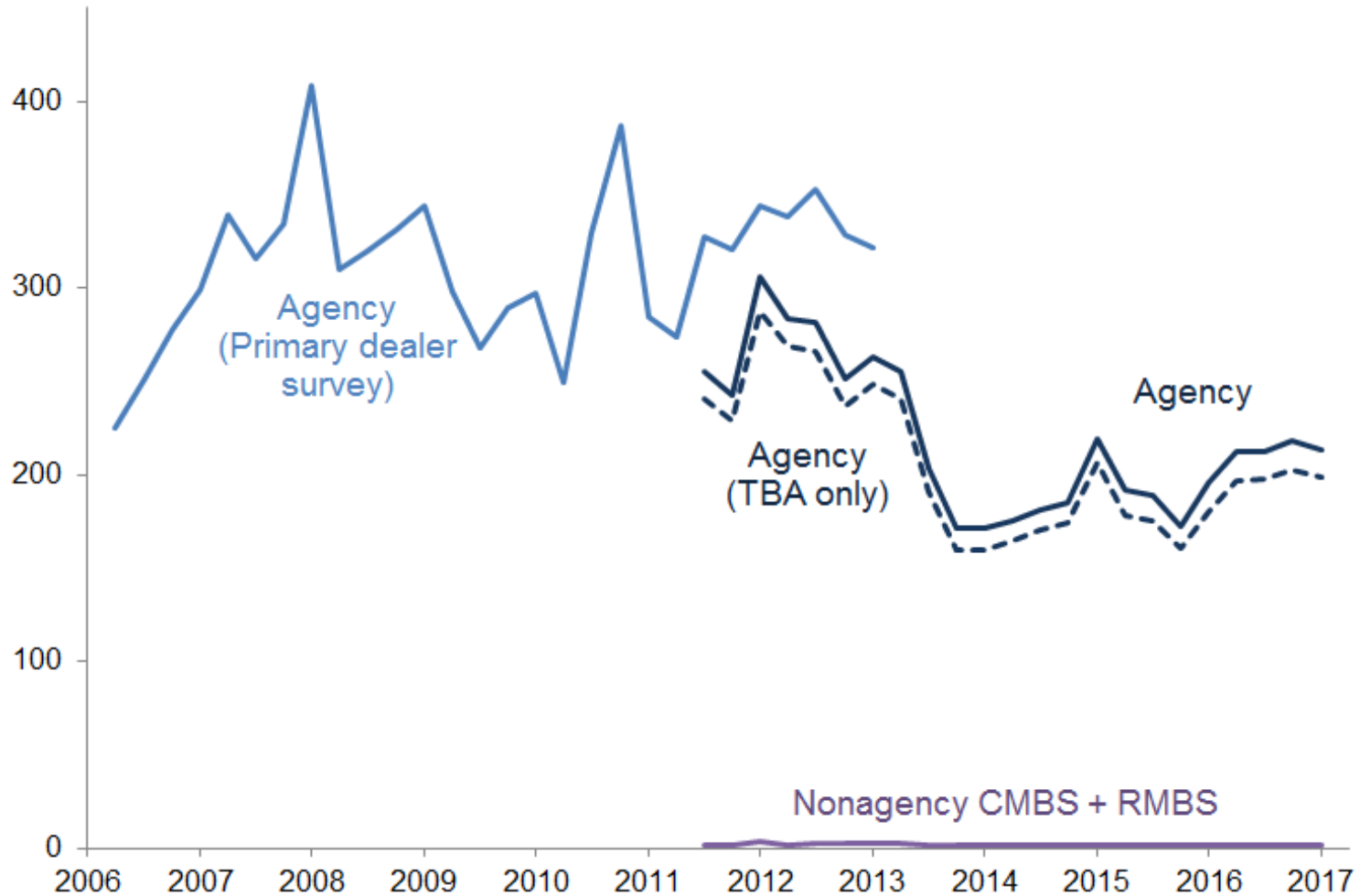
# Secondary market liquidity for mortgages

- Mortgages are risky:
  - Credit risk
  - Interest rate risk
  - Prepayment risk
  - Liquidity risk
- Likely not desirable for these risks to be borne entirely by mortgage originators.
- Agency MBS market has built up a lot of infrastructure for transferring and diversifying these risks.
- Worth preserving as part of reform of Fannie and Freddie.



# Agency and nonagency MBS trading volume

Trading vol (daily avg, \$bn)



Source: SIFMA



# Bid-ask spreads

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Bessembinder, Maxwell  
and Venkataram  
(FAJ, 2013)

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Gao, Schultz  
and Song  
(JF, 2017)

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**Agency:**

TBA

1bp

3-4bp

Specified pool

40bp

- TBA eligible

23bp

- Not TBA eligible

63bp

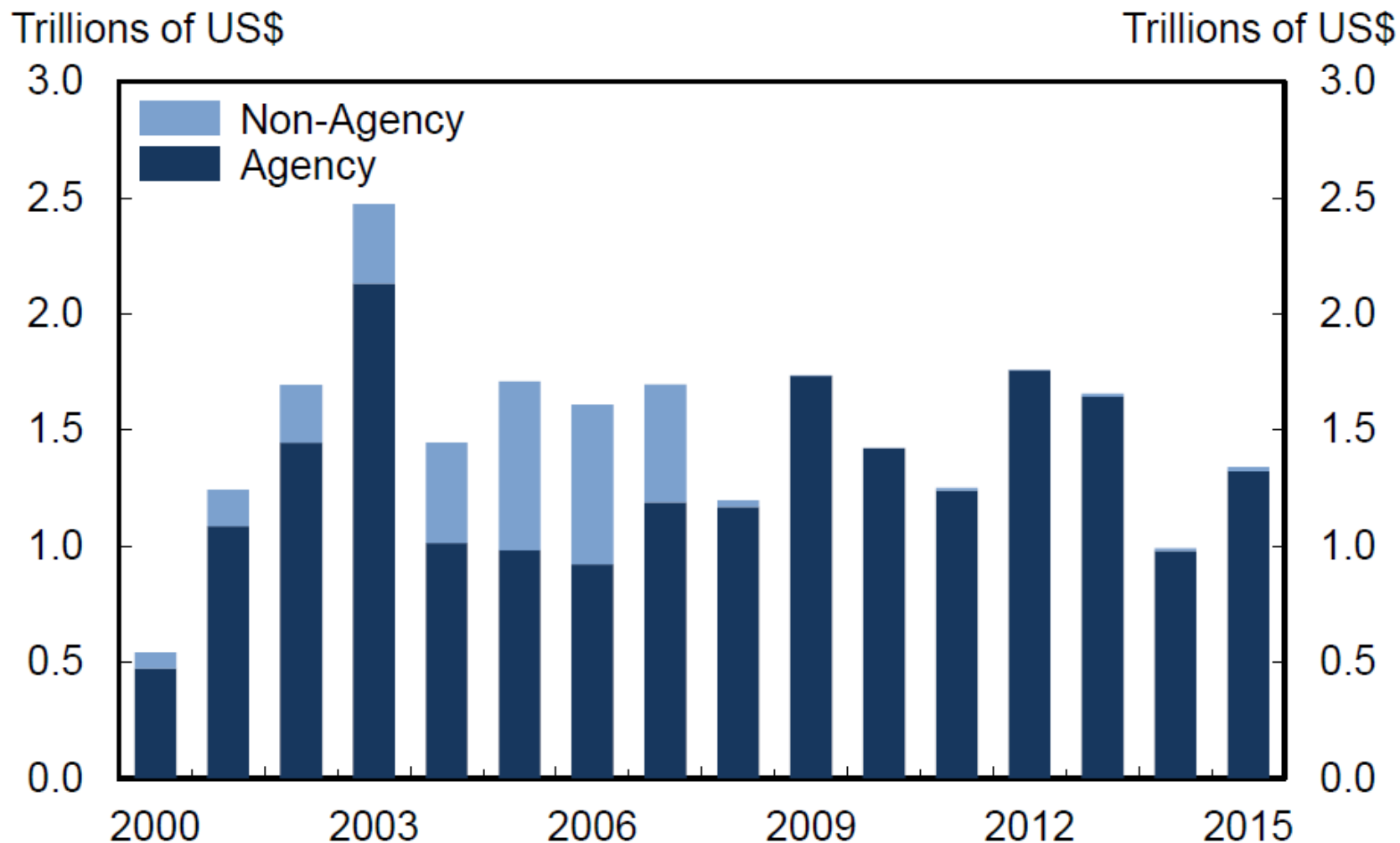
**Nonagency:**

Private label CMO

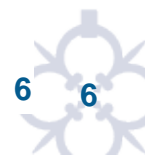
70bp



# RMBS securitization volume



Source: Fannie Mae, Freddie Mac, Ginnie Mae, Bloomberg, L.P., Dealogic, Thomson Reuters, SIFMA



# Why is TBA (“to be announced”) market liquid?

- TBA market concentrates agency MBS trading in a small number of liquid forward contracts.
  - Provides reference prices for the entire market
  - Pay-up pools can be delivered into TBA as a backstop
  - TBA can be used for hedging, financing
- Works well because:
  - **Standardization** due in part to small number of issuers. (Single security initiative will further improve fungibility).
  - **Credit guarantee** reduces dimensionality of risk. (E.g., allows passthrough pools to be securitized and traded).



# Babies and bathwater

- Fannie and Freddie provide a well-functioning standardized *platform* for securitization.
  - Possible (although not inevitable) to maintain this infrastructure as part of GSE reform
  - Possible even if private sector bears non-tail credit risk.
- What could cause breakdown in market liquidity, stability?
  - Too many issuers + no central coordination, standardization
  - Absence of credible credit guarantee on the securities
  - Too *little* risk transfer (why bother securitizing at all?)
- One model: utility owned in common by mortgage lenders (Mosser, Tracy & Wright, 2013; DeChario et al., 2010)

