GSE Activity Report

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TBA or Not to Be

Summary

A new Fed staff paper sharply questions an axiom of mortgage securitization: the sanctity of the TBA market. Using both empirical and model-derived methodologies, the paper finds that the TBA-market structure allows for adverse selection, undermining key diversification benefits fundamental to the risk-mitigation rationale of securitization. TBA-market efficiency is one of the planks on which the GSEs' implicit guarantee rests but the paper counters that only an explicit guarantee comparable to Ginnie's will ensure efficient mortgage securitization in the best interest of investors and, we would add, likely also homeowners.

Impact

This is a massive study, speaking like all of these papers to findings by staff – not the Board – that are deemed to warrant public release. Lenders for the TBA market are found to segregate like-kind loans into pools and send the "low-value" ones along to the forward TBA market, reserving high-value loans for specified pools (SPs) such as REMICs. The cheapest-to-deliver incentives are said to account for this adverse selection, which is also said to undermine agency-MBS liquidity under stress.

The overall GSE MBS market is heterogeneous, but this breaks down along TBA and SP lines. The TBA market is also said to reduce earnings for all lenders, a negative externality not taken into account because of the ability of lenders (at least large ones) to access SPs. The paper demonstrates this by comparing the Fannie/Freddie TBA market to Ginnie Mae, finding far less Ginnie adverse selection.

Outlook

The paper doesn't damn the TBA market as much as say that its implications warrant policy consideration as GSE charter decisions advance. Arguing that loan-value heterogeneity should be limited to preserve TBA-market liquidity, the paper concludes that this is best achieved with an explicit federal guarantee.

Federal Financial Analytics, Inc.
2101 L Street, N.W., Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail : info@fedfin.com www.fedfin.com