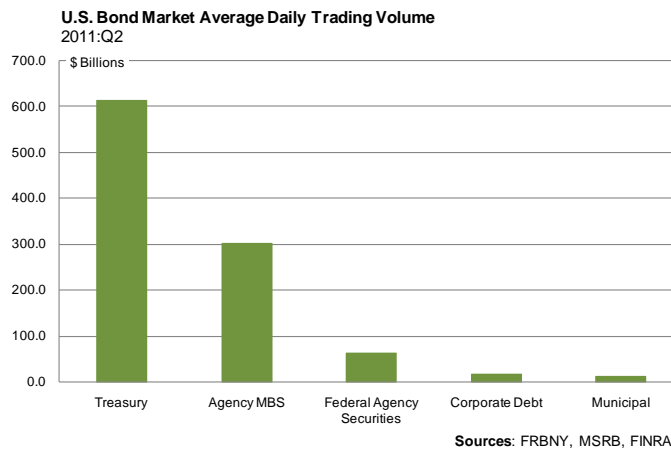


THE TBA MARKET

What is the TBA market and why is it important?

Established in the 1970s with the creation of pass-through securities at Ginnie Mae, the To-Be-Announced (TBA) market facilitates the forward trading of mortgage-backed securities (MBS) issued by the GSEs (Fannie Mae and Freddie Mac) and Ginnie Mae. The TBA market creates parameters under which mortgage pools can be considered fungible and thus do not need to be explicitly known at the time a trade is initiated. This is where the name for the product “To Be Announced” comes from. The TBA market is based on one fundamental assumption – homogeneity; at a high level, one MBS pool can be considered to be interchangeable with another pool. The TBA market is the most liquid, and consequently the most important secondary market for mortgage loans. The TBA market is responsible for significant capital flow from a wide range of investors. During Q2 2011, an average of \$302 billion of agency MBS was traded each day by the primary dealers and this volume is second only to the U.S. Treasury market.



As TBA trade settlements are often scheduled significantly into the future, the TBA market serves a critical market function by allowing mortgage lenders to hedge and/or fund their origination pipelines. By hedging the risk that market interest rates may change, lenders can lock in a price for the mortgages they are in the process of originating. The liquidity of the TBA market also creates efficiencies and cost savings for lenders that are passed on to borrowers in the form of lower rates.

How does a TBA trade function?

The process flow of a TBA trade is found below:



The key dates for a TBA trade are the trade date, the notification date (48-hour day) and the settlement date. On the trade date, 6 criteria are agreed upon for the security or securities that are to be delivered: issuer, maturity, coupon, face value, price, and the settlement date. For example: Customer A agrees to buy, at an agreed price, from Bank B \$100 million of Fannie Mae 30-year securities with a six percent coupon for delivery in two months. TBA trades normally settle according to a monthly schedule set by SIFMA.¹ According to industry practice,² two business days before the contractual settlement date of the trade, the seller will communicate to the buyer the

¹ A full calendar of the settlement dates can be found at: <http://www.sifma.org/Issues/Capital-Markets/Securitization/Housing-Finance-and-Securitization/Resources/>.

² SIFMA's "Uniform Practices Manual" can be found at <http://www.sifma.org/research/bookstore.aspx>.

exact details of the MBS pools that will be delivered (the 48-hour rule). Due to the required two days notice, the notification date is often called the 48-hour day. On the settlement date, the securities that were specified two days earlier are delivered and the buyer pays the seller for the securities.

How is the TBA market structured?

Participants in the TBA market generally adhere to market-practice standards commonly referred to as the “Good-Delivery Guidelines.” These guidelines cover a number of areas surrounding the TBA trading of agency MBS, and are promulgated by and maintained by SIFMA, through consultation with its members. The purpose of the guidelines is to standardize various trading and settlement related issues to enhance and maintain the liquidity of the TBA market. Many of the guidelines are operational in nature, dealing with issues such as the number of bonds that may be delivered per one million dollars of a trade, the allowable variance of the delivery amount from the notional amount of the trade, and other similar details. However, others deal with qualitative aspects of the loans that underlie the securities, as well as the structure of the securities themselves. A concept that underlies the TBA guidelines is that of a “standard loan.” Standard loans are loans which are eligible collateral for bonds which are traded in the TBA market. While each standard loan may not be exactly the same, they share many general characteristics, and perform in a more consistent manner.

Mortgage pools which are not eligible for TBA delivery may be traded in what is called the “Specified Pool” Market. In the specified pool market, unlike the TBA market, the actual identities of the bonds that are to be bought and sold are known at the time of a trade, similar to how most other bonds, such as corporate bonds are traded. Many products which do not fit into the TBA guidelines are traded as specified pools. For instance these pools could be pools backed by interest-only loans, which in 2006-2007 became part of Agency issuance; pools backed by 40-year mortgages; pools backed by loans with prepayment penalties; and pools of various types of adjustable rate mortgages. Pools with specific desirable characteristics, such as low average loan balances, which are eligible for TBA trading may also be traded in specified pool markets if they can be sold at a premium to the prevailing TBA market prices.

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