MEMORANDUM

TO: File Number SR-FINRA-2015-036

FROM: Jessica Mark
Law Clerk
Office of Financial Responsibility, Division of Trading and Markets
U.S. Securities and Exchange Commission

DATE: February 29, 2016

RE: Meeting with Prudential

On February 29, 2016, Commission staff met with representatives of the Prudential to discuss Financial Industry Regulatory Authority, Inc. ("FINRA") proposed rule change to amend FINRA Rule 4210 (Margin Requirements) to establish margin requirements for the TBA Market (Release No. 34-76148).

Commission staff at the meeting were Michael Macchiaroli, Thomas McGowan, Randall Roy, Timothy Fox, Sheila Swartz, and Jessica Mark from the Division of Trading and Markets.

The Prudential attendees at the meeting were: Lauren Sarper, Jeffrey Jacobs, and Roman Gabriel (Prudential Financial, Inc.) and Robert Cahn, Hal Collett, and Bill Fecteau (Prudential Mortgage Capital Company).

Impacts of January 21, 2016 Partial Amendment No. 1 to FINRA Rule 4210 (Margining) on the Multifamily Market

Prudential Mortgage Capital Company

A business of Prudential Financial, Inc.

Proposed Rule Overview

- The proposed rule (October 2015) requires sellers of MBS to post a margin of two percent of the value of forward MBS with FINRA broker-dealers plus a daily mark-to-market margin
  - Covers single-family TBA market and individual multifamily loans that support Ginnie Mae and Fannie Mae MBS
  - The two percent margin does not apply to mortgage bankers
- The proposed rule indicates the changes are necessary because of:
  - The growth in volume in the TBA market;
  - The number of participants in the TBA market; and
  - Credit and systemic risk concerns that have arisen in the housing finance market since the recession

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Partial Amendment Overview

- The partial amendment (January 2016) to the proposed rule attempts to distinguish multifamily MBS by giving the broker-dealer the discretion to elect to waive the margin requirement in the event MBS are issued in conformity with certain GSE or FHA programs
  - Subject to the broker-dealer establishing a specific risk limit for each MBS seller
- However, the partial amendment does not fully address the industry's concerns with any margining on multifamily MBS

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Exempt Multifamily MBS from the Rule

- Multifamily MBS do not contain the market risks the proposed rule seeks to address:
  - Trading multifamily MBS is vastly different than trading single-family MBS
  - The multifamily market is significantly smaller than the single-family market
  - Multifamily MBS have a number of risk mitigation tools (i.e., good faith deposit, strict underwriting, and tight regulations) that address most of concerns raised in the rule

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Multifamily Mortgage Origination Process

Prior To Rate Lock

Third Party Reports
- Appraisal
- Market study(new construction)
- Property condition needs assessment
- Plan and cost report (sub rehab and new construction)
- Environmental report

Financial Analysis & Mortgage Credit Review
- Financial analysis of property operations
- Review tax abatements and rent/income restrictions
- Review cash flow
- Mortgage credit review on entities with op/financial control
- Mortgage credit review on the management
- Contact utilities and tax assessor for rate increases or assessments
- Insurance review

Legal Review
- Title and survey review
- Review/analysis of existing debt, deed restriction, or regulatory documents
- Review of all draft documents to ensure they are in satisfactory form and substance
- Obtain "will issue" letter from municipality for any required building permits

Other
- Site inspection of property, comparables and market by underwriter
- Review FHA or GSE loan commitment and pricing summary

After Rate Lock

Financial Credit
- Review final development budget and proposed initial draw

Legal Review
- Review of final loan documents

Other
- Review closing/settlement statement

Exempt Multifamily MBS from the Rule

- Potential Rule Impacts
  - Decreased liquidity for lending
  - Reduced competition in the lending market
  - Fewer new construction deals
  - Increased costs to borrowers and renters
  - Fewer multifamily—particularly affordable and workforce—units overall

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Exempt Multifamily MBS from the Rule

- Implementation Issues
  - Extremely difficult to determine a daily mark-to-market margin
  - Unclear how the counterparty and broker-dealer would determine a margin
  - Unclear if a broker-dealer can apply a margin to a counterparty trading multifamily MBS if a risk limit determination is conducted
  - Lack of specific resolution mechanisms
- The impact on the multifamily market was not properly vetted, contrary to FINRA's rulemaking requirements

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Margining Concerns

- The determination of whether a margin requirement would be required for a given multifamily MBS trade would be solely determined by the FINRA broker-dealer
- The margin requirement only goes one way, on the counterparty
- The good faith deposit is not accounted for in the margin
- Determining a mark-to-market margin on a daily basis is subjective and opaque

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Conclusion

- Multifamily MBS should be exempt from the rule because:
  - The multifamily MBS market is not systemically risky;
  - Multifamily MBS transactions already contain ample risk mitigation; and
  - The impact on the multifamily market was not properly vetted
- The implementation guidelines should be clarified to:
  - Address the good faith deposit;
  - Discuss the resolution mechanisms if a counterparty disagrees with a margining decision; and
  - Specify that a broker-dealer shall not apply margining requirements to a counterparty trading multifamily MBS if a risk limit determination is conducted

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