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FAQs: MBS Purchase Program

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The following frequently asked questions (FAQs) provide further information about the program to purchase agency mortgage-backed securities (agency MBS) that was announced by the Federal Reserve on November 25, 2008. On Wednesday, March 18, the FOMC announced the expansion of the Federal Reserve's program to purchase agency MBS up to $1.25 trillion by the end of the year. On September 23, 2009, the FOMC announced that the Federal Reserve will purchase a total of $1.25 trillion of agency mortgage-backed securities and gradually slow the pace of these purchases, anticipating they will be executed by the end of the first quarter of 2010.

This agency MBS program is managed by the Federal Reserve Bank of New York (New York Fed) at the direction of the Federal Open Market Committee (FOMC). The New York Fed selected four investment managers to help implement the agency MBS program and has since streamlined to two.

Effective November 18, 2009

General

What is the policy objective of the Federal Reserve's program to purchase agency mortgage-backed securities?
The goal of the program is to provide support to mortgage and housing markets and to foster improved conditions in financial markets more generally.

Why is it necessary for the Federal Reserve to transact in the agency MBS market via external investment managers?
The operational and financial characteristics of MBS purchases are significantly more complicated than those associated with the assets that have traditionally been purchased by the Federal Reserve. The Federal Reserve has chosen external investment managers as a means of implementing the MBS program quickly and efficiently while at the same time minimizing operational and financial risks. Because of the size and complexity of the agency MBS program, a competitive request for proposal (RFP) process was employed to select four investment managers and a custodian. The selection criteria were based on the institutions' operational capacity, size, overall experience in the MBS market and a competitive fee structure.

As of August 2009, the Federal Reserve streamlined the set of external investment managers, reducing the number of investment managers from four to two. The New York Fed retained Wellington Management Company, LLP for trading, settlement and as a secondary provider of risk and analytics support; and BlackRock Inc. as the primary provider of risk and analytics support. The program custodian is J.P. Morgan.

The New York Fed anticipated that it would make adjustments to its use of external investment managers as it gained more experience with the program. The agency MBS program has matured since it began in January, and the New York Fed has had time to further develop its internal analytical and operational expertise in this area. The change in the number of external investment managers was not performance related. The New York Fed is committed to implementing its programs in the most efficient and cost effective manner possible.

Consistent with the continued evolution of the program's operation, the New York Fed will begin in late November to use internal staff on select days to execute the program's agency MBS purchases. From an operational perspective, the New York Fed's trading approach will replicate the one currently employed by the program's trading investment manager, Wellington, although the New York Fed will be trading in its own name. From a settlement perspective, the New York Fed will continue to leverage the middle office settlement support of Wellington for any trades executed by New York Fed staff. While the New York Fed plans to continue to employ the services of outside investment managers, the New York Fed anticipates that, through the balance of the program, the trading days on which its own staff conducts the program's purchasing activity will gradually increase relative to those trading days on which Wellington executes the program's purchasing activity.

What securities are eligible for purchase under the program?
Only fixed-rate agency MBS securities guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae are eligible assets for the program. The program includes, but is not limited to, 30-year, 20-year and 15-year securities of these issuers. The program does not include CMOs, REMICs, Trust IOs/Trust POs and other mortgage derivatives or cash equivalents. Eligible assets may be purchased or sold in specified pools, in "to be announced" (TBA) transactions, and in the dollar roll market.

What is the investment strategy that is employed?
Investment managers will largely employ a passive buy and hold investment strategy in

accordance with investment guidelines prescribed by the Federal Reserve. Purchases are guided by general MBS market conditions, including, but not limited to, supply and demand conditions, market liquidity, and market volatility. The agency MBS program will involve the outright purchase of a total of $1.25 trillion in agency MBS by the investment managers on behalf of the Federal Reserve by the end of the first quarter of 2010. The pace of purchases will moderate gradually to promote a smooth transition in markets. The program will gradually reduce the average weekly purchase amounts of agency mortgage-backed securities, starting with purchases conducted during the reporting week beginning Thursday, September 24, 2009. The pace of purchases may be adjusted, as necessary, based on input from the investment managers about market conditions and the impact of the program. The investment managers are required to purchase securities frequently and to disclose the Federal Reserve as principal.

The Federal Reserve continually evaluates a range of investment strategies to best achieve its policy objectives. To date, the Federal Reserve's investment strategy has also involved the use of dollar rolls as a supplemental tool to smooth market supply and demand. A dollar roll is a transaction generally involving the purchase or sale of agency MBS for delivery in the current month, with the simultaneous agreement to resell or repurchase substantially similar (although not necessarily the same) securities on a specified future date.

Does the agency MBS program expose the Federal Reserve to increased risk of losses?
Assets purchased under this program are fully guaranteed as to principal and interest by Fannie Mae, Freddie Mac, and Ginnie Mae, so the Federal Reserve's exposure to the credit risk of the underlying mortgages is minimal. The market valuation of agency MBS can fluctuate over time based on the interest rate environment; however, the Federal Reserve's exposure to interest rate risk is mitigated by the conservative, buy and hold investment strategy of the agency MBS purchase program.

When did the purchases begin?
Purchases began in early January 2009 and will continue until the end of the first quarter of 2010.

Who do the investment managers trade with and who is eligible to sell agency MBS to the Federal Reserve under the program?
Initially, the investment managers will trade only with primary dealers who are eligible to transact directly with the Federal Reserve Bank of New York. Primary dealers are encouraged to submit offers for themselves and for their customers.

Are the agency MBS held by the Federal Reserve through this program eligible for lending through the Term Securities Lending Facility (TSLF) or the daily System Open Market Account (SOMA) securities lending operations conducted by the New York Fed?
There are no plans for the agency MBS held by the SOMA to be available for borrowing through the TSLF or the daily securities lending program.

How are purchases under the agency MBS program financed?
Purchases will be financed through the creation of additional bank reserves.

What is the legal basis for the agency MBS purchase program?
Purchases of agency MBS in the open market, under the direction of the FOMC, are permitted under section 14(b) of the Federal Reserve Act.

How is the Federal Reserve's agency MBS purchase program related to the U.S. Treasury's efforts to purchase agency MBS?
The Federal Reserve's agency MBS program is separate and distinct from the U.S. Treasury's program but both programs are aimed at fostering improved conditions in mortgage markets.

How are holdings under the agency MBS program reported?
Balance sheet items related to the agency MBS purchase program are reported after settlement occurs on the H.4.1. statistical release titled "Factors Affecting Reserve Balances of Depository Institutions and Condition Statement of Federal Reserve Banks."Securities acquired in dollar roll transactions are also included with other holdings of agency MBS. Trade settlements may occur well after trade execution due to agency MBS settlement conventions. This report also includes information on total outstanding commitments to buy and sell MBS in a supplemental table.

In addition, the New York Fed publishes the most recent weekly SOMA agency MBS transaction activity in more detail on its external website on a weekly basis. As of October 1, 2009, consistent with New York Fed's regular practice of publishing detailed data on other SOMA holdings, such as Treasury and agency debt securities, the New York Fed also began publishing on a weekly basis detailed data on all settled SOMA agency MBS holdings. Any change in the composition of these reported holdings over time is a function of new program purchases, paydowns, and, as explained in more detail in the next question, the program's dollar roll activity.

Why have there been sales from the Federal Reserve's portfolio?
As the investment managers conduct dollar rolls they simultaneously buy and sell agency MBS securities for different forward settlement dates. To date all sales for the SOMA have been

associated with dollar roll transactions. These transactions have not represented any outright sales of agency MBS from the SOMA.

What measures does the Federal Reserve take to ensure that an investment manager implementing the MBS program does not have an unfair advantage relative to other market participants due to the information it receives about the MBS program?
Each investment manager is required to implement ethical walls that appropriately segregate the investment management team that implements the Federal Reserve's agency MBS program from other advisory and proprietary trading activities of the firm. The New York Fed monitors each investment manager's compliance with this requirement.

Where should questions regarding the MBS purchase program be directed?
Questions regarding the MBS program should be directed to the New York Fed's Public Affairs department: 212-720-6130.

FAQs: October 1, 2009 ››