

THE DEPOSITORY TRUST COMPANY

IMPORTANT

B#: 0057

DATE: June 1, 2000

TO: All Participants and Interested Parties

FROM: Lawrence J. Gallaway, Managing Director

ATTENTION: Senior Officers and Operation Managers

SUBJECT: Future DTC Eligibility of Ginnie Maes

Executive Summary

Recently, the Executive Vice President of the Government National Mortgage Association (Ginnie Mae) announced during a speech at a Mortgage Bankers Association conference that he had made the decision to have the settlement of Ginnie Mae securities move from DTC's MBS Division to the Federal Reserve's (the Fed) book-entry system. During a subsequent meeting with DTC management, he stated he had made this decision based on a recommendation by consultants that Ginnie Mae securities would be more appealing to foreign investors, particularly foreign central banks, if they settled in the Fed system rather than at DTC. Although he expressed satisfaction with DTC's handling of Ginnie Maes, he noted that Treasury securities and most Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) securities also settle at the Fed and he would prefer to have Ginnie Mae securities settle there as well.

At a subsequent meeting in New York of various committees of The Bond Market Association (BMA), the attendees agreed to accept the decision made by Ginnie Mae provided that the Fed make appropriate changes to its systems to provide additional functionality already provided by DTC's MBS Division and provided that an acceptable detailed and comprehensive transition plan was put forward by both the Fed and Ginnie Mae.

This memorandum is being distributed to Participants and other customers to apprise you of the background surrounding this decision and to solicit your views on what actions DTC should take to make the transition from DTC to Fed settlement of Ginnie Maes as seamless as possible.

Background

In 1998, DTC took on responsibility for processing Ginnie Maes from the Participants Trust Company (PTC) which had been the depository responsible for their custody and settlement. The staff of PTC became DTC employees and DTC formed the Mortgage-Backed Securities (MBS) Division of DTC to process Ginnie Maes. In order to expedite the absorption of PTC and its members (almost all of whom were DTC Participants), DTC management made the decision to keep processing Ginnie Maes on the PTC system under PTC rules and membership criteria. As a result, DTC Participants that had not been PTC members could not process Ginnie Maes directly through DTC unless they elected to become members of the MBS Division.

DTC management then began planning how to migrate Ginnie Mae processing away from the older PTC computer platform and on to DTC's. One of the objectives of the migration was to allow all DTC Participants (not just MBS Division members) to settle Ginnie Maes through DTC once the systems changes had been effected.

Early in 1999, DTC presented its migration plans to a representative group of broker-dealers and banks that process large volumes of Ginnie Mae transactions. These firms had some reservations about the changes DTC initially proposed (although subsequent revised DTC proposals were acceptable) and the costs involved. As a result, the firms decided to work with the BMA to evaluate whether having Ginnie Maes settle at the Fed could mitigate those costs. That evaluation was still ongoing and the BMA had not yet concluded its review when Ginnie Mae's management made its decision to have its securities settle primarily at the Fed.

During the BMA's review there were substantive arguments raised by those wishing to use the Fed as well as those wanting to have Ginnie Mae settlement remain at DTC.

The major reasons cited for moving to the Fed were:

- There might be industry savings in reducing some of the costs DTC would incur to port the old PTC system to DTC's primary systems.
- Other mortgage-backed securities like Fannie Maes and Freddie Macs settle at the Fed so there would be a uniformity benefit in having Ginnie Maes settle there as well.
- Having Ginnie Maes on the Fed might permit Participants to achieve balance sheet relief under the Financial Accounting Standards Board's Interpretation Number 41 (FIN 41). (FIN 41 is an FASB pronouncement that allows organizations to net for balance sheet presentation purposes offsetting obligations under repurchase agreements, providing the characteristics of those repurchase agreements meet certain criteria as detailed in the FIN 41 pronouncement. Therefore, repo obligations in Fannie Maes, Freddie Macs, and US Government securities, for example, could be offset for balance sheet presentation purposes by repo obligations in Ginnie Maes if FIN 41 requirements were met. This could reduce the size of the dollar values of positions reported on firms' balance sheets.) FIN 41 balance sheet relief can also apply to Ginnie Mae positions held at DTC. DTC has received an opinion from an accounting firm that FIN 41 relief would be available for repo transactions processed through DTC if the FIN 41 criteria are met.

The reasons cited for staying at DTC were:

- There could be substantial costs to the industry to make the change to processing at the Fed.
- The Fed needs to develop a fail tracking system and a repo tracking system, both of which systems DTC already has.
- The Fed will not want to process principal and income (P&I) collections from individual mortgage servicers as required for the P&I processing of Ginnie Mae 1's so Ginnie Mae would have to hire an organization at an unknown cost to collect P&I and then interface with the Fed so that the Fed could make the payments. DTC has already completed the conversion from PTC's older P&I collection and allocation system to DTC's primary P&I processing systems
- Once DTC made its systems changes to port the old PTC system to DTC's primary systems – a conversion which had been scheduled to be completed in the second half of 2002 -- Ginnie Mae processing fees charged to Participants would be reduced by an estimated \$10 million (36%) on an annual basis.
- DTC Participants who are not members of the Fed book-entry system would now have to clear Ginnie Maes through banks that are. Two commercial banks currently have the majority of the clearing business for Fed book-entry-eligible securities and some felt that was too narrow an alternative to DTC processing.

Recommendations

DTC management will work with Ginnie Mae and Fed officials to make the transition to the Fed system as seamless as possible. A specific transition plan from both organizations is now being developed and once it is available, DTC will work to implement it expeditiously.

DTC management believes, however, that some DTC Participants might prefer the alternative of using DTC instead of a commercial bank or another financial intermediary to settle Ginnie Maes when those securities transition to the Fed system.

DTC already has a securities account in the Fed book-entry system. Management has begun preliminary discussions with Fed staff regarding the possibility of DTC's developing a full interface with the Fed book-entry system so that Participants could elect to receive and deliver Ginnie Mae positions through DTC's Fed account. The operational details for any such link would be developed in consultation with both the Fed and the BMA.

DTC management expects that broker-dealer and bank Participants that trade and settle large volumes of Ginnie Maes will transition their positions and activity to the Fed. Assuming that a full interface with the Fed can be developed, however, any trades by a Participant that elects to keep its positions at DTC (DTC Participant) with a counterparty that settles at the Fed (Fed Participant) will settle at the Fed using the proposed interface. If the delivering party is a DTC Participant, DTC will deliver the securities from its Fed account to the Fed account of the Fed Participant (or its clearing bank) for value. If the delivering party is a Fed Participant, the securities will be delivered to DTC's Fed account on behalf of the DTC Participant receiving them for value. Transactions among Participants that keep Ginnie Maes exclusively at DTC would settle within DTC.

Next Steps

Before DTC goes any further with its discussions with the Fed concerning potential future processing of Ginnie Maes through a Fed/DTC interface, DTC management needs to gauge participant and customer reaction to the issues addressed in this memorandum. Specifically, we need Participant feedback on whether DTC should continue to keep Ginnie Maes as eligible securities after the transition to the Fed and, if so, whether Participants agree that an interface with the Fed book-entry system is required.

Participants are requested to send written comments regarding these issues to Lawrence Gallaway, Managing Director, The Depository Trust Company, 55 Water Street, New York, NY 10041 or via e-mail to lgallaway@dtcc.com.