August 16, 2016

VIA E-MAIL: Financial_Products@finance.senate.gov

The Honorable Ron Wyden
Ranking Member
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, D.C., 20510

Dear Ranking Member Wyden:

The undersigned organizations welcome the opportunity to provide comments on your legislative discussion draft of the Modernization of Derivatives Tax Act of 2016 (MODA), which, among other things, generally would require mark-to-market and ordinary income treatment for all derivatives.

We very much appreciate that the current draft of MODA incorporates previous comments requesting an exception to ensure that common real estate transactions, e.g., a sales contract to purchase real estate that is pending at year-end, would not be subject to the mark-to-market rules for income tax purposes. However, we would like to suggest a clarification be made to this exception to exempt “to be announced” (TBA) forward contracts to acquire mortgage-backed securities (MBS) guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae (collectively, the Agencies) from the definition of “derivatives” requiring mark-to-market treatment. The TBA market does not exist as a tax minimization strategy. Instead, as further described below, the TBA market provides liquidity to the market for residential MBS that helps to minimize the interest rates borrowers pay on residential mortgage loans and allows lenders to offer 30-year, fixed-rate mortgages to the public.

More specifically, we request that the MODA be modified to clarify that TBAs, which facilitate the purchase of Agency securities, thereby allowing lenders to offer 30-year, fixed-rate loans to the public, be exempted from the definition of “derivative” under MODA.

**DISCUSSION**

**A. Year-End Pending Contracts to Purchase Real Property**

Again, we greatly appreciate that the MODA discussion draft includes a provision exempting from the definition of “derivative” “any contract with respect to interests in real property (as defined in section 856(c)(5)(C)) if such contract requires physical delivery of such real property.” As a result, real estate investors would not need to mark-to-market (MTM) at year end pending contracts for the disposition of real property. Marking-to-market such contracts would have been particularly problematic for REITs because they are required to distribute at least 90% of their taxable income to maintain REIT status (the Distribution Requirement), so that a REIT would have had to distribute “phantom income” from a MTM

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1 For purposes of this letter, “section” refers to the Internal Revenue Code of 1986, as amended (the Code).
2 Section 857(a)(1).
event though it would not have cash from the pending sale to distribute.

A REIT is not required to distribute “excess noncash income,” which is certain noncash income, or phantom income, in excess of 5% of the REIT’s taxable income (excluding net capital gains). However, a REIT is required to distribute noncash income that does not exceed 5% of the REIT’s taxable income (the 5% Basket). A REIT is required to pay corporate income tax on any “excess noncash income” that it does not distribute to its shareholders. The current draft of MODA would treat MTM income as “excess noncash income.” Thus, a REIT would be required to distribute any MTM income included in the 5% Basket, and REIT would either have to distribute or pay corporate tax on any MTM income in excess of the 5% Basket.

When a REIT has phantom income that must be distributed to its shareholders, the REIT may incur debt or sell assets it otherwise would have held long-term in order to satisfy the 90% Distribution Requirement. Similarly, a REIT with a corporate tax liability may also have to incur debt or sell assets to pay the corporate income tax on the phantom income. Neither incurring debt nor selling assets that would otherwise be held long term is typically in the best economic interests of the REIT’s shareholders. Incurring debt to satisfy the 90% Distribution Requirement or paying tax on excess noncash income would necessarily increase the REIT’s leverage beyond what it otherwise would have been, and that increased leverage may make it more difficult for the REIT to survive an economic downturn.

B. Clarifying that MODA Excludes TBAs from the Definition of “Derivative” Would Help Preserve the Ability of Borrowers to Obtain Low 30-Year, Fixed-Rate Mortgages

1. Housing Sector Provides Tremendous Financial and Social Benefits to the Economy and Communities

As the National Association of Realtors® (NAR) stated to the Committee on Finance last year, “[h]omeownership has long been central to American values, and its economic and social benefits are immense and well documented.” Moreover, the housing sector directly accounted for more than 15 percent of total economic activity in 2015. Household real estate holdings totaled approximately $22.5 trillion in the first quarter of 2016. After subtracting mortgage liabilities, net real estate household equity totaled approximately $13 trillion.”

Furthermore, “every home purchase contributes $60,000 in direct and indirect spending

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3 Section 857(e)(1).
6 NAR calculations based on Bureau of Economic Analysis and Federal Reserve data.
to the economy, housing accounts for 15% of GDP, and every 2 homes sold create one job.”\(^7\)
The residential mortgage market is vital to ensuring potential and current homeowners the ability
to purchase and continue to own their homes.

2. **TBA Market: Allows Borrowers to Lock-in 30-Year, Fixed-Rate Mortgages**

The TBA market is what connects the residential mortgage borrower to the ultimate
funders of residential mortgages – the secondary mortgage market. As investors enter into TBA
purchase contracts to acquire Agency MBS in the future, loan originators enter into TBA sale
contracts to sell loans (through the market makers) to investors. This enables a residential
mortgage borrower to “lock in” a mortgage interest rate up to 30, 60 or 90 days in advance. By
entering into a TBA sale contract, a loan originator can hedge the risk of its loan origination
pipeline and “lock in” a price for the mortgage loans they are currently originating, which, in
turn, allows borrowers the ability to “lock in” interest rates on their mortgage loans up to 90 days
in advance of closing on their home purchase. Although there are other means available, TBAs
are a simple and low-cost way for originators to hedge loan production. Indeed, as a report from
the Federal Reserve Bank of New York concluded, “[w]ithout TBAs, originators would have to
engage in sophisticated trading strategies using a variety of derivatives to replicate the effect of a
TBA.”\(^8\) The report further noted that, without TBAs, it would be more difficult for smaller loan
originators to securitize loans through the Agencies.

The TBA market is the mechanism through which the vast majority of Agency MBS
trading occurs,\(^9\) and only the market for trading in Treasury securities is larger than the Agency
MBS market.\(^10\) According to the Securities Industry and Financial Markets Association
(SIFMA), the TBA market is the most liquid and most important secondary market for mortgage
loans.\(^11\) Moreover, TBAs are the means through which many newly issued Agency MBS are
distributed to investors.

Approximately 90% of residential mortgage loans are currently guaranteed by the
Agencies.\(^12\) Agencies guarantee mortgage loans by guaranteeing the payment of principal and
interest in return for a guarantee fee paid by the borrower. A vital risk management component
of the market for Agency MBS, and thus the market for residential mortgage loans, is the TBA
market.

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7 Written Testimony of NAR, Hearing before the United States Congress Joint Economic Committee on “The
Economic Exposure of Federal Credit Programs,” at 3 (June 15, 2015), available at:
8 Id. at 14.
9 Federal Reserve Bank of New York, Staff Report No. 468, TBA Trading and Liquidity in the Agency MBS Market,
10 Written Statement of Thomas Hamilton, Managing Director, Barclays Capital, on behalf of The Securities
Industry and Financial Markets Association, Hearing before the U.S. Senate Committee on Banking, Housing and
Testimony] at 14.
11 Id. at 13.
SIFMA has summarized the importance of the TBA Market as follows:

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. 

…[A]n average of $184 billion of agency MBS was traded each day in June 2015 by the primary dealers and this volume is second only to the U.S. Treasury market.13

Mortgage REITs and other investors may enter into TBAs to lock in prices of Agency MBS. However, rather than taking physical delivery at settlement, an investor may elect to “dollar roll” a TBA. A dollar roll is the combination of one TBA trade with a simultaneous offsetting TBA trade settling on a different (future) date. The ability to dollar roll TBAs allows investors and market makers flexibility in adjusting their positions for economic or operational reasons. For example, an investor who purchased a TBA but faces operational concerns with taking physical delivery on the scheduled settlement date could sell an offsetting TBA on that date and simultaneously buy another TBA due one month later, effectively avoiding the operational issue but retaining much of the economic exposure.14

The liquidity of the TBA market reduces risk management costs, thereby raising MBS prices and improving market functioning, which ultimately lowers the interest rates paid by borrowers for residential mortgage loans and enhances the availability and reliability of mortgage credit.15 This liquidity helps mortgage originators manage risk, as it allows them to “lock in” mortgage rates in the TBA market before originating a mortgage loan.16 This ability to sell mortgages forward through the TBA market allows loan originators the ability to offer borrowers fixed-rate loan terms well in advance of an actual mortgage closing, and is an important feature of labor market mobility in the United States. This, in turn, greatly facilitates the final negotiations of home purchases and the overall viability of the fixed-rate, 30-year residential mortgage loan.

Mortgage REITs can play an important role in the TBA market and in the market for new MBS more generally. Because of their unique structure and ability to raise capital in equity

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15 Federal Reserve Report at 1; SIFMA Testimony at 2.
markets as well as short-term debt, mortgage REITs have traditionally entered MBS markets during periods when spreads between MBS yields and short-term interest rates are relatively wide. This ability to bring liquidity to the market when spreads are widening helps maintain MBS pricing and keep mortgage rates from spiking. The ability of mortgage REITs to enter the market at key moments to support new issuances can be critical. Between 2009 and 2012, mortgage REIT holdings of Agency-backed securities increased nearly 250% from $105.1 billion to $357 billion. During that period, the annual growth in mortgage REIT holdings was equivalent to 3% of RMBS issuance in 2010, 8.5% in 2011 and 6% in 2012.17

We believe that requiring mark-to-market accounting of TBAs could disrupt the TBA market. Investors in new Agency MBS may avoid acquiring TBAs near the end of their taxable year so they do not have to recognize ordinary mark-to-market income. Any disruption to the TBA market would ripple through the markets for Agency MBS and residential mortgage loans, likely increasing the interest rate paid by borrowers under standard fixed-rate, 30-year residential mortgage loans. Not only would the avoidance of TBAs have the effect of reducing the availability of mortgage credit over year-end, but it may also force market participants to reduce their prudent interest rate risk management by reducing their TBA hedging activity.

Marking to market TBAs may make it difficult for some mortgage REITs to satisfy the 90% Distribution Requirement. Under current law, a REIT seeking to acquire a new Agency MBS through a TBA would not have an income event as a result of entering into a TBA and taking delivery of the TBA. If TBAs had to be marked-to-market, the same REIT would have ordinary income if the TBA was “in the money” at the end of its taxable year. Although the REIT would have no income from the TBA (indeed, the REIT would have to pay for the Agency MBS subject to the TBA), the REIT would have an increased distribution requirement. In addition, the REIT could have a significant corporate tax liability on any mark-to-market income treated as “excess noncash income” under the REIT rules. REITs would either have to reduce their participation in the TBA market, which could contribute to difficulties in arranging for home financings, or potentially face difficult issues satisfying the 90% Distribution Requirement and paying the corporate income tax on any excess noncash income.

We Recommend Clarifying That TBAs Are Not “Derivatives” Under MODA Because They Facilitate the Sale or Purchase of Physically Delivered Real Estate

3. We Recommend Clarifying That TBAs Are Not “Derivatives” Under MODA Because They Facilitate the Sale or Purchase of Physically Delivered Real Estate

In order to avoid potentially disrupting the residential mortgage market, we recommend explicit clarification that TBAs are “derivatives that facilitate the sale or purchase of physically delivered real property.” As noted above, the MODA discussion draft excludes from the definition of “derivative” “any contract with respect to interests in real property (as defined in [the REIT rules in] section 856(c)(5)(C)) if such contract requires physical delivery of such real property.” Moreover, the Joint Committee of Taxation’s Technical Explanation indicates that MODA intends to exempt from the definition of “derivative”:

contracts that facilitate the sale or purchase of physically delivered real property. For example, the discussion draft would treat a residential mortgage interest rate lock entered into by natural persons as a contract with respect to interests in real property requiring physical delivery because the interest rate lock contract is related to the purchase of real property that will be physically delivered even though physical property is not delivered under the interest rate contract itself.

(Emphasis added).

While not explicitly stated, it appears that TBA contracts might not be treated as “derivatives” by the discussion draft because, like interest rate locks, they facilitate the sale or purchase of residential real estate that will be physically delivered to the homeowner. However, it would be very helpful for the discussion draft to be modified to clarify specifically that TBAs are not derivatives under MODA.

Again, TBAs provide the liquidity to the residential mortgage market necessary to facilitate the ability of borrowers to lock in fixed-rate, 30-year mortgages, which, in turn, facilitates the sale or purchase of physically delivered residential real estate. We therefore respectfully request that either MODA be amended specifically to provide that TBAs are excluded from the definition of a “derivative” and/or any subsequent explanations of MODA clarify this point.

We look forward to continuing to work with you and your staff on these issues. If you would like to discuss these issues in greater detail, feel free to contact Evan Liddiard, Senior Policy Representative, Federal Taxation, National Association of Realtors, at (202) 383-1083, or ELiddiard@realtors.org, or Dara Bernstein, VP & Senior Tax Counsel, National Association of Real Estate Investment Trusts, at (202) 739-9446 or dbernstein@nareit.com.

Respectfully submitted,

Mortgage Bankers Association
National Association of Home Builders
National Association of Real Estate Investment Trusts
National Association of Realtors
The Real Estate Roundtable