

**Agency Mortgage-Backed Securities
Fails Charge Trading Practice Summary**

June 28, 2011

Updated September 23, 2011

The Treasury Market Practices Group (TMPG) is committed to supporting the integrity and efficiency of the agency mortgage-backed securities (MBS) market. Widespread, persistently elevated fail levels in the agency MBS market create market inefficiencies, increase credit risk for market participants and heighten overall systemic risk. The TMPG is recommending a fails charge trading practice for the agency MBS market with the objective of reducing the incidence of delivery failures.

Applicability of a fails charge

The recommended fails charge trading practice is applicable to agency pass-through MBS issued or guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae.

A fails charge is applicable on failing securities regardless of whether they are related to specified pool, to be announced (TBA), repo, dollar roll, option or forward transactions. A fails charge is not applicable on transactions where delivery is not against the payment of funds or the transfer of securities (i.e., where there is a free delivery). The TMPG has not recommended that a fails charge apply to collateralized mortgage obligations or other structured mortgage securities.

Calculation of a fails charge

A fails charge accrues on each calendar day in the period from and including the date of the delivery failure (contractual settlement date) to, but excluding, the date the delivery failure is resolved (actual settlement date), and becomes effective on the third business day following contractual settlement date. That is, a fails charge is not applicable for fails that settle on either of the two business days following contractual settlement date, referred to as the resolution period. On the third business day following contractual settlement date, a charge accruing from contractual settlement date becomes effective.

Example 1

A delivery is contracted to occur on settlement date (S), a Tuesday, but does not occur until the second business day following contractual settlement, Thursday (S+2). The failing party would not be subject to a fails charge because delivery occurs during the resolution period.

Example 2

A delivery is contracted to occur on settlement date (S), a Tuesday, but does not occur until the third business day following contractual settlement, Friday (S+3). The failing party would be subject to a three-day fails charge.

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Example 3

A delivery is contracted to occur on settlement date (S), a Wednesday. Delivery does not occur until the third business day following contractual settlement, Monday (S+3). The failing party would be subject to a five-day fails charge, as the charge accrues on each calendar day in the fail period.

A fails charge for each day would be calculated according to the following formula:

$$C = \frac{1}{360} \times 0.01 \times \text{Max}(2 - R, 0) \times P$$

where:

C	=	fails charge amount
R	=	the TMPG reference rate at 5:00pm New York time on the preceding business day, in percent per annum (the current TMPG reference rate is the Federal Open Market Committee's current target level for the Federal funds rate, or the lower limit of the FOMC's target band)
P	=	settlement proceeds

Fails charge claims and payment

A non-failing party aggregates cumulative fails charges for each failing party for a given calendar month. A failing party is not subject to any fails charge if the sum of the cumulative fails charges for all delivery failures between the failing party and the non-failing party for a given month is less than or equal to \$500.

For these purposes, parties are considered to be the legal entities that are counterparties to one another in a trade. When a transaction is executed by an investment manager on behalf of multiple principals and the allocation of the transaction to the principals is disclosed to their counterparty, each principal is a distinct party for purposes of calculating a fails charge. If a principal utilizes more than one investment manager, each investment manager's transaction executed on behalf of the principal constitutes a transaction by a distinct party for purposes of calculating a fails charge (i.e., one investment manager's transaction is not aggregated with other investment managers' transactions executed on behalf of the same principal).

Non-failing parties would provide notice to the failing party of the amounts owed by the 10th business day of the month following the month in which the fail is resolved. Failing parties would make full payment of all fails charges by the last business day of the month following the month in which the fail is resolved.

Example 1

In month A, a failing party delivers a \$1 million pool and a \$500,000 pool on the third business day (Friday) following contractual settlement date (Tuesday). Three days of fails charges accrue

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for each pool: \$167 for the first and \$83 for the second, assuming a reference rate of 0. Aggregate fails charges for the failing party for month A are \$250. Because the aggregate charges are less than \$500, the failing party would not be subject to any fails charge for month A.

Example 2

In month B, a failing party delivers a \$1 million pool, a \$750,000 pool and a \$500,000 pool on the Monday following contractual settlement date (Tuesday). Six days of fails charges accrue for each pool, given that six calendar days are in the fail period: \$333 for the first, \$250 for the second and \$167 for the third, assuming a reference rate of 0. Aggregate fails charges for the failing party for month B are \$750. Because the aggregate charges are greater than \$500, the non-failing party would provide notice to the failing party of the amount owed by the 10th business day of month C, and the failing party would make full payment by the last business day of month C.

Example 3

A fund manager allocates a settlement to the accounts of multiple clients. In month C, the failing party delivers four \$1 million pools to account A and a \$500,000 pool to account B on the third business day (Friday) following contractual settlement date (Tuesday). Three days of fails charges accrue for the pools: \$667 for account A and \$83 for account B, assuming a reference rate of 0. Because the aggregate charges for account A are greater than \$500, the fund manager would provide notice to the failing party on behalf of account A by the 10th business day of month D, and the failing party would make full payment by the last business day of month D. Because the aggregate charges for account B are less than \$500, the fund manager would not make a fails charge claim on behalf of account B.

Participation in the trading practice

All trading practices published by the TMPG are recommendations only.

Fails charge effective date

The TMPG recommends that the fails charge apply to transactions entered into on or after February 1, 2012, as well as to transactions that were entered into prior to, but remain unsettled as of, February 1, 2012. For transactions entered into prior to, and unsettled as of, February 1, 2012, the TMPG recommends that the fails charge begin accruing on the later of February 1, 2012, or the contractual settlement date.