



SERVICE DESCRIPTION FOR CENTRAL COUNTERPARTY (CCP) FOR MORTGAGE-BACKED SECURITIES – THE NEXT STEPS

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SERVICE DESCRIPTION FOR CENTRAL COUNTERPARTY (CCP) FOR MORTGAGE- BACKED SECURITIES – THE NEXT STEPS

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1 . EXECUTIVE SUMMARY

The Fixed Income Clearing Corporation (FICC), a subsidiary of The Depository Trust & Clearing Corporation (DTCC), working with its members, has identified a strategy to align the services provided by its Mortgage-Backed Securities Division (MBS) with a central counterparty (CCP) model of settlement.

Given the complexity in moving from a bilateral settlement process that does not involve FICC to settlement directly with FICC as the CCP, FICC and its members agreed upon a multi-phased development approach, leveraging existing infrastructure as much as possible in order to minimize development efforts. The first two stages of the development, introduction of a Specified Pool Trade (SPT) service and creation of a Pool Substitution service for FICC's Electronic Pool Notification (EPN) system were rolled out in June, 2007 and January, 2008 respectively. It is anticipated that this third phase, which will introduce a Pool Netting service with FICC as the trade guarantor on all matched trades and the novated counterparty on eligible pool obligations, will begin its pilot production in Q2, 2009, with full production availability by the end of Q3, 2009. As we move toward the realization of these initiatives, FICC would like to take this opportunity to introduce to our members the next steps of the CCP development initiative.

FICC's primary objective in taking these next steps is to expand novation beyond select pool obligation settlements by becoming the CCP to the TBA net positions and obligations themselves. This effort will incorporate a number of development initiatives into one major program.

The primary objective of MBSD TBA Novation is the development of a new model that will retire the settlement balance order model of netting that has been at the core of MBSD processing since its inception in 1979. The balance order model generates multiple settlement counterparties at multiple settlement prices out of its once-monthly (per TBA CUSIP) netting model. The TBA Netting and Novation model will change the process in a number of significant ways. Firstly, FICC will run the netting process daily. This will eliminate the netting cut-off on 72 hour day that currently limits the number of trades that make it into the netting process in today's balance order driven environment. Next, as part of the netting process FICC will be placed as the single novated settlement counterparty to all net positions and obligations in its system. Thirdly, with FICC becoming settlement counterparty to those net positions and obligations, FICC will be able to retire the notification of settlement (NOS) process.

Since introducing the concept of a TBA Netting and Novation model in previously published papers, FICC has vetted the potential value of such a service with its Industry Steering Committee. Through preliminary market analysis, FICC has shown the service's potential to save members' operating costs through a decrease in allocations that must be made and the associated settlements of those allocations, and as a way of providing a stabilizing influence on the market during periods of market uncertainty.

Secondary initiatives center on developing enhancements to existing services and leveraging off the introduction of TBA Netting and Novation to introduce new services that will broaden the MBS membership base and offer new matching tools to members. Discussions with members on SPT, Pool Substitutions and Pool Netting over the past few months have highlighted areas where FICC can bring further efficiencies to these services. FICC intends to further enhance the services as directed by our members to meet the needs of an ever-developing industry. Additionally, FICC will introduce fail netting for both TBA obligations and pool obligations; it will also create a stipulated trade matching service, a comparison-only service and expand the prime brokerage service into the MBS space.

As with TBA Netting and Novation, the objective of the second set of initiatives is to maximize the number of matching events performed by MBS systems and to consequently increase the number of trades executed by our members that will fall under our risk management structure. To maintain a uniform and consistent settlement process, all matched trades will be guaranteed by FICC, and FICC will become the CCP of all resultant net positions and obligations, i.e. net positions and obligations will novate versus FICC. The scope of the development efforts proposed in this paper will warrant a multi-year development program and a significant commitment from all of FICC members.

OVERVIEW OF PLANNED INITIATIVES

TBA Netting and Novation: The fundamental elements of the proposed TBA Netting and Novation model will place FICC as the legal counterparty to all TBA net positions and obligations as well as any allocations performed against those net TBA positions and obligations. The trade guarantee that will become effective with the introduction of Pool Netting later in 2009 will remain in place (i.e., settlement guarantee at time of trade match). To achieve the novation of TBA net positions and obligations versus FICC, and to extend the cut-off for the submission of TBA netting-eligible trades beyond the current cut-off on 72 hour day, this phase will introduce a daily TBA netting event whereby all fully-matched netting-eligible TBA trades will be netted and the resulting positions will be novated against FICC, creating a single net TBA position by settlement date and by TBA CUSIP. The model will leverage FICC's government securities' netting model, with changes made for the nuances of the MBS marketplace. Net positions will be marked to a uniform price daily, and the mark-to-market adjustments on trades will be passed through to members as a daily cash movement.

Members, in order to satisfy their TBA obligations versus FICC, will have the option, prior to settlement, of either allocating pools to/or receiving pools from FICC or trading against their positions versus FICC (reducing or eliminating those positions) and consequently removing the need to execute allocations. With FICC as the CCP, having full knowledge of the settlement status of all trades and allocations, NOS processing will no longer be needed. FICC and the Steering Committee will work with the Securities Industry Financial Markets Association (SIFMA) and the U.S. Securities Exchange Commission (SEC) to modify procedures that will be established for Pool Netting transactions settled versus FICC.

Fail Netting: FICC will introduce a daily TBA fail netting service that will re-net TBA positions/obligations that remain unallocated on their contractual settlement date (and beyond) with the TBA activity for the next business date as part of the end-of-day process. Additionally, any pool obligation that remains unsettled on its delivery date will be re-netted with that evening's Pool Instructs for the next delivery date. Fail netting will initially be limited to offsetting TBA or pool obligations within the same contractual settlement month.

Blind Brokering: The Give-up (GUP) model of brokering is incompatible with MBSB TBA novation, as fully-matched brokered trades will result in a net-out of the broker on a daily basis and novation of the dealers' positions versus FICC. (In the case of non-TBA netting eligible trades, novation will occur versus FICC with FICC replacing the broker.) As a result, the introduction of blind brokering, along with the advantages of anonymity it provides, is a natural side-effect of MBSB TBA novation. Since this benefits our members, FICC will not take steps to retain the GUP model currently offered, but will allow the market to evolve into one that offers blind brokering of MBS trades. (The GUP model will eventually be phased out.)

Stipulated Trade Matching (Stip) service: With the planned introduction of MBSB TBA Novation services, FICC must provide a way to isolate those trades executed with stips from those trades destined for TBA netting. We aim to address this by introducing a Stipulated Trade Matching program. Stips will not net versus other TBA netting-eligible trades; however, pools allocated against them can be entered into the Pool Netting Service. Matched stips, as settlement obligations, will novate versus FICC, thereby maintaining a homogenous settlement process and providing for the elimination of NOS processing.

Enhanced Services for Specified Pool Trades (SPT): The introduction of SPT in June, 2007 was a critical first step toward opening the FICC trade matching environment to processing trades executed with a pool specified as a matching term. This next phase will open the system to SPT matching and risk management of SPTs executed in pools that do not fall under a netting-eligible TBA CUSIP. Matched SPTs, as settlement obligations, will novate versus FICC. Another new feature will offer matching on bid-lists.

Comparison-Only Service: By offering a comparison-only service that will allow members to join as comparison-only members, or by accepting certain securities as comparison-only for trade input, FICC will further expand our membership and offer new services that lend themselves to a comparison-only input. Prime Brokerage: FICC will initiate a prime brokerage service for our MBSB members. To minimize members' development efforts, the MBSB service will be based on FICC's Government Securities Division (GSD) service, which was introduced in November, 2007.

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SERVICE ROLLOUT

FICC's goal is to incorporate industry feedback in defining the business requirements and development processes of these initiatives. To that end, FICC will continue to convene, on a regular basis, the Industry Steering Committee to provide guidance on strategic issues identified during the development of the business requirements for this phase. FICC has also begun working with a sub-committee of the Industry Steering Committee (i.e., the CCP Working Group) that is dedicated solely to the task of defining the scope of the initiatives and helping FICC resolve any functional questions that arise. Additionally, FICC welcomes feedback on this paper from our broad membership and other interested supporting parties, such as vendors or service bureaus. All feedback should be directed to one of the following:

- Kate Connelly kconnelly@dtcc.com
- Sean Delap sdelap@dtcc.com
- Michele Hillery mhillery@dtcc.com
- George Parasole gparasole@dtcc.com
- Murray Pozmanter mpozmanter@dtcc.com

It is anticipated that FICC will complete definition of the project in 2009 and work on development and testing through 2010 with a projected rollout date in mid-2011.

2. TBA NETTING AND NOVATION

OVERVIEW

The primary development initiative proposed in this paper is a move away from the current multilateral TBA netting and bilateral settlement process between two members to a daily TBA netting and novation process with settlement of obligations versus FICC. In this model FICC will complete TBA netting on a daily basis for all fully-matched TBA netting-eligible trades: all buy trades within a TBA CUSIP and settlement date will be net against sell trades within the same TBA CUSIP and settlement date to generate a daily single net position by TBA CUSIP and by settlement date. The daily TBA netting process will occur at the end of each business day up to and including contractual settlement date minus one (fail netting will run thereafter –see section 3 for more information on fail netting). With this proposal, the current process of executing a single TBA netting event on the SIFMA-designated 72 hr day, generating balance order output from that netting process, locking in a netting cutoff time and submission of notification of settlement (NOS) will be retired. It will also replace processing of an AM and a PM pass with one end-of-day process per day.

At the beginning of each day, the member will have a start-of-day position versus FICC by TBA CUSIP and settlement date. At the end of each day, FICC will analyze the trades matched by the member that day and incorporate them into the single net position and novate that position., (i.e., as part of the daily netting process FICC will become the legal counterparty to all members' netted positions and the end-of-day process will establish FICC as CCP. As settlement date approaches, members have the option to satisfy the obligation versus FICC by either: a) flattening their position versus FICC with offsetting trades; or b) entering into the allocation process versus FICC. To the extent that the member executes trades to flatten its position, the reduction in position versus FICC will not need to be allocated against.

The net position will be marked to a uniform end-of-day system price for that TBA CUSIP. With FICC as the guarantor and the settlement counterparty to the resultant net positions, FICC will introduce a cash pass-through for the mark-to-market profit or loss captured on the net position versus each day's market uniform price movements. These cash pass-through events will occur each day up to the point that the obligation is dissolved either via allocation versus FICC or by having a flat position on contractual settlement date.

TRADE INPUT

In an effort to minimize the development effort, FICC does not expect to make substantial changes to the submission and matching process for TBA trades. Members will continue to enter trades via SWIFT format interactive messaging, SWIFT format Batch entry or via web entry. The bilateral matching process will continue to operate via RTTM as it does today.

Members will continue to have access to a full complement of inputs that support trade matching such as modify, DK and cancel. Some new inputs will need to be developed in order to support the model, such as the TBA-level Customer Delivery Request as well as and pair-off/real-time TBA netting function described later in this section.

ELIGIBILITY FOR TBA NETTING AND NOVATION

The current designation of a trade as either Trade-for-Trade (TFTD) or Settlement Balance Order Destined (SBOD) will be replaced by single trade type – for example, TBA Netting and Novation Destined (TND) in TBA CUSIPs that are eligible for the TBA netting process. Matching on trades executed in TBA CUSIPs that are not eligible for TND will potentially be offered as either a comparison-only service or on a stipulated trade basis, e.g. ARMs, 10 year TBA CUSIPs, 20 year TBA CUSIPs etc.

A SPT or a stip trade will not be considered TND, and as a result, any trade that is marked as a SPT or as a stip trade will be excluded from the TBA trade netting process (however, as settlement obligations, they will be novated with FICC established as CCP). See Sections 5 and 6 below for more details on these types of trades. Option (OPTN) trades will not be eligible for TBA Netting.

SATISFYING THE OBLIGATION VERSUS FICC

FICC will act as any other counterparty would to the TBA net position. As the position approaches its settlement date, a member must choose to either execute TBA trades to offset its net position versus FICC, or to allocate and settle pools versus FICC (or receive allocations from FICC in the case of a buyer). To the extent that the member executes trades to flatten its position, the reduction in position versus FICC will not need to be allocated against. If the position is completely offset by trading activity that has been included in the net, the member will not need to be involved in the allocation process at all, but will have a funds settlement obligation for the offsetting trades.

Real-Time Netting: A netting system that only performs an end-of-day TBA netting process will not capture trades intended to offset the net position until the end of the day. This poses a timing issue for MBS Products. For example, if on 48 hr day a member is net long versus FICC and then executes a short trade to flatten its position, if FICC were to rely on an evening TBA netting process, both the long and short position could be allocated against intraday throughout 48hr day. Execution of allocations against both positions would go against the member's wish to flatten its position and absolve itself from any allocation processing. FICC's solution is to make available, upon optional request of the member, a real-time intraday TBA netting process, or a pair-off solution.

In essence, by marking a trade available for intraday real-time TBA netting, the trade will net against the open FICC position immediately, thereby adjusting the open par of the FICC position by the value of the trade. Choosing to make the trade available for real-time TBA netting will be solely at the discretion of the member. Any trades that are not marked for real-time TBA netting will be available for allocation up until the TBA netting process is executed that evening when they will be incorporated into the net position. In this way FICC preserves the members' right to see allocations throughout the day if they so wish, while offering a means to flatten positions and remove the need for allocations intraday if so desired.

Allocations: Any allocations made against FICC will reduce the open par of the TBA position by the value of the allocation. Members can allocate against a net TBA position or against any matched TBA trades that are open (i.e. trades matched 'today' that were not folded into the net position via intraday real-time TBA netting). All allocations will be made versus FICC, even if they target a trade not yet included in the net. This allows for streamlining the allocation process for members and ensures that FICC has all relevant information on the status of all trades.

For clarity, FICC will show members their modified net positions on a real-time basis. In other words, as trades are compared (even if they are not netted real-time) or as allocations are made, FICC will display the impact that the event will have on the overall net position after its inclusion in the evening TBA netting process. The price on allocations against the single net position will be at the system uniform price; the price on allocations against trades not yet included in the single net position will be made at the trade price and must include a unique reference ID.

Allocations made against trades will continue to have the opportunity to net via FICC's MBS Pool Netting Service. As part of the allocation process, FICC will have validated the terms of the allocation against the position. Following validation of the terms of the allocation, FICC will, pass the allocation on to the appropriate buyer.

Inclusion of allocations into the Pool Netting process will help members further reduce their settlement obligations for those instances where the member chooses to see security flow but, subsequent to seeing it, seeks to minimize the number of associated deliveries and receives of the allocated pools.

	Position Open
Trades matched and marked for Real-Time Netting	The position is immediately adjusted by par of trade
Trades matched but not marked for Real-Time Netting	Multiple positions exist and can be allocated against: 1) Real-time position 2) Separate positions for each trade
Allocations made versus TBA positions or trades	Real-time position or trade par adjusted by current face of allocation.

SETTLEMENT OF THE OBLIGATION VERSUS FICC

With the introduction of MBSD TBA Novation, members will no longer submit Notification of Settlement (NOS) against obligations. Because settlement will be versus FICC, FICC will have complete knowledge of the settlement status of all obligations in its system. This knowledge will negate the need for members to advise FICC when a trade has settled.

TBA CUSTOMER DELIVERY REQUEST (CDR)

Preliminary analysis of current trade data flowing through MBSD's trade matching system has shown that the model described above will significantly reduce the value of positions available for allocations and subsequent settlement that members would have to make because of offsetting trades that could have reduced the SBO net position but were not included in the net. Our initial estimates show that by removing the TBA netting cutoff and employing a daily netting process, well over half of the allocation and settlement events could be removed with the introduction of TBA Netting and Novation. However, in discussing the trade flow with the CCP Working Group and Industry Steering Committee

it became clear to all that the model must also allow members have offsetting long and short positions for times where their trading strategy requires it. To provide for this, FICC will offer a TBA CDR.

The TBA CDR will be an indicator that the member places on a trade, either at time of trade input or on part of the net position prior to contractual settlement date. It will preclude the trade (or portion of the net position) from being operationally netted by the system. A similar concept is offered in MBSD's Pool Netting service. Any Pool Instruct that is marked with a TBA CDR will be novated and marked to the uniform system price but will be excluded from the single net position. Trades with a TBA CDR placed on them will always be available for allocation.

Members will be able to release a TBA CDR any time prior to contractual settlement date. Once released, the trade (or portion of the net position) can be immediately included in the net if marked for real-time TBA netting, or will be included in the net that evening (if not allocated against intra-day).

FAIL NETTING

Taking the proposal past contractual settlement date, FICC sees the introduction of MBSD TBA Novation as the ideal opportunity to develop a fail netting model for TBA trades. Refer to Section 3 below for additional details on fail netting.

GUARANTEE

With the introduction of Pool Netting in 2009, all TBA trades compared in MBSD eligible securities will be guaranteed at time of match. This guarantee will continue to remain in place for all TND eligible trades.

TIMELINE

	TBA Trade Input	TBA/Pool Netting	Allocations	Pool Obligations
Up to and including 48 hr Day	TBA Trades accepted as executed versus counterparty.	<p>Intraday real-time TBA netting: TBA Position versus FICC adjusted by par of the trade.</p> <p>End-of-day TBA netting: Performed on any trades that did not undergo intraday real-time TBA netting or not allocated against.</p>	<p>Allocations can be made against the TBA position versus FICC.</p> <p>Allocations can be made against trades that did not undergo intraday real-time TBA netting.</p> <p>All allocations will be made versus FICC (even if the target a trade that has not yet been novated).</p> <p>Any allocation made will reduce the open position by the value of the allocation.</p>	Allocations are available for submission into the Pool Netting system.
24 hr Day	Same as 48 hr day	Same as 48 hr day	Same as 48 hr day	<p>Allocations are available for submission into the Pool Netting system.</p> <p>Allocations submitted for Pool Netting with Delivery date equal to the next business day will undergo Pool Netting to create Pool Obligations.</p>
Contractual Settlement Date (CSD)	TBA trades accepted as executed against the counterparty.	<p>Unallocated TBA Position will undergo fail netting as part of the evening TBA netting cycle.</p> <p>Unsettled Pool Obligations with delivery date equal to 'today' and a contractual settlement date less than or equal to today will undergo fail netting as part of the evening Pool Netting cycle.</p>	<p>Allocations vs trades matched on CSD: TBA trades with contractual settlement date the same as allocation delivery date may be accepted and settled for cash (with membership approval of FICC's solution).</p> <p>Allocations can be made against trades that did not undergo intraday real-time TBA netting with delivery date following normal rules.</p> <p>Allocations vs FICC TBA Position: Allocations can be made against the unallocated TBA position versus FICC.</p>	<p>Pool Obligations with Delivery date equal to the contractual settlement date will begin to settle versus FICC.</p> <p>Allocations submitted for Pool Netting with Delivery date equal to the next business day will undergo Pool Netting to create Pool Obligations.</p>

BENEFITS OF THE PROPOSAL

This proposal represents a complete overhaul of the existing system. It represents a new way of thinking of MBSD trade processing as it moves members away from the time-sensitive monthly balance order model to daily netting process without cut-off's prior to settlement date and one settlement counterparty. Given the development effort that will be required by all involved in this market, some major benefits must be achieved to make it a worthwhile proposition.

The primary economic benefit that will be realized with the implementation of this model is a significant reduction in the number of allocations and settlement obligations that any member will be required to make. This is directly because of the extension up to settlement date that members can submit trades into the netting process, rather than the 10:30AM cut-off on 72hr day as exists today. The extension will greatly increase the number of trades that are netting eligible and as more trades make it into the netting process (and fail netting), the netting process itself will become more efficient and fewer settlement obligations will be generated. There will be an equivalent reduction in the associated system and time expenditure needed to satisfy these obligations. FICC's preliminary analysis of members trading activity has proven this out. By folding members' trades into a single net position, members will see settlement efficiencies that are not currently available in the existing settlement balance order model.

For those members who have no desire to step into the allocation space, the benefits of the real-time TBA netting tool are evident. Trades marked to net immediately against the single net position will adjust the open par of the net position by the value of the trade. If the trade offsets the net position, the value of the offset will not need to be allocated against, nor will it need to be settled. This achieves FICC's goal of generating market efficiency and freeing our members from a process that offers them little benefit but has associated fees and time costs.

The TBA CDR preserves a member's ability to see securities flow (by applying a TBA CDR to a trade) and offers our members choices of when to net and to what degree they net; they retain the flexibility to drive the number of allocations that they will need to complete.

FICC expects that the Pool Netting service, which will be introduced to all members in Q3, 2009 will greatly reduce the number of NOS that must be submitted to close out obligations. However, a number of members have expressed a desire to completely retire the

process. One of the benefits derived from MBSD TBA Novation is that the elimination of NOS can be achieved. FICC expects that this will have a number of benefits. Firstly, it will free up personnel from a tedious, manual process that is prone to all the issues that any manual process experiences – occasional delay in submission by a member, entry errors etc.; and secondly, it will provide transparency on the actual settlement status of failing positions.

The service also offers improvement in the area of operational risk management. Although with the introduction of Pool Netting in 2009 all trades will be guaranteed, FICC will not be the settlement counterparty to trades. It will only be the settlement counterparty to those Pool Obligations that were generated out of pool netting. While the guarantee of trades under Pool Netting offers a major benefit to members, this proposal goes further to mitigate operational risk for members. As mentioned above, one major benefit of the system is an integration of the gross trades into a net position for any forward settling item. In the event of a member's liquidation, having FICC as the central counterparty for positions held by the liquidating firm will reduce the market disturbance when compared with bilateral liquidation of the gross position by member firms. This was proven out in recent months when FICC was asked by members to step in and become central counterparty for a day because of member concerns that bilateral liquidation of gross positions would cause significant market disruptions. MBSD TBA Novation will provide an ongoing rule-based agreement for such actions (rather than the one-time action). Additionally, with FICC as the settlement counterparty, status of fail trades as represented on FICC books due to incomplete NOS information (due to timing issues) will be clarified. And once again, FICC will be the responsible counterparty to take action against a failing position(s) for a liquidating member. This should reduce market disturbance and make the process cleaner for all surviving members. Added to this is the introduction fail netting which is discussed in greater detail below.

CHANGES FROM THE CURRENT TBA NETTING MODEL

As can be seen from the above descriptions, numerous changes to the current TBA Netting model will be made with the introduction of this process. The following chart provides a high-level overview of these changes:

	Current TBA Netting Model	Proposed TBA Netting and Novation Model
TFTD vs SBOD	Only SBOD trades are TBA netting eligible. TFTD trades do not qualify for TBA netting.	All TBA trades (unless marked as either SPT or as a Stipulated trade) will be TND. Trades may be excluded from TBA netting (but the resultant position will be novated) if the member marks the trade with a TBA CDR.
TBA netting	Once per month, 72hrs before the SFIMA-designated settlement date for the TBA CUSIP. Any netting destined trades that are not matched prior to netting miss the netting process entirely. They must be allocated against. The balance order model generates positions with a maximum value of 1MM (note with the introduction of Pool Netting, balance order output will be changed to a 500MM multiple rather than a 1MM multiple).	Daily event that captures trades up to contractual settlement date and recalculates a net position versus FICC for each forward settlement date and each TBA CUSIP. Position can be withheld from the net by use of a TBA CDR. No maximum position unless requested by members.
Pricing	Balance order positions have multiple prices based on the CAP and FCAP against a counterparty in addition to prices on TFTD trades.	The single net position is marked daily to the current market value and a daily cash pass through will be made to capture the change in mark.
Allocations	Members must allocate and settle against all open TBA trades even if they offset each other. Allocations must be made versus multiple counterparties.	Either intraday or at end of day, offsetting TBA trades can be netted and will not need to be allocated or settled. All allocations are made versus FICC.

CHANGES FROM THE CURRENT TBA NETTING MODEL
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	Current TBA Netting Model	Proposed TBA Netting and Novation Model
Fail Netting	No fail netting of TBA trades is provided.	Fail netting within the current month is proposed in this model for both TBA and Pool Obligations.
Guarantee	With the introduction of Pool Netting in 2009, trades are guaranteed at time of match through actual settlement.	Trades are guaranteed at time of match through actual settlement. (Unchanged.)
NOS	Bilaterally-matched NOS must be submitted to release the margin obligation and release the position from FICC's risk management process.	All net positions and obligations are novated with FICC as the settlement counterparty. This negates the need for NOS submission as FICC will always know when the position has settled.

3. FAIL NETTING

TBA Fail netting cannot be supported by the settlement balance order model that is currently used by MBSD to net TBA trades because FICC is not directly involved in the allocation or settlement process. Given the criticality of knowing whether a trade has been allocated against and whether the trade has settled, FICC has never entertained entering into fail netting of TBA trades. With the introduction of MBSD TBA Novation, the question over the settlement status of trades is answered. This opens the way for implementing a fail netting service. FICC expects to offer fail netting in two different ways. Firstly, we will allow a failing netting eligible TBA position to be included in the activity of the next business day's TBA net (i.e., to offset the next day's settling position). The failing TBA position will be a position that has not been allocated against. Secondly, FICC will introduce fail netting at the pool obligation level for pool obligations generated through Pool Netting but failing to settle on their anticipated delivery date. FICC is not proposing allowing TBA positions and pool obligations to offset each other; the Fail Netting service will run two parallel services.

Including fail netting as a component of this netting and novation initiative makes sense as it will provide members with the maximum degree of offset in their trading activity and in their pool obligation positions. TBA fail netting will be offered for those trades that satisfy the criteria to be TND if the settlement date is within the same month. We will not, at this stage, offer TBA fail netting across settlement months. Additionally, those pools that undergo allocation and enter into the Pool Netting process will undergo daily pool fail netting against pools with settlement dates within the same month.

TBA FAIL NETTING

The TBA fail netting process will be executed as part of the overall daily netting process. Any unallocated TND trades/position, on and after settlement date, will be rolled into the single net position against other trades/position with the next business day's settlement date. Failing obligations will be marked to the uniform system price, and a fail mark will be passed to members to account for the price difference.

To account for the different settlement dates and risk associated with the differences in the interest owed to the member when these obligations ultimately settle, FICC will capture the difference on a daily basis and process cash pass-through adjustments accordingly. FICC will, in this phase, limit TBA fail netting to those trades that are executed within the same settlement month. FICC may expand the service and remove the 'within month' limitation at some future date.

Allocated TBA trades/positions will not be eligible for TBA fail netting, because, as mentioned above, the allocation adjusts the open TBA position immediately upon processing the allocation; the TBA trade/position targeted by the allocation is no longer included in the open TBA position.

POOL OBLIGATION FAIL NETTING

The Pool Netting model that will be introduced to the full membership in Q3, 2009 captures the majority of pool netting opportunities, but may miss the chance to net certain Pool Instructs due to allocations having contractual settlement dates other than the SIFMA-designated dates or allocations that are failing settlement, are substituted or are allocated late. Fail netting pool obligations will capture these events and potentially further reduce the number of settlements that a user may have to make.

FICC plans on applying a comparable set of rules to pool fail netting of pool obligations as it does to fail netting of TBA positions to reduce development efforts and code maintenance requirements for our members. Therefore, like TBA trade fail netting, fail netting of pool obligations will initially be limited to pool obligations within the same settlement month. Also, like TBA trade fail netting, fail netting pool obligations will mark all trades to a uniform system price and make a fail mark payment to capture the price difference. FICC will also make any necessary cash adjustments to account for and capture risk associated with interest differences between pool obligation settlements.

BENEFITS

With the introduction of both the pool-level and the TBA trade-level fail netting, we will maximize the netting processes' capture of offsetting activity. This is done with one objective in mind – to minimize the settlement activity of our members and save our members the indirect and direct costs associated with those settlement events.

4. BLIND BROKERING

Brokers currently use a give-up (GUP) process where they enter a two-sided trade against which both dealers match. After a specified number of days the dealers are disclosed (or “given-up”) as the settlement counterparties to one another. With the introduction of MBSD TBA Novation, the GUP model no longer is operable and will no longer be supported. Once MBSD TBA Novation is implemented, the GUP process will be replaced with ‘blind brokering.’ The basis for this decision is a simple matter of timing. Upon reaching fully-matched status, all resulting net positions and obligations will novate versus FICC. This system action will apply to both dealer and broker trades. In the case of TND trades, it will result in the incorporation of the dealers’ trades into their single net position with FICC as the settlement counterparty and the net-out of the broker trade. The TBA netting process will make trades versus the broker unavailable for GUP since they will no longer exist. In the case of trades that are not netting eligible, the dealers will novate versus FICC, the broker will drop out of the trade and FICC will retain the relationship between the buyer and seller. Again, the trade is unavailable for GUP.

In the blind-brokering model, the broker will submit and match versus each of the dealers consistent with its actions today, but, unlike the GUP model, the name of the counterparty dealer will never be disclosed; rather, the trade will go directly from dealer versus broker as the counterparty to the trade to dealer versus FICC as the novated settlement counterparty. The dealer will only be aware of one of two counterparties: the broker until the trade is fully matched and the end-of-day processes are run, and FICC thereafter.

Because, as noted above, the net positions and obligations stemming from all fully-matched trades will novate versus FICC, even those trades that are not TND will be subject to blind brokering. This includes all SPT and stipulated trades. This represents an expansion of the brokering service into this space. The broker GUP model is not currently used for SPT, rather the current process forces dealers to match against a broker’s dealer-designated account and compels dealers and brokers to maintain two sets of processing rules – one for those trades executed as TBA, and one for those executed as SPT. As part of this development initiative, we intend on allowing matching versus the broker account and allowing one uniform set of streamlined rules to be applied to the trade regardless of the type of trade executed (see section 6 for more details on SPT changes).

BENEFITS

Blind brokering will advance the degree of anonymity our members will see in their trading practices. It will also make processing brokered trades more efficient for the dealer and broker community because the secondary level of processing (the GUP) will no longer be needed. It will also likely simplify system code structure because, under this

model, brokers can be treated as any other counterparty (with the possible exception of commission payments).

Additionally, opening broker trading to SPT will address a concern raised by members of their current exclusion from executing SPT trades.

5. STIPULATED TRADES (STIPS)

In the model of MBSD TBA Novation described above, all fully-matched netting-eligible TBA trades are automatically designated as TND. The FICC view, and one corroborated with the Industry Steering Committee, is that members will not want trades contracted with stipulations to be included in the TBA netting process. FICC intends to offer members a new service – a Stipulated Trading service (Stip service) that will differentiate stips from non-stips and will prevent stips from being incorporated into TBA netting. FICC expects members to include a “stip indicator” as a matching component of the input message.

Stips must be allocated against, and FICC will pass the allocation along to the relevant buyer. FICC will retain a link between the seller and buyer of the trade to offer the buyer the opportunity to validate the allocated pools against the terms of the trade. To ensure that the allocation is passed to the correct buyer, the seller will have to provide FICC with a unique identifier, such as a trade x-reference or a trade ID, on the EPN message. FICC will use this unique identifier to find the correct trade and its associated buyer. Post allocation, the pools associated with this service could continue to be submitted for Pool Netting if traded in a Pool Netting-eligible TBA CUSIP to get the benefit of Pool Netting on these allocations.

There are a number of products that are traded as TBA but are not currently FICC-eligible and will not be eligible for the TBA Netting and Novation service described in this document. These include products such as ARMs, 10-year TBA trades, etc. Although not Pool Netting-eligible, to offer a broader service, FICC will develop the stip service to include a wider number of TBA products and will publish a comprehensive list of acceptable products for matching by the service in a later document. Inclusion on the list is contingent upon FICC receiving accurate pool information and end-of-day pricing on the product to allow for appropriate risk management of the trade. All stips will settle versus FICC and all stips will be marked to a daily uniform price. The mark will be passed through daily as a cash movement.

Guarantee of Stipulated trades: FICC will offer two levels of guarantee on stips. Those that fall under a TBA CUSIP that is Pool Netting-eligible will be guaranteed at the TBA level. The guarantee will be provided on the underlying TBA trade terms and will not be extended to the specific terms of the trade when executed. In the case of a liquidation of a member, these trades of the surviving member will likely be converted to TND and included in the TBA netting process.

The obligations represents by stips traded in TBA CUSIPs that are not eligible for Pool Netting will be novated and guaranteed. The member will be guaranteed to be made whole through a cash settlement rather than through satisfaction of the position with securities, i.e., in the case of the liquidation of a member's position, the surviving member's trades will be liquidated for cash settlement.

Whether in a Pool Netting-eligible TBA CUSIP or not, all stips will be risk managed out to actual settlement date.

BENEFITS

A common theme in many of these proposals is the retirement of the NOS process. As with TND trades, because the obligations represented by these trades will novate versus FICC, they will not require NOS input. Again, FICC feels this benefits our members because it maintains one settlement process for all trade types and reduces operating costs.

The primary benefit of the service is, however, the novation of net positions and obligations versus FICC and receipt of the guarantee FICC is offering. This, accompanied by the opportunity to further reduce settlement costs and the effort to include allocated pools in the Pool Netting service, means that the service is not just a risk reducer, but that it also achieves efficiencies for members.

6. ENHANCED SERVICES FOR SPECIFIED POOL TRADES (SPT)

The initial development of SPT, introduced in June, 2007, allowed members to submit and match a TBA trade with a specified pool as one of the matching terms on the trade. The standard trade entry messaging and web input was modified to allow submission of the pool number and the associated final money. The goal of the initial offering was to create the groundwork and backbone of the SPT service with the idea that FICC would expand the service into new products as a second phase and provide a more comprehen-

sive service to our members. As part of the development initiative outlined in this document, FICC will complete the second phase of the SPT service by expanding it to support submission of SPTs beyond pools that fall under TBA netting-eligible securities and by offering submission of a bid-list for matching.

Eligible Pools for SPT trading: FICC has received multiple requests from members to expand the SPT service outside the range of TBA-eligible securities that are now acceptable for submission. Since there is a clear industry need to untie the relationship between a pool entered on the SPT to an MBS-eligible TBA CUSIP, FICC will modify the service to accommodate submission of trades without reference to a TBA CUSIP. This will greatly expand the types of securities against which members can submit SPT.

The limitations placed on trade input by SPT Phase 1 restrict FICC from servicing a portion of the trading activity seen in the market place today. These trades do not fall under our risk-management process and leave our members open to market events without the protection FICC offers through its mark-to-market process and margining tools. Our objective in this development is to accept the broadest set of MBS-derived pools as possible. All MBS pools will be acceptable in the service as long as FICC can attain reliable pool information and end-of-day pricing on the pools that will be used for risk management of the trades. It is anticipated that daily mark changes on SPT trades will follow the cash pass-through model outlined above in the TBA Netting and Novation section (section 2).

Guarantee of SPT Trades: FICC views SPT trades in two tranches: those trades with specified pools that fall under a TBA netting-eligible CUSIP (and eligible for TBA Netting and Novation) and those trades with specified pools that do not fall under a TBA netting-eligible CUSIP. The guarantee will differ depending upon the group to which a trade belongs.

FICC will guarantee SPT trades carried out in TBA netting-eligible securities under the same terms of guarantee as will be introduced with the implementation of Pool Netting in 2009 – namely that FICC will guarantee the TBA terms of the trade but not the specific pool named in the trade. The obligations represented by the SPT trades will be novated and, in the case of the liquidation of a member, the trades of the surviving member will be included in the net position to offset TND trades.

Trades matched in a non-TBA-netting eligible security will be guaranteed by FICC and the obligations represented by these trades will be novated. However, unlike the liquidation process described above, these trades will be settled for cash to the surviving member in the case of the liquidation of one of FICC's members. FICC will determine the fair market value of the securities.

Settlement of SPT trades: Although the obligations represented by SPT trades will novate and settle versus FICC, they will not net (except in the exceptional circumstances of a liquidation as described above). To ensure delivery of the securities, FICC will retain a link between the seller and buyer and, upon receipt of securities from the seller, will pass them directly to the buy counterparty. Settlement of the securities will be completed at the uniform price for that pool. As noted above, a cash pass through of the mark will be employed on a daily basis to account for differences in trade price versus the uniform price and, should the trade fail, a fail mark will be completed that also accounts for interest.

All SPT trades will settle versus FICC and, as such, FICC will know the settlement status of the trades. This makes NOS redundant and unnecessary and in view of this the service can, and will be, retired.

Bid-lists: FICC understands that a significant segment of the SPT market are trades executed as bid lists, whereby numerous pools and their associated values are traded specified against a single trade position. In SPT Phase 1, each of these pools is entered as a unique trade input despite the fact that in reality it is a component of a single trade.

As part of SPT Phase 2, FICC will develop a new input type that will allow entry of a trade with numerous pools underneath it. In other words, when a specified pool trade is executed in a bid list fashion, FICC will provide a matching service for the submission of bid lists. It is anticipated that this type of trade input will require a new message format as the existing SWIFT-based Interactive Messaging format will not support multiple entries in one message, nor will it support linked inputs. FICC will provide members with additional details on the format at a later stage.

The pools associated with the bid-list must satisfy the same criteria as an individual pool submission must meet, i.e., FICC must have reliable pricing on all pools within the submission in order to risk manage and guarantee the list effectively.

BENEFITS

FICC's directive is to offer innovative solutions that alleviate the risk exposure our members have to marketplace fluctuations. Offering a guaranteed, novated service in a broad number of securities will provide members with an improved risk model and will allow FICC to fulfill one of its fundamental services to the industry.

NOS for SPT will also be eliminated as part of this phase because all trades will settle versus FICC as CCP.

Finally, the expansion to handle bid list-type SPT trades will more accurately represent the way trades are processed in today's and in future trading environments. By capturing the trade in our systems as it is processed in the market, FICC will better align its systems to members' internal systems and provide a more transparent tie to their internal representation of such trades.

7. COMPARISON-ONLY SERVICE

In order to expand our member base and to equip existing members with a new tool to manage their trading activity, we will offer a comparison-only service that will function in at least two different fashions. Firstly, members could join the service and be eligible to submit and match comparison-only trades in any product that FICC supports. All existing members will also have the right to use this service to effect a match against a comparison-only account. Secondly, the service will include MBS products that are ineligible for any of the services mentioned above – for example, in cases that FICC cannot retrieve reliable pricing on the pool CUSIPs.

Comparison-only trades will not net, nor will they represent obligations with the clearing corporation. As such, they will not be risk managed. FICC will not require NOS against such trades, rather, upon reaching their settlement date, it is expected that these trades will drop off the system.

Early in 2008, FICC was asked by SIFMA to investigate the possibility of supporting an automated process for trade assignments. In considering how to resolve the SIFMA request, FICC determined that a potential solution would be to use a version of the proposed comparison-only service. To provide benefits to members and potential members, the input message will be modified to accommodate the terms needed on trade assignments, such as lender identity, par of the assignment (partials or full), and any other terms that will be needed on the message to make it a legally binding agreement. FICC sees significant importance to making the message legally binding, as this will allow users of the service to replace the assignment letter with an interactive message.

The trade assignment could be entered into in a number of ways. Firstly, a mortgage originator could match the terms of the assignment with an existing FICC member. This would be a one-sided submission that would simply match the terms of the assignment. An alternative solution would be to allow the mortgage originator to submit a two-sided submission, whereby it will identify itself and both the dealer members involved in the

trade assignment. The entry could be executed as a 'demand' trade, where the dealers are absolved from the burden of entering the trade, but can take action to DK it if the terms do not match what they know. If the dealer agrees with the submission, the trade will be compared as a part of the evening processing, otherwise it will not compare. It may be possible for the compared assignment between the dealers to then be dropped into the TBA Netting and Novation system to generate a matched trade that will follow the usual pattern for all TND trades. FICC will continue to work with its members to determine the best option(s) for this proposed service.

8. PRIME BROKERAGE

Since introducing a prime brokerage service in GSD, some MBSB members have expressed interest in developing a similar service for MBSB. The MBSB prime brokerage service will be modeled on the existing GSD service.

At a high level, transactions between executing broker dealer and prime brokers (PB) will be submitted to FICC for comparison. The PB will have two options when setting up a relationship with the PB Client in MBSB that will direct the type of trade processing that the PB Client can enter into. The PB will be able to set up the PB Client, using a specific symbol to represent the client, to be either netting-eligible (for both TBA and Pool Netting services) or comparison-only. TND activity matched in the PB Client will be included in the net position for the PB. FICC will guarantee settlement for its member, in this case the PB, if the trade is netting-eligible. In contrast, if the PB Client is comparison-only, the system will only accept trades for matching under the service and therefore will not be risk managed nor will the trade be incorporated into the PB's net position.

The PB will receive multiple sets of risk reports for the activity. Activity will be reported at the PB level and also for each individual PB Client. This will mean that the PB will see its overall exposure for the net position, but will also be able to tie back to the exposure each individual PB Client has brought into the system.

For example, if a member currently maintains three accounts in three separate aggregates where one account/aggregate is its primary proprietary account and the second and third accounts/aggregates represent two hedge funds for which they serve as PB, under the new PB service, the PB will close the second and third aggregates associated with the

hedge funds. The PB will then set up a relationship with the PB Client. If the PB determines that its relationships with both the hedge funds (the PB Clients) are designated as netting eligible, one net position will be calculated based on the activity of all three accounts. Alternatively, if one PB Client is netting-eligible but the other is comparison-only, then the trading activity of the netting-eligible PB Client will be included in the net position while the trading activity of the comparison-only PB Client will not be incorporated into the net position. If both the PB Clients are designated comparison-only, the trading activity will not be included in the net position.

BENEFITS

For the prime brokers, the set-up gives them the ability to consolidate activity under one account while retaining the ability to identify the risk of netting-eligible accounts through individualized reporting of exposure by PB Client account. In cases where the PB Client is netting-eligible, the PB will benefit from the potential offset of positions, an offset that is not currently available through maintenance of separate aggregates. It is anticipated that this will provide both allocation and settlement efficiencies to the market.

By consolidating the activity into one aggregate the member will see some savings charges applied monthly to maintain multiple aggregates. Members will also see a reduction in the minimum cash requirement that members must currently keep for each aggregate maintained.

9. SUBMISSION ELIGIBILITY SUMMARY

The chart below presents the type of service that a trade may be eligible for given the characteristics of the CUSIP that was used when executing the trade. As noted above, not all CUSIPs are eligible for all the services mentioned above.

	TND	Stip	SPT	Comparison-Only (Counterparty is comparison-only)	Comparison-Only (Security is comparison-only)
	Elegibility for Service				
TBA Netting-Eligible	Yes	Yes	Yes	Yes	No
Pool Netting-Eligible	Yes	Yes	Yes	Yes	No
Other eligible TBA CUSIP (ARM, 10 yr etc)	No	Yes	Yes	Yes	No
Non-TBA CUSIP (FICC has pricing on it)	No	Yes	Yes	Yes	No
Any other Mortgage CUSIP	No	No	No	Yes	Yes

10. MEMBER FEEDBACK

The above proposal has been vetted with a number of FICC members through the Industry Steering Committee and the CCP Working Group. While FICC will actively solicit input through the Industry Steering Committee and the CCP Working Group on an ongoing basis, given the scope of the initiatives and their impact on the industry as a whole, FICC is interested in receiving comments, questions and feedback on the proposal from its full membership and other interested industry members. To do so, please contact one of the following or any member of MBSD:

- Kate Connelly by telephone at (212) 855-7611 or via email to kconnelly@dtcc.com
- Sean Delap by telephone at (212) 855-7617 or via email to sdelap@dtcc.com
- Michele Hillery by telephone at (212) 855-7475 or via email to mhillery@dtcc.com
- George Parasole by telephone at (212) 855-7670 or via email to gparasole@dtcc.com
- Murray Pozmanter by telephone at (212) 855-7522 or via email to mpozmanter@dtcc.com

11. NEXT STEPS

In proposing the above initiatives, FICC is offering an innovative set of solutions that will result in enhanced processing efficiencies and a significant reduction in processing costs for its members. Additionally, these initiatives will provide a risk management and settlement solution that will create a more secure environment in which its members operate; however, the initiatives will require a significant commitment from FICC, its members and other industry participants on whom FICC members rely, such as service bureaus or vendors.

As work progresses we will issue a more detailed service description. Members are advised to closely follow new service announcements and other publications on this topic and to proactively contact FICC with any concerns or questions they may have.