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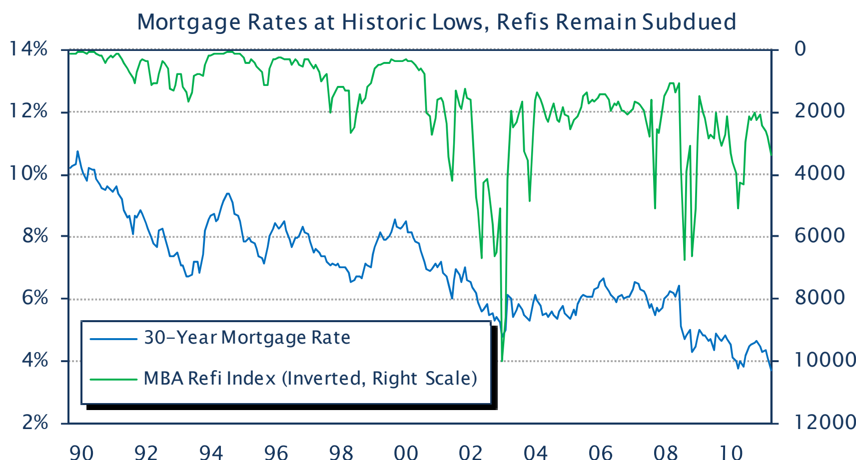
INVESTMENT UPDATE

The Congressional Budget Office (CBO) just released a paper that examined the feasibility and costs of a new program that would allow more homeowners to take advantage of today's historically low interest rates to refinance their existing mortgage loans and reduce their monthly payments. While there are obvious benefits to this type of plan (keeping more homeowners "in the game" being the primary goal), there are some serious side-effects that should give bondholders a great deal of concern.

As the chart on this page shows, in the current environment, homeowner refinancings of existing mortgages are a fraction of what one would expect given the ultra-low rates for mortgage loans (note that the Mortgage Bankers Association's Refinance Index, shown in an inverted scale, is far below its all-time highs, while 30-year mortgage rates have fallen below 4%, the lowest levels in more than fifty years). There are two primary reasons: First, many homeowners' balance sheets have been decimated in the recession, mainly due to home prices which fell 30% or more (much more in certain areas of the country) from their peak; when combined with reduced income levels nationally, the result is that many homeowners are not financially healthy enough to qualify for a new loan. The second reason is that the lenders themselves have raised their own requirements for who qualifies for a mortgage loan. Many of those who qualified in years past cannot get a loan today due to more stringent underwriting standards. In addition, home buyers today simply aren't offered the kind of "affordability products" that were available a few years ago, leaving fewer choices for homeowners seeking to refinance from an older, more expensive, mortgage loan.



If the idea of making refinancing more available sounds familiar, that's because there is at least one main government-sponsored program currently in place, although it has had limited success. One of the first moves the Obama administration made in early 2009 was to give Fannie Mae and Freddie Mac (two of the three mortgage "GSEs"—Government Sponsored Enterprises) the ability to extend streamlined refinancing to qualifying homeowners of GSE-backed mortgages. The program is called the Home Affordability Refinancing Program (HARP). It, and its sister plan, HAMP (the "M" in HAMP stands for "modification"), were designed to assist five million qualifying homeowners to refinance or modify their existing mortgage loans to reduce their monthly payments; unfortunately, the programs have fallen far short of that mark, with approximately 838,000 loans refinanced through HARP, according to the GSE's overseer, the Federal Housing Finance Agency. HARP is due to expire in June 2012.

Under HARP, homeowners who are currently paying their home mortgages can get a new, lower-rate mortgage, even if they have a second mortgage on the home, provided that the existing loan-to value ratio (LTV) of the home is less than 125%. In other words, if a homeowner hasn't gone more than 30 days past due on a mortgage payment in the last 12 months, and if they have no more than $100 in mortgage principal for every $80 in current home value, they can qualify for a new, lower rate mortgage. There may be fees involved, including appraisal and other legal fees, as well as fees charged by the underwriter, especially if the LTV is high and the borrower's FICO score is low.

While the government is behind the plan, it is still up to the homeowner to choose the lender (lenders are free to contact existing customers and offer the opportunity to refinance). But there are good reasons why these borrowers may still be turned away, even if they otherwise qualify under HARP. For instance, the lender must, under Freddie Mac's rules, accept the original mortgage lenders' "reps and warranties;" for example, if you are trying to refinance an existing mortgage through Bank of America, and the mortgage was originally provided by Citibank, BofA would have to rely on the original

documents in Citibank's files. In general, banks like to do their own "due diligence" and are (especially in this environment) reluctant to trust documents that are years old, and provided in a sunnier economic climate (not to mention the possibility of fraudulent or missing documentation). In addition, the new lender is on the hook for his own underwriting for at least the first 90 days—Freddie will guarantee the loan after 90 days, but if the borrower goes "toes up" before then, the new lender eats the loan.

To compensate for the additional risk, Freddie and Fannie have imposed additional interest rate charges ("loan level price adjustments") above the prevailing mortgage rates for refinancers with weak LTVs and credit scores. Even with an LTV as low as 90%, a homeowner will have to pay an additional 50 to 300 basis points (0.50% to 3.00%) in interest, on a sliding scale, the lower the FICO score is below 720 (the median score for US households).

Given these hurdles, is there any wonder that HARP has not been more successful? The loan level price adjustments, in particular, appear to be counterproductive. The loans already reside with Fannie and Freddie; why would they charge extra interest for rolling over a loan to an existing "customer" when the new loan will be more affordable and, thus, less likely to impose financial hardship on the borrower? If the borrower's FICO score is low enough, or LTV high enough, the extra interest rate charges can easily wipe out any interest rate savings, even in today's ultra-low rate environment. And this is before the appraisals, taxes and fees that refinancers already face when closing a new loan.

Now, of course, there are many benefits from a macroeconomic standpoint for encouraging homeowners with high interest rate mortgages to refinance. The extra savings from lower monthly principal and interest payments, when aggregated among a few million households, would have a measurable impact on the US economy. Moody's estimates that an expanded HARP program would add one quarter of one percent to US GDP growth. In addition, there are larger (and harder to measure) societal benefits to keeping homeowners from losing faith and walking away from a house that might be tens of thousands of dollars underwater: less disruption to families, fewer vacant homes in neighborhoods, and ultimately, more stable home prices.

In addition to (or perhaps the driving force behind) the CBO report, there are pending Acts in both houses of Congress, and studies by Moody's and Nomura Securities, among others, which propose changes to HARP to ease some of the impediments of the current program and expand the financing of home mortgages. Most of the remedies include either eliminating or relaxing the LTV requirements for borrowers who are deeply underwater, limiting or abolishing the interest rates and fees which are tacked on to the new mortgage (including the "loan level price adjustments"), and streamlining the underwriting process to eliminate some of the disincentives that keep lenders from refinancing existing loans (e.g., reps and warranties, mortgage insurance rollover, etc.).

For their part, the FHFA, the federal overseer of the GSEs, has only stated that they are "carefully reviewing the mechanics of the HARP program to identify possible enhancements that would reduce barriers for borrowers already otherwise eligible to refinance using HARP." In other words, they aren't terribly interested in making any changes to the program.

Which brings us to the other side of the discussion: What are the costs of an expansion of HARP, and who will bear those costs? The answer is straightforward: essentially all the costs will be borne by holders of Fannie and Freddie mortgage-backed securities (and GNMAs, too, if the FHA's refinance program is expanded). The costs will come as a result of increased prepayments, or early return of principal, for MBS holders. Let's back up quickly to explain.

In a typical, healthy, housing market, as we've seen, homeowner refinancing would be occurring at a very rapid pace with rates this low, and mortgage-backed securities would be experiencing high levels of prepayments; as an old mortgage loan is refinanced, the principal payoff is passed through to the bond holder. But with prepayments at historically low levels, the prices of MBS backed by higher-rate mortgages have spiked up, as investors have been willing to pay up for high interest income with little risk of early return of principal. But if barriers to refinancing are removed, refis will ramp up, and bondholders will experience a far more rapid return of principal, at par value, on bonds that have been trading at well above par. Worse, they will be forced to reinvest those dollars in an environment where yield is hard to find.

Currently, the average Fannie/Freddie mortgage pass-through security is trading at a price of $107 ½, near all-time highs. If the proposed changes begin to look more likely to be enacted, we would expect the prices of these agency backed MBS to drop, as their values are highly sensitive to prepayment rates. Fixed-rate FNMA and FHLMC pass-throughs, which represent approximately 25% of the Barclays Aggregate Index, have enjoyed excellent performance over the past few years, but that performance advantage could come to a crashing halt, as these changes represent a backdoor transfer of wealth from bondholders to underwater homeowners.

Those bondholders include investors (like Agincourt's clients), as well as the Federal Government, including the Treasury and the Fed, who have collectively purchased $1.2 trillion in MBS over the past three years. Under an expanded HARP, the GSE's are projected (CBO figures) to save $3.9B in credit guarantee exposure as fewer homeowners default, but the Fed and Treasury will lose an estimated $4.5B in the market value of their MBS holdings, with other investors losing $13B-$15B more.

As always, there is no free lunch.