NOVEMBER 2020

# INVESTMENT UPDATE

Now that the election is over (ha!), we can focus on another source of 2020-style craziness: the US home mortgage market. Residential mortgage rates are currently at their lowest levels since the Great Depression (and maybe before), due to a combination of anemic economic growth as well as the Federal Reserve's ongoing purchases of mortgage-backed bonds, both of which have driven borrowing costs down for anyone considering buying or refinancing a house.

Great, you say. Mortgage rates are low, other rates are low, that's good news, so what's the problem with you bond guys—can't you just enjoy one piece of good news at a time when good news has been a rare commodity? And the answer is "no." No, because these ultra-low rates just add to our misery. They cause our analytical models to crash, forcing our mortgage team to raise their slide rules to the heavens and rend their pocket protectors in frustration. Honestly, it's not a pretty sight, even on a Zoom call.

Today's home mortgage market—and by extension, the mortgage-backed securities (MBS) market—is not just characterized by low rates; it's undergone wholesale changes over the past dozen years or so. Some of this came about as a result of the global financial crisis, as new regulations turned the heat up on traditional banks and other depository institutions, including more stringent reserve and capital requirements that made it far less profitable to underwrite, hold, or even service existing mortgage loans.

| | Loans Originated, 2019 | | |
|---|---|---|---|
| | Home Purchase | Refinance | Total |
| Quicken Loans | 134,000 | 381,000 | 541,000 |
| United Wholesale Mortgage | 152,000 | 160,000 | 339,000 |
| Wells Fargo | 112,000 | 92,000 | 232,000 |
| JP Morgan Chase | 65,000 | 80,000 | 186,000 |
| Fairway Independent Mortgage | 94,000 | 33,000 | 147,000 |
| LoanDepot | 52,000 | 81,000 | 146,000 |
| Caliber Home Loans | 71,000 | 52,000 | 136,000 |
| Bank of America | 62,000 | 59,000 | 134,000 |

As the US housing market recovered in the aftermath of the crisis, both existing and potential home owners looking to finance the purchase of a home (or refinance an existing loan) found that banks were increasingly uncompetitive when compared to newer, "nonbank" mortgage rivals. The internet made it easy to shop for competitive terms, and companies like Quicken, United Wholesale, and LoanDepot responded by offering better terms and faster response times. Today, despite the continued presence of Wells Fargo, JP Morgan, and Bank of America in the mortgage market, nonbanks originate over 60% of the new mortgage loans in the US, and their market share continues to grow, at the expense of traditional deposit-taking institutions.

These smaller, more lightly regulated lenders are not just more nimble than the traditional banks, they have also done a better job of exploiting the benefits of online technology. Their focus is on transactions—earning the fees that come with the origination of new mortgages, including refinancing existing mortgages for current homeowners. In today's environment of ever-lower rates, they're able to use available data to pinpoint homeowners who will benefit most from refinancing, and offer them better terms on their existing mortgages, which can be done rapidly and remotely. As the chart below shows, Quicken, the largest originator, underwrote more than 540,000 loans in 2019, nearly 70% of which were taken out to refinance existing home mortgages. By comparison, for Wells Fargo, the largest lender among depository institutions, refinancings represented less than 40% of its mortgage originations in 2019.

While the technology is a boon for consumers, it has increased the risk for mortgage bond holders. That's because the biggest risk when buying agency-backed MBS (i.e., FNMAs, FHLMCs, and GNMAs), isn't the risk of default; these securities are guaranteed by the federal government to cover timely principal and interest payments every month. No, the biggest risk for holders of agency MBS is the risk that you get your principal returned sooner than you expected, due to prepayments. When interest rates decline, bondholders don't want their bonds redeemed for cash, since it limits the price appreciation of that bond (when interest rates fall, bond prices should be rising), and forces the bondholder to invest the proceeds at now-lower rates. Even worse, when interest rates are already low (like they have been for the past few years), MBS will be trading at a premium to par value; prepayments come in at par (100 cents on the dollar), resulting in capital losses.

This is a big deal for us, especially for our "core" bond portfolios, as MBS represent nearly 30% of the US Aggregate Bond Index, the primary benchmark for portfolios managed in this

strategy. In 2020, with rates at historic lows, MBS prepayments have soared as existing homeowners are refinancing their homes. When that happens, the old loan is paid off, creating a prepayment. When this happens *en masse,* MBS holders can experience prepayment waves that can return 50% (or more) of their principal in just a few months. Nonbanks, with the technology to pinpoint refinance candidates, and the motivation to earn mortgage origination fees, have added to the prepayment sensitivity of the US housing market. This is especially true for GNMA, which sources more than 85% of its loans from nonbanks.

Anything that increases prepayments, especially when interest rates are dropping, is bad news for MBS holders. And it's not just refinancing, and the associated prepayments, that's causing headaches for mortgage investors today. If it's 2020, there must be a COVID-related issue, and there is. One of the lesser-publicized aspects of the CARES Act, which was passed in March and designed to provide relief for US citizens during the pandemic, were two provisions protecting homeowners. First, the Act prohibits mortgage underwriters or servicers of agency-backed mortgage loans from initiating or finalizing a foreclosure on any homeowner until at least December 31, 2020. The second provision provides mortgage forbearance for any homeowner experiencing hardship from the pandemic for a minimum of 180 days (plus an additional 180 days, upon request); the mortgage issuer/servicer may not charge penalties or fees for missed payments, and may not charge for missed interest, although any missed principal payments must eventually be made up by the homeowner.

More than four million homeowners applied for relief after the program was announced, helping to prevent widespread foreclosures and eliminating, at least for a time, penalties for missing mortgage payments. Tossing families from their homes due to financial difficulties caused by an epic global health crisis, a crisis that impacts everyone, but which is ultimately far more destructive to those in lower income groups, is bad public policy. No arguments there. But, as mentioned above, when homeowners miss monthly mortgage payments, agency MBS holders are still entitled to receive these monthly payments. The CARES Act did nothing to modify this policy.

How have the three big MBS issuers been handling these payment deferrals, while keeping bondholders "whole" over the past few months? In a word, differently. Nearly all GNMA MBS are comprised of home mortgages that come through the Veterans Administration (VA) or Federal Housing Administration (FHA); these mortgages are typically offered to lower income and first-time home buyers, and are heavily non-bank underwritten and serviced. By contrast, FNMA and FHLMC pool their mortgages from a variety of bank and nonbank sources, which are, from a credit standpoint, of higher quality.

When a homeowner whose mortgage is in a GNMA pool asks for relief under the CARES Act, it falls to the loan servicer (again, very likely to be the nonbank which underwrote the loan in the first place) to deal with the homeowner. GNMA allows these servicers considerable flexibility in dealing with borrowers; for instance, once in forbearance, the servicer can select individual loans for special servicing, and modify the loan. If the servicer determines that the borrower will not be in a position to resume timely payments, the loan will be removed from the GNMA pool, and the bondholder will receive the prepayment of the remaining principal value. While the servicer is also typically responsible for making up the lost interest owed to the GNMA bondholders for up to 12 months, servicers will eventually be reimbursed by either the FHA or VA for these out of pocket expenses. But the important point here is that GNMA MBS have experienced much faster prepayments over the past few months than those issued by FNMA and FHLMC, as GNMA's servicers have been more active, and are given much more flexibility, to pick out and modify troubled loans. This, on top of the fact that the mortgage loans that go into GNMA's FHA and VA loans are from lower income borrowers, with higher default rates (and prepayments) in any recession.

Meanwhile, FNMA and FHLMC's administration of their MBS pools is far more orderly, as FNMA and FHLMC, not the mortgage servicer, retain control of what loans get bought out of MBS pass-throughs. There's less of a motivation for a quick resolution (and new origination fees) when compared to a nonbank servicing GNMA loans. And since FNMA and FHLMC's mortgage loans are more likely to have been originated by a large, traditional bank, there's greater financial stability underpinning the underwriting function. Yes, due to low interest rates, even Fannie and Freddie are seeing high prepayments, but the wave is more predictable and manageable for a bond portfolio manager.

One solution to all this mess, for investors who must hew somewhat closely to a mortgage-heavy index, is to simply avoid GNMAs for the time being. That's a perfectly reasonable response, and GNMAs relatively poor performance since March (trailing like-duration FNMA and FHLMCs by 60 to 70 basis points) reflects mortgage investors' lack of enthusiasm for taking a chance that GNMA prepayments will slow. Even for value investors, like Agincourt, who believe in going against the grain if it means enhancing returns for our clients, GNMAs still look like a bad bet. Fee-hungry nonbank servicers pulling loans out of pools is exacerbating an already bad situation, leading to prepayment spikes over already-inflated, refinance-driven prepayment levels.

Hopefully, COVID vaccines will be effective next year in bringing down the risk of infection, businesses and households will be on steadier footing, and programs to assist homeowners can be safely phased out. Even then, structural issues in the MBS market will continue to pose challenges to MBS investors. It's complicated stuff, and not a lot of fun to read about, so please call or email if you have any follow-up questions. Our mortgage team — and their slide rules—are here to help!