

## Agency MBS Weekly

### Election outcome may drive policy risk

- **Market Overview:** 30-yr Production coupon MBS underperformed treasury hedges by 2-5 ticks (Thursday-Thursday close). Hurricane Sandy disrupted trading activity and led to fixed-income markets closing early on Monday and remaining closed on Tuesday. The MBA conventional refi index declined by another 6% and registered its fourth consecutive drop. The index has declined by approximately 24% since reaching multi-year highs at the end of September even though mortgage rates have sold off by only 3-4bps.
- **Sandy's Impact on Prepays:** We expect prepayment speeds for October to be lower by 2-3% due to the hurricane. Thus, we are reducing our forecast for the upcoming factor release from up 10-15% to up 7-13%. Note that the impact should be temporary and November/December prepayments should make up for the artificially lower October speeds. Further, the prepay impact on pools with a large concentration of loans from the north-east (specifically New York and New Jersey) is likely to be larger in October.
- **Elections and the MBS Basis:** We think that either a Romney victory or a narrow Obama victory could lead to a break-out of the range for the 10-year Treasury. In the short-term, a Romney win could lead to a 20-25bp selloff in Treasuries and pressure the MBS basis. However, the higher yields are likely to attract bank and REIT buying. At the same time, we assign a very low likelihood to the Fed stopping their QE3 purchase program before the end of 2013 even if Romney wins. Thus, over the longer-term, the MBS basis should perform well versus Treasuries even in this scenario.
- **Policy Risk to Prepayments:** We think it is very unlikely that president Obama would replace Ed DeMarco in the short-term. However, if he is re-elected, there is a possibility of a change at the helm of FHFA towards the middle of next year. If Romney is elected, we assign a low likelihood to Ed DeMarco being replaced. We expect that some minor tweaks to HARP will be on the cards even if Ed DeMarco is not replaced. There has been significant opposition to a change in the HARP cutoff date both within FHFA and in the MBS investor community. In the base case, we assign a low likelihood to the cutoff date being changed. However, if Ed DeMarco is replaced and if the housing market and the overall economy continue to struggle next year, policy is likely to be driven by what benefits the homeowner/borrower. Since the HARP eligible population is declining rapidly, one could make a compelling case for the cutoff date to be changed in this scenario. Finally, there is also the possibility of a re-introduction of the streamline refinance program that Fannie and Freddie had in place prior to the unveiling of HARP.

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## Market Overview

30-yr Production coupon MBS underperformed treasury hedges by 2-5 ticks (Thursday-Thursday close). Hurricane Sandy disrupted trading activity and led to an early close on Monday and full close on Tuesday. The MBA conventional refi index declined by another 6% and registered its fourth consecutive drop. The index has declined by approximately 24% since reaching multi-year highs at the end of September even though mortgage rates have sold off by only 3-4bps.

The presidential elections next week is likely to impact both the rates and MBS market. We think that an Obama win will be positive for MBS whereas a Romney win may cause a selloff and lead to a short-term widening of the basis. Over the longer-term, we remain positive on MBS even if Romney wins. Apart from the basis, the results of the presidential elections could also dictate policy risk in prepayments. We discuss this topic in more detail later in the weekly.

## Hurricane Sandy's Impact on Prepays<sup>1</sup>

Hurricane Sandy wrecked havoc in the north-east over the past few days impacting 50 to 70 million people and causing billions of dollars in damage. The storm also resulted in significant flooding and power loss in New York and New Jersey. Although it is difficult to assess the exact impact, we think it is fair to assume that lenders in the storm affected areas were unable to complete closings in the final three days of the month. This would effectively reduce the number of business days corresponding to October prepayments from 22 to 19 for those severely impacted by the storm. Overall, we expect prepayment speeds for October to be lower by 2-3% due to the hurricane. Thus, we are reducing our forecast for the upcoming factor release from up 10-15% to up 7-13%. Note that the impact should be temporary and November/December prepayments should make up for the artificially lower October speeds. Further, the prepay impact on pools with a large concentration of loans from the north-east (specifically New York and New Jersey) is likely to be larger in October.

Unlike Katrina, where we saw a mass exodus of people from the area, we expect the impact of Hurricane Sandy to be more muted. As homeowners get reimbursed by insurance companies, they are more likely to rebuild their homes than payoff their mortgage. Thus, we should see a minimal impact on turnover/buyouts over the next couple of months.

## Elections and the MBS Basis<sup>2</sup>

As the presidential election race has gotten tighter over the last few days, investors are starting to assess the impact of different outcomes on the rates and MBS markets. While there are endless permutations of potential outcome, three general outcomes that have meaningful chances are:

- **Romney Wins:** Our rates strategists think this could take 10yr Treasury yields higher, fairly quickly. This will increase the likelihood of an easy fiscal negotiation. It even brings in the possibility, however slight, of a grand bargain. Further,

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<sup>1</sup> A majority of this section is a reprint of the Agency MBS comment published on November 1 2012

<sup>2</sup> This section is a reprint from our last Agency MBS weekly published on October 26 2012

discussions of Fed leadership changes in 2014 may lower expectations of the Fed being on hold until 2015.

- **Obama Wins - Fiscal Negotiations Acrimonious:** Obama could win in a relatively tight race and stick with his recent reported position of vowing to veto any bill that gives tax cuts to the rich. This could be matched by a House of Representatives that remains Republican and will send him such a bill anyways. While this outcome may not be immediately obvious on Election Day, it could creep into market expectations in the weeks following.
- **Obama Wins – Quick Deal:** Alternatively, both sides could be more accommodating following the election and a compromise could be reached prior to January. This would likely move rates modestly higher, but not necessarily out of recent ranges.

Looking at it this way, the two most likely outcomes could lead to a break-out of the range for the 10-year Treasury. In the short-term, a Romney win could lead to a 20-25bp selloff in Treasuries and pressure the MBS basis. However, we think the higher yields are likely to attract bank and REIT buying. At the same time, we assign a very low likelihood to the Fed stopping their QE3 purchase program before the end of 2013 even if Romney wins. Thus, over the longer-term, the MBS basis should perform well versus Treasuries even in this scenario.

## Policy Risk to Prepayments

Last Wednesday, the Financial Times reported that Edward DeMarco, current acting director of the FHFA, could be replaced if Obama wins re-election. The news article reported that administration officials have asked housing groups to supply a list of potential candidates, and are weighing how and when to make a “recess” appointment which would bypass congressional approval. A change at the helm of the FHFA could once again elevate policy risk for prepayments in the agency MBS sector. In this article, we assess the likelihood of such a change and the possible policy/underwriting changes that could take place if it happens. We focus on changes to the refi program rather than discussing the possibility of principal forgiveness. Although the latter might have an impact on housing, we expect a minimal impact on prepayments since principal modification is likely to take place for delinquent loans, which in the case of agency MBS are bought out from the pool anyway. Our key takeaways are as follows:

- **Election outcome and policy risk:** We think it is very unlikely that president Obama would replace Ed DeMarco in the short-term. However, if he is re-elected, there is a possibility of a change at the helm of the FHFA towards the middle of next year. If Romney is elected, we assign a low likelihood to Ed DeMarco being replaced.
- **Expect continued relaxation of HARP underwriting:** Given that the FHFA has consistently been trying to make it easier for HARP borrowers to refinance over the last year, we think that some minor tweaks to HARP will be in the cards even if Ed DeMarco is not replaced. This could lead to an increase in prepaids on slower servicers like Bank of America. The impact on Wells and Chase serviced loans should be minimal. Although we think HARP speeds have peaked, further changes could reduce burnout in these pools.
- **Changes to the HARP cutoff date:** There has been significant opposition to a change in the HARP cutoff date both within the FHFA and in the MBS investor

community. Any change in the date is likely to dent investor confidence in the market, lead to losses on MBS<sub>1</sub> and lead to higher mortgage rates for borrowers, all else being equal. In the base case, we assign a low likelihood to the cutoff date being changed. However, if Ed DeMarco is replaced and if the housing market and the overall economy continue to struggle next year, policy is likely to be driven by what benefits a majority of the homeowners/borrowers. Since the HARP eligible population is declining rapidly, one could make a compelling case for the cutoff date to be changed in this scenario.

- **Re-introduction of the streamline refi program:** Fannie and Freddie could re-introduce the streamline refi program which existed prior to the introduction of HARP. This program had more restrictive requirements on LTV, MI portability and appraisals than HARP. FHFA may re-introduce the program with the ability to use automated appraisals and offer rep and warrant relief which is similar to HARP. If these changes are made, it could have a meaningful impact on post-May 2009 loans with a mark-to-market LTV less than 95%.

## Election Outcome and Policy Risk

We outline our expectations for the likelihood of a change in the FHFA directorship based on the outcome of the election below:

**Obama win:** Similar to any other administration, President Obama would like to fill vacant positions, including the FHFA directorship, in his new term. It is worth highlighting that there is currently no nominee for this position and a recess-appointment of someone who has not even been nominated would be a far more aggressive move than the recess appointment of Richard Cordray as the head of CFPB earlier this year. It would be extremely antagonistic to the Congress and come at a very high political cost at a time when the President will need all the political capital he can muster to work a deal over the fiscal cliff and debt limit. Thus, we think it is very unlikely that a new FHFA director will be appointed in the short-term. That said, we do think that the Administration could officially nominate someone early next year, sending a nomination package to the new Congress, after which hearings would likely be scheduled and held. If Republicans remain recalcitrant, it is not impossible to imagine a recess appointment but we think this is a remote likelihood until at least the middle of the year given all the other nominations a new Administration will need to get through Congress.

**Romney win:** It is likely that Ed DeMarco will continue as the FHFA director if Romney wins. There is an outside chance that President Obama attempts to nominate someone in the lame-duck session and push for a recess appointment during Christmas. However, this would need to be preceded by conclusive negotiations on the fiscal cliff and debt limit and we assign a very low likelihood to it.

## What could Change?

There have been numerous changes to the HARP program since it was introduced in early 2009 (Figure 1). Apart from the changes to the sunset date and initial increase of the LTV cap from 105% to 125%, the biggest change took place in October last year when the program saw an overhaul to HARP 2.0. Even though FHFA said at that time no further changes would be made, we have seen a slow but consistent move towards making it easier for HARP eligible borrowers to refinance. The most recent piece of legislation which aims to improve HARP has been the

Boxer-Menendez bill. Note that in the latest version, the language requiring an extension of the cutoff date from May 2009 to May 2010 was removed due to strong opposition from the MBA, SIFMA and ASF. However, the slew of changes to HARP over the last year does show that the FHFA and the GSEs are consistently working towards making HARP more efficient. We discuss three possible changes that could make it easier for borrowers to refinance in the following section.

**Figure 1. There have been constant changes to HARP since its introduction in 2009**

Date	Change	Summary
Mar-09	HARP introduced	Borrowers with LTV as high as 105% eligible to refinance without a new Mortgage Insurance; No payment delinquencies allowed in past 12 month, appraisal waivers fairly difficult, higher fees
Jul-09	HARP LTV ceiling raised	HARP LTV ceiling raised from 105% to 125%
Mar-10	HARP sunset date extended	Extended by 1-yr to June 30, 2011
Mar-11	HARP sunset date extended	Extended again to June 30, 2012
Mar-11	HARP cutoff eligibility changed for Fannie Mae	Fannie Mae moves HARP cutoff eligibility from March 2009 to May 2009
Oct-11	HARP 2.0 introduced	Program sunset date extended to December 31, 2013; Elimination of 125 LTV cap for fix-rate borrowers; Waiving reps and warrants; reduction/elimination of LLPAs; greater use of AVM; streamlining refi process; allowing solicitation
Dec-11	Fannie eliminates "ability to repay" language	For Refi Plus, the lender is no longer required to determine the borrower has a reasonable ability to repay the mortgage based on a review of the information provided on the new loan application
Apr-12	Boxer-Menendez Bill Proposed	Proposals include: Change HARP eligibility date to May 31, 2010; removal of delivery fees; use of AVMs to reduce cost; modify rules based on employment status, income; require mortgage insurers to carry over MI to new loan; equalize cross-servicer reps and warrants to same servicer refis; resubordination of second liens; GSE to notify borrower of eligibility
May-12	Income documentation relaxed	Reduced income documentation for DU Refi Plus and Refi Plus mortgage loans
Jul-12	Reps and Warranty	Freddie Mac announced Reps and Warranty relief on existing loan for LTV <80, align requirements of loans with LTV <80 to those with LTV>80 under HARP 2.0
Jul-12	Cross servicer refinancing	Steps to be taken to encourage more Cross servicer refinancings
Sep-12	FHFA introduces new rep and warrant guidelines	Aims to clarify lenders' repurchase exposure and liability on future deliveries. Effective Jan 1, 2013, rep and warranty relief for non-HARP loans with 36-months of consecutive, on-time payments. HARP loans will be eligible for rep and warranty relief after an acceptable payment history of only 12 months following the acquisition date.

Source: Citi Research, Fannie Mae, Freddie Mac

### More Changes to HARP Underwriting Standards

We expect that some minor tweaks to HARP will be in the cards even if Ed DeMarco is not replaced. As highlighted in Figure 1, the FHFA has consistently tried to make it easier for existing HARP borrowers to refinance and over the last year we have seen further changes to the new HARP guidelines in the form of less documentation checks and more rep and warrant relief (starting early next year). We expect this push to continue with a specific focus on cross servicer refinancings as same servicer refinancings seem to have picked up significantly over the last year.

Currently, one of the biggest hurdles to cross-servicer refinancings is the limited sharing of borrower information across lenders. If the GSEs figure out a way to

share information more efficiently across lenders, we could see a pick up in prepayments for servicers whose speeds have not increased materially after HARP 2.0 was implemented. Bank of America is the most notable of these servicers. We don't expect prepay speeds on Wells and Chase serviced loans to pick up even if this change is implemented as they seem to have courted their existing borrowers fairly aggressively. Even though we think HARP speeds have peaked, any further easing of underwriting standards could reduce burnout on HARP eligible pools going forward.

### **Will the Cutoff Date be in Play?**

A change in the cutoff date presents the biggest policy risk to the MBS market. FHFA acting director Ed DeMarco has been cognizant of investor concerns and he has been very vocal about his opposition to a change in this date. However, a change at the helm of the FHFA could at the very least re-ignite a debate on this topic. It is well known that the non-HARP eligible vintages have been prepaying much slower than the HARP eligible loans. Some of this is due to the more streamlined refinance guidelines of HARP but another contributing factor is the inability of high LTV borrowers to refinance without a new MI policy. Another contentious issue is whether borrowers who have gone through HARP once should be allowed to do so again. We broadly discuss the pros and cons of a change in the cutoff date below.

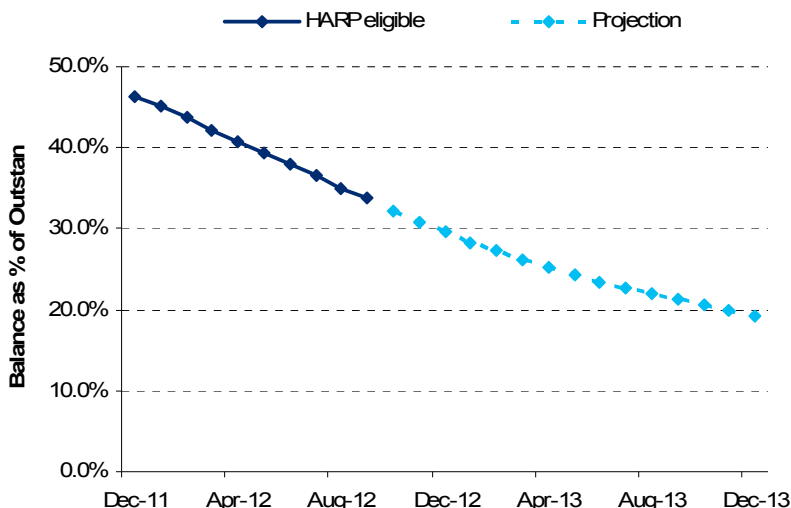
#### **Reasons why cutoff date should not be changed:**

- **Investor losses:** A large portion of the agency MBS outstanding at this point is not eligible for HARP. If these loans are made HARP-eligible, prepayments could spike and given the agency MBS universe is trading at an average dollar price of \$108, this could lead to severe losses for investors.
- **Ad-hoc changes to underwriting:** Investors bought MHA pools with the understanding that the HARP cutoff date will continue to be May 2009. These bonds are now trading at significant payups and a change or removal of the cutoff date is likely to wipe out the call protection offered by these pools. Further, the constant change in underwriting makes it very difficult to appropriately price the prepay option and investors are likely to start assigning a premium on new issue MBS to account for this uncertainty. Eventually, this would result in higher mortgage rates for borrowers, all else being equal.
- **Private participation may be hampered:** The GSEs will continue to be the dominant force in the mortgage origination process if all existing loans become HARP eligible. This could hamper private market participation in the mortgage market.
- **Focus may move from seasoned high coupon borrowers to new borrowers:** If the HARP cutoff date is moved forward or removed, lenders may start focusing on lower coupon newer borrowers due to capacity constraints. This would also eliminate payups on MHA pools giving lenders a lower incentive to target higher coupon pre-2009 borrowers.

### Reason why cutoff date could be changed:

- **HARP eligible population is shrinking:** We think the most compelling argument for a change in cutoff date comes from the fact that the success of HARP 2.0 is leading to a rapid decline in the HARP eligible universe (Figure 2). Currently, approximately 35% of the outstanding agency MBS universe is HARP eligible but by the end of next year, we expect it to decline to 20%. If the administration and FHFA want to make a change to underwriting such that it has a noticeable impact on housing and the economy, they may be forced to consider changing the cutoff date because only a small fraction of the agency universe will qualify for HARP by the end of next year if the cutoff date remains unchanged. Note that if housing improves, there may not be a need to make such a change.

Figure 2. HARP eligible population is declining rapidly



Source: Citi Research, Fannie Mae, Freddie Mac

- **30-year mortgage rates are much lower now:** When HARP was first introduced, mortgage rates were 5% and a large portion of high coupon borrowers (backing 5.5s and 6.0s) were unable to refinance. Mortgage rates have since rallied to 3.375% and now borrowers backing 4.0s and above are more than 100bp in-the-money but they continue to prepay below 35%CPR. A lot of the arguments made for introducing the original HARP can now be made to improve the refinancability of these recently originated loans as well.
- **Addressing private market participation:** As we argued above, an expansion of HARP may hamper private market participation in the mortgage market. However, a consistent increase in the g-fee can prevent this from happening. Once g-fee is high enough, borrowers with good credit and LTVs will start being underwritten through the private market whereas credit impaired borrowers who are stuck in their loans due to very high LTVs will still get a change to refinance into a lower GSE loan thus reducing the credit risk on the books of Fannie and Freddie.



- **Benefit to taxpayers:** As insurer of loans, the GSEs have a strong incentive to make it easier for borrowers to refinance into mortgages that are more affordable. Although difficult to quantify, a lowering of mortgage payments should reduce defaults on loans guaranteed by the GSEs, all else being equal. Further, the GSEs will now be able to charge a higher g-fee on these refinanced loans which will result in increased revenue. Lastly, most of the MBS held by the GSEs in their mortgage portfolio were issued prior to 2009 so their investment losses should be minimal.
- **Capacity:** The lower underwriting requirements and streamline nature of HARP should help alleviate capacity constraints even though the number of loans being underwritten may increase significantly.

We think there is a fair amount of opposition to a change in the cutoff date both within the FHFA and in the investor community and in the base case scenario, we assign a low likelihood to it being changed. However, if Ed DeMarco is replaced and if the housing market and the overall economy continue to struggle next year, policy is likely to be driven by what benefits a majority of the homeowners/borrowers. In this scenario, one could make a compelling case for the cutoff date to be changed. If the cutoff date is completely removed, it would lead to a significant increase in post-May 2009 prepaids in general and MHA pools in particular.

### Re-introduction of the Streamline Refinance Program

Both Fannie and Freddie had their own streamline refi programs prior to the introduction of HARP. The major difference between these two programs is highlighted in Figure 3. The three key differences worth elaborating are as follows:

- **LTV restriction:** the streamline refi program could be used to refinance loans with LTV as high as 95-100% whereas HARP has no LTV restriction on fixed-rate loans.
- **MI on the new loan:** HARP does not require a new MI policy on the loan whereas in the case of streamline refi, the standard MI policy was applicable.
- **Automated appraisal:** HARP allows automated appraisals whereas streamline refinancing required a new appraisal.

Overall, the streamline refi program was a lot more restrictive than HARP. We think that if it is re-introduced, FHFA could allow the use of automated appraisals to make the program more efficient. However, GSE charter restrictions may prevent the program from carrying over the old MI policy to the new loan (similar to what is done in the case of HARP). FHFA may also allow borrowers to do streamline refi multiple times and offer rep and warrant relief which is similar to HARP on these loans. If these changes are made, it could have a meaningful impact on post-May 2009 loans with a mark-to-market LTV less than 95%.



**Figure 3. Streamline Refi requirements were more restrictive than HARP**

<b>Underwriting</b>	<b>HARP 2.0</b>	<b>Streamlined Refinancing</b>
Prior Payment History	Current over past six months and one delinquency in last 12 months	Current over past three months and one delinquency in last 12 months
Income/Employment Verification	Stated income/employment	Stated income/employment
Property Appraisal	Automated appraisal	Manual appraisal
Reps and Warrants on Old Loan	No reps to the original loan other than fraud	Any previous rep and warrant relief on original loan does not apply to new loan
Max LTV	Unlimited for fixed-rate loans	Generally under 95-100%
Eligibility	Pre May 2009 loans	Original loan needs to be full documentation so borrower can only do one streamline refi
Mortgage Insurance	No new MI required	Standard MI requirements are applicable

Source: Citi Research, Fannie Mae, Freddie Mac

## Appendix A-1

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