

# Policy Risk in the Agency MBS Market: Increasing the Effectiveness of HARP

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**The Home Affordable Refinance Program (HARP) was introduced in 2009 to provide high—LTV borrowers an opportunity to refinance into a lower mortgage rate. As of June 30, 2011, this program has helped roughly 840,000 borrowers refinance. Though not insignificant, this number still falls well short of the 4 to 5 million high LTV borrowers that the Administration originally hoped to help. Since early September, policymakers have clearly signaled their intention to carefully review the mechanics of this program to identify possible enhancements. In our view, there is considerable risk of changes to HARP that accelerate prepayments more than the market expects, and thus we have an underweight to higher coupon MBS in favor of lower coupon MBS. In the remainder of this paper, we elaborate on this view.**

## Introduction

The rally in the bond market has pushed the dollar price of the Agency MBS index to roughly \$108. At such a high dollar price, MBS valuation is quite sensitive to the associated prepayment assumptions. For example, all else being equal, if the market came to expect 10 more borrowers out of every 100 to refinance over the next year, that would lower the dollar price of the index by \$0.80, which is roughly equivalent to a spread widening of 25 basis points.

Several weeks ago, we began increasing the probability we assign to the implementation of a government policy change that accelerates prepayments, and thus puts downward pressure on MBS prices. In general, we have long held the view that the worse the economic outlook gets, the greater the policy risk in the MBS market. There were three main considerations that caused us to upgrade this risk most recently:

1. The 30-year mortgage rate had fallen to about 4.125%, nearly the lowest level in at least 50 years.
2. The probability of a recession had risen significantly, with job growth sputtering, consumer confidence low, fiscal stimulus lacking bipartisan support, and monetary policy under increasing criticism.
3. President Obama is facing a difficult reelection campaign, and would welcome any boost to his standing. Lower borrowing costs could put a few thousand extra dollars into the pockets of many voters. This would provide stimulus without extra Federal spending.

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All Figures in US Dollars

The counterargument was, and continues to be, that the conservator of the Government Sponsored Enterprises (GSEs), namely the Federal Housing Finance Agency (FHFA) has a statutory requirement to preserve and conserve GSE assets. To date, the FHFA director, Edward DeMarco, has been true to this mandate, resisting pressures to use the GSEs as a tool of public policy. However, since we took our more cautious stance, the risk of a FHFA—supported policy change has come into increasing focus by three events:

1. On September 7, the CBO released a report entitled “An Evaluation of Large-Scale Mortgage Refinancing Programs.”<sup>1</sup> This paper, which came as a surprise to the market, analyzed a stylized large-scale mortgage refinancing program that would relax current income and loan-to-value restrictions for borrowers who wish to refinance and whose mortgages are currently insured by Fannie Mae, Freddie Mac, or the Federal Housing Administration.
2. On September 8, before a joint session of Congress, President Obama unveiled a \$447 billion jobs bill, and also made allusion to a plan to allow millions of eligible borrowers to refinance their mortgages at current rates. The timing between the CBO paper and the President’s speech was likely much more than a coincidence.
3. On September 9, FHA Director Edward DeMarco, issued a statement<sup>2</sup> indicating this his Agency was “carefully reviewing the mechanics of the Home Affordable Refinance Program (HARP) to identify possible enhancements that would reduce barriers for borrowers already otherwise eligible to refinance using HARP. If there are frictions associated with the origination of HARP loans that can be eased while still achieving the program’s intent of assisting borrowers and reducing credit risk to the GSEs, we will seek to do so.”

While these events have certainly created a lot of chatter and speculation in the market regarding the nature of any HARP changes, the price action has still been relatively muted. In particular, the Street has been downplaying the likely impact of any HARP changes, and are touting the cheapness of higher coupon MBS. However, this sanguine outlook must be viewed skeptically, because the Street is long a considerable amount of prepayment—leveraged risk in the form of interest-only (IO) securities and inverse IO securities, both of which depend on slow prepayments to preserve their value. In contrast to the Street, we think there is considerable risk of changes to HARP that accelerate prepayments more than the market expects.

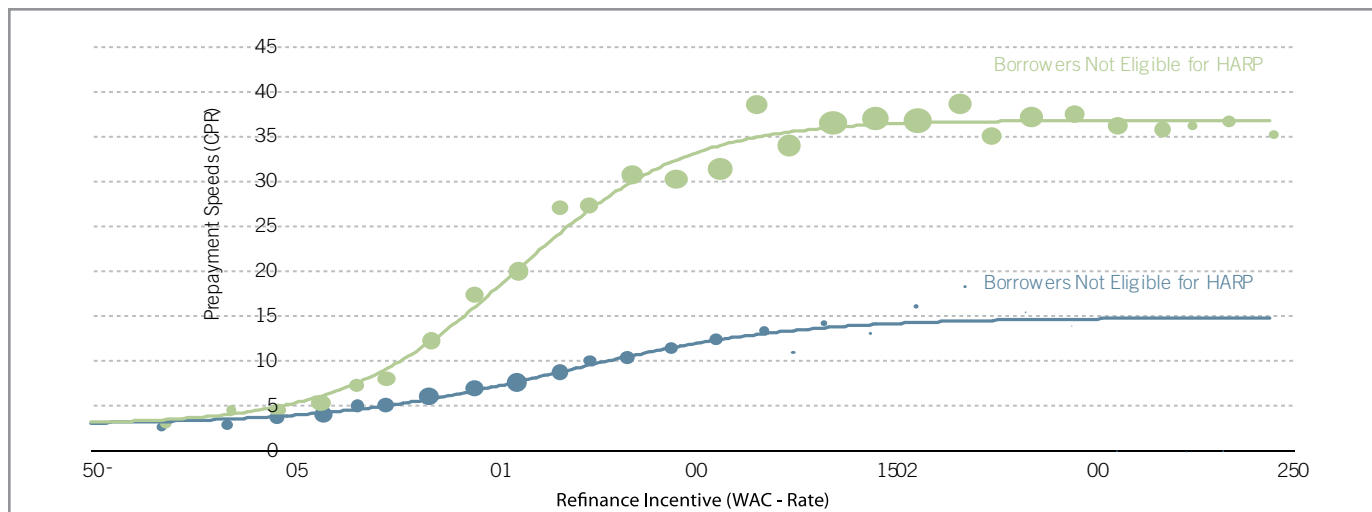
## Review of HARP

HARP<sup>3</sup> was introduced in 2009 to provide high-LTV borrowers an opportunity to refinance into a lower mortgage rate, in an effort to avoid future mortgage defaults, and thereby reduce credit losses for Fannie Mae and Freddie Mac. The program covers only mortgages owned or guaranteed by Fannie Mae or Freddie Mac, and originated before June, 2009. To be eligible, borrowers must be current on their payments and have a current loan-to-value (LTV) ratio less than 125%. An essential feature of this program is that it allows borrowers to carry forward into the new loan any existing private mortgage insurance from the prior mortgage; also, if no mortgage insurance existed on the original mortgage, then none is required for the refinanced mortgage.

As of June 30, 2011, this program has helped roughly 840,000 borrowers refinance. Though not insignificant, this number still falls well short of the 4 to 5 million high LTV borrowers that the Administration originally hoped to help. There are four main frictions that may be limiting HARP’s effectiveness<sup>4</sup>.

1. Putback risk. This risk arises from the possibility that the loan originator may have to repurchase a defaulted loan from the GSEs if the underwriting violated GSE guidelines. Although HARP guidelines do not require lenders to verify all aspects of a borrower’s application, lenders who process the HARP refinancing can have putback risk both from the refinance and the original underwriting, even if the refinancing lender did not underwrite the original loan. To date, the GSEs have been aggressive in pursuing legal action against loans that have defaulted. This posture by the GSEs has made banks much more cautious in their origination process, particularly for HARP loans, given their inherently higher credit risk.
2. Loan-level pricing adjustments. These are the upfront fees that are added to the refinancing costs of loans that are judged to be more risky, e.g., loans with LTVs above 80% or for borrowers with low credit scores. Risk-based pricing is a standard risk-management tool, but it does not necessarily make sense for the refinance of loans for which the GSEs are already exposed to principal loss. Furthermore, these fees can increase the cost of refinancing by thousands of dollars and thus discourage borrowers from participating in the HARP program.
3. Second liens. In some cases, holders of junior liens are refusing to allow their loans to re-subordinate the refinanced first lien, thus impeding the HARP process.
4. Mortgage insurers. In some cases where the original loan had associated mortgage insurance, the insurers are not agreeing to re-underwrite their policies despite presumably diminished default risk after the refinancing.

## EXHIBIT 1: PREPAYMENT SPEEDS AND HARP PROGRAM ELIGIBILITY



Source: eMBS and Fidelity Asset Management as of September 2011.

In addition to these HARP—specific frictions, the capacity of the mortgage banking industry is at a multi-year low. Despite low rates and high up—front margins, originators appear either unwilling or unable to increase capacity.

Finally, we reiterate that loans originated after June 2009 are not HARP eligible. This distinction between HARP eligible and ineligible loans has a big impact on security valuation, as evidenced by figure on the next page. This figure compares the prepayment responsiveness of high loan—to—value borrowers eligible for HARP (red line) versus ineligible for HARP (blue line). The horizontal axis quantifies the incentive to refinance, while the vertical axis quantifies the associated prepayment speed. For example, at an incentive of 100 basis points, roughly 35% of HARP eligible borrowers will prepay on an annualized basis, while only 10% of HARP ineligible borrowers will prepay.

### Possible Refinements to HARP and Their Implications

We believe that the FHFA will make the following changes to the HARP program.

First, and most significantly, we think they will waive the putback liability on loans that have been current for a significant time, say three years. The CBO report referenced in the Introduction would appear to provide the FHFA with a rationale for making this change. In particular, this report had the following key findings:

- The net cost to all federal agencies would be \$600 million.
- There would be \$7 billion in savings for borrowers in the first year, an annual saving of \$2,000 for the average borrower
- The total cost to non—federal holders of mortgages would \$13-15 billion.
- Waiving their legal right on put backs would cost the GSEs \$100 million. Importantly, however, the net impact on the

GSEs would be positive as credit losses would be lower which offsets the negative impact on the GSEs portfolios from faster prepayments.

If loan originators got relief on putback liability, that change would most significantly accelerate prepayments on the 30-year Fannie Mae and Freddie Mac 5.5 and 6 coupons. This change would have a smaller impact on lower coupons, where the credit quality of the borrowers is generally better and so the perceived putback risk is lower. In our opinion, this change has started to get priced into the market, though it has the potential to go much further, as many market participants remain skeptical that this policy change will happen.

Second, we think the FHFA will announce efforts to streamline the re—subordination of second liens and the transfer of mortgage insurance from one loan to the next. Again, this would have the biggest impact on 30-year 5.5 and 6 coupons.

Third, the FHFA might reduce the upfront LLPA fees for HARP loans. We assign a lower probability to this change, primarily because the Director of the FHFA has continued to advocate for higher fees, not lower fees, in order to bring private capital back into the mortgage market. This change would hurt 4.5s and 5s the most.

Fourth and also less likely, the FHFA could expand HARP eligibility to include loans with LTVs greater than 125. As DeMarco has said, “there are several challenging issues to work through here and the outcome of this review is uncertain. Even if this change were made, we think it would have a relatively muted impact on the market, since only a small percentage of loans have LTVs exceeding this threshold.

Finally, the FHFA could change or eliminate the cutoff date for HARP eligibility. This change would accelerate speeds on recently originated pools. We agree with the market consensus that this change is the least likely.



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#### References

<sup>1</sup>Mitchell Remy, Deborah Lucas and Damien Moore, "An Evaluation of Large-Scale Mortgage Refinancing Programs", Working Paper 2011-4, Congressional Budget Office Working Paper Series, September, 2011.

<sup>2</sup>Edward J. DeMarco, "Statement of Edward J. DeMarco on Home Affordable Refinance Program (HARP)", Federal Housing Finance Agency, September 9, 2011

<sup>3</sup>Fannie Mae. [www.efanniemae.com/sf/mha/mharefi](http://www.efanniemae.com/sf/mha/mharefi)

<sup>4</sup>Elizabeth Duke, "Rebalancing the Housing Market", speech at the Federal Reserve Board Policy Forum. "The Housing Market Going Forward. Lessons Learned from the Recent Crisis", September 1, 2011

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