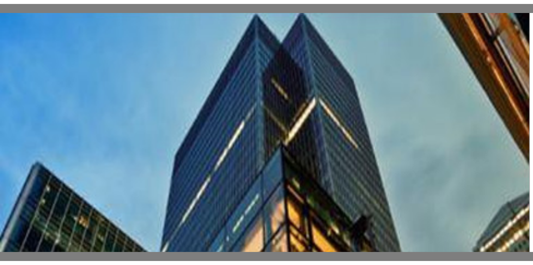
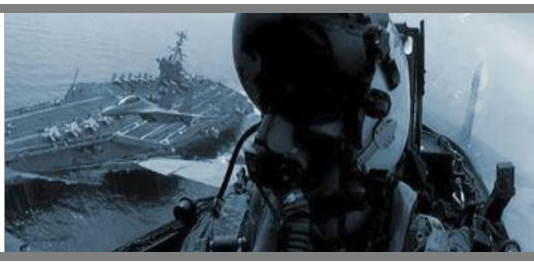
Affordable Mortgages: Upfront Fees Elimination Spotlights Different Convexity Profile





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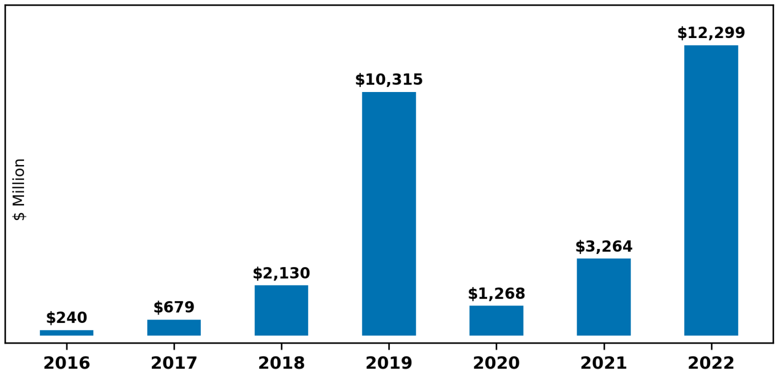
100% HomeReady and Home Possible Pools May Exhibit Unique Prepay Path

The recent elimination of upfront fees on GSEs affordable mortgage programs underscores the unique path the affordable segment may take as the broader housing market weakens and single-family pools face slower prepays. The Federal Housing Finance Agency (FHFA) eliminated upfront fees for HomeReady and Home Possible loans, among other targeted changes to the GSEs guarantee fee pricing that the regulator announced.[1] Fannie Mae notified lenders last Friday that it will implement the changes on December 1, 2022, via Loan Level Price Adjustments (LLPA) waivers.[2]

The fresh changes follow on increases to upfront fees FHFA implemented earlier in the year on certain high balance loans and second home loans. Taken together, the g-fee changes could further bifurcate prepayment speeds across MBS pools based on product categories. Overall, Fannie and Freddie's average g-fees stood at 61.7 bp and 62.0 bp in Q2 2022, slightly increasing from the previous quarter, according to ULI.

Investors can now find over 2,700 Fannie Mae or Freddie Mac pools that are completely backed by HomeReady or Home Possible loans. The overall volume of 100% HR/HP pools now stands at $17.2 billion. HR/HP issuance has picked up in 2022, reaching $12.3 billion, compared to $3.3 billion last year (Figure 1).

Figure 1. 100% HomeReady and Home Possible Pools Issuance



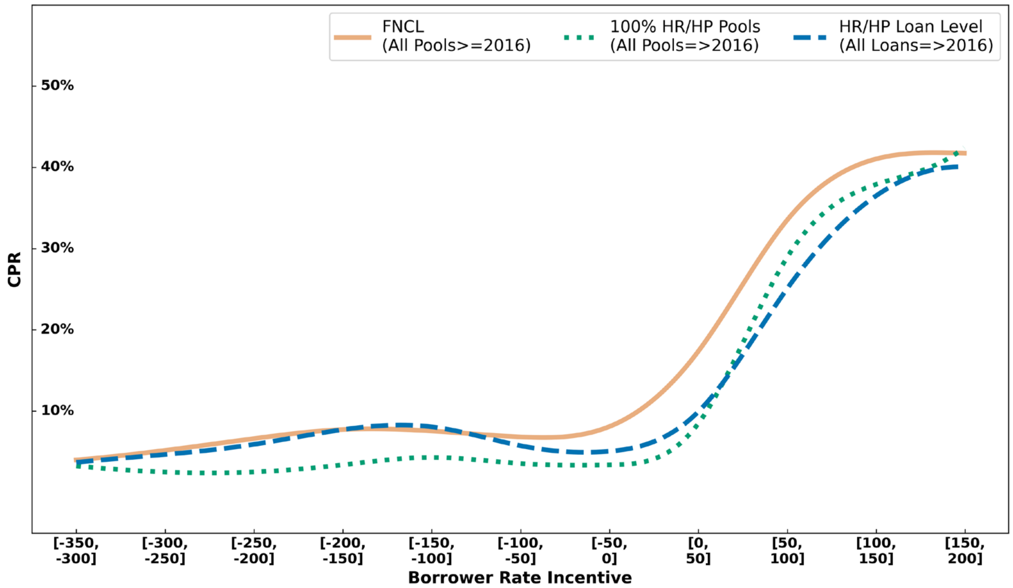
Source: Bloomberg and Academy Securities

1 FHFA Announces Targeted Pricing Changes to Enterprise Pricing Framework, October 24, 2022
2 Lender Letter (LL-2022-05): Updates to Loan-level Price Adjustments, Fannie Mae, November 4, 2022

HR/HP Speeds Largely Lower Across the Incentive Buckets

The advantageous g-fee schedule HR/HP loans face following the FHFA changes could potentially increase prepay speeds in the segment. 100% HR/HP pool speeds across most of the incentive buckets have generally been lower compared to generic collateral (Figure 2). For example, HR/HP speeds are 0.74 to 4.72 slower than FNCL speeds for out-of-money buckets. The GSEs started issuing 100% HR/HP pools only in 2016. To compare 100% HR/HP pools' speeds to generic pools on a normalized basis, Figure 2 shows an S-curve for FNCL pools issued 2016 and later.

Figure 2. HomeReady and Home Possible Prepayment Trends



Source: Bloomberg and Academy Securities

The 100% HR/HP pool speeds remain slower than generic collateral for most in-the-money buckets, offering call protection on the affordable collateral. At the top ITM buckets HR/HP speeds exceed generic collateral. Figure 2 also shows the 100% HR/HP pool speeds versus the overall HR/HP loan universe, as HR/HP loans can also comprise a certain percentage of generic pools.

Low Down Payment Programs

A key feature of the affordable mortgage program is low down payment requirements. For example, Fannie's HomeReady allows 3% down payment for eligible borrowers. All else equal, the low down payment allowance may reduce borrowers' incentive to perform, compared to homeowners with higher equity stakes. The focus of the affordable programs on low-income borrowers may exacerbate the concern over payment performance. In the Home Possible program the annual income of eligible borrowers, with some exceptions, cannot exceed 100% of the area median income (AMI) or a higher percentage in designated high-cost areas. Borrowers can have credit scores as low as 660 for purchase transactions, and 680 for no cash-out refinances.

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