

## Assessing Relative Value in Fannie Mae Is

### Program Description

The Fannie Mae I program pools newly originated FHA/VA mortgages that are issued with quarter- or eighth-gross-note rates (for example, a 6.75% or a 6.875% mortgage). Because of the servicing requirement, WACs on Fannie Mae I pools are on average 30bp above the coupon rate. Key features of the program include:

- ▶ Fannie Mae I securities require only 25bp of servicing.
- ▶ Fannie Mae I pools trade with Fannie Mae delay (54 days) but are priced using the Ginnie Mae settlement convention.
- ▶ Fannie Mae I securities are often pooled together and issued as Fannie Mae Major pools.

### Execution

The Fannie Mae I program provides additional flexibility to lenders in pooling government guaranteed mortgages. Traditionally, a lender would have had to place FHA/VA loans with loan rates of 6.75% and 6.875% into a Ginnie Mae II 6% pool.<sup>5</sup> As a result of its 25bp servicing requirement, the Fannie Mae I program allows lenders to put these loans in a 6.5% pool after buying down the guarantee fee. In essence, in deciding whether to put a loan in a Fannie Mae I or Ginnie Mae II pool, the tradeoff for the lender is between cash up front (the higher dollar price of 6.5s versus 6s) and servicing income (the higher servicing income from 6s with a WAC of 6.80% versus 6.5s with the same WAC).

### Issuance

Although Fannie Mae's FHA/VA program has been around for a number of years, recent issuance through the program was at a trickle until 1998. Figure 18 shows the distribution of issuance by coupon for Fannie Mae Is in 1998. Ginnie Mae I and II issuance is also provided for the purposes of comparison.

*About \$2.3 billion Fannie Is were issued in 1998.*

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<sup>4</sup> See *Bond Market Roundup: Strategy*, Salomon Smith Barney, January 22, 1999.

<sup>5</sup> These loans would not be eligible for a Ginnie Mae II 6.5% pool because Ginnie Mae pools require a minimum of 44bp of servicing.

**Figure 18. Fannie Mae Is and Ginnie Maes — Distribution of Issuance, 1998 (Dollars in Billions)**

Coupon	Fannie Mae I	Ginnie Mae I	Ginnie Mae II
6.5%	\$1.0	\$38.9	\$18.1
7.0	1.2	35.0	9.4
7.5	0.1	8.0	2.2

Source: Salomon Smith Barney.

Most of the issuance for Fannie Mae Is was concentrated in the latter half of the year, with issuance averaging \$300-\$600 million a month over this period. Reasons for the popularity of the program include lenders' requiring more flexibility in pooling FHA/VA mortgages, better execution offered by Fannie Mae, and perhaps most important, a desire to exchange servicing income for cash up front given the high level of refinance volume. Recently, Freddie Mac also began to offer lenders a program to pool FHA/VA mortgages.

#### Relative Value

*Fannie I 6.5s and 7s are about 8-10 ticks cheap to Ginnie Maes.*

Figure 19 displays current pricing levels in the Fannie Mae I sector, and offers a theoretical valuation<sup>6</sup> of how much Fannie Mae I coupons would be worth relative to their Ginnie Mae I and II counterparts if investors were (1) indifferent to liquidity, and (2) indifferent between replacing the full faith and credit of Ginnie Mae securities with the implied full faith and credit of Fannie Mae. The valuations for Fannie Mae I 6s are subject to some uncertainty because issuance of these pools has been relatively small.

Because the WAC of a Fannie Mae I pool is typically 20bp below that of a Ginnie Mae I pool with the same coupon, the value of Fannie Mae I pools comes from the additional call protection they offer. Fannie Mae I pools can therefore be thought of as the FHA/VA equivalent of the low WAC pool story in the conventional sector. In the conventional sector, low WAC pools typically trade two to three ticks above TBAs, implying that Fannie Mae Is are offered at attractive levels. However, unlike conventional low WAC pools, Fannie Mae Is are not TBA eligible.

**Figure 19. Fannie Mae Is — Theoretical Valuations, 11 Feb 99**

Coupon	Issue	WAC	WAM	Age	Market Prices			Theor Price @ TBA OAS	Price Spreads to TBA			OAS Pickup
					Price	OAS	Eff Dur		OAS	Market	Difference	
6.00%	GNMA I	6.50	29-10	1	98-17	70	6.0	98-17	0-00	0-00	0-00	+0
	GNMA II	6.80	29-10	1	98-01	71	5.8	98-03 +	-0-13 +	-0-16	0-02	+1
	FNMA I	6.30	29-10	1	98-05	77	6.3	98-20	+0-03	-0-12	<b>0-15</b>	<b>+7</b>
6.50%	GNMA I	7.00	29-08	2	100-23	75	4.5	100-23	0-00	0-00	0-00	+0
	GNMA II	7.28	29-08	2	100-09	76	4.3	100-11	-0-12 +	-0-14	0-01	+1
	FNMA I	6.80	29-08	2	100-17	81	4.8	100-26 +	+0-03 +	-0-06	<b>0-09</b>	<b>+6</b>
7.00%	GNMA I	7.50	29-10	1	102-12	77	3.1	102-12	0-00	0-00	0-00	+0
	GNMA II	7.75	29-10	1	102-00	77	3.0	102-00	-0-12	-0-12	0-00	+0
	FNMA I	7.30	29-10	1	102-08	84	3.4	102-16 +	+0-04 +	-0-04	<b>0-08</b>	<b>+7</b>

Source: Salomon Smith Barney.

<sup>6</sup> These calculations can be duplicated on the *Yield Book* by defining a Ginnie Mae User Bond with a 54-day delay and the appropriate WAC/WAM/age characteristics.

*Fannie Is offer a compelling alternative to Ginnie Maes for investors who can give up some liquidity.*

### Conclusion

For investors who are able to go down in liquidity, Fannie Mae Is offer attractive alternatives to Ginnie Mae I 6.5s and 7s (or Ginnie Mae II 6.5s and 7s). In our opinion, the future outlook for Fannie Mae I securities is positive for several reasons. First, the recent outperformance of Ginnie Mae IIs suggests that less liquid sectors will continue to shine as the overall tone of the market improves. Second, the Fannie Mae I sector is receiving some sponsorship from commercial banks and insurance companies that are willing to trade liquidity for value. Finally, given the current high-refinance environment, it is likely that issuance of Fannie Mae Is will continue to grow, improving liquidity in the process.