

Dubious Payups for New Issues: Don't Be Fooled by What They've Pooled

Like the mythical town of Lake Wobegon, "where all of the children are above average," some mortgage dealers would have us believe in a pass-through market "where all of the pools should be priced above TBA." Indeed, remarkably large fractions of newly originated mortgages are now being marketed at 4- to 8-tick payups for commonplace characteristics that supposedly render them less refinanceable than average. As a very knowledgeable official at a very large originator noted with amazement, "This is just a great program for us — the investors paying up for this product are simply out of their minds!"

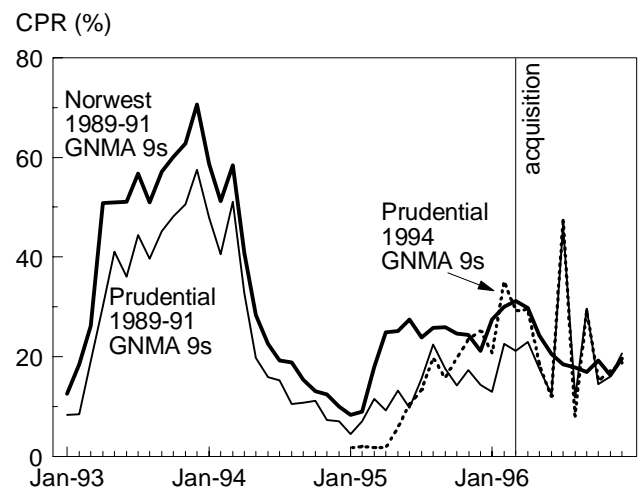
On the whole, we tend to agree. Low WACs do correspond to marginally slower prepayment rates, and low loan balances do contribute to the call protection of *seasoned* mortgages. (In fact, this was one of the cornerstones of the prepayment modeling technique we introduced to the market in 1994.) However, for *new* mortgages, we expect that these sources of call protection will be less strong, and might not even be present at all, after considering the servicers of the pools in question. With TBAs rolling consistently above carry, with prepayment risk only a minor concern at this market level, and with little evidence that these pools will provide meaningful call protection in a rally, we are not convinced of the value of this paper.

The Power of the Servicer

In theory, there is indeed a marginal degree of call protection for unseasoned loans with marginally lower WAC, WAM, equity, and loan size. In practice, these characteristics present no obstacle to an efficient mortgage banker determined to protect its servicing portfolio by refinancing its premium loans. Moreover, such bankers tend to be the very originators who've been providing the market with most of these "call-protected" pools in the first place. When this is the case, the pools for which you're charged a payup are likely to refinance faster than average in the next rally anyway.

For similar mortgages with different servicers, the prepayment differences can be dramatic. To follow up on an example we analyzed in this publication

last spring¹, mortgages serviced by Norwest had registered monthly prepayment rates averaging about 50% faster than those of otherwise comparable loans serviced by Prudential — consistently and for many years. (This is five times our standard measure of refi sensitivity, and for the GNMA 9s shown in the graph below, it translated into a carry difference of nearly 6/32nds per month in the 1993 refinancing environment.) Following Norwest's acquisition of Pru's mortgage business in early 1996, the loans that had been "slow" for years suddenly became quite fast. And even the *seasoned* GNMA 9s have been exactly as fast as the unseasoned GNMA 9s in each of the last eight months. Similarly, Pru's 1995 GNMA 8.5s surged to 53% CPR last month, and even Pru's barely refinanceable 1991-93 GNMA 8s registered a 43% CPR spike last summer following the servicing transfer.



These examples show quite vividly how the impact of an efficient, low-cost servicer can dominate the prepayment characteristics associated with the underlying loans. They should serve as a strong signal not to pin one's hopes on the "inherent" call protection of newly originated pools with marginally advantageous loan characteristics.

According to our valuation models, a new FNMA 7.5% pool with an 8.00% WAC, an \$80,000 average loan balance, and a "fast" servicer is worth no more than a typical new FNMA 7.5% pool with an 8.15% WAC and a \$100,000 average loan balance. The

¹ "Mortgage Banker Consolidation Means Structurally Faster Refinancings," March 8, 1996

WAC advantage is worth approximately +2 ticks, and the loan size advantage perhaps about +4 ticks; but the servicer effect is about -8 ticks for a current coupon, so the net valuation turns out no better than TBA. Indeed, investors looking for unusually valuable pools should probably *begin* their search by seeking out originators and servicers with established histories of slow refinancing.

Misconceptions About Loan Size

The outstanding dollar balance of a mortgage is an important element in determining a homeowner's financial incentive to refinance, and it accounts for a good portion of the refi protection of seasoned mortgages. However, at least three misconceptions seem to have led the market to exaggerate the added value of low-balance mortgages in the new-issue market.

To begin with, the average loan size in agency pools is much smaller than many investors realize; low-priced homes are still the norm across much of the U.S. The maximum loan balances are \$214,600 for FHLMC and FNMA, \$203,000 for VA, and \$161,000 for FHA. But in all these cases, the *average* loan balances are just *half* the legal maximum — and for 15-year loans, the averages are lower still. A 6-tick payup for perfectly normal pool characteristics like a \$90,000 average loan size becomes very difficult to justify in light of this information.

Another misconception is that costs are burdensome for refinancing new, low-balance mortgages. On the contrary, the time, expense, and sophistication involved in refinancing an unseasoned mortgage is much lower than some would have you believe; today it requires scarcely more than a fresh signature. The cost of refinancing a new loan is quite small regardless of the loan size — and borrowers generally face similar proportional charges unless the balance is extremely low, perhaps under \$50,000. Even when there are fixed costs that might ordinarily loom large for small-balance borrowers, lenders are motivated by the Fair Lending Practices Act to keep pricing proportional, to minimize the possibility of being questioned about discriminatory lending practices.

Finally, investors need to consider “the value of a dollar” in different categories of homeowner wealth.

An \$80,000 seasoned loan will typically represent an “average” conforming mortgage for the lower home price levels of the past. In contrast, \$80,000 *unseasoned* loans correspond to *smaller-than-average* homes, whose owners would consider each dollar of monthly savings more valuable than would wealthier homeowners. Therefore, the incentive to refinance a smaller unseasoned loan does *not* diminish proportionally with the nominal dollar balance.

Limited Impact of Geography, LTV, and WAC

With so much origination now coming from large national lenders, it's increasingly difficult both to find large, geographically concentrated pools from “slow” originators, and to disentangle geographic effects from loan size, LTV, and other mortgage variables that vary considerably by region. Furthermore, geography and LTV usually matter more for *discount* prepayments (housing turnover) than for premiums (refinancings). High-LTV Northeast 7s are, if anything, *less* valuable than TBAs because of their slow speeds as discounts; emphasis on the marginal amount of call protection is misplaced.

WAC effects can be similarly complicated. It's reasonable to assume that lower WAC pools should prepay more slowly, both as premiums and as discounts. But there's a very broad range of WACs in the TBA float anyway, and the effect is very difficult to disentangle from related variables such as refi share, LPMI share, and points paid at origination. All things considered, a 5 bp lower WAC is probably worth less than 1/32nd on a current coupon.

Adverse Effect on TBA Market

Once a dealer (or an originator) begins to charge payups for every conceivable advantage of specific pools, it's logical to conclude that the pools it delivers into small- to medium-sized TBA trades will be inferior with regard to every one of these variables, and investors will eventually come to discount any TBA sales by that party. If the process goes to the extreme, then TBA premiums will become dominated by very high loan balances, very high WACs, very short WAMs, very small pools, and so forth — and small- to medium-sized trades in TBA issues will have to cheapen up considerably.

On the other hand, TBA liquidity has already dwindled to the point that even moderately large pur-

chases often force sellers to deliver pools that would otherwise trade well above TBA levels. If the TBA market deteriorates and narrows even further, then these squeezes will become even more common — and it only takes three months of rolling two ticks above carry to wipe out the marginal value of a six-tick payup.

Paying Up for ‘Good’ Loans Will Encourage Mortgage Bankers to Originate Them — Over and Over and Over

Finally, we note that the nascent practice of paying up for new mortgages — if it doesn’t die out before the next rally — will change mortgage banker behavior so as to offset whatever call protection investors thought they were paying for. In the same way that we have more expensive mortgage rates for jumbos, largely because of the market pricing their heightened refinancing risk, we would end up with cheaper refinancings of “mini” mortgages. Think about it: If an investor pays an extra 1/4 point for new \$80,000 loans, then he’s essentially offering the mortgage banking industry a \$200 subsidy for refinancing every \$80,000 loan in the country. In the next rally, we doubt the mortgage banking industry would let such generous rewards go unclaimed.

Conclusions

For a greater degree of call protection, the best new-issue product we can think of would be pools whose originator and servicer have a history of “slow” refinancing. However, with the relentless consolidation in the origination and servicing businesses, and with the ever-rising market share of efficient mortgage bankers and brokers, any remaining pockets of servicer-based call protection could disappear literally overnight with a simple transfer of servicing. Instead, we would continue to pursue opportunities in well-seasoned paper, at payups that are recognized consistently in the marketplace. These are the small loans with established prepayment histories that have survived the most severe refinancing cycles of the past — so for reliable call protection, these seasoned pass-throughs are tough to beat.

As for the current claims of “unseasoned call protection,” investors should think twice before paying up for newly originated pools from the dealers touting them — and should probably think *ten* times before buying “TBA” pools from these dealers. Indeed, we might suggest that when you see large pay-

ups quoted for new 30-year originations, you should buy a block of TBAs from someone *else*, sort the pools yourself for the supposed “good” characteristics (WAC, average loan size, etc.) — and then hit the bid. With minimal supporting evidence in the agency pool data, it’s hard to see how this “payup party” can last very long.

Given the very real costs in TBA pricing, liquidity, and back-office systems that such pool-specific mortgage originations would entail — in contrast with the unproven theoretical benefits worth at most a few ticks in a major rally scenario in the indefinite future — mortgage investors almost certainly have more to lose than to gain from such schemes.