STRATEGIC INSIGHT

VINING SPARKS

May 15, 2020

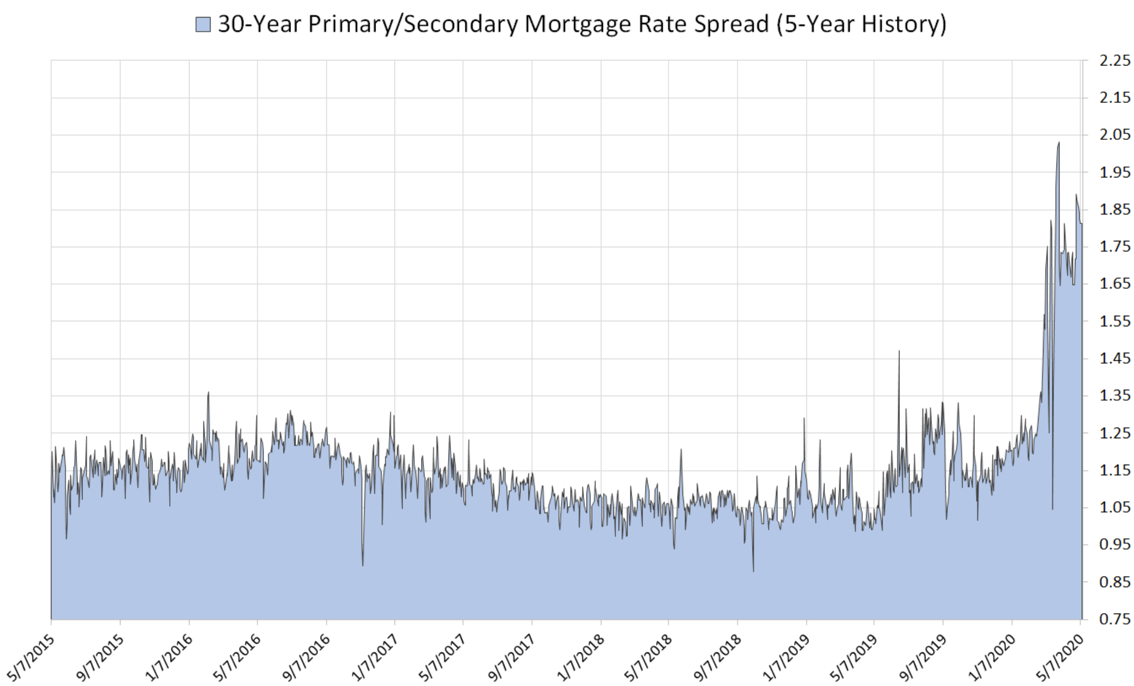
Mortgage Rates and Prepayment Speeds

- Mortgage market is in a state of flux with many factors working for and against prepayment speeds.
- Fed purchases of TBA MBS exacerbates this, expected to own approximately 40% of Agency MBS by end of year.
- A drop in origination spreads and/or lower mortgage rates could boost prepayments higher.
- A recent program announced by a large lender, 30-Year FRMs as low as 2.50%, is a shot across the bow.
- Buyers looking at prepay protection via low-coupon, low loan balance, and favorable geographies (100% NY).

It is anyone's guess what will happen with mortgage prepayments in the future. Opinions and models can vary widely and it's easy to understand why when we stop to consider the current landscape. First, mortgage rates are already at or near all-time lows, but origination spreads (using the Primary/Secondary spread as a gauge) are historically elevated. More on this below. If origination spreads return to more historical levels, then prepayments would likely rise as lower mortgage rates would be available to more borrowers. Second, Fed purchases (by design) have driven prices up. All else equal, higher premiums on mortgages will magnify affects (both positive and negative) to a yield given a change in prepayments.

The Primary/Secondary Spread (and why you care).

The Primary/Secondary spread is essentially the difference between the actual mortgage rate and the "par" coupon rate for an MBS. For example, if a lender could make a 30-year mortgage at a rate of 3.50% and the par coupon rate is 2.00%, then the primary/secondary spread would be 1.50%.



Currently, the Primary/Secondary spread is historically high for a multitude of reasons, including low absolute yield levels and lenders effectively rationing their refinancing bandwidth. Why do you care? If the P/S spread returns to a more "normal" level it would portend lower mortgage rates and hence more borrowers would be "in the money" to refinance their mortgages. A return to "normal" would indicate a 30-Year rate of approximately 2.50%.

Mortgage Rates

It has been the topic of much conversation about why mortgage rates aren't lower given current Treasury levels. Part of the reluctance, at least initially, was likely a capacity issue. Even prior to social distancing, refinancings were progressing at a fast clip. Take that kind of volume then add "working from home" into the mix and it's a recipe for managing refi demand by having a higher than otherwise origination spread, effectively putting some borrowers out of the money to refinance.

According to the Freddie Mac Primary Market Survey, the U.S. weekly average 30-Year fixed rate mortgage rate (as of 5/14/2020) is 3.28%. Consider the borrower profiles across different subsets of loans below, it's clear those who have the ability to refinance are doing so. For example, consider the "FNCL 3.0 New", their average rate is 3.88%, moving down to the current average of 3.28% would represent a 60 bps rate savings. Meanwhile, the "FNCL 2.5 New" would only have a 19 bps rate savings and their prepays are muted. The theme repeats itself when we also look at Jumbo Conforming and 20-Year MBS.

Security Type	Remaining Maturity	Borrower Rate	Wtd. Avg. Orig. Loan Size	50bps rate decrease annual payment decline	May 1-mo CPR	April 1-mo CPR	March 1-mo CPR	February 1-mo CPR
FNCL 2.5 New Fannie 30yr 2.5 MBS	354	3.47	$371,919	$1,222	9.2	7.6	3.3	2.3
FNCL 3.0 New Fannie 30yr 3.0 MBS	352	3.88	$332,909	$1,125	23.6	17.8	9.9	5.8
FNMA Jumbo Conforming 2.5 New MBS	356	3.46	$627,501	$2,061	6.1	9.9	2.3	2.8
FNMA Jumbo Conforming 3.0 New MBS	352	3.88	$613,641	$2,073	41.0	32.3	17.6	7.8
FNCT 2.5 New Fannie 20yr 2.5 MBS	236	3.40	$325,889	$987	9.6	7.3	3.2	2.2
FNCT 3.0 New Fannie 20yr 3.0 MBS	236	3.78	$284,743	$879	24.9	16.7	9.6	6.8

How Low Can Mortgage Rates Go?

Given that economic prepayments are highly dependent on this question, I really wish I knew the answer! In a conversation with one of our traders earlier this week, I surmised that it is tough for me to see a 30-Year Mortgage rate below 2.50% without some sort of subsidy. Not a day later did a *Housing Wire* article catch my attention. The article announces a program by United Wholesale Mortgage (UWM) that will introduce 30-Year mortgages with rates as low as 2.50% for both purchases and refinances. There are some limitations, no cashouts or investment properties to name a couple. If you've never heard of UWM, according to Inside Mortgage Finance, they're the 2nd largest overall lender behind Quicken. A 30-Year mortgage at 3.00% (and especially at 2.50%) should alter prepay expectations if other lenders react to remain competitive. Borrowers previously out of the money to refinance could see significant savings.

Where to Go From Here?

With the mortgage market in such a state of flux, there is certain value to be found and of course, likely pitfalls to avoid. The best way I know to identify these is to first take a step back. All the sophisticated models aside, let's not forget what we're really doing here. At the end of the day, prepayment assumptions are attempting to predict consumer behavior, which is hard even in a normal environment. The world is certainly not normal by any stretch of the imagination right now, but I do think we know this, Americans love a good bargain. If they have the ability to save money on their mortgage payment they will do so, especially now. As always, shock prepayment assumptions to levels that may seem highly unlikely, apply some common sense, and make sure you can live with unlikely circumstances.

To that end, we are seeing investors increasingly consider MBS and CMOs backed by collateral that minimizes the opportunity for a borrower to refinance. Pools with lower coupons (and hence lower borrower rates) are the most common at the moment. Low loan balance pools are another example. A loan with a $80,000 balance is nearly impossible to refinance from an economic standpoint, the interest savings is just too little for the borrower. Lastly, favorable geographies is another good example. 100% New York (NY) pools are known to prepay slower than similar collateral due to higher taxes in New York on mortgages, raising the fixed cost to refinance (chart on next page).

Things to Keep an Eye on in the Future - Defaults, Forbearance

I've limited this discussion to economic prepayments, not defaults, which count equally as prepayments. It stands to reason an environment such as the current should cause defaults to be higher, I think it is too early to even guess at the magnitude though. Forbearance is another issue. Specifically, whether or not it will affect a borrowers' ability to refinance is currently up in the air. This is my opinion only, but I think it likely the FHFA will make accommodations for those who are/were in forbearance but are current on their mortgage. Lastly, FHFA recently announced a deferral option for borrowers who use forbearance. This is important from a prepay perspective as they said mortgages who use deferral will "remain in Enterprise Mortgage-Backed Securities, subject to the terms of the trust agreements." This takes the risk to mass modifications due to forbearance, which would require buyouts, much lower in my estimation.

The best place to keep up with all of this in a timely fashion is via our *Mortgage Prepay Commentary* which is published monthly as prepayments are released.

As always, if you have any questions, comments, or would like to discuss further, please don't hesitate to reach out to your account representative or directly to me.

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Other Recent Publications

- Viewing Municipal Finances through the Lens of a Pandemic (5/14/2020)
- Investment Alternatives Matrix (5/12/2020)
- Mortgage Prepayment Commentary (5/7/2020)

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