

MARKET INSIGHTS

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Striking a new chord: HARP 2.0 and the US housing market



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Introduction: What is HARP?

Recently there has been a push for the US government to provide additional assistance to borrowers who have been unable to refinance at lower interest rates. These borrowers have been unable to take advantage of refinancing opportunities for various reasons (high loan-to-values (LTV), weaker credit, etc). One programme that has been in place to help since 2009 is the Home Affordable Refinance Programme (HARP).

HARP was designed to allow owner occupied borrowers, who met certain conditions, the ability to refinance. These conditions include: 1) a mortgage that is already owned or guaranteed by home finance government-sponsored enterprises (GSEs) Fannie Mae or Freddie Mac; 2) borrowers that are current on their mortgage payments; 3) a first mortgage that does not exceed 125% percent loan-to-value (LTV); and 4) a loan that was originated prior to June 2009, among others.

Although HARP has helped a number of high LTV and credit impaired borrowers take advantage of lower interest rates and/or improve the long-term stability of their mortgage, it has fallen well short of its intended goals. Some of the reasons cited for this include the LTV restriction, loan level pricing adjustments required by Fannie Mae and Freddie Mac to compensate for borrower credit risks, as well as concerns about representation and warranties that originators must provide when selling the refinanced loans to Fannie and Freddie.

HARP 2.0 helps more borrowers refinance

On 24 October 2011, the Federal Housing Finance Agency (FHFA) in the US announced changes in an attempt to get more borrowers to refinance under the HARP initiative. HARP 2.0 changes include:

1. eliminating or reducing loan level pricing adjustments for borrowers who refinance into shorter mortgages;
2. removing the 125% LTV cap for fixed-rate mortgages backed by Fannie Mae and Freddie Mac;
3. waiving certain representation and warranties that lenders commit to in making loans owned or guaranteed by Fannie Mae and Freddie Mac;

4. eliminating the need for a new property appraisal where there is a reliable automated valuation model estimate provided by the GSEs;
5. streamlining the refinance process;
6. harmonising some of the existing HARP 1.0 differences that currently exist between Fannie and Freddie; and
7. extending the end date of HARP until 31 December 2013 for loans originally sold to GSEs on or before 31 May 2009.

The particulars around HARP 2.0 are not final and implementation will vary as lenders and related mortgage industry participants must adjust their processes.

The details of HARP 2.0 are generally in line with our expectations. Two of the changes, however, were more generous than our original expectations. These include the waiving of certain representations and warranties and the expanded use of the automated valuation model. We think these changes will grant more borrowers the ability to refinance under the programme.

As it now stands, HARP 2.0 eliminates some of the representation and warranty risk for loans banks originally underwrote and refinanced under the new rules for HARP, and reduces the representation and warranty risk on the new loans as long as banks follow the guidelines under the new HARP program. By reducing the representation and warranty risk to the banks, the banks will be more likely to refinance borrowers under the programme.

Prepayments should remain modest

To date, almost 900,000 loans have been refinanced under HARP. We estimate that an additional 1m to 1.5m loans could ultimately be refinanced under the revised guidelines. This, although significant, will not drive prepayment speeds to astronomical levels seen in prior refinance waves. In the short run, prepayment speeds on some pools may increase marginally but we expect speeds to subsequently return to current levels.

We still expect to see a number of bills introduced in the US Congress calling for some type of housing assistance, including mass refinance initiatives, but we believe it will be very difficult to get anything passed. A mass refinance programme is extremely unlikely to occur as it would be negative to banks, home builders, and investors in mortgage-backed securities. It is also likely to drive mortgage costs up for new borrowers. Not least, it is contrary to the role the government has as a conservator of Fannie Mae and Freddie Mac.

The impact of HARP on Mortgage Backed Securities (MBS)

HARP 2.0 will have only a limited impact on segments of the mortgage market. This is because the mortgage market is very heterogeneous. For example, a 6.0% Fannie Mae pool from 2003 may perform dramatically different from a 6.0% Fannie Mae pool from 2008. Some mortgages are therefore more protected from prepayment risk than others:

- Given the uncertainty surrounding HARP and further refinancing initiatives, specified pools have become an even more attractive investment alternative to to-be-arranged, or TBA pools. Favouring seasoned (pre-2005) mortgage structures as well as securities backed by low loan balance mortgages is preferred. These mortgage loans are exempt from HARP eligibility.
- High-LTV mortgages and high premium mortgage securities (coupons 5.5% or higher) that were issued in 2006 to 2008 will be the bonds most at risk for a significant uptick in prepayment speeds.
- Collateralised Mortgage Obligations (CMOs) are favoured since a portfolio manager can target specific cash flows and own securities with a broad range of protection from prepayment volatility. A planned amortisation class (PAC) bond is an example of a CMO that may provide consistent cash flows within a range of prepayment speeds. In the event there is an uptick in prepayments, structures like this are built to weather temporary storms.
- In addition to geographic diversification, diversification of structure is also an important consideration. Buying the right structures at attractive prices provides insulation and opportunity in any environment.
- As the market conditions evolve, we are also looking at the full spectrum of structures that offer value in the mortgage space. One such example is the DUS bond market (Delegated Underwriting and Servicing), which are bonds backed by multi-family mortgage loans, subject to strict underwriting, and guaranteed by Fannie Mae. These bonds are typically longer in duration (seven to nine years), but carry strong prepayment protection, and would not be affected by HARP.
- We believe non-agency and Ginnie Mae mortgage backed securities will be unaffected by HARP and will remain excellent diversifiers and sources of relative value.

Conclusion: MBS still offer long-term value despite temporary HARP disruption

Although we expect the ultimate effect of HARP 2.0 to be moderate, some bonds may suffer temporary guilt by association. Nevertheless, we still find good value in many areas of the mortgage market and ultimately believe bonds that are well structured should outperform in the long term.

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