Flying the Hump

Fannie/Freddie prepayments begin to normalize

Among the most storied feats of World War II were the missions to fly “the Hump.” This required U.S. Army Air Force crews to scale the Himalayas, the highest mountain range on earth, in fully loaded C-47 transports to deliver supplies to Chinese in Japanese-occupied territories of Asia. These hair-raising efforts helped sustain resistance to the Japanese long enough for the Allies to overcome Imperialist Japan’s plans to dominate the Pacific.

Many community bankers have figuratively flown the Hump in the last six months. Since March Fannie Mae and Freddie Mac have returned hundreds of billions of dollars in principal to holders of their mortgage-backed securities (MBS) in a concentrated pattern that graphically would resemble the Himalayas. These prepayments represent delinquent loans that the government-sponsored enterprises had accumulated over the last year.

Fannie and Freddie warned the market that these catch-up payments would be coming over a period of several months. Certain MBS holders received the final pass-through of delinquent principal in July. Now that the agencies have cleaned out their attics, we can assess the effect of these payments and give some suggestions on future behavior.

Loans stockpiled
In the face of the largest drop in housing values in more than 60 years and a loss of 8 million U.S. jobs, delinquencies on even high-quality loans have skyrocketed. Historically, both Fannie and Freddie would repurchase loans once they became 120 days delinquent. An MBS investor would see this in the form of a prepayment of principal. Recall that both agencies guarantee timely payment of principal and interest.

Beginning in late 2007, as many thousands of loans went crashing through the 120-day barrier, the agencies decided to continue to pass through scheduled P&I but not pay off the remaining balance, perhaps hoping for a cure of the delinquencies by the homeowners. By early 2010, as inventory grew to an aggregate of about $200 billion, both Fannie and Freddie had had enough.

Prepayment principles
Freddie Mac MBS owners were hit with a one-time catch-up payment, primarily in March; Freddie adjustable rate (ARM) pools were caught up in April. Fannie Mae MBS investors had their “bonus” payments spread
out over a four-month period, based on coupon. Fannie’s additional payments came through from April to July, with the highest coupons first and coupons below 5.0 percent last.

All pools regardless of age or coupon showed an increase in prepayment speeds, and many showed a spike. The securities that showed the biggest upticks were completely predictable: those with the highest coupons, those that originated near the peak in housing prices or both. Vintages of 2006 and 2007 in particular showed significant increases in prepayments. Interest-only pools, which are characteristic of hybrid ARMs issued during that period, also had big delinquencies regardless of coupon.

As an example, 30-year Freddie Mac 5.5 percent pools with moderate seasoning (30 to 60 months old) posted the following one-month CPRs from January through June, respectively: 17.6, 58.12, 25.47, 23.84, 21.19 and 23.71. The February spike in speeds resulted in extra principal with the March payment.

So if you as an investor have noticed a much larger than normal return of your principal, you are not alone. The good news is most of the effect is behind you. Adjust your expectations, and don’t be too hasty to dump a pool that has shown a pickup in historical prepayment activity.

**Forward strategies**

Fannie and Freddie have indicated that they will henceforth repurchase loans when they reach the 120-day delinquent mark. For the next several years, that will probably create prepayments (and constant prepayment rate speeds) faster than historical averages. You will therefore want to run prepayment “what if’s” at some fast speeds, especially if you are looking at moderately seasoned loans and/or substantial premium prices.

The effects will also make their way through collateralized mortgage obligations (CMOs) issued by the agencies. You may notice on a given CMO tranche your average life has shortened substantially even if no principal has yet been received. I would recommend more frequent reviews of your average lives and expected cash flows for the next several quarters at least, until delinquencies and foreclosures revert to their long-term averages.

Good news: Ginnie Mae securities are immune to this problem. These securities are available in greater volume than before (see this column in August’s ICBA Independent Banker). Prepayments on them should continue to be more consistent over the next two years than their Fannie and Freddie brethren. That might just be your ticket for flying the hump of increased MBS prepayments.

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