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US Economics Slam Dunk Stimulus

If it were possible to inject a significant amount of stimulus into the US household sector, and this stimulus had zero impact on the budget deficit, did not require an exit strategy, did not distort the markets, and took effect almost immediately, wouldn't it seem like a slam dunk?

Such an option actually exists in the form of a change to mortgage refinancing requirements. The Fed and market forces have pushed mortgage rates to historic lows, yet many homeowners are unable to take advantage because they are blocked from refinancing. This problem could be addressed if the Government merely recognized its existing guarantee on the principal value of a large part of the mortgage market – the mortgages that are backed by Fannie, Freddie and Ginnie – and acted to streamline the refi process.

There are 37 million mortgages outstanding whose principal value is backed by the Federal government. When these homeowners apply for a refinancing, the application is subject to a standard underwriting process that involves an LTV test (requiring a property appraisal), an analysis of the borrower's FICO score, and income verification.

We estimate a potential average rate reduction of 125 bp on 50% of the outstanding volume of agency-backed mortgages. In the aggregate, the savings amounts to \$46 billion per year. That's more than the cost of the latest extension of unemployment benefits and more than taxpayers saved under the Make Work Pay tax credits in the 2009 fiscal stimulus legislation.

The bottom line is that market conditions have created a potential costless windfall that is not being used. There is no need for a case-by-case analysis of a borrower's credit quality when the principal value of the mortgage is already backed by the government.

Slam Dunk Stimulus

David Greenlaw (New York)

If it were possible to inject a significant amount of stimulus into the household sector of the US economy over the near term and this stimulus had zero impact on the budget deficit, did not require an exit strategy, did not distort the markets, and took effect almost immediately, wouldn't it seem like a slam dunk? Such an option actually exists in the form of a change to mortgage refinancing requirements. The Fed – and market forces – have pushed mortgage rates to historic lows (see Exhibit 1). However, many homeowners are unable to take advantage of the low rates because they are blocked from refinancing by a high loan-to-value ratio (LTV), appraisal problems, unemployment, and low credit score, etc. This problem could be addressed if the Government merely recognized the guarantee that already exists on the principal value of a very large portion of the mortgage market – specifically, the mortgages that are backed by Fannie, Freddie and Ginnie – and acted to streamline the refi process.

Exhibit 1

Mortgage Rates Fall to Historic Lows



Source: Freddie Mac

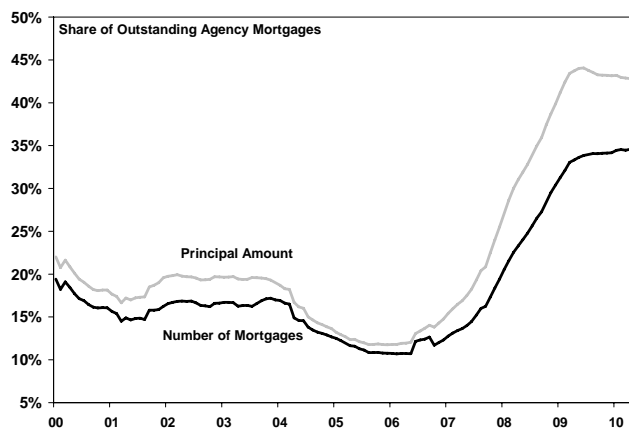
How Many Borrowers Could Be Impacted?

As seen in Exhibit 3, roughly half of all US households have a mortgage. Of these 55 million households, 37 million have mortgages whose principal value is already guaranteed by the Federal government. Yet, when these homeowners apply for a refinancing, the application is subject to a standard underwriting process that involves an LTV test (requiring a property appraisal), an analysis of the borrower's FICO score, and income verification. Obviously, the drop in home prices during the past few years means that many borrowers will not

meet the LTV requirement – especially since there has been a significant tightening in the appraisal process according to press reports. Indeed, our housing analyst Oliver Chang estimates that more than one-third of all agency-backed mortgages outstanding now have an LTV above 80% (see Exhibit 2). Looking at the principal value of these mortgages, the proportion is even greater (a little above 40% of the total) because an outsized share are located in California, where property values are higher than the national average. There are probably an additional 10% or so of borrowers who don't qualify for refinancing because of job loss or a low FICO score. Thus, we believe that perhaps 50% of the outstanding principal value of agency mortgages may not be refi-able at present. As seen in Exhibit 4, this estimate is broadly consistent with actual versus predicted prepayment speeds that currently prevail in the mortgage market.

Exhibit 2

High LTV's Act as an Obstacle to Refi



Note: Includes second liens
Source: Morgan Stanley Research

Exhibit 3

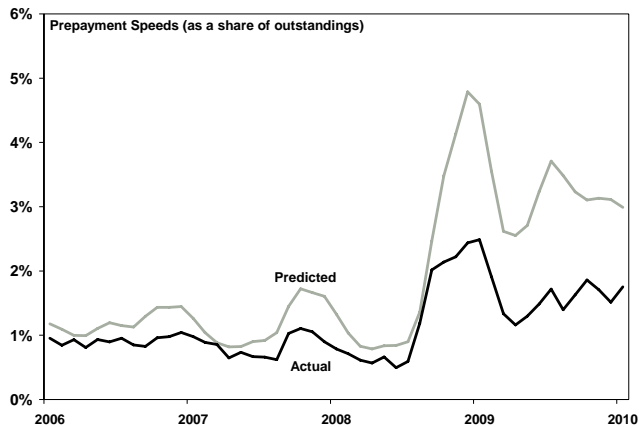
Housing and the Mortgage Market

Households	112 million
Homeowners	75 million (67%)
Have a Mortgage	55 million (49%)
Conforming (Fannie/Freddie)	31 million (27%)
Other Govt Guaranteed (FHA/Ginnie)	6 million (5%)
Other	18 million (16%)

Sources: Census Bureau, Federal Reserve Survey of Consumer Finances, Fannie Mae, Freddie Mac and eMBS.

Exhibit 4

Prepayment Speeds Are Running Well Below Expectations



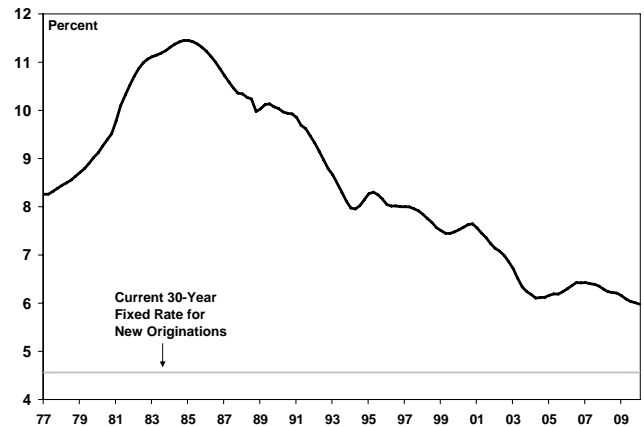
Source: Morgan Stanley Research

How large is the potential impact on household cash flow?

As seen in Exhibit 5, the average interest rate across all outstanding mortgages stood at about 6% as of 2010 Q1. In the agency space, our mortgage strategist Janaki Rao estimates that the median rate on the universe of outstanding 30-year fixed-rate mortgages is currently 5.75%. With the 30-year fixed rate for new originations now hovering around 4.50%, the potential rate reduction would be an average of 125 bp. Assuming a \$200,000 principal balance, the debt service reduction for the typical borrower would be about \$2500/year. And this would represent sustained cash flow savings over the life of the mortgage – not a one-time benefit. Economists have long established that such a permanent change induces a more powerful spending response than a one-off rebate. In the aggregate, \$2500 of annual savings on an estimated 18.5 million mortgages (50% of the government-guaranteed market) amounts to \$46 billion per year. As a comparison, that's more than the cost of the latest extension of unemployment benefits and more than taxpayers saved under the Make Work Pay tax credits in the big 2009 stimulus legislation (the American Recovery and Reinvestment Act, or ARRA).

Exhibit 5

Effective Interest Rate on Outstanding Mortgages



Source: Bureau of Economic Analysis

Not only would there be an immediate benefit to the economy from streamlining the refi process, but any future monetary stimulus aimed at reducing mortgage rates would carry a more powerful impact. In his Monetary Policy Report to Congress, Chairman Bernanke indicated that the Fed would consider additional securities purchases if the economic recovery faltered. A change in the refi process along the lines that we recommend would increase the impact of the Fed's remain bullets.

Who needs to act? Anything related to the GSEs is highly toxic in Washington these days, and politicians are sure to tread carefully when a legislative initiative involves Fannie and Freddie – even when the change seems to be such a clear-cut winner as this one. However, in our view, Fannie and Freddie's regulator – the Federal Housing Finance Administration (FHFA) – has the authority to implement the type of changes in the underwriting process that are involved here. Most importantly, we are not recommending any change to the qualification for new mortgages – only refis. Thus, there is no subsidy involved, and credit quality actually improves somewhat due to the lower payment burden. This implies fewer foreclosures going forward and *less* credit risk for the guarantor of the mortgage (i.e., the US government).

What's changed? Until recently, it may have made sense for the agencies to reevaluate the credit quality of a borrower who already had an agency-backed mortgage when they submitted a refi application. That's because Fannie and Freddie shareholders represented a capital cushion between the borrower and the US government. But Fannie and Freddie are no longer listed on the NYSE (as of June 26), so this cushion no longer exists, and the Federal government stands alone as

the guarantor of the principal value of agency-backed mortgages. In addition, Fannie Mae and Freddie Mac have been in Federal conservatorship since September 2008. These agencies had long enjoyed the implicit guarantee of the Federal government, and this step created an even “stronger backing” according to regulators.

Who would be the winners and losers? While the US household sector would be the clear beneficiary of a streamlined refi process, the losers would be the holders of agency MBS. Prepay speeds would rise dramatically and MBS spreads would adjust accordingly. Admittedly, this could temper the magnitude of our estimated benefit to borrowers – unless the Fed were to step in and serve as the backstop buyer once again.

The notion that the Federal government should recognize the mortgage guarantee that is already in place when establishing the qualifications for refinancing has been raised by others in the past. For example, Glenn Hubbard and Chris Mayer of Columbia University advocated such a policy in numerous forums over the past couple of years (for example, see their *Wall Street Journal* op-ed “First Let’s Stabilize Home Prices,” October 2, 2008). However, the Hubbard/Mayer proposal surfaced at a time when mortgage rates were considerably higher than they are now and involved a subsidy for the borrower in addition to streamlining the refinancing process (they argued that the government should subsidize the differential between a normal mortgage spread to Treasuries and the unusually wide spread that prevailed at the time). Presumably, their proposal would have helped to stabilize the housing market, stem the rising tide of foreclosures, and provide a cash flow benefit to the borrower. When the Congressional Budget Office scored the proposal as having a significant impact on the budget deficit – due to the subsidized mortgage rate – political support quickly evaporated. But since that time, the Fed has accomplished one of Hubbard/Mayer’s main objectives – shrinking the mortgage spread. And the markets have driven Treasury yields to extremely low levels. All that’s left is to streamline the refi process.

Finally, a streamlined refi process for agency mortgages is not inconsistent with other foreclosure mitigation programs that are already in place (such as HAMP). If the government wants to subsidize restructurings or principal writedowns for distressed borrowers, that is fine. Indeed, a streamlined refi process would likely reinforce the impact of these initiatives and help alleviate the strategic default problem. The bottom line is that market conditions have created a potentially costless windfall that is not being used. Quite simply, there is no need for a

case-by-case credit analysis when the principal value of the mortgage is already backed by the government.

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