

Specified Pool Pay-up Indications (Special Edition)

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Considering that this Friday marks the official beginning of summer, many kids are now dreaming of pools and roller coasters. From the perspective of many specified traders, this dream has become reality, since the pools they trade have recently been on their own wild roller coaster ride. Given the big moves in payups over the past several months, in this edition of our specified commentary we take a deeper look into the mechanics of specified pools and assess how they have performed since reaching their peaks late last year.

A Brief Overview of Specified Pools

First off, how do we define a “specified” pool? Specified Mortgage Backed Securities (MBS) are pools created with loans that have similar characteristics, or “stories.” One such example is an LLB (low loan balance) pool, which is comprised of individual loans less than \$85k in size. To the owner of the specified pool, the low loan balance story provides what is known as “call protection,” which is also referred to as “prepayment protection.” Since one of the most common forms of prepayment in an MBS pool is a borrower’s right to refinance, investors are willing to pay a spread (in 32nds) above the TBA price (called a “payup”) in the hopes that the borrower will not prepay his mortgage as interest rates fall. Obviously, when rates move lower like they did in 2012, many borrowers will have some degree of refinance incentive. In the case of the LLB pool, borrowers with the lowest loan sizes have the least refinance incentive. Here is a basic example:

A borrower with a loan balance of \$85,000 and a 30-year fixed rate of 4.50% would have a principal and interest payment of \$431 per month. Likewise, a borrower with the same rate but a loan balance of \$400,000 would have a payment of \$2,026 per month. The refinance incentive for the borrower with the larger loan balance is much greater since he/she could save \$230 per month if he/she refinanced into a 30-year loan with a rate of 3.50%. In contrast, the borrower with the loan balance of \$85,000 would only save \$49 per month as his/her new payment with a 3.50% rate would decrease to \$382. Therefore, the borrower with the lower loan balance is generally less likely to refinance given the same movement in rates.

While there are many types of specified stories that offer call protection, two other common loan balance stories are MLB (mid loan balance or \$110k max) and HLB (high loan balance or \$150k max). Obviously, the higher a borrower’s loan balance, the greater the refinance incentive, so the payup would not be as high on the \$110k max pool as the \$85k max pool. Hence, the payup would be even lower on the \$150k max pool.

In addition to specified stories, payups also vary by coupon. At the time of this writing, FN30 3.5s are trading at ~\$103-04. In other words, they are priced 3.125 points above par, so they contain 3.125 points of premium. Likewise, FN30 4.0s trade at ~\$105-08, giving them 5.25 points of premium. Absent of market technicals, investors are willing to pay up more for prepayment protection on higher coupons because they have more premium risk (they paid a greater price above par for the higher coupon). This is because if a loan within a pool refinances, investors who own the pool get their principal on that loan paid back to them at par. For example, if an investor paid \$105.125 for a \$100,000 investment in a pool, he/she spent \$105,125 for a \$100,000 portion of that pool. In other words, he/she is paying a premium of \$5,125 for the right to earn the coupon on that pool. However, if the loans in the pool paid off, the investor would receive back only the initial principal balance of \$100,000 and lose the premium paid. Therefore, on coupons priced above par (all tradable coupons were priced at a premium in 2012), investors who purchase specifieds are willing to “pay up” for slower-paying pools in order to protect the premium they paid up front. The higher the coupon, the more premium risk that must be protected, and thus, the higher the payup value assigned to the pool.

Besides protecting premium risk, investors purchase specified pools to collect positive carry. Bloomberg defines positive carry as a strategy of holding two off-setting positions, one of which creates an incoming cash flow that is greater than the outgoing obligations of the other. For example, to offset their duration exposure, many investors who participate in the specified pool market will hedge their specified positions with TBA. In other words, an investor could be long a FN30 \$85k 3.5 pool while being short a similar amount of FN30 TBA 3.5s. Therefore, the interest they earn on the long (specified) position needs to be greater than the cost of maintaining the short (TBA) position. If it is, the investor is earning positive carry. Slower prepay speeds plays a significant role in earning positive carry on coupons priced above par (again, to protect premium risk), so investors are willing to pay up for pools that are more likely to prepay slowly.

The Run-up in Payups in 2012

Next, we discuss specified pool performance and what exactly caused payups to reach all-time highs toward the end 2012. The simple answer is the rally in all fixed-income products. In 2012, the US economy was still trying to find its footing and European headlines were forcing many investors into safe haven investments such as US Treasuries and other US government-backed fixed-income products. Also, a very large amount of securities were being purchased by the Fed due to a government-sponsored stimulus program commonly referred to as QE3. QE stands for “Quantitative Easing” and the term describes the stimulus efforts the Fed employed to support the economy. There have been three rounds of QE, with the third announced in September of 2012. At that time, the Fed stated it would continue to support the economy by increasing its purchase activity to \$85 billion of fixed-income securities per month, split between MBS and US Treasuries. With overwhelming demand like that, it’s easy to see why MBS prices rallied through the end of 2012, sending mortgage rates lower and lower. These new highs in MBS prices meant that investors were taking on more and more premium risk. According to Bloomberg, FN30 3.0s closed at a price of \$105-30+ on October 2, 2012. Because of the additional prepayment risk, as rates drifted lower, investors were willing to pay more for call protection.

Meanwhile, the yield curve remained steep. In October, the difference between the 2-year Treasury yield and the 10-year Treasury yield was ~140 basis points. Additionally, CMO demand was robust. (CMO stands for “Collateralized Mortgage Obligation,” and they are used to structure MBS pools into more predictable cash flows. In other words, if an investor needs a short-term investment, say for around three years, a dealer can structure the cash flows of mortgage-backed securities to slice off a portion of them, creating a tranche with a three-year weighted-average life. The cash flows can be made even more predictable if superior collateral such as specified pools are used.) Therefore, CMO Desks were large buyers of specifieds including CQ & CR pools (CQ is the FNMA prefix for pools with LTVs between 105.01 – 125% and CR is the FNMA prefix for pools with LTVs over 125%). Combined with the Fed, this source of demand kept payups well-supported through the end of 2012.

Last year, REITs also raised significant amounts of cash to invest. REITs, or Real Estate Investment Trusts, are traditionally large investors in MBS, and 2012 was no exception. According to the [Wall Street Journal](#), the top 10 equity underwriters participated in \$35.5 billion in REIT equity raises in 2012 versus \$30.56 billion in 2011. REITs invested a healthy portion of their capital into MBS and many of those dollars found their way into the specified market, further supporting payups.

How Payups Have Fared in 2013

Now that we know that robust demand and favorable market conditions helped payups appreciate in 2012, what has happened since then? First, on January 3, the Fed minutes of the December 2012 meeting were released, showing that “a number of participants expressed the concern that additional purchases could complicate the Committee’s efforts to eventually withdraw monetary policy accommodation.” Additionally, on January 4, the November payroll numbers were revised upward from 146k to 247k, painting a much stronger economic picture. These two factors contributed to the initial slide in dollar prices and had the market believing

that the Fed could possibly taper purchases of MBS and US Treasuries earlier than initially thought. By February 1, the price of FN30 3.0s had dropped almost two points to the low \$103s (from low \$105s as recently as early December). With interest rates moving higher, demand for call protection in specified pools lagged, causing payups to decline significantly. For example, after peaking in December at ~75/32s, an all-time high, payups on FN30 \$85k 3.5s slid to ~38/32s by February, ~30/32s by April, and finally, ~18/32s for June settlement.

While headline risk associated with government stimulus continues to roil the markets, ongoing political risk has, too. This has affected CQ and CR payups, in particular, because borrowers in these pools have refinanced their high-LTV loans through the government's HARP program. One of the main reasons CQ and CR payups are significantly lower this year is because the market is also pricing in some risk that the government could change the eligibility, or cutoff date of the program to include more borrowers. Currently, to be eligible for a HARP refinance, a borrower's loan must have been sold to Fannie or Freddie prior to June 2009. If the government changes this cutoff date, it could allow some borrowers to refinance out of their original HARP loans, thereby, likely increasing prepayment speeds which would cause payups to decline even further. Recently, the government lengthened HARP's expiration date by two more years, extending the program through 2015, so another change is not out of the question.

Is it just the selloff in MBS prices that have caused specified pay-ups to trend lower? Despite this significant move, lower dollar prices are not the only factors putting downward pressure on payups so far in 2013. The roll markets have also inflicted serious harm on specified pool owners through the decline in positive carry. As mentioned earlier, many investors prefer to hedge their specified pools with TBA, so as long as the interest they earn on the long (specified) position is greater than the cost of maintaining the short (TBA) position, their carry will be positive. If the investor holds a specified pool over month end, he/she would have to roll the short TBA position to the next month. In other words, he/she would have to buy the hedge back in the front month and sell it in the back month. (This is called buying the roll.) When demand for the front month is high, which implies a shortage of bonds in the market, the roll will trade at a higher (more expensive) level. Furthermore, when the cost of hedging a specified pool exceeds the carry earned, the roll is thought to be trading "special." Specialness in the rolls makes hedging a specified position more difficult, and specified payups tend to depreciate.

Roll risk is also important because if the duration of a specified pool is longer than that of TBA (due to its inherent prepayment protection), a trader's hedge ratio may be greater than 1 to 1. For example, in order to properly hedge a specified pool, a trader may sell \$150 million of TBA versus owning a long position of only \$100 million. This would imply a hedge ratio of 150% on the specified pool. If an investor believes the market will sell off, (which it has done in 2013), then he/she is more likely to use a larger hedge ratio than a smaller one. This is because in a selloff, payups for call protection will decline. Therefore, by assigning a larger (longer) hedge ratio, a trader can offset the losses he/she may experience on a diminishing payup with the gains made on the hedge. (Remember, gains are made on a short/hedge position when the market sells off). This is a common strategy and works very well unless dollar rolls are expensive, or if pay-ups underperform into a rally. Under current market conditions, these factors make owning specified pools very difficult.

Where We Find Ourselves Today

The overall tone has changed in the marketplace. As we have discussed, news headlines have recently pointed toward improved economic conditions which are leading to more rhetoric from Fed participants around tapering its QE purchases. Looking to the future, investors could see the potential for lower dollar prices and higher mortgage rates if the Fed slows or stops purchases altogether (unless demand can be found from another source). Obviously, this will diminish the need for prepayment protection, putting further pressure on call-protected specified pools. Even as the fixed income markets have been rallying recently, uncertainty around the Fed's intentions have kept payups at depressed levels. In short, due to an unclear message regarding the likelihood and timing of the Fed tapering, specialness in the rolls, overall lower dollar prices, and a decline in investor demand will continue to negatively impact payups for call protection stories. Until we see less volatility as market conditions begin to stabilize, the specified pool market will be difficult to navigate.

For reference, the tables below compare today's payups with December 2012, when the high watermark in call-protected stories were reached. As can be seen, levels are drastically different today than where they were just a short time ago.

FNMA Historical Specified Payup Comparison 06/17/2013										
30yr	LLB (85k max)		MLB (110k max)		HLB (150k max)		CQ (105-125 LTV)		CR (125+ LTV)	
	December 2012 High	June 2013 85k	December 2012 High	June 2013 110k	December 2012 High	June 2013 150k	December 2012 High	June 2013 CQ	December 2012 High	June 2013 CR
3.0	29	1	25	0.5	16	0	12	-47	8	-55
3.5	75.75	18	63	15	41.75	9	69	-21	54	-27
4.0	148	62	143	54	90.5	31	149	32	N/A	26

Date: 6/17/2013

All pay-up levels are for indication purposes only and are subject to change without notice

*Assumptions: WAC 50bps over coupon Max, New production (0 - 2 wala), 1 pool

FNMA Specified Payup Indications 06/17/2013								
30yr	85k	110k	125k	150k	175k	investor	FICO <700	New Prod
3.0	1	0.5	0	0	0	0.25	0	0
3.5	18	15	11	9	3	2.5	4	0.5
4.0	62	54	43	31	25	21	23	15

15yr	85k	110k	125k	150k	175k	investor	FICO <700	New Prod
2.5	1	0.5	0	0	0	0	0	0
3.0	16	14	9	8	6	3	2	2
3.5	46	37	24	22	18	14	16	13
4.0	90	78	68	58	51	35	34	31

Other	CN	CJ	CV	CW	CT	CK	CQ	CR
2.0	76	-17						
2.5	51	-22	-22	-28	108			
3.0	32	-33	-3.5	-16	73	-21	-47	-55
3.5			20	18	42	-34	-21	-27
4.0					48	-67	32	26

Date: 6/17/2013

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*Assumptions: WAC 50bps over coupon Max, New production (0 - 2 wala), 1 pool

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