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Research Insights: The Impact of the Agency's New Adverse Market Fee

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Announcement and Industry Feedback

Announced on August 12th and applied to all refinance mortgages with settlements dates on or after September 1, 2020, both Fannie Mae and Freddie Mac will begin charging a 0.5% adverse market fee on most refinances (including both cash-out and rate-term refinances). Both Fannie Mae and Freddie Mac requested and were granted permission from the FHFA for the change which the GSE's implemented as a result of risk management and lost forecasting precipitated by COVID-19 related economic and market uncertainty. Importantly, this fee is not applicable to purchase loans.

The Mortgage Bankers Association estimates that the fee will amount to around $1,400 per loan on average. Critics argue that the pricing increase will be particularly harmful for our nation's low-and-moderate-income homeowners and for the emerging, but unsteady, improvements to the national economy. While the fee is being met with much disdain, such fee increases are not unprecedented. In 2007 Fannie Mae imposed a 0.25% surcharge on all mortgages it bought from lenders in response to the great recession. Part of the discontentment has to do with the extreme lack of communication – with most arguing that Fannie and Freddie should have issued a longer notice period. One firm emotionally described the fee as a "total cash grab by the federal government" and Bob Broeksmit, President and CEO of the MBA, was very clear and to the point when he said, "The implementation timeline is intentionally punitive and absurd and while it's true that millions of borrowers nationwide requested forbearance on their mortgages since the pandemic began, that number has been falling in recent weeks". In a decisive 'Call to Action', the Mortgage Bankers Association's grassroots advocacy arm, the Mortgage Action Alliance, is urging its 50,000 members to contact their congressional representatives and the Federal Housing Finance Agency to roll back the directive.

The Primary Impact will be Higher Borrower Rates, Higher Passthrough Prices, and Higher MSR Values

Regardless of any opinions that you might have about the fee or its timing, the fee will be positive for passthrough security and MSR values alike. A 50 BP price adjustment equates to a 12-14 BP note rate increase for 30-year, assuming that this price adjustment is fully passed on to borrowers. The impact on 15-year Agency loans will be slightly higher at 14-18 BPs, given their shorter duration. This rate increase will reduce refinance-based prepayments (and the resulting retention benefit) by 2-6% annually - depending upon on how far in the money the borrower is.

In states with higher average loan balances, where speeds can be 30% faster than the national average, servicers may see an even larger voluntary prepayment reduction. Turnover-based prepayments will not be affected since purchase rates are not impacted by this policy change. Similarly, curtailment-based prepayments (generally a modest 0.5-2.0 % annually) will be unchanged.

Evidence from Optimal Blue, a leading provider of mortgage data, confirms the above predictions. The median rate on conventional Agency refinance locks jumped 12.5 BPS the day after the announcement, while the median rate on conventional Agency purchase locks was flat.

Additional Impacts

Several additional impacts are worth mentioning. First, refinance speeds on other mortgage sectors will also decline somewhat, since “cross sector” refinancing will be less profitable for borrowers. By “cross sector”, we mean a borrower changing product sectors in the context of a refinance. For example, a certain fraction of borrowers refinance from their exiting FHA into a new Agency loan as their mark-to-market LTV declines - in order to avoid the ongoing FHA mortgage insurance premium. This Adverse Market Refinance Fee (implemented as a Loan-Level Price Adjustment or LLPA) will make these FHA-to-Agency refinances somewhat less profitable.

Second, mortgage originators will experience mark-to-market losses on their existing pipelines. It generally takes 5-10 business days from closing a loan with the borrower to delivering it to the Agencies. Given the September 1 effective date, the bulk of originator pipelines will be impacted by this LLPA change. Further, TBA hedges will exacerbate this mark-to-market loss, although by a small amount, since originators were short TBAs that increased in value. However, given the outsized gain-on-sale margins currently enjoyed by originators, we do not expect any financial distress from these mark-to-market losses.

Third, the divergence between rate surveys will increase. Freddie Mac's Primary Mortgage Market Survey (PMMS), a primary barometer for prime-quality borrower opportunity rates, will not be impacted. This is because the PMMS survey is explicitly limited to fully-amortizing home purchase loans to borrowers with excellent credit and a 20% down payment. In Freddie Mac's June 2019 Economic and Housing Research Note, researchers highlight the fact that their approach is free from compositional biases. In fact, they provide an example where refinance rates are higher than purchase rates – exactly the situation we have today. In contrast, the Mortgage Bankers Association's Weekly Application Survey does not control for the purchase/refinance share. As a result, we would expect greater divergence between these two surveys.

Lastly, the impact on the housing market will be muted by the fact that this policy does not apply to purchase loans.

Conclusion

The primary impact of this change in LLPAs will be higher rates for Agency refinance borrowers, higher Agency passthrough prices, and higher Agency MSR values. Furthermore, there will be somewhat reduced prepayments on other mortgage sectors (e.g., FHA in particular) due to lower "cross sector" refinancing, a one-time mark-to-market loss on originator pipelines, and greater divergence across mortgage rate surveys.

For further details, please contact your MIAC representative.

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