RATELAB
MERRILL LYNCH US RATES STRATEGY

Value Concepts from the ML Trading Desk

"The GSE Solution: What's Next ??"

Faithful readers of the RateLab know that we were spot on in our August 22, 2008 prediction of when and how the US Government would take action. Moreover, our prediction that MSB rates could have a "discontinuity" of 30bps to 50bps occurred, even faster than even we expected. So with the Victory Lap now complete, let's turn our attention to the only real question: What's Next ??

To review, we believe there are three main public policy goals at work:

1) Add liquidity to the Residential Mortgage Market;
2) Lower the Primary Mortgage Interest Rate;
3) Accomplish this without benefiting the "Fat Cats" [moral hazard]

Placing the GSEs into conservatorship laid the groundwork. But to fully accomplish these stated Public Policy goals, the Government must unclog the ReFinance plumbing.

The two month forward price of FN 5.5s closed at 100-28. As long as this price is ABOVE 100-16, a prime borrower whose loan has been securitized into a FN/H 6.0 should theoretically be able to costlessly ReFinance. This is because the mortgage issuer can create a "no points" Par loan, sell it forward at 100-16 (or better), and book a half point profit. The reason this is not yet occurring is that a grand proportion of the borrowers no longer qualify for a new GSE mortgage because either: 1) their house has declined in value and the LTV is above 80%; or 2) they have lost their job and no longer have a qualifying income. While this is a fine reason NOT to make someone an initial prime loan, it is lousy reason NOT to ReFinance an existing homeowner.

Since the GSEs already have the "credit risk" on their books, ReFinancing cannot make the risk they are incurring any worse. On the contrary, a ReFinance REDUCES the GSE risk since the borrower would now have to pay a smaller proportion of his income to service the debt. In fact, the GSEs should actively

and aggressively encourage ReFinancing of all above market rate loans as a way to reduce their credit exposure.

What's the Holdup ??

Current rules require new loans to qualify by FICO (a proxy for income) and LTV into a sliding scale grid for an ever increasing Guarantee Fee. Since many borrowers no longer qualify, they cannot ReFinance the remaining balance of the loan. This is the main reason MBS bonds presently trade to much longer effective durations. (They trade like 10 year notes as opposed to 7 year notes).

This is pure foolishness. The longer the borrower is forced to pay an above market rate, the higher the chance he will default and send his house into the GSEs already bulging REO (Real Estate Owned) portfolio.

How large is this benefit ? Taking the extreme macro view, if all $725 billion FN/H 6.0s were ReFinanced into FN/H 5.5s, the borrowers would save in aggregate $3.62bn a year. On a micro-basis, the average homeowner would save about $100 a month, maybe close to 2.5% of his take home paycheck !!

Additionally, some of these dollars would be spent on retail purchases which could add some support to nominal GDP.

Who is the Loser ??

In this case, the loser is the bondholder of the FN/H 6.0s that are currently trading at 102-16 since they will be prepaid early (called) at Par. But the loss is not actually that large since recent Government action effectively converted those FN/H 6.0s into GN 6.0s which used to trade at a one point premium.

How can this be Done ??

Since the Government is now the Owner and the Regulator of the GSEs, all that is required is a wave of the hand. They need to allow all homeowners with loans in GSE MBS pools to ReFinance on a Par for Par basis without a new appraisal or income check. [Par for Par means that only the remaining balance can be ReFinanced] Moreover, there will be no G-Fee adjustments.

The Government will empower the Master Servicer to buy all qualifying loans out of the MBS pools, re-securitize them into new lower rate MBS, and promptly sell them back into the marketplace. A qualifying loan is one where the forward selling price is greater than the loan value less reasonable processing fees.

From the homeowners stand point, all he will see is a lower monthly payment since this entire transaction can be done as a costless "loan modification" which will incur no tax consequences.

Let's tie this back to our original concept. A homeowner with a 6.65% mortgage had his loan packaged into a FN/H 6.0 MBS. The Master Servicer would simultaneously lower his rate to 6.15% and then sell a new FN/H 5.5 two months forward at 100-16 or better. The half point above the Par mortgage should easily cover all processing costs. The Servicer would retain the servicing rights with a now lower GWAC so he would accrue some extra value in the process and incentivize him to work quickly. The two month window should be enough time for the Servicer to buy the loan out of the pool and re-securitize with the GSE. The GSEs credit risk is reduced in all cases. Even if the LTV is 110% and the homeowner is now unemployed, the likelihood of him mailing in the keys has now been materially reduced !

The Kinks

The obvious problem is that the market could raise the rates (lower the price) of Secondary MBS bonds (because of the greater convexity risk) so that a ReFinance is no longer economic. However, as they say, "no bad bonds, just bad prices". Full American Callable GSE bonds have always found a home at an OAS spread tighter than MBS. As such, this concern is probably overstated. Moreover, if the market raises rates too much, the Government can just step in, execute the ReFinance, and keep the newly wrapped bonds on their books. This would be a fine way to quietly buy their stated $5bn (or more) a month.

This plan meets all of our Public Policy goals in the least disruptive manner.

Trade Ideas:

Sell MBS options (strangles) as long-dates as possible

Buy PO's on High GWAC // High LTV FN/H 6.0s

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