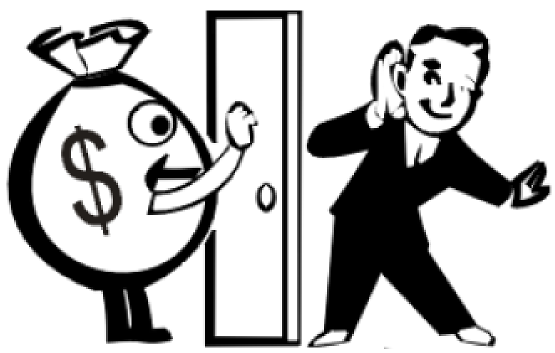
Musings from Harley Bassman:

THE CONVEXITY MAVEN

Value Concepts from the BAS/ML Trading Desk
February 2, 2010

"**A Missed Opportunity ?**"

An Open Letter to the Treasury VI

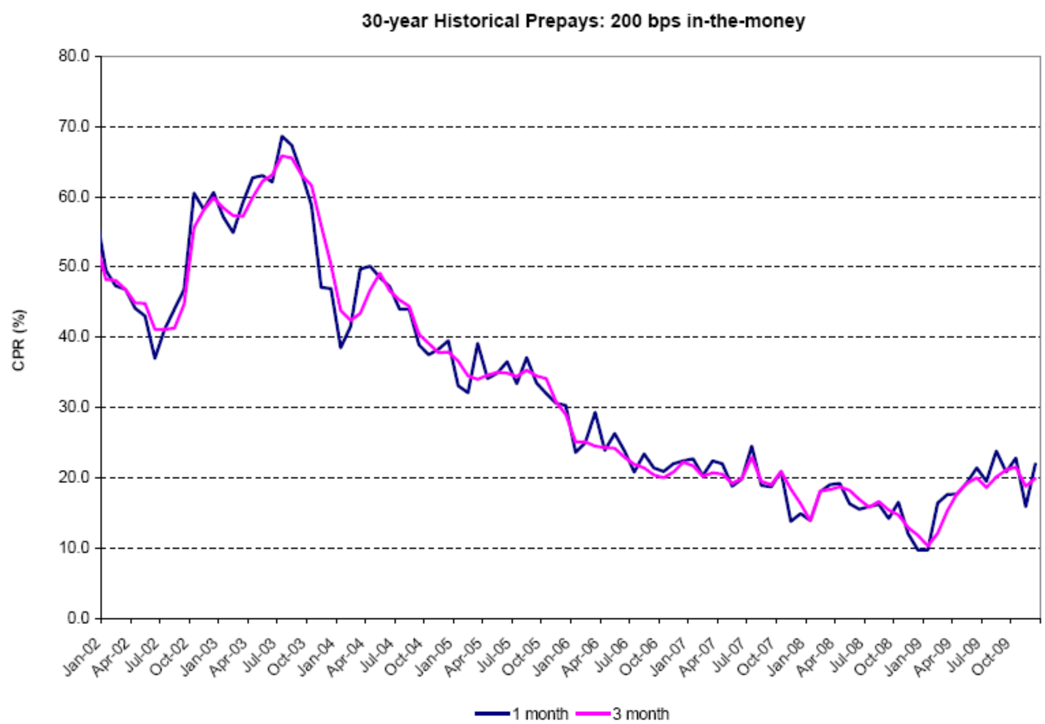


On August 27, 2008 we published *"An Open Letter to the Department of Treasury"* where we advised the Government to buy $500bn FN 5.5s (then trading at 98-16) and fund it by issuing $500bn Treasury Five year notes (then priced at 3.02%). [Note: CMM vs. 10CMS was at 135bps]

Soon afterwards, they took our advice in spades, eventually agreeing to buy $1.25Trillion MBS bonds. This has lowered the Par MBS rate by over 140bps and tightened spreads by 70bps. (Actually, 165bp and 125bps respectively from the Post-Lehman wides.)

Unfortunately, this policy brilliance has not been executed in the most optimal manner. This has resulted in a missed opportunity to reach deep into the market to help those homeowners who are most distressed.

The best way to show that the most truly distressed homeowners have failed to benefit from the lower rates created from the MBS purchase program is to look at the prepayment history of securitized mortgage bonds that are continuously 200bps "in-the-money". As shown below, during the 2003 to 2004 ReFinance frenzy, these mortgages prepaid at a 60% annualized rate. Presently, for both reasonable and not so reasonable credit issues, prepayment rates on these mortgages, that are clearly "in-the-money", is barely above 20%. In a nutshell, the plan is not helping those most in need of assistance.



All charts, unless otherwise noted, are sourced from BAC/MER data

Recall the original notion of the LSAP (Large Scale Asset Purchase) program. The FED would use Quantitative Easing to lower all rates, particularly MBS rates, to kick start the economy from a Monetary perspective. Simultaneously, the Government would spend nearly $800bn to create a Keynesian style Fiscal stimulus to reverse the decline in Velocity. Since $M*V = P*Q =$ GDP, an increase in both M and V would reverse the decline in GDP.

The core idea was for the FED + Government to induce a "ReFinance Wave" that would redirect monies spent on mortgage payments towards retail consumption.

How powerful could this have been ?

The table below details the current distribution of the “high coupon” MBS market. There are slightly more than $810 billion of current principal MBS bonds with a Gross Weighted Average Coupon above 6.50%. Over the past six months, the average secondary MBS rate has been 4.35%, or more than 200bps below the coupon rate of this cohort.

		Coupon	Current Balance	GWAC	Annual Payments	Monthly payment on 150k loan
	FN/FH	6.0%	$577bn	6.53%	$43.9bn	$951
	FN/FH	6.5%	$183bn	7.02%	$14.6bn	$1,000
	FN/FH	7.0%	$50bn	7.57%	$4.2bn	$1,056
Current Total -			$810bn	6.71%	$62.7bn	$969
If ReFinanced -		4.50%	$810bn	5.25%	$53.7bn	$828
Diffenence -			0	1.46%	$9.0bn	$141

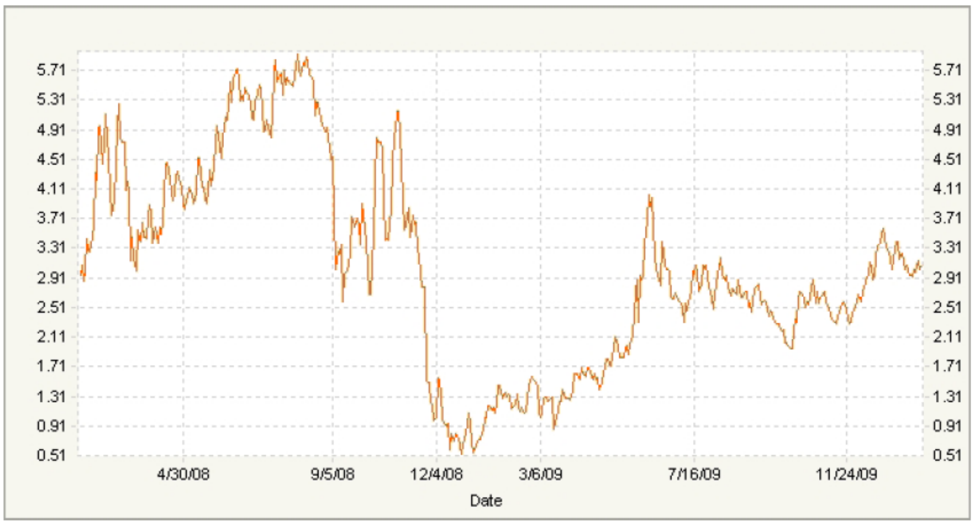
IF the Government had been successful in ReFinancing these homeowners out of their current mortgages and into 5.25% GWAC backed FN/FH 4.5% MBS:

1) The average homeowner with a $150,000 principal mortgage would save almost $1,700 annually.
2) The economy as a whole could see an additional $9 billion increase in consumer spending as those savings are re-directed to consumption.
3) Since all these mortgages were securitized (guaranteed) by the GSEs, the credit risk exposure of FN/FH would be reduced since the default rate on these mortgages can only decline as homeowner expenses decline.
4) The return of principal created by the accelerated prepayments of the High Coupon MBS would redirect capital to other investments and provide added liquidity to the Capital Markets.
5) The economic benefit of lower rates would have gone to homeowners, instead of MBS bondholders, who sold their securities to the FED at inflated prices.

As soon as policy makers realized that the lower rates they induced were not benefiting homeowners, they should have immediately explored executing a “Passive ReFinance” program whereby the GSEs would buy-out all the high coupon mortgages and automatically refinance the homeowner without any additional documentation. After all, the GSEs already have the credit risk. Their problem would be transferring the duration to the markets. The Government could have facilitated this by having the GSEs sell the new 4.5s to the FED on a forward basis in a private transaction while at the same time issuing Treasury supported Discount Notes for the interim financing period.

Yes, this would have come at the expense of the owners of high coupon MBS, but at that time early in the game, the losses would not have been so great. In fact, the markets fully expected the Government to do precisely this. How can you tell? The chart below is the dollar price difference between FN 6s and FN 5s. Notice how the price spread collapsed soon after the LSAP started. This spread only widened once it became clear that the Government wound not step in to clear away the potential regulatory and liability issues.

FN 6 price minus FN 5 price



Now one could argue that such Government interference in the private Capital Markets would be disruptive. Moreover, some have insisted that a Government manipulated ReFinance wave would ruin the MBS market and that buyers would never return for fear of other capricious activity. Well, what exactly do you call what we have now ?

The FED + Treasury own most of the 4s and 4.5s as well as almost all the available float of low WALA MBS bonds. FN 5s repo at -64bps and FN 5.5s finance at -91bps. (The most special Treasury security barely finances at zero.) There are in theory $725bn FN/FH 5 and $860bn FN/FH 5.5s. The MBS market is already fully disrupted.

Is it too late ? No…..

The Government should use the short squeeze in the 5s and 5.5s coupon bonds to support an accelerated “Auto-ReFinance” program. The GSEs could start to ReFinance current homeowners as described above. The FED would then effectively execute a “down in coupon” trade by selling 5s and 5.5s into the market that were matched by private sales from the GSEs to the FED of 4s and

4.5s. In this manner, the FED would not add to its holdings, they would just change the distribution. They would vastly improve liquidity in the markets by collapsing the shorts in the mid-coupon bonds as well as reducing their proportional ownership of the discount coupons. Moreover, "down in coupon" at 3-00 points would be a nice yield pick up for the FED.

Since it is too late to ReFinance all $810bn high GWAC mortgages, the GSEs would need a selection method that could be executed quickly and on a huge scale. The solution is to prioritize from high WAM to low WAM. Since the highest WAM mortgages most likely have most "upside down" LTVs, these homeowners are most in need of help. Conversely, low WAM homeowners probably have a lot of equity in their homes and do not want to lengthen out their debt from 23 years back out to 30 years. Moreover, low WAM homeowners with low LTVs probably have a reason they have not yet refinanced since they are presently the most eligible to lenders.

Would it have been better to do this originally, you betcha. But you may recall that TARP was initially a "buy bad bonds" program that morphed into a vastly superior "inject capital" program. Eight weeks to March 31 is a long time in Bondland. Hopefully our policy makers can alter their course in time.

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Bank of America
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