Musings from Harley Bassman:

THE CONVEXITY MAVEN

Value Concepts from the BAS/ML Trading Desk
February 9, 2010

"Reverse Robin Hood"

Circa late 12th Century

The legend of Robin Hood promotes him as a contemporary of King Richard the Lionhearted who *"took from the rich to give to the poor"* to spite the King's evil brother, Prince John. Chased by the Sherriff of Nottinghamshire, Robin Hood hid in Sherwood Forest with his band of Merry Men (plus Maid Marian) where he robbed wealthy travelers and used the funds to help the less fortunate.

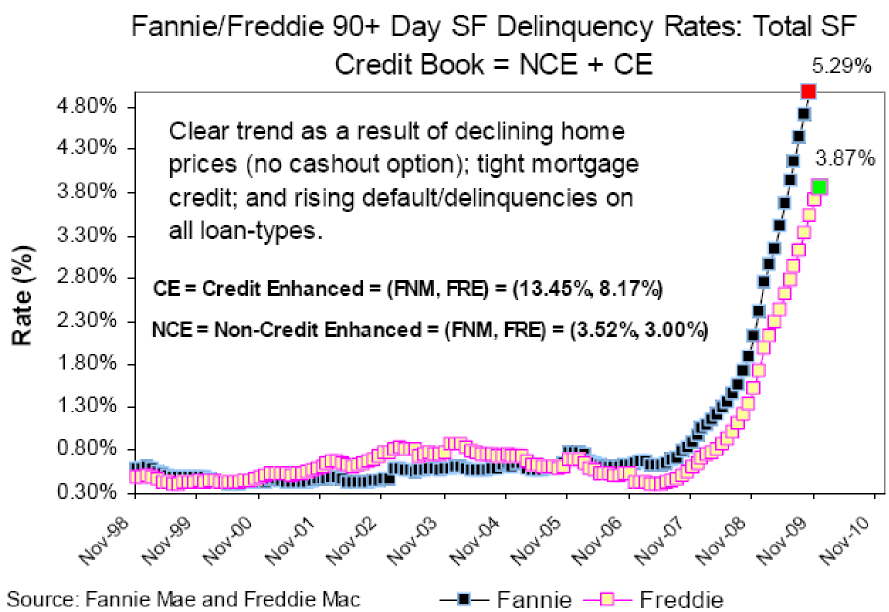
Whether this story is true or not is of little consequence since the notion of the ends justifying the means to help the down-trodden always plays well.

So it is with deep regret that we must reveal that the ballad of the Reverse Robin Hood, where the poor provide funds to the rich, is being written as you read these lines. How is that? Let us explain.

As detailed in past comments, the GSE Mortgage Guarantee function, aka the G-fee business, serves a vital purpose in our economy and is akin, in many respects, to a public utility. The GSEs take thousands of disparate loans that meet a set of qualifications, bundle them into multi-billion dollar packages, wrap them with their guarantee for the timely payment of principal and interest, and then release them into the markets to be variously bought and sold by investors.

The Mortgage Servicers collect the payments from the homeowners, and after deducting a schedule of negotiated fees and expenses, remit the remaining funds to investors. Thus derives the term "MBS Passthrough Security".

Since the GSEs guarantee these payments to investors, short-term cashflow deficiencies that occur when a homeowner misses a payment must be made up. The Servicer "advances" these payments to the bondholders with the knowledge that the GSEs will reimburse him if the borrower does not "cure" his loan. The GSEs will reimburse the Servicer by "buying the loan out of the pool" if the loan is not "cured" in no less than four months and no more than twenty four months after the last full payment of interest and principal.



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

Although an important concept, the "buy out" topic has never been truly meaningful until recently. This is because the number of loans that required a buy out has never been that large. In the chart above, the –blue line- represents the total percentage of loans, by the unpaid principal balance (UPB), that are 90+ days delinquent for FNMAs entire G-fee (credit) business. The –pink line- is the same for FHLMC.

Using the most recent public data:

	Credit Guarantee	% 90+ Delinquent	Total UPB 90+ Delinquent
FNMA	$2,826 billion	5.29%	$149 billion
FHLMC	$1,869 billion	3.87%	$72 billion

As noted, the GSEs have a buy-out delinquency window that ranges from four to twenty four months. They will make that decision based upon a number of economic and accounting factors. With their current cost of short-term funds near zero (14bps for three months, 21bps for six months), the bond math leans decidedly towards a massive acceleration of buy-outs.

Let's place pencil to paper. Public documents point to about $221 billion of UPB loans that are 90+ days delinquent. Assuming an average 6% net coupon, the two GSEs are ultimately forwarding $1.11 billion each month to the holders of Passthrough bonds whose underlying loans are delinquent. If the GSEs were to buy out all of these loans, they could in theory fund it somewhere near 20bps running or roughly $3.7mm a month. As such, by not buying out these loans, the GSEs are overspending by about $12.8 billion annually.

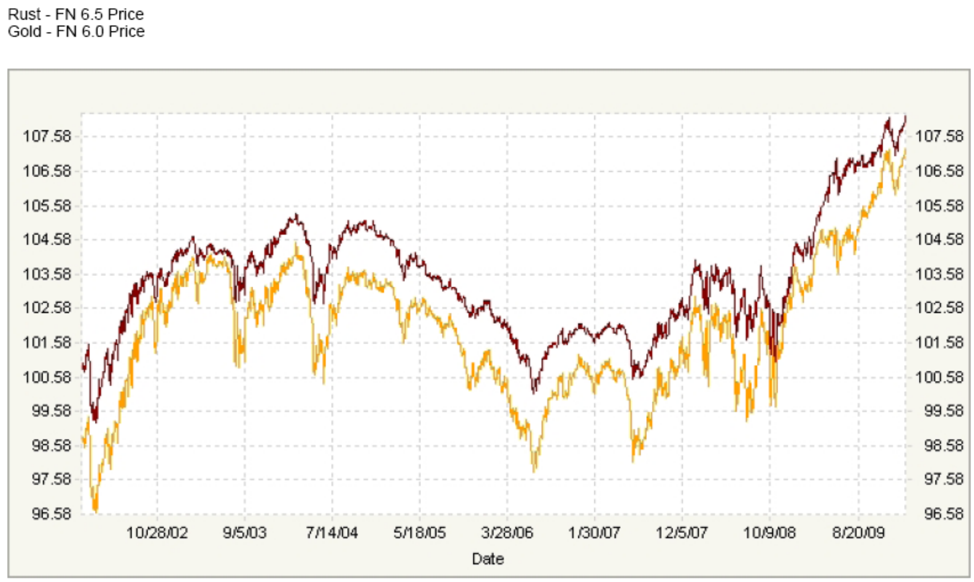
Since the GSEs are under conservatorship with a large credit backstop from the US Treasury, they are for all intents and purposes owned by the taxpayers. And since the average taxpayer is by definition average, he is therefore not "rich" since "rich" tends to be defined as possessing well above average wealth. Furthermore, the mere fact that bondholders have funds to invest in such bonds disqualifies them from being categorized as "poor". Although not all bondholders are "rich", those who have such substantial excess funds that they can invest in bonds are probably closer to rich than average. Taken altogether, one could consider the fact that the GSEs are using taxpayer funds to advance a 6% coupon to bondholders when they could be funding this cost in the public markets at 20bps to be in essence a "Reverse Robin Hood" situation.

To be fair, the GSEs specifically disclose that their buy out decisions are based upon many factors beyond the mere net cost of funds including an efficient loss mitigation strategy, impact on reported capital, administrative costs, counterparty exposure, statutory obligations under their Charter Act, and other legal obligations under consumer finance laws.

Of these, the accounting impact on their capital would be the most affected by a significant increase in buy outs. Since many loans are now "upside down" with respect to their LTVs, a buy out would likely lead to a mark to market impairment charge since an immediate recovery attempt would probably return less that Par. This issue was alleviated by FASB's promulgation of statements #166 and #167, implemented last year and effective for reporting periods that began after November 15, 2009. Our reading of these statements indicate that the GSEs could now buy out delinquent loans and leave them on their books at par until such time that actions are taken where a loss is realized. Considering the non-transparency of home prices in many areas due to the lack of comparable sales, this seems quite reasonable.

To further encourage the GSEs to accelerate buy outs, regulators expanded the GSEs mortgage holding limitations so loans brought back on to their balance sheet will not require matching portfolio sales.

Although this accounting change has been in the public domain for quite awhile, it seems that the markets have not taken them too seriously.



Above, the –rust line- is the dollar price of FN 6.5% bonds while the –gold line- is the price of FN 6.0% bonds. Notice how the peak prices reached during the 2003/04 ReFinance wave was about 105 and 104 respectively. Presently, these same coupons trade almost three points higher. Bondholders are seemingly challenging the GSEs to implement an accelerated buy out program.

As a matter of public policy, we strongly support any actions that will help the GSEs swiftly ramp up their buy out program. But the important ramification here is much larger than merely saving taxpayers up to $13 billion a year. Buy outs would return dedicated MBS dollars to investors that would certainly be mostly re-invested in current coupon MBS. This dovetails so nicely with the soon to expire FED MBS purchase program as a method to add support to the MBS market. Remember, homeowners ReFinance into a current coupon bond, not a premium security. Even a hint of increased buy outs will quickly redirect the market to discount bonds as premium bondholders race to sell their 106-dollar price bonds before they prepay at Par.

Are we recommending that investors go "down in coupon" in anticipation of accelerated buy outs ? Hhhhhmmmm. We have made this case more than once in the past, and have been dead wrong each time. But to repeat our bottom line, investors in premium bonds are betting upon the economic inefficiency of politics. We prefer to make our investments upon a more rational foundation.

The managers at the GSEs are quite familiar with both the economics and the politics of their situation. An increase in buy outs will demand the issuance of more debt. Also, these buy outs will certainly lead to an increase in reported losses. Both of these are anathema to the political class. That said, not increasing buy outs is worse since it not only costs much more but also delays the critically important modifications process. As such, I suspect it is more of a question of 'when' as opposed to 'if'.

Much like picking up pennies in front of a steam roller, it sure is fun until it's not. Owners of premium bonds should not be exposed by more than an "Index" weighting to the asset class.

Harley S. Bassman
BAS/ML US Rates Trading
February 9, 2010

Bank of America
Merrill Lynch