Convexity Maven

A Commentary by Harley Bassman

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"Busting the Housing Log Jam"

In response to the Global Financial Crisis (GFC) in 2008/09, the US Federal Reserve Bank (FED) initiated Quantitative Easing (QE) and Zero Interest Rate Policies (ZIRP) where it respectively purchased trillions of US Treasury bonds (UST) and Mortgage bonds (MBS) and lowered its Federal Funds interest rate to near zero.

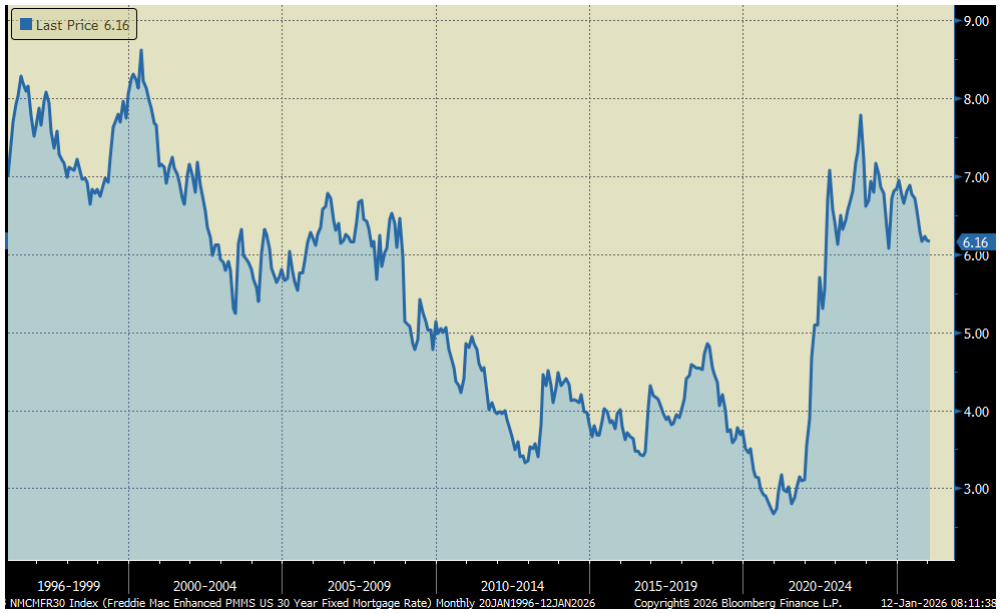
It took similar actions in March 2020 to support the Financial Markets as the Covid pandemic shuttered much of the Global economy.

Lowering interest rates is a time-honored policy to support an impaired economy as a lower cost of borrowing frees up funds to be used elsewhere to enhance economic activity; but sometimes there are unintended consequences.

Today we examine how such policies have gummed up housing activity and suggest a rational and viable policy to bust up the housing log jam.

Most standard thirty-year mortgages are guaranteed by one of the housing related Government Sponsored Enterprises (GSE); you know them as Ginnie Mae, Fannie Mae and Freddie Mac. I detailed this process in "A Deep Dive into Mortgage Bonds" published on November 3, 2022.

The -zaghal line- Freddie Mac commitment rate tracks the average rate the "retail" borrower pays on a standard mortgage loan. These loans are then guaranteed and packaged into MBS that trade on the open market.



The -gharmaz line- MBS coupon rate is usually three-quarters (75bps) less than the loan rate. This spread funds the cost to "service" the loan.

As shown above, QE1 lowered that average -zaghal line- home buyer mortgage rate from about 6.0% to about 4.0%. The FED's actions during Covid further reduced this rate such that between mid-2021 and mid-2022 a financially qualified home buyer could lock-in a thirty-year rate below 3.0%.

An unintended consequence has been the increase in house prices. This is because except for a few Silicon Valley fat cats, most people do not buy a house for cash but rather sign up for a thirty-year payment plan.

Using the old rules of allocating 28% of one's income to the cost of a mortgage, a family earning a median income of $71,000 could afford $19,880 annually, or $1,656 per month. This supports a -baranzeh line- $300,000 mortgage at 5.25%.

Loan Size	Rate	Monthly Payments
$300,000	5.25%	$1,656
$400,000	3.00%	$1,686

With no change in the family's income, a 3.00% mortgage rate could now support a -sabz line- $400,000 loan balance. For simplicity I have ignored the down payment, as well as the various expenses of taxes and insurance; but aside from the hand waving of insufficient home construction and various local NIMBY policies, much of the increase in the price of a home over the past decade can be traced to lower mortgage rates.

Most of the mortgage activity from 2021 to 2022 was for re-financing legacy loans into new mortgages with a much lower rate. In fact, by mid-2023 nearly two-thirds of all thirty-year borrowers paid a rate of less than 3.75%.

The FED starting hiking interest rates in early 2022 after their preferred inflation measure exceeded 3% for the first time since late 1992. Retail mortgage rates soon exceeded 6.0% for the first time since November 2008.

The profile of the MBS market has changed (below), but still about 42% of all mortgages have a -banfesh columns- coupon under 3.35%.

Borrower's Mortgage Rate	30yr MBS Coupon	Original Balance	Original Percent Total	Cumulative Total	MBS Price	MBS Duration
2.48%	1.50%	$222	2.4%	2.4%	77.72	8.45
2.94%	2.00%	$1,976	21.4%	23.8%	81.25	8.08
3.35%	2.50%	$1,669	18.1%	41.9%	85.09	7.72
3.77%	3.00%	$989	10.7%	52.6%	88.92	7.29
4.24%	3.50%	$721	7.8%	60.4%	92.77	6.81
4.94%	4.00%	$447	4.8%		95.75	6.17
5.48%	4.50%	$409	4.4%		98.56	5.33
6.01%	5.00%	$631	6.8%		100.44	3.84
6.49%	5.50%	$897	9.7%		101.64	2.26
6.89%	6.00%	$813	8.8%		102.63	1.20
7.29%	6.50%	$368	4.0%		103.84	0.47
7.60%	7.00%	$94	1.0%		105.19	0.47

Sand in the gearbox of the Housing Market

In 2005 it was reported that the actress Mia Farrow lived in a rent controlled 11-room apartment on Central Park West and paid the paltry sum of $2,500/month. The market rent was likely ten times higher.

She was not moving.

Thus, one of the main problems with rent control - it freezes the market. Most people focus on the landlord's finances, but the greater problem is that nobody can move since even a smaller market-rate space might rent for much more.

California passed the infamous Prop 13 in 1978 as a balm for rapidly rising property taxes. This proposition linked property taxes to the price you paid for the home, with a maximum 2% annual limit on the increase of this value.

Run this game for a few score decades and the house grandma paid $70,000 is now worth $3.5mm. Grandma is now paying perhaps $2,500 a year in property taxes, but when this house is sold, the new owners will pay about $38,000.

Imagine grandma sells the house and downsizes to a small condo in Laguna Beach for $1mm; she would then be on the hook for taxes of $11,000/year.

She is not moving.

A similar situation is happening nationally to the millions of homeowners who cleverly locked-in low a fixed rate in 2021/22, they cannot afford to move.

Consider our -sabz line- borrower from above who took out a $400,000 mortgage at 3.00% with monthly payments of $1,686.

Loan Size	Rate	Monthly Payments
$400,000	3.00%	$1,686
$355,000	5.75%	$2,072

A standard thirty-year mortgage is "self-amortizing", which means one pays both interest and part of the principal loan amount. Over five years since 2021 this borrower would have paid down about $45,000, so only $355,000 remains.

If he traded up a new house and took out a new -khon line- mortgage for only this remaining balance at the current rate of 5.75%, his monthly payments would jump by 23% to $2,072 or $386/month.

He too is not moving.

The Solution: Mortgage Portability

Ginne Mae (GNMA – Government National Mortgage Assn) guarantees home mortgages issued to FHA and VA qualified borrowers. These mortgages have always been **Assumable**, which means that a new buyer of the home can step into the shoes of the seller and keep that payment schedule (both size and rate).

This was a big deal in the late 1970s and early 1980s when mortgage rates exploded from under 8% to touch as high as 18%.

A $100,000 mortgage at 9% issued in 1978 would have a monthly payment of $804. A new borrower in 1983 taking out a $100,000 mortgage at 17% would pay $1,425 / month.

As such, a house with an assumable low-rate mortgage would sell for a higher price than a house without one. The math is a bit tricky to calculate the present value of an assumable loan, but it is certainly greater than zero.

But assumable loans do not help the housing market that is clogged by homeowners with 3% loans who cannot afford our current higher rates.

The answer is to make loans **Portable**, which means that the borrower keeps the low-rate loan and can use it to buy a new home.

For a **Portable** loan the borrower is fixed and the address changes, while for an **Assumable** loan the house is fixed and the borrower changes.

I have not invented the wheel since mortgage portability already exists in Canada, Australia and the U.K.; although these are shorter 2-to-5-year loans.

Moreover, Portability is better for the financial system. The lender of an assumable loan has the risk that the new borrower is a greater credit risk while for a portable loan the borrower is known as a good credit.

The only risk for a portable loan is if new home is of lesser value than the remaining loan balance, so the collateral of the house is insufficient to cover a loss in a foreclosure sale.

Since the GSEs already guarantee these loans against default, keeping the same borrower who has already passed their review does not change their risk profile. And since the rate and maturity are unchanged, the Servicer is unaffected.

What will happen is the duration of the MBS that contain these loans will lengthen as prepayment on lower coupon securities will decrease.

An Affordability Policy

On July 23, 2010 I published a commentary titled "The Best Laid Plans of Mice and Men" where I proposed the creation of **CARP**:

The **C**orporation for the **A**ccelerated **R**efinancing of **P**rincipal.

The notion was to help borrowers with high interest rates, but low credit quality to refinance lower-rate mortgages. The deal killer was that the GSEs could not mandate this policy alone since it would impact the Servicers as both the coupon and maturity date would change.

This **Mortgage Portability** policy proposal is different.

President Trump could wave his hand and ask Bill Pulte, the head of the FHFA, to instruct Fannie and Freddie to permit these GSE guaranteed loans to travel with the borrower, so long as the next house creates an LTV (loan to value) that does not to exceed 80% certified by a reputable appraiser.

The only "losers" would be the owners of MBS bonds with super-low coupons. There would not be "losses", per se, but rather small mark-to-market price declines as prepayments slow down and the durations of these MBS extend.

Housing turnover should increase significantly, and while prices may not come down immediately, removing friction in the system should be beneficial to the overall housing market.

And even if prices do not decline, **allowing people to move more easily as their lifestyles change is a public policy good.**

Remember: For most investments, sizing is more important than entry level.

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Your comments are always welcome at: harley@bassman.net

If you would like to be added to my distribution, just ping me.

To become better educated on macro-economic fundamentals and policy, I urge you to connect with my partner, Michael Green, better known as @profplum99.

Special Coda: *Some of the ideas I suggest can be particularly complex via the use of futures contracts and options embedded into Strategies for leverage and/or convexity that is both clever and tricky. I urge you to ping my associates who are waiting for your call to detail these strategies more fully.*

For reference literature on the financial markets - particularly about options and derivatives - I will immodestly direct you to my educational archive at:

https://www.convexitymaven.com/classroom/

If you still have kids in the house, please take a vacation that is more interesting than the Four Seasons, Costa Rica – life is not a dress rehearsal. Turn off the Crackberry (did I just date myself ?) and explore with the family. You don't need to break the bank, rent an RV and see the U.S. We traveled with our four kids on five incredible RV trips.

http://bassman.net

Special credit to Gerard Minack, the best macro analyst on the planet.