# Higher Refi Volumes and Tighter Spreads

## Implications for Mortgage Banking in 1Q13

### Highlights

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**Companies Mentioned**

| Ticker | Price Target | Rating |
|---|---|---|
| BBT | $34.00 | Neutral |
| EVER | $15.00 | Neutral |
| FITB | $17.00 | Neutral |
| NSM | $48.00 | Buy |
| OCN | $44.00 | Buy |
| PHH | $24.00 | Neutral |
| PNC | $66.00 | Buy |
| STI | $30.00 | Neutral |
| STSA | $20.00 | Neutral |
| USB | $35.00 | Neutral |
| WAC | $52.00 | Buy |
| WFC | $38.00 | Neutral |

The first weeks of the year have shown a material increase in refinance volume, while the primary-secondary spreads have tightened. If this trend continues, it could cause mortgage production revenue for the industry to decline 15-30%, depending if volumes and margins stay near current levels. A slight increase in mortgage rates may cause a fair value markup in mortgage servicing rights, but this likely won't be enough to offset the decline in gain on sale margins.

The Mortgage Bankers' Association reported an 8% increase in the seasonally-adjusted refinance index and a 7% increase in the overall market index. On a non-seasonally adjusted basis, the purchase index is at its highest level since October and the overall market index was up 8%. The refinance index is at its highest level since the first week of December when 30-year fixed mortgage rates were hitting all-time lows below 3.40%, according to BankRate.

Meanwhile, the average quarterly spread between the primary and secondary mortgage market has fallen from the peak of 1.28% in 3Q12 to 1.17% through the first few weeks of 1Q13. On January 22, the primary-secondary spread measured 1.12%. If we take into account the 16 bp decline in the primary-secondary spread and the 10 bp increase in the guarantee-fee implemented by Freddie Mac and Fannie Mae in December 2012, the 26 bp decline in mortgage spreads could cause 100+ bp decline in average gain on sale margins from 3Q12 to 1Q13. We would note it is still early in the quarter and the spread could bounce back, but initial measures show gain on sale could see material contraction in 1Q13. We have been expecting a slight contraction in the first half of this year followed by further contraction in the back half of 2013, but it seems to have accelerated. See our January 8 brief: "Why the Gain on Sale Party Will Not Last" for further analysis.

### Why are refinance volumes increasing?

**First possibility: new reps/warrants rules.** Starting in 2013, the FHFA implemented new reps/warrants provisions for loans sold to the GSEs. All HARP refis sold to the GSEs would have reps/warrants provisions expunged if the borrower made 12 months of on-time payments. All other originations would have reps/warrants provisions in place for 36 months following the sale of the mortgage to the GSEs. Due to the changes, it is possible the increase in refi volumes could be due to an increase in "cross-servicer" HARP refis. Prior to this rule being implemented, originators were hesitant to refinance a HARP loan in another mortgage originator/servicers' portfolio because of the potential for reps/warrants putbacks on high LTV loans. The new provisions could have lowered the risk enough to make it attractive to mine other servicers' portfolios.

**Second possibility: slight rate bounce causing borrowers to finally refi.** Mortgage borrowers have watched mortgage rates continue to fall from roughly 4.0% in March 2012 to sub-3.4% in December. From October to December, 30-year mortgage rates remained in a range between 3.35% and 3.45% and have since started to increase to the 3.45-3.50% range in recent weeks. This slight increase could have caused some borrowers looking to time the low to finally refinance a higher rate mortgage.

## What is the impact to mortgage production revenue?

**Material declines for gain on sale.** We estimate average gain on sale margins could decline 50-75 bps from 4Q12 levels after taking into account the tighter primary-secondary market spreads and the higher guarantee-fee. From their peak in 3Q12, we estimate gain on sale spreads could be down roughly 100 bps. We would note it is still early in the quarter and margins will differ from originator to originator due to several factors, but the market is indicating material declines.

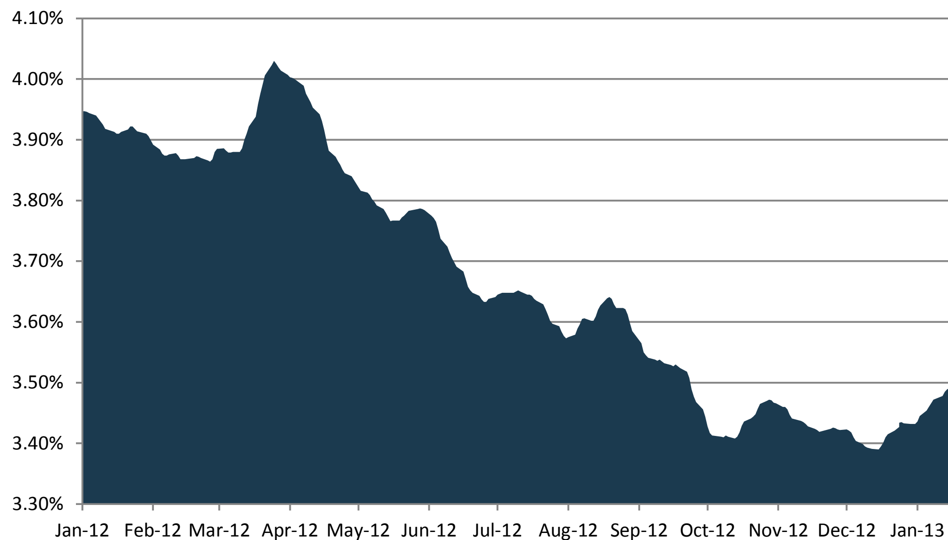
**Production revenue down 15-30%.** If we assume origination volumes equal 4Q12, 1Q13 mortgage banking production revenue could be down 15-20% due to lower gain on sale margins. If we assume the current leading forecasts for a 12% decline in origination volume hold true and spreads stay near current levels, the decline could be 25-30% lower than the previous quarter.

**MSR fair value could adjust higher.** The slight increase in mortgage rates could cause a markup in mortgage servicing rights (MSR) as originator/servicers extend the effective duration of their servicing portfolio. If prepayment speeds remain near current levels, there could be some negative offset to the markup, but fair value adjustments could counter some of decline from lower gain on sale margins.

## Mortgage Rates

Mortgage rates have shown a slight increase after establishing a base through 4Q12. This may have caused borrowers that were attempting to time a bottoming of mortgage rates to finally refinance their mortgage.

**BankRate 30-Year Mortgage Rate Index (10-day moving avg.)**




*Source: Bloomberg (MTGEFNCL), Compass Point*

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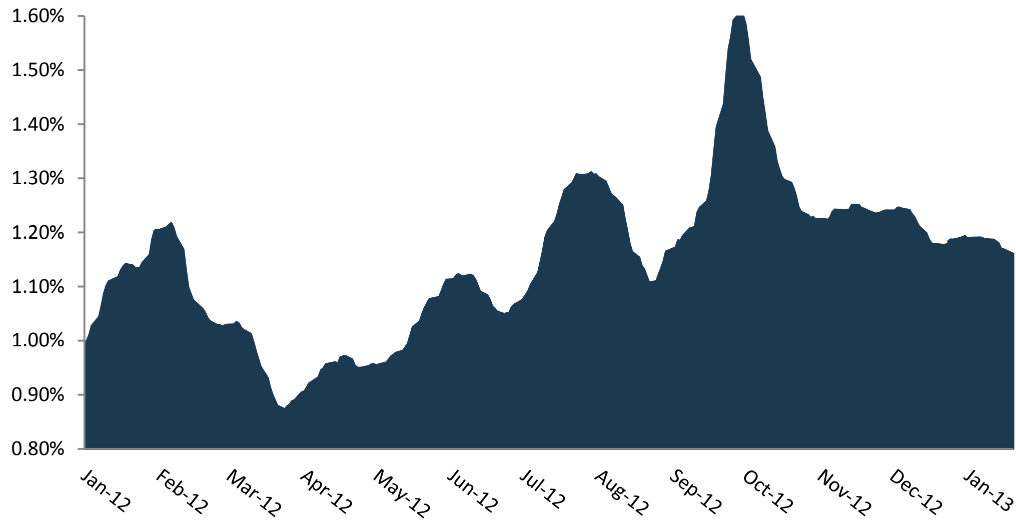
## Primary-Secondary Mortgage Spreads

The spread between mortgage rates advertised to borrowers (primary) and the yield on agency mortgage backed securities (secondary) has declined from an average of 1.28% in 3Q12 to an average of 1.17% through the first few weeks of 1Q13. As of January 22, the spread was 1.12%.




*Source: Bloomberg (ILM3NAVG v. MTGEFNCL), Compass Point*

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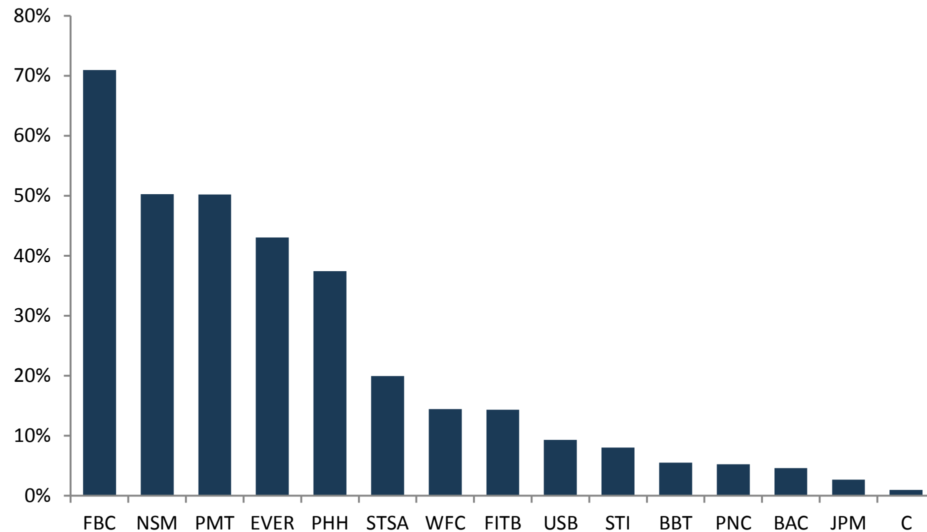
## Who is Most Levered to Gain on Sale?

We expect a significant drop in margins going forward, but we have already taken a very conservative approach in our numbers. On average, we have 42% drop in gain on sale margin in our models. Also, if we see rates move higher or prepayment speeds start to slow, mortgage servicing rights could mark higher, providing a lift to total mortgage banking revenue. However, we would emphasize caution with those companies who are most exposed to a continuation of gain on sale margins remaining near current levels to justify earnings expectations.




*Source: Company Reports, Compass Point*

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## Gain on Sale Illustration

The following chart gives an illustration of how changes in mortgage rates, the guarantee-fee and MBS yields cause significant swings in gain on sale margins. This table is for illustrative purposes only and presents a very basic view on the economics of originating a mortgage.

**Gain on Sale Margin Economics 101**

| Inputs | 3Q12 Avg | 1Q13 Avg | HARP | Notes |
|---|---|---|---|---|
| Duration (years) | 6 | 6 | **7** | assumed mortgage duration |
| Coupons per yr | 12 | 12 | 12 | monthly mortgage payment |
| Mortgage rates | 3.58% | 3.49% | **4.00%** | primary rate |
| Guarantee-fee | 0.40% | 0.50% | 0.50% | paid to GSE |
| Servicing fee | 0.25% | 0.25% | 0.25% | paid to servicer |
| Other | 0.10% | 0.10% | 0.10% | hedging, fall-out, etc. |
| Net Yield | 2.83% | 2.64% | 3.15% | |
| MBS yield | 2.29% | 2.32% | **2.10%** | yield in MBS market |
| Net Spread | **0.54%** | **0.32%** | **1.05%** | |
| Secondary Market Price | $1,030.25 | $1,018.70 | $1,068.30 | price of bond in market |
| Face Value | $1,000.00 | $1,001.00 | $1,000.00 | original value of mortgage |
| Priced-in Margin | 3.02% | 1.77% | 6.83% | diff between secondary $ and mortgage balance |
| Capitalization of MSR | 0.90% | 0.90% | 0.90% | initial value of MSR created (non-cash) |
| **Total Gain on Sale** | **3.92%** | **2.67%** | **7.73%** | |

*Source: Compass Point, Bloomberg*

Gain on sale margins vary tremendously from company to company depending on a host of factors, including: (1) the difference between the rates the company funds a mortgage and sells into the market (company-level primary-secondary spread), (2) type of mortgages sold (Fixed, ARM, 30Y, 15Y, etc), (3) valuation of MSR capitalized, (4) hedging results, (5) mix of retail, correspondent, and wholesale originations, (6) mark-to-market of loans in warehouse and several other factors. Also, many companies will include/exclude certain expenses associated with the origination of a mortgage. Hence, it is important to look at trends on the company-by-company level in order to forecast gain on sale margins rather than the market as a whole.

The basic calculation of gain on sale margin (excluding expenses) assumes a mortgage is originated at the going rate in the market, a guarantee fee is paid to the GSEs, servicing fees are paid to the mortgage servicer, and the mortgage sold into the secondary market. The difference between these rates, fees and the effective duration of the mortgage in the secondary market results in a price in which a pool of mortgages could be sold. The fees and other costs associated with originating that loan could be excluded from this calculation. For instance, a correspondent lender may pay the originator of the mortgage 0.75% for originating the loan.

**Isaac Boltansky is Compass Point's Washington Policy Strategist. His contributions to this research report relate solely to Washington Policy and should not be attributed to any company specific research, ratings, or conclusions.**

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|---|---|---|---|---|---|
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| Neutral | 57 | 50 | Neutral | 1 | 2 |
| Sell | 6 | 5 | Sell | 0 | 0 |
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