



# Gain on Sale Margins Contracting Faster Than Expected

## 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
PHH	\$24.00	Neutral
PNC	\$66.00	Buy
STI	\$30.00	Neutral
STSA	\$20.00	Neutral
USB	\$35.00	Neutral
WFC	\$38.00	Neutral

Mortgage production revenue for the first quarter could be down as much as 35% from 4Q12 due the recent contraction of gain on sale margins. We estimate gain on sale margins are down 30-40% from 4Q12 due to a 15 bp contraction in the primary-secondary spread and a 10 bp increase in the guarantee fee (g-fee). This would imply margins are already running close to 2010-2011 levels. We originally forecasted gain on sale margins would contract back to 2011 levels in 2013, but not at this pace. If this trend continues, it would likely cause us to decrease our EPS estimates for mortgage originators. It has also become apparent the FHFA increase in the g-fee did not cause an increase in mortgage rates, rather it has eaten into mortgage banking profit margins.

**Competition is heating up.** The increased capacity in the market for mortgage originations, combined with lower refinance volumes, has created much stronger competition in the origination market and significantly lower pricing than we saw in the second half of 2012. Commentary from most major mortgage banks and the aggressive nature of several "recent" entrants looking to capture share, including Quicken Loans, PennyMac (PMT - NC), EverBank (EVER - Neutral, \$15 PT, Barker), and FlagStar (FBC - NC), supports our view that competition is the strongest we have seen in several quarters.

**Gain on sale margins could be down 30-40% from 4Q12.** The primary-secondary spread averaged 1.24% in 4Q12 and 1.28% in 3Q12. During the first six weeks of 2013, the spread has averaged 1.09% and stood at 1.03% as of 2/19/2013. After taking into account the 10 bps increase in the g-fee implemented in December, there could be significant contraction from 4Q12 levels if margins stay near current levels. However, we would note, originators with a greater share of their originations coming from retail channels or from HARP refis could see their margins hold up better than originators reliant on correspondent/wholesale lending.

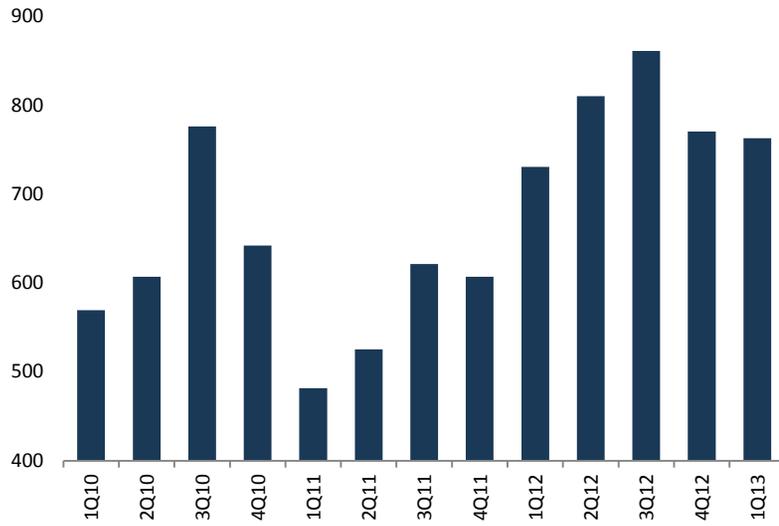
**HARP cross-servicer refis?** During 4Q12 earnings season, several mortgage originators stated they are refinancing HARP loans that are currently being serviced by another mortgage bank. We believe the very attractive economics of refinancing a HARP loan (6.0%+ margins) and the new reps/warrants rules, have made the risk-adjusted returns attractive enough for more lenders to make these loans. On January 1, 2013, the FHFA implemented new rules for reps/warrants that would remove the provisions if a newly originated loan sold to the GSEs has 36 months of on-time payments for regular-way originations and 12 months of on-time payments for HARP loans.

**Stocks most levered to gain on sale.** The companies with the most leverage to origination gain on sale margins for earnings include: FBC, NSM, PMT, EVER, and PHH. Other large mortgage market participants that have material exposure to mortgage banking, but not necessarily the heavy exposure as some non-bank originators include: STSA, WFC, FITB, USB, and STI.

## Origination volumes down slightly...

On an unadjusted basis, the MBA mortgage application index is indicating mortgage originations are down very slightly from 4Q12 even though rates have backed up roughly 20 bps since their lows in November. This is counter to the consensus forecast of a 12% decline in 1Q13 and 4% forecast from the MBA.

### MBA Application Market Index (Unadjusted)

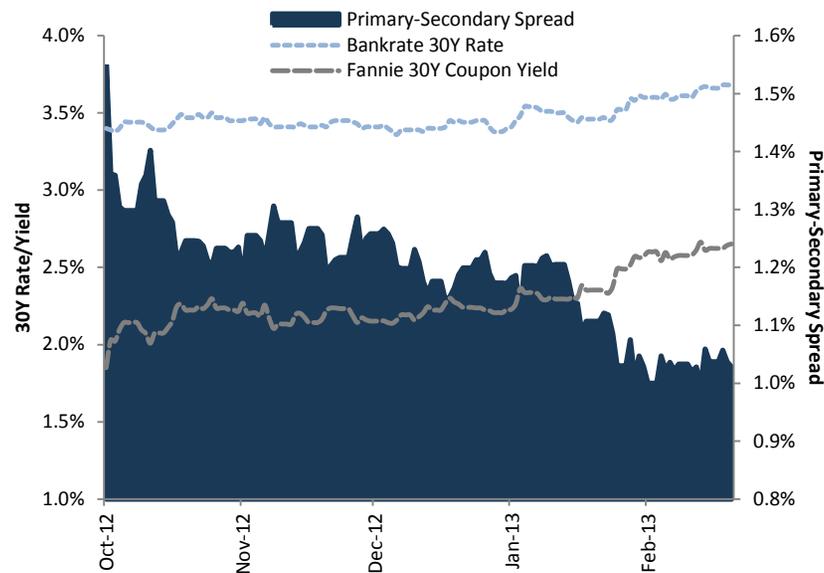


Source: MBA, Bloomberg, Compass Point

## ...but, primary-secondary mortgage spreads continue to tighten

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 1.09% through the first half of 1Q13. As of February 19, the spread was 1.03%. As shown in the chart below, the primary-secondary spread actually contracted following the 10 bp increase in the g-fee on December 1, 2012. Also, we have seen a material decline in the spread as we entered the new year. This may be delayed reaction from originators to react to rates and/or an indication that banks may be more willing to originate HARP loans in another servicers' portfolio following the implementation of new reps/warrants provisions.

### Primary-Secondary Spread (5 Month)



Source: Bankrate, Bloomberg, Compass Point

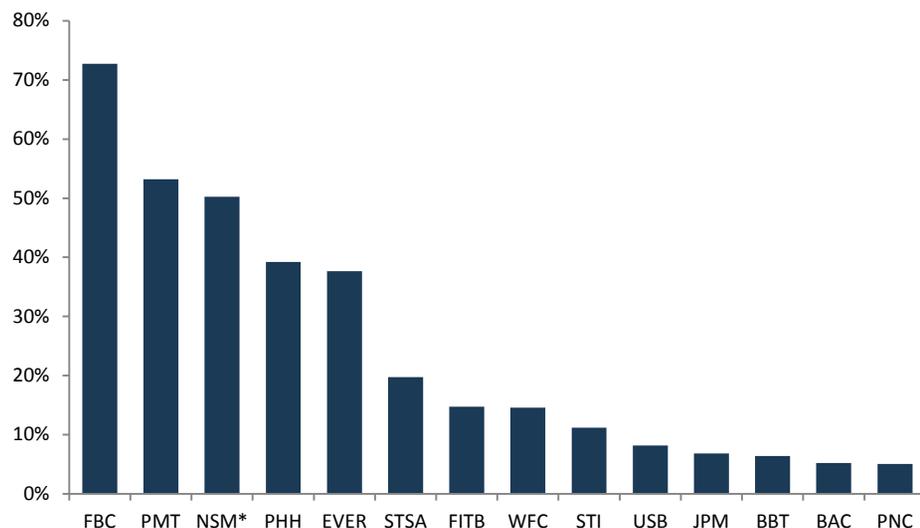
## ...which will have a bigger impact on production revenue

**Material declines for gain on sale.** We estimate average gain on sale margins could decline 100+ bp from 4Q12 levels after taking into account the tighter primary-secondary market spreads and the higher g-fee. From their peak in 3Q12, we estimate gain on sale spreads could be down roughly 150 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 significant declines.

**Production revenue down 30-40%.** If we assume origination volumes stay near current levels, 1Q13 mortgage banking production revenue could be down 30-40% 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 40-45% 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. The markup in the MSR could have an outsized impact on PHH Mortgage (PHH - Neutral, \$24 PT, Barker) given the limited amount of hedging the company has implemented.

### Production Revenue as % of Total Revenue - 4Q12



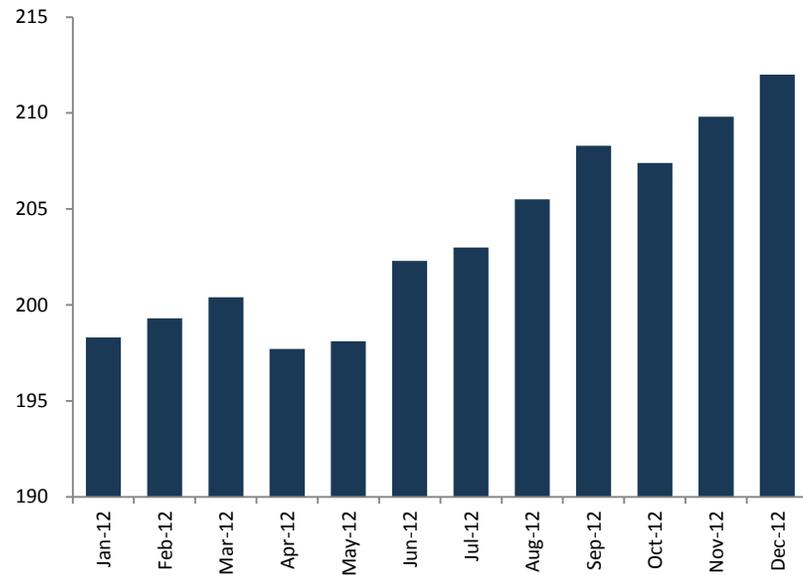
\* As of 3Q12

Source: Company Reports, Compass Point

## Capacity continues to build...

As shown below, the mortgage industry has been on hiring spree throughout 2012 as companies try to take advantage of very attractive HARP margins and the surprising increase in refinance volumes. If origination volumes were to slow, we would expect mortgage industry employment to decrease, but there would likely be a 2-3 quarter lag before capacity adjusted to volume.

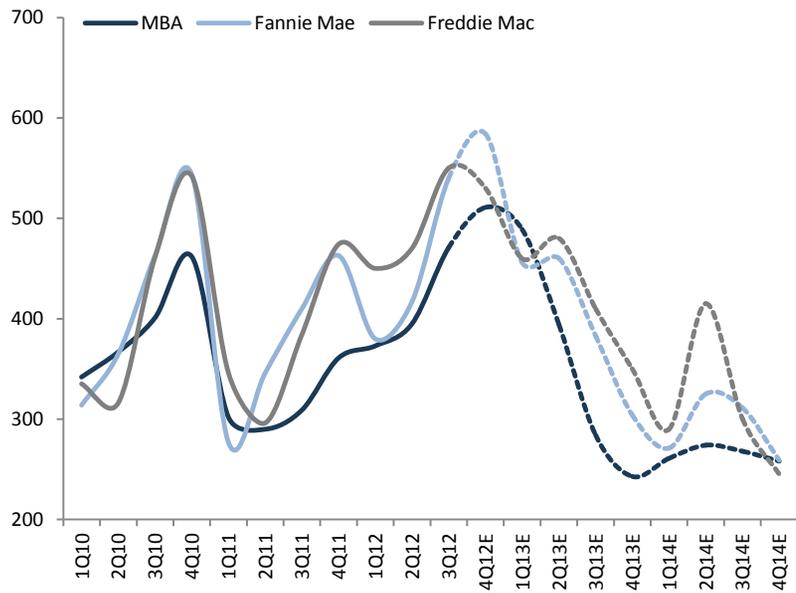
**Mortgage Industry Employment (2012, 000s)**



Source: Bureau of Labor Statistics, Compass Point

**...yet, origination forecasts expect big declines in volume**

**Mortgage Origination Forecasts (\$B)**



Source: MBA, Fannie Mae, Freddie Mac, Compass Point

## 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	4Q12 Avg	1Q13 Avg	HARP	Notes
Duration (years)	7	7	8	assumed mortgage duration
Coupons per yr	12	12	12	monthly mortgage payment
Mortgage rates	3.43%	3.55%	4.00%	primary rate
Guarantee-fee	0.40%	0.48%	0.48%	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	2.68%	2.72%	3.17%	
MBS yield	2.18%	2.46%	2.30%	yield in MBS market
Net Spread	0.50%	0.26%	0.87%	
Secondary Market Price	\$1,032.43	\$1,016.70	\$1,063.52	price of bond in market
Face Value	\$1,000.00	\$1,000.00	\$1,000.00	original value of mortgage
Priced-in Margin	3.24%	1.67%	6.35%	diff between secondary \$ and mortgage balance
Capitalization of MSR	0.90%	0.90%	0.90%	initial value of MSR created (non-cash)
<b>Total Gain on Sale</b>	<b>4.14%</b>	<b>2.57%</b>	<b>7.25%</b>	

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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