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AGENCY MORTGAGE BACKED SECURITIES
HOW MIGHT PANDEMIC RELIEF IMPACT BOND HOLDERS?

First Quarter 2020

With a substantial portion of the country (and the world) subject to some form of lock-down, the economy has ground to a standstill, leaving millions of Americans without a regular paycheck. Indeed, the last few weeks' worth of new unemployment claims (3.3 million and 6.6 million respectively, the largest two weeks ever recorded) foreshadow a considerable increase in the unemployment rate. As a result, Government agencies have initiated payment relief programs designed to relieve borrower cash flow stress for those who suddenly find themselves unemployed. At just over $10 trillion, residential mortgages are the single biggest form of consumer debt in the United States. Furthermore, housing related debt payments typically chew up 20% - 40% of pre-tax monthly income, considerably more than other forms of debt payment. As a result, mortgages are fertile ground for COVID-19 hardship payment relief programs.

Initiatives to relieve mortgage payment stress naturally involve Fannie Mae and Freddie Mac (the GSEs) as well as Ginnie Mae (FHA & VA). At $6.3 trillion market value (27% of the Bloomberg Barclays Aggregate Index), Agency MBS represents a considerable component of the investable fixed income universe. Payment forbearance and deferral programs naturally raise a number of questions. How do these deferrals impact bond investors' cash flows? Are servicers still responsible for advancing interest to bondholders? What do the GSE guarantees cover?

Under the current forbearance programs, borrowers can apply for temporary hardship payment forbearance for an initial period of up to six months. Obviously, there are certain conditions that need to be met (like affirming hardship) before forbearance is granted. Under certain circumstances, borrowers can apply for an additional six month forbearance extension. Until recently, forbearance payments must be brought current at the expiration of the forbearance plan (six-months); however, the FHFA recently announced a new deferral plan to allow forbearance balances (missed payments) to be rolled to the end of the mortgage term IF a borrower is unable to get completely caught up. Unpaid forbearance will be non-interest bearing, borrowers will be considered current, and the loan will not be considered "modified". As long as the borrowers can continue to make ongoing contractual payments, they can continue to defer missed payments.

Importantly, Agency MBS investors will not miss any scheduled interest or principal payments. Mortgage servicers are contractually required to advance principal and interest (P&I) for any loans in delinquency and forbearance status. Under normal circumstances, when a loan becomes 120 days delinquent, the GSE buys the loan out of the pool at par, and the foreclosure/recovery/ modification continues to take place beyond the view of the Agency MBS investor. When it's all said and done, the GSEs reimburse the servicers for any unrecovered advances.

In the current situation, the application of delinquency status will be suspended to prevent widespread negative credit reporting at the borrower level. As a result, the normal GSE buyout timing could be delayed. Regardless, the GSEs guarantee of timely payment of interest and principal doesn't change. We are merely highlighting that under the current circumstances, things are more nuanced. There have been additional questions regarding the adequacy of servicer and GSE liquidity to continue advancing P&I. As luck would have it, the GSEs are still in receivership with the US Department of Treasury following the mortgage market collapse in 2008. As such, they have considerable access to liquidity lines with the Government, in addition to their ability to issue debentures to fund increased buyouts and servicer reimbursements.

Notably, this type of servicing requirement is not unique to Agency MBS servicing as it's a common feature of virtually all asset securitizations. In the non-agency world (RMBS, ABS, CMBS), servicers will continue to advance P&I to the point they deem those advances unrecoverable. The servicer provides liquidity but NOT credit enhancement. As such, servicer advances move to the top of the waterfall in subsequent periods in non-agency securitizations. Implications for non-agency collateral types are more nuanced but, in general, senior bonds are relatively well protected.

One final thought - How big has QE4 been relative to previous QE? Answer: Massive! Previously, QE1 and QE3 (most comparable due to MBS buying) both saw the Fed purchase gross MBS amounts of ~$1.4 trillion. Furthermore, those programs were implemented over a longer time period of years. In the last three weeks, the Fed has purchased ~$340 billion of MBS already. That's almost 20% of previous QE programs in only two weeks. Using past Fed behavior as a predictor, some estimates of QE4 are equivalent to QE1 and QE3 combined, and possibly much more. In the Fed's own words, they will purchase whatever amount is necessary to keep the MBS market functioning. With an open checkbook at the Fed, effective NET supply to the market will be massively negative.

In closing, our approach to Agency MBS is relatively unchanged. We look to maintain our core allocation to Agency MBS as they are a well-supported, high quality source of liquidity and spread. Additionally, we will look to add better convexity when relative value presents an opportunity. As always, we remain cautious in our approach and we are cognizant that Agency MBS could see additional volatility as constrained balance sheets and de-leveraging stress the financial system.

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