GSE Activity Report

Tuesday, July 11, 2017

Asleep as the RMBS Switch is Thrown

Summary

The Federal Reserve Bank of New York today laid out what it thinks will happen when the Fed begins to wind down its agency RMBS book, positing steady-as-you-go mortgage securitization with or without the Fed based on a series of assumptions we think are far from certain. More likely is the pricing turmoil many in the market anticipate.

Impact

As we noted in our prior assessments, working through the agency wind-down is more complicated than the Treasury portfolio reduction because of the far less certain pay-off dates of residential mortgages underlying agency obligations. Unlike Treasuries, mortgages also amortize, meaning that MBS principal reduces even when not paid off.

The FRB-NY blog post takes all of this into account but then goes on to a more dubious assertion – that agency issuers will always issue a new MBS for one that is paid down or prepaid. We view this as less certain since Ginnie responds only to market demand which of course fluctuates and the GSEs not only do the same, but are also under considerable political pressure that could alter their operations over the prolonged time it will take the Fed to do anything meaningful with its huge RMBS portfolio. The Fed paper also assumes that any RMBS not purchased by the Fed would be purchased by banks – not unreasonable since banks hold lots of RMBS, but again far from certain due to the host of balance-sheet pressures we have previously described, not to mention the pricing pressures on banks to which the Fed now is insensitive as it reinvests its run-off RMBS.

Based on all these assumptions, the FRB-NY paper concludes that nothing much happens as the Fed reduces its agency book because everyone else makes up the difference.

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Outlook

The FRB-NY model in our view is like many econometric models: figure out who your "representative agent" is or whatever variable you like, move the variable around in a scenario you construct, and voila. In fact, disposing of the $1.8 trillion in agency paper the Fed now holds will be anything but the tidy affair posited by this paper. As we have noted before, the Fed's agency book is not only huge in light of total RMBS issuance, but also even a tidy share of U.S. GDP.

In fact, the FRB-NY knows how big the agency book is – when it takes its eyes off its models and looks at the market, its most recent calculations under-pin ours and also show how slowly the RMBS portfolio is likely to run off due to the natural forces necessary to a no-worry wind-down.

The only way for the Fed portfolio run off to be as smooth as the models forecast in light of the huge book is for the Fed to hope for the best in terms of prepayments, prepayments less likely to come of course if rates normalize as the Fed also hopes. We thus continue to anticipate a huge book of agency paper in the Fed's hands for the foreseeable future unless a new Fed of Trump appointees decides on a more active wind-down strategy.

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