Thursday, December 2, 2021

Going Down?

Summary

Two recent studies add fuel to the fire we first spotted late last year: demands for ARMs that only go down. Director Thompson's latest scorecard combines with her equitable-finance mission to make this option a top political priority even if its market feasibility remains at best uncertain.

Impact

These new studies come from the Federal Reserve Bank of Richmond and FDIC. They join a raft of those we assessed last year from the Federal Reserve Bank of Atlanta, Federal Reserve Bank of Boston and MIT researchers. All of these conclude that mortgage refis principally benefit only the affluent, a challenge not only to a core Fed monetary-policy transmission assumption, but also to the President's racial-equity edict.

The FDIC study concludes that the difference in refi savings between high- and low-income borrowers at the start of the pandemic when rates dropped precipitously was ten times higher than the pre-pandemic differential. Importantly, neighborhood economic condition is found to be the key determinant of how refi savings are allocated after the pandemic; before it, refi benefits were allocated by "off-the-shelf" variables such as LTVs and FICOs which, while racially correlated, are said not to be location-specific. Anyone looking for the kind of "modern redlining" Acting Comptroller Hsu has vowed to battle or the mortgage-finance disparate impact in CFPB Director Chopra's sights may well find these conclusions a compelling rationale for policy intervention.

The FRB-Richmond study calculates the total first-lien origination book in 2020 at an astounding $4.04 trillion, with refis accounting for about two-thirds of these transactions. It goes on to detail how much of this activity – i.e., most of it – went to higher-income borrowers. The study also notes that refis aren't free, citing a total of $44.5 billion in costs and arguing that these costs combined with potential disparate impact create undue barriers to cost-effective refis for under-served borrowers. They also cite the complexity of refi decision-making as another impediment to efficient refis for under-served borrowers.

Ultimately, the FRB-Richmond study concludes that a "decreasing-rate mortgage" should be part of the product panoply to resolve these policy questions. This would, the study suggests, be attractive not only to borrowers but also to investors due to reduced pre-payment rates that then drop *ex post* capital-redeployment cost.

Outlook

Although pre-payment optionality principally benefits borrowers, the market believes it knows how to price it and agencies ensure liquidity in its wake. ARMs that only go down would not only benefit

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borrowers, but also eliminate one core structural feature of mortgage finance: the fixed rate on fixed-rate loans that adds considerable value for collateral, margin, and related market functions. In a period of lower rates – let alone a period of ultra-low rates sparked by crisis – mortgages with rates that only go down would be subject to stressed asset valuations that might make counterparties unwilling to accept them.

All this presumably could be hedged, but that would add cost to these loans that, while likely lower than those associated with refis, might still undermine the wealth-equality value proposition. This one-way interest-rate risk likely also complicates the extent to which banks would undertake these loans in any meaningful fashion for their portfolios.

Will any of this matter as Thompson, Hsu, Chopra, and other officials decide how best to attack racial in inequity and economic inequality? We doubt it, especially after the announcement not only of the new, sky-high conforming-loan limit, but also FHFA's determination to do something about it. If the GSEs buy some of these loans or HUD decides that FHA must back them, a new market may well be born that puts a lot of pressure on lenders and even investors to accept it.