GSE Activity Report

Thursday, January 6, 2022

The Cost of Equity

Summary

As noted yesterday, FHFA followed through on its heavy hints in the 2022 GSE scorecards, mandating significant hikes in upfront fees on most high-balance mortgages and those for second homes. There is little question in our mind that these price hikes will restore portfolio-based origination channels for these loans and, to a lesser degree, also give PLS a boost. How much of the market transfers out of the GSEs will determine the extent to which remaining high-balance and second-home fee business cross-subsidizes lower-fee products aimed at more affordable, lower-income market segments. If, as FHFA seems to expect, business migrates and GSE capitalization improves, then cross-subsidization might be minimal.

Impact

As detailed yesterday, FHFA's new upfront fees for high-balance loans can be as much as 75 bps, applicable to all jumbos except when some kid 's parents cough up and the loan is deemed one to a first-time homeowner and thus eligible for upfront-fee mercy. FHFA has also exempted "affordable" loans up to the high-balance limit, but these are sure to be few and far between.

Under ordinary circumstances, even 75 bps at the high end of the LTV spectrum might not dent GSE competitiveness given other cost factors, but this segment is already competitive for portfolio lenders, especially when there are cross-sell opportunities. As rates rise, the market's ability to absorb surcharges will wane, giving banks a growing jumbo edge they are sure to exploit with new PLS products into a market still hellbent on yield chasing.

This is even more likely to be the case for second-home mortgages, where upfront surcharges could be as much as 3.875% (again based on LTV). There seems little doubt that, unlike jumbos, FHFA here is following Mark Calabria's lead in essentially kicking second-home loans out of the GSEs' purview.

Given smaller originations and the LTV-tiering, MIs may be particularly affected by these new fees. Although current bank-capital rules include a risk-based penalty for high-LTV loans without MI, this is washed away in the stress capital buffer that dictates capital requirements for the largest banks on whom the mortgage market most depends. As a result, big banks now hold jumbos without benefit of MI and will do so for more jumbos and second homes to the extent they choose to portfolio rather than securitize them. Nonbank originators will compete with the banks where markets allow because PLS investors still prefer CRT or credit-enhancement structures over loan-level MI.

This action also addresses one GSE risk – slow recapitalization – while creating another: reduced deal flow and resulting earnings. If cross-subsidization allows continued volumes below the high-balance threshold and for at least some without second homes, then the GSEs will dodge this bullet along with Realtors and nonbank originators and servicers. As noted, we think overall interest rates will determine the extent to which these upfront fees are offset by GSE-derived efficiencies, but the higher they rise,

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the less likely this is as long as bank balance-sheet capacity remains and the secondary market stays hungry.

Outlook

To be sure, FHFA satisfied nonbank originators in one key respect: it isn't simply banning second-home loans. FHFA also eliminated one key industry concern – transition risk – by making its new pricing schedule effective in the second quarter. With these actions, Thompson also addressed one key political risk – the new, nearly $1 million high-balance threshold – sure to confront Thompson in her confirmation hearings had she not penalized them to the extent permissible under current law. Doing so with fees, not prohibitions, should also appease Democrats who opposed prior caps largely because Calabria wanted them, not because of their inequality impact.

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