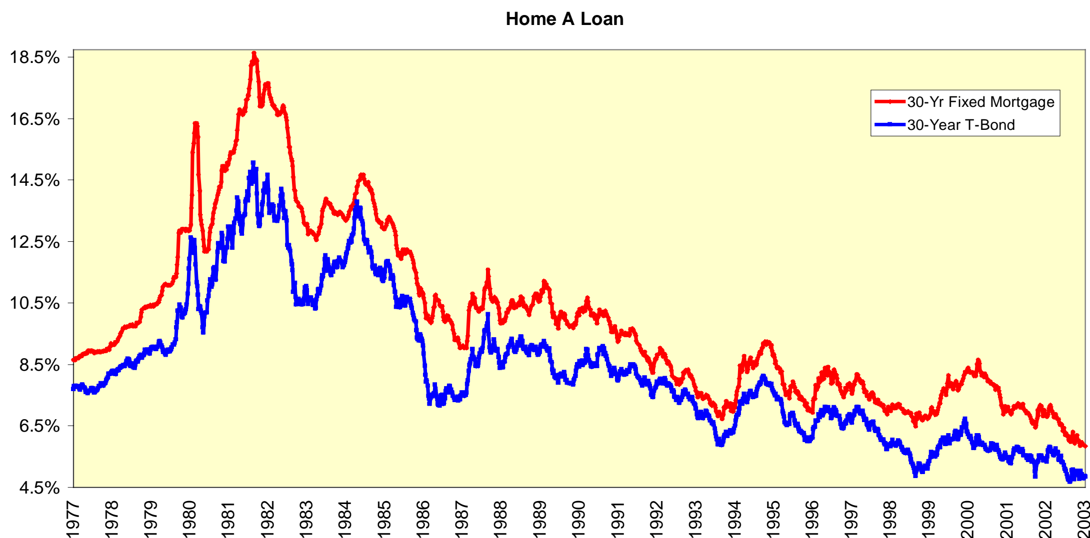
Mortgages In A 30-Year Fix

Alan Greenspan approaches a simple declarative sentence as if it were about to explode. In his parlance, homeowners have not been refinancing like mad, no, they have been "extracting" equity from their houses. He used the word no fewer than 17 times in his speech last week to the Independent Community Bankers of America in Orlando, befittingly the home of Goofy.

In financial terms, mortgagors (someone with a mortgage, quite possibly you) simply are exercising a call option on bonds. As rates fall, the value of the bond rises; prepayment simply is the act of calling this bond away from the issuer. The mortgagee (a mortgage lender) now has to reinvest the proceeds at a lower rate.

The Mother of All Mortgagees, of course, is Fannie Mae, the government-sponsored enterprise that has been forced into buying Treasury bonds like they are going out of style – come to think of it, they were during the later Clinton years – to match the duration of their assets and liabilities. Fannie's particular risks and exposures were discussed here last September.

Extract This
While everyone knows the reason for all the refinancing and the estimated $200 billion of net equity extraction has been lower interest rates, most of us are unaware of just how volatile the spread between Treasuries and mortgages has been.



Thirty-year mortgage yields have been falling far more quickly, albeit from higher levels, than have long bond yields. For those of us still enamored of supply and demand as an explanatory tool, this would suggest that rumblings of a housing bubble aside, lenders see less risk in the nation's homeowners relative to the nation's government than they did only three years ago.

Well, Uncle Sam still has one more printing press than you and I, and the combination of rising housing prices and a weakening economy should be increasing, not decreasing, mortgage lending risk. Yes, real estate is a secured loan, but you cannot foreclose on everyone at once, and the Mortgage Bankers Association has reported rising delinquencies. Some other factor, therefore, must account for the narrowing spread at lower rates.

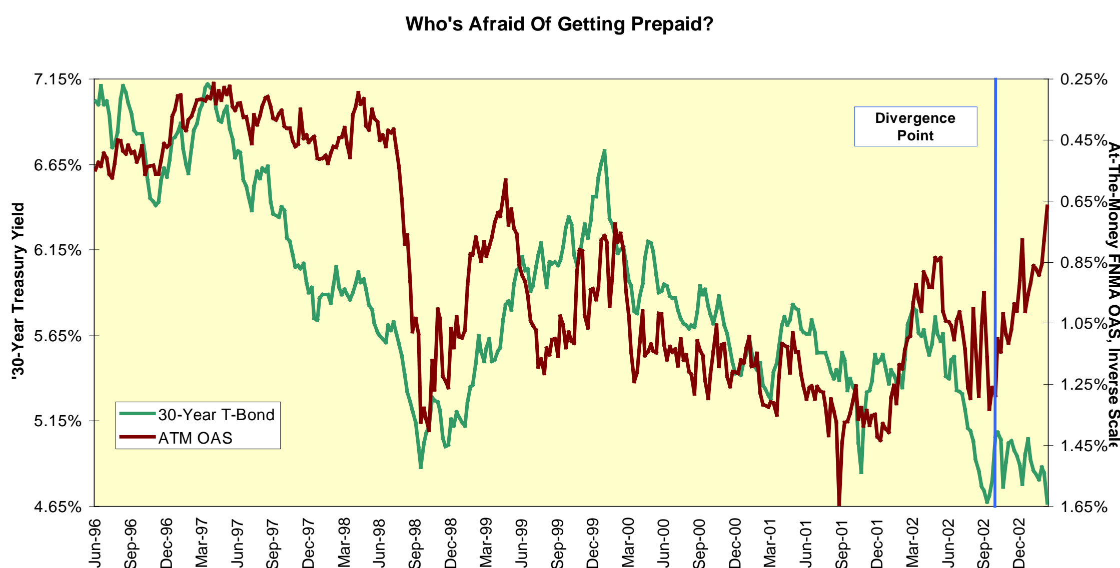
All In All, Another Trick With A Call
The refinancing boom, like all booms, busts, bubbles, manias, panics and crashes cannot continue forever. At some point, everyone who could and wanted to refinance will have done so. Yields can only go to 0%, after all, and the existing stock of homes will be mortgaged at yields sufficiently low to preclude further prepayment demand. Just as lower interest rates eventually produce counterintuitive behavior elsewhere, as noted here recently, they eventually

cease to stimulate equity extraction by homeowners, too. The risk of prepayment falls, and we see a contraction of mortgage spreads.

The options embedded in mortgages make a measure called option-adjusted spread, or OAS, the key thermometer for the mortgage-backed securities market. OAS reflects the additional compensation in terms of basis points the mortgagee requires to compensate for the risk of prepayment. The greater the OAS, the greater is the perceived risk of mortgages being prepaid.

An active over-the-counter market for trading the OAS on to-be-announced Fannie Mae securities has developed in recent years. Since data became available in June 1996, the OAS on these securities has had an inverse relationship with Treasury yields; OAS has also spiked higher in times of bond market volatility, such as the Russian default/Long Term Capital Management debacle of 1998 and September 2001.

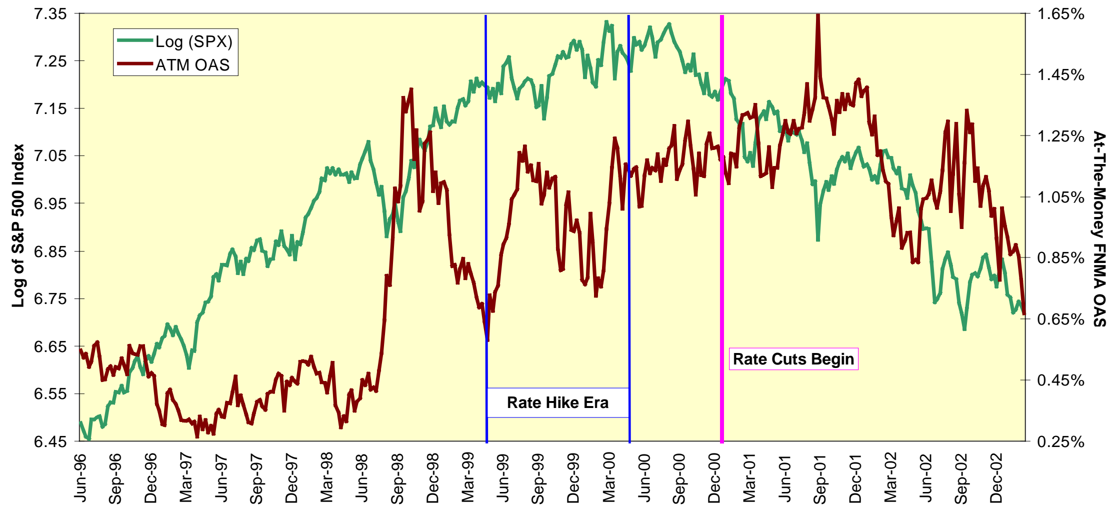
This inverse relationship started to break in late 2002. The OAS of the current coupon or at-the-money Fannie Mae benchmark security is falling at the same time as Treasury yields. The OAS scale on the chart below is inverted to highlight the close long-term relationship between bond yields and OAS.



The implications are clear: Mortgagees are demanding less insurance in the form of higher yield or OAS. The refinancing boom is over unless long-term interest rates move below 4%. If you are waiting for more equity extraction, you'll just have to keep on waiting.

The Equity Link

Fannie Mae OAS generally rose during the late 1990s; the history is distorted by the aforementioned Russian/LTCM debacle. The general increase in prepayment risk even withstood the period of rate hikes by the Federal Reserve, which suggests the mortgage market might have feared stockholders extracting equity from their bloated accounts to prepay mortgages.



Once the Federal Reserve started raising rates in January 2001, OAS continued to move higher under the weight of the hoped-for refinancing boom. Now both OAS and stocks are headed lower, which suggests that neither stocks nor real estate will be available as a source of wealth extraction to maintain consumer spending.