LOAN LEVEL PRICE ADJUSTMENTS AND YOUR ALL-IN EXECUTION

Look beyond the rate sheet to uncover value

your
SECONDARY MARKET SPECIALIST

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Find out more about Chris and our funding specialists at **FHLBTOPEKA.COM/INTELLIGENCE.**

In April of this year, the Federal Housing Finance Agency, the regulator of Fannie Mae and Freddie Mac, announced modest changes to the Loan Level Pricing Adjustment (LLPA) grids used to determine price adjustments to loans purchased by the housing agencies. The LLPA changes were characterized as modest and revenue neutral. The following description of the changes was taken from the April FHFA announcement.

The guarantee fee adjustments directed by FHFA fall into two categories:

1 The foundational adjustment is removing the 25 basis point upfront adverse market charge. The Enterprises established this fee in 2008 as an on-top pricing increase to reflect the unfavorable condition of the national housing market at that time. FHFA believes it is appropriate to remove this housing crisis-era fee in light of improvements in the housing markets. The agency is also setting aside its December 2013 decision to retain the adverse market charge in certain states with higher than average foreclosure related costs.

2 The agency is applying targeted and small fee adjustments to a subset of Enterprise loans. This includes small fee increases for certain loans in the Enterprises' upfront loan-to-value (LTV) ratio/credit score pricing grid and for certain loans with risk-layering attributes (i.e., cash-out refinances, investment properties, loans with secondary financing, and jumbo conforming loans).

The second change above involves assessing fees for loans with an loan to value (LTV) ratio of 80 percent or less and credit scores of 700 or more.

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What does that mean to you and your borrowers?

For the vast majority of FHLBank Topeka's members, it means a large percentage of their loan production will see an increase in upfront costs. These will either be factored into the rates quoted to the borrower or added into the settlement fees. Either way, beginning Sept. 1, home loans will become more expensive.

What if you didn't have to pay these price adjustments? What if instead of an upfront fee that impacts your net income on each loan, you were assessed a potential risk exposure that didn't influence the rate you are able to offer your customers and didn't reduce the income you can make on the sale of each loan?

This is the philosophy of the Mortgage Partnership Finance® (MPF) Program. Instead of being charged for risk regardless of the performance of the loans sold, we simply identify the risk and have you hold it as a contingent liability. In fact, the MPF Program will actually pay you for holding the risk – we call this the Credit Enhancement (CE) Fee.

It's this combination of the CE Fee income and the lack of LLPAs that gives the MPF Program the advantage when looking at the "all-in" execution. Our analysis shows that the LLPA changes becoming effective in September would result in a 20 basis point increase in LLPAs on 30-year production sold into the MPF Program. If members were currently selling the same loans to Fannie Mae or Freddie Mac, their current average LLPA would increase from 95 basis points to 115 basis points taking more than a point off the price they receive when selling the loan.

Fannie Mae v. the MPF® Program

	30-year Conventional (20-day)	
	FNMA	MPF
Rate Sheet Price	100.30	100.13
10 bp CE Fee PV		0.68
Most Common LLPA	-1.15	
All-in Comparison Price	99.15	100.81

Above is an example of a price comparison between Fannie Mae (FNMA) and our traditional risk-sharing products (under the MPF Program).

The rate sheet price shown is the base price available on the rate sheet. You can see from this example that the FNMA base price is 17 basis points (bps) better than the MPF Program price. In many scenarios, this is where the analysis would stop. If we dig a little deeper, we can see the true income potential and why the MPF all-in value is stronger.

As we mentioned before, we must account for the CE Fee income stream that will be paid to you for holding your risk on the loans sold into the MPF Program. This income stream is typically 10 bps annualized and paid on a monthly basis. Using an average duration of seven years on the 30-year mortgage production, the net present value (PV) of the CE Fees equates to 68 bps. This increases the MPF Original Program price to 100.81.

In addition we must deduct potential LLPAs from the FNMA prices as they would directly impact the price received on the loans. As mentioned previously, the average LLPA on 30-year production being sold into the MPF Program is 115 basis points. Taking the MPF Original product price from 17 basis points weaker to 166 bps higher illustrates the significant value of the MPF Program. How meaningful would an additional 166 basis points in upfront price be to your institution?

The value of the CE fees change with the prepayment speed of the mortgages. However, considering where we are in the current interest rate cycle suggests the 7-year estimated duration and 68 basis point present value is reasonable. Also, the CE fees have far outweighed credit losses absorbed by members with $42 million in fees being paid since 2003 and only $1.9 million in credit losses.

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Final Considerations

In closing, a few other things to consider related to the all-in execution available through the MPF Program are:

- What if you didn't adjust your loan rates for lack of LLPAs? Because a large percentage of mortgage production is sold to Fannie Mae and Freddie Mac, your offering would likely be competitive and you would be able to retain the price that normally would be lost to LLPAs. This results in increased upfront income from the retained LLPAs plus the CE Fee income received ongoing.
- The payment structure of the CE Fee can work as a natural hedge against mortgage production. While production is high, you are generating your income from the price on sold loans, but as the market shifts and production slows, you will then be able to reap the continued benefit of the CE Fees that are paid based on the unpaid balance of your MPF portfolio. This will level out income from your mortgage area even as production fluctuates.

It is important to look beyond the rate sheet or your pricing engine. The uniqueness of the MPF Program takes it outside standard pricing valuation to make sure you are maximizing your income potential.

Please contact me with any MPF questions or to further discuss this comparison.

Contact Chris today for solutions that work for you.

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