Mortgage Rates are Artificially High

A Major Data Issue in the Mortgage Market

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Abstract

A large financial firm takes a controlling stake in the bonds of a company, suffers massive losses and has all but one Wall Street analyst suspend coverage. The firm is economically owned by the Federal Government, who is ultimately responsible for the losses incurred. They are worth over $12 trillion and responsible for setting mortgage rates for US consumers.

- The US Agency Residential Mortgage Bond Market (RMBS) is valued at over $12 trillion, making it the second-largest bond market in the world, after U.S. Treasuries.
- As a result of quantitative easing, the Federal Reserve has accumulated dominant positions in certain segments of the RMBS market.
- The largest segments of this market consist of low-coupon RMBS, created during the COVID-19 pandemic when the Federal Reserve lowered interest rates and implemented large-scale stimulus programs. The Fed's holdings are concentrated in this segment, which accounts for more than half of the overall market.
- Since the Federal Reserve has taken a dominant share of the market and raised interest rates, the prices of these bonds have fallen by an average of nearly 20%. Consequently, the Fed has suffered more than $100 billion of market-to-market losses. The America taxpayer is ultimately responsible for these losses.
- It was once a standard practice for several Wall Street firms to provide prepayment forecasts (similar to earnings forecasts for stocks) on these securities. However, in recent years, many firms have withdrawn their coverage, leaving only JP Morgan to provide forecasts. This reduction in coverage decreases transparency and heightens the risk of manipulation in this vital segment in the fixed-income market.
- Monetary and Fiscal policies have created a historically unprecedented market environment in Agency mortgage bonds and mortgage rates, which are a primary target for monetary policy.
- The firms that most actively trade these securities are large money management firms, such as BlackRock, which also have close ties to the Federal Reserve and have been hired by the Fed as an investment advisor for these securities.[1]
- The misallocation of trillions of dollars of investment capital has negatively affected mortgage rates and increased the cost of home ownership in the US.

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[1] https://www.forbes.com/sites/pedrodacosta/2020/04/20/a-glaring-new-conflict-of-interest-undermines-public- trust-in-federal-reserve/

Mortgage rates remain stubbornly high as the Federal Reserve has kept interest rates elevated in recent years to combat persistent inflation. There's another reason keeping mortgage rates elevated: a lack of transparency in how prepayment speeds, a metric that estimates just how fast a homeowner will prepay their mortgage, are calculated. This metric plays a key role in calculating mortgage rates for consumers.

Prepayment speed estimates were once calculated by multiple investment banks, but now they are calculated by only one: JPMorgan Chase. Mortgage rates are artificially high, in part, due to a data vacuum in the mortgage bond market.

The U.S. single-family mortgage-backed securities (MBS) market stands at over $12 trillion in market value, making it the largest fixed-income market in the world after the U.S. Treasury market. MBS offer investors higher yields than Treasuries because they contain an embedded option that every homeowner with a mortgage holds: the option to refinance. MBS investors are compensated for selling this option to homeowners through the extra yield they earn above Treasuries. Since this prepayment option is a primary driver of MBS valuations, one of the most important factors when purchasing a mortgage bond is the assumed speed at which borrowers will prepay their mortgages. The entire $12 trillion MBS market hinges on a key assumption: borrower prepayment speeds. We will explore the 30-year Agency MBS new-issue market and examine the intricacies of the underlying inputs that drive the pricing of trillions of dollars of securities held by the U.S. government, banks, mutual funds, and nearly every fixed-income investor in the world. We will also discuss how MBS valuations influence the setting of mortgage rates, which in turn affects home prices, consumers, and the broader economy.

The U.S. mortgage market serves as a key transmission mechanism for monetary policy to reach the average consumer, and the valuation of this massive market is crucial to the economy. The process for establishing consensus prepayment assumptions—a key input in the valuation process—is opaque and susceptible to manipulation, as investors pay little attention to the valuation process. As we will demonstrate, adjusting prepayment assumptions up or down can lead to billions of dollars in market value changes, as well as potentially higher mortgage rates and increased borrower costs.

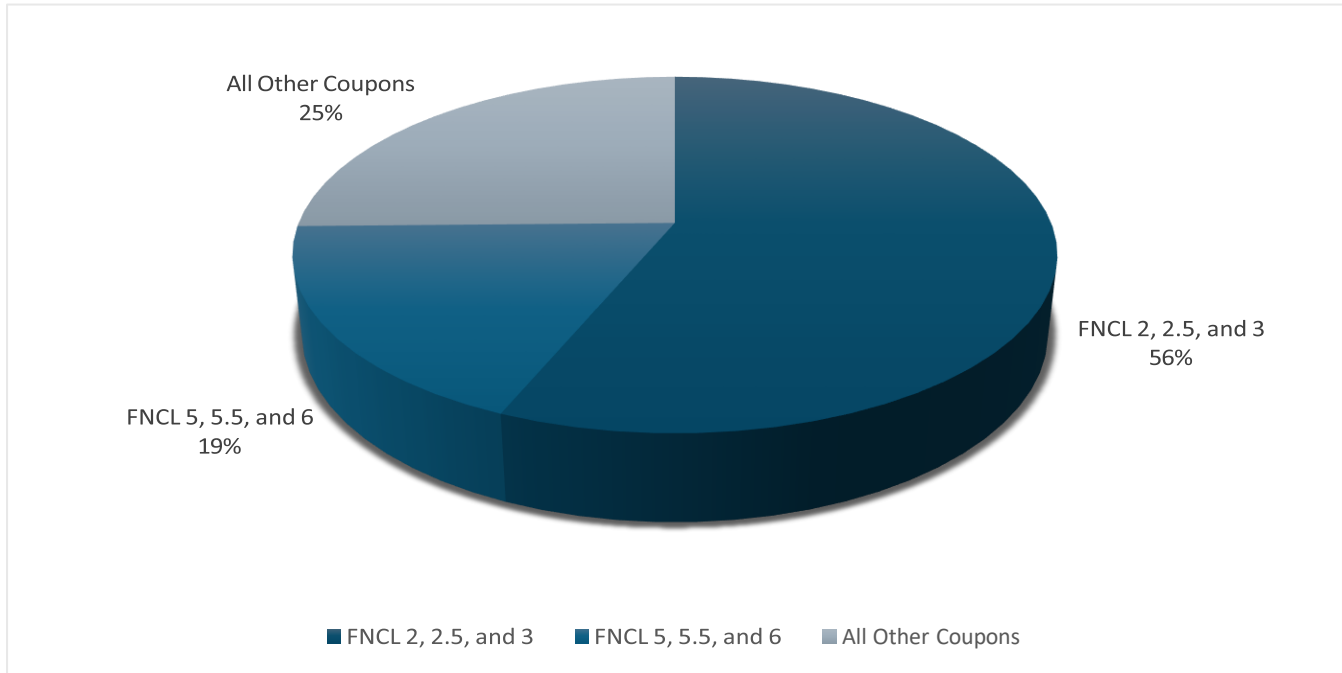**Size of the Market: Fannie Mae 2.0%, 2.5%, and 5.5% Coupon Mortgage Bonds**

The largest outstanding Fannie Mae issues, the 2.0% and 2.5% coupons, were issued primarily in 2020 and 2021 when refinance activity exploded as borrowers rushed to take advantage of near-zero interest rates. These two coupons comprise the largest portion of the market and dominate aggregate and core bond indices and funds. Fannie Mae 5.5% notes, which are currently being issued closest to $100, represent new loans being issued and are a focal point for consumer mortgage rates. Trading activity is concentrated in the lower coupons due to the large outstanding amount of those coupons and their place in market-weighted indices.

There is approximately $5.2 trillion in principal outstanding of Fannie Mae Mortgage-Backed Securities (MBS). Fannie Mae (FNCL) 2.0%, 2.5%, and 5.5% securities represent 53% of the total FNCL market. Other issuers in the Agency mortgage market include Freddie Mac and Ginnie Mae.

Ticker	Coupon	Outstanding Amount ($bb)	Share of Total Outstanding Amount
FNCL	2.0%	1,387	26.3%
FNCL	2.5%	1,024	19.4%
FNCL	5.5%	359	6.8%

Source: Bloomberg. Data as of January 6, 2025

Figure 1: Share of Outstanding Amount by FNCL Coupon

All Other Coupons
25%

FNCL 2, 2.5, and 3
56%

FNCL 5, 5.5, and 6
19%

■ FNCL 2, 2.5, and 3   ■ FNCL 5, 5.5, and 6   ■ All Other Coupons

Source: Bloomberg. Data as of January 6, 2025

Figure 2: Percent of Year-End Outstanding Amount of Top 5,000 FNCL Issuances Since 2000 by Coupon

■ 0-2%   ■ 2-4%   ■ 4-6%   ■ 6-8%   ■ 8+%
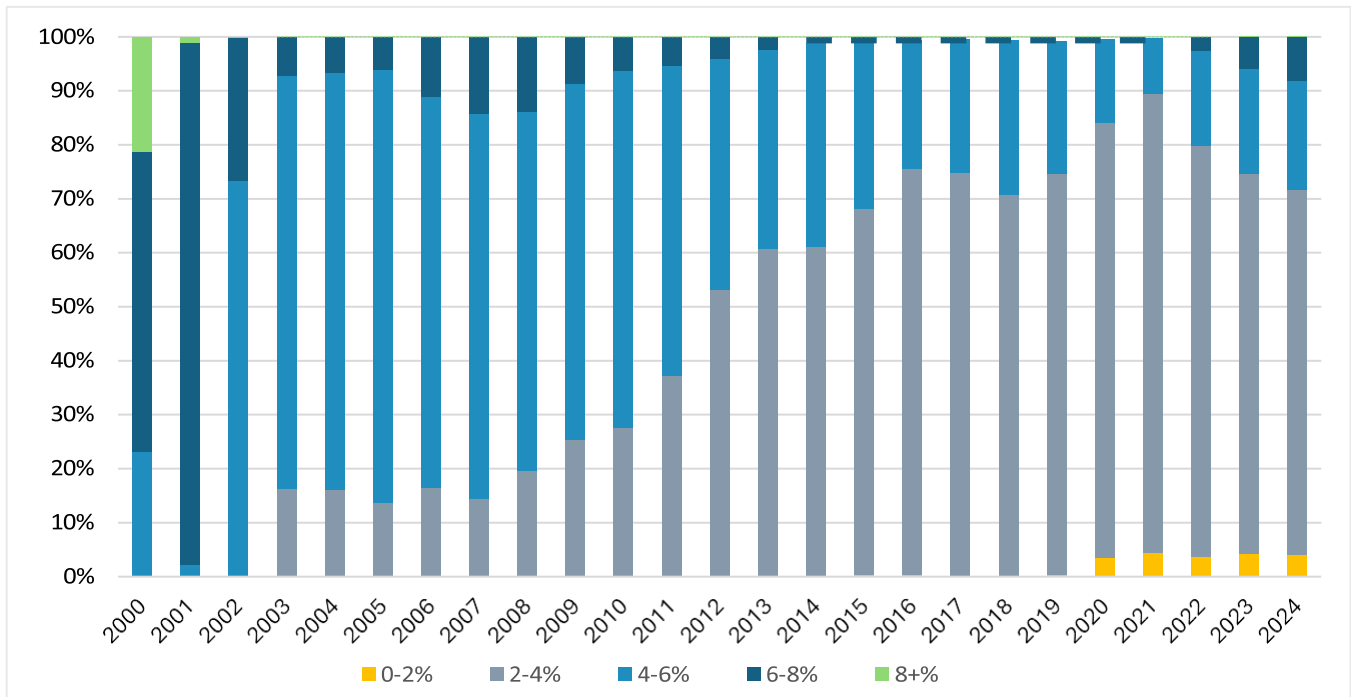
Source: Bloomberg. Data as of October 15, 2024

Fixed-income investment managers allocate risk among MBS and other asset classes based on their views of relative value, the direction of interest rates, and their outlook on the economy. When these managers allocate

to the MBS market, they typically do so with a mandate to deliver total returns that match or exceed a benchmark index. Given the abnormal distribution of outstanding coupon MBS, the indices are skewed toward lower coupons. Since the Federal Reserve started raising interest rates in 2022, mortgage rates have risen, and housing market activity has decreased dramatically. This slowdown has significantly reduced the volume of new mortgage originations in current coupon MBS, further concentrating investor attention on the larger and more actively traded lower coupon MBS.

One of the unintended consequences of the policies enacted during the COVID pandemic, which continue to linger and impact mortgage rates today, is the abnormal distribution of outstanding MBS in the current market. During the pandemic, rates dropped sharply, followed by a sharp rise in interest rates in 2022, leaving most homeowners "stuck" in low-interest mortgages. While this has lowered mortgage payments for these homeowners, it has also made refinancing or moving very difficult. Today's coupon distribution is unprecedented, presenting unique challenges to MBS investors and homeowners, and making it harder for investors to gauge prepayment speeds.

The Largest Holders of Low-Coupon MBS

The Federal Reserve is by far the largest owner of Fannie Mae 2.0% and 2.5% securities. Vanguard, BlackRock, and Fidelity are among the other major holders. The Federal Reserve holds 84% of FNCL 2% securities, which are considered "off-market" since the Fed does not actively trade its portfolio like other MBS investors. Firms like Vanguard, BlackRock, and Fidelity primarily hold these MBS within large, total-return-oriented mutual funds. These investors are the ones actively trading the 16% of the "tradeable float" in FNCL 2s.

FNCL 2 30-year Mortgage Bonds		
Managing Firm Name	*Held ($bb)*	*Share of Total*
FEDERAL RESERVE BANK OF NEW YORK	856.49	83.8%
VANGUARD GROUP	31.99	3.1%
BLACKROCK	26.67	2.6%
DODGE & COX	14.06	1.4%
FMR LLC	10.66	1.0%

Source: Bloomberg. Data as of January 6, 2025

FNCL 2.5 30-year Mortgage Bonds		
Managing Firm Name	*Held ($bb)*	*Share of Total*
FEDERAL RESERVE BANK OF NEW YORK	516.61	74.4%
VANGUARD GROUP	28.29	4.1%
BLACKROCK	21.30	3.1%
FMR LLC	12.20	1.8%
DODGE & COX	8.85	1.3%

Source: Bloomberg. Data as of January 6, 2025

While this is an unusual market structure, we can look to Japan as an example of what happens when the government owns most of the outstanding bonds in the market. Individual issues of Japanese Government Bonds (JGBs) have been known to go an entire day without any trading activity, which is unheard of in sovereign bond markets—some of the most actively traded markets in the world.

However, this has not been the case in the MBS market. Something else may be impacting MBS investors. Since low-coupon MBS have longer durations than current coupon MBS, they account for a larger share of duration

risk in investor portfolios. This may lower investors' capacity for duration risk in current coupon mortgages and other alternatives. There is evidence that demand for current coupon mortgages is lower than it would otherwise be, as the relative value of new-issue MBS is far more attractive on a risk-reward basis than that of lower-coupon MBS. Mortgage bond investors appear to be bidding up the value of lower-coupon MBS while leaving current coupon MBS to languish. As we can see in the tables below, higher-coupon mortgage bonds offer superior yields and spreads, yet have diminished interest-rate risk or duration (labeled OAD).

Figure 3: Current FNCL Yields and Duration

Agency FN	Settle G0	View Yield/Spread							Yield	WAL	I	A	P
30yr TBAs	Bid	Ask	Chg	SOFR	Treas		W/W/W	Prepay					
FNCL 2.5	81-00	05	- 03¼	+ 06	+ 02		3.35(323)33	84 PSA	5.22	9.97	59.28	59.62	107.72
FNCL 3.0	84-18	22	- 04	+ 05⅛	+ 01⅛		3.77(324)32	89 PSA	5.23	9.88	60.93	60.99	109.18
FNCL 3.5	88-00	05	- 05	+ 03¾	- 00⅛		4.25(325)31	97 PSA	5.26	9.65	64.61	63.90	112.29
FNCL 4.0	90-31	04	- 04¼	+ 03⅞	+ 00¼		4.85(326)28	107 PSA	5.36	9.37	75.56	73.85	122.51
FNCL 4.5	93-22+	27+	- 03¾	+ 04	+ 00+		5.50(355)3	121 PSA	5.40	9.97	77.44	77.78	125.88
FNCL 5.0	96-05+	09	- 03¼	+ 03⅞	+ 00⅞		6.01(354)3	136 PSA	5.57	9.45	96.31	94.88	143.47
FNCL 5.5	98-12+	16	- 01+	+ 04⅜	+ 01¾		6.52(351)5	193 PSA	5.77	7.52	122.85	124.74	164.72
FNCL 6.0	100-10	13+	- 01	+ 02⅞	+ 01		6.97(351)6	261 PSA	5.89	5.99	141.80	146.84	177.70
FNCL 6.5	102-04+	09	+ 01+	+ 04¼	+ 02¾		7.44(351)5	399 PSA	5.80	4.27	141.87	138.15	169.54
FNCL 7.0	103-27	00+	+ 02+	+ 04⅜	+ 03¼		7.89(342)12	482 PSA	5.47	3.27	114.28	116.00	136.59
15yr TBAs													
FNCI 3.5	94-07	19+	- 01¾	+ 02¾	+ 00		4.20(146)29	121 PSA	4.77	4.95	35.53	35.38	66.68
FNCI 4.0	95-20+	01	- 03	+ 01¼	- 01¼		4.83(153)19	142 PSA	4.93	4.99	51.07	51.11	82.40
FNCI 4.5	97-22	24+	+ 01¾	+ 05⅞	+ 03+		5.35(173)4	176 PSA	4.98	5.41	53.90	56.04	87.16
FNCI 5.0	99-11	19+	+ 01+	+ 04⅞	+ 02⅞		5.85(170)5	215 PSA	5.07	4.94	64.78	64.59	95.88
FNCI 5.5	100-13+	26	+ 01	+ 03¾	+ 02		6.36(168)5	333 PSA	5.21	3.98	84.28	89.71	110.44
FNCI 6.0	101-15	27+	+ 03	+ 05⅝	+ 03⅞		6.74(155)14	350 PSA	5.30	3.43	95.96	98.54	119.16

Source: Bloomberg. Data as of January 6, 2025

Agency FN	Settle G0	View Duration					OAD	CT2 Perf		CT5 Perf	
30yr TBAs	Bid	Ask	Chg	SOFR	Treas						
FNCL 2.5	81-01	04+	- 03	+ 06⅛	+ 02⅛		8.12	3.44 - 04⅞		1.46 - 01	
FNCL 3.0	84-18+	21+	- 04	+ 05⅛	+ 01		7.80	3.44 - 05⅞		1.46 - 02	
FNCL 3.5	88-01	04+	- 04¾	+ 04	+ 00		7.35	3.36 - 06⅝		1.43 - 02¾	
FNCL 4.0	90-31	04	- 04¼	+ 04⅜	+ 00⅝		6.80	3.20 - 05+		1.36 - 01⅞	
FNCL 4.5	93-23+	27	- 03+	+ 03+	- 00⅛		6.48	3.12 - 06		1.33 - 02⅜	
FNCL 5.0	96-05+	10	- 02¾	+ 03⅜	+ 00¼		5.71	2.79 - 04⅞		1.19 - 01⅝	
FNCL 5.5	98-12	16+	- 01+	+ 04	+ 01+		4.83	2.39 - 02⅝		1.02 + 00⅛	
FNCL 6.0	100-09+	14	- 01	+ 02⅞	+ 00⅞		3.83	1.91 - 02⅛		.81 + 00⅛	
FNCL 6.5	102-04+	09	+ 01+	+ 04⅜	+ 02¾		3.03	1.51 + 00⅝		.64 + 02⅜	
FNCL 7.0	103-26+	00+	+ 02¼	+ 04¼	+ 03		2.37	1.20 + 01⅝		.51 + 03	
15yr TBAs											
FNCI 3.5	94-07	19+	- 00¾	+ 02¾	+ 00		4.32	2.14 - 03		.91 - 00+	
FNCI 4.0	95-20+	01	- 03	+ 01⅜	- 01¼		4.21	2.11 - 04⅛		.90 - 01¾	
FNCI 4.5	97-22	24+	+ 01¾	+ 05⅞	+ 03+		4.05	2.04 + 00⅝		.86 + 03	
FNCI 5.0	99-11	19+	+ 01+	+ 04⅞	+ 02⅞		3.48	1.77 + 00+		.75 + 02+	
FNCI 5.5	100-13+	26	+ 01	+ 03⅞	+ 02⅛		3.04	1.56 + 00⅛		.66 + 01⅞	
FNCI 6.0	101-22+	23	+ 04+	+ 07¼	+ 05⅜		2.88	1.51 + 03⅝		.64 + 05⅜	

Source: Bloomberg. Data as of January 6, 2025

The Federal Reserve owns a much smaller share of newer issue bonds, as it stopped purchasing MBS in the fall of 2022. A similar group of large money managers ranks among the largest holders of FNCL 5.5%, but the top five hold a much smaller share of the total in this coupon than in the lower coupons.

FNCL 5.5 30-year Mortgage Bonds		
Managing Firm Name	**Held ($bb)**	**Share of Total**
FEDERAL RESERVE BANK OF NEW YORK	64.35	24.9%
VANGUARD GROUP	32.87	12.7%
CAPITAL GROUP COMPANIES INC	14.95	5.8%
CREDIT SUISSE GROUP AG	14.62	5.7%
ALLIANZ SE	12.95	5.0%

Source: Bloomberg. Data as of January 6, 2025

Valuing Mortgage-Backed Securities (MBS)

Bonds generally have a few inputs to determine their value. Valuation inputs include:

- Coupon
- Maturity
- Rating
- Price, yield, or spread over a benchmark like treasuries
- Callability by the issuer and/or investor

Mortgage bonds are distinct from other fixed-income instruments in that there are many underlying borrowers who have the option to prepay their individual loans at any time over the 30-year life of their mortgage. To their benefit, mortgage bonds amortize alongside their underlying mortgages and pay both principal and interest monthly. However, that monthly principal feature allows for uneven mortgage principal payments to investors, as all or none of the underlying borrowers could prepay their mortgages in any given month.

30-year Fannie Mae mortgage bonds are backed by pools of mortgages on U.S. residential homes. A 2.50% coupon Fannie Mae mortgage bond would be backed by hundreds of underlying borrower loans, each paying over 3.00% in interest, originated at different times. When valuing a mortgage bond, inputs like Weighted-Average Maturity (WAM), Weighted-Average Loan Age (WALA), and Weighted-Average Coupon (WAC) are used to determine the expected prepayment speeds of the mortgages in the pool.

Prepayment Assumptions: PSA – What is it?

The most important input for mortgage security valuation is the annualized prepayment assumption (i.e., the percentage of borrowers expected to pay down their mortgage each year). The market widely accepts and uses two metrics to satisfy this input when trading: the PSA standard prepayment model (PSA) and its counterpart, the conditional prepayment rate (CPR). Developed in 1985 by the Public Securities Association, PSA is the annualized prepayment rate of the full outstanding principal amount of a mortgage loan. Taken monthly as the 'Single Month Mortality' and annualized, this metric is dynamic and sensitive to ever-changing economic conditions.

100 is the base PSA rate, which can be directly translated to CPR by multiplying by 0.06 after the mortgage has "seasoned" for 30 months. For a "seasoned MBS," 100 PSA is equal to 6 CPR, 200 PSA is equal to 12 CPR, and 300 PSA is equal to 18 CPR. Seasoning accounts for the tendency for there to be very few prepayments in the early life of a mortgage, with the PSA or CPR speed rising over time through month 30, after which it tends to flatline. By utilizing the WALA (Weighted Average Loan Age), we can determine how seasoned a pool of mortgages is. Then, using the WAC and WAM (Weighted Average Coupon and Maturity), we can determine the remaining principal and interest payments due on the mortgages. The prepayment assumption tells us how

many unscheduled prepayments are received. Taking all of these into account, we arrive at the output of expected cash flows for the pool of mortgages. Using the Bloomberg screenshot below, we can see how an MBS investor would evaluate a FNCL 2.5% bond.

Figure 4: PSA Prepayment Curves

Source: Internally calculated by Regan Capital

Figure 5: FNCL 2.5 Yield Analysis

Source: Bloomberg. Data as of January 6, 2025

In the highlighted "vary" row, consensus PSA speeds are automatically loaded and can be adjusted by the investor. The first column shows the median or consensus PSA for today, and the other columns represent expected PSAs for different interest rate shocks (typically +/- 100bps, 200bps, 300bps). Consensus PSA is the

"street" median projection for prepayment speeds on this bond. Projected speeds are determined based on a myriad of variables such as WALA, WAC, WAM, etc. As the image demonstrates, the expected yield and duration for MBS can vary dramatically based on the PSA speed. Investors rely on consensus speeds, and other MBS markets trade at a spread based on FNCL consensus speeds.

Historically, Wall Street's mortgage prepayment speeds were tabulated by 5-10 investment banks. However, as of recently, this data is only being tabulated by JPMorgan Chase, which updates their speed data weekly rather than daily. For reference, "BAM" stands for Bloomberg's model, not a bank input.

Figure 6: Most Recent Dealer Prepayment Forecasts

100% FNCL 2.0		2.944(322)34	CUSIP 01F020612		Pool Level		95) Buy	96) Sell			
Summary	Bloomberg Median	TBA									
Dealer Prepayment Forecasts											
Median as of	01/03/25							● Table	● Graph	● History	
Firm	As Of	PSA	Maturity	-300	-200	-100	-50	+0	+50	+100	+200	+300
BAM	01/03/2025	74	322	130	104	87	80	74	70	66	61	58
CS												
MS												
JPS	12/29/2024	83	326	125	102	91	86	83	80	78	75	73
BOA												
BAR												
NOM												
AMH												
MIZ												
WF												
AVG		79	324	128	103	89	83	79	75	72	68	66
MED		79	324	128	103	89	83	79	75	72	68	66

Source: Bloomberg. Data as of January 3, 2025

Given the trading volumes in MBS and the sheer size of the market, one would expect that forecast speeds would be updated daily, with at least five banks submitting forecasts. The table below contains every new PSA forecast over the last six months, through December 31, 2024. Pay attention to the "0" column, which represents the base case PSA projection by week. It has ranged from 80 to 90, equivalent to 4.8 to 5.4 annualized prepayment speeds. It has barely changed, despite mortgage rates dropping almost 1%, from peak to trough in 2024.

Figure 7: FNCL 2 Dealer Forecasts – Last 6 months of 2024

Firm	As Of	PSA	Maturity	-300	-200	-100	-50	0	50	100	200	300
JPS	7/7/2024	82	332	126	102	90	86	82	80	77	74	73
JPS	7/15/2024	84	331	134	105	92	88	84	81	78	75	73
JPS	7/21/2024	83	331	128	103	91	87	83	80	78	75	73
JPS	7/28/2024	83	331	132	105	92	87	83	80	78	74	73
JPS	8/4/2024	87	331	159	113	97	91	87	83	80	76	73
JPS	8/11/2024	85	330	145	109	95	89	85	82	79	75	73
JPS	8/18/2024	86	330	150	111	95	90	86	82	80	75	74
JPS	8/25/2024	87	330	161	114	97	92	87	83	80	76	74
JPS	9/1/2024	86	330	154	112	96	90	86	82	80	75	73
JPS	9/8/2024	88	330	176	118	99	93	88	84	81	76	74
JPS	9/15/2024	90	329	201	122	101	95	90	85	82	77	74
JPS	9/22/2024	89	329	198	122	101	94	89	85	82	77	74
JPS	9/29/2024	89	329	200	122	101	94	89	85	82	77	74
JPS	10/6/2024	87	329	161	114	97	91	87	83	80	76	74
JPS	10/13/2024	86	328	153	112	96	91	86	83	80	76	74
JPS	10/20/2024	86	328	147	110	95	90	86	82	80	75	74
JPS	10/27/2024	84	328	132	105	92	87	84	81	78	75	73
JPS	11/3/2024	83	328	128	103	91	87	83	80	78	75	73
JPS	11/10/2024	84	328	133	105	92	88	84	81	78	75	73
JPS	11/17/2024	83	327	127	103	91	86	83	80	78	75	73
JPS	11/24/2024	83	327	128	103	91	87	83	80	78	75	73
JPS	12/1/2024	84	327	138	107	93	88	84	81	79	75	73
JPS	12/10/2024	85	327	140	108	94	89	85	82	79	75	73
JPS	12/15/2024	83	326	129	104	92	87	83	81	78	75	73
JPS	12/22/2024	83	326	125	103	91	86	83	80	78	75	73
JPS	12/29/2024	83	326	125	102	91	86	83	80	78	75	73

Weekly submissions from one source were not always the case. For example, on January 1st, 2022, four firms had made PSA submissions within the previous two weeks: Credit Suisse, JP Morgan, Bank of America, and Barclays. However, around the end of 2022 and into early 2023, JP Morgan was the only firm still submitting speeds, and they only submitted them weekly. When we asked Bloomberg why this was the case, they indicated that all major banks are asked to submit these projections daily, but JP Morgan is the only firm still submitting estimates—and only on a weekly basis.

Figure 8: January 1, 2022, Dealer Prepayment Forecasts

Firm	As Of	PSA	Maturity	-300	-200	-100	-50	+0	+50	+100	+200	+300
BAM	12/31/2021	181	355	1368	865	409	252	181	148	124	103	96
CS	01/01/2022	130	357	2142	1528	390	207	130	114	102	90	87
MS												
JPS	01/01/2022	197	358	2500	2229	1011	455	197	132	112	96	91
BOA	12/17/2021	177	358	1653	1562	779	351	177	144	108	108	108
BAR	12/31/2021	158	351	1511	1511	882	540	158	120	101	86	81
NOM												
AMH												
MIZ												
WF												
AVG		169	356	1835	1539	694	361	169	132	109	97	93
MED		177	357	1653	1528	779	351	177	132	108	96	91

Top banner: 100% FNCL 2.0 2.944(334)23 CUSIP 01F020612 Pool Level 95) Buy 96) Sell
Summary | Bloomberg Median | TBA
Dealer Prepayment Forecasts
Median as of 01/01/22 ○ Table ● Graph ● History

Source: Bloomberg. Data as of January 1, 2022

Having only one bank submit prepayment assumptions is like having just one analyst covering Apple or Microsoft. The mortgage market is a vital gear in the transmission mechanism of monetary policy into the real economy. The Federal Reserve controls only the Fed funds rate, or short-term interest rates. It is up to the MBS market to set mortgage rates.

Impact on Mortgage Rates

When you buy a home or refinance a mortgage, the interest rate is determined by the current coupon mortgage bond. As we have seen, demand for current coupon MBS is depressed by the focus on lower-coupon MBS, which directly translates into higher mortgage rates for consumers. Since JPMorgan is the only bank left contributing prepayment estimates to this multi-trillion-dollar market, the decreased transparency around one of the most important valuation assumptions has negatively impacted MBS valuations and added undue costs for mortgage borrowers. The sensitivity of mortgage bonds to prepayment assumptions is high; a small difference in consensus prepayment speeds could translate into billions of dollars of risk from a small change in interest rates. If the prepayment speeds provided by JPMorgan are too slow, it could result in more risk being allocated to lower coupons, further dampening demand for current coupon MBS. If the estimated speeds are too fast, it would make lower coupon MBS look more attractive, as they trade at a discount. In both cases, the demand for current coupon MBS—the ones by which mortgage rates are determined—is reduced, resulting in higher mortgage rates for consumers. Because of the opaqueness in the data surrounding how prepayment speeds for MBS are calculated, we believe that mortgage rates are higher than they should be. While measuring the actual impact of these effects requires complex assumptions about institutional investor behavior and risk management practices, we have internally calculated, using a risk-based approach to portfolio construction, that current coupon MBS are trading up to 30bps higher than they would be otherwise. While we view this as an attractive relative value for investors, it also results in higher borrowing costs for consumers.

Disclosures

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