FannieMae

# 5/1 Hybrid ARMs: 2/2/5 vs. 5/2/5 Cap Structure

August 2013

Fannie Mae accepts delivery of both 2/2/5 and 5/2/5 cap structures on 5/1 hybrid ARMs. The associated plan numbers for both cap structures are listed below along with recent MBS pricing indications and MBS issuance statistics. Two borrower payment scenarios are included below.

## Background

- Fannie Mae
  - Fannie Mae accepts delivery of both 2/2/5 ***and*** 5/2/5 cap structures
- Freddie Mac
  - As of 7/1/2013, Freddie Mac no longer accepts the delivery of 5/1s with a 5/2/5 cap structure (see Freddie Mac Announcement, October 16, 2012)

## Fannie Mae 5/1 Hybrids

- 5/1 LIBOR 2/2/5
  - Whole Loan Plan Number: 2725
  - MBS Prefix / Subtype: LB / P9CW or P9CF
- 5/1 LIBOR 5/2/5
  - Whole Loan Plan Number: 2737
  - MBS Prefix / Subtype: LB / P92W or P92F

## Pricing

- In the MBS market, 5/1s with the same coupon but different cap structures trade differently
- A 5/1 with a 2/2/5 cap structure generally trades behind a 5/1 with a 5/2/5 cap structure due to the potential for the investor to forgo yield in an upward rate environment
- Currently (data as of August 9, 2013), 5/1s with a 2/2/5 cap structure are priced back ~20/32nds vs same coupon 5/1s with a 5/2/5 cap structure
- We believe an increase in FN 5/1 2/2/5 issuance will lead to more liquidity in the product, which may improve pricing levels vs. the 5/2/5 structure

## Issuance

- Since 2012, issuance of FN MBS 5/1s (LB Prefix) was nearly 13 bln (source: Bloomberg)
  - 5/2/5 issuance represented over 99% of FN 5/1 issuance during this time period
- Over the last three months (May, June, and July 2013), issuance of FN MBS 5/1s LB Prefix was over 1.3 bln
  - 5/2/5 issuance represented over 97% of FN 5/1 issuance during this time period

## Scenarios

- The below hypothetical scenarios show the payment difference for the borrower between the first 5 years and subsequent years in two higher-rate environments
- For a lender to make the same return, the lender may need to offer a higher rate on a 2/2/5 5/1 vs. a 5/2/5 5/1, given the pricing differences that exist in the marketplace today
- Scenario 1 shows the fully indexed rate at each adjustment for both cap structures
- Scenario 2 shows a 2.5% increase in rates

| Scenario 1 – Fully Indexed | | | | Scenario 2 – +2.5% in Rate | | |
|---|---|---|---|---|---|---|
| Start of Year 1 | 5/1 - 5/2/5 | 5/1 - 2/2/5 | | Start of Year 1 | 5/1 - 5/2/5 | 5/1 - 2/2/5 |
| UPB | 300,000 | 300,000 | | UPB | 300,000 | 300,000 |
| Rate | 3.50% | 3.75% | | Rate | 3.50% | 3.75% |
| P&I | 1,347.13 | 1,389.35 | | P&I | 1,347.13 | 1,389.35 |
| | | | | | | |
| Start of Year 6 | 5/1 - 5/2/5 | 5/1 - 2/2/5 | | Start of Year 6 | 5/1 - 5/2/5 | 5/1 - 2/2/5 |
| Rate Scenario | +5% | +2% | | Rate Scenario | +2.5% | +2% |
| UPB | 269,091 | 270,232 | | UPB | 269,091 | 270,232 |
| Rate | 8.5% | 5.75% | | Rate | 6% | 5.75% |
| P&I | 2,166.79 | 1,700.05 | | P&I | 1,733.76 | 1,700.05 |
| | | | | | | |
| Year 7 (no change/+2) | 2,166.79 | 2,031.09 | | Year 7 (no change/+0.25) | 1,733.76 | 1,739.91 |
| Year 8 (no change/+.75) | 2,166.79 | 2,158.43 | | Year 8 (no change/no change) | 1,733.76 | 1,739.91 |

- Scenario 1 – significant increase in rates
  - Advantages of 5/2/5
    - Borrower benefits from lower payment for first 5 years
  - Advantages of 2/2/5
    - Significantly smaller payment increase in year 6
    - Payment remains lower in year 7
    - Payment remains slightly lower in year 8 and beyond
- Scenario 2 – moderate increase in rates
  - Advantages of 5/2/5
    - Borrower benefits from lower payment for first 5 years
    - Payments are slightly lower for 5/2/5 cap structure in year 7 and beyond
  - Advantages of 2/2/5
    - Slightly smaller increase in payment in year 6
- In our experience, many borrowers prepay their 5/1 loan prior to the first reset date, so neither scenario may be applicable.