

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/+0.75)	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.

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