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Several Reasons Why Mortgage REIT Investors Could Benefit From Recent Rule Changes

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| includes: [AGNC](#), [CIM](#), [IVR](#), [MFA](#), [NLY](#), [NYMT](#)

Disclosure: I am long [AGNC](#), [NLY](#), [MFA](#), [CIM](#). (More...)

On January 10th 2014 the Consumer Financial Protection Bureau will implement [a final rule](#) detailing the laws requiring mortgage lenders to consider consumers' ability to repay home loans before extending them credit. Some of the highlights of the rule are as [follows](#): (1) The borrower's debt-to-income ratio cannot be more than 43% to qualify for an FHA loan, and (2) Interest-only and balloon payment feature are not allowed for qualified loans. By breaking these elements down and asking ourselves some key questions we can get a better sense of how several of the agency Mortgage REITs could potentially benefit.

The borrower's debt-to-income ratio cannot exceed 43% (for FHA loans): For those who may not know, a borrowers debt-to-income ratio is broken down into the front-end ratio (housing expense) and back-end ratio (total debt-to-income ratio). The front-end ratio [or](#) "the housing expense, ratio shows how much of your gross (pretax) monthly income would go toward the mortgage payment" and the back-end ratio [or](#) "total debt-to-income ratio, shows how much of your gross income would go toward all of your debt obligations, including mortgage, car loans, child support and alimony, credit card bills, student loans and condominium fees". The lower a borrowers debt-to-income ratio, the less riskier the mortgage is.

For example, a borrower with a total debt-to-income ratio of 37% has a better chance of paying their mortgage on-time then a borrower with a maximized total debt-to-income ratio of 43%. As it stands now, the current maximum front-end ratio is 29%, while the current maximum back-end ratio is 41%. This 2% increase will actually benefit agency Mortgage REITs such as Annaly Capital ([NLY](#)), American Capital Agency ([AGNC](#)) and hybrid agency Mortgage REITs MFA Financial ([MFA](#)) and Invesco Mortgage ([IVR](#)), since the number of potential FHA mortgages could increase as a result of the rule.

Interest-only and balloon payment features are not allowed for qualified loans: According to an article [written](#) by Elizabeth Weintraub, "A balloon payment occurs when a loan is not amortized. It is generally an early due date, involving the payoff of an existing loan balance. Interest-only loans, also known as straight notes, generally contain a balloon payment provision". The good news for agency Mortgage REITs such as Annaly, American Capital and MFA is the idea that they'll benefit from the fact that each individual loans life-cycle may be prolonged due the fact there is a lesser potential for default.

Could investors see a run-up prior to the effective date of the CFPB's rule change? When it comes to developing an investment strategy focusing on non-agency Mortgage REITs, one needs to consider the possibility that the Fed may in fact ease up on its aggressive spending habits. During the current half of the year as the Federal Reserve's third round of quantitative easing should come to a close, which I predict will happen on or around June 30.

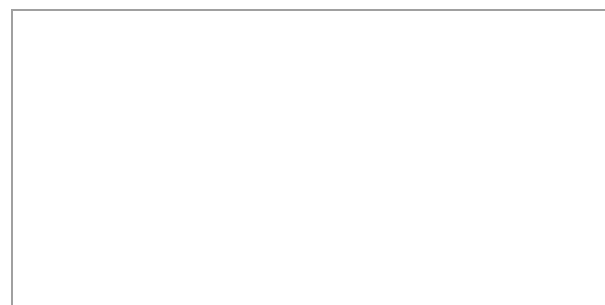
Under the terms of QE3, the Federal Reserve had been buying as much as \$85 billion is mortgage-backed securities and treasuries per month, which has subsequently limited the buying power of many of the agency Mortgage REITs. Once the aggressive purchasing strategy by the Fed ends, the purchasing power of the agency Mortgage REITs should increase and as a result a run-up in near-term shareholder value prior to the rule's implementation should occur.

Will non-agency Mortgage REITs be affected by the CFPB's rule changes? Given the fact predatory lending [played](#)

[a role](#) in the basis behind both the change in a borrowers debt-to-income ratio and the change which stated interest-only loans are no longer allowed to carry a balloon payment, a precedent, in my opinion, has been set not only for FHA loans but for conventional mortgage products as well.

This precedent has the potential to affect non-agency Mortgage REITs such as Chimera Investment ([CIM](#)) and New York Mortgage Trust ([NYMT](#)) since such REITs primarily invest in both non-agency MBS and non-agency ABS. One of the benefits potential investors are presented with is the fact the number of borrowers could increase substantially as a result of both changes. Simply broken down, a higher number of potential borrowers could mean higher revenues for the non-agency REITs and as a result key fundamentals such as Funds From Operations (FFO) could also see an improvement.

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