The Growing Role of Ginnie Mae

Prepared for Ginnie Mae

Prepared by: State Street Global Advisors and Urban Institute's Housing Finance Policy Center

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RESEARCH REPORT[1]

There has been a sustained increase in the volume of mortgage-backed securities (MBS) issued by Ginnie Mae in recent years, and by extension in the role of Ginnie Mae in the mortgage market. This increase has pushed Ginnie Mae from being the third largest issuer and guarantor of MBS, far behind Fannie Mae and Freddie Mac, to the second largest, behind only Fannie Mae. As of October 2016, outstanding amount of MBS guaranteed by Ginnie Mae totaled $1.68 trillion, three times the roughly $600 billion it guaranteed in at the end of 2008. At the same time, the composition of loans backing Ginnie Mae MBS has also changed significantly. Loans backed by the Department of Veteran Affairs (VA) now constitute a much larger and a growing share of Ginnie Mae pools as VA lending volumes have increased multiple fold.

Although the growth of Ginnie Mae's issuances is partly a reflection of strong refinance activity ushered in by ultra-low interest rates, Fannie Mae and Freddie Mac (the government-sponsored enterprises or GSEs) have been far more reliant on refinance than Ginnie Mae. Therefore if the recent post-election increase in mortgage rates is sustained, the resulting drop in refinance activity will affect Ginnie Mae's issuance volumes less than the GSEs'. This suggests that moving forward Ginnie Mae issuances should remain strong relative to the GSEs.

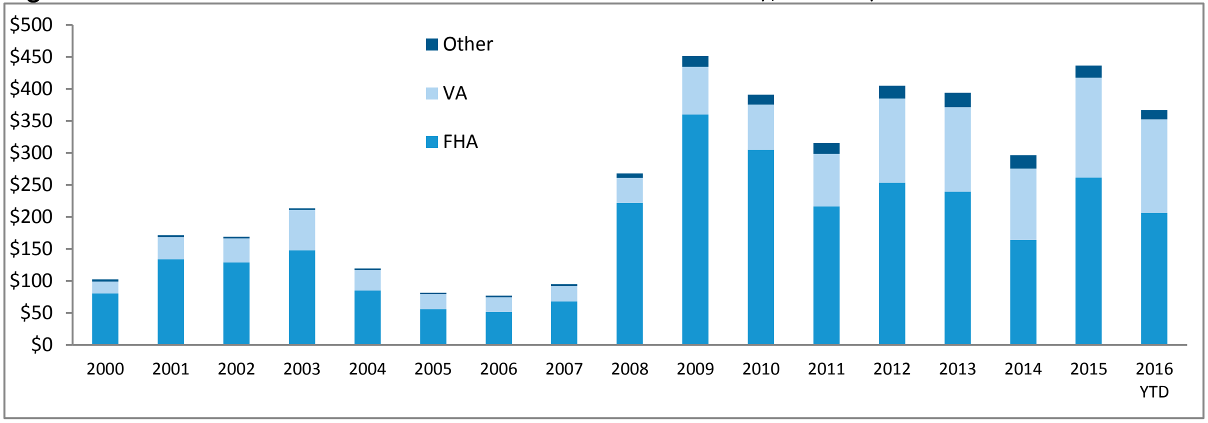
Post-crisis Trends in Ginnie Mae Issuance Volume

Figure 1 shows gross annual issuance volume for Ginnie Mae securities as well as the composition of loans collateralizing Ginnie Mae pools by government channel from 2000 to 2016 (YTD September). Ginnie Mae annual issuance volume was relatively small from 2000 to 2007 averaging about $130 billion a year, with a peak issuance volume of $213 billion in 2003. But the post 2007 period has been markedly different as annual issuances have more than quadrupled. Issuance volume increased from $95 billion in 2007 to $436 billion in 2015. Based on current run rate, it is expected that full year 2016

[1] Authored by Karan Kaul, Research Associate at Urban Institute. All statements and opinions contained herein are those of the author. See page 10 for detailed information on the author and important disclosures.

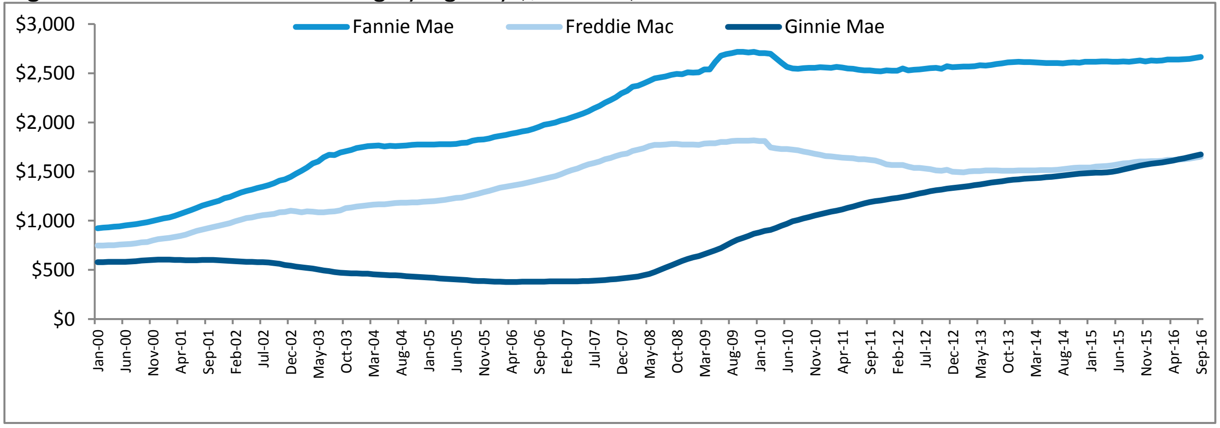
issuance volume will even exceed 2015 levels. Although volumes have moved up and down from one year to another – partly due to changes in the mortgage rate and the ensuing refinance activity – overall volumes have remained unquestionably strong. Figure 2 shows the positive impact of strong Ginnie Mae issuances on its total MBS outstanding, which has also quadrupled since 2007 even as GSE MBS outstanding has remained largely flat.

Figure 1: Ginnie Mae Gross Annual Issuances from 2000 to 2016 ($ billions)



Source: eMBS and Urban Institute **Note**: 2016 numbers YTD through September
"**Other**" refers to loans insured by HUD's Office of Public and Indian Housing and the Department of Agriculture's Rural Development.

Figure 2: Total MBS Outstanding by Agency ($ billions)

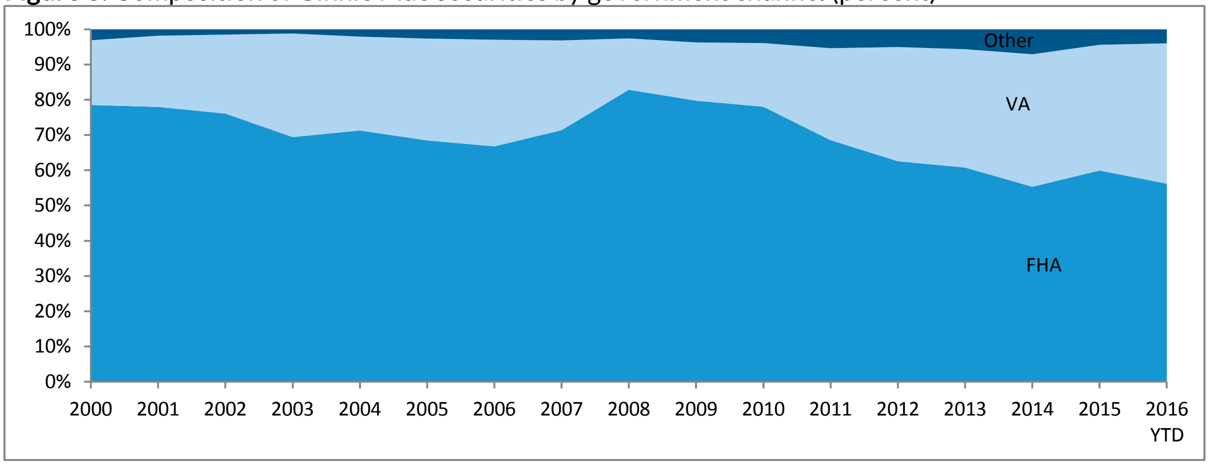


Source: eMBS and Urban Institute **Note**: 2016 numbers YTD through September

Equally noteworthy is the change in the composition of loans backing Ginnie Mae MBS. Of the total $95 billion in gross issuance in 2007, a large majority, $68 billion or 71 percent was FHA-insured loans while only $24 billion or 25 percent was VA-insured. However, once again, a markedly different picture had emerged by 2015 (see figure 3). FHA's share of Ginnie Mae issuances had declined to 60 percent while VA's share had increased to 36 percent. Although issuances backed by FHA loans initially skyrocketed from $68 in 2007 to $360 billion in 2009, as private capital fled the mortgage market, the post-2009 era has witnessed a decline in FHA's volume to $261 billion by 2015. VA-backed issuances on the other hand increased from $24 billion in 2007 to $156 billion in 2015, a six fold increase. In other words, the decline in FHA volume has been offset to a large extent by the growth in VA.

The growth of VA loans in Ginnie Mae securities has also continued into 2016. During the first nine months of 2016, VA's share of Ginnie Mae issuances had increased to 40 percent while FHA's share has declined further to 56 percent. Despite these declines however, FHA annual origination volume is still running well in excess of pre-crisis levels.

Figure 3: Composition of Ginnie Mae securities by government channel (percent)



Source: eMBS and Urban Institute **Note**: 2016 numbers YTD through September
"**Other**" refers to loans insured by HUD's Office of Public and Indian Housing and the Department of Agriculture's Rural Development. Data as of September 2016

The third component of Ginnie Mae securities, which includes loans insured by HUD's Office of Public and Indian Housing and the Department of Agriculture's Rural Development, has also grown in recent years but nevertheless remains a very tiny share of overall issuances. Thus, two factors have driven the increase in Ginnie Mae issuance volume: the growth of VA lending and elevated FHA originations relative to pre-crisis levels.

The growth of VA lending

The volume of mortgages backed by the VA has historically been very small as shown in figure 1 above. VA originations averaged only about $33 billion annually from 2000 to 2008. This was in part due to wide availability of mortgage credit through the private-label securitization (PLS) channel, which competed with VA (and FHA) for market share. Many subprime lenders aggressively targeted[2] veterans during the housing bubble by offering them loans with highly appealing but often risky features like teaser rates, interest-only payments and negative amortization. Although there is no publicly available dataset that shows how many veterans received subprime mortgages during the bubble, there is evidence that military towns were hurt more by the foreclosure crisis. According to one study, towns within 10 miles of military bases witnessed significantly higher foreclosure rates than the country as a whole[3], suggesting greater prevalence of risky mortgages.

Although the PLS channel was able to increase lending to veterans by offering attractive features, its growth was also driven by the fact that the maximum loan amount for VA mortgages had failed to keep

[2] See Daniel Goldstein, "Why More Veterans Aren't Using VA Loans to Buy a Home", MarketWatch, Nov 11th, 2015.
[3] See Kathleen Howley, "Foreclosures in Military Towns Surge at Four Times U.S. Rate", Bloomberg news, May 27th 2008 and Gregg Zoroya, "20,000 Military Members, Vets Faced Foreclosure in 2010", USA Today, Feb 3rd 2011.

up with rapidly inflating house prices. Prior to Jan 2005, the maximum amount the VA could statutorily guarantee for purchase loans and VA-to-VA streamlined refinances (officially known as the Interest Rate Reduction Refinance Loan or IRRRL) was $60,000. The maximum guaranty amount for cash-out[4] and non-VA to VA refinances (collectively called “other refinances”) was much lower, only $36,000. Because the VA can only guarantee 25 percent of the loan amount, the $60,000 cap translated into a de facto loan limit of $240,000 for purchase and IRRRL loans and even lower, $144,000 for other refinances. Given the rapidly inflating house prices at the time, the $240,000 purchase cap was insufficient to buy a home in many parts of the country. This created an opportunity for private lenders who were often willing to lend higher loan amounts.

The Veterans Benefits Improvement Act of 2004[5], which was passed in Dec 2004, subsequently indexed the maximum VA guaranty amount for purchase and IRRRL loans, but not for other refinances, to 25 percent of the conforming limit. Effective from Jan 2005, this change essentially increased the VA maximum loan amount for purchase and IRRRL loans from $240,000 to the then conforming limit of $359,650. After house prices began declining in 2006, several subprime lenders went out of business and the PLS channel, which was the predominant secondary market outlet for subprime lenders, came to a complete standstill in 2008. The result was a sudden expansion of lending through the VA, nearly doubling from $39 billion in 2008 to $75 billion in 2009. The growth in VA lending in this period was also helped by a couple of timely and well targeted policy changes.

The Veterans’ Benefits Improvement Act of 2008[6], which was signed into law in October 2008, allowed the VA to expand its refinance offerings in two ways.

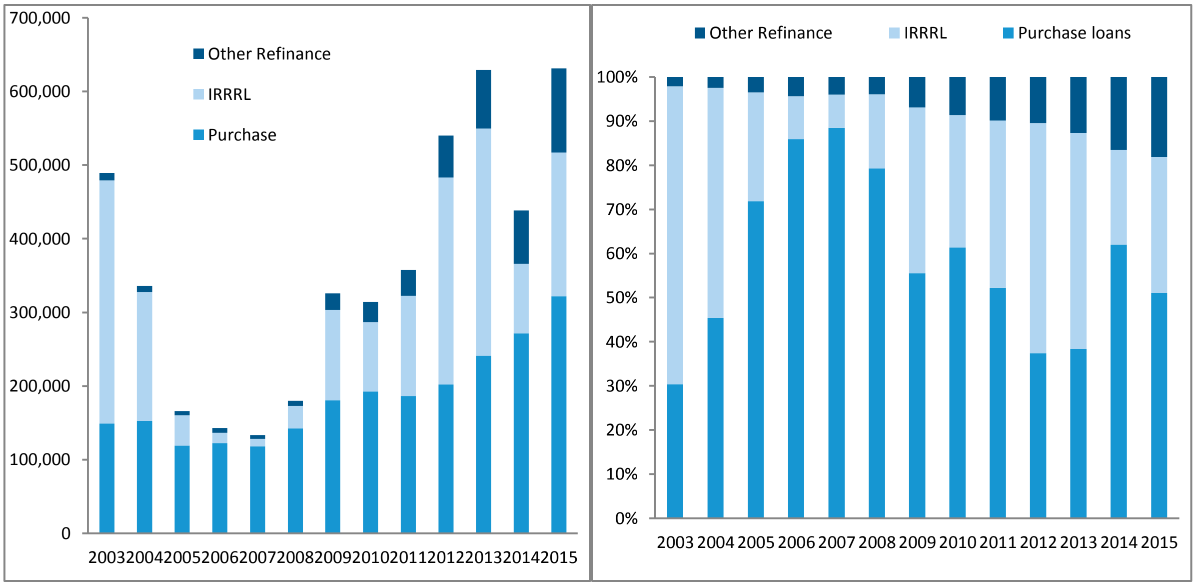
- First, this law raised VA’s maximum guaranty amount for other refinances from $36,000 to $104,250 (thus aligning with VA’s purchase and IRRRL limits as well as with the 2008 conforming limit of $417,000). The goal was to enable veterans who had obtained subprime or other non-VA mortgages to refinance into a more sustainable VA loan while taking advantage of lower rates.
- The 2008 law also increased the maximum loan-to-value ratio for cash-out refinances to 100 percent. Previously the maximum LTV for such refinances was 90 percent. Once again, the objective of this change was to enable veterans with high LTV non-VA mortgages to refinance into a more sustainable VA loan.

Figure 4 shows the immediate effect of these two changes on VA lending. Notable is the significant jump in refinance activity for both IRRRL and other refinances in fiscal year 2009. Specifically, the number of other refinances more than tripled from 7000 to over 22,000 and the number of IRRRL loans more than quadrupled from 30,000 to 122,000 between 2008 and 2009. As a result, the share of VA originations that were refinances surged from just 20 percent in 2008 to 45 percent in 2009.

[4] The VA has traditionally offered two refinance programs: The Interest Rate Reduction Refinance Loan for VA to VA streamlined refinances, and the Cash-out Refinance Loan for tapping into home equity or refinancing a non-VA mortgage into VA. The de facto loan limit for IRRRL and purchase loans was based on the conforming loan limit even before the 2008 law. The 2008 law extended those limits to the Cash-out Refinance Loan to enable veterans with non-VA mortgages, such as subprime mortgages, to refinance into VA
[5] See Public Law 108-454
[6] See Public Law 110-389

Figure 4: VA Home Loans Guaranteed by Fiscal Year

Loan count *Share based on loan count*



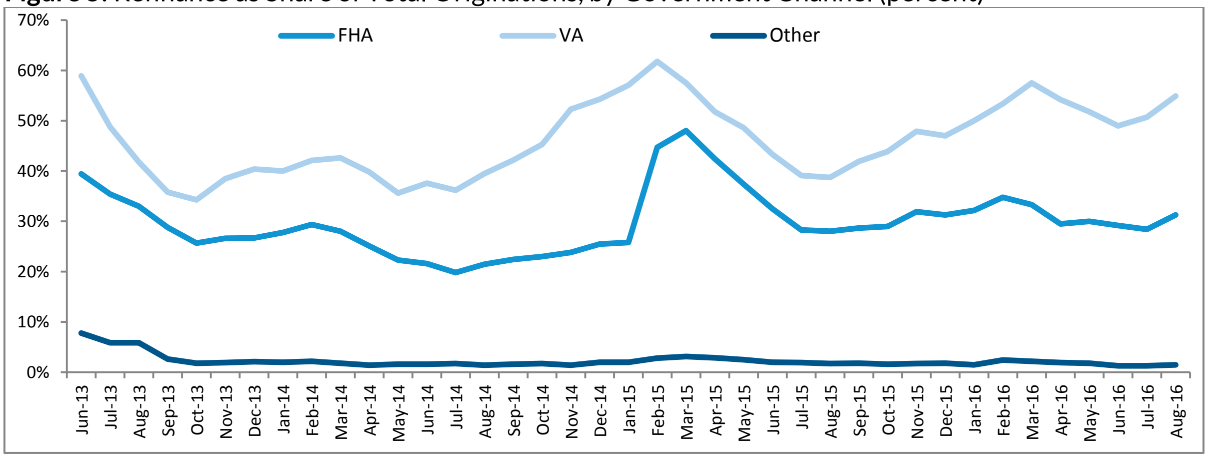
Source: VA Annual Benefit Reports 2003 t0 2015, **Note:** “Other refinance” includes cash-out and non-VA to VA refinances

But the increase in refinance activity in 2009 explains only part of VA’s growth story. As figure 4 shows, VA’s growth has sustained well beyond 2009 and has included purchase originations as well. There are three drivers of VA’s growth in more recent years.

Tight overall credit availability: Loose availability of credit during the housing bubble meant that veterans were not necessarily dependent on VA for their lending needs. As stated earlier, the PLS channel became a major source of credit for veterans, and less creditworthy borrowers in general, as lending standards deteriorated. However with the post-crisis demise of PLS as well as a significant tightening of credit more generally, the VA has emerged as a less stringent provider of credit for purchase originations. In addition to no FICO minimums, the VA is unique in allowing veterans to borrow 100 percent of the purchase price of the home. In other words, veterans can purchase a home without any down payment. Although borrowers have the option of making a down payment, most veterans are currently obtaining 100 percent financing. According to VA data, 80 to 90 percent of VA’s purchase originations during the last five years had zero down payment. The VA offsets the risk of high LTV lending in part by relying on the residual income test. Residual income represents the amount a household has left every month after setting aside major monthly expenses such as mortgage payments, taxes, and other debt payments. In other words, residual income is the financial buffer left for typical household expenses such as groceries, gas etc.

Strong VA refinance activity: VA lending also received substantial boost from refinancing activity under IRRRL in recent years as interest rates declined. IRRRL requires no appraisal, no credit underwriting and no out of pocket expenses making it very easy, economical and efficient for borrowers to refinance. Although FHA also offers streamlined refinance, it is restricted to borrowers with mortgages endorsed before Jun, 1st 2009, and is a one-time deal. The IRRRL on the other hand has no cut-off date and allows borrowers to refinance multiple times. As a result, the share of VA originations that is refinance has remained elevated compared to FHA's in recent years. VA refinance activity has also been helped by an increase in cash-out refinances as house prices have recovered in many areas. Figure 5 shows the refinance share of VA originations compared to other government channels.

Figure 5: Refinance as Share of Total Originations, by Government Channel (percent)



Sources: eMBS and Urban Institute. **Note**: "Other" refers to loans insured by HUD's Office of Public and Indian Housing and the Department of Agriculture's Rural Development.

Operational enhancements: Lastly, during the last eight years, the VA has made substantial investments in operations, processes, technology and outreach. In 2008, President-elect Barack Obama set a goal to modernize and transform VA to allow it to more effectively and efficiently care for Veterans[7] . This transformation involved fundamental changes to VA operations. As a result of these investments, which are ongoing, the VA has been able to cut wait times for obtaining the certificate of eligibility (to verify veteran status) and issue more certificates electronically without manual intervention.

Strength of FHA lending

Although FHA originations have not exhibited the same upswing as VA in recent years, lending volumes have remained strong compared to the pre-bubble era. FHA-insured originations averaged about $94 billion annually during the eight years from 2000 to 2007, with a cumulative origination volume of $750 billion over the period. However, during following eight year period from 2008 to 2015, FHA originations have averaged $253 billion annually while cumulative originations have surpassed $2 trillion. As with VA, the strength of FHA originations is driven in large part by the absence of PLS market, leaving FHA the predominant provider of credit for low- and moderate-income borrowers. But two other factors have also assisted FHA lending volumes:

- The FHA Streamlined refinance program, which was announced in 2012, allowed FHA mortgages originally endorsed before June 1, 2009, to refinance to a lower rate and pay substantially reduced mortgage insurance premiums (55 basis points annual MIP and only 1 basis point upfront). This was

[7] See VA Strategic Plan FY 2010 to 2014 http://www.va.gov/op3/Docs/StrategicPlanning/VA_2010_2014_Strategic_Plan.pdf
See VA Strategic Plan FY 2014 to 2020
http://www.va.gov/op3/docs/strategicplanning/va2014-2020strategicplan.pdf

highly appealing to borrowers because the FHA had increased its mortgage insurance premiums significantly between 2009 and 2012. At the time the streamlined refinance program became effective, FHA's general upfront premium was 175 basis points and the annual premium was 125 basis points, significantly higher than those charged by Streamlined Refinance. Therefore borrowers who wished to refinance to take advantage of lower mortgage rates would see a significant share of savings wiped by higher insurance premiums. The Streamlined refinance took this disincentive away, encouraging more borrowers to refinance, thus giving FHA originations a boost.

- After steadily increasing mortgage insurance premiums 2008 onwards, the FHA finally reversed course in January 2015 by announcing a 50 basis point cut in the annual premium from 135 to 85 basis points. In addition to ushering in another refinance wave which allowed borrowers to take advantage of lower interest rates, the premium cut also led to an increase in FHA's purchase originations. These increases gave FHA volumes and Ginnie Mae issuances another lift.

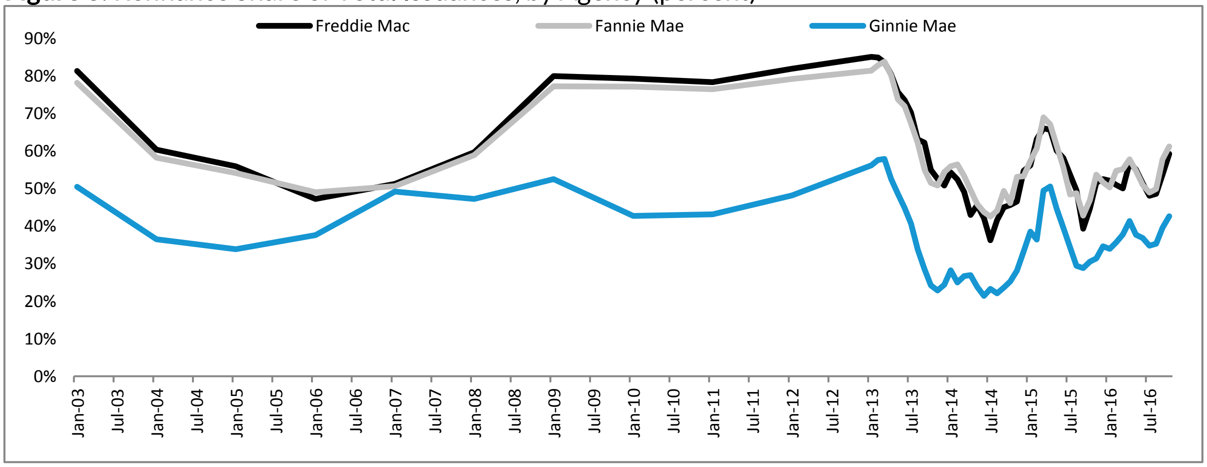
Implications for Investors

The growth of lending through VA and FHA has transformed Ginnie Mae into a significantly larger player in the mortgage market compared to eight years ago. This growth and the changing composition of loans backing Ginnie Mae issuances have also unfolded against the backdrop of an ultra-low and a stable interest rate environment. But the recent increase in mortgage rates[8] – with more Fed hikes expected in 2017 – will surely put downward pressure on mortgage lending, especially on refinance volumes. This has two important implications for MBS investors.

First, any downturn in refinance activity as rates rise will affect issuance volumes for both Ginnie Mae and GSE channels. But the magnitude of the decline will likely be different for each. Because refinance loans constitute a smaller share of Ginnie Mae issuances than of GSEs', any reduction in refinance activity will affect Ginnie Mae issuances less than GSE issuances. During the peak of the refinance wave from 2009 to 2013, the share of loans backing Ginnie Mae's issuances that were refinances ranged from roughly 50 to 60 percent. In contrast, the GSE refinance share ranged from 75 to 85 percent. Currently, the refinance share is roughly 40 percent for Ginnie Mae but a much higher 60 percent for GSE issuances (Figure 6).

[8] According to Freddie Mac's Primary Mortgage Market Survey, mortgage rates averaged 3.57 percent for the week ending November 10th 2016. However for the week ending November 17th, just after the election, rates had increased to 3.94 percent. And by the end of November, the PMMS rate was at 4.08 percent, representing a 50 bps increase over the month of November.

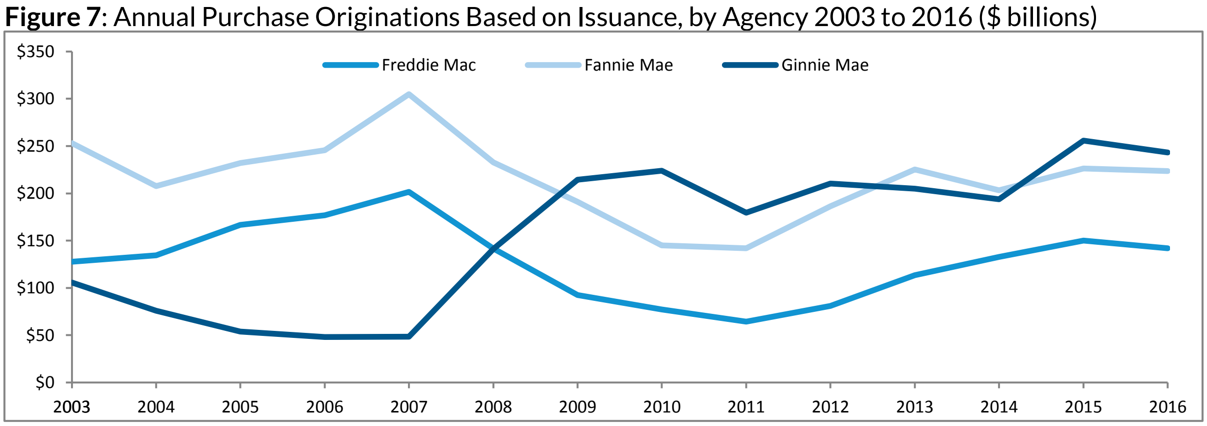
Figure 6: Refinance Share of Total Issuances, by Agency (percent)



Source: Urban Institute calculations based on eMBS data.

Stated differently, Ginnie Mae MBS issuances are more dependent on purchase activity and thus should be affected less by the anticipated downturn in refinances. Figure 7 shows the annual purchase origination volumes based on Ginnie Mae, Fannie Mae and Freddie Mac's issuances from 2003 to 2016, clearly illustrating Ginnie Mae's strength in purchase driven securitizations. Especially noteworthy is the fact that Ginnie Mae's purchase originations have exceed Fannie Mae's in 2015 and 2016 even though Fannie Mae is the largest MBS issuer overall. Thus, while issuances will likely soften across the board as rates rise, Ginnie Mae's issuances should hold up better than those of the GSEs.

Figure 7: Annual Purchase Originations Based on Issuance, by Agency 2003 to 2016 ($ billions)

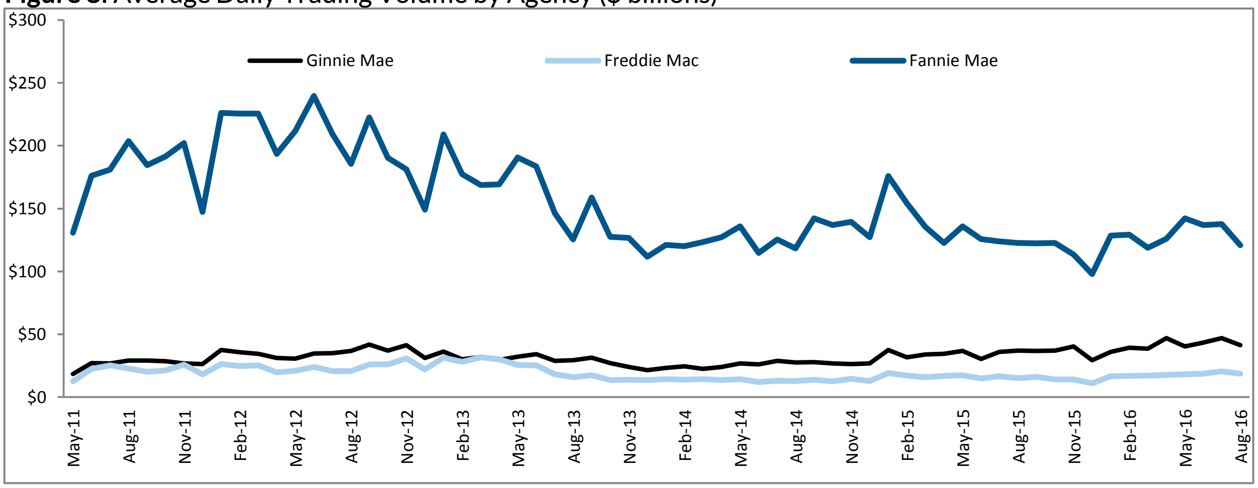


Source: Urban Institute calculations based on eMBS data. **Note**: 2016 numbers YTD through October

The diverging effect of rising rates on Ginnie and GSE issuances also has implications for trading volumes and MBS liquidity. In general, trading volumes tend to be positively correlated to new MBS issuance activity because new securities are typically bought and sold several times upon issuance as traders try to benefit from temporary pricing imbalances, before long-term investors step in and trading activity falls off.

Figure 8 shows the average daily trading volume for Fannie Mae, Freddie Mac and Ginnie Mae MBS 2011 onwards. There are two important observations. First the trading volume of Fannie Mae MBS is several times larger than that of Freddie Mac's or Ginnie Mae's. But more importantly, the trading volume of Ginnie Mae securities has been on a sustained upswing – nearly doubling from $21 billion a day in Dec 2013 to $41 billion currently– even as volumes of Fannie Mae and Freddie Mac have remained largely flat. This divergence in liquidity is a result of stronger net issuances for Ginnie Mae compared to GSEs in recent years. Ginnie Mae liquidity has also received a boost from the success of the Ginnie II program, which allows for larger, more homogenous pools with less idiosyncratic risk, thus attracting greater investor interest. Regardless, if the recent increase in mortgage rates affects GSE issuances more than Ginnie Mae, as is expected, then the liquidity of Ginnie Mae MBS could continue to further improve relative to GSEs'.

Figure 8: Average Daily Trading Volume by Agency ($ billions)



Source: Urban Institute calculations based TRACE data.

Conclusion

The post-crisis growth of Ginnie Mae is a direct outcome of the increase in VA lending and the strength of FHA originations as private-label securitization has pulled out. This growth, which has also altered the composition of loans backing Ginnie Mae MBS, is a highly positive development for veterans and low- and moderate-income borrowers from the point of view of access to credit. And given continued challenges with access to credit through private channels, it is unlikely that Ginnie Mae's growth will reverse in the foreseeable future.

At the same time, this shift has also created a new dynamic for MBS investors. The growth of VA and the strength of FHA originations have led to significant increases in Ginnie Mae's issuances and MBS outstanding, as well as substantially improved the liquidity of Ginnie Mae MBS relative to that of GSEs. While rising interest rates will create strong headwinds for refinance activity, issuance volumes, and MBS liquidity across the board, Ginnie Mae's smaller reliance on refinance relative to the GSEs should serve as a mitigating factor.

About the Author

Karan Kaul is a research associate in the Housing Finance Policy Center at the Urban Institute. He researches topical housing finance issues to highlight the market impact of ongoing regulatory, industry, and related developments. He is also responsible for monitoring and reporting on mortgage market trends and current events weekly. Kaul came to Urban after five years at Freddie Mac, where he worked on various housing policy issues primarily related to the future of housing finance and the reform of the government-sponsored enterprises. Before Freddie Mac, Kaul worked as a research analyst covering financial institutions. He holds a bachelor's degree in electrical engineering and an MBA from the University of Maryland, College Park.

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