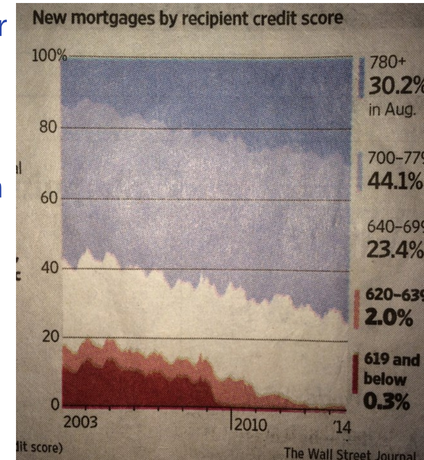
Weekly Market Review

C.F. Whittelsey Holdings

November 24, 2014 — November 28, 2014

“I’ve been told with absolute confidence that some lenders are lifting almost all of their overlays” - David Stevens—President of the MBA

“Unless we are convinced that the rules are going to be permanent and there is not going to be a look back or a reach back in future times.. We are simply going to stay on the side-lines in the concerns of both compliance risks and other uncertainties” - Richard Davis—US Bank CEO



Default rates of Fannie Mae loans by downpayment and FICO score

Year	FICO	Downpayment size (percent of home price) ≥20	10-20	5-10	3-5	All
2001	≤700	2.2	4.1	4.8	5.1	2.9
	700 - 750	0.6	1.6	1.6	2.2	0.8
	>750	0.2	0.8	0.9	1.2	0.3
	All	1.0	2.6	3.1	3.3	1.5
2004	≤700	7.7	11.3	12.5	13.1	8.6
	700 - 750	3.4	6.4	6.8	7.3	3.9
	>750	1.4	3.8	4.3	4.1	1.6
	All	4.3	8.2	9.3	10.2	5.0
2007	≤700	20.9	30.7	30.8	35.6	23.3
	700 -750	11.1	19.7	18.2	21.3	12.6
	>750	4.5	11.7	11.5	13.5	5.4
	All	11.9	23.2	22.7	27.8	14.0
2011	≤700	1.0	1.1	1.4	0.7	1.0
	700 -750	0.3	0.4	0.5	0.5	0.3
	>750	0.1	0.2	0.2	0.4	0.1
	All	0.2	0.3	0.4	0.4	0.2
2012	≤700	0.3	0.3	0.5	0.3	0.3
	700 -750	0.1	0.1	0.1	0.2	0.1
	>750	0.0	0.0	0.1	0.1	0.0
	All	0.0	0.1	0.1	0.2	0.1

Mortgages and Risks, Modelers and Biases

There was an interesting article in the WSJ this weekend titled ‘Mortgage Lenders to Ease Standards’. The article tells us that new guidelines released by the FHFA will allow the GSEs to take on mortgages that have lower LTV ratios, amongst other things. The GSEs set guidelines as to the type and quality of mortgages they will securitize and sponsor the credit risk for. Currently, they will not accept mortgages with down payments less than 5% (aka, LTV>95%). Banks, have little incentive to issue such mortgages and hold that risk on their book, thus, those with little money to make down payments will not receive mortgage credit. The FHFA has lowered this guideline to 3%. Will banks follow through with this?

It’s a 50/50, some banks are excited to expand their reach to this new pool. Wells Fargo seems amenable where Bank of America has announced they will sit on the sidelines. The reason for such hesitation could be from three sources, either 1) they don’t have a competitive advantage or program to initiate mortgages to higher risk borrowers, 2) they have not been made to feel certain they will not be punished by regulators in the event that these mortgages were to sour, or, 3) they simply don’t believe that these mortgages have similar likelihoods of default as those with <95% LTV.

A study out of the Housing Finance Policy Center produced the table to the right which shows default based on LTV and FICO score. The research suggests that FICO is a much more important predictor of default than LTV, which they believe that in the best of vintages, isn’t significant, and in the worst of vintages, isn’t too far from the current <95% mandate.

When Both Case Shiller and FHFA HPI data came in flat MoM, I’m not sure how prudent it may be to expand into the ultra high LTV category. Legal risks aside (and they are material to be certain), there seems to be too little equity buffer to withstand even a short term deterioration in housing prices. Any thoughts?

. - דער מענטש טראַכט און גאָט לאַכט- a Yiddish proverb meaning *Man Plans and God Laughs*

I spent some of this weekend thinking about confirmation biases, and how I display this when managing my personal investments. When times are good, we often believe ourselves to be better than we are, and as a result, we are far to quick to reject the belief that much of what we see in life is random. This subjective confidence is not a well reasoned conclusion of superior modeling capabilities or even a fan of confidence defined probabilistically. Instead, this sort of confidence is the reflection of a coherent series of information that we interpret to be causal. We know the human mind doesn't do well with non-events and when we have limited information, we put the pieces together in the most coherent story possible, and if its really coherent, we believe it to be fact. Our conviction that the world makes sense or that our portfolio performances is of pure skill is based on the foundation that we have almost no limit in our ability to ignore the certainty of randomness in the world.

I think reflections like this are useful for those of us whose line of work is in modeling. We have a tendency to construct and believe narratives that make it difficult to accept that limits of our own forecasting capabilities. Furthermore, because we can tie well linked stories together, we often become way to comfortable in the position that long term averages + short term variations (aka mean reversion with some noise) is a prudent methodology for forecasting the future of things. I wanted to share a paragraph from Daniel Kahneman’s book *Thinking Fast and Thinking Slow*.

“The idea that large historical events are determined by luck is profoundly shocking, although it is demonstrably true. It is hard to think of the history of the twentieth century, including its large social movements, without bringing in the role of Hitler, Stalin, and Mao Zedong. But there was a moment in time, just before an egg was fertilized, when there was a fifty-fifty chance that the embryo that became Hitler could have been female. Compounding the three events there was a probability of one eighth of a twentieth century without any of the three great villains and its impossible to argue that history would have been the same in their absence. The fertilization of these three eggs had momentous consequences, and it make a joke of the idea that long term developments are predictable”