Independent Banker

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Portfolio

[tag] Portfolio Management

[hed] Mayday for mortgages?

[dek] Rising borrower costs have consequences for MBS.

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The term “May Day” has generally positive connotations. In many European countries it celebrated the end of winter, with happy children dancing around a maypole. The celebrants would sing songs, crown a May Queen and look forward to a prosperous growing season.

The term “mayday” is something altogether different; its origins are barely a century old and decidedly less celebratory. It’s used as an international distress signal, mainly for aviators. As we proceed into the spring of 2022, many investment managers are wondering if it’s time to sound the mayday alarm about their mortgage securities, which have been losing altitude and market value for several quarters now. And, as we’ll see, their attendant cash flows, which were running at record high levels just a year ago, are hovering barely aloft.

[subhed] It matters to most

There’s really no way to downplay the importance of mortgage-backed securities (MBS) to community banks. When we account for all the various permutations of amortizing bonds, they make up more than half the investments in all the industry’s bond portfolios. We know that your collection of bonds is far larger than just two years ago (in some cases, double or triple in size), so MBS performance has a substantial impact on bottom lines.

A couple of other quantitative comments: First, the mortgage lending industry is producing as much long-term fixed rate product as it ever has. Adjustable-rate mortgages (ARMs) have recently been just 5% of new production, and even those usually have long, fixed rate initial terms before they become true floaters. Around 88% of outstanding mortgages began life as generic 30-year paper. Still, there is adequate supply, and reasonable spreads, of MBS varieties favored by community banks, which are the 10- to 20-year pools.

[subhed] Pushed to the limit?

To this frothy mix add the fact that mortgage rates have headed north since the beginning of 2022. As of this writing, the average conventional mortgage offering is now over 4%, after averaging just 3.21% in 2020-21. This means that anyone who took out a mortgage, and more importantly refinanced a mortgage, over the past two years is now out-of-the-money for refinancing. And that is a lot of loans.

More relevant in the near term for portfolio managers is the quick evaporation of the monthly cash flow that MBS had provided in the past two years. Using 30-year FNMA 2.5% pools as a test case, single-month prepayment activity peaked around a year ago, and cash flows (which are mostly due to refinancings) are now less than half they were in mid-2021 (see Table 1). Different cohorts have reacted to varying degrees, but it’s safe to say that any pools that your community bank has owned for more than six months are now projecting longer durations than any time in the past two years.

[subhed] Cash flow retention routes

So, what can we do with all this? There are several strategies that can be employed, starting right now. The most obvious is the “up in coupon” trade. Buying premium, versus discount, MBS will both produce more coupon cash flow and will likely create higher cash flows via some continued refis. Recently, a popular structure has been a 15-year 2.5% pool. These have recently been available in the 101.0 price range, which is down more than 2% since the start of the year.

This drop in “altitude” (market price) should be a net plus for community banks. While this column has made the point that the avalanche of cash flows has slowed to a crawl, overall the industry is positioned to benefit from higher interest rates. And most banks continue to have at least sufficient liquidity to buy more, lower-priced MBS. So maybe you don’t need to declare mayday on your MBS. Perhaps this month it’s time for some purposeful restocking of securities that will produce more stable principal returns, all at more favorable prices.

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[sidebar] Education on tap

2022 webinar series continues

ICBA Securities and its exclusive broker Vining Sparks present the next installment of the 2022 Community Banking Matters webinar series on May 10 at 10 a.m. Central. The topic is “Balance Sheet Management and Your Loan Portfolio.” To register, visit viningsparks.com

Education calendar online

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