



# Tips of the Caps

Interest-rate caps on floaters have a big impact on performance

By Jim Reber

Everyone likes a thrill ride. Roller coasters that climb into the sky, making scary-sounding squeaks and rattles, reaching an apex with land and sea far below, then rushing brake-less toward the cold, hard ground is great fun for most of us. Investments with similarly carnival-riding yields have provided, if not excitement for community bankers, then at least comfort. Comfort in knowing that returns will rise and fall with general market yields.

Organically, community banks struggle to produce enough floating-rate assets. Most borrowers want to lock in longer-term fixed rates. At the same time, we know core depositors usually want the shortest term available. So, often a community bank has to balance its asset/liability mix by purchasing some manner of adjustable-rate mortgage-backed securities (ARMs). That makes perfect sense.

With quantitative easing coming to a close, ARMs are becoming

more interesting to portfolio managers. Many community bankers, in fact, haven't had to deal with them in the current low-rate cycle, as the premiums (high) and yields (low) were just plain unattractive. But as higher rates may be in the offing, this is an opportunity to review the nuances of different interest rate caps, which will help to identify the best fit for your bank's portfolio.

## Cap standards

Let's examine three types of floaters to highlight their different cap features. One will see that, as always, there's no free lunch. Investments that have small periodic caps are great in some environments and a curse in others. Uncapped bonds are the same.

The middle ground in the interest rate cap story is bonds issued by Fannie Mae and Freddie Mac. These will typically have three components to their cap features and are usually described as "5/2/5."

This means that the first rate adjustment can be as much as 5 percent higher

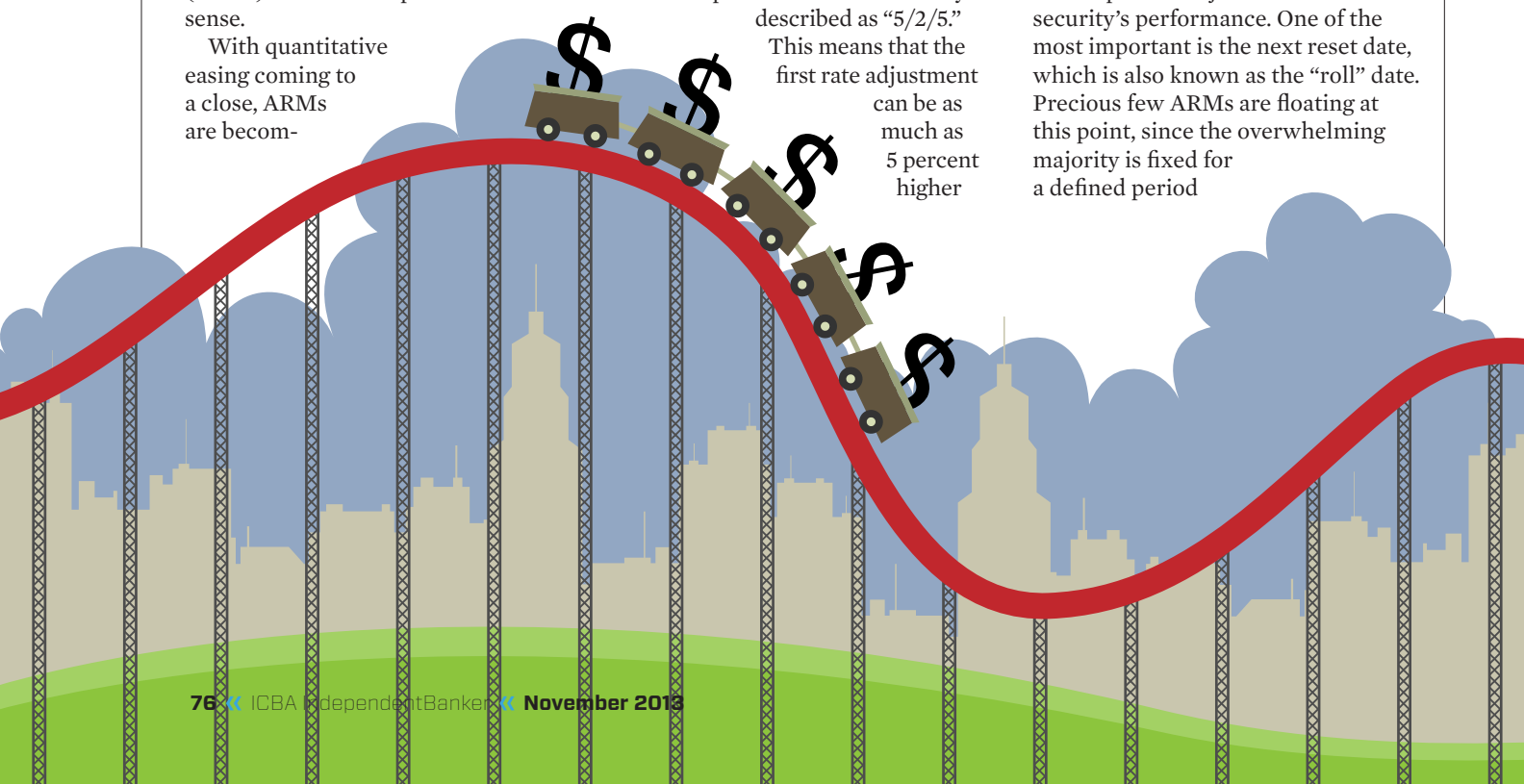
(or lower) than the initial rate, after which the annual cap is 2 percent; the life cap is 5 percent higher than the initial rate. As an example, a security that begins life with a 2.25 percent coupon can rise as high as 7.25 at the initial reset, and thereafter can move a maximum of 2 percent each year thereafter.

The most restrictive cap structures are those on Ginnie Mae securities. These have "1/5" caps, meaning the initial and future periodic annual caps are limited to 1 percent incremental changes each time, with a lifetime limit of 5 percent over the initial rate.

Finally, the most liberal cap structures are those on Small Business Administration loan pools, which have no caps, either periodic or lifetime. So wherever the prime rate goes, so goes the coupon on your bank's SBA pool.

## Fix, then float

There of course are other variables that impact an adjustable-rate security's performance. One of the most important is the next reset date, which is also known as the "roll" date. Precious few ARMs are floating at this point, since the overwhelming majority is fixed for a defined period



at the outset. These so-called hybrid ARMs can have an initial fixed period of three, five or up to 10 years before they start adjusting. (SBAs are floating-rate from the moment they're hatched.)

Still, the floating-rate aspect of ARMs is one feature that makes them attractive for community banks. Another is their limited price volatility. The theory is that the more frequently an asset's rate will re-price, the less it is exposed to interest rate risk. So a hybrid ARM with a roll date in five years will, at least temporarily, have a reasonably high amount of price volatility.

### ARM risk profiles

This circles us back to cap features. When a given ARM has, for example, 60 months until it begins to float, coupled with a fairly restrictive cap structure like Ginnie Maes, the price fluctuations it can experience are quite dramatic. The best way to estimate price risk for ARMs is the effective duration.

Effective duration should be disclosed in the offering documents by your broker and in your community bank's monthly bond accounting reports. Like other duration models, it is an estimate of the price volatility a bond will have. For ARMs, it takes into account the first reset date, index, margin and, yes, caps. For hybrid ARMs, the duration will shrink over time as the first reset date approaches.

### Webinar Series

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As an example of the effect of interest rate caps on an ARM, consider two example offerings. Recently, a Ginnie Mae with a 2.00 percent coupon and a Freddie Mac with a 1.95 percent coupon were available at prices around par. They both had fixed coupons for about five years before they begin to float annually. Their effective durations were quite different however, owing mainly to the different period caps; recall that Ginnie Maes have 1 percent annual caps, versus 2 percent for Freddie Macs. As of the date of issue, the Ginnie Mae had an effective duration of 5.8 years, and the Freddie Mac of 4.0 years. This is a significant difference.

The point is to pay close attention to all variables of an ARM, including caps, when comparison shopping. If "effective duration" isn't clearly displayed, ask your broker for it. It can help to fasten your seat belt for your ride up and down the interest rate cycle. ☐

