



Look Both Ways

Big swings in mortgage-backed security prepayments merit attention

By Jim Reber

It's really quite simple. So fundamental, in fact, that it's listed in the book "All I Really Need to Know I Learned in Kindergarten." Your mother begged you to, and chances are you've asked your own children to follow the same advice: Watch out for traffic.

Traffic in this sense is the steady stream of principal payments received by holders of mortgage-backed securities (MBS). Community banks have long been investors in MBS issued by Fannie Mae, Freddie Mac and Ginnie Mae. Such investments in one form or another comprise nearly half of all community bank portfolios. It has been well documented that higher performing banks have an ample weighting in these instruments.

Amortizing investments do not run on autopilot, though. Lenders readily understand the monthly return-of-principal feature, but MBS can also have additional early principal

reduction. The individual homeowners, whose mortgages form the collateral behind the pools, have the right to prepay ahead of time. This has given rise to an elaborate



guessing game involving financial modeling and the use of acronyms with names like CPR, FMED and PSA.

Mortgage rate shocks ...

These prepayments will increase or decrease based primarily on two factors: 1.) existing borrowing rates, and 2.) current borrowing rates. In fact, I would guess that most of the readers of this column are enjoying recently-reduced interest costs on their own home mortgage via refinance, so you get the idea.

The science transitions into art when market rates exhibit erratic behavior and, likewise, housing (collateral) prices fluctuate.

During 2013 alone, 30-year conventional mortgage rates tracked

by Freddie Mac ranged from 3.34 percent to 4.58 percent. The rise of well over 100 basis points took place in slightly over three months and took the home lending (and borrowing) market by surprise. Rates have since retreated from their peak, but prepayments have plummeted.

... produce prepay hiccups

Which is why I recommend looking both ways before and after investing. A benchmark in today's MBS market for measuring prepay activity is the 30-year Fannie or Freddie 4.00 percent security. There are thousands of outstanding pools (more than 26,000 CUSIPs), with a variety of seasoning. Many brand-new loans being minted today end up in these pools.

The prepayments in the early part of 2013 for this cohort were averaging about 30 percent on an annual



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basis. In MBS-speak the one-month “speed” in January was 31 percent, and in February the speed was 28 percent. This is extremely high on an historical basis.

The rate spike, for better or worse, took care of the speeding. By September, the numbers were down in the single digits. It’s an accepted standard that MBS will prepay at 6 percent annually regardless of refinance opportunities. So for 30-year, 4.00 percent MBS, we are nearly at this “default” speed. What does this mean to your investment portfolio?

Traffic safety hints


By “looking both ways,” I suggest reviewing the yield tables provided by your brokers that display prepayment speeds, and corresponding yields and average lives, over a wide range of interest rate shocks. The relatively small change in rates last year

(around 125 basis points from valley to peak) created a huge difference in refinance activity. Plus and minus 300-basis-point prepayment speed estimates should be available at the time you are considering a purchase.

Because of the dramatic slowdown in late 2013 in refinance activity, community bank investment portfolio durations have grown substantially. Just between March and September, the average duration of the 500-plus banks that use Vining Sparks for bond accounting increased from 2.9 years to 4.0 years. Now would be a good time to pay attention to your community bank’s portfolio’s estimated length.

A handy technique for limiting your community bank’s extension risk is to buy MBS with high-enough coupons to ensure at least some prepayment activity even if rates move higher from here. That will require the buyer to pay some premium, but premium

bonds relative to par or discount ones will generally have more stable average lives and market prices.

This strategy, too, needs to be exercised with caution, as higher coupons with faster prepayment activity can seriously erode yields. Just like your mother used to say: Be careful out there. 

Prepayment Monitor

ICBA Securities can produce a Prepayment Exposure Impact Report to aid in your mortgage-backed securities management. This document quantifies the horizon prices and yields given historic and projected prepayment data. To order this complimentary report, contact your ICBA Securities sales rep.