

# What goes down...

Floating-rate investments come in a variety of structures

By Jim Reber



**O**K, folks, the time has come to take another look at floaters. These investments, whose yields adjust in concert with general market rates, sound great to community bank portfolio managers. This is especially true of

those who are exposed to rising rates, and particularly those who think 2017 is the year rates will finally move noticeably higher.

There is a wide variety of securities that accomplish this objective, including some that are, in fact, fixed rate. You've likely heard the term

"cushion bond," which is simply a callable security that is priced above par. The yield to maturity will increase if general interest rates rise by virtue of the issuer not exercising the call.

Below, we look at three of the more traditional floating-rate securities; to some extent, they will mirror what interest rates do in general. Many community banks mix in a combination of them to diversify their adjustable portfolios.

## 1 Adjustable-rate mortgage securities (ARMs)

True adjustable-rate mortgage loans are hard to find these days. This is because homeowners insist on a fixed rate, at least for a start-up period, before they begin to adjust. You commercial lenders out there know the drill.

The product that is available is known as a hybrid ARM. It allows you, the buyer, to choose how long a fixed-rate period you're willing to accept prior to the bond becoming a floater. It can be as short as three years and as long as 10. Be aware, however, that as the initial "reset" date approaches, the prepayment speeds tend to increase, sometimes dramatically. Hybrid ARMs are also generally priced at moderate premiums.

## 2 Collateralized mortgage obligation (CMO) floaters

Many of you will recall that a CMO is a bond that has dedicated cash flows carved out of a generic batch of fixed-rate mortgage securities. The underwriters who create these "tranches" can also produce floating-rate CMOs. The benefit to you, the buyer, is that these usually come with very low premiums, and they tend to be especially rate sensitive, as they are tied to money-market rates like 30-day LIBOR and have no periodic rate caps.

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## How floaters stack up

Type	Common index	Periodic cap	Lifetime cap	Reset period	Price range	Current yields
ARM	1-year Treasury	1.0%–2.0%	5.0–6.0% over initial rate	Annual	101.00–106.00	1.0%–1.7%
CMO	3-month LIBOR	None	6.0%–10.0%	Quarterly	100.00–100.50	0.8%–1.0%
SBA 7(a)	Prime	None	None	Quarterly	108.00–116.00	1.3%–1.8%

What CMO floaters also have are erratic principal cash flows. Their average lives can swing from less than a year to more than two decades. Community banks that invest in these don't seem to mind, since they are more interested in the fact that the bond will float than when they get their money back. Note that CMO floaters can have lifetime ceilings on their rates that are as low as 6%.

adjustable-rate security. Given that short-term rates (two years and less) are at their highs since 2009, yields on all these options are beginning to be more attractive. If the Fed does indeed orchestrate several more rate hikes this year, floaters stand a good chance of being among the best performers in your own community bank's investment portfolio. [E](#)

### 3 Small Business Administration (SBA) securities

The SBA's flagship floating-rate product is the 7(a) program. About two-thirds of all 7(a) loans originated by community banks each year are sold into the secondary market, usually at significant gains. The "poolers" group them into homogeneous sets and issue securities that are zero percent risk-weighted.

These pools appeal to community banks because they are true floating-rate securities. They are tied to prime (which is almost perfectly correlated to Fed funds), and there are no rate caps, either periodic or lifetime. As a result, the risk metric known as "effective duration" is very low for 7(a). However, care needs to be exercised in managing the premiums that come attached to these securities.

Community banks have about 12% of their portfolios in some type of



### Floating-rate research

ICBA Securities' exclusive broker, Vining Sparks, publishes the ARM Market Update each Monday. It reviews the performance of the adjustables market and contains tables that allow investors to compare alternatives.

To learn more, contact your Vining Sparks sales rep or visit [www.viningsparks.com](http://www.viningsparks.com)