» PORTFOLIO MANAGEMENT

# Paydowns may pay off

High cash-flow securities could provide liquidity when needed most.

By Jim Reber

This just in: Loan demand at community banks is rising. Just like April showers bring May flowers.

The preceding wasn't meant to be cheeky. In fact, it's welcome news for the industry that lending has been growing for several years now—especially since credit-quality indicators, so far, are holding up very well. The FDIC has reported that community bank loan and lease balances as of year-end 2016 were 8.3 percent higher than the previous year. At the same time, noncurrent balances and charge-offs declined. Someone is doing his or her job.

However, because loan demand is growing at the same time as interest rates seem to be on the rise, this could create a hole between the cash needed to fund the credit needs and the cash being produced by the font of liquidity known as the investment portfolio. Most community banks' investment cash flows have been slowing since 2014, and they could be at risk of drying up further. Therefore, this column will suggest a couple of investment sectors that community banks are utilizing to pump up the cash flow.

ICBA VOICE

**Jim Reber** (*jreber@icbasecurities.com*) is president and CEO of ICBA Securities, ICBA's institutional, fixed-income broker-dealer for community banks.

### Durations on the rise

Actually, you may have noticed that the metric known as "effective duration" has already increased since 2016. Effective duration on a fixed-rate investment is shorthand for how long it will take to get paid back, both principal and interest. Durations will increase as general interest rates rise, and the fourth quarter of 2016 is a test case.

During that 90-day period, community bank durations rose from about 2.6 years to about 3.4 years. If we were to extrapolate that onto the calendar, it would be about 10 months, which doesn't sound like much. However (that word again), this represents a 32 percent increase in price volatility in just a few months. Hence our interest in reining in some of that risk.

### Premiums present priority

I know, I know. Community bankers have limits on how much premium they will pay for an amortizing security. With judicious selection, however, one can limit the amount of price risk and ensure that monthly cash flows remain stable. It requires some pre-purchase analysis.

Table 1 displays what experienced portfolio managers understand innately—that the higher the coupon on a mortgage-backed security (MBS), the faster the prepayment speeds. Something else that attaches to higher coupons is higher prices. At this point in the interest-rate cycle, any 15-year MBS with a stated coupon of 3.5 percent or less has little risk of faster prepayments, because the homeowners whose mortgages collateralize the

pools have little incentive to refinance. So the recommendation is to consider a 3.0 or 3.5 percent MBS if your objective is to limit the downside to your market value.

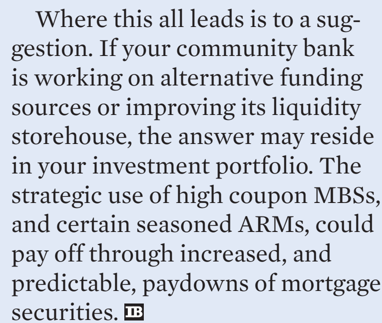
### Roll with the roll date

Another variation on this theme is to consider seasoned adjustable rate mortgage (ARM) pools. These days, virtually all newly issued ARMs have an initial fixed-rate period, ranging from three to 10 years.

After this fixed-rate window lapses, the remaining balance from then on will see its rate reset every 12 months. This structure is known as a "hybrid ARM."

What we have seen repeatedly is that the prepayment speeds on a hybrid ARM will begin to ramp up as the pool approaches its initial "roll" date. This demonstrates that most homeowners really don't like floating rate debt and are willing to borrow on that basis only as long as the loan isn't yet an annual adjuster.

As an example, Ginnie Mae pool MA0803 was issued in February 2013 as a "3/1 Hybrid." It had an initial coupon rate of 2.00 percent until April 2016, when it began to reset annually. For the first two years, it averaged about 20 percent principal prepayments each year. As the roll date has gotten shorter, and as short-term rates have risen, this pool has become "speedier": The last six months have averaged 30 percent. An astute banker will see that principal cash flows of this pool have increased even as the remaining principal on the pool continues to decline. And this is precisely the desired outcome.



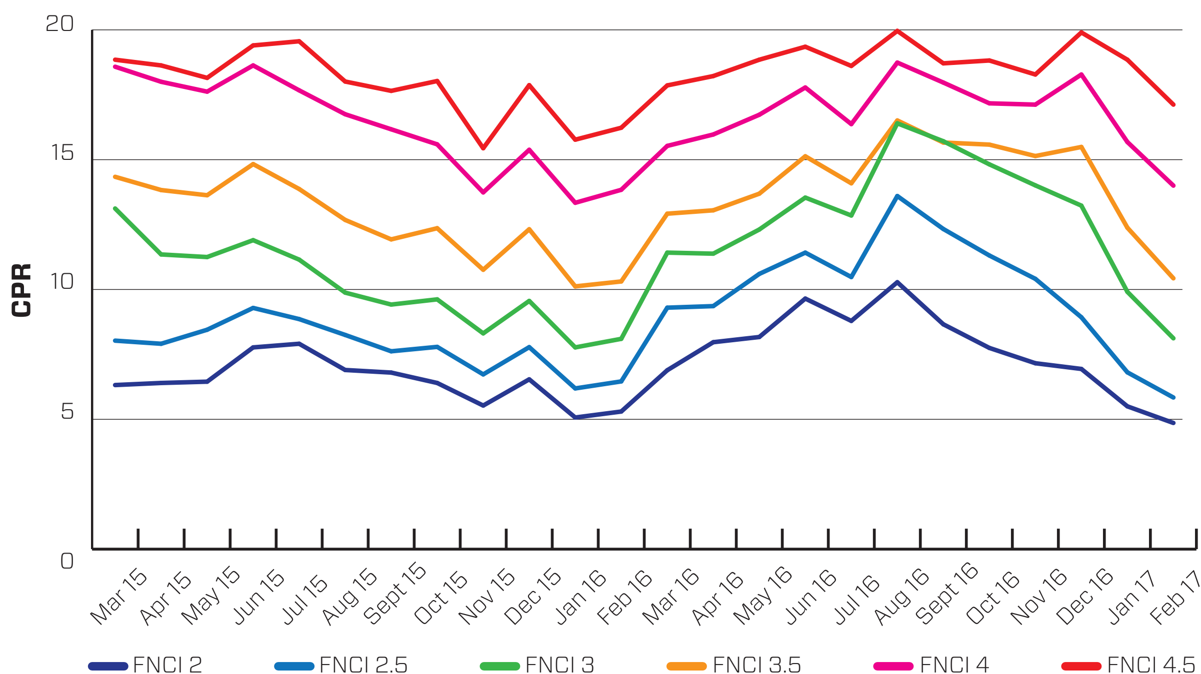
Where this all leads is to a suggestion. If your community bank is working on alternative funding sources or improving its liquidity storehouse, the answer may reside in your investment portfolio. The strategic use of high coupon MBSs, and certain seasoned ARMs, could pay off through increased, and predictable, paydowns of mortgage securities. IB

## Mortgage market update

ICBA Securities' exclusive broker Vining Sparks publishes regular research on the mortgage securities market. This includes weekly updates on the fixed and adjustable sectors and also monthly prepayment history commentary. To subscribe to this publication, contact your Vining Sparks sales rep.

## Webinar series continues

ICBA Securities will present the next segment in its popular Community Bank Matters webinar series on May 16. Katharine Bray and Dan Stimpson of Vining Sparks will present "Capital Market Solutions for Your Balance Sheet and Your Customers." One hour of CPE credit is available. To register, visit *icbasecurities.com*.




*Source: Bloomberg*