Paydowns may pay off
High cash-flow securities could provide liquidity when needed most.

By Jim Reber

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.

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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. 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.

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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.

**Mortgage market update**

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**15-year Fannie Mae prepayment trends**

Source: Bloomberg