Hybrid ARMs

Good yields today, and coupons that rise tomorrow

by C.J. Pickering

In today's low interest rate environment, with a steep yield curve and rates that could rise rapidly in the near-term, hybrid adjustable rate mortgages make sense. The current yields are reasonable and the adjustable-rate coupons reduce future price volatility.

Hybrid agency ARM pools are made up of 30-year mortgages that have fixed-rate coupons for periods ranging from three to 10 years and then float with six-month LIBOR, one-year LIBOR or one-year Treasury rates.

Hybrid ARMs come in many shapes and sizes. Fannie Mae, Freddie Mac and Ginnie Mae issue agency hybrids with interest rates that float with LIBOR or one-year Treasury rates. Their initial reset periods are scheduled for three, five, seven or 10 years, and their initial coupons can be higher or lower than their fully indexed coupons. More often than not, the initial coupons are higher than their fully indexed coupons.

For simplicity, two popular types of Freddie Mac securities will be used to illustrate hybrid concepts—one with an initial three-year reset date and one with an initial five-year reset date. After the initial reset, the rates on both securities float at 2.22 percent over the one-year constant maturity Treasury.

Table A shows the initial characteristics of the two Freddie Mac hybrids. Both share the same one-year Constant Maturity Treasury index rate of 1.29 percent, the same margin of 2.22 percent over the index, the same annual rate cap of plus or minus 2.0 percent and the same lifetime cap of 9.25 percent. The major differences are the initial coupons (3.30 percent versus 4.25 percent), the reset periods (2007 versus 2009) and the prices (101.25 versus 100.84).

Table B shows the projected characteristics of the two Freddie Mac hybrids under level and rising rates. If rates remain level for the life of the securities, both will experience a constant prepayment rate of 15 percent annually, which will produce average lives of 5.4 years.

Now the differences—under level rates, the three-year will yield 3.0 percent for the first three years and, in fact, for the entire life of the pool. The five-year will yield 4.0 percent for the first five years (until the first reset) and will yield 3.8 percent for the entire life of the pool. This drop in coupon after the first five years will occur because the initial coupon was set above the stated margin; that is, the initial coupon of 4.25 percent was set by Freddie Mac at a higher level than the stated one-year Constant Maturity Treasury plus a margin of 1.29 percent plus 2.22 percent equals 3.51 percent.

For stress-testing purposes, assume that the one-year Constant Maturity Treasury rises 300 basis points immediately after purchase and the Constant Prepayment Rates of the example hybrids drop to 6.0 percent annually. Because the coupon rates are fixed until the first reset, the yields to reset of these two securities rise very little from the level rate scenario—from 3.0 percent to 3.1 percent for the three-year and from 4.0 percent to 4.1 percent.
percent for the five-year. The slight increase in rates is due to slower premium amortization when rates rise and prepayments slow down.

There are, however, major changes in a few characteristics. The yield to maturity of the three-year rises from 3.0 percent to 5.0 percent and the yield to maturity of the five-year rises from 4.1 percent to 5.2 percent. And the market value of the three-year drops by 7.4 percent while the market value of the five-year drops by 11.0 percent. These drops in market value are similar to the drops that would be experienced by fixed-rate securities with durations of about 2.5 and 3.7 years respectively.

Each of these securities has something to offer. The three-year has a shorter time to reset and less price volatility while the five-year offers a higher yield during the first three years under both level and rising rates.

New types of hybrids are being generated all the time. Ginnie Mae started issuing its three, five, seven and 10-year hybrids last year. And, there are hybrids designed to react to very steep rate rises; for example, Fannie Mae offers a five-year hybrid whose coupon can reset all the way up to the lifetime cap of 9.41 percent at the first reset date (after the first reset, the plus or minus 2.0 percent annual cap applies).

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**Updated Info Available**

The trends referenced in this column are based on December 2003 data. These examples will be conceptually correct this month, but bankers interested in more current information for comparisons of hybrid ARMs are invited to call ICBA Securities at (800) 422-6442.