It appears the mortgage-backed securities (MBS) market is attempting the old bait-and-switch on portfolio managers.

As community bankers have gradually become more comfortable with MBS and the sector weightings for fixed-rate mortgage-backed securities, collateralized mortgage obligations and ARMs, many of the tried-and-true products have begun disappearing from the investment landscape. It's therefore an appropriate time to talk about new MBS products that have nuances, but are for the most part, manageable for many bank portfolios.

Let us first review the preferred mortgage-backed securities sectors historically. Investment policies, having strong mandates regarding extension risk and stated final maturities, have naturally gravitated to the products that do a very good job of keeping average lives short. Among these fixed-rate products are 10- and 15-year amortizing pools, and five- and seven-year balloons.

These products have been successfully used to produce predictable cash flow with limited extension risk and callability, all with excellent credit quality and liquidity. They in essence were alternatives to callable agencies or corporates.

Another reason these were, and are, popular was their availability. For example in 2003, 15-year and shorter pools comprised fully 30 percent of the total securitized production by FNMA, FHLMC and GNMA, (Fannie Mae, Freddie Mac and Ginnie Mae, respectively).

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<th>New Mortgage-Backed Security Options</th>
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<td>Type</td>
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<td>Hybrid ARM</td>
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<td>Interest-Only Mortgage</td>
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For bankers who wanted or needed to own adjustable-rate securities, the agencies have historically produced an ample supply of that product as well. The ARM share of total mortgage originations will rise during high-rate periods and fall during low-rate periods, but the share has averaged around 20 percent of total conforming production over the last decade. These loans by and large have adjusted annually to the one-year Constant Maturity Treasury index, with varying margins and caps.

Again, Fannie Mae, Freddie Mac and Ginnie Mae have all participated in this market. The product’s popularity stems from the very short effective duration that any pool would have.

**New Production, Products**

Last year saw the advent of a number of variations on these traditional themes. Probably the most dramatic shift was the near shutdown of balloon originations, replaced mostly by hybrid ARMs. By late 2005, the share of 10-year and balloon pools securitized by the agencies was barely 1 percent of the total on a monthly basis. Hybrid ARMs, on the other hand, have expanded geometrically and have recently been accounting for more that 50 percent of total closings.

Hybrids are really a cross between balloons and traditional ARMs, in that they will have a fixed rate of, say, five or seven years, after which the loan reverts to an annual adjustor for the remainder of the term. Because the fixed period mirrors that of a balloon, the price volatility/yield relationship (also known as risk/reward) is very similar to a balloon. A major difference, which is significant, is that the stated final maturity at the start is 30 years, versus the five- or seven-year final in the case of a balloon.

However, it would appear that the margins and caps (which are usually quite generous), plus the fact that at the reset date a hybrid is a one-year adjustor, should put a floor under the future market value as it approaches the adjustment period. And even if at reset the pool is worth less than the book value, the remaining balance is likely to be small enough for the loss to be insignificant.

As the hybrid market has expanded, a subset of that product has come firmly into focus: interest-only loans. The rise in housing prices, which has been well documented in the national media, has caused the thought process of borrowers (and apparently lenders) to arrive at two conclusions. First, prices are going to continue to rise, and secondly the lower monthly payments which interest-only loans afford can be used to buy more house.

The general structure of these loans is for interest-only payments for a period—again, usually five or seven years. At that point, they begin to amortize based on the remainder of the original 30-year term. A five-year, interest-only will therefore have 25 years to amortize. And, the payment stream is much lower during the interest-only period.

For example, a 30-year, 5 percent loan will have a full 20 percent lower payment for the first five years. By mid-2005, interest-only loans were accounting for almost a quarter of all new mortgages, and 90 percent of them were of the hybrid variety.

Also as a consequence of the balloon market drying up, FHLB began issuing “Reference Notes” in 2004. These have the alternative acronym of an IAN (Indexed Amortizing Note). These notes are technically not MBS, but have an amortizing payment stream based on the actual prepayment experience of a reference pool type, such as all 30-year FNMA 5 percent MBS. These Reference Notes have two features which a bank portfolio manager should like: the FHLB label, which has state tax benefits in many states, and short maturities, such as five, seven or 10 years. The short maturities are assured by a feature known as “mandatory redemption.” These bonds are therefore seen as balloon replacements by many investors.

Finally, the jumbo market needs mentioning. While jumbos are not securitizable by the agencies, the increase in housing costs has resulted in a skyrocketing of whole loan pool issuance by private label issuers. In fact, jumbo production on a dollar basis far exceeds that of conforming production.

Most of these “whole loan” pools do have excellent credit quality, and as their numbers have increased so has their liquidity (which, in this context, refers to the shrinkage of the bid/ask spread). The structure of the pools basically mimics the agencies—namely, lots of hybrid ARMs, lots of interest-only pools.

Also, if the IRS were to limit mortgage interest deductions, which has been discussed only preliminarily, the supply of jumbos would take a hit, meaning...
that their prices should rise compared to conforming pools. So jumbo pools could represent a good value at the present.

**Practical Application**

The purpose of this column is to educate, and maybe alert, portfolio managers that the more traditional MBS products are simply not available in anywhere near the numbers they were two years ago. This is not necessarily a problem. It does, however, make a demand on the buyer to study up on the new products that seem to be the wave of the present, if not future.

Yields on a five-one or a seven-one hybrid ARM are superior to that of a five- or seven-year balloon, owning mostly to the supply issues mentioned earlier. The same is true for interest-only and whole loan pools compared with more traditional, conforming securities.

Another variable, which has yet to be determined, is the prepayment patterns for IOs. It is thought that they will mimic coupon-bearing hybrid pools, but the jump in payment could cause them to prepay faster than normal as they approach the amortization date.

There are a number of other new products and trends in the MBS arena that are not mentioned here. Still, the above makes it clear that it will become necessary for MBS investors to familiarize themselves with the new products which are dominating the mortgage lending market.

If you would like ICBA Securities to analyze your current portfolio for recommendations regarding adjustable rate mortgage products, contact your account rep or call (800) 422-6442.

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