This month’s Portfolio Management column is really the latest in a series that has become a trilogy. I wrote about new innovations in the mortgage-backed securities (MBS) market in January 2006 and about new takes on old products in September 2006. The motivation is to explain in some detail how these new products are structured and to highlight their plusses and minuses. It is correct, however, that high-yielding bank portfolios have a generous allocation of these products.

As of Sept. 30, 2006, the average community bank had about 22 percent of its portfolio in fixed-rate MBS. This 22 percent represents the largest sector weighting, outpacing even callable agencies (19 percent). This is a positive development, as MBS usually (not always) have superior risk/return characteristics compared to callables.

Production Trends

As the demographics and economics of America change, so too do Americans’ borrowing habits. The rapid rise in housing prices in 2004 and 2005 has been well documented. The aging of the baby boom generation continues. Self-employed workers as a percentage of the total workforce is at an all-time high.

Each of these contributes to a record amount of non-conforming mortgage loan production. In 2005, nearly one in four mortgage loans had some characteristic which prevented Fannie Mae or Freddie Mac from purchasing or pooling it. Two MBS products that are the residue from this shift away from conforming pools are relocation pools and Alt-A pools. The rest of this column will provide details on these viable options.

Relo Pools

Since both Freddie Mac and Fannie Mae have relocation pool programs, it is possible that you own one without knowing it. Relocation pools, as the name implies, are made up exclusively of loans to facilitate the relocation of employees. As a means of compensating key personnel for the inconvenience, an employer may offer a below-market rate with otherwise conforming underwriting criteria (such as loan size, documentation and debt loads).

The homeowners involved are generally more upwardly mobile
than the population, and by definition they work for an employer that has the need to periodically relocate its workers. These two factors contribute to an important characteristic of these pools: They will prepay in line with generic collateral for two, three or even four years, after which time they will prepay much faster. This often takes several years to occur, but when it does, it does so regardless of general interest rates.

Therefore, relocation pools can be a great tool for producing good cash flow in high-rate environments. It can be doubly beneficial if the pools are purchased at a discount to par, as faster prepay speeds translate into higher yields.

Alt-A Pools
The term “Alt-A” refers to loans that are an alternative to “A”-quality loans. They are an alternative because they often simply lack documentation or have minor deficiencies such as inconsistent earnings histories. These are not to be confused with subprime loans, which do, in fact, have credit deficiencies.

While Alt-A loans are not sellable to or poolable by Fannie or Freddie, they are periodically issued as private-label MBS by issuers such as WAMU, Bank of America or Countrywide. They generally will have credit enhancement features that allow them to have AAA credit ratings. And, just like relo pools, they have prepayment characteristics that can make them desirable vis-à-vis conforming pools.

Since Alt-A borrowers have to borrow at somewhat higher rates than conforming borrowers, they tend to keep close watch on current mortgage rates and will prepay their Alt-A loan as soon as their documentation can be made up-to-snuff. This means a number of them will “cure” in any rate environment, including high rates. Consequently, Alt-A pools will prepay faster in high-rate scenarios than Fannie/Freddie pools, which is a good thing.

Further, since some Alt-A homeowners are less able to take advantage of refinance activity as rates fall, as some will remain non-conforming, these pools will prepay slower in low or falling scenarios. This again is a good thing. The slower-than-average experience is also caused by higher closing fees charged to such borrowers.

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