I know what you’re thinking. You’re wondering how the subprime mess/credit crunch/liquidity crisis will affect your community bank’s investment portfolio. I know you’re thinking this because the question has been posed to my colleagues and me at ICBA Securities over the last 90 days in myriad ways.

The answer, as usual, is, “It depends.” It depends on your duration, your credit quality, your sector weightings and your optionality. Optionality is that elephant in the community bank’s lobby that no one wants to talk about but which has a huge impact on a bank portfolio’s performance. This month’s Portfolio Management column focuses on this characteristic, and, in particular, how it pertains to mortgage securities.

**Risk Reviewed**

Optionality, in a nutshell, is the degree to which the issuers of your bank’s investments can call them away at their behest. Most bonds in a bank’s portfolio have some call option; our most recent figures indicate about 90 percent of bonds are in some way callable. However, non-callable bonds, or “bullets,” are certainly desirable in a falling rate environment.

Mortgage securities, which include straight pass-through mortgage-backed securities (MBS), collateralized mortgage obligations and adjustable-rate MBS, contain what is known as an imbedded option. That is, the borrowers can usually prepay their mortgages at any time, with no penalty. This means that your community bank, the investor, has little control over when it gets its money back.

Sometimes, though, a portfolio manager may want to have fast prepayments. For example, investors would welcome fast prepayments if they expect high rates in the near future. Similarly, prepayments would aid a bank that calculates that it is liability-sensitive and needs more assets to reprice in the short term.

In these cases, an MBS buyer would prefer to buy high coupons, probably at premiums. The assumption is that a reasonable number of borrowers will be prepaying their in-the-money loans (read: higher than current market) sooner than later.

**Flip Side**

If one man’s trash is another’s treasure, who would benefit from slower prepayments? The answer: entities that do worse in falling-rate environments. This includes most community banks. One traditional method of limiting
portfolio management

Subprime Fallout
I am going to limit this next section to the role of conforming loans—the ones that Fannie Mae and Freddie Mac purchase and pool. I’m doing so because these are the loans that will likely depart from normal performance, and because they comprise the vast majority of a community bank’s mortgage-backed securities.

As the summer/autumn of 2007 progressed, it became clear that even conforming lenders were tightening the underwriting screws. Minor documentation deficiencies, debt-to-income ratios that bump against upper limits, or appraisals that don’t get loan-to-values in sync with conforming standards will get loan applications rejected out of hand.

Also, the lack of appreciation in home prices, or more precisely their decline in value, hinder both sellers’ ability to get out of an old house and current homeowners’ ability to refinance an old loan. While the drop in home values has been concentrated on either coast, the median price of homes for the entire country showed a decline in the third quarter of 2007.

The final whammy is that credit spreads widened dramatically during this period (see graph on this page). Non-conforming (including subprime) investors slowly but surely dropped their required risk premia for a four-year period starting in 2003, only to get religion once the foreclosures began piling up. Conforming lenders reacted by greatly increasing the quoted loan rates, relative to Treasury rates, offered to even their best borrowers.

What to Expect
As you’re considering your bank’s next MBS purchase, you should expect slower than historical prepayment activity on any mortgage pool. Even seasoned loans, which sometimes begin to pick up speed in the 36- to 60-month period, will have less ability to refinance or prepay. An exception would probably reside with Relocation Pools, discussed here in the past.

Overall, this confluence of events would seem to beg for a strategy of buying premium mortgages. If the faster prepays don’t materialize—and I’m suggesting they won’t for some time—then your premium doesn’t cost you any yield. And, if the secondary mortgage market returns to “normal,” the increased cash flow should still allow for superior returns relative to discount pools.

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