We’re going to try this story from yet another angle.

Last year in this column you read about the huge yields in certain types of amortizing bank investment products. First, last February, I presciently suggested that prepayments were likely to slow down. Then, in July, I pointed out the benefits of leveraging with 15- and 20-year agency mortgage-backed securities (MBS). I followed that up with a story in October about FHA Secure loans backing Ginnie Mae securities. In December, you read about Small Business Administration (SBA) products.

What makes us return to the font of imbedded-option investments again?

Let’s begin with the often misunderstood but crucial variable known as spread. Spread in this case means the additional yield an investor will earn over and above a comparable maturity Treasury. Recall that Treasuries are used as a baseline because they are considered risk-free from a default standpoint, and are consequently relatively low-yielding. That is certainly the case as the new year gets moving.

The spreads in traditional MBS expanded to generational-wide levels in 2008 and remained near their “wides” as of the beginning of 2009. This is good news for new investors and not-so-good news for both current holders and potential new homebuyers. It represents an opportunity to buy very high yields relative to Treasuries, and to lock in yields during a near-term horizon that may not see much economic growth.

It also will hamstring current and new homeowners alike by making it difficult economically to either refinance existing loans or borrow new money efficiently.

Compelling Value in MBS

There Are Many Benefits in Imbedded-Option Investments

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It may surprise you to learn that over the last three and one-half years mortgage rates have essentially gone sideways. There seems to be a perception among borrowers that home loan rates have roughly tracked Treasury rates lower as the Fed began cutting rates in late summer 2007. There have been some peaks and valleys, but no secular trends have emerged.

What changed, significantly, were the prepayments speeds on virtually all mortgage products. (Chart II, on page 105, shows the slowdown in Constant Prepayment Rates for 30-year agency pools.) It is clear now that a combination of falling home prices (caused in turn by oversupply and falling employment) and a tightening of credit standards have reduced the ability of Joe the Homeowner to sell his house or to refinance.

The tighter credit has manifested itself in MBS yields as well, so while Treasuries are near their all-time low yields, mortgage yields are some 200 basis points wider than recent history.

**Take Advantage**

A community bank portfolio manager does not have to purchase a 30-year, fixed rate MBS to take advantage of the spread bonanza. Traditional bank products, such as 15- or even 10-year pools, have participated in the spread widening. Chart I (below) displays the yields on current-coupon (meaning priced near par) 15-year MBS issued by Fannie Mae or Freddie Mac since mid-2005, alongside the yield on 5-year Treasuries. The widening is quite visible.

Bankers like 15-year pools for a number of reasons. One is the fairly predictable stream of cash flow from both the scheduled principal (compliments of the compressed amortization schedule) and predictable

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**Chart I**

**Historic Yields for 15-Year MBS and 5-Year Treasuries**

06/01/2005 to 11/19/2008

Source: Bloomberg

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**MBS Tools Available**

ICBA Securities can provide complimentary mortgage-backed securities management tools through its Web site, www.icbasecurities.com. Contact your sales rep or Jim Reber for representative offerings.
prepayments. Another is that the resultant average life at the outset of about five years is in the comfort zone of most banks.

A third is that the yields in such instruments are usually enough “better” than slightly shorter bonds to make them attractive from a cost/benefit perspective. Yet another is the limited extension risk if prepayments were to slow further.

**Other Benefits**

This Portfolio Management column specifically addresses government-sponsored enterprise (GSE) pools, and fixed rate ones at that. Fannie Mae’s and Freddie Mac’s MBS are the most liquid on the planet, so variables like a narrow bid/ask spread are attractive to those investors that occasionally sell bonds prior to maturity. Also, pledgability versus Federal Home Loan Bank advances or Fed discount window borrowings is not an issue, as they are universally accepted.

In January, as this column went to press, the presumed enhanced backing by the Treasury Department of Fannie Mae and Freddie Mac debt caused the FDIC to propose that the risk weighting for all GSE debt drop from 20 percent to 10 percent.

In summation, the enormous yields coupled with the slowdown in prepayments currently being realized make simple Fannie Mae or Freddie Mac pools a compelling story for a community bank’s investment portfolio. It is entirely possible that, when the Fed begins to again hike Fed funds and then Treasury rates follow in step, a narrowing of spreads will help maintain much of the value captured in today’s prices.