Mortgage-Backed Security Prepayments Will Pick Up Speed

And now, mortgage-backed securities investors, is the moment you’ve all been waiting for. …

And this is not necessarily a good thing.

As we’re now almost a year into the current recession, and nearly two years since the beginning of the Federal Reserve’s rate-cutting cycle, the MBS market should have been well into a phase of rapid prepayments thanks to increased refinance activity. “Should have” being the operative phrase.

Especially when one considers that fed funds have been pegged at near zero for most of 2009 and posted mortgage rates are hitting all-time lows. Did we mention the Fed’s own program to buy $1.25 trillion of GSE mortgage-backeds on the open market?

Experience

The best, most recent, barometer of prepayments activity is the period from June 2001 through May 2003. The Federal Open Market Committee cut fed funds from 4 to 1 percent during that time, and the entire Treasury yield curve hit a cyclical low. Benchmark mortgage rates, which typically are Fannie Mae/Freddie Mac-posted rates for 30-year fixed-rate loans, fell as low as 5.21 percent in June 2003. This was down from over 7 percent two years earlier.

As borrowers were gradually more able to refinance into lower coupons, prepayments soared. Thirty-year 5 percent MBSs averaged 7 percent CPR in 2001 and reached as fast as 19 percent in 2003. Recall the CPR, Constant Prepayment Rate, represents the amount of principal that is prepaid (not repaid) in a given pool, expressed in annual terms. For example, a pool that posts a 12-month average of 15 percent CPR had 15 percent of its unscheduled principal returned to the investors in the past year.

Why You Care

The expectations of faster prepayments have a multitude of implications for MBS investors. For one, spreads usually widen out to compensate owners for increased call risk. Widening spreads are good for those looking to purchase, but not for current holders.

For another, as speeds pick up, portfolio durations
shrink faster than expected. A too-short duration, particularly during a period of interest rate troughs, will aggravate net interest margin compression at precisely the time that slack loan demand is doing the same thing.

Another consequence is that your yields on your current positions are virtually certain to change. Very few Fannie/Freddie pools are sold at par, and lately even fewer are sold at discounts. (There are, however, plenty of private-label MBSs trading at deep discounts, but that’s another story for another day.)

Mortgage securities owned at prices below par will perform very well as prepayments pick up, but the opposite is true for premium securities, which are the vast majority of recent offerings. My advice: Be sure to make your broker display prepayment speeds that are much faster than recent history, and pay attention to the average lives and yields at these ramped-up speeds. That could well be your actual experience.

Differences This Time
The well-documented drop in housing values since 2007 has introduced a wholly new set of dynamics into the mortgage market. We all know of the variety of stimulus features, some of which have actually moved borrowing rates. There are, however, reasons that speeds haven’t taken off, at least through April. Employment, or lack thereof, has limited borrowers’ ability to qualify for refinanced debt. The U.S. unemployment rate isn’t expected to peak till late 2009, and possibly near 10 percent. Also, the finger-pointing continues among Congress, bank regulators and banks about whether banks are being too cautious about lending or being bullied into not lending.

Still, thanks to record-low posted rates prepayments on Fannie Mae/Freddie Mac, 6 percent pools doubled in April compared with December 2008. The fact that their 12-month average is still only 14 percent CPR, when they averaged 52 percent CPR in 2003, tells me that it’s time to buckle up.

Keep your eyes on the road, and drive safely.

Reports Available
ICBA Securities provides complimentary MBS prepayments reports to all community banks through its interactive Web site. Visit icbasecurities.com or contact your sales rep for more details.