If you are like many political commentators, business columnists, late-night TV hosts and small-talk mavens, you’ve availed yourself of the ample opportunities to take a poke at our central bank. Since the financial crisis that begat the current recession began in earnest in fall 2008, the Federal Reserve, chaired by Ben Bernanke, has been a veritable beehive of activity. The consensus is that its efforts have produced mixed results.

One of its most visible initiatives has actually been an unbridled success, at least through the end of 2009. However, depending on your community bank’s near-term investment strategy, you may see it as fingernails on the blackboard. I am speaking of the Fed’s decision to purchase up to $1.25 trillion in mortgage-backed securities (MBS).

Fed’s MBS Purchases Have Subsidized Your Balance Sheets

Why MBS? Why Now?

At first glance, many persons (including bankers) are surprised to learn that the MBS market is much larger than the U.S. Treasury market, even after the profligate spending of 2009. If you make the analysis more personal, and if you are a typical debtor, your mortgage is easily the largest single liability on your balance sheet. It is far larger than your per-capita share of the nation’s debt.

Therefore, if the Fed is interested in promoting real economic growth, it should endeavor to aid debt-ridden consumers, especially during an economic phase in which many homeowners are struggling to make their monthly payments. One way to do that is to lower effective mortgage rates. The best way to lower rates is to purchase MBS in the open market in enough volume to push prices up and rates down.

Theory Turns to Practice

As of the end of October 2009, the Fed had bought almost $1 trillion in MBS pools issued by Fannie Mae, Freddie Mac and Ginnie Mae. The bulk of the purchases have been in 30-year products, as those are the majority of the supply and also the type that banks typically shun due to their long duration. All MBS products,
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A big issue is whether interest rates will remain steady for the next few quarters. What will be the market’s reaction once this subsidy has ended? We clearly are in uncharted waters. Some market analysts have suggested a spread widening of 20 to 30 basis points. In a static rate environment, that would cause a drop in 15-year MBS prices of about 1.25 percent. That is not a disaster.

The bigger issue is whether we will see static rates for the next few quarters. A sustained rise in the 5- to 10-year Treasury notes will take all bond prices down without Federal Reserve support. So as the new year gets started, it may behoove portfolio managers to look at some of their longer-duration securities and consider liquidating them. Fixed and floating MBS that have amortized down to smaller block sizes are great candidates. It could be the final act in capturing the new income bestowed on the banking industry by your friendly Federal Reserve Bank.

Possible Complications

With justification, investors have been increasingly worried about these rising prices. Not only have their purchase yields been shrinking, but the exposure to prepayments has been rising. On a long-term basis, 15-year, 4.5-percent MBS have averaged prepaying at an annual rate of about 10 percent. For a pool that is purchased at 103.75 (the current offering price), just a doubling of prepayments will cause a drop in yield to maturity from 3.64 percent (not pretty) to 3.24 percent (downright homely).

Also, it appears the Fed is nearing the end of its purchase program. Evidence of the success of this effort is that MBS prices have risen handsomely since the buying spree took root in late spring. At the time, 15-year Fannie Mae 4.5-percent pools were available at about 101.00. By the end of October, they were priced near 104.00. This is even more dramatic when one considers that the benchmark five-year Treasury note rose in yield during this period. The resulting yield spread narrowed by more than 60 basis points.

If your community bank has been fortunate enough to own similar products during this period (and chances are it has), your portfolio’s market value has been subsidized. If you have been fortunate enough to refinance your home mortgage during this period, you have been further subsidized. A double dip compliments of Ben Bernanke and colleagues.

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