Over the last decade, there was an ugly duckling in the mortgage security pageant. Perhaps “ugly duckling” is a bit harsh. Let’s say instead that Ginnie Mae mortgage-backed securities (MBSs) had a good personality. That personality wooed many a community bank portfolio manager. The benefits of full faith and credit, zero-percent risk weighting, diversification from Fannie Mae and Freddie Mac and easy-to-understand adjustable-rate mortgage (ARM) structures were beguiling to many risk-adverse bankers.

So while the credit profile of many FHA and VA borrowers (who provide the collateral behind Ginnie Mae securities) has historically been unattractive to lenders, the resulting MBSs were devoid of warts, which in this case mean default risk. The last year, however, has seen a dramatic shift in the borrowers’ makeup, which should have some positive effects on the performance of these securities.

**Increased volume**
Changing FHA and VA rules have greatly increased the number of FHA loans in the market. These government-subsidized loans have always been in the minority in terms of total originations. The very mission of the FHA program, administered by the Department of Housing and Urban Development (HUD), is to provide inexpensive financing for low- and moderate-income homebuyers. This necessarily resulted in their volume being a fraction of that of conforming loans.

This paradigm has changed substantially in the last year. Increases in qualifying income levels and drops in market prices of housing in virtually every corner of the country, not to mention modest downpayment requirements, have grown the number and volume of FHA loans substantially.

In 2009, about 28 percent of mortgage originations were of the FHA variety. This compares with about 6 percent just two years earlier. Ginnie Mae MBS issuance as a percentage of total securitization was more than 25 percent in 2009, an all-time high.

**Better credit, too**
To keep the housing recovery on track, Congress has expanded the qualifications of FHA-eligible borrowers. Most significantly, income and loan size levels have expanded to the point that there is little difference between them and conforming loans in most parts of the country.

The result is an average FICO score for recent originations of over 700. This clearly puts those loans in the “prime” category. It has been well documented that prepayments on Ginnie Mae pools have been much higher than on those of similar coupon Fannie Mae/Freddie Mac pools due to the increased
incidence of defaults. This is a positive development—especially because almost all securities are trading at prices above par lately, which creates prepay risk. The rise in average FICOs could spell slower prepayments in the future.

**Qualitative benefits**

If you’ve strayed from Ginnie Mae pools lately because you refuse to pay the incremental price above Fannie/Freddie prices, you could stand a refresher as to why they cost more. For one, the direct-obligation label carries some value; one can increase risk-based capital merely by buying Ginnies instead of Fannies or Freddies.

Also, as FHA loans are assumable by qualified purchasers, the attractive rates (from a borrower’s standpoint) could further keep prepayments under control. Let’s face it: Mortgage rates in the low 5 percent range will be attractive to homebuyers in the future. It’s tough to quantify that effect, but it’s fair to think that some loan assumptions will occur.

If these theoretical improvements in the performance of Ginnie Mae securities actually take root, it is reasonable to expect their prices to rise relative to Fannies or Freddies. As of this writing, the differences in yields are almost exactly at their long-term averages. In other words, the market hasn’t priced in the future benefits of these factors.

The vast majority of FHA loans have 30-year terms with a fixed rate—of little use to a community bank. However, the increased volume for the time being should give underwriters the raw materials to create collateralized mortgage (CMO) tranches that do match a bank’s needs in terms of cash flows and price risk.

In fact, Ginnie Mae adjustable-rate MBSs and CMOs have recently been favorite picks in ICBA Securities’ monthly Strategic Insight report, “Products Poised to Outperform.” I’ve explained here many of the reasons we put these securities in our publication. You may want to peruse recent Insights to see if you as an investor would agree that Ginnie Mae tops your best-looking list.

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**Investment Resource**

ICBA Securities’ monthly Strategic Insight report, “Products Poised to Outperform,” is available from your sales rep or icbasecurities.com.

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