The first half of 2014 went into the books as one big head-fake. Remember how the year started? The 10-year Treasury note, from which 30-year mortgage rates are derived, yielded 3.03 percent (after averaging 2.33 for all of 2013). The interest rate curve flattened from five years out, even though the Federal Open Market Committee continued with its “tapering” of QE3. Expectations for a continued improvement in the labor market were universal.

So while many community bankers entered the year fearing that their bank’s bond portfolio’s market values would continue to plummet, they now have a different set of concerns: mainly, that there aren’t any bargains to be had. Prices for certain mortgage-backed securities (MBSs) actually hit all-time record highs in May. And spreads, which we define here as the additional yield an investor earns over that of a comparable Treasury security, are at historical lows too.

Lofty levels
There are myriad reasons for the drop in yields, too many to recount in this column. But to drill down to the subject at hand, I want to remind community bank portfolio managers that supply/demand dynamics are still keeping a floor underneath bond prices in general and MBSs in particular.

Through the first five months of 2014, there were $340 billion of new MBSs issued by Fannie Mae, Freddie Mac and Ginnie Mae. Simple annualization puts the 2014 projection at about $820 billion, which is just half of the 2013 total. As community banks and other investors keep searching for high-quality loan surrogates (mostly conforming, generic MBSs, a.k.a, “the house”), prices for certain pools have risen to unforeseen levels.

High prices have a multi-pronged effect, of course. One is that bonds currently in portfolios have unrealized gains. The other is that the prospect of buying more, at prices that can be charitably termed as ambitious, is a dicey proposition. The good news is that there are several alternatives to the most generic MBS that can give some price relief on purchase date, and can perform more to a community bank investor’s liking.

Crank up the cash flow
The first option is to consider MBS pools, issued by your favorite GSEs or Ginnie Mae, that are collateralized by jumbo mortgages. For most of the United States, an individual mortgage of greater than $417,000 at inception cannot be placed into a generic pool, also known as a “TBA.” Starting in 2009, loans between $417,000 and $625,500 began to be securitized into “jumbo pools,” and these have unique ticker symbols and prepayment characteristics. And a lower price.

A jumbo mortgagor would enjoy more benefit from a refinancing than
a conventional borrower would. Therefore jumbo pools should be expected to prepay faster, even in stable rate environments, than generic pools. This has been borne out by recent prepayment experience. The lower price is residue of the shorter average lives that jumbo pools produce, along with the somewhat lesser liquidity. The amount of the discount is purely a function of the relative coupons, and the maturities of the securities being compared. Still, a jumbo MBS investor can enter the market at a lower price than with TBAs.

**Slow down that train**

Home Affordable Refinance Program (HARP) has enabled homeowners with little or no equity to refinance into near-conforming rates provided several characteristics are in place. These include the date of the original mortgage (before June 1, 2009), the loan-to-value (LTV) ratio at refinance date (greater than 80 percent) and the delinquency history (clean for the prior 12 months). Through 2013, about three million borrowers have participated in HARP. The window is closing on this program, as the number of HARP-eligible loans in the United States is estimated to be only about 500,000.

The pools that are collateralized by HARP loans behave very differently than jumbo pools. There are fees charged to the participant, and the loans could be seriously underwater as there is literally no cap on LTVs. As such, prepayments should be extremely slow compared to generic, conforming MBSs. Again, recent history has borne this out.

The profile of an investor in HARP pools is a community bank that is looking for relatively consistent cash flow over an extended period of time. The average lives and duration of such instruments will be longer than for TBAs. That, and the fact that they have lesser liquidity compared to TBA pools, produces lower prices. Just as for jumbo pools, the amount of the market discount is a function of the coupon and the average maturities.

**Call your game**

Although supply is not unlimited in either alternative product, your broker should be able to locate examples of jumbo and HARP pools for you to examine. If your community bank is in need of shorter durations in its MBS collection, jumbos may be of interest. If the asset/liability posture of your community bank requires cash flows to be delayed into future periods, perhaps HARP pools are the answer.

Be sure to make your interests known, and as always study the possible outcomes of your investments over a wide range of prepayment scenarios. Off-the-run MBSs have enabled many a community bank to beat the house.

**New Direction**

ICBA Securities welcomes two new leadership bankers to its board of directors: Dennis Doyle, president and CEO of Great Midwest Bank in Brookfield, Wis., and Kathy Underwood, president and CEO of Ledyard National Bank in Norwich, Vt. Doyle serves on ICBA’s Mutual Bank Council, while Underwood serves on the Bank Operations and Payments Committee and is a member of the ICBA’s Federal Delegate Board.