Tidy Up

Well-structured CMOs can limit investment portfolio risks

By Jim Reber

At the risk of being labeled a shill for the industry, I’d like to point out a positive about fixed-income broker/dealers. Over the last generation, large bond houses have received a surfeit of criticism, much of it deserved. A big part of the current, enduring housing mess can be attributed to a handful of financial engineers working for primary dealers who were grinding out private-label mortgage-backed securities (MBS) that had, as we now know, major design flaws.

Now, however, community bankers have asked for investment vehicles that both limit their extension risk if and when rates start to rise and place a floor under their prepayment risk. As it turns out, such products are in fact being manufactured by these same parties. The demand, in other words, is being met by supply. Some of these products may be a nice complement to your bank’s bond portfolio.

MBS supply perspective

It’s noteworthy that the types of MBSs that community banks actually own come from raw loan products that have always been in short supply.

The great majority of single-family residential loans in the United States are of the 30-year fixed-rate variety, and most ICBA members simply have no interest in owning them. This is a function of the pools’ long average lives, which can be up to 10 years at the outset.

Through the first five months of 2012, fully 70 percent of new MBS issues were 30-year fixed rate pools. That is a historically low number. As mortgage rates have plummeted, more homeowners have been able to afford the monthly note with a 20-, 15- or even 10-year amortization period.

But—there’s always a “but” in bond land—as rates go down, prices go up. Community bankers are understandably concerned about continually dumping more premiums into their portfolios. A safe harbor could be collateralized mortgage obligations (CMOs) that improve cash flow profiles and come at lower dollar costs.

Neater cash flow

In addition to the long average lives of 30-year pools, there is also the maintenance. Even at slow prepayment speeds, your bank will receive half its principal back in about five years, so the tail period can be quite long. Often a portfolio manager will have to “clean up” tail pieces when they start to become illiquid, even when they still may have 15 years until they fully pay off. Such are the cash flows with long amortization periods.

If you were to purchase a CMO that has a tighter payment window, your maintenance can be cut down. Often a certain class, or “tranche,” of a CMO will have an expected final payment many years shorter than the collateral. This compression of the repayment period both normalizes cash flow during the open window period and lessens the need to dispose of the tail piece.

Contain your premiums

Another possibility is the purchase of a CMO that has a much lower stated interest rate, or “coupon,” than the pools backing it. In this era of low yields and high premiums, many community bankers have simply gotten nervous about the absolute amount of premiums lurking in their portfolios.

As an example of the above, a given tranche can have a coupon of 2.0 to 3.0 percent, even if the collateral pools have 5.0 or 6.0 percent rates. This process, known as “coupon stripping,” creates an investment that comes to market with a lower dollar price, perhaps appealing to edgy investors.

Worth a look

As an example of a CMO that has both of the characteristics described here, ICBA Securities recently offered the CMO class Freddie Mac 4045 PA. It is backed by new 30-year fixed-rate pools with borrowers’ rates of 5.38 percent. This class has a stripped-down coupon of only 2.0 percent, so its purchase price is well below the price of the collateral—around 101.00. Its cash flow window, instead of extending all the way out to 2042, is estimated to...
close in 2023. As an indication of its average life stability, FHR 4045 PA will have less than a six-year average life even if interest rates rise 300 basis points.

So for you premium-ravaged portfolio managers who also spend sleepless nights thinking about extension risk, well-structured CMOs can solve both of your problems.

The broker/dealer industry, which includes ICBA Securities, has heard your concerns and created a product that can tidy up your bank’s investment portfolio.

ICBA Securities, in addition to having three offices in Memphis, Tenn., also has branches in Chicago; Fort Lauderdale, Fla.; Dallas; Little Rock, Ark.; New York; Overland Park; Kan.; Seattle; and Spokane, Wash.