Questions to answers

Net interest margin in jeopardy? Here are some solutions.

By Jim Reber

To start out the year, I’d like to both properly memorialize the late, great Alex Trebek and provide some helpful suggestions for investment management for this challenging rate environment in which we find ourselves. And I’d like to do it in the space of this column, so let’s pick up our signaling devices and see what answers we have in front of us.

Answer: This segment of the municipal bond market is being embraced by community banks after being shunned for the last three decades.

Question: What are general market munis?

General market munis are differentiated from bank qualified (BQ) munis in two ways. First, there is no limit on the size of the issue (BQs are limited to $10 million per issuer, per year). Secondly, the uses of the proceeds in general market munis are virtually limitless; BQs must be for essential services.

As to why BQ issues have been favorites of community banks since 1986, they qualify for beneficial tax treatment related to an institution’s cost of funds. This TEFRA application normally creates higher tax-equivalent yields for bank-qualified issues. However, this advantage begins to shrink when tax rates and/or cost of deposits decline, and both of these conditions have been in play since 2017. The result? Community banks have been buying roughly twice the volume of general market issues vis-à-vis BQs lately. We’ll see if that trend continues if cost-of-funds levels—or marginal tax rates—ever rise again.

Answer: Community bank bond strategies have recently begun including these types of mortgage-backed securities (MBS).

Question: What are multifamily MBS?

All three of the major housing agencies, GNMA, FNMA and FHLMC, have stepped up their issuance of multifamily MBS in the past five years. The main reason for the growth is that more of us are living in 5+ family dwellings than ever before. Another is that they can offer some structural advantages over generic pass-throughs.

For example, many multifamily pools have short state final maturities of seven to 10 years. Another is that they almost all have some type of prepayment penalty baked into the structure. While penalties (or “yield maintenance” provisions) are common in commercial real estate lending, they’re almost non-existent for single family loans. The prepayment protection they afford are especially attractive in yield environments like we have at the present.

Answer: These three factors can each help limit prepayment risk on amortizing securities.

Question: What are borrowers’ rate, loan size and geography?

At the end of the day, there are only a few criteria that can provide tangible protection against wholesale refinancing (read: prepayment risk) in generic MBS. The one with the most causal relationship is the borrowers’ rate (in bondspeak, the “gross WAC”). Obviously, the lower the current rate, the harder it is for a homeowner to economically benefit from a refinancing. There is a high correlation between note rate and prepayment speeds.

Similarly, the more a borrower owes on his or her dwelling, the more likely the math works in favor of a refinancing. What isn’t quite as universally known is that certain states (e.g., New York and Florida) have punitive taxes and fees that make the prospects of cutting the debt service costs much more difficult. As an investor, you can ask for “prepayment friction” pools containing some type of specific collateral that can significantly reduce prepayment risk.

Answer: This is by far the most popular month for municipal bond maturities and calls.

Question: What is January?

Given that we’re embarking on a new calendar year, and, generally speaking, community banks have more cash and liquidity than they prefer, it’s worthwhile to mention in the near term there will be a lot of money being turning over in muni land. It’s possible that the “January effect” could play out in all its glory this year.

That is the outcome from a lot of money chasing a limited supply of bonds. Many municipal borrowers, and this certainly includes BQ issuers, don’t tap the market until later in the year. So, it’s entirely plausible that the combination of the wave of redemptions coupled with scant early-year supply will put a serious lid on yields. Many community banks forward purchase in January and February once they identify which bonds in their portfolio will be maturing or will be called away.

Answer: This financial services sector punched above its weight in extending credit to small businesses at the height of the COVID-19 pandemic.

Question: What are community banks?

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[Sidebar]

2021 webinar series will commence soon

ICBA Securities and its exclusive broker Vining Sparks will present a seven-part webinar series, Community Banking Matters. The first event is Feb.16 at 10 AM Central. CPE credit of one hour is offered for each webinar. For more information visit [*www.viningsparks.com*](http://www.viningsparks.com)