Ready to run

After a lag, prepayments are primed to take off.

By Jim Reber

If you are inclined to read bond analysts' research reports, eventually you'll chance upon some commentary that addresses the performance of mortgage securities. To many of the uninitiated, which I pointedly state do not include community bankers, mortgage-backed securities (MBS) are an abstract collection of investments that have long maturities and a volatile series of principal paydowns. They seem to require a lot of effort and are only marginally tethered to the housing finance market in general.

But not so fast: Further analysis reveals that community banks have a higher weighting of their investments in the mortgage sector than at any time in the past. So, MBS must have some kind of appeal, and tellingly, it's with financial professionals. The qualitative features that are attractive to community banks include:

- cash flows that complement the loan portfolio
- ability to modify price risk profile efficiently
- high degree of liquidity
- outstanding credit quality

What's not to like? Well, in the 2020 interest rate environment, the total lack of control over prepayments. In fact, this year may set new standards for refinance activity. Let's see what the near future for MBS may look like and try to develop a game plan to insulate against unwanted cash flow.

Where we've been

A good place to start is to look back a decade or so ago, to see if we've been to these current secondary market levels yield levels before. The answer is close, but no. The required rate for a new conforming mortgage to be worth par to Fannie Mae or Freddie Mac, also known as the Commitment Rate, is closely tracked by mortgage lenders. For example, if the Commitment Rate is 2.5%, a lender can make a 3.25% loan to a borrower, keep 25 basis points (0.25%) for servicing income, pay the agency about 50 basis points (0.5%) for its guarantee fee and deliver the net coupon at par.

Back in late 2012, the lowest the 15-year Commitment Rate hit was 2.07%. Not coincidentally, prepayments on all coupons of MBS spiked and peaked about 60 days later. The elevated refinancing activity continued throughout the first half of 2013. The second half of the decade saw some general stability in the mortgage market and reasonably steady cash flows from mortgage securities. No so today.

Where we may be going

As of this writing, we are at truly historic required rates. The Fannie Mae 30-year Commitment Rate has been well south of 2.5% for several months, and its 15-year cohort has hovered in the 1.7% range. This means that 30- and 15-year loan rates around 3% and 2.375% respectively could be sold into the secondary market at or near par.

And here's the kicker: Mortgage lenders have not yet rushed to be the cheapest on the block. Lender surveys indicate that conforming loan rates have stayed at least 50 basis points (.5%) more than the Commitment Rates after accounting for servicing and guarantee fees. A combination of factors, including resource limitations and the—understandable—quest for fee income, have kept the loan rates relatively high compared to Fannie's secondary rates.

First in its class

In mid-June, there was a unicorn sighting in the MBS market: A 15-year Fannie Mae MBS with a 1.5% coupon. It was the first in history with a coupon that low. If Commitment Rates remain anchored where they are now, there will be more to follow. Given the rush by many community banks to remain more or less invested, since overnight rates appear to be destined to remain near zero for some time, the prices on these low coupon MBS are in the 102 range. While that may be a challenge for some investors, at least these pools should have relatively muted refinance profiles.

If the mortgage lending community eventually throws in the towel regarding pricing discipline, there will be a bunch of recently originated loans that will be in the "drop zone." At the end of the day, there are really only three strategies that provide much hope in the way of prepayment protection:

1. MBS with very low borrowers' rates
2. pools comprised of loans with low outstanding balances
3. securities such as DUS (Delegated Underwriting and Servicing) bonds or Freddie K's that have defined prepayment penalties.

Some combination of these can help stabilize the cash flows in your community bank's bond portfolio. Prepayments that walk, not run, will likely be a desirable trait for investors in 2020.

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Prepayment commentary

Vining Sparks, ICBA Securities' exclusive broker-dealer, publishes a monthly analysis on mortgage security refinance activity on a wide selection of MBS. To subscribe to the Mortgage Prepayment Summary, visit *viningsparks.com* or contact your Vining Sparks sales rep.