Balance Sheet Insights

PIPER SANDLER FINANCIAL STRATEGIES

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Analyzing Fast-Prepay Sales and Losses in the Investment Portfolio

*Please see this week's **Rate Sheet** and **Yield Curve Opportunities**.*

Over the better part of 16 months, financial institutions have navigated a wide range of challenges – global health crisis, work-from-home, unprecedented government intervention, and market volatility, to name a few. With those challenges, opportunities have also arisen. One strategy that has benefitted many institutions is utilizing inflated prices in agency pass-throughs to proactively shed prepayment risk, and utilizing gains in that sector to improve credit, earnings, or liquidity on the wholesale Balance Sheet. In truth, for many instiutions, the trade has been more defensive than proactive: prepayments rose from a sleepy 13-17CPR, before the drop in rates due to COVID, to 25-35 CPR on average collateral for 15yr, 20yr, and 30yr MBS. For many, it was more extreme than that. For example, a popular 20yr 3.5% with a 2019 vintage pre-paid in the 40-50 CPR range during that period.

Selling those bonds, for those that acted early, has been a winning strategy. The trade is accretive to forward earnings, securities portfolio yield, and NIM. When reinvesting into other agency product, tail risk from credit deterioration seems limited, so management can feel relatively comfortable that the ROA and ROE accretion experienced initially will likely hold for the life of the investment. Many institutions have reduced convexity risk, resulting in a more durable balance sheet and earnings profile. With the recent steepening of the curve, the financial metrics of the transaction look even stronger: for asset-sensitive institutions, we recommend that clients look at extension trades, and have helped a number of clients extend in the corporate, taxable municipal, and mortgage sectors.

But Is It Too Late Now? (Hint: Not Likely)

With rates rising since the start of the year, it is possible that mortgage prepayments are approaching their peaks. Many financial institutions that have held on to fast-paying MBS may wonder if they've already experienced the pain, making now the worst time to sell. We observed in a recent piece that the departure from 2021's rising rate trend may suggest a pattern of consolidation may be unfolding, which could mean we may have seen the highest yields (or close) for the rest of 2021. If the case can be made for interest rates to either rise or fall, then the possibility exists that prepayment speeds are not facing an imminent slowdown. Further, if rates peak but hold, prepayments may also sustain their current levels. Both scenarios would mean that selling fast-payers is best done sooner rather than later.

What happens, however, if prepayment speeds do slow down? The financial benefits of selling bonds that are about to slow depends on both the timing and magnitude of that slowdown. When helping clients analyze the prosposed transactions, we have often included a vector analysis. Look at the yield of the bonds at current speeds, then compare that to the yields of the sold bonds assuming rates ramp down in a reasonable scenario, and again in an aggressive slowdown. Often the result is that the yield on the proposed reinvestment remains higher than the yield of the sold bonds, in most reasonable vectored scenarios. This argues for the proactive shedding of those bonds, as, even in a slowdown, they will remain underperformers.

Which Individual Bonds to Sell?

The decision whether to sell is often not as important as which bonds to sell, in order to ensure financial success. The first priority is to identify collateral that remains vulnerable: higher GWAC and larger loan sizes that will have a propensity to retain elevated prepayment speeds. Start by targeting pools with high pass-through coupons, especially ones that are currently owned at more vulnerable premiums above $102. It is also important to evaluate other collateral characteristics: loan balance pools, 100% NY, High LTV, Low FICO, etc., have less negatively-convex collateral profiles. These are generally going to be winners in this environment—continue to hold them, or target them as reinvestments. Certain vintages have experienced the most significant increase in prepays—identify and sell those. Finally, utilize some form of breakeven yield or market yield analysis to ensure that the individual line item is accretive to the transaction. It is not always helpful to sell bonds with the lowest yields, if the loss required to sell them is so burdensome that the transaction is no longer accretive. Breakeven yields can help quantify that decision at the line-item level.

Is It Ever Worth Including a High Yielding Bond? (Hint: Possibly)

Having selected appropriate specified pools to target for sale, the next step is to analyze how the transaction as whole benefits the overall balance sheet. Sometimes in order to sell a large group of low-performers, it may be necessary to sell a few limited "good bonds" with higer yields to make the gain/loss profile of the overall transaction more attractive. The breakeven analysis of those individual bonds, paired with the breakeven period of the whole trade, will tell whether they're an efficient inclusion in the overall trade.

Furthermore, you can often use potential gains as part of a program to improve the efficiency of your balance sheet beyond just shedding underperformers. You may be able to reduce credit exposure. Given recent economic pressures, we have been very active in helping clients strategically reduce credit exposure in CLOs and Municipals. Consider odd-lot cleanup trades. Smaller pieces are less liquid but have also experienced price inflation. There may be situations where gains in the securities portfolio are best utilized as part of a de-lever. With elevated liquidity levels, shedding any remaining negative leverage may still be a good way to drive earnings.

What If The Trade is at a Loss?

For this framework, we assume a loss trade consists of selling Available for Sale (AFS) securities. The AFS designation means that most of the loss should already be housed in other comprehensive income, so a transaction simply requires a reclassification out of AOCI and into retained earnings through the P&L. Since most of the unrealized loss is already included in GAAP capital calculations, the TCE ratio and tangible book value should not move meaningfully, though regulatory capital ratios will decline for most banks. Management teams need to ensure that the pro forma regulatory capital position aligns with their growth and capital return objectives.

Communication will also be important: a loss program requires the support from key internal stakeholders and your auditors. Management and the Board of Directors need to buy in to the strategic and financial rationales supporting the trade, and be able to look past potential short-term stock price dislocation resulting from lower-than-expected reported earnings. If messaged well to investors, the loss should be viewed as one-time in nature and pulled out of core earnings. Investors should then focus on the lift to go-forward recurring earnings and profitability metrics.

If structured correctly a loss trade could fit very neatly into the story the company is trying to tell, while being accretive to go-forward EPS, ROA and ROE. By proactively communicating the rationale for the loss trade, management can guide the narrative and provide a forum for investors to ask questions. Whether a loss or not, there is still time to proactively consider which fast-payers in your portfolio are worth selling.

If any of our observations pique your interest, please contact your Piper Sandler representative or email us at PSFS@psc.com. For derivatives, please email our affiliate, Piper Sandler Hedging Services, LLC, at FSG-Derivatives@psc.com.

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