

CMO Investors Feeling Pinch from Prepay Trend

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By Alissa Schmelkin

The increase in mortgage prepayments, a byproduct of the refinancing boom that has already hurt U.S. banks' servicing portfolios, now is becoming an issue for those that have invested in collateralized mortgage obligations.

Banks bought CMOs, bonds that are backed by pools of mortgages of differing maturities, at a premium over the last couple of years with the expectation that they would help the banks avoid the effects of a prepayment of principal under most rate environments.

However, with interest rates at historic lows, borrowers have been paying back their mortgages at an unprecedented rate, and in a matter of months rather than years, and banks have been forced to amortize premiums over a shorter period of time than many had planned.

The result has been "low to negative yields," according to Bruce S. Goldstein, a partner in the Short Hills, N.J., office of the bank advisory firm Milestone Advisors LLC.

"A lot of bank investors didn't really anticipate the amount of CMO principal being returned as quickly as it has been," Mr. Goldstein said. In many cases, they need to adjust their accounting systems "to reflect the shorter average lives," he said.

Fred Price, the chief operating officer at Sandler O'Neill & Partners LP, said these vehicles are "less stable than any of us thought they were going to be" when they were created.

The issue "is just another one of the consequences" of the extreme level of prepayments in today's rate environment, Mr. Price said. It is not indicative of a fundamental problem of CMOs, he said.

CMOs are backed by pools of mortgages and carved into different classes of bonds. Some classes are designed such that the holders receive interest only, and are "locked out" from getting principal payments for a defined period, as long as original prepayment assumptions hold. Investors are willing to pay premiums for classes with lock outs.

Many accounting systems that banks utilize to determine how much premium to amortize in a particular month do not pick up the underlying prepayments of the CMO collateral. These prepayment assumptions usually must be input manually.

"Given the tremendous prepayment wave that has occurred, CMO structures tend to break down," Mr. Goldstein said.

According to Mr. Price, most of the portfolio managers that Sandler works with have used other methods beyond their accounting system to deal with the prepayment problem. Those that are still completely dependent upon their own accounting systems will have a "lower earnings environment" this year, he said.

Brian D. Kaufman, another partner at Milestone, said that the "assumptions that both the investors and Wall Street have made on prepayments have really been inadequate."

He said that the problem is widespread enough that investors in bank stocks should be concerned.

"Banks are taking one time impairment charges or are absorbing the increased amortization within their income statements," Mr. Kaufman said. "Either way, they are going to have to play some catch-up here. We think that we are still early on in this problem impacting these companies."

According to Mr. Goldstein, Milestone has worked with a number of clients who needed advice about how to address the issue of increased prepayment activity.

Among the large banking companies, the problem would typically show up in their securities portfolios but could be lumped in with agency securities, including pass-throughs.

Milestone, which advises banking companies with assets of \$200 million to \$15 billion, would not name any of its clients. However, Brock Vandervliet, an analyst at Lehman Brothers, said that the issue would be more prevalent at banks that typically buy consumer paper, such as Bank of America Corp.

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