



How Market Spreads Impact Relative Value

Overview

The relative value of credit union earning assets is often determined by a glancing review of various market rates. But value should also be a function of the risk premium associated with the instrument from which investors can derive whether they are being compensated adequately. For example, as spreads on conventional 30-year fixed rate mortgages ballooned to 300 basis points during the first quarter of 2009, one would have assumed they presented tremendous value. In actuality, they didn't because the market rates at the time were approximately 4.75% and exposed a credit union to significant cash flow extension risk.

In general, the change in loan rates and investments yields can be traced to a combination of movements in the Treasury yield curve (re: bond market) and specific risk premiums (re: spreads). Treasuries provide a risk-free rate and an inflation premium while liquidity, credit and maturity premiums compensate investors for bearing distinct types of risk.

With that, this paper details the factors that impact asset spreads, evaluates current levels for core and non-core assets and concludes with an overall strategic recommendation.

U.S. Treasury Yield Curve

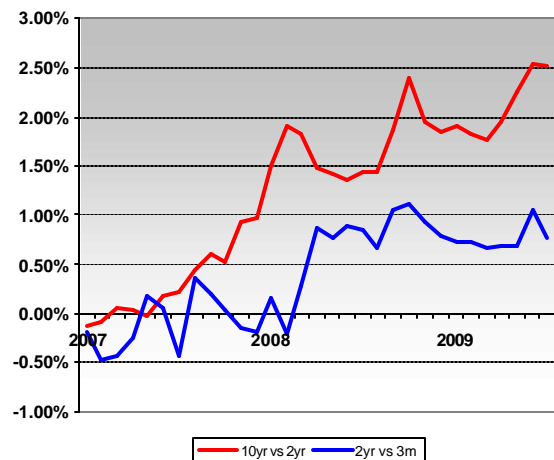
Treasury yields are commonly referred to as nominal, risk-free interest rates as they present no default risk (due to the full faith and credit guarantee of the federal government) together with an inflation premium attached. For that reason, the Treasury curve commonly is used as a beginning reference point (or benchmark) from which loan and investment market rates are derived.

The Treasury curve plots rates from the 3-month T-Bill to the 30-year T-Bond and its shape can either be positive, negative or flat depending where short-term rates are in relation to long-term rates. For the most part however, the yield curve is positive sloping as investors require compensation to invest their money for longer periods of time.

The slope of the curve is further impacted by additional market-related variables and expectations that either compensates or entices investors for the related holding period of the instrument.

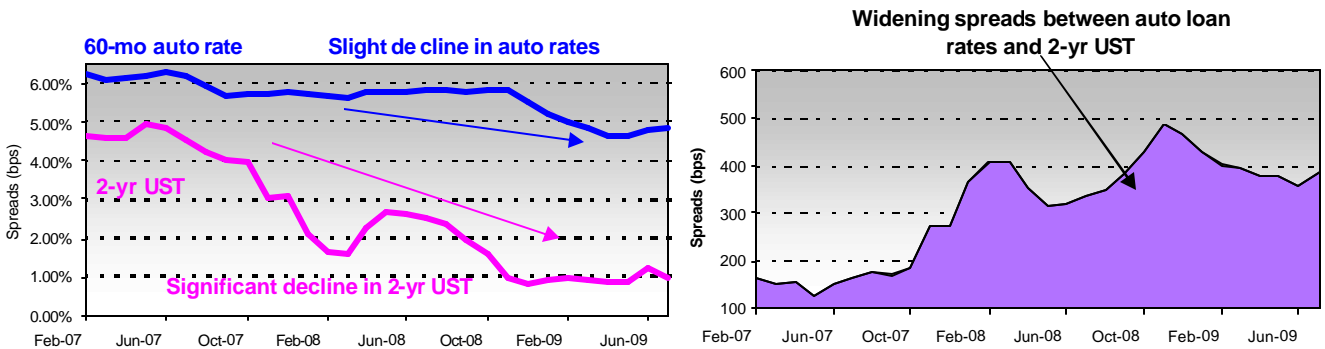
Over the last year, the shape of the Treasury curve has gone from relatively flat to positively sloping as short-term rates have declined significantly more than longer-term rates. From June 2008 to June 2009, the 3-month, 2-year and 10-year Treasuries decreased 155, 168 and 53 basis points, respectively.

Correspondingly, the slope between the 2- and 10-year Treasuries increased 115 basis points.



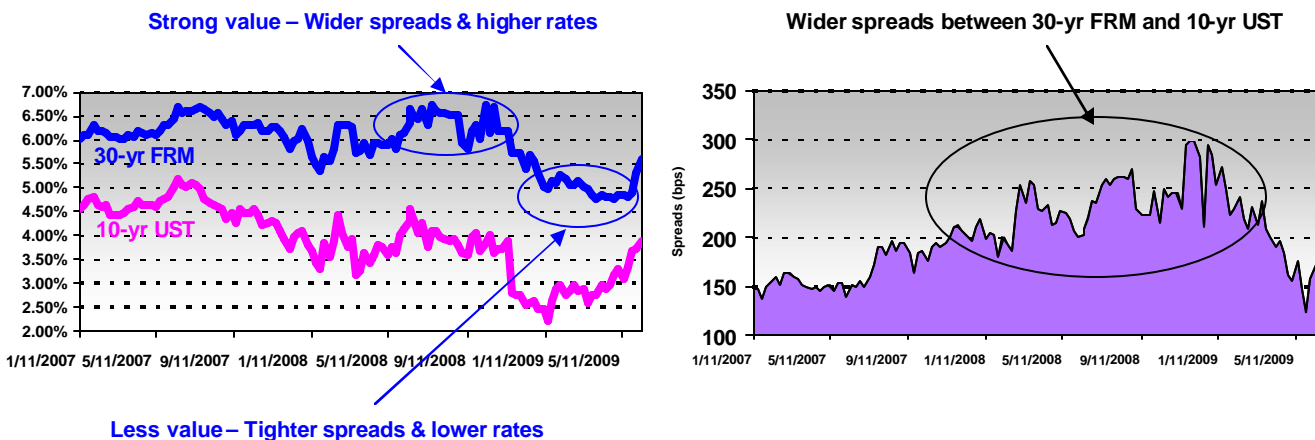
Loan rates and investment yields incorporate additional spreads above the nominal risk-free rate to compensate for perceived risk variables associated with liquidity, credit and maturity. Each spread is unique and vary depending on the type and duration of the asset. Liquidity risk premium compensates investors for the risk of loss relative to an investment's fair value should the investment require converting to cash prior to maturity. Credit risk premium compensates investors for the possibility that the borrower will fail to make scheduled principal payments. Maturity risk premium compensates investors for the increased sensitivity of the market value of debt to a change in market interest rates as maturity is extended.

Since 2007, auto rates in general have declined slightly. But the drop in auto rates has not been as great as the decline in the benchmark 2-year Treasury rate, indicating that spreads have widened over this period of time. In fact, for most of 2007, spreads between a 60-month auto loan and the 2-year Treasury was 150 basis points. This spread has increased more recently to around 400 basis points and is most likely tied to competitive market conditions and heightened credit risk premium.



Real estate loan rates and spreads have continued their see-saw path since the start of the year. Based on Freddie Mac's Primary Mortgage Market Survey, 30-year conventional mortgages rates decreased 23 basis points to a low of 4.78% from January to April followed by an 81 basis point increase to 5.59% from April to early June.

During the recent decade, the spread between a conventional, 30-year fixed rate mortgage and the 10-year Treasury yield has been approximately 190 basis points. From September 2007 through May 2009, this spread widened to 235 basis points as Freddie Mac and Fannie Mae tightened their underwriting standards and lenders became more reluctant to make home loans due to growing losses from rising delinquencies and foreclosures. The wide spread from January to May 2009 was also impacted by the Federal government's purchase of mortgage back securities in an attempt to lower mortgage rates and normalize spreads. Spreads since May have tightened somewhat and now range between 150 and 200 basis points.



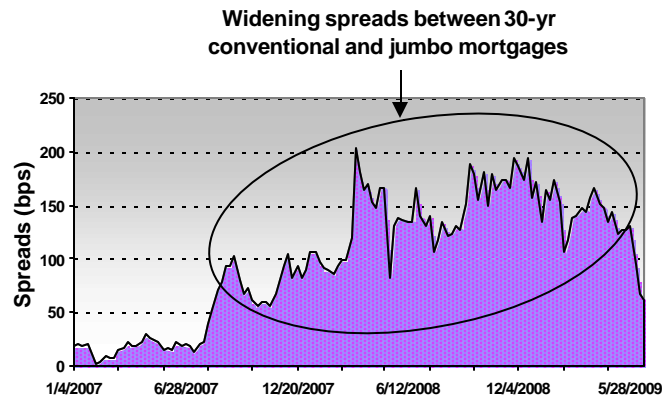
Less value – Tighter spreads & lower rates

Even though spreads on conventional 30-year mortgages have returned close to their more traditional levels, their market rates range between 5.00% and 5.50% - still what could be considered relatively low levels from an historical point of view. From a risk to earnings viewpoint, questions would persist regarding the long-term value these loans would bring to a credit union's revenue stream specifically in a rising rate environment.

Even within the fixed rate mortgage sector, the spreads between 30-year conventional and jumbo mortgage rates have widened. A jumbo mortgage is a conventional mortgage whose loan balance at origination exceeds the Freddie Mac and Fannie Mae conforming loan limit. Freddie Mac's conforming jumbo loan limit for example is only applicable to high cost areas and is the higher of either the 2008 conforming loan limit of \$417,000 or 125% of the median house price not to exceed \$729,750. The main reason for the wider spreads is the fact they're less liquid and carry a higher dollar exposure to the lender. Even though the originators of jumbo mortgages are similar to those originating conforming mortgages not as many institutions hold them in their portfolio. It's also more difficult for institution to sell their jumbo mortgages to the secondary as Freddie Mac for instance purchases them on a limited and negotiated basis.

The following graph plots the spread between a 30-year fixed rate jumbo mortgage and conventional 30-year fixed rate mortgage. Since January 2007 the average spread has been approximately 100 basis points and been as wide as 204 basis points. Three and five years ago this spread was 19 and 17 basis points respectively.

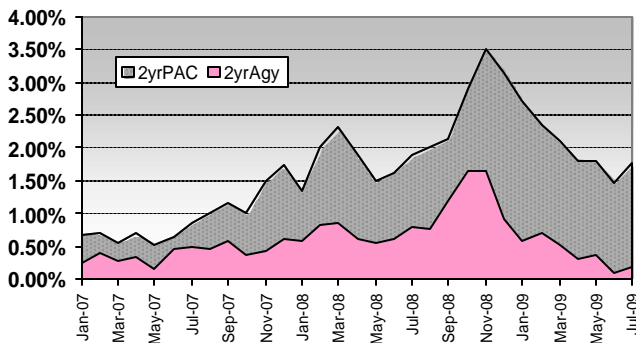
So, the spreads on jumbo mortgage loans have widened even greater than conventional mortgages for the reason noted.



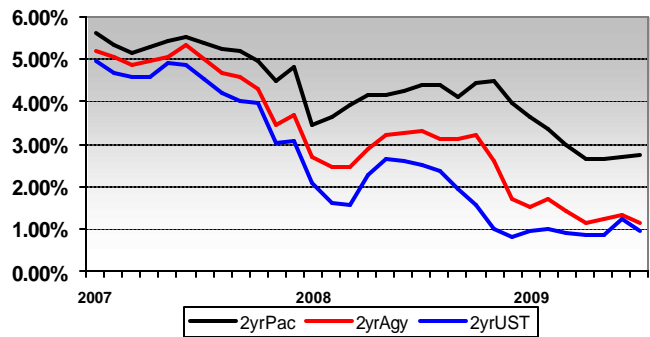
Investment security spreads have shown tremendous volatility over the last two and half years as the economy has been working through a slowdown and interest rates have decreased to historically low levels. This volatility has also been impacted by flights-to-quality associated with the equity market and portfolio managers who have been fine-tuning their duration and credit profiles.

In early 2007, the yield for a 2-year Agency bullet was 5.02% and the yield for a 2-year Agency CMO was 5.36% – a spread of 30 and 64 basis points, respectively, over the 2-year Treasury. As the 2-year Treasury rate subsequently fell 372 basis points from 4.72% to 1.00% in late-2008, the yields on Agency bullets fell by only 338 basis points to 1.64% and Agency CMOs fell by 184 basis points to 3.52%. In essence spreads widened by 34 and 252 basis points, respectively.

2-yr Agy PAC & Bullet spreads over 2-yr UST



Investment Rates



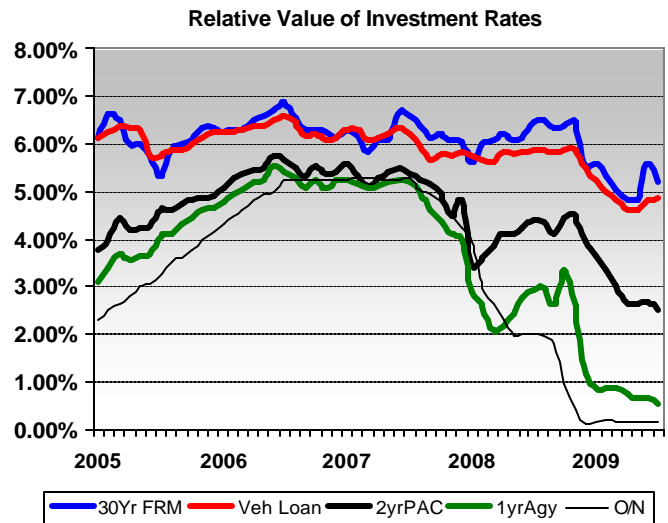
Currently, Agency bullets and CMO spreads have tightened back to 22 and 170 basis points, respectively. Certainly, the relative value of the Agency CMO remains but the Agency Bullet is more questionable.

Relative Value and Strategic Considerations

With spreads on loans and investments changing over time, it's crucial for credit unions to proactively monitor the asset portfolio profiles including pricing, yields and durations. This also includes assessing relative value between the various asset classes. Given today's low overnight rates and steepness in the yield curve, credit unions need to balance the high cost of liquidity against lengthening duration in light of a potential rising rate environment.

As such, a combination of vehicle loans, fixed-term investments and mortgage-backed securities would provide the ideal cash flow diversification to obtain an effective overall portfolio return. Vehicle loans present tremendous opportunities because of their wide spreads (385 basis points) and relatively short duration. Fixed-term securities, either Agencies or certificates of deposit, provide a defined cash flow structure until it can be reallocated into loans. Agency CMOs, PACs and Sequentials, provide respectable yields with relative short average lives while creating monthly cash flows which could be reallocated more frequently based on the relative value profile of the market.

With mortgage rates around 5.50% and refinancing tough to come by, closely monitor the portfolio to protect against potential extension risk – especially in a rising rate environment.



These strategic considerations should be considered in conjunction with a credit union's balance sheet allocation and risk profile. For instance, a credit union with a lower Loans-to-Asset ratio could have more capacity from an earnings and risk management perspective to entertain longer asset durations in their investment portfolio. Moreover, the relative value of specific asset classes change as the economic, rate and spread environment, therefore, the cash flow dynamics of each asset class can change such as prepayment outlook, relative price and associated spreads, etc.

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