

# COASTAL SECURITIES, INC.



## Financial Strategies

### Department

5555 San Felipe

Ste. 2200

Houston, TX

77056-2725

(713) 435-4300

www.coastalsecurities.com

## GNMA Multi Family CMOs

### Introduction

GNMA multi-family mortgage securities are similar to those issued by FHLMC and FNMA, except that GNMA carries the full faith and credit guarantee of the U.S. government as to the timely payment of both principal and interest. Their prepayment behavior also differs from that of FHLMC and FNMA issued mortgage securities due to the differences in the underlying mortgage collateral. We believe that these securities merit further investor consideration due to their attractive relative value and full faith and credit guarantee.

### Background

In 1968, Congress created the Government National Mortgage Association (GNMA) as a new Housing and Urban Development entity in order to help facilitate and develop a secondary market for Federal Housing Administration (FHA) project loans. The FHA helps to accomplish the goals of expansion of home ownership and affordable rental housing by insuring lenders against default on mortgages that are originated according to the guidelines of their programs. GNMA multi-family CMOs are collateralized by FHA insured Project Loans commonly used to fund apartments, condominiums, land developments and health-care facilities such as nursing homes, assisted-living facilities and hospitals.

### Structure

Most GNMA issues are comprised of individual loans pooled together in pass through or CMO structures. Traditional pass through bonds pay investors the principal and interest cash flows received from the underlying collateral mortgage loans with maturities ranging from 15 to 40 years. As many investment policies forbid investments with such long horizons or maturities, GNMA issues structured securities with various CMO tranches such as sequentials, IOs and Z Classes that receive cashflows directed from the underlying collateral. The variety of structures available has the benefit of allowing cashflows to be “tailor made” for individual risk/reward tolerances and extension scenarios.

Some of the major differences between GNMA mortgages and FNMA/FHLMC mortgages include:

	GNMA	FNMA/FHLMC
Guarantee	Explicit full faith & credit guarantee as to timely principal and interest	Implied government backing
Borrower FICO Scores	Typically lower	Must meet conforming loan requirements
Loan to Value Ratios	Typically higher	Must meet conforming loan requirements
Fees	Borrowers pay an approximate 0.50% annual fee in addition to their mortgage rate	No additional fees

### Prepayments

In general, prepayments occur due to borrower refinancing, sale of the property, principal payment in excess of normal amortization, loan modifications or foreclosure due to default. All of these events can be triggered by various macroeconomic factors, including the prevailing interest rate environment, the performance of the housing market, employment situation or by changes in the borrower’s personal situation. GNMA multi-family loans have prepayment penalties included to prevent borrowers from quickly refinancing. This results in low and steady prepayments to investors in GNMA multi-family

CMO tranches. The way prepayments are measured with respect to GNMA multi-family loans is through CPJ, instead of Constant Prepayment Rate (CPR) used with “plain vanilla” mortgage securities. CPJ, is Bloomberg’s prepayment rate notation which utilizes Donaldson Lufkin & Jenrette’s Project Loan Default (PLD) model for involuntary prepayments. The industry standard CPJ used when analyzing GNMA multi family bond yields is 15%. A 15% CPJ assumes the following project loan default curve:

<u>Project Loan Default (PLD)</u>	
Mortgage Loan Age <u>(in months)</u>	Involuntary Prepayment <u>Default Rate</u>
1 – 12	1.30%
13 – 24	2.47%
25 – 36	2.51%
37 – 48	2.20%
49 – 60	2.13%
61 – 72	1.46%
73 – 84	1.26%
85 – 96	0.80%
97 – 108	0.57%
109 – 168	0.50%
169 – 240	0.25%
241 – maturity	0.00%

The actual speed that these securities encounter is a combination of the voluntary and the involuntary prepayments. For example, 10 CPJ is 10% CPR for voluntary prepayments plus 100% of the base PLD curve rate for involuntary prepayments.

Conclusion

GNMA multi family CMOs present a compelling opportunity for investors to own a government guaranteed asset with slow and steady prepayments at attractive yields. The wide availability of tranche types makes for a flexible investment with upside for most any type of investor. We invite you to take advantage of this lesser-known segment of the market. Contact your Coastal Securities representative for more information or for current investment offerings.

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