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CONSULTING SERVICES

Challenging Financial Paradigms

Reconsidering The Role of Fixed-Rate Mortgages In Your Portfolio

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Pssst, come here.

Youqe doing them, arenq you? Youqe making those fixed rate mortgages.

Feeling a little guilty, a little defensive? Well, you say, maybe I am, but Iqn selling them right away or at least as soon as Iqe picked-up a point or two in capital gains.

You donq want to admit to anyone that youqe officially declaring any fixed rate mortgages as good loans for your portfolio. Because you know all the crap youqe going to get · from examiners · from ±holier than thouqpeers · and from all the board members who you spent the last decade getting to worship at the altar of the adjustable rate mortgage.

I can just hear it: %What! Make fixed rate mortgages now? Only if you sell them without touching them.+

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%But keep them, · when rates are at a 20 year cyclical low?+%But keep them, · when rates are most likely to go up, driving them deep under water, deep enough to keep company with phosphorescent fishes?!+

%But keep them, · when for the first time regulators are actually measuring and monitoring the market value volatility of financial institution balance sheets?+

%But keep them, · when borrowers are likely to sit on them until they hatch?+%Get serious!+But I am. Dead serious. Iqn not talking about portfolioing 30 year FRMs, but I am talking about portfolioing 15 year FRMs, Bi-weekly FRMs, and any other species of shorter-term FRM that can be originated. Iqn not suggesting returning to a mortgage portfolio consisting entirely of FRMs, but instead, creating a more balanced, efficiently priced portfolio of both FRMs and ARMs.

Financial institutions asset portfolios must reserve the capacity to warehouse interest rate risk for retail mortgages. This risk-taking capacity must fully consider the market value of funding sources, especially core deposits. The question these institutions must ask themselves is whether they have enough of a %mark-to-market+capital budget to afford FRMs, manage the resulting prepayment risk, and thereby improve earnings.

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Folks, Tom and I have been championing the cause of efficient pricing of retail deposits and loans for years. Anyone who has ever attended any of our seminars, read our books and articles, or heard us speak can attest to the fact that weqve literally been pains in the butt on this issue. And the most controversial application of these theories has been with respect to decisions regarding the design, pricing, and portfolioing of ARMs and FRMs. Now, weqre glad to report, we have some substantive support in the campaign for rational debate on this issue. Noel Fahey of the Financial Research Institute has written a significant book entitled Measuring and Pricing Mortgage Risk Itqs the best piece of applied research that weqve seen on this subject, bar none. Weqre telling all of our clients to get it and use it.

In this issue and in the next issue of the newsletter, I want to explore some of the reasons why lenders must give increased attention to FRMs and examine some of the analysis used to support decision-making in this area. In fact, with respect to one critical area of analysis, the funding of FRMs, Tom Farin is devoting an entire article in this issue solely to this topic.

First, letqs just talk for a few minutes. Weqll put the technical issues aside, for now, and just discuss the situation currently facing both mortgage borrowers and portfolio lenders.

Timing From the Mortgagors Point of View

%Letqs get the house paid off within the next 15 years,+is increasingly the cry market of middle-age householders. Interest rates are low and the time to retirement is shortening. These are the driving forces behind the demand for shorter-term fixed-rate mortgages.

Mortgagors are trying to protect themselves against the uncertainty of higher mortgage payments by securing fixed-rate mortgages now. And, mortgagors are trying to insulate themselves against the uncertainty of post-retirement cash flow by owning their home outright before retirement. The former objective is made possible by the current low-rate environment, while the latter objective is made possible by the population bulge of baby boomers planning for retirement over the next 20 years. Of course, these baby-boomers are in the right phase of their economic life cycle to be able to afford the higher cash flow that is required to amortize mortgage debt for a term of 15 years or less.

In fact, with the fixed rates on shorter-term mortgages between 6%-7%, paying down the mortgage can be considered an extremely attractive savings vehicle for most households. One of my Mid-western clients, when faced with the competitive pressure to rewrite existing seasoned mortgage debt, turned predatory. They marketed the concept of shorter-term FRMqs as one of the householdqs best investment alternatives. Of all of the feared competition for deposits from mutual funds and other investment vehicles, the accelerated repayment of mortgage debt may be the best savings vehicle of all. When institutions can successfully market the %savings vehicle approach+, and service the mortgages in-house, they are able to promise to recast the mortgage

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once again if yields on alternative investments become competitive. This safe exit from the shorter-term mortgage, while unlikely to be exercised by the mortgagor, is seen as a unique attribute of a locally based portfolio lender which services its own mortgages.

All of these factors explain the strong demand by mortgagors for shorter-term fixed rate mortgages. But why have portfolio lenders been so slow to embrace the mortgagor's demands? The answer is perceived interest rate risk. Portfolio lenders have been very slow to distinguish the interest rate risk characteristics of shorter term FRM's and their 25-30 year term cousins. This is an analytical void that Fahey's book obliterates. But first, let's build a little fire under the portfolio lender.

Timing From the Perspective of the Lender

For the majority of depository institutions, the key to competitive vitality and profitability is defined by its ability to generate fee income and to capture the stable source of funding characterized by core deposits. The foundation for enhancing and preserving the market value of the institution lies in the institution expanding its core deposits. And the preservation of market value is a concern that both accountants and regulators have shown a new interest in monitoring.

The mortgage refinancing boom of the last five to six years has afforded institutions ample opportunity to capture the customer relationships upon which fee income and core deposits are based. Relationship building has been behind the attention paid by commercial banks to the refinancing of residential mortgages. The availability of a secondary mortgage market has separated the decision to originate mortgages from the decision to put mortgages in portfolio. Bankers have been quick to exploit the secondary market to avoid putting unwanted mortgages in their portfolio, while capturing consumer lines of credit and deposit relationships.

However, the window of opportunity to capture customer relationships through mortgage refinance is narrowing. How long do we have — 6 months, 12 months, 18 months — until the next rise in mortgage rates draws out the last refi holdouts and ends the refi boom? Most of my clients are expecting a reduction in mortgage originations of up to 2/3 of their current volume when the refi market dries up. Then they will be left to squeeze whatever relationships they can out of the remaining "purchase money" mortgage market.

Thus, I am constantly enjoining institutions to be as aggressive as possible in attracting mortgage refi business. Offer a complete menu of mortgage products, selling off the mortgages you don't want, and keeping those mortgages on which you're earning enough to compensate for the additional risk introduced to your portfolio.

While the timing for capturing customer relationships is right, many portfolio lenders are not comfortable with the implications that originating FRM's has on both actual and perceived interest

rate risk management. Too many lenders see themselves as having to keep any fixed-rate mortgages that they originate. Also, lenders worry that once offered at competitive prices, fixed rate products will hurt the ability of the institution to originate their own adjustable rate products. They are concerned about the efficiency of their mortgage pipeline hedging tools. Will they be able to originate and sell mortgages without losing money? Most importantly, many lenders have not analyzed the substantial differences in the interest rate risk characteristics between shorter and longer term FRMs.

On top of all these questions pertaining to the actual amount of interest rate risk introduced by originating fixed rate mortgages, one must not ignore the question of %perceived+interest rate risk attributable to this strategy, especially on the part of regulatory agencies. Iql comment on this issue momentarily. First, letqs concern ourselves with the actual interest rate risk of fixed rate mortgages.

Cash flow, Cash flow, Whenqs the Cash flow!

The retirement risk and price risk of a fixed rate mortgage relate directly to how quickly cash is flowing from the mortgage. A FRMqs cash flow is a function of both the certainty of the scheduled amortization and the uncertainty of the speed of prepayment. The more quickly that a loan is amortized, the greater will be the amount of cash flow that can re-price to current market yields.

Of course, faster cash flows are a mixed blessing; they benefit investors with the opportunity to reinvest in a rising rate environment, while penalizing investors with the same reinvestment opportunity in a falling rate environment. Many depository institutions are concerned about their exposure to the risks of rising interest rates when investing in FRMs. That being the case, faster cash flows produced by shorter amortization schedules can significantly reduce the interest rate risk of FRMs.

Listen to this folks. Listen. A FRM amortizing over 15 years has substantially less interest rate risk than a FRM amortizing over 30 years. And once you get the amortization schedule of a FRM down to 10 years, the FRM may be considered to have essentially the same amount of interest rate risk as an ARM.

The benefit of shorter amortization schedules is similar to the protection that an investor gets from the contractual repricing of the principal in an ARM, but without the constraints of annual and lifetime caps or the ±albatrossqof teaser rates.

The key to comparing the interest rate risk between FRMs and ARMs lies in considering the results of reinvesting the cash flows as a component of the total rate of return of the mortgage. Now, I promised that I would keep our discussion nontechnical, but I will tell you that one of the really useful features of Faheyqs book is how he develops this measurement of total rate of return

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and uses it to derive the efficient pricing of both ARMs and FRMs. Fahey develops, and so can you, a process by which the interest rate risk of mortgages can be more accurately modeled, thereby more efficiently priced.

In our next issue, we'll develop some ways for you to use your simulation model to examine FRM-ARM alternatives. Without getting too fancy, we'll look at how you can model total cash flow rate of return for generic investment alternatives.

Now to return to our stated concerns about the risk of getting stuck with unwanted FRM originations and the potential losses associated with hedging operations. The concerns are still real. But we are now weighing these concerns in the context of a more accurate measurement of risk. And that accurate measurement of risk is absolutely essential if the FRM is to be part of your mortgage menu.

Unfortunately, that leaves us with the perceived risk associated with fixed rate mortgage lending. What can I say? The tools used by regulators to measure and monitor interest rate risk in general and of FRMs in particular is both flawed and inadequate. You're going to have to develop your own analytical tools. And it's going to be one hell of a lot of work to re-educate your board about this issue. You're going to have to document and analyze and document some more any strategies involving FRMs. In effect, you must prove your ability to manage the risks.

I've given you ample reason to reexamine your strategies regarding fixed rate lending. Don't wait too long.

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