Managing Your Mortgage Portfolio Effectively in a Dynamic Market

By Todd L. Hempstead

During 2002 and most of 2003, mortgage portfolio managers were focused primarily on garnering the significant profit opportunities created from the lowest interest rate environment in 50 years. As we move into 2004, however, interest rates are steadily on the rise, causing concern among portfolio managers.

Mortgage industry experts have now shifted their analysis from credit risk to interest rate risk. Thoughts about duration, convexity and extension rate risk are being revived from the past rising rate environments to understand their impact on mortgage portfolios and community bank profitability.

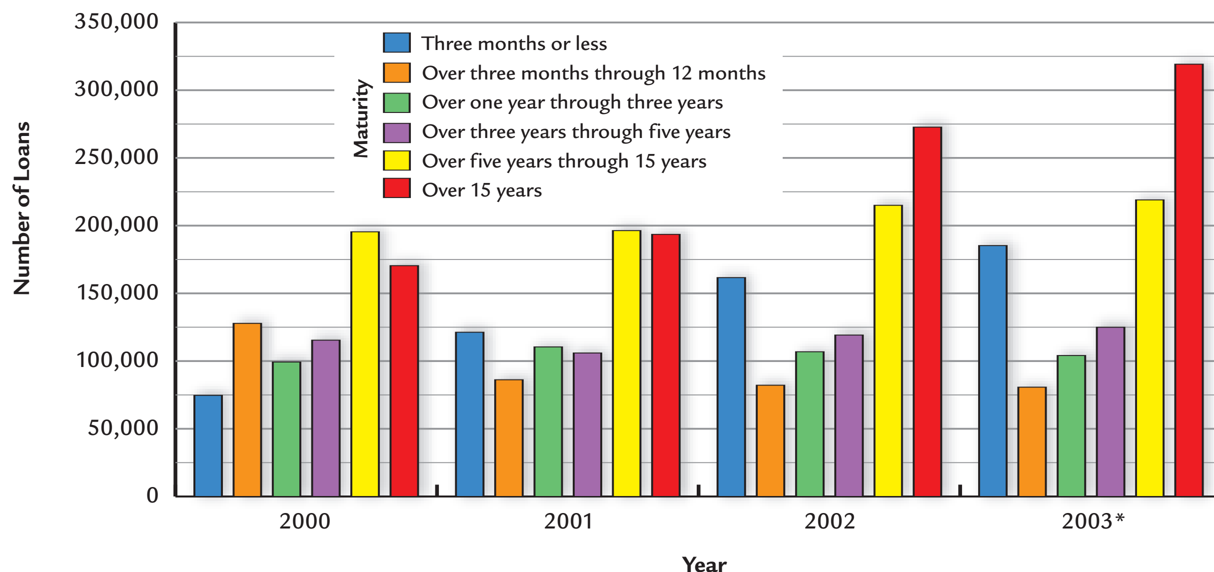
For community banks, exposure to interest rate risk is considerable. Consider the following:

- Residential mortgage assets account for two-thirds of the net increase in banks' total financial assets since 2002.
- Of that increase, nearly three-quarters of those assets remain in the bank's portfolio. The majority of these unsecuritized assets are single-family, fixed-rate, first-lien mortgages.
- The maturities of single-family, 30-year, fixed-rate mortgages have lengthened considerably, while the maturities of shorter-term mortgages have either remained static or declined.

This lengthening of maturities is commonly referred to as extension risk because

Going Long

Maturity of single-family fixed-rate mortgages at banks



Source: Financial Information Systems.

**Represents second quarter data. All other data from fourth quarter.*

it extends the prepayment of principal beyond expected prepayment rates, impacting the bank's ability to fund future loans at previously anticipated costs. This happens because as mortgages refinance off a bank's books, they are replaced with new mortgages of longer maturities. Funding longer-term mortgage assets with shorter-term liabilities is not an issue during a declining rate environment because the cost of these liabilities decreases as rates decrease. The opposite effect occurs, however, in a rising rate environment. It becomes more and more expensive to align assets and liabilities during a rising rate environment.

As you begin to re-evaluate your own bank's portfolio asset management strategies for the next year, this marks the perfect time to take advantage of the unique ways in which the secondary mortgage market can help you create liquidity and enhance profitability through your portfolio, while still meeting your capital requirements.

A secondary mortgage market partner such as Fannie Mae can assist you in reviewing your portfolio for eligible loans, can provide execution recommendations, and ultimately can complete the transaction for you, buffering you from the potential open market risks. The steps outlined below follow a simple, step-by-step procedure Fannie Mae uses to examine a seller's portfolio before determining the best solution for them.

Set transaction goals. Clearly defined transaction goals are key to your institution's successful activity in the secondary market. Timely, agile course adjustments to overall asset and liability management strategy should be a driving goal. To most portfolio managers, this agility means having the market knowledge and ability to sell whole loan assets at the most optimal price to generate desired profits and meet liquidity goals, particularly when other funding sources are either inadequate or too expensive. At the same time, the manager must be sure to maintain the desired asset/liability gap.

Conduct a Portfolio Review. Our portfolio review can give you a complete picture of your portfolio's product that is eligible for secondary market execution. As part of our extensive portfolio review, Fannie Mae provides you with loan-level detail about how home price appreciation or depreciation, shifts in the yield curve, and credit quality changes impact your fixed-rate and adjustable-rate loans, broken out further by seasoning, geographic distribution, credit score, property type and loan to value. By stratifying interest rate risk within sets of loans, we can help you determine where the highest and lowest risk is likely to occur. Based on this information, you can match the risks associated with these loans to the capital requirements necessary to keep some or all of the loans in your portfolio. The review enables you to clearly define which loans to sell or retain based on the transaction goals you set at the beginning of this process.

Provide execution recommendations. You can take advantage of Fannie Mae's team of experienced portfolio analysts who can recommend customized solutions that fit your business model.

The secondary market is a valuable asset/liability management tool. Directly selling loans in the secondary market, rather than through a third party, is beneficial for a number of reasons. Fannie Mae provides insightful analysis of your mortgage portfolio from a cash flow and credit perspective, and helps enhance your ability to manage capital more effectively. You can also create better asset-liability matches on funding, and stay attuned to new mortgage products and services that will benefit your customers.

Entering the secondary market enhances your profitability by maximizing the value of your portfolio as you increase liquidity by selling off loans with hard-to-manage interest rate risk, which frees up capital to originate more loans. By replacing long-term mortgages in your portfolio with higher yielding and/or shorter-term receivables, you can feel confident that you are proactively managing your portfolio in a dynamic home loan marketplace.

With the ACB/Fannie Mae Affinity Partnership, you have preferred access to Fannie Mae's Structured Transactions Department. We can help you discover a fresh approach to fine-tuning your bank's mortgage balance sheets, to yield liquidity, and to enhance profits. CB

Todd Hempstead is Fannie Mae's vice president for single-family structured transactions in Washington, D.C. In support of the ACB/Fannie Mae Affinity Partnership, his group offers data analysis, strategy, and support to help identify portfolio management opportunities. For information, call (202) 752-7616.

Coming to a City Near You

The Challenges of Managing Mortgage Loan Portfolios

Due to overwhelming feedback from ACB members on the importance of portfolio management and developing strategies for their institution as interest rates change, ACB and Fannie Mae have joined together to take this topic on the road for a multi-city Breakfast Tour.

During these sessions, we will cover the challenges facing managers of mortgage loan portfolios in a volatile and low interest rate environment. Hear the answers to these questions and more:

What does extension risk mean for a mortgage portfolio?

What can depositories do to minimize interest rate risk?

What is the market's outlook for residential mortgage credit risk?

Dates and locations are still being finalized. Initial target locations include:

- Boston/Framingham
- Chicago Metro Area
- Washington, D.C., Metro Area
- Pittsburgh

Please watch for further details on ACB's home page, *www.americascommunitybankers.com*, or call Fannie Mae's Janice Ponson at (202) 752-3581 to put your name on our Breakfast Tour Advance Registration list.