Winning a Moderate, Orderly Race

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Well, it's official. In May, Federal Reserve Chairman Ben S. Bernanke told a Chicago audience of financiers and reporters that the housing market is cooling off in a "moderate" and "orderly" fashion. This dovetails with most forecasts, including ours, which sees a steady rise in mortgage rates, a halving of home price appreciation rates, and some $400 billion less in single-family mortgage originations this year compared to last year.

That's because volatile energy prices will continue to stoke inflation worries and drive interest rates higher—despite comparatively tame wage and price inflation. This will propel the average 30-year fixed mortgage rate to around 6.7 percent and the introductory rate on one-year adjustable rate mortgages (ARMs) to about 5.8 percent by the fourth quarter, and push the average yields on 10-year and one-year constant maturity Treasury notes between 5.0 and 5.2 percent for the rest of the year — but market volatility or further Fed actions could push them higher.

This, in turn, will cause housing starts and home sales to stop setting records on a routine basis and instead dip 7 percent this year to a still very respectable 1.93 million units and 7.0 million units, respectively. At the same time, average home value appreciation growth rates are likely to slip from double-digits to about 7.5 percent.

We estimate these indicators will trigger a 14 percent decline in mortgage originations—from $2.8 trillion to $2.4 trillion—and a commensurate decline in origination fees and servicing income.

At the same time, we see refinancing slipping from 44 percent of mortgage applications in 2005 to 34 percent this year.

This means that, like other financial institutions, community banks will continue to struggle with thinning margins this year.

But thinning margins aren't the only challenge community banks face. There's also fierce competition from national and regional financial institutions, which has slashed the ranks of community lenders from 14,000 to 7,000 over the past 20 years and increased the share of industry deposits held by the top 10 U.S. banking organizations from 16 to 40 percent, according to the Federal Deposit Insurance Corp.

So the big question, returning for a moment to Chairman Bernanke's speech, is can you fine-tune your mortgage operation for better-than-moderate returns in an orderly way? We think the answer is yes. The mortgage market, while it isn't running like a NASCAR winner, is still a strong, healthy machine that can produce solid returns. An expected $2.4 trillion in originations would make 2006 the industry's fifth best year ever, and originations are still expected to top 2001's then-record high.

So, what should you fine-tune?

Here are three suggestions: your portfolio selling strategy, your technology, and your products.

Sell loans from your mortgage portfolio. Nearly two-thirds of the nation's community bankers hold their single-family and Community Reinvestment Act mortgages in portfolio. But a rising interest rate environment can play havoc with earnings by extending durations and triggering bigger risk-based capital set-asides. One alternative is to restructure your balance sheet and sell underwater portfolios to an investor, such as Freddie Mac (which has a dedicated team to provide portfolio analytics, sales assistance, and single, integrated bids). Lenders can

significantly buoy liquidity by freeing up capital that would otherwise have been set aside, as well as using the proceeds of the portfolio sale for new loans or operational upgrades.

Upgrade your mortgage technology. Although community bankers lead the pack in personalized customer service, technology sets the bar for faster decisions, lower-cost operations, and maintaining a competitive full-service footprint in the local market.

Not surprisingly, more community bankers than ever use automated underwriting services—71 percent in 2005 versus 66 percent in 2004, according to *Community Bankers'* 13th Annual Real Estate Survey. What's more, 66 percent of the survey respondents already use Freddie Mac's Loan Prospector either exclusively (44 percent) or with another service.

But mortgage technology isn't static; by one rule of thumb, capacity doubles every 18 months. Consequently, Freddie Mac is in the process of upgrading its Web-based selling system and Loan Prospector to eliminate more manual steps, back-and-forth phone calls, and e-mails, while improving data quality, catching more fraudsters, and building a stronger reputation for quicker decision making.

For example, planned upgrades to Loan Prospector will enable community bankers to adjust it to process automatically their special waivers, provide more precise and responsive feedback messages, and spot more potential frauds by verifying Social Security numbers, flagging investor loan applications being passed off as owner-occupied, and identifying multiple loan applications submitted in a short period of time that use the same borrower's name.

Expand your mortgage menu. Other changes in the pipeline will give you a wider spectrum of mortgage products to offer your borrowers so they can find the one that fits their particular financial situation and take advantage of the latest interest rate trends.

For example, the current rising interest rate environment favors fixed-rate mortgages, which also accounted for 58 percent of all community bank originations, according to the *Community Banker* survey. The challenge now is to expand the range of fixed-rate products so community banks can competitively accommodate a wider range of current and potentially new customers, from first-time borrowers to ARM holders looking to refinance into a lower monthly payment.

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Freddie Mac is in the same boat and is diversifying its fixed-rate line; a fuller sweep of 40-year products will be available as early as this month. Our HomePossible suite of affordable products now offers qualified borrowers a 40-year fixed rate mortgage with only $500 out of pocket. This gives borrowers an option to reduce their upfront costs and monthly payments by as much as 4 percent—which in today's tight market could spell the difference between a closed loan and a lost opportunity.

At the same time, we expect 25 to 30 percent of borrowers to opt for an ARM, which maps to the 2005 survey's finding that 38 percent of community banker mortgage originations were ARMs. There will be continued growth in demand for niche products like interest-only (fixed and adjustable) mortgages and Alt-A mortgages.

To help our customers support this demand, we're also upgrading Loan Prospector and our Web-based selling system to:

- Offer 20 additional rate and cap structures, including five new fully amortizing LIBOR-indexed ARMs with initial periods of three to 10 years, followed by six-month adjustment periods;
- Support more Alt-A bulk deliveries, interest-only deliveries, and A-minus deliveries to Freddie Mac — which are all up between 300 and 400 percent since 2002; and,
- Enhance HomePossible to cut the minimum borrower contribution to 3 percent for a three - to four-unit property, enable borrowers to use Mortgage Credit Certificates and Rural Housing Service Leveraged Seconds, and provide a servicing-released, cash-sale option to lenders who deliver HomePossible loans through our Web-based selling system.

To sum up: the mortgage market is slowing down, but we aren't. We are committed as never before to expand the horizons of responsible mortgage lending. We are doing this by responding more quickly than ever to financial institutions across the size spectrum with the mortgage products, technology and selling opportunities they demand to compete for borrowers in every interest rate environment—even if those environments are less than orderly and more than moderately challenging.

For more information contact your Freddie Mac account representative at 1-800-FREDDIE or visit freddiemac.com.