Unwinding the Suspension of Agency Seasoned Bulk Transactions

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Ongoing balance-sheet management is a critical element of strong financial performance for credit unions. Most institutions go through an annual budgeting process, but changes in operating conditions during the year can necessitate taking action to address specific financial issues that may arise.

Excess liquidity might result in the purchase of a loan participation pool. Faster prepayment speeds from low interest rates might require more aggressive loan origination rates or an expansion of product offerings.

An emerging issue among credit unions is concern over rising interest rates, which can quickly create greater interest rate risk (IRR) exposure. Regardless of the strategic challenge, credit unions need to be able to adapt to changing circumstances.

In November 2021, the Federal Reserve announced that it would begin to taper its purchases of Mortgage Backed Securities (MBS). Fixed-income markets have started adjusting to the timing of expected increases in the Fed Funds rate from its current record low level, and the impact those changes will have across the yield curve.

As a result, many financial institutions have begun to focus more on their IRR exposure and how it should be prioritized in their balance sheet management plans. This represents a shift for credit unions that have had their attention on replacing assets that have prepaid at record speed during the course of the Covid pandemic.

Strategic actions to mitigate exposure to higher rates can include, among other things, locking in longer-term funding, hedging assets or liabilities, shifting new originations to adjustable-rate loans, or selling long-term fixed rate mortgages. Any one or combination of these may be a potential solution, depending on the individual credit union's comfort level and ability to execute.

Selling residential mortgages has proved to be an effective way to manage IRR, generate liquidity to continue new loan originations and maintain member relationships through the retention of servicing.

The most common transaction for credit unions for the past 30-plus years has been a sale or securitization of seasoned mortgages with Fannie Mae or Freddie Mac. Both agencies have provided liquidity to credit unions by facilitating transactions through their seasoned bulk window for these loans that have aged more than six months. Typical flow sales to the agencies must be completed within six months from

the origination date.

In April 2020, the FHFA required both Fannie Mae and Freddie Mac to suspend seasoned bulk transactions. This was largely due to several very large capital markets participants attempting to execute seasoned bulk sales in excess of $1 billion each at the outset of the pandemic.

Despite the negative liquidity conditions that created the rush to the seasoned bulk window having subsided within a few months, the suspension remains in place almost two years later. Unless it is reversed in the near future, the suspension will have the unintended consequence of leaving credit unions at a liquidity disadvantage to many other financial institutions.

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This disadvantage will be exacerbated in a rising rate environment where private buyers back away from long-term fixed rate purchases as pricing deteriorates.

SEASONED PORTFOLIO MORTGAGES

In accordance with their charters and federal regulations, credit unions must extend credit to their field of membership. Mortgage lending is an effective way to meet this mandate. As part of the process of managing the balance sheet, credit unions commonly sell some of their newly originated mortgages on a flow basis to Fannie Mae or Freddie Mac, but the majority are held on balance sheet for investment.

Mortgages are very desirable assets to credit unions for a variety of reasons including:

- **New loans:** Cash from sale redeployed into new loans.
- **New members:** Build and diversify membership base.
- **Cross-sales:** Relationship opens the door for other products and services.
- **Credit quality:** Conservative lending equates to very low historical loan losses for portfolio mortgages.
- **Investment returns:** Enhance net interest margin by earning interest at higher rate than many other investment alternatives.
- **Balance sheet growth:** Leverage capital to optimize returns.

Originating a new mortgage to hold on balance sheet is largely the same process as originating one to sell to the agencies at closing. The underwriting and documentation standards tend to be almost exactly the same, with minor exceptions. But for reasons stated above, credit unions will often choose to retain the mortgage rather than sell, earning the coupon and keeping the credit risk.

By retaining mortgages, credit unions have "skin in the game" that other institutions who sell immediately do not. The credit union is comfortable that the interest income generated by holding it long-term, coupled with very low losses, is more profitable than selling at a gain shortly after closing.

In addition to the strong underwriting and documentation requirements at origination, seasoned loans prove their value by creating a payment history that new originations do not have.

Typically, over 95% of portfolio mortgages have spotless payment histories and require relatively low loan loss reserves compared to other loan types.

SEASONED BULK PORTFOLIO SALES

All sales of seasoned loans are executed in pools (bulk) because the loans were originated six months or more in the past. Bulk sales of seasoned loans by small to mid-size credit unions are almost always "needs based." A variety of strategic needs or challenges often arise during the course of a year—some of which can interfere with a credit union's ability to serve their membership with as many new mortgage originations as they would like.

The ability to conduct bulk mortgage sales through a viable agency partner is a key tool that can help address numerous strategic issues such as:

- **Interest Rate Risk:** Reduce exposure to longer-term assets.
- **Concentration:** Manage excess growth of a particular loan type (30-year fixed rate).
- **Liquidity:** Sale proceeds needed for investment in new loans; don't have access to the many different funding sources of large institutions.
- **Loan/Deposit Ratio:** Need to stay within regulatory and internal guidelines.
- **Capital:** Reduce asset size in order to maintain acceptable capital ratios.

Seasoned bulk transactions are not regular or scheduled events for credit unions. As mentioned, they occur solely when there is a strategic need and may take place several years apart.

The majority of loans purchased by Fannie Mae and Freddie Mac are new production flow loan sales conducted by a very small number of very large lenders. Seasoned bulk sales by credit unions represent a very small part of Fannie Mae and Freddie Mac's business, but nevertheless a vital liquidity requirement for hundreds of credit unions to continue funding new portfolio loans.

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Fannie Mae and Freddie Mac have specific requirements for seasoned mortgage loans that they will purchase. In general, their guidelines are very similar to those for new originations.

While credit unions typically use the same underwriting process and guidelines for their portfolio loans as the agencies, they often may make minor

exceptions based on the member's borrowing and deposit relationship.

Additionally, agency guidelines may change over time so that a conforming balance loan that was initially eligible may not seem to qualify under the revised requirements. But with a perfect pay history, the agencies will allow the loan's seasoning to be an offsetting factor in their approval process, granting certain waivers and variances that are not allowed on flow originations.

In addition to having excellent credit characteristics, mortgages held by credit unions on balance sheet are very liquid for secondary market transactions. The process used to determine which loans are potentially agency-eligible involves reviewing the loan and borrower characteristics as well as performance since origination.

Graph A shows an example of a liquidity filter for a credit union's mortgage portfolio that segments the loans into three different groups—Portfolio, Private and Agency.

The loans that fall into the Portfolio category are those that have specific issues such as low FICO, elevated DTI, high LTV or historical delinquency. These loans are typically worth less in the secondary market than they are for credit union to hold.

The Private category includes loans that either have balances above conforming limits (jumbo) or slight underwriting differences from agency guidelines. These loans cannot be sold to one of the agencies, but are liquid with credit unions or other private market buyers.

The Agency category includes the loans that passed through all of the Portfolio and Private grade filters. These loans are conforming balance and have the highest credit characteristics.

At this point these mortgages are considered "potentially" agency eligible because each loan must be re-underwritten in advance of a delivery to Fannie Mae or Freddie Mac. Between the loan data filtering, the enhanced underwriting and perfect pay histories for more than six months, loans delivered to the agencies in seasoned bulk transactions are outstanding credits.

GRAPH A: EXAMPLE INSTITUTION, WATERFALL LIQUIDITY FILTER REPORT

Description	No. Of Loans	Principal Balance	% Of Total
C : Portfolio Grade			
Currently Delinquent 30 or More Days	6	2,099,632	0%
Hist. DQ 30 or More Days Last 12 Mos	7	2,673,335	0%
Borrower Credit Score Under 660	53	12,036,704	2%
Co-Borrower Credit Score Under 660	11	2,599,162	0%
Housing Co-Operative Share Loan	32	2,866,262	0%
DTI Ratio Over 50 %	19	2,142,819	0%
DTI Ratio > 45 % Seasoned < 36 Mos	14	5,766,624	1%
Current Balance Under $15,000	13	90,289	0%
Amortized LTV Over 95 % & O\O With PMI	5	1,164,501	0%
Subtotal Portfolio Grade (C)	**160**	**31,439,326**	**5%**
B : Private Grade			
Original Balance Over Agency Maximum	125	83,501,103	13%
Updated LTV Over 75 % & Cash Out Refi	22	12,598,398	2%
Updated LTV Over 70 % & Condo	13	6,150,983	1%
Amortized LTV Over 75 % & Cash Out Refi	57	28,649,628	5%
Amortized LTV Over 70 % & Condo	23	11,479,078	2%
LIBOR Indexed ARM Seasoned Over 6 Mos	113	50,639,317	8%
Non-Agency Investor Eligible	4	675,878	0%
Subtotal Private Grade (B)	**357**	**193,694,385**	**31%**
A : Agency Grade			
No Data Exceptions Coded	1,577	397,082,823	64%
Subtotal Agency Grade (A)	**1,577**	**397,082,823**	**64%**
Grand Total	**2,094**	**622,216,534**	**100%**

Source: FHN Financial Capital Assets Corp.

AGENCY VS. PRIVATE TRANSACTIONS

Since the FHFA suspended seasoned bulk purchases, credit unions have lost a reliable and price-efficient source of liquidity for their highest quality loans. While these agency eligible mortgages are attractive to private investors because of the strong credit characteristics, the private market for these loans can be much less reliable.

Seasoned mortgages sold to one of the agencies end up as collateral in mortgage-backed securities (MBS). Fannie Mae and Freddie Mac don't hold the mortgages on their balance sheet; they insure the bonds against credit losses. The bondholders assume all of the interest rate risk and any prepayment exposure of the underlying collateral.

Because the Agency purchases are backed by a highly liquid market for MBS, there is always liquidity for the seasoned mortgages. Private buyers may move in and out of the market depending on balance sheet availability, interest rate changes and desired exposure to certain product types.

For example, in a rising interest rate environment, many private buyers back away from purchasing 30-year fixed rate mortgages, regardless of price.

In addition to the availability of liquidity, there is a material difference between Agency and Private pricing for the same pool of agency eligible mortgages.

Graph B illustrates the difference in pricing of the loans identified as Agency Grade from our previous Example Institution, Waterfall Liquidity Analysis. The same pool of loans are priced two ways: 1) as an agency transaction, and 2) as a private transaction.

Private transactions of seasoned mortgages tend to trade at a yield above

GRAPH B: AGENCY GRADE – PRIVATE GRADE

Product Type	Agency Grade				Private Grade				Difference
	Principal Balance	Weighted Average Coupon	Weighted Calc. Maturity	Est. Gain Or Loss	Principal Balance	Weighted Average Coupon	Weighted Calc. Maturity	Est. Gain Or Loss	
Fixed Rate									
CONVENTIONAL	385,225,914	3.18%	266	1.80%	385,225,914	3.18%	266	-0.46%	-2.26%
Subtotal	**385,225,914**	**3.18%**	**266**	**1.80%**	**385,225,914**	**3.18%**	**266**	**-0.46%**	**-2.26%**
Adjustable Rate									
1 X 1 YEAR CMT	88,224	3.12%	100	1.31%	88,224	3.12%	100	-0.52%	-1.83%
3 X 1 YEAR CMT	320,408	3.12%	188	0.96%	320,408	3.12%	188	-1.55%	-2.51%
7 x 1 YEAR CMT	173,525	2.63%	160	0.30%	173,525	2.63%	160	-2.02%	-2.32%
15 X 1, 5 YEAR CMT	2,548,121	3.72%	330	-1.47%	2,548,121	3.72%	330	-4.27%	-2.81%
5 X 5 YEAR CMT	5,440,223	3.07%	283	2.93%	5,440,223	3.07%	283	0.08%	-2.84%
5 x 1 SOFR	1,331,000	2.48%	349	-0.85%	1,331,000	2.48%	349	-3.86%	-3.00%
10 x 1 SOFR	1,955,407	2.72%	358	-0.49%	1,955,407	2.72%	358	-3.49%	-3.00%
Subtotal	**11,856,909**	**3.08%**	**307**	**0.89%**	**11,856,909**	**3.08%**	**307**	**-1.96%**	**-2.85%**
Grand Total	**397,082,823**	**3.17%**	**267**	**1.77%**	**397,082,823**	**3.17%**	**267**	**-0.50%**	**-2.28%**

Source: FHN Financial Capital Assets Corp.

comparable MBS, often 100 basis points. That spread can move up or down, depending on the specific needs and risk tolerance of the buyer. While guarantee fees and loan level price adjustments are part of the Agency formula, the net pricing to the credit union seller can be significantly higher because it is tied directly to the current MBS trading levels.

In this example, the agency pricing is over 2% higher than private, but at times the difference can be even greater.

The suspension of seasoned bulk transactions by the FHFA leaves credit unions with less reliable liquidity and pricing below the true value of their mortgages. This problem will be compounded in a rising interest rate environment as there are fewer buyers and lower pricing levels.

INTEREST RATE RISK GROWTH

Credit unions with balance sheet exposure to long-term fixed rate mortgages will be much more sensitive to the higher rates that are being signaled by the Federal Reserve. Because of the record low interest-rate environment during 2020-21, the dominant product type originated by all institutions has been the 30-year fixed rate mortgage.

Other fixed-rate terms and ARMs have been much more difficult to source, resulting in mortgage portfolios with far more interest rate risk than in 2019 and prior. As a result, mortgage portfolios have become much more weighted to these lower yielding fixed-rate loans.

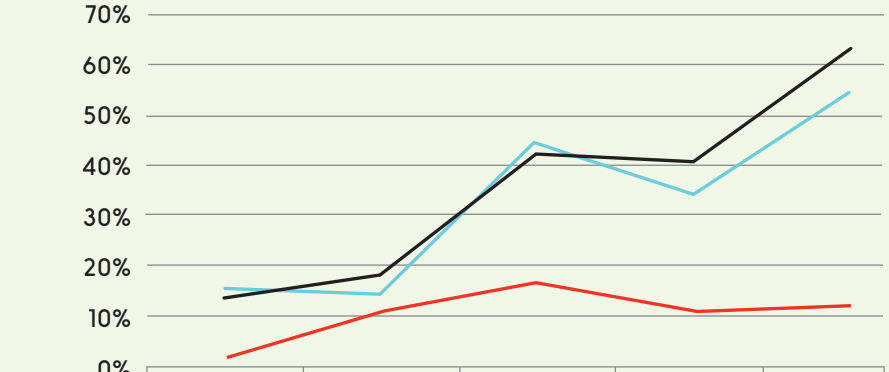
As mortgage production slows, it will be difficult to move the portfolio back to a more favorable fixed/ARM balance in a short period of time.

Mortgages that have terms longer than 180 months and low fixed-interest rates are often referred to as Long-Lows. This has been the fastest growing segment of mortgage portfolios for credit unions of all sizes.

Graph C illustrates how much these Long-Lows have grown as a percentage of the total fixed-rate portfolio.

When rates begin to increase, these long-term, interest-sensitive loans extend in duration and drop in value much more quickly than other assets.

GRAPH C: GROWTH RATE OF LONG LOW BOX



	2017 Q4	2018 Q4	2019 Q4	2020 Q4	2021 Q1
Example	13.3%	17.5%	42.1%	40.3%	63.1%
Peer Group	14.9%	13.9%	44.3%	34.0%	54.1%
All Portfolios	1.7%	10.3%	16.4%	11.0%	11.8%

Source: FHN Financial Capital Assets Corp.

GRAPH D: EXAMPLE INSTITUTION, INTEREST RATE STRESS

Agency Grade Fixed Rate Portfolio				
		Interest Rates Change By		
	LEVEL RATES	+1.00%	+2.00%	+3.00%
FNMA Posted 30 year	2.60%	3.60%	4.60%	5.60%
$385,225,914				
Retained Value	100.62%	94.57%	87.63%	78.32%
Total Price Change	**0.0%**	**-6.1%**	**-13.0%**	**-22.3%**
Volatility Rates +1	-6.1%	-6.9%	-9.3%	-12.5%
Wtd. Avg. Life	5.9	7.4	8.4	8.8
Change in WAL (%)	**0%**	**27%**	**44%**	**50%**

Source: FHN Financial Capital Assets Corp.

Graph D is an example of the volatility of our Example Institution's agency-filtered, fixed-rate loans we previously priced. In the +2.0% scenario, the price of the loans decline by a total of 13% and the weighted-average life (WAL) extends from 5.9 to 8.4 years, a 44% increase.

Large banks and capital markets participants have access to risk mitigation alternatives that many credit unions don't such, as derivatives, private label securitizations and debt issuances. The seasoned bulk market was created by the agencies in the early 1980s in response to the significant interest-rate increases by the Federal Reserve during a period of exceptionally high inflation.

Access to the Agency seasoned bulk window has proved to be a critical source of liquidity for credit unions during many periods of rising interest rates over the subsequent four decades. Among other things, implementation of a risk-reduction strategy creates liquidity by selling seasoned mortgages that can be invested in new loans as rates rise.

These unique seasoned transactions will hopefully be an important avenue for credit unions to manage interest-rate risk moving forward if the FHFA can be convinced to lift its suspension of these transactions.

CONCLUSION

Seasoned bulk sales have not been a priority for credit unions over the past 18 months as most have excess liquidity they would like to put to work funding loan growth.

Over the past two years, fast prepay speeds of their portfolio mortgages have proved difficult for credit unions to offset with new originations. As the market transitions towards higher rates and slower prepay speeds, liquidity and interest-rate risk will become more important strategic issues that need to be addressed.

While there is a strong market of private buyers for interest-sensitive mortgages today, that appetite may wane as rates increase and long-term mortgages aren't viewed as favorably.

Agency seasoned bulk transactions have proved over time to be the most stable and price-efficient source of liquidity for conforming balance mortgages with excellent credit quality. Pricing for private transactions of the same loans can be significantly lower than agency execution, well below their true value.

While many credit unions may not have a specific need to sell seasoned bulk mortgages today, it should be important to all that this critical source of liquidity be available when needed. This is a tool that is definitely better to "have and not need" than to "need and not have."

Without agency seasoned bulk sales, credit unions will be at a significant disadvantage to larger banks and capital markets participants who compete for the same business. Reinstatement of agency seasoned bulk transactions by the FHFA should be an important policy objective of all credit unions to ensure they have ample liquidity for their mortgage portfolios.

As you meet with your regulators and agency representatives, FHN Financial Capital Assets strongly encourages you to reinforce the importance of the Agency seasoned bulk channel to credit unions. The more the FHFA hears from financial institutions like yours, the more likely the suspension will be lifted in the near future.

Additionally, many credit unions have political contacts that are completely unaware of this situation and the potential problems it creates. Notify your U.S. Senators and Representatives about how seasoned bulk transactions can be vitally important to your credit union.

It is critical to act now before interest-rate risk becomes more urgent. If you wait until after rates rise, the damage will already have been done to your portfolio.

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