



## Making a Case for Mortgages

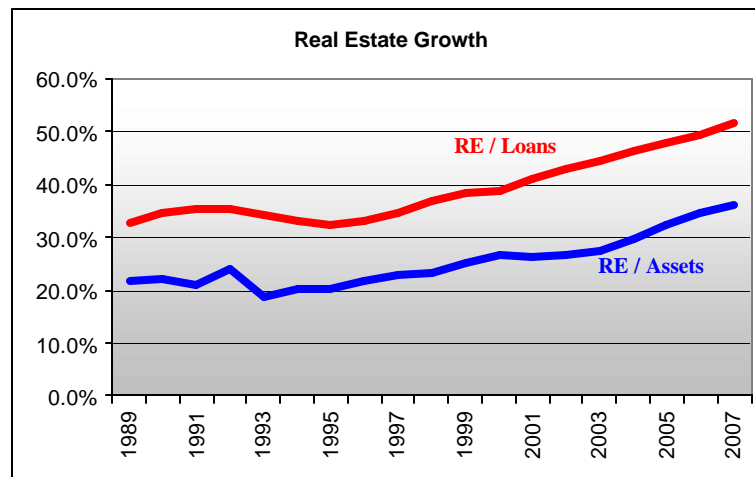
### Overview

It's probably not the first thing that pops in your mind when you read about the worst domestic housing downturn in nearly thirty years. Yet for many credit unions, making mortgage loans is exactly what the doctor ordered when it comes to serving their members needs and protecting the bottom line at the same time. This report addresses the need for mortgage holdings in credit union portfolios, combats the argument that mortgage lending is too risky, and reveals the value of mortgage lending in today's messy mortgage market.

### Loan Flows

Credit union mortgage loan holdings have steadily increased over the years. So much so that, as an industry, real estate loans have exceeded all other loan categories since 2001 and account for approximately 52% of total loans. Figure 1 illustrates the consistent ascension of mortgage holdings in the credit union industry over the past two decades.

**Figure 1**



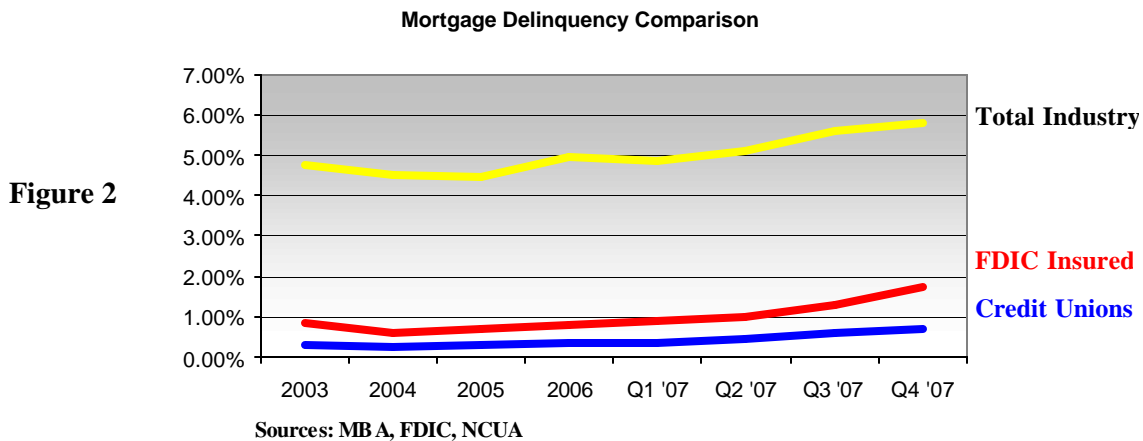
Source: CUNA

During this same period of time ('89 to '07), much to the dismay of credit unions, vehicle lending (as a percentage of loans) has been virtually unchanged. In fact, but for the prevalence of indirect lending programs, auto lending could just as easily have declined. However, recent trends suggests many credit unions are beginning to retreat from indirect lending programs as outstanding indirect loans peaked in the third quarter of 2007. Industry-wide auto loan originations for 2007 experienced just 1.50% growth, following growth of just 3.5% in 2006 (compared to the last 10-year average growth rate of 6.8%). There is little reason to believe 2008 will be markedly better.

The outlook for mortgage originations in 2008, however, is much better. Despite the slowdown in home sales, credit unions can add to market share because many snake-bit lenders have all but exited the mortgage lending market for the time being.

### Credit Quality

Spurred largely by foreclosures on subprime real estate properties, turmoil in the mortgage market has dominated recent financial headlines. However, industry data suggests that fears of material credit losses on credit union-owned mortgage loans are misplaced.



**Figure 2**

While they may pale in comparison to the overall market, mortgage delinquencies have been on the rise for credit unions in recent years. Mortgage delinquencies of just 0.28% in 2003 were up to 0.67% by year-end 2007. Furthermore, net charge-offs on real estate loans have risen from 0.02% to 0.13% on average loans outstanding. This compares to bankruptcies and net charge-offs on non-mortgage loans of 1.22% and 1.13%, respectively. Further increases in delinquencies and charge-offs are projected going forward.

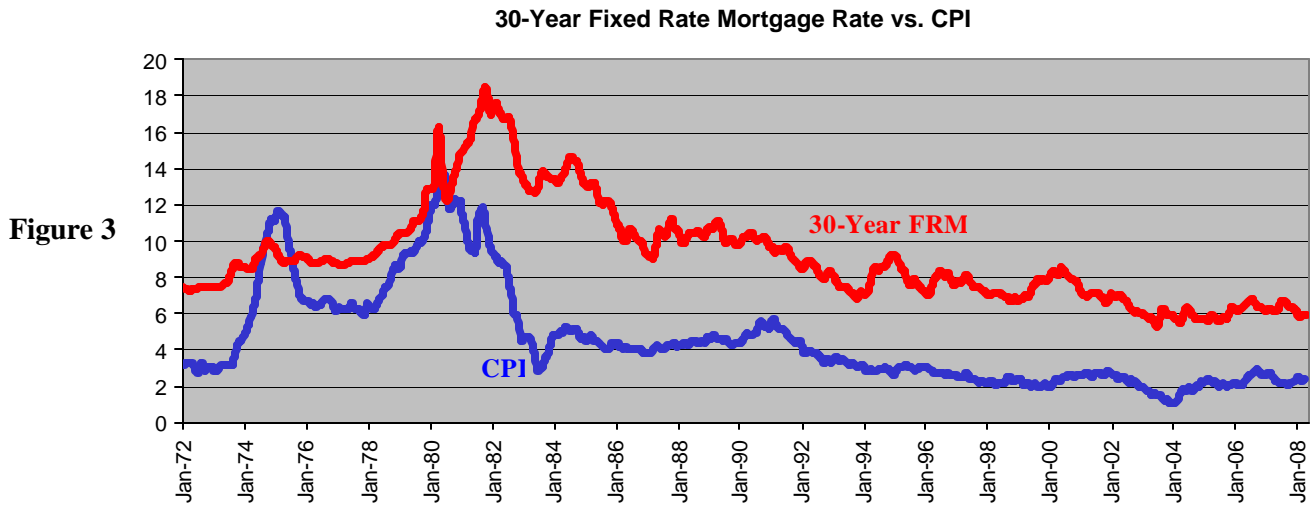
Judging by Figure 2, it is safe to say that most credit unions (and banks for that matter) do not contain any material amount of subprime or ALT-A mortgage loans in their portfolios. And but for a handful of credit unions in the hardest hit real estate markets in the country, the overwhelming majority of credit unions have thus far navigated these treacherous financial waters unscathed. This is primarily due to both the prudent underwriting standards of credit unions as well as the disinclination of credit unions to offer exotic mortgage products to members that could cause their members to be financially harmed. As long as credit unions continue down the prudent path of conservative underwriting, there is no reason to believe that credit quality should be an impediment to growth.

### Interest Rate Risk

The mortgage “crisis” notwithstanding, real estate lending is often synonymous with interest rate risk in the minds of many credit union executives. With mortgage rates near all-time lows, the risk to earnings of originating low-rate long-term loans is a legitimate concern. Nonetheless, most credit unions have ample capacity to absorb additional interest rate risk on their balance sheets. And for those few credit unions approaching their tolerable rate risk capacity, there are solutions that can mitigate the rate risk inherent in mortgage lending that will enable those institutions to continue originating and holding mortgage loans.

Typically, the primary concern with originating long-term fixed rate mortgages is the potential exposure to earnings should interest rates rise after the date of origination - a plausible assumption in the current rate environment. However, fixed rate mortgage rates (like most long term interest rates), are driven by a combination of market driven events and inflation expectations. If inflation is low, then mortgage rates will likely be low as well.

Figure 3 charts the relationship between 30-year fixed rate mortgage rates and the year-over-year Consumer Price Index (CPI) going back 35 years. With the exception of the mid- to late 1970's, inflation has historically been relatively low in the United States. Recent monetary policy actions taken by the Bernanke-led Federal Reserve give little reason to believe core inflation will rise materially any time soon. If true, mortgage rates will remain low and the actual interest rate risks of mortgage lending will be subdued.



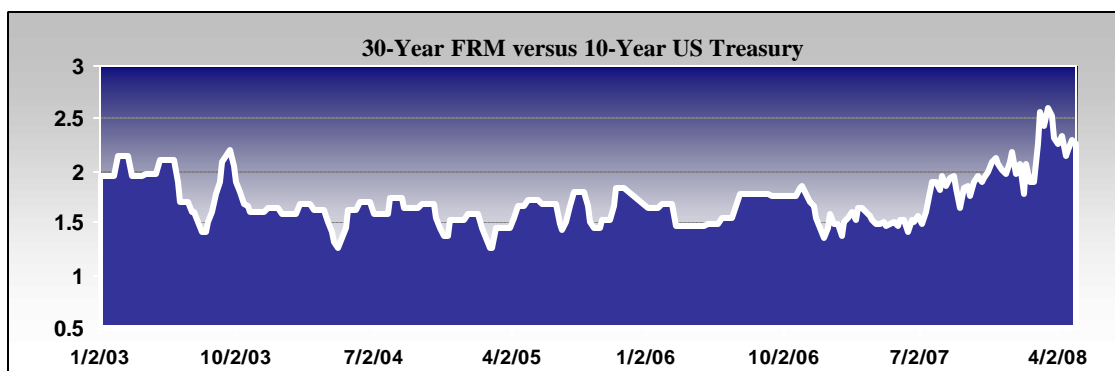
Sources: Bloomberg

If leaving your rate risk management up to the Fed is a bit unnerving, more definitive measures of risk measurement do exist that afford credit unions peace of mind when originating long-term fixed rate mortgages. Credit unions may use derivatives to offset interest rate risk. One such derivative would be a SWAP transaction whereby the credit union agrees to pay a fixed rate payment to a counterparty while receiving a floating rate payment in return. This transaction would effectively lock in a portion of the credit union's funding cost which may offset the rate risk inherent in fixed rate mortgages. Alternatively, the credit union could swap the fixed rate interest payments it receives from its mortgages for a variable rate payment in return. This fixed-for-floating SWAP transaction would considerably reduce the duration of a fixed rate mortgage loan. A more common approach to rate risk management is to simply obtain a fixed rate term borrowing to "lock-in" prevailing spreads. In the end, there are numerous ways a credit union can counteract the interest rate risk inherent in mortgage lending.

### Current Spreads

The increasing volume in credit union mortgage lending does not necessarily mean that it is a more profitable activity than alternative lending activities. The profitability will depend upon, amongst many other factors, the origination and servicing costs from one credit union to the next. The profitability will also differ from one period to the next due to ever changing spread relationships in the marketplace.

For example, the 30-year fixed rate mortgage is historically most correlated with a United States Treasury Bond with a 10 year maturity. Figure 4 charts the spread relationship between those two rates over the past 5 years. The spread has typically been between 140 to 160 bps. However, recent mortgage market turmoil has pushed spreads as high as 260 bps in the first quarter of this year. Spreads remain elevated. At the time of this publication, the national average 30-year fixed rate mortgage is at 6.05% at a time when the Federal Funds Target rate is at 2.00%.



**Figure 4**

Referring back to Figure 3, recall that 30-year fixed rate mortgages are near historic lows. However, the spread between the rate earned on a mortgage loan and the cost of funding that loan is at a historically elevated level. Therefore, the relative value of mortgage lending is heightened at the present time. And while the cost of funding will likely rise from their current low levels, there is sufficient spread built in today that should help preserve adequate net margins going forward.

### Conclusion

Liquidity is high, interest rates are low, and credit unions are looking for profitable avenues to invest their funds. The mortgage sector continues to reflect the best relative value in comparison with a weak consumer lending market and prevailing investment security options. Credit quality remains high, interest rate risk is manageable, and the spreads currently available make mortgage lending a valuable opportunity for credit unions.

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