Weekly Post: Funding Loan Production by Selling Securities

September 15, 2016

Dear Clients-

When interest rates are low, many investments tend to trade with unrealized gains. Also, some fixed rate mortgage-backed securities (MBS) trade at a significant premium with unrealized gains. Because some of these MBS run the risk of significant prepayment shortly, selling these premium MBS to minimize the prepayment risk becomes a possible strategy.

On the other hand, many regions in the country are experiencing loan production growth. One way to fund this new loan production would be to consider selling some securities. Last year, when loan production was low, many banks shifted their focus to growing their investment portfolio. Perhaps, the market has now moved to another cycle that lends itself to an alternative strategy of shrinking your investment portfolio to fund the growth of your loan portfolio.

This Post describes how Risk Officer™ can be used to model and then implement this strategy.

Challenges

- How does this strategy affect my balance sheet performance?
- How should I select the securities to sell?

Solution

To begin, Risk Officer™ enables you to select the securities to be sold. In transactional network (TFO), the Bond Monitor tab is listed under the Asset Liability Management tab, which will display your entire investment portfolio. In this situation, I like to rank all the securities by unrealized gains to select bonds for the simulation. Once they are selected, Risk Officer™ will update the indicative prices to correspond with evaluation date. All prices are indicative. You can contact your broker for dealing quotes before trading and then you can re-run the simulation using dealer quotes if desired.

Furthermore, you can monitor that your tax implications by viewing the summary of the bonds' unrealized gains.

Market Wisdom - Art Hilliard*

Servicing Released vs Servicing Retained

Many banks and credit unions want to keep servicing for a number of reasons

- Don't want to give competitors access to customers
- Ability to retain and manage strong relationships
- Earn additional servicing income/long-term income stream/smooth earnings
- Increased value of the bank/credit union name

There may be times when credit unions and banks may want to sell servicing

- Servicing released premium provides additional, immediate fee income
- Simplified servicing operations or no staff and systems – less operational risk
- Avoid risk management issues – interest rate risk, mark-to-market, impairment risk
- Cherry pick servicing – sell loans that are more difficult to service like those with escrows

There is no right answer when it comes to servicing retention. Capacity, needs and objectives of the institution are major determinants.

Art Hilliard has been in the mortgage industry for 29 years. He has originated, managed secondary marketing, securitizations and settlements, provided mortgage financial advisory and performed multiple mortgage portfolio sales and acquisitions.He was past president of the Illinois Mortgage Bankers Association.

Bond Sale Monitor

Summary	Sell Size	Size	Book Price	Fair Price	Unrealized gain	Yield	Dur
MBS 15yr	2,002,272	2,002,272	106.23	106.36	2,725	0.38	1.19
Total	**2,002,272**	**2,002,272**	**106.23**	**106.36**	**2,725**	**0.38**	**1.19**

Submit to Asset-Liability Management/Strategy Analyzer & TRO/Trade Simulation

Muni
CD
MBS 15yr
Govt

daily update for selected bonds

	Sell Size	Size	ID	Desc	CPN(%)	Maturity	Book Price	Fair Price	Unrealized gain ▼	Yield	Dur	As of Date
☐	1,064,772	1,064,...	71850936	FN AD1608	4.00	2/1/2025	106.31	106.72	4,437	0.43	1.01	
☑	2,002,272	2,002,...	71850932	FG G14450	3.50	10/1/2026	106.23	106.36	2,725	0.38	1.19	2016/09/13

The screen shot above shows that a $2,002,272 15 yr MBS was selected from a hypothetical investment portfolio. The bond price was updated to the evaluation date of 9/13/2016. The MBS is trading at the significant premiumof 106.36. One motivation of selling the bond, perhaps, is to minimize the prepayment risk. Note, the duration of the bond is 1.19 year, much lower than that of a recently issued 15 yr FRM, indicating high probability of prepay.

Once the bond is selected, the summary presents the total unrealized gain. You can continue this process to select the bonds that you may consider selling. Once you have selected the bonds to review for selling, click on the Submit button. Then the bonds you have selected will be treated as a Strategy in Trade Simulation.

Numerical Example

In Trade Simulation, you will find the strategy based on the bonds you have selected for selling the $2mm 15 yr MBS. Now you can use “edit” the strategy and simulate using the funds to originate 30 year FRM (or other loan types.) Trade Simulation allows you to model orginating your loan’s interest rate and other loan features. The simulation results of the strategy of buying $2mm loans and funding them by selling the investments selected is presented below, under Pre-Trade report.

The results show that:

Performance	Base	Pre-Trade	Diff
EVE ratio(%)	12.31	12.31	-
Duration	0.57	0.70	0.13
% EVE Chg up 400	-3.79	-4.20	-0.41
% NII Chg up 400	-17.57	-	17.57
Short Term/Asset(%)	63.27	63.29	0.02
Margin(%)	0.70	0.71	0.01
NII($000)	4,792	4,856	64
Earning($000)	2,127	2,172	45
ROE(%)	2.82	2.88	0.06

- The EVE ratio does not change because the strategy is simply replacing $2mm securities by loans. The total asset value does not change.
- The duration increases by 0.13 year because the 30 year FRM is less asset sensitive than that of the higher premium MBS.
- The increase in balance sheet duration monitors and show that the simulation does not exceed your policy limits for either EVE and NII.
- The yield of the loan is higher than that of the premium MBS and therefore the margin and NII both increase, resulting in a $45,000 increase in Earnings.

This simulation quantifies the impact of a strategy on the balance sheet. This is important because I have often been asked in the cycle review: Why did my trade affect the balance sheet duration so much? By knowing the impact of the trade ahead of time, on the balance sheet, the simulation enables you to attribute the changes in the balance sheet to the risk exposure. Often, the change of the risk profile does not arise from the transactions. Instead, the changes come from the market interest rate levels affecting the likelihood of prepayments of FRMs.

Conclusion:

You can consider selling securities to fund your loan origination when interest rates remain low. By using Bond Monitor and Trade Simulation, you can select bonds to sell, and you can quantify the impact of the strategy on the balance sheet performance beforehand. Many clients say this is also very useful in communicating your proposed strategies with the Board, ALCO or regulators.

If you have any questions regarding using Bond Monitor and Trade Simulation, please do not hesitate to contact THC.

Regards,
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THC is NOT a broker-dealer. THC only offers an analytical platform for clients to work together to meet your customers' needs or your balance sheet requirements. THC does not collect any commission.

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