JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

I. Other Presentations In Which Either The Date And / Or Sponsoring Organization Is Missing

6. Real Estate Finance/Mortgage Banking/Mortgage Guaranty Insurance

j. "Money Risks to Mortgage Lender", no date

Money Risks to Mortgage Lender

I. The risk management process of mortgage lending to date has dealt with individual loans delinquency, default and foreclosure risks, individual institution administrative variance, and institutional and system issues of liquidity and solvency. However, the greatest risk to day are inherent in the score keeping medium itself, namely money.

   A. Money risks are of two types:

      1. Portfolio devaluation due to rising interest rates in the long term
      2. Devaluation due to decline in real value due to long term inflation.

   B. Certainly rising interest rates have prospects of continued inflation are related problems but interest rate volatility over 1-3 year span has also become more significant due to FRB and federal policies.

   C. The interest rate risk and the purchasing power risk both have a real impact on the supply of funds provided intermedearies making mortgage loans and the demand for funds by borrowers. Particularly in home mortgages, rising interest rates quickly make home purchase too expensive for growing numbers of families, generating very unstable construction cycles.

II. The interest risks over the relatively moderate term has been handled with a variety of techniques without requiring much alteration of the standard mortgage form.

   A. From time to time Congress, by allowing the treasury to advance funds to the old FNMA and now GNMA permits the purchase at par of loan portfolios made in years of low interest rates, unlocking thelender from an otherwise devalued portfolio. Fortunately regulators have not required accountants to report mortgage portfolios at present value less some instutions, other than real estate trust suffer serious write-offs of asset and surplus values.

   B. As coops or mutuals the standard S&L mortgage contract in Wisconsin has always given the S&L the right to raise tbe interest rate, a form of assessment on members of the coop philosophically intended to maintain parity between savers and borrowers. An S&L is conceptually an accessible mutual.

      1. In a Milwaukee case the use of this contract rate to raise interest rates on apartment house loans rather than single family loans was determined to be discriminatory by the Wisconsin Supreme Court. Rates had to be raised for everybody or nobody within a given S&L.
      2. In Madison First Federal exercised its rights to raise everybodies and was forced to recind the assessment under the truth and lending rule when some borrowers argued the truth and lending law required that the be thoroughly informed at the time of closing on the possibility of interest increase.
      3. Under the Wisconsin law the borrower must have six months notice and the right to refinance without a penalty should the S&L exercise its standard statutory right.

C. As an alternative S&L's are beginning to use clauses which permit an increase in interest rates due to some technical default by the borrower such as delinquent payment, failure to renew an adequate amount of insurance, etc.

D. Another alternative is to expand the conditions which accelerate maturity of the mortgage note including: at the option of the lender

1. Sale of the property subject to the mortgage
2. Sale of the property under land contract
3. Placing any new encumbrance against the property
4. All of the above utilized the attrition of housing mobility to reduce the average term of a mortgage and permit reinvestment at higher current rates.
5. In Canada they have simply gone to a "rollover" loan which permits the loan to mature every five years but requires the lender to guarantee renewal of the loan balance to the borrower at the current rate of interest. Loans have a standard 25 year amortization and so the constant is recomputed every 5 years.

E. In other countries more elaborate systems are used to establish variable rate mortgage which index interest rates to some internal or external measure of cost to fund and in some countries the balance due is indexed against a measure of purchasing power. These plans will be discussed later in the semester.

III. To protect mortgage originators against interest fluctuation within a 12 month period, a number of new devices have appeared in the past few years including the Fannie May Auction and the Board of Trades Teachers Market.

A. The FNMA auction provides for 30,90, and 360 day commitments to buy eligible mortgages by FNMA to eligible mortgage bankers and traders

1. To protect the small bidder, a certain portion of each months allotment are reserved at the average bid rate
2. It provides the mortgage banker with a fixed cost guatanteed sales price for a portfolio requiring future assembly and closing.
3. The auction bids provide a thermometer of expectations for the immediate future of residential building

B. The Chicago Board of Trades has just initiated a futures market in GNMA collateral trust certificates with a base rate of 8%.

1. Basic price fluctuation unit is 1/32 of a basis point or $31.25 per $100,000 contract. To control daily price fluctuations specialists must limit total spread per day from previous settlement price at 24/32 seconds or $7.50 per contract.

C. Certificates are backed by pools of government insured mortgages and the basic unit provides 8% yield calculated at par under assumptions of a 30 year certificate prepaid in the 12th year. There is a bona fide limit of 600 contracts for any trader not defined as a hedger. A small margin on the teacher's contract is required but it it only an option to buy and therefore there is no unpaid balance and no interest to be paid on margin extended by brokers. Commissions are assessed on a round term, meaning a complete purchase and sale and are assessed when the transaction is completed.