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OPPORTUNITIES IN THE MORTGAGE MARKET

FOR MORE CREDIT UNION STRATEGY & PERFORMANCE VISIT

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Credit unions nationwide held $276.7 billion in first mortgages as of first quarter 2014, according to Peer-to-Peer analytics by Callahan & Associates. That's nearly 42% of the entire portfolio. Mortgages comprise the largest component of credit union lending, but new rules and regulations changing the mortgage landscape could change that. This Callahan Collection offers credit unions a discussion of the Ability-to-Repay Rule and Qualified Mortgage standards as well as presents four strategies to maximize the potential in the mortgage portfolio.

THE LIABILITY IN THE ABILITY TO REPAY RULE

The much-discussed Ability-To-Repay Rule affords borrowers more legal rights to challenge a creditor, but what is the potential liability if an institution fails to verify a borrower's ability to repay?

BY MICHAEL EMANCIPATOR

Dozens of articles have been written about the CFPB's new ability-to-repay rule and the qualified mortgage requirements resulting from it. However, few authors have examined the heart of the issue, which is: What is the potential liability if an institution fails to verify a borrower's ability to repay?

WHAT IS ABILITY TO REPAY?

In 2010, when the country was responding to an unprecedented meltdown in the mortgage market, the Dodd-Frank Act amended the Truth in Lending Act (TILA) and introduced the ability-to-repay (ATR) rule. TILA is designed to inform borrowers about the true terms and costs of consumer credit. Regulation Z, the regulation that implements TILA, requires disclosures that outline the annual percentage rate, the lender's method of determining financing charges, and the total and amount of payments. Reg Z now also includes ATR requirements.

Among other provisions, ATR mandates that "a creditor shall not make a loan that is a covered transaction unless the creditor makes a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability to repay the loan according to its terms."

If the creditor fails to verify ATR, then it might be responsible for certain penalties and damages if the borrower defaults on the loan. ATR gives borrowers more legal rights to challenge a creditor in court, but it also offers more legal protection to creditors who comply with certain conditions that go well beyond ATR requirements. If a creditor meets those conditions, then its mortgages conclusively, or in some cases presumptively, go well beyond ATR requirements and are deemed qualified mortgages (QM).

Most lenders want to limit their legal liability, or be able to sell the loan to the secondary market, so they want to make QM loans. Indeed, most ATR and QM information focuses on how originators can make qualified mortgages and avoid liability. But QM is not a fail safe-safe strategy. QM loans provide a safe harbor and legal protections, but creditors might still be susceptible to legal liability. For example, a borrower who defaults on a qualified mortgage can try to prove the loan is actually not a QM and therefore does not comply with ATR requirements.

The liability risk for QM loans is drastically lower than with non-QM loans; however, liability does exist for both, and it's important for creditors to understand that liability.

KINDS OF LEGAL LIABILITY

In order to understand non-compliance liabilities, credit unions should refer to TILA. Section 1640 of TILA lays out the civil liabilities that can result from violations. These fall under two main avenues: 1) an affirmative cause of action, and 2) a defense against foreclosure in the form of a set-off.

The first legal liability a creditor faces is an affirmative cause of action that allows a borrower to bring suit within three years against a lender that fails to verify ATR. However, borrowers can only use the affirmative cause of action against the original lender. TILA explicitly states assignees are only liable to the extent the violation is apparent on "the face of the disclosure statement." ATR is not a disclosure rule, so the TILA language is not applicable to ATR violations.

The second legal liability a creditor faces is a defense against foreclosure that comes in the form of a set-off. This defense does not prevent foreclosure, but it does implicitly create a judicial foreclosure, which adds time to the process even in non-judicial states. If a borrower is successful in defending against foreclosure, then their penalties are offset against the creditor's claim.

For example, if a court finds a creditor failed to verify ATR on a $200,000 loan and the damages total $50,000, then that $50,000 is offset against the $200,000, which reduces the creditor's claim to $150,000. Unlike an affirmative cause of action, this defense has no statute of limitations and borrowers can use it against any subsequent assignee that attempts foreclosure.

TOTAL DAMAGES FROM LIABILITIES

Section 1640 of TILA outlines how to determine ATR violation damages:

1. Actual damages from failure to verify ATR; PLUS
2. Statutory damages between $400-$4,000; PLUS
3. Consumer's cost of litigation plus reasonable attorney's fees; PLUS
4. Sum of all finance charges and fees paid by the consumer on the loan within three years of ATR violation.

To determine a creditor's total liability for an affirmative cause of action or to determine the damages a borrower can use in a set-off defense, it is helpful to use an example with assumptions. Assume a borrower receives a non-QM loan of $200,000 at 6.0% on a house valued at $220,000. The borrower defaults after three years and has paid 36 months of finance charges totaling $36,000 (for this example, assume the borrower made interest-only payments and paid nothing toward principal). Further assume the creditor moves to foreclose upon the property, but the borrower contests the foreclosure and wins. Using Section 1640 calculations — and assuming there are no actual damages — the court will award the borrower $4,000 in statutory damages, $30,000 in attorney fees, and $36,000 in financing charges (6% on $200,000) to total $70,000. The creditor's original $200,000 claim is now offset by $70,000, which reduces the claim to $130,000, or by 35%.

This example, however, is a worst-case scenario. In the real world, different probabilities will affect the equation. For example, what is the likelihood of a borrower defaulting? Default rates vary widely, but this example will use a 25% default probability, which is likely on the high end. It is important to note that default probabilities are not significantly higher than before ATR went into effect because the statutory cap on damages is $4,000, which means there's no material incentive for a strategic default, and as such, no reason why defaults would increase.

Next, what is the probability the creditor will need to foreclose, and what is the likelihood the borrower will contest a foreclosure? A high percentage of creditors would likely foreclose on a defaulted loan, so this probability could be as high as 90%. The likelihood of whether a borrower will contest a foreclosure depends on if the jurisdiction is in a judicial or non-judicial state. In a Methodology and Assumptions Report, S&P assumes that 35% of foreclosure in a judicial state would be contested; in non-judicial states, it is closer to 25%.

Finally, what percentage of borrowers would be successful in defending a foreclosure? Based on a CFPB study published in the Federal Register when it proposed ATR, TILA defenses on non-QMs have a 50% success rate compared to 20% for qualified mortgages with a higher priced mortgage loan (QM/HPML).

These probabilities are exaggerated for illustrative purposes, and the chances of these events occurring is less likely than modeled. However, planning for 25% of borrowers to default on their mortgages, foreclosing on 90% of those defaults, facing contests in 35% of those foreclosures, and losing 50% of the contestations still results in a loss probability of only 3.9% (0.25 X 0.90 X 0.35 X 0.50 = 0.039).

If a creditor multiplies that 3.9% loss probability by the 35% loss severity (aka, the worst case-scenario), then the average set-off loss from a non-QM would cost 1.37% (0.35 X 0.039). On a loan portfolio with an average balance of $200,000, the average liability risk for a non-QM loan would be approximately $2,740 per loan. Creditors can cover this with a 25-basis-point premium in less than six years.

4 TYPES OF DAMAGES

Section 1640 of TILA uses the following damage types to calculate the total amount of damages arising from a violation of ATR.

ACTUAL DAMAGES

Actual damages are but for the failure of the creditor to verify ATR, the borrower would not have incurred damages. TILA allows borrowers to recover the full amount of any actual damage they sustain from a TILA or Reg Z violation. Most courts will limit actual damages to an amount awarded to a complainant to compensate for a proven injury or loss. However, it's a very high burden of proof for borrowers to meet, and most experts agree that actual damages are too difficult to prove and won't likely be included in total damages calculation.

STATUTORY DAMAGES

Because of the difficulty of proving actual damages, Congress also established statutory damages for violations of TILA, regardless of whether the borrower suffered any harm. These statutory damages range from $400-$4,000.

ATTORNEY'S FEES

The consumer's cost of litigation plus attorney's fees can widely vary, but the CFPB estimated the 60 hours of borrower attorney time and 150 hours of creditor attorney time, both at $150/hour, totals approximately $30,000.

FINANCE CHARGES

Finance charges include the principal and interest paid to the creditor within the first three years of the ATR violation. This also can widely vary, but can be determined using an assumption for modeling purposes.

ADDITIONAL LEGAL LIABILITIES

In addition to borrowers, TILA allows for the CFPB and states' attorneys general to bring an affirmative cause of action against the original lender. However, these actions would likely be less prevalent than the foreclosure set-off defense because there's not likely to be a systemic problem in a creditor's ATR determination like there would be in a faulty disclosures, and even if there was a systemic deficiency in a creditor's ability to determine ATR, loan defaults and foreclosures would be the most likely avenue to discovery. TILA also allows for class action suits. But section 1640(a)(2) of TILA caps class action suits at the lesser of $1 million or 1% of the defendants' net-worth, which would be less damaging to a creditor than the sum total of individual set-off defenses.

UNDERWRITING AND THE QUALIFIED MORTGAGE RULE

In the hands of skilled credit union underwriters, creative loan structures can help deserving buyers acquire affordable homes and achieve the American Dream.

BY CHRIS HOWARD

There are two different-but-accurate ways of looking at the new qualified mortgage (QM) rule. It is a new standard for conforming loans that defines a common form of home mortgage to create an efficient secondary market. It is also a tool of moral suasion to discourage the use of loan types that are safe, sound, and fair to the buyer when used properly and sensibly.

Forty-year terms, higher than average debt-to-income or loan-to-value ratios, low credit scores, interest-only loans, balloon payments, and higher than average points and fees … these are practices that were abused during the 2000s to put people in houses they couldn't afford and should not have been buying. But in the hands of skilled, experienced credit union underwriters, they are also responsible ways to help buyers acquire homes they can afford and keep.

The QM rule locks loans with these terms out of the core secondary market, hurting the hardworking, middle-class Americans the original conforming standard was conceived to help. That's a problem for credit unions because these folks comprise a large cohort of member-owners who depend on their credit unions to tailor mortgages to meet their individual needs. That was simple when a credit union could sell any properly underwritten conventional loan to a GSE, but with the tight new constraints of the QM rule, things are different.

So what's a credit union to do? The popular press would have us believe the QM is like a seal of approval and anything non-QM is somehow substandard, subprime, or even sub-ethical. That's nonsense. In credit terms, there is no difference between a conforming loan that a credit union would have made on January 9, 2014, and a conforming loan that does not qualify for GSE purchase because it was made after January 10. Credit union leaders, management, and boards need to understand this; there is nothing wrong with a non-QM loan.

The difficulty with these loans is their lack of liquidity. For the time being, credit unions must hold them in portfolio. This entails interest rate risk and the potential for concentration risk. Unfortunately, there is also a modicum of additional liability risk because of the new ability-to-repay (ATR) rule. As with QM, it's important for credit unions to understand the difference between the hype and the facts regarding ATR. It's also important to understand the illogical relationship between QM and ATR.

THE RELATIONSHIP BETWEEN QM AND ATR

ATR is the codification of good underwriting and record-keeping practices — things credit unions should already be doing. To comply with ATR, the lender must make "a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability to repay the loan according to its terms." The lender must also document this effort. However, ATR was written as an amendment to the Truth-in-Lending Act (TILA). TILA is a disclosure rule, but ATR is not about disclosure. This creates a disconnect between the application of the rule and the consequences of failing to comply with it.

Because ATR is part of TILA, it does not create new liability for creditors as much as more of the same type of liability they already face. As in the rest of TILA, there is the limited possibility of affirmative legal action, including the possibility of a class action lawsuit against the lender by borrowers or regulators. In addition, all creditors — originators and investors alike — also face broader exposure to the set-off defense in the case of foreclosure.

In other words, ATR is a reasonable and manageable, "To comply with ATR, the lender must make 'a reasonable and good faith determination at or before consummation that the consumer will have a reasonable ability to repay the loan according to its terms.'"

if poorly located, standard. Or at least it would be if not for a third legislative non sequitur. As established, QM is a set of restrictive loan terms masquerading as a conformance standard and ATR is an underwriting standard pretending to be a disclosure rule. The third leg of this bizarre stool is the QM exemption to ATR.

THE THIRD SHOE DROPS

QM and ATR are unrelated in function, but they are both provisions of Dodd-Frank. This shared parenthood is the only justification for a so-called safe harbor from compliance enforcement. If a mortgage complies in form with all the restrictions of the QM rule, the lender is presumed to have complied in practice with all of the totally different obligations of ATR. Although this makes no sense, it means lenders making QM loans are effectively exempt from ATR rules on those loans. This has the triply unjust result of stripping many borrowers of a meaningful form of consumer protection, focusing all compliance efforts on a small subset of loans to which ATR applies, and exacerbating the conflation between "non-QM" and "somehow toxic."

Despite this web of illogic and inconsistency, credit unions can and should continue to make mortgage loans that best meet the particular needs of their member-owners. Remember, a well-underwritten, carefully configured loan can be safe, sound, and sensible even if it isn't QM-compliant. The risks are largely known and can be managed, and the following considerations can help credit unions do just that.

The only true unknowns regarding the liability of non-QMs relate to court behavior.

- How liberal will the courts be in allowing class actions and class action discovery, which can be burdensome?
- How high a bar will the courts set regarding what satisfies as proof of ATR compliance?

Class action exposure is limited.

- Affirmative legal actions can only be brought within three years of origination and class actions can apply only to loans less than three years old.
- Liability exposure is capped at the lesser of $1 million or 1% of the lender's net worth. This is a lot of money for a credit union, but not for a class action, which will limit the motivation for bringing such a suit.

The longer a loan is in repayment, the stronger the evidence of ATR compliance, particularly for fixed-rate loans and ARMs that have not reset.

The nature of the set-off defense means the party in default cannot collect any cash.

Total financial exposure from the set-off defense is limited to not more than three years of interest payments plus reasonable attorney's fees and up to an additional $4,000 set-off.

- In total, this is not enough to drive additional strategic defaults in which the borrower triggers foreclosure to game the system.
- Because this amount is known, and default rates are also known for various types of loans, credit unions can factor a provision for this exposure into the cost of the loan.

A 25-basis-point premium in the mortgage rate more than covers the worst-case scenario of ATR exposure with non-QM loans over the average seven-year life of a loan.

— Michael Emancipator contributed to this article.

3 TIPS TO TRANSITION FROM A REFI TO A PURCHASE MORTGAGE MARKET

How credit union mortgage departments can rethink their strategies to survive in a market with decreased refinancing opportunities.

BY DREW GROSSMAN

On January 9, 2009, long-term mortgage rates fell below 5% for the first time in recent history. The market took advantage and homeowners flocked to financial institutions to refinance their mortgages and reduce their monthly payments. The week was an indication of the record refi year to come and of the coming refinance boom. Now, March 2014 data from the Mortgage Bankers Association shows applications for refinancings are down nine percentage points from five months ago and account for 56.5% of all mortgages.

"With the refi business taking a step back, every business would be prudent to start taking a look at expanding on their purchase money market," says Tisha Hartman, director of real estate lending at KeyPoint Credit Union ($865.9M, Santa Clara, CA), whose refinancings account for approximately 72% of its mortgage portfolio.

According to Coldwell Banker's Home Listing Report, five out of the top 10 most expensive real estate markets in the United States are located in and around KeyPoint's San Francisco Bay-area headquarters, and KeyPoint is still flush with jumbo mortgages in need of refinancing. Jumbos loans exceed the loan limits set by the Office of Federal Housing Enterprise Oversight, meaning Fannie Mae and Freddie Mac will not purchase them, so lenders usually charge higher interest rates and approve lower loan-to-value ratios for refinances. When home values decrease, as many did during the housing crisis, consumers holding a jumbo loan can have troubles meeting the LTV criteria and must put off refinancing until property values start to increase, as they did in 2012 and 2013.

Although KeyPoint's refinance business has yet to slow, leadership is aware of the changing market and it is preparing for the shift to a purchase market in 2014. But like credit unions across the country, KeyPoint is faced with one key question: As refinance opportunities taper out, how do we transition to a pragmatic purchase mortgage market?

Here are three tips to make the shift. »

> "Inevitably, losses will happen when you step out of the typical box. Price that riskier business to the point where it makes sense when the credit union incurs losses."

DATA AS OF 12/21/13

CU QUICK FACTS

KeyPoint Credit Union
SANTA CLARA, CA

$865.9M
ASSETS

42,244
MEMBERS

4.67%
12-MO SHARE GROWTH

23.17%
12-MO LOAN GROWTH

0.52%
ROA

1. CONSISTENTLY DELIVER HIGH-QUALITY SERVICE

For consumers, the pressure to process a purchase mortgage and close on a home is on.

"There's a certain type of urgency in the purchase world that many refinance lenders are not accustomed to," Hartman says. "There are a lot of moving parts that need to be managed, and a lender that cannot successfully do that, no matter how strong their products are and how strong their rates are, is going to fail."

Credit union lending departments need to be ready to turn on a dime to service mortgages in highly competitive housing markets. A reputation as slow, even if steady, can squash opportunities to lend.

2. PARTNER ANALYTICS WITH GRASSROOTS RELATIONAL DATA TO UNDERSTAND THE MARKET

It's important to understand what homebuyers are purchasing, what realtors are leveraging for financing, and what needs the all-around market has. To do that, get out into the community and build relationships with agents.

"My business strategy is to work with fewer people but go deeper in those relationships," says Faye Nabhani, chief lending officer at KeyPoint. "It allows you to maintain a higher level of control and accountability throughout the process for both parties."

Partner those grass-root, deep connections with market analytics to confirm trends heard from sources.

"Do a sanity check," Nabhani says. "You're hearing all of this data from your resources and your relationships, but you also need to be watching industry trends in your area."

3. MEET THE CREDIT UNION CREDO: TAKE ON RISK TO HELP MEMBERS

According to Hartman and Nabhani, there is an opportunity for credit unions to make a meaningful difference to members by creating mortgage products that banks and other financial institutions won't touch because they are unwilling to take on the risk. But remember, as the credit union takes on more risk, it must also set limits and understand risk allowances for higher loan-to-value offerings.

"Inevitably, losses will happen when you step out of the typical box," Hartman says. "Price that riskier business to the point where it makes sense when the credit union incurs losses."

TO GET NEW BUSINESS, THINK LIKE A BUYER

Four ways that cooperatives can attract first-time homebuyers and ramp up their purchase mortgage activity.

BY AARON PUGH

Where first-time homebuyers are concerned, good rates aren't everything. A lender who is willing to guide them through the home-buying process, however, is priceless.

But before a credit union can demonstrate its friendly philosophy to buyers, it must entice them through the door. That can be hard to do because many first-time buyers face all sorts of obstacles to homeownership. Demographics, poor credit, and challenging local housing markets all play a role, sometimes simultaneously.

Below are four ways that cooperatives can better attract first-time buyers and ramp up their purchase mortgage activity.

1. BELIEVE IN THE TRANSFORMATIVE EFFECT OF HOME OWNERSHIP

First-time homebuyers come from all demographic groups, and credit unions can't afford to overlook any of them. According to 4Q 2013 data from the US Census Bureau, home ownership rates for those under 35 — the median age for first-time buyers — is just 36.8%, roughly half the rate of those ages 45 and up. Even more disturbing is the fact that there is up to a 30% difference in ownership rates between white borrowers and people of other races and ethnicities.

Exceptions to these discouraging trends do exist, but they are hard fought and forged — often cropping up in the most unexpected of places.

For example, mortgages currently make up the lion's share of the loan portfolio at Hope Credit Union ($187.8M, Jackson, MS), which aims to fill the capital gap that disproportionately affects entrepreneurs, women, and people of color along the Mississippi Delta. About 86% of the mortgage loans that Hope made last year went to first-time homebuyers, a large percentage of whom were also minority, female, or low-income individuals.

These "high-impact loans," as the credit union calls them, help improve the region's economy while breaking the cycle of poverty that has plagued some local families for generations. Although you won't see it catalogued in a call report, a full 60% of Hope's homebuyers last year reported that their kids did better in school because they lived in a safer neighborhood.

"I really think it is a matter of will," says CEO Bill Bynum of Hope's commitment to these borrowers. "There are certain communities that others are walking away from, but as a credit union, our profits are directly tied to the fate of our members."

2. SEE THE FIELD FOR THE FLOWERS, NOT THE THORNS

The recession was a financial battlefield for many Americans, but even today, so many institutions remain hesitant to triage the wounded, preferring instead to label all less-than-perfect borrowers dead on arrival.

That approach simply doesn't fly at Hope, where the institution's three-person mortgage underwriting team frequently connects non-traditional homebuyer candidates to opportunity despite abundant obstacles, including an average borrower income of around $40,000 and marred or non-existent credit histories as par for the course.

"If someone doesn't fit traditional underwriting criteria, we see if there are less significant items like a phone bill or a subscription that hasn't been paid and is causing issues," says Shirley Bowen, Hope's senior vice president of mortgage lending.

If the lapse was more significant, including missed payments for rent or a car loan, the credit union then determines whether it was because of a temporary setback like medical bills that were beyond the borrower's control.

Long before the Consumer Financial Protection Bureau began recommending such measures to financial institutions, Hope had proactively adopted the VA method of residual income for weighing a borrower's ability to repay. This method not only takes into account how much money the borrower has left after paying monthly bills but also varies qualifications by region so that those in low-income areas aren't shut out.

By looking beyond superficialities, Hope has been able to grow its adjustable and fixed real estate loans by 2% and 8% respectively year-over-year while keeping mortgage-related delinquencies at a manageable 50 basis points.

3. GRANT ACCESS FOR SPECIAL CASES

The first rule of real estate is location, location, location. So perhaps it's surprising that many cooperatives that have excelled in the first-time homebuyer space are not necessarily located within some uncanny bubble of real estate opportunity. Sometimes in fact, it's just the opposite.

For example, Jackson currently has an abundance of vacated property thanks to decades of economic hardship, the more recent recession, and a mass exodus of the middle class. However, Hope's affordable housing product — which sometimes uses a grant to lower the LTV ratio and allows borrowers to go as high as 100% financing following a comprehensive credit counseling process — has proven an effective tool for encouraging members to participate in alleviating this inventory and improving neighborhood home values.

By working with the Federal Home Loan Bank of Dallas and Home Again, Inc., Hope also provides funding to secure and rehabilitate foreclosure properties and get them back on the market affordably for families in need.

Because first-time homebuyers aren't typically known as big spenders, regions with especially high demand or inflated home values can also present their own set of challenges. In March 2013, home purchases by cash-laden investors rose 40% year-over-year compared with just 2% growth for other buyers, according to a study by Radar Logic, a data and analytics firm.

A combined mortgage and renovation loan, which many credit unions offer, is a great way to help first-time borrowers better compete for fixer-upper opportunities.

In more rural markets where buyers may have the means but can't find properties to suit their needs, some coopertatives may also choose offer a construction-to-permanent mortgage loan.

Typically, this type of loan would require a huge up-front investment from the borrower, says John Phipps, the chief lending officer of Heritage Federal Credit Union ($474M, Newburgh, IN), and this can knock many first-time buyers out of the running. Most are also balloon loans, requiring a refi at the end of the building process.

To remove these roadblocks, Heritage currently offers a fixed loan with a one-time close that requires as little as 5% down. Although the member pays interest during construction, once the house is finished the loan is amortized over the remaining term at the rate initially agreed upon.

This and other purchase-oriented products have helped Heritage tune in to the needs of local borrowers. And as of 1Q 2014, roughly 40% of its mortgage loans have gone to first-time buyers.

4. MAKE NEW CONNECTIONS

To encourage home purchases, credit unions typically need realtor and broker partnerships, but competition for these partners is fierce. That's why credit unions looking to get ahead with first-time borrowers should also pay attention to all the other feeders and channels that these individuals rely on to educate themselves and influence their decision-making.

"At Heritage, we're looking to do some continuing education programs to bring realtors in and make them aware of what we have," Phipps says. "But our mortgage originators are also getting involved in networking groups that are not traditional."

Everyone calls on realtors, but accountants and financial planners have clients who need mortgages too, he says.

In many markets, virtual connections have become just as important as human ones. According to the National Association of Realtors, 43% of buyers in 2013 found their dream homes using the Internet while only 33% discovered the properties through a real estate agent.

Even if your members are disinclined to shop for a home online, they probably still view the Internet as a prime channel for researching the buying process and comparing their financing options.

For example, at Hope, a self-guided online program from the Housing Partnership Network and Minnesota Homeownership Center called FRAMEWORK allows potential first-time homebuyers to learn more about the terminology, processes, and professionals involved, including lenders, home inspectors, and realtors.

These electronic offerings can be convenient, says Laura Howe Repp, Hope's senior vice president of community development. But they're no replacement for in-person counseling.

HOW TO CREATE A STRONG MORTGAGE BRAND

GTE Financial's five-day guarantee assures homebuyers their closing documents will be ready to sign when they are.

BY ANDREW BOLTON

During a breakout session at the 2013 American Credit Union Mortgage Association (ACUMA) annual conference, Joe Brancucci, CEO of GTE Financial ($1.6B, Tampa, FL), talked about a personal mortgage closing experience. When Brancucci started at GTE, he moved across the country from Seattle to Tampa. He scheduled the closing for his new home on the Friday before he was to start as CEO, but when he arrived at the credit union, not GTE, to sign the closing papers, they weren't ready. The credit union told him he would have to wait until Monday. Brancucci reached out through his credit union connections, which included the CEO of the institution that had his mortgage, and was able to close as planned.

The experience made Brancucci question whether this was a regular practice across Florida, and after asking around, he discovered it was. The new CEO recognized an opportunity for GTE to create a strong brand in the mortgage market by promising to deliver closing papers in advance of the closing date. GTE now guarantees to deliver closing papers to the title company five business days prior to the closing date for purchase money mortgages. Brancucci brought the idea from his previous credit union, BECU, which had implemented a similar strategy.

To date, GTE has been successful in hitting its five-day promise and delivers the papers early nearly 100% of the time, according to Brancucci.

"We created a brand, the brand was dependability," Brancucci said during the conference. "We knew how to do this [and] we were professional.

This improved brand helped GTE increase its mortgage market share in the Tampa metropolitan area from 1.14% in 2011 to 1.81% in 2012, an annual improvement of 67 basis points according to Home Mortgage Disclosure Act (HMDA) data. Efforts like this in conjunction with its HARP loans promotions helped GTE become the largest credit union mortgage originator in Florida.

"We want to be known as THE home loan lender in the state of Florida," Brancucci said at MACUMA.

In 2011, GTE sold $70 million of mortgages to Fannie Mae and Freddie Mac. That number increased to more than half a billion in 2012. The jump was a direct result of GTE increasing its first mortgage origination nearly six fold from 2011 to 2012, going from $99.5 million to $573 million. The increased non-interest income generated from these mortgage sales helped the earnings of the credit union, too, which increased from 27 basis points in 2011 to 56 basis points in 2012.

The refinancing boom is over, and credit unions are now shifting their focus to purchase mortgages. To remain competitive, the industry must now look for opportunities to elevate service and expectations. Members, realtors, and title companies are more inclined to do, and refer, business with financial institutions they can rely on to have closing papers ready in advance. All it takes is changing the internal expectations at the credit union of when it will deliver the papers.

A STRATEGY TO KEEP MEMBER MORTGAGES IN PORTFOLIO

In this Q&A with Brian Ross, the SVP and treasurer of Star One Credit Union discusses why Star One holds nearly all of its 30-year fixed-rate mortgages in-house and what that means for asset liability management.

INTERVIEW BY SHARON SIMPSON

In 2012, credit unions originated more than $300 billion in total loans, $123 billion of which was in first mortgages. In the first quarter of 2013, first mortgage originations reached $31.2 billion. That's up 19.3% versus the first quarter of 2012. Despite the accelerating origination volume, first mortgage balances — which credit unions hold in their portfolios — are up only 5.2% over the same period last year. This is largely the result of sales to the secondary market.

During the first quarter, credit unions sold $18.1 billion in first mortgages to the secondary market. That's a new high for the quarter and is nearly 60% of the quarter's originations. The sales held the ratio of fixed rate first mortgages to total industry assets at 14.5, which is unchanged from one year ago.

Record numbers of credit unions are selling mortgages as part of an asset liability management strategy; however, Star One Credit Union ($6.4B, Sunnyvale, CA) is bucking that trend. Despite the institution's 12-month loan growth of 6.72% — which is stronger than credit unions with more than $1 billion in assets, 5.76%, credit unions in California, 1.38%, and all credit unions nationally, 5.35% — Star One holds the majority of its mortgages in-house.

Here, Brian Ross, senior vice president and treasurer of Star One, discusses the credit union's ALM strategy.

DOES STAR ONE HOLD ALL OF ITS 30-YEAR-FIXED MORTGAGES IN PORTFOLIO?

BRIAN ROSS: On occasion we sell a few loans to test our ability to sell to Fannie Mae so we know that option is available. Apart from that, we hold almost all our mortgages in our own portfolio. We offer other mortgages in addition to the 30-year-fixed, but the 30-year-fixed is the majority as that is what our members want.

HAS THE CREDIT UNION ALWAYS KEPT MORTGAGES IN ITS PORTFOLIO OR IS THIS A NEWER STRATEGY?

BR: I've been at Star One for approximately eight-and-a-half years, and the credit union has kept mortgages in its portfolio as long as I've been here. I believe the credit union did sell some of its loans prior to that, but the portfolio strategy has been in use for nearly a decade at least.

HOW DO YOU HEDGE AGAINST THE INTEREST RATE RISK?

BR: We borrow from the Federal Home Loan Bank at a fixed rate. Through the borrowings, we match funds — not dollar for dollar but pretty close — to offset the interest rate risk. We also test our borrowing strategy every six months to see how it compares against our other options, specifically, if we had sold the loans or not hedged versus hedging with the borrowings.

DO YOU CONDUCT THE TESTING INTERNALLY OR DO YOU USE AN OUTSIDE FIRM?

BR: We model it ourselves, but we use an outside source to calculate our current average life estimate every six months so we can put that in our modeling. We have policy ranges regarding how much we're going to borrow and for how long. ALCO (asset liability committee) reviews the ranges each month along with an estimated amount that's in the pipeline. We try to borrow before we fund. We have a large pipeline and want to avoid borrowing after the fact.

IS THERE AN ONGOING EDUCATION PROCESS TO HELP THE BOARD UNDERSTAND THE HEDGING STRATEGY?

BR: Yes, absolutely. We share all of our reports with the board every six months. I also put together an annual department summary and incorporate more information on the hedging strategy.

HOW MANY PEOPLE ARE IN THE FINANCE DEPARTMENT?

BR: I'm the senior vice president and treasurer. I have an asset liability manager that works for me. And that's the finance department. I report to the CFO and there is a separate accounting department that is made up of six employees, a manager, and a controller.

DO YOU THINK CREDIT UNIONS NEED TO HAVE A CERTAIN ASSET SIZE TO EMPLOY A SIMILAR STRATEGY?

BR: No, not at all. Risk is risk. Whether you are a $100 million institution or a $5 billion institution, you're going to face the same challenges when rates change. The beauty of using the FHLB is it will do any size borrowing and customize it to what you need, so there are no real economies of scale. As this has ramped up and mortgages have become a larger part of our portfolio, we haven't had to add staff at all.

WHAT ADVICE WOULD YOU HAVE FOR ANOTHER CREDIT UNION CONSIDERING THIS STRATEGY?

BR: In 2009 we started adding a call option to all of our borrowings. Basically, this gives us the right to give the funds back to the home loan bank after a year and then quarterly thereafter. Since 2010, when our first call option came up, we have called more than $600 million of our borrowings, which has saved millions in interest expense. It all depends on how you've structured your mortgage products, though. At Star One, refinancing is easy for members, which is why we added the call option to our borrowings. If rates dropped substantially and we had a lot of modifications or refinances, borrowing a ladder just wouldn't have worked. Adding a few extra basis points for the call option was a no-brainer.

My other piece of advice is to track how your borrowing program is performing versus the amount of refinancing and modifications you're doing. We know the exact cost versus the benefit of the program because we are always tracking it.

Q&A **BRIAN ROSS**
SENIOR VICE PRESIDENT AND TREASURER, STAR ONE CREDIT UNION

DATA AS OF 06/30/14

CU QUICK FACTS

Star One Credit Union
SUNNYVALE, CA

$6.7B
ASSETS

91,904
MEMBERS

5.86%
12-MO SHARE GROWTH

3.74%
12-MO LOAN GROWTH

0.89%
ROA

ARE THERE OTHER BENEFITS TO KEEPING THE MORTGAGES AS PART OF STAR ONE'S PORTFOLIO?

BR: One of the main benefits is you're able to provide service. You still have control of the loans so you can make refinancing easier. If you sell the loan and retain the servicing, you no longer have the ability to do easy modifications or refinances; you have to do a completely new mortgage. At Star One, we allow members to lower their interest rate for a fee (read Star One Builds Loyalty With Streamlined Modifications). We don't extend the term of their loan, but they don't have to go through the appraisal process or re-qualify their income for a lower rate. This has been popular with members as it makes their existing mortgage with us more affordable and the credit union gains member loyalty. From June 2011 through March 2013, we've modified more than $2 billion in mortgages at an average savings to members of 56 basis points.

DO YOU HAVE OTHER LESSONS LEARNED OR ADVICE TO SHARE?

BR: It's critical to make sure you can prove your hedging strategy is working — run your reports, educate your board, track your average life, and stay on top of the net economic value. It has been hard for credit unions flush with liquidity to borrow, but it's an insurance policy. You might not need it, but if you do, it can protect you.

Taking your investment portfolio into consideration is important as well — we use it to hedge our real estate exposure by keeping our investment duration short. Our effective duration in our investment portfolio only goes out two years. Even if rates were to go up by 400 basis points, it would only extend to two-and-a-half years. You need to be disciplined on the investment side if you're going to portfolio your real estate loans. Another item to note is that the FHLB accepts securities as collateral.