FHN FINANCIAL
CAPITAL ASSETS CORP.

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WEEKLY COMMENTS

Retained Mortgage Portfolios Are More Dynamic Than Ever

If I had a nickel for every time I've heard, "2020 has been a year like no other," I'd own an island. Historically, the size and composition of the typical mortgage portfolio change slowly over time as older loans amortize, some pay off, and new loans are added to the balance sheet. In a normal year, the quarter-to-quarter organic change of your mortgage portfolio happens slowly, but as the tiresome saying goes — "2020 has been a year like no other." When rates dropped to historic lows in March, new loan production volume skyrocketed and prepayment speeds accelerated to all-time highs. These two dynamics, combined with an unusually high concentration of refinancing, caused many portfolios to experience remarkable changes in a relatively short period of time. It's not only changes to the size of the portfolio that is happening so rapidly, but also the composition and risk profile. Without keeping our information updated just as rapidly, we risk it going unnoticed or, at best, undernoticed.

We're all functioning through a time period riddled with unknowns, so without historical reference on how we should be handling the current situation, now more than ever customers are wanting to know if their portfolios are doing anything similar to other portfolios. The last of the Q2 data mortgage databases have been processed and incorporated into our massive $10 trillion Peer and Trend Database, and retained portfolios are on the move.

During the spring, prepayment speeds had reached such fast levels that we thought they surely couldn't be any faster. The fast prepayments were being driven by an unusually high concentration of refinance loans, which commonly exceeded 70% of the pipeline. At some point, you reach "prepay burnout" when almost everyone that would benefit from a refinance has done so. When we began running Q2 PPAs and prepayment studies, we realized we were not anywhere near burnout. The large spike at the end of the graph below is Q2 prepayment speeds averaging at a blistering 33.1%, up from an already hot 19% in Q1, with many portfolios experiencing even faster speeds.

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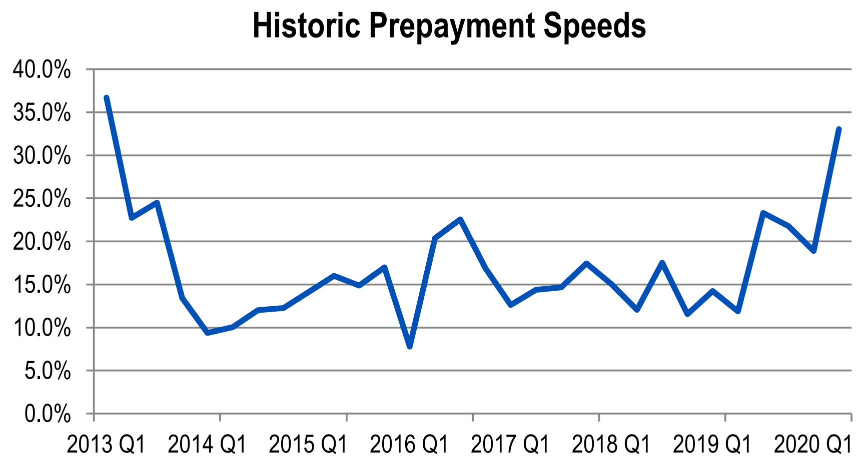
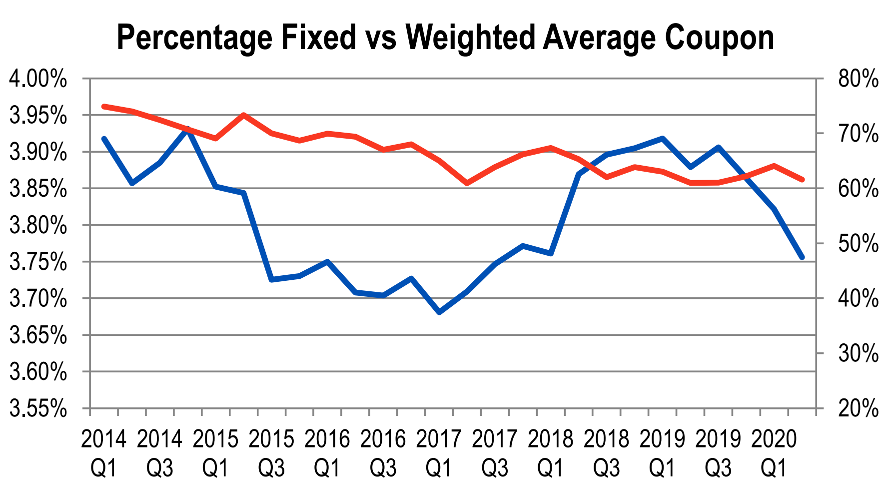


Source: FHN Financial Capital Assets Corp.

You can see from the graph that we haven't seen speeds within retained mortgage portfolios this fast since 2013. All of this churn within portfolios means changes are happening fast and, without careful monitoring and active management, that could result in a post-pandemic portfolio that looks very different than before. If those changes are complementary to your balance sheet, that's great, but the trends we're seeing indicate some warning signs that will present problems further down the road.

IRR/Yields/Fixed vs Adjustable

With so many different challenges being faced today, duration or IRR has not been at the top of the list. We've spoken many times about the extremely "sticky," long-low mortgages that have been coming out of the Great Recession. Rates moved up, originators kept trying to originate at the higher levels, but yet the yield on the retained mortgage portfolio never seemed to budge. Finally, in 2018, we began to see some noticeable upward mobility in portfolio yields. During the first quarter of 2020, we were hit with COVID-19 and the ever-slow adjusting mortgage portfolio has changed dramatically through the first two quarters of 2020. Yields within retained portfolios lead the charge, dropping 10 bps from year-end to June 30.

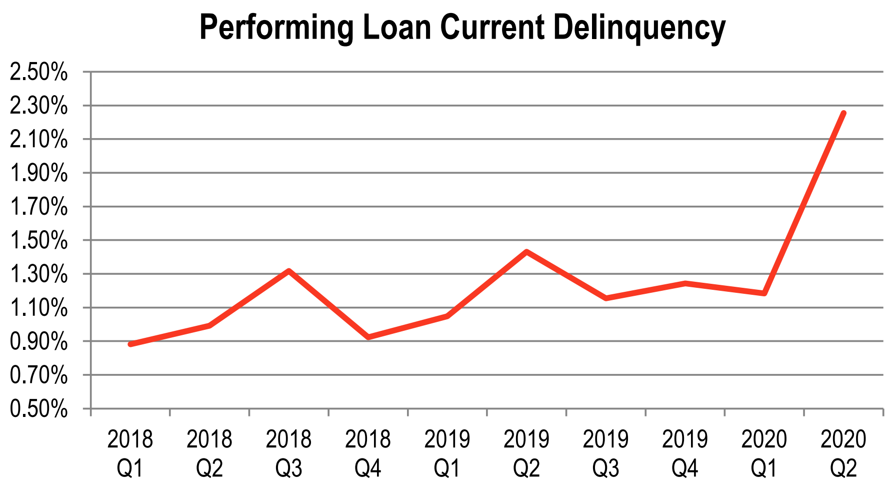


Source: FHN Financial Capital Assets Corp.

Interestingly, this wave of lower-coupon loans is distinguishing itself slightly from the long-lows peak of 2014 by keeping the fixed-to-adjustable ratio stable at just over 60/40. Unfortunately, there is also a difference in what is currently making up those long-lows, loans with the vast majority of the interest rate risk within a portfolio. Back in 2014 when fixed-rate loans hit their peak and made up more than 70% of the average portfolio, about half of those fixed-rates were long-lows. At the time, we were concerned about that 50%. Today, while the percentage of overall fixed-rates has come down, the percentage of fixed that fall into the long-low category continues to increase. While it has remained fairly consistent through 2019, in Q2 2020 we saw it begin to inch back up again to 67% of fixed-rate loans.

Delinquency

Another trend that we're keeping our eye on is the delinquency rate which has been creeping up within portfolios.



Source: FHN Financial Capital Assets Corp.

It's no secret that many good borrowers have been impacted by the economic and social challenges COVID-19 has inflicted on us all. We know through our Forbearance Risk Assessment ("FRA") data that many customers were granted generous deferments on their payments. The vast majority were able to resume their regularly scheduled payments after the deferment period, and some even continued to make regular payments while under the grace period. But, inevitably there has been some increase in overall delinquency rates within retained portfolios. Historically, even through much of the Great Recession, current delinquency rates almost never cracked 2% of the portfolio. In Q2 2020, we saw a 2.3% DQ rate, although we anticipate this being a short-lived blip in the data. Still, over 80% of the portfolio continues to be Investment Grade, which speaks to the conservative underwriting standards of our customers. Additionally, collateral has so far managed to maintain value in most areas of the country. But as we move through the pandemic, delinquency is a data point we will also be monitoring closely.

Monitor and Pivot

Is your portfolio handling 2020 in line with peers, or are there areas that may require some strategic action? How are you supposed to be able to catch a negative trend running off with your portfolio at historic speeds before the damage requires an even bigger fix? By running an FRA, you can keep your eye on how many loans within the portfolio are being directly impacted by COVID-19 and the specific lockdown restrictions in your area and the potential loss impact of any defaults within the portfolio. In *Weekly Comments* just last week, Tom McLemore highlighted the strong secondary market for distressed assets/problem loans should a balance sheet cleanup at some point be in order. If a dwindling portfolio balance on your largest interest-earning asset or if a composition-shift towards fixed-rates is becoming concerning, our Supplemental Loan Program ("SLP") is geared towards being flexible as both a short-term fix if there needs to be a small counterbalance to market pressures or available on a long-term basis if fundamental change outside of organic originations is needed. Even if you are one of the few institutions that are not seeing dramatic changes within the portfolio, right now the phrase "knowledge is power" has never been more important. Knowing what market changes are directly impacting your portfolio, how your portfolio compares to regional and national peers, and what strategic options might be available as needs arise will provide a perspective that will help you to better understand and manage your seasoned mortgage portfolio through this unusual time. A full copy of the Q2 2020 FHN Financial Capital Assets Corp. ("Capital Assets") Quarterly Peer and Trend Analysis of Seasoned Portfolio Mortgages is linked below. Contact your sales representative or Capital Assets directly at 800.456.5460 to get your own individual trend and peer analysis run today.

Q2 2020 Quarterly Peer and Trend Analysis of Seasoned Portfolio Mortgages