Mortgage loan portfolio optimization using multi-stage stochastic programming

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Abstract

We consider the dynamics of the Danish mortgage loan system and propose several models to reflect the choices of a mortgagor as well as his attitude towards risk. The models are formulated as multi-stage stochastic integer programs, which are difficult to solve for more than 10 stages. Scenario reduction and LP relaxation are used to obtain near optimal solutions for large problem instances. Our results show that the standard Danish mortgagor should hold a more diversified portfolio of mortgage loans, and that he should rebalance the portfolio more frequently than current practice.

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1. Introduction

1.1. The Danish mortgage market

The Danish mortgage loan system is among the most complex of its kind in the world. Purchase of most properties in Denmark is financed by issuing fixed-rate callable mortgage bonds based on an annuity principle. It is also possible to raise loans, which are financed through issuing non-callable short term bullet bonds. Such loans may be refinanced at the market rate on an ongoing basis. The proportion of loans financed by short-term bullet bonds has been increasing since 1996. Furthermore, it is allowed to mix loans in a mortgage loan portfolio, but this choice has not yet become popular.

Callable mortgage bonds have a fixed coupon throughout the full term of the loan. The maturities are 10, 15, 20 or 30 years. There are two options embedded in such bonds. The borrower has a Bermudan type call option, i.e. he can redeem the mortgage loan at par at four predetermined dates each year during the lifetime of the loan. When the interest rates are low the call option can be used to obtain a new loan with less interest payment in exchange for an increase in the amount of outstanding debt. The borrower has also a delivery option. When the interest rates are high this option can be used to reduce the amount of outstanding debt, in exchange for paying higher interest rate payments. There are both fixed and variable transaction costs associated with exercising any of these options.

Non-callable short-term bullet bonds are used to finance the adjustable-rate loans. The bonds’ maturities range from 1 to 11 years and the adjustable-rate loans are offered as 10, 15, 20 or 30-year loans. Since 1996 the most popular adjustable-rate loan has been the loan financed by the one-year bond. From 2001, however, there has been a new trend, where demand for loans financed by bullet bonds with 3 and 5-year maturities has risen substantially.

1.2. The mortgagor’s problem

It is known on the investor side of the financial markets that investment portfolios should consist of a variety of instruments in order to decrease financial risks such as market, liquidity and currency risk while maintaining a fixed level of return. The portfolio is also rebalanced regularly to take best advantage of the moves in the market.

The portfolio diversification principle and rebalancing is, however, not common in the borrower side of the mortgage market. Most mortgagors finance their loans in one type of bond only. Besides they do not always rebalance their loan when good opportunities for this have arisen.

There are two major reasons for the mortgagors reluctance to better taking advantage of their options (that they have fully paid for) through the lifetime of the mortgage loan:

1. The complexity of the mortgage market makes it impossible for the average mortgagor to analyze all the alternatives and choose the best.
2. The mortgage companies do not provide enough quantitative advice to the individual mortgagor. They only provide general guidelines, which are normally not enough to illuminate all different options and their consequences.


We assume in the following that the reader is familiar with the dynamics of a mortgage loan market such as the Danish one, as well as the basic ideas behind the mathematical modeling concept of stochastic programming.

The Danish mortgagor’s problem has been introduced by Nielsen and Poulsen (2004) (N&P). They use a two-factor term structure model for generating interest rate scenarios. They have developed an approximative pricing scheme to price the mortgage instruments in all nodes of the scenario tree and on top of it have built a multi-stage stochastic program to find optimal loan strategies. The paper, however, does not describe the details necessary to have a functional optimization model, and it does not differentiate between different types of risks in the mortgage market. The main contribution of this article is to make Nielsen and Poulsen’s model operational by reformulating parts of their model and adding new features to it.

We reformulate the Nielsen and Poulsen model in Section 2. In Section 3, we model different options available to the Danish mortgagor, and in Section 4, we model mortgagor’s risk attitudes. Here, we consider both market risk and wealth risk.

In the basic model we incorporate fixed transaction costs using binary variables. We use a non-combining binomial tree to generate scenarios in an 11 stage problem. This results in 51175 binary variables, making some versions of the problem extremely challenging to solve. Dupačová et al. (2003) and Heitsch and Römisch (2003) (Scenred) have modeled the scenario reduction problem (SRP) as a set covering problem and solved it using several heuristic algorithms. We review these algorithms in Section 5 and use them in our implementation to reduce the size of the problem and hereby reduce the solution times. Another approach to getting shorter solution times is proposed in Section 6, where we solve an LP-approximated version of the problem. In Section 7, we discuss and comment on our numerical results and we conclude the article with suggestions for further research in Section 8. We use GAMS (general algebraic modeling system) to model the problem and CPLEX 9.0 as the underlying LP and MIP solver. For scenario reduction we use the GAMS/SCENRED module (scenred manual).

The obtained results show that the average Danish mortgagor would benefit from choosing more than one loan in a mortgage loan portfolio. Likewise he should readjust the portfolio more often than is the case today. The developed model and software can also be used to develop new loan products. Such products will consider the individual customer inputs such as budget constraints, risk profile, expected lifetime of the loan, etc.
Even though we consider the Danish mortgage loan market, the problem is universal and the practitioners in any mortgage loan system should be able to use the models developed in this paper, possibly with minor modifications.

2. The basic model

In this section, we develop a risk-neutral optimization model which finds a mortgage loan portfolio with the minimum expected total payment.

We consider a finite probability space \((\Omega, \mathcal{F}, P)\) whose atoms are sequences of real-valued vectors (coupon rates and prices of mortgage backed securities) over discrete time periods \(t = 0, \ldots, T\). We model this finite probability space by a scenario tree borrowing the notation from King (2002).

Consider the scenario tree in Fig. 1. The partition of the probability atoms \(\omega \in \Omega\) generated by matching path histories up to time \(t\) corresponds one to one with nodes \(n \in \mathcal{N}_t\) at depth \(t\) in the tree.

In the scenario tree, every node \(n \in \mathcal{N}_t\) for \(1 \leq t \leq T\) has a unique parent denoted by \(a(n) \in \mathcal{N}_{t-1}\), and every node \(n \in \mathcal{N}_t\) for \(0 \leq t \leq T - 1\) has a non-empty set of child nodes \(\mathcal{C}(n) \subset \mathcal{N}_{t+1}\). The probability distribution \(P\) is modeled by attaching weights \(p_n > 0\) to each leaf node \(n \in \mathcal{N}_T\) so that \(\sum_{n \in \mathcal{N}_T} p_n = 1\). For each non-terminal node one has, recursively,

\[
p_n = \sum_{n \in \mathcal{C}(n)} p_m \quad \forall n \in \mathcal{N}_t, \quad t = T - 1, \ldots, 0
\]

and so each node receives a probability mass equal to the combined mass of the paths passing through it.

We assume that we have such a tree at hand with information on price and coupon rate for all mortgage bonds available at each node as well as the probability distribution \(P\) for the tree at hand.

In the basic model we only consider fixed-rate loans, i.e. loans where the interest rate does not change during the lifetime of the loan. For the sake of demonstration, we consider an example with four stages, \(t \in \{0, 1, 2, 3\}\), and 15 decision nodes, \(n \in \{1, \ldots, 15\}\), with the probability \(p_n\) for being at the node \(n\).

We want the basic model to find an optimal portfolio of bonds from a finite number of fixed-rate bonds. Consider the four bonds shown in Fig. 1. Each bond is represented as Index:Type-Coupon/Price, so 3:FRM32-06/98.7 is a fixed-rate callable mortgage bond with maturity in 32 years, a coupon rate of 6% and a price of 98.7.

To generate bonds information we can use term structure and bond pricing theories (see Hull, 2003; Luenberger, 1998; Björk, 1998 for an introduction to these topics and further references to articles). It is also possible to use expert knowledge to predict possible bond prices in the future. A combination of theoretical pricing and expert information can also be used to generate such scenario trees. Nielsen and Poulsen (2004) (N&P) propose an approximative approach for pricing fixed rate bonds with embedded call and delivery in a scenario tree. In this paper, we use the
Black et al. (1990) interest rate tree to represent the underlying interest rate uncertainty and estimate the prices of the mortgage backed bonds in all the nodes of the tree using the commercial pricing module RIO 4.0 developed by Scan Rate Financial Systems A/S.

Given a scenario tree with $T$ stages and its corresponding coupon rate and price information on a set of bonds $i \in I$ we can now define the basic model.

**Parameters:**

- $p_n$: the probability of being at node $n$.
- $d_t$: discount factor at time $t$.
- $IA$: the initial amount of loan needed by the mortgagor.
- $r_{in}$: coupon rate for bond $i$ at node $n$.
- $k_{in}$: price of bond $i$ at node $n$.

---

**Fig. 1.** A binomial scenario tree, representing our expectation of future bond prices and coupon rates. All bonds are callable fixed-rate bonds.
Callkin \( i \) price of a callable bond \( i \) at node \( n \). We have \( \text{Callkin} \) \( i \) = \( \min\{1, k_{in}\} \) for callable bonds and \( \text{Callkin} \) \( i \) = \( k_{in} \) for non-callable bonds.

\( \gamma \) tax reduction rate from interest rate payment.

\( \beta \) tax reduction rate from administration fees.

\( b \) administration fee given as a percentage of outstanding debt.

\( \eta \) transaction fee rate for sale and purchase of bonds.

\( m \) fixed costs associated with rebalancing.

Next, we define the variables used in our model:

\( B_{i} \) total net payment at node \( n \), time \( t \).

\( X_{i} \) outstanding debt of bond \( i \) at node \( n \), time \( t \).

\( S_{i} \) units sold of bond \( i \) at scenario \( n \), time \( t \).

\( P_{i} \) units purchased of bond \( i \) at node \( n \), time \( t \).

\( A_{i} \) principal payment of bond \( i \) at node \( n \), time \( t \).

\( L_{i} \) \( \begin{cases} 1 & \text{if there are any fixed costs associated with bond } i, \text{ node } n, \text{ time } t, \\ 0 & \text{otherwise.} \end{cases} \)

The multi-stage stochastic integer model can now be formulated as follows:

\[
\min \sum_{i=0}^{T} \sum_{n \in \mathcal{N}} p_{n} \cdot d_{i} \cdot B_{i},
\]

\[
\sum_{i \in I} k_{i1} \cdot S_{i01} \geq IA,
\]

\[
X_{i01} = S_{i01} \quad \forall i \in I,
\]

\[
X_{in} = X_{i,t-1,a(n)} - A_{in} - P_{in} + S_{in} \quad \forall i \in I, \ n \in \mathcal{N}_t, \ t = 1, \ldots, T,
\]

\[
\sum_{i \in I} (k_{in} \cdot S_{in}) = \sum_{i \in I} (\text{Callkin} \cdot P_{in}) \quad \forall n \in \mathcal{N}_t, \ t = 1, \ldots, T,
\]

\[
A_{in} = X_{i,t-1,a(n)} \left[ \frac{r_{i,a(n)}}{1 - (1 + r_{i,a(n)})^{-T+t-1}} - r_{i,a(n)} \right] \quad \forall i \in I, \ n \in \mathcal{N}_t, \ t = 1, \ldots, T,
\]

\[
B_{01} = \sum_{i \in I} (\eta \cdot S_{i01} + m \cdot L_{i01}),
\]

\[
B_{i} = \sum_{i \in I} (A_{i} + r_{i,a(n)} \cdot (1 - \gamma)X_{i,t-1,a(n)} + b \cdot (1 - \beta)X_{i,t-1,a(n)}
\]

\[
+ \eta \cdot (S_{in} + P_{in}) + m \cdot L_{i}) \quad \forall n \in \mathcal{N}_t, \ t = 1, \ldots, T,
\]

\[
\text{BigM} \cdot L_{i} - S_{i} \geq 0 \quad \forall i \in I, \ n \in \mathcal{N}_t, \ t = 0, \ldots, T,
\]

\[
X_{in}, S_{in}, P_{in} \geq 0, \ L_{i} \in \{0, 1\} \quad \forall i \in I, \ n \in \mathcal{N}_t, \ t = 0, \ldots, T.
\]

The objective is to minimize the weighted average payment throughout the mortgage period. The payment for all the nodes except the root is defined in Eq. (8) as the sum.
of principal payments, tax-reduced interest payments, tax-reduced administration fees (Danish peculiarity), transaction fees for sale and purchase of bonds and finally fixed costs for establishing new mortgage loans. The principal payment is defined in Eq. (6) as an annuity payment. The payment in the root (Eq. (7)) is based on the transaction costs only.

The dynamics of the model are formulated in constraints (2)–(5). Constraint (2) makes sure that we sell enough bonds to raise an initial amount, \( IA \), needed by the mortgagor. In Eq. (3), we initialize the outstanding debt. Eq. (4) is the balance equation, where the outstanding debt at any child node for any bond equals the outstanding debt at the parent node minus principal payment and possible prepayment (purchased bonds), plus possible sold bonds to establish a new loan. Eq. (5) is a cashflow equation which guarantees that the money used to prepay comes from the sale of new bonds.

Finally constraint (9) adds the fixed costs to the node payment, if we perform any readjustment of the mortgage portfolio. The \( \text{BigM} \) constant might be set to a value slightly greater than the initial amount raised. If a too large value is used, numerical problems may arise.

3. Modeling mortgagor’s options

The model described in Section 2 has three implicit assumptions which limit its applicability:

1. We assume that a loan portfolio is held by the mortgagor until the end of horizon.
2. We assume that all bonds are fixed-rate and callable, i.e. they can be prepaid at any time at a price no higher than 100.
3. The mortgagor is assumed to be risk neutral.

We will relax the first two assumptions in this section and the third in the following section.

The first assumption can be easily relaxed by introducing a constant \( H \) indicating mortgagors horizon, such that \( H \leq T \), where \( T \) is the maturity time of the underlying mortgage portfolio. The decision nodes represent only the first \( H \) stages, while the cashflows (principal and interest rate payments) are calculated based on a \( T \) year maturity.

These changes mean that the outstanding debt at stage \( t = H \) is a positive amount which needs to be prepaid. We define this prepayment amount (\( PP_{Hn} \)) as

\[
PP_{Hn} = \sum_{i} (X_{ihn} \cdot \text{Callk}_{in}) \quad \forall n \in \mathcal{N}_H.
\]  

(11)

We add this equation to the model and we update the object function as follows:

\[
\min \sum_{t=0}^{H} \sum_{n \in \mathcal{N}_t} p_n \cdot d_t \cdot B_{tn} + \sum_{n \in \mathcal{N}_H} p_n \cdot d_H \cdot PP_{Hn}.
\]  

(12)
The objective is now to minimize the weighted payments at all nodes plus the weighted prepayments at time $H$.

The problem with the second assumption is more subtle. Consider the scenario tree in Fig. 2, where two adjustable-rate loans have been added to our set of loans at time 0. Loan 5 (ARM1) is an adjustable-rate loan with annual refinancing and loan 6 (ARM2) is an adjustable-rate loan with refinancing every second year. For adjustable-rate loans (ARMm-loans) the underlying $m$-year bond is completely refinanced every $m$ years by selling another $m$-year bond. But unlike normal refinancing this kind of refinancing does not incur any extra fixed or variable transaction costs since an ARMm-loan is issued as a single loan rather than a series of bullet-bonds following each other. We model an ARMm-loan by using the same loan index for an adjustable-rate loan throughout the mortgage period. For example, index 5 is used for the loan with annual refinancing, even though the actual bonds behind the loan change every year. Since we use the same index, the model does not register any actual sale or purchase of bonds when refinancing occurs. We should, however, readjust the outstanding debt given that the bond price is normally different from par. To take this into account we introduce the set $I' \subseteq I$ of non-callable adjustable-rate loans. For these loans we use the following balance equation.

![Fig. 2. A binomial scenario tree where both fixed-rate and adjustable-rate loans are considered.](attachment:image.png)
instead of Eq. (4):
\[ k_{in} \cdot X_{itn} = X_{it-1,at(n)} - A_{itn} + S_{itn} \quad \forall i \in I', \ n \in N_t, \ t = 1, \ldots, T. \] (13)

Note that variables \( P_{itn} \) and \( S_{itn} \) remain 0 as long we keep an adjustable-rate loan \( i \in I' \) in our mortgage portfolio. The outstanding debt in the child node is, however, rebalanced by multiplying the bond price.

When we consider the adjustable-rate loans we should remember that these loans are non-callable, so for prepayment purposes we have
\[ \text{Call}k_{in} = k_{in} \quad \forall i \in I', \ n \in N_t, \ t = 0, \ldots, T. \]

Another issue to be dealt with is that if a bond is not available for establishing a loan at a given node, we have to set the corresponding value of \( k_{in} \) to 0 to make sure that the bond is not sold at that node in an optimal solution. For example, bond (6:ARM1-04/95.8) at node 2 is not open for sale but only for prepayment.

4. Modeling risk

So far we have only considered a risk neutral mortgagor who is interested in the minimum weighted average of total costs. Most mortgagors, however, have an aversion towards risk. There are two kinds of risk which most mortgagors are aware of:

1. **Market risk**: In the mortgage market this is the risk of extra interest rate payment for a mortgagor who holds an adjustable-rate loan when interest rate increases, or the risk of extra prepayment for a mortgagor with any kind of mortgage loan when the interest rate decreases so the bond price increases.
2. **Wealth risk**: In the mortgage market this is a potential risk which can be realized if the mortgagor needs to prepay the mortgage before a planned date or if he needs to use the free value of the property to take another loan. It can be measured as a deviation from an average outstanding debt at any given time during the lifetime of the loan.

In the following, we will model both kinds of risks. To that end we use the ideas behind minmax optimization and utility theory with use of budget constraints.

4.1. The minmax criterion

An extremely risk averse mortgagor wants to pay least in the worst possible scenario. In other words, if we define the maximum payment as \( MP \) then we have the following minmax criterion:
\[
\min MP,
\]
\[
MP \geq \sum_{t=0}^{T} \sum_{n \in N} B_{tn} \quad \forall s \in S,
\] (15)
where $\mathcal{NP}_t$ is a set of nodes defining a unique path from the root of the tree to one of the leaves. Each of these paths define a scenario $s \in \mathcal{S}$. For the example given in Fig. 2 we have

\[
\begin{align*}
\mathcal{NP}_{t,1} &= \{1, 2, 4, 8\}, \\
\mathcal{NP}_{t,2} &= \{1, 2, 4, 9\}, \\
\vdots \\
\mathcal{NP}_{t,8} &= \{1, 3, 7, 15\}.
\end{align*}
\]

### 4.2. Utility function

Instead of minimizing costs we can define a utility function, which represents a saving and maximize it. Nielsen and Poulsen (2004) (N&P) suggest a concave utility function with the same form as in Fig. 3.

The decreasing interest for bigger savings is based on the idea that bigger savings are typically riskier than small savings. Nielsen and Poulsen use a logarithmic object function, which can be formulated as follows:

\[
\max \sum_{t=0}^{T} \sum_{n \in \mathcal{N}_t} p_n \cdot \log(d_t \cdot (B_{m}^{\text{max}} - B_m)),
\]

where $B_{m}^{\text{max}}$ is the maximum amount a mortgagor is willing to pay. Nielsen and Poulsen fix $B_{m}^{\text{max}}$ to a big value so that the actual payment will never rise above this level.

Adding this non-linear objective function to our stochastic binary problem makes the problem extremely challenging to solve. There are no effective general purpose solvers for solving large mixed integer non-linear programs (see Bussieck and Pruessner, 2003). There are three ways of circumventing the problem: either we use a linear utility function in conjunction with budget constraints (mip) or relax the

![Utility vs. Saving](image-url)
binary variables and solve the non-linear problem (nlp) or both (lp). We demonstrate the first approach in the following and comment on the second and third approach in Section 6.

Instead of maximizing the logarithm of the saving at each node we can simply maximize the saving: $B_m^{\text{max}} - B_m$. If $B_m^{\text{max}}$ is so large that the saving is always positive, then we are in effect minimizing the weighted average costs similar to the risk neutral case presented in Section 2. However, if we allow the saving to be negative at times and add a penalty to the objective function whenever we get a negative saving, we can introduce risk aversion into the model. For this reason, we need to have a good estimate for $B_m^{\text{max}}$. The risk neutral model can be solved to give us these estimates. Then, we can use the following objective function and budget constraints:

\[
\begin{align*}
\max & \quad \sum_{t=0}^{T} \sum_{n \in \mathcal{N}_t} (p_n \cdot d_t ((B_m^{\text{max}} - B_m) - PR_m \cdot BO_m)), \\
B_m^{\text{max}} + BO_m - B_m & \geq 0 \quad \forall n \in \mathcal{N}_t, \ t = 0, \ldots, T, \\
BO_m - BO_m^{\text{max}} & \leq 0 \quad \forall n \in \mathcal{N}_t, \ t = 0, \ldots, T.
\end{align*}
\]

We allow crossing the budget limit in constraint (18) by introducing the slack variable $BO_m$. This value will then be penalized by a given penalty rate ($PR_m$) in the objective function (17). The penalty rate can, for example, be a high one-time interest rate for taking a bank loan. The budget overflow ($BO_m$) is then controlled in constraint (19) where the overflow is not allowed to be greater than a maximum amount $BO_m^{\text{max}}$.

### 4.3. Wealth risk aversion

So far we have only considered the market risk or the interest rate risk. In the following, we will model the other important risk factor in the mortgage market, namely the wealth risk.

Wealth risk is the risk that the actual outstanding debt becomes bigger than the expected outstanding debt at a given time during the lifetime of the loan. For example, selling a 30-year bond at a price of 80, we have a big wealth risk given that a small fall in the interest rate can cause a considerable increase in the bond price, which means a considerable increase in the amount of the outstanding debt.

We consider the deviation from the average outstanding debt, which we define as $DX_n$:

\[
DX_n = \overline{X}_t - \sum_i X_{tn} \quad \forall n \in \mathcal{N}_t, \ t = 0, \ldots, T,
\]

where $\overline{X}_t$ is the average outstanding debt for a given time $t$:

\[
\overline{X}_t = \sum_{i \in I} \sum_{n \in \mathcal{N}_t} p_n \cdot X_{tn} \quad \forall t = 0, \ldots, T.
\]
A positive value of $DX_{tn}$ means that we have a saving and a negative value means a loss as compared to the average outstanding debt $X_t$. We introduce a surplus variable $XS_{tn}$ to represent the amount of saving and a slack variable $XL_{tn}$ to represent the amount of loss:

$$\left( X_t - \sum_i X_{tn} \right) - XS_{tn} + XL_{tn} = 0 \quad \forall n \in \mathcal{N}, \ t = 0, \ldots, T. \quad (20)$$

To make the model both market risk and wealth risk averse, we update the objective function with weighted values of $XS_{tn}$ and $XL_{tn}$ as follows:

$$\max \sum_{n \in \mathcal{N}} \sum_{t=0}^T p_n \cdot d_t((B_{tn}^{\text{max}} - B_{tn}) - PR_{tn} \cdot BO_{tn} + PW_n \cdot XS_{tn} - NW_n \cdot XL_{tn}),$$

where $PW_n$ is a parameter which can be used to encourage savings and $NW_n$ is a parameter to penalize a loss as compared to the average outstanding debt. If we set $PW_n = NW_n$, it means that the model is indifferent towards wealth risk. On the other hand $PW_n < NW_n$, means that the model is wealth risk averse, since it penalizes a potential loss harder than it encourages a potential saving.

5. Scenario reduction

Since the number of scenarios grows exponentially as a function of time steps the stochastic binary model is no longer tractable when we have more than 10 time steps. For an 11-stage model we have the scenario tree in Fig. 4.

As of today there are no general purpose solvers which can solve stochastic integer problems of this size in a reasonable amount of time. Notice, however, that a great number of nodes in the last 3–4 time steps have such a close distance that a reduction of nodes for these time steps might not effect the first-stage results. We are in other words interested in finding a way to optimally reduce the number of scenarios. If we get the same first stage result for a reduced and a non-reduced problem, it suffices to solve the reduced problem, and then at each step resolve the problem until horizon. In that case the final result of solving any of the two problems will be the same. The reason for this is that we initially only implement the first stage solution. As the time passes by and we get more information we have to solve the new problem and implement the new first stage solution each time.

Dupačová et al. (2003) and Heitsch and Römisch (2003) have defined the SRP as a special set covering problem and have solved it using heuristic algorithms.

The authors behind the SCENRED articles have in cooperation with “GAMS Software GmbH” and “GAMS Development Corporation”, developed a number of C++ routines, SCENRED, for optimal scenario reduction in a given scenario tree. Likewise they have developed a link, GAMS/SCENRED, which connects the
GAMS program to the SCENRED module (see GAMS/SCENRED). The scenario tree in Fig. 5 is obtained after using the fast backward algorithm of the GAMS SCENRED module for a 50% relative reduction, where the relative reduction is measured as an average of node reductions for all time steps. If we, for example, remove half of the nodes at the last time step, we get a 50% reduction for that time step only. Then, we measure the reduction percentages for all other time steps in the same way. The average of these percentages corresponds to the relative reduction (see Dupác’ová et al. (2003); Heitsch and Römisch, 2003). In our example, the number of scenarios is reduced from 1024 to 12.

We use GAMS/SCENRED and SCENRED modules for scenario reduction, and compare the results with those found by solving the LP-relaxed non-reduced problem.

6. LP relaxation

Whenever we refinance the mortgage portfolio we need to pay a variable and a fixed transaction cost. The variable cost is \( 100 \cdot \eta \) percent of the sum of the sold and purchased amount of bonds and the fixed cost is simply DKK \( m \) (see constraints (8) and (9)). The binary variables in the problem (1)–(10) are due to incorporation of fixed costs \( m \). The numeric value of these fixed costs is about DKK 2500, whereas \( \eta = 0.15\% \). While the value of the variable transaction costs decreases as the time
passes by, the fixed costs remain the same. Besides, fixed costs are incurred per loan and not per loan portfolio which is why we cannot simply approximate the fixed costs by adding a small percentage to the variable transaction costs, even if we let this percentage increase as a function of time to adjust for the decreasing outstanding debt of the total loan portfolio. We, therefore, suggest an iterative updating scheme for the variable transaction costs, so that we can approximate the fixed costs without using binary variables. We do that by iteratively solving the LP problem $k$ times as follows.

We define a ratio $c_{itn}^k$ and initialize it to $c_{0itn} = 0$. The ratio $c_{itn}^k$ can then be used in the definition of a node payment (8) in the $k+1$st iteration as follows:

$$B_{itn} = \sum_i (A_{itn} + r_{itn} \cdot (1 - \gamma))X_{itn}$$

$$+ b \cdot (1 - \beta)X_{itn} + \eta \cdot (S_{itn} + P_{itn}) + \psi_{itn}^{k+1} \cdot S_{itn})$$

$$\forall n \in N_t, \; t = 0, \ldots, T.$$  

(22)

Solving the LP problem at each iteration $k$ we get $S_{itn}^{sk}$ as the optimal value of the sold bonds at the $k$th iteration. Before each iteration $k > 0$, the ratio $\psi_{itn}^k$ is then updated according to the following rule:

$$\psi_{itn}^k = \begin{cases} \frac{m}{S_{itn}^{sk}} & \forall i, \; n \in N_t, \; t = 0, \ldots, T \; \text{if } S_{itn}^{sk} > 0, \\ \psi_{itn}^{k-1} & \text{otherwise}. \end{cases}$$  

(23)
This brings us to our approximation scheme for an LP relaxation of the problem:

1. Drop the fixed costs and solve the LP relaxed problem.
2. Find the ratios $\psi_{itn}$ according to (23).
3. Incorporate the ratios in the model so that DKK $m$ is added to the objective function for each purchased bond, given the same solution as the one in the last iteration is obtained. Solve the problem again.
4. Stop if the solution in iteration $k + 1$ has not changed more than $\alpha$ percent as compared to the solution in iteration $k$. Otherwise go to step 5.
5. Update $\psi_{itn}$ according to (23).
6. Repeat from step 3.

Our experimental results show that for $\alpha \approx 2\%$ we find near optimal solutions which have similar characteristics to the solutions from the original problem with the fixed costs.

7. Numerical results

We consider an 11-stage problem, starting with three callable bonds and one 1-year bullet bond at the first stage. We then introduce seven new bonds every three years. An initial portfolio of loans has to be chosen at year 0 and it may be rebalanced once a year the next 10 years. We assume that the loan is a 30-year loan and that it is prepaid fully at year 11.

The 24 callable bonds used in our test problem are seen in Table 1. The table only presents the average coupon rates and prices for these bonds at their dates of issue. Note that only the first three bonds have already been issued, so the start prices for these three bonds are market prices on 20/02/2004, which is the date for the first stage in the stochastic program. The next 21 bonds are not issued yet, and we find their estimated prices at their future dates of issue. Since there are several states representing the uncertainty in the future we have several of these estimated start prices. In Table 1, however, we only give an average of these prices. Besides these 24 callable bonds we use a 1-year non-callable bullet bond, bond 25. The effective interest rate on this bond is about 2% to start with. Using a BDT tree (see Black et al., 1990; Bjerksund and Stensland, 1996) with the input term structure given in Table 2 and annual steps, the effective rate can increase to 21% or decrease to slightly under 1% at the 10th year. The term structure of Table 2 is from 20/02/2004 and is provided by the Danish mortgage bank Nykredit Realkredit A/S. The BDT tree has also been used for estimating the prices and rates of the 24 callable bonds during the lifetime of the mortgage loan using the bond pricing system Rio 4.0 (see Scan Rate Financial Systems).

A practical problem arises when writing the GAMS tables containing the stochastic data. The optimization problem is a path-dependent problem, whereas the BDT tree is path independent. GAMS is not well suited for such programming tasks as mapping the data from a combining binomial tree (a lattice) to a non-combining
binomial tree. A general purpose programming language is better suited for this task. We have used VBA to generate the input data to the GAMS model, and we have run the GAMS models on a Sun Solaris 9 machine with a 1200 MHz CPU, 16 GB of RAM and 4 GB of MPS.

The purpose of our tests can be summarized as follows:

1. Comparing the results of the four versions of our model with simple sell and hold strategies.
2. Observing the effects of using the GAMS/SCENRED module.
3. Trying our LP approximation on the problem.

For each of these objectives, we consider all four versions of the model and compare the results.

7.1. The original stochastic MIP problem

Fig. 6 shows the solutions found for the first three stages of the problem for all four instances of our model, namely the risk neutral model, the minmax model, the model with interest rate risk aversion with budget constraints and finally the model
with interest rate and wealth risk aversion with budget constraints. Notice, however, that no feasible solution could be found for the model with interest rate and wealth risk aversion with budget constraints within a time limit of 10 h.

A full prescription of the solution with all 11 stages will not contribute to a better understanding of the dynamics of the solution, which is why we present the solution to the first three stages of the problem only. It is thus enough to give us an indication of the behavior of each solution. In the risk neutral case we start by taking a 1-year adjustable-rate loan. If the interest rate increases after a year, the adjustable-rate loan is prepaid by taking a fixed-rate loan. Even if it means an increase in the amount of the outstanding debt, it proves to be a profitable strategy since if the rates increase again in the next stage we can reduce the amount of outstanding debt greatly by refinancing the loan to another fixed-rate loan with a higher price. The minmax

<table>
<thead>
<tr>
<th>Maturity (Year)</th>
<th>Yield (%)</th>
<th>Yield volatility (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2.23</td>
<td>–</td>
</tr>
<tr>
<td>2</td>
<td>2.35</td>
<td>32.20</td>
</tr>
<tr>
<td>3</td>
<td>2.73</td>
<td>32.10</td>
</tr>
<tr>
<td>4</td>
<td>3.08</td>
<td>29.50</td>
</tr>
<tr>
<td>5</td>
<td>3.41</td>
<td>27.00</td>
</tr>
<tr>
<td>6</td>
<td>3.68</td>
<td>25.00</td>
</tr>
<tr>
<td>7</td>
<td>3.92</td>
<td>23.00</td>
</tr>
<tr>
<td>8</td>
<td>4.12</td>
<td>22.00</td>
</tr>
<tr>
<td>9</td>
<td>4.30</td>
<td>20.90</td>
</tr>
<tr>
<td>10</td>
<td>4.44</td>
<td>20.10</td>
</tr>
<tr>
<td>11</td>
<td>4.56</td>
<td>19.40</td>
</tr>
<tr>
<td>12</td>
<td>4.62</td>
<td>18.80</td>
</tr>
<tr>
<td>13</td>
<td>4.68</td>
<td>18.30</td>
</tr>
<tr>
<td>14</td>
<td>4.74</td>
<td>17.90</td>
</tr>
<tr>
<td>15</td>
<td>4.80</td>
<td>17.55</td>
</tr>
<tr>
<td>16</td>
<td>4.87</td>
<td>17.25</td>
</tr>
<tr>
<td>17</td>
<td>4.93</td>
<td>17.00</td>
</tr>
<tr>
<td>18</td>
<td>4.99</td>
<td>16.85</td>
</tr>
<tr>
<td>19</td>
<td>5.05</td>
<td>16.75</td>
</tr>
<tr>
<td>20</td>
<td>5.11</td>
<td>16.70</td>
</tr>
<tr>
<td>21</td>
<td>5.16</td>
<td>16.65</td>
</tr>
<tr>
<td>22</td>
<td>5.21</td>
<td>16.60</td>
</tr>
<tr>
<td>23</td>
<td>5.25</td>
<td>16.56</td>
</tr>
<tr>
<td>24</td>
<td>5.29</td>
<td>16.52</td>
</tr>
<tr>
<td>25</td>
<td>5.34</td>
<td>16.48</td>
</tr>
<tr>
<td>26</td>
<td>5.37</td>
<td>16.45</td>
</tr>
<tr>
<td>27</td>
<td>5.40</td>
<td>16.42</td>
</tr>
<tr>
<td>28</td>
<td>5.43</td>
<td>16.39</td>
</tr>
<tr>
<td>29</td>
<td>5.46</td>
<td>16.36</td>
</tr>
<tr>
<td>30</td>
<td>5.49</td>
<td>16.34</td>
</tr>
</tbody>
</table>
strategy chooses a fixed-rate loan with a price close to par to start with. This loan is not refinanced until the ninth stage of the problem.

The risk neutral and the minmax model represent the two extreme mortgagors as far as the risk attitude is concerned. The third model reflects a mortgagor with a risk attitude between the first two mortgagors. The solution to this model guarantees that the mortgagor will not pay more than what his budget allows at any given node. Table 3 indicates the difference in the characteristics of the solutions for the three different models.

The risk neutral model gives the lowest average total cost. The standard deviation from this average cost is, however, rather high. The minmax model has a much smaller standard deviation. This higher level of security against variation has thus an

![Fig. 6. Presentation of the solutions for the first three stages of the problem. Variable s is for sale and p for purchase and the units are given in 1000 DKK, so s_3 = 1128 means that the mortgagor should sell approximately 1.128,000 DKK at the given node. The short rates from the BDT tree are indicated using the letter r.](image-url)
average cost of about 72 000 DKK. The third model has reduced the risk considerably without having increased the total average cost with more than about 7000 DKK.

We also see that these results outperform the simple sell and hold strategies (strategies 5 and 6). A traditional market risk-neutral mortgagor who chooses an ARM1 loan and keep it until horizon (year 11) is better off following either strategy 1 or 3 and a traditional market risk-averse mortgagor who chooses a fixed-rate loan and keeps it until horizon is better off following either strategy 2 or 3.

Regarding the budget constraints in models 3 and 4 we use the constants in Table 4. Note that we are reporting these budget constraints on an aggregate level. Furthermore, we define the constants $PP_{Hn}^{max}$ and $PPO_{Hn}^{max}$ as the target prepayment amount and maximum deviation allowed from this target, respectively.

These constants are chosen after considering the average payments and the standard deviations from these in the risk neutral model.

The major problem with these solutions is the computing time taken to find near optimal solutions by CPLEX 9.0. Except for the first strategy, we cannot find solutions within 1% of a lower bound after 10 h of CPU time. For the fourth strategy no feasible solution is found at all. Strategies 5 and 6 take a few seconds to calculate, however, we do not need the optimization model for these calculations.
7.2. The reduced stochastic MIP problem

After reducing the number of scenarios from 1024 to 12 we get the solutions given in Fig. 7 and Table 6.

Regarding the budget constraints in models 3 and 4 we use the constants in Table 5.

We can see in Table 6 that the behavior of the solutions for the different models is similar to that of the original problem. Notice also that we get a feasible solution here for the fourth model with interest rate and wealth risk aversion.

The numeric values of the total costs for the first four strategies have, however, decreased considerably. Except for the risk neutral model we do not obtain the same first stage solutions as we saw for the original problem. It seems that the reduced problem gives a more optimistic view of the future as compared to the original
problem. By testing the scenario reduction algorithms for different levels of reduction on our problem we notice that even much less aggressive scenario reductions do not guarantee that the same initial solutions as found for the original problem are found. One explanation for this more optimistic view of the future is that since scenario reduction destroys the binomial structure of the original tree, significant arbitrage opportunities arise in parts of the new tree structure. Another explanation is that for all levels of reduction which we have performed the reduced problem has an overweight of scenarios with lower interest rates. We therefore need a method which (1) optimally reduces the number of scenarios while the tree remains balanced and (2) modifies bond prices in the reduced tree so that the arbitrage opportunities which are introduced as a result of scenario reduction are removed.

The question here is whether points 1 and 2 play an equally important role in getting similar first stage solutions for the original and the reduced problem. Comparing strategies 5 and 6 in Tables 3 and 6 indicates that performing point 2 might remove most of the difference between the solutions in the reduced problem as compared to the original problem. Apparently, the average total costs for the ARM1 loan are slightly decreased in the reduced tree, whereas the average total costs for the fixed-rate loan are slightly increased. This slight change in opposite directions can only be explained by the observation that the reduced tree has an overweight of scenarios with lower interest rates, since no trading is allowed for these two strategies and therefore the arbitrage opportunities cannot be used. We are currently working on better ways of reducing scenario trees taking into accounts points 1 and 2.

Table 5
Budget limits used in models 3 and 4 for the reduced data

<table>
<thead>
<tr>
<th>Constant</th>
<th>Definition</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>BMAX</td>
<td>$\sum_{i=0}^{H-1} \sum_{n \in \Sigma} p_n \cdot B_{in}^{\text{max}}$</td>
<td>565915</td>
</tr>
<tr>
<td>PPMAX</td>
<td>$\sum_{n \in \Sigma} p_n \cdot PP_{in}^{\text{max}}$</td>
<td>601983</td>
</tr>
<tr>
<td>BOMAX</td>
<td>$\sum_{i=0}^{H-1} \sum_{n \in \Sigma} p_n \cdot BO_{in}^{\text{max}}$</td>
<td>50000</td>
</tr>
<tr>
<td>PPOMAX</td>
<td>$\sum_{n \in \Sigma} p_n \cdot PP_{in}^{\text{max}}$</td>
<td>35000</td>
</tr>
</tbody>
</table>

Table 6
Comparison of the four strategies for the reduced problem

<table>
<thead>
<tr>
<th>Model type</th>
<th>Total costs</th>
<th>Std. dev.</th>
<th>Max</th>
<th>Min</th>
<th>Time (s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Risk neutral</td>
<td>1.169.173</td>
<td>49.765</td>
<td>1.274.079</td>
<td>1.064.525</td>
<td>12</td>
</tr>
<tr>
<td>2. Minmax</td>
<td>1.187.938</td>
<td>0.00</td>
<td>1.187.938</td>
<td>1.187.938</td>
<td>52.2</td>
</tr>
<tr>
<td>3. Int. rate risk averse</td>
<td>1.171.926</td>
<td>24.270</td>
<td>1.229.897</td>
<td>1.136.655</td>
<td>300</td>
</tr>
<tr>
<td>4. Int./wealth risk averse</td>
<td>1.172.479</td>
<td>25.610</td>
<td>1.229.742</td>
<td>1.128.412</td>
<td>300</td>
</tr>
<tr>
<td>5. Loan 25 (ARM1)</td>
<td>1.301.237</td>
<td>120.958</td>
<td>1.560.244</td>
<td>1.129.983</td>
<td>&lt;1</td>
</tr>
<tr>
<td>6. Loan 2 (fixed-rate 5%)</td>
<td>1.356.228</td>
<td>59.356</td>
<td>1.410.190</td>
<td>1.249.483</td>
<td>&lt;1</td>
</tr>
</tbody>
</table>
7.3. The reduced and LP-approximated problem

When we use our LP-approximation algorithm on this problem we get the solution as presented in Table 7 and Fig. 8.

The algorithm uses 10–18 runs for the different problems to find solutions which are over all less than 2% different from the solutions found in the last iteration.

It is important to point out that simply dropping the fixed costs results in solutions which deviate considerably from the problems with the fixed costs, whereas approximating the fixed costs using our algorithm gives very similar results as found by the MIP model.

7.4. Comments on results

The results presented in this section are in agreement with the financial arguments used in the Danish mortgage market. Even though the original problem is hard to solve we have shown that useful results can be found by solving the reduced problems. The reduced scenario trees represented a more optimistic prediction of the future, but the results found are still quite useful. In practice, the mortgage portfolio manager should try several scenario trees with different risk representations as an input to the model. This way the optimization model can be used as an analytical tool for performing “what-if” analyses on a high abstraction level.

8. Conclusions

We have developed a functional optimization model that can be used as the basis for a quantitative analysis of the mortgagors decision options. This model in conjunction with different term structures or market expert opinions on the development of bond prices can assist market analysts in the following ways.

**Decision support:** Instead of calculating the consequences of the single loan portfolios for single interest rate scenarios, the optimization model allows for performing “what-if” analysis on a higher level of abstraction. The analyst can provide the system with different sets of information such as the presumed lifetime of
the loan, budget constraints and risk attitudes. The system then finds the optimal loan portfolio for each set of input information.

**Product development:** Traditionally, loan products are based on single bonds or bonds with embedded options. In some mortgage markets such as the Danish one it is allowed to mix bonds in a mortgage portfolio and there are even some standard products which are based on mixing bonds. The product $P_{33}$ is, for example, a loan portfolio where 33% of the loan is financed in 3-year non-callable bonds and the rest in fixed-rate callable bonds. These mixed products are currently not popular since the rationale behind exactly this kind of mix is not well argued. The optimization model gives the possibility to tailor mixed products that, given a set of requirements, can be argued to be optimal for a certain mortgagor.

The greatest challenge in solving the presented models is on decreasing the computing times. We have experimented with scenario reduction (Dupačová et al.,

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![Diagram of solutions for the first three stages of the LP approximated reduced problem.](image)

**Fig. 8.** Presentation of the solutions for the first three stages of the LP approximated reduced problem. Units are given in 1000 DKK.
2003; Heitsch and Römisch, 2003; GAMS/SCENRED, 2002) (scenred) and we have suggested an LP approximation method to reduce the solution times while maintaining solution quality. It is, however, an open problem to develop tailored exact algorithms such as decomposition algorithms (see Birge, 1985; Birge and Louveaux, 1997) to solve the mortgagors problem. Another approach for getting real time solutions is to investigate different heuristic algorithms or make use of parallel programming (see Nielsen and Zenios, 1996b; Ruszczynski, 1988) to solve the problem.

Integration of the two disciplines of mathematical finance and stochastic programming combined with use of the state-of-the-art software has a great potential, which has not yet been realized in all financial markets in general and in mortgage companies in particular. There is a need for more detailed and operational models and high performing easy to use accompanying software to promote use of the mathematical models with special focus on stochastic programming.

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References