

Topic of the Month: Making the Leap from Best Execution to Mandatory **Notes from the Field: Part II of II**

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For mortgage originators, maximizing profits while minimizing risk is the key to operating a successful business. One way originators selling and delivering loans on a Best Efforts basis can increase profitability is by transitioning to Mandatory Deliveries and managing the interest rate risk themselves or with the help of a third-party vendor. Recent observations have shown that the spread between the all-in Best Efforts price and the all-in Mandatory price has increased from the typical 20-30 basis-points to over 60+ basis-points* on some product/note rate combinations, making the switch from Best Efforts to Mandatory deliveries more appealing than ever before. This article will identify and discuss the key factors that are required to make a successful transition from Best Efforts to Mandatory selling. In last month's article we identified the need for developing appropriate lock-in and hedging policies and procedures, establishing relationships with Broker Dealers and Whole Loan Investors, and the need for accuracy when transferring data from the Loan Origination System to the Risk Management System. In the conclusion of this article we will discuss different methods of managing Pipeline Risk, the importance of performing Best Execution Analysis and the selection and implementation of hedge accounting methodology.

One vital step when considering the switch from Best Efforts to Mandatory is developing a hedging strategy to manage the interest rate risk inherent with Mandatory execution. Mortgage originators granting a loan's rates and terms weeks and sometimes months in advance of its actual closing, expose themselves to changes in market interest rates and mortgage pricing from the lock-in date until the loan is allocated to a mandatory commitment and the sale price is set. The risk being that a lender grants rates and terms on day N at price X and when the loan has closed on day N+15, interest rates in the market are higher, and the loan is sold mandatory at a price of X-0.25, with the worse execution eroding the expected profit margin on the loan by 25bps. In order to offset this risk, avoid market losses and preserve the loans expected profit margin, originators can sell forward or otherwise enter into short positions in various fixed income instruments to hedge their pipeline's exposure to fluctuations in rates. Rather than offset the market risk on every individual loan, hedging is performed in aggregate, in an attempt to reduce the overall market exposure of the pipeline. Among the more popular hedge instruments are Agency MBS, MBS Options, Treasury Futures, Treasury Future Options, EuroDollar Futures and Mandatory Forwards. Originators choosing to hedge can do so with the help of a third-party vendor like Compass, or with the proper tools, analytics and expertise, hedging can be performed in-house.

Another form of Pipeline risk is Fallout Risk, or the risk that a hedged loan lock fails to close. This typically occurs when interest rates fall after loan terms and rates are set, and can result in the pair-off transaction of a hedging instrument, at a possible loss to the originator. The conundrum faced by lenders choosing to sell loans Mandatory is that in a rising rate environment, when loans in the pipeline are out of the money, we expect a high percentage of the loans to close, whereas conversely in a declining rate environment, when loans in the pipeline are in the money, we would expect a lower percentage of the loans to close. This situation where loans carrying losses are more likely to close, and

vice versa, requires lenders that are hedging to adjust the amount of hedge coverage applied to the pipeline depending whether a loan is in or out of the money to the originator. By observing historical fallout across different market environments, lenders can implement dynamic pullthrough assumptions by market move and apply coverage based on the percentage of loans that they expect will close. For example, a loan that has a Mark-to-Market value that is 50bps underwater might be covered at ~75%, while a loan that is 50bps in the money might be covered at ~60%. By conducting regular pullthrough analysis, originators can reduce their exposure to Fallout risk by ensuring that they have the optimal level of coverage applied to the pipeline.

In order to maximize profits, lenders need to search for ways to squeeze every last dollar out of each loan. One way to do this is to conduct Best Execution analysis on loans ready for allocation to Mandatory commitments. Since most lenders have several delivery channels for selling loans mandatory, originators must price out each individual loan using the different investor's models to ensure that the maximum mandatory price available to the lender is captured. It is important to conduct the analysis every day, as even in the event that the market levels remain unchanged day over day, a loan's Best Execution can change, since most whole loan investors publish daily changes to their model's pricing components, such as par note rates, note rate adjusters and buy up, buy down schedules. It is also important to analyze execution at the loan level in order to take Loan Level Price Adjustments (LLPA's) into consideration. For example, let's assume we have 2 Conforming 30 year 5.375% loans, one with escrows and one without, that are eligible for Mandatory sale with 2 different investors. The loan with escrows Best Exes to Investor A because the all-in price is better than Investor B's by 10bps. However, the loan without escrows Best Exes to Investor B because Investor B only charges 12.5 bps for no escrows, while Investor A charges 25bps, making investor B the better execution by 2.5 bps. By diligently conducting daily Best Execution analysis, originators ensure that they are maximizing profits on a loan by loan basis.

Now that we've discussed ways to reduce risk and maximize profits, we need to determine the best way of recording and reporting financial results. The final topic covered in this article will be the selection and implementation of hedge accounting methodology. Today, most lenders have moved away from FAS 133, which required somewhat complicated effectiveness testing and was known to cause volatility in earnings from one month to the next, and have switched to some form of Fair Value Accounting. Companies wishing to use fair value accounting must first elect to apply the provisions of FASB 157, "Fair Value Measurements" before they can adopt FASB 159 or other variations of fair value accounting. The main difference between hedge accounting and best efforts accounting is that in hedge accounting, the lender is able to book the change in mark-to-market value of their liabilities and assets on their balance sheet while in best efforts accounting, only cash accounts from purchased loans are reported on.

By tracking historical fallout and managing pullthrough assumptions, modeling the changes in duration and convexity of the loan pipeline and hedging instruments that result from rate shocks and applying a hedge strategy, mortgage originators can reduce the pipeline risk inherent with selling loans mandatory. By accurately deriving the true market value of the loans on a daily basis, and determining the best method of reporting financial results, lenders can ensure that they are maximizing profits and reporting their financial results in a way that reduces earnings volatility month over month. Investors interested in



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making the leap from best efforts to mandatory sales can use the steps identified in parts I and II of this article as a guide in order to help facilitate a smooth transition. -**Bob Gundel**

*Actual Best Efforts/Mandatory spread may vary by originator and is subject to change.