

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

An excerpt from Compass Analytics January 2010 *Month in Review*

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 risk management provider. 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/noterate 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. The topics covered will include implementing appropriate lock-in and hedging policies and strategies, setting up relationships with the appropriate counterparties, managing loan data and transfers, managing interest rate risk (in-house as well as outsourced), best execution analysis and implementation of hedge accounting.

Developing and applying updated policies and procedures is essential to a successful transition from Best Efforts to Mandatory selling. Originators should review investor guidelines and internal operational parameters in order to identify which products they will choose to hedge, what lock-terms they will offer to brokers, loan officers and borrowers, what extension fees will apply when necessary, what types of Mandatory deliveries will be utilized and what the appropriate hedge instruments and application of that hedge are for each product. Rather than jumping in head first, and hedging the entire portfolio of products, many originators choose to begin with a sub-group of "vanilla" products in order to familiarize themselves with the nuances of Mandatory delivery and the hedging process and then add products to the hedge as they see fit.

The next essential step when transitioning from Best Efforts to Mandatory is to set up the appropriate counterparty relationships required to deliver loans on a Mandatory basis. This requires developing relationships with whole loan Investors and entering into Assignment of Trade (AOT) or other types of Mandatory agreements. Investors typically will review the product mix, monthly origination assumptions (based on historical data), financial health and equity of the company as well as the hedge policy and risk management strategies or relationships, and based on that data provide terms of the mandatory agreements. If existing Best Efforts relationships are in place with investors that provide Mandatory execution, the transition to deliver loans to these investors on a Mandatory basis is typically faster and easier as the investor is already familiar with the company's operations. Additionally, it is essential to establish credit lines with Broker Dealer securities counterparties in order to execute trades to hedge the interest rate risk inherent with selling loans Mandatory. Again, Dealers will require specific information regarding the company's operations and financial health when determining the how much credit to provide and any stipulations that will be applied.

Another key element required for originators making the move to Mandatory delivery is data integrity and the accurate transfer of data from the Loan Origination System (LOS) to a Risk Management System

that models the value of the loan pipeline and hedge instruments. Data integrity is important for several reasons when Selling Mandatory ranging from hedge coverage ratios to accurate accounting entries. The accuracy of lock terms, product types, noterates, loan level price adjustment triggers such as FICO and LTV as well as Lender Cost and Day-1 Profit Margin are essential to the pricing of the loan. Since many originators use pullthrough assumptions based on a loan's in or out-of-the-moneyness to drive hedge coverage applied at the loan level, accurate pricing of each loan is critical to the success of the hedging strategy.

By implementing lock-in and hedging policies and procedures, establishing relationships with whole loan investors and Broker Dealer counterparties and managing data integrity and the transfer of that data to a risk management system, originators are well on the way to making the switch from Best Efforts to Mandatory selling. In next month's newsletter we'll continue this article, covering additional topics such as the management of interest rate exposure, best execution analysis and choosing the appropriate loan delivery methods, and the implementation of hedge accounting procedures. **-Bob Gundel**

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