

# Is The Time Right To Hedge Jumbo Loans?

*Understanding the risks can help ensure  
you are on the road to rewards.*

By Rob Kessel and Brandon Case

**Y**ou may have recently asked yourself: “When will it be time to start hedging jumbo loans again?” You know that the margins are bigger, and you know there is a demand out there, especially in high-cost areas where the median loan is

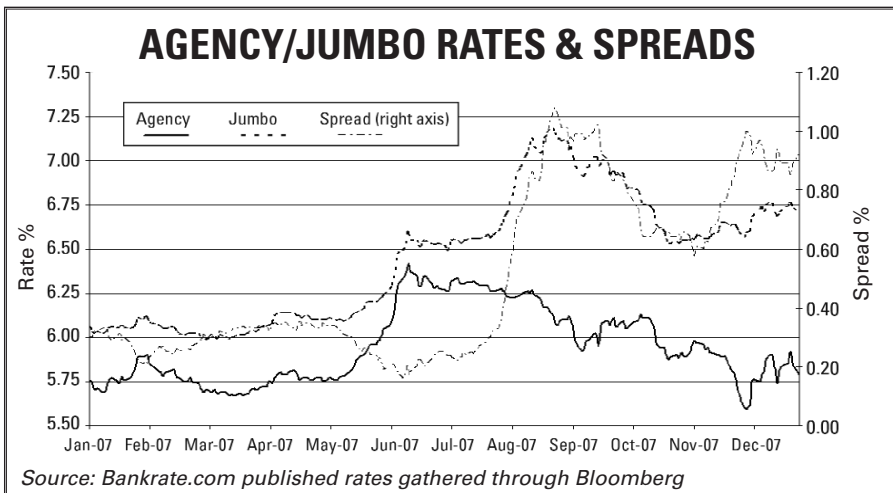
gest possible pickups in price in excess of 30 basis points (bps) by selling jumbo loans on a mandatory flow or bulk basis, so it might seem tempting to get back into the game. Even more tempting is the fact that the rate spread between agency and

locked, hedged pipelines suffered dramatically as investors systematically stopped accepting certain credit features and jumbo spreads quickly widened (prices dropped).

Before deciding on whether or not to hedge your jumbo production again, you need to understand what caused last summer’s “value realignment,” and the best place to start is by dissecting what went wrong and how the mortgage crisis began.

The common themes from the prolific analysis on “what went wrong” include: underwriting standards were too loose, inappropriate loans were too easy to come by, and the default potential of mortgage loans was grossly underestimated – all due to overly optimistic expectations of future housing appreciation. The housing bubble was fueled by low rates, easy underwriting standards and the promise of spectacular profits to be made in real estate. Prior to the meltdown, the economy was chugging along, inflation was in check, and everyone was making money in subprime and Alt-A origination.

Then, within short order, subprime delinquencies ticked up appre-



above the \$417,000 conforming limit.

In answering the hedging question, a natural place to start is by identifying the value proposition - more specifically, what is the current pickup in price you might expect by selling loans on a closed, mandatory basis versus selling loans upon lock on an individual, best-efforts basis? Another question you might ask yourself is what additional volume, market share and profits can you generate by offering more competitive pricing?

Current market conditions sug-

jumbo loans is at or near historically wide levels with the chance of any narrowing of this spread during the hedging period accruing straight to your bottom line.

Besides identifying the possible gains associated with hedging your jumbo production again, you also need to be comfortable with where you will be on the risk/reward continuum. Since July 2007, as you went out on the risk curve (i.e., lower-credit-quality loans), your risk has grown significantly. Memories are still fresh from last summer when

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ciably, home-sales inventories started their steady climb, lending standards tightened, and the secondary market for subprime and Alt-A evaporated as liquidity for all non-agency products disappeared.

Now that we've laid the foundation as to why the crisis occurred, we can start to identify what signals we might observe to help us decide when to get back into hedging jumbo loans. One of the first things to look for is stabilization and/or a narrowing of the jumbo-to-agency rate spread. The accompanying chart shows the average spread of conforming A paper to jumbo rates for 2007. It is highlighted how much wider spreads have become since the mortgage crisis began.

So what does this chart mean to you? One of the most common practices when hedging jumbo loans is to hedge them with a "to be announced" (TBA) agency mortgage-backed security, because that hedge represents the most correlated hedge instrument available to hedge fixed jumbo production. This choice of hedge works well as long as the spreads between conventional and jumbo pricing remain stable.

### ***Spread 'em***

Whenever spreads widen significantly, as they did as the mortgage crisis unfolded (see the July-September period on the chart), this correlation goes sour, and the hedge performance using this method performs poorly. In other words, hedge gains/losses do not offset loan gains/losses. In the July-September period of 2007, both TBA hedges and loans lost money!

Now that spreads have widened out, they have to narrow again eventually, right? To appreciate the ups and downs of spreads, talk to the secondary marketing managers who resumed hedging jumbos last November.

Ongoing analysis should rest on whether the best efforts-mandatory spread, potential bulking opportunities and other hedging pickups available are large enough to warrant the risks of spreads widening out after locks are accepted. To get a better

handle on what may cause jumbo-conforming spreads to widen, we need to take a deeper look at the fundamentals underlying the spreads.

Currently, the primary reason for jumbo pool pricing diverging from agency pricing is the utter lack of liquidity in non-agency product. When the crisis began, agencies widened to treasuries initially, jumbos widened to agency, and Alt-A widened to jumbos.

Agencies have since tightened back to treasuries, but non-agency products have not tightened back to pre-July 2007 levels. When there is no difference in credit quality or prepayment assumptions between jumbo and conventional loans, shouldn't they have reasonably similar pricing? We have observed the answer to that question - the agencies' government-backed principal guarantee and portfolio bid has translated into substantially different perceptions of risk. Non-agency investors do not have principal guarantees and fear rating agency accuracy and future housing depreciation will translate into principal losses.

More important than principal loss concerns, investors still remember last summer when no traders would even bid on non-agency loans or bonds. In today's environment, few investors want to commit to owning loans or bonds to maturity or until the market recovers.

This is the biggest hurdle with regard to a return to an increased jumbo loan bid. The investor community, having been recently burned, has to feel comfortable with its risk in jumbo loans and the models that value them. As of New Year's Day, traders have described the trading and liquidity of AAA bonds backed by jumbo product as "spotty," meaning that there is still a substantial amount of uncertainty in valuation and potential for price volatility in the near term.

What does this tell us? It suggests to us a laundry list of events that need to happen to portend the tightening or stabilization of spreads and a return of liquidity. Credit rating agencies need to regain investor confidence while, at the same time, gain confidence in the underlying funda-

mentals and assumptions that impact their credit ratings. In other words, the rating agencies have to see what they have not seen to date, predictability in delinquency rates and house values, to feel confident about their ratings and models. This will start to happen as new jumbo production with far tighter underwriting guidelines starts to outperform previous vintages and the housing market starts to stabilize.

More specifically, what signs should you watch for to pick your point of re-entry? Ultimately, your point of entry will depend on your risk tolerance, but the following signals should provide useful guidance in picking that point:

- Stabilization of jumbo-conforming spreads (i.e., several months of consistent or tightening spreads);

- Predictability of Case-Schiller or Office of Federal Housing Enterprise Oversight home price indexes (i.e., results consistent with or better than expectations for several months);

- Delinquency and foreclosure data on newer jumbo vintages start to show markedly better delinquency performance;

- Older vintage production exhibits improved or more predictable delinquency and foreclosure performance;

- Cessation of rating agency downgrades;

- Cessation of bank loan-reserve write-downs; and

- Growth in the number of jumbo investors.

At this time, 2008 looks like a year fraught with risk. As loan-reserve write-downs and Wall Street settle down, we hope reason will prevail, and investor research will start to focus more narrowly on the performance of high-credit-quality jumbo production. This research and color should help investors regain confidence in jumbo production, which will drive the tightening of spreads and the return of liquidity. The market remains intimidating, but paying diligent attention to market conditions will present significant opportunities to those willing to resume hedging their jumbo production. **SME**