



Challenges in Pricing Non-Conforming Loans

Many lenders employ successful delivery strategies with non-conforming loans (Fixed and Adjustable Alt-A & Jumbo A) that entail hedging and selling closed loans in bulk packages (greater than \$3M). Such lenders are often able to realize substantial execution improvement over Best Efforts delivery strategies. Unlike conforming mandatory pricing, no transparent pricing exists for bulk mandatory non-conforming loan sales. Consequently, many lenders simply take the best Best Efforts pricing and then add some of their anticipated mandatory bulk execution improvement, i.e. they sweeten their price to their originators by some or all of their expected profits. Other lenders gradually ease off on price adjustments as they gain a comfort level that bulk execution results in less negative price adjustments. The challenge lies in accurately valuing this portion of the pipeline.

Lenders who price off of Best Efforts pricing must be cautious as bulk mandatory/best-effort spreads move around on a daily basis and in some cases, an investor's Best Efforts pricing may actually be better than mandatory bulk execution. Given the lack of transparent pricing for these products, how should lenders address these challenges?

Most risk management services, such as Compass, provide lenders with a New Lock report comparing the lender's secondary cost (rate sheet cost + expected profit margin) to a current economic value derived by market pricing on the day of the lock plus any feature adjustments. The first day mark compared to the secondary cost is equal to the estimated marketing gain; the purpose of hedging is to maintain the expected profit margin. If a loan is locked at a loss on day one, there is no hedge strategy that can be employed to mitigate this loss, unless the hedge is not working as intended. Conversely, when a loan is locked in-the-money, it is probable that the gain will be greater than the corresponding hedge cost. This gain, however, would only be realized if the loan actually closed, which is less likely given the ability of borrowers to shop around. A lock that is in-the-money has a higher chance of falling out, which is a cost that one must consider.

The gain or loss of a lock on day one is a key factor in determining the pull-through of the loan, which ultimately affects hedge effectiveness. Consider the example below, in which we have \$10M worth of locks. In scenario A, we have locks that appear to be 2 points in-the-money, and a pull-through factor of 75%. In scenario B, we have locks that are at-the-money and a pull-through factor of 85%. In this example, the market sells off from the day of lock and is 1 point worse on the day that the loan is allocated. Presumably, we lose on the sale of the loan, but because MBS prices have now dropped, we have profited from the hedge. However, due to the disconnect in the pricing in Scenario A, we have been under covered in the market sell-off and do not realize as much of a hedge gain as we do in Scenario B.

	Amount	MTM Price	Secondary Cost	Pull-Through
A) ITM	10,000,000	102	100	0.75
B) ATM	10,000,000	100	100	0.85

When reconciling Day 1 pricing, one may assume that the ideal result when comparing the economic valuation to the actual secondary cost would be for no or little mismatch to exist. This perception must be balanced versus the various objectives of reporting on Day 1 pricing, and the complexities involved in



valuing non-conforming products, as discussed above. Lenders may choose to price products to cash pricing and a standard set of adjustments to avoid large discrepancies in Day 1 price reporting. This method, however, may not necessarily depict the true economic value of the loan, specifically for lenders who sell such products in mandatory bulk packages. With this in mind, lenders may choose to sacrifice a “clean” New Lock report for a more accurate picture of what the aggregate pipeline would be worth if sold bulk mandatory.

Despite the challenges in achieving a perfect G/L match on a New Lock report, monitoring Day 1 pricing on a loan level basis provides for the opportunity to discover potential issues associated with certain products. A specific program that is continuously locked in or out-of-the-money should be a red flag, particularly if the difference is not compensated for at the time of allocation. In addition to product profitability, analyzing Day 1 pricing aids in determining originator profitability, which can lead to more profitable production strategies. Determining the most accurate valuation method is not only critical to effective reporting and profitability analysis, but the in or out-of-the-moneyness of a lock affects its pull-through percentage, corresponding hedge ratios, and ultimately the hedge cost of the lock. – *Vimi Vasudeva*