

The Value Of Knowing Your Day-One Profit Margin

Secondary marketing managers pricing loans in a best-efforts-to-mandatory spread might run the risk of forgetting key considerations.

By Bob Gundel

Do you know what your profit margin is when you originate a loan? Profit margin is the most important driver of a lender's profitability, but it is often an obscure topic for most secondary marketing managers (SMMs). Surprisingly, many SMMs cannot answer that question with 100% confidence.

Control over profit margins will lead to better control of a firm's overall profitability. However, many SMMs have unknowingly given up control of their day-one margin.

One of the biggest mistakes that both new and seasoned SMMs make when originating loans is using an investor's best-efforts rate sheet to price the loans and set their margin, while selling the loans on a mandatory execution. Why is this a mistake? Because, by doing so, these managers are allowing the most important driver of profit to be manipulated by a third party and, thus, have effectively given up control of their day-one margin.

When lenders use best-efforts pricing to originate a loan they plan to hedge and sell using a mandatory execution, a portion of the day-one margin built into the loans when they are originated is attributed to the spread between the all-in best-efforts price and the all-in mandatory price. Let's use the hypothetical data on this first chart to illustrate the point.

Using this data, let's say that an originator prices the Jones loan, a Fan-

nie Mae, 30-year, 4.75% note rate using a best-efforts rate sheet, with the intention of hedging that loan and selling it on a mandatory execution. The total effective margin on the day the loan is originated is equal to the base margin of 45 basis points (bps) plus the difference between the all-in best-efforts execution and the all-in mandatory execution of 27 bps - or 72 bps.

That may seem like a healthy margin, so what's the problem? The problem is that the best-efforts-to-mandatory spread is a moving target. On any given day, the spread can vary by product and delivery term and, as observed in the table, by note rate. So, if the SMM is assuming that the Jones loan is receiving the average total margin of 85 bps (the average best-efforts-to-mandatory spread of 40 bps plus the 45 bps of base margin), in reality, it is already underperforming by 13 bps on the day-one margin due to variation in spread between the average and value of the 4.75% note rate.

For SMMs pricing loans in this manner, unless they are performing this analysis every day by product, note rate and delivery term, their day-one profit margin is unknown or, at best, inaccurate.

Additionally, the average best-efforts-to-mandatory spreads expand and contract in different market environments and changes to investor

demand for the product. Now, let's consider the second chart, which provides some observed best-efforts-to-mandatory spread average values for May 2010.

As clearly expressed in the second chart, the spread is volatile, and contracts and expands day over day. This means that the 72 bps of total margin that was built into the aforementioned Jones loan on day one could be more or less than 72 bps on the day the loan is sold on a mandatory execution.

For example, let's say 23 days have passed, and the Jones loan has closed. When the SMM goes to sell the loan as mandatory, the best-efforts-to-mandatory spread on the 4.75% note rate is now only 17 bps, and the effective margin on the loan is now 62 bps - a reduction of 10 bps from the day of origination and 23 bps worse than the average total margin expected across all note rates. Add in 5 bps to 10 bps of hedge cost to this scenario, and allowing a third-party to influence your margin has proven very costly.

Aside from increasing profit and loss statement (P&L) volatility, there are several other problems caused by pricing to best efforts and selling mandatory. In a dynamic pull-through model, originators assume that loans with positive P&L above and beyond the day-one margin - we'll refer to this as positive secondary marketing P&L - have a lower-percentage chance of closing, because increased market prices mean rates are lower and the

borrower is more likely to get a more favorable rate elsewhere.

Conversely, when loans have negative secondary marketing P&L, the model assumes that a higher percentage of these loans will close as lower prices drive market rates higher and the rates and terms of the existing loan lock become more attractive to borrowers. This means that originators pricing to best efforts and valuing loans with a mark-to-market mandatory execution will have the true secondary marketing P&L of the loans distorted by the amount of the best-efforts-to-mandatory spread.

Using the Jones loan as an example, in a flat market, there would be a 27 bps profit on day one. Because

loans that are profitable are covered at a lower percentage, the loan is effectively under-hedged starting on day one. This situation stays true the entire time the loan is in the pipeline, assuming that the best-efforts-to-mandatory spread is greater than zero.

However, using an average to proxy the best-efforts-to-mandatory spread will not work in this situation, because the spread varies by product, note rate and delivery term, and those spread values can change from one day to the next. In a down market, improper hedge coverage can be extremely costly.

Additionally, pricing loans in this manner leads to distortions in

profitability reporting and hedge-effectiveness testing. If originators do not know the profit margin for each loan, how well can they determine how effective their hedge is?

P&L concerns

Going back to the Jones loan, which had a total effective margin of 62 bps on the day it was sold, how is this P&L being reported in the financial statements? Most likely, the originator is booking the 45 bps of base margin as P&L from margin and the additional 17 bps that is attributed to the best-efforts-to-mandatory spread as P&L from execution, thereby understating the effective total margin and overstating the gain on sale from market movement. In this scenario, loans will almost always have a negative hedge cost, unless the cost to hedge is greater than the best-efforts-to-mandatory spread on the day the loan was sold.

Not only is that unrealistic, but it is also dangerous. Understanding hedge cost allows managers to make prudent decisions about which products are better to hedge and sell mandatory and which products are better to sell as best efforts.

Again, using an average to proxy the best-efforts-to-mandatory spread will not work in this situation, because the spreads vary by product, note rate and delivery term, and can change day over day, leading to distortions in hedge performance. A manager assuming that he or she will make the average total margin of 85 bps on the Jones loan introduces 13 bps of noise on the day of origination (85 bps versus the 72 bps of actual total margin built in on day one) and 23 bps of noise on day N+23 when the loan is sold (85 bps versus the actual total margin of 62 bps on the day it was sold). Add in 10 bps of hedge cost, and SMMs using averages to determine their day-one margin would be left scratching their head as to how the hedge performed so poorly in the case of the Jones loan.

If all this is true, why do SMMs price loans that they plan to hedge and sell mandatory using best-efforts rate sheets, when they would clearly benefit from pricing the loans to a

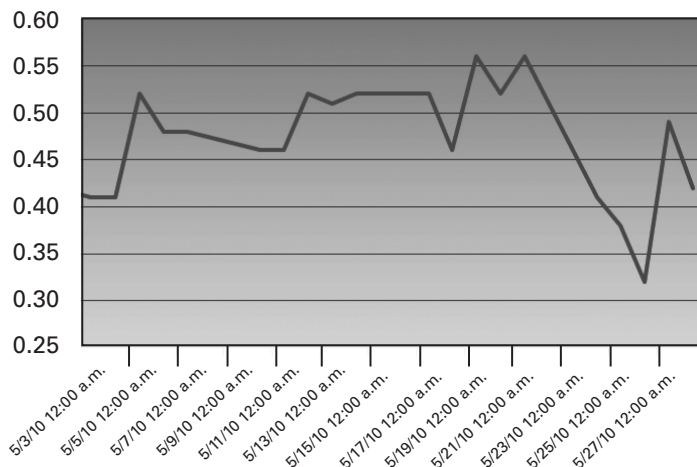
FNMA 30-Year (30-Day Locks)

Note Rate	Rank 1 Best-Efforts Price	Rank 1 Mandatory Price	Best-Efforts-to-Mandatory Spread	Base Margin	Total Margin
4.625	101.25	101.62	0.37	0.45	0.82
4.750	101.77	102.04	0.27	0.45	0.72
4.875	102.17	102.63	0.46	0.45	0.91
5.000	102.76	103.10	0.34	0.45	0.79
5.125	103.35	103.79	0.44	0.45	0.89
5.250	103.95	104.47	0.52	0.45	0.97

Average best-efforts-to-mandatory spread: 0.4 Average total margin: 0.85

Source: Compass Analytics

Best-Efforts-To-Mandatory Spread



Source: Compass Analytics

mandatory execution on day one? The answer is because it is very simple to take a listed best-efforts price from an investor's rate sheet, back out a base margin and put out pricing to the street. Conversely, without the right technology and tools, it can be extremely difficult to produce a rate sheet based on mandatory executions.

In the past, originators pricing to a mandatory execution had to update the investor model with live mortgage-backed security prices and update applicable pricing components, such as par note rates, note-rate adjusters,

buy-up and buy-down grids, early-delivery bonuses and various other spiffs, some of which can change daily in order to produce a base set of rates.

As if that were not enough, they would then have to perform a best-execution analysis among different investors' mandatory executions to determine the best prices to put out to the street. With such an extensive process, there is a lot of room for human error, making it difficult to train backup individuals within the department to generate rates in this manner.

By pricing hedged loans with a

mandatory execution on day one, SMMs can take back control of their margins and will have more accurate data and, therefore, better metrics in place to identify what's working well and what areas need improvement. By following this strategy, SMMs can confidently affirm that they know the profit margin when they originate a loan. **SME**

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