

Best Efforts Vs. Mandatory: Which Is The Right Path?

A rare convergence of market conditions has created an environment where the profit opportunities are simply too attractive to ignore.

By Linn Cook and Curtis Richins

What if someone offered to increase your monthly pay by \$500 if you were willing to run your own business? Is 500 bucks worth shouldering the extra responsibility of being the boss? Now imagine if the incentive were an extra \$50,000 per month. Does the question even need to be asked?

Believe it or not, this is precisely the situation that correspondent lenders face today. Conduit investors are offering serious financial rewards to lenders who are willing to shoulder more of their share of the risk and deliver loans with mandatory commitments. While a normal market pays a premium to lenders delivering mandatory over best efforts in the range of 25 to 35 basis points (bps), the current upheaval in the mortgage market has blown out net gains to 75, 100 or even 200 bps. At this level, any concerns about pipeline hedging go out the window.

So why are investors paying above-normal premiums for mandatory delivery? At a fundamental level, the secondary mortgage market pays a premium for loans that are delivered sooner rather than later. A 30-day price is always better than a 45-day price, which is better than a 60-day price, etc.

In short, investors are willing to pay more when there is greater certainty that a loan will be delivered. And when lenders opt to hedge their own pipelines, it provides even more

certainty to investors, because loans are guaranteed to be delivered, as opposed to the fallout risk of best efforts delivery.

It is obvious that a multitude of factors are contributing to an environment that favors mandatory over best efforts loan execution.

But today's environment goes far beyond the typical arguments for hedging. The convergence of unprecedented market volatility, pull-through challenges and capacity constraints have exaggerated spreads between best efforts and short mandatory/direct trade pricing, offering tremendous profit opportunities for correspondent lenders.

How did this all happen? In its attempts to arrest the slide into financial meltdown, the U.S. government took several steps intended to shore up confidence throughout the global financial marketplace. Starting on Sept. 18, 2007, the Federal Open

Market Committee began a campaign of cuts to the federal funds rate that was simply astonishing in its pace. Over the next 14 months, the rate dropped 475 bps, culminating in the Dec. 16, 2008, decision to essentially set the rate at zero.

During this free fall in rates, on Nov. 25, 2008, the Federal Reserve stated it would begin to buy mortgage-backed bonds in an attempt to unfreeze credit markets. This move sparked an incredible 10-point rally in the current coupon mortgage-backed securities pricing over the next 45 days. The resulting market volatility likely led to significant hedge losses for conduit investors on their best efforts channels as pull-through ratios dropped precipitously. In order to avoid the hedge exposure that hurt them so badly at the end of 2008, conduit investors are paying extraordinary premiums for mandatory delivery.

Another consequence of the government's action has been a massive spike in mortgage activity. Millions of homeowners rushed to refinance their loans as rates slipped below 5%, creating a surge of mortgage applications that rivals the historic levels of 2003.

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Already straining under the twin weights of market volatility and balance sheet constraints, some conduit investors were reaching their capacity to fund mortgage purchases and throttled back volume by slowing down best effort channels. This phenomenon was observed in December and January, when best efforts pricing at certain investors was reduced significantly, while market-based pricing for mandatory delivery was maintained. As a result, the pricing spread between 30-day best efforts and short-term mandatory widened out to unprecedented levels - over 200 bps at certain investors.

It is obvious that a multitude of factors are contributing to an environment that favors mandatory over best efforts loan execution. The profit and competitive advantages of hedging loans are simply too strong to ignore. But lenders need to be aware of the logistics involved with implementing a pipeline hedging strategy in order to ensure the certainty of their own success.

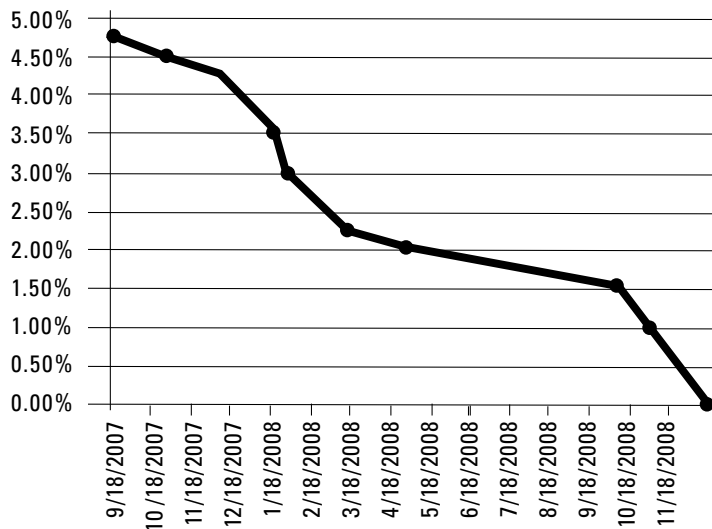
Requirements for mandatory

Running your own business requires a different mind-set than being just an employee. Your concerns are larger in scope and have more to do with structure and strategy, instead of the minutiae of day-to-day tasks. The same can be said for lenders that choose to transition from best efforts to mandatory delivery.

To start with, lenders need to consider their overall financial position in order to prove to investors that they have the capacity and capability to deliver on loan commitments. A net worth value of \$1 million with at least \$400,000 in cash is recommended. Production volume should be around \$10 million a month, although smaller volumes are feasible.

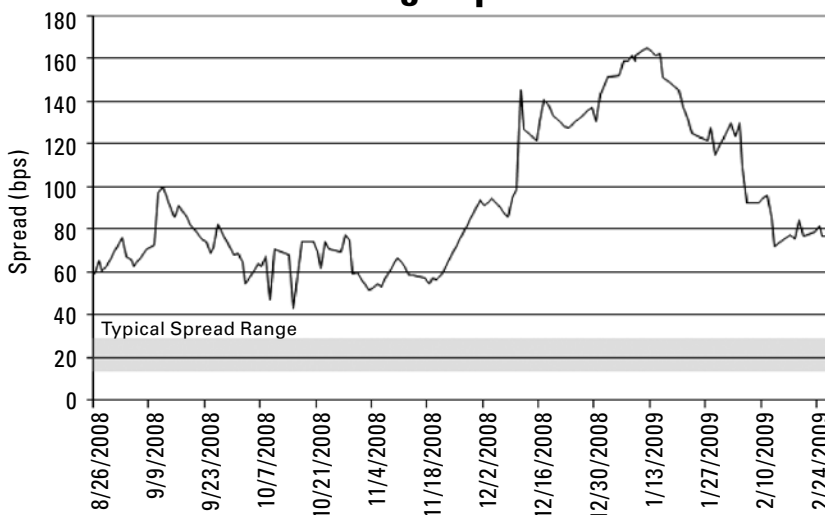
Because hedging is a delicate process, lenders need to commit to a disciplined, data-driven approach to their workflow. Implementing a centralized lock desk is essential, because it ensures a level of pricing and pull-through consistency that secondary marketing managers require in order to value their hedge positions.

Historical Changes Of The Target Federal Funds Rate



Source: Federal Reserve Bank of New York

30-Day Best Efforts vs. Short-Term Mandatory Average Spreads



Source: MCTTrading

This issue of a centralized lock desk is not to be taken lightly. Lenders that are coming from a strictly best efforts environment frequently get pushed back from their originators, who are used to locking loans with investors themselves. The shock of losing control over the locking process can sometimes result in top producers' leaving the organization. But the risk of poor hedging cannot be overstated and can only be mitigated by enforcing a strict locking procedure.

A data-driven approach, from a hedging perspective, means having accurate and timely access to pipeline information. The faster and more accurate the data are, the lower the hedge costs and the greater the profitability.

The influence of technology

Investing in a sturdy technology infrastructure has many benefits that go beyond improving hedging capabilities. Automation of time-consuming

and labor-intensive tasks yields productivity gains that will improve profitability, regardless of the method of loan delivery. But in the context of mandatory executions, automated underwriting and loan-pricing technology have a particular benefit that aids secondary marketing in their ability to hedge more efficiently.

Automated underwriting and loan pricing systems are designed to provide determinations of loan eligibility and pricing. They apply investor

guidelines to indicate whether a loan will qualify and utilize pricing matrices with rate sheet information to generate a competitive price.

By applying underwriting rules in an automated fashion prior to loans' reaching a lender's pipeline, these systems reduce the risk of errors that are attributed to underwriting in general.

While there are a number of variables that impact whether a loan is ultimately funded, automated un-

derwriting provides a higher degree of confidence in secondary's ability to predict the pull-through rate of a lender's pipeline, resulting in lower hedging costs. To put it in simple terms, automated underwriting and loan-pricing technology makes it easier for secondary marketing to hedge pipelines by removing a layer of uncertainty. Although eliminating hedging losses is impossible, reducing the size of those losses is the key to maximizing profitability. **SME**