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How can mortgage pipeline hedging help manage risk and protect mortgage profitability?

According to the Mortgage Bankers Association, the average profit earned per loan originated in 2018 was only $367, a decrease from $711 per loan in 2017. Those narrowing margins mean that every basis point of profitability counts in the increasingly competitive mortgage lending market. Many depository institutions utilize an originate-and-sell model for a sizeable portion of their mortgage lending operations, in which production is sold to investors like Fannie Mae and Freddie Mac.

Setting Appropriate Pricing

A mortgage lender must appropriately price its products to be profitable. Just as your local supermarket prices the inventory it purchases from vendors according to a targeted margin, a mortgage lender must price its interest rate locks according to a targeted margin. When a lender extends an interest rate lock commitment, it essentially "purchases" (on a probability weighted basis to account for potential fallout) the "inventory" that it will eventually sell in the secondary market. But unlike your local supermarket, a mortgage lender's final selling price will vary with interest rates over the loan's "shelf life" of about 30 days, the average time period from the rate lock extension until sale.

At the time of lock, the margin of the loan depends on two factors: the investor's current commitment price for the loan product and the buy price of the loan. The difference between the two is called the locked margin. For example, assume a lender extends a 30-day interest rate lock commitment of 4.75% for a 30-year fixed rate loan. Furthermore, assume the borrower receives 1 point at closing, making the buy price 101. If on the day of lock, the investor is offering 102.15, then the lender's locked margin is 1.15 (102.15-101). From this margin, the lender must cover all its operational costs and, hopefully, realize a profit. What is critical to realize is that at the time of lock, the lender locks not only the interest rate to the borrower, but also the margin it will earn on the eventual sale of the loan. This, of course, assumes the final selling price is hedged.

Protecting Your Profitability

From the time of rate lock extension until sale in the secondary market, interest rates can fluctuate and materially impact the originator's final margin. For example, in the days following the 2016 election, Treasury yields skyrocketed as investors feared the inflationary consequences of the proposed policies with the election's outcome. Consequently, mortgage rates, which have historically moved in tandem with the 10-year Treasury yield, were significantly impacted. Just a week before the election, the average 30-year mortgage rate was about 3.50%, and FNMA's commitment price for such a loan was about 101.9487. By the end of November 2016, FNMA's price had dropped to 98.3462. An originator who had extended $10 million of 3.50% rate locks in

early November was forced to sell, if unhedged, at a loss of about $165,000, some $360,000 less than the locked margin.

Similar, less pronounced, market movements in recent times have materially impacted mortgage rates. In early January 2018, recently enacted tax cuts and hawkish rhetoric from European Central Bank officials lead to a spike in yields. During the first week of 2018, the average 30-year fixed mortgage rate was 3.95%, and the corresponding FNMA price was 101.8134; by month's end, the price was 100.2164. As a result, an originator who had extended $10 million of 3.95% rate locks at the beginning of the month would be forced to sale at a final margin $160,000 less than its locked margin. While less significant than the 2016 post-election spike in rates, rate movements during this period would have greatly impacted an unhedged originator.

Of course, rates can fall just as easily. For instance, in late March 2019, the dovish tone that emerged from the FOMC meeting, weaker than expected global economic data, and geopolitical concerns from Brexit all led to a drop in yields. In early March 2019, the average 30-year mortgage rate was 4.50%, and FNMA's corresponding offer rate was 101.3195. By month's end, the price had jumped to 102.9778, an increase of more than a point. Under these conditions, a mortgage lender who had not hedged its mortgage pipeline risk would have benefited.

Clearly, interest rates can fluctuate within a given lock period, but originators have multiple options when hedging mortgage pipeline risk. Mandatory forward commitments, which are offered by FNMA and FHLMC, allow lenders to lock the selling price for delivery in a specified number of days. If unable to deliver at the expiration date, the lender may be forced to pay expensive pair-off fees. Another option is to forward commit on a best-efforts basis. Like a mandatory commitment, the lender can lock the price for future delivery, but there is no penalty if the loan does not close. Best efforts pricing, however, is much less favorable than mandatory commitments, which eats into final margins.

Another option is to establish a short position in the TBA MBS market, where originators can forward sell agency MBS. Because daily TBA price changes are highly correlated with daily FNMA commitment price changes, TBA MBS contracts can be used as an effective cross hedge for mortgage pipeline risk. Furthermore, because the lender is not bound to deliver loans at a specified time as with a mandatory or best-efforts commitment, using TBA's allows the originator to earn additional interest income. After originating a loan, the lender can continue to hedge and earn the interest on the first few payments before selling in the secondary market. Even after accounting for the additional funding and hedging costs, the TBA hedging strategy uniquely allows the originator to enhance its profitability.

There is no doubt that factors including inflation projections, rhetoric from central bankers, geopolitical concerns, and a host of other issues will move Treasury yields and, thus, mortgage rates. This is beyond the institution's control. However, appropriately priced interest rate lock extensions and successful hedging programs can establish—and protect—profit margins that are so difficult to achieve in the mortgage lending business.