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Why Should Depositories Hedge Mortgage Pipeline Risk?

If your institution is like most of the depositories we work with, then mortgage lending is a substantial part of your business. However, it's important to understand your current mortgage pipeline process and periodically evaluate whether your institution is exposing itself to unnecessary interest rate risk by not hedging or overpaying the agencies to hedge. We often find there are opportunities to enhance profitability and better manage risk in both of these scenarios.

It is common for institutions to sell groups of mortgages to a purchasing agent such as Fannie Mae or Freddie Mac. These government sponsored entities (GSEs) package the loans with like mortgages for sale in the secondary market. The time between the loan going on the lender's books and its sale to the purchasing agent is called the "mortgage pipeline."

Benefits of hedging the mortgage pipeline

Managing the pipeline is a critical part of mortgage lending that calls for skilled management to keep risk under control and ensure profitability. Hedging is often used to offset risk and increase efficiency, but it can be confusing – even daunting – to some because it involves complex computations and the use of models to manage risk and determine pricing. Yet, when done right, hedging strategies may offer lenders more selling flexibility, greater efficiencies and the ability to hold loans on the balance sheet longer – all leading to potentially higher returns. Usually, this process is most successful when financial managers work with qualified investment advisors that have proven hedging experience.

Pipeline management strategies

When a mortgage lender grants a homebuyer a loan, the borrower locks in the current rate and the loan enters that lender's pipeline. If rates fall, the borrower is free to choose another lender without penalty. But mortgage loan commitments are considered firm on the part of the lender (e.g., the originator), so the institution may be left with a hefty portfolio of loan commitments with significant risk from pipeline fallout and/or price fluctuations between the time of loan commitment and when the loan is sold off. This is where good pipeline management becomes essential. The most common strategies for pipeline management are using forward-sale commitments and hedging the pipeline with capital market instruments.

Forward sale commitment

This type of commitment requires the mortgage originator to make either a "mandatory" or "best-efforts" commitment for future delivery of the loan to the purchasing agent. A "mandatory" commitment requires the originator to deliver a set dollar amount of mortgage loans at a certain price by a specific date; if the originator can't deliver, the agent charges a "pair-off" fee. A "best efforts" commitment doesn't require a pair-off fee, but the price for the loan will be less favorable, often with a large markup.

Figure 1: Mandatory vs. Best Efforts

	Mandatory	Best Efforts
Commitment Type	Multiple or Single Loan	Single Loan (Borrower & Property Specific)
Loan Substitution	Yes	Not allowed
Live Pricing	8:15 a.m. – 5:00 p.m. ET	8:15 a.m. – 5:00 p.m. ET
After-hours Pricing	No live pricing; Close of business mandatory prices available from 5:00 p.m. – 10:00 p.m. ET	Available to commit from 5:00 p.m. – 10:00 p.m. ET
Desktop Underwriter® (DU®) System Integration	No	Yes
Extensions Allowed	Yes (1-30 days)	Yes (1-30 days; if loan closed, up to 60 days)
Pair-off Fee	Yes, based on market movement	No, unless the loan closes and is not delivered to Fannie Mae
Product Change	Not allowed	Allowed
Commitment Amount Change	Subject to certain tolerances	Allowed with no restriction
Commitment Pass-Through Change	Delivery allowed within 5 pass-through rates or 50 bps	Allowed with no restriction

Source: www.fanniemae.com

Pipeline management strategies

As discussed, a lender might experience "pipeline fallout" when loan commitments don't close, because the borrower isn't obligated to take the lender's mortgage. But instead of the significant costs incurred with forward-sale commitments, originators that internally hedge the pipeline can potentially increase profitability.

A successful hedging program includes the following:

- **Maintain models and accurate data**
  To improve the accuracy and timeliness of forecasts, it's important to ensure accurate and timely data. Also, automated data recovery and integration should be available with the institution's modeling software and they must be able to maintain sophisticated, reliable models for trading and monitoring their positions.

- **Create pipeline stages and estimate the likely fallout**
  Originators use pipeline fallout ratios to estimate pull-through ratios (one minus the fallout ratio). The pull-through ratio is the likelihood that a loan commitment will be funded. Variations in interest rates and time to closing affect fallout rates, with rising rates usually increasing the borrower's incentive to close and vice versa.

- **Computing the Hedge Dollar Amount**
  Forward contracts can mitigate pipeline fallout risk by protecting open positions from adverse price movements. Because the originator has a long position in mortgages, taking short forward contracts on "To Be Announced" (TBA) mortgage-backed securities (MBS) protects the originator if prices decline as the hedge position's value would rise.

To determine the amount that needs to be hedged, the risk manager must measure the duration and convexity risks associated with the mortgage assets, and then adjust for the estimated fallout. The hedge position is calculated by adjusting the dollar duration of the mortgage pipeline by the projected fallout. The firm places the hedge by selling short the appropriate amount of TBA MBS.

A well-planned mortgage pipeline management program reduces the risk of price volatility of loans in the commitment phase. Eliminating all risk would mean a perfect score, even if the hedge position resulted in a loss. Adjustments to the hedging process should reflect post-process evaluations of the accuracy of predictions.

While internal hedging may result in substantial cost savings and enhanced profitability, its success is reliant on the accuracy of the data input, the effectiveness of modeling and the expertise of the risk manager at controlling costs and implementing a hedging strategy. Most financial institution originators partner with firms that are experienced in analysis and capital markets and can offer expert advice.

Contact us today to learn how ALM First may assist your institution with Mortgage Pipeline Hedging.

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