

Are Best Efforts Your Best Bet?

BY DEAN A. BROWN

Recently we have seen quite a few new or small mortgage bankers committed to selling most, if not all, of their loan production servicing released through what is known in the industry as "Best Efforts" delivery.



BROWN

These companies often ask when they should hedge their own production and how to determine what the best deal is. This article reviews the analysis framework for determining when it is or is not in a mortgage banker's best interest to sell loans on a best efforts basis.

The best efforts approach can be defined as the delivery of loans to an investor at a predetermined price within a specific time period if the loan closes with the mortgage banker. The best efforts part comes in when the borrower theoretically does not qualify or does not go through with the loan transaction and, therefore, the loan is not available for delivery to the investor.

After notification that the loan has been canceled or withdrawn, the investor drops the lock-in from its system and does not require delivery or a

Dean A. Brown is president of Mortgage Capital Management Inc., San Diego, a mortgage consulting firm specializing in secondary marketing, interest rate risk management, trading, valuation, and product and builder business development.

pair-off fee. The mortgage banker has done its "best efforts" to deliver and is not subject to a pair-off fee.

The best efforts delivery contrasts directly with the mandatory delivery contract, wherein a specified price is paid within a certain time period subject to pair-off for non-delivery.

For example, if the loan was locked in on a mandatory basis, the investor does not care which loan is delivered as long as the one delivered has the same balance and other characteristics as the loan locked in.

Whether traded on a loan-by-loan basis or as a pool through an assignment of trade, mandatory delivery entails penalties for non-delivery. Non-delivery under a mandatory execution is subject to a pair-off fee, usually determined by the market movement over the period plus a transaction fee. Hence the term "mandatory" when referring to the lock-in agreement.

Drawback scenarios

There are a few drawbacks to executing best efforts.

First, if a borrower calls to say that he will not be able to close the loan within the lock time, and that he will need an additional month, the obvious drawback is that the best efforts delivery is subject to negotiation.

In the best scenario, the investor simply extends the lock according to the roll cost in the market at the time for an additional month.

However, other outcomes may occur including: cancellation of the lock at expiration with the market moving higher and adjustment of the price to a much higher price relative to the roll cost.

As one can imagine, the outcome is

uncertain, subject to the policy and goodwill of the investor. Another question you have to ask is: Can you afford to subject your customers to this circumstance when most companies simply extend their lock at no fee or a minor roll charge?

A second drawback is the possibility a borrower may call to request a new loan program, say a 5-year fixed that extends into a 1-year CMT ARM, after having been locked in under a 30-year fixed-rate. What is the response of the investor? Does it:

A. Give you the price of the 5/1 ARM as of the original lock date?

B. Renegotiate the price subject to a hedge cost fee?

C. Allow the loan to fund under the new program at the new price and forgive the old lock, even when the market has improved?

D. None of the above?

These questions need to be asked because not every investor treats each situation the same. One may be more reasonable in one area and less reasonable in another. How much control do you need over the service and profitability of each transaction?

These questions, in addition to the issue of expected profitability, should be considered.

The viable alternatives to selling all of your loans on a best efforts basis is to hedge your pipeline independently, or to not offer locks before the documents stage. From a risk management perspective, best efforts works when the expected cost of hedging is higher than the all-in price differential between hedged mandatory delivery and best efforts.

Let's assume that investors price loans in a rational manner, i.e. the

mandatory delivery is more efficient and therefore more valuable for investors than best efforts which contains an additional optional component to their risk profile.

Then the solution to the issue is to measure the expected net profitability of delivering production in one method versus the other. The mandatory execution (or call it pipeline hedging approach) calls for a sophisticated daily application of pipeline hedging technique and analysis. Concepts like fallout analysis, OAS hedge ratios, hedge optimization, option theory, market-to-market reports, etc., need to be employed to decrease the costs of hedging.

The accompanying graph depicts the costs of hedging a mortgage pipeline given various fallout volatility assumptions. Fallout volatility is the spread and/or error expected from predicting closing rates on a loan by loan basis.

The larger the volatility to the closing rate function the higher the fallout volatility and hedge cost. Hence, a wholesale originated jumbo refinance loan has a higher fallout volatility profile and hedge cost compared to a retail originated government purchase transaction.

Thus, each product type should be examined to compare the alternative delivery executions in order to maximize your expected returns.

Under a best efforts delivery execution, no additional hedge cost should be incurred. The cost is borne upfront from a reduced all-in price whether in the form of a lower note price, servicing price, warehouse interest spread, or transaction costs (underwriting or transfer fees).

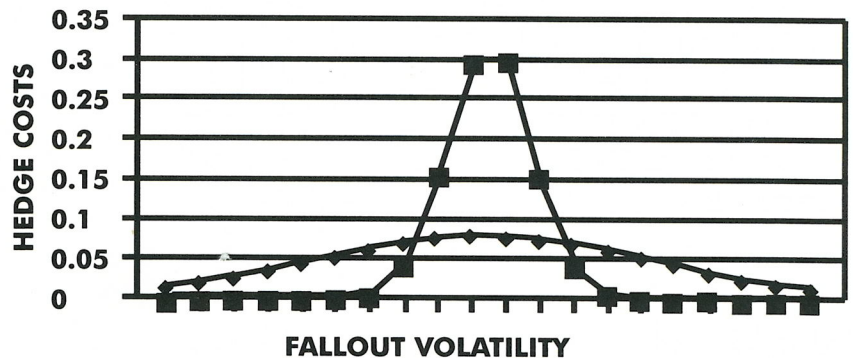
On the positive side of the analysis, the best efforts delivery is a "known." That is, the expected profitability from the best efforts transaction is fixed and should not vary. That is assuming the loan does not renegotiate, need extension, or change from one program to another during the processing period.

All things considered, the problem boils down to the following: Can your company hedge certain product types for less than the spread between the

HEDGE COSTS ASSUMPTIONS

The costs of hedging a mortgage pipeline are based on various fallout volatility assumptions. The larger the volatility to the closing rate function the higher the fallout volatility and hedge costs.

Wholesale Jumbo Refi **Retail FHA/VA Purchase**



SOURCE: Mortgage Capital Management Inc.

alternative delivery methods?

After carefully examining the various components of your pipeline and investors' best efforts agreements and practices, you should come to realize that at times when the spread narrows between the mandatory and best efforts delivery executions, it is best to sell loans on a best efforts basis.

However, many types of loans and lock periods are better hedged independently. That is, your expected net profit is substantially higher. This holds true even when you find an investor who allows you to walk from a best efforts delivery agreement "at will" as opposed to expecting you to deliver if the loan closes.

Furthermore, if one were to assume that an effective pipeline hedging approach would cost a company 12.5 basis points on average per loan, then a succinct analysis can be expedited to compare the best efforts versus mandatory delivery approach.

For example, assume that the following rates, prices, terms, and conditions were offered by the most aggressive whole loan purchaser on a given day: Rate: 7.5%, 30-day Mandatory Price: 100, Best Efforts Mandatory Price: 99.75.

Under these conditions, one easily could determine that the mandatory

delivery execution would be more profitable and therefore in the best interest of the company given that $100 - .125 = 99.875 > 99.75$.

This simple analysis assumes that one knows the cost of hedging individual loan types, the interest earned over the warehouse periods are equal, the servicing premiums are equal, and the transaction costs are equal. Big assumptions!

However, as shown in the chart, one can look at the cost of hedging an individual jumbo loan from a wholesale source with a long lock-in period for a cash-out refinance transaction loan and be safe to assume that this loan probably has a higher hedge cost on average. This is due to increased closing rate volatility than a retail originated government short-term lock on a purchase transaction.

To sell the government loan on a best efforts basis under these assumptions would be like giving money to the investor, while the jumbo transaction should be carefully reviewed to determine whether the loan should be sold on a best efforts or mandatory basis.

If the all-in expected profitability is greater by employing the best efforts approach you should use it - if not, try hedging your pipeline efficiently to maximize your earnings.