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Builder Forwards Ready For A Comeback

What are the benefits of forward builder commitments for your business?

By Dean Brown

Regardless of which way interest rates go, it is solid business practice for mortgage lenders, builders and borrowers to continually look for ways to remove contingent liabilities from an otherwise risky business. Historically, an effective tool for mortgage bankers to remove or decrease risk has been to offer forward commitments to builders and developers to lock in current market pricing for their borrowers.

Something of a lost art, forward builder commitments have been offered in the past by many mortgage lenders to help builders protect their inventories against volatile or rising rates and provide opportunities for lenders to secure and process more loans. The practice of offering forward builder commitments has significantly declined in recent years, especially since the market has been experiencing lower interest rates and with the implosion of the housing market.

Builders need to be reminded that the housing market can change at any time, and it can do so rapidly. In a strong housing market, many builders are not aware of forward commitment options, or they don't think they need to spend extra money on them because sales are very brisk. It is in their best interest, and in the best interest of the buyer, to have a contingency plan to protect all parties from risk.

The impact of a changing market can be significant and can make or break the sale of a home. For example, a buyer who qualifies for a $500,000 loan at 3.75% will have monthly principal and interest payments of $2,315. If the market takes a turn and interest rates jump to 5.75%, the monthly payments will increase by more than $600 to $2,917. The higher rate basically increases the cost of the home and eliminates some buyers from purchasing. The builder would have to lower the price of the home to $396,000 for the buyer to get the same monthly payment at the higher interest rate.

As the U.S. economy continues to recover, mortgage rates will inevitably begin to rise. History is bound to repeat itself, and we will once again return to the environment that existed before. Currently, demand for new housing is outpacing the number of houses being built - but this could reverse itself in the future as the market stabilizes. Although we are seeing an increase in the number of new homes being built, much of the new construction is under way to replace inventory that has been sold to consumers taking advantage of the historically low interest rates.

Insurance to minimize risk

Forward commitments are a form of insurance for builders, lenders and buyers. They are put options that act as a guarantee from a lender that for a specific period of time, anywhere from 180 days or longer, a block of financing will be available at a guaranteed rate to any of the builder's customers who qualify, no matter how high rates go.

Forward commitments are a smart way for builders to protect their products' salability in future markets. Builders want to avoid situations where they begin construction under an agreement with a buyer only to find out the buyer doesn't quali-

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fy for financing due to rising interest rates. In these types of cases, the builder is left with excess inventory that needs to move quickly. If it entered into a forward commitment with a lender, the builder can be confident that affordable financing will continue to be available to another buyer with a guarantee that the interest rate will not exceed the agreed upon amount if the buyer qualifies for financing.

A developer who does not engage a lender for forward mortgage commitments before completion or sale leaves open the possibility that the inventory will not be sold during a given or expected time period because mortgage rates may increase. In other words, if mortgage rates increase in the future, the builder will have a harder time securing affordable financing for buyers.

So, to limit the contingent risk that affordable financing will not be available, developers are willing to pay a commitment fee to mortgage bankers for a guarantee that financing will be provided at the commitment contract's specified rate and volume.

How it works

The pricing of a forward builder commitment is dependent on many factors. As a simple example, let's say a builder wants to protect $10 million worth of home sales in a housing development it is currently constructing where it should begin closing in six months and finish closing in 12 months. If the current interest rates are 3.5% at 1 point rebate for a 30-day lock on an FNMA 30-year fixed rate, under a standard builder commitment, the mortgage banker would offer a 12-month agreement to fund loans for clients of the builder at 4.25% and 1 point or lower rebate for up to a year for an upfront fee of approximately 1 point.

If during the commitment period rates are lower and loans are ready to fund, the builder commitment-capped loans would be locked as normal to the daily rate sheet. If rates are higher, say 6% and -1 point during the period, the clients' loans would be locked and close at 4.25% and -1 point.

What's in it for me?

A forward builder commitment allows builders to guarantee they will have affordable financing available to their buyers regardless of current interest rates. Builders who purchase these puts have a competitive advantage in their market by offering this type of financing and peace of mind to their buyers.

The advantage of forward commitments for lenders is the opportunity to increase their pipelines through an increase in loan applications driven by the builder. By entering into a forward commitment, the lender becomes a preferred vendor of the builder because of the commitment. Even if the agreement does not include an on-site lending representative at the point of sale, the builder representatives will suggest that potential buyers work with the preferred lender to ensure a favorable interest rate at closing. Buyers are motivated to work with the preferred lender because they do not have the guarantee of a capped interest rate with other lenders. Although not all loans will be eligible for financing through the forward commitment, the lender still has the opportunity to offer competitive financing to the buyer, thanks to the preferred vendor status resulting from the forward commitment.

Protect assets and minimize risk

Forward commitments are more than an insurance policy for builders. They are also tools that mortgage bankers can use to protect assets and minimize risk. If interest rates rise after a borrower's rate is locked or if a lender is holding closed loans in inventory, risk is incurred. When rates rise, prices generally fall. As rates rise, loans in production are more likely to close because borrowers have a strong incentive to complete the transaction. If a lender has not taken steps to protect its position, it could be caught with loans that only sell at a discount or place in portfolio at a yield lower than the current market yield, an opportunity loss.

Mortgage lenders may continue to face price risk even after closing by placing loans in inventory without assurance of the price at which they will eventually be sold. To avoid interest rate or price risk, many lenders routinely sell loans into the secondary market via a forward sale agreement at the same time they lock in a rate with borrowers. This practice insulates lenders from adverse movements in market rates. However, in determining how much of the pipeline to cover, fallout risk must also be considered. By committing more loans than can actually be delivered, lenders face the expense of pairing out of the commitment.

Lenders are exposed to fallout risk if borrowers fail to close on a loan after a rate has been locked and a mandatory commitment has been established with an investor to purchase the loan at a specific price. Borrower fallout can be difficult to gauge, especially if the market is at all unstable. Lenders may be unable to approve some loans, or borrowers may withdraw their applications. Borrower fallout is sensitive to changes in interest rates. In a falling rate environment, borrowers may negotiate with mortgage lenders to lower their rate, or they may walk away from the loan altogether.

Looking to the future

The difference between a profitable mortgage lender and a highly profitable one comes down to the methods and tools used to minimize risk and decrease liability. There are many options available to lenders and knowing which ones to use and when to use them is the key differentiator. Lenders offering forward commitments will not only increase their pipelines, but also minimize the risk for fallout. As the U.S. economy remains volatile, mortgage lenders must be diligent in their work to offer attractive financing options to customers. SME

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