Float-down locks as a hedging tool in rising interest rate environment

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Over the past 30 years, the U.S. economy experienced the longest bull run in interest rates ever. This unprecedented event has led to many secondary marketing managers not having managed a hedge position during an extended period of rising interest rates. With limited practice in this type of volatile market, today's secondary market managers may not know how to effectively use the wide variety of hedging tools that are available. Failing to take advantage of these tools will result in mortgage bankers and depository institutions having substandard profitability, combined with a significant decrease in loan production.

The **free float-down lock** is an effective tool to help minimize risk, increase earnings stability and grow production.

The current rising interest rate environment is leaving mortgage bankers to look for valuable ways to stabilize earnings and increase growth without incurring additional risk. There are several effective hedging options to add business, decrease risk and manage pipelines in a rising interest rate environment.

Lenders often use a variety of hedging techniques to reduce their exposure to various systemic and interest rate-related risks. Hedging against an investment to offset the risk of any adverse price movement is good business practice in the secondary market. In this paper we will provide valuable information about one specific hedging tool, the free float-down lock, which is an effective tool to help secondary marketing executives minimize risk, increase earnings stability and grow production.

The free float-down lock is basically a put option with no up-front fees. Many lenders shy away from offering free float-down locks to customers because they don't incorporate optional coverage in their hedge strategy, or in many cases don't have relationships with the right broker-dealers. Some mortgage bankers subscribe to the myth that hedging with options is too expensive, too complicated and requires too much up-front cash, therefore shying away from this very useful strategy.

Put options give bankers the right but not the obligation to sell a mortgage loan at a specified price. The put option owner has the right to exercise the contract at any time up until the expiration date. The value of a put option increases as the loan price falls. A hedge strategy that utilizes optional coverage allows mortgage bankers to maintain their profit margins in a rising rate environment with higher loan pull-through rates.

Advantages of free float-down options

Selling float-down locks (put options) allows the lender to hedge against borrowers who are betting on interest rates decreasing before the mortgage loan rate lock expires. If the borrowers are wrong and interest rates increase, then the put option purchased by the mortgage banker will increase in value allowing the mortgage banker to profit from the borrower's bet.

Free float-down options allow lenders to increase volume by providing financing to customers requiring longer lock periods and/or float-down pricing. Lenders increase their pipelines by attracting new borrowers with the offer of free float-down options. Borrowers pay no up-front fees for the put options and can be certain about the affordability of the homes they are planning to purchase with the added bonus of knowing they will get lower rates if the market improves.

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Suppose a borrower locks in a loan at a rate of 5 percent. Before the mortgage application is processed and closed, interest rates drop to 3.5 percent. With a mortgage rate lock float-down, the borrower may lock in the lower mortgage rate before the mortgage is approved.

Float-down locks also allow for improved pipeline retention and margin management for the lender. By offering a free float-down lock, a lender reduces the risk of a borrower lock-jumping if the market improves and rates fall. Borrowers with the one-time option to lock in at a lower rate if the market improves are more likely to close the loan rather than let the lock expire to begin the process again with another lender.

Borrowers who lock-jump increase the cost of locks to lenders, who then pass on the costs to other borrowers. Not an ideal situation for anyone. An obvious way to discourage lock-jumping is to charge a nonrefundable fee for a lock. The problem is that lenders who adopt such policies place themselves at a competitive disadvantage. Fortunately there are other options for lenders to deter lock-jumping without a negative effect on profitability.

Rate protection plans

Working with a seasoned and experienced secondary marketing firm, lenders can learn to use appropriate methods to reduce fallout and secure long-term market assurance. Free float-down options are a tool utilized as part of a rate protection plan (RPP) when a borrower is facing long processing times during new home construction. Rate protection, offered with a float-down lock, can mean the difference between securing a loan and suffering fallout. For the borrower, it can mean buying a dream home instead of experiencing a nightmare.

A **rate protection plan** (RPP) is a lock structure designed for longer-term rate locks for borrowers buying homes under construction.

An RPP is a lock structure designed for longer-term rate locks for borrowers buying homes under construction. The plans offer potential borrowers peace of mind when experiencing long processing times and provide worst-case pricing in rate and discount points. A borrower risks rising rates and the possibility of not qualifying for the loan if he waits to lock until construction on the home is complete. An RPP eliminates that possibility because the borrower knows the worst-case scenario and can lock at lower pricing, even if the market declines before he is ready to close.

As an example, let's assume the 60-day price for today's market is 3.75% at -1 point on a mortgage company's rate sheet and the home will be available to close in 180 days. If the mortgage company doesn't offer a rate protection plan, then borrowers have only two options: float or lock, if available.

If the borrower floats until he is ready to close, he risks rising rates, potentially not qualifying for the loan or accepting a much higher payment. Instead, borrowers who lock in at a much higher rate for the extended lock period to cover the 180-day construction timeframe are usually offered a guaranteed rate, but at a significantly increased price. The increased price would reflect the actual roll cost in the market – currently around 37.5 basis points per month, plus a hedge cost. So, for 180 days the roll cost might be: 6 months times 37.5 basis points plus 25 basis points for hedge costs, which equals 250 basis points.

The alternative to offering a rate protection plan is offering financing at a higher current market rate but risking the loan not closing. If rates decline, the borrower has no option with the current lender to obtain a lower rate unless both parties are willing to renegotiate, which is a form of fallout.

Fallout risk

Many borrowers will often seek a loan with another lender to obtain a lower rate, leaving the original lender with a significant pair-off loss. For example, if the market remained the same under the period, the lender's rate sheet would show 3.75% at -1 point, while the borrower is locked in at 4.25% and -1 point. This difference in pricing would give the borrower plenty of incentive to shop around before closing.

Some mortgage bankers apply an up-front fee to keep borrowers from falling out under such circumstances. A lender may collect a 1-point fee that is credited toward closing costs and retained by the lender in the event the borrower cancels the transaction. The borrower receives the higher rate and is protected from rising rates under a worst-case scenario, but has to pay the high forward-market pricing locked in under the normal lock structure. In the event the market improves significantly, the borrower may still decide to go elsewhere when the incentive to do so is greater than the 1 point they paid up front.

> A float-down lock structure lets the borrower pay an upfront fee, but benefit from rate protection during the construction period.

The better tool for both the borrower and the mortgage company in this situation is a float-down lock structure where the borrower pays an up-front fee for protection against rising rates, but can benefit from rates not moving much or decreasing during the construction period. Given the current example, if the 180-day float-down pricing is stuck at 4.25% and -1 point as a worst-case scenario and the market does not move during the period, the borrower would be able to lock the loan at 3.75% and -1 point on day 150. If the market improved significantly during the period, on day 150 the borrower would lock in the lower rate and points. If rates increased during the period, the lock pricing would be protected at 4.25% and -1 point.

Lenders also can pay for the up-front fee, or at least reduce up-front costs, by adding an extra .125% to the cap and rate sheet price when the loan is ready to draw docs. To the lender, the extra .125% may be worth at least .5 points and would reduce the borrower's perception that the lock structure is not affordable. While the mortgage company would spend more on option costs to hedge the loan during the period, the extra .125% would provide a reasonable compensation for taking the extra risk.

Margin protection

A mortgage banker offering a float-down program needs to protect his margin on the loan by purchasing option coverage. The coverage will hedge the potential change in value of the loan regardless of which way interest rates move. Hedge coverage in the form of option contracts can mitigate potentially significant pair-off costs in a falling-rate environment.

It is also important for a mortgage banker to measure the correct amount of option costs needed in order to price the float-down in the market on day one. Accurately measuring option costs allows the lender to manage the hedge to ensure the margin originally priced on day one is achieved on day 180+ when the loan is closed and sold to an investor. The cost of an RPP option is not as simple as just calling a dealer to get a put option quote. Many other factors come into play because the value of the loan is not fully reflected in the mortgage-backed security price or potential price changes. Factors including servicing value, interest income and the profit margin on loan can all affect the pricing of float-down locks, among others.

Customized programs

Working with secondary marketing experts and consultants who have extensive experience pricing float-down risk can help lenders customize a program that minimizes costs and maintains margins. A customized program can result in an increased pipeline as well as the best service to borrowers. The following table is an example of a rate protection plan. It indicates example pricing for a float-down lock program designed to use the rate sheet as a basis to price.

30-year Conforming Float-down Lock Pricing			
Start with 60-day rate and discount			
Upfront Fee	**Period**	**Rate Adj**	**Disc Adj**
0.000	90-day	0.250%	0.250
0.250	120-day	0.250%	0.250
0.500	180-day	0.375%	0.375
0.750	240-day	0.500%	0.250
			Source: Mortgage Capital Management

In the example above, the 180-day rate protection plan base cap pricing is set according to the rate sheet, plus rate and discount adjustments. Additional requirements to successfully manage the RPP include, but are not limited to, the ability to purchase option contracts from dealers, issue mortgage-backed securities and track float-down locks as a separate exposure in the pipeline.

Are float locks more effective than mandatory locks?

Armed with the knowledge of no-fee float-down locks, one may pose the question, “How does a float-down lock compare to a normal lock?” The following example will explain the difference.

Let’s assume the same profit level is desired under each type of lock after costs to hedge are calculated. We will also assume that an up-front fee would be collected for a float-down lock. To determine the most effective lock, simply compare pricing of the two lock types under each scenario.

Many pricing structures are available under the float-down option pricing mechanism to make the upfront fees less expensive.

If the best investor price 60 days out for a 3.75% note rate FNMA 30-year fixed rate loan is 104, the targeted profit margin is 1 point and the loan officer compensation is 1.5 points, then a 60-day lock under normal circumstances would be at a rebate of 1.5 points. The same lock under a float-down scenario with the same price and rate should reflect the at-the-money option cost of the lock.

If a lender were to call a dealer who sells option contracts over the counter on FNMA MBS 3.0, the up-front fee would be approximately 20/32, or .625 points. Without taking into account the differences and/or complications around different notice dates, excess yield, hedge costs, etc., the float-down lock would cost an additional .625 points to hedge versus a normal mandatory lock.

The up-front fee for a float-down can be reduced by increasing the capped rate from 3.75% to 4.0%, thereby creating an out-of-the-money exposure on the float-down lock. In such a case the mortgage banker would simply purchase an out-of-the-money put option to hedge the value of the loan so the cost of the option would be approximately the value of the increased rate. If the buy-up factor for the .25% in extra rate is worth 4 to 1, then the option purchased would be set at a strike 1 point out-of-the-money and the fee would be approximately 10/32 up-front, or .3125 basis points.

Many pricing structures are available under the float-down option pricing mechanism to make the up-front fees less expensive. Not allowing float-down locks to occur unless the loan is ready to draw documents, or setting the market for the float-down rate to a 30-day rate and price when there are 15 or more days left, are just two examples.

Some lenders agree to renegotiate a mandatory lock when the market improves. Renegotiating a mandatory lock and giving customers better pricing can affect profitability because the cost to renegotiate comes directly from the bottom line, especially if the lender did not use options in any proportion to hedge the pipeline. In general, if a lender were to offer every client a better price after the market improved by 2 points and the same percentage of loans closed either way as expected, the gain on sale would be 2 points less. While this circumstance is not likely to occur, if the lender offered a renegotiation when the market improved, the amount of loss would still far exceed the gain from the increased amount of business closed.

Float-down options are one of the many tools that can be used to determine pricing and hedging on rates and fees.

Renegotiations should only occur when documents are ready to be drawn, the market has improved significantly and the borrower initiates and insists on the lower rate or they will cancel the transaction. Lenders should work to avoid allowing the full amount of market movement to be extended in the renegotiated price.

In the past the loan officer's compensation would have been reduced on loans that received a renegotiation. The current comp rules do not allow for a loan officer comp change to occur, but the cost should be tracked and allocated for pricing and management purposes. Loans with a renegotiation are considered fallout to the extent they move all the way to the current market. If loans can be kept to a halfway market movement, only 50 percent of the loan balance would be considered renegotiated.

Float-down options are one of the many tools that can be used to determine pricing and hedging on rates and fees, although few, if any, of today's mortgage bankers utilize these tools because they have never experienced a protracted and volatile rising interest rate environment. Researching the many hedging tools and methods available and knowing which ones to use and when can make the difference between a profitable mortgage lender and a highly profitable one. The volatility of the U.S. economy means that mortgage lenders must be diligent in their work to manage their pipelines and minimize risk.

About Mortgage Capital Management

Mortgage Capital Management provides the mortgage banking industry with the gold standard in pipeline risk management services, software and consulting. Its services help clients grow revenue, increase earnings stability, improve profitability and powerfully manage their risks. Mortgage Capital Management strives to build partnerships through commitment to superior service, complemented by excellent results.

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