FEATURE

Minimize Risk in a Rising Interest Rate Environment

Effective tools help remove contingent liability in a volatile marketplace.

By Dean Brown, CEO of Mortgage Capital Management

We knew it would happen at some point. It was inevitable. Interest rates are on the rise and so is market volatility. With increasing rates and market volatility, mortgage bankers are looking for valuable ways to stabilize and increase growth without increasing risk. There are several effective alternatives to add business, decrease risk, and manage pipelines in a rising/volatile interest rate environment including builder commitments, long-term and float-down locks, and incorporating options in the risk management toolbox, among others.

Forward Builder Commitments

Forward commitments are a form of insurance for builders, lenders, and buyers. They are put options, or contracts to sell assets at an agreed price on or before a particular date, 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 qualify 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 the builder entered into a forward commitment with a lender, he 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.

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. Even if the agreement does not include an on-site lending representative, 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. Additionally, the number of loans originated through the builder relationship will be greater than the number of loans protected under a commitment.

Long-Term and Float-Down Locks

Long-term locks help define the worst-case scenario for the borrower. They can be used effectively to allow borrowers to lock their loan for a specified time frame, usually up to 180 days, at a price that reflects the current forward market. If rates improve or stay unchanged relative to where they are when the loan locks, or if the market gets worse, the borrower always knows what their rate will be.

The cost for a long-term lock typically requires a refundable upfront fee toward closing costs if the loan funds. In the event the borrower cancels the transaction, the fee is usually retained by the mortgage banker to guard against fallout and roll costs during the lock period.

With many lenders, a borrower waiting for a builder to finish a home can apply for a mortgage and purchase interest rate protection. The borrower pays one point up front, at the time of locking, for the protection. By collecting the

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Effectively utilizing the proper tools will not only increase lender pipelines, but also minimize the risk from fallout volatility.

point up front and possibly paying it back only if the borrower closes, the lender protects itself against the possibility the customer will go to another lender for funds during the lock period.

A float-down lock structure is like a one-off builder commitment sold directly to a buyer. The mortgage banker agrees to fund a loan at a maximum rate and price over a longer period, usually 180 days (the construction period). A float-down lock provides the same upside protection to the borrower as a rate lock, along with an option to reduce the rate if market rates decrease.

The float-down lock option can be applied to any type of mortgage, but a borrower pays more for it since it is more valuable to the borrower than a rate lock and costs more for the lender to provide. Applying a float-down lock, the lender promises that the agreed-upon loan terms will be honored at closing, regardless of where market rates move to that point. Float-downs give borrowers the one-time right to have their rate reduced, at which point the float-down converts to a lock.

The pricing is registered and hedged as an optional exposure sold to the buyer, and the borrower has the right during the period to lock at the current pricing available or the maximum set at the float-down registration, whichever is lower. Float-downs impose an additional cost to the lender because it committed to the terms agreed upon if interest rates go up before closing. If rates decrease before closing, the borrower has the right to lock at the lower rate. This option cost can be offset through pricing, the upfront fee, or a combination of both.

The float-down lock structure and pricing can be customized to suit the specific needs of a buyer or market. For example, the upfront fee could be set low or equal to zero with higher caps and/or spread added on top of the current market pricing to pay for the option cost to hedge the loan. Alternatively, the upfront fee could be set at the market cost for the options, which would lower the cap level for the borrower.

ARMs: More Bang for the Buck

Historically, adjustable-rate mortgages, or ARM loans, have been used to combat a rising interest-rate environment. An ARM loan is a mortgage with an interest rate that may change, usually in response to changes in the Treasury bill, London Interbank Offered Rate (LIBOR), or prime rate. The mortgage holder is protected by a maximum interest rate, which can adjust in three, five, seven, or 10 years, depending on the terms of the loan. ARMs usually start with better rates than fixed mortgages in order to compensate the borrower for the additional risk that future interest-rate fluctuations will create.

Until recently, it didn't make sense for most borrowers to look seriously at ARMs. With fixed-rate mortgages available at interest rates near or below those

offered for ARMs, there was no substantial reward to make up for taking on the risk of frequent changes in the interest rate a borrower would pay on a loan. In the current rising interest-rate environment, ARM loans can mean the difference between an affordable house and a borrower's dream home.

The benefits of an ARM when fixed rates are relatively high are easy to see. With payments that are amortized during the same period as a 30-year fixed mortgage, monthly payments on ARMs can be much lower when there's a big gap in rates between fixed and adjustable mortgages. For instance, at 3 percent, the monthly payment on a $200,000 home would be $843. At 4 percent, the payment would be $955. Another way to look at it is if a borrower's income only qualified him or her for a monthly payment of $843, then paying a higher rate would only allow that borrower to take out a loan for $177,000. Having access to lower-rate ARMs allows borrowers to spend more on their dream home, which is useful especially in light of the increases in home prices over the past year.

ARM products provide borrowers with lower initial interest rates than what is currently offered for 15- or 30-year fixed-rate programs and must be pooled separately. These lower rates are used for qualifying purposes, however, not on the 3/1 ARM, as either 2 percent above the initial rate or the fully indexed rate is used.

Effectively Minimize Risk

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 methods available to lenders, and knowing which ones to use and when to use them is the key differentiator. Options on mortgage-backed securities (TBA puts and calls) and options on Treasury notes and bonds (CME puts and calls) should be used when the timing is right and should be employed when the lender is faced with optional exposure from the borrower, whether from an outright builder commitment, float-down lock, long-term lock, or general locked loan. Borrower behavior is measurable and manageable, and with the right tools your business can prosper. Effectively utilizing the proper tools will not only increase lender pipelines, but also minimize the risk from fallout volatility. As the U.S. economy remains volatile, mortgage lenders must be diligent in their work to offer attractive financing options to customers. **M**

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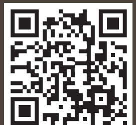

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