SECONDARY MARKETING EXECUTIVE®

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Rate Protection Plans Versus Renegotiations

When executed properly, the costs associated with a rate protection plan should be more than offset by the increased returns.

By Dean Brown

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, especially in the mortgage banking business. However, over the past 30 years, the U.S. economy experienced the longest bull run in interest rates ever. This unprecedented event has left many secondary marketing managers not having managed a hedge position during an extended period of rising interest rates or even relatively brief periods of rising rates.

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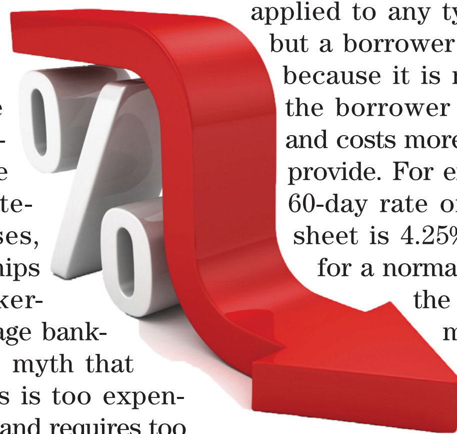
With limited practice in this type of volatile market, today's secondary market managers may not know how to effectively use a few of the hedging tools available. The difference between a profitable mortgage lender and a highly profitable one not only comes down to the methods and tools used to minimize risk and decrease liability, but also knowing which ones to use and when to use them.

Mortgage bankers who fail to take advantage of the right tool at the right time will see their institutions suffering from substandard profitability and/or a significant decrease in loan production. Effectively utilizing proper hedging tools can increase a lender's pipeline and minimize risk. As the U.S. economy remains volatile, mortgage lenders must be diligent in their work to offer attractive financing options to customers.

The rate protection plan is a product and method that helps lenders minimize risk, increase earnings stability and grow production. Essentially, it's a put option offered to customers with no upfront fees. Why no upfront fee when a lender certainly could charge for the cost of the program up front? Because borrowers looking to buy homes usually need to save all of their cash for the down payment and closing costs, and don't want to part with cash on a loan that they don't even know if they qualify for yet. Therefore, mortgage bankers should finance this cost of the program and charge no upfront fee - a task that is difficult, but possible.

Many lenders shy away from offering 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 upfront cash, therefore drawing back from this very useful strategy in a volatile market.



To effectively hedge a rate protection plan, mortgage bankers must include an options strategy in their pipeline risk management toolbox that incorporates both put and call options on mortgage-backed securities, and forward sales of TBA mortgage-backed securities with options on Treasury securities, when applicable. Failure to price and value the puts imbedded in the float-down offered to customers could result in a negative outcome, especially if not properly valued, monitored and hedged. However, the costs of offering this product should be more than offset by the increased returns from increased business, higher closing rates and reduced hedge costs overall.

How do you price it?

The float-down lock option can be applied to any type of mortgage, but a borrower pays more for it because it is more valuable to the borrower than a rate lock and costs more for the lender to provide. For example, if today's 60-day rate on a lender's rate sheet is 4.25% and -1.5 points for a normal mandatory lock, the mortgage banker might price the float-down rate protection plan for 90 days at

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4.5% and -1.5 points. Therefore, the mortgage banker is adding 0.25% to the rate and setting a cap, and the cost of offering this float-down option up front would be approximately 0.25 points in upfront option fees to the mortgage banker.

If rates subsequently decreased after 75 days of the processing period - for example to 3.5%, at -1.5 points - then the borrower would receive that rate from the mortgage banker. If rates increased to 6.5%, the borrower would receive 4.5%. If rates stayed the same, the borrower would receive 4.25%.

Applying a float-down lock, the lender promises that it will honor the agreed-upon loan terms at closing, regardless of where market rates move up to that point. The float-down option gives borrowers the one-time right to have their rate reduced (usually set at the time documents are drawn), at which point the float-down converts to a normal lock.

In other words, when interest rates go down before closing, a borrower's interest rate goes down as well. The benefit to the borrower is that they receive valuable interest rate protection at no upfront fee, know their worst-case pricing scenario in rate and discount points, and know they have locked-in financing for a longer period.

Advantages of float-down options

Float-down options allow lenders to increase volume by providing financing to customers requiring longer lock periods, anywhere from 90 to 365 days, with float-down pricing. Lenders increase their pipelines by attracting new borrowers with the offer of float-down options. Borrowers pay no upfront 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.

Float-down locks also allow for improved pipeline retention and margin management for the lender. By offering a float-down lock, a lender reduces the risk of a borrower who renegotiates the terms of his lock or falls out 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 renegotiate, or fall out, increase the cost of locks to lenders, which then pass on the costs to other borrowers and/or suffer from lower profitability. Not an ideal situation for anyone.

The bottom line is that a rate protection plan offers mortgage bankers the following:

- More business, because they're offering a product that borrowers want;
- Reduced fallout, because borrowers no longer go somewhere else when the market rallies or ask for a renegotiation; and
- Reduced hedge costs, because mortgage bankers don't have to renegotiate unexpectedly and/or buy back underwater TBA mortgage-backed securities hedge coverage.

The combination of these three benefits should more than make up for the initial hedge costs and, at the very least, won't cost more than the initial hedge costs.

What's the difference between float-down locks, long-term locks and builder commitments? It is essential for pipeline managers to recognize that the behavior of a float-down lock will be different from that of an extended lock, which, in turn, is different from that of a spot or larger builder commitment.

An extended lock is a lock for a period in excess of 75 days and tends to be offered to individuals who may be shopping for a home but haven't found one yet, or have found one that is already under construction. These shoppers are looking for a guaranteed rate to lock in today's prices and protect themselves from rising interest rates during the home-shopping or construction process.

Normal locks that have extended terms have a higher probability of fallout, as longer lock periods present more opportunity for interest rates to fluctuate. The longer the lock term, the more closing uncertainty. Therefore, lenders must hedge accordingly.

If the company hedges with TBAs on these longer-term locks and the market improves, the chance of the loan falling out is greatly increased. If the loan does fall out in a rising price environment, the pair-offs associated with the trade will be high because there is no loan to sell to offset the hedging losses. Some lenders charge upfront fees to offer these locks, but rarely does the structure work out to the lender's benefit.

Builder commitments are different from float-down locks or long-term locks because a builder commitment is an option purchased by the builder to guarantee a group of unknown borrowers a set rate, whereas a float-down lock is associated with an individual loan that has a set lock date, term and loan amount. Often, this is the case when a builder does not want to lose the opportunity to sell a home or an entire subdivision that is under construction. The builder commitment is designed to guarantee a specific rate with float-down features to borrowers, and the builder pays the upfront fee for option coverage. Builder commitments - whether for individual loans, phases of a development or entire subdivisions - and float-down locks require that hedges be structured according to the risk associated with each type.

Although each of these commitment types is typically hedged with option contracts, it's important for companies to manage, track and separate each type of product in distinct buckets and hedge them independently from one another. Doing so ensures that their unique behavior patterns are modeled correctly and hedge costs are minimized.

Options a must

In lieu of implementing a float-down strategy, some lenders believe that they are covered by offering a simple rate renegotiation policy. For example, every loan in the pipeline gets the lower market rate after the market improves by over a set amount - usually one point. This policy used to be acceptable for some companies, with minimal fallout back

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when it was only offered to customers who asked for a renegotiation. But times have changed: Loan officer compensation is fixed, and all borrowers must be treated equally.

Therefore, the truth of the matter is that if a company allows renegotiations in a positive market movement, it will have a negative impact on the company's profitability if the loans in process are solely hedged with TBAs. Basically, in the case of renegotiations, the company is offering a float-down with no ability to cover the cost of the float-down, thereby giving up the price differential that was granted for the float-down plus any additional costs from pair-offs due to an improving market.

In both float-downs and renegotiations, the borrower is given the option to obtain a lower rate at some future date. Given that the borrower can choose, the pipeline manager should protect himself by utilizing the correct amount of option contracts in lieu of forward TBA trades to protect the pipeline and his company's profit margin from the increased fallout and the associated costs due to declining interest rates.

By correctly pricing and hedging rate protection plan types of business, mortgage bankers should be able to gain enhanced profitability while offering a product that could become in high demand by consumers. An example of this would be if the value of new business is 150 basis points and the rate protection plan helps mortgage bankers generate 10% more business, which equates to 15 basis points. In addition, if fallout from the new product is reduced 10%, that equals another 15 basis points. Finally, if the mortgage bankers reduce their overall hedge costs by five basis points, the total is 35 basis points, which clearly is more than the 25 basis points in hedge costs to offer the rate protection plan product.

Mortgage lenders today must be meticulous in their work to manage their pipelines by stabilizing earnings and increasing growth while minimizing risk. Part of this includes researching the many hedging tools and methods and knowing which ones to use and when to use them. Armed with a disciplined strategy, mortgage bankers will find that float-down options are one of the many tools they can use to determine pricing and hedging on rates and fees while proactively managing their pipelines in the current protracted and volatile rising interest rate environment. When executed properly, the costs associated with a rate protection plan should be more than offset by the increased returns from more generated business, reduced fallout and reduced overall hedge costs.

[Editor's note: This article was adapted from a white paper titled "Float-Down Locks As A Hedging Tool In A Rising Interest Rate Environment," available on MCM's website and accessible via this link: https://www.mortcap.com/papers.]

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