SELECTING THE RIGHT STRATEGY FOR YOUR MORTGAGE PIPELINE: TBA MBS HEDGING VS. NOTE-RATE HEDGING

Effectively manage pipeline risk and increase returns with the right hedging option.

WHITE PAPER

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BACKGROUND

Whether your institution is new to mandatory delivery, or you are interested in re-evaluating your current hedging approach, selecting the right hedging instrument for your business goals is rarely a black-and-white decision. However, by understanding the pros and cons of different options, you can make an informed decision and relay the right recommendation to your executive team with confidence.

When comparing hedging strategies, your primary consideration should be risk management for your pipeline: how can you most effectively mitigate the increased risk of mandatory delivery and fully realize the benefits that come with it? As a secondary consideration, you can then evaluate your return profile in a risk-adjusted context.

This document compares two common pipeline risk management strategies:

1. **TBA MBS Hedging**: Hedging with to-be-announced (TBA) mortgage-backed securities (MBS)
2. **Note-Rate Hedging**: Hedging with agency cash window forward commitments (note-rate hedging)

This information provides an objective, comprehensive resource to help you determine the right approach for your business goals.

INTRODUCTION TO TBA HEDGING

Making the decision to hedge your pipeline with TBAs involves the use of a well-known, highly liquid hedging instrument – but what, exactly, are TBAs? TBA markets are made by broker-dealers, which means a seller choosing to hedge its pipeline with TBAs must first establish broker-dealer credit lines.

When a lender sells forward a TBA MBS to hedge its pipeline, the following elements are included in the agreement:

- Security price
- Type of security
- Settlement month
- Coupon
- Notional amount

For example, let's assume today is July 1. The seller might agree to sell $2 million GNMA 30-Year 3% for September 2021 delivery. The seller would choose the settlement date based on the expected closing dates of the interest rate lock commitments it would like to hedge.

At the time of settlement, a lender must either deliver a recently formed MBS into the TBA contract or execute a buy transaction (aka pair-off) to close out of the hedging trade. Because the seller sold forward TBA contracts settling around the same time as its locks are expected to close, the seller will have approximately the same amount of TBA contracts to pair off as loans to sell into the secondary market each month. Pair-offs due to or from the broker-dealers are exchanged on settlement day.

Correspondent investor prices and government-sponsored enterprise (GSE) cash window rate sheets are based on the TBA market as an underlying price source. For this reason, TBAs represent an appropriate hedge for a lender's pipeline. There is a strong correlation between the loan-level price indications the lender receives on a daily basis and the hedging instrument that the lender has chosen to utilize. Simply stated, the same TBA market used by the lender to execute hedging trades is used by investors to provide pricing.

This hedging strategy can also offer operational efficiencies because TBA hedges are not specific to a particular correspondent lender or GSE. With this in mind, loans can be put into a competitive auction at the time of closing; their end investor is not predetermined. When loans close and are ready for sale into the secondary market, a lender implementing a TBA hedging strategy will sell its closed loans and simultaneously pair out of its TBA hedges.

Additionally, lenders can see benefits in terms of growth and scale. Reducing manual tasks, such as the management of daily commitments, allows mortgage groups to grow without materially adding head count. The potential for greater profitability means more competitive pricing for loan originators, in addition to an effective recruiting tool that feeds further growth.

INTRODUCTION TO NOTE-RATE HEDGING

Note-rate hedging represents an alternative approach commonly leveraged by lenders that primarily deliver directly to the GSEs (Fannie Mae and Freddie Mac) with smaller or mid-sized pipelines primarily consisting of conventional, fixed-rate loans. These lenders may use actual agency-specific loan commitments to hedge their pipelines. This hedging instrument is often considered to offer more conservative, predictable cash flow and price basis than TBA hedging. It can also help lenders realize significant operational enhancements when paired with the right technology.

When a lender implements a note-rate hedging strategy, TBA hedges are not typically used. Instead of forward-selling a TBA MBS at the time of lock, the lender will enter into a mandatory commitment with the relevant GSE cash window. These cash window commitments then serve as the actual hedging instrument for the lender, which commits loans against these cash window commitments to remain risk neutral. When these commitments cannot be delivered within their contractual tolerance, pair-offs are due to the GSE with which the commitment was created. For this reason, note-rate hedging tends to have more regular, smaller amounts of pair-offs due to the end investor, whereas TBA hedging has fewer, larger amounts of pair-offs due to or owed from the broker-dealers.

In note-rate hedging, the best execution decision is generally made at the time of lock; with TBA hedging, however, a competitive best execution auction is performed at the time the loan closes. Lenders then manage their inventory of cash window commitments relative to their pipeline of interest rate locks.

Note-rate hedging offers a conservative hedging strategy with an attractive risk-adjusted return profile relative to best efforts delivery. The challenge in note-rate hedging tends to be operational; managing the number of GSE cash forwards can be complicated as a pipeline grows. Each commitment must be allocated within its contractual tolerance by its settlement date and lenders can have dozens of different commitments each month. Implementing Black Knight's note-rate hedging technology can help mitigate this challenge by simplifying manual processes, organizing data, and seamlessly integrating with loan origination systems and agency online portals.

	PROS	CONS
TBA MBS	• Reduction in direct pair-off fees and extension charges • Increased profitability from selling via competitive auction; more competitive prices • Well-known, highly liquid instrument with security of government-backing • Reduction in manual tasks • Can be recruiting tool for further growth	• Greater price variability and risk • Potential cash-flow imbalances • Additional counterparty relationships/oversight
NOTE-RATE	• More conservative approach • Predictable cash flow with low risk • Operational simplicity • Price predictability • Reduce pair-off cost/fees	• Less scalable and efficient with manual, loan-by-loan handling • Limited to conventional products

Note-rate hedging strategies are often implemented by lenders that deliver primarily conventional loans. In particular, this hedging strategy represents a common, appropriate opportunity for many credit unions. As lenders grow in volume and product mix, many consider shifting their strategies to include TBAs as a component of their overall hedging programs, or potentially as full replacements. However, many successful lenders grow and prosper through use of a note-rate hedging strategy exclusively.

SUMMARY

Selecting t he right hedging instrument ultimately comes down to your institution's risk-return profile and business model. If you are interested in growing and introducing more scalability to your operation, TBA market hedging may be appropriate. If you operate on a smaller scale, deliver only to the GSEs, and prefer a more conservative strategy, note-rate hedging may be the right choice.

Black Knight offers advisory services and industry-leading risk management technology that delivers a unique combination of advanced hedging functionality and industry best practices to help you confidently manage pipeline risk and improve profitability. For more information, contact **Sales@OptimalBlue.com**.

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