

10 Best Practices for Hedging and Trading with Optimal Blue



10 Best Practices for Hedging and Trading with Optimal Blue

By Steve Baselice—Capital Markets Solutions Specialist, Optimal Blue
and Mike Vough—Vice President, Hedging and Trading Products, Optimal Blue

In today's environment, it's important to review your secondary marketing strategies and behaviors to ensure you are as profitable as possible. In our role serving a wide array of lenders, Optimal Blue (OB) has observed many best practices. Here are the 10 most critical for today's market, including related solutions and services from Optimal Blue.

1. ALIGN YOUR FRONT-END PRICING TO YOUR ACTUAL EXECUTION MARKS.

Challenge

It wasn't too long ago when secondary didn't have to put their true execution into their front-end pricing. In fact, it was rare when some did. This has continuously evolved over the years, but it has really manifested since the beginning of 2022 when rates started to steadily climb higher, and pipelines became depleted. The ability to not put your "best foot forward" was no longer an option. When prices decrease on bonds, the rate or yield typically goes up.

Best Practice

Originators pooling loans into MBS have had a distinct advantage given the greater certainty in execution. This is also evident in the fact that many of them were the first to fully align front-end pricing to actual execution. It is not a coincidence that these originators are also some of the largest and most successful in the mortgage business. However, this practice has been a bit challenging for bulk sellers that want to be more aggressive because they don't have a safe and efficient way of doing this without taking what they perceive as Day 1 margin risk. There is still a degree of the unknown for some when selling bulk, because you are unaware of the price until an aggregator can crack your bid tape. This has started to change with the availability of bulk-bid APIs for mark-to-market (MTM) purposes.

How Optimal Blue Can Help

OB provides live access to mandatory bulk pricing for several of the top aggregators, which can not only be used for MTM, but also as a source for your front-end pricing. When you incorporate this with the additional supported price executions, OB hedge customers can have the best price discovery in the market. Better price discovery on loans allows for more transparent margin management from the CFO to secondary.

2. INCORPORATE HEDGE COST ON THE BRANCH OR LOAN OFFICER LEVEL.

Challenge

Loan officers always want to be able to sell the most competitive rates. Who wouldn't want to sell what other people want to buy? It is always the challenge of secondary to put loan officers in the best position to bring in the most volume. Loan officers want the best rates, and although you want to give them just that, it never seems to be that easy.

Best Practice

One way to make sure highly efficient origination sources are armed with the best rates is to factor in their hedge cost into your margins. If they manage their business with the least number of human touches and changes from Day 1, they should be rewarded. On the flip side, for those origination sources that are more high touch, and as a result have an above-average hedge cost, you also want to make sure you are protecting that valuable Day 1 corporate margin by aligning your margins accordingly. The challenge that secondary has around this is being able to pinpoint that hedge cost. It is a very complex problem to solve when considering top-line pull-through versus clean pull-through, with clean pull-through being defined as the percentage of locked loans that close without a renegotiation or an extension. Also, what is the cost of fallout, extensions, and renegotiations? Again, the cost is not easy to identify.

How Optimal Blue Can Help

OB provides pinpoint analysis down to the basis point for hedge cost on both the branch and loan officer level. What better way to reward your best-performing branches while protecting yourself from the ones that need to take a more defensive action?

3. PASS ON A PERCENTAGE OF SPECIFIED PAY-UPS INTO FRONT-END PRICING.**Challenge**

Specified pool pay-ups are a focal point for any originator for maximizing profitability. The call protection that these loans have is highly valued by mortgage bond holders. As a result, they will pay a premium to acquire them. However, where those premiums are at the time of origination versus the time of sale are very sensitive to interest rate changes. This leaves secondary with a dilemma on how much of this premium they should pass on to their front-end pricing.

Best Practice

The delicate balance of just how much of the spec premium to pass on is always hotly debated because of the risk exposure to secondary. However, it is uncommon that this is held back entirely. While it does vary by originator, we see the neutral percentage of the spec premium that is put into front-end pricing in the 50-75% range. This allows originators to have the necessary competitive positioning in pricing to the market, while also protecting themselves from the possibility that the spec premiums are less than what they were at time of origination.

How Optimal Blue Can Help

OB allows users to customize how much of the spec premium is used for front-end pricing, as well as your accounting gain/loss (G/L). This can also be configured to be adjusted based on the stage/milestone of the locked loan and by various loan data characteristics. All this allows for full transparency in not only front-end pricing, but also for secondary hedge accounting G/L, which leads to a more accurate assessment of secondary performance.

4. HAVE CONFIDENCE IN YOUR PROFITABILITY RECONCILIATION.**Challenge**

The mortgage business today is obviously very difficult. When it comes to secondary, a common phrase is that every basis point counts. It was the case when volume was at record highs, and it is even more so now that we're seeing dozens of originators fighting over single loans at times. It is also necessary to be able to dial this in for the purpose of identifying any possible areas for improvement in your hedging strategy. However, in many cases, hedgers aren't given the reporting or resources to get granular enough to uncover any discrepancies or deficiencies.

Best Practice

Every secondary person needs to be armed with the best position and G/L reconciliation tools to help manage their pipeline. You need to have insight into loan- and trade-level detail for proper attribution. When secondary can fully understand why their position is what it is and how that impacts G/L, then their performance can be maximized, because you are better equipped to identify problems in real-time. These issues might only be on the loan or trade level, but they can often be a much less contained issue. Having anything less is irresponsible.

How Optimal Blue Can Help

OB provides real-time position and G/L reconciliation tools, as well as interactive reports with historical data storage capabilities to allow for even greater audit functions. Our systems are designed to be accountable with detailed loan and trade trace logs that allow the user to uncover possible problem within your position or G/L. We are not a slot-it-and-forget-it platform like some others; rather, we look at every possible scenario and “show our work” to eliminate blind faith.

5. LEVERAGE ALL POSSIBLE EXECUTIONS IN YOUR MTM.**Challenge**

Can you imagine running a manufacturing business without having a true count of your inventory? You wouldn't be very successful with only an estimate. So why is it OK to have only an estimate of what the MTM is on your hedged pipeline by not utilizing all executions that you consider when selling your loans? Times are tough because margins are tight and volume is low, so don't you want to know the price to expect for your loans? Also, without accurate MTM, pull-through and other risk metrics are not going to be as precise as they could be.

Best Practice

When secondary thinks MTM, they think accounting. After all, secondary people have been supplying MTM reporting to their CFOs for years. Yes, it does give insight into how the company's most valuable asset is currently priced, and this is required to effectively run a business and anticipate cash flow, as well as to validate forecasting – but it is so much more. Using the most accurate real-time executions allows your hedge platform to adjust the loan-level duration to market movement, as well as to capture a true indication of the in or out of the money of your locked pipeline. Strong analytics drive hedge precision. Guesstimates of your locked pipelines' MTM are simply not the foundation for an accurate hedge position.

How Optimal Blue Can Help

OB can help improve your price discovery in a few ways. For one, we are fully integrated with the Optimal Blue PPE to capture your PPE investor pricing as a source for MTM. This integration also comes with eligibility scrubbing, which allows us to identify if a loan doesn't meet a certain investor's guidelines as well. Second, Optimal Blue supports some of the top aggregators through our buy-side-bidding tool. This tool allows aggregators to process bulk bids within seconds. As a result, we can integrate via API the investor's bulk bidding pricing into our hedging platform. Third, OB has various other integrations to support MBS pricing, cash pricing, and retained/releasing servicing valuations. This summation of all these pricing options is unparalleled in the industry.

6. LEVERAGE LOAN-LEVEL MARKET MSR VALUATIONS MANAGED BY MSR BROKERS.

Challenge

Mortgage servicing rights (MSRs) are traditionally a very opaque asset subjected to valuations driven off assumptions. Secondary marketing folks can't just go to Reuters or Yahoo Finance and type "MSR" into the search bar and get a price. The value of an MSR is also very specific to the loan being priced, hedged, or sold in the secondary market. The size, property state, taxes and insurance, credit profile, and remittance type all drive the valuation. MSRs also happen to be a large component of the discretionary pricing power held by secondary folks. Additionally, MSRs move counter to the valuation of the loans in your pipeline, making hedging more complicated.

Best Practice

It is undisputed that MSR valuations are a large part of critical secondary functions such as price generation, MTM, hedging, and loan sales. Servicing right valuation depends on daily interest rate moves, loan-level data, and execution option. The execution option of the loan can impact the servicing right valuation materially, especially in today's interest rate environment. Secondary participants need to have models that can value all these component parts of servicing rather than waiting for someone to update a grid.

How Optimal Blue Can Help

OB has been a fixture in the MSR valuation space for years, supporting numerous MSR brokers, MSR investors, lenders, and more. The OB MSR model has the granularity and flexibility needed to provide loan-level cash flow valuations for every loan execution option, such as remittance type differences, high versus low coupon, and economic versus fair value. OB designed an integration that allows for MSR broker assumptions to be seamlessly streamed to lenders for loan-level cash flow-based valuations. Loan-level cash flow, plus MSR broker assumptions leads to the most accurate servicing valuation possible. These same loan-level cash flow assumptions, can also be utilized to produce dialed-in MSR DV01 hedge offsets that are directly correlated to the valuations.

7. DIAL IN YOUR HEDGE STRATEGY WITH ADVANCED DURATION CONCEPTS.

Challenge

Secondary uses the interest rate sensitivity (aka duration) of a loan to derive hedge ratios used to minimize interest-rate-driven pricing changes across the mortgage pipeline. The hedging instrument most used by secondary to minimize this risk is the to-be-announced security (aka TBA). The TBA is a future contract that conforming agency loans can be delivered into by a specific settlement. Due to this fact, TBAs are thought of as "vanilla." The "vanilla" nature of a TBA helps with the liquidity of the security but may lead to some hedge performance issues for loans with specific criteria.

Best Practice

To increase hedge effectiveness of a pipeline, secondary needs the ability to both calculate the duration of individual loans in the pipeline and to create coverage ratios in comparison to liquid TBAs. The duration of the loan will be dependent on the TBA security slotted to during the MTM projected settlement month, MSR duration, potential spec pay-up, and more. The amount of data points that go into this process adds more accuracy, but with it, complexity.

How Optimal Blue Can Help

OB has a robust process for producing TBA durations, including specified pool durations, loan-level MSR duration offsets, and more. OB will adjust hedge-weighting at the loan level due to the differences in duration from specified pay-ups and the inverse relationship of servicing to loan valuations. Lenders can use these advanced analytics to increase hedge effectiveness by hedging the individual loan and not a proxy or pipeline-level duration.

8. USE ALL EXECUTION TYPES DURING YOUR LOAN SALE.

Challenge

Investors are disseminating pricing several ways via APIs, portals, platforms, and other means. This is much different than where the industry was just several years ago. The pricing delivered from these investors can be different based on how the loan is sold mandatory or best efforts, whether it's spec pool eligible, retained or released servicing, and how much of the servicing strip is retained (i.e., base versus excess servicing). Given all these flavors, lenders can truly get a live market auction for their individual loan, but the number of options makes this process complicated.

Best Practice

Secondary's main goal is to maximize the profitability of each loan in the pipeline, and all potential execution options need to be evaluated during the loan sale process. Best efforts pricing, mandatory bulk bids, MBS securitization pricing, agency cash pricing, released or retained servicing bids, and more should all be considered during the loan sale process. This quickly can become 30+ individual outlets when you combine investors plus various outlets. Layer in various specified pool/cash commitment options and different servicing basis points, and a secondary marketing department can be evaluating 50+ executions per loan. This equates to price discovery that we have never seen in the mortgage market, but the added complexity requires additional technology.

How Optimal Blue Can Help

OB is facilitating the digestion of and presentation of these various executions to simplify the secondary marketing decision-making process without limiting the price discovery or complexity of the process. OB is integrated with the following technologies/partners to facilitate this:

- Optimal Blue PPE to get the most up-to-date best efforts pricing
- Thompson Reuters for live MBS pricing
- Resitrader to facilitate communication and bidding with the aggregator/investor community
- Real-time, loan-level retained MSR values from an array of third-party MSR mark providers
- Fannie and Freddie for cash pricing
- Fannie Servicing Marketplace for released servicing
- Freddie Cash-Released XChange for released servicing

This breadth of execution options is unparalleled in the industry, and it gives lenders the most defensible price discovery for loan sales.

9. CONSIDER AGGREGATE EXECUTION DURING LOAN SALES.

Challenge

Lenders, secondary marketing managers, hedge providers, and other market participants all live by the mantra of "sell high, buy low." When it comes to loan sales, it's as simple as sell to the highest price, right? Unfortunately, it's not that easy. Aggregators, agencies, co-issue investors, and broker-dealers are increasingly looking holistically at the summation of all loans delivered to that outlet. What happens if your organization is known for a certain credit profile (e.g., 680 FICO, 80 LTV), but then your recent loan sales push that weighted average for the last month down? The investors may start to negatively impact pricing because your aggregate delivery stats are changing. This is just starting to scratch the surface of this issue, especially when you consider MBS pooling requirements, month-to-date high balance limits, social credit scoring, and more.

Best Practice

Lenders that regularly do aggregate best ex analysis can get a better handle on future profitability (e.g., How many high-balance loans can I fit into this month's multi-issuer pool and avoid the MJM/CK drop?) and avoid any negative surprises or conversations with investors. The problem is this analysis isn't easily automated for most lenders or hedge providers. It could take several resources and very complicated Excel spreadsheets to accomplish. Not to mention the hours spent maintaining Excel models and a lot of key person risk associated with this process. In this environment, lenders need an easier way to manage profitability and investor delivery mixes, and to save time.

How Optimal Blue Can Help

OB's Pool Solver has been used by some of the largest lenders in the country to tackle aggregate or pool-level best execution. Pool Solver is the summation of years of algorithmic experience designed to iterate through potentially millions of computations needed to squeeze the most out of your aggregate loan sales without jeopardizing the loan-level best execution. In the time it takes to leave your desk to grab that next cup of coffee, millions of iterations and hundreds of requirements are incorporated into your best execution or loan sale process. Pool Solver can also be incorporated into daily processes, such as position management, MTM, and minimizing future surprises. The minute a loan can be confidently put into a low-loan-balance pool or moved from high-balance to a "vanilla" pool, the duration of the loan will adjust, leading to more effective hedging to go hand-in-hand with better profitability expectations.

10. MINIMIZE BID/OFFER OR HEDGE COST WITH BULK AOTS.**Challenge**

With the proliferation of selling loans directly to investors via bulk bids over the last ~5 years, lenders have become more exposed to the bid/offer spread trading TBAs for hedging. When a lender sells a loan to an investor via a bulk bid, the lender must then go and buy back TBA coverage incurring the bid/offer spread to neutralize the position impact from a loan sale. This differs from older AOT pricing models when a lender could deliver into an existing TBA trade, avoiding the bid/offer spread.

Best Practice

Enterprising investors wanted to offer their sellers the pickup from bulk sales, but allow lenders to avoid the bid/offer spread like with AOT models. Investors created bulk AOT programs to offer the same pricing as bulk bidding, but to allow lenders to assign trades back to the investors to avoid the bid/offer spread. Lenders also need to be cognizant of the position impact of the bulk AOT. If doing an outright bulk sale, a lender's position will get shorter by the duration weighted amount of loans sold bulk. When doing a bulk AOT, a lender's position will be the summation of the duration weighted amount of the loans sold, plus the duration weighted impact of the trades that are assigned to the investor. A \$1M bulk AOT can save a lender \$312.5 if the bid offer spread is 1 tick. Imagine the savings lenders can realize in larger volume examples and larger bid/offer spreads for less-liquid coupons.

How Optimal Blue Can Help

OB's hedging and trading products allow lenders to take advantage of bulk AOTs seamlessly with an additional three clicks. This includes the management of investor AOT rules, the generation and signing of AOTs, AOT tracking, and position management done throughout the loan sale process. Regardless of whether you are a licensed or managed account with OB, lenders should be taking advantage of this trade efficiency and cost-saving mechanism.

SUMMARY

These best practices are core to success, but there are many other things to consider to successfully manage the profitability of your loans post-origination. The decisions made in the secondary market have a direct impact on the overall profitability of your business. In today's market, every basis point is critical to the future of mortgage originators.

ABOUT THE AUTHORS

Steve Baselice

Capital Markets Solutions Specialist | Optimal Blue

In this role, he advises clients on best practices and use cases related to Optimal Blue's hedging, trading, and mortgage servicing rights (MSR) products. He joined the company in 2018 after serving in the mortgage business for over three decades. Prior to joining Optimal Blue, he was with the private equity firm Global Mortgage Capital. He also spent 18 years building and successfully managing a secondary marketing desk on the originations side of the mortgage business. This experience gave him firsthand knowledge of challenges that come with selling loans into the secondary market, as well as the day-to-day demands of a lock desk. Prior to his time in originations, he served as a vice president for mortgage-backed securities trading at both HSBC Securities and Nomura Securities International. Steve has a Bachelor of Business Administration from Iona College with a major in finance and economics.

Mike Vough

Vice President of Hedging and Trading Products | Optimal Blue

In this role, Mike is responsible for managing the product development cycle of pipeline risk management, loan buy-and sell-side tools, mortgage servicing rights (MSR) valuations, whole loan valuations, and lead generation software. Mike also serves as an advisor to some of the largest lenders and servicers in the country on critical functions such as MSR valuation, pipeline risk management strategies, hedging strategies, technology, and pricing/loan sale strategies. Mike joined Optimal Blue in 2021 following the company's acquisition of Compass Analytics. At that time, he served as the product manager of Compass's suite of MSR products and advised many servicers, investors, and MSR brokers on how to leverage Compass's MSR model and general MSR strategies. Prior to that role, Mike worked on Compass's trading desk providing strategic and tactical advice to a number of lenders, including hedging, position management, profit and loss reconciliation, hedge cost, and margin strategy. Mike earned his Bachelor of Science in finance from the Pennsylvania State University.



Ready to get started?

Contact Optimal Blue today to begin implementing these best practices into your hedging and trading strategies.

Nothing herein shall be construed as, nor is Optimal Blue providing, any legal, trading, hedging or financial advice.