

Prototype Software Tests Hedges in Refinance Runoffs

By [Greg Crosby](#), ASC Secondary Marketing Product Manager & Michael Murray of the MBA

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Associated Software Consultants Inc., Middleburg Heights, Ohio, is developing a prototype software called "Servicing Shepherd." The software, once operational, would value a company's servicing operations and run "stress tests," using shifts in prepayment speeds and falling and rising interest rate environments, to ascertain pipeline sensitivity on impairment risk with shorter cashflow expectations.

The software, now in beta-testing and expected to go into production early next year, could become one of the modules of ASC's PowerSeller system. That system's upgraded version 5.0 was recently released.

The PowerSeller 5.0 system can manage a mortgage pipeline and the mortgage banker's commitments to sell the pipeline. "It can introduce [the pipeline] to the mark-to-market with the exposure analysis and the best execution for investor take-outs and value for servicing," said Greg Crosby, director of the secondary marketing software unit at ASC.



Greg Crosby, director,
secondary marketing software unit at
Associated Software Consultants Inc.

"Servicing Shepherd," a name that Crosby said might be changed to "Servicing Value Manager," would most likely roll out in production as a Web service so that servicers can connect to it and introduce valuations through an XML-feed to the pricing engine, making it available to the user.

"We can then look into the data as well and provide commentary on the dynamics of the data," Crosby said.

The system will calculate the effect of historic prepayments on the portfolio and take into account original loan balance and geographic characteristics.

Servicers in the mortgage industry have been hit with significant runoffs based on booming refinancing activity that began last year following a sharp drop in interest rates. Phil Colling, senior economist with the Mortgage Bankers Association of America, described the refinance boom as a "three-wave" boom that has had little letup since January 2001.

Crosby said that the refi boom appears to have sparked a new phenomenon: "serial refinancing," in which homeowners have refinanced more than one time in the past two years. As a result, Crosby said, it has created a new dynamic for servicers.

"There are an extreme amount of runoffs," Crosby said. "The net servicing in the marketplace is being redistributed to some degree."

According to Crosby, the redistribution is in lieu of obtaining derivatives for hedging through the capital markets. Lenders replace the pipeline with the same amount of flow that is running off, with the result being that some players become net gain winners while others lose out on net outflows.

"During the initial shocks, some people reduced the multiples they were willing to pay for servicing," Crosby said.

But the overreaction might have "blown" the natural hedge for some servicers, causing them to not be as competitive or productive while experiencing runoffs.

PowerSeller 5.0 allows servicers to build rate sheets and make price quotes into the marketplace and identifies

best-to-worst possible investor take-outs for alternative investors and lay in margins on an “apples to apples” basis, Crosby said. As a result, ASC analyzes the production sources, such as increases or decreases in sources and if they are asking for more concessions or extensions in reductions on interest rates or discount points. By having a metric on the production sources and managing the prices, PowerSeller 5.0 can help in the production based hedging or natural hedge in preserving the servicing value.

Crosby said PowerSeller 5.0 also provides “what if” scenarios to lay in short-term hedges based on a possible upsurge of production or a potential fallout from runoffs. Past interest rate volatility and the time frames are among the dynamics that the technology can take into account.

According to Crosby, there is no end in sight at this time for refinance activity based on the yield curve. He said borrowers have begun to gain interest in shorter-term mortgage products such as the 5/1 or 3/1 adjustable rate mortgages (ARMs) and the uptick in short-term mortgage products has created a new type of economy for borrowers to recycle their loans even if interest rates stabilize.

Additionally, mortgage spreads have widened as treasury rates have fallen. If treasury rates stabilize, Crosby said, refinance volume will continue to increase as spreads narrow and the capacity to handle it shrinks to a more historically consistent level over the yield curve component that determines mortgage spreads.

“When you look at that part of the bell curve, there are two conditions where mortgage rates can go lower,” he added. “There is a real good shot that this refinance activity will continue at a healthy pace.”