Does the Early Bird Really Catch the Worm?

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Every day opportunities arise in the market place as creative motivated people strive to differentiate themselves as investors from their competitors. One such opportunity that is available from investors is the early delivery price bonus. At face value it enables a seller to commit to a mandatory deferred delivery, while preserving the opportunity to improve that pricing should an earlier delivery become possible.

While the price recovery of the forward price drop is not complete, it definitely adds a desired element of flexibility and reward to operations that can expedite loan processing, packaging and delivery.

The seller seeking to optimize their marketing harvest has many tradeoffs to sift. Many questions, for example: If your processing times & closing tendencies are easy to predict then, you can compare the price you would get from a more firm forward price window (MBS or Whole Loan) vs. the base price + early delivery bump. If packaging time tables are volatile, then you could evaluate the trade-off between short-term window pricing less the pair-off cost of a MBS trade used to immunize price risk, but not necessarily used as the delivery vehicle.

Once a decision to lock in a forward delivery has been made. Another choice is available. This choice contrasts the merits of exercising the early delivery option or holding the loans for a later available alternate delivery date. There are a couple of practical considerations that would lead one to choose to exercise early delivery. First, you may need to draw down your warehouse inventory to free up capacity. The second is you may need the additional time to clear issues with loans that might place them in suspense.

If neither of those conditions are relevant then it's number crunching time. But, wait a minute. Before, number crunching can begin you must be able to put your finger on one (sometimes) elusive piece of information. That being, what is the cost of short-term borrowings that you apply to loans held in warehouse (aka the cost of funds or financing rate)? If you know this value and your pencil is sharp you are good to go. So… the answer is … it depends.

You will want to construct a table. Step one, segregate the pool of loans to be delivered by their note rates.

For each note rate, pass it through this handy dandy cost of funds machine that looks something like this… Note Rate – The Price Bump x (365 or 360) / (The number of days between Early Delivery and Standard Delivery). What comes out the other door is the Implied Cost of Funds (a.k.a. Implied Repo Rate w/ no haircut).

How do you use it? Well… you would hold those note rates for deferred delivery whose actual cost of funds is less than this Implied Cost of Funds.

Example: Note Rate = 6.000, Cost of Funds = 3.000, Early Delivery Bonus = 0.125, Difference between Early and Standard Delivery = 14 days.

Implied Cost of Funds = 6.000 – 0.125 x 360 / 14 = 2.786

Cost of Funds at 3.000 is more than Implied Cost of Funds at 2.786, So… Exercise the Early Delivery Option.

This would obviously be a lot easier when a software package that tracks the trades, the terms and does the math is engaged. Once again, we see a case where the optimal answer is struck by integrating technology, mathematics and professional understanding of business constraints that can not be reduced to an equation.

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