

# ***Determining the Cost of Hedging***

By [Greg Crosby](#), ASC Secondary Marketing Product Manager

*This article appeared in the April 20, 2006 Issue of the  
Holm Mortgage Finance Report newsletter*

---

In every corner of the country and in every product line the competition for mortgage borrowers is intense. Profit margin for every product line have been shrinking. For many this has been accompanied by shrinking volumes.

It is not unusual to see mortgage originators expand their product offerings to include products and product lines which are outside their pricing, hedging and back office core competencies.

Many secondary teams are pressured to improve their pricing. With tight margins this may be forcing them to enter into mandatory style rather than best efforts style commitments with their investors.

Working with tight margins can conger a vision of walking the high wire in the dark without a net. Shining a light on what it costs to hedge a given product line will serve to bring sanity back into the pricing and risk management exercise.

## **Gain on Sale**

The most basic form of the gain on sale equation indicates that gain on sale = net receipts less net expenditures.

Applying this formula reveals that several complicating factors arise. The gain on sale value becomes a question of scope and context.

At the enterprise level, indirect costs (overhead) would be allocated to the equation. The mortgage transaction may have residual and contingency elements. If the seller is co-insuring or retaining an interest in the debt servicing stream only an "educated" guess can be made as to what the gain from the transaction will ultimately become.

Bundling the costs together that will comprise the transaction's cost basis becomes a question of context. There may be several consumers of the information. The alphabet soup that accounting must use might well differ from the framework that upper management desires when monitoring the economics of the specific transaction or on-going business.

Some consumers of the profit equation may be wishing to isolate the contributions of individual departments or processes.

The cost associated with hedging the transaction would complete the picture of marketing performance. Associating the cost of hedging with something as fluid as a mortgage pipeline raises significant challenges.

## Life Cycle Influences

Let's break the mortgage origination / marketing process into four segments. Each of these segments serve to either add or deduct value. The four segments of the marketing life cycle are the lock desk phase, hedge aggregation phase, secondary market execution phase and the post delivery phase.

The lock desk phase encompasses the process of negotiating and accepting a quoted rate/price/term for an interest rate lock commitment (IRLC) directly or indirectly (correspondent, loan officer, etc) with a mortgage applicant.

The initial profit margin in the lock will often be different than the profit margin targeted when a rate sheet was developed. The degree of the variability depends upon locking policies and negotiating tolerance afforded the loan officers and/or the lock desk.

The objective of isolating the cost of hedging requires that one not commingle the profit inherited from the lock desk phase with hedging performance.

The hedge aggregation phase will be the phase in which hedge costs will be harvested. We will come back to this phase.

The secondary market execution phase is one in which the focus is upon delivering the portfolio of now closed loans to investor commitments. Mortgage marketing operations that are entering forward commitments to sell on a best efforts basis typically do not have a hedge aggregation phase. As such the profit they will receive for each IRLC that closes is fairly well known at the point the commitment is placed. The question is which of the specific IRLCs will in fact close and whether or not they will be deliverable by the time the forward commitment expires.

This lack of a hedge cost component is inherent to best efforts commitments. A seller is exchanging a lower price for the commitment in exchange for the investor/buyer assuming the hedge responsibilities (risk).

Isolating the profit margin inherited from the lock desk phase is key to making apples-to-apples comparisons between mandatory and best efforts marketing alternatives.

For product lines that are delivered into mandatory forward commitments the need to isolate the cost of hedging from marketing execution is useful.

Costs or profits from boarding the loans are realized during this phase.

The secondary market execution phase should also isolate the market opportunities exploited once the loan was ready for sale. The best execution pick up over a benchmark forward price would be trapped. A more unusual case occurred in certain markets during the latter part of 2005 and early 2006. This is one in which transaction prices were lower than the benchmark. It is useful once again to isolate this as it measures an element of marketing risk that may or may not be hedged by classic market approaches or diversification. In this case either credit spreads themselves were being adjusted or a fairly immediate reassessment of demand for a product shocked the marketplace.

The post delivery phase concentrates on, well, events that impact profit once the loan or loan package has been delivered to the investor. Example, profit may be impacted during this phase by loan

repurchases. Residuals such as retained servicing or other forms of yield participation or credit enhancement are realized during this phase.

Hopefully, through this process of elimination we can see what is not being tracked during the hedge aggregation phase.

The Hedge Aggregation phase begins at the point the IRLC is granted and continues until either the IRLC is withdrawn or the sale of the loan is set.

By filtering the value impacts from the other three stages we are able to capture the net realized change in value (or delta) of the hedged mortgage pipeline. Should the net change in value be positive (not an unlikely instance) the cost of hedging would actually be a net benefit (or contribution). Otherwise, if the net change in value is negative a net cost from hedging would be noted.

Future articles will describe issues, pitfalls and useful methods in isolating, uncovering and applying the cost/contribution from hedging statistic.