

Gambling? Who? Me?

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Most Secondary Marketing Execs, if asked if they were gamblers would honestly, vehemently, emphatically answer NO.

The dictionary defines gambling as:

1. To bet on an uncertain outcome, as of a contest
2. To play a game of chance for stakes.
3. To take a risk in the hope of gaining an advantage or a benefit.
4. To engage in reckless or hazardous behavior.

At some level any business venture involves "... taking a risk in hope of gaining ... a benefit (profit)".

If asked what constitutes gambling in mortgage banking the answers might range from taking a position based on what you think the CPI number will be or based on what you think Chairman Greenspan will do or say.

Most would say we don't take market positions. We just try to stay flat. We comply with our risk policy mandates. The recitation of that risk policy might be something like ... The pipeline and warehouse position must be no more than 100% covered and no less than 80% covered. But statements like these just beg for more questions.

Is this based upon a pipeline net of fallout?

Is this for both a rising and falling interest rate scenario?

How big or how small of a move in interest rates are we covering?

Is the coverage percentage based upon the dollar volume of loans or the value sensitivity of the loans?

How is value being determined?

Are you using a single fallout point or an array of fallout levels?

Is this coverage based upon parallel shifts or beta weighted shifts in interest rates?

Many times determining what was intended by a risk policy statement can be as challenging as being a Supreme Court Justice trying to interpret the Constitution. Risk policies that are ambiguous or not precisely defined fail to provide a clear road map. Risk policies that don't allow the use of certain tools, such as options may be setting unobtainable limits for the manager.

It is not uncommon for a myopic view of the coverage question to be taken. The user looks at an

immediate time frame, a small parallel shift upward in interest rates with a constant fallout factor applied. Within these filters action is taken to bring coverage within compliance. However, these three factors are fantasy and three wrongs definitely don't make for the right assessment of risk.

The result of applying this approach is to unwittingly take a market position. Unfortunately, this unintentional market position is often a bet that as the saying goes "if you were a betting man you would not want to make".

As the model used to measure exposure (value sensitivity) becomes more sophisticated the nuances of the pipeline are revealed. Risk models at a minimum need to simultaneously consider multiple rate vectors, multiple rate betas, multiple delivery exit points, rate-sensitive fallout dynamics, impact of time on pricing dynamics and valuation dynamics based upon the magnitude and direction of rates. The user should then apply multiple scenarios with variations in the driver sets. This exercise will reveal the volatility of the effective coverage rates of the pipeline position. In other words, you will see whether a given hedging strategy holds up under all the alternative market scenarios that you consider feasible.

One might argue that they like "to keep it simple". That's fine, but that just means the approach is simple, it doesn't mean it's safe.

The true nature of things is that your position will always have a bias. It is nearly impossible to neutralize a position as multi-threaded as a mortgage pipeline. The profit potential chart of a pipeline will always range from a frown, to a smirk, to a smile. The risk manager that embraces this fact will then work to shape this profit profile in the most opportunistic way while minimizing downward value volatility.