

Performance Hedging (Part 1)

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If profit is the focus of business owners, shareholders, corporate executives, and regulators, then why are so few risk managers focused on profit when we hedge? Managing value or profit is a mindset change for many. Often risk policies and risk managers speak of being flat or fully covered. But sadly, the context in which the statement is made is without reference to profitability (value). Instead hedgers and policies are focusing upon (or believe they are focusing upon) loan volumes.

Shouldn't we manage for the goal and not just the limits? Performance hedging differs from many other approaches to hedging in the context in which it measures success and failure. Hedges are weighed in terms of their net contribution toward achieving a profit / value goal and preserving a profit / value floor.

This approach allows the exposure question to have the appropriate context and be correctly normalized. A goal phrased in terms of basis points of profit per each dollar of loans delivered is both more empowering and less ambiguous than an alternative risk policy directive of covering a minimum of 90% of the loan volume.

Exposure in the performance hedging context is now seen over a landscape and not a single point in space and time. The relative likelihood of the risk is stratified in such a way as to make efficient use of hedge devices and avoid unwarranted transactions.

Performance Hedging provides for a means to manage the moving parts / risks that can decrement value:

- Fallout / Pair-off Risk
- Systemic Risk (Price Sensitivity)
- Basis Risk (Rate Sensitivity)
- Non-systemic Risk (Investor viability / stability, pricing idiosyncrasies)
- Execution Risk (hedge liquidity, cost to execute a transaction)
- Marketing Risk (volume size, volume consistency and volume quality. ..delivery selection and delivery issues – realm of best execution, work flow management, and loan/data quality management)

A Solution for the Information Age

We believe that many risk managers have been diverted from this path due to growing up with the legacy of older technologies that required simple techniques and / or drew upon financial engineering tools designed for other business models. These once state of the art approaches patched solutions, meant for other industries, over to mortgage banking and were presented as the panacea to cure all ills. We've all heard knowledge is power and we are living in the information age. It follows that the unquestioned utilization of the black box solution or following an approach solely because others do it does not necessarily lead to remarkable performance.