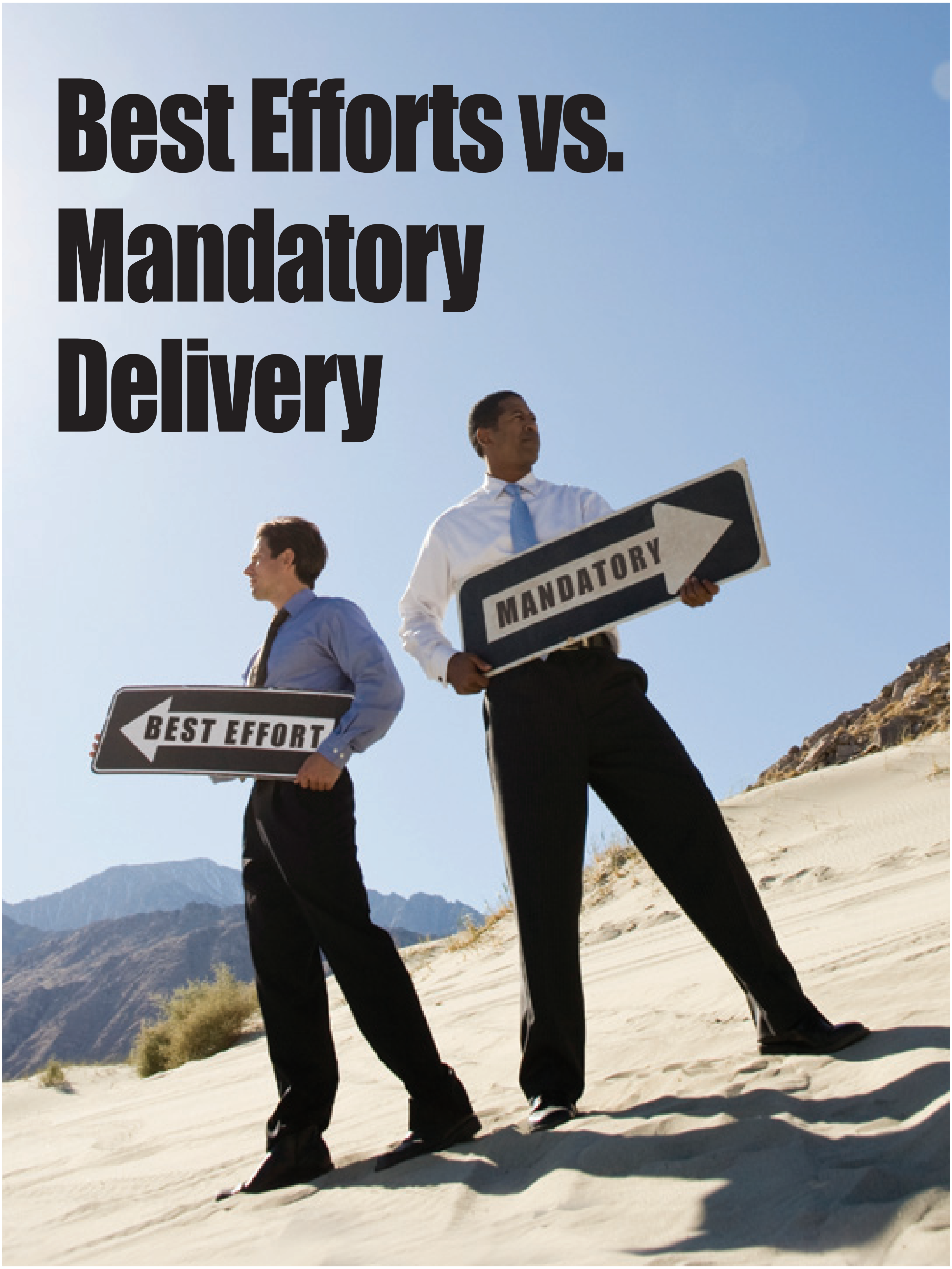
Best Efforts vs. Mandatory Delivery



Don't let fear of commitment sabotage your secondary market income

By Lutz Wudtke

When evaluating options for selling loans into the secondary market, credit unions may shy away from mandatory delivery commitments, assuming that best efforts delivery is the "safer" choice.

But the truth is more complicated, and depending on market conditions and the lender's individual business model, mandatory delivery often makes better business sense.

How can you make the best choice for your credit union? The first step is to look more closely at the risks and benefits of each strategy.

KNOW YOUR OPTIONS

Instead of keeping fixed-rate mortgage loans on their balance sheets, many credit unions prefer to sell them to secondary market buyers, including Federal Home Loan Banks (FHLBs) under the Mortgage Partnership Finance® (MPF®) Program.

To lock in interest rates and protect themselves and their borrowers from market fluctuations that may occur between application and closing, lenders usually take out rate locks, also known as delivery commitments, to sell a loan or group of loans to an investor at a particular rate within a certain period of time—typically 15 to 60 days.

Those commitments can be made on either a "best efforts" or "mandatory" basis.

BEST EFFORTS COMMITMENT

Under a best efforts commitment, the originator agrees to make a genuine attempt to deliver a particular loan with a specified note rate, term, and dollar amount, within a certain period of time.

Best efforts commitments are made on a loan-by-loan basis, and one loan cannot be substituted for another.

If the borrower closes on the loan, the originator typically must deliver that loan to the secondary market buyer. However, if the loan doesn't close for any reason (for example, if the borrower doesn't qualify or backs out of the loan), the investor simply cancels the lock-in without any financial penalty.

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MANDATORY COMMITMENT

Under a mandatory commitment, the originator agrees to deliver a particular dollar amount with predetermined terms by a certain date.

The commitment is not loan-specific, and any combination of loans can be used to make up the agreed-upon volume, as long as their terms fall within the parameters of the delivery commitment.

If the originator fails to meet this

commitment, it is subject to a financial penalty known as a "pair-off fee," which is calculated based on the undelivered portion of the commitment as well as market movement. However, the originator also receives a higher up-front price.

PROS, CONS AND BEYOND

Each option comes with obvious advantages.

The best efforts model boasts the ability to lock in interest rates without the risk of pair-off fees. It's a known quantity and thus commonly considered a safe bet.

The mandatory model, on the other hand, provides a better up-front price, and is flexible enough to allow the originator to substitute a different loan or loans to make up for any fallout, mixing and matching loans as needed to meet the delivery commitment, as long as those loans fulfill the necessary terms. This model may require more effort to manage the risk but also provides greater reward, especially for the organization able to manage that risk.

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On the face of it, best efforts delivery may appear to be the most conservative option, but when you consider the lost revenue opportunity, best efforts delivery may not be as "safe" as it first appears.

Ultimately, the best model for your credit union will depend on your institution's individual business model and loan volume, as well as other factors. Make sure your analysis includes:

- **Fallout Risk.** Consider your credit union's typical fallout rates in comparison with total loan volume. Does the risk of occasional pair-off fees outweigh the benefits of consistently higher prices? The math may vary, depending on interest rate fluctuations: In a rising rate environment, fallout rates will typically be lower, as customers are happy to lock in lower rates while they can, and mandatory delivery will be a safer bet. In a falling rate environment, however, the opposite may be true as borrowers are more likely to hold out for lower rates. The wisest choice may be to evaluate which strategy will yield the most profit for your credit union in the long term. What kinds of fallout rates has your credit union seen historically across fluctuating rate environments?
- **Interest Rate Risk.** In a best efforts scenario, interest rate risk is built into the price. Lenders that adopt amandatory delivery model typically minimize this risk by hedging their pipeline in aggregate, rather than on a loan-by-loan basis. How efficiently could you hedge your mortgage loan pipeline under a mandatory commitment model? Would you manage this hedging in-house or with a third-party vendor? How would the hedge costs compare with the "cost" of reduced prices under the best efforts model?
- **Operational efficiency.** How much could you save by centralizing and streamlining your underwriting, locking, processing, and loan delivery operations by manufacturing loans "in bulk" under a mandatory commitment model? What kinds of organizational, cultural, and policy changes would be necessary to realize those efficiencies?
- **Your pipeline management style.** If your credit union has a large, active pipeline of mortgage loans, a mandatory delivery strategy is likely to yield greater benefits, as you may find it easier to substitute lost loans and avoid pair-off fees, and you may also see more savings by aggregating your hedging and loan manufacturing processes. However, if your organization tends to manage its pipeline very closely, on a loan-by-loan basis, a best efforts model may make more sense.

TIME TO REVISIT DELIVERY MODEL?

If your credit union originates a high volume of mortgage loans, and especially if your loan volume is growing, you could benefit by reconsidering your choice of best efforts vs. mandatory delivery.

Don't be intimidated by the idea of penalties for non-delivery; instead, consider the fact that every dollar you lose through lower up-front prices under a best efforts delivery model is, in effect, a "fee."

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Take the time to do the math based on your organization's unique circumstances and pipeline management style, and find out which option will maximize your secondary market income over time. In the long run, fear of commitment could cost you.

Lutz Wudtke is the Vice President of the Mortgage Partnership Finance (MPF) program at the Federal Home Loan Bank of Chicago. Contact him at (312) 616-8645 or lwudtke@fhlbc.com.