

Hedging 101

A Mortgage Lender's Guide to Managing
Interest Rate Risk



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Introduction

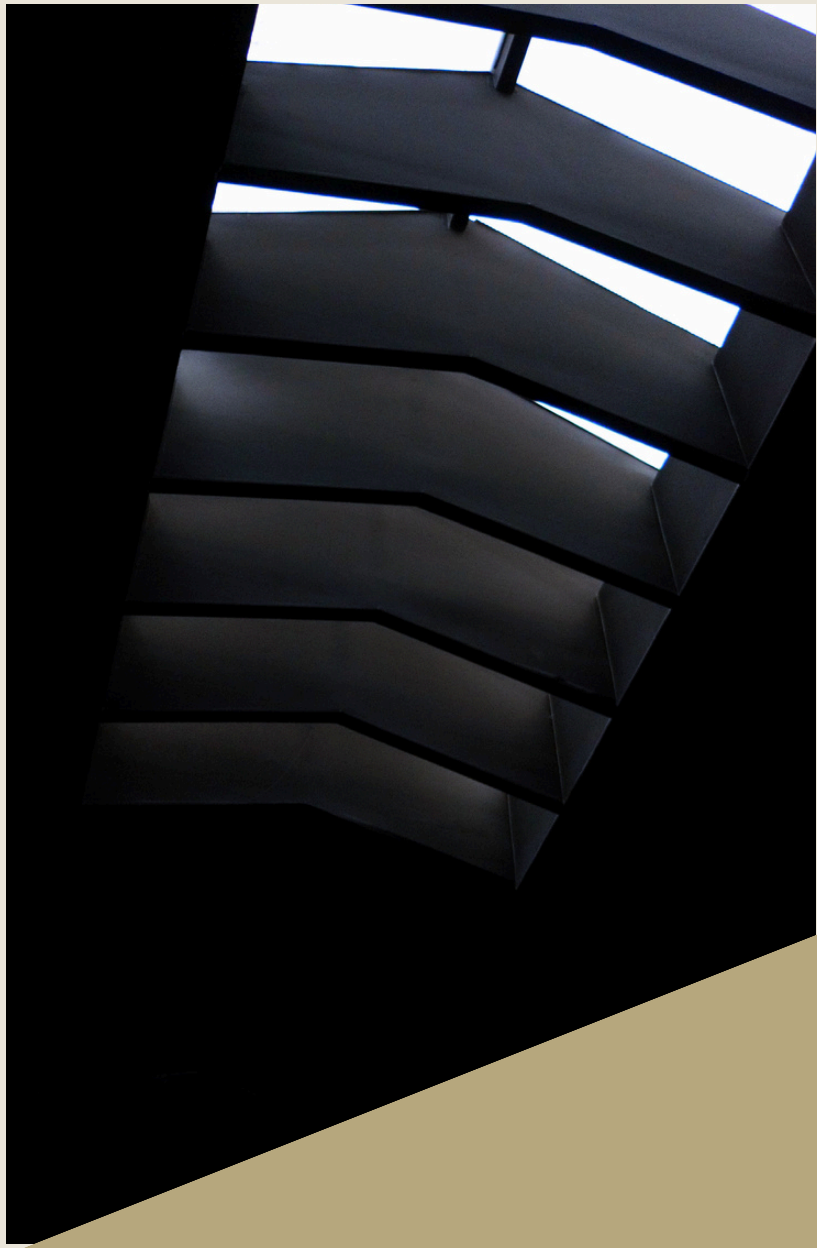
Few things are as critical to financial performance in mortgage lending as the ability to manage interest rate risk. With market conditions often shifting unpredictably, lenders must protect themselves against adverse price movements that can erode margins and compromise loan sale execution. This guide offers a foundational understanding of hedging in the mortgage industry—what it is, how it works, who should do it, and why it matters.

NOTE: For a higher-level Hedging 201, 301, 401 or graduate-level discussion on much more advanced concepts, please reach out to [Chris Bennett](#) or [Troy Baars](#) directly.





What Is Hedging?



At its core, hedging is a financial strategy to protect against the risk of price movements that can negatively impact a business. It involves entering into a secondary transaction designed to offset the risk associated with the primary transaction.





Hedging in Everyday Terms

To better understand hedging, consider these real-world analogies:

A farmer plants corn knowing that the current market price is \$5 per bushel, expecting a profit. But since prices may fall by harvest, the farmer sells corn futures contracts to guarantee a sale price today and protect against the risk of price declines.

An oil company develops a field that is profitable only if oil remains above \$55 a barrel. To manage risk, it enters into futures contracts to sell oil at a fixed price, ensuring project viability regardless of market dips.

These principles directly apply to mortgage lending, where lenders face a similar risk: between rate lock and loan closing, market interest rates can move, impacting the eventual sale price of the loan.





The Risk of Rate Locks

When a lender issues a rate lock, it's committing to a specific interest rate and price structure for the borrower's loan, often 30 to 75 days in advance of closing. This commitment introduces interest rate risk. If rates rise before closing, the loan becomes less valuable in the secondary market.

Conversely, if rates fall, the borrower might not close at all or may require re-locking at better terms, which can also impact profitability. In both scenarios, the lender is exposed to potential financial losses if no risk mitigation strategies are in place.



Why Hedging is Essential in Mortgage Lending

Hedging exists to neutralize this rate lock risk and allow lenders to safely and profitably offer competitive pricing. Here's why it matters:



Preserving Margins in a Volatile Market

Mortgage prices fluctuate daily based on bond market activity. A lender might expect to sell a loan for 103 (103% of par), but if rates spike before closing, that price may fall to 101 or lower, resulting in a significant loss. Hedging can offset that loss by creating gains on a corresponding financial position.



Unlocking More Profitable Execution

Advanced execution options—such as bulk mandatory sales, direct-to-agency deliveries, or securitization—can yield better prices than best efforts commitments. However, they require a hedging strategy to manage associated risks.



Greater Operational Control and Flexibility

Hedging puts the lender in control by ensuring that extensions, program changes, and relocks are governed by the lender's own policies, not those of investors. In addition, lenders can dynamically shift their loan delivery strategies based on market conditions or investor behavior.



Who Should Hedge?

**Hedging isn't just for large lenders.
It's appropriate for:**



Banks & Credit Unions

that retain servicing or sell to the secondary market.



Independent Mortgage Bankers (IMBs)

with at least \$2.5 million in net worth (the GSE minimum).



Mid-Size Lenders

seeking to boost profits & gain execution flexibility.



Community Lenders

with centralized operations and pricing control.

The hedging threshold isn't fixed. Some lenders with \$50M in monthly volume don't hedge, while others with \$5M do. What's more critical are centralized pricing/secondary operations and strong broker-dealer/investor relationships.

How Hedging Works

The most common and effective mortgage hedge is the forward sale of mortgage-backed securities (MBS).

This approach involves:



Rate Lock Issuance

Borrowers lock in an interest rate, fixing terms upfront while the loan moves through underwriting.



Pipeline Evaluation

Lender evaluates the expected performance and characteristics of its locked pipeline, including pull-through.



Hedge Transaction

Lender sells forward mortgage-backed securities (MBS) or other contracts to offset potential pricing declines.



Loan Sale or Delivery

When the loan closes, the lender either delivers it into the forward trade or pairs off the hedge for better execution.

The result is a natural offset: when MBS prices fall, the hedge gains value; when MBS prices rise, the hedge loses value, but the loan can be sold at a higher price. In either case, the lender's economic outcome is protected.



Getting Started with Hedging

Infrastructure Requirements

Implementing a successful hedging program requires:



Financial Foundation

- \$2.5M minimum net worth, depending on dealer relationships
- Sufficient liquidity to handle margin calls or settlement lags



Systems & Operations

- Robust LOS with accurate real-time data
- Clear pipeline status tracking: locks, changes, denials, withdrawals
- Reporting to capture pull-through assumptions and fallout



Partnerships

- Relationships with broker-dealers
- Approval for mandatory delivery to investors
- Robust internal software and/or a hedge advisory firm to provide analytics and execution support



Human Capital

- A centralized capital markets function
- Cross-functional awareness in secondary, compliance, ops, and closing

Getting Started

Transitioning from Best Efforts



For lenders currently operating under best efforts delivery, transitioning to hedging can feel daunting, but it's often simpler than anticipated.

Key changes include:



Stop locking best efforts and begin managing locks as pipeline assets.



Update closing processes (e.g., goodbye letters delayed until final investor is known).



Adjust investor delivery strategies based on best execution for immediate delivery after closing, rather than at lock-in.

Many lenders maintain hybrid models, hedging vanilla, agency products while locking niche or specialized loans (e.g., non-QM, 203(k), high-balance jumbos) on a best-efforts basis.

Getting Started

Preparing for a Hedging Strategy

Even if hedging isn't viable for your organization today, there are meaningful steps you can take to prepare:

- 01** **Centralize**
secondary
operations & pricing
decisions
- 02** **Strengthen**
pipeline data
integrity across your
LOS
- 03** **Build**
new broker-dealer
relationships
- 04** **Request**
mandatory delivery
approval from
preferred investors
- 05** **Benchmark**
practices with peer
lenders
- 06** **Engage**
with a hedge advisor
to understand your
potential upside



The key is laying the groundwork now so that when your volume, resources, or strategy align, you're ready to activate a hedging program quickly and confidently.



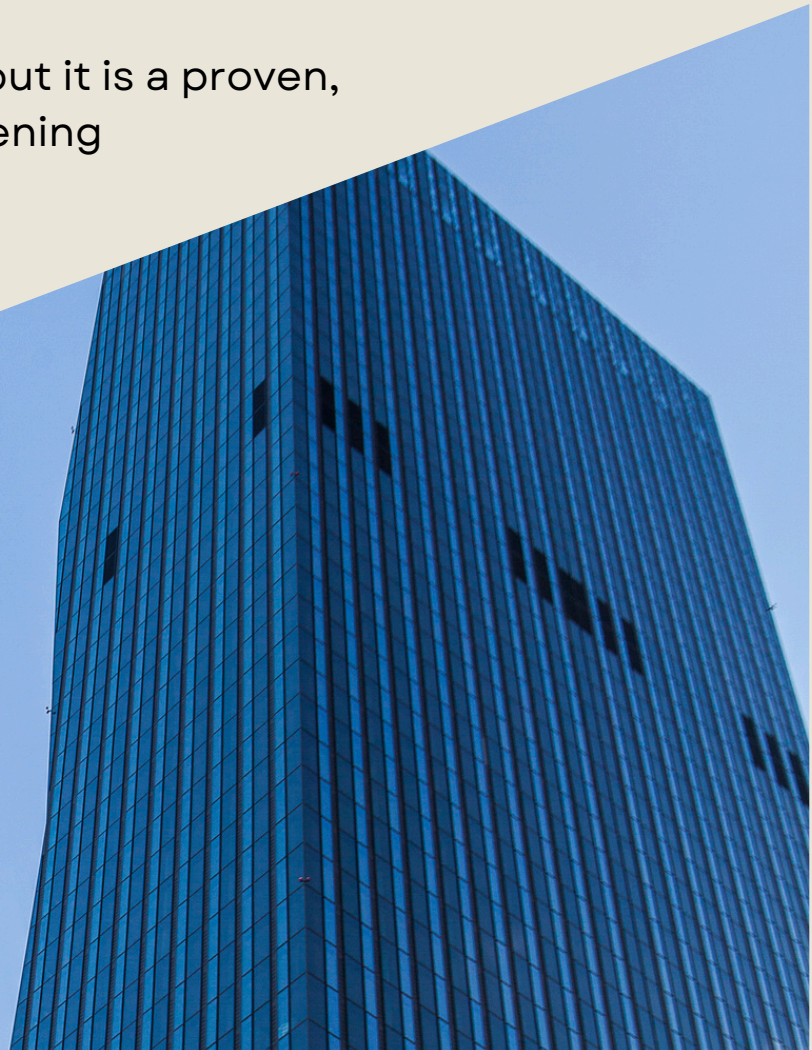
Conclusion

Hedging transforms a lender's approach to interest rate risk from reactive to strategic. It empowers organizations to:

- Protect against market volatility
- Unlock better execution
- Manage pipeline risk with discipline
- Improve secondary margins

In an increasingly competitive and rate-sensitive mortgage market, the lenders who succeed will be those who control risk and maximize optionality.

Hedging is not a silver bullet, but it is a proven, scalable method for strengthening your financial performance and operational agility.



About Us

Since 2001, Vice Capital Markets has expertly navigated interest rate risk and driven profitability on over \$1 trillion in MBS trades and mortgage-related transactions for a diverse range of financial institutions. Utilizing proprietary risk-management models and an advanced investor and agency platform, Vice Capital has enabled clients to enhance their secondary market strategies and achieve optimal sales gains.

The company's Vice Execution Portal™ (ViceEx) is an all-inclusive, whole-loan trading platform that enables lenders and secondary market managers to seamlessly send and receive aggregator bulk bids, compare agency executions with customizable retained or co-issue servicing values while guaranteeing the best execution that might otherwise be missed in a manual process.

With traders averaging over a decade of experience, Vice Capital brings the expertise necessary to tackle market challenges and consistently deliver secure and effective profit growth for its clients. For further information, visit www.vicecapitalmarkets.com or call (248) 869-8100.





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