Hedging Loan Commitments with Eris SOFR

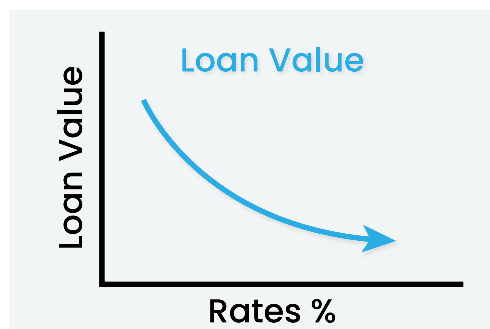
By Geoffrey Sharp

A lender's loan underwriting pipeline will generate interest rate risk that can adversely impact loan profitability due to changes in interest rates. CME Group's Eris SOFR Swap futures make hedging this interest rate risk easy, low cost and more widely accessible to all lenders.

As lenders experienced in Q3-Q4 of 2024, locking rates on loan commitments results in the assumption of interest rate risk that can adversely impact the final profitability of those loans: If interest rates rise after a loan commitment, the resale value of that loan falls, as shown in Exhibit 1. And the longer the final maturity of the loan, such as with 30 year Debt Service Coverage Ratio ("DSCR") loans, the greater the loss from an increase in interest rates.

In the conventional 30-year Agency Guaranteed Residential Mortgage ("Agency") space, this risk can be hedged by selling To-Be-Announced ("TBA") Mortgage-Backed Securities. These are over-the-counter ("OTC") commitments to sell a pool of loans for a certain price on a future date, and the TBA sale can be satisfied by delivering eligible loans into the settlement of the TBA sale. As Agency originators lock loans, they effectively sell them for future delivery into the TBA market, anticipating loan closing and funding. They then deliver the closed loan(s) into the TBA delivery.

Exhibit 1: Loan Value vs. Rate %

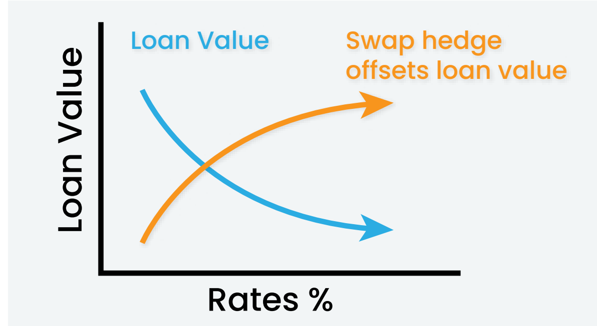


No such market exists for Residential Transition Loans ("RTL"), DSCR and Non-Qualified Mortgage loans, and it is unlikely that any such TBA market for these loans will develop; however, these loans may still be hedged using interest rate swaps ("swaps") indexed to the Secured Overnight Financing Rate ("SOFR"). While SOFR is not the loan rate, SOFR is the index rate used in the financing terms supporting these loan originations. As the benchmark interest rate, changes in SOFR and the expectations of the path of future SOFR rates are the principal driver behind changes in loan rates.

SOFR's role as the benchmark lending rate index is behind the development of a liquid and actively-traded market in swaps. As swaps may be traded to benefit from rate increases that decrease loan values, they are, therefore, widely used by bank and non-bank lenders to hedge the interest rate risk exposure from their lending operations, with swap hedges offsetting loan values as shown in Exhibit 2.

Historically only tradable bilaterally with bank swap dealers, swaps were harder to access, credit-intensive, and operationally cumbersome. However, capital market innovations today now make swaps widely available to anyone as listed, exchange-traded contracts that are centrally cleared as futures contracts: Eris SOFR Swap futures ("Eris SOFR"). Traded at CME Group in standard tenors from one year to 30 years and in units of $100,000 notional, Eris SOFR is accessible to even the smallest hedgers.

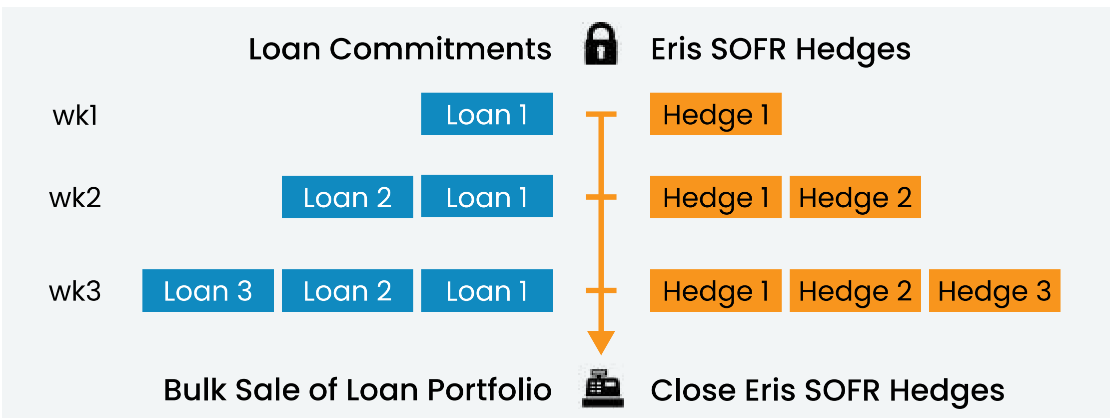
Exhibit 2: Loan Value vs. Rate, with Swap Hedge



Trading Eris SOFR Swap futures to mirror lending operations

- As one locks loans, one sells the matching maturity Eris SOFR contracts to pass the risk on to the market
- Trade in sizes as small as $100,000 notional to protect the resale value of originations
- Accumulate larger pool of loans and improve execution through bulk sales, rather than selling single loans, small pools or working best efforts

Exhibit 3: Adding Eris SOFR hedges as loans are committed, exiting hedges upon bulk pool sale



Sample hedge with Eris SOFR Swap futures, as shown in Exhibit 3

- Lock $250,000 of loans daily, closing $5,000,000 of DSCR loans each month
- Sell 2-3 matching maturity Eris SOFR Swap futures contracts each day, or 10-15 contracts each week, accumulating Eris SOFR positions to offset the interest rate risk of committed loan originations
- Close loans and accumulate larger pools for improved execution through bulk sales
- Unwind or transfer Eris SOFR hedges at time of bulk loan pool sale
- Cost: Approximately 1 basis point on the loan rate (0.01%), covering exchange fees, broker commissions, futures account clearing fees, and market bid/ask costs

To learn more contact Eris Innovations at questions@erisfutures.com