

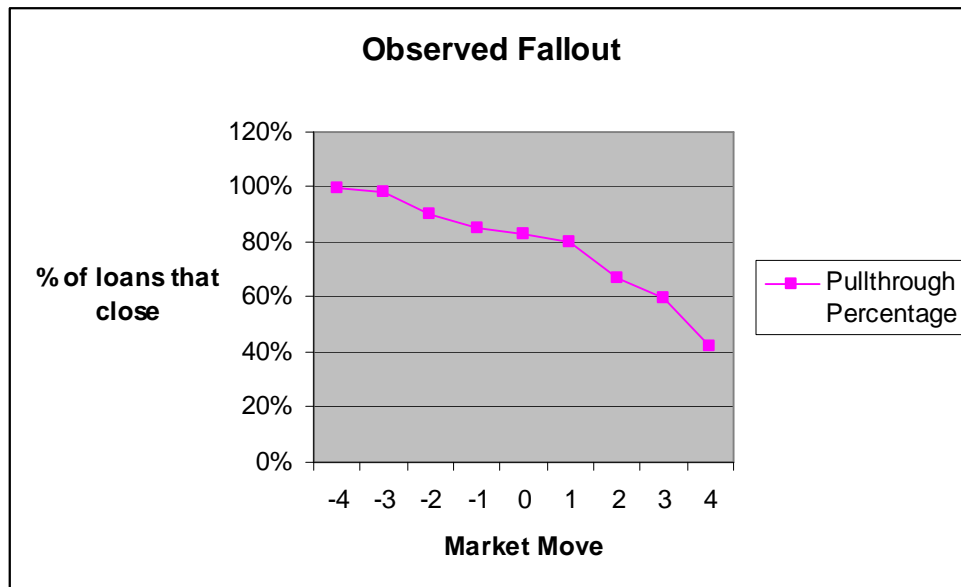


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## Topic of the Month: Thoughts, Parameters, and Considerations when Measuring Fallout Risk

One of the biggest risks Lenders incur when granting loan locks is Fallout Risk. Changes in interest rates not only affect the value of a Lender's pipeline but also have a direct influence on the percentage of loans that will close. By observing and measuring Historical Fallout in a variety of market scenarios, Lender's can create models in order to predict the percentage of loans in their pipeline that will close and adjust their hedging strategy accordingly. Additionally, by analyzing Fallout at the loan level, Lender's may discover ways to adjust the dynamics of their pipelines in an effort to reduce fallout and maximize profits.

There are three scenarios that can occur following a rate lock: rates increase; rates decrease; or rates stay unchanged. In the event that interest rates increase following a loan lock, Borrowers are more likely to accept the terms of the lock and thus a higher percentage of loans in the pipeline will close. In the event that interest rates decline during the lock period, Borrowers are more likely to look elsewhere for a better rate causing a lower percentage of loans to close. In the final scenario rates stay unchanged following the lock date and an average number of loans in the pipeline close. The Graph below illustrates a sample of Observed Fallout.



Following the date the loan was locked, if prices fall and rates rise, a higher percentage of loans should close all other thing equal. This increase in closed loans occurs at an inopportune time since the value of the loans closing in this scenario will be valued less than they were at the time the lock was granted. This illustrates how Fallout Risk in a rising rate environment magnifies the Interest Rate Risk that Lender's accept when granting rate locks and emphasizes the importance of a strong hedging policy. By observing



historical fallout, Lender's can anticipate increased volume in a rising rate environment and allow for an increase in the amount of hedge. As the value of the mortgage pipeline declines in this example, the short position of hedging instruments should increase in value and help to offset the pipeline's losses, protecting the Lender's profit margin.

Conversely, when prices increase and rates decline, the percentage of loans that close should decrease all other things equal. Although the loans in the pipeline that do close are valued higher than they were at the time the rate locks were granted, the decrease in volume means less opportunity to generate a profit. By measuring historical fallout, Lender's can anticipate the percentage of loans that will close and adjust the amount of hedge accordingly. For example, let's assume that the Lender Pairs-Off hedges at the same time loans are sold. In this scenario, although the Lender may make a profit on his/her loan sales above and beyond their initial margin, they will incur a Pair-Off Cost when buying back their short hedging instruments at higher prices. Having too much coverage on in this scenario would eat into a Lender's profit margin (on reduced volume) again illustrating the importance of measuring Fallout.

In the final scenario, rates are unchanged following the date the lock was granted. Without any influence from changing rates, an average number of loans in the pipeline should close, with the value of the loans being unchanged from the lock date. Again, as an example, let's assume the hedges are Paired-Off at the time of loan sale. Since the value of the hedge is relatively unchanged in this scenario as well, the Lender can expect to make the profit margin on the loan and simply incur a transaction cost on the hedge based on the Bid/Ask spread of the hedging instrument in question.

There are many different factors to consider when measuring observed fallout at the loan level. Loan type, origination source, purpose, stage, lock length, and lock type can all factor into a Borrower's sensitivity to interest rate moves. Additionally the skills of the Loan Officer and even the geographic location of the loan can factor into the probability of a loan to close. By monitoring Historical Fallout through a variety of market scenarios, Lender's can incorporate the findings into their hedging strategy in an effort to create more effective hedges. As described above, Pullthrough rates can directly influence profits, so Lenders often find valuable information in looking at Pullthrough across a number of dimensions, including Pullthrough by originator. *-Bob Gundel*