

With the volatility that has been experienced over the last few months in the market, fallout has re-taken its spot center stage as one of the most important issues facing a secondary marketing manager (SMM) today. Model based hedging programs try to predict pull-through functions so that lock value may be preserved. All models, from a dynamic pull-through to a delta-based model have had their challenges in this latest environment due to a couple of factors: the further commoditization of the product-base and market volatility.

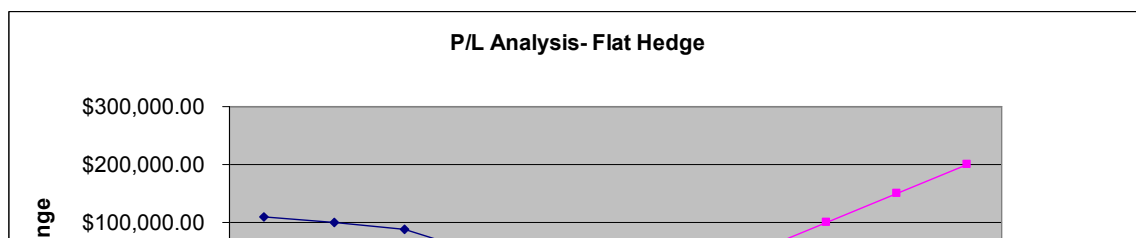
In order to hedge effectively, a mortgage banker must have a good handle on the pipeline and what is/isn't going to pull-through. To the extent that an SMM can accurately gauge the quality of the lock base and the respective values, the more accurately he/she can hedge the pipeline. This quality manifests itself through a sustained 2-way communication highway between the secondary department and the originators. If a lock that has 20 days remaining is really not going to close, and the SMM knows it, then it clearly needs to be taken out of the pipeline and/or hedged position.

Aside from the very important aspect of knowing the pipeline, there are also myriad of other factors of the loans origination that affect the quality of the pull-through assumption. Some of these are:

1. Market Move
2. Product Type
3. Loan Purpose (Purchase vs. Refi)
4. Lock Period
5. Processing status
6. Source of Loan
 - Retail vs. Wholesale
 - Geographic
 - Branch
7. Other Considerations
 - Rate Lock Policy
 - Management Decisions

Any one of these attributes can substantially increase/decrease the effective pull-through and affect overall profitability. It is imperative that the SMM discovers through evaluation which of these attributes correlates with originator practices that are beneficial/non-beneficial to the company, and incent/disincent those behaviors. For instance, if the SMM discovers that all loans from a particular broker have a pull-through of 20% there needs to be serious repercussions impacting the broker at the very least which may include disincentives for continued low pull-through, and/or a model change to a delta based approach to better match the risk of that broker.

The topic of fallout ultimately gets back to the hedging model that is employed. A hedging model in its most simplistic format is a static percent coverage strategy based on historic pull-through. Below is a chart of typical profit results from a static pull-through when the market shocks in one direction.



As you can see, when the market moves in either direction, the negative convexity of the underlying asset shines through and creates greater and greater losses when the yields move further away from zero change in either direction. Because SMM's face lower pull-throughs in a rallying market and higher pull-throughs in a declining market, the static coverage percentage performs its best in a flat market, where it only breaks even.

In order to counter this negative convexity, there are a couple of things that can be done such as moving to a more powerful model that adjusts its pull-through assumptions based on market movement like a dynamic pull-through model or a delta model that will treat the locks as a put option to the borrower. Other choices include more complex solutions such as adding options.

Finally, the last consideration in managing fallout is to evaluate the company's rate lock policy and its effects on fallout. Make no mistake; renegotiations are fallout because the SMM is giving away the inherent value of the lock in exchange for being able to close the loan. However, since the loan was hedged when the market rallied, the full value of the loss on the hedge is realized, thus resulting in a net loss. The rate lock policy has everything to do with controlling this slow bleed. The more renegotiations, the more the originators will come to expect it. It is imperative that originators understand that the rate lock policy is set in stone and that exceptions will be made only in rare circumstances. Not only do renegotiations cost money, they also are a major time sink to negotiate with the sales force on price and rate. In the end, a rate lock policy that is fair, reasonable and promotes positive business relationships is ideal. It is to the advantage of the SMM to play up the business relationship with the originators as much as possible.

– *Brandon Case*