Don’t Let Fallout Affect Your Outlook

Mortgage Borrowers and Brokers decide what is best for them given any specific real estate transaction, sometimes those decisions have a beneficial impact to your bottom line and obviously sometimes they don’t. It’s human nature to pay attention to and to do those things that in the long run will benefit you the most. They call you crazy or bankrupt otherwise! Most mortgage bankers talk about fallout when discussing the management of their mortgage origination business, but few have an adequate grasp as to what fallout is, how it is calculated, where these numbers can be used to manage risk, and why they need to do so in the first place. This article will answer these questions and more.

Historically, mortgage bankers who have survived multiple real estate lending cycles have all had a legitimate scheme…that is…to make a profit! As part of this scheme they have had to employ people, tools, and information required to conduct business in a profitable manner. Without getting into reasons for hedging mortgage pipelines versus best efforts operating strategies, the tools needed to manage a mortgage company or the people one must employ, I will discuss the information requirement concerning the effective secondary marketing of loans today.

It is difficult to imagine a mortgage pipeline without fallout risk, in which fallout is a known quantity. Such a condition, if it existed, would doubtless be excruciatingly dull - especially for secondary marketing professionals who are charged with minimizing gain on sale risks while maximizing profits. Secondary marketing professionals are apparently lucky, then, to have fallout as an uncertain quantity. Paradoxically, however, they are constantly seeking to minimize pipeline risks associated with fallout and movements of interest rates. Mortgage Bankers seem to like uncertainty, but would prefer a little less of it than they usually have.

What is Fallout/in? Fallout has been traditionally defined as the dollar amount of price and rate protected loans that are cancelled, rejected or renegotiated divided by the total dollar amount of price and rate protected loans originated over a specified time period. Thus, loans that are not locked in with a customer, whether a borrower or loan broker, do not qualify in either the numerator or denominator of the equation – they are not counted because loans that are not locked in do not result in risk to the mortgage banker given any market movement. Loans that are included are those loans that do contain interest rate risk to the mortgage banker. The value of these loans change according to changes in the secondary market and thus are hedged by mortgage bankers to maintain a targeted profit margin.

What goes into the numerator? Loans that cancel are usually easy to identify within an loan data base system – they are the ones that do not have close dates and usually have cancellation or rejected by underwriting dates attached to the record. The other source of loan amount for the numerator of our equation is renegotiated loans. Renegotiated loans are those loans that have terms whether interest rate or fees reduced during the processing

period before close. In other words these loans get a better deal than what was originally locked-in. The borrower or broker has negotiated a better deal and forced the mortgage banker to close the loan at better terms than what they had agreed to on day one. How much of a loans balance gets added to the numerator in our equation depends on how much renegotiation took place. For example, suppose a borrower received a lock @ 6% and 0 points and fees; and, that later on during the processing period, the borrow calls a loan officer and makes it clear that they will cancel their loan request unless they can receive a lower rate say 5.5% with no points or fees; and, further that the loan officer received permission to lower the borrowers rate in order to keep the transaction from going to another mortgage banker. What happened… the loan was renegotiated is what happened. If the market movement for loans like the one in question also went down by .5%, then the loan was 100% renegotiated, if the market went down by 1% during the period then the loan was 50% renegotiated. Thus, assume a market movement of 100 basis points or 1% in yield during the processing period of the loan. If the loan had a balance of $400,000 then $200,000 (.5%/1%=50%) would be included in our fallout numerator above and $400,000 would be included in the denominator. The effect of renegotiated based fallout should be obvious: it reduces the amount of value originated in the loan by decreasing its value in the secondary market. If the mortgage banker assumed a fixed amount of fallout during a rallying market, even if the same percentage of loans closed after renegotiations, a severe reduction in income would accrue to the unwise.

Fallout may also arise from switching loan programs. Suppose a borrower calls your loan officer and asks to have their loans changed to a program in which the price has not decreased by as much as the decrease in the borrower's original loan program. In this situation, the negative price change differential should be considered renegotiated fallout as the borrower receives a better deal and the mortgage banker ends up with a loan whose value has been reduced.

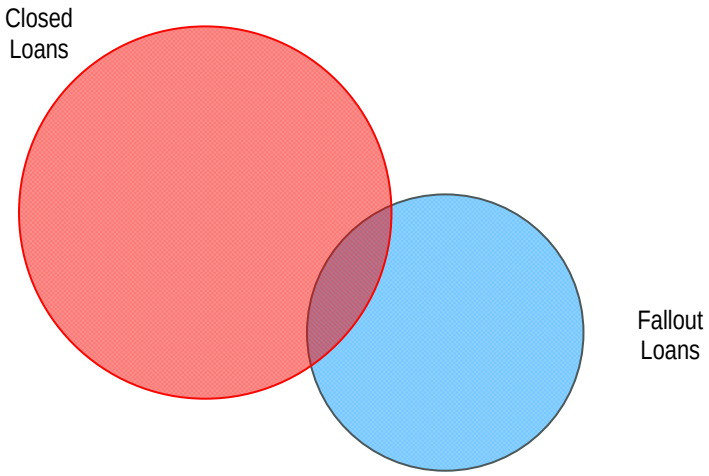
For example, assume our borrower receives a priced-protected rate lock @ 6% & 0 points and fees for a 30 year fixed rate loan and subsequently renegotiates a change to a 5/1 Hybrid ARM @ 4.5% & 0 points and fees. If the market for the new program and the old has not changed since the original lock no losses could occur, however, if the market for the 30 year loan increases by more than value of the 5/1 during the time it took for the borrower to change their mind, then a loss to the mortgage banker would occur. So if the 30 year loan's value went up by 1 point and the 5/1 ARM's value went up by .5 points, then a loss of .5 points would accrue to the mortgage banker when it repurchases it hedge position that offset the 30 year loan. The .5 point negative market movement differential should be added to the renegotiated fallout by taking the loss divided by the market movement. Hence, if the loan was again our $400,000 loan amount $200,000 would be added to the numerator and $400,000 would be added to the denominator of our fallout equation.

The data required by a mortgage banking company to accurately calculate its fallout includes most of the data usually tracked in most Loan Origination Systems including but not limited to Borrower name, address, loan program, rate, price, ltv, purchase or refi, intent, etc…, however, most systems do not track original lock information versus the last

lock information on a loan. For example, after a loan is renegotiated whether for a new lower rate or price or to a new program the original pricing fields (program, interest rate, discount points, life cap, margin, intent, ltv, fico, purpose, documentation, etc..) would be required for comparison with the last pricing fields in the database for each closed loan in order to calculate renegotiated fallout whether from rate and price changes or program changes. Also required is a daily loan program pricing history so initial yield and last yield comparisons can be computed. For example, if on day one the 6% and 0 points and fees locked loan would have a gross yield of 6%. If in the database it closed @ 5.5% and 0 points and fees and on the closed date the market was @ 5% yield. The database would need to track the original lock date loan program yield and the closed date loan program yield in order to calculate the renegotiated fallout amount. In this case again it would be 50% fallout on the loan (.5%/1%=.5%)

The Diagram below illustrates the mutually exclusive outcomes from locked loans: loans either close as show in the green section, fallout as shown in blue portion or renegotiate and close as shown by the intersection of both events as red. The probability of any one loan falling out within the mortgage pipeline can be determined by using statistically based methods relying on multiple sources of individual loan characteristics and market conditions. For example, a database of loans could be broken up into several discrete groups including: purpose of the loan: purchase or refinance; source: wholesale or retail; product type: Jumbo, Conforming, Government…. These distinct groups would be further refined by combining terms into Wholesale Jumbo Purchase loans, Wholesale Jumbo Refinance loans …. Until the entire database of loans have been broken down into corresponding mutually exclusive buckets. That is, all of the loans in the database of locked loans have been distributed into buckets with characteristics that are statistically significant to fallout. Characteristics that are not proven to be significant, e.g., the color of hair of the second borrower would be ignored and not set up as a pool of locked loans for fallout analysis. In addition to breaking these loans into distinct mutually exclusive pools on must further consider transitive stages loans go through while being processed. For example, loans are usually tracked within many loan origination database systems through the following stages: in process, approved documents and closed. This status's are not mutually exclusive to any one loan but may be a transitive state that is shared with some loans. For example, a closed loan was in documents, approved and in process before reaching its final stage of closed; whereas a loan having a final status of in process never reached approved, documents of closed stages. In order to incorporate these transitive stages in the evaluation of fallout one must expand each pool of loans into sub groups that may contain a single loan repeated in many subgroups. For example, a loan that falls out with a final status of documents would not be included in the closed group, but would be included in the documents, approved, and in process groups for determining fallout.

By increasing the granularity of statistically significant groups one can improve vastly the accuracy of predicting which loans have a higher likelihood of fallout under current conditions both internal and external. By improving the ability to predict the probability of your pipeline's closing percentage, you will significantly reduce your primary source of earnings volatility, albeit, at the cost of reducing mortgage pipeline risk.


Closed
Loans
Fallout
Loans