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Measuring the Fallout Risk in the Mortgage Pipeline

Sam Hakim, Manochehr Rashidian, Eric Rosenblatt

The Journal of Fixed Income Fall 1999, 9 (2) 62 - 75

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Abstract

Banks guarantee mortgage rates for a period of sixty days or more. These commitments represent put options for the borrower, who has the right but not the obligation to sell a mortgage to the bank at the promised rate. This article presents a proportional hazard model to estimate the closing rate on mortgage loan applications. The findings reveal that the closing rate accelerates with high rates and for owner-occupied dwellings, and slows for brokered loans, second residences, and borrowers who refinance an existing mortgage. The volatility of interest rates as well as the variation in the spread between fixed and adjustable rates during the lock period have a significant impact on the decision to close. In particular, the impact of volatility is in line with options theory, and suggests that in a volatile interest environment, borrowers delay closing in an effort to maximize the value of their put.

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