

**SMALL LENDER
SURVIVAL—
PART 1**

Performance

History AND Outlook

A look at recent industry data confirms smaller lenders operate at a stubborn pricing disadvantage to megalenders in the marketplace. However, the numbers alone don't destine smaller lenders to extinction. This article is the first in a series on small lender survival.

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ational media coverage of the ongoing turmoil in the mortgage industry has highlighted the failures and extreme difficulties of larger prime and subprime lenders. Such coverage has obscured the devastation being visited on smaller lenders, the results of a confluence of adverse conditions and developments that may well wipe out a majority of such lenders. ● As used here, “smaller lenders” are independent mortgage bankers that originate \$100 million to \$5 billion annually, depending upon where we are in the interest-rate cycle. Typically, such lenders operate retail branches and do not service loans, opting instead to sell their production on a correspondent basis to one or several of the major wholesale lenders. They fund closed loans with short-term credit lines provided by independent warehouse banks, although occasionally they may

have such a line in place with one of their wholesale lenders.

Frequently, smaller lenders supplement their warehouse lines with so-called repo lines that allow them to conserve capital and/or originate more loans with the same amount of capital. (In the typical repo line or repurchase arrangement, the lender sells closed loans to a financial institution under an agreement to repurchase the loans at a later date at an agreed-upon price. During the interim period, the lender is able to conserve capital since the repo loans are not drawing down warehouse lines, which have minimum capital requirements attached to them.)

In the current environment, smaller lenders have been besieged by a number of extremely adverse developments, including the following:

- A flat yield curve that has virtually eliminated net-interest income on loans held in warehouse. Indeed, smaller lenders are typically paying net interest—i.e., experiencing a negative carrying cost—on their warehoused loans.

- The meltdown in subprime and low-documentation loans (alternative-A) has drastically reduced the origination volume of many smaller lenders. In recent years, such loans have been a significant—often, dominant—proportion of the loans originated by smaller lenders. Because of fixed costs, reduced origination volume increases unit costs and lowers profit margins. Moreover, because such non-agency loans have yielded high revenues, their contribution to overall lender profits has been disproportionately higher than their share of origination volume.

- A number of wholesalers have simply refused or been unable to honor purchase commitments from their correspondent lenders. This has been especially true where riskier segments of subprime and alt-A loans are involved, but has extended into nonconforming prime loans as well—e.g., jumbo loans. Such unsalable loans consume warehouse lines, thereby diminishing, if not eliminating, a lender's ability to originate new loans—which, of course, can spell disaster.

- Warehouse and repo lenders that have responded to industry developments in ways that serve to tighten the already tightening noose around the necks of smaller lenders. As losses deplete lenders' capital base, they become subject to calls by their warehouse lenders for additional capital (with such additional capital generally not available); or, alternatively, to reductions in the size of their warehouse line. Some warehouse lenders have increased their interest rates, thereby increasing the negative carry of warehoused loans. And, to make matters worse, repo credit lines have dried up in response to the deteriorating financial position of many lenders and the increased—often irrational—risk aversion currently gripping the debt markets.

These conditions have fostered a downward spiral for many lenders, from which there is no obvious escape other than to shut down. While the mortgage industry is no stranger to hard times, what is truly extraordinary about the current environment is the speed with which adverse conditions have pushed lenders to shut

their doors. Instead of surviving a relatively protracted decline in origination volume and profits, many lenders have gone from business-as-usual to out-of-business in a matter of days.

Against this harsh backdrop, a series of articles in *Mortgage Banking* titled the "Small Lender Survivor Series" may appear to be too late, possibly irrelevant and, perhaps, even somewhat insensitive. But our goal in writing is not to offer quick fixes or nostrums to the current situation. Rather, the focus is first to understand what has happened and why; and second, to propose solutions or business models for smaller lenders that may help to mitigate or avoid a repeat of the current debacle.

While many smaller lenders already have departed from the scene, we are confident that new lenders will spring up once the environment improves. Such startups represent an opportunity to reconsider old mantras and bring fresh thinking to the table. It is with a brighter and different future in mind that this series is being written.

This first article is intended to set the stage for the series by reviewing and analyzing smaller lender financial and operating performance from 2000 to 2006 in comparison to the largest lenders. We want to shed light on those factors that drive the going-concern performance of smaller lenders with an eye toward isolating where sales and operational effectiveness can and should be improved.

We also want to underscore those areas in which smaller lenders (and, indeed, many larger lenders) are highly vulnerable to the actions of their wholesalers, warehouse lenders and, more generally, the capital markets. As recent events have shown, these players have the capacity to cut off the air supply of smaller lenders and, quite simply, put them out of business.

Smaller lenders vs. megalenders: Financial and operating performance (2000–2006)

The Mortgage Bankers Association (MBA)/STRATMOR Peer Group Survey includes a group of small to mid-size lenders (Group C). Because many of these lenders operate significant broker and direct-lending channels in addition to retail lending, their total originations are significantly larger than the typical smaller lender, which usually operates only retail branches. However, when you just consider their retail branch originations, Group C lenders fit our definition of smaller lenders and therefore provide a reasonable proxy for the performance of smaller lenders.

Figure 1 compares the average retail origination volume of Group C lenders with the Group M megalenders (the largest lenders in the survey). Note that Group M retail originations are typically 10 to 20 times that of Group C lenders. This much larger scale gives Group M lenders significant advantages in terms of both revenues and expenses.

Figures 2 and 3 compare the average net retail production income in basis points of Group C with Group M lenders.

Except for 2005, net production income for megalenders exceeded that for smaller lenders by approximately 10 to 40 basis points, despite the fact that total income (i.e., revenues)

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for smaller lenders was generally higher than that for megalenders by a substantial margin.

For example, during 2003, the peak year of the most-recent refinance boom, smaller lenders' retail income was 308.1 basis points versus 269.7 basis points for megalenders. Nonetheless, because megalenders typically enjoyed a substantial retail expense advantage (e.g., 171.1 basis points versus 221.4 basis points in 2003), they were regularly able to outearn smaller lenders.

The megalender expense advantage was most pronounced for

total production expenses (i.e., direct-channel expenses—sales and marketing, processing, underwriting, closing and funding expenses), but also occurred in production support (post-closing, quality control, shipping and delivery, secondary and production technology expenses) and allocated corporate expenses (executive, finance and accounting, human resources, other information technology and parent allocation expenses) as well.

Not unexpectedly, net production income was greatest for both smaller lenders and megalenders during the peak years of the refinance boom (2002 and 2003). During these years, industry capacity was stretched so thin in meeting loan demand that price concessions were generally unnecessary. Often, borrowers were just happy for someone to answer the phone and take their refinance application.

In 2004, however, the megalenders apparently adjusted to volatile interest rates and declining refinance demand better than the smaller lenders. While megalender net production income declined by about 62 percent, from 98.6 basis points to 37.4 basis points, smaller lenders saw profits plummet from 86.7 basis points to 14.9 basis points—about an 83 percent drop.

During 2004, smaller lenders were surprisingly slow to adjust their operations to the significant, albeit erratic, decline in refinance volume. On the plus side, smaller lenders were able to sustain revenues at 2003 levels, about 308 basis points. On the negative side, smaller lenders appear to have been slow to downsize their operations, thereby allowing expenses (in basis points) to increase by almost one-third and nearly wipe out overall margins.

One of the surprising observations that can be drawn from Figures 2 and 3 is the consistent ability of smaller lenders over the

Figure 1 Smaller Lenders vs. Megalenders, Retail Originations (2000–2006)

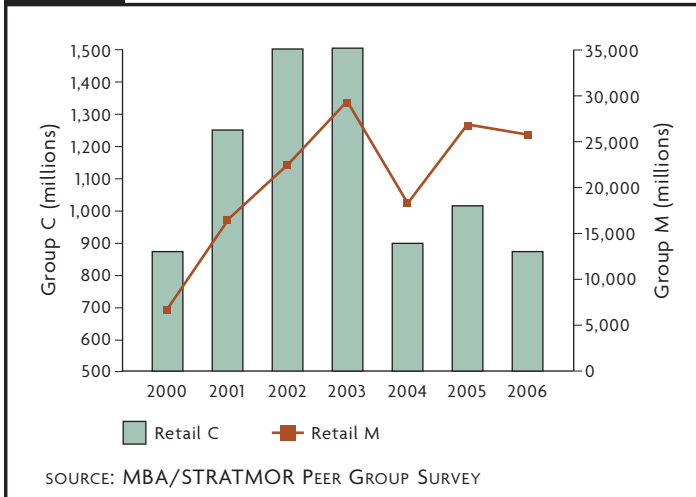


Figure 2 Group C: Smaller Lenders—Net Retail Production Income in Basis Points (2000–2006)

Basis Points	2000	2001	2002	2003	2004	2005	2006
Total Income	222.1	236.8	308.5	308.1	308.3	272.8	228.5
Total Production Expenses	192.0	143.6	178.3	176.8	222.1	192.0	177.7
Total Allocated Prod. Support Expenses	30.5	20.2	21.3	19.8	32.0	24.2	24.4
Total Corporate Allocation	46.1	24.6	30.4	24.8	39.5	34.3	32.6
Total Expenses	268.5	188.4	230.0	221.4	293.5	250.4	234.7
Net Channel Production Income	(47.3)	48.4	78.6	86.7	14.9	22.4	(6.2)
Average Loan Size	\$126,134	\$127,928	\$132,823	\$156,870	\$144,638	\$190,670	\$211,004
Average Retail Volume (\$ millions)	\$883	\$1,259	\$1,590	\$1,557	\$901	\$1,021	\$879

SOURCE: MBA/STRATMOR PEER GROUP SURVEY

Figure 3 Group M: Megalenders—Net Retail Production Income in Basis Points (2000–2006)

Basis Points	2000	2001	2002	2003	2004	2005	2006
Total Income	259.7	265.3	262.7	269.7	244.9	210.4	221.0
Total Production Expenses	229.1	141.0	136.6	138.6	160.9	152.9	177.5
Total Allocated Prod. Support Expenses	16.1	14.7	12.7	10.6	16.3	13.8	17.6
Total Corporate Allocation	51.2	21.6	21.0	21.9	30.3	29.6	25.0
Total Expenses	296.4	177.4	170.3	171.1	207.5	196.3	220.1
Net Channel Production Income	(36.7)	87.9	92.3	98.6	37.4	14.1	0.9
Average Loan Size	\$135,797	\$151,225	\$177,272	\$170,487	\$181,798	\$203,755	\$197,891
Average Retail Volume (\$ millions)	\$6,487	\$16,457	\$22,507	\$29,266	\$18,381	\$26,943	\$25,880

SOURCE: MBA/STRATMOR PEER GROUP SURVEY

past five years to earn higher revenues than the megalenders. Several explanations are frequently offered for this result:

- Smaller lenders often operate in second-tier markets in which they do not have to compete toe-to-toe with megalenders.

- Lead referrals in such smaller markets are much more relationship-driven than in the larger metropolitan markets. The relationships between small-lender owners and Realtors®, for example, play a larger role in a small market than a large market.

- Loan officers with smaller lenders tend to be more customer-oriented and service driven—perhaps even better at selling loans on more than just price—thereby allowing them to price loans somewhat higher than their megalender counterparts.

- During the refinance boom, in particular, smaller lenders benefited from the especially poor upfront service borrowers experienced from their existing lender/servicer, typically a large or megalender. It was only natural for most borrowers to call their existing servicer first to inquire about refinancing. However, call volume was typically so high among the major lenders that holding times became excessive, causing many borrowers to drop off the line and go elsewhere.

- Smaller lenders were quicker to move to higher-margin, non-agency-eligible production. For example, smaller lenders increased alt-A originations (as a percent of total retail originations) from 12 percent in 2004 to 38 percent in 2005. Meanwhile, megalenders increased their alt-A originations from 7 percent in 2004 to only 9 percent in 2005.

- Most tellingly, we think, is that megalenders use their cost advantages to subsidize their loans more aggressively than smaller competitors, with the objective of grabbing market share from others.

In terms of this last point, it's instructive to compare the income or revenue gaps between smaller and megalenders in Figures 4 and 5 with the expense gaps, especially during the last five years. Clearly, the megalenders have booked lower revenues per loan than smaller lenders over that time period.

This overall comparison, in fact, understates the true revenue differential between smaller lenders and the megalenders because it does not explicitly take into account the impact of net interest income. Figures 4 and 5 make this point abundantly clear.

In these figures, net gain on sale is defined as origination fees + originated mortgage servicing rights (OMSRs) + servicing release premiums (SRPs) ± net price concessions + gain/(loss) on loan sales + loan losses.

Although the total channel income in 2006 of 228.5 basis points for the Group C smaller lenders is only 7 basis points higher than the 221 basis points received by the Group M megalenders, the sum of net gain on sale plus underwriting/ closing/administration fees received by smaller lenders was 215.7 basis points versus the 198.8 basis points received by the megalenders—about a 17-basis-point differential. This revenue difference was likely driven by the megalenders' more "vanilla" product mix and more aggressive price subsidization.

In 2006, during which time the yield curve substantially flattened, this revenue difference was largely offset by the positive difference in net interest income enjoyed by the megalenders over smaller lenders—18.7 basis points versus 6.4 basis points. (Typically, megalenders can borrow short-term funds at the 30-day London interbank offered rate [LIBOR]. Smaller lenders, on the other hand, will typically pay a premium over 30-day LIBOR, ranging from 75 basis points to 175 basis points.)

These revenue differentials were even larger during the peak years of the refinance boom, when a steep yield curve further amplified the net interest advantage of the megalenders over

Figure 4 Group C: Smaller Lenders—Retail Production Income in Basis Points (2000–2006)

Basis Points	2000	2001	2002	2003	2004	2005	2006
Net Gain on Sale	183.4	185.0	239.7	241.5	255.6	231.8	195.4
Underwriting/Closing/Administrative Fees	17.9	27.5	33.8	30.9	27.7	28.6	20.3
Net Interest Spread	9.5	19.8	27.2	23.7	23.4	11.0	6.4
Other Income	10.3	4.6	7.9	12.1	1.7	1.5	6.4
Total Channel Income	221.1	236.8	308.5	308.1	308.3	272.8	228.5
OMSR + SRP Received (basis points)	138.2	132.9	149.0	117.7	123.9	105.2	101.0

SOURCE: MBA/STRATMOR PEER GROUP SURVEY

Figure 5 Group M: Megalenders—Retail Production Income in Basis Points (2000–2006)

Basis Points	2000	2001	2002	2003	2004	2005	2006
Net Gain on Sale	207.7	213.8	197.9	198.9	184.4	160.4	176.4
Underwriting/Closing/Administrative Fees	20.2	18.2	20.3	23.4	18.9	20.6	22.4
Net Interest Spread	17.0	28.3	38.6	44.8	38.2	24.8	18.7
Other Income	14.8	5.0	5.8	2.5	3.5	4.6	3.6
Total Channel Income	259.7	265.3	262.7	269.7	244.9	210.4	221.0
OMSR + SRP Received (basis points)	140.3	149.9	126.6	100.2	100.8	101.8	102.2

SOURCE: MBA/STRATMOR PEER GROUP SURVEY

their smaller competitors. For example, in 2002 and 2003, the revenues earned by the megalenders (i.e., net gain on sale plus fees) were 218.2 basis points and 222.3 basis points, respectively, compared with 273.5 basis points and 272.4 basis points for the smaller lenders—roughly a half-point revenue advantage for the small lenders.

So, relative to smaller lenders, the megalenders are in the enviable position of being able to leverage their cost and net-interest-income advantages to create superior profit margins, despite lower revenues driven by a more “vanilla” product mix and more aggressive pricing.

Even these considerable megalender advantages may understate the true case. Because smaller lenders rarely hold mortgage servicing rights, their net gain on sale income includes cash SRPs and virtually no capitalized mortgage servicing rights. For the megalenders, the situation is almost entirely the reverse—with net gain on sale income, including substantial OMSRs and virtually no SRPs.

Because OMSRs are calculated values, albeit subject to accounting standards, megalenders have a degree of latitude as to how aggressive or conservative they can choose to be in calculating their OMSRs. Based on anecdotal information, STRATMOR Group believes that most megalenders have opted to value their OMSRs conservatively, thereby storing potential income for a rainy day within their servicing portfolio.

Summing up

In this first article in the series on small lenders’ survival prospects, we have demonstrated that even in good times, smaller lenders operate under inherent strategic disadvantages relative to the largest lenders that severely challenge them in the marketplace. Specifically, scale disadvantages that result in higher operating costs per loan and lower net interest income put smaller lenders at a perpetual competitive pricing disadvantage vis-à-vis megalenders.

While these disadvantages cannot be ignored, they do not in our judgment necessarily constitute a death knell for smaller lenders. It is our view that despite the common perception that mortgages are a commodity and price is king, marketing and sales skills coupled with superior service to borrowers are also critical success factors. Further, when it comes to these additional success factors, many megalenders are not top performers. That is why, over the years, their retail origination operations have lost ground to brokers and remain vulnerable to well-run smaller lenders.

Future articles in this series will address specific sales, marketing and operations strategies by which smaller lenders can overcome or significantly mitigate the strategic advantages of much larger lenders. We will also address strategies by which smaller lenders can insulate themselves from the extreme vulnerabilities exposed by the recent mortgage industry meltdown. Absent these strategies, it is debatable whether the smaller mortgage banker is a viable business concept in the future. **NB**

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