SMALL LENDER SURVIVAL—PART 2

Surviving in a Down Market

This second article in our Small Lender Survival series looks at strategies and tactics smaller mortgage bankers can use to make it through down markets. It probes the challenges common during downturns, including the extraordinary liquidity and investor default risks that have recently forced so many smaller players out of business.

BY MATTHEW LIND

In the normal course of business, competing successfully against super-large mortgage lenders is no easy challenge for a smaller lender. The first article in this series ("Performance History and Outlook," *Mortgage Banking,* October 2007) concluded that "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." That article went on to say, "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." These factors historically have allowed well-run smaller lenders and brokers to compete against the behemoths.

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That is not to say sales and marketing skills alone are enough. Indeed, STRATMOR Group believes that smaller lenders, including both existing survivors and new entrants rising from the ashes, must also take steps to improve their cost competitiveness and operating efficiencies if they are to survive. This will be especially true in the near to midterm and possibly the long term, because the share of higher-margin subprime and alternative-A loans will be sharply lower than their pre-meltdown percentages.

In short, going forward, for almost all smaller lenders, business as usual will not be a survival or winning strategy.

A risky business

Mortgage banking entails a variety of risks that must be managed across a range of business conditions in order to achieve consistent and acceptable profitability and returns.

Limiting our focus to production operations, these risks include the following:

- ***Short-term interest-rate risk***—as rates rise, the value of loans held for sale and locked pipeline loans decline.
- ***Pipeline risk***—as rates decline, a lower percentage of the loans in pipeline will close unless the lender makes rate concessions to the borrower.
- ***Delivery risk***—the risk that the loan fulfillment process cannot be completed quickly enough for timely delivery of the loan to an investor or into a security.
- ***Product/repurchase risk***—the risk that you cannot sell a closed loan to an investor or have to repurchase a sold loan because its characteristics do not match with investor requirements.
- ***Investor default risk***—the risk that an investor will simply back out of a commitment to purchase a loan.
- ***Operational risk***—the ongoing risk or challenge of managing capacity and fixed costs in a volatile or cyclical business; in particular, in down markets.
- ***Warehouse risk***—the risk of being able to maintain warehouse line capacity sufficient to support production volumes; the risk of lines being pulled, reduced or not renewed; the risk of additional capital calls; and the risk of cost-of-funds increases and/or increases in line maintenance fees.
- ***Yield curve risk***—the risk that a flattening yield curve will erode net warehouse interest, possibly even resulting in a negative warehouse spread.
- ***Default/credit risk***—the risk that an originator will have to buy back a loan in the event of an early payment default.
- ***Prepayment risk***—the risk that an originator will have to compensate an investor in the event of an early payoff.
- ***Fraud risk***—the risk that an originator will suffer economic losses resulting from civil and criminal prosecutions of either "soft" fraud (e.g., inflated income or appraisal values) or "hard" fraud (e.g., straw borrowers).
- ***Compliance risk***—the risk that an originator has violated regulatory compliance requirements and will incur onerous fines, lawsuits and potential loss of license. Included here is the risk that an originator grossly overcharges a borrower, or unnecessarily puts a borrower into higher commission/margin loans or into loans that are unsuitable to the borrower's situation.

These risks are present in varying degrees under all market conditions. However, aggregate risk becomes more acute in what is loosely referred to in the industry as a "down market."

Typically, a down market is characterized by high interest rates that result in lower origination volumes and depressed profitability. The bite of fixed costs per loan coupled with the greater pricing concessions that are a normal consequence of lower demand can quickly eat into loan profitability. But any mortgage banker knows that interest-rate volatility and a flat or flattening yield curve—something that can occur even when interest rates are relatively low—exacerbate risk and erode profits. And as recent events have vividly shown, unexpected macro-market shocks to the system can be disastrous.

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For purposes of this article, a down market is defined as one in which the inherent risks of mortgage banking are heightened, and effective management requires a combination of intensity and skill across many mortgage banking functions.

Here STRATMOR Group needs also note that while mortgage brokers have to deal with some of these same risks, several of them are unique to mortgage banking. Indeed, it is the assumption of these additional risks—along with the related functions involved—that earns mortgage bankers substantially more net income than mortgage brokers.

Unfortunately, in STRATMOR Group's experience, we have witnessed too many mortgage brokers who see only the upside from becoming a mortgage banker. They underestimate the additional operational challenges, risks and expenses involved.

Similarly, we know mortgage banking firms that might be better off operating as mortgage brokers. Sadly, most of these players are now on the sidelines.

Strategies for survival

In thinking about small lender survival, potential strategies fall into two broad types:

- Strategies that are likely to improve a small lender's operating performance and profitability; and
- Strategies that lessen a small lender's vulnerability to the stability and behavior of its investors and warehouse lenders.

To some extent, these two types of strategies are not independent, and indeed sometimes can be in conflict. For example,

small lenders that adopted strategies emphasizing subprime and alt-A originations were typically more profitable over the past few years than lenders that largely stuck with agency-eligible production. They were also typically among the first to fail during the recent industry meltdown.

While we offer no simple formula for managing this type of trade-off, it is dangerous to pursue strategies that promise short-term gains without explicitly and realistically considering how they might increase downside vulnerabilities.

Strategies for improving your operating performance

Experienced mortgage bankers know that building a performance edge is generally the result of lots of little steps that can add up to a significant competitive advantage. In this article, I will discuss just a few such steps—steps that STRATMOR Group thinks are important for smaller lenders to consider.

And if there are any overarching themes, they are that smaller mortgage bankers should 1) focus their efforts on sales and marketing excellence; 2) simplify their business as much as possible; and 3) transform fixed costs to variable costs wherever possible.

Consistent with these themes, STRATMOR Group would recommend that smaller lenders consider the following:

Limit channels of distribution. Think twice about operating a broker channel. While it may add some origination volume, especially in high-volume markets, if you are a smaller lender you are likely to bring no competitive advantage to the table relative to large wholesalers.

When the market is down, most brokers will desert you for the better pricing of large wholesalers. It just adds to the operational complexity and risks you must manage, without adding to the franchise value of your business. Think of it this way: Should you ever sell out to one of the large lenders, they won't pay you a thing for your wholesale business. They are probably already sourcing loans from many of your brokers. So why should they pay you for what they are already doing?

The same can be said about consumer-direct lending. Unless you have developed unique and potent proprietary lead-generation tools, you are unlikely to generate a franchise premium for your business. Remember, the large lenders all have direct-lending operations and have access to the same lead sources you do. So stick with retail lending if you want to create franchise value.

Outsource/offshore select back-office functions. Consider transferring those fulfillment and back-office functions that do not involve direct borrower or real estate agent contact to a reliable outsourcing firm. By doing so, you will not only lower your fulfillment and post-closing costs but eliminate significant fixed costs as well. Recognize, however, that the "handoffs" between your in-house functions and systems, and those of your outsource service provider, need to be carefully planned and implemented.

Consider outsourcing or "co-oping" select secondary marketing functions. If you are able to securitize your production, consider having your trading, hedging and negotiating functions performed by an outside service provider. Chances are you can improve your net execution and eliminate the substantial fixed costs of your secondary marketing operation. If you are selling whole loans on a best-efforts basis, you can probably improve your net pricing by aggregating your production with other smaller lenders via a third-party secondary marketing provider or marketing cooperative.

Join a small-lender cooperative. Consider joining a lender cooperative. By pooling purchasing power, such co-ops have proven effective in helping lenders materially lower a wide range of operating costs, including office supplies, furniture, fixtures and equipment (FF&E); utilities; telecommunications; credit reports; and employee benefits. Remember, every dollar or basis point of cost reduction helps.

Reconsider your operating model. Historically, smaller lenders have tried to sell superior service to borrowers (and real estate sales agents) against the price advantages of larger competitors. Often, this positioning has translated into high-cost fulfillment operations characterized by underwriting, processing and closing operations that are decentralized to the retail branches. Such decentralized branch-fulfillment operations have also been a key selling point in attracting seasoned loan officers and branch managers.

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Unfortunately, such a decentralized operating model can be highly inefficient and costly—especially for smaller branches and especially in a down market. Therefore, consider eliminating or downsizing in-branch fulfillment personnel if origination volume falls below clear economic thresholds. Move fulfillment operations for such branches to larger branches or perhaps to central or regional fulfillment centers that support or back up smaller branches. In other words, make branches earn their dedicated fulfillment personnel.

It may be argued that sustaining low profits or losses during down markets is a necessary cost of doing business that will keep top producers on board for better times. Or, it might even be argued that losing top producers will make matters even worse. This kind of thinking can be a never-ending trap that should be avoided. Indeed, it may be better to accept the predictable costs of having to close an unprofitable branch than risk the costs of sustaining uncertain monthly losses for an unpredictable amount of time. (Here, it may be appropriate to look at branch losses on an incremental basis as opposed to a reported basis.)

Build and maintain a retail branch network based on factual market analytics and competitive intelligence. Most smaller lenders build their retail branch network based on the availability of a good branch manager. While lip service is also paid to expanding into "attractive" markets, few smaller lenders actually analyze markets with any rigor in making decisions either to open new branches or continue or downsize existing ones. Attractive mortgage markets combine a relatively large number of mortgage transactions in proportion to the population, with relatively high projected growth rates. (An excellent article on this subject, "The Mortgage Continuum," by Dennis Hedlund, can be found in the October 2007 issue of *Mortgage Banking*.)

Just as a rising tide lifts all boats, an attractive mortgage market can give almost any branch a lift and cover a lot of sins. Conversely, even with a strong branch manager, it may be difficult to profitably build a new branch or sustain an existing one in an unattractive market. Competitive intensity must also be factored into the branch location equation, especially by smaller lenders. The cost, revenue and capital advantages of large lenders allow them to intensify local price competition in a down market and generate substantial red ink for smaller competitors, possibly forcing them out of the market. During down markets, the largest lenders also typically ratchet up efforts to cannibalize top loan officers and even whole branches from smaller competitors.

Thus, STRATMOR Group believes smaller lenders should avoid markets—even attractive mortgage markets—in which there is a significant large-lender presence. Instead they should focus on attractive markets that are not saturated with large lenders. Second- and third-tier markets, in particular, are often underserved by the largest lenders and also tend to be more relationship-oriented.

As recent events have shown, being a well-run, higher-performing lender does not provide immunity from the vicissitudes of a credit crunch and liquidity crisis.

Improve your sales management. Loan officer turnover among smaller lenders has recently been in the 50 percent to 60 percent range, substantially higher than large-lender turnover. Even in good times, smaller-lender loan officer turnover is typically about 40 percent. Such high levels of turnover are expensive, waste sales management's time and energy, and make it difficult to grow existing branches. They are a testament to weak links in the recruitment, training, performance-monitoring and retention processes within retail sales operations; in effect, to weaknesses in sales management.

The linkage between turnover and profitability, however, is unclear. Recruitment of weak-performing loan officers can drive high turnover levels and obviously hurt profitability. But the recruitment of weak loan officers who are not actively monitored and then quickly terminated will result in lower turnover but even poorer profitability.

STRATMOR Group's consulting experience has demonstrated time and time again that smaller lenders do not engage in sales management. Branch managers, in particular, are not adequately held accountable for recruitment, development and retention of their loan officers and meeting production and profitability goals for their branch. Indeed, most branch managers are also personal producers who often relax on the job once they have reached their personal financial comfort zones.

Training programs that reasonably equip loan officers with the sales and product skills to be successful are typically nonexistent in smaller-lender operations, which instead assume, often wrongly, that the experienced loan officers they recruit have these skills. Sales management is not rocket science, and many proven programs and methodologies exist by which you can significantly upgrade your sales management practices without spending lots of money. It just takes the will. So, do it.

Ramp up government lending. Government production among smaller lenders fell from about 15 percent to 20 percent in 2000 to about 6 percent in 2006, according to the Mortgage Bankers Association (MBA)/STRATMOR Peer Group database. This decline reflected the rapid growth of both subprime and alt-A lending since 2000, which siphoned off the better-quality loans from what would otherwise have been government production.

Indeed, in recent years, the quality of government production has declined dramatically, and origination of government loans for many lenders has been extremely costly and often unprofitable. The recent implosion of subprime and alt-A lending as a result will be a boon for government lending. Adding to this boon will likely be a larger-than-normal increase in Federal Housing Administration (FHA) loan limits intended to fill some of the void left by the meltdown in subprime and alt-A lending. Therefore, STRATMOR Group anticipates government origination volume to increase to its earlier share levels, e.g., 15 percent, along with sharp improvements in government profitability.

Further, because the typical government-loan borrower will need higher levels of service, government lending should be less price-sensitive than conventional lending, and play to the potential sales and marketing strengths of smaller lenders. Of course, originating a government loan is a more complex process than a conventional loan, and you will need to carefully and diligently build your government-fulfillment capabilities. But it will be worth it.

Strategies to decrease vulnerability to investors and warehouse banks

As recent events have shown, being a well-run, higher-performing lender does not provide immunity from the vicissitudes of a credit crunch and liquidity crisis. So, what should a lender do to reduce exposure to such deadly risks? A few rather obvious strategies arise.

Focus on agency-eligible, government and basic jumbo loans. As many lenders found out too late, there is no free lunch. The superior margins of the more "esoteric" subprime and prime products masked the grossly underestimated risks of borrower, and then, investor default. By focusing on reliably marketable loans, you can mitigate—if not eliminate—the risk of large-scale investor default and the related risk that your warehouse banks will squeeze you.

It will, of course, be argued that the margins available from agency-eligible production are so thin that it will be hard for a small lender to make money. While there is some truth to this, I would direct the reader to the earlier *strategies for improving your operating performance* section of this article. STRATMOR Group is confident that if you adopt these strategies and implement them well, you will be able to achieve reasonable margins and returns without putting your entire business at risk. It will also be argued that a limited product menu will make it harder for you to attract and retain superior loan officers. In the near term, this objection is moot because esoteric loans have pretty much been taken off the table.

While the longer-term outlook is less clear, momentum appears to be building at the federal and state levels for much tougher regulation of lending practices that will severely and permanently limit the market for the kinds of wildly esoteric loans that brought about the recent credit crisis. When such regulation is in place and the dust settles, you can probably resume originating a variety of alternative lending products without taking on the hidden risks of the recent past.

Be selective about your investor—stay with quality and financial strength. Maintain multiple investor contracts for all types of loans. You can reduce or virtually eliminate your risk of investor default and being stuck with closed loans that you cannot sell if you deliver most of your production to financially strong investors. Just as investors will perform due diligence on you before approving you as a correspondent, so should you conduct initial due diligence and maintain ongoing surveillance of your investors.

This will be especially true for investors that will buy your non-agency-eligible/non-government production. Fortunately, at least for the foreseeable future, the available investors for such production are likely to be financially strong major banks and Wall Street houses, inasmuch as most of the financially weaker independent subprime and alt-A investors have left the business.

To the maximum extent practicable, you should also maintain multiple investor contracts across all product types that you originate. Not only will this give you pricing options, but it will protect you against the possibility that even a financially strong investor may elect to leave the market. These days, with so much money having been lost, there is a risk that even financially strong investors will view any business with the word "mortgage" in it as unattractive.

Consider turning your warehouse faster than you do today, maintaining multiple warehouse lines and underutilizing your lines. For most smaller lenders, it makes financial sense to minimize the time a loan spends in the warehouse. In general, any gains in income resulting from slower turn times (e.g., net interest income, better pricing for larger securitizations) are largely offset by price reductions for slower delivery, hedging costs, etc. Most important, however, production returns on equity tend to decrease in direct proportion to increases in warehouse turn time.

For example, all other things being equal, turning your warehouse in 20 days will generate twice the returns of turning it in 40 days. This is because a 40-day turn time will require twice as large a warehouse line and therefore twice as much lender equity as a 20-day turn time. Of course, faster delivery of whole loans or loans into securities will likely increase your post-closing staffing and expenses. But in a well-run company with reasonable margins, these minor expense increases and the impact on profits are likely to pale in comparison with the improvement in returns.

An often-overlooked benefit of faster delivery is that, with the same capital, it gives you the option of underutilizing your available lines—i.e., maintaining a cushion. By underutilizing lines provided by multiple warehouse lenders, you can protect yourself from your warehouse lender exiting or reducing its participation in the business.

For example, assume that you need and have the capital to support $100 million in warehouse lines at a 30-day turn time. By reducing your turn time to 15 days, you will reduce your warehouse need to $50 million. What we are suggesting, in this example, is that you establish two warehouse lines of $50 million each. At a 15-day turn time, each of these lines would, on average, be drawn down by $25 million, leaving a $25 million cushion in each line. In this situation, should one of these warehouse lenders terminate your line or exit the business, you would still have the $50 million line you require available from the other warehouse lender.

While this strategy will incur unused line charges and utilize more capital than you actually need, it will provide you with warehouse risk protection. Especially in this environment, where the risk of warehouse lenders exiting the business is heightened, such protection may be worth the price.

Actively manage your warehouse lender relationships. Stay close to your warehouse lenders. Keep them informed about the state of your business. Go beyond the reporting requirements of your warehouse agreement. Visit with them on a regular basis. Why? By doing so, they are likely to feel more comfortable about doing business with you than with lenders that don't stay in touch and keep them personally informed. And should they have to cut back their lending lines, you are less likely to be in their sights.

Conclusion

No article of this length can do justice to the many strategies and tactics available to improve the performance and survivability of small lenders. Indeed, many of the strategies suggested here could each be the subject of an entire article. What STRATMOR Group hopes is that these suggestions will stimulate small lenders to re-examine and rethink how they do business, and inform them as to the many strategies available for achieving success. **MB**

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