

In-Focus

PLIGHT OF THE INDEPENDENT LENDER

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INSIGHTS



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PLIGHT OF THE INDEPENDENT LENDER

By Jeff Babcock and Garth Graham

Recently, our colleague and STRATMOR Senior Advisor Rob Chrisman said of Independent lenders: "I know many owners and CEOs of Independent residential lenders and would never bet against their success. They represent a very savvy, entrepreneurial, and street-smart group of individuals." We couldn't agree more. At the same time, there are certainly some challenging headwinds that will impact virtually all Independents and should not be ignored.

We recognized that lenders would benefit from more details on the plight of the Independent lender and that STRATMOR could provide such needed guidance. In this In-Focus article, we are concentrating on the outlook for the typical Independent lenders where Retail is the dominant channel.

Our goals for this piece:

- Point out why some factors driving the industry outlook impact Independents especially negatively.
- Identify possible strategies by which Independents might mitigate or finesse these challenges, including the options of selling-out to or joint-venturing-with another lender.

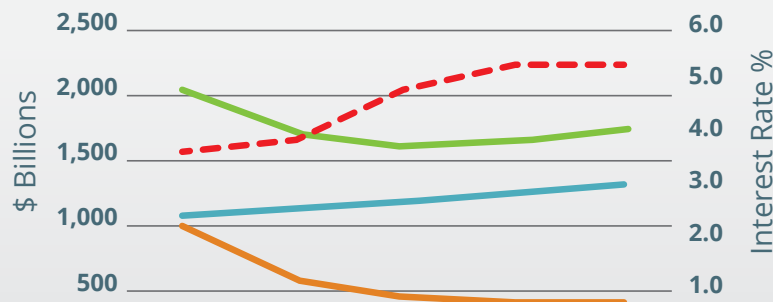


THE BIG PICTURE

To understand what is impacting Independents, specifically, we examined the recent history and projected trajectory of mortgage origination volume and purchase/refinance mix for the entire industry. Figure 1 shows this in a two-year look-back (2016-2017) with a three-year MBA projection (2018-2020) of mortgage originations.

Figure 1

Mortgage Origination Volume



	2016	2017	2018	2019	2020
Total 1-to-4-Family (\$Bil)	2,051	1,710	1,611	1,645	1,712
Purchase (\$Bil)	1,052	1,110	1,168	1,250	1,317
Refinance (\$Bil)	999	600	443	395	395
30-year Fixed Rate Mortgage %	3.8	4.0	4.9	5.4	5.4

Source: MBA Research, Economic Forecast June 2018.

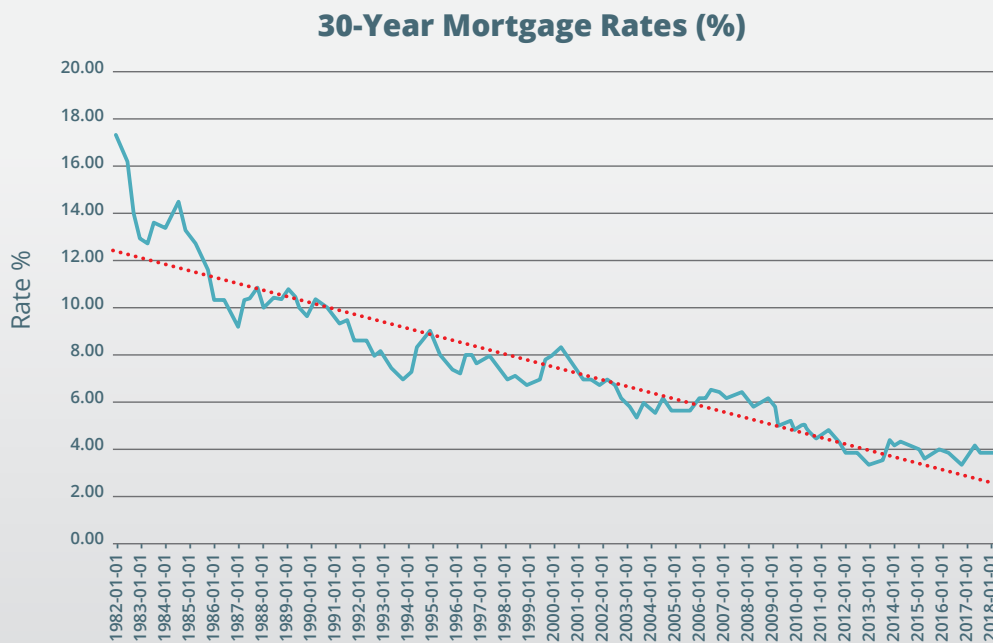
Note first the 17-percent decline in total one-to-four family origination volume (the green line) in 2017 compared to 2016. This drop-off results almost entirely from a \$400 billion, 40-percent decline in refinance volume (the orange line), despite extremely low mortgage interest rates in both 2016 and 2017 (the dashed red line). What’s behind this \$400 billion decline is the steady “burnout” of primarily rate-and-term refinances (full “burnout” occurs when virtually all refinance-able loans have been refinanced).

Looking ahead, refinances are projected to fall to \$443 billion in 2018 before leveling off at about \$395 billion in 2019. At \$395 billion — a 60 percent decline from the \$999 billion refinance volume booked in 2016 — refinance originations will largely consist of cash-out refinances taken out by borrowers whose property value has substantially appreciated and who are willing to pay a somewhat higher mortgage rate to obtain a relatively low cost, largely tax-deductible loan to finance home-improvements, higher-education costs and typically other big-ticket items. Over this same time frame, the average interest rate for a 30-year fixed rate mortgage (FRM) is expected to increase from 4.0 percent in 2017 to 4.9 percent in 2018 before leveling off at 5.4 percent 2019.



The \$64,000 question is whether the 160 bps rise in the 30-year FRM interest rate between 2016 and 2019 is just a temporary condition or if it signals a more sustained longer-term rise in rates. This is more than an academic question since, as Figure 2 shows, over an almost 40-year time frame, 30-year FRM rates have consistently trended downward (see the red dashed trend line) despite short periods of flat or even rising rates around the downward trend-line.

Figure 2



Source: Federal Reserve Bank of St. Louis, Economic Research Division. Link: <https://fred.stlouisfed.org/series/MORTGAGE30US#0>

This protracted long-term decline in rates has produced a steady and predictable tailwind for refinances. Why? Because at any point in time, mortgages originated several years earlier will usually bear a significantly higher interest rate and therefore be candidates for rate-and-term refinancing.

However, if recent rate increases continue as projected, as many economist believe will be the case in light of large anticipated budget deficits, the refinance faucet will be largely turned off and growth will have to come from increases in purchase volume.

Further, despite historically attractive interest rates, a strong economy and stock market gains (that consumers can cash-in to fund down payments), the projected six to seven percent growth in purchase originations — which traditionally has benefitted Independents more than refi-oriented Bank and Bank-affiliated lenders — does not exactly move the growth needle. And if mortgage rates rise beyond 5.4 percent as projected by the MBA for 2019 and 2020, even purchase growth may be significantly stifled.

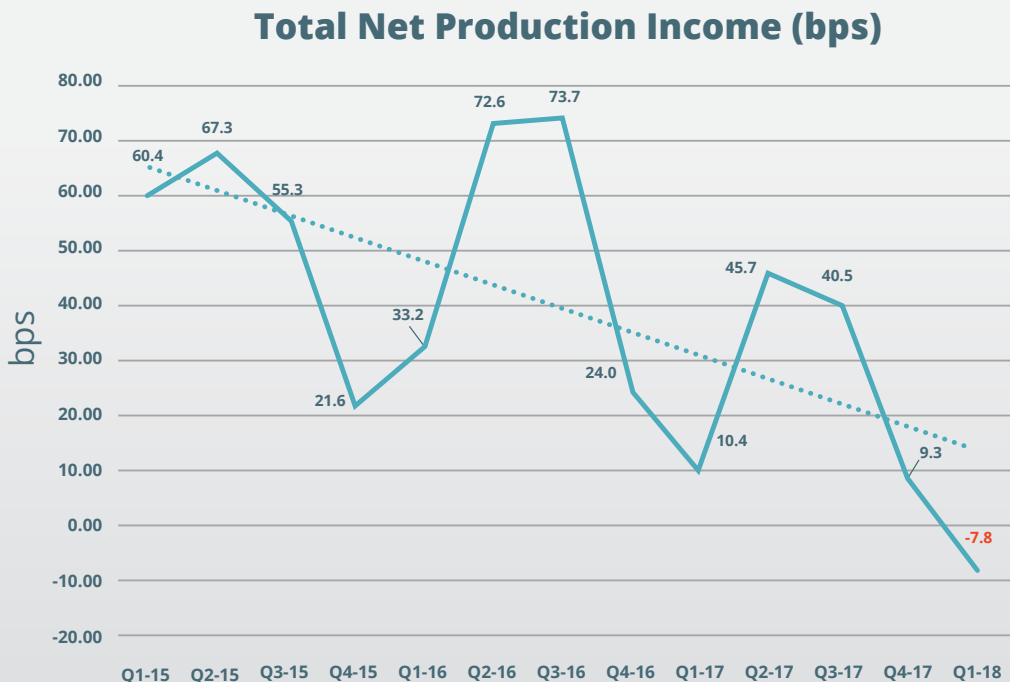


When industry growth is slow, flat or possibly even negative, lenders must “steal share” from competitors in order to grow. The resulting excess capacity has invariably led to aggressive pricing and efforts to recruit LOs and even whole branches away from competitors via signing bonuses and other costly incentives. All of which leads to substantial margin compression and possibly sustained losses.

Evidence of such margin compression can be seen in Figure 3 which plots quarterly net production income in bps (including corporate allocations) from Q1 2015 through 1Q 2018 for all lenders participating in the MBA Quarterly Performance survey (who on average originated roughly \$2 billion during the preceding 12 months).

Note that net production income in bps exhibits sharp seasonal peaks and valleys — ranging between **-7.8** and 73.7 bps — around a decidedly negative sloping trend line. This indicates that from 2015 through 1Q 2018, a period of virtually no unit growth, margins badly deteriorated for the Independent lender segment, and went negative (**-7.8 bps**) in the first quarter of 2018.

Figure 3



Source: MBA Research, Quarterly Performance Reports Q1 2015 — Q1 2018.



THE SPECIAL CHALLENGES FACING THE INDEPENDENT LENDER

For several key reasons, the overall outlook for the industry outlined in the preceding pages creates special challenges for the Independent lender, especially the smaller or lightly-capitalized Independent mortgage bankers.

Limited Financial Resources

Typical Independent lenders often do not retain earnings beyond regulatory requirements or have the servicing assets that can give them the financial wherewithal to get through sustained down periods.

Absent servicing rights or other liquid balance sheet assets that can be sold to offset production losses, Independents will need to raise additional capital to continue originations, meet regulatory capital requirements and absorb any negative cash flow generated from operations. Raising capital during periods of operating losses will be difficult, if not impossible, as is recruiting strong LOs from competitors.

On the other hand, large Independents and Bank mortgage lenders will usually have the servicing assets, balance sheet strength or, in the case of Bank-owned or affiliated lenders, a financially strong parent to help them navigate the hard times.

Lack of Geographic Diversification

Independent lenders are typically regional in scope with their loan originations. Lack of geographic diversification increases a lender's exposure to extreme seasonality, winter weather, regional or local economic downturns, housing inventory shortages, etc.

For example, lenders originating loans solely in Great Lakes states — the "snow belt" — will have greater

exposure to extreme cold spells and blizzards than multi-regional or national lenders. While such exposure may mostly affect the timing of originations, a few slow origination months in an otherwise down market can pose existential risks for a thinly capitalized lender.

Dispersed Fulfillment Operations

Processing and, to a lesser degree, underwriting personnel of Retail lenders are generally dispersed across their branches. Indeed, in-the-branch processing and underwriting are often a key selling point in attracting proven LOs. But, such dispersed fulfillment operations don't scale well, especially in down markets.

It's harder to lay off fulfillment personnel that are placed in branches than it is when such personnel function out of centralized or regionalized operations centers. To a considerable degree, therefore, processing and underwriting personnel costs act as fixed-costs over a fairly wide range of origination volumes.

The Domino Effect

While margin compression is not unique to Retail lenders, when combined with a lack of financial resources to buffer losses in down markets, Independents are at greater risk of being cut-off by their correspondents and warehouse banks.

Further, it is hard for a lender to maintain staff morale and retain top producers and back office personnel in the face of falling origination volumes, staffing reductions and losses. The departure of top producers may exacerbate losses, which further encourages their flight or cannibalization by stronger competitors of more top producers which can become a vicious downward spiral.



STRATEGIES FOR INDEPENDENTS

In the challenging business environment we have described, we believe that the top strategic objective for the Independent lender is to avoid being watch-listed by warehouse and correspondent lenders. To do this, an Independent lender must not only stay profitable, but maintain reasonable profit margins despite the forces causing compressing margins.

Expand the Product Menu

While many lenders speak of product strategies designed to improve revenues — for example, expanding into or increasing the sale of FHA/VA loans or diversifying into such niche products as state bond, non-QM and reverse mortgages — we think that such strategies can be challenging to implement and require experienced subject matter expertise to ensure that these new products generate the expected margin improvements.

Already, low down payment Agency products that compete with FHA/VA loans are trimming FHA/VA pricing without regard to the additional training and process modifications that a lender would need to implement to originate FHA/VA loans. Jumbo loans have very slim margins. And, reverse mortgages are a world unto themselves and could require extensive investment in people, processes and systems for what is likely to be a relatively small pickup in origination volume.

While the production organization typically pressures for state bond and other low-down-payment programs in heavy purchase markets, these programs have never been profitable due to restrictions on revenue per loan that often limit revenues to less than the cost of originations.

So, what about non-QM? While the non-QM market segment is still very small, it certainly has higher margins. But to originate non-QM loans, a lender will need to convince warehouse lenders that it has the capability to fund these riskier mortgages, and of course believe that these higher risk mortgages are not going to come back in repurchase and trigger existential threats to the business.

Lower Sales Expenses

Currently, with end-to-end origination costs running close to \$9,000 per loan, the ratio of sales expense to back-office fulfillment expense is about 70:30. Yet, when management approaches cost reduction initiatives, they too often rely on back-office fulfillment and post-closing functions and expense. We think that this focus is backwards; that efforts to lower origination expense should give priority to reducing sales expense so that the lender can afford to provide originators with more competitive pricing.

We see several strategies for accomplishing this:

- **Consolidate regions, divisions and branches.** By terminating managers who have not demonstrated strong sales management skills — efficiently increasing the size of a high-quality sales force, improving sales productivity, etc. For terminated managers, consideration should be given to not replacing them but instead, merging their region, division or branch into others. Where they are to be replaced, lenders should consider redeploying strong sales managers into these open positions.
- **Prune low-productivity originators.** STRATMOR's Originator Census Survey has shown that the bottom 60 percent of originators account

for just 20 percent of originations. Therefore, just a 25 percent increase in the sales productivity of the top 40 percent of originators would completely replace the production of the bottom 60 percent. While the cost of such a 25 percent increase in relation to the cost of maintaining the bottom 60 percent is not clear, our instinct is that retaining weak producers would be throwing good money after bad and compromise a culture based on performance.

- **Reduce subsidies or eliminate Loan Officer Assistants (LOAs).** Many lenders absorb or subsidize the cost of LOAs for their high-producing LOs, thereby give such high-producers more time to generate leads as opposed to performing what are often processing functions. But in down markets in which margins are slim and originator productivity has declined, fully or substantially absorbing the cost of a LOA may no longer make sense for the lender. Our experience has shown that, fearing the loss of high-producing LOs, lenders are loath to reduce their LOA subsidies, again reflecting the historic stranglehold top-LOs often have over their lender-employer. While we understand this concern, we think that when faced with a protracted down market, lenders need to be willing to cut back on their LOA subsidies. By not doing so, LOA costs are effectively fixed costs that can significantly increase unit costs when volume declines. It would also be beneficial to conduct an assessment to determine if there is redundancy between LOAs and processor tasks.
- **Eliminate pure volume incentives for branch and regional sales managers** by basing their incentive compensation on improved sales management, including such considerations as recruitment success, retention of top producers, increasing LO productivity and both setting and enforcing pricing disciplines.
- **Convert traditional Retail branches to Expense Management Branches (EMBs).** One approach to both changing branch manager incentives and pruning low-productivity originators is to convert traditional branches to EMBs. The compensation of Retail branch managers has traditionally included an override

on the production of branch LOs. This approach incents branch managers to increase origination volume — the top line — but gives them little or no stake in branch efficiency and profitability — the branch bottom line that rolls up into lender profits.

Conversion of traditional branches to EMBs, for which branch manager incentive compensation is based on a branch P&L, gives branch managers a significant stake in branch expenses, including both sales and fulfillment expenses. For this reason, EMB branches can improve overall retail channel profitability. Moreover, basing branch manager compensation on a branch P&L fosters a more entrepreneurial, performance-driven culture for all lender operations. The switch from Corporate to EMB can be substantial, and can impact other intangible issues such as company culture.

Sale/JV Options

A decision to sell the company in whole or in part is perhaps the most difficult decision an owner of an Independent lender will ever make. But if, following a brutally honest self-assessment of the company's situation, the conclusion is that the deck is stacked against surviving as a stand-alone enterprise, sale or joint-venture options should be considered before the market becomes crowded with necessitous sellers and the company's performance deteriorates to the point that warehouse lines and investors maybe be lost.

- **The Classic Sale**, without respect to servicing assets, is typically structured as an asset sale of the production-platform. In such a transaction, the seller's consideration is calculated as tangible book value plus a potential production premium paid out as a combination of up-front cash and an earn-out.

Usually, a classic sale will involve substantial consolidation of the seller's back-office personnel into the buyer's operations, with the seller's sales force operating as either a new sales region or division of the buyer — typically the case where there is little market overlap — or consolidated into the buyer's existing sales network.



Independent sellers typically seek to take off the table or lock-in the value of their company, preserve as many jobs as possible and maintain a high degree of autonomy. These often-competing objectives are best satisfied when the buyer has geographic gaps in their production network and has tangible acquisition synergies that the seller can participate in through the earnout or employment contracts. But to negotiate the best deal, a seller needs to be early to the party. And the company needs to have solid forecasted earnings into the future.

- **The True Joint Venture (JV)** takes place when the seller sells a majority interest in their company to a buyer who then operates the company under the buyer's or seller's name as a new region or division of the majority-interest buyer. Generally, the seller continues their fulfillment operations but essentially outsources post-closing and secondary marketing functions to the buyer, thereby converting what were essentially fixed production support costs to variable costs. This also leverages the technology and other corporate investments that may be required to continue to compete in this difficult climate.

For the seller, a true JV with the right partner allows them to take a substantial portion of their capital off the table, retain most of their employees, continue their brand, improve their competitive position and finesse the existential risks of being cut-off by their warehouse lenders and investors.

For the buyer, the true JV represents a way for them to leverage their production support infrastructure and achieve lower unit costs. Importantly, a true JV can serve as a first step towards a Classic Sale — a sort of “date-before-marriage” arrangement.

Reduce Back Office Expenses

Although we see less opportunity to achieve significant cost reductions in the back office, several strategies are worthy of consideration:

- **Increase regionalization/centralization of fulfillment functions.** As we have previously discussed, although originators and branch managers love having processors and underwriters within earshot, placing fulfillment personnel in branches does not scale well. Lenders should therefore consider taking processors and underwriters out of smaller branches and moving their functions or relocating them to regional or centralized operations centers¹.
- **Schedule processing, underwriting and ready-to-close based on throughput standards.** In many back offices, scheduling of processing, underwriting and closing for purchase loans is dictated by the closing date of the home purchase and sale agreement (which generally occurs at or near the end of a month). Too often this generates a mad-dash in the back office a week or two before closing, which effectively results in “peak-period” staffing.

An alternative to this inefficient approach is for a lender to process every loan to a “ready-to-close” state within a prescribed cycle time that typically has the loan ready-to-close well in advance of the date on which the home sale closes. Lenders who have adopted this approach find that it allows them to level back-office workload, lower costs and provide better service to borrowers.

- **Develop a cadre of cross-trained employees.** In most companies, many fulfillment employees will have idle periods during which they are waiting for a loan-in-process to come their way. As an example, closing personnel are likely to be

¹We should note that unlike processors and underwriters, closers are typically located in regional centers or larger branches that serve many branches.

underutilized during the early part of the month insofar as most purchase closings occur at the end of the month. Therefore, creating a cadre of closer-processors who could perform processing functions during periods when closing workload is low can both improve cycle times and fulfillment productivity.

- **Change the incentive compensation of fulfillment personnel to recognize both improvements in productivity and borrower satisfaction.** Many lenders have stopped paying back office personnel incentive compensation based on volume because it will lead to both lower loan quality and customer service (borrower satisfaction). In fact, however, there are many metrics for loan quality that can be incorporated into incentive compensation. And with tools like STRATMOR's MortgageSAT, lenders can now measure borrower satisfaction as it impacts be specific underwriters, processors and closers.

WHAT'S AN INDEPENDENT LENDER TO DO?

For the Independent lender, go-forward, stand-alone success will demand exceptional management across a wide front of sales and back-office operations. Absent that, Independents will face declining and often negative profit margins that threaten both their warehouse lines and correspondent lender outlets.

There are steps you can take to help mitigate risks and maintain profits:

1. Conduct a quick but eyes-wide-open operational assessment as compared to your company's long-term strategy. Do you have what it takes to survive? Do you have realistic options for maintaining adequate profit margins? If you don't have a target operating model in place, you are going to find your company floundering in this "new normal" slow-growth market.

2. Specifically, if you are committed to lower costs / improving your margins, STRATMOR highly recommends starting with a cost/benefits analysis of your bottom tier originators. Who should you keep and why? Determine who you should not keep and then don't procrastinate; it's not good for your culture and it's not fair to the under-performing originator. This tactic can make an immediate positive impact on your bottom line.
3. Take a hard look at back office efficiencies. Do you have duplicate / redundant tasks (e.g. loan officer assistants and processors) or would cross-training provide more flexible resource allocation? Process reengineering coupled with a better trained / more flexible back office team is another way to see positive margin results.
4. Are you considering the advantages of merging with another mortgage lender? As cited above, there are multiple advantages in terms of scale, geographic advantages, and improving your capital position.
5. If the answers to acting on the above recommendations are likely "no or probably not", take steps to sell your company or enter into a true JV with the right buyer. Remember, the clock is ticking, and you want to act early.

STRATMOR stands ready to assist our mortgage lender clients in acting now to withstand these current market challenges and execute a more sustainable long-term strategy.

WE WELCOME YOUR FEEDBACK

STRATMOR works with bank, independent and credit union lenders on strategies to solve complex challenges, streamline operations, improve profitability and accelerate growth. Please contact your STRATMOR partner or principal for assistance or email STRATMORinsights@stratmorgroup.com. ■