STRATMOR GROUP

FEATURING

THE VALUE OF CUSTOMER RETENTION AND WHAT TO DO WITH IT

STRATMOR *INSIGHTS*

Volume 1, Issue 4
October, 2016

DON'T READ THIS REPORT...

...unless you are interested in a cutting-edge think piece on the economic value of borrower retention and varied data-driven insights drawn from STRATMOR's mortgage industry surveys, programs and consulting experience.

This month's In-Focus article, "The Value of Borrower Retention and What to Do with It", written by Senior Partner Dr. Matt Lind, a STRATMOR founder and head of our internal development activities, presents an analysis of how the likelihood of retaining a borrower affects the economic value of a mortgage servicing right. I believe that Matt's analysis — and I had him take out the equations and stick to just graphs — will rank as a major contribution to the industry's understanding of borrower retention.

Our "Mortgage Metrics Matter" section takes a look at some of the resulting from our most recent Originator Census Survey, including what percent of production is done by the top 20% of originators (and other quintiles) and the age distribution of originators broken down between Independents and Banks.

"In The Spotlight" highlights some of the key findings coming out of our recently completed Spotlight Appraisal Process and Turn-Times Survey, including how lenders obtain appraisals and how appraisal costs and turn-times have changed since TRID became effective about a year ago.

And finally, in "Speaking Borrower Satisfaction," our Topic of the Month, Borrower Satisfaction vs. Method of Contacting Borrowers, presents and discusses 2016 MortgageSAT data that underscores the importance of lenders being proactive in keeping borrowers informed during the origination process and the emerging importance of texting and smart-phone apps to communicating with borrowers.

All of us at STRATMOR hope that *STRATMOR Insights* is becoming a monthly staple of what you read to keep up with the mortgage industry. In this regard, your ***feedback*** is more than welcome.

Lisa Springer, CEO

Our New Website

In late September, STRATMOR launched a new website that represents a complete overhaul of our prior site. I invite you to visit the new site at **www.stratmorgroup.com** and let us know what you think; whether you like the look and feel of the new site, found it interesting and, in particular, were easily able to find what you wanted.

STRATMOR
INSIGHTS

IN THIS ISSUE

THE VALUE OF CUSTOMER RETENTION AND WHAT TO DO WITH IT

By Dr. Matt Lind

In this thought piece, I demonstrate the compelling economics of borrower retention. In particular, I show that the financial benefits of competitively high borrower retention can, like low back office expenses, be applied to fund significant price concessions that can both grow new customer origination volume and, in a continuous feedback loop, further increase borrower retention rates.

In virtually every industry, marketing experts will tell you that your best customers for future business are your existing customers. Residential mortgage lenders that service loans almost always speak to the importance of customer retention. Yet in my experience, I haven't come across a single lender that could tell me – in dollars and cents – what they think customer retention is worth. Instead they say that the value of customer retention is reflected in the market price of servicing used in both correspondent pricing and bulk servicing purchases.

Borrower retention can increase the value of servicing a new mortgage by 1.5 to 3 times.

Of course, common sense tells us that satisfied borrowers are more likely to be repeat borrowers (in addition to being a source of quality referrals). But how much more likely? A program like STRATMOR's MortgageSAT quantifies both borrower satisfaction and the likelihood of becoming a repeat borrower. But it does so at a single and special moment in time – the closing of a new loan. It does not reflect the post-closing experience of the borrower as a servicing customer nor the simple erosion over time of the "halo" effect of a positive origination experience. Few lenders ask repeat borrowers why they returned and I don't know of a single lender that asks payoff borrowers who weren't retained why they went elsewhere for their new loan.

We still really don't understand borrower behavior related to retention when viewed over the life of a loan from application to payoff. But even if we did understand how various processes and borrower interactions affected retention, we would still want to know how much an increase in borrower retention is worth. Without knowing this, lenders cannot really assess all of the benefits associated with investments in people, processes and systems that, among other benefits, would be expected to improve borrower satisfaction and customer retention.

In this thought piece, I demonstrate the compelling economics of borrower retention. In particular, I show that the financial benefits of competitively high borrower retention can, like low back office expenses, be applied to fund significant price concessions that can both grow new customer origination volume and, in a continuous feedback loop, further increase borrower retention rates.

Analysis – The Conceptual Framework

The easiest way to think conceptually about customer retention is that it simply extends the effective life of a loan and the associated servicing cash flows. For refinances, the old loan pays off at precisely the same time as the newly originated loan closes. Of course, the new loan will virtually always involve a different monthly payment because of a new interest rate, a different term and for cash out refinances, a new principal balance.

Similarly, where the new loan is a purchase loan, the new monthly payment will reflect a new interest rate, term and principal balance. But, in the case of a purchase loan, there will likely be a delay between the payoff of the old loan and the closing of the new loan.

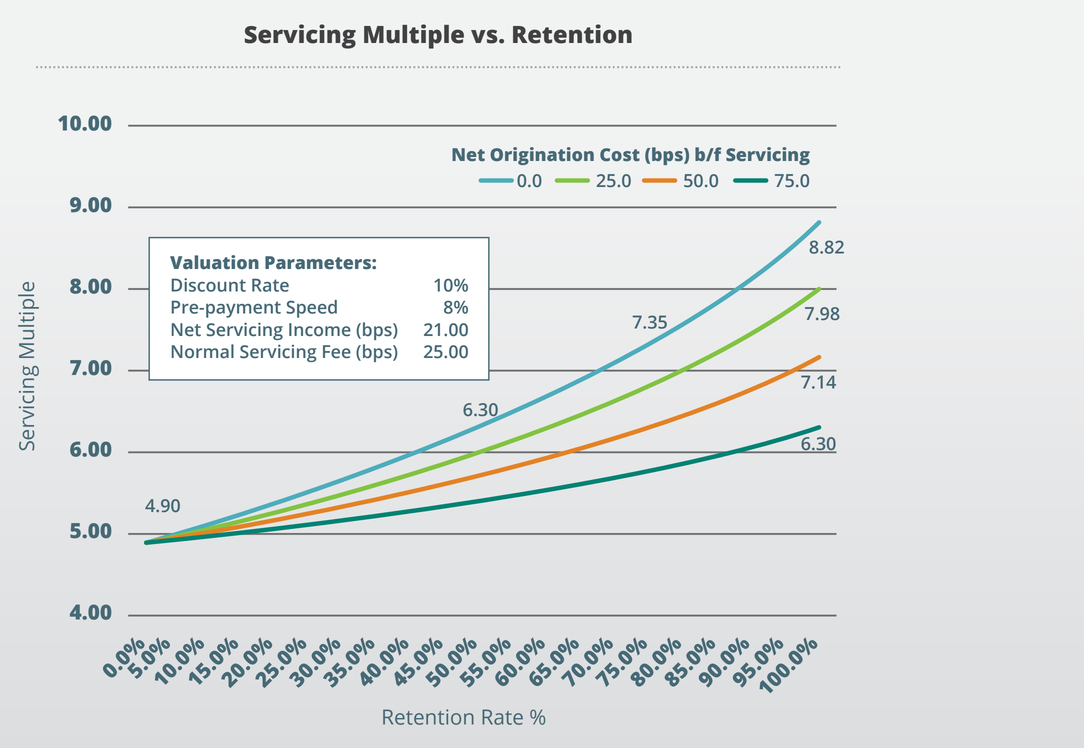
My analysis ignores these differences and assumes that the monthly payment and servicing fee of the new loan are the same as for the old loan and that the new loan closes simultaneously with the payoff of the new loan. These conceptual assumptions allow me to formulate a long, but relatively straightforward, equation for calculating the value of customer retention under a variety of financial and operational assumptions.

Analysis – The Results

Trained as a mathematician, I love including equations in anything I write and the *Value of Customer Retention* equation is pretty long. But for purposes of this article, my STRATMOR partners have told me to stick to graphs under threat of expulsion from the firm. So, graphs it is!

Chart 1 below illustrates the value of servicing, expressed as a multiple of the "normal" servicing fee, versus the retention rate (the probability that a loan

Chart 1



will be retained by the current servicing lender every time it pays off while being serviced by that lender).

- **A retention rate of 0% means that the lender never retains a loan that pays off**
- **A retention rate of 100% means that the lender always retains a loan that pays off.**
- **At 100% retention, the borrower essentially becomes a customer for life**

Traditionally, servicing valuations are based solely upon the net present value (NPV) of servicing cash flows over the life of a loan. In this NPV calculation, revenues include the normal servicing fee net of guarantee fees, float income, late charges and other ancillary income. Servicing expenses include one-time set up costs, the normal servicing expenses associated with collections, disbursements, customer service, delinquency and foreclosure (and foreclosure losses) and payoff expenses.

But when one considers the added servicing value created by customer retention, the net origination costs to create a renewed servicing right must also be taken into account. Typically, such origination costs, measured without respect to OMSR or SRP revenue credits, will range from 0-25 bps for highly efficient lenders originating streamline refis or portfolio loans up to 75-100 bps for low efficiency lenders originating Agency or government loans.

Chart 1 displays how the value of a servicing right changes as the retention rate increases from 0.0% to 100.0% for net renewal origination costs ranging from 0 bps to 75 bps in 25 bps increments. Additional valuation assumptions — which reflect the current low interest rate environment — consist of the following:

- **A 10% pre-tax discount rate**
- **An 8% pre-payment or payoff speed**
- **Net servicing income of 21 bps (includes all revenues net of servicing expenses and is based on recent STRATMOR servicing data)**
- **A normal servicing fee of 25 bps (the nominal servicing fee for conventional Agency servicing stripped of guarantee fees)**

At a 0% retention rate, the nominal servicing multiple in Chart 1 is 4.90, irrespective of the lender's net origination cost since no servicing is renewed. For 25 bps nominal servicing, this equates to a servicing value of 1.225% of the loan amount which, for a $250,000 loan, is $3,063.

For a high efficiency lender – a lender that can originate a loan at a net cost of 0.0 bps – the servicing multiple (illustrated by the light blue line in Chart 1) rises sharply as the retention rate increases, reaching a multiple of 8.82 at a 100% retention rate.

This higher multiple – 1.8 times the multiple of 4.9 at 0% retention – corresponds to a servicing value of 2.21% or $5,525 for a $250,000 loan, or roughly $2,511 more than at a 0% retention rate. But as the net origination cost to retain a servicing right increases, the value of customer retention decreases, as illustrated by the teal, green, orange and dark green lines in Chart 1.

Because of extremely low interest rates, the current origination environment lowers the economic value of customer retention. Obviously, from a purely mathematical perspective, if pre-payment speeds go to zero (not a real-world possibility), there would be no need for customer retention at all. But what would happen if rates were to rise and pre-pay speeds increase?

The results illustrated in Chart 2 below are based on an assumed pre-payment speed of 15% (or, in the vernacular of the industry, a PSA Speed of 2.5) with other assumptions the same as assumed in Chart 1 above.

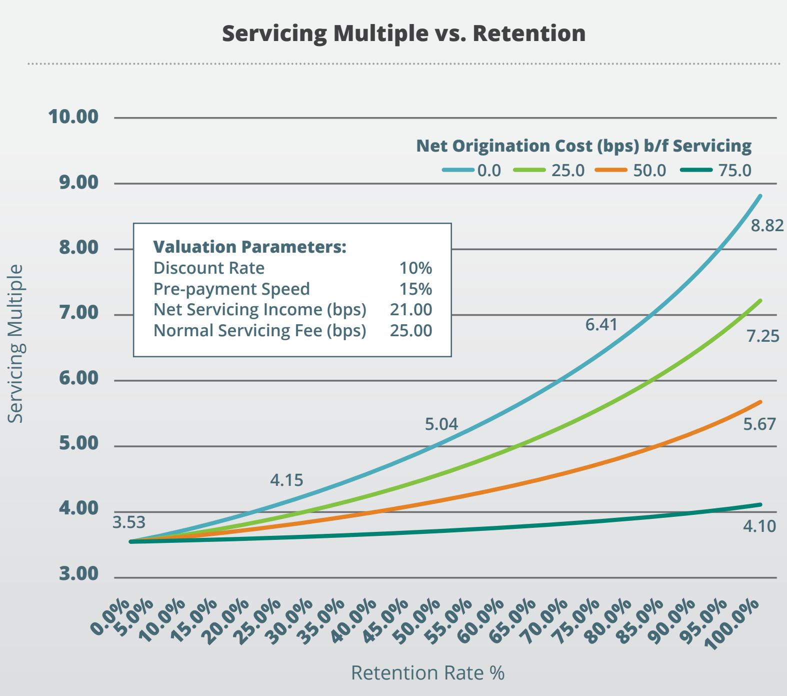


Chart 2

- **The servicing multiple at 0% retention is 3.53 versus a 4.90 multiple at the 8% pre-pay speed assumed for Chart1, corresponding to a servicing value of 88.25 bps or $2,206 for 25 bps servicing. This lower value makes sense since higher pre-pays speeds mean that servicing stays on the books for less time.**
- **At 100% retention, the servicing multiple in Chart 2 at a net origination cost of 0 bps remains at the same 8.82 as in Chart1.** This too makes sense because at 100% retention, higher pre-payment speeds have no effect if the net origination cost for retention is 0 bps.
- **For positive net origination costs, the multiples in Chart 2 (teal, green, orange and dark green lines) are systematically lower than in Chart1.** This makes sense since at a higher pre-pay speed, the number of recaptures for any given retention rate increases, thereby increasing the costs of retention. So, for example, at 100% retention and a 25 bps net origination cost for recapture (the red line), the multiple in Chart 2 is 7.25 versus 7.98 in Chart 1.
- **As pre-pay speeds increase, the relative value of retention increases under just about any reasonable assumptions for net origination costs.** So, for example, in Chart 1, for a net origination cost of 0 bps, the 8.82 servicing multiple at 100% retention is 1.8 times the 4.9 multiple at 0% retention. But in Chart 2, the 8.82 servicing multiple at 100% retention is 2.5 times the 3.53 multiple at 0% retention.

Increases in servicing value can be used to fund price concessions, further improving retention and helping to enhance competitive edge.

Analysis — Strategic Implications

The most important implications of this analysis concerns what lenders can or should do with the added value they can realize through superior customer retention (high retention rates coupled with low origination costs).

A portion of the value created by customer retention can be allocated to operational improvements that increase borrower satisfaction and hence, the likelihood that a borrower will become a repeat customer. It can also be used to price more aggressively, not just at the time of the lender's first loan origination with a borrower, but every time thereafter.

In this regard, it should be noted that a 25 bps price concession is equivalent to adding 25 bps to the net origination cost. So for example, if my net origination cost without aggressive pricing is 0 bps (the blue lines in Charts 1 and 2), a 25 bps price concession would effectively increase my net origination cost to 25 bps (the green lines in Charts 1 and 2) and could pay for itself if it sufficiently increased my retention.

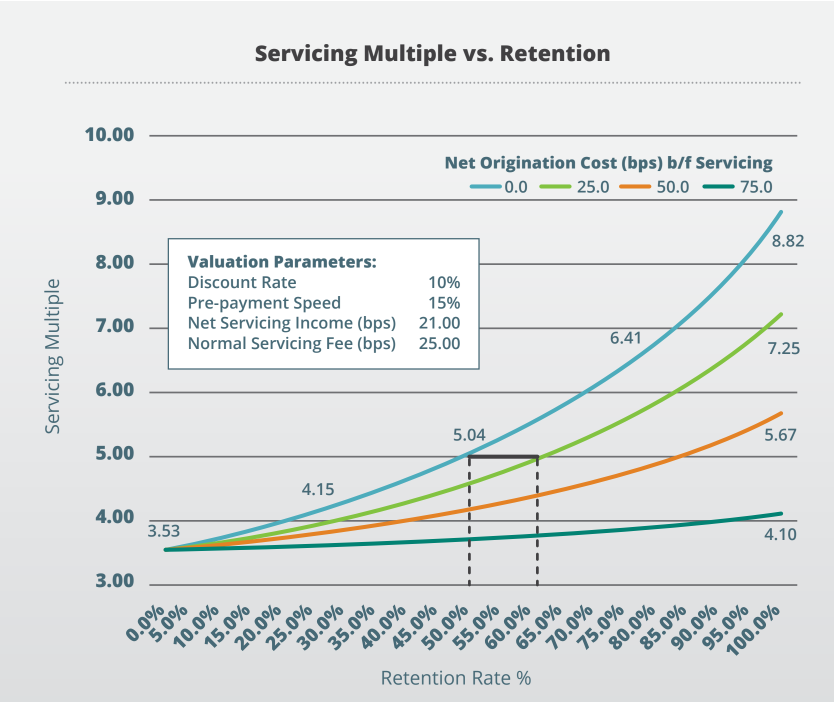


Chart 3

In Chart 3, for example, I assume that without a price concession and at 0% net origination cost the lender is realizing a 50% retention rate. If the lender then builds a 25 bps price concession into their pricing, they will achieve the same servicing multiple (5.04) after the concession if the concession increases retention from 50% to 65%.

But even if it doesn't, the economics of using high customer retention to fund price concessions remain compelling. After all, lenders have been doing this for years by seeking to be low cost producers and using a portion their back office expense advantage to improve their pricing.

LEARN MORE

To contact Matt Lind for more information, click here.

ORIGINATOR CENSUS

The STRATMOR *Originator Census Survey* is a unique survey that allows lenders to gain valuable insights into the makeup of their sales force and how it compares to peer lenders.

The participant report includes 15+ pages of individualized results including:

- **Productivity in units and dollars**
- **Age of Originator**
- **Turnover by Quintile, Age and Tenure**
- **Tenure**
- **Ethnicity**
- **Classification**

The more you can understand and measure the key attributes of your sales force, the better you will be able to proactively manage them and this, more than anything else, will improve the franchise value of your company.

This year's survey includes results from 39 lenders – 22 Independents and 17 Bank Owned/Affiliated mortgage companies. They range in size from under $500 Million in annual production to over $10 Billion. The sample includes results from 15,710 Retail Originators. What follows is an excerpt of the wider data set.

Mortgage Metrics Matter

ORIGINATOR CENSUS

Excerpts From the Survey Results

The following are select results from the *Stratmor Originator Census Survey*:

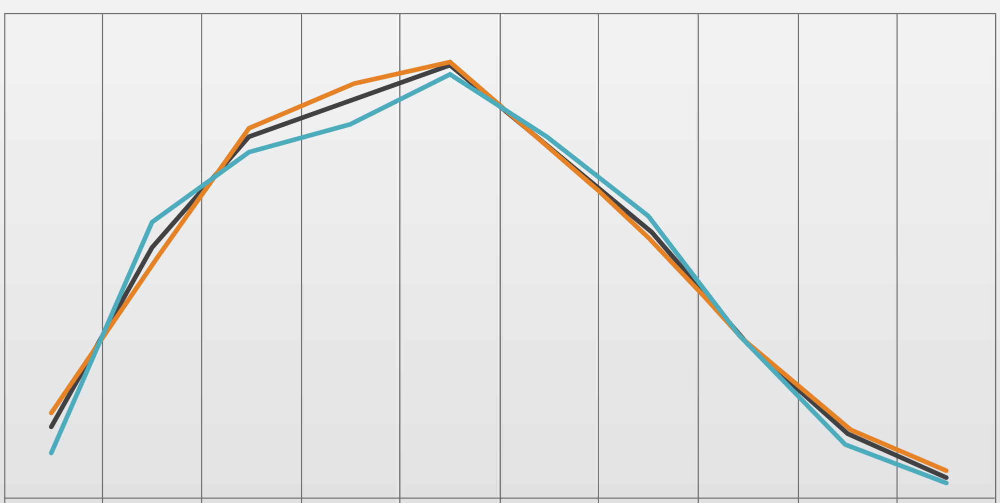
Q **How old is the average Loan Originator?**

A **According to our data, the average Loan Originator is 47 years old.**

- **The Bank Originators skew slightly older at 47.4 versus 46.9 for the Independents.**
- **The data also shows that there are more Originators over 65 (3.5%) than under 30 (2.9%).**

With the increased focus on Millennials and recruiting and training new Originators, STRATMOR expects to see more Originators in the Under 40 categories going forward.

Originator Age Distribution



	Under 30	Between 30 & 35	Between 35 & 40	Between 40 & 45	Between 45 & 50	Between 50 & 55	Between 55 & 60	Between 60 & 65	Between 65 & 70	Over 70
Total Population	2.9%	10.4%	15.0%	16.5%	17.9%	14.7%	11.1%	6.3%	2.6%	0.9%
Independants	3.5%	9.7%	15.4%	17.1%	18.1%	14.5%	10.8%	6.4%	2.9%	1.0%
Banks	1.9%	11.4%	14.3%	15.5%	17.5%	15.0%	11.6%	6.3%	2.2%	0.6%

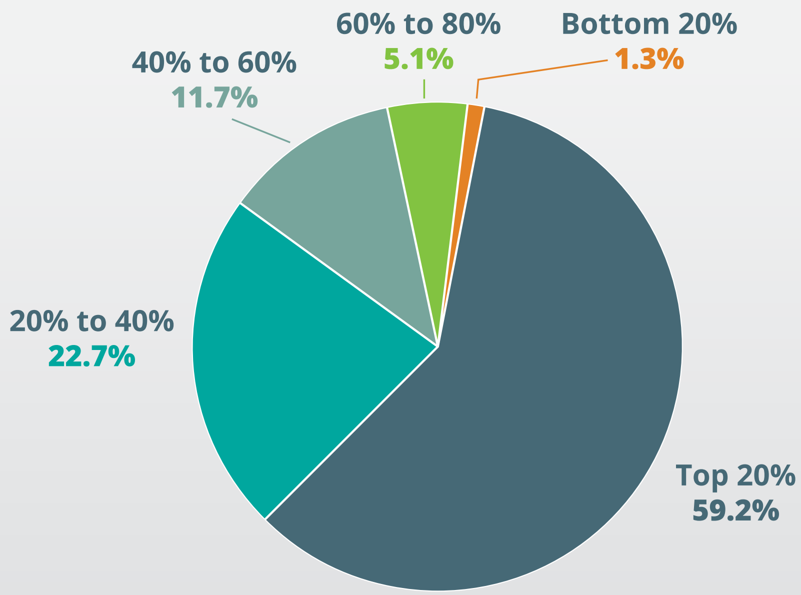
Mortgage Metrics Matter

ORIGINATOR CENSUS

Q **How much of production volume is originated by the Top 20% of a company's Originators?**

A **The conventional wisdom has always been that 80% of production comes from the Top 20% of Originators. Our data says otherwise.**

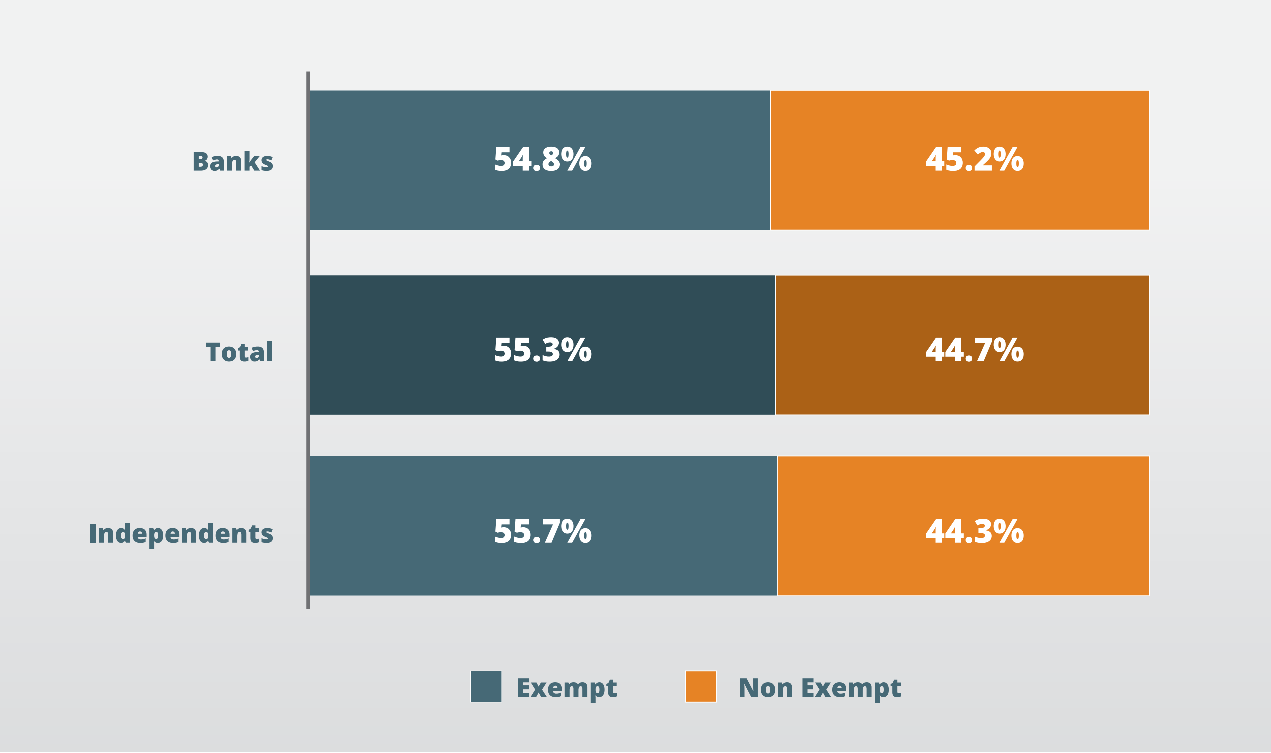
- **According to the STRATMOR Census, the Top 20% of Originators at a company will originate just under 60% of the volume.**
- **To be certain, this still concentrates the majority of the volume into a relatively small number of Originators, but it shows that the next 20% of Originators also make significant contributions to overall volume.**



Q Are Loan Originators classified as Exempt or Non-Exempt employees?

A The majority of Originators (55%) are classified as Exempt which means that they are not eligible for overtime pay.

- This holds true for both the Banks and Independents. Given the rulings on Originator classifications, this is somewhat surprising. We would expect many more Originators to be classified as Non-Exempt. The Independents have some cover for the Exempt classification under the 'Outside Sales' rule, but many of the Banks do not. STRATMOR expects theses splits to tilt to the Non-Exempt category going forward.



PARTICPATE IN THE SURVEY

The 2017 Originator Census, which covers 2016 results, will be open for registrations in January 2017. If you are interested in learning more about the results or would like to be added to the invitation list, contact originatorcensus@stratmorgroup.com.

APPRAISAL PROCESS AND TURN-TIMES SURVEY

Regulatory changes and pressures have impacted the way mortgage lenders manage real estate appraisals today. STRATMOR's Appraisal Process and Turn-Times Survey explored how mortgage lenders are managing appraisals and the impact of regulations such as the TILA-RESPA Integrated Disclosure Rule (TRID) on appraisal turn-times and costs. The survey is part of the STRATMOR Spotlight Survey Program. It was launched on August 16, 2016 and remained open until September 16th. Responses were received from 56 unique lenders.

SIGN UP TO PARTICIPATE IN STRATMOR SPOTLIGHT SURVEYS

The STRATMOR Spotlight Survey Program is a fast turnaround, short survey program. You can learn what actions your peers are planning or have taken relating to key industry developments. As a participant, you can expect to be surveyed whenever a hot topic or issue arises. Surveys will typically be short and to the point, with results in your hands quickly. We expect to facilitate at least one STRATMOR Spotlight Survey every two months. During an introductory trial period, surveys will be free to participants, after which they will be available for purchase by participants at a low cost.

SIGN UP

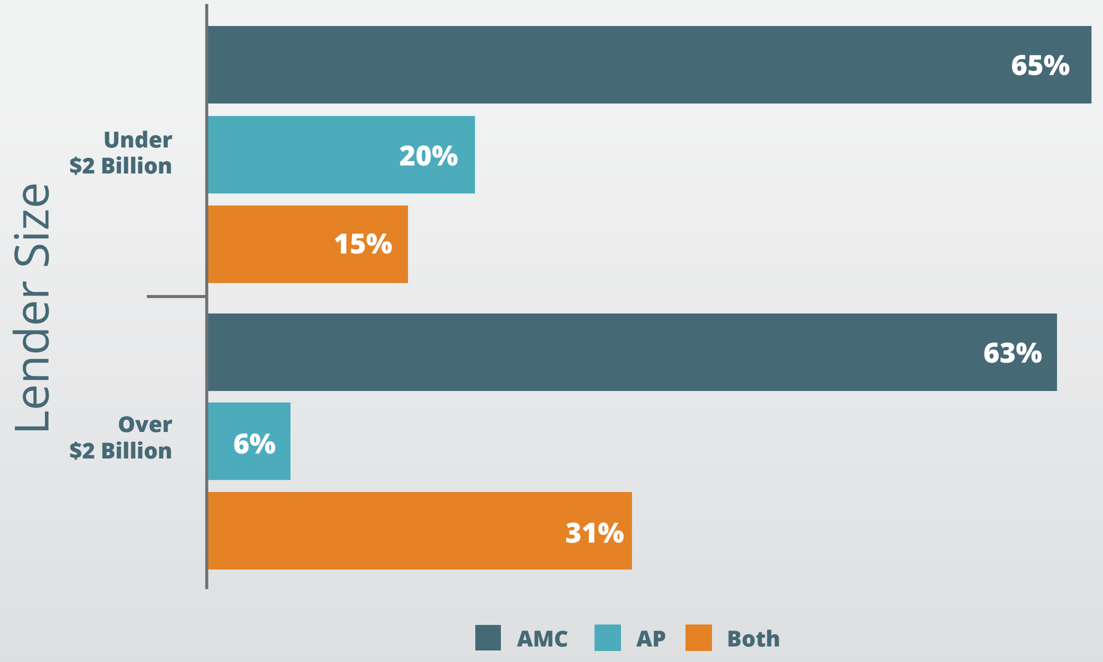
In The Spotlight

APPRAISAL PROCESS AND TURN-TIMES SURVEY

The following are select results from STRATMOR's recent *Appraisal Process and Turn-Times Survey:*

Q **How do lenders obtain appraisals?**

A **About two-thirds of lenders use Appraisal Management Companies (AMCs) with the rest either using an in-house Appraisal Panel (AP) or a combination of AMCs and an AP. Property location and service, i.e., turn-times, are the primary factors driving the use of AMCs.**

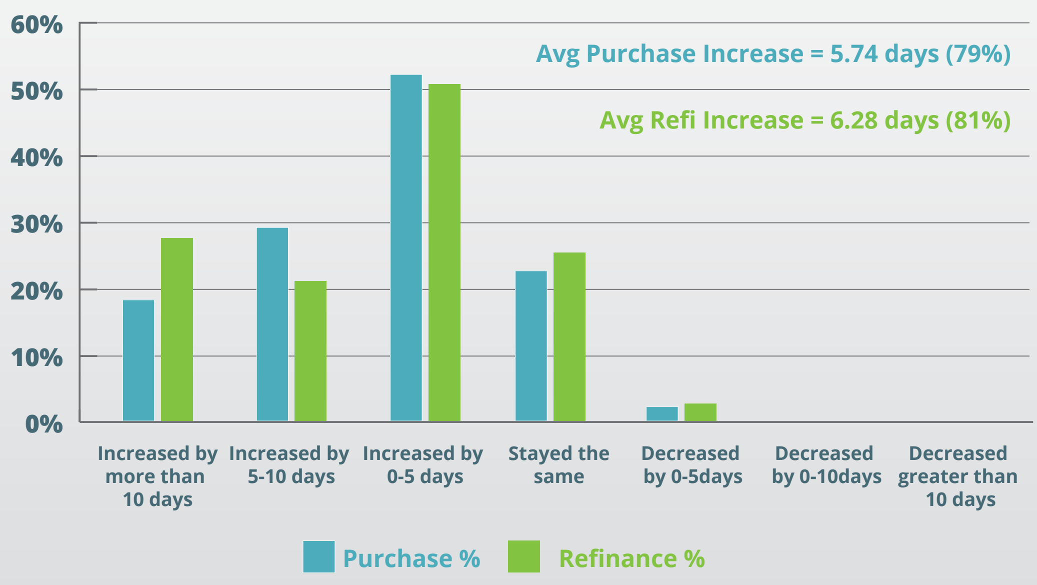


Q **By how much did appraisal turn-times increase post-TRID?**

A **The estimated post-TRID increase in average turn-times was 5.74 days for purchase loans and 6.28 days for refinance loans.**

- **These increases correspond to increases of 79% and 81% respectively over pre-TRID turn-times; however...**
- **We would caution that many lenders do not attribute these turn-time increases to TRID but to sharply increased origination volumes in 2016 Q2 and Q3 coupled with a lack of qualified appraisers.**

Post-TRID Increases in Appraisal Turn-Times



In The Spotlight

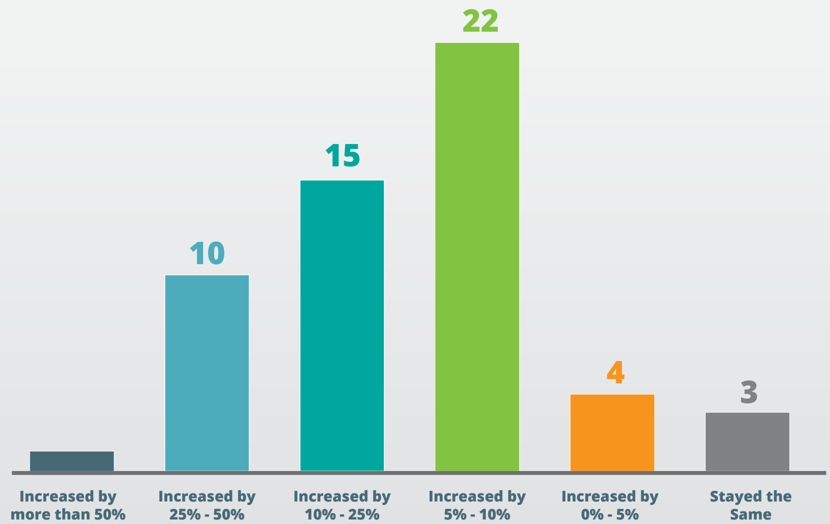
APPRAISAL PROCESS AND TURN-TIMES SURVEY

Q **By how much did appraisal fees increase post-TRID?**

A **Post-TRID, appraisal fees have increased, on average, by an estimated 15.8%**

- **Not a single lender reported a decrease in their appraisal fees**
- **Again, we would caution that these turn-time increases may not be a consequence of TRID but rather a result of sharply increased origination volumes in 2016 Q2 and Q3 coupled with a lack of qualified appraisers.**

Increase/Decrease in Post-TRID Appraisal Fees



	Increased by more than 50%	Increased by 25% - 50%	Increased by 10% - 25%	Increased by 5% - 10%	Increased by 0% - 5%	Stayed the Same
% of Total	2%	18%	27%	40%	7%	5%
# of Respondents	1	10	15	22	4	3

To purchase, view and download the complete *Process and Turn-Times Survey,* click here.

Speaking Borrower Satisfaction

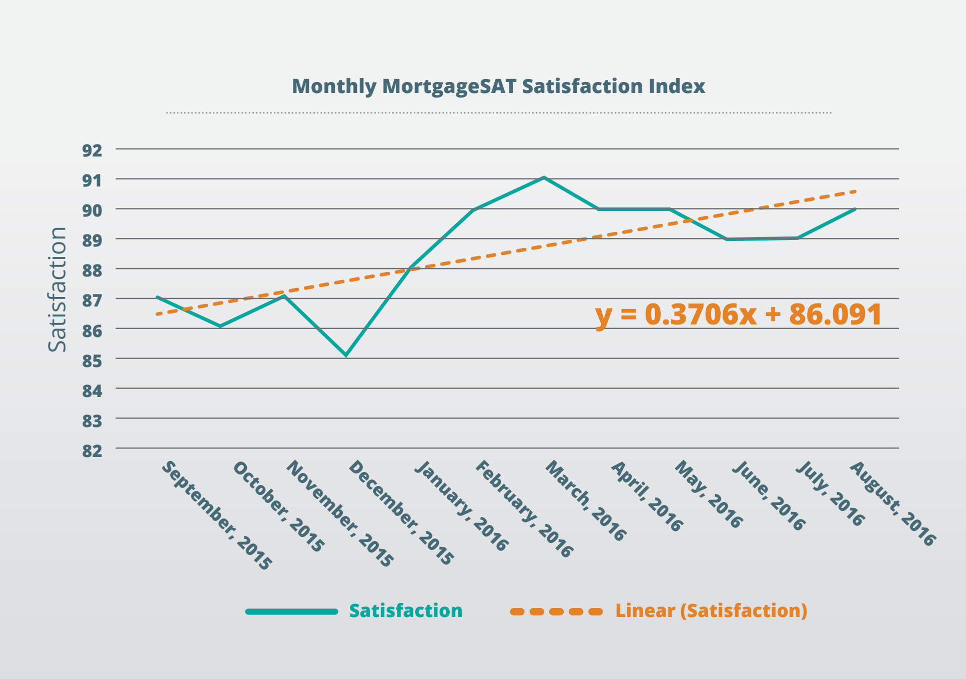
OVERVIEW

Each month's edition of STRATMOR Insights includes a *Speaking Borrower Satisfaction* section containing a National Borrower Satisfaction Index plus a Topic of The Month based on data collected by STRATMOR's MortgageSAT Borrower Satisfaction Program.

National Borrower Satisfaction Index

The National Borrower Satisfaction Index Chart below displays the *Total Borrower Satisfaction Score* for MortgageSAT participating lenders over a 12 month look-back period. For the October edition of *STRATMOR Insights*,the look-back starts with the August 2016 satisfaction score.

The Index Chart also includes a best-fit linear trend line along with the equation for that line. So, for example, in the Chart below, we see from the equation defining the orange dashed linear best-fit line, that from September 2015 through August 2016, borrower satisfaction has on-average increased by 0.3706 points per month.



Total Borrower Satisfaction Peak

The chart shows that Total Borrower Satisfaction peaked at 91 points in March, declined to 89 in June and July – a decline we attributed to an origination volume surge of roughly 20% as the industry entered the peak origination season starting in April – but has increased back up to 90 in August. This unexpected August increase occurred despite a continued surge in origination volume coinciding with vacations for back office fulfillment personnel.

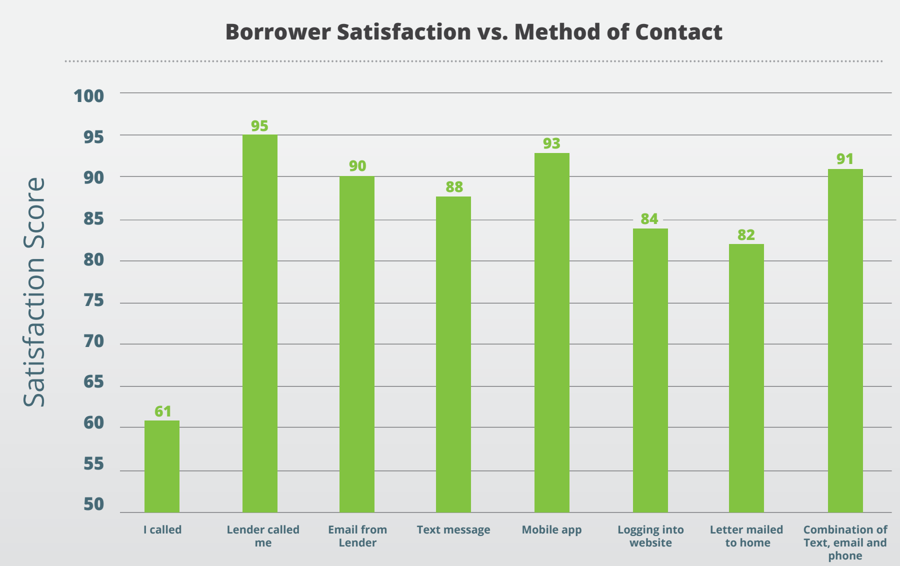
While a 1 point Satisfaction improvement is modest, for it to occur in the midst of surging origination volumes and summer vacation time attests, we believe, to the increased focus on borrower satisfaction amongst MortgageSAT lenders.

Speaking Borrower Satisfaction

TOPIC OF THE MONTH: BORROWER SATISFACTION VS. METHOD OF CONTACTING BORROWERS

Like Kitty Kallen's 1954 hit song "Little Things Mean a Lot," lenders can get a big boost or avoid taking a sharp hit in borrower satisfaction by doing little things right. One such "little thing" involves how lenders keep in touch with their mortgage applicants. The Chart below is based on MortgageSAT data for 2016 through September and shows the following interesting findings:

- **When a borrower has to call the lender in order to know the origination status of their loan, their satisfaction score plummets to an unacceptably low level (61).**
- **When a lender is proactive in keeping borrowers informed, satisfaction scores run in the 90s, with the highest score (95) resulting when the lender calls the borrower, i.e., keeps the contact personal.**
- **A high satisfaction score (90) can be also achieved -- and probably at much lower cost than calling the borrower -- by simply sending the borrower an email.**
- **Fortunately, only 4% of borrowers chose low-satisfaction "I called" as the method of contact with their lender; and high-satisfaction email accounted for 44.4% of contacts among MortgageSAT participating lender.**
- **Although relatively few borrowers (0.13%) cited "Mobile App" as their method of contact -- presumably because few lenders currently offer their borrowers a Mobile App for their smart phone or tablet -- the high satisfaction score (93) given this method should alert lenders to the growing significance and potential of this method.**



	I called	Lender called me	Email from Lender	Text message	Mobile app	Logging into website	Letter mailed to home	Combination of Text, email and phone
Sample Size #	2,192	7,865	31,947	1,344	93	823	71	26,762
Sample Size %	4.05%	10.93%	44.39%	1.87%	0.13%	1.14%	0.10%	37.18%

If you are interested in learning more about STRATMOR's industry-leading *MortgageSAT Borrower Satisfaction Program*, click here.

GET THE **DATA-DRIVEN** ADVANTAGE

STRATMOR Group offers a suite of data products and mortgage advisory services to power your performance.

SURVEYS

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SPOTLIGHT SURVEYS

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