MORTGAGE BANKING ACCOUNTING AND REPORTING AT BANKS

Overcoming the Challenges of Managing a Transaction-Based Business Model

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Executive Summary

Bank-owned mortgage entities face unique accounting and reporting challenges that traditional banking financial management systems struggle to address. Unlike portfolio lending models that focus on net interest income, mortgage banking is a transaction-based, high-volume, low-margin business requiring granular loan-level controls and specialized reporting capabilities. Mortgage banking is also highly cyclical, often stressing the ability of banks to manage budgets and drive consistent performance.

The Challenge: Core Systems vs. Mortgage Banking Requirements

Residential lending at banks encompasses a range of activities, including origination and servicing of mortgages, sales of loans to outside investors, and investing in mortgages for the bank's loan portfolio. The business can include specialty products such as construction loans and must also support the bank's mortgage lending in all its communities and for a wide range of customer profiles. However, there are significant differences between a simple, "originate to hold" mortgage model and a more complex "originate to sell and service" model.

Traditional Banking vs. Mortgage Banking Models

Traditional Portfolio Lending	Mortgage Banking Business Model
• Loans originated and retained in bank's portfolio	• Transaction-based activity focused on originating, selling, and servicing loans
• Revenue focus on net interest income over loan lifetime	• Revenue generated from fees, gain on sale, and servicing rights
• Accounting aligned with traditional banking general ledger systems	• Requires loan-level tracking and real-time performance metrics

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Core Problem: System Misalignment

Banks typically require all operating units to use enterprise-wide accounting and general ledger systems. However, these systems are typically designed for portfolio lending and cannot adequately support the transactional nature and specialized requirements of mortgage banking operations.

Key Complications:

- Portfolio net interest income can overwhelm current period transaction results
- Historic portfolio loan, interest income, performance data obscures current production economics
- Lack of loan-level granularity prevents effective cost control

The Current State: Widespread Challenges

Banks are challenged with many issues with understanding and accounting for mortgage banking activities.

Common Deficiencies Observed

STRATMOR Group research indicates that many banks struggle with:

- **Limited Visibility**
  - Focus on isolated metrics (gain on sale, commission expense)
  - Lack of comprehensive mortgage banking P&L
  - Inability to assess true business profitability at the channel, branch, or product level
- **Inadequate Systems**
  - Core systems not designed for mortgage banking complexity
  - Management may not recognize system limitations
  - Gap between operational needs and system capabilities
  - Infrequent updates to financials make it hard to adjust to changes in market conditions or the business performance
  - “Closing the mortgage books” each month becomes a time intensive and distracting activity

Operational Workarounds and Their Limitations

Many mortgage banking teams resort to extensive spreadsheet systems to bridge the gap between operational needs and system capabilities.

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Problems with Manual Workarounds:

- Difficult integration with general ledger systems
- Significant manual effort required for maintenance
- Prone to errors and inconsistencies
- Limited scalability for growing operations
- Challenges in audit trail and regulatory compliance

The Critical Operating Requirements for Mortgage Banking

Mortgage banking accounting and reporting must address a number of critical components to provide support for management of the business.

1. **Loan-Level and Loan Officer/Production Channel Financial Management**
    - Revenue and expense tracking at the loan level
    - High-volume fee processing with loan-level attribution
    - Vendor payment management tied to specific transactions
    - Drive visibility into branch, channel, and loan officer level profitability

1. **Investor Relationship Management**
    - Loan sale and delivery processes to outside investors (i.e. Fannie Mae, Freddie Mac, Ginnie Mae, FHLB and Private Investors)
    - Secondary market performance tracking, including:
        - Pricing concessions
        - Rate lock extension costs
        - Hedge performance analysis
        - Audit trail for sales and funding activity

2. **Comprehensive Revenue Accounting**
    - Cash-based revenue components (fees, commissions)
    - Non-cash revenue elements (servicing rights, gain on sale)
    - Real-time revenue recognition for transaction-based activity

3. **Business Line Reporting**
    A complete mortgage banking P&L must include:
    - **Direct Costs**
        - Origination expenses—both sales and fulfillment
        - Non-commission marketing costs
        - Production support costs (QC, Production IT)

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- **Indirect Costs (Often Allocated)**
  - Property, plant & equipment costs
  - IT support and infrastructure
  - Corporate functions (HR, Legal, Finance, Compliance)
- **Revenue Components**
  - Origination fees and points
  - Gain on sale of loans
  - Secondary market adjustments
  - Warehouse (Loans Held for Sale) net interest income
  - Servicing fee income

More effective financial management of the mortgage line of business ultimately creates a better opportunity to drive performance and accountability.

Business Impact of Inadequate Systems

Without adequate financial accounting systems in support of mortgage banking, banks face difficulties in managing the mortgage banking function.

Decision-Making Challenges

- **Poor cost control**
  - Inability to track expenses at loan level, including for applications which do not close
  - Lack of visibility into total cost to originate
  - Difficulty identifying unprofitable loan types or channels
- **Pricing Inadequacies**
  - Insufficient secondary market performance data
  - Limited understanding of true overhead costs
  - Inability to adjust pricing based on actual costs
- **Operational Inefficiencies**
  - Fee collection problems go undetected
  - Resource allocation decisions made without adequate data
  - Missed opportunities for process improvement

The High-Stakes Environment

Mortgage banking's characteristics make accurate accounting critical:

- High-volume operation requiring automated controls
- Low margins demanding precise cost management
- Cyclical nature requiring rapid expense adjustments
- Regulatory scrutiny demanding comprehensive documentation

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The Path Forward: Technology Solutions

There are options for banks to supplement their existing legacy accounting systems with mortgage banking focused technology in order to address the needs discussed in this document.

Available Solutions

Banks can supplement their core systems with specialized technologies designed for mortgage banking operations. These solutions provide:

- **Enhanced Capabilities**
  - Loan-level accounting and reporting
  - Real-time transaction processing
  - Comprehensive business line P&L generation
  - Integration functionality with existing core systems
- **Operational Benefits**
  - Automated data collection and processing
  - Reduced manual effort and error rates
  - Improved decision-making through better data visibility
  - Enhanced regulatory compliance and audit capabilities
  - Improved profitability management

Conclusion

Banks seeking to operate successful mortgage banking businesses must recognize that traditional banking systems are insufficient for this specialized, transaction-based activity. The complexity of mortgage banking operations demands purpose-built solutions that can provide the granular visibility and control required for profitability in this high-volume, low-margin business. Appropriate systems promote management of the true economics of the business, without the fee deferral and other GAAP accounting concepts on portfolio loans masking those economics.

Banks should be able to address the needed improvements in mortgage banking accounting without abandoning use of core systems which are in place via the addition of supplemental technology solutions specifically designed for mortgage banking operations.

Banks that fail to address these foundational requirements risk operating blindly in a highly competitive and regulated environment. Banks can likely achieve significant improvements in mortgage business line profitability if these issues are addressed.

NOTE: This analysis is based on STRATMOR Group observations of mortgage banking operations across various banking institutions.

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