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Thoughts and Observations On The Market

Margins or Volume?

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September 25, 2013

Once you think rates are up, they're down. Anyone, particularly hedgers who think they've figured out the market continue to get knocked around. For the last few months management has been struggling with volume, margins, overhead, and shifting business models. This week we are focusing on two knee-jerk trends the mortgage business also falls back onto when rates increase or volume slows - slicing margins and personnel. Our take is, and always has been, not so fast!

Also, we are planning on attending the Encompass Experience Conference and putting together our schedule for the 100th MBA in Washington DC next month. Please reach out if you would like to connect!

We strive to keep you all well-informed, as we share our views. Staying a step ahead and running a tight operation are the keys to success in the mortgage banking world, and we are here to help bankers do so. We hope you find our newsletter useful, and if there is anything you want us to cover, please let us know.

Whatcha Want? Margins or Volume?

Our last newsletter spoke of lenders pressing to maintain volume. The few who have been successful have focused on growth through branch recruiting and acquisition. Even purchase-focused shops have seen volume slip a bit, just not as vigorously as refi shops. But here's something to think about - what about margins? Maintaining volume is well and good but margins always seem to be an afterthought and have a small voice of support within a firm. It's about time they get some support. The issue of margins has never been more relevant with the volatile rise in rates and now the sharp drop last week which has the stronger Secondary Departments closely managing corporate margins and ensuring tight renegotiation policies.

When rates increase, just about all lenders have a similar knee-jerk reaction. How do we keep volume levels up? And how deep can we cut margins? This is a sales-centric approach, which is not necessarily aligned with success. Margins are just as important, if not more so than volume. While conventional margins can be set at 50-125bps for many lenders, depending on origination channel and marketing, once ever-rising origination costs are netted out, net margins could be 20-75bps for many conventional lenders. That doesn't give much 'wiggle room.' A 10-20bp reduction in margin doesn't sound like much. Most will take this approach: We have 100bp margins, we can reduce them by 15bps, that's only 15%. The problem here is that the 100bps is a gross margin and the 15bp reduction comes off of the net margin. If the cost to originate is 40bps, the net margin is really 60bps and a 15bp reduction off 60bp, rather than 100bps is a 25% reduction in net margin or secondary revenue, not 15%. And our concerns go deeper. For anyone who actually lowered margins by 15 or 20bps, we have to ask WHY?????

Yes, we understand the importance of remaining competitive against other lenders in ones own geographical footprint but lenders must be very careful to chase the competition down. And there are certainly targeted plans to remain competitive that are a bit more strategic than simply cutting margins by 20bps to stay within 25bps of other lenders. And yes, we understand how competitive consumer direct models are, but again, rather than chasing competition, we would at least question the long term viability of these models. Staying on the first page of results will keep the leads coming in but a lender could quickly be originating those loans at a break-even level. We're thinking diversify.

The approach to managing margins should be careful and methodical, with specific purposes and goals in mind.

-How is the price comparison done? Price comparison sheets like ICON can be VERY misleading, especially when most lenders are really within 10-25bps of one another. Are turn-times accounted for? For how long was the comparison made and when? What rates are modeled? What about LLPAs? With such a volatile market, the timing of the comparison and daily or weekly comparisons can quickly shift.

-For many who are focused on wholesale or core retail originations which are shifting to a higher purchase allocation, what is the actual impact of a 10-20bp reduction in margin? How much volume is REALLY gained by a reduction of this size? In the end, this is likely the difference of say 4.375 at 100.1 vs 100, or 100.15 vs 99.95. Is this difference really saving a deal? We highly doubt it, especially as LOs are recognizing that 10-20bps spread in their paycheck.

-Now what about the true financial implications? Did anyone actually perform simple multiplication and model this out? A simple example:

Lender ABC Mortgage originates 50MM with 101.4 margins yielding a gross secondary gain of $700,000/mo. Volume is expected to drop to 40MM which would have a secondary gain of $560,000. Margins are then reduced by 20bp to 101.2. If volume still drops to 40MM, secondary is left with $480,000. To

break even with the 40MM and an average price of 101.4 model, the 101.2 levels must bring in over 46.5MM. So the general question is, will a 20bp reduction in margins / improvement to price, increase volume from 40MM to 46.5MM? We're not quite sure about that. And if target revenue is $550,000-$600,000, wouldn't most like to reach that level with having to originate fewer units and less infrastructure / overhead to support? Wouldn't most think that 30-50bps is necessary to really have an impact on volume as it would likely translate to .125% in rate? Let's not even think about how much additional volume would be needed to offset a margin cut that large.

-And now that rates dropped by .25-.375 within 24 hours last week how, if at all, have margins been recalibrated? And how many renegotiations are have been processed? How are they noted and accounted for in the LOS and hedging models? Does the renegotiation policy even make sense? Hint: We've seen dozens of policies that left us scratching our heads. Honestly, the true costs and allocations of such renegotiations are lost on most secondary managers.

Reducing margins is easy and can offer sales a shot of adrenaline but it also has a significant impact on net revenue that is rarely accounted for. Modeling out the actual dollar impact on net revenue would be shocking for most, particularly owners and CFOs. Oh, and a 10-20bp price improvement for sales is often forgotten about a week, or even 48 hours later. Now you've just set a new, lower baseline that will have a significant impact on net revenue and financials.

Productive Personnel

Volatility is rarely a positive in the mortgage industry. Sure, there's not much anyone can do to rates and only so much one can do to volume. But one thing that is under a lenders control, personnel. Hiring, then training, only to let them go?

Managing overhead to volume is never easy and the never ending question of how many units should a ________ fulfill each day or month has no simple answer. It cannot be answered blindly without seeing a lenders operation in action. A short, non-specific answer could be **Business Model + Talent Level = Capacity.**

There are just too many variables in work force capacity and if anyone offers a blanket answer they are not being fair to you or your employees. The productivity per employee ratio depends on so many things that start with the origination process, responsibilities and technology. This week we will ask the questions that we normally evaluate when coming on site which can help formulate an educated response:

- What do your Loan Officers do? Yes, it sounds simple, but the answer varies greatly between lenders.
- Do you have Junior Loan Officers or Loan Officer Assistants?
- Do you have minimum standards to submit a file?
- Do you have business rules that enforce these standards at submission?
- Do you have an opening team that orders items e.g. title, payoffs, appraisals, VOMs, VORs, VOEs etc?

- Do you have Processors or Junior Underwriters?
- Are you paperless?
- How do Underwriters underwrite their files? Do the physically write out their conditions and then enter into the LOS for the conditional approval?
- Do Underwriters spend twenty minutes getting the file into their own stacking order and then begin underwriting the file?
- Does Processing submit conditions as they are available or once all have been collected?
- Does Underwriting clear conditions at a specific time of the day, when Processors bring them files or when they can get to them?
- Do you have more than two underwriter "touches" on the majority of your files? Do you even monitor "touches"?
- Are approvals more than one page long?
- Do any conditional approvals have more than ten non-standard conditions?
- Are your Loan Officers responsible for Change of Circumstance? Disclosures?
- Does Closing review the same items that Processing and Underwriting already did?
- Are you still seeing those items incorrect?
- Is a majority of your data not being transferred from your LOS to your closing document system?
- Do you have a tracking system for files that have been sent out and not received back from closing?
- How does Shipping prioritize their workflow?
- Does Shipping wait until the full file is received before scanning/uploading?
- Do Closers fund their own loans?

We can go on for hours with these questions. Our point is that if we asked twenty companies the same list of questions we would receive fifteen to twenty sets of answers, and that impacts the capacity model. A business model and individual responsibilities in how it is supported has the biggest effect on capacity.

Please do not make rash decisions on personal off of some calculation or competitors claim. Do not jump on a hiring binge when volume picks up and ultimately have a quick trigger on layoffs when volume slows. Understand your own model, its strong and weak points, and account for them in your capacity calculation. If you are still struggling, call us we can help you figure it out.

About Us:

Matchbox is a collection of gritty industry veterans who decided to create a company aimed at helping mortgage companies ignite ideas that are outside the box to realize their true potential. We have years of real life, hands on experience in the business, and we want to offer our keen insight to others as they take on the challenges before them.

As individuals, we each contribute unique perspective and expertise. Collectively we provide a true roadmap to success, regardless of your current situation. Like any

master craftsman, we are very passionate about our work and we approach each client as if your company were our own. In the end, we help you, be a better you.

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