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Thoughts and Observations On The Market

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June 30, 2014

Quite a while back, we wrote a newsletter about COGS (costs of goods sold.) In the mortgage lending business, our goods are mortgages and thus COGS have been making headlines with origination costs increasing every quarter. This week we'll take another look and perspective on COGS as they apply to most lenders. And as COGS seemingly rise, what's up with margins? We will also speak to the importance of margin management. Although it won't lower COGS, they will offset the cost.

Have a great 4th of July!

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.

COGS Revisited

We have seen a nice bump in volume for many, but still expectations for Q3 and Q4 originations will trend lower for most. As volume remains unstable, the cost to originate continues to be a hot topic. Depending on the business model, there are multiple factors that go into how each lender calculates this important number. Let's stop right here - you are calculating your COGS, right?!?!?! While we are not going to discuss or dispute what does and does not go into this calculation, we would like to discuss potential areas of exposure that will significantly impact your number.

Direct Response Model

This model usually carries a greater number of loan originators than operational employees and the COGS exposure point here is fallout. In this model, loan originators are going to look to get as many files in the pipeline and see how many of them stick. The model is laden with last minute unknowns (remember these

aren't referrals) which leads to multiple touches on files and sometimes clients getting frustrated and leaving late in the process after time and expenses have been incurred. In addition there is typically a high acquisition cost to keep the phones ringing. Shifting to new states, new strategies, new sales groups, etc., can have an erratic impact on a lender's COGS. The goal in keeping the cost to originate in line is to hone in on campaign success ratios and identify the hooks of the loan as early as possible. Two killers in the COGS equation, unsuccessful campaigns and people working on loans that are ultimately going to die. Easier said than done, but a good marketing manager along with tight opening/submission processes could go a long way in this model.

Realtor/Referral Purchase Model

Clearly this model is all the rage in 2014. Low acquisition costs and purchase business is a model to sustain lenders over the long term. This model usually contains good loan originators with good conversion rates. The exposure point here is the pipeline volatility as each loan has a relationship tied to it and it carries the immense pressure to produce service regardless of the challenges. A bad experience or two can lead to losing a source or LO. This model contains a high level of pre-approvals which are rarely tracked and neither are the lead sources. Some models are better than others in tracking the valued relationships, but we have also seen a lot where the benefits are not truly known and a lot of exceptions are ultimately being made for relationships that are not producing a lot of value. Is the effort spent writing up pre-approval letters paying off with submissions and closings? Which lead sources have better conversion rates? Managing these levels are a key component to your COGS.

Wholesale Model

This model has varying costs to originate in the form of Account Executives/Salespeople in bringing the business in. The exposure point here is allocation. In most cases, 20% of the approved brokers are closing 80% of the business which creates both concentration risk as well as possibly a high fall-out risk. The allocation spread may not be much different from a retail channel but with wholesale, we're dealing with people/firms who have no real tie to corporate. Wholesale platforms are more fickle and unpredictable. Because there is no cost to submit and these models are mostly very broker friendly, there are minimal standards to get business in the door. There are no (or far too few) requirements for submission, so file quality varies overall and deteriorates quickly as you dig into the pipeline of the 80% accounting for 20% of volume. While there is no good answer on how to improve this up front, the best solution would be to identify a section of good accounts that are struggling. If their submission habits can be improved, efficiencies and conversions will follow, lowering the COGS. AEs aren't paid to just sign up brokers and bring volume in the door. A key driver should be focused on quality submissions, minimum standards and pull through. If 80% of the brokers are submitting loans but not meeting those standards, COGS are sure to remain high.

Undefined Model

We often refer to this model as the "little bit pregnant model." This model is for the companies which have traditionally been successful at one model and are dipping their toe into other

models to try to recoup some of the lost revenue. Exposure points here are vast and new ventures are costly with the least amount of success because the new platform/division is usually not given the time or investment to succeed. A lender cannot try "wholesale" or "mini correspondent" and have it work out in a beneficial fashion. This experiment can work out, but it usually does not and ultimately comes at an expensive price tag as unrealistic expectations doomed the business model from the beginning. Our suggestion for this model would be to have a good budget and time frame allocated for the new platform up front with dedicated staff if at all possible. Now just like a home renovation project, take your budget and timeframe and double it. That will be more realistic.

In summary, while the cost of compliance, technology, etc., are valid concerns as they continues to rise, there are also very large areas of cost exposure that we feel dwarf the cost of compliance. "Fallout" risk that comes in the form of very talented underwriters working on files that are not closing, or good loans from good relationships/accounts being pushed back in the pipeline in favor of loans that are not going to close, or services being ordered that comes at a direct cost (AUS, Flood, Credit, etc) early in the process on a bulk of loans that are not closing, are all examples of the fall out cost. Add the additional costs in time spent managing key relationships and cleaning up sloppy files with poor communication and the cost meter continues to rise. In this market, there has to be a balance of getting loans into the pipeline as soon as possible and taking some additional steps to ensure that the loans coming in are worth the expense of moving forward.

Margin Management 101

On the heels of rising COGS, what do most businesses do when their costs rise? Raise prices. It's rather simple isn't it? Not so much in the mortgage industry but hey, we see milk and OJ prices rise. Manufacturing costs rise and so do our other consumer goods. With competitive pressures, we've seen lenders lower margins in late '13 and early '14 as costs rose. Talk about a dangerous equation. No wonder the MBA quarterly study has the average independent lender posting losses. Of course, volume and costs are contributing factors to lender's performance, but margins are too often forgotten about, especially when everyone is focused on compliance and volume.

In the world of secondary management, there is a constant balance of weighing the right margins to keep volume at expected levels. Over the past six months there have been many meetings where margin levels have been discussed. The conversation is usually as follows:

Sales or management: "We need to increase volume, so we should look to lower margins/rates."
Secondary: "Well if we lower margins, how much more volume are we going to pick up?"
Sales or management: "I do not know, but nothing is going to improve if we do not lower margins/rates."
Secondary: "I am concerned if I lower margins and volume does not increase, then we have just lowered our margins for no reason. Can you guarantee that we will increase volume if we lower volume?"

Sales response: "Yes! Definitely" or Management response: "I will not guarantee anything, but something needs to be done."
The outcome: lower margins

You know the drill and ultimately it boils down to timing. Sometimes lowering margins/rates sends a shot of adrenaline into sales and volume does surge and other times, it does nothing except actually cost the firm significant revenue. All lenders faced the challenge of cutting margins 3-9 months ago when rates increased and volume dropped. Did that strategy really play out well? Or was volume going to drop by 50% as you shifted to a purchase-based pipeline regardless? And how easily/quickly have margins increased back up now that rates have rallied? Or have they not been adjusted since Q1/Q2???

One of the biggest problems, tracking the impact of adjusting margins is almost impossible and certainly never even attempted from our discussions with clients. Another problem, does blindly lowering margins really make sense? Would other well-run businesses do this? Or would their 'sales' be targeted? Shouldn't a reduction in margin (i.e. putting your rates on sale) be targeted for certain criteria and for a certain period of time?

Now more than ever, it is crucial to be managing margins in a more pro-active fashion by really delving into pipeline details. Maybe applications are stable, it's just locks that are down. Maybe Applications are down, but locks are stable. Lenders need to drill down into behaviors of certain aspects of the originations and have a strong indicator of what impact changes in margin will have. Understanding the pipeline will allow for better margin management and more focused rate specials.

And of course this works both ways as there are times margins should increase. And no, this doesn't require a meeting with Sales. We've wrote on this before, but who is responsible for this? Does the Secondary Manager have the ability to manage margins up or down at their discretion? Even if it's for a few bps on a particular day or week - these adjustments will have a substantial impact on the bottom line (and offset those rising COGS.) If margin management is an afterthought and discussed only when it's brought to management's attention, you have a problem. A strong Secondary Department will be analyzing it's pipeline on a daily/weekly basis and with an eye on the market and time of month, know when they should increase or decrease margins.

To put it simply, we know a few things:
1. Across the board margin cuts do more harm than good. These must be well-thought out plans with specifics criteria and timelines.
2. Pro-active margin management by a qualified Secondary Department will pay dividends.
3. Without the above strategies, revenue growth is stunted and net revenue will continue to ebb and flow with COGS.
4. If margin management and net revenue are constant struggles, then a Secondary Review is order where we can show you how to manage your pipeline details in a fashion that will benefit the bottom line.

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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