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Thoughts and Observations On The Market

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Let's be clear - we write from the heart and are passionate about the mortgage industry. There are never-ending obstacles we all face on a daily basis and we want our clients, readership and the lending community to prosper. For the first time last week, the CFPB announced it was taking action against a mortgage banker for violating Loan Officer compensation regulations (click here) This news certainly made some immediate headlines, but we get the feeling that the shock waves are already diluted. With this in mind, we implore every lender to take a serious look in the mirror. We do not need to see any other lenders face these issues. The goal is to prosper and we are passionate about keeping everyone in business and poised for success.

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.

LO Comp - Pay Attention!

It was only a matter of time. Our concern has never waned. We have seen VERY few lenders with compensation plans that truly pass the matchbox smell test. Whether it is LO comp or Fair Lending issues caused by LO comp policies that may be technically sound, the vast majority of lenders out there should be re-evaluating their compensation and pricing structures.

The problem is that most lenders truly believe their compensation and pricing policies are compliant. Let's be fair, some certainly are compliant and some certainly are not. Unfortunately, doing things the correct way these days is not enough. In our industry, you have to prove your innocence and as any compliance attorney will attest, if you cannot document it, it didn't happen. If you pay attention to the CFPB press release, record keeping was highlighted as violation. Of course mortgage bankers have come

up with various compensation plans and pricing strategies, but truly documenting these can become a problem.

How common are various compensation levels? There are a few standards we see over and over again that may technically be ok on the surface, but they should all be documented, in agreements and tie back to payroll records which banking departments are asking for. At a minimum we're talking payroll records, employee lists and closed loan tapes. Then comes rate sheets, lock confirmations, disclosures and HUD-1s.

The most common three:
Quarterly bonus / Annual raise - Allowed, yes. In reality, we've never seen any of these documented with clearly defined tiers. It's more likely that these distinctions are tied to quasi tracked overages. Unless it is very clear cut (e.g. close 5 loans and you get $$$) the bonus or raise is not going to fly. Some have gone the route of defining these compensation levels based on items like pull through, file quality, EPDs, etc., but honestly, these are all likely code for point/banks and upselling. NOBODY is really tracking this and even if they tried, it would be near-impossible. Do firms really maintain LO scorecards on a monthly and quarterly basis? We've never seen one. It is not realistic to monitor file quality on a Loan Officer and loan by loan basis. And EPDs? How often do these occur that it would be a point of distinction? Talk about a small sample set. Loan performance? How is that to be monitored? It would take 12-24 months to begin to put this together and if loans are sold off to correspondent investors, how would originators ever see detailed performance metrics? Like the CFPB asserts, there was no documentation as to why some LOs received the bonus and others did not. There better be real documentation and metrics on these items and let's be honest, there never is.

Lead source/Origination costs - Certainly valid, but again we've yet to see any lender truly document this. How does one actually document that FHA loans are more work? Or that a loan came from lead source "A" rather than "B"? Does the LO enter the data? Is the LOS/lead management software locked down or editable? If someone has access to change a lead source after say the application or credit pull, there should be serious concerns.

Multiple rate sheets/Discretion - We all know the numerous models built around some LOs or branches pricing at 102 margins or comp and others at 104. Compliant with LO compensation regulations? You bet. Are these lenders asking for significant fair lending issues? You bet.

And who is checking rate sheet/PPE pricing against the price offered to the client? Are loans priced at 101 with no lender credits? How about loans priced at 99.5 with no discount? This happens every day. Will pricing be perfect at 100 on every loan? Of course not, but we're not talking about the +/- 25 bps here. Worst case - although nobody will ever admit to it, this is the definition of a point bank. Best case - there's a serious lack of documentation, disclosures, concession notes, etc. still a violation.

Secondary and management will often claim their policy allows

for no discretion. The problem? As noted above, loans are locked at 99, but nobody is redisclosing or updating the GFE to have the associated 1 discount. The files still close at 99, with no discount which is essentially LO discretion. There is no confirmation that the LO is really charging the price they locked. The same goes for the 101 pricing without issuing a lender credit. How many firms allow a 101, 101.5 or 102 price without forcing a lender credit of some kind? That's the definition of upselling and pricing discretion. The processes to validate corporate policy is missed and it creates a point bank system - and possible fair lending concerns.

If you don't think this creates a point bank, let's look a bit further. The CFPB will see John Q Loan Officer price two files at 101 with no lender credit and four files at 99.3 with no discount. There are no time-stamped notes or concessions posted by management. And now you've got yourself a piggybank - even if you pay the same comp on every loan. Again, if it's not documented, it didn't happen.

And a final note, the fines are nothing to joke about and it appears that even Loan Officers can be found personally responsible for damages and fines. Maybe if Loan Officers or Managers are educated to the risk exposure things will start to change. We understand the pressure lenders are under to stay competitive in local markets and the urge to bring on various business models or branches that may operate differently, but this often leads to pricing/compensation exposure. The biggest issue is that the industry is simply failing to recognize its own problem.

Again and again, we speak to lenders who truly believe they are following all regulations to the "T". They've consulted with compliance attorneys and gotten the thumbs up. The problem here is that more times than not, a compliance attorney is not told or aware of the actual execution and details of the compensation plans/pricing policies. All of the examples we provided above are technically allowable, but without the correct implementation and management they are just asking to be part of the next press release.

Let us know if it's time for an assessment. Hint: If any of the above sounds remotely familiar, give us a call!

Hey Secondary, Know Your Pipeline?

We have a few consistent messages that we never waver from regardless of client and business cycle. One of the most important ones was put to the test over the past month or so. As the month sold off and rates continued to rise, the successful firms who were on top of, and understood their pipeline excelled. Those we stayed true to their models and never attempted to outsmart the market prevailed. Others has a different fate. Certain management and Secondary teams jumped into action, pulled pipeline reports and made swift and affirmative decisions to limit their risk. There is no playbook on how to handle rapid market movement other than to not sit and see how things 'work out.' We continuously preach that Secondary Managers should

understand their pipeline and more importantly how the pipeline reacts to market movement. It is easy to gauge pull through in a flat market, but the challenge is understanding your organization in order to make proactive decisions and minimize exposure.

Unfortunately there are a number of items or importance that have (hopefully) just been realized over the past two months:

-**Know your pipeline!!!** This sounds crazy but in it's simplest form, what is your volume? In the last three weeks we've spoken with four clients who had an inaccurate handle on their volume. Example: Client A runs their volume tape from their LOS and loads it into a hedging model which reports 20M in volume to hedge. Simple enough right? But nobody quite understands how the LOS report was built and what filters are included in the report itself and the hedge model. In all four recent cases this month, we have found that actual volume (committed the the LO and client) was +/- 10-30% off from the volume being hedged. YIKES!!!

-**Outsmarting the market** Our favorite. It is not difficult to find Owners, Managers, of Secondary folks who think they're smarter than the market or their models. Maybe until now. Over the last few years, pricing has rallied and many have been riding a hot deck. Consistently remaining under-covered has been a theme for many, gambling in a sense, and rolling with a wave that made them profitable. But now times have changed and many have been severely burned. Hedging is supposed to eliminate and reduce risk, not create a vehicle to increase it. Nobody is smarter than the market, if they were, they belong on a yacht somewhere, basking in the sun, and not in the mortgage industry. Manage your data and trust the model and all will be ok. Be disciplined and do not allow temptation take you into dangerous water.

-**Allocations, trends and themes** It's not about simply running a report and looking at the totals. It is digging into the data in an attempt to find out the "culprits" that could increase exposure. What is your product mix? What about coupons? What are your lock expiration dates? Are pricing policies refreshed or actually followed? And how are those polices reflected with updated LOS data? Who are the originators and how confident are you in their conversions?

-**Exposure** Gauging the monetary exposure based on assumptions is critical. What is the exposure if a majority of loans close or if a majority of the loans fall out? This is more that looking at a shock analysis for two seconds each day. What is the cost of ensuring specific loans to close? It is sometimes better to lock-in losses (and exposure) than letting it ride and watch the losses accumulate.

-**Hedge reports and coverage** Although your model is based on historical pull through, this does not mean that your history accounts for dramatic rate moves. Everyone should have a shock analysis (which they never pay attention to) but how accurate or reliable is it in times of recent volatility? How many sell-offs of 400+ bps have we had over the last two or three years? In addition, pipelines are fluid and most rapidly changing

with exception requests during this time so you need to be aware of your pipeline changes and how they are flowing into your hedge reports and conversion estimates. New branches and LOs are brought on and new marketing campaigns are developed. The business changes and although historical pull through is vital, it should not be relied upon and never questioned as the business evolves. This is not the time to assume the "set it and forget it" mentality with your hedge model.

-**Post-Mortem** After the dust settles, do not proceed with business as usual. Make sure you do a post-mortem on how your pipeline responded to the rate movement. Who and what loans converted as expected? More importantly, what did not? It is important to do this while the data is fresh and you can make notes that will help you in the future.

-**Cash flows** More than ever this is the time Accounting, Secondary and Management must understand cash flows. There will most likely be big cash flow gaps for two or three months which need to be understood to properly gauge risk. A big pairoff is only a bad thing if none of the corresponding loans close the following month(s).

We have spoken to many clients over the past few weeks - some were successful because they got out in front of it and made proactive decisions. Alternatively the companies that sat back with their fingers crossed hoping for a rebound have some hurt fingers.... as well as P/L's.

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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