The Future of Mortgage Banking

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Here's a case for why now is a good time for investment capital to enter the mortgage banking space.

Predicting the future of any industry, especially one as complex as mortgage banking, can pose its challenges. In 2007, economists predicted that by 2010 mortgage volume would exceed $4 trillion. As we all experienced, the volume in 2010 was approximately 25 percent of those predicted levels—so much for predictions. ■ From 2002 through 2006, we were riding an unsustainable wave of volume lifted by home sales to unqualified borrowers and speculators. We all want profitable volume, and we all know that higher volume is not always better, especially when the borrowers are not reasonably able to afford their homes. This is basic knowledge that was set aside by segments of the mortgage lending industry, the consequences of which we are all now painfully aware. ■ Now that the tsunami has subsided, we can examine the landscape to carefully assess the foundation and future of mortgage banking. ■ Let's start with one of the most fundamental concepts in economics: the law of supply and demand. As long as the American dream of homeownership exists, there will be comparable demand for residential real estate financing. ■ We have painfully discovered the depths to which homeownership is in the DNA of our economy. As goes homeownership, so goes our economy. Therefore, the "demand" component is not really in question, as the purchase of a home will continue to be financed by lenders indefinitely. ■ The "supply" component of the equation is less certain. How will mortgage financing be provided and who will provide it? ■ Most recognize that at the core of the problem

is not a lack of willing participants in mortgage finance, but rather a lack of capital to support the activity. We also know that currently there is an abundance of capital on the sidelines that could be available to support the lending industry, given the right opportunity with a reasonable assurance that the invested capital will produce an expected return on investment (ROI). Just like warehouse lenders, at the end of the day, investment capital providers want to get their money back along with a return on their investment commensurate with the risk.

Investment capital's ROI analysis is primarily driven to equate the return potential available in mortgage banking with the risks associated with the activity generated by mortgage banking.

For any ROI calculation, the key question is: How much is enough?

The clearing of the landscape in 2008 and 2009 resulted from the elimination of subprime activity, a significant decrease in home sales, the consequence of repurchase volume and a significant reduction of warehouse funding. This exposed the vulnerability mortgage banks experienced with rapidly expanding systemic risks.

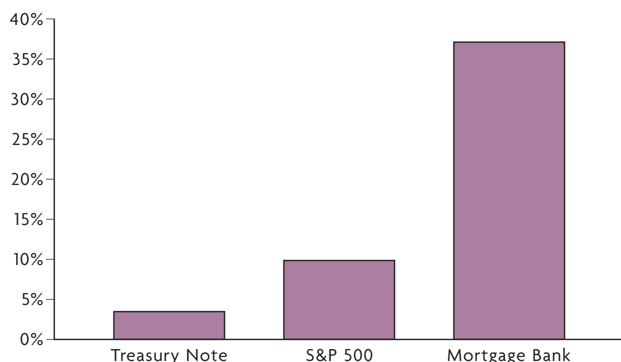
To be successful, mortgage banks need demand for their product (borrowers); a consistent funding source (warehouse lines); access to purchasers of mortgage volume (Fannie Mae, Freddie Mac, Ginnie Mae and aggregators); effective repurchase mitigation procedures; and a management team that can measure, assess, respond and monitor the profitability of the business.

As investment capital assesses the passing financial disaster, there is an opportunity to discuss how these risks can both be identified and mitigated so that the anticipated significant ROI from a capital investment in mortgage banking can be achieved.

Why invest in mortgage banking?

For any ROI calculation, the key question is: How much is enough? With Treasury note returns, as this was written, at less than 3 percent and with stock returns measured by the S&P 500 approaching 10 percent, it seems that a return of three to four times the S&P 500 would be attractive (see Figure 1).

Figure **1** **Return on Investment (ROI) of Various Investments**



SOURCES: Treasury Department, Standard & Poor's, Mortgage Banking Solutions

The first question then is: What is the return potential in mortgage banking? The formula to calculate an ROI is very simple. Divide the annual return by the amount of the investment: a $360,000 net income generated from a $1 million investment is a 36 percent ROI ($360,000 divided by $1 million).

The next question is: How can a mortgage bank generate $360,000 on a $1 million investment? The metrics that drive this are fairly straightforward.

The first component is to understand the amount of leverage a mortgage bank can achieve from a warehouse bank loan. It is common for a warehouse lender to extend credit to a qualified mortgage bank up to 15 times the tangible net worth. With 15x leverage, a $1 million increase in net worth can be used to borrow an additional $15 million in warehouse funds outstanding at any given time.

Most mortgage banks can borrow using a warehouse line to fund a loan, sell the loan and borrow to fund another loan more than once within a month. This is defined as warehouse turn rate, and it ranges from less than 1x a month to 2.5x a month.

Assuming a 1.2x warehouse turn rate, an available line of $15 million can be used to fund $18 million a month in loan volume ($15 million times 1.2) (see Figure 2). This represents an annual origination volume of $216 million ($18 million times 12 months).

The second component is earning on volume. Our firm's mortgage bank clients are generating earnings on volume before tax ranging from 10 basis points to 50 basis points, and sometimes more than 90 basis points. The earning potential in this example is $216 million in volume times an average of 20 basis points on volume generates $432,000 in earnings or a 43.2 percent ROI ($432,000 divided by $1 million).

If 30 percent of the earning is retained by the company, then 70 percent is distributed to the capital investor, generating a return of 30.24 percent ($432,000 times 70 percent = $302,400 to the investor divided by $1 million).

All of the calculations can be confusing; however, the bottom line is that a mortgage bank can generate a confirmed and sustainable ROI of 30 percent to 60 percent—well in excess of the returns from the S&P 500.

Our firm currently represents many mortgage banks that are achieving or exceeding this level of ROI.

When a mortgage bank follows the rules, implements risk controls and carefully complies with investor guidelines, it can generate a significant ROI. Our firm currently represents Federal Deposit Insurance Corporation (FDIC) banks and private investors looking to buy mortgage banks because of these significant potential returns.

We think it is fair to conclude that, yes, the returns in mortgage banking are sufficient to attract capital and

offset the systemic risks in the lending process.

Demand for financing

There is growing evidence that the housing market is showing signs of recovery. New and resale home sales continued to increase through 2010. The National Association of Realtors® (NAR), Chicago, reported that existing-home sales increased month-over-month from July 2010 (3.84 million) through December 2010 (5.28 million). Although the U.S. savings rate has increased, it is unlikely that very many consumers will be purchasing a house without mortgage finance. As the number of home sales increases, the volume of purchase transactions should also increase, although total volume is expected to dip during 2011. Nevertheless, now remains an excellent time to invest in mortgage finance while there is uncertainty in the market.

Now, warehouse lenders are returning with a focus on well-qualified mortgage banks.

Revenue potential

There are significantly fewer mortgage originators at the end of 2010 than there were in 2007, as evidenced by a significant decline in the employment base within mortgage banking—a loss of 116,738 jobs from 2007 through the third quarter of 2010, according to a MortgageDaily.com report on data from the Department of Labor. This leads to less competition for existing lenders.

The significant decline in the ranks of mortgage brokers and the fewer numbers of smaller-tier mortgage banks have helped reduce competition, which in turn results in higher margins for remaining mortgage banks. The pending changes to loan officer compensation standards will eliminate overage splits and secondary pricing gain participation by April 1, 2011, thus resulting in a further increase to those already increased margins.

Warehouse lender liquidity

During 2009, we experienced an unprecedented liquidity crisis in warehouse financing. Now, warehouse lenders are returning with a focus on well-qualified mortgage banks.

The number of warehouse lenders is growing, and based on the activity among our client base, well-capitalized mortgage banks with strong liquidity and experienced management teams are able to obtain sufficient warehouse sources to support their mortgage lending activity. In fact, we are helping even more new warehouse lenders enter the market.

Secondary market

Ginnie Mae, Fannie Mae and Freddie Mac have all increased their capital requirements and, despite the ongoing conservatorship of Fannie and Freddie, the group persists in its support of mortgage finance liquidity. There is continuing discussion about the ultimate structure of these securitization engines, but it is clear for at least the near and intermediate term they will maintain a significant level of participation.

The ability to sell directly into these agencies will be important for the independent mortgage bankers' survival. This is especially true for mortgage bankers that are wholesalers funding third-party originations.

As for margins between best efforts and mandatory commitments, we anticipate the aggregators, such as Wells Fargo Home Mortgage, Des Moines, Iowa, and Bank of America, Charlotte, North Carolina, will continue to provide a significant pricing advantage to those that sell their loans on a mandatory basis while hedging their rate volatility with the help of a hedge adviser.

Reporting and metrics

Management by the numbers is a critical component of a successful mortgage bank. This reporting process will need to include activity metrics, capacity by function and financial reports that include profit by loan, profit by branch and by profit by loan officer, in addition to the current volume-based reporting.

Integration of data into a single reporting module is important to receive accurate and timely information. All reporting systems must be evaluated based on the ROI of the technology investment.

Repurchase controls

If a non-fraudulent loan is closed and sold in the secondary market, provided the loan was originated in compliance with all regulatory and purchaser guidelines, the

Figure **2** **Formula to Calculate an ROI**

Net Worth:	$1 million[1]	Warehouse Line Turn Rate:	1.2x
Leverage Ratio:	15:1	Monthly Funding Volume:	$18 million
Warehouse Line:	$15 million	Annual Funding Volume:	$216 million
Pre-Tax Earnings on Volume:	200 basis points	Investor Distribution:	70%
Pre-Tax Earnings:	$432,000	Investor Pre-Tax Earnings:	$302,400[2]
Total Pre-Tax ROI:	43.2%	Investor Pre-Tax ROI:	30.2%[3]

[1] Amount of investment in mortgage bank
[2] Amount earned by investor
[3] Investor ROI based on initial investment

SOURCE: Mortgage Banking Solutions

resulting risk of repurchase should be virtually eliminated. Even if the loan subsequently goes into default, the lender is only liable if there is an origination defect or fraud.

The controls needed to prevent origination defects have been available to mortgage bankers for decades. In our view, the failures in 2008 and 2009 were caused, for the most part, by disregarding proper control procedures.

Most mortgage banks today have and utilize effective risk controls. We have clients who survived the crash without a repurchase because they continued to implement comprehensive risk-management procedures.

Technology

To prosper in the future, a mortgage bank must have a well-thought-out technology plan. It should be tailored to the bank's specific business model, because there is no technology solution that is a universal fit for all companies.

Investors that are considering participation in the mortgage banking industry will find two vastly different attitudes toward technology. Some companies are less adaptive to technology because they experienced the over-reliance on automated underwriting systems (AUS) that came at a great price in the form of repurchase demands from investors. By contrast, other companies have a tendency to invest in technology without having a clear objective in mind. In such instances, many will adopt technology that is not yet proven.

We believe investment capital should look for companies that utilize technology wisely to support origination and management efforts, not replace it, and for companies that justify any technology investment by an ROI standard.

Management talent

Generally speaking, there seems to be two groups of mortgage banking executives—those with an unyielding entrepreneurial drive that compels their decision process, and those with an unyielding adoption of the process by which informed decisions are made. An entrepreneurial focus is a valuable perspective, provided the compulsion to "shoot from the hip" is tempered with empirical assessment and contribution from informed sources. It is also important to not rely solely on data. A sixth sense for decisions can be an important asset.

We assume that any management team should have a deep knowledge of the mortgage lending industry. Our experience with management groups of all perspectives and varying caliber leads us to the conclusion that, to be successful, the leadership team must combine the understanding of the process to lead and inspire a team with the ability to measure, assess, respond and monitor the decisions that lead to profitability.

All large mortgage banks have an advisory group or board of directors that help map the path to sustainable profitability. This is an important component that should be adopted by all lenders. It is not possible for one person to know it all.

The essential management skill for the future is the ability to listen, learn and adapt quickly. It takes a special person to do this.

Generally, people don't stop smoking until they have cancer and don't lose weight until a heath event forces them to change their behavior. Many times, entrepreneurial leaders will not listen to guidance until there is a disaster.

In the books *Built to Last,* by Jim Collins and Jerry Porras, and *Good to Great,* by Jim Collins, the authors argue that all successful companies implemented a well-reasoned plan with leadership that listens to counsel from advisers.

No other single development in our industry will have a greater impact on our future than the avalanche of new rules and regulations coming out of Washington, D.C., and from a growing number of states.

Higher capital requirements

Increasing capital requirements are a reality in the future of mortgage banking.

In 2009, the capital requirement for a Department of Housing and Urban Development (HUD) "Full Eagle" certification was only $250,000. As of Dec. 31, 2010, the HUD requirement increased to $1 million and will further increase to $2.5 million. This is a tenfold increase in capital requirements.

One factor leading to this increase is aggregated contingent liability. We failed as an industry to consider the ever-increasing contingent liability that each mortgage banker was accumulating as it funded more and more production following risk-laden procedures with flawed underwriting standards. It is no surprise we now have higher capitalization requirements.

One positive aspect to this change is that the higher the barrier to entry, the fewer participants will be entering the market.

Even with the new capital requirements, mortgage banking has a relatively low capital-entry requirement. When compared with the minimum requirement to start an FDIC depository institution of $15 million, mortgage bankers enjoy a significant reduction from their FDIC competitors and are able to generate a ROI greater than the typical depository.

With a bank capital ratio of 8 percent and a return on assets of 1.5 percent, a well-run FDIC-insured bank may generate a 20 percent return on investment. Compared with the more than 30 percent return generated by a mortgage bank, it is obvious why FDIC banks are looking to more aggressively re-enter the mortgage lending arena.

New regulations will continue

No other single development in our industry will have a greater impact on our future than the avalanche of new rules and regulations coming out of Washington, D.C., and from a growing number of states. At a minimum, we can anticipate a dramatic increase in the cost of doing business, which of course will have the adverse consequence of higher rates and fees to the consumer.

At this time, it is almost impossible to stay on top of all the regulatory developments, by virtue of the volume of changes being put forth and the thousands upon thousands of pages related to each proposed rule and regulation being implemented. To say all this is overwhelming doesn't come close to describing the impact—and alarmingly, based on what we are seeing and hearing, most executives do not have a plan to address the changes.

All of these changes can be overwhelming, but if we understand and embrace the changes, we can take advantage of an unprecedented opportunity to capture market share and generate significant earnings. Regulation can create a level playing field by requiring operational compliance for all companies, which may lead to increased margins for mortgage banks. The unfortunate reality is that much of the increased regulation will also increase borrowing costs for consumers.

What the future holds

As we consider the future, here is what we can be certain of as it relates to our industry:

- Significant returns exceeding 30 percent ROI can be achieved;
- Demand for mortgage banking will remain strong;
- Private capital is entering the industry;
- Warehouse lenders are expanding;
- Agencies/investors/aggregators are here to stay;
- Increasing capital requirements can be met; and
- More regulation can help improve profitability.

With all of that said, opportunity abounds as never before. We believe that now—more than any other time in the past 30 years—is the best time to enter and expand in mortgage banking, because profitability will remain strong with fewer competitors and higher margins.

The bottom-line objective/mission of our industry should be to facilitate the American dream of homeownership by providing affordable, common-sense financing for consumers, and to do so by offering products and programs designed to promote sensible long-term homeownership.

If that is our focus and as we adapt to whatever changes the future holds, we confidently predict that mortgage banking will generate significant wealth over the years to come. **MB**

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