Five Themes for 2021 – Mortgage Banking

Executive Summary

Five key themes will dominate mortgage lending in 2021. While 2020 was catastrophic for many people and businesses, persistent low-interest rates made it a banner year for mortgage production. Now the Federal Reserve expects to hold the line on rates at least until 2023, and mortgage production should stay at full capacity through 2021. This high volume and high margin environment is great for profitability.

Persistent low rates and strong earnings provide a window of opportunity to raise capital and/or monetize investor's equity. Executing an IPO requires a lot of time and hard work – 4-6 months during which IPO execution will feel like a second full-time job for key executives; it also requires operational improvements, improved internal controls and very disciplined execution. An IPO is not for everyone (for details, see our research on IPOs). Most mortgage businesses will *not* benefit from the IPO trend. However, all can take advantage of the robust market for capital raising. This is the best opportunity to raise capital and/or monetize equity in 20 years, and it may not last long.

Capacity and throughput demands accentuate the need to improve operations and technology. The best mortgage lenders recognize that it is important to reinvest current earnings in improving operations to control risk. Sloppy operations in good times result in high risk in the future. 2021 is the year to invest in tools to reduce risk in (i) servicing operations, (ii) funding and liquidity, and (iii) origination activities like processing, underwriting and closing.

Raising Capital and/or Monetizing the Equity in Your Business

- Evaluate strategy and operational activities in context of public market standards
- Consider dual-track strategies such as public vs private equity and/or a M&A transaction
- Determine if conversion into a bank, whether via acquisition, sale or de novo charter, is viable and the right strategy for you
- Prepare for extensive due diligence on your people and operations
- Carefully evaluate potential investors for strategic and cultural fit
- Use trusted advisors to validate valuations and develop customized personal wealth optimization plans

Scaling Funding to Match Volume While Minimizing Cost

- Expand and diversify funding relationships, including warehouse lines, gestational repo lines, MSR facilities and term loans to ensure you have resources when you need them
- Resolve bottlenecks in post-closing to ensure timely delivery of collateral
- Evaluate all-in pricing to determine optimal funding strategy

Managing Risk in the Servicing Portfolio While Managing Cost

- Provide positive customer engagement that will translate into *Customers for Life*
- Plan to meet surge capacity needed to process forbearance exits
- Perform cost/benefit analysis of technology upgrades; manage vendor selection and negotiations to maximize leverage with the vendor
- Improve loss mitigation activity tracking with imaging tools, which extract data from loan correspondence (we like NEST's SMARTLM™)
- Analyze the impact of government mandates on MSR value to inform correspondent pricing decisions and MSR purchase/sale strategies

Technology & Operational Improvements to Meet Volume Demands and Reduce Marginal Costs

- Implement robust, state of the art point-of-sale software and streamlined end-to-end processes to increase pull-through and reduce processor time
- Redesign operational processes that are costing time, money, and customers
- Use image data extraction tools to expand QA/QC sample at low cost to identify loan deficiencies, enabling remediation before they become a problem (we like NEST's SMARTDiligence™)
- Increase the percentage of loans with Day-1 Certainty
- Triage loan pipeline to identify those with high repurchase risk for expanded QC
- Outsource IT infrastructure and Administration to a US-based provider, such as GuideIT

Using Data & Analytics to Improve Decision-Making

- Create a robust data warehouse using vendor solutions customized to the mortgage industry
- Implement real-time dashboards to identify problems and keep product moving
- Identify offices to close and markets to expand in; identify the right teams to hire
- Optimize pricing to include variations in MSR value, hedge execution and funding choices
- Evaluate and manage breakeven volume for ramp-down scenarios
- Replace outdated loans-per-staffer rubric for back-office functions with new metrics

Optimizing Equity Structure

Most mortgage banks lack the planning skills and internal controls necessary for a successful capital raise. In order to attract outside equity, it is often necessary to perform a gap assessment between current and best practices to identify areas of improvement. For example, it is necessary to plan and project volume and earnings since public companies face quarter-by-quarter scrutiny and must be able to credibly explain changes in key operating statistics and financial ratios. Governance routines and risk management also differ: add outsiders to the board and develop a robust internal audit. The same is true whether public or private equity.

For mid-sized firms, private equity may be better than public. For companies that need growth capital, a dual-track strategy (allowing for either private or public equity) is prudent. In both cases, the Company first needs to get its house in order. Following that review, the Company needs to manage the trade-offs between the enhanced scrutiny of an IPO and the expectation for a subsequent private equity liquidity event. Finally, most firms considering public and private equity also entertain M&A proposals since an acquiror often brings the appetite and resources necessary to grow the business.

Becoming a bank is another exit strategy. There are hundreds of publicly traded banks and several private equity firms devoted only to bank investments. Bank earnings tend to be more annuity-like and closely managed by regulators, and thus command higher premiums. As a bank, the company will have access to either public or private equity. Some mortgage banks consider the transformation into a bank as the first step in ensuring the long-term success of the firm. Of course, to work, the transformation must be substantive. Certain assets (like MSRs) will be limited and certain income (like gain on sale) will be discounted, but the result can still be a good equity valuation.

Strong market conditions provide a window of opportunity but also come when operating at full capacity. It is challenging to manage through the distractions caused by an equity deal; it is doubly challenging when the firm's management is already stretched thin. As a result, we expect most companies to procrastinate – perhaps missing the window entirely. Others may benefit by outsourcing as much of the capital raising project as possible. Endurance can identify key advisors (recommending investment banks and legal counsel), develop the timeline of key deliverables, and work side-by-side with the management team to get it done. We understand how to communicate with investors and free up executives to manage the business.

Strategic and cultural fits between the company and investor are critical. In the course of time, companies evolve – typically building on their strengths to take advantage of opportunities to grow and prosper. A company's strengths and weaknesses *and strategy* are often a reflection of its company culture. It is important to evaluate the perspectives of potential investors so that you choose the one(s) that understands and supports your vision and the strategy and culture behind it.

Matching personal wealth planning, company valuation, and capital raise requirements is the final piece of the capital raise puzzle. Mortgage banking is a cyclical business with limited hard assets and few barriers to entry. This makes valuation difficult and leads to volatile market prices, which, in turn, causes investors to opt for a high earnings payout at the expense of retained earnings. After all, it is difficult to project when a sale will be possible and how much any retained earnings will be worth. A trusted advisor can help the Company, its board, and its shareholders balance capital needs with personal wealth planning goals.

Scaling Funding to Match Volume While Minimizing Cost

Warehouse funding capacity often does not keep pace with production. This can leave mortgage banks with insufficient unused availability to close loans on time. In some cases, high volumes enable warehouse providers to tighten their credit box without losing business – leaving you without funding. The solution is to increase aggregate availability while diversifying sources of funding by bringing a few new warehouse lenders.

Turning loans faster is another way to make the most of limited warehouse availability. Particularly for loans going into Ginnie MBS, mortgage banks can agree with their trade counterparty to settle before the TBA settlement date (early settlement). Mortgage banks can also establish "gestational repo" lines, which function like warehouse lines where the collateral is TBA securities rather than the underlying loans.

Another way to go faster is to speed up post-closing. Endurance works with mortgage banks to identify bottlenecks in the post-close and delivery process (NEST Global Solutions' SMARTCertify™ is one solution that we use). Streamlining operations can often shave a few days off, enabling secondary to pool and deliver earlier. As loans come off the line, it creates availability to close more loans. Moreover, to the extent that closings follow a monthly cycle, with over half occurring in the last week of the month, it is most critical to deliver loans to investors in the third week.

Differences in loan terms make it hard to optimize warehouse usage. Warehouse facilities contain per loan funding fees, cash collateral requirements, sub-limits, and interest rates. Mortgage banks need to choose which line to draw on to fund each loan. Which line is cheap, high fee/low rate, or low fee/high rate? What capacity must be reserved to take advantage of sub-limits? Are their innovative structures that can provide competitive advantages?

Converting from mortgage bank to depository solves funding issues. Surety of funding, *at far lower cost*, is one of the key benefits of becoming a bank. Rather than depending on warehouse lines, banks can use deposits, whether they are escrow deposits controlled by servicing operations, wholesale deposits from other institutions, digital deposits from retail and small business, or other customer deposits. Banks can also fund mortgage lending operations through the Federal Home Loan Bank system or the inter-bank market at very low cost.

Managing Risk in the Servicing Portfolio While Managing Cost

Converting accounts into *Customers for Life* is the Holy Grail for most servicers. Servicing operations are usually designed to minimize cost rather than maximize customer engagement. Inbound calls are routed to get an answer to the customer *without* engagement – automatically if possible. Outbound calls seek engagement, just not customer engagement. These are focused on achieving investor timelines and exiting the relationship. Servicers need to go beyond offering a refi quote when a customer submits a payoff request (too little, too late). To add value in customer interactions – true engagement – servicers need to offer relevant financial advice using multiple sources of data even when questions aren't explicitly asked.

The most important issue in servicing is managing forbearance plans and other delinquencies. As a result of the COVID-19 pandemic, missed payments (whether delinquent or not) and eligibility to miss payments under a forbearance plan have reached unprecedented levels. Servicers need to prioritize loss mitigation efforts to minimize risk, meet investor guidelines, and prevent loss of the investor guaranty. Even with only existing technology, add a decision layer to lower repurchases and the expected cost on such repurchases.

The cost:benefit of technology upgrades largely depends on scale and careful selection of a vendor. Tools that cost too much to justify on last year's volume may make sense now. Endurance helps clients prioritize the implementation of technology like auto-dialers, call routing software, automated decision trees, electronic access to loan files, payment history, and call logs to narrow the performance gap between mid-size and large servicers.

Managing documents related to loss mitigation efforts needs to become seamless. The unprecedented volume of forbearance calls for an automated approach to loss mitigation. NEST Global Solution's SMARTLM™ product merges document scanning capabilities with automated intelligence to increase capacity and improve the quality of the loss mitigation process. Servicers must evaluate their current staffing and processes to choose between adding resources or implementing a better way to reduce risk, lower cost, and improve service.

It is now critical to take loan-level cost to service into account in your MSR strategy. Historically, MSR pricing, acquisition, and sale decisions have been based on note rate and seasoning with per loan cost to service held constant. Now government mandates for loan servicing have resulted in large variation of cost to service, making it imperative to consider loan-level cost when originating loans, especially in the correspondent channel. MSR strategy is becoming a game of “hot potato” where the most successful servicers (i) price correspondent purchases to attract the right loans and (ii) optimize the profitability of MSR sales, for example by pricing in the risk of becoming high cost to service.

Tech & Ops Improvements to Meet Volume Demands and Reduce Marginal Costs

Pull-through is one of the most important, but neglected, operating statistics. Retail loan origination accounts for most of the value-added in the production side of the business. At some shops, loan originators have stalled adoption of point-of-sale technology fearing, rightly, that automation weakens LOs lock on revenue. Despite LOs protestations to the contrary, studies show that customers who use technology (i.e. uploading documents) have higher pull-through than those doing it the old fashioned way (working through an LO or his processor). Higher pull-through means more volume and income. More importantly, POS implementation increases origination capacity.

Improving efficiency can radically reduce costs. The pandemic forever changed the way that customers interact with their mortgage bank. It is now common for customers to close loans without meeting their LO in person. In this environment, the mortgage bank with seamless integration from solicitation through POS and LOS to closing wins. State of the art technology can achieve origination cost at half the industry average without cutting total compensation to LOs (meaning more volume at a lower commission rate).

Operational improvement can reduce risk in addition to cost. In most cases, mortgage banks perform QA/QC primarily to meet investor requirements, often striving for Day 1 Certainty. A more nuanced approach expands pre-close QA to include those with the highest repurchase risk. We think of this as triage, though you achieve a better outcome by increasing your QA/QC rate. It is now possible to perform limited QA/QC on 100% of loan files. NEST Global Solutions uses automated intelligence to “read” scanned documents and compare content to loan data files (SMARTDiligence™). Tools like this may identify errors before closing, increase the number of loans qualifying for Day 1 Certainty, and lower repurchase risk. The right technology also lowers cyber/information security risk, enhances data governance, and improves application resiliency.

Outsource IT Infrastructure and Administration. The pandemic highlighted the limitations of captive IT teams. The ability to scale up and down rapidly and rapidly adopt new technologies is critical as the industry and market changes. Outsourcing to a domestic provider carries a number of advantages – 1) reduced operational requirements of IT leadership, 2) improved IT solutions and responsiveness to the business, 3) greater linkage to IT initiatives to support the business initiatives, 4) improved efficiency cost ratios for the organization, 5) use of industry best practices for support and security services, 6) the ability to support increased IT demand with a variable pricing structure and 7) seamless integration with the internal IT department to function as one-team. These advantages can be found at a quality provider, like Perot backed-GuideIT in Dallas, Texas.

Using Data & Analytics to Improve Decision-Making

Data Analytics requires a robust data warehouse drawing from POS, LOS, and servicing systems. Several vendor solutions have been customized to the mortgage industry. A data warehouse meets the need for loan originators to access current servicing data when targeting refis or for servicing staff to see information from the loan origination process. Building a complete data warehouse is the lynchpin of the data analytics effort.

Most mortgage banks need better dashboards to make data actionable. Mortgage banks have “big data” but often lack good analytics. We think of this as the difference between data and information. Information is data that has been sorted, grouped, or transformed to make it useful. For example, the number of inbound/outbound servicing calls is data, but total loans meeting/near/missing investors’ servicing standard is information. Similarly, turn-times can mask a bottleneck in loan production. Good dashboards enable management to see the forest as well as the trees. Endurance has utilized cloud capabilities to integrate portfolio data and enable analytics.

Smart growth is difficult to achieve. It involves targeting the right markets and then hiring the right teams of originators. It is just as important to cut your losses when an LO, team for office are not working out. The best mortgage banks follow a disciplined approach, putting remediation plans in place for underperforming offices and targeting LOs/teams to fill in markets during the next hiring window.

Margin management and pricing is the key driver of profitability, in part because pricing also impacts volume and vice versa. Pipeline hedging programs need to empower management to make value-added decisions ranging from pricing to hedging and funding. Pricing decisions obviously incorporate the base price and loan-level price adjustments; pricing decisions should also include low balance pay-ups and loan-level MSR value. Hedging must incorporate basis risk, transaction costs (to the extent that you pair-out of trades), and loan-level variability in projected pull-through. Funding decisions cover anticipated dwell time and which warehouse line to use for each loan.

Mortgage banks need to know how much volume they need to breakeven and plan for how to ramp down fixed costs if/when volume wanes. Even as management struggles to fill open positions and increase capacity, it is critical for mortgage banks to keep track of breakeven volumes for a variety of margin assumptions – *margins will fall as volume dries up*. Management needs a game plan for cutting costs to manage breakeven ever lower and stay profitable.

Rules of thumb for managing back-office staffing are no longer relevant. Many mortgage banks scale staffing for processing, underwriting, closing, and servicing by using loans/person metrics. Technology tools and shifts in the borrower experience are making the old rules irrelevant. Endurance works with clients to improve utilization of technology to improve performance, lower risk, and cut costs. Financial planning and analysis improves operational effectiveness.

Summary

Endurance Advisory Partners provides support, enabling companies like yours to endure. We help clients sustain performance through informed strategic decision-making, continuous innovation, and effective governance. Endurance follows strategy development with implementation–robust and efficient tactical practices to ensure firms can meet or exceed expectations in 2021. Now more than ever, it is necessary to adapt quickly and reflexively in order to thrive during change. To endure, firms require disciplined risk management programs that are integrated into the culture and decision-making process.

To meet the challenges of 2021, Endurance Advisory Partners will:

- Develop a strategy and risk management plan to enable an IPO or other capital raise,
- Prepare companies for exits from forbearance plans,
- Raise new sources of funds, and
- Architect systems to streamline processing and reduce both cost and risk

Endurance Advisory Partners is personally committed to your success.

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