THE NEW NORMAL FOR MORTGAGE BANKING

— by KELLI STARKEY —

The mortgage industry has faced its share of challenges through the Great Recession and into an era of much tighter regulation. But today's landscape holds promise for those who can navigate the new normal.

Since 2008, mortgage bankers have seen more changes in their industry than ever before. Stricter governmental oversight, changing loan programs, the erosion of warehouse funding capacity and the exit of many longtime secondary market investors are just a few examples of the significant changes facing mortgage companies today. At Fidelity Bank, we've been providing mortgage warehouse funding to independent mortgage bankers for more than 25 years and understand that today's challenges are numerous. ¶ For instance, two developments are likely to collide in the coming months: projected volume declines and increased governmental regulations. How mortgage companies reconcile these two trends will certainly be top of mind for those charged with leading their mortgage company into the future. ¶ With the collapse of the residential real estate market in 2008, city, state and federal governments have rushed to stabilize the industry. The Federal Reserve moved quickly to maintain liquidity in the mortgage-backed securities (MBS) market and to keep interest rates low in an effort to spur home purchases and refinances. ¶ Through three rounds of quantitative easing (QE, QE2 and then QE3), long-term interest rates declined, falling to historical lows during the latter half of 2012. This drop in interest rates, coupled with expanding loan programs such as the Home Affordable Refinance Program (HARP), HARP 2.0, Federal Housing Administration (FHA) Streamline Refinance programs and various state and local bond programs, greatly expanded the pool of borrowers eligible for home refinance and purchase.

The conventional refinance programs HARP and HARP 2.0 alone made it possible for 2.2 million borrowers with high loan-to-value ratio (LTV) loans to refinance since the program was introduced in April 2007. Nearly half of these borrowers (1 million) refinanced in 2012 alone.

As a result, residential loan originations, propped up by low interest rates and broadened loan programs, have grown since 2008, increasing from $1.5 trillion in 2008 to an estimated $1.7 trillion in 2012.

Refinances comprised a vast majority of these originations in 2012, growing from 51 percent of originations in 2008, to 67 percent of originations in the first half of 2012 and to more than 73 percent of originations in the second half of 2012.

Alongside the growth in originations has been an increase in regulation and governmental oversight. Since 2008, new and revised regulations have extended beyond the regulated banking industry to include independent mortgage bankers. The Consumer Credit Protection Act, Real Estate Settlement Procedures Act (RESPA), Truth in Lending Act (TILA) and the most widely debated of them all—the Dodd-Frank Wall Street Reform and Consumer Protection Act—have all added a layer of compliance to an industry that previously had not operated under such levels of regulation.

In addition to volume and credit quality, mortgage bankers are now charged with complying with a plethora of regulations, which for many has resulted in the addition of entirely new departments, staffed with high-quality, non-producing, compliance and quality-control personnel.

In some cases, mortgage bankers have seen their overhead expenses increase 10 percent to 20 percent as a result of compliance. While some of this expense has been shared with borrowers, it represents a real expense in the equation of profitability for mortgage bankers in the new era of mortgage lending.

And 2013—specifically the second half of 2013 and beyond—has the potential to be a particularly challenging time for independent mortgage bankers. The current tone of the regulatory environment is not expected to lighten in the near term as the Consumer Financial Protection Bureau (CFPB) continues its auditing of the largest industry players. Even small to mid-sized mortgage originators are keeping a keen eye on the movements of the bureau.

The overall uncertainty surrounding the actions of the CFPB have the industry on edge, and it remains to be seen how its actions will ultimately impact mortgage bankers.

Running parallel with the regulatory environment is a projected decline in origination volume, with some sources projecting as much as a 35 percent reduction in originations for 2013 when compared with 2012. The projected decline in originations is largely attributable to a sharp drop-off in refinance activity expected to occur during the second half of 2013.

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A majority of qualifying homeowners took advantage of historically low interest rates and refinanced during 2011 and 2012, in some cases more than once. This has left the pool of borrowers eligible to refinance in the current housing market quite dry.

Refinance activity in the future is likely to be prompted by increasing home values and/or an even further broadening of loan programs. Further reduction in interest rates below levels seen in the latter half of 2012, while a possibility, is not likely.

However, there has been upward movement in home values and continued commitment from governments to continue loan programs aimed at existing and prospective homeowners. After 36 or more months of declining or stagnant values, home values are beginning to rebound across the nation.

Year-over-year, cities such as Phoenix (up 24 percent), Los Angeles (up 15 percent), Seattle (up 10 percent), Dallas (up 5.7 percent), Minneapolis (up 10.6 percent) and many others have seen median home values rise in 2012 over 2011 levels. On average, median home values are up 5 percent across the largest U.S. cities, according to Seattle-based Zillow's first-quarter 2013 Zillow Home Value Index.

Rising values will help broaden the pool of eligible borrowers for refinance. Coupled with this is an effort by the federal government to continue programs aimed at helping underwater borrowers. Through the extension of HARP through 2015, it is estimated an additional 1.5 million homeowners will be eligible for refinance, and an additional 400,000 borrowers may become eligible as borrowers improve their credit standing.

While rising property values and prolonging programs will no doubt help to buoy refinance activity, it is unlikely that it will be enough to maintain the volumes seen in 2012.

Many mortgage bankers will be affected by the projected decline in refinance activity; however, mortgage bankers with a higher proportion of refinance originations will see and feel the largest impact.

At the same time, higher overhead expenses due to increased compliance and quality-control requirements puts significant pressure on the mortgage banker to originate higher and higher volumes or earn higher and higher margins in order to maintain profitability, not to mention an appropriate return on investment on ever-increasing equity requirements of the Department of Housing and Urban Development (HUD), Fannie Mae and Freddie Mac.

How can lenders maintain profitability?

What can a mortgage banker do to maintain profitability in this new environment? Profitability is a product of many factors—most succinctly for mortgage bankers it is volume, margin on the volume and overhead expense.

With origination volumes expected to decline, what can be done to maintain or grow originations? Adding loan originators and additional locations is an option, but can be challenging in both identification of quality targets and execution. Adding offices for the sake of head count could be more damaging than maintaining the status quo.

Alongside growing locations, it is also crucial to routinely review existing branches to ensure continued alignment with the company's mission, culture, volume and profitability targets, and to prune the branch network as needed. Augmenting originations with other revenue sources is also an option, such as accessing additional volume through a wholesale operation or through servicing a mortgage loan portfolio.

What can be done to improve upon the margin earned? This question has prompted an increasing number of mortgage bankers to consider the expansion of their operation to include the mandatory sale of mortgage notes, direct sales to Fannie and Freddie and securitization of mortgage-backed securities. Each of these has the potential to increase loan margin.

Consider the mandatory sale of mortgage notes. The spread between mandatory and best-efforts pricing can vary dramatically from period to period depending upon current market conditions. Industry factors, such as pull-through challenges, capacity constraints and market volatility, can all play a part in impacting the spread between mandatory and best-effort pricing.

Historically, on average, a mortgage banker selling its notes on a mandatory basis can earn a 20- to 30-basis-point premium over best-efforts pricing. In current market conditions, the current spread is averaging 50 basis points or more.

Then there is overhead expense management. It is true that mortgage bankers have seen their expenses swell under the weight of added layers of regulation and the demands of quality control. Keeping a tight watch on overhead levels, performing frequent break-even analyses and reacting quickly to shifts in volume will be key to ensuring profits are not leaked.

The ability for management to forecast three or more months into the future based upon existing pipeline levels is central in effectively managing overhead in light of anticipated volumes. Finding ways to automate processes, such as an online application feature, electronic record-keeping, and document indexing can drive efficiencies and reduce overall costs.

Overhead may continue to be one of the most difficult areas to manage in an industry that experiences dramatic swings in origination volume. Reacting too quickly in reducing personnel can create significant pain if/when the volume trajectory reverses. As a mortgage warehouse funder serving the industry, we have seen how reductions in personnel can create backlogs at various levels in the mortgage banking process, from underwriting to pre-closing to sale of the mortgage note on the secondary market.

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Volume hard to predict

The mortgage industry is vastly different today than the mortgage industry of 10 years ago. Even though refinance volumes are projected to decline in the latter half of 2013, many other developments may combine to keep overall volumes strong.

As described earlier, rising home values and the continuation of targeted loan programs will have a positive impact on mortgage originations. In addition, the resurrection of the jumbo and subprime markets is beginning to take form.

Over the past several years, a secondary option for larger mortgage loans akin to the MBS market for agency and government product has not existed. Because of this, the ownership and servicing of jumbo loans has been almost entirely limited to regulated banks. This has limited product variety and increased interest rates for high-loan-balance borrowers.

In addition, borrowers with poor credit and who are unable to qualify for a home loan are currently on the sidelines. An April 2012 *Los Angeles Times* news story stated, "In the aftermath of the housing crash, there's no shortage of Americans who . . . are eager to rebuild their shattered finances. In response, lenders are emerging to offer the classic subprime tradeoff: high-priced loans for high-risk customers."

As market investors' appetite for jumbo and subprime loans returns, it will enable mortgage lenders to more fully utilize these product lines and augment their originations into the future.

Economic developments overseas can also impact the mortgage industry here at home. Uncertainty in the European Union has proven to affect the mortgage-backed securities market in the United States. In general, questions and uncertainty surrounding economic policy and conditions in Europe and other foreign countries results in a flight to safer assets by investors, namely to assets like mortgage-backed securities. This can increase the price of domestic MBS, which results in downward pressure on mortgage interest rates.

Could unknown global events drive interest rates to even lower levels and spur another refinance trend? Keeping an eye on developments not only domestically but overseas is critical.

Independent mortgage bankers are truly navigating a new normal in their industry—one ripe with regulation, uncertainty, volume pressures and new market opportunities. However, with proper management of revenues and expenses, risk and rewards, and quality versus quantity, mortgage bankers of today will become the successful mortgage bankers of tomorrow. **MB**

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