AMERICAN BANKER
THE FINANCIAL SERVICES DAILY

January 15, 2010

bankthink.com

Mortgage Bank Deal?
What to Consider

JOE GARRETT & MIKE MCAULEY

There are a number of commercial banks these days whose only profitable business line is mortgage banking. Margins are wide, volumes are high, and profits are at all time highs. This has led other banks to consider getting into the mortgage businesses, often through acquisition.

For banks thinking of buying mortgage companies, we suggest 10 areas for examination during the due diligence process.

Loan demand: The temptation is to look at current profitability and at what profits would be if, as a result of being part of a bank, volume could grow by 50% to 100%. Though this is a worthwhile exercise, the more important one is to model a 50% decline in volume and a 30% decline in margin. This will happen one day, and you need to know in advance what the change would do to earnings.

Production channels: Though mortgage bankers are trying to move away from wholesale origination, this still is a significant part of the industry. Each channel (retail, wholesale, Internet, call center, etc.) has risks; but fraud risk is much greater in wholesale than in any other channel. You need to see whether the acquisition target has all the controls needed to catch fraud before it occurs.

Compliance: Lots of mortgage bankers think that "compliance" means doing truth-in-lending statements and a handful of other disclosures. They have no idea how vast and wide-ranging compliance efforts are at a commercial bank. You need to examine the target's compliance department, if it has one, and get a feel for its culture. Also, the Department of Housing and Urban Development has adopted new regulations for FHA loans, and not all mortgage companies have met these requirements. Penalties for noncompliance can be significant. Some mortgage bankers just will not be able to adapt, and it is best to find that out before an acquisition, not after.

Cost of funds: Most mortgage banks borrow money from warehouse lenders and are currently paying 5% to 6%. When you perform due diligence, be certain to model the effect of your bank's cost of funds on the mortgage company's profitability. Earnings might explode when the mortgage bank starts using your 2% money rather than 6% borrowed money. And escrow deposits from servicing are more lucrative for commercial banks since they can be invested directly into earning assets.

Net interest margin: Another positive for a commercial bank is that, for the 10 to 15 days the mortgages are on your books before they are purchased, you will be holding loans at about 5%. Depending on loan volume, this could have a big impact on your net interest margin. This, too, must be modeled.

Trailing liabilities: Look at how many subprime or Alternative-A loans the target company originated from 2005 to 2007. It is liable for any fraud losses for the life of the loan, and quantifying how many such loans were originated and how much trailing liability might exist is crucial.

Operations: Mortgage banks generally do not have as many controls as commercial banks, and it is important to understand what is in place in the back office. To cite just one example, many companies allow the person handling closing documents to draw them and send them to escrow or title without a second signature. It may seem like a small thing, but it can lead to big problems and big losses. Look at every step on the mortgage operations assembly line and make certain controls exist at every stage.

Interest rate risk: Review not only the hedging strategy but also the internal controls that would prevent someone from hiding trades. What are trading limits? Is an outside hedging advisory service used? How are hedging activities monitored and reported?

(continued)

Systems: It is quite possible that the mortgage company will have systems that can be easily integrated into your bank's existing systems. Some of the more widely used mortgage systems are also used by banks, so this is typically not a problem area. However, mortgage bankers are often light on data security and disaster recovery relative to commercial banks.

Loan servicing: Numerous reporting and compliance issues need to be reviewed by a servicing expert if your target company retains servicing. As but one example, unless the contracts with investors call for Actual/Actual remittances, you may find yourself advancing large sums on mortgages in varying states of delinquency or foreclosure. Scheduled/Actual contracts require that you advance interest payments that were scheduled, regardless of whether the borrower paid. This is just one of several dozen areas that must be assessed in order to avert major surprises.

For the right bank, acquiring the right mortgage banking company can add earnings and a new borrower base. Unfortunately, the history of such purchases is littered with failed deals and disappointed directors.

Thorough due diligence on the target company will not guarantee a successful acquisition, but poor due diligence can almost guarantee a transaction that will, at best, not meet expectations.

Joe Garrett and Mike McAuley are principals in Garrett, McAuley, a bank advisory firm in Berkeley, California