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Why do mortgage banking companies have such varied profitability?

By Joe Garrett and Mike McAuley

In 2014 we saw companies that made over 100 bps per loan, but we also saw companies that barely made 10-15 bps. What were the drivers of that disparity?

First, let's define a term or two. When we talk of profits per loan, we're talking about pre-tax earnings divided by total closings and then converted into basis points. When we refer to a company that made 50 bps per loan, an example would be a company that closed $500 million in loans for the year and had pre-tax earnings of $2.5 million.

The question we pose is a simple, "Why do the results vary so much?" If everyone is doing the same kind of loans and selling them to the same investors, why do we have such widely varying results? Why do some companies make 100 bps or more and some companies make only 10-15 bps?

Let's think about it.

- Every mortgage company is producing the same sort of widgets. They all originate Fannie Mae, Freddie Mac, FHA and VA loans.
- Everyone almost exclusively sells to the same small handful of investors. Chase and Wells are usually the biggest, followed by a limited number of other investors. If our clients aren't selling to FNMA or Freddie Mac, they're typically selling to aggregators who sell to the two GSEs.
- Everyone has pretty much the same credit standards as set by FHA and VA, FNMA and Freddie Mac.
- A big percentage of mortgage bankers also use one of maybe 3-4 different loan origination systems.
- Everyone largely uses the same hedging techniques, and there are only 4-5 hedging advisory services that dominate the field. If companies hedge on their own, they're using pretty much the same techniques as everyone else and the same ones generally that the hedging advisory services use.

What we're talking about here is an increasingly commoditized industry. There's almost nothing proprietary, almost nothing that any one company has that gives it a big competitive advantage.

This isn't an industry where companies have patents like Pfizer once had with Lipitor, and it's not like Microsoft whose operating system has almost a 90% market share.

Put another way, there's no secret sauce.

It kills us to say this, but in many ways, mortgage banking has become not that different from farmers growing and selling bushels of wheat. Every bushel of wheat is pretty much the same as every other bushel of wheat. Every 30 year fixed rate FHA mortgage is pretty much like every other 30 year fixed rate FHA loan.

Yes, the companies with charismatic leaders or great sales cultures can excel, and like any commodity business, the low-cost producers have an advantage.

Still, some companies do vastly better than others.

Why?

In our review of hundreds of companies the past 12 years, we've found that overhead explains only a limited percentage of performance. We saw one company that paid absurdly excessive salaries and had ridiculously ornate offices. But when we normalized these expenses, it only added 7 basis points to their profitably.

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Obviously, selling mandatory generates greater profits than selling best efforts, but the wide disparity in earnings we're writing about was among mandatory sellers only.

We looked at a wide variety of areas, but none came close to explaining this disparity in earnings like the secondary marketing capture rate.

It was the one great predictor.

What we saw was that most companies built in about the same profit margins, and that makes sense, doesn't it? There's a lot of information out there about mortgage rates and fees, and it's hard to charge much more than everyone else.

Some companies will pursue a low-margin, high-volume business, but this typically doesn't work unless accompanied with a very low cost structure. We've seen call center companies succeed with this model by eliminating branches and paying very small commissions to their telephonic sales force.

The most profitable companies didn't always build in a bigger profit margin than their competitors. Nor did they typically control costs that much better.

What they did, however, is capture that profit margin.

Let's repeat that: What they did is capture their profit margin.

If they built in 250 bps of profit on an FHA loan, they made 250 bps when that loan was purchased. Or if they failed to do so, it was really close, maybe getting 246.

It sounds terribly simple, and it is.

The companies that had poor earnings built in that same 250 bps profit. But where they hurt themselves was what we call leakage. They built in 250 bps of profit and only realized, say, 200 bps.

Ultimately, leakage is due to bad data and poor pipeline management. Here are just a few examples of things that we've seen go wrong:

- One company sold a large number of loans as owner-occupied, but they'd been mis-coded. The investor saw that they were actually non-owners, and the mortgage banker got dinged by 150 bps. The 75 bps they expected to get on these conventionals turned out instead to be a 75 bps loss. That's more than a minor leak.
- Another company somehow didn't price a bunch of loans for lower FICO borrowers. We forget how much this cost them, but this particular credit overlay had pricing adjustments that they didn't build into their rate sheet. Ouch.
- A third company was really bad about purging their pipeline of loans that had been cancelled or denied. They lost over $1.0 million in less than a week because they only occasionally cleaned stale loans out of their pipeline. When rates dropped suddenly, they were way over-hedged, and their pair-offs were devastating.
- A fourth company was understaffed in the shipping area, and they missed a lot of delivery dates.
- Many companies were downright promiscuous in how easily they gave extensions. We could write a whole article on this, but suffice it to day that the most profitable companies also tend to be the ones that grant the fewest extensions.

We could go on and on, but it makes us kind of sick thinking about how mortgage bankers can be their own worst enemy.

We're not going to rattle on about what you need to do to fix these leaks. We'll just say, quite simply, that it's all about data integrity and the accuracy of every bit of information on every single loan in your pipeline.

If you don't have a Pipeline Czar or a Lock Desk Nazi, you should get one. It's not necessarily a highly paid position, but it's a critical one.

And once you have that person in place, the best starting point is to simply look at every single loan that gets purchased. Look at the profit you expected to make on each loan and look at what you actually received. Track these screw-ups, find out what caused them, and we guarantee you'll figure out on your own what needs to be done.

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