



Topic of the Month: Targeted Profit Margin Adjustments

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In an environment where higher mortgage rates are putting pressure on production volumes, it becomes increasingly important to have the necessary information available to make sound pricing decisions and stay competitive. One typical strategy used to combat decreasing lock volumes is to “sharpen the pencil” and trim back expected profit margins. Just as many lenders increase their expected profit margins when rates are low and volumes are high, lenders may choose to tighten margins when volumes slip to help maintain market share and keep the operations departments working at a reasonable clip. Profit margins can be tightened across the board (i.e. the expected margin passed-through on the ratesheet would be uniformly cut on each product and/or note rate). But a more targeted strategy, one that may produce a better combination of volume and margin, requires segmenting the pipeline and cutting those margins that would be expected to produce the best overall results.

In looking at the margins for a given product, for instance, it may be more beneficial in total to target cuts in specific note rates, rather than spread the margin reduction evenly across all note rates. For example, many lenders face rate surveys (either structured, 3rd-party surveys or impromptu surveys done by their production sources) and these surveys often target specific note rates for ease of comparison. Let’s assume that for a given product type, a widely used rate survey is currently ranking lenders on the price of their 6.50% note rate. Although a lender’s ratesheet may be very competitive on note rates of 6.25% or lower and note rates of 6.75% or higher, if the lender is being compared solely on their 6.50% price, they may appear to fall short of the competition and the rates that they’re competitive on may go unnoticed. To alleviate this situation, the lender may choose to cut their expected profit margin on 6.50% notes and, hence, improve their price on the rate that their clients are focusing on.

The difficulty and danger in trimming expected profit margins, especially on a targeted basis, arises when the secondary marketing department does not have a clear picture of the effect of the margin change. To make an informed decision on the expected effect to the overall profit margin and loan volume, secondary marketing needs accurate data on current, actual profit margins, segregated by the factors defining the targeted change, plus reasonable assumptions as to the expected change in lock volume across defined factors once the margin change is in place. The chart below shows a simplified example of how a targeted, note-rate specific margin adjustment might look.

Note Rate	Current Margin (bps)	Current Volume (M)	Current Margin (\$)	New Margin (bps)	New Volume (M)	New Margin (\$)
6.25	50.0	10.0	\$ 50,000	50.0	10.0	\$ 50,000
6.50	50.0	10.0	\$ 50,000	25.0	10.0	\$ 25,000
6.75	50.0	20.0	\$ 100,000	50.0	20.0	\$ 100,000
	50.0	40.0	\$ 200,000	43.8	40.0	\$ 175,000



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In this example, the lender was making a flat 50 bps on each note rate, which generated \$200,000 in revenue on 40MM in closed volume. The lender decides to target the 6.50% note rate and lower the margin there to 25 bps. If no assumption is made as to a change in volume across notes rates, then the 25 basis tightening on the 6.50% would lower the average margin to 43.8 bps and lower the revenue on the 40MM to \$175,000.

In contrast, the chart below shows a more likely scenario where volume on the targeted note rate would increase due to the improved pricing.

Note Rate	Current Margin (bps)	Current Volume (M)	Current Margin (\$)	New Margin (bps)	New Volume (M)	New Margin (\$)
6.25	50.0	10.0	\$ 50,000	50.0	10.0	\$ 50,000
6.50	50.0	10.0	\$ 50,000	25.0	30.0	\$ 75,000
6.75	50.0	20.0	\$ 100,000	50.0	20.0	\$ 100,000
	50.0	40.0	\$ 200,000	37.5	60.0	\$ 225,000

In this example, the lender assumes that the 25 bps improvement on the 6.50% note will triple volume on that note to 30MM, while leaving volume on the other two note rates (where they were already competitive) the same. This boosts total volume to 60MM but effectively lowers the average margin across notes even further, to 37.5 bps. Even with the lower average margin, the lender still makes more total revenue (\$225,000) as the volume pick-up more than makes up for the drop in average margin. But, it's important to note that all scenarios, even those that do not contemplate a change in margins, require an accurate picture of the profit margins, within each segment and across the pipeline. Making any pricing decision without a clear understanding of the actual profit margins involved can be costly. You can't make up for a zero or negative margin through increased volume.

This describes just one simple example and many other types of targeted adjustments (by product, production source, lock period, etc.) can be made. In each case, the analysis would be similar: define your current margins, segregated by the targeted attribute, develop assumptions for the effect on production volumes across the attributes, and model the effect of the proposed change on average margin and expected revenue. By using a more targeted approach to margins and margin changes, the lender can maximize their competitive position and keep volume and revenue flowing.

–Lindsay Hill