

# A Secondary Marketing Manager's Guide To Today's Business Challenges

***Knowing your profit margins, hedging strategies, delivery options and markets is invaluable.***

By Rob Kessel

These days, mortgage professionals are asking each other if they ever remember it being this bad in the mortgage industry. Tales of the previous no-doc craze and spread blowouts are exchanged without making anyone feel any better about the current tough environment. Yes, we all saw it coming, but now that we are in the midst of it, this part of the cycle is really, really dark.

Contributing to the industry malaise is the signification uncertainty around how the performance of lower credit quality loans will impact the housing market and how the potential retreat of the housing market may serve to exacerbate defaults, accelerating the vicious cycle. And to top it off, we are looking down the barrel of hundreds of billions in adjustable-rate mortgage resets over the next two years, many of which will reset to payments unaffordable to the borrowers, many of whom who will be unable to refinance, given the recent tightening of credit standards.

So what is the secondary marketing manager (SMM) supposed to do in this environment? After all, it is an environment that has already seen credit tightening from the investors and warehouse lenders alike - an environment that has resulted in substantial secondary losses as product has been written or

traded down overnight, while warehouse banks have followed suit, substantially raising lender cash requirements.

The knee-jerk reaction for many lenders and SMMs is to stop originating non-agency product altogether and to stop hedging most, if not all, of their production. Instead of throwing the baby out with the bathwater, successful SMMs will return to discipline and fundamentals: Know your profit margins, know which products to hedge, know your delivery options and know your markets. For savvy participants, volatility creates opportunity, and those who seize opportunities as they arise will thrive as others flounder.

### ***Know your profit margins***

Sound financial planning is always prudent but is particularly crucial during this part of the business cycle. SMMs must begin to face the reality of significantly different production mixes and the impact they will have on the profitability of the firm. Pricing and profit margin policies cannot be implemented without regard for overall production volumes. Consider the following simplified, hypothetical example of ABC Wholesaler, to put not-so-unrealistic context to the decision many SMMs now face.

Table 1 reflects a fairly typical production mix for lenders in late

2006 along with reasonable profit margins net of hedge cost and direct commissions. Table 2 reflects the reasonable operating costs to support \$100M in originations. In this example, ABC Wholesaler has pretax profits of \$150,000 a month.

Now fast-forward to Table 3, representing May 2007, where ABC's beleaguered SMM, like many other SMMs, has decided to cease lower credit quality originations and concentrate on agency and higher credit quality production.

Table 3 represents ABC's May 2007 production, which reflects a 25% decline in origination volume, but more relevant, a nearly 50% decline in weighted profit margin and a 56% decline in gross revenues. Like many lenders, ABC tightened credit standards, and stopped subprime and second production while facing tighter margins in higher credit quality loans as more lenders chased fewer loans. Despite the painful 20% reduction in operating costs reflected in Table 4, ABC has now swung from a gain of \$150,000 to a loss of \$91,500.

Beyond providing a realistic scenario facing many lenders today, Tables 1-4 highlight additional key

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distinctions. In Tables 1 and 3, the profit margin is simply provided as a given. Its simple presentation belies the challenge associated with measuring and defining profit margin net of hedge cost, particularly for non-agency product.

This challenge underscores the absolute necessity of having accurate day of lock and ongoing valuations for pipelines as well as accurate hedge cost determination. Without accurate profit margins, SMMs may make misinformed decisions on rate sheet pricing and staffing decisions.

No less benign are the implicit assumptions for June 2007 and after. Can current margins and production levels be maintained? Will credit standards tighten further? What can be done to improve margins?

The first key recommendation for SMMs is to be vigilant regarding assumed and actual profit margins and to actively and realistically model prospective volume and profit margin assumptions.

### ***Know which products to hedge***

Before the SMM can determine profit margins for any products in applicable markets, he or she must know what each product's secondary market execution will be. On a product-by-product basis, SMMs must continually decide and reevaluate which products will be hedged and how the products will be delivered.

For example, if the price that a single loan will fetch for a best efforts delivery is a net (of hedge cost) 25 basis points (bps) less than the mandatory delivery, that difference in execution will greatly impact how competitive the SMM is for that product, which will in turn impact attainable profit margins.

Notwithstanding the pressure to improve pricing and profit margins, SMMs must consider interest rate risk, basis risk (the risk that your hedge doesn't track your loan prices) and fallout risk (the risk of under- or overestimating how many unclosed loans will become closed loans). On non-agency loans, SMMs must also consider spread or credit risk, the mostly unhedgeable risk that mort-

gage spreads (additional yield required for riskier products) widen (demand for more spread), causing prices to decline and/or for investors to simply refuse to buy the product.

The decision paradigm as to what products to hedge remains the same as it was before 2007: evaluate the opportunity (best execution delivery versus best-efforts price), characterize the risks (interest rate, basis, fall-out, credit/spread), decide if the value proposition sufficiently exceeds the expected risks, and continually reevaluate the decision.

Successful SMMs will avoid categorical decisions to stop hedging all products. In this environment, risk is restricted not to hedge risks, but to company profitability and viability. Risk/return decisions must be made in the context of how such decisions will impact pricing, production levels and resultant revenues.

Return to Table 3 to see what losing 25 bps in execution might do to

the realistic recognition of targeted profit margins. Successful SMMs will pick and choose which product they hedge by evaluating each risk/return profile and continually reevaluating their decision.

As an example, higher credit quality Alt-A and jumbo fixed and ARMs may represent sufficiently minor spread risk that it makes sense for many SMMs to continue to hedge that product with the expectation that the growing dearth of such product in the mandatory market may result in larger mandatory/best-efforts spreads in the future.

For some SMMs, moving all product to best-efforts, even conforming agency product, may simply not be an option, given how tight margins are in their marketplace (i.e., it could actually introduce far greater profitability or cash flow risk).

Finally, the decision to hedge certain products does not end once the lock is accepted. Many nimble SMMs

**Table 1:**

**ABC Wholesaler – December 2006 – Monthly Production: \$100M**

Product	Production (M)	Margin1 (bps):	Gross Revenue
Agency	25	30	\$ 75,000
Jumbo Prime	15	30	\$ 45,000
Alt-A	35	80	\$280,000
Subprime & 2nds	15	100	\$150,000
Option ARMs	10	100	\$100,000
<b>Totals:</b>	100	65 (wtd)	\$582,500

Margin net of hedge cost and direct commission

**Table 2:**

**ABC Wholesaler – December 2006 – Income**

Gross Revenue	G&A, Operations	EBIT
\$582,500	\$432,500	\$150,000

**Table 3:**

**ABC Wholesaler – May 2007 – Monthly Production: \$ 75M**

Product	Production / Change (M)	Margin1 / Change (bps):	Gross Revenue
Agency	35 (+10)	22 (-8)	\$ 77,000
Jumbo Prime	20 (+5)	20 (-10)	\$ 40,000
Alt-A	15 (-20)	65 (-15)	\$ 97,500
Subprime & 2nds	0 (-15)	100 (N/A)	\$ 0

**Table 4:**

**ABC Wholesaler – May 2007 – Income**

Gross Revenue	G&A, Operations	EBIT
\$254,500	\$346,000	-\$ 91,500

minimized losses during the recent credit tightening by quickly selling affected unclosed loans on a best-efforts basis as investors announced underwriting changes.

### ***Know your delivery options***

Beyond determining the actual execution price of a loan or group of loans may fetch, delivery methods can also mitigate losses in many cases. Addressing the former, SMMs must evaluate their delivery options in determining what their best execution price would be by product type.

For agency-released production, that may include AOT, bulk and single loan sales. For non-agency released production, best execution delivery may be single loan or bulk sales. As an example, if delivering mandatory Alt-A loans in bulk resulted in 25 bps on average better execution than single loan mandatory sales, that execution price would determine how competitively and with what margin the SMM can approach each market for that collateral.

With respect to troubled loans, enterprising SMMs will consider all viable options in selling recently abandoned credit profiles. One common strategy includes securing additional documentation or other investor requirements from borrowers. In many cases, SMMs can improve their execution prices by several points.

Other SMMs are exploring lender mortgage insurance (MI) when possible. Lender MI can reduce the poten-

tial loss of lower credit product sufficiently to make the product more attractive to investors. Some SMMs have negotiated delivery pricing without EPD indemnification. Many SMMs are keeping bulk delivery execution in place on higher credit quality collateral yet performing whole loan best execution when the bulk bids come back - just to make sure they are not being arbitrated by traders fighting for their own gains in this volatility.

On conforming product, lenders can profit by revisiting assignment of trade agreements and having that execution in place to compare against bulk bid execution. Successful SMMs continue to test delivery options, network for ideas and continue discussions with investors.

### ***Know your markets***

In parallel to establishing which products are hedged and in what ways they are delivered, knowing and understanding the markets in which one originates, i.e., the applicable products and acceptable profit margins, can make a successful or unsuccessful SMM.

SMMs must be familiar with current production and anticipate changes in future production given changing investor and lender credit standards. SMMs must then actively iterate and freshen targeted profit margins to validate competitiveness and resultant production in each marketplace.

Successful SMMs must synchronize projections with reliable production feedback and model and present meaningful production estimates and sensitivity to competitiveness of pricing. In addition to understanding each market's favored product set and acceptable pricing, successful SMMs must be knowledgeable about their competitors in those markets.

It is in this environment that expanding production resources can dramatically influence an originator's performance. Successful SMMs who made a point of keeping tabs and developing relationships with competing production resources are now first in line to pick up production resources as competitors close or inappropriately scale back productions.

Survey 100 lenders today, and you will find that at least 20 are growing for this reason alone. To summarize, how well the SMM knows the market is directly proportionate to the accuracy of his or her Table 3 forecasts.

As during any crisis, participants often benefit by returning to the fundamental. Many lenders will not survive this part of the cycle. Some lenders will prudently decide to exit gracefully, and others will flame out. Many lenders will improve their market share and future prospects through this part of the cycle. But those that follow the fundamental analysis and strategies laid out above will improve their chances of successfully navigating this period and emerging from the dark side. **SME**