The Upside of the Downturn

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This may be one of the few positive articles you will read this year about the mortgage industry. It examines what some lenders are doing well, rather than focusing on lenders that are exiting the business. This article is devoted to the lenders that have successfully stayed on the upside of the downturn. ■ In other words, these lenders have managed to increase origination volume from mid-2005 through the end of 2006 despite the national decline in originations. ■ Achieving growth must have more to it than just having deep pockets. So, who are some of these lenders, and what's their special sauce? We selected a few lenders and looked for insight into what strategies might have contributed to their success. ■ But first, let's take a quick look at the signs and symptoms of the residential mortgage industry downturn. Since origination market volume peaked at $869 billion in the third quarter of 2005, the market has continued to shrink, landing at $573 billion by the fourth quarter of 2006, according to First American Real Estate Solutions, Santa Ana, California (final figures are subject to county filings.) The vast majority of lenders also have reduced staff, and scaled back the scope of operations and strategic initiatives to compensate for the reduction in origination volume. ■ There is

A look at four lenders that are managing to grow in the current environment proves sound strategies and solid management still work.

concern about rising interest rates. Fraudulent loans are being discovered with increasing frequency. Accounting errors are causing more lenders to restate their earnings, causing their publicly held mortgage stock prices to be pulled down in value due to perceptions about the subprime market.

Continued strife in the subprime market led to a forecast by the National Association of Business Economics (NABE) in which 47 top economists called the subprime sector a more serious concern to financial markets than hedge funds.

Factors such as sagging home prices and higher payments upon ARM reset are pushing a growing number of borrowers into delinquency. The industry has reacted with tighter lending standards, while lawmakers and regulators have reacted with tougher rules and more stringent compliance requirements, including more scrutiny on Home Mortgage Disclosure Act (HMDA) disclosure and fair-housing guidelines.

Of course, the mortgage industry is dealing with negative market forces as best it can, and calling on congressional committees to exercise discretion. Lenders are saying that the market will work to self-correct the factors driving an uptick in delinquencies and foreclosures. The industry points to data showing that the real primary reasons for homeowner defaults are unanticipated economic difficulties such as job loss, income curtailment, illness, high consumer debt loads and marital problems. Of course, all of this is playing out against a backdrop of certain specialty lenders closing divisions and shuttering their doors, and in some cases even seeking bankruptcy protection.

Pursuit of the next big thing also has left many lenders stretched thin.

Despite the rough sailing, some lenders are still growing. We decided to take a closer look at Indymac Bank, Pasadena, California; SunTrust Mortgage Inc., Richmond, Virginia; Wachovia Mortgage Corporation, Charlotte, North Carolina; and Thornburg Mortgage Inc., Santa Fe, New Mexico, to see if we could identify the business strategies and technology initiatives that have contributed to their growth.

The result of our research and interviews revealed several strategies to consider when deciding how to grow origination volume into the future. In many cases, several thriving lenders shared a strategy—although only one or two lenders may be provided as an example. These strategies include:

- Target your market, then stay on target.
- A Good-Faith Estimate—guaranteed.
- Customer service is about counting the smiles.
- Spanish-language business-to-business (B2B) Web portal: If you build it, they will come.
- A complementary merger-and-acquisition (M&A) strategy.

Target your market, then stay on target

Lenders often spend a great deal of time finding the best match between customer profile and loan product in order to maximize profitability and best serve the customer. Analysis of market data, internal performance reports and intuition eventually lead to a core set of products that can be marketed to the right customers at the right time.

Sometimes, the customers will slightly favor one set of core products over another. Other times, as with the booming 2000–2005 real estate market, new products, looser underwriting standards and new customer segments can seem to offer a bounty. Also, temptation to pursue new markets can lead to dramatic changes in core product offerings.

Many lenders pride themselves on their ability to quickly adapt and evolve to exploit new opportunities and changes in the market. However, pursuit of the next big thing also has left many lenders stretched thin, offering many new products and trying to be everything to everyone.

Thornburg Mortgage proposed something of a contrarian approach to that all-things-to-all-borrowers orientation. Maybe deviation from what a lender does best—offering core products—caused lenders to lose focus on marketing to the most desirable customers. Perhaps pursuit of short-term change diverted attention from what should not change at all—namely, long-term customer relationships.

Short-term gains were not as tempting to Joseph Badal, Thornburg's senior executive vice president and chief lending officer. "We did not follow the trends, because doing so would have deviated from our disciplined approach to doing business," he says. "We focused on high-value customers and remained true to them and ourselves," he adds.

Thornburg seems to have been rewarded by this strategy. Its average loan size rose from about $500,000 in 2005 to around $800,000 in 2006.

When asked if the increase could be attributed to higher loan-to-value (LTV) ratios, Badal says, "Higher LTVs were not the most significant factor. Most of the growth came from continuing to target the high-end, sophisticated borrower, and the end result was more high-end customers buying more expensive homes."

So, by avoiding the temptation to loosen underwriting standards and be all things to all people, lenders may be able to increase origination volume by specializing in serving a focused niche really well.

A Good-Faith Estimate—guaranteed

Let's face it. As lending industry insiders, we know more about loan transactions and their ins and outs than the average borrower. We are blessed with knowledge about the complexities and intricacies in even the most plain-vanilla loan transaction. We understand why fees and closing costs are typically provided upfront as estimates, in good faith. However, it is the faith of the borrower that truly matters. We want borrowers to be faithful to us, and not shop around. We want higher pull-through rates and lower customer-acquisition costs.

So how can we achieve that goal? For SunTrust Mortgage, the answer was easy: convert estimates into guarantees.

The underlying concept was that borrowers would be more willing to give us a guarantee of their business if we guarantee the terms of ours. Sterling Edmunds, chief executive officer of SunTrust Mortgage, says it plain and simple: "We honor the Good-Faith Estimate because it just makes sense from a customer-service perspective."

Of course, this approach does require more diligence on the part of the lender to collect enough information to accurately determine fees upfront in the application process. Because many of the last-minute changes and previously undisclosed items are often charged by third parties, lenders must press all parties to calculate and disclose items upfront. This effort can be worth it, as it also reduces the risk of differences between guaranteed estimates and actual costs.

SunTrust has been pursuing this strategy since late 2005. The company listened to complaints from customers, and realized it had a golden opportunity to differentiate itself, offering what SunTrust calls good-faith guarantees. Edmunds believes that the good-faith guarantee is a key element to SunTrust's overall focus on customer service, and a key factor helping to boost its loan origination volume by increasing pull-through rates.

Customer service is about counting the smiles

With the slower pace of the mortgage origination market, many customers are looking forward to the return of customer service. As origination volumes have dropped, lenders are able to catch their breath and also catch up with past customers. Loan officers can farm their networks instead of just frantically answering the phone.

For some lenders, a focus on customer experience, service and relationships has been paramount for many years—even preceding the 2005 downturn. It is no coincidence that some of these same lenders are winning customer satisfaction awards for the positive attributes of their application/4approval process, interaction with the loan officer or mortgage broker, and the closing experience.

For example, in Westlake Village, California–based J.D. Power and Associates' 2006 *Primary Mortgage Origination Study*sm, Wachovia placed third with an overall index score of 774 (on a 1,000-point scale), and SunTrust placed first with a score of 782. Such industry customer satisfaction surveys count the smiles of customers, and help lenders better understand how they rate among the competition.

However, these studies are not performed frequently enough to enable SunTrust Mortgage to provide real-time feedback to management and the broader organization on progress being made toward improving customer service. Achieving the No. 1 ranking in the J.D. Power and Associates study certainly gives credence to SunTrust's approach to keeping customers happy. According to Edmunds, SunTrust Mortgage has implemented an internal service quality-assessment system to rank the performance of sales associates.

SunTrust Mortgage ranks all its associates based on service quality, retention and repeat business, and publishes the list every month to the entire company. Several years ago, 20 percent of associates received the "top box" rating of excellent, whereas now 54 percent of associates are in the top box, according to Edmunds.

Edmunds believes in this approach because, as he says, "We live and breathe customer service. We quantify it, and we publish the results. That is how we are able to measure progress and motivate the sales associates to focus on the customer."

Perhaps lenders that are currently relying solely on annual customer satisfaction studies published by outside third parties could benefit from implementing an internal measurement system to provide key performance metrics in a more timely manner.

Lenders that can help their customers reach out to the Hispanic community may find success within the growing Spanish-reading market.

Spanish-language B2B Web portal

By now it is common knowledge that the U.S. Hispanic population is rapidly growing and, as a result, opening a potentially expansive new market for customers. Homeownership among Hispanics is on the rise, documenting the interest that the Spanish-speaking community has in owning rather than renting their homes.

However, there are many barriers to homeownership that are unrelated to ability to qualify financially. Many Hispanics could qualify, but are discouraged by the lack of information available in Spanish, because the vast majority of loan documents, mortgage Web sites and literature is available only in English.

During the real estate boom, many real estate brokerages, mortgage brokers and mortgage lenders began hiring Spanish-speaking staff to help explain key information to Spanish-speaking customers. But the addition of written information in Spanish still lagged behind.

As a result, some lenders have been trying to open the doors of homeownership wider to the Hispanic community by creating literature and Web sites in Spanish; most notably, perhaps, is Indymac Bank.

It can be difficult and expensive for an individual mortgage broker or banker to produce information in Spanish. According to an Oct. 29, 2004, press release, Indymac decided to help overcome that hurdle by building a Spanish B2B microsite, Zona Hipotecaria ("Mortgage Zone"), specifically designed to provide its bilingual mortgage broker, mortgage bank and financial institutions customers with a "resource for mortgage product and marketing information in Spanish, enabling them to easily explain Indymac product features and services to their own Spanish-speaking consumers."

The Zona Hipotecaria site allows customers access to private-label marketing materials with their own brand, logo and contact information, and makes those materials available in Spanish. The site also provides bilingual content related to product information, online tools and a glossary of mortgage terms.

By following Indymac's lead, lenders that can help their customers reach out to the Hispanic community may find success within the growing Spanish-reading market.

A complementary M&A strategy

Some would argue that in the long run, organic growth is more successful and less risky than growth by merger and acquisition, due to the high risk and failure rate often experienced with the latter strategy. Others would argue that if done right, M&A is a great way to grow quickly.

Most M&A strategies are designed with sound principles in mind, such as expansion of geographic footprint, access to new customer segments, addition of new products and opening of new channels. However, the clash of culture and business models often yields less-than-desired results and can adversely impact financial performance. Still, if done right by focusing on the aspects of a targeted company that complement the business model, M&A can be a powerful strategy.

This strategy has paid dividends for Wachovia. As a result of lessons learned during its mergers with First Union Corporation and Prudential Securities between 2001 and 2003, Wachovia was well-positioned for success during the five mergers and acquisitions that it completed in 2005 and 2006. According to Wachovia, the company's origination volume grew from just $737 million in the third quarter of 2005 to $5.4 billion in the fourth quarter of 2006—an incredible 630 percent increase—as a direct result of the way these additional companies complemented Wachovia's growth plans.

Entering 2005, Wachovia's mortgage product offerings focused primarily on conventional prime lending through its retail channel. By the end of 2006, Wachovia had added significant alternative-A originations via the merger with American Mortgage Network (AmNet), and a small percentage of subprime originations through EquiBanc Mortgage Corporation, a subsidiary brought in through the acquisition of SouthTrust Mortgage Corporation.

These mergers also added substantial wholesale lending capability on top of Wachovia's existing retail lending channel. Wachovia continued to expand its product offerings with a full array of fixed- and variable-rate multifamily loan products through the acquisition of American Property Financing Inc. (APF), a wholly owned subsidiary of Emigrant Bank.

Wachovia continued to focus on growth in prime/alt-A originations through its merger with Golden West Financial Corporation in late 2006. In early 2007, Wachovia quickly exited the subprime industry by shuttering EquiBanc.

Wachovia also grew its geographic footprint through M&A. The acquisition of SouthTrust gave Wachovia a leading market position in the South and Southeast states, especially in the fast-growing state of Texas. Wachovia gained a nationwide branch network that served more than 7,000 mortgage brokers from its merger with AmNet. Wachovia then achieved name recognition on the West Coast by purchasing Westcorp and its 19 retail banking offices in Southern California.

When Wachovia merged with Golden West in October 2006, it solidified its presence as a national mortgage lender (albeit under the World Savings Bank name) in 39 states, with 285 branches in 10 states and accelerated branch presence in California, Texas, Colorado and Arizona.

Wachovia has been one of the few lenders seizing the upside of what for many other lenders is a down market. As such, it may be beneficial for other lenders to learn more about why Wachovia's M&A strategy has been so successful.

Closing thoughts

The business strategies and technology initiatives that have contributed to the growth of this group of thriving lenders have placed these companies in a strong position to outlast the downturn. Many of these strategies most likely will be imitated by other lenders as it becomes apparent they are key to successful growth in the current environment.

The entrepreneurial spirit is alive and well within the lending community, and borrowers will be the ultimate beneficiary of the leaner, smarter mortgage lending industry that is emerging. **MB**

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