STOP LEAKING REVENUE

— by JAMES M. DEITCH —

On a recent flight back from a Mortgage Bankers Association (MBA) event, I was thumbing through cost-per-loan statistics over the past five years. One set of numbers from MBA's *Quarterly Mortgage Bankers Performance Report* caught my eye. ¶ There were four quarters in which the average midsize bank and mortgage banker produced about $300 million in a quarter—the second quarter of 2009, fourth quarter of 2010, first quarter of 2012 and first quarter of 2014. ¶ The shocker: Total production expenses jumped from $3,581 per loan in the second quarter of 2009 to $8,025 per loan in the first quarter of 2014. This is an increase in cost of 125 percent. The cost per loan declined to $6,779 as volume increased by 40 percent in the third quarter of 2014—but the cost per loan was still almost twice that of 2009. ¶ I happened to be sitting next to an Intel (the semiconductor manufacturer) executive on the flight, and asked him what happened to the cost of a microprocessor from 2009 to 2014. His answer: A dollar's worth of processing in 2009 cost about 9 cents five years later, or a decrease of about 90 percent. ¶ As we talked about our industries, the Intel executive stated the obvious.

Here's some management advice on how to reduce revenue leakage in your origination shop.

"Your industry has a productivity problem," he said. "You get 10 times the performance for every dollar spent on computer technology versus 2009, but closing a loan costs twice as much as in 2009."

How should the mortgage industry best tackle these significant productivity issues? That question spawned this article.

The 2015 and 2016 residential mortgage market volume projections are about $1.2 trillion, according to the most recent MBA forecasts. Refinance volume is expected to be down considerably, but purchase volume is expected to rise to about $750 billion.

The next two years may look remarkably like 1999—about $800 billion of purchase business and about $400 billion of refinance volume.

Current loan quality is very high, due to a tight government-sponsored enterprise (GSE)/lender credit box and some degree of self-selection by borrowers (i.e., borrowers know poor credit, lack of documented earnings or lack of stable employment is disqualifying). One might expect that per-unit costs to originate would be falling, not increasing, under these circumstances because only high-credit-quality, fully documented loans are being underwritten. Fewer loans are being closed overall, resulting in higher fixed costs per loan, especially when factoring in higher compliance costs.

The Dodd-Frank Wall Street Reform and Consumer Protection Act has imposed many prescriptive compliance requirements on mortgage bankers, but for many lenders, the loan manufacturing process has not changed.

Many lenders use a business process that was designed years ago in a different regulatory, product and cost environment. The process has been modified to meet the prescriptive requirements, but the basic business process has not changed for most lenders. This observation applies to retail, wholesale and correspondent lending channels.

MANY LENDERS USE A BUSINESS PROCESS THAT WAS DESIGNED YEARS AGO IN A DIFFERENT REGULATORY, PRODUCT AND COST ENVIRONMENT.

Retail consumers tell many of us in the mortgage industry that the process needs improvement: Why does it take 45 days to get a mortgage when I can get a car loan or credit card in under an hour? Why do I have to keep supplying more information throughout the process? Why do I feel lost during the process?

Brokers tell us that our communication and integration with their systems is poor.

What can mortgage bankers learn from other industries? Talking to a Southwest Airlines captain on another flight recently (he was deadheading to his duty station) he said, "Southwest Airlines has 6,500 pilots, and every pilot can fly every one of Southwest's aircraft. We fly in pairs, a captain and a first officer. I may fly with nine to 15 different first officers each month, but we know exactly what is expected of each other and the aircraft. Our procedures and operational methods are called crew resource management, where we back each other up and cross-check each action we take. Every phase of every flight has procedures to ensure safety and success. We flew 130 billion seat miles in 2013 without a fatality or major incident."

Later, when speaking with Andrew Liveris, chairman, chief executive officer and president of The Dow Chemical Co., Midland, Michigan, he stated, "Businesses today must travel at the speed of 'live.' Companies must be flexible enough, fast enough and open-minded enough to keep up with the competition. If you can't innovate faster than your competitors, and you offer commodity products and get commodity pricing, you get run over. . . . Manufacturing is an innovation-centric activity."

Based on my 25 years of experience working in the mortgage industry and conversations with executives from a wide variety of industries, I recommend that mortgage executives evaluate their business processes and productivity in the following ways to innovate and compete at a much faster speed.

Optimize business processes

Mortgage executives need to define the experience they want their customers to have. This experience can be defined in both qualitative and quantitative terms.

They should be asking questions such as: How long should the approval and closing process take? How fast should a wholesale or correspondent transaction be funded? What is the exact role of the loan officer, both in terms of originating a quality file and in interacting with the customer after the application is completed? What is expected from the lender's wholesale or correspondent sales staff?

How many times should a customer be contacted for more information? How is a customer kept abreast of progress on the loan? How should different personnel in the loan approval process interact with the customer, broker or lender?

How many times should a processor, underwriter, closer or funder touch the file? What should the origination process cost the lender for retail, wholesale and correspondent? How can quality be designed into every process?

The lender then should diagram its current business process and compare it with the desired customer experience. In some cases, the business process and desired customer experience are far apart.

One lender Teraverde Management Advisors worked with found that underwriters exchanged a file with processors an average of 11 times. Another lender found that loan officers submitted loans to the automated underwriting system (AUS) system an average of 13 times and the computation of stable monthly income was deficient in half of the submissions.

The business process must be examined in very granular terms, or key observations such as the number of file passes or AUS runs may be missed.

Once the business process is diagrammed, milestones can be identified for each key process and the time required to perform the milestone can be specified.

Each key process should be translated into step-by-step procedures for training purposes and for reference by employees. Each employee's job description should tie into the step-by-step procedures and milestones. And of course all of this documentation should match the actual work practices in effect at the lender.

This is standard practice in many industries, but we observe complete business process documentation and deployment in only about two out of every five lenders.

Hiring retail loan officers

How does another highly regulated business handle this business process? It takes an average of 12 weeks to screen and hire a new airline pilot. Southwest Airlines pilot candidates must have 2,500 hours of flight time, a four-year college degree and an airline transport pilot certificate issued by the Federal Aviation Administration (FAA) with a Boeing 737 aircraft qualification.

Pilots then complete a month-long indoctrination training, and must pass multiple "check rides" and flight proficiency tests to demonstrate competence in company procedures and crew resource management.

Not surprisingly, professional airline pilot turnover at major carriers is about 3 percent to 5 percent due to the rigorous hiring process.

Based on our experience, it appears that loan officers are usually hired much more casually, without a thorough background review, testing of competence or indoctrination into the lender's culture.

According to MBA's fourth-quarter 2014 *Quarterly Mortgage Bankers Performance Report*, the average loan officer turnover rate is about 50 percent or higher in surveyed companies.

TURNOVER ULTIMATELY ARISES FROM POOR SELECTION PROCESSES.

Turnover ultimately arises from poor selection processes. Turnover contributes to poor customer experience and to poor economics. The cost to recruit, hire and train a loan officer for Teraverde's typical mortgage banking clients can run from $10,000 to $25,000—and sometimes much more.

What hypothetically would happen if a lender's hiring practices were more selective, and patterned along the way that an airline hires pilots?

Assume a lender instituted comprehensive hiring procedures and materially improved its retention and loan officer productivity. For example, the lender required an extensive day-long interview performed by multiple representatives of the lender. The candidate was asked to explain his or her last five years of employment history from the Nationwide Mortgage Licensing System and Registry (NMLS) and why the candidate left each job.

The lender then reviewed the prior employers of the loan officer candidate, looking for lenders that were subject to enforcement action, or that failed or had a business model not compatible with the lender interviewing the candidate.

The candidate was required to provide income documentation for the past three years and explain why income changed (up or down), explain his or her method of business development and provide business references.

The lender conducted an extensive background assessment of the candidate, including social media and other expansive background reviews. The customer lead source and loan type/purpose mix of the candidate was covered by extensively questioning how and where he or she developed business, the credit characteristics of the candidate's borrowers and detailed questions on prior employers' business models.

The questions that the lender might ask the candidate include: Were you responsible for collecting income documentation? Did you develop income data by reviewing the borrowers' tax returns? How were consumer disclosures made and delivered? Who kept the customer abreast of the process? How were loans locked?

Assuming a lender adopted this detailed process for assessing candidates, the lender would likely hire fewer originators, but would hire more thoroughly vetted candidates that were better suited for the lender's business model. Productivity and retention would likely increase.

The expanded background review can also prevent regulatory nightmares by avoiding candidates who did not disclose federal indictments for mortgage fraud; convictions for financial fraud; cease-and-desist orders from state regulators; revocation of mortgage brokerage licenses; Federal Trade Commission (FTC) complaints against former employers; and other character issues. This type of adverse information does not generally show up on standard credit and background checks.

In fact, several of our clients have implemented a much more selective hiring process. The clients collectively reported lower turnover and better loan production from loan officers hired after implementation of a more selective hiring process. Several candidates were eliminated by the expanded background review who would have passed a typical credit and background check.

This recruiting and selection process for individual loan officers is equally applicable to wholesale and correspondent sales teams. The wholesale or correspondent salesperson touches a very broad constituency of clients, and a poor selection can quickly damage a lender's reputation.

Loan origination systems

Loan origination system (LOS) technology should be configured to support the lender's business process. Teraverde has reviewed more than 100 LOS deployments at various lenders, and a large percentage of the LOS systems are poorly configured to meet the lender's business model.

A well-configured LOS dovetails into the lender's business process and customer experience requirements. It is also well integrated to minimize manual or repeated entry of data.

Poor retail LOS system configuration issues are widespread. For example, less than half of the LOS installations we reviewed automatically generate a list of required documents from the borrower at point of origination, based upon the individual borrower circumstances. This is a major lost opportunity to speed the document collection process when the borrower is most motivated to assist the lender.

Another symptom of poor configuration may be incorrectly computed income, especially for self-employed borrowers with Internal Revenue Service (IRS) Schedule C income or closely held businesses and/or rental properties generating IRS Schedule E income. The LOS can be configured to open a self-employed income computation script, a small income property computation script, or other loan officer scripts to assist the loan officer in getting the income correctly computed at the time of origination.

Some LOS deployments use scripts for less-experienced loan officers in the origination process. While some loan officers are experts at structuring a loan, many loan officers could benefit from a script that walks the loan officer through the interview as required by the lender's desired customer experience. Scripted training aids ensure an application is complete and well structured with the required documentation.

Integration between the LOS, servicing system, general ledger, warehouse lenders and other third-party service providers provides both efficiency and control over the entire business process. Teraverde's experience is that the amount of revenue lost due to systemic leakage can easily top 15 basis points.

Many LOS systems measure productivity of sales and operational personnel, but the measurements are not focused on root-cause analysis. For instance, the number of times a file is opened by a processor can indicate how well a processor organizes and completes the processing task set.

Milestones can be set to script how long each process should take, and to identify and remediate lagging loan files before customer service levels are impacted. Expediting expiring locks can save relock and/or hedge costs, and also increase customer satisfaction.

Many LOS systems are not configured to produce actionable coaching data for loan officers and operations personnel. Few lenders measure turnaround time and errors by performing statistical reviews of loan officer/processor/underwriter/closer personnel combinations. Remarkably, there are some combinations that produce statistically significant improvements in revenue realization and cost efficiency. Find them, study them and spread the know-how throughout the employee base.

Low value-added activities should be automated. One lender automated the ordering of all third-party services upon reaching the "application and disclosures complete" milestone to ensure that the processor focuses on higher value-added activities. This lender segmented each employee's job in the manufacturing process to a very specific and well-defined job description. The result was a 40 percent decrease in turnaround time.

Many of these observations apply to wholesale and correspondent lender channels. The most frequent criticism we hear is the lack of integration between the lender and the wholesale or correspondent's LOS.

Financial and internal controls

Integration between the LOS and general ledger can also provide actionable data to improve profit. One lender validated end-to-end pricing to ensure that the expected loan revenue from the lender's pricing engine is reconciled with the final amount received from an investor.

Such a process detects revenue leakage in a number of areas. For example, configuration exceptions or errors in the pricing engine can be detected by end-to-end pricing validation. This is especially important when regional or branch-level pricing is used, and where lender overlays involve price adjusters. Changed circumstances that affect loan pricing can also open the door to revenue leakage unless careful validation of price changes and application of appropriate loan-level price adjusters is performed.

Frequent reconciliation of the loan warehouse lines can detect bank errors, interest computation errors, collateral exceptions and related issues.

Reconciling the investor funding sheet at a loan level to expected profit can detect revenue leakage from missed price adjusters, uncollected fees, correspondent or GSE price errors, secondary market hedging exceptions, high fallout rates and best-execution exceptions.

THE MOST FREQUENT CRITICISM WE HEAR IS THE LACK OF INTEGRATION BETWEEN THE LENDER AND THE WHOLESALE OR CORRESPONDENT'S LOS.

IT security

Good internal controls also include the information technology (IT) security of the LOS and related systems. Every LOS has known security "exploits" that internal employee collusion and/or outside agents can compromise.

Good IT security can ensure that customer and internal confidential data is not compromised by internal or external actors.

Vendor management review and internal controls should be applied to every vendor that has access to your network or confidential data. Particular attention should be paid to the vendor's security procedures and whether it has liability and data-breach insurance.

Internal data can be compromised by a lender's employees. Branch pipeline or loans in process data can be compromised when loan officers or branch managers leave the company. Control must be maintained over operations to ensure that only authorized loan officers, brokers or correspondents have access to company IT resources.

Administrator privileges should be confined to the fewest number of administrators who have a need to access broad system functions. Poor control over administrator privileges is one of the most frequent security exploits that leads to losses for lenders.

Readers are welcome to visit our website (www.teraverde.com/checklist) for a free summary of more than 60 ideas to improve profitability and reduce revenue leakage in their mortgage lending business. **MB**

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