

Optimizing Best Efforts Flow While Preparing For Mandatories

Access to clean, accurate data for decisioning boosts efficiencies and profits in secondary marketing.

By Greg Crosby

Today's changing mortgage market presents many new challenges, and originators are under more pressure than ever to maximize efficiencies and boost profits in their secondary marketing. For some, it's more than a matter of remaining competitive - it's become crucial to survival. Many look to mandatory sales as a way to increase profit margins, but are wary of and often unprepared to deal with the heightened risk exposure that comes with the opportunity.

It's not an all-or-nothing proposition, however. For those selling loans on a flow basis, great gains in efficiency can be achieved by optimizing current best efforts processes. In addition to seeing an immediate improvement to profits and operations, originators with highly efficient and sound best efforts processes become perfectly poised to move into mandatories when it makes sense to do so.

When it comes to increasing efficiencies in a best efforts flow, the goal is to maximize the profitability equation, which is itself a function of risk management dependent on quality data. For the originator, the time between locking a commitment with a potential borrower and then closing and selling the loan is marked by

two primary risks: market fluctuations and the borrower's likelihood to close.

Opportunity knocking

Originators need to guard against market price drops by selling loans forward at the optimal price without leaving money on the table. At the same time, if the market goes up but the borrower backs out before closing, the originator loses money on a forward sale. With such a narrow window of profitability, it becomes especially important to manage exposure to market volatility. Playing the margins intelligently is key to maximizing success.

Another risk is in mis-locking the loan entirely based on faulty data and having to absorb the cost when the loan is refused. To avoid such mistakes, make informed secondary marketing decisions and maximize profits, originators must have access to sound information. Unfortunately, access to such data can be problematic.

Many originators still manage best efforts processes using spreadsheets, and most operate under the assumption that loan originating system (LOS) data is accurate. These methods often produce an unhealthy dependence on internal resources to manage cumbersome spreadsheet configurations, relying on inaccurate

data. Inherently, manual data entry holds significant potential for human error, leading to mis-keyed information propagating throughout the originator's systems - and backing crucial sales decisions.

While high-end LOSs have controls in place to avoid input errors and/or falsifications, a great many do not. Data used to make loan sales decisions is only as sound as the LOS from which it is taken. Incorrect conversion between systems or attempts to merge multiple sources without proper integrity checks can lead to data errors and faulty decision-making. By confirming the integrity of their data, originators can substantially increase operational efficiencies and reduce the risk of loan buybacks and strained investor relationships.

The first step is to screen data for potential problem items - and their source - and to rectify errors before they trigger a loss. Catching and fixing errors immediately allows the origination process to continue without incurring costly delays or fueling faulty decision-making based on bad data. No matter how good the predictive models are, if based on faulty data, they will produce flawed results.

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The originator should also be tracking changes to loan data. A loan sold forward according to specific product terms may become ineligible if key elements subsequently change. More often, the lock still qualifies for an investor commitment, but at a lower price. This would normally be priced back to the borrower, but if not discovered until after closing, the lender takes the loss. Whether the result of simple error or overt fraud on the part of a rogue loan officer, the originator must be made aware of any changes early on.

It's therefore important that the originator tracks loans all the way through the secondary process, including confirming that loans in the work queue are actually sold as expected. Identifying unsold commitments and those for which investor confirmation has yet to be received can serve as an early warning to a possible problem, allowing the originator to take steps to resolve the issue.

Without stringent controls, the originator also risks fostering ill will with investors. Investors will refuse purchase if a loan is found to differ from what was put forward in the commitment, forcing the originator to hold the loan at its own cost. If that investor also provides the originator's warehouse line, repeat errors can lead to constrictions of lines, erosion of pricing, decreased sell-forward times and, ultimately, termination.

Costs are many

Costs from data errors come at the originator from a variety of directions, including negatively affecting the originator's own capacity to push loans through the system. The shop that has to spend time and slow production to fix errors after the fact will find loans sitting on warehouse lines longer, drying up available credit to fund new business. The seller then usually takes a hit on pricing to move those loans off the lines.

The seller with shrinking profit margins is likely to offer less advantageous pricing to its own sources, often losing top originators to other lenders offering more attractive terms. Having better access to accurate data means that

the originator can isolate and correct any errors in processing, sell that loan at the best price to the right investor and remedy any errors with its originating party while the cost to do so is still negligible.

Originators with a better sense of their data can focus on making best execution decisions that positively impact the bottom line. Running an analysis of the terms, requirements and pricing of various investors allows the originator to make the most informed decision for selling a particu-



lar loan. Freed from spending an inordinate amount of time fixing issues, originators can explore the highest pricing for a given lock and attend to growing their core business.

In the process, the originator also wants to be certain that loans originated are actually bringing a profit. Properly analyzing market and loan data can show clearly - at the point of lock-in - what the expected gain on sale would be. There are situations where, while an originator is achieving best execution, the borrower has locked in at a rate/price that would actually result in a loss for the originator. Obviously, the originator wants to know immediately if this is the case.

Many originators are pulling data from multiple systems, both internal and external. By introducing consistency of format and enabling the accurate conversion of data from one system format to another, errors are diminished and workflow accelerated. As the loan moves through the pipeline, the originator has more confidence in its decision-making, knowing it was based on the full benefit of quality, accurate data.

Streamlining the transfer of clean, verified data also helps in the back office. The accounting department benefits by receiving financial data in the format most useful for its needs, reducing time, cost and effort on that front, as well. Setting up an automated cycle for these data exports will dramatically reduce the resource strain of meeting periodic accounting requirements.

The same dynamic applies to sending data upstream to the investor. By ensuring the investor is getting the data in the format requiring the least effort to process and review, the originator is effectively expediting validation and payment. If the originator shifts to a bulk mandatory method of sales, expediting and easing delivery to the investor will increase good will in that relationship at the same time.

While some sellers may feel they can handle all of the above through a combination of spreadsheets and homegrown databases, they're most likely mistaken. It's an enormous task to create a system that is as robust, secure, tested, supported and adaptable as currently available specialty solutions. That is not to mention the enormous resource risk that comes from depending upon particular individuals for core processes to function correctly.

When a single person or small group is responsible for handling complex spreadsheets and calculations on which the originator is relying for pricing or managing best efforts executions, if that resource is suddenly gone, so is the originator's ability to function properly. It makes much more sense to align mission-critical operations with a system that is equally effective irrespective of the individual resources using the system.

Actionable intelligence

These systems also offer valuable intelligence that simply would not be available with a homegrown approach. For the originator looking to shift to mandatory sales, understanding fallout tendencies and other characteristics can mean the difference between success and failure. A loan's fallout tendency is the percentage -

given specific interest rate movements - of borrowers who close lower than the original terms of the lock or walk away before closing.

For the originator selling loans on a mandatory basis, understanding fallout tendencies is also key to properly hedging against risk and maximizing the profit equation. Building fallout tendency models based upon real assumptions shows what characteristics these loans hold in common. Data can be analyzed to find what percentage of borrowers decline and what model they fit (i.e., point in the lock stage; length of lock, purchase or refinance; Internet or in-person origination; individual product type, etc.).

This information is particularly illuminating for the best efforts flow originator thinking about moving into mandatories. Before ever taking on the first mandatory commitment, the originator can see how similar sales would have trended. Decisions

can be made knowing exactly what sort of fallout curves and exposure to the market could be expected in similar situations in the future. With that understanding, and by optimizing the costs of hedging, the originator can calculate how much additional profit it would actually retain based on exposure to fallout and make informed sales decisions from that position.

By basing these decisions on the originator's own data rather than outsourcing to a risk management service, projections become much more accurate and uniquely applicable than those hinged on generalized assumptions. Only by examining its own data can the originator get a picture of its actual gain on sale and find out where profit leaks can be plugged. Analysis of the firm's own data can also provide a much more granular understanding of individual loan products' suitability for mandatory sales.

Fallout tendencies may show that

one or two products are perfect candidates for mandatory - presenting the lowest risk for the reward - while others have curves too erratic or investors too unstable to warrant the extra risk. Knowing one from the other is crucial before making mandatory commitments. Some loans are absolutely better off left best efforts, while other situations can be hedged effectively and affordably so as to widen profit margins while still minimizing risk.

Whether planning a shift to selling loans on a mandatory basis or simply seeking to maximize efficiencies and profit margins on existing best efforts flow, robust data analysis and streamlining software make a huge difference in overall profitability. Originators can play margins more intelligently, patch efficiency leaks in their operations, focus less on fixing problems and more on originating loans, and take their business to the next level.

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