

With superior brand strength and deep customer ties, alert regional banks can gain profitable market share amid the mortgage shakeout. Will they act in time?

Mortgage Crisis: Opportunity for Regional Banks?

BY KENNETH ALVERSON

At a time of crisis in the U.S. residential mortgage industry, surviving lenders are understandably preoccupied with containing the damage. In addition to working through a growing book of problem loans, regional banks must also focus on rebuilding both capital and core funding.

But even as the mortgage mop-up continues, a new window of opportunity is presenting itself for players who previously may have stayed on the sidelines. A sizable vacuum has been created amid the collapse of the securitization market, the exit of hundreds of small mortgage companies and brokers, and the distractions of forced mergers among the biggest players in the market.

Regional banks are particularly well positioned to capitalize on this situation. Their competitive advantages include a rediscovered status as trusted providers, deep market knowledge and customer ties, and dense distribution

systems within desirable regional markets. The two main growth opportunities include cross-selling mortgages to established banking customers and selectively acquiring new mortgage customers situated within the franchise footprint.

To take advantage, regional banks will need three major types of strengths:

- ❖ *Advanced customer-analytical capabilities.* Rich insights into major customer segments are essential in precision-targeting and -pricing for attractive prospects.

- ❖ *Mastery of the inter-related elements of profitable lending.* This includes risk management (including credit, interest-rate and liquidity risks), as well as debt management of capital and risk-adjusted returns.

- ❖ *An efficient and effective operating model for distribution, fulfillment and servicing.* A system is needed that reinforces the bank's consumer objectives (e.g., convenience, speed, reliability) while delivering transactions at a low unit cost.

Such capabilities are well within the grasp of regional banks. And they are eminently worthwhile to develop, given the competitive disarray and profitable growth potential emerging from the current market. Relatively swift action is needed, however, before the newly merged titans of the business start flexing their muscles.

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In the span of just a few months in 2008, federally mandated and assisted mergers concentrated 57 percent of the mortgage origination business and 46 percent of the mortgage servicing business with just three institutions: Bank of America Corp. (BoFA), Charlotte, North Carolina; JPMorgan Chase & Co., New York; and Wells Fargo & Co., San Francisco. As the megabanks put integration issues behind them over the next year or two, each will emerge with additional scale economies, operating efficiencies and national market clout. Thus, the time for regional banks to act is now.

MOMENT OF DECISION

There is a substantial window of opportunity for regional bank expansion following the exodus of hundreds of mortgage-origination entities and the collapse of the non-agency securitization market. Borrowers are justifiably skeptical in the wake of the very public blunders by former major players such as Countrywide Financial Corp., Washington Mutual Inc. and Wachovia Corp.

In turn, more customers are turning to regional banks and local credit unions as trusted providers of residential mortgage financing—a powerful relationship anchor, given that a mortgage is the largest obligation that most families typically assume.

Meanwhile, the economics of residential lending have swung back to the favorable environment of the late 1980s. Prime residential lending margins, particularly on jumbo products, are wider than ever—despite much tighter underwriting and appraisal processes—opening an attractive profit window for new entrants (Figure 1).

In fact, 24 top lenders reported a combined \$9 billion in first-quarter 2009 mortgage profits, according to *Inside Mortgage Finance*, roughly twice as much as the previous record for a quarter. Handled correctly, this opportunity to generate profitable mortgage growth is unparalleled in the current environment.

While spreads are not expected to last indefinitely at the current lofty levels, neither will they soon return to the valleys of 2006. After all, bank liquidity remains at a premium, the securitization market for nonconforming products continues to languish, and government-sponsored enterprises (GSEs) are

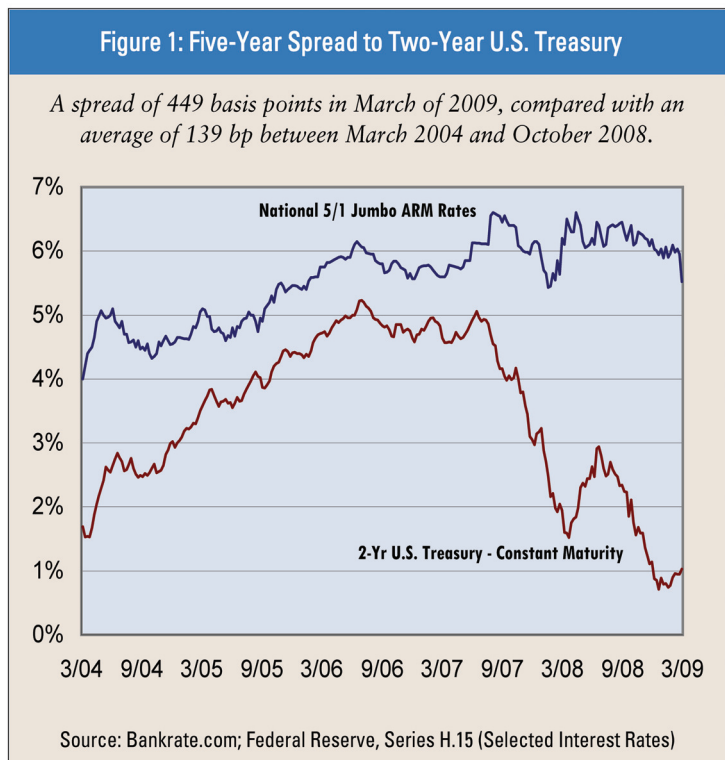
more appropriately pricing for risk. For some time to come, regional banks will have the luxury of fully pricing for risk while curbing credit exposure through tight underwriting.

As credit markets slowly recover, residential lending offers a substantial growth and profit opportunity, particularly for skilled players that are able to gain market share. From the standpoint of originations, the market already is rebounding from the nadir of 2008.

The Mortgage Bankers Association’s latest consensus forecast anticipates \$2.07 trillion of origination volume in 2009, up 29% from the previous year, followed by an estimated \$1.96 trillion of volume in 2010 and \$1.89 trillion in 2011. If markets rebound more quickly, origination volumes would expand as well, presenting an even more compelling opportunity to grow revenue and improve risk-adjusted returns.

Beyond their attractive spreads, residential mortgages are simply one of the few remaining areas of profitable growth for regional banks. Together, first mortgages and home-equity credit constitute more than 80 percent of total consumer debt for Americans, according to Federal Reserve statistics. They facilitate core consumer borrowing needs such as primary housing, home improvement, debt consolidation and educational finance.

The expansion opportunities in mortgages are



especially compelling compared with other asset categories. But the residential mortgage expansion opportunity won't wait forever, nor is it exclusive.

As BofA, JPMorgan Chase and Wells Fargo work to regain their footing, nonbank players sense an opening as well. Examples include insurers such as State Farm Mutual Automobile Insurance Co., Bloomington, Illinois, and Metropolitan Life Insurance Co., New York; asset managers such as Fidelity Investments Institutional Services Co., Boston, and Charles Schwab & Co., San Francisco; and private-equity-sponsored entities such as Prospect Mortgage Co. LLC, Northbrook, Illinois.

Mortgage origination volume also is being claimed by affinity-flavored institutions, including credit unions and the banking arm of the United Services Automobile Association (USAA), San Antonio, which serves military personnel.

Some of these new entrants may soon be nipping at the heels of regional banks in residential mortgage expansion. They have substantial resources, solid brands and valuable customer inroads backed by proprietary databases. Nonbanks also may be less encumbered from an operational perspective, free from outdated legacy platforms and impaired loan portfolios built up during the recession.

FOCUS FOR SUCCESS

The most immediate opportunity for regional banks is to cross-sell mortgage products to established customers. This cross-sell connection is especially compelling for banks that previously emphasized the depositor aspect of customer relationships, in that they have the greatest untapped potential and already are established as trusted providers.

From a marketing perspective, the goal is to develop a precise understanding of the needs and preferences of prime prospects, as gleaned from proprietary customer data. By analyzing the behavioral patterns and profiles of established customers, banks can develop solid lists of the prospects who are most likely to respond to targeted marketing initiatives. This is a great advantage over out-of-market and nonbank competitors, whose mortgage cross-sell possibilities are more limited.

The second major opportunity is to attract new customers within the broader branch footprint. Regional banks have marketing advantages in this area as well, including superior local brand presence, solid reputations and detailed market knowledge. These attributes are especially valuable at a time when so many mortgage-related entities have suffered reputational damage and are in internal disarray.

Among regional banks scoring early wins in mortgage expansion, some are augmenting their traditional sales force and fulfillment models with direct-to-consumer capabilities, including over the phone and the Internet. They want to do more than just wait for customers and prospects to walk into the branch or respond to newspaper ads.

As Paramus, New Jersey-based Hudson City Savings Bank has demonstrated, residential mortgage lending can be quite helpful in attracting and binding customers to the institution. And if properly targeted and marketed, mortgage loans serve as a profitable anchor product that paves the way for the cross-sell of other banking products. And from a risk perspective, multi-product relationships often correlate with lower loan default rates and improved risk-adjusted returns.

Hudson City has pursued a growth strategy centered on conservative and targeted high-value residential lending, as evidenced by details in Hudson's 2008 annual report showing a loan portfolio almost entirely composed of first mortgages—two-thirds of which are jumbo loans.

The institution was actually able to improve performance during the recent market downturn. Between 2006 and 2008, a calamitous era for many lenders, Hudson City increased mortgage loan balances, earnings per share and its return on equity, while improving efficiency and delivering superior credit quality, also according to the 2008 annual report. This is an encouraging example for well-managed banks considering an expansion into residential mortgage lending.

WINNING CAPABILITIES

To achieve consistent profitable growth in residential lending, regional banks will need to

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develop three types of differentiating competencies, including: 1) advanced customer analytics; 2) profitability-based decision models; and 3) “best-fit” operating capabilities.

Advanced Customer Analytics. The edge that many regional banks bring to mortgage lending is an unmatched depth of understanding about their current customers. This insight can be sharpened by applying advanced analytical methods and tools to the vast stores of customer data available to the bank through its retail systems.

From a marketing perspective, the goal is to discern subtle differences among customers, their relative profitability profiles, and their distinct needs and preferences. In turn, an understanding of segment-specific patterns can allow a bank to selectively tap attractive pockets of opportunity, both with established customers and among high-value prospects across its geographic footprint.

One approach, for example, is to array various customer segments by estimated profitability and risk (Figure 2). Within “priority” and “average” segments for potential risk-adjusted profitability, the bank can then look deeply at customer profiles to determine the product features, marketing messages and pricing dynamics that will work best with each group.

By creating clearly defined customer segments, it becomes possible to identify the most profitable

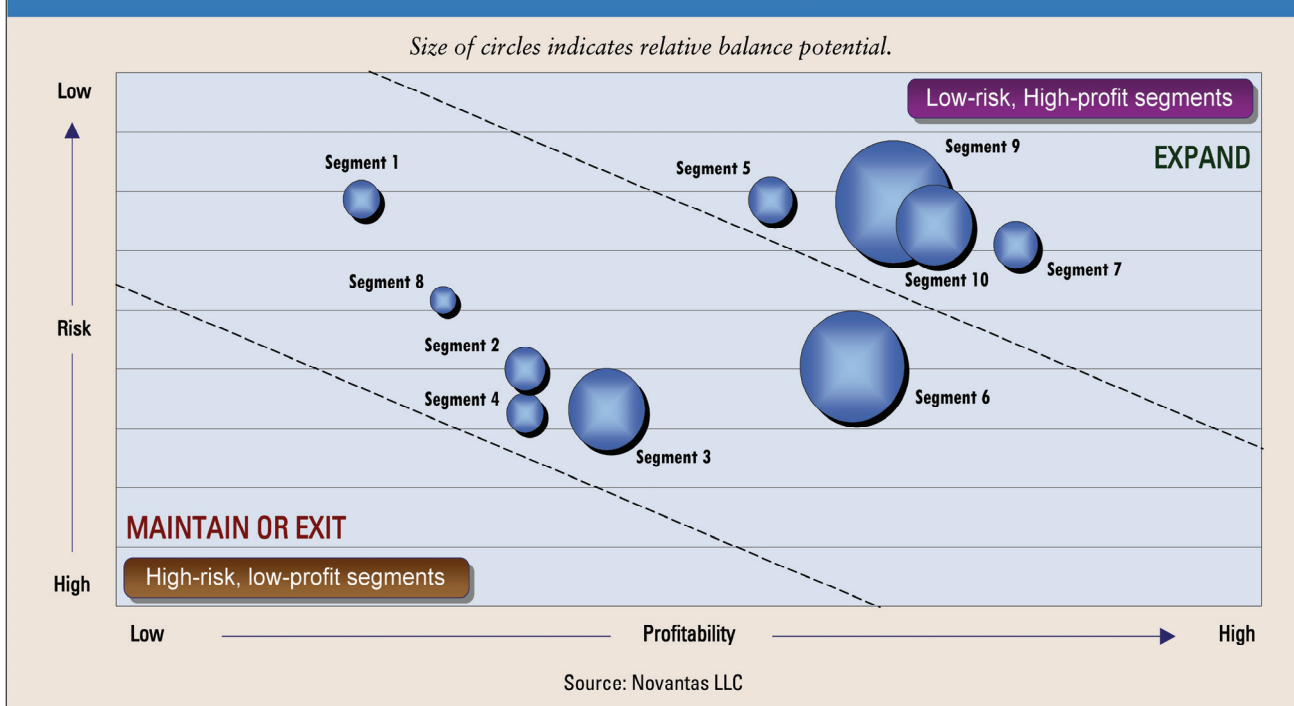
mortgage lending prospects across different risk levels. Ultimately, some market segments may be de-emphasized or avoided, as indicated by lackluster projections of risk-adjusted profitability.

Precision analytics can support strategies and decision-making over the entire customer life cycle, including product development, account management, loss mitigation and even collections. While it is true that the newly formed “Big Three” mortgage lenders bring scale and sophistication to this endeavor, many capabilities are well within the reach of regional banks, particularly given the wealth of local market and customer data already residing within these institutions.

Profitability-Based Decision Models. With balance sheets that are generally in better shape than those of the very largest banks, many midsized players have the opportunity to carry more residential mortgages directly on their books—an advantage at a time when securitization and other forms of liquidity are constrained. Compared with other lending options, this is a potentially superior way to improve net interest margins and risk-adjusted returns.

A systematic approach is vital, however, calling for 1) risk-adjusted profitability models; 2) precision pricing capabilities; 3) advanced asset-liability management strategies, including economic capital allocations and funds-transfer pricing; and

Figure 2: Illustration of Hypothesized Segment Scoring by Risk and Profitability



4) advanced performance metrics and an ability to incorporate them into decisions on customer prospecting, product design and product pricing.

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Novantas research repeatedly reveals dramatic variations in risk-adjusted profitability among various portfolios, products and client segments. In examining client bank portfolios, for example, we have found instances where up to half of all residential mortgage accounts are not yielding adequate returns on a risk-adjusted basis.

While it is essential to stay on top of such baseline risk factors, the most successful players will be those that also consider the larger picture of customer preferences and strength of demand, particularly as these factors relate to pricing. To manage tradeoffs between margin optimization and balance formation, progressive institutions increasingly are incorporating segment-based calculations of price elasticity of demand.

“Best-Fit” Operating Capabilities. While regional banks have well-established distribution systems, they likely will need to tailor the operating model. Considerations include efficiency in mortgage sales, fulfillment and servicing; pricing and secondary marketing; and managing customer relationships and a complex set of risks.

One emerging requirement is a streamlined mortgage fulfillment mechanism. Typically, the bank needs a setup that: 1) minimizes the time and involvement of busy branch officers in handling new business; and 2) smoothly hands off clients to a specialized direct lending center that can efficiently take applications and follow through to close. In fact, PHH Mortgage Private Label Solutions, Mount Laurel, New Jersey, has made a fast-growing business from providing “white label”

mortgage fulfillment capabilities to literally dozens of regional banks.

In the realm of ongoing customer interaction, expansion-minded banks are taking a systematic approach to expanding and retaining relationships with their mortgage and home-equity borrowers. Areas of emphasis include promoting product utilization, identifying cross-sell possibilities through migration-propensity models, and creating targeted retention strategies. Additionally, progressive banks have learned that an iterative test-and-learn capability can provide quick and meaningful insights into what works—and what doesn’t—with their customers.

Given the current challenging market, regional banks also will need advanced skills in loss mitigation and default management. Requirements include risk-identification tools that span the customer life cycle, and a full menu of creative remediation capabilities—especially loan modification techniques—to maximize recoveries.

To preemptively identify customers on the path to default and manage the bank’s exposure, institutions will need to conduct active account reviews; provide hands-on management of limits and draw activity on home-equity lines of credit; and set up pre-collection default programs.

Relationship-oriented collections and default management require an understanding of customer value at-risk, as well as the nature of customer delinquency. The most successful banks will be those that engage in proactive negotiation with distressed borrowers to rectify troubled accounts. The goal is to go beyond government-sponsored efforts, such as the HOPE for Homeowners program sponsored by the U.S. Department of Housing and Urban Development (HUD).

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Currently, credit card issuers are leaders in early problem detection and systematic workout programs with overextended households, and we anticipate that many regional banks will learn to

apply such skills in mortgage and home equity lending over the next few years.

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ROADMAP APPROACH

On the road to becoming a top regional mortgage lender, there are three waves of activity that will facilitate a successful bank migration, including stabilizing performance, laying the foundation for growth, and attaining leadership (Figure 3).

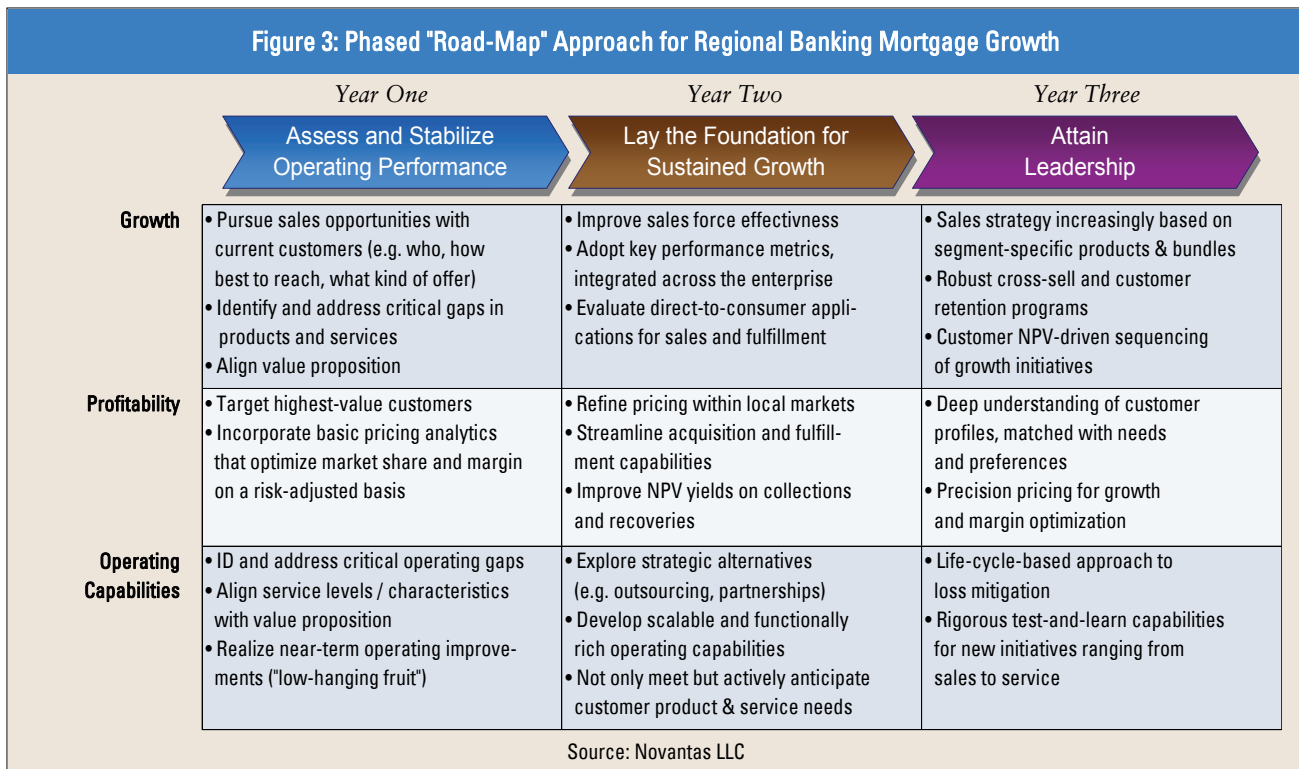
◆ *Stabilize performance:* Near-term objectives include identifying and prioritizing major operational, product and service gaps; ensuring bank-wide alignment with the underlying consumer value proposition (i.e. convenience, price, service); and then taking full advantage of quick-win sales opportunities with established banking customers.

Simultaneously, banks should begin honing in on high-value sales prospects and applying basic pricing analytics that balance the twin objectives of building market share and maximizing risk-adjusted margins.

◆ *Lay the foundation for growth:* This phase includes deploying advanced analytics; establishing efficient and scalable operations; and instituting rigorous performance standards to improve profit margins while building balances and revenues. Regional banks also will need to evaluate strategic alternatives, such as outsourcing or partnerships, for essential mortgage-related functions such as fulfillment, servicing and default management.

Critical to building lending momentum is engaging customers in a consistent manner that fulfills the brand promise and stands out distinctively from competitors. The organization must become adept at anticipating customer product and service needs, and it will need solid operational capabilities that provide rich functionality. At the same time, banks must invest in capabilities that will help to uphold long-term profitability, such as precision pricing and optimizing collections and recoveries.

◆ *Attain leadership:* Future regional banking leaders in mortgage lending will be the ones that develop a deep understanding of customer needs and preferences; nurture a profitability-based



culture; and seamlessly manage the various aspects of residential mortgage risk across the entire customer life cycle.

Banks at this elite stage will go to market with segment-specific product bundles, backed by robust sales and retention programs targeted at high-priority customers. Finely honed value propositions will enable the market leaders to provide unique value to customers while ensuring proper pricing and risk safeguards for themselves. To ensure continued improvement, leaders will employ rigorous test-and-learn capabilities for the ongoing development of new insights into more effective sales and service strategies.

IMMEDIATE TRACTION

Clearly, some regional banks may feel overwhelmed at the prospect of fleshing out all the capabilities needed for robust residential mortgage growth. It's a long list that includes segmentation analytics, profit models and operating capabilities. Yet many of the essential strengths already are in place,

including customer knowledge and local brand strength. With a phased growth plan, it is possible to gain fairly immediate traction while steadily layering in the advanced skills and tools needed to sustain long-term growth.

There's a fleeting window of opportunity to make headway, before both the Big Three and new market entrants shift into high gear. Alert regional banks will seize the moment to effectively cross-sell existing clients, as well as expand their share of profitable in-footprint mortgage lending opportunities. These priorities can become an integral part of a winning regional consumer banking strategy.

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