



Performance Capital Services Newsletter

Organizing Complexity into Execution!

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Dear Tony,

The objective of our newsletter is to provide strategic news and analysis for financial services and banking leaders regarding current and future market conditions, strategic positioning and execution as it relates to organizational strategies.

The underlying assumption at all times is that the markets continue to become more complex, change faster, and require better thinking and aligned execution for companies to meet their goals.

Sincerely,
Tony Pallante

Meaningful Short Term Planning

I couldn't help crossing from music to business while listening to Dirk Bentleys great little song with the chorus "I know what I was feeling, but what was I thinking?"

In situations where fear and uncertainty rein, it is natural for management teams to disconnect from facts and information gathering and to rely more heavily on "gut instinct". That is not to say that experience and expertise shouldn't be relied on. What I am saying is that experience and expertise joined with facts and meaningful information provides the basis for the best decision making.

The natural tendency is to move quickly on tactical objectives like staff reductions since they are financially based i.e. our financial forecast indicates we need to reduce headcount by 500 FTE. Armed with this information lists are gathered and decisions are made often at the expense of achieving as many of the strategic goals as possible while concurrently reaching the immediate financial demands.

This is not to say that speed should be sacrificed. Speed will be improved by organized thinking and coordinated execution while limiting the negative impact on morale and culture.

Below are a few of the strategic questions executive teams should be answering in developing short term plans;

- What do we know?
- What don't we know that we need to know?
- What do we control?
- What don't we control?
- Using what we know and what we can control how do we align to our financial objectives?
- Using what we know and what we can control how do we align to our strategic objectives?

| Meaningful Decisions | | | | | |
|--------------------------|---|--|--|---|--|
| | Guess | We Know | Need to Know | Don't Control | Do Control |
| Liquidity | Will return in "x" time frame | Does not exist for some products, limited for others, strong for a segment | Firms ability to deploy products with liquidity that maintain minimum profitability | Capital markets and timing, product availability | Product choices |
| Margins | Will return to acceptable levels on "y" products in "x" time frame | Unprofitable/ Profitable to the firm at current margins | What is the profitable margin | Competition and margin volatility | Origination revenue, expense, channels |
| Profitability | If we hold for "x" timeframe the market will come back and we'll be profitable | Not profitable today | Which business configurations provide competitiveness and acceptable profitability with what we know and control | Liquidity, capital market pricing, volatility | Business configuration i.e. business lines, channels, organizational structure, products, expenses |
| Lines of Business | Minimize and hold unprofitable lines of business since they are sure to return to profitability | The size of the balance sheet and strength of other business will/will not support our guess on unprofitable lines | Financial forecast and period for holding unprofitable business lines. | Market factors affecting the business line(s) | Other lines and/or balance sheet meet/miss forecasts. Definitive decision points for action |
| Org Structure | If our existing alignment supported similar products and processes it will support others | Current competencies and weaknesses | Strategic mismatch between our current competencies and newly required competencies. What will it take to bridge the gap | Organizational acceptance of strategic and cultural changes necessary | Quality, level and periodicity of communications and compensation and reward alignment |

The Blame Game

We've been queried frequently this year about who is to blame for the industry crisis. This is not an exercise we like to engage in since hindsight is always 20/20; however if we leave the blame out and use the benefit of hindsight, we gain knowledge and are better educated to deal with the future.

The focus of the discussion has revolved around the mortgage banker/broker, the investment bankers and the rating agencies. Without going into the detailed complexities of the flow of these transactions (a PowerPoint presentation training module we use may be found here [Secondary Marketing](#)) I would posit the following;

Mortgage Banks

Mortgage Bankers and Brokers have originated over 60% of annual mortgage volume for the last 10 years. The business is, in its basic form, is matching customers to capital markets (Investment Banks, Banks, other Mortgage Bankers, GSE's). Whether selling loans individually, in pools and/or through securitization Mortgage Companies attempt to find the balance between serving the customer's product needs and offering profitable products. The value proposition to the customer is the one-to-many relationship. The Mortgage Company is one point of contact, takes one customer application, and provides one "trail guide" if you will that has access to many lending relationships, products and terms the customer may not be aware of. The customer receives value for their service, as does the eventual purchaser of the loan who has foregone the significant marketing expenses associated with gathering new customers.

Capital Markets

Banks and Investment Bankers buy and hold loans or buy and more typically securitize these loans. Again, simplistically, this is a method of maximizing the efficient use of capital not dissimilar from a retail store that increases profitability by increasing product "turns". Turning, or selling inventory, at greater frequency increases profitability. Selling and securitizing loans (turning) more frequently brings more profit on the same amount of capital investment. If the firm has to borrow \$95 to make \$100 in loans (traditional bank model using deposits and lends the "borrowed" money) and then hold the loans, the \$95 is not available to make additional loans. If the company sells their loans, then they receive their profit and free up the initial \$95 to make another \$100 in loans. The faster they can generate and sell their loans the higher the return on capital and profit.

Investment Banks package and trade pools of mortgages by converting them into securities in the form of bonds. Income to the Investment Bank is derived through a variety of fees and commissions for packaging the pools and issuing bonds to investors. Large volume and faster turns equals higher the revenue.

Rating Agencies

The rating agencies (i.e. Moodys, Standard & Poor's) are structured to act as the

independent third party in securitized transaction. They provide guidance in structuring the risk characteristics of pools assessing a host of risk factors including; the quality of the company originating the loans, their adherence to underwriting guidelines, quality control and risk mitigation procedures and mortgage loan characteristics (credit quality, terms, pre-payment penalties, delinquency and loss forecasts).

Structuring pools is an iterative process between three parties. Originators/sellers and the investment bankers are trying to maximize the profit they receive, the rating agencies are trying to quantify investor risk to the greatest degree possible.

The Moral Hazard

Each of the parties are, of course, involved in these transactions to make a profit. The competition is fierce. To point at the originator/sellers and say they shouldn't have been making these loans when the capital markets are buying them and their competition is selling them is, in effect saying, "limit your growth, fall behind the competition and put the business at risk."

Investment Banks through their creativity and goal to make a profit have created liquidity and products that benefit the market as a whole. Investors get investments and returns, banking is not limited to the banking system and customers get more products, liquidity and options. They make the market and to point to them and say they should have limited the risks is akin to telling a NASCAR driver he has to race in a Volvo.

Is there moral hazard in all of this?

Of course there is. There is moral hazard in every activity, and every business where economic profit is involved. It is why structures are created to reduce the hazard to the extent possible. This is typically done through regulation, increased transparency and the check and balance of disinterested third parties. One doesn't have to travel far to make the connection to the role of independent auditors in the review of public companies that affirm to stakeholders (stock holders, lenders, investors) that the financial and operational representations presented by management are as stated. It is also just as easy to make the linkage between the current mortgage market situation to Enron and their "independent auditor" Arthur Anderson.

Let's look at each of the checks and balances: regulation, transparency and disinterested third parties. The banking industry is already over regulated. The web of disclosures and regulations that have been constructed over time under the auspices of making things clear to the customer are only more obfuscating for them. For the debt instrument, the loan, transparency is quite clear in that they are made for certain terms, at certain yields. What is not so transparent is the underlying credit (performance) and collateral value. If we leave out obvious issues like fraud, these factors are managed based on the best available information at the time. Complex modeling and experience are applied to forecast these outcomes. The fact that it is a "forecast", by its very nature, implies volatility. The further we move beyond known, proven factors and experience in our forecasts, the higher the volatility range around those forecasts.

This brings me to disinterested third parties. First the concept of "disinterested" proves the most difficult moral hazard of all. The rating agencies compete for the opportunity to earn fees from the transactions they are rating, just as independent auditing firms compete and are paid by the companies they audit, clouding the definition and purpose of being "disinterested". Rating agencies core currency and strength of their brand is their credibility in the marketplace. Balancing this against the economic incentive is an issue that will rarely be in balance. This is not the "fault" of the rating agencies; it's the way the system is structured and in my opinion the area that needs to be addressed.

To be more clear, regulations, creating fiduciary responsibilities and assigning them through the chain, are not the answer. All we will do here with an increase in oversight and additional regulations is provide more fodder for ambulance chasing attorneys and our court system.

I do not have the answer, but will posit an option and would look forward to any suggestions others might have. Pay the rating agencies an up-front fee and tie future compensation to how closely the performance of the transaction is to their representations. Too far under performance, or too far over performance (this to insure originator/sellers are in full consideration also) and the payment is forfeit.

The Fed

I wasn't going to comment on the Fed this month however I feel compelled to point out that the Fed is holding its benchmark rate to control inflation. On the other side they are adding liquidity to the market as of this writing by injecting reserves into the banking system. If this translates normally through the system it will have an inflationary effect. This is a bit like pumping the gas and the brake at the same time. It is not enough and they need to stop riding the brakes and let the car get up to speed.

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implementation.

Our Strategy-Cycle-Strategy approach recognizes the requirement to set your business strategy, to integrate the plans into daily operations, to forecast the results, to monitor and measure the outcomes and to adjust the plans on a real time basis.

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