



# Performance Capital Services Newsletter

***Organizing Complexity into  
Execution!***

**July 2007**

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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

### **Margin Compression Hurt; Reduced Liquidity and Regulatory Changes Can Kill**

We're all painfully aware of the pressure put on the non-conforming industry as a result of rising delinquencies and foreclosures. Nervous capital market participants began increasing their loss forecast and reducing return assumptions in turn lowering prices paid to originators.

As we've seen in previous mortgage boom-bust cycles, originators have begun cutting expenses, tightening underwriting guidelines and trimming product offerings as a reaction to the current market environment. Some made it in time or have large enough balance sheets to carry them through, while others did not.

While margins decreased liquidity still held. However, last week the rating agencies changed their assumptions and ratings on a voluminous number of mortgage assets. These changes are an admission that the volatility ranges in the assumptions have increased to a level that signals to investors a much higher degree of outcome uncertainty moving forward. In other words the range of volatility around the assumptions has grown so large that the return (if any) cannot be forecasted with any accuracy.

Remaining participants are again reacting through expense reductions, further tightening of underwriting guidelines, the complete elimination of products and, for some, a hard look at the viability of the business.

Added to this is the increased scrutiny by law makers and regulators as the pain is felt by the consumer. Last week an interagency statement was adopted by the Conference

of State Bank Supervisors, the American Association of Residential Mortgage Regulators and the National Association of Consumer Credit Administrators in a move to expand the guidelines beyond the federal level.

With conditions changing so quickly it is difficult for executive teams to step back to get a view of the future to formulate the future successful business model and adjust their resource allocations accordingly.

There is also not a more critical time to do so.

To be blunt the fact is that these conditions are not a surprise. Perhaps the severity may be claimed as unforeseeable, the "bust" was not. The booms in the mortgage industry have always been followed by a bust.

### **Why?**

Unlike other industries that carve out niches in products or services the mortgage industry is, to an extreme degree, dependent upon Federal Reserve policy. A home is the largest asset, wealth building opportunity and purchase most consumers will ever make. Slight changes in interest rates and economic conditions have a much larger effect on the consumer and thus our industry, than in goods and services in the hundreds or thousands of dollars price ranges.

The Fed is on one of its cyclical missions to slow the economy. It does this, as it has historically, on the backs of middle and lower middle class consumers (something I'll address in another newsletter).

Regardless of the press on how surprisingly great the economy and corporate earnings are, the fact of the matter is we are headed for more trouble.

Since 9/11 the economy has been buoyed by defense and government spending, foreign investment and the housing boom. The Fed's interest rate policies have turned the boom again to bust, and foreign investments are shifting into equities, US Treasuries, and other countries. As a result the consumer spending momentum from the housing boom will wind down.

Note that I say will wind down. *It has not yet reached bottom and the negative effects are not fully realized.* An early indicator is the increase in consumer credit, revolving and non-revolving, increasing both in March of 2007 and May of 2007 by 6.4% which are some of the highest quarterly numbers in 5 years. Equity extraction is now limited and consumers are maintaining spending through personal credit. Time will tell.

## Strategic Implications

The mortgage volume for 2007 and 2008 is still projected to be over \$2 Trillion by the Mortgage Bankers Association. The US population was approximately 270 million in 1999, and is approximately 302 million today increasing by one person every 10 seconds. The demand will be there boom or bust. It is an issue of who will capture market share and how, profitably.

If demand is a given the strategic question is where and how to structure your origination business model moving forward.

### The Business Models

1. The ability to provide mortgage products across the credit spectrum.
2. The move to be a "lender" that provides a variety of lending products and services including mortgages across the credit spectrum.

### Channels

#### Wholesale and Correspondent

Extremely challenging with tighter margins.

Margin pressure will increase further as the regulatory burden increases the level of fiduciary responsibility to the customer not only on the customer facing originator but also the wholesale purchaser.

This will increase operating overhead and risk in most cases to intolerable levels unless the model is radically changed. Centralization of operations and centralization and right sizing of sales forces will be a requirement as will extremely enabled technological support to provide value to the customer and minimize risk to the firm. In short; smaller and centralized, more knowledgeable staff with sophisticated, enabling technology.

An in depth look at how wholesale and correspondent channels might be structured through legal and control structures to mirror retail as closely as possible is an imperative.

#### Retail

Should be a significant focus due to increased control over every factor including risk, the sales process, training and education, pricing, products and pipeline control.

#### Products

Gain on sale in the non-conforming boom reached premiums as high as 104-108bps while low margin Prime products held at 175-200bps.

Today this has inverted with Prime margins stable and non-conforming heading south of 150bps.

The strategic answer is that a company must have the ability to offer profitable products and adapt quickly (within 2 weeks) to shifting consumer and capital market conditions. Prime will always have more stability due to the presence of the GSEs. That does not mean there is zero volatility in Prime. However, if a business is built to these relatively low, stable margins, future profitable opportunities are additive to margins. Other profitable opportunities will shift in and out over time and a business should be prepared to add and subtract conditionally. The goal should be to forget the traditional names we have used (i.e. Sub-Prime, Non-Conforming, Alt-A, and Conforming/Prime) and manage the spectrum.

#### Margin Management

In boom periods with significant margins it's easy for industry participants to manage profitability. During these periods, spreads and revenues outrun inefficient processes, pricing mistakes, and a general abundance in spending. Gathering customers is a far simpler process since the customer experience is typically poor and they are begrudgingly willing to accept the treatment.

This of course, is not an optimal way to manage the firm in boom or bust periods. The main focus should be on all of the revenue and expense factors, managing them with daily frequency and adjusting accordingly.

## Performance Capital Services

Performance Capital® Services ("PCS") is a strategic management consulting company specialized in helping financial services companies achieve results through strategic planning, modeling and 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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