

MARGIN MANAGEMENT BEST PRACTICES

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MARGIN MANAGEMENT BEST PRACTICES

ABSTRACT

This whitepaper provides an overview into the complexities of margin management within the dynamic mortgage lending landscape. Against the backdrop of evolving market dynamics, this paper elucidates the crucial role of recalibrated margin management strategies. Drawing upon extensive industry experience, the author expounds on the core concepts, challenges, and actionable techniques for enhancing profit margins and orchestrating lending volumes in an agile and responsive manner.

SUMMARY AND INTRODUCTION

Within this whitepaper, we'll review the intricate world of margin management, a pivotal driver of success in the ever-transforming mortgage industry. Learn how analyzing market share dynamics and volume trends becomes a strategic compass for effective margin management. Safeguard profitability by managing volatility and navigate through market complexities with the following strategies that empower lenders to adapt and thrive.

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MARGIN MANAGEMENT THROUGH HISTORICAL HIGHS AND LOWS

Mortgage markets exhibit cyclical patterns influenced by economic factors and interest rate fluctuations. During periods of economic growth, demand for mortgages tends to rise as consumers are more confident in their ability to repay loans, while in economic downturns, demand may decrease due to heightened uncertainty and reduced purchasing power.

As the industry witnesses significant pipeline contractions in 2022 and 2023 after a 25-year origination boon, this section emphasizes the importance of a prudent and disciplined margin management strategy for mortgage companies aiming to thrive amid market fluctuations and low-volume periods.



The Impact of Historical Highs

When looking back in recent history, margin management over the twelve months from 2020-2021 could very easily become a lost art. There was a combination of staggering volumes and exploding margins that made it nearly impossible not to post record profits. Most lenders were preoccupied just trying to figure out how they were going to turn their inadequate warehouse lines or find another fifty loans to send through their already exhausted operations team. The last thing they had bandwidth for was micromanaging their margins, which left a large vulnerability, and many lenders were later forced to close their doors during the next economic downturn.

Importance of Margin Management Through Pipeline Contractions

As the market emerged from this 25-year origination boon, lenders started witnessing very significant contractions in their pipelines. In fact, the average MCT client quickly saw a 30% drop from market highs of May 2021 with refinance-focused shops faring even worse. It became quite clear that a prudent and disciplined margin management strategy would soon become the pillar of successful mortgage companies that wished to stand out against their peers.



It is important to reinforce margin management basics. While it may sound like common sense, during times of low volume, it is more valuable than ever to be prepared and focus on your margin management strategy.

SET IT & FORGET IT VS. ANALYSIS & ACTIVE MANAGEMENT

With the invention of the pricing engine and the functionality that has allowed lenders to simply drop a spread in between the investor's published price and that lender's street-facing price, it became simple to establish a pass-through strategy that fixed the lender's anticipated profit margin.

The problem with this strategy is that it becomes a "set it and forget it" approach, which fails to optimize the lender's opportunities for profit gain when the market will bear it by testing price elasticity. This type of price elasticity testing involves adjusting margins up and measuring the immediately following lock volumes.

By actively managing margins, a company can pick up basis points (bps) that might otherwise have been unnecessarily passed through. If volumes subside week over week, the margin can always be tightened back up again. MCT recommends very small increments, but an extra three basis points is an extra three basis points.

Going back to those twelve months of 2020-2021, three basis points was only noise, but if you go back six months farther, three basis points at the bottom line was paramount.

Balancing Volume with Internal Resources

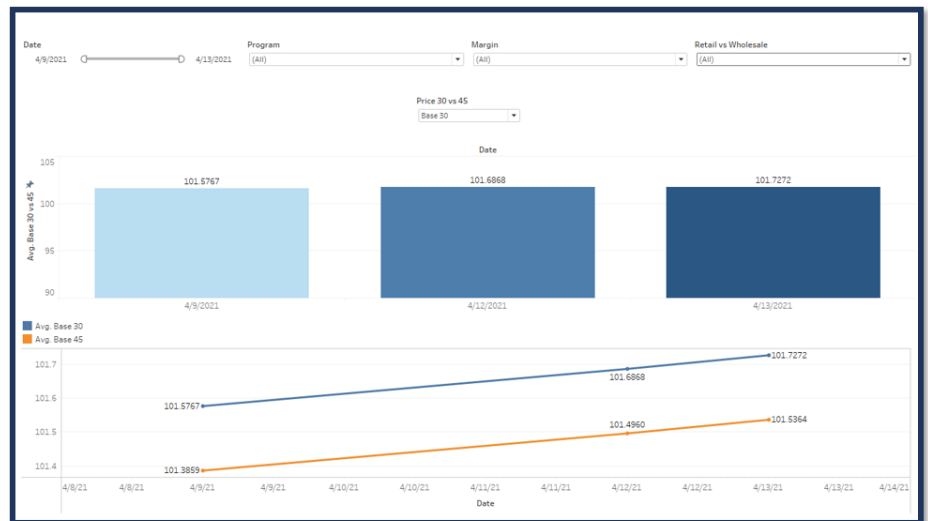
Another issue with unmanaged profit margin is that it really ignores the lender's need to regulate volumes against the company's internal resource capacities.

For example, if resources are being stretched to the point that service levels are being compromised, an increase in the margin could solve the problem by limiting new production, while making up the revenue loss on the conceded volume through larger gains on the loans that are originated.

Essentially, when a company holds a static margin on the pricing engine, it is tethering its price decisions to those of the targeted investor. It is very likely that all the major investors are actively managing their own margin changes based on their own particular circumstances. This can be limiting, especially where lenders differ in their desire to retain [mortgage servicing rights \(MSRs\)](#). A leading investor may have completely different objectives, or could be a standout on specific products which could cause bias to the lender's product mix overall through the process of tethering.

Often times, margin changes can be significant. In that scenario, the lender's margin and profit are just going along for the ride. If the price-targeted investor realized they were over their skis in terms of volume the day before, they might have thrown an extra 25 bps into their pricing to slow down origination. Now, lenders with a static margin tethered to that investor's price have inadvertently widened their price by 25 bps.

It's extremely important to understand where you fit in relative to your peer group as a lender. MCT's [Business Intelligence Tool](#) allows lenders to do just that! Lenders can track the competitive landscape over time using a peer group approach. Lenders of equitable size with geographic origination similarities are undoubtedly competing for loans. Use the BI Tool to search for average rate offerings across your peer group.



MCT Rate Comparison Tool

What Should a Lender Consider in their Margin Management Decision?

Understanding a lender's unique cost to originate is often the best starting point in setting margin. It may also open doors to other issues operationally which could further that lender's ability to set margin more competitively. Investment in technology is paramount in today's environment. Focusing on this one area can lead to reduced cycle time, increased efficiencies, higher customer satisfaction, and a referral basis that promotes additional growth as well as improving overall pull-through rates. Technology can come at a cost that must be factored into the overall cost to originate, but if implementation leads to gains that exceed the current process costs it is worth the money spent.

Operational headcount will always be a large piece of any lender's cost to originate. If we isolate the role of secondary personnel within an organization, we may find that the lack of cohesive technology which supports the role will place the associated personnel in a position to do mundane repetitive tasks. We may also find processes that could lead to a high

degree of error which could cause significant loss if not managed properly. Automation of tasks will not only prevent error, but will free up personnel, allowing them to manage the results and become more of a strategic partner in the approach to improve efficiencies. Comprehensive capital markets software, such as [MCTlive!](#), was built to improve and automate the secondary role. From electronic [to-be-announced \(TBA\)](#) trading to [bid tape assignment of trade \(AOT\)](#), MCTlive! offers increased execution coupled with automation. MCTlive! allows a secondary user to review their hedge position, create a loan sale, and bid to multiple investors quickly and efficiently. Users can also review a best execution analysis that encompasses all their investors, review retained/released considerations, commit quickly and efficiently with aggregators, and write back commitment data to their loan origination software (LOS) all within a short time frame.

Leveraging Technology for Compliance and Efficiency

Heightened compliance requirements over the past decade have forced lenders to spend more on compliance than ever before. Ensuring the technology stack keeps the lender in compliance is now more paramount than ever.

There are a variety of technological advancements that could help across the operational framework. Robotic Process Automation (RPA), can under certain circumstances be a valuable addition, allowing technology to fill out forms or emulate other human actions in the origination process. Using application programming interfaces (APIs) to move data seamlessly and securely has also become more prominent in today's environment.

Reviewing a profit and loss report to see how a company is fairing against target financial goals is also a valuable exercise. This is a different exercise than an ongoing tactical analysis required to adjust pricing mid-flight toward the optimal levels.



Hitting targeted profitability goals does not necessarily mean that a lender achieved maximum profitability or appropriate pricing objectives.

Pricing objectives outside the context of actual profitability mean that a firm should be thinking of pricing not only as a means of bottom-line growth, but also as one of its most effective tools in managing other flows in the business. An example would be the opposite of pricing for volume, but rather using price to push volume away. As talked about previously, price can be a throttle used to slow the machine down when volumes compromise service levels.

This does not need to be in terms of total volume. It could be used in the context of product mix or production mix. A lender could use margins to steer production of purchases versus refinances, or it might free up underwriting space for more profitable loans such as non-QM or Jumbo. There are different scenarios where pricing can be adjusted, not globally, but to adjust production mix. Another scenario would be a lender that's trying to clean up performance based off of investor or agency scrutiny where low FICO loans might have them on the radar of the entities that are buying their loans.

It's important to remember that margin management does not happen in a vacuum. For instance, if a lender's low FICO government production is spiking, even when the lender hasn't made any changes to its margin or pricing, it could be a competitor that has made changes. By not paying attention to your production mix, a lender can become victim to adverse selections in the market, even though no active changes were made. This highlights the necessity for regular analysis and decision-making processes on margins.

MARGIN MANAGEMENT DATA & ANALYTICS

The following section addresses key aspects of effective mortgage management, offering insight into vital considerations for lenders in navigating the ever-changing landscape of the industry. The analysis begins with a focus on volume versus capacity, emphasizing the importance of evaluating fixed duration employment (FDE) requirements in the context of loan production. The discussion extends to the significance of competitive rate comparison, urging lenders to understand their position in the marketplace and leverage third-party competitive intelligence data.

Market share analysis is then explored as a crucial metric, providing a nuanced perspective on a lender's performance relative to peers. This section also reviews the concept of price elasticity testing, advocating for a meticulous approach to adjusting margins in response to market dynamics while considering factors like loan purpose and economic conditions. Finally, the exploration concludes with an examination of day one (basis) versus final execution analysis, offering a comprehensive view of profitability beyond a single month and enabling lenders to fine-tune their margin decisions based on an understanding of their financial performance.

Volume vs. Capacity

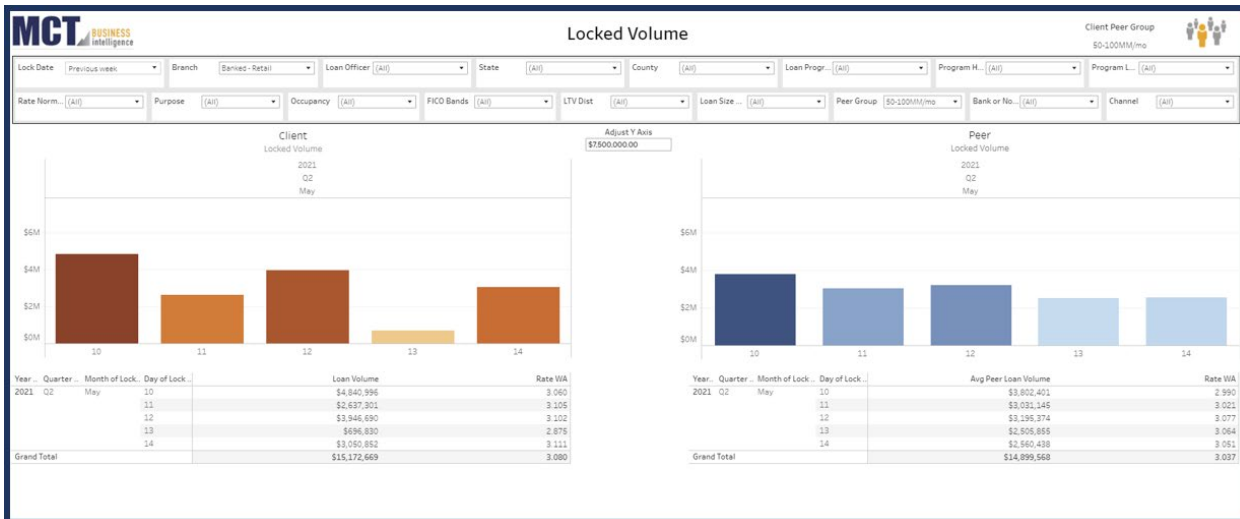
First, volume versus capacity analysis should be completed to provide a good review of FDE requirements for producing a loan and then measuring that capacity against actual production. This not only determines the appropriate headcount for the long run, but also on a short-term basis. You can potentially use price to adjust volumes to bring the firm back to an optimal capacity, rather than taking the time to add or reduce workforce.

Competitive Rate Comparison

Understanding your competitive position within the marketplace is extremely important to drive business, especially in today's highly competitive environment.

Subscribing to third party competitive intelligence data can be helpful when coupled with cost to originate as a backdrop. Remember that there can be more than just the note rate and discount or premium in comparison. Fee structure can also play a big role in a consumer's decision when looking at various lenders. The Consumer Financial Protection Bureau promotes that consumers review multiple lenders before deciding on which one to go with. APR, or the annual percentage rate, is often overlooked by the consumer but is a great tool to look at the overall cost to the consumer for taking out the loan. APR includes not only the rate and points being offered but also the fee structure.

Lenders may find themselves competing in the early stages of the origination process. Secondary managers should understand the differences of what is being offered by their lending institution compared to their competition. Often a consumer will share the Loan Estimate (LE) of a competitor to show what they are being offered. Having an educated sales staff at the ready to review or discuss with clients as they review different LEs and be able to point out differences can be beneficial.



MCT Market Share Analysis within MCTlive!

Market Share Analysis

Within the [MCT Business Intelligence suite](#), a lender can monitor their locked volume versus their peers’ week over week. This can be a great indicator of market share, which is more telling than an actual volume analysis. This lets the lender determine if the increases or decreases in volume are simply market driven, the result of price competitiveness, or of any changes they have made in pricing. Tracking results over time can isolate lending opportunities in terms of product or geographic lending mix.

Price Elasticity Testing

It’s recommended that lenders test elasticity in small but regular increments to ensure that margin is not being given away without an appropriate pickup in volume to merit the thinner margin. We’ve all heard the phrase, “don’t give away the farm.” It’s best to stick within a specific product or isolated product margin in this approach as buyer preferences and demand can shift across product offerings due to differing down payment requirements, mortgage insurance (MI), as well as rate and payment offerings.

To establish a useful rate comparison, a lender might consider looking toward the law of averages. Digging back into historical originations to determine what your average score, loan to value (LTV), loan amount, state, and more, is within the given program that you will be tracking. Keep in mind that economic conditions can shift this scenario. It’s necessary to shift loan purpose to “purchase” in the current environment. Having this baseline scenario establishes loan level price adjustments (LLPA) impact which can then drive an equitable “market” rate for comparison, allowing for the lender to get down to the nitty-gritty of a rate and price offering for comparison. A lender may decide to have several scenarios that can drive competitiveness across credit bands or other loan parameters.

Keep in mind that it’s important to keep track of margin and results over time. Historical review of margin can help in reviewing and establishing future margin decisions.

Example of Price Elasticity Testing

By isolating a single scenario, the lender can then adjust margin in relation to competitive offerings on a given day. Let's say we're offering 7.5% at 100.23 while our competitor is at 7.5% and 100.31. We might look to match day-one reducing margin on our scenario by .08. On the next day you will want to collect the results. Did lock volume increase or decrease? If you remove market movement, did the competition adjust their price or does it appear that their margin remained constant? It may take a few days or even a week to whittle out the variability of market movement to feel comfortable with the results. Once you feel comfortable, you can then begin to adjust margin daily in connection with your baseline scenario, keeping track of the competitive landscape, and look to the changes in volume, adjusting for market moves or any other impacts that could have impacted results.



In testing elasticity, secondary managers must remain diligent. Prolonged market moves can weigh heavily on margin as investors and lenders look to reduce risk and build in extra margin in an upward rate environment, or may thin margins as rates improve, increasing competition.

Every day can bring forth unknown or unforeseen volatility. After testing for a period of time, it's best to collect and review the results. It's helpful to overlay the baseline scenario rate/price offering against competitors over the time series. Overlaying lock volume specific to the baseline program, applied margin, and market movement can call out potential impacts from the test.

Inevitably, service and lead source may prove stronger than price. If a consumer has options, they may look to having a loan officer that's very communicative at a company that touts service. It could be that the consumer is referred to the lender by a friend or family member making them stickier. At the end of the day, it's important to also realize the value your organization brings. Having the best price does not always equate to winning volume.

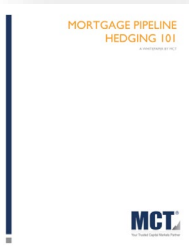
Day One (Basis) vs. Final Execution Analysis

This is another great way to review performance and is often used by lenders who like to review lift over best efforts. This requires the lender to track a day one best efforts price over the course of the loan. The lender can then compare their net sell mandatory price to the day one best efforts price to look at the gain/loss over time. The lender will also recognize hedge gains on the loan, but over time, mandatory execution has proven to pay upwards of 25 bps more than best efforts. Because hedge gains may not necessarily align with the timing of loan purchases, it's important to expand the view of profitability beyond a single month to upwards of 3 months at minimum. Reviewing overall performance, specifically between an expected and realized price allows secondary personnel to have a backdrop to set margin. If financial performance is tracking downward, it may be necessary to adjust margins upward. It's ideal to have some understanding of the decline. Questions worth considering may include:

- Did investors decline loans this month?
- Did they take longer to purchase?
- Did aggregator pricing worsen over the course?
- Were there operational hindrances that impacted profitability?

RATESHEET CONSIDERATIONS

The evolution of technology has revolutionized mortgage pricing, reshaping the landscape of margin management. From manual processes in the early 2000s involving basic Excel spreadsheets to the emergence of pricing engines, lenders now enjoy enhanced flexibility in setting margins and tailoring programs. This technological progression enables intricate adjustments across diverse loan attributes, creating a sophisticated margin environment. This section explores the evolution of pricing engines in margin management, delving into best practices for displaying pricing to loan officers and addressing the intricacies of managing investor relationships in a dynamic market environment.



Further Reading...

[MCT Whitepaper: Mortgage Pipeline Hedging 101](#)

This whitepaper will review information on moving to mandatory, the strategy of hedging, the benefits of hedging, and how to determine if you are ready.

[Read whitepaper...](#)

The Evolution of Pricing Engines in Margin Management

The evolution of technology has revolutionized the approach to pricing in the mortgage industry. Reflecting on the initial process in the early 2000s, it involved manual interactions with brokers and loan officers, utilizing a rudimentary Excel spreadsheet that was converted to PDF. This document outlined investor base pricing, deducted lender margin, and incorporated a grid of LLPAs. At that time, pricing engines were not established, necessitating a manual pricing process involving phone conversations to gather loan details and subsequent entry into the LOS for locking. The advent of pricing engines in the ensuing decades has fundamentally transformed this landscape, offering lenders a range of benefits, including enhanced flexibility in setting margins and tailoring programs and pricing to organizational requirements.

This technological progression has empowered lenders to intricately adjust pricing across diverse loan attributes, creating a sophisticated and matrixed margin environment if desired. Furthermore, pricing engines enable secondary teams to consolidate multiple investor rate sheets, providing loan officers with a streamlined front-end best execution experience. This shift represents a significant advancement, eliminating the burdensome task of memorizing extensive and often redundant Loan-Level Price Adjustment, pricing, and eligibility information.

How to Display Pricing to Loan Officers

Secondary managers can still drop margin on top of investor rate sheets so that loan officers no longer see the exact name of the investor, which they're locking with in the product and pricing engine, or PPE. This is a common feature known as aliasing. The efficiencies have trickled down to underwriters as well, who can quickly begin to pull down the guidelines and start underwriting loans accordingly. Underwriters can keep notes and call out soft guideline issues in the underwriting process that may not be acceptable with specific investors. These rules can also be managed within MCTlive! to assist secondary personnel when it comes time to sell those loans. This is a great way to prevent ineligible loans from being sold to the wrong investors.

As lenders gain agency approvals and have delegated underwriting options, lenders may look to create their own products where they can choose to mirror agency guidelines or look to portfolio and keep loans for investment on the books.

For lenders who aren't comfortable displaying or always selecting the best possible price, most PPEs have some guardrails that are available. Secondary managers can select the second-best price or use an average of the top two or top three, or an average of all four. Over time, you can monitor investor pricing and competitiveness in order to ensure your pricing remains consistent. Lock terms, rate offerings, state assumptions and other lock attributes can also be programmed and customized to ensure margins are maintained. This approach must be watched closely as investors can step in and out of the market to control their volume. Being tethered, as previously discussed, can lead the lender to be unnecessarily competitive or uncompetitive at times.

SUMMARY OF MARGIN MANAGEMENT

Margin mastery is an ongoing journey. There are a lot of variables to consider, requiring secondary marketing professionals to remain diligent in managing and monitoring margins and overall profitability. MCT's unwavering commitment to empowering lenders through knowledge, tools, and strategies is the bedrock of our shared pursuit of enduring success for our clients.

MCT is dedicated to the exploration and innovation of margin management. Best execution strategies take center stage to guide lenders in aligning pricing with optimal outcomes. Effective volatility management through guardrails and spreads is a cornerstone of safeguarding profitability.

For inquiries, discussions, or further guidance, MCT welcomes you to [connect with MCT's team](#). Together, we can forge a path towards a future characterized by resilient and prosperous lending practices through the mastery of margin management.

ABOUT THE AUTHOR



Cody Echols, Capital Markets Technology Advisor, MCT

In his role as a Capital Markets Technology Advisor, Cody Echols leverages his years of capital markets, leadership, and coaching experience to help MCT clients exceed their goals. His demonstrated capabilities in mortgage operations and technology ensure a successful onboarding experience for new clients, as well as a hands-on approach to ensuring current users are able to conquer new market challenges as they arise. Mr. Echols is also experienced in managing integrations, product and pricing development, hedging strategy, and compliance requirements. This has enabled him to create educational material such as training guides as well as author the daily market commentary.

ABOUT MORTGAGE CAPITAL TRADING

For over two decades, MCT has been a leading source of innovation for the mortgage secondary market. Melding deep subject matter expertise with a passion for emerging technologies and clients, MCT is the de facto leader in innovative mortgage capital markets technology. From architecting modern best execution loan sales to launching the most successful and advanced marketplace for mortgage-related assets, lenders, investors, and network partners all benefit from MCT's stewardship. MCT's technology and know-how continues to revolutionize how mortgage assets are priced, locked, protected, valued, and exchanged – offering clients the tools to thrive under any market condition.

For more information, visit <https://mct-trading.com/> or call (619) 543-5111.

