

## Time to ramp up mortgage lending? (May 28, 2009)

There's opportunity amid the carnage

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Before you get too excited about that headline, there is a caveat. Starting from scratch may be a difficult and expensive option for those community banks who up till now have only made mortgage loans as an accommodation. But there are other options.

One result of the shakeout and consolidation in the mortgage markets is that borrowers are left with fewer choices and also want to deal with someone solid and local. Mortgage banks can fit that description and community banks definitely do. There may be a synergy there right now that could work well for both. Here's why: Mortgage banks have the expertise and contacts, but limited sources of funds, now that many warehouse lenders have either closed or become far more restrictive. Many banks, on the other hand, have limited experience with mortgage lending, but they do have ready sources of funds and capital.

The mortgage lending business, still reeling from the excesses of the subprime era, is embracing a more conservative model. Congress will likely force the issue with new restrictions, this year or next.

"The mortgage business is now more in line with banks' risk tolerance," says Barrett Owens, senior vice-president and chief lending officer for First National Bank of Trenton, Texas, situated near Dallas. Owens was a mortgage banker for ten years and is now building the \$142 million-asset bank's mortgage effort into not only a local business, but a resource for other community banks that don't want to make a large investment in technology.

Marshall Boyd, another mortgage banker now working for a bank, believes that community banks have the best opportunity of all the possible players to fill the vacuum in the mortgage lending business.

"They understand their local markets and don't have the valuation questions that the national mortgage players do," says Boyd, Mortgage Division president for Southwest Bank, Ft. Worth. He explains that community

banks' knowledge of local economic conditions, and their local contacts enable them to make loans that larger, more distant mortgage lenders won't do now. Jumbo loans are one example. There is no secondary market for these loans anymore, but the demand for them still exists.

"We're putting together some great jumbos to fill the vacuum," says Boyd. These consist of a second mortgage behind a Fannie Mae first, he says, and are carried in portfolio.

"I'd be scared to death to make these mortgages in cities I didn't know," says Boyd.

The mortgage banker also points out another advantage for small and midsize banks in the mortgage business:

"The public has tired of the 800 call-center experience," says Boyd. Local banks not only have a feeling of stability, but can say, "We're financing our neighbors."

Mortgage lending vendors are also seeing a shift in their business. Rob Katz, president of Del Mar DataTrac, San Diego, which supplies software for the entire mortgage lending process including origination, processing, and sale to the secondary market, says that "over the past six months, we've seen a shift to community banks and credit unions doing mortgage lending. It comes down to a source of funds."

Katz, a former mortgage banker, sees great potential for banks in the business.

"If you ignore the toxic stuff, there is plenty of money to be made in mortgage lending. People are coming to banks now as a safe haven."

He says that before the crash, only one out of six of his clients were community banks and credit unions. Now it's four out of five.

Hit a single every day

Neither Southwest Bank nor First National were significant players in the mortgage business before now.

"It was ad hoc," says Owens; "when a request came in, the bank would service the customer."

Boyd says that at Southwest, which has total assets of \$653 million, a couple of employees would broker loans as an accommodation to customers. But Vernon Bryant, CEO of the bank's holding company, First Texas BHC, wanted to step up involvement in mortgage lending.

The two banks have pursued variations of a similar approach. First National of Trenton hired an experienced mortgage banker, Owens, to build its capabilities, whereas Southwest Bank acquired a mortgage bank and its book of business.

Both Owens and Boyd maintain that mortgage banking and commercial banking are very different.

"You can't just get into the mortgage business a little bit and do a good job," says Boyd. "You have to have all the capabilities." Among these are, contacts, credit policy, underwriting and servicing, processing, and disclosure.

"Mortgages are an income event," Boyd continues, referring to the fact that they are mostly sold into the secondary market. "You've got to hit a single every day." By contrast, commercial loans produce a steady stream of income.

[Some banks, and many savings institutions, of course, have extensive experience in mortgage lending. For an interesting counterpoint to the models described here, see, "A world apart, in more ways than one," on page 26.]

Owens, who worked at another community bank and in the insurance business in addition to being a mortgage banker, agrees that mortgage banking and traditional banking are not the same—there are different risks involved.

"Community banks are very conservative," says the outspoken Owens, "They all have the 'secret sauce'—personal contacts and [a focus on] serving the needs of the community." He believes this time-honored and successful recipe will have to change—or be augmented—as the needs of customers become more sophisticated. Building a mortgage banking operation in his view is part of that evolution.

First National Bank of Trenton currently is building origination volume to a goal of \$25-30 million per month in residential mortgages. (The bank did \$2.5 million in April.) Owens says banks can have profitable mortgage operations at lower volumes as long as they scale their operations accordingly.

First National uses the DataTrac platform as a foundation, on which it is adding additional proprietary features. The bank was about two-thirds of the way through creating the expanded platform in mid May. It had hired six additional people to do this work.

"We have the systems and technology and people to handle about \$40 million in originations," says Owens. Changes need to be made on the bank's commercial side, as well, he says, noting that tech advances in mortgage banking overall have moved further than in commercial banking.

#### Leads flow both ways

The benefits to the mortgage bank—a source of low-cost funding—are clear enough. But what are the benefits to the bank of a mortgage banking subsidiary?

Boyd addressed that question from the perspective of Southwest Bank's acquisition of his mortgage bank.

Basically, he says, "You're buying a ringing phone versus trying to get one to ring." His firm brought 16 years worth of clients, "every one of whom is calling right now to refinance." The bank sends its own refinance candidates to the mortgage company, says Boyd, while the mortgage bank, which, he says, "touches a lot of high-end people around town looking for a banking relationship," refers those people to the bank. "Vernon [Bryant] had a good understanding of that," says Boyd.

#### FHA will stay hot

Currently First National of Trenton's mortgage volume by type breaks down this way: conventional conforming—40%; FHA, VA, and USDA rural housing loans—55%; fixed-rate jumbos—5%. The government category is the most profitable right now, says Owens, but the gap with conventional has narrowed from a year ago.

"Government loans is where the industry is right now," agrees Del Mar DataTrac's Rob Katz. Subprime and Alt-A loans have been replaced by FHA loans, he says, which have grown from less than 5% of total originations three years ago to 95% now. This presents some challenges, because FHA loan underwriting is not automated.

"There is no Desktop Underwriter for FHA loans," says Katz referring to the Fannie Mae automated underwriting program. "Lenders therefore have to find experienced FHA underwriters. Those folks are hard to find," says Katz, "and that is the biggest constraint to growth." He predicts FHA loans will remain hot for another two to three years. After that, Katz believes the Alt-A market will return. "I personally think it was a reasonable market, in contrast to subprime," he says.

Owens agrees, and takes it one step further, stating that both Alt-A and subprime lending "will definitely come back, but they will look different."

There was nothing wrong with subprime per se, he maintains. Most of the problems resulted from fraud, he says, not from ARM resets.

“Sub-prime will be very profitable again,” he believes, “and will be a smart investment for those that are good at it.”

#### Current market

In First National’s market, centering on Dallas, values are still declining, says Owens, although certain price ranges have stabilized. However, there is still six months of inventory on average.

“Everybody thought the [housing] bubble would re-inflate,” says Owens, “but they’re coming to realize it won’t, so there is a lot of refinancing going on.” He says the people who still believe in the value of real estate (individuals, not speculators) have “hunkered down,” and are getting on with life in the new environment. “They accept the conditions,” he says, and, believing that inflation will return, are selling some properties, buying others, and refinancing.

Owens is distressed that housing starts in the Dallas area recently increased. “Some builders maybe haven’t learned their lesson,” he adds.

Boyd points out that refinancing can’t happen in the parts of the country where values have declined sharply.

The Ft. Worth area and north Texas generally, he says, have been much less affected by the housing troubles.

“We’ve been lucky,” he says, but then again, Ft. Worth, a conservative market, “never went nuts” in terms of home values and LTV ratios. As a result the area has been “last in, first out” of the housing downturn. Nevertheless, because warehouse loans came from national players, where valuation models are often put together based on national appraisals without local knowledge, the mortgage banking business was affected, prompting he and his partners to sell to Southwest Bank.

Both bankers are still strong believers in the Fannie Mae/Freddie Mac model.

“They may have gotten fancy with Alt-A and subprime,” says Boyd, “but they were caught in a collateral crisis just like the rest of us. Everybody learned a lot of lessons. My hope is that we don’t swing too far the other way and have too rigid guidelines.” BJ

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