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Dèjá Vu *All Over Again*

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A refi boom of a decade ago holds many lessons for today. In the first full quarter of the 1991–1992 refi boom, the refi share shot to 46 percent from 21 percent. The current boom's refi share soared to 55 percent from 25 percent in its first quarter. What other parallels exist?

GEORGE BUSH IS IN THE WHITE HOUSE. Concerns over the economy dominate headlines. Tensions are mounting in the Middle East, and residential mortgage professionals are riding the crest of a refinance boom that has been going for more than a year. ● The old adage, "The more things change, the more things stay the same" could not be more appropriate. This is especially true if we compare today's home mortgage refinance market with that of a decade ago. ● Six months ago, some factors indicated that the most recent refinance boom was winding down. But heading into the autumn of 2002, it now appears refinance volumes are as strong as ever.

What should mortgage professionals make of this? How can they best position themselves to make wise strategic choices and technology investments to both capitalize during the current refinance boom and continue to do so when it finally ends?

Luckily, industry professionals have history on their side. A comparative analysis of the market climate in the early 1990s may provide some insight. Then, as now, refi business was booming. If we review what happened in the wake of that boom, it may help the industry make prudent decisions today and avoid some of the pitfalls it faced a decade ago.

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Some universal truths regarding the mortgage industry offered 10 years ago by industry observers bear repeating today. Looking back, the two topics that feature most prominently in industry commentary about the last refinance boom are consolidation and servicing.

For instance, Jerry Baker, then managing director with Countrywide Funding Corporation, highlighted these topics in his article, "The Other Side of the Rainbow," in the March 1994 issue of *Mortgage Banking*. In the article, Baker debunked reports of the impending demise of the mortgage industry from what he called "refi anemia" as premature.

In the article, Baker cites some fundamental business trends, including: "The mortgage banking industry will continue to consolidate, but corporate appetites for the mortgage business will continue to vary widely." He also states, "Growth of purchase business and servicing portfolios will largely offset the decline in refinancings" once the refi boom is over.

What did happen to the mortgage business in the early 1990s once that memorable refinance boom finally ended? What were the issues that emerged in terms of industry consolidation and servicing operations? And most important, what valuable lessons can we learn from those post-refi boom days of a decade ago?

A look at the numbers

To best evaluate the similarities and differences between the current refinance boom and the one 10 years ago, a look at the numbers is in order.

Quarterly data on total mortgage originations, refinance originations and refinance share is a good place to start. Comparing these statistics for the period covered by each refi boom helps highlight where the true differences lie. But first we need to define when each boom began and ended.

A decade ago, the first four quarters of the last refinance boom started in fourth-quarter 1991 and went through third-quarter 1992. The numbers we examine were provided by the Department of Housing and Urban Development (HUD). Fast-forward to the current boom, where the first four quarters went from first-quarter 2001 through fourth-quarter 2001. The data for this period is based on estimates provided by the Mortgage Bankers Association of America (MBA).

In fourth-quarter 1991, mortgage originations totaled more than $168 billion, with 46 percent of that total being refinances. This indicates a significant increase in refinance percentage from the previous quarter, in which refinances only accounted for 21 percent of $151 billion in total mortgage originations. The percentage of refinance share remained high over the next four quarters, averaging 46.25 percent of total mortgage originations with total production being more than $829 billion.

Data for first-quarter 2001 indicates that refinance share accounted for 55 percent of $396 billion in mortgage originations, up from 25 percent of $262 billion in mortgage originations the preceding quarter. This represents a rise in refinance share similar to what took place in the first quarter of the last refinance boom. Looking at the first four quarters of the current refinance boom (first-quarter 2001 through fourth-quarter 2001), refinance share averaged 55 percent, for more than $2 trillion in total mortgage originations.

During both refinance booms, the increased volume was

fueled by extended periods of low interest rates. During the first 12 months of the last refinance boom (fourth-quarter 1991 through third-quarter 1992), interest rates averaged 7.96 percent on 15-year fixed-rate mortgages and 8.41 percent for 30-year fixed-rate mortgages, down from 9.18 percent and 9.51 percent, respectively, for the 12 months preceding the beginning of the boom.

Interest rates have followed a similar track during the current refinance period, with rates averaging 6.41 percent for 15-year fixed-rate mortgages and 6.93 percent for 30-year fixed-rate mortgages for the first 12 months of the current boom (first-quarter 2001 through second-quarter 2002). That was down from 7.73 percent and 8.05 percent, respectively, for the 12 months preceding the current refinance period.

According to industry data, the early 1990s' refinance boom lasted approximately 30 months. The industry now finds itself 18 months into the current boom. If contributing factors (such as low interest rates) continue to hold steady and this current boom follows the lead of its predecessor, we could (conceivably) be in for another 12 months of high refinance volumes. Of course, that is entirely up to other economic factors that might not follow the lead of a decade ago at all.

Consolidation in the industry

Consolidation in the mortgage industry, among both lenders and vendors, has been a constant source of attention and speculation during the last decade. The topic is discussed in detail in "After the Party," an article by Fred E. Portner, then president of Portner Consulting Associates, in the October 1993 issue of *Mortgage Banking.*

In the article, Portner writes: "Lessons from other industries teach us unambiguously that as fragmented industries consolidate, the market segments into two natural classes: very large firms, which make major investments in changing the economics of the business and have the scale to afford these investments, and numerous small niche competitors that compete on speed, service, special products or some combination. What history also demonstrates is that medium-sized firms attempting to compete in such an environment usually find 'tough sledding.'"

Portner's prediction warrants attention because it is applicable to both mortgage technology vendors and mortgage lenders during refinance periods, such as today.

During a refinance boom, a host of new technology vendors usually form to quickly capitalize on the opportunities created by the increase in mortgage volume. Often, these vendors invest all their resources in one project and when the boom stops they may find themselves unable to continue operating because too many resources have been committed on the front end and they are unable to downsize accordingly.

For vendors in this situation, the only appropriate course of action is to try to merge with another vendor. Many startup origination technology vendors and their interface package providers (such as appraisal and title software vendors) are formed during a refinance period. But often they fail to prepare for life after the refi boom. Rather than taking the appropriate steps to safeguard and grow their business, they jump in head-first and suffer later.

When technology vendor consolidation occurs, lenders can be left holding the bag for their vendors' shortsightedness. Lenders should look for vendors with a proven history that demonstrates evidence of long-term stability, especially during frenzied refi periods. Lenders failing to do that run the risk of having to convert their systems if their technology vendor merges with another. Or worse, lenders could find themselves stuck supporting a system on their own should their vendor go out of business or lack the necessary resources to adequately maintain their technology.

What is interesting in looking back is finding that the same issues regarding consolidation that existed a decade ago remain prominent today. What has changed is the scale of operations. A midsized lender in 1992 may have had a servicing portfolio of roughly $3 billion, whereas a midsized lender today may service a portfolio of more than $10 billion. The overlying issues are the same; the scale has just ratcheted up.

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"The cyclical nature of the business during the last 10 years has placed the most pressure on the middle market," says Jeff Lebowitz, principal at MORTECH LLC, Silver Spring, Maryland. "As volume ebbs and flows, midsized lenders tend to get pushed out of the business. The larger lenders can better withstand the cycles and pick up the independents, which is why there are basically no more independents [with the exception of a few players such as Countrywide Home Loans Inc., Calabasas, California.] The economies of scale are not so pronounced to keep midsized companies out of business, but it makes it increasingly difficult for them to make as much money.

"According to our data, there is more consolidation now than there was 10 years ago, meaning that the 10 to 25 leading mortgage companies do the majority of the servicing," says Lebowitz. "The problem is that among those 10 to 25 companies, things are highly competitive. They have not enjoyed the benefits of consolidation usually gained in other industries, in that someone eventually dominates the marketplace. Being larger does not necessarily give companies an advantage on the origination side, but it does give them an advantage on the secondary marketing side, however, as GSEs [government-sponsored enterprises] will negotiate with larger firms in a way that they often will not with smaller firms. It also bears mentioning that it is in the interest of the GSEs to help keep as many lenders in business as possible—both large and small, because they do not want to be consumer-direct. Rather, they want to directly influence the company that sits between them and the consumer."

Servicing gains importance

Origination, warehousing and marketing are all positively affected by the increased volume associated with a refinance boom. Yet, what's a plus for the production side creates potential downsides for servicing operations if lenders are not proactive in establishing their servicing systems.

In the February 1994 issue of *Mortgage Banking,* Robert Rosenblatt, then director of surveys and statistics for the economics department at MBA, wrote in his article, "Refi Wave Soaks Servicing," about the importance of effective servicing operations following a refinance boom. He states: "Servicing, or loan administration, is the mainstay of most successful mortgage companies. It should be viewed as an asset, which if managed properly will yield a stable long-run return for the mortgage company."

Baker takes this concept a step further in his March 1994 *Mortgage Banking* article, when he states that "growth of servicing portfolios will also be a big part of many mortgage companies' future profitability and stability. For those who can afford to keep the servicing rights on their originations, or buy servicing in bulk, servicing portfolios will provide a reliable income stream, a macro-hedge against interest rate increases and declines in originations."

These conclusions ring true today even though hedging and the required accounting treatment for servicing have made that business much more challenging for many.

Advances in front-end technology have played a pivotal role in increasing the pressure on servicing systems by enabling an exponential rise in origination volume over the past decade. "The elimination of paperwork through automated underwriting technology has greatly impacted the speed with which we can originate and close loans now as opposed to the early 1990s," says Kathy Levitt, vice president of Circle Mortgage, Hollywood/Fort Lauderdale, Florida. "The result is that we have gone from a process that then took as long as three to four weeks to something that today takes one or two weeks—which allows more people to take advantage of the rates while they are low."

Understandably, lenders have tended to focus their technology investments on loan origination systems and other supporting systems during the recent refinance boom. The lenders that will remain successful when the heavy refinance volume subsides will be those that invest in technology that allows them to effectively service the loans generated by the refinance boom.

"In a way, a symbiotic relationship exists between refinancing and servicing, in that lenders that do not offer easy refinancing for their customers will probably see their servicing portfolios diminish as borrowers tend to go where rates are better," says Mike Howard, treasurer of Merrillville, Indiana–based Lake Mortgage Company.

"Additionally, if servicing companies do not service with care . . . they run the risk of having portfolio losses because their borrowers will want to move their mortgage loans to another company. In the early 1990s, the lesson we learned was that we needed to do something with technology to get the loans processed and closed without hassling our customer," Howard says. "Then we needed the capability to move the loan into servicing quickly, because there are many other companies out there promising to do it quicker and easier."

One big problem that emerged for lenders during the early 1990s stemmed from payoffs. Lenders today should be evaluating their servicing technology's ability to handle large numbers of payoffs. Payoffs require the lender to release a lien and report the appropriate information to the Internal Revenue Service (IRS) for each loan. With today's high loan volumes, lenders may find their servicing systems have become inundated, creating an expensive backlog of unprocessed payoffs.

To the borrower, a refinanced loan through the same lender may seem like a single product because it applies to the same home. But to a servicer, a refinanced loan represents an entirely new product because the old loan must be set aside in order to board the new loan.

This means that servicers must be able to board the new loan promptly and accurately so as to avoid potential negative customer impact of the first payment being due before the loan has been boarded. If the loan is not boarded in time, no customer service data will be available should the borrower have any problems. This is a prevalent issue, especially with lenders that use various correspondents and front-end systems trying to interface with their servicing operation.

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"Even when a lender refinances a loan [for one of its existing borrowers], they still lose the original loan because the loan must be pulled out of its original pool," says Nicki Beam, insourcing director for Mortgage Professionals Inc., a provider of consulting, investor accounting and training services to the mortgage industry.

"Lenders are typically not allowed to refinance within the same pool because the term and interest rate will be different. So, on the servicing side, the loan must be pulled out of one pool and paid off, then placed into another pool. This means that the monthly payments and escrow payments must be transitioned in a way in which it all appears transparent to the borrower—which is a challenge," says Beam.

"In servicing, you will typically pool most of your loans to an investor, so ensuring that the data is accurate, reported on and remitted in a timely manner has a great impact," says Beam. "In addition to doing all of this, servicers have the human component to factor into implementing the decisions that management has made regarding pooling certain loans, getting all of the closing documents on time and filling in all of the components [whether Fannie Mae, Freddie Mac, Ginnie Mae or private] required by a pool. Therefore, it is imperative that a servicer's staff know where those loans are going and what pooling requirements must be met."

But for servicers, the real issue produced by heavy refinancing is the variability of return on servicing assets. When refinancing waves hit, lenders find they have put an asset in the

servicing portfolio only to see it run off a few years later. From a financial point of view, that makes servicing a risky business for many lenders.

"Larger companies, probably because they have to write off servicing periodically, do not appear as profitable as they could be," says Lebowitz. "Asset impairment hits large lenders much harder than small to midsized ones, because the larger lenders have more loans. So the effect is that larger companies may look less profitable even though they may in fact be more profitable on an operating basis. Since things keep recycling, they never really catch up."

Based on the level of interest rates and the wobbly outlook for the economy, it would appear the current refinance boom has some life left in it. It is possible that the industry will follow a similar course as it did a decade ago when refi business ruled for a long stretch but eventually faded. Certainly, many of the same opportunities that existed for lenders and vendors 10 years ago still exist today. Industry consolidation remains an important factor. And lenders and vendors that have built their business around generating quick profits from refinance volume without planning for the future run the risk of disappearing when the boom finally subsides.

For lenders—especially those that service loans—to be most successful during a refinance boom, it is vital they keep as much of their existing customers' refinance business as possible. Perhaps the biggest lesson to be learned in comparing this refinance boom with the last pertains to servicing and its impact on customer retention. Lenders that effectively service their portfolios in between refinance booms are in a much stronger position to keep their customers when the next boom rolls around. **MB**

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