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The margin compression everyone has experienced is our own fault

Here's how we get out of it

It is no surprise that mortgage origination volumes and margins have compressed across the board this year. And if lenders are going to be profitable, or even stay in business, they really need to focus on just one thing.

They need to stop pricing loans they are losing money on.

Yes, it’s that simple. At least according to Mike McFadden of Riivos, a provider of cloud-based, value chain management applications for the mortgage industry that connects core systems — GL, Payroll and Capital Markets — into a single application so lenders can immediately see the future financial impact of business decisions across the lending operation.

And, well, he should know. Previously a senior finance executive who was instrumental in taking a large independent mortgage bank public and later overseeing its sale, McFadden has seen his share of industry ups and downs. And now, as group head of the mortgage technology division at Riivos, he spends a good deal of his time helping mortgage lenders become more profitable.

“It’s not rocket science, but most originators are originating loans at margins that are impossible to make money on,” McFadden says. “Pricing loans solely based on what their competitors are doing — they look around at the market and price at the going rate in order to compete. But if you’re pricing loans below your threshold of profitability, below your marginal cost to originate, it won’t matter whether you win business or not, you’re not going to make money — the only thing you might do is put yourself out of business,” he concludes.

And with profitability as the end game, having access to relevant data — which according to McFadden includes the fixed/ variable cost structure of the organization — is critical. The key is knowing exactly what the marginal cost to originate a loan is by product, channel, etc., and refusing to price loans below that.

He contends that secondary and capital market leaders need access to fixed/variable P&Ls by channel every month, otherwise they are flying blind when trying to make pricing decisions. He likens it to Apple selling iPhones without knowing what input costs are. “[Apple] would never do it,” he says, “but for some reason, mortgage lenders do it every day when buying billions of dollars of loans.”

One of the things McFadden works with lenders on is promoting information flow between finan

cial teams. “Company and channel financials provided by the finance team help secondary and capital markets know what’s profitable so they can price loans,” McFadden says. “While real-time volume, margin and product decisions made by secondary and capital market teams have a massive impact on finance’s ability to forecast the P&L and balance sheet.” The problem is, the two groups typically don’t communicate effectively enough.

And while his company, Riivos, provides technology that puts critical financial information directly into the hands of those who need it to make timely business and financial decisions, McFadden says the bigger fix at most firms requires a cultural shift in which capital markets and finance teams understand the necessity of working closely together toward ensuring profitability of the enterprise. To that end, secondary and capital markets should be communicating and exchanging information with finance at a cadence that’s conducive to real-time decision making — at minimum a couple of times a week and, optimally, daily, McFadden contends.

The path forward for the industry — particularly in times of lower volumes, he says — is better information, more relevant information and better analytics around the fixed/variable cost structure of the organization, something that’s difficult given the complexities of multiple new channels of origination and an ever-growing cache of products.

Further, at the point where profitability becomes difficult given market dynamics, finance needs to have real-time visibility into variable origination costs, so that timely and impactful financial decisions can be made.

And his message is resonating. He speaks frequently to both finance and secondary/capital markets leaders on the need to focus on profitability, not volume, and working together toward that end.

“If everyone adopted a policy of not pricing loans below their marginal cost to originate, we wouldn’t be experiencing the margin compression we’re seeing today, and lenders would start making money again,” he concludes. And if McFadden has his way, they will.