



Rising Variable Interest Rates Mean a New Environment for Banks

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In 2003, the mortgage market was running hot due to low interest rates. The industry could not book the mortgage loans fast enough, and keeping pace with volumes represented the most serious constraint for many banks. But 2004 showed a clear cooling off of this boom as rates increased at the beginning of the year.

Although rates dropped at the end of 2004, they are now again inching up, and most analysts predict that the interest rate environment will return to more “normal” levels by mid 2005. As interest rates rise, the demand for purchase mortgages declines as monthly mortgage costs increase and fewer households are able to purchase a new home; the clamor for mortgage refinancing diminishes as the attractiveness of refinancing becomes less worthwhile to the homeowner.

During the mortgage boom, most banks’ strategies were focused on “volume-selling production” — that is, the number of mortgage loans booked and the dollar outstandings each represented. The objective was to

sell as many mortgage loans as possible, keeping pace with the market demand. However in the new rate environment, with a shrinking mortgage market, this strategy will no longer be a viable option for most banks.

Since mortgage lending can represent a significant portion of banks’ income statements, weakening market demand will directly impact net earnings. In addition higher rates also mean that those consumers who are currently in variable-rate products may find themselves unable to make monthly payments, and past dues and losses may increase. This, too, will directly impact net earnings.

So back to the drawing board in this environment for the next few years, and new strategies are now sorely needed. As a start, banks will need to refocus their marketing and sales approaches with criteria and strategies that focus not on the *number* of mortgage loans booked, but on *how profitable* each one is for the bank.

The key is to zero in on the return on assets (ROA) for all factors involved in mortgage lending, and then use that knowledge to target customers and customer segments that will provide higher return on

investment (ROI) per mortgage loan booked. The ability to assess the net contribution of each mortgage loan booked, on a fully loaded profitability basis, will become the cornerstone for successful marketing and sales in the

mortgage lending industry. For many banks, this may be a completely new strategy, and one that has not typically been the foundation for establishing production and measurement objectives for

mortgage lending, or for other parts of the bank as well. Few banks today can truly assess ROA and ROI on a mortgage loan-by-loan, customer-by-customer basis. Yet in order to succeed in the new rate environment, this approach is required. It means that the entire bank has to begin to think differently about how it makes its overall goals, and the mortgage lending component needs to be understood based on its profitability contribution.

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Most importantly, if this “profitability-driven” approach is solidly backed by both management and loan officers, the result will not be just a means to combat the drop-off in mortgage volumes, but may become a means for ensuring net income growth during this rising interest rate environment. Net income growth? How is that possible if volumes are declining? It’s possible because it forces the establishment of a structured and disciplined approach to mortgage lending (and to banking in general) that will lead to long-term increases in income stability, and yes, profitability growth. Here’s how to get started ...

- 1. Compare the mortgage lending product line with all other product lines in the bank on a fully-loaded profitability basis.** It is important to look at mortgage lending relative to other product lines so as to fully assess its *absolute* and *relative* value to the bank in terms of net income. By so doing, a complete understanding of the value of mortgage lending is uncovered, and the role of mortgage banking as an integral part of the income statement is assessed. Measuring mortgage lending profitability on a comparative basis allows for a true understanding of the role mortgage lending plays in growing the income statement. A “profitability-driven” strategy requires this kind of conceptual framework and measurement.
- 2. Measure mortgage lending on an ROA basis, where each mortgage loan is assessed for its unique ROA based on the type of mortgage, rate, fee structure, amount, and, of course, costs associated with the specific**

mortgage loan. By understanding the ROA dynamics of each mortgage loan, the marketing and sales process can be refined so as to target those mortgage product types and specific market segments that yield the greatest ROA.

- 3. Target appropriate customers for mortgages that maximize each customer and mortgage ROI.** Instead of trying to “push” product, gather specific demographic and financial data for each customer. Sell them only the products that garner a high ROI and that are appropriate for their individual circumstances.
- 4. Manage and reward sales staff for profitable sales vs. volume sales.** Provide incentives to encourage the sales officers to focus on ROA and ROI instead of volumes. Educate the officers on what these measures mean and how best to sell for ROA and ROI.
- 5. Know how to package mortgages with other products so as to create multi-sale profitability.** Mortgage lending should not be a “stand-alone” business, but should be fully integrated into the bank’s customer relationship building process, where the bank focuses on developing customers with high profitability (and not just high cross-sales).
- 6. Track profitability and performance by officer, branch, product, and customer relationship.** Mortgage lending profitability should be tracked on all these levels, not just on a divisional basis. The value that this kind of tracking affords is that it provides the needed details for

target marketing and sales. The more fine-tuned the profitability measurements are, and the more exacting the performance measurements are, the greater the success in targeting for the right kinds of mortgage lending products and customers. In addition, measuring officers and branches by mortgage lending profitability allows the bank to move beyond a “volume-driven” approach, and genuinely reward those officers and branches that are making a difference to the income statement.

- 7. Implement complete customer/product profitability dynamic reporting.** Using a data-driven analysis system will provide the specific information on customers needed to accomplish all of the above.

Although the next few years will be tougher ones in the mortgage lending area, it need not be one in which earnings from mortgage lending decline. The key is to move from the traditional “volume-driven” approach to an approach that is “profitability-focused.” ♦

About the Author



Rich Weissman is founder and chief executive officer of The Database Marketing Agency Inc., a national systems and service provider to banks providing profitability, marketing and sales support. Established in 1996, the company is a member of the American Bankers Association, the Independent Community Bankers of America and the American Marketing Association.