ECONOMIC RECESSION QUICK GUIDE

9 Ways Lenders Can Prepare for an Economic Recession

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Introduction

It seems every second article you read these days foreshadows our imminent economic demise. This onslaught of recession-focused think pieces seem like an overreaction, but if we learned anything from our recent past, it's that we'd be foolish to ignore the economic red flags in front of us.

Stock markets are skittish, the yield curve has inverted, the student loan debt burden has more than doubled (to $1.5T) since the last recession, and mounting geopolitical tension is increasingly impacting the economy.

A new survey of economists found that three in four economists now believe we will tip into a recession by 2021, some believe we will see a recession as early as 2020.

Regardless of specific timing, it's clear that it's less a matter of if we'll see a recession soon and more a matter of when we'll start to feel the impact.

Luckily, we're better equipped as an industry to handle a recession this time around. And with the right preparation, mortgage lenders can mitigate the negative impact of a potential recession and come out on top when the market rights itself.

Here are 9 ways mortgage lenders can prepare to survive (or even thrive) in an economic recession:

#1. Understand cost- & profitability-per-loan

Many mortgage lenders employ less-than-scientific methods for pricing loans. Because lending rates are usually a function of a competitive environment and therefore set at whatever the market will bear, mortgage loans that are booked at less than profitable spreads are often only discovered in hindsight.

Whether you get help from an outside firm or do the diligence in-house, it's imperative to understand — at a very granular level — your profitability metrics. From LO compensation and costs-to-originate to compliance costs and IT spend, you need to go beyond just looking at revenue and net income to understand your true cost-per-loan.

Digging into your loan pricing and cost structures to understand profitability at the loan level is crucial to understanding your true profit margins and knowing which levers you can pull in an economic downturn to reduce spending and finetune your lending operation to maintain profitability.

2. Conduct a breakeven analysis

With your profitability-per-loan figured out, the next step is to conduct a breakeven analysis to determine what loan volume you need to be profitable in a given timeframe based on your fixed costs, variable costs, and selling prices.

Once you hit breakeven, you still have to pay variable costs but each new loan after that point is wildly more accretive to your bottom line than those loans originated before breakeven. Thus, it's essential to understand what your breakeven is in your current lending environment.

Breakeven point *(# of loans needed to break even)*

$$= \frac{\text{Fixed costs}}{(\text{Profit per loan target} - \text{Variable costs per loan})}$$

(Costs that must be paid whether or not any loans are originated, like rent, utilities, payroll, etc.)

(Variable costs increase or decrease depending on a company's production volume. Higher volume = lower variable costs. Variable costs include things like LO commission, warehouse line expenses, appraisal/credit pull costs not recouped, marketing/advertising, etc)

From there, you can use your breakeven analysis to compare various 'what if' scenarios to forecast how your lending team would need to modify your strategy to remain profitable in a recession. Play around with your breakeven analysis to see how your profitability changes if you reduce fixed costs, reduce variable costs, or if loan volume increases or decreases.

LEARN MORE:

"A Detailed Look at How to Conduct a Breakeven Analysis"

3. Don't rely on volume as a quick-fix for inefficiencies

When business is booming, it's easy to rely on increasing volume as a shortcut to smooth over any organizational inefficiencies or redundancies. But relying on the notion that 'volume will fix that' quickly becomes risky as the economy slows.

It's far easier to decrease spending or streamline your team's processes than it is to increase revenue, especially during a recession.

As the busy season slows down, take the time now to go through your budget with a fine-tooth comb and audit your team's lending processes to actually fix those inefficiencies rather than relying on volume to act as a band-aid.

Part of this goes back to understanding your cost structure and really taking a hard look at how things like early payoffs, LO comps, overtime, warehouse line utilization, and more impact your overall financial forecasts.

LEARN MORE:

Mckinsey's Proven Method for Transforming Organizational Efficiency & Performance

4. Fight the urge to ease underwriting standards

As the economy slows and leads to lower yields, lenders may feel competitive pressure to become more aggressive and write loans at higher loan-to-values.

Savvy lenders will resist this urge to compete by lowering their loan parameters.

> ***"Stay conservative [with your underwriting standards] and stay in business."***
>
> — *Noah Brocious, President, Capital Fund 1*

As enticing as it might be to significantly bend your underwriting standards to make more aggressive, higher LTV loans to maintain your market share, it will be the lenders who stick to their guns and resist becoming too lax with underwriting that will be in a better spot when the market corrects.

5. Encourage borrowers to build an 'equity cushion'

While there are undoubtedly circumstances where a low downpayment mortgage loan is right for borrowers, with a recession on the horizon and lower interest rates in play, it can be beneficial for borrowers to put down more upfront to help them built an 'equity cushion' in their home in anticipation of an economic downturn.

Instead of putting down the minimum for a down payment and maxing out an approval amount, homebuyers may wish to put down more money upfront, which will help them build an "equity cushion" in their home to prepare for if/when the economy heads south.

This prevents homebuyers from being 'underwater and allows for the possibility to sell the home in case of a pressing financial circumstance.

6. Work with struggling borrowers in tough times

When a recession hits, navigating the downturn with grace will require lenders to partner with their borrowers to help them work through their financial challenges rather than making the first and fastest claim on their assets.

Companies that are early to adopt broader financial health strategies have shown how beneficial it can be to foster this trust and goodwill with borrowers to mitigate the negative impact of an economic downturn.

For example, U.S. Bank saw this play out in 2016 when its mortgage delinquency call center partnered with SpringFour to provide referrals to tens of thousands of outside resources for struggling borrowers (including utility assistance, food savings, prescription drug rebates, and employment help).

U.S. Bank customers who received these referrals were 10% more likely to remain current on their mortgage, and more than twice as likely to engage in foreclosure prevention activity.

Invest in financially empowering and educating your borrowers now, and work with them down the road when a recession hits.

What's good for borrowers is good for business, even in an economic slump.

As for lenders who don't retain servicing, there is still a prescient need for more financial advocates in the community to help borrowers that need advice. Be sure to increase your social media presence to broaden your reach.

7. Think like an economist

If you're a small- to mid-sized lender, you likely don't have someone on your team who plays the role of in-house economist. Mortgage lenders have so many balls in the air, and tracking macroeconomic forecasts is likely far down on your list of priorities.

But paying attention to the macroenvironment is the best way you can anticipate problems down the road and arm your lending team against the upcoming economic challenges.

The smartest lenders will keep a close eye on these market indicators and take proactive steps (like adjusting their underwriting standards to be more conservative, not less) to help them come out on top when the market rights itself.

8. Out-prepare your competitors

If your competitors aren't heeding economic warnings and shoring up their business to weather an oncoming storm, let that motivate your proactive preparation even further.

Thankfully, the next recession will not be quite as devastating to the mortgage industry and those who adequately prepare stand to benefit.

Because inventory shortages and rising home prices have been so prevalent in the market as of late, an economic slowdown may contribute to a more balanced housing market and find savvy real estate investors looking to buy at more reasonable prices once the market shifts.

Real estate investors are credited with lifting the housing market off the floor in 2012. Likewise, because the next recession will be less detrimental to the real estate market in general, these investors — and the lenders who finance them — actually stand to play a large part in the future turnaround once market correction does hit.

Outwork your competition and stay one step ahead. Not all companies will prosper — or even stay in business — during the next recession, but the ones who prepare now will be best poised to thrive relative to their competitors.

9. Play the long game

It's uncomfortable to confront our own fallibility when it comes to our financial decision-making, but we must accept that we are, unfortunately, at the mercy of our own cognitive biases.

We are innately biased towards the present, and the subprime crisis showed us firsthand the disastrous consequences of what happens when present bias (also called 'hyperbolic discounting') goes unchecked.

Likewise, behavioral economists after the 2008 crash noted how our susceptibility to the self-serving bias lured both individuals and companies to attribute their financial gains to their own skills, rather than accepting that their gains were largely the result of a rising market.

Both of these biases, along with the demonstrated psychological tendency for people to follow the crowd, naturally predispose us towards inaction in the face of a looming economic downturn.

This time around, with that alarming clarity of 20-20 hindsight, we have to resist our innate urges to myopically focus on the short-term gains without regard for how that will impact our futures.

By thinking long-term, you can both insulate your business from economic turmoil and set yourself up for success farther down the road. After all, if an acquisition is your goal down the line, investors will look for sustained performance even in times of economic stress as an indicator of your long-term value.

Conclusion

Though cloudy skies may be on our economic forecast, this impending storm feels less ominous than ones we have weathered before.

Homeowners and real estate investors have more equity in their residential properties today than they did before the Great Recession hit, and mortgage lenders are better equipped to navigate a period of economic turmoil this time around.

Mortgage lenders who adequately prepare for an economic slowdown stand to maintain performance in the short-term and prosper in the long-term once the recession wanes and leaves a more balanced market in its wake.

All in all, a recession may result in a more balanced housing market with healthier supply and demand, which will, in turn, make homeownership more accessible for the would-be homebuyers and stimulate the market.

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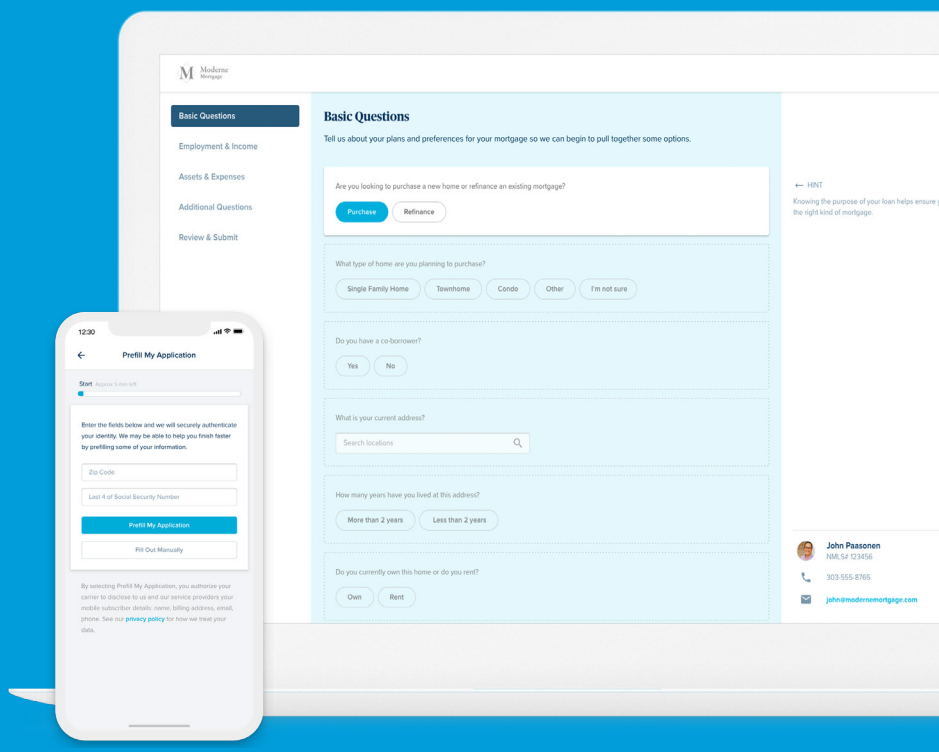

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Founded in 2015, Maxwell is a member of the Mortgage Bankers Association and the Colorado Mortgage Lenders Association. In 2017, we were named one of the most innovative companies in real estate by HousingWire Magazine.
Every day, our software is used at hundreds of lenders across the U.S. to serve thousands of homebuyers. Maxwell is funded by venture capital firms in Silicon Valley and New York City. We're proud to be built in Denver, Colorado.

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