3 CUs Share Strategies for Delivering Mortgage Value.(Pentagon Federal Credit Union)(State Employees Credit Union)(Eastern Financial Florida Credit Union)

Credit Union Journal; 4/17/2006; Diekmann, Frank J.

ORLANDO, Fla. -- There are values beyond just pricing. Just ask Pentagon FCU, or any of two other credit unions that have found value is often best expressed not on the balance sheet, but in the intangibles.

During a Financial Solutions Symposium here hosted by WesCorp and Callahan & Associates, a trio of credit unions shared their strategies for building their mortgage portfolios. Below is a look at each.

A Trip To The Bankers' School Teaches Lesson About CUs

ORLANDO, Fla.-For Pentagon FCU's Deborah Ames Naylor, VP-mortgage services, all it took was a trip a school hosted by the Mortgage Bankers Association to demonstrate the value a credit union can bring to the mortgage lending process for the consumer.

Apparently, members see the value. PFCU has watched first mortgages grow to $3 billion by February of this year, up from about $1.5-billion in 2005. In all, it has 14,500 first mortgages held in portfolio, 20,700 fixed equity loans representing $880 million, and 21,400 home equity lines representing $1.4 billion.

Pentagon FCU has one of the largest mortgage operations among credit unions, operating seven days a week from 8:30 a.m. to 10 p.m. from mortgage lending offices in Eugene, Ore., Omaha, Neb., and its home market of Alexandria, Va.

The credit union offers fixed products of 10, 15, 20 and 30 years, but really focuses on ARMs because its military membership tends to relocate often. Last year it introduced a 40-year loan, Ames Naylor noted, but it "has not taken off like we thought it would. Members are really looking at the interest-only ARMs that we don't offer and don't plan to offer."

It also offers fixed equity loans of five to 20 years with LTVs to 100% at competitive rates. On lines of credit, it offers an interest-only option with an LTV cap of 80%, and regular payment up to 90% LTV.

"We have a very high-quality portfolio. We monitor very closely including for utilization," she said, adding that one reason for the close eye is the loans it makes in certain areas have appreciated quickly and could be overvalued.

Among the "member values" PFCU offers, said Ames Naylor, is a 90-day lock with a contract or refinance fee, no lender fees, jumbos priced similarly to conventional loans, and its PenFed Realty CUSO. Other member value is delivered via low rates, partnerships with vendors to keep costs down, and online status available on second mortgages. "We squeeze our vendors hard to keep our costs down," said Ames Naylor.

As for another feature, she explained, "In Washington, D.C. you can't find a house under $350,000 so we do a lot of jumbos in the D.C. area and we find our pricing gives us a real advantage.

As interest rates have risen, Ames Naylor said PFCU has become concerned over losing the first mortgage market. For that reason it bought a real estate firm in the D.C. area that has 18 agents called PenFed Realty. Instead of the 6% commission typically charged, PenFed charges 4% and credits 1% of the price back to the member. "The reason we did this is we hope we will get the mortgage," she said, adding Pentagon Federal is looking to partner with others in the Realty program.

Ames Naylor noted Pentagon Federal places a lot of emphasis on first mortgages on online applications, with more than 95% of apps received electronically through Mortgagebot, through which it is connected to Fannie Mae and Fiserv's Unifi Pro origination solution.

The credit union also receives 50% of applications for second mortgages online, and members can similarly check status online. "One thing we did find is that when we put up the conditions, if we indicated we need your tax returns and they faxed it, they are on the phone in five minutes. The member expectations are that you are going to update your system as soon as they've done it," she said.

Billions In Mortgages Based On One Very Simple Credo

Yes, we're big, but member-friendly comes in all sizes. - Phil Greer

ORLANDO, Fla.-State Employees Credit Union in Raleigh, N.C., is the second biggest natural-person CU in the world, yet it credits all of its growth and complex operations to some rather simple principles.

Chief among them is to do right by the member.

SECU is apparently doing all right itself. It has $7.3 billion of ARMs (69,551 loans) and another $1 billion (11,770 loans) in fixed rates, portfolio, and services $1 billion in fixed-rate loans.

"Today's economic climate means risk management is more important than ever," noted Greer. "Deregulation, industry consolidation and industry overcapacity all have combined to make competition more fierce in the mortgage lending market. Stronger competition has resulted in short-sighted behavior by some lenders in their efforts to maintain marketshare or just stay in business."

Greer pointed to another quote about the financial services marketplace: "Don't rely on a slightly lower interest rate or faster loan approval process to gain a lasting competitive advantage. Differentiate yourself by offering value-added products and superior customer service." That statement was made by Ellen Scholemer, VP-business development, GE Capital, in 1987.

SECU, which made fixed-rate loans from the 1950s through 1980, began offering ARMs in the 1980s seeking to do "something unique so we were not going head to head with the big lenders."

"After years of experimentation during the 1980s, we came out with a two-year ARM. It wasn't really rocket science, it was a desire to do something right for the members," said Greer. "We started this in the fourth quarter of 1993 and finally settled upon the two-year ARM."

SECU's ARM product has a maximum change per adjustment of one percentage point with a maximum change over the life of the loan of eight percentage points. It is indexed to the one-year CMT, charges no PMI, and offers a 90% LTV. Typically SECU charges 150 BPs below the 30-year fixed, typically 50 BPs above the one-year ARM.

"In the worst-case scenario," said Greer, "a member comes out ahead vs. fixed rate for 10 years on 90% of the loans made. It's very easy to demonstrate that to them."

But all that pricing isn't what SECU believes its strength. "How do we put members first?" asked Greer. "None of our staff are on any commission. We desire to be our members' trusted advisor. We give timely disclosures and we service what we sell, because we think it's important to keep that relationship. With the exception of Fannie/Freddie loans, there is no PMI."

SECU also pays interest on the escrow, charges a low origination fee of one half of 1% capped at $750. It closes refinances in its branches with no attorney and no title insurance, and it charges no prepayment penalty. "This saves the member easily $500 to $600 per closing," said Greer.

In addition, it uses a 30% to 40% debt-to-income ratio, and has a very decentralized lending authority with mortgage officers at its 180 branches empowered to approve mortgages. "All we really ask of our loan officers is to be reasonable," he explained. "We want a reasonable ability to repay, reasonable credit history and reasonable collateral." State Employees does not use an automated system to approve mortgages.

SECU also does a 90% cash out refinance, modifies rates when rates decline as a "somewhat defensive" measure on which it charged a fee but did not require new documentation or "jumping through hoops," uses a single file credit report, stated income above 650 BEACON. Thirty-eight to 40% of SECU's mortgage loans are to members who are at or below median income, according to Greer.

The CU has had a 90-day delinquency rate of .24%, foreclosure losses (without PMI) have averaged over the past eight years .0089%. A 2005 CUNA Membership survey found 98% member satisfaction, with 69% of SECU members considering it their PFI.

"Mortgage lending is something that is important to members individually, and also important to communities in which they reside," Greer told the meeting. "You need to do the right thing, and that's what we attempt to do day in and day out."

1 CU Learns The Theory Of Constraints

ORLANDO, Fla.-Sometimes you can be too successful.

When mortgage rates began their slide in the 1990s and the first of the mortgage refi waves began, Eastern Financial Florida Credit Union found itself in the same position as many other lenders, especially in South Florida, where members kept the phone ringing and the fax machine humming with applications. That was not the good news.

Kendrick Smith, chief investment officer with EFFCU, said that while pursuing an MBA in 2003 he would come to learn of the Theory of Constraints, a theory he would soon be putting to use.

With a mortgage balance sheet of $2 billion, and a Broward County, Fla. market where the average house price is $400,000, mortgage lending has become an important function within the credit union that was founded to serve employees of the old Eastern Airlines. But to get to where it is today, Smith said it had to reexamine its mortgage workflow and all the challenges the organization was facing.

First, it took apart the process, beginning with contacts and moving onto origination, mortgage processing, underwriting, closing, post closing, loan review, secondary market, document management and internal audit.

In examining its challenges, Eastern Financial found it was difficult to respond to urgent member requests with too much expediting going on and priorities being shuffled. Lead times had become too long, (at the time 95% of the people with a mortgage had an economic incentive to refinance), with consistent work in process and a workplace that had become stressful, leading to high turnover. It also found that all the overtime wasn't being equated with profits, and all the ineffective multi-tasking on the part of staff members required a lot of rework due to errors. "It was kind of embarrassing," he admitted.

Here, the credit union turned to the Theory of Constraints, developed by Eliyahu M. **Goldratt.** "The Theory of Constraints is a continuous improvement philosophy that looks at an organization as a system," Smith explained. "It focuses on improving the 'throughput' from the system. Instead of focusing on costs, you focus on getting things through the system faster, which then reduces costs. By increasing throughput, the end-result will be improved."

But before improving, "constraints" must be identified. "The theory compares the system to a chain or a network of chains," Smith went on to explain. "The weakest link within the system is the system's 'constraint.' Improving any piece of the chain won't matter because it will still break at the weakest link. By improving the performance of the constraint, the weakest link is strengthened and throughput is improved."

In EFFCU's case, underwriting was identified as the weakest link after an operational analysis that included asking the question, "Do I have enough protective capacity in front of the constraint and behind the constraint? One of the things that Theory of Constraints does is it identifies what are the core issues," said Smith.

In the past, he noted Eastern Financial would take any application even if it really couldn't close the loan in a reasonable time.

"You have to regulate the flow of applications into the pipeline at the speed of which the underwriter can process them," said Smith. "When we went through the operational analysis, some very startling things came out of it. We learned we were losing money on every loan we did. "

By ensuring its internal process could handle the workload, its pricing became more competitive as it also improved member service. It began delivering closing dates at the time of application. "Do you know how many phone calls stopped coming when we explained that we hit our delivery date 99% of the time? We developed placeholders in the schedule, so that if a friend of the CEO showed up, we could close the loan in five days. This also reduced the volume of errors we had. If you have a closer making the same mistake and you don't close for 180 days, you could have several hundred loans with the same mistake."

Overall, EFFCU appears to have succeeded. Smith said he hasn't heard a member complaint in two years, it has increased its loan capacity 24% without adding any headcount, and it has dropped the cost from $1,900 per file to $1,360 per file.