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How To Use Return On Capital To Determine Profitability

Don't make decisions about allocating resources before considering cost of capital and the true net income.

By Joe Garrett and Corky Watts

In our consulting practice, we often have clients who don't fully understand the inner workings of their profitability. We see companies that can give us their profitability per loan. While it is usually an accurate number, it lacks much that is needed to make proper decisions.

It is not uncommon to find mortgage banking companies that know, to the basis point, what their profitability is. They will tell us that it is 78 basis points per loan year-to-date, 83 basis points last year and 76 basis points the year before.

Clearly, some loans are more profitable than others, and knowing average profitability per loan is rarely of much help. In fact, our response is to tell them that a non-swimmer can drown wading across a river with an average depth of only two feet. The average depth ignores the fact that there is a 10-foot hole in the middle of the river.

Put another way, what averages tell you is interesting, but what they conceal is critical and can be dangerous to your health.

The first step to truly understanding one's income statement is to analyze the profitability per loan based on loan-level attributes. Even within a very specific type of loan, say conforming loans sold to Fannie Mae, the need still exists to break profitability down by loan characteristics.

Is your profit the same on owner-occupied vs. non-owner? What about second homes? High FICO borrowers? Low loan-to-value loans?

It's quite possible that an owner-occupied, 40% LTV loan to a borrower with a 763 FICO will be 20 to 25 basis points more profitable than a loan to someone getting the same coupon, but with a 87% LTV and a 651 FICO.

If you're forming a security or doing a bulk sale, you simply cannot know too much about the individual loans. You need to customize the MBS or pool to get best execution, and there is no substitute for knowing your profitability per loan.

When we first got into this business in the 1970s, there were only three flavors of loans: FHA, VA and conventional. Beyond the chocolate, strawberry and vanilla, there was nothing more.

Adjustables didn't exist, 15-year or 20-year loans were unheard of, and hybrids were a few decades away. All loans were essentially 30-year and fixed, and underwriting was binary. You either qualified for the loan or you didn't. There was no such concept as charging a higher rate for a less creditworthy borrower.

In fact, there was even no such thing as wholesale, as all loans - strange as it seems - were originated retail. Our point is that back then, there wasn't much to analyzing profitability.

But things have changed.

Managers should go to the effort of looking at profitability by product and

Comparing Cost Of Capital

Comparing the cost of capital of the wholesale and retail channels reveals that retail is losing money, despite its greater income per loan.

	Wholesale	Retail
a. Income per loan	$200	$400
b. Cost to originate	$1,000	$4,000
c. Cost of capital (by rate)	15%	15%
d. Cost of capital (in dollars)	$150	$600
e. True net income (a–d)	$50	($200)

SOURCE: Garrett, Watts & Co.

by loan characteristics. They should know their profitability by fixed rate vs. intermediate ARMs, by jumbos vs. conforming, and by governments vs. conventionals.

But this is just the first step.

Having done this, management must now look at returns on invested capital. Let's use a simple example, looking at profitability per delivery channel.

Resolving the unending debate

An unending debate exists within a company about retail vs. wholesale. Retail argues for more resources because of its wider margins, yet wholesale counters that, while its margins are smaller, it makes up for it in more volume at a lower cost.

Let's now assume that retail generates a profit of $400 per loan and wholesale generates a profit of $200 per loan. (We're intentionally making these numbers small to make the example easy to follow.) We'll also assume that this is net of all expenses, and that it adjusts for all loan-level attributes, such as LTV, occupancy status and so on.

The less sophisticated manager would see that retail is twice as profitable as wholesale: $400 per loan vs. $200 per loan. The more sophisticated manager will demand to know how much capital is used by each division.

Let's now assume that the cost of capital is 15%, that retail has an origination cost of $4,000 per loan, and that it costs $1,000 to originate a wholesale loan. As shown in our chart, the calculation now changes dramatically.

At first glance, the manager favors his retail division over his wholesale division because he can make twice as much per loan in retail ($400) as he can in wholesale ($200). As a result, he would want to allocate more resources to retail.

However, retail uses up $4,000 of capital to produce a profit of $400 per loan, while wholesale uses only $1,000 of capital to produce a profit of $200.

Retail's profit of $400 is not even enough to cover its $600 cost of capital.

In fact - and this is the shocker when managers first see it - the more retail loans the company closes, the more it depletes its capital.

Before doing this analysis, everyone believes that retail has a higher profit margin - and it does. But when we factor in the cost of capital, we find that retail is actually a destroyer of value. Thus, the rational mortgage banker would want to allocate more resources to wholesale, even though he has a higher margin in retail.

We are obviously not favoring wholesale over retail. Our point is simply that profitability analysis is not as easy as the raw numbers on an income statement. Management must:

- look at loans based on all their characteristics and product types, and
- look at the capital required by each product or division.

Can there be exceptions? Of course. Let's now think of a mortgage originator that is part of a bank. The bank can look at our example and still decide to favor retail. The bank executives could believe that it's important to offer retail loans in their banking branches. This might even make sense if they are successful at cross-selling other products to their retail-originated borrowers.

They might consciously decide that it is acceptable to destroy capital originating a certain type of loan through a certain channel if it is a loss leader that leads to more profitable products. Destroying capital originating a retail loan may be acceptable if - and this is a big "if" - they also sell that customer a checking account, HELOC and a credit card.

Our point, however, stands. Decision makers should have the profitability metrics before making such decisions. It is absolutely critical to do so. Only then can management make the appropriate decisions about allocating resources and capital. SME

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