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Method of Loan Acquisition

In contrast to the series compiled by the Federal Home Loan Bank Board and the Federal Reserve Bank of Chicago, which are restricted to loans originated by the reporting lenders ("direct loans"), the National Bureau series also covers loans acquired from mortgage correspondents ("correspondent loans"); the correspondents are generally mortgage companies which originate loans for sale to "permanent" investors, retaining the servicing for which they receive a fee (expressed as a per cent of the loan balance) as long as the loan is outstanding.[1] In this chapter, we discuss the nature of company transactions with correspondents, the influence of service fees on the gross yield of correspondent loans, and the comparability of direct and correspondent loans.

Relationship of Life Insurance Company to Correspondent

The correspondent is viewed as a borrower rather than as the agent of the life insurance company in a transaction with a third party (builder or mortgagor). From the legal standpoint, at least, the correspondent is free to negotiate the terms on which a mortgage is to be transferred to the company. At a result, the terms and timing of the deal between the company and the correspondent could differ from those of the transaction between the correspondent and the third party. It is true, of course, that the contract rate and other characteristics of the instrument will be the same, since the instrument created (or, rather, authorized to be created) is the same in both transactions. But the price at which the instrument is transferred need not be the same. The finance committee records disclose the price at which the company authorizes purchase of the mortgage from the correspondent, but *not* the price at which the correspondent extends his own commitment, or the time of that commitment.

[1] For a full discussion see Saul B. Klaman, *The Postwar Rise of Mortgage Companies,* Occasional Paper 60, NBER, 1959.

This does not mean that the terms of a transaction between the company and the correspondent are necessarily independent of the terms of the transaction, covering the same instruments, between the correspondent and mortgagor or builder. Although from the legal standpoint the transaction between company and correspondent is a negotiated market transaction, the actual working relationships between them may take a variety of forms, some of which reduce their freedom to bargain for the best terms possible under current market conditions. To the extent that this is the case, the terms of the transaction between the correspondent and the third party may influence the transaction between the correspondent and the company.

Several kinds of company-correspondent relationships may be distinguished in terms of the degree of independence that can be exercised in bargaining on a specific transaction. These relationships differ from company to company, and for any individual company they may differ from one correspondent to another.

First, the relationship may be one of *strict independence.* The company feels free to adjust its buying rate at any time without any notice, and the correspondent is free to offer a loan to another company if he can obtain a better price. If the correspondent extends his own commitment before obtaining a commitment from the company, he does so at his own risk, e.g., if he commits on FHA 5 per cent mortgages at a price of 97 and the company lowers its buying price to 96 before he obtains the company's commitment, the correspondent bears the loss. (Of course, if prices rise in the meantime the correspondent makes a speculative profit.) Correspondents having this kind of relationship with life insurance companies usually deal with a number of companies, and shift offerings from one company to another, depending on the kinds of mortgages they have to sell and on which companies currently have funds to invest. Companies dealing with correspondents on this basis usually do not feel any obligation to provide them with a steady source of funds.

Second, the relationship between company and correspondent may be one of *quasi-independence,* where a continuing relationship causes some modification in their short-run behavior. The company may give the correspondent an *allotment,* permitting him to plan his operations for some period ahead, i.e., the correspondent will be told that the company will accept some specified volume of mortgages during a future period (say, six months or a year). Allotments are not legally binding on the company, offers by the correspondent still have to meet

the company's credit requirements, and the company's buying price remains subject to change without notice. Yet behavior is constrained by concern for the relationship. If the company finds it necessary to drop its buying price sharply at a time when a "faithful" correspondent is heavily committed, the company may bail out the correspondent by buying at the higher price in the correspondent's commitment. (If the company adopts this policy, it likely will expect the "faithful" correspondent to pass along any special bargains he may have acquired.) As an alternative, the company may try to soften the impact of a price drop by giving the correspondent short notice (say, a week) that the drop is coming. This involves the hazard to the company that the correspondent will try to dump all its loans on the company, including loans that had been intended for other lenders. (Even if the company is adamant about never bailing out a correspondent or giving notice of a price change, it will feel constrained not to change prices too often or too drastically.)

A third relationship between company and correspondent may be one of virtually *complete dependence*. This arises when the company grants the correspondent precommitment authority. Under such an arrangement, the correspondent is authorized to commit himself at the company's current buying rate up to some maximum amount (e.g., 20 per cent of his annual allotment) without risk. If the company lowers its buying rate after the correspondent extends its own commitment but before he obtains the company's commitment, the company is obligated to accept the loans at the terms of the correspondent's commitment. By the same token, when the company lowers its buying rate, it expects correspondents with commitments outstanding at a higher rate to pass them along.[2] In effect, the correspondent commits the company and for practical purposes becomes the company's de facto agent for as long as the relationship remains intact. Under such arrangements, the terms of the transaction between the correspondent and the company will always be the same as the terms of the transaction between the correspondent and the third party. This type of relationship is most likely to develop when the company provides the sole or largest outlet for a given correspondent.

The implications of various types of company-correspondent relationships for the *timing* of statistical series on correspondent loans were discussed in Chapter 4.

[2] The company may or may not reserve the right to refuse mortgages that do not meet its credit standards.

Variability in Service Fees as an Influence on Gross Yield

From the standpoint of mortgage-yield data, correspondent loans have the disadvantage that the recorded yield on the credit transaction may be affected by the terms of the servicing transaction. (The reverse, of course, is also the case.) Saulnier has remarked that "sometimes loan servicing is partly remunerated by a relatively high acquisition fee, and in other cases loan acquisition is remunerated in part by a relatively high servicing fee."[3] The service fee may also be varied to compensate for differences in contract rate. For example, a lender might pay a service fee of ½ per cent on a 6.00 per cent mortgage and only ¼ per cent on a 5.75 per cent mortgage that in other respects was identical.[4] In such case, different gross yields would be recorded for the two mortgages, although the return net of service fee would be the same.

This problem can be viewed from the standpoint of structural (cross-section) analysis and time series analysis. Regarding the structural problem, the service fee is one variable of many affecting gross yield. Differences in service fees can affect gross yield if individual lenders pay different service fees for different loans, or if there are interlender differences in general policy toward service fees. The first effect is illustrated in Table 6-1, which shows gross yield and service fees on loans authorized by one lender in California during February 1960. Of the 215 loans authorized in that month, 198 carried a service fee of ¼ per cent. These loans had gross yields ranging up to 6.12 per cent, but most were concentrated at 5.88 per cent. The remaining seventeen loans all had a service fee of .37 per cent and gross yields of either 6.25 per cent or 6.50 per cent.

Prior to 1959, interlender variability in service fees was small. The standard fee was ½ per cent, and monthly averages were generally within the range of .47 to 51 per cent for all the companies.[5] In 1959, one company dropped its standard service fee to .375 per cent. By in-

[3] Saulnier, *Urban Mortgage Lending by Life Insurance Companies,* p. 61.

[4] Such contract-rate differences may arise because correspondents have held loans in inventory over a period of rate change, or because of market imperfections at the origination level.

[5] VA loans, however, occasionally carried lower service fees when the maximum contract rate was far below the market.

TABLE 6-1

Gross Effective Yield and Service Fee on Conventional Mortgages in California by One Life Insurance Company, February 1960

Gross Effective Yield	Service Fee	Number of Mortgages
6.50	.37	6
6.25	.37	11
6.12	.25	23
5.90-5.99	.25	11
5.88	.25	163
5.63	.25	1
Total		215

creasing intercompany variability in service fees, this may have increased structural variability in gross yield.[6]

Time series of gross yields could be affected by service fees to the extent that average fees change for individual companies, or shifts occur in the mix as between companies with different average fees. Neither effect could have been of any quantitative importance for United States averages on FHA and conventional loans during the period 1951–58, since the monthly averages for all companies hugged the standard fee of ½ per cent very closely (Chart 6-1). When average service fees fell to a lower level in 1959, month-to-month variability became somewhat greater, as shifts in the mix had a greater effect on the average. The variability was not systematic, however, and cyclical patterns in gross yield were not significantly affected.[7]

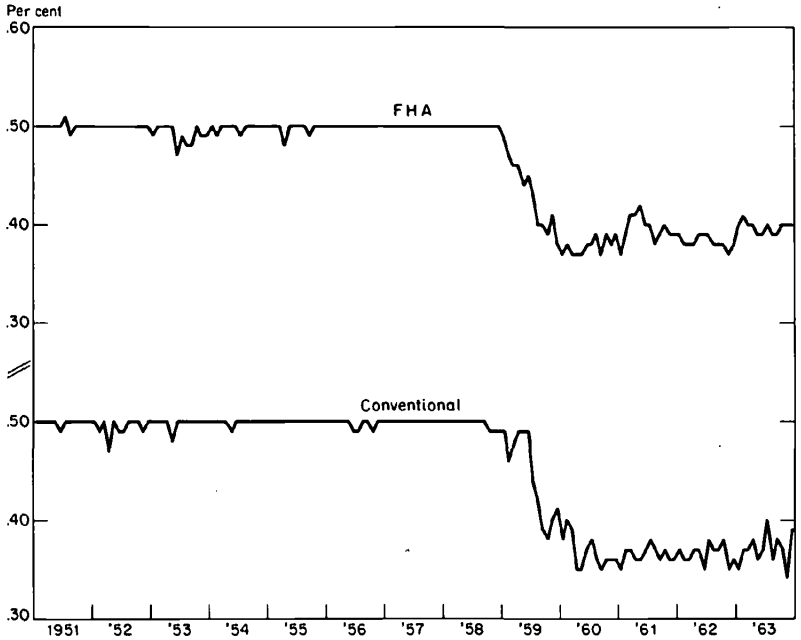
The influence of service fees on yield can be avoided, of course, simply by measuring yield net of service fee. Correspondent loans cannot, however, be compared to or combined with direct loans on a net basis because data are not available on servicing costs of direct loans. Correspondent and direct loans can be combined only on a gross yield basis. This raises a question regarding the comparability of gross yields on correspondent and direct loans.

[6] Any increase would have been small, however, since our data do not show a rise in over-all gross yield dispersion after 1959.

[7] It is possible, however, that the average *level* of gross yield on correspondent loans was .10 to .15 per cent lower after 1959 than it would have been if service fees had not fallen.

CHART 6-1

AVERAGE SERVICE FEES ON CORRESPONDENT LOANS, 1951–63



Comparability of Gross Yield on Correspondent and Direct Loans

On direct loans, the costs of servicing are borne by the life insurance company, while on correspondent loans, these costs are borne by the mortgage company. There is evidence to suggest that service fees paid to correspondents are higher than servicing costs of large companies that do their own servicing. Hence, we might expect competition to force gross yields on correspondent loans below those on direct loans, so as to equalize yields net of service costs. As an example assume that (1) the cost of servicing mortgages (including profits adequate to provide a competitive return on capital) is ¼ per cent but the service fee is set at ½ per cent by convention, and (2) direct and correspondent loans are alike in every other respect, including contract rate. In

such case, we might expect price competition to bring about results such as the following:

	Direct Loan	Correspondent Loan
Contract rate	6.00	6.00
Less: servicing costs	.25	.50
Equals: contract rate net of servicing	5.75	5.50
Plus: fee required to equalize yield	—	.25
Equals: yield net of servicing	5.75	5.75
Gross yield (contract rate plus fees)	6.00	6.25

The gross yield would be larger on correspondent loans by the amount of the "surplus" in the service fee.

On the other hand, net costs of origination are borne by the life insurance company on direct loans, whereas on correspondent loans these costs are borne by the mortgage company.[8] If origination costs (expressed as an annual rate) were exactly equal to the "surplus" in the service fee, competition would tend to equalize gross yields on direct and correspondent loans, as in the following example.

	Direct Loan	Correspondent Loan
Contract rate	6.00	6.00
Less: servicing costs	.25	.50
net cost of origination	.25	—
Equals: contract rate net of servicing and origination	5.50	5.50
Plus: fee required to equalize yield	—	—
Equals: yield net of servicing and origination	5.50	5.50
Gross yield (contract rate plus fees)	6.00	6.00

The upshot is that although gross yields on direct and correspondent loans are not strictly comparable, the elements of noncomparability

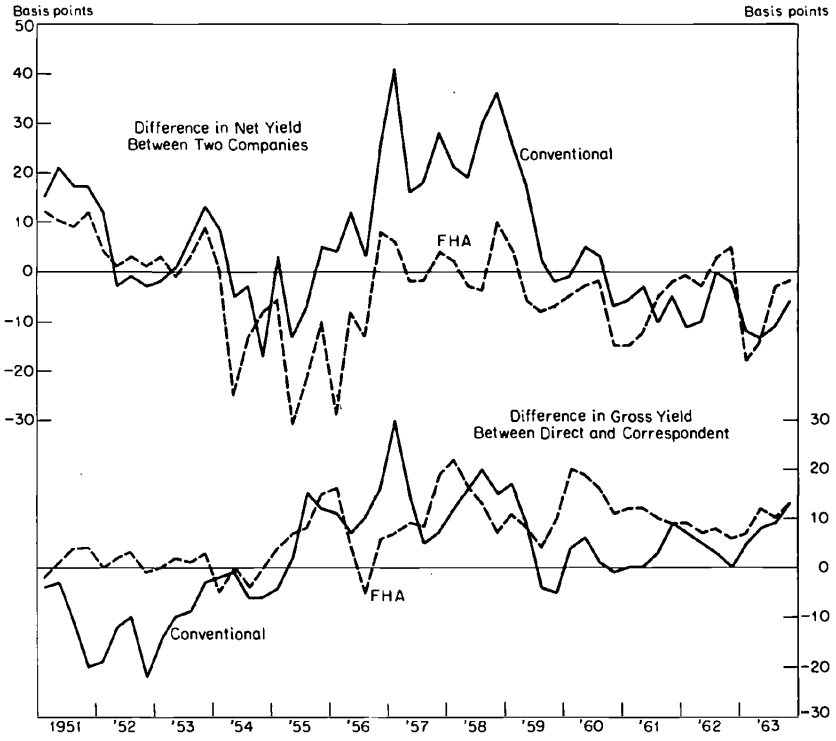
[8] Originating loans also generates income, but apparently most mortgage companies do it at a net loss. See Oliver H. Jones, "Mortgage Banking in 1963," *The Mortgage Banker,* December 1964, p. 23.

tend to be offsetting. If the net cost of origination is larger (smaller) than the surplus in service fees paid to correspondents, the gross yield of correspondent loans is biased downward (upward) relative to the gross yield on direct loans.

Gross yields on direct and correspondent loans may also differ because of market imperfections, even if the surplus in the service fee were entirely offset by net origination costs. For the same reason, intercompany differences exist in the net yield on correspondent loans alone. This suggests the following pragmatic test of the appropriateness of combining gross yields on direct and correspondent loans. Such consolidation is appropriate if yield differences between correspondent

CHART 6-2

INTERCOMPANY DIFFERENCES IN NET YIELD ON CORRESPONDENT LOANS COMPARED TO DIFFERENCES IN GROSS YIELD BETWEEN DIRECT AND CORRESPONDENT LOANS, QUARTERLY, 1951–63



and direct loans are no greater than intercompany yield differences on correspondent loans alone.[9]

This turns out indeed to be the case, as illustrated in Chart 6-2. The upper part of the chart shows differences in net yield on correspondent loans between two companies, while the bottom part shows differences in gross yield between correspondent and direct loans. The differences are calculated quarterly to minimize the effect of sampling error, which on this basis is only slightly larger in the individual company comparisons. It is clear that for both FHA and conventional loans, differences in gross yield between direct and correspondent loans are of the same general order of magnitude or, perhaps, somewhat smaller than differences in net yield on correspondent loans between individual companies. This pragmatic test shows no reason why direct and correspondent loans should not be combined.

[9] The direct-loan sample is not large enough to permit intercompany comparisons on direct loans.