

Asset Securitization



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report

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Accredited's Konrath talks strategy in bubble environment

As talk of the housing bubble bursting looms and affordability mortgage products proliferate, ASR chatted with Accredited Home Lenders Inc. Chairman and CEO Jim Konrath to discuss his company's future prospects.

JK: We were pleased with the quarter, as well as the first half of the year.

We made a decision several years ago to be much more active as a portfolio lender. That portfolio has grown to \$8.3 billion at the end of the quarter, which contributed 37% of total net revenue in the second quarter, and roughly the same amount of profits. Increasing the percentage of net revenue and profit from the portfolio has, and will, allow Accredited to produce more stable, consistent earnings regardless of what is happening currently in the origination market.

Another factor is what we call platform growth. We continue to increase our number of offices and people. In terms of people, we continue to spend a lot of money and resources on training our people to improve their product and industry knowledge. It is basics. It is blocking and tackling, and continuing to do those things right.

One other important factor is that we have never been a price leader. We try to compete with knowledgeable people, good products, and good relationships with mortgage brokers. If you can provide a better level of service, you can command a slightly better price.

ASR: What incentives are used to insure sales managers produce high quality loans?

JK: A large part of the sales manager's compensation is paid on the profits of their particular unit, so I think that helps to drive the pricing discipline. If something changes on a loan, our peo-

ple are more willing to price the loan to its inherent risk because they are not just paid for volume, but primarily paid for profit. And the portfolio is better protected because if the loan does not sell, or it is repurchased, any loss on that loan is charged back to the origination team.

Once a loan is booked, the originating team is given credit for what that loan would sell for in the secondary market. So, if the team originates a \$200,000 loan that would generate 3% premium, they would get credit for \$6,000 on their P&L. Now, if the loan comes back a couple months later because it didn't sell, and we had to sell it at a discount of \$0.95 on the dollar, that is a \$10,000 hit. We charge the \$10,000 discount to the sales team and take back the \$6,000 credit. So they get a \$16,000 hit for that one mistake. As a result, our people and processes are very focused on rooting out fraud, and other problems that would affect the profitability of a loan.

Another key component of maximizing the profitability of a loan is data integrity. I think we know more about our borrower and what is in our loan files than our competitors know about what is in their loan files. Delivering the most accurate and complete loan files is another way that our people can maximize the profit in their individual units and thereby increase their personal compensation.

ASR: There has been a lot of speculation about the future performance of the

housing market amid decelerated home-price appreciation and record number of new homeowners. What is Accredited's outlook on the future viability of the housing market, and how do you factor the risks into mortgage lending?

JK: For some time, our view has been that the market-value appreciation across all parts of the country cannot be sustained at the current pace, so we've been expecting home prices to flatten out somewhere. Are there bubbles out there that could or would burst?

Our answer is "probably," but we have stopped predicting where or when it will occur. When the whole dot.com industry went bust in Northern California a few years ago, we made the decision to continue originating loans there, but to sell all those loans, rather than hold any in portfolio. That proved to be a mistake because the portfolios from that area have been among the best performance from any region.

So we figured out that the best strategy was to diversify our originations throughout the country in order to be able to offset any regional decline by generating loans from all of the other, performing regions of the country.

Many experts are pointing to California as the most likely place for a real estate decline. The percentage of our California originations has declined over the last couple of quarters, but not because we are predicting a decline in real estate prices, rather because of competitive pressure. Pricing competition in the California market has become so cutthroat that we have

decided to concentrate our origination efforts on markets that allow us to compete with rational pricing to risk.

ASR: Do you price differently across markets to account for speculative risk?

JK: We do not price differently in different markets. Ultimately, every regional real estate decline that I think I've ever seen, and I've been around a lot of years, were related to loss of jobs. I have never seen a housing bust, if you will, that didn't have some significant association with loss of employment, and I assume the next one will be the same. Trying to outguess it is beyond what we think we can and should do.

ASR: Do you see secondary market buyers asking for higher premiums in certain areas?

JK: I think the whole loan sale market takes about the same approach that we do. They do not like concentration. If a pool has a 50% concentration in California or New York, that would raise some eyebrows. I really can't speak directly for loan buyers in general, but I know our investors. If a concentration arises in any one pool for any reason, they'll comment on it or ask about it. We see that in securitizations as well. It is certainly on people's radar screens, but I haven't seen differentiation in pricing.

ASR: Are there any new products in the nonprime lending market that Accredited will not offer, such as interest-only and option arm products? What is your view on the future performance of the products with little-to-no historical performance data?

JK: We don't do option ARMs. As for interest-only loans, the percentage of IO loans of our total originations is usually in the teens. I think all of these new products have a place, so long as all of those products can be appropriately used. But, what borrower do you put into which product is the key issue or concern. My daughter just bought a house in San Francisco, one of the hottest real estate markets in the country. She is four or five years into her career and has a

steadily increasing income level, so for her the IO product works well. So, we look at how are they being used, and are they being used in situations that will work best for the borrower.

ASR: How far do you go down in FICO for the IO product?

JK: Minimum FICO scores for the interest-only product vary by the other attributes of the loan. For customers with optimal LTV, debt ratio and income documentation, etc., the minimum FICO is 550. For riskier profiles, the minimum FICO requirements range from 600 to 680.

ASR: Does such a stance make it difficult to compete in the current nonprime lending atmosphere?

JK: There is no question that it is extremely tough competing in the marketplace today. And I suppose the competitive environment is not so much a matter of unusual or exotic products, but are we pricing for risk. There are some products that we'd love to do, but not at that LTV and not at that price. I think today where we see the price competition lies in whether or not the competition is pricing to all of those risk factors as they should be. You are seeing virtually conforming prices today in the nonprime sector, so you have to wonder if we are pricing for risk at all on some of those products.

ASR: How would you describe the current atmosphere in the secondary market? Are you finding whole loan sales or securitization to be the most efficient funding source?

JK: Our loan dispositions are typically split 70/30, which is driven by leverage. Our leverage right now is in the low teens, and we are very comfortable with that. We originate more than we can keep, so we will continue to sell loans. In addition, certain loan types don't securitize very well, like second mortgages and high LTV first mortgages. Those products tend to be sold to banks or companies that have rated balance sheets and issue their own commercial paper. After that, what I think we are

seeing is that the whole loan buyers are probably working for a little bit less than they were a year or two ago.

We continue to see strong prices for the spread that we are delivering, and we are also seeing a lot of interest. We try to keep all of those categories of buyer active, and it really hasn't been a problem at all this year. They've all had a strong appetite for loans.

On the securitization side, worldwide the appetite is very good. We have had international interest in the bonds. Some of our bonds have been sold to investors in Asia and Europe, and I would not be surprised if the same occurred in this last securitization. The demand for Accredited ABS bonds continues to remain high.

ASR: Could you elaborate on the international interest you are seeing?

JK: Extensive interest from European investors is a recent phenomenon, although we had bonds sales with **Abbey National plc** going back to 1996. Asian investors began purchasing our bonds in 2004.

ASR: Where do you expect whole-loan sale premiums to trend this quarter?

JK: We expect premiums to be flat or down slightly for the industry. While we've recently seen some increases in pricing from competition, we do not think that the industry as a whole has come close to absorbing the increase in the underlying cost of money over the past few months, and therefore will "pay the piper" in the form of flat or declining premiums.

ASR: Do you plan to stay on track with quarterly securitizations?

JK: We are on a quarterly securitization schedule. We definitely have a plan to do a securitization on the quarter, in the middle month of each quarter.

ASR: If you could get across any point to the secondary market, what would it be?

JK: If I had one point to get across to the secondary market I'd say: "Know your originator."



ACCREDITED
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