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Subprime Lenders *Have Been Lousy Fishermen*

By Bob Kasper

IF YOU WERE AN OYSTER FISHERMAN, WHAT WOULD YOU DO WITH THE PEARLS YOU FIND ALONG THE WAY? You'd find a buyer and sell them. Pearls may not be your specialty, but selling them is relatively easy and the extra revenue helps pay for the gas and maintenance on your boat. ❍ ❍ ❍ Most subprime lenders I've known haven't worked that way. I recently called one of the major subprime lenders. I said I had excellent credit and wanted to refinance with cash-out. The lender told me that I'd "probably want to talk to another company." The result: That lender lost a customer. ❍ ❍ ❍ There are many valid reasons why subprime lenders don't handle conforming customers—the "pearls." But would they be more profitable if they did? Are they evolving toward that model? ❍ ❍ ❍ I've had the pleasure of working with some of the late, great subprime lenders as well

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Subprime-only lenders must diversify if they want to survive the ups and downs of the mortgage business.

as some of the survivors. Now that most are either deceased or transformed by acquisition, it's finally safe to share the experience and help some of the survivors prepare for the transitional years ahead. This article is not intended to be a history or even an analysis of subprime lending. My hope is to simply shed light on the trends associated with retail subprime marketing programs.

Once upon a time

Subprime's heyday began in the early 1980s, when interest rates recovered from the stagflation run-up that brought conventional 30-year, fixed rates to more than 18 percent in 1981 (see Figure 1).

By the early 1990s, subprime was growing so vigorously that lenders were able to pick and choose their customers. Throwing away the less-lucrative "A" customers enabled subprime lenders with limited available capital and/or a high cost of capital to focus their resources on the high-yielding subprime customers.

Loan officers and processors were quite busy as well. It made quite an impression on me back in 1996, when I overheard some loan officers at a major lender comparing notes and one said, "I wouldn't even do a loan for my own mother for less than 2 points." Those days ended abruptly in the late 1990s, as the subprime market was hit with a liquidity crunch started by the Asian currency crisis of 1997 and finished off by the Russian debt default of 1998. Subprime lenders large and small went under, taking with them risky niche products such as 125 percent loan-to-value (LTV) home-equity loans.

Database assets

Finance companies such as Prospect Heights, Illinois–based Household Finance Corporation (a subsidiary of Household International), Dallas-based Associates First Capital Corporation (a subsidiary of Citigroup Inc.) and Prospect Heights, Illinois–based Beneficial Corporation (a subsidiary of Household International) had large databases of existing customers that they used for cross-selling and upgrade programs. Unsecured personal loan customers often had equity in their homes and could be switched over to a less-risky home loan. Private-label credit card customers, who were often unaware that they already had an account with the company, provided the lenders with rich data on their use of credit as well as product purchase behavior. Affiliate companies, particularly credit-card divisions, offered tremendous databases with a wealth of product purchase information.

Marketing to these customers was easy and lucrative. Bank holding companies such as Chicago-based Bank One Corporation expanded their subprime divisions partially to exploit existing database assets. Wilmington, Delaware– based First USA's (a subsidiary of Bank One Corporation) database assets were added to Indianapolis-based Bank One Financial Services' (BOFS) marketing program shortly after First USA was acquired by Bank One in 1997. With a customer base of more than 40 million and other database assets gained in the course of doing business, First USA proved to be a significant contributor to BOFS' marketing program.

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Most subprime lenders haven't had the benefit of extensive database assets. Therefore, smaller or less-established lenders and brokers used aggressive, proactive marketing to grow their businesses. Direct mail, telemarketing, direct-response television, Internet leads and newspaper advertising were the most popular choices. According to sources at the company, more than 25 percent of West Sacramento, California-based The Money Store's (a subsidiary of First Union Corporation) mass-media responses came from "A" credit responders. This number was apparently much higher before some advertising changes were made in 1993

Figure 1 Interest Rates—30-Year Fixed, Conventional Mortgage Average Contract Rates

SOURCE: MBA

to discourage response from this group. Despite advertising in broadcast media, where the majority of the audience could be described as conforming-type customers, and where a large portion of responders are conforming, lenders such as Parsippany, New Jersey–based Champion Mortgage Co., Inc. (a subsidiary of KeyCorp) and The Money Store were able to easily grow their businesses by turning up the marketing.

According to Jim Cachules, manager of client services at Sacramento, California–based America's Lending Partners, a lead generation company that uses mostly late-night and fringe television and radio advertising to generate mortgage leads, only "46 percent of respondents obtained through mass-media campaigns would be considered subprime." Much like the mass-media subprime lenders of the 1980s and 1990s, America's Lending Partners chose to advertise in dayparts (mostly fringe and late-night slots) that would likely skew its response toward subprime while promoting debt-consolidation and home-improvement loans.

Keith Dyer, a vice president and principal at Langhorne, Pennsylvania–based Resource One Mortgage, which was bought by Hatboro, Pennsylvania–based ContiMortgage in 1996, says that 80 percent of Resource One's business was conforming and only 20 percent subprime before it started extensive mail programs in 1993 and telemarketing programs in 1995. By the beginning of 2000, "only 9 percent of our business was conforming," Dyer says.

"[Resource One] was designed to emphasize subprime," says Dyer, "but we wanted to be a company that captured the business at the time. We were in the middle of a refi boom, and senior management wanted to develop a culture where we could meet the financial needs of all borrowers regardless of their credit history."

Just like Resource One, many mortgage companies learned that their businesses could easily be shifted toward subprime simply by changing their marketing mix.

Choosing a market space

Where should a subprime lender target its marketing to reach motivated customers as cost-effectively as possible?

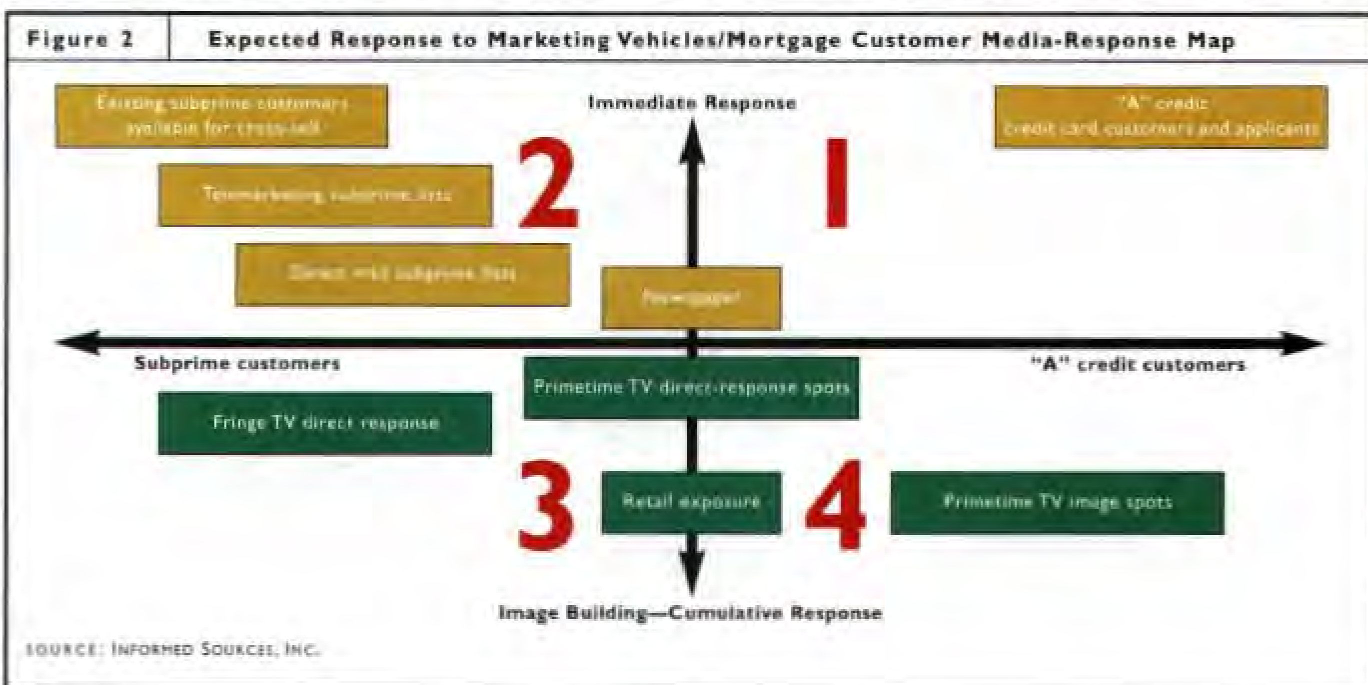
Figure 2 is divided into four quadrants, with the most popular marketing vehicles placed in the space that best represents the effects of that marketing vehicle. The y-axis represents how long it takes to see a response to marketing. The x-axis represents credit grade of likely responders to that type of marketing.

If you could build the perfect marketing campaign, your marketing would be predictable, immediate and accurate. Subprime lenders would win all the business they need by cost-effectively spending all their marketing dollars (see the upper left corner of quadrant 2 for best media vehicles) using marketing resources such as existing customer cross-sell lists. Conforming lenders would spend all their marketing dollars (see the upper right corner of quadrant 1 for best media vehicles) using marketing resources such as A-grade existing customer cross-sell lists.

"The most accurate and predictive data [in building a direct-marketing program] for financial products is your internal transaction data, followed by individual credit data. Next is the individual demographic data and last is the other data," says Peter Harvey, president of IntelliDyn Corporation, Bethpage, New York, an analytic services company specializing in direct-to-consumer marketing and risk management.

Individual transaction data is especially valuable because it can provide an indication of the customer's propensity to respond along with insight into the products and promotions the customer is likely to need or want. Harvey makes a strong case for using any previous knowledge about the customer to obtain estimates of individual consumers' propensities to respond or their needs for subprime mortgage products. "Unfortunately, many lenders are unable to easily access this transaction data, or link it to their customers," he

Figure 2 Expected Response to Marketing Vehicles/Mortgage Customer Media-Response Map



SOURCE: INFORMED SOURCES, INC.

says. "Even those who can, need to supplement with external data to capture the opportunity beyond their customer bases. Experience in sifting through the hoard of external data for only the most predictive elements that boost results has separated the successful subprime lenders from those that no longer exist. If you can harness the predictive power of your internal data and apply it to your external data for prospecting, you'll improve your return on your marketing investment and maximize your opportunities for growth."

It's true, as Harvey points out, that you can recycle a lot of your internal data, but growth is certainly limited when you're constrained to simply using internal lists.

Examples of different types of internal transaction data sometimes used for marketing list selection include the following:

Depository institutions

- Dwindling balance customers
- Consistent, but low-balance customers
- Former customers

Credit card issuers

- Customers with credit card balances
- Cash-advance users
- Declined customers (those who own homes and are turned down for revolving credit such as credit cards, who are frequently saddled with high-interest debt and make great candidates for home-equity loans to be used for debt consolidation)

Finance companies

- Personal loan customers
- Private-label card customers
- Personal loan declinations

According to Harvey, prior knowledge about customers gained from internal transaction data can enable lenders to "gain more control across both marketing and risk."

Choosing marketing vehicles

Referring back to the media-response map (see Figure 2), quadrant 1 contains marketing vehicles that would elicit immediate response from "A" credit customers. Unlike broadcast media, which require repeated exposure before respondents pick up the phone, direct mail and telemarketing have shown themselves to pay out quicker. Marketing to lists that contain "A" customers is possible for subprime lenders who offer high-LTV programs. However, "A" customers can be a difficult group for lenders to service. Many of these customers feel that they deserve the best mortgage rates they see advertised in the Sunday newspaper, even if they're looking for a second mortgage, have significant unsecured debt balances and want to borrow more than 100 percent of the home's value. The incentive to marketing high-LTV loans to "A" customers is that there's little competition for their business.

Immediate response from subprime credit customers (see Figure 2, quadrant 2) can be obtained from cross-sell lists, which include personal loan customers, credit card customers, customers with dwindling bank accounts, etc. This group has offered the highest return for subprime marketers, because their transaction data reveals a need for the lender's products while their credit profiles reveal compatibility with the lender's products. In addition, return on investment can be quick and measurable. Subprime credit customers understand that they have credit problems and haven't historically worked as hard to get the best rate they can, leaving more room for profit.

Both of these immediate-response marketing areas would be quite limited if lenders were restricted to marketing only to their own customer lists. However, response-modeled noncustomer lists have proven to be valuable resources,

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even in cases where there is no awareness of the lender's brand name.

A study conducted in 1997 by Plainview, New York–based Informed Sources, Inc., a mortgage industry marketing consulting and telemarketing company, showed that customers interested in home-equity loans were only 8 percent more likely to respond affirmatively to a telemarketing pitch if they recalled the lender's advertising (aided and unaided recall).

Stuart Goldberg, president of Informed Sources, says that "subprime mortgage customers have been minimally affected by brand identity or familiarity with the lender. Over the course of 12 million telephone interviews performed for numerous lenders over the past nine years, neither the lenders' brand names nor their presence of media advertising (when compared with nonmedia markets as well as premedia markets—where the advertiser has not yet introduced broadcast advertising) had a substantial impact on subprime customers' willingness to respond."

Broadcast media are the dominant components of the image-building half of the map (see Figure 2). The problem with this space is that there aren't many marketing vehicles that are overwhelmingly subprime, which would enable lenders to cost-effectively reach their target market without wasting lots of valuable resources on "A" customers. Therefore, lots of valuable advertising impressions are made on customers whom subprime lenders haven't been able to service well. Now shuttered mortgage companies such as The Money Store; FirstPlus Financial, Dallas; and Personal Mortgage Cor-

poration, Brewster, New York (a subsidiary of Beneficial Corporation), relied heavily on fringe and late-night TV advertising hoping to reach subprime customers in a less-competitive market space. However, it's likely that they found themselves spending almost as much time fielding calls from "A" customers, whom they couldn't service well.

The subprime image-building market space has been occupied mostly by lenders who no longer exist. Most of the subprime lenders who had spent significant resources building a brand have vacated this space or are out of business. With product offerings that are off-target for a large percentage of their respondents, the large investment in a retail brand identity didn't pay off long-term.

Primetime broadcast media are a desired space for many banks and other traditional mortgage lenders trying to reach "A" customers. Brand building, corporate advertising with memorable jingles and sophisticated creative efforts often require substantial long-term investment and patience, which is a barrier to entry for smaller lenders with fewer financial resources. Customers with "A" credit have many options, so competing for these customers in a market space with less competition is a competitive advantage that larger lenders such as J.P. Morgan Chase & Co. and Citibank can currently afford. According to a December 27, 1999, article in *Forbes* magazine by Seth Lubove, "Bust and Boom in the Subprime Market," it's estimated that 10 percent of homeowners would fit into the subprime category. The larger that number becomes, the more necessary it will be for marketers in this space to widen their brands' product offerings to include subprime, or to create a referral network to somehow handle subprime customers. This would bring image-building retail marketers back into the subprime market, crowding out some of the current competitors.

Many subprime marketing strategies worked well while the subprime market was booming and competition was limited. However, there are now more obstacles to winning subprime business, including growing regulation limiting how much a customer can be charged and more wholesalers offering risk-based pricing to brokers. In addition, soaring home values in many housing markets have created a wealth effect by providing homeowners with newly found equity that they've been borrowing against. The result has been that many of these homeowners have already cashed out, using all the available equity they've won in the housing boom.

These increasing market pressures are forcing many subprime lenders to start selling the "pearls," or conforming mortgages, to survive. Retail marketing and product strategies are incorporating risk-based pricing more frequently, where the customers providing the least risk get the best rates and pricing. This enables lenders and brokers to service all customers. It's true that the conforming loans typically have smaller profit margins, which would decrease overall gross profit margins. However, the marketing cost per loan funded improves dramatically because the incremental cost of finding these additional customers is so small.

Based on numbers obtained from two different marketing companies, many subprime lenders are currently paying marketing costs of $600 or more per funded subprime loan. Therefore, if subprime lenders service the conforming loans they find along the way, they could frequently afford to make $600 less on these loans without affecting their average loan revenue. On a $50,000 loan, that would mean they could earn 1.2 points less due to the reduction in marketing costs.

This is nothing new, according to Steve Alonso, president of Carmel, Indiana–based mortgage bank Cresleigh Bancorp. "There was a time when loan officers handling conforming loans were located in Household's branches," says Alonso. He recalls the environment during the early 1990s, when he was senior vice president of Mortgage Central, a division of Household that sought to centralize much of the company's conforming and finance company operations. Household's conforming operation, which was sold in the mid-1990s, had enabled the company to offer conforming and subprime loans. According to Alonso, loan officers "referred business back and forth to each other, often working together in the same branch offices." Using this strategy, "Household was able to offer two different delivery strategies to two different types of customers," Alonso says. In markets where Household operated conforming and finance company operations, the company's consumer image was neither subprime nor conforming—it was both, Alonso says. Alonso cautions, however, that although it makes economic sense from a marketing perspective, "there are many operational impediments" to handling conforming and subprime loans under one roof.

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How to fish where the fish are

Telemarketing and direct mail have been effective vehicles for targeting the subprime market, without wasting a lot of resources mismarketing to "A" consumers. Marketers with access to existing subprime customer lists or even modeled lists are able to choose who receives their messages. Subprime customers are also more likely to respond, skewing all direct-response marketing in the subprime direction, even if the list is not perfect. Our experience has shown that brand building has not proven to be entirely necessary in winning subprime business, reducing the barriers to entry. However, this market space has been becoming very crowded, increasing customer acquisition costs.

Internet leads have also been a popular resource for subprime lenders. Although many of the lead sources provide the same leads to multiple lenders and the volume is often smaller and less predictable, the customers are usually motivated. According to Loren Brown, president of Quality Mortgage, St. Louis Park, Minnesota, Internet leads also tend to be "higher-class," skewing them in the conforming direction.

An Informed Sources survey of 1,265 randomly selected New York State homeowners (excluding Manhattan) who expressed, over the phone, that they were actively seeking home loans in the fourth quarter of 2000 indicated that 57 percent of respondents appeared to be subprime candidates based on their responses to numerous questions about their credit and payment history. Comparing this finding with *Forbes* magazine's estimate that subprime loans comprise

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10 percent of total mortgage loans, it's highly likely that subprime prospects are very heavily represented in telephone-response programs compared with their size in the overall loan population.

Marketing for survival

In a competitive market, specializing in a narrowly defined credit category can be volatile and cyclically expensive. Economic downturns will easily cause business slowdowns, while economic spikes can cause unmanageable upturns. Lenders wouldn't know that unless they've survived at least two economic cycles.

Illustrating this point for the subprime lending industry is difficult, because the industry didn't become competitive until the 1990s, which was within the most recent bull market. Nevertheless, the Russian financial crisis, though sudden and short-lived, provides us with a case study.

ContiFinancial, Hatboro, Pennsylvania; Cityscape Financial Corporation, Elmsford, New York; FirstPlus Financial Group; and Southern Pacific Funding Corporation, Lake Oswego, Oregon, were among the larger subprime specialists that grew tremendously in the 1990s. Now they're all deceased. Many of the larger survivors of the 1990s have been taken over just to be disassembled or dissolved. Household, in business since 1878 and more diversified in its businesses, remains lonesome on a short list of survivors that seemed unaffected by the situation.

An economically balanced marketing plan requires evening out the economic cycles and maximizing revenue per dollar spent on marketing rather than maximizing revenue per customer. Some suggestions follow:

Even out the economic cycles. This strategy requires lenders to save significant marketing budget for the down cycle rather than spending most of it during the up cycle. It's true that advertising cost per prospect reached may be higher in slow times, but many marketers cut ad budgets during slower times, creating less competition for customers' attention on the air. This enables the remaining marketers to obtain a higher "share of voice" with their marketing. Apportioning marketing budget for slow times will also make for a soft landing and enable lenders to provide their sales forces with predictable, consistent sources of leads.

Adopt a multimedia marketing approach, including flexible media such as direct mail and telemarketing, which can be predictably bumped up or turned down during unexpected busy or slow periods. This will keep staff busy at all times. An additional reason to adopt a multimedia strategy is the synergy between marketing vehicles. For example, we've seen a 17 percent lift in telemarketing response rates when the telemarketing call was immediately preceded by a direct mailing.

Adopt risk-based pricing strategies that enable lenders to effectively compete for all customers (no matter the credit grade) that come their way. Why throw away customers who would typically cost hundreds of marketing dollars to obtain? Even if an originator has to broker the loans to do it, the "pearls" have value and the broader product offerings will provide diversity, which will be valuable in times of economic fluctuation.

Continue building upon existing customer relationships by using and reusing existing database assets. It's a good investment to periodically contact current and past customers to see how they're doing and to update them on current programs—because if you don't service them when they're ready to take action, someone else will. In addition, it's a convenient reason for you to contact them without appearing to be a huckster. Most of all, it's the easiest sale you can make because you already have a relationship. For example, customer-retention programs that I've worked on have typically produced results that are 300 percent to 500 percent as high as programs using ordinary modeled lists.

Re-evaluate marketing return on investment (ROI), with an eye on the market of the next five years rather than the past five years. This can be accomplished by accepting some basic economic principles:

- Accept the law of "diminishing marginal returns." Large marketing programs usually reach a plateau where each incremental customer costs more to acquire than the previous customer. Therefore, for already large marketing programs, it can be more expensive (on a per-customer basis) to expand your business than it is to maintain it. But as long as revenue per new customer exceeds the cost of acquiring new customers, marketing pressure can be kept up.
- Accept the fact there will be cyclical changes in

consumer demand. When demand drops, lenders may have to swim upstream just to maintain current loan volumes. Marketing cost per customer will go up—but that's OK as long as the law of diminishing marginal returns is remembered.

■ Cost per dollar loaned may be a better measure of marketing success than cost per customer. Few lenders or brokers have a fixed-fee schedule, where revenue would not be tied to the size of the loan. The bigger loans usually bring in more revenue. Therefore, comparing marketing programs based on cost per loan closed does not produce a fair comparison.

■ Competition makes it more expensive to win business. Seek greener pastures. Staying ahead of the pack is easier when you're doing business where the pack is smaller. Informed Sources' Goldberg says, "There are a lot of rural areas which have largely been ignored due to concentration on the geographically convenient markets. Changes in economic conditions have had different effects on different geographies." So fish where there are fish—but not that many fishermen.

A mature market

Because of recent advances in mortgage technology, combined with market pressures, the mortgage industry is now driving toward maturity. In a competitive market, the drive to maturity is usually marked by increasing productivity and decreasing profit margins.

Increasing productivity will enable mortgage companies to process loans quicker and more efficiently, creating economies of scale that offer an opportunity to compensate for the drop in profit margins. However, for companies to enjoy economies of scale it requires increased volume. For lenders who can't successfully grow their volume, the alternative is to enhance current revenue opportunities by finding a way to offset the drop in profit margins.

Vertical integration is one way that mortgage companies can offset falling profit margins by enhancing the revenue collected from each mortgage customer by extending more products and services. Numerous lenders have acquired or allied themselves with title companies, credit services, appraisal companies and marketing companies—companies that provide services essential to the mortgage process. Other lenders without such alliances will have to find a way to cost-effectively increase volume on their own.

As subprime lenders define their business strategies for the years ahead they must understand the forces at work in their market. The resulting market pressures will increasingly require subprime lenders to diversify and take advantage of productivity enhancements. The subprime lenders of the 1980s and 1990s didn't have to do much more than toss a hook into the water to catch all the fish they needed. Today's subprime fishermen must not only learn to fish the rough waters, they must learn to make a meal of anything that's big enough to eat. **MB**

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