Lender reaping benefits of hot mortgage market

By Mike Freeman
STAFF WRITER

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Jim Konrath gets asked one question a lot these days: When is the red-hot mortgage market going to cool?

He doesn't know. But Konrath, the co-founder and chief executive of San Diego's Accredited Home Lenders Holdings Inc., hopes it's not for a while.

Thanks to record low interest rates, mortgage lenders such as Accredited have been on a roll lately. After a disappointing initial public offering on Feb. 14 – the company's shares dropped 9 percent on their first day of trading to close at $7.25 – Accredited's shares have soared. They closed yesterday at $19.38.

The company, which specializes in making loans to borrowers with flawed credit, posted a record $1.5 billion in loan originations in the first quarter, nearly double from a year earlier. It earned $28.8 million in 2002, up more than 65 percent from the prior year.

But Konrath keeps the question about a cooling market near the front of his mind. For managing the company through a downturn in the notoriously cyclical mortgage market will be critical for Accredited, which employs 1,500 nationwide and nearly 500 in San Diego.

While Konrath doesn't foresee an industry slowdown anytime soon, he has piloted Accredited through one before. Six years ago, the mortgage market was roaring just like today. Lenders were posting heady double-digit gains in revenue and profit.

Then the bottom dropped out, thanks to a liquidity crisis that drained away investor capital for mortgages. Scores of once high-flying lenders either went out of business or filed for bankruptcy. The purge reduced the number of publicly traded lenders that dealt with tainted credit borrowers – called subprime in industry parlance – from more than 30 to 10.

Accredited, then privately held, survived the carnage. And the lessons learned are likely to come in handy. That's because subprime lenders deal with riskier loans. So they're considered more vulnerable during downturns because their borrowers are more likely to default.

The subprime mortgage market also is competitive, with gigantic players, such as Wells Fargo and Washington Mutual, vying for business.

Finally, subprime lenders are in the cross hairs of lawmakers in several states, who aim to protect poor-credit borrowers from the high interest rates and fees subprime lenders charge.

Despite these hurdles, Konrath thinks Accredited is well-positioned. He founded the company 13 years ago with partner Ray McKewon and a $30,000 investment. Their first office was above an auto parts store in Rancho Bernardo, and they sometimes funded loans with personal credit cards.

But they also practiced disciplined underwriting – which Konrath says is the cornerstone of the company to this day.

Accredited trains its underwriters to set interest rates at levels appropriate for the company's risk, Konrath said. Even though bankruptcies and foreclosures are up nationwide, only 3 percent of Accredited's borrowers are delinquent on their mortgage payments.

"Maybe we're a little bit more conservative" than subprime competitors, he said. "We like to think we know more about what's in our (loan portfolios) than anyone in the business."

To smooth out peaks and valleys in its financials, Accredited has increased the dollar value of loans that it keeps on its balance sheet. Doing so hurts profits in the short term, but makes the company's performance more consistent.

Accredited, however, still sells most of its loans on the secondary market, where it makes an average of $4,000 for every $100,000 loan, Konrath said. Mortgage originators often sell their loans to investors on the secondary market – thus freeing up money to make more loans.

Bjorn Turnquist, an analyst with SNL Financial in Charlottesville, Va., said companies like Accredited are in "the right place at the right time" in the mortgage market, with investor capital flowing freely to buy mortgages.

"My view of the mortgage industry over the last year and a half is if you haven't been able to make money now, you shouldn't be in the business," he said. "Every mortgage stock out there has risen dramatically. The earnings and growth have been phenomenal, and it's been created by the refinancing boom."

But Turnquist added that if interest rates rise, the subprime business could face some difficult times, particularly public companies who must please investors each quarter.

"If you offer a customer one price, and some fly-by-night competitor is offering this great deal, you have to say 'No, I'm not going to underwrite this loan' and accept the fact you may not grow originations year-over-year," he said.

Subprime lenders also face increasing pressure over predatory lending. State and city lawmakers have taken steps to curb the fees and high interest rates that some subprime lenders charge to borrowers.

Household International Corp. last year paid $87 million to settle claims that it charged higher interest rates than promised and levied exorbitant prepayment penalties on mortgages in California. Household later was acquired by a Hong Kong bank.

Subprime lenders, including Accredited, back federal legislation that would create one standard nationwide for predatory lending laws, instead of piecemeal state laws.

David Olson, the president of Wholesale Access Mortgage Research and Consulting, said the biggest threat to Accredited may not be a cooling market or tough regulation. It may be competition.

Fannie Mae and Freddie Mac are expanding to the subprime market. While these government-backed entities don't originate loans, they do buy mortgages on the secondary market. And they're so large that they have tremendous pricing power.

Big banks also compete in the subprime market. And they, too, have pricing power.

"The Washington Mutuals and the Wells Fargos, that's where the future is," Olson said. "So with the smaller players, I don't see a role for them."

But Konrath says Accredited has a future. Its formula is diversity. The company sells its loans to a variety of buyers, receives credit to make the loans from several different lenders and originates loans across the country, so a regional housing downturn won't overly burden the company.

Moreover, Konrath said any uptick in interest rates is likely to cool the refinancing market first. But more than 50 percent of Accredited's borrowers are tapping equity in their homes to pay off high interest consumer debt. An additional 30 percent are home buyers, an unusually high percentage for a subprime lender.

Konrath said these customers will continue to need loans even when interest rates rise.

"Every one of our loans has a borrower's benefit test in it," he said. "The underwriter asks: Why does this loan make sense for the borrower? If you can pull it off right, it will be a good deal for the borrower and a good deal for us."

Mike Freeman: (619) 4293-1515; mike.freeman@uniontrib.com
