BACK TO THE FUTURE

BY LINN COOK

Let's face it: It's scary out there. Current indicators throughout the entire economy are extremely negative, and the housing market overall remains in a freefall (see Figure 1). ◆ But instead of burying our heads in the sand, the mortgage lending industry needs to rebuild itself—and do it quickly. Millions of borrowers are struggling, and a vast inventory of unsold properties is clogging the market. The combination is creating stagnation in mortgage lending that is weighing down the entire economy. ◆ The question is, where to get started? Lenders might want to take a look back for a little history lesson with a twist: reinstate the sound lending practices of yesterday and apply them with the aid of today's technology. The result might give us the best possible chance to restore stability and confidence to an industry that remains vital to the health of our economy.

Combine a return to common-sense underwriting, low-risk loan products and the latest technology, and you have what it takes for a mortgage industry rebound.

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The consequences of a volume-driven industry

Bill Sias has seen his share of ups and downs in the mortgage industry. A 25-year industry veteran and a senior vice president at SMH Capital, Houston, an investment banking firm, Sias has a unique perspective on mortgage lending and the problems that led to the current market turmoil.

Sias realized the industry was headed in the wrong direction when investors he talked to stopped concentrating on asset quality and started to demand quantity. "There wasn't any focus on profitability," says Sias. "The entire industry was incented on volume, and that created a whole host of problems."

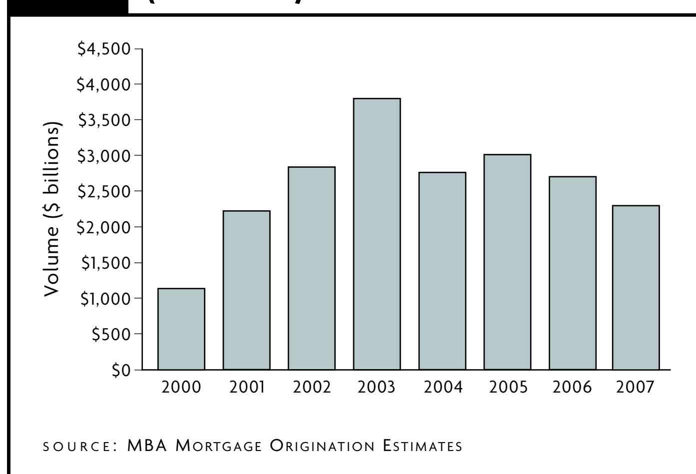
The drive for volume was a symptom of a complex financial infrastructure that ignored basic credit principles and led to the commoditization of homeownership. "If you go from the borrower signing the loan, to the loan being put into an agency security and sold, to the agency security being placed in a trust, the trust getting sliced and diced, and then sold to an investor, there's all this disconnect," says Sias.

Most investors believed that specialized vehicles such as mortgage-backed securities (MBS) shielded them from risk, especially if the MBS were highly rated by the credit-rating agencies. In their quest for higher yield, investors purchased loans of successively lower quality, and mortgage lenders, seeing demand for such assets, began to serve that market demand. "Lenders had already saturated the prime market, and were venturing down into subprime in order to generate volume," says Sias.

Subprime volumes surged at an alarming rate. Between 2001 and 2005, subprime loan origination had grown by almost 200 percent, reaching 20 percent of the total origination volume for 2005, according to Harvard University's Joint Center for Housing Studies, Cambridge, Massachusetts. But generating volume at this rate came at a cost. "Let's face it, many lenders made loans to people who shouldn't have gotten them," says Sias. "But as long as there were investors willing to buy those loans, they went ahead and made them."

Sias knew that the volume-incentive model was destined to break at some point, but nobody imagined that entire swaths of the industry would disappear so quickly. A perfect storm of massive unsold housing inventory, spiking delinquencies and foreclosures, tighter credit markets and rising unemployment has taken its toll on mortgage volume. The Mortgage Bankers Association (MBA) Mortgage Application Index showed that the Market Composite Index, a measure of mortgage loan application volume, touched a low of 398.6 during the week of Nov. 14, 2008, which was the lowest level of activity since December 2001.

Figure **1** **U.S. Mortgage Origination Volume (2000–2007)**



SOURCE: MBA MORTGAGE ORIGINATION ESTIMATES

A return to sound lending

The mortgage market's decline has been swift and unrelenting. For those still counting, the infamous Mortgage Lender Implode-o-Meter (http://ml-implode.com) lists more than 300 mortgage banking firms that have been shuttered since late 2006. The toll this has taken on industry employment and business owners' careers has been significant. Too often, that particular cost appears to take a back seat to stories about homeowners in over their heads.

But for some industry participants, the market's fall back to grace evoked a sense of nostalgia, although not necessarily in a sentimental way. Andrew Schell, a certified public accountant (CPA) and managing partner of the consulting firm Mortgage Banking Solutions, Austin, Texas, conjures up the 1980s when talking about the current crisis.

Schell believes that in order for the mortgage industry to successfully recover, everyone needs to return to the basics of common-sense lending. "The way we did mortgage lending in the past was very bank-like. It was very underwriting- and compliance-focused," he says. "In many respects, we operated within a regulated depository banking environment."

Schell maintains that lenders need to have discipline to avoid the allure of risky products. "Lenders need to be more selective and prudent about the products they sell," he says. In spite of the market turmoil, some lenders have actually increased volumes and grown their market share because they avoided high-margin, risky products in the first place.

Hindsight may be 20/20, but the current problems facing the industry stemmed from more than just lenders selling risky products—there was a general lack of solid financial planning and controls. "Coming from a CPA, it sounds cliché," he says. "But it really starts with staying on top of your financials."

Financial transparency and maintaining strong balance sheets are the basic building blocks of stability and growth. Schell admits that obsessing over accounting is not exciting or innovative, but he speaks from years of experience in consulting on the health of mortgage lenders. "You would be amazed at the number of lenders that don't have their accounting in good order," he says.

The benefits of a sound financial strategy extend beyond a lender's organization, because clean balance sheets are critical to establishing warehouse-lending relationships. "Warehouse lenders look at financial statements, so you'd better have your books in order," Schell warns. With only a handful of warehouse lenders still in existence, access to credit is even harder to come by.

"Warehouse lenders have more applications than they can deal with. They get [the pick of] the litter [in terms of] the best mortgage banks to work with," he says. Consequently, demonstrating a firm handle on financials is what separates the

wheat from the chaff.

Sias agrees. "A good balance sheet enables lenders to hedge and get better pricing for loans. It allows lenders to negotiate better terms with warehouse lenders and directly improve their bottom line," he says.

The influence of technology

The post-bubble world of mortgage lending harkens back to a simpler, more tempered philosophy toward risk. The dramatic scaling back of subprime and alternative-A loan products (returning them to the niche markets they were intended for) inherently purges the industry of much of the problems that were the result of poor underwriting decisions. And greater government oversight, through the conservatorship of the government-sponsored enterprises (GSEs) and through growth in Ginnie Mae securitization, should further shake out remnants of bad lending practices.

But with lower risk comes lower returns. Lenders today are acutely aware of the thin margins offered on conventional and government products, and must accept the fact that subprime gains will not be seen by the industry for a long time, if ever again.

In this leaner environment, it becomes even more important for lenders to follow a strategy that focuses on profitability by way of efficiency. "As the mortgage market stabilizes, the folks with the most efficient operations will do the best," Sias explains, "and technology is at the front end of putting them into that kind of a business."

Lowering the costs

There's no doubt that technology has made significant advances over the past several years. Technology products can be found throughout the mortgage process, touching on almost every aspect of loan production and delivery.

But by far the most important advancement related to technology has not been breakthroughs in terms of capabilities, but rather in terms of cost. "The affordability of technology has been a democratizing kind of force for lenders," says Binh Dang, president of software vendor MeridianLink Inc., Costa Mesa, California. "Affordable technology means smaller lenders have opportunities to take advantage of the efficiency gains that used to be reserved only for top-tier lenders," Dang says.

The lower cost has been the result of improvements made on both the development and the deployment side. New software architecture, increased utilization of the Internet and the implementation of true industry data standards like MISMO® have shortened the distances between development cycles and allowed for greater interoperability between systems.

"Systems used to be like islands in an ocean, because they were totally self-contained and unable to interact with others," explains Dang. "That type of environment didn't allow for scalability, so the inherent cost to develop was higher."

In particular, the emergence of Web-based systems has created a new paradigm in software development that alters both the cost and scope of technology utilization. "Web-based systems have fundamentally changed the rules of the game," says Dang. "Vendors are able to spread the cost of development over many clients, giving us the resources to create tools that are both robust and affordable." The result is software that is less expensive for vendors to produce and more affordable for lenders to buy.

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But the other side to technology, the deployment costs, can be an even larger and more burdensome expense. Again, Dang explains the game-changing benefit of Web-based technology for lenders. "We're talking about replacing servers, a network and security infrastructure, and the salaries for all those people required to support a system with a desktop computer and an Internet connection," he says. According to Dang, Web-based systems reduce the total cost of technology by as much as 70 percent.

Given the relative affordability of technology, lenders now have a legitimate means of achieving productivity gains that can have a real impact on their profitability, even on a smaller scale. The next step for lenders is to develop a coherent technology strategy that actually allows them to realize this goal.

Developing a technology strategy

Todd Moncrief, vice president of business development at Alpharetta, Georgia–based Xerox Mortgage Services' BlitzDocs®, thinks lenders need to first analyze their workflow and identify areas of inefficiency. "Look at those processes that are labor-intensive and time-consuming," says Moncrief.

"Staffing is the biggest expense for lenders. If you find bottlenecks in your process that are currently being solved by bringing in more bodies, technology can help you improve the productivity of a smaller staff," he says.

The cost of risk is another area that lenders need to focus on. When data enter the workflow and are carried through the process manually, either via paper documents or rekeying information into different systems, the risk of error increases and can result in poor delivery of loans.

"Technology brings more transparency to the process," says Moncrief. "When you can demonstrate that your data is reliable

and sound, it's an improvement on your entire business model. Originators, warehouse lenders and investors all gain confidence in your ability to deliver."

By identifying points of inefficiency and risk, lenders can more easily evaluate where they can get the biggest bang for their buck. But Moncrief stresses that workflow issues need to be clearly defined. "Keep the analysis simple and to the point. If you overthink a problem or get distracted by technology that is not relevant to your problem, then you run the risk of mission creep," he says.

Strategy in action

If we look at the current challenges that many lenders have in their workflow, we can get an idea of this strategy in action. Today, lenders face tremendous downward pressure on profits due to the thinner margins of conventional and government loan products. Add to this an anemic level of volume, and it's easy to see the need to increase revenue and streamline costs.

Attracting more originators and getting them to send more volume is one way to increase revenue. Originators prefer working with lenders that can meet their demand for speed, convenience and reliability. They want to know what products their borrower qualifies for, what the price of a loan is and how quickly they can obtain the funds.

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One problem is that accurately determining borrower qualification and pricing is a resource-intensive task. Guidelines need to be checked, rate sheets need to be updated and results need to be compared across multiple investor product lines. This process takes up more and more resources as the lender attempts to shorten the response time, which increases the risk of error as volumes rise.

Product and pricing technology offers an elegant solution to this problem. As a point-of-sale origination tool, product and pricing engines satisfy the need for speed and convenience by allowing the originator to qualify and price their loans online. As a productivity tool, product and pricing engines automate the process of guidelines checks, rate-sheet updates and best-execution comparisons between multiple investors.

The result is a task that might normally take 30 minutes and require the resources of one full-time employee can be compressed into a 10-second response that requires no employee involvement at all, as pre-qualification now becomes a self-service affair.

"Product and pricing engines create a halo effect for lenders," says Gigi Campbell, national sales director of PriceMyLoan, Costa Mesa, California. "Originators get hooked when a lender's engine gives them the products and pricing they want, so they bring more volume to the table. Lenders can handle this increase in volume more efficiently because the engine filters bad loans from entering the pipeline, allowing lenders to focus their resources on loans that generate revenue," says Campbell.

One effective way for lenders to streamline costs can be achieved through the use of document imaging technology. By digitizing documents, lenders reduce the physical movement of paper and the shipping costs associated with it. Electronic documents are passed between the originator and the lender with greater speed, and the fidelity of documents is maintained throughout the workflow, from origination all the way to investor delivery. Cost, risk and labor are all reduced as a result.

Moreover, both of these technologies can be implemented within a fully Web-based environment, endowing lenders with the inherent cost benefits of a hosted system. And to take the value incentive one step further, seamless data transfer between systems allows lenders to harness the combined advantages of technologies with relative ease.

"We believe that integration between technology vendors is where lenders gain a significant advantage," says Moncrief. "There's a real synergy that takes place when best-of-breed vendors come together and work toward a common goal: to improve the profitability of lenders by solving specific problems, collaboratively."

Stronger and smarter

The mortgage industry is experiencing a period of massive change that presents lenders with both daunting challenges and exciting opportunities. We're facing a unique moment where the industry has a chance to rebuild a stronger and smarter version of itself.

The main drivers of this movement will be mortgage lenders. Their ability to adapt to the new market environment will in large part determine the speed and direction of change. By returning to the sound lending practices of the past and leveraging the new technologies of today, lenders are well equipped to quickly nurse the industry back to health.

Other industry innovations, such as business process outsourcing, further streamline mortgage lending to an extent that profits can be maximized on low-risk products. With the proper management and technology in place, investor incentives could be shifted from volume to loan quality, bringing a steady stream of smart capital back into the market. **MB**

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