

# Introduction of the Mortgage Superhighway for Residential Lenders

by John D. Koch

The American savings bank business, having been battered by institutional failures in the late '80s and early '90s and then having watched the erosion of its market share position in residential mortgage lending during the refinancing boom years of 1992 and 1993, now faces yet another challenge.\* The formidable opportunity now confronting United States savings banks is the challenge of maintaining vigor as new technologies redefine the business practices and delivery systems of mortgage lending for the rest of this decade.

As mortgage lenders vigorously seek to unburden themselves of excess capacity by streamlining their operations, they find the

\* [Editor's note: Although different in origin from savings and loan associations, savings banks today are virtually identical to savings and loans both from an operational and a regulatory standpoint.]

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waters they navigate are embroiled with new players, new technology and new solutions. Some of the new players are most skeptical of the savings banker's ability to compete. For example, Bill Gates of Microsoft states, "Banks are dinosaurs; they can be bypassed."

This paper will summarize the current impact that technology is having on the U.S. marketplace and will posit various conclusions and unanswered questions as these mortgage "superhighways" evolve. The writer's perspective is that of a \$6 billion, midwestern U.S. savings bank with annual originations of residential loans of approximately \$800 million projected for 1995, with a servicing base of 65,000 loans and a company with excellent delinquency levels and a strong capital base. Charter One Bank, F.S.B. is a publicly traded thrift on the NASDAQ exchange under Charter One Financial, Inc.

## MARKET CONDITIONS FOR SAVINGS BANKS

In 1994 market shares of thrifts in mortgage lending plummeted to 18% in the first quarter and gradually increased to 24% by year-end 1994. As interest rates increased in 1994, the strength of thrifts in delivering ARMs (adjustable rate mortgages) has enabled them to increase market share. Overall current market share of ARM loans in the United States is approximately 33%.

The increase of interest rates in 1994 was good for thrifts, as the increasing consumer demand for ARMs allowed them to increase their market share. Mortgage bankers and brokers were unable to compete with the aggressive pricing of ARM loans by thrifts. As we enter the middle part of 1995, thrifts continue to maintain a strong presence in the marketplace. In addition, they enjoy good business penetration in construction lending. Thrifts enjoy a competitive advantage versus other providers of mortgage debt in that they can offer land loans, model home loans, model home lines of credit and other construction loan products that other providers generally do not offer. The emergence of ARM loans and the construction loan business in the United States argues for a solid residential lending year for thrifts in 1995 but, obviously, well below the refinancing boom years of 1992 and 1993.

## TECHNOLOGY IMPACT/APPLICATION PROCESS

We will now address some of the issues facing residential lenders and review some possible implications as technology and changing market conditions reorder residential lending priorities. Most lenders in the United States are driven by the challenge of point-of-sale lending. By point-of-sale lending, it is meant that the loan decision, to a large extent, will be made instantly with the customer early in

the application process, probably at the first meeting. As the market develops, these point-of-sale capabilities will be in the hands of not only loan officers but mortgage brokers, mortgage bankers, builders, realtors and others. The vision of a homebuyer signing a contract to purchase a home and, simultaneously, at the realtor's office, borrowing the money to refinance the home by way of communication links to credit bureaus, government agency lenders and others is already a reality.

Other lending will occur in a strictly electronic format. VANs, or value added networks, are rapidly developing which will enable mortgage customers to access rates, costs and other loan information electronically. These systems are accessible via a modem. They may be compared to a shopping mall; but the shopping mall exists only electronically. This shopping mall is filled with various lenders, who display their rates and fees electronically. Customers can enter this mall by modem and peruse or scan through the various items for sale. Customers in this context would be individual homeowners, realtors, builders, agents and others who wish to shop for a new loan. Once the proper loan is selected, the customer is able to begin the application process electronically. VAN systems are rapidly expanding throughout the United States.

#### **ARMCHAIR REFI'S/AUTOMATED UNDERWRITING**

The undisputed winner of this increasing efficiency in mortgage lending is the consumer. We can envision a homeowner relaxed in the comfort of his or her home who is able to refinance that home simply by using a standard home computer with a modem.

The heart of this new technology is the development of automated underwriting systems. These systems enable instant answers to underwriting. They include, at a minimum, access to credit bureau information, and they provide instant answers on many

underwriting questions. These systems can incorporate electronic appraisals which are collateral evaluations done without the appraiser ever physically seeing the home. By way of electronic evaluations of properties, one can envision the entire application process being reduced from 30-45 days down to three days. This system generally includes statistical modeling as well as rule-based decision-making software. Leading this effort in the United States has been the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). These agencies are leading the automated underwriting process with their formidable investments in technology and software expertise. Numerous others are offering their own versions of automated underwriting. Most notable are the mortgage insurance companies.

These systems enable lenders to sell loans without recourse virtually at the same time the application is taken. This process has serious implications for savings banks who retain large percentages of loans and do not sell them instantly. Mortgage lenders need to compete with the secondary market participants with similar services to survive.

As lenders install these systems, there are major opportunities for back-office centralization and consolidation. The systems should reduce the overall personnel costs in the mortgage process.

#### **MERS PROJECT**

Integral to the transfer of information electronically is the establishment of communication language in standard formats. The American National Standards Institute (ANSI) has been developing X12 Standards which establish formats for mortgage lending documents. These formats include credit bureau reports, application forms, mortgage notes, title insurance policies and a variety of other standard documents used in mortgage lending. This standardization will hasten the

entire electronic process. Once documentation is standardized, software programmers are able to develop common fields for all required data elements. To transfer from one software system to another then requires only interfacing the fields which already exist in a common format.

An effort with significant ramifications for the mortgage industry is the joint venture project between the mortgage bankers and the federal agencies called MERS or mortgage electronics registration system. This system is a whole-loan, book-entry system which establishes a process for registering ownership rights for mortgage loans in a clearinghouse. Once the loan and legal description have been registered electronically, future assignment of the servicing and possibly future assignments of the lender can occur electronically. The MERS is yet one more facet in the evolving application of electronic developments to the mortgage industry.

#### **APPRAISAL PROCESS**

The appraisal process is similarly enjoying a transformation but for somewhat different reasons. Appraisers now have fingertip access to huge amounts of information. The tax records of many cities are now accessible electronically in the United States in a CD-ROM format. Those tax records include square footage of the property, year built, number of bathrooms, tax valuations and other information.

Appraisers can also dial up the Multiple Listing Service (MLS) for current sales information. The multiple listing service is an automated tracking system with listing information for houses bought and sold. This information, via modem, includes the capability to view a photo of properties recently sold along with the listing of the property being bought. Appraisers now scan through the system for homes sold for good comparable information, using a modem hook up. By providing residential tax records and multiple listings at

the finger tips of appraisers, we can, for a significant portion of all loans, eliminate the process of visiting the home, taking photos and inspecting the entire property.

The process of photography is also undergoing a technological change. Digital cameras feed the photo directly into the computer, therefore eliminating the need for traditional photo development and the time-wasting process of pasting photographs on paper.

The appraisal business is being radically transformed by simply integrating existing technology and information. The last step in this process is the electronic delivery of these appraisals. This is a straightforward process utilizing existing communication software to distribute the appraisal electronically, with digital pictures, throughout underwriting networks. Charter One Bank has utilized this fully automatic electronic appraisal process and electronic delivery of appraisals since the fourth quarter of 1994. This process has dramatically improved our productivity. Appraisals do not ever need to be printed with our system.

#### **TRANSACTION BARRIERS DISMANTLED**

One result of all of this is cost reduction. As documentation becomes standardized and as efficiencies become realized in the delivery of the mortgage loan, the ease of financing and refinancing is enhanced. These reductions in cost will serve to reduce the financial barriers inherent in the mortgage process. As such, ease of refinancing will increase as these systems are installed. The age-old problem of mortgage volume volatility and the incessant staffing up and staffing down process should diminish. Lenders will be able to electronically ramp-up for higher levels of productivity. This process will further the continuing employment

erosion which exists in the industry. As the underwriting systems become installed, the need for large numbers of underwriters decreases.

#### **THROWAWAY MORTGAGES**

As costs reduce and efficiency in the mortgage industry accelerates, the propensity of consumers to refinance will accelerate. Mortgages become more expendable as technology makes refinancing less time consuming and less costly. Customers will become even more adept at shopping for the lowest possible rates and fees. As consumers become smarter shoppers, is it so far fetched to imagine that some consumers will refinance their homes every 90 days? In such an environment, what happens to the value of servicing? If consumers can refinance every 90 days, then servicing rights become considerably less attractive.

#### **GATEKEEPER?**

As these processes increase, few lenders are considering the question: Who will manage the burgeoning networks of information exchange? The owners of the networks who now are feverishly constructing the bricks and mortar of the superhighway are anticipating big profits. Lenders who will use these networks and need them for basic survival are generally not involved in the ownership of these networks.

#### **SUMMARY**

The applications for technology in mortgage lending are rapidly evolving. These new uses create tremendous opportunities and hazards for the traditional lender. Will our perspectives reduce us to simply holding on to the status quo in a futile attempt to maintain control? Or will we adjust to change by adopting and

adapting new systems to our needs. Jack Welsh, Chief Executive Officer of General Electric Corporation, states, "A fast organization has the advantage of relishing change because of the constant opportunity it presents. The faster the pace of change, the bigger the advantage."

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