## Global Insight: Technology and Competition

Hardly a day goes by in the business press without a new dot.com story. Housing finance is no different. The Internet is already having a profound impact on housing finance and it is likely that we are just seeing the tip of the iceberg. The most visible impact is on how products and services are being delivered to the customer but perhaps the larger and more fundamental impact is on the competitive structure of the housing finance industry.

The application of new Internet-based technologies is changing the mortgage origination process. The Internet is a new distribution channel. As discussed in the article by Richard Beidl of the Tower Group in the March 2000 issue of *Housing Finance International*, Internet originations are still a small portion of the total market (less than 1% in 1998) but are forecast to grow to 10% of the U.S. market by 2005. Although established players like Countrywide Home Loans and Cendant have a major Internet presence, new entrants like E-Loan and Mortgage.com are attracting media and investor attention, if not yet major market share. Aggregator sites such as Quicken Mortgage and iOwn allow consumers to compare price and terms of a large number of loan products from a number of lenders. Beidl predicts a growth in Internet origination as the number of households connected to the Web increases, their connection speed improves, and security concerns are alleviated. It is likely that all major brokers and lenders now have an Internet presence and a substantial proportion of borrowers shop on the Web.

As Beidl notes, business-to-business use of the Internet is proceeding more rapidly than business-to-consumer use. In the US, nearly 60% percent of loans are originated through mortgage brokers and correspondents. The Internet is becoming the major communication vehicle between brokers and lenders allowing real time delivery of information on products, prices and status of loan applications. Companies like GHR Systems, a technology vendor that encodes and transmits pricing information, underwriting standards, and closing requirements from lenders to brokers, are helping reduce the cost and time to deliver loans to consumers [HFI, June 1997]. Successful lenders will be those that provide origination tools like those of GHR (the arms merchant to the lending industry according to Morgan Stanley Dean Witter) to brokers at the point of sale.

Other technologies are also profoundly impacting the market. Automated underwriting (AU) improves the transparency of the market and helps break down barriers between different products. AU has its roots in computerized credit scoring models such as those developed by Fair Issac. The March issue of HFI contains an article by Fair Issac that explains what credit scoring is and how it is being utilized by lenders worldwide. The use of AU is blurring the distinction between prime and sub-prime lending. Major prime lenders are increasingly able to penetrate the sub-prime business, thanks to more flexible underwriting and the willingness of the investors to purchase and insure the loans that are underwritten by “approved” AU systems such as those developed by Fannie Mae (Desktop Underwriter) and Freddie Mac (Loan Prospector).

The Internet is opening up new competition from unexpected sources**.** The web gives companies with strong brands, loyal customers, or highly trafficked websites a chance to earn fees for finding mortgage leads. Microsoft, Intuit, Yahoo!, and priceline.com have all in-vested in mortgage lenders, built their own mortgage referral models, or acquired mortgage companies. Online brokers like E-Loan and iOwn have integrated backward into funding (i.e., they have become mortgage bankers) in order to capture additional revenues. As Internet companies move from marketing to fulfillment to funding, they increase their share of total origination revenues, leaving less for traditional lenders.

This phenomenon is not restricted to the US. Technology has allowed non-traditional lenders to take a substantial market share in the UK. New entrants like the Prudential insurance company (through its Egg subsidiary), Standard Life and Virgin accounted for 25% of net originations during 1999, up from virtually zero in 1998. These lenders are using a combination of the telephone and Internet to enter the mortgage market, competing heavily on price and speed of service. New players such EuropeLoan and E-Loan Europe are bringing US style consumer direct lending to Europe, and in virtually every major country, existing and new entrant lenders are coming to market with direct origination options.

Where is the market headed? As explained in a recent report by Morgan Stanley Dean Witter [The Internet Mortgage Report II: Focus on Fulfillment, February 10, 2000] the Internet will increase the “transparency” of the market, which is likely to accelerate concentration among originators. The Internet makes it relatively easy for consumers to shop for mortgages from hundreds of lenders, compare them on an apples-to-apples basis, and choose the cheapest rate. As more and more consumers adopt the web for mortgage shopping, the lenders that consistently offer the best price and service should expand market share. As more consumers use the Internet, traffic to the aggregator sites will expand and volume will be directed to those lenders offering the fastest turnaround and lowest rate.

Technology is also affecting the servicing function, long regarded as the unwanted stepchild of the mortgage lending industry. Increasingly servicing is being viewed as a major contributor to profitability. Development of advanced management information systems and call centers has already had a major impact on servicing, leading to substantial industry consolidation. The top 10 servicers in the US now service 41% of the total stock of mortgage debt of $4.5 trillion. Increasingly the focus of large servicers is data mining with the intention of retaining customers who wish to refinance or move. Technology is leading to a growing interest in outsourcing. In the UK, the major US servicing system provider Alltel has signed a joint venture agreement to install its platform for the Bradford and Bingley building society. Woolwich and Countrywide, in a joint venture, are expected to begin offering third party servicing solutions to other lenders in the UK, and eventually to continental Europe. The Dutch firm, Stater has is a third party servicer in the Netherlands, and is expanding into Germany and Belgium.

What will the mortgage market of the future look like? For origination, the result is likely to be a bifurcated market dominated by a small number of mega-lenders at one end, with thousands of small brokers armed with the latest in technology by their wholesale partners, at the other. The mega-lenders of the future may not be the dominant lenders of today, however. As companies as diverse as Microsoft and Virgin move into the mortgage market, the combination of brand image, aggressive pricing made possible by technology and lack of legacy systems and branch networks make it likely that at least some will be displaced. Mid-tier lenders, including the majority of banks and thrifts, are the most likely casualties. They will gradually be forced out of the mortgage production business, although they may capture mortgage cross-sells from their deposit customer base and turn them over to vendors for fulfillment. And competition and rapid product innovation will force many to outsource their servicing to specialists.