Stretching Systems to Cover Multiple Distribution Channels

by Allan Redstone; President and CEO, GHR Systems, Inc.

Mortgage bankers are in a bind. Technology--particularly technology surrounding the Internet--is breaking down the classic mortgage channel we have spent the past 40 years making so efficient--the one that starts with a face-to-face, lender-borrower application process. Ignoring the new channels means slow and almost certain death. Trying to exploit the new channels without the systems needed to apply product and pricing rules consistently and to structure and identify mortgage loans precisely means being an inefficient player in an efficient market--another prescription for slow, certain death.

Yet spending the money and time to build redundant systems to cover multiple channels could easily bring a fairly rapid death by capital hemorrhage. Unless players up and down the mortgage banking chain can find a way to build a common system to support multiple channels--or extend their current system to cover new channels as they develop--their prognosis for surviving very long in the 21st century is not favorable.

Niche Strategies

The old paradigm of cookie-cutter products homogenized for quick, easy sale into the secondary market is sadly out of date and getting more so all the time. As investors, supported by sophisticated risk-analysis and portfolio management tools, refine their criteria to build complex portfolios that have been modeled by elaborate computer systems, they know exactly what they want and what they should pay for it. It's no longer enough to deliver plain vanilla products based on simple but solid underwriting standards. Investors now seek or avoid specific characteristics that affect default risk, prepayment risk and servicing costs.

Consequently, the mortgage market today is full of niches. Successful lenders find and exploit those niches. But niche strategies are only effective when systems can capture and communicate the characteristics of these niche products--a strategy that could be called "nichification."

The market has acquired a financial engineeering mentality. Adding value means producing mortgages "milled" to exact specifications. Players up and down the mortgage delivery channel must have the systems that can capture and communicate those precise specs. Successful nichification requires originators and consolidators of mortgage pools to be able to deal with an exceptionally large number of specific borrower and property characteristics; they must adapt underwriting and pricing practices to reflect those characteristics.

The specs that go into nichification are both huge in number and highly refined, but an oversimplified example will make the point:

Suppose you were originating a $150,000, 30-year fixed-rate mortgage at 7% with 3 points and 7.5% with no points. In the old cookie-cutter days, that might qualify as your basic gingerbread man, and you could call the job done. But nichification now requires you to record and price a lot of specific characteristics. For example, you might have to

- Increase the rate by 25 basis points if the loan is for more than $250,000 or less than $75,000.
- Up the rate by 50 bps if the loan is secured by a two-family house.
- Add 25 bps if the property is in Southern California.
- Deduct 25 bps from the rate if the loan-to-property-value ratio is below 70 percent.

- Add 50 bps to the rate if the borrower is refinancing and will take cash out of the transaction.
- Add .5 to the points if the borrower does not escrow tax payments.

For mortgages sold into the conforming marketplace (mortgages that conform to standards for resale to Fannie Mae and Freddie Mac), nichification means pricing. In the nonconforming marketplace (mortgages held in lenders' portfolios or sold through conduits other than Freddie and Fannie), nichification is everything.

As the market gets increasingly discriminating and efficient, the tolerance for mispricing disappears. The number of characteristics that must be recognized, reflected in the price and communicated is huge. One could easily have 40 million relevant characteristics for one 30-year fixed-rate mortgage and a different 40 million for a 15-year FRM. That many combinations of property, borrower and transaction characteristics could go into determining the final niche product.

The only way to cope with nichification on this scale is to have powerful systems that recognize and price all those characteristics. Lenders who try to play without adequate systems will have to resort to two crutches, neither of which will keep them in the race very long.

1. They can use average pricing, essentially make a "ball park" guess and hope that the various plusses and minuses even out. If they don't, overpriced products will go unsold and underpriced ones will erode the lender's profit margin. Over time, precise pricers will drive out the price averagers. It probably won't take very long.
2. They can fall back on manual retrieval--communicating product features and pricing modifications to the loan officer or mortgage broker at the point of sale by means of thick paper manuals, faxed price sheets or telephone calls--an inefficient, time-consuming process fraught with frequent and costly mistakes. And if the point of sale is located on one of the rapidly growing direct-to-consumer networks that use the Internet, manual retrieval will be impossible. Such networks either will be supported by a point-of-sale system that supports nichification or it will lose out to networks that do.

Success in a world of nichification requires a point-of-sale system that can do three things:

- Enter all the required pricing modifications at the lender's "back office,"
- Deliver it electronically to the point of sale, and
- Retrieve it there quickly and accurately when a customer shows up.

Point-of-sale systems on the market today can accommodate up to 40 million distinct prices that reflect various combinations of specific borrower, property or transaction characteristics--all for any one loan program.

Impact of the Internet

The proliferation of mortgage channels is partly a consequence of the proliferation of investors' portfolio strategies but partly a result of the emergence of direct-to-consumer origination channels. More and more, borrowers survey, through channels they can access directly, an array of mortgage products displayed in ways that make comparisons easy and allow them to shop among a variety of products and prices that are national or even international in scope.

Once prospective homeowners begin to shop directly for mortgage loans over the Internet, negotiation dynamics change fundamentally. In the classic channel, the borrower's ignorance of what's out there gives the lender bargaining leverage. The lender simply has no incentive to

spend time and money educating a borrower so that the borrower can drive a harder bargain and reduce the lender's profit.

In the classic channel, prospective borrowers confront a lender they have chosen but have no way of knowing what products they are not being shown and whether the prices they are offered are truly competitive. If they deal with a mortgage broker, they worry that the unknown broker may overcharge them. Either way, they must put their trust in people who are paid on commission and get paid more for steering them to the highest commission products.

Shopping among competing lenders is a shrewd strategy in theory but not very practical within the classic channel. The complex array of products makes apples-to-apples comparisons difficult, and market conditions can change so quickly that such research already is obsolete before it can be completed.

The bargaining leverage flips dramatically once the direct channel is seized by network sponsors who use information and education as competitive tools and who offer borrowers an array of products from multiple lenders and all the information they need to make wise choices. Although these network sponsors necessarily will function as mortgage brokers and be licensed, they will come from outside the mortgage industry. They will think and act like direct-channel marketers instead of classic lenders.

In the direct channel, the people prospective borrowers deal with are their agents, not their adversaries. They are salaried employees who don't care which product is chosen. They are rewarded for showing borrowers a variety of competing options and providing unbiased, objective information and advice to help them make the wisest decisions. Sponsors run the networks on behalf of the borrowers collectively; lenders will get in line to offer their products alongside other lenders. Consumers can log on and see an array of current offerings in one sitting. Displays are set up to make apples-to-apples comparisons easy. Customers will see the lender's wholesale prices plus the network sponsor's mark-up.

A self-reliant borrower will be able to do it all on-line: select a loan, register it with the chosen lender, fill out and send the application and get back status reports from the lender. Borrowers who still want a little hand-holding will be able to tap a growing cottage industry of independent, fee-for-service mortgage counsellors, who, unlike traditional brokers, have no incentive to encourage the customer to pay as much as possible.

If a borrower wants help preparing and filing the application, he or she can call a "super broker" who, in addition to advice, will take the application over the phone and forward it to the chosen lender, typically using a clearing house and wide area network (WAN), rather than the Internet. The network sponsor will refer customers to the super broker, and the super broker will carry out the sponsor's policies.

Or the borrower, having chosen a lender on-line, can then call that lender directly and get the lender's telemarketing agent to take the application over the phone. If the lender pays the network sponsor for leads, the sponsor must be licensed as a broker; if the borrower pays the sponsor, a license is not required.

Who will these network sponsors be? They won't be traditional mortgage brokers for the same reason that stagecoach companies, vested in old technology, did not become the manufacturers of railroad trains or automobiles. Instead, they will be technology companies with existing networks for providing consumer financial services, or perhaps mutual funds or electronic bill payment networks. Perhaps the most conspicuous current example is Intuit.

These networks will become the dominant players in the new direct-to-consumer mortgage market, and they will share six characteristics:

1. They will have--or quickly develop--a recognizable national identity.
2. They will piggyback the delivery of home loans onto a distribution network for other financial services.
3. They will sell the quality of their lenders, not pretend to be one.
4. They will sell their neutrality in the choice of lenders and loans.
5. They will sell the quality of the information they offer customers.
6. They will charge all customers with similar risk profiles the same price and make that consistency a selling point.

The emergence of networks will diminish the importance of lenders in the mortgage chain because the network, not the lender, will own the customer. Super brokers will emerge as lenders licensed in all 50 states and will be under contract with network sponsors for the right to provide telemarketing services. Many different user screens will be developed, but only a handful will survive, greatly simplifying life for the new breed of mortgage counsellors.

Some lenders will use channels other than the classic and direct-to-consumer channels. Wholesale lenders will need to distribute informaton to multiple brokers. A single wholesale broker like HomeSide Lending might establish a site where multiple brokers can get transaction-specific pricing. Or an integrated system may support one of the multi-lender wholesale web sites like First Mortgage Open-Close.com that are springing up to collect information from multiple wholesale lenders.

Building the Information Infrastructure

The growing complexity of products and pricing is driving nichification and the need to leverage technology across multiple channels. Even today, many lenders still rely on thick, printed product manuals and rate sheets to originate mortgages--a slow, difficult, unreliable process. As the underwriting rules and product variations proliferate and become more complex, the only smart solution is to build a central computerized database, probably on a powerful server, and then link client computers in a network to distribute the information to all who need it, especially point-of-sale players.

A powerful server can provide the infrastructure backbone to support multiple distribution channels. It is also an effective engine for supplying data to and collecting data from various web sites as direct-to-consumer, multi-lender networks continue to grow. How thin the client should be is an issue to consider. Most clients depend heavily on the server for both functionality and information, but clients can be stocked with software functionality and depend on a server only for price and program updates.

Client-server architecture will be critical as mortgage bankers seek to build and stretch a common information infrastructure to cover all channels. Originating and selling a mortgage requires multiple steps and the use of various technology modules that specialize in each step. Those modules often require and create data. If the data is trapped on these technology "islands," the system fragments, requires manual intervention to transfer data from one module to another, creates databases that are perpetually out of date, and allows inconsistencies to develop. It's not unusual for a large lender today to use different systems for different functions--to have one system for wholesale lock-in and another for quality control, for example--and to have totally separate databases of product and pricing rules for each system.

Turning these modules into clients that are linked to a powerful, central server goes a long way toward solving this problem. A common database practically guarantees the consistent application of underwriting and pricing rules. Posting updates to a central server is relatively simple, a critical feature in a business where things are always changing. If a borrower files an application, then decides to take a higher rate to avoid paying points, the processor can ask the server to find the rate/point options offered by the chosen loan program on the date the terms were locked in.

Testimony to the value of integrated information systems came recently from one wholesale lender who has many brokers calling for lock-in rates. About 30% of the requests come in mispriced or out of compliance with underwriting rules and must be corrected. When he used paper product manuals and rate sheets, it took five or ten minutes to validate each request. When he switched to an integrated system, each validation was cut to 20 seconds. He simply runs the details against the host database, and the system determines whether each request conforms to guidelines and supplies the correct price.

Logically, validating that a given mortgage meets guidelines and is priced correctly is one process that should require one database, regardless of where it is initiated. But lenders often use separate, redundant databases to feed different applications from different vendors.

As the mortgage market becomes increasingly responsive to change, it gets riskier to hard-wire the mortgage instruments that currently dominate the market. Exotic instruments like PLAMs (price level adjusted mortgages), dual-rate mortgages and dual-index mortgages that have proved popular in other countries might some day find a spot in the U.S. market. Systems flexibility that can accommodate change, therefore, is critical.

It may take a significant investment in writing interface programs to make each application a client that is served by one central data engine, but the return on investment could be tremendous. You'd only have to build, upgrade, supply and maintain one server that could drive the product and pricing rules out to all the delivery channels you use, including a direct-to-consumer web site.

Client applications can be programmed with relative ease, opening the door for a common server-based clearing house to feed a variety of customized functionalities. To get information onto a network, lenders must feed data to a clearing house, which then sends it to an application server.

Information covering loan programs--especially the critical underwriting rules and pricing rules and updates--is entered in the system's back office. Pricing and design characteristics can be defined in a design and price module. That module can merge underwriting rules, including insurance requirements, that are likely to come from the lender's underwriting department with pricing rules, likely to come from the lender's secondary marketing department. The back office then exports updated program and pricing information to a powerful computer that acts as a clearing house. Data are stored there and distributed to multiple points of sale. The clearing house also receives information on registrations, applications and pre-approvals back from the point of sale and forwards it to the lender's processing system.

Systems can package functionality in bundles that might be called "dynamic linked libraries." For example, one DLL might pull together pricing and program information, while another pools borrower and qualification information and a third contains documents. An application program interface (API) links data stored on the server to the client application. The client application, typically displayed as a user interface on a screen, turns the data and analytics into accomplished tasks.

Web browser technology greatly simplifies the process of making data available to home buyers because they don't have to buy and install software that is compatible with the lender's. For

example, a mortgage transaction done through the Intuit's Quicken network involves four parties: the lender, the network manager (Intuit), the consumer and the software provider--in this case, GHR, my company. To work, both Intuit and the lender need GHR software, but Intuit's 7 million Quicken users do not. They need only their browsers to tap into a rich data base that is displayed on their user screens. Similarly, brokers accessing a wholesale web site only need browsers, not major point-of-sale software.

One example of using the Internet for multiple lender applications can be found at Cendant Corp., which, in addition to Coldwell Banker, Century 21 and ERA, now owns The Home Mortgage Network. Cendant uses that network to offer the programs of about 30 lenders to several hundred Coldwell Banker offices. HFS now is in the process of expanding the network to its other franchise firms and additional Coldwell Banker offices. To deliver the products of multiple lenders to multiple real estate sales offices requires a computerized clearing house.

Although the trend clearly favors direct, browser-based access to multi-lender networks via the Internet, more than half the loans originated by most lenders still are taken by retail loan officers. These officers are in the process of chucking those thick manuals and printed rate sheets in favor of laptop computers.

Lenders use laptops to take mortgage applications that can be upstreamed automatically to a computerized clearing house. If the laptops are loaded with the equivalent of a paper product manual and rate sheet, they may not support a winning nichification strategy. But if they are linked through a wide area or local area network (WAN or LAN) to a central clearing house, it will speed up the origination process considerably and generate mortgages that are based on valid, current and comprehensive product and pricing information.

Mortgage systems in the future will be expected to deliver the products of multiple lenders to a single point of sale, offering consumers a rich choice of structures and rates. Borrowers want it; technology now can provide it; and the players that will dominate the market in the future--more likely to be technology firms, investment banking firms and real estate firms than traditional mortgage lenders--are preparing to deliver it.

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