

Home Equity Lending – Originations Comparing Mortgage Companies to Banks

BenchMark Consulting International
Rod Arends & Jim Leath

In today's lending environment, the inevitable Federal Reserve rate increases will force banks and mortgage companies to seek alternative sources of revenue enhancement. As interest rates begin to increase, the demand for first mortgages and refinancing will drop from the recent historical highs. To offset this decline in the revenue associated with these products, many lenders are looking to the home equity lending arena.

Home equity lending volumes are trending upward and this is expected to continue through 2004. According to Keefe, Bruyette & Woods Inc.'s 2004 earnings outlook report, analysts wrote that home equity loans are expected to be a product of choice. The report went on to say that demand for these products could easily match the 20% growth rate of 2003. The 2003 CBA Home Equity Study conducted by BenchMark shows a home equity net portfolio change reported by participating banks of 29% from June 2002 to June 2003. This figure combines total Home Equity portfolio growth with an adjustment for portfolio runoff.

This article explores the revenue and risk, process, marketing and pending legislative reform differences between mortgage companies and banks in the home equity arena. For the purposes of this article, mortgage companies are defined as

institutions originating home equity loans or lines of credit, bundling them into pools, and selling these pools of receivables and servicing to investors in the secondary market. Traditional banks are defined as institutions originating the home equity loan or line, holding these loans or lines in their portfolio, and servicing them for the full term.

Revenue and Risk

Mortgage companies rely on the yield spread premium (or the spread between the customer's interest rate and the wholesale interest rate) to provide fee income from each mortgage loan. By operating as a mortgage company that sells off receivables along with servicing (i.e., servicing released), the only risk to be managed is market risk (or interest rate risk) that ultimately determines the yield spread premium. Because of the 'single' risk management aspect of a mortgage company, it can operate on a significantly lower cost structure as compared to a bank.

Banks rely on the revenue stream from interest income, net of cost of funds and servicing costs during the life of the loan. A bank must manage not only market risk but operational risk, as well. Operational risk is process-oriented and involves the control of servicing costs and effective leveraging of technology for the life of the loan.

A revenue differentiator between mortgage companies and banks is higher loan officer or broker commissions paid by mortgage companies on a per loan basis. These commissions put additional pressure on mortgage companies to achieve a sufficient spread to reach profitability goals. Banks usually have an incentive plan in place, but these plans are not generally based on a per loan method and do not impact the per loan revenue as significantly. The bank's loan officer compensation model can also incorporate loss or delinquency rates since they retain the servicing of the assets.

Turnaround Time

Turnaround time is defined as the elapsed time from application submission to boarding or booking the receivable to the host computer system. When comparing origination turnaround time between mortgage companies and banks, it has historically been the banks that have provided a more consistent, and overall shorter, turnaround time for credit approvals and closings.

For mortgage companies, turnaround time will be adversely affected by the somewhat volatile nature of the origination volume. Since the mortgage company revenue model relies on meeting delivery deadlines for inclusion in a given pool of loans for sale, the overall turnaround time may be impacted by swings in origination volume as the deadline draws near.

Banks generate home equity transactions that will be held for the life of the loan or line. As stated earlier, the major source of revenue comes from the interest revenue stream over the life of the asset. As such, the focus for banks is the efficient and effective processing of the loan application through closing, and the ultimate servicing. Once again, this effort combines the market (interest rate) risk with the operational risk.

Banks are also better capitalized to be able to pursue and implement leading edge technologies that will assist in decreasing and stabilizing turnaround times. Since the data entered during application processing will ultimately become the basis for the loan accounting system and servicing

system, automation and accuracy play a more significant role, and IT investment (to achieve these goals) can be more easily justified. In contrast, the mortgage company's transaction-based income is based on an asset where the receivable and servicing will be quickly sold with no future use of the application data. Therefore, investment in technologies that will ensure efficient and effective data capture are not as easily justified.

Underwriting

The underwriting process involves rendering a credit decision based on the borrower application and credit information. In addition, the value of the underlying collateral must be reviewed to determine if sufficient equity exists in order to approve the requested loan amount.

For mortgage companies, the underwriting process is normally dictated by investor expectations. Investors will generally have certain covenants in their financing agreements that define items that must be verified and may define certain credit score guidelines that must be met. In addition, the loan-to-value guidelines may require more robust appraisal methods to ensure the accuracy of the collateral risk level. These attributes combine to make the underwriting process within mortgage companies less flexible and more rigorous than the underwriting process within a traditional bank. The mortgage company must render a credit decision based on strict investor guidelines that define the salability of the asset, secondary market servicing, and price.

The underwriting guidelines for banks are generally more flexible. Since the bank is assuming the full risk of the loan for its duration, the underwriting guidelines can be driven by historical loss experience, efficiencies within their own servicing department, and local economic conditions. A borrower's prior experience with the bank may also factor into the underwriting criteria. While a customer may not meet the stringent guidelines of a mortgage company underwriter, the same customer may have a long, satisfactory history with the bank and be a good candidate for the bank to fund.

Data Verification

Data verification typically includes any activities associated with the review or verification of data elements or supporting documentation within the application package. The amount of data verification necessary to complete the review of a credit application or collateral will also drive turnaround time.

Mortgage companies tend to derive their data verification guidelines based on the underlying investor covenants or expectations in order to ultimately place the asset and its servicing into a saleable pool. These guidelines tend to be based on a formulaic approach where the FICO score of the applicant will dictate fields that must be verified.

In the banking environment, there tends to be more flexibility built into the data verification process. The customer's existing or prior relationship with the bank may be acceptable as partial verification and alleviate some verification requirements. The type of product that the customer is applying for, in terms of loan-to-value ratios, may also provide more flexibility. For example, some banks may only require evidence of the local government tax assessment of the collateral and then apply a multiple to the assessed value to determine the collateral value. This is done in lieu of a full or partial appraisal. Local knowledge of economic conditions and/or the local housing market may also impact the bank's verification guidelines. All of these aspects of data verification allow a bank to be more flexible in their approach and to devote less time and resources to the verification process, yet still be in a comfortable position from a collateral valuation and risk assessment standpoint.

Appraisal Method

The appraisal method utilized by a lending institution is an area where leading edge technology and system architecture, in terms of accepting and processing third party data, can lead to great increases in efficiencies and effectiveness.

The mortgage company appraisal method is usually dictated by investor guidelines. The methods are usually either a full appraisal or, at the very least, an Automated Valuation Model (AVM) based on an automated retrieval and comparison of comparable property sales data in the local area. These methods involve a greater commitment of either human resources to order, track, and process the full appraisals; or advanced system architecture coupled with a vendor relationship to process the AVMs. There will also be a necessary vendor management aspect of the AVM process to ensure consistency and quality of results.

For banks, there is more latitude in determining the appropriate appraisal method. The ultimate method will be driven by the bank's risk tolerance, their knowledge of the local housing and real estate markets, and their commitment to technology investment. Usually, a bank will be in a better position, from a capital expenditure and budget standpoint, to make the investment in leading edge technology to provide a fully compatible third party data channel. Banks are also able to provide the resources necessary for an efficient vendor management process. However, because the loans are not subject to any investor guidelines, the chosen appraisal method becomes more of a risk tolerance issue. The bank has more flexibility in determining which loan applications need which appraisal method, rather than prescribing the same method for all applications of a similar credit score and/or loan-to-value. This scenario provides significant opportunities for revenue enhancement as the bank can better control the ancillary costs associated with the origination of the loan.

Title Reports

For the mortgage company or broker, the underlying investor will likely have more stringent title insurance requirements in order to make the loan available for sale in the secondary market. Some investors will require a 'bringdown endorsement' that will allow transfer of the title insurance benefits from the initial lender to the ultimate investor. This type of title insurance will require more effort and time on the part of the

mortgage company and will likely have an increased cost.

For banks, the titling requirements are established based on the policy within the lending institution. Since the loans will be held and serviced by the lending institution, the ability to determine the most appropriate title insurance requirements results in more flexible titling guidelines. More flexible titling guidelines result in fewer FTE devoted to the process, thus reducing costs, and possibly decreasing the overall turnaround time from application to closing.

Generally, a bank that originates loans within a specific geographic region will likely be more familiar with the local governing offices title procurement procedures. This knowledge may aid in the bank's overall title policy decisions as well as decrease overall turnaround time!

Flow of Origination Volume

For mortgage companies, the flow of origination volume tends to fluctuate due to the deadlines for inclusion in pools for sale. The fluctuation in the flow of origination volume is a function of the revenue model for a mortgage loan company as a per transaction fee-based income model. The more loans that are fed into the pipeline, the more income that can be earned. Because of this model, origination volumes will tend to increase as the sale deadlines approach, which may produce a load management environment that challenges staffing levels. The response may be to utilize temporary staff or increase the hours per day for existing staff. In either scenario, it is likely that accuracy and turnaround time will both be adversely affected. In the temporary staffing case, training becomes an issue. For the increased hours scenario, staff may become less efficient and less accurate as they work longer hours to address the increased volume. The error rate is likely to increase, thus increasing the turnaround times as the errors are detected and corrected as a part of the workflow.

Banks do not rely on a transaction-based revenue model since the loan will be originated and owned by the lending institution. As such, monthly

volume targets have a less important role in the overall revenue model. The more important aspects of the revenue model become the efficiencies in the servicing of the loans and the effectiveness of the collection process.

Marketing Strategies

The marketing strategies and methods vary widely between mortgage companies and banks. Primarily, these differences are driven by the inherent differences in whether a lending institution retains the loan and the servicing or sells on the secondary market.

For mortgage companies, the most prevalent methods of origination volume generation are media outlets (TV / radio / newspaper), direct mail, and telemarketing. These avenues are fairly costly, and the response rate cannot always be counted on to drive the volume needed to support the profitability targets.

Because the mortgage company has a very limited opportunity for interaction with the customer beyond the initial application and closing functions, there is little opportunity to continually make contact to take advantage of additional financing needs.

There is significant opportunity for banks to cross-sell an existing bank customer on any of the products offered by the bank. The most prevalent channel of volume tends to come from existing first mortgage customers who may have a desire to utilize the equity in their home for a financing need. It is likely that one of the first sources these mortgage customers will consider is their bank.

Because of the existing relationship with customers, banks also have a distinct advantage over mortgage companies by data mining their CIF system for pre-approval, targeted direct mailing campaigns, and a traditional source of origination volume.

The Future of Home Equity Originations

Another consideration for the future of the home equity and mortgage lending markets is the pending Real Estate Settlement Procedures Act (RESPA) reform. Once enacted, it is likely to place more stringent disclosure requirements on mortgage brokers, as related to home equity loans. Brokers would be required to disclose the full APR for a home equity loan, which would include the yield spread premium. The yield spread premium represents the difference between the customer's mortgage rate in the contract and the wholesale rate paid by the originator. The requirement to disclose the full APR, including the yield spread premium, would have the impact of classifying many home equity loans within the high interest rate category according to the Home Ownership and Equity Protection Act of 1994, triggering additional disclosure requirements. The additional disclosure requirement would spell opportunity for banks. Since they would not be bound to the same APR disclosure requirements, they would not be reselling the loan on the secondary market.

RESPA reform is also likely to bring about Guaranteed Mortgage Packages. Guaranteed Mortgage Packages will force all mortgage lenders to disclose an up-front cost for completing the mortgage transaction with a relatively small tolerance for differences in the final costs. The Guaranteed Mortgage Package requirement will force lenders to invest in technologies to lower origination costs. Lenders who have fully embraced the latest efficiencies to be gained through technology investment will become the low cost providers of mortgage loans and will likely reap the benefits through increased market share. Some of the technologies would include automated property valuation, interfacing application processing systems to document

preparation systems and loan accounting systems, and automated retrieval and population to host system of third-party vendor data.

It is likely that there will be some consolidation within the home equity lending arena, as scale will become a more important factor in justifying the increased investment in technology. The increase in scale is also likely to justify investment in single platform systems, which would provide additional cross-sell opportunities for banks. All customer information and relationships could be housed on one platform, providing seamless servicing and data exchange between unique product lines.

As RESPA reform combines with the decreased demand for first mortgages and refinances, it is likely that banks will continue to realize a significant demand for home equity products. Those lenders who have made the appropriate technology investments will be poised to gain significant market share along with the resulting increased revenue.

Summary

Mortgages companies and banks must find an alternative means of revenue generation as the demand for first mortgages and refinances begins to decrease due to the impending rise in interest rates. Home equity lending appears to provide the perfect alternative as the origination and delivery channels utilized for first mortgages and refinances can now be leveraged for the home equity volumes.

Advantages exist in the approach taken by both mortgage companies and banks in home equity lending. From a process, marketing, and impending legislation perspective - banks appear to have an edge.

Rod Arends is a consultant at BenchMark International with over 14 years of experience in indirect auto finance and consumer lending. Arends specializes in Indirect Lending and Consumer Finance and associated business process design.

Jim Leath is the Mortgage and Consumer Lending practice manager at BenchMark Consulting International. He has extensive background in mortgage and consumer lending, strategic planning, consolidations and corporate restructuring.

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BENCHMARK CONSULTING INTERNATIONAL
3535 Piedmont Road, Suite 950
Atlanta, Georgia 30305
(404) 442-4100