# What Were They Thinking?

**Recent polling data of small groups of industry players reveal surprising trends in technology, competition, consolidation and regulatory burdens.**

BY JAMES JONES

Ever wonder what the consensus view of the mortgage industry is on any one topic that might be critical to setting corporate strategy? Innovative new polling technology is allowing the mortgage industry to get virtually real-time snapshots of their colleagues' attitudes on a variety of important issues. Say, for example, what do your competitors think is the time frame for Internet lending becoming mainstream? Well, almost half of those polled for this article think the dominant retail channel by 2010 will be the Internet. That estimate is just one of the findings yielded by this polling technology applied in various industry settings during 2006. At conferences and other industry gatherings in recent months, more than 800 professionals sitting in large conference rooms were able to instantly learn their colleagues' views on industry issues and challenges. Those roughly 800 participants learned what their colleagues were thinking via live, interactive, instant, electronic polling sessions. First Wellesley Consulting Group Inc., Wellesley Hills, Massachusetts, the creator of the custom polling service SurveyMatters™, conducted group polling sessions at several different industry venues. These included real estate finance conferences; vendor user conferences, such as Mequon, Wisconsin–based Mortgagebot LLC's 2006 Partner Conference; industry educational programs, including the Mortgage Bankers Association's (MBA's) School of Mortgage Banking Course III; and individual lender sessions.

SurveyMatters, exclusively offered by First Wellesley, is a custom group-polling service that enables each meeting participant to register his or her opinion on a variety of questions. SurveyMatters is integrated with Microsoft® PowerPoint® and, as a result, all participant responses to individual questions are immediately summarized and displayed to the group. Polling data are saved, archived and reported on after the session, permitting detailed analysis.

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This article highlights some of the accumulated polling data for 2006. It also probes some of the implications of the findings. As one colleague put it, SurveyMatters creates a repository of primary polling data that permits an organization to improve its "knowledge to guess" ratio.

As of this writing, SurveyMatters' data had been collected from 18 polling sessions in 2006. Participants included chief executive officers as well as other senior and middle managers. Each polling session contained its own set of questions, although in many cases the same question was asked in multiple sessions.

No one question received answers from all 800 respondents. Responses, however, are combined from sessions that included the same question. Most polling questions were answered by at least 100 respondents.

Often, First Wellesley facilitated guided discussions to examine group responses to specific questions. This article includes insights from these discussions. Most respondents were anonymous. Responses may have been submitted by more than one employee from the same company.

Some of the key findings from our polling sessions will be discussed now in detail, starting with technology.

**LOS replacement plans**

A sizable number of lenders appear to be actively looking to replace their loan origination systems (LOS), according to respondents from multiple sessions (see Figure 1). While a total of 56 percent of lenders report no plans to replace their LOSes, the remaining 44 percent are in some stage of replacement.

Fully 24 percent of lenders indicate that they are in the process of implementing a new LOS during the next 12 months. An additional 10 percent will replace their system in 13 to 24 months, while another 10 percent are currently considering a new system.

According to our polls, it appears lender size is a factor in determining the likelihood of LOS replacement. Figure 2 shows LOS replacement plans by lender size. Interestingly, the top-10 lender segment is reporting the highest level of replacement activity, with 70 percent of top-10 lender respondents reporting plans to replace their system in the next 24 months. An additional 12 percent of this group is considering doing so.

Two other lender segments—large and midsized lenders, and small lenders—report almost the opposite: 24-month replacement plans of 18 percent and 27 percent, respectively, a much lower replacement rate.

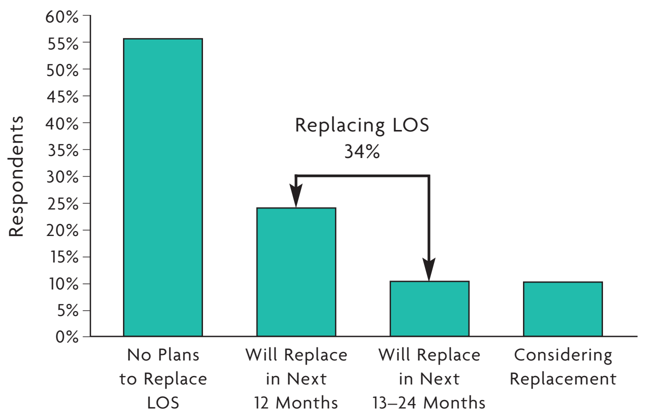
There may be several explanations for why so many top-10 lenders indicated they were contemplating or already involved in LOS replacement efforts. A number of top-10 lenders have legacy LOSes that may be more than 20 years old. Over the years, legacy system users' business rules have been hard-coded into millions of lines of common business-oriented language (COBOL) that may still run on mainframe computers. As a result, today's product innovation, compliance, company acquisition, data mining and channel integration efforts can be significantly hindered by the older legacy systems.

In addition, the record high volumes over the last few years have exposed weaknesses in some legacy systems' reliability and performance. Recently, new technologies have appeared—notably Web services and service-oriented architecture (SOA)—that address some of these issues.

In addition, a major business problem remains for the industry. A high percentage of mortgage lenders' cost structure remains fixed. That means that lenders in 2006 have been forced to resort to office closings, business unit sales and employee layoffs as the principal ways to respond to lower volumes.

Top-10 lenders, First Wellesley believes, see the new advanced technologies such as Web services, SOA and extensible markup language (XML), supported by emerging MISMO® standards, as the best way to achieve several important goals. These goals include allowing them to automate more origination and production functions; make more of their cost structure variable; better accommodate application volume swings; eventually support eMortgages and reduce the

*Figure* **1** **Lenders' Loan Origination System (LOS) Replacement Plans**




SOURCE: FIRST WELLESLEY CONSULTING GROUP

cost to originate. It is for these reasons that First Wellesley believes top-10 lenders are pursuing LOS replacement plans so aggressively.

We believe large to midsized and small lenders, on the other hand, have simpler business models, fewer channels, less volume, smaller technology staffs and less interest in assuming the role of technology innovator in areas such as eMortgage. Generally, technology plays less of a strategic role for non-top-10 lenders, and a lender is more likely to extend the life of its existing LOS rather than expend the effort and time required for a major LOS implementation project.

We conducted one polling session comprised exclusively of small lenders. This lender segment provided us with some insight as to lender motivation for replacing a LOS. The small lender group revealed the top three reasons for considering a new LOS: They have outgrown the existing LOS (56 percent), they require new functionality (56 percent) and they want support to eventually move to eMortgages (62 percent).

The highest level of existing-LOS functionality dissatisfaction by top-10 and large to midsized lenders focused on the state of their current third-party interfaces. Some lenders rated the overall third-party interface functionality as poor or below average for three areas: the application, production and pricing/risk-management activities. The number of those rating these functionality areas poor or below average ranged from 26 percent to 35 percent (see Figure 3).

The quest for the eventual eMortgage may also be fueling large lenders' plans for new LOSes. Top-10 lenders report a high level of eMortgage interest, with 15 percent of respondents reporting they are at the forefront of eMortgage adoption (see Figure 4). Another 30 percent of top-10 lenders report some eMortgage implementation success. Non-top-10 lenders report much slower eMortgage progress, with 40 percent claiming no progress to date.

*Figure* **2** **LOS Replacement Plans by Lender Size**

| | Top-10 Lenders | Large to Midsized Lenders | Small lenders |
|---|---|---|---|
| No Plans to Replace LOS | 18% | 82% | 66% |
| Replacing in Next 24 Months | 70% | 18% | 27% |
| Considering Replacement | 12% | 0% | 7% |

SOURCE: FIRST WELLESLEY CONSULTING GROUP

*Figure* **3** **Rating of Third-Party Integration Functionality**

| | Total Poor to Below-Average Functionality Ranking | | |
|---|---|---|---|
| **Lender Size** | **Application** | **Production** | **Pricing/Risk Management** |
| Top-10 | 27% | 35% | 26% |
| Midsized | 27% | 31% | 33% |

SOURCE: FIRST WELLESLEY CONSULTING GROUP

*Figure* **4** **Reported eMortgage Progress to Date**

| | Reported Progress | | | |
|---|---|---|---|---|
| **Lender Size** | **None** | **In Early Stages of Adoption** | **Some Implementation Success** | **At the Forefront of eMortgage Adoption** |
| Top-10 | 0% | 50% | 30% | 15% |
| Large and Midsized | 40% | 27% | 20% | 7% |

SOURCE: FIRST WELLESLEY CONSULTING GROUP

*Figure* **5** **Type of Retail Internet Loan Site**

| | Lender Size | | |
|---|---|---|---|
| **Type of Site** | **Top-10** | **Large to Medium Size** | **Small** |
| No Site | 0% | 7% | 14% |
| Basic Site | 47% | 57% | 46% |
| Advanced Site | 53% | 36% | 40% |

SOURCE: FIRST WELLESLEY CONSULTING GROUP

**Internet lending**

Lender size seems to be related to the complexity of a lender's retail online application technology. Top-10 lenders report the most progress with implementing advanced online application Web sites that include online decisioning and eDisclosures.

A total of 53 percent of top-10 lenders report advanced Internet Web sites for their retail channels (see Figure 5). Large and midsized, and small lenders report lower percentages, with 36 percent and 40 percent, respectively, claiming advanced Web sites.

One polling result that is somewhat surprising, given that Internet lending has been a reality for more than a decade, is the high percentage of lenders of all sizes still offering merely "basic" retail Web sites. Many top-10 lender (47 percent), large and midsized lender (57 percent) and small-lender (46 percent) respondents still report having only basic Internet applications that do not include online decisioning or eDisclosures.

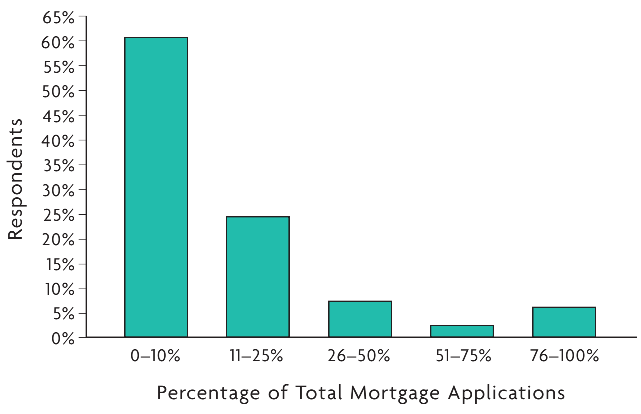
It also appears that consumers have yet to generally adopt the Internet channel as the preferred way to apply for a mortgage. Small and midsized lenders report mixed success in steering applicants to their online channels.

The best results were reported by the manager of a federal credit union with a single branch and worldwide membership. Fully 92 percent of all mortgage applications at this credit union are taken over the Internet. Typical lender results, however, are significantly less dramatic.

More than 60 percent of respondents report online application percentages from zero percent to 10 percent of total applications, illustrating that the industry is still in the early years of consumer adoption of the online application (see Figure 6).

Lenders at Mortgagebot's 2006 Partner Conference in June 2006 were asked to identify the drivers of Internet lending success. These lenders reported that online success overwhelmingly relied on two key drivers: (1) Web site usability and functionality, and (2) applicant service levels.

*Figure* **6** **Internet Applications as Percentage of Total Mortgage Applications**




SOURCE: FIRST WELLESLEY CONSULTING GROUP

Many respondents believe that the preferred retail mortgage channel in 2010 will be the Internet channel.

Our polling session participants, however, were extremely bullish on the future of the Internet channel. Lenders are betting on the convergence of several factors. These include continued improvements in Internet technology; significantly increased overall mortgage demand from Generation X (born 1965–1980) and Generation Y (born after 1980)—combined with the Gen X and Y preference for online channels; the expanded availability of broadband Internet access in suburban and rural locations; and greater lender experience with Internet lending.

Interestingly, many respondents (47 percent) believe that the preferred retail mortgage channel in 2010 will be the Internet channel. Mortgage brokers (25 percent) and retail loan originators (15 percent) were the other channels that received many votes.

First Wellesley's belief is that the Internet channel will eventually become the preferred channel by consumers for the reasons cited here. We believe, however, that the accession of the Internet to the dominant channel position will take longer—perhaps by 2012 or so.

More lenders will need to adopt ever-developing, advanced online application technology; Generation X and Y consumers need to buy more homes; and Internet security and regulatory issues must continue to be satisfactorily addressed before the mortgage industry will see the mainstream adoption of the Internet channel by lenders of all sizes and types. Online applications as a mainstream delivery channel will require the continued convergence of Internet technology advances, higher consumer adoption, more lender deployment and additional regulatory acceptance.

**Industry challenges, issues, attitudes and strategies**

What do lenders and industry service providers think about the current state of the industry, especially given the dramatic drop in origination volume since the peak of the boom? While the saying "The rising tide lifts all the boats," attributed to the Boston-based New England Council and popularized by President John F. Kennedy, may be accurate, the opposite event—a lower tide—unfortunately mires lots of boats in the mud flats.

Our polling participants listed a series of major challenges for 2006 that would not have appeared three years ago. Respondents were permitted to select multiple industry challenges when responding. Not surprisingly, "generating applications" leads the list of respondents' greatest challenges, cited by 53 percent of those polled (see Figure 7).

Because lenders have a high percent of fixed costs, including salaries and benefits, the current business challenge is twofold: producing more volume and reducing costs. In fact, 22 percent of lenders also claimed cost reduction as a major challenge. Preserving the bottom line was a challenge cited by 27 percent.

Lenders' sales forces also came under scrutiny. More than one-quarter of lenders (27 percent) identified a major challenge to be refocusing the sales force from an "inside" to an "outside" sales mindset this year.

Tough competition is weighing on the minds of small and midsized lenders alike. Two major competitor types were identified as the stiffest competition for community banks and credit unions, based upon our polling results. Most respondents to this question represented small to midsized community banks and credit unions.

Two interesting facts emerged from their polling responses. First, mortgage brokers; small, nimble, low-cost and entrepreneurial mortgage originators represent the greatest perceived competition to community banks and credit unions. The brokers' greatest advantages, according to these bank and credit union executives, include local offices; strong sales staff; broad product selection (including prime, nontraditional and subprime loans); and the willingness to negotiate rates and fees on a loan-by-loan basis when necessary. This accounts for why 48 percent of these lenders identified mortgage brokers as their toughest competitors (see Figure 8).

Second, national and regional mortgage lenders were named the toughest source of competition by 32 percent of participants. Reasons provided by those voting for this group included the facts that national and regional lenders have huge media budgets; multiple production channels; broad product selection (including prime, subprime and nontraditional products); often strong underwriting and Internet technologies; and large sales forces.

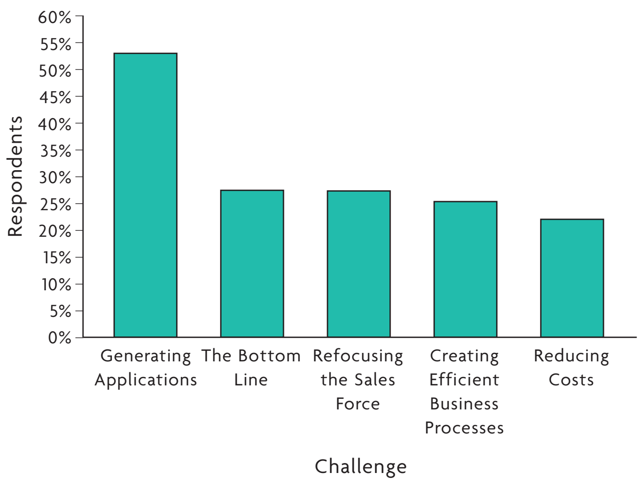
Interestingly, very few votes were cast for Internet lenders as tough competitors, indicating that even with the attention given to the Internet channel, Internet lenders have not ascended to the status of dominant competitor.

**Consolidation and regulation**

Lenders and vendors were also polled about their opinions on two critical industry issues—consolidation and regulation.

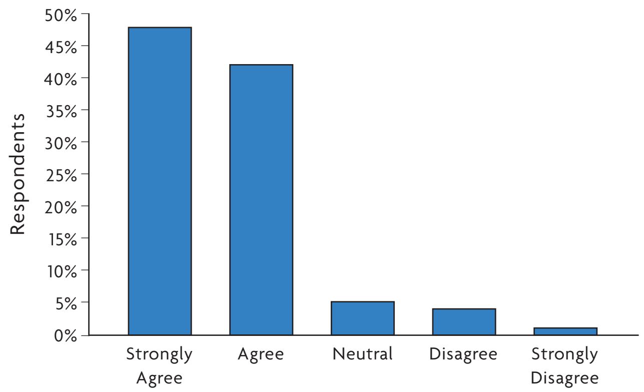
Overwhelmingly, lenders and vendors believe the industry will continue to consolidate. In fact, 90 percent of respondents agree or strongly agree that the number of total lenders in the

*Figure* **7** **Major Lending Challenges in 2006**



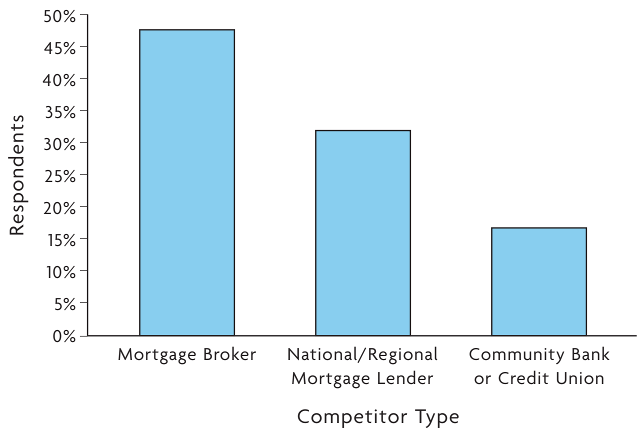

SOURCE: FIRST WELLESLEY CONSULTING GROUP

*Figure* **9** **Total Number of Mortgage Lenders Will Decline Through 2015**



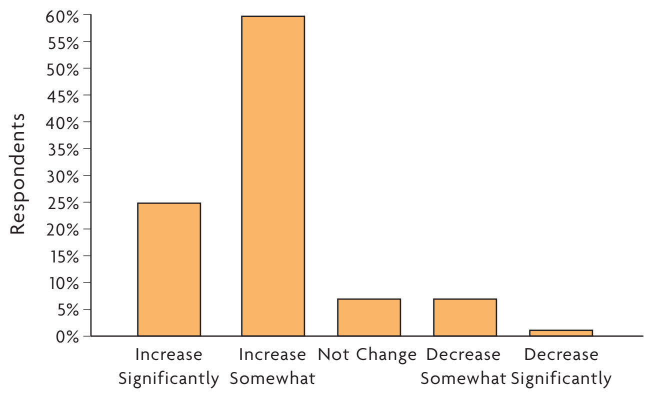

SOURCE: FIRST WELLESLEY CONSULTING GROUP

*Figure* **8** **Lender Type Representing Greatest Competition in 2006**




SOURCE: FIRST WELLESLEY CONSULTING GROUP

*Figure* **10** **Combined Market Share for the Top 25 Lenders Over the Next Decade Will:**




SOURCE: FIRST WELLESLEY CONSULTING GROUP

United States will continue to decline over the next decade (see Figure 9).

Parallel to this perceived trend, the majority of respondents—85 percent—project that the combined market share of the top-25 lenders will rise as part of the projected trend of consolidation (see Figure 10).

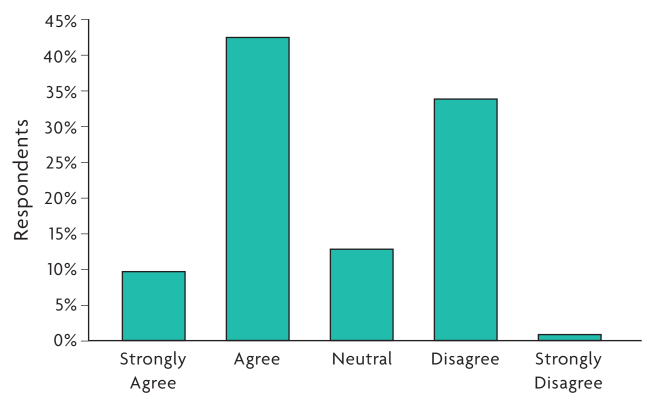
Reasons cited for this ongoing lender and market share consolidation include the formidable advantages commonly attributed to megalenders. These include economies of scale and scope; future investments in advanced technologies; pricing advantages; the aggressive pursuit of eMortgages by megalenders; brand advantage; multiple production channels; extensive product lines; large sales forces and better Wall Street price execution.

Combined with anticipated increased regulatory costs and overall industry complexity, many lender and vendor polling respondents project future overall consolidation and higher market share concentration at the top.

> Polling respondents predict a further regulatory tightening by 2010—now less than three and one-half years away.

Interestingly, respondent views on lender consolidation do not smoothly track with their opinions about future industry service-provider consolidation. Lender and vendor opinions about vendor consolidation are split, with somewhat more (52 percent) favoring the view that service providers will consolidate at roughly the same pace as lenders (see Figure 11). The vendor consolidation camp has developed this conclusion for two major reasons: recent vendor consolidation history and future large-lender requirements.

**Figure 11** **Industry Vendors Will Consolidate at About the Same Rate as Lenders**




SOURCE: FIRST WELLESLEY CONSULTING GROUP

The last several years have provided many examples of vendor mergers and acquisitions. Major vendors have evolved toward a "one stop" shopping model for lenders requiring traditional mortgage services as well as mortgage technology. Also, megalender requirements for vendors have changed as a result of lender consolidation.

Megalenders are now requiring vendors to provide services covering most or all of their geographical markets and channels, along with custom integration with the lender's proprietary technologies and strong security and compliance performance that satisfies increasingly rigorous regulatory requirements. It appears that top national and regional vendors are acquiring companies, adding products and investing in technologies to respond to these megalender requirements.

On the other hand, 34 percent of respondents disagree that vendors will consolidate at the same rate as lenders (see Figure 11). One of the major reasons for this view relates to the type of companies they believe will drive future industry innovation.

The proponents for a non-consolidated vendor community argue that future industry innovation ideas will come from small, new, incubator-type vendor companies that believe they have discovered the next meaningful innovations to transform the mortgage industry. Proponents of this non-consolidated view believe the new company formations will outpace the total acquisitions of established vendor companies by larger vendors. And that trend will either stabilize or even increase the total number of vendors in the industry.

One final polling topic was the future course of mortgage regulatory oversight. Polling respondents predict a further regulatory tightening by 2010—now less than three and one-half years away.

An overwhelming number (76 percent) of lenders and vendors believe new federal laws and regulations will be enacted by 2010 that address predatory lending. A clear majority (66 percent) also believes that a federal Real Estate Settlement Procedures Act (RESPA) reform package will be adopted by 2010.

**Figure 12** **New Mortgage Laws and Regulations to be Enacted by 2010**

| | Law and Regulation Category | | |
|---|---|---|---|
| **Response** | **National Predatory Laws and Regulations** | **RESPA Reform** | **Mandatory Loan Originator Licensing by Most States** |
| Yes | 76% | 66% | 67% |
| No | 24% | 34% | 33% |

SOURCE: FIRST WELLESLEY CONSULTING GROUP

Finally, many respondents (67 percent) believe that most states will require mandatory individual loan originator licensing.

If all three predictions become reality, it will be interesting to see what impact these new laws and regulations have on the total number of lenders and the pace of consolidation.

**Summing up**

This year's SurveyMatters polling revealed several interesting trends. The major findings include:

■ Strong evidence of relatively high LOS replacement activity, especially among the largest lenders.

■ A meaningful technology opportunity to develop and implement comprehensive integration between lenders' core technology applications and major vendor services relying on new technologies. Advanced integration could, if achieved, variabilize a meaningful portion of the industry's fixed cost structure.

■ eMortgages are at the beginning stages of development, and the highest level of lender interest and participation is found among megalenders. First Wellesley believes that megalenders, national vendors, MBA and other large organizations will be the primary drivers of eMortgage development and adoption.

Many respondents believe that most states will require mandatory individual loan originator licensing.

■ Signs are evident of the beginnings of adoption of advanced Internet lending technologies by lenders. There is a relatively low level of consumer adoption of the Internet channel by consumers currently. First Wellesley believes the use of advanced online mortgage applications will continue to rise, and will build to a critical mass in six to seven years.

■ Stiff and growing competition from national and regional lenders and mortgage brokers is confronting small to mid-sized financial service institutions, including banks and credit unions.

■ A strong likelihood for further lender and, perhaps, vendor consolidation over the next decade.

■ Lenders will face long-term, additional layers of federal and state regulations, adding to the complexity and cost of doing business for industry participants.

First Wellesley Consulting will continue to conduct mortgage-focused SurveyMatters sessions nationally in order to add to its data repository of industry issues and trends. **MB**

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