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Are Banks Ready for the Future of Home Equity Lending?

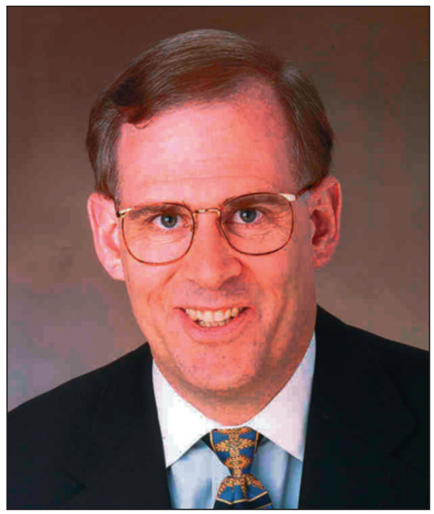
By James D. Jones

IN OCTOBER 2005, A GROUP OF MASSACHUSETTS community bankers participated in an interactive electronic polling session designed to better understand the current state and the anticipated future of Massachusetts home equity lending. The session was part of a Massachusetts Bankers Association home equity seminar. Participants shared their views on Internet lending, competition, customer preferences and demographics. Some of the bankers' views may surprise you. Clearly, if these home equity lenders are on target, the future of Massachusetts home equity lending will be dramatically different than today, requiring that community bankers explore new strategies to profitably compete in the future.

Home equity Internet lending by Massachusetts community bankers, based on our survey results, is in its infancy. Fully 50 percent of bankers report that their banks do not offer home equity loans over the Internet. Forty percent offer only basic Internet lending sites. Only one out of 10 banks report that they offer advanced Internet lending sites. Mortgage Internet lending is more established in banks, with 65 percent of bankers reporting Internet mortgage sites.

Internet application volumes are generally low. The percent of Internet applications compared to total applications from all sources is reported to be small. Fully 60 percent of bankers report receiving no Internet home equity applications. Only 15 percent of bankers report amounts in excess of 25 percent of total applications. The small number of Internet applications coupled with either the absence of or a very basic Internet lending site illustrates the low level of Internet adoption by bankers and consumers.

The home equity product line appears, however, to be an important business line for community banks. Over one-half of the bankers report healthy home equity market shares for their banks in excess of 10 percent. These loans were sourced primarily through bank branches and also from Internet and mail applications.



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Home equity competition appears sharp. Eighty-five percent of bankers report that they do not charge their customers closing costs. However, the majority of banks do stipulate prepayment fees. Many community bankers, asked to name their toughest competition, identify other community banks (38 percent). An equal number (38 percent) claim regional banks are their primary competition. Interestingly, only 14 percent view credit unions as their greatest competition.

What about customer preference? Overwhelmingly, bankers report that their customers' primary channel choice is bank branches (82 percent). So much for the imminent demise of the bank branch!

Who are today's most likely customer for home equity products? According to our poll, baby boomers (77 percent) represent the primary home equity age group. This is not surprising, perhaps, to the so-called "sandwich generation" often found juggling the financial responsibilities for two generations – parents and children.

To summarize, our poll reflects generally low lender and consumer adoption of the Internet channel, a consumer preference for bank branches, baby boomers as the primary customers and healthy bank market shares.

Dramatic Shifts

If our respondents are anywhere near the mark in predicting the future, Massachusetts bankers will see major changes over the next five years. Our respondents predict dramatic shifts in Internet lending, customer behavior and competition.

Many bankers (47 percent) predict that by 2010 more than four of every 10 home equity applications will be taken over the Internet. Only a small majority of bankers (11 percent) project continued low levels of Internet applications. This forecast is exactly the opposite of today's Internet volumes of 10 percent or less reported by 85 percent of bankers.

Respondents predict a dramatic shift in the competitive landscape by 2010. Rather than the continued dominance of today's major competitors – community and regional banks – lenders see tomorrow's chief competitors as Internet lenders (41 percent); large, national lenders (32 percent); and, to a lesser degree, regional banks (23 percent). This dramatic shift in competition may reflect the bankers' underlying views about future consumer Internet adoption, national and Internet lender invest-

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ments in Internet lending technology and bank consolidation.

Interestingly, bankers saw customers favoring the Internet channel by 2010 (81 percent) over any other delivery channel. If true, the Internet channel preference will completely contradict today's branch preference (82 percent). What are the major age groups driving this channel switch? Respondents believe that baby boomers will adopt the Internet as their primary channel of choice. Not surprisingly, respondents also believe that Generation Xers also will overwhelmingly choose the Internet as their primary channel. Overall, by 2010, bankers believe that baby boomers (57 percent) and Generation X (38 percent) will be the primary customer segments for their banks.

This does not mean that seniors will not continue to demand home equity loans and lines. Our survey participants forecast that the primary loan product of choice will be home equity products for both seniors (76 percent) and baby boomers (81 percent) over first mortgages, auto loans, credit cards and personal loans.

Adopting a Strategy

We see that drastic changes are predicted by the bankers involved in home equity lending today. If these changes materialize, the shifts in customer behavior, demographics and competition may require community banks to adjust their future lending strategies. Here are several points to consider when determining what strategies will be most effective for your bank. First, remember that the trends in this poll may or may not apply to your specific bank's market and customers. Invest time developing market-specific customer intelligence to understand what your consumers prefer for products, pricing, channels and service. Analyze the current and future demographics within your lending area. Conduct first-hand customer intelligence by age group and other key demographics. This detailed research will reinforce or refute the premise that your consumers and prospects will increasingly prefer Internet loans. Targeted customer intelligence also will enable you to blend the optimal strategies of product features, pricing, promotions, channels and service to best appeal to your consumers.

For bankers convinced that Internet channel investments are justified, our best advice is to find established technology vendor partners that share your long-term view of Internet lending. Most community banks will be better served by outsourcing the development of Internet lending technologies rather than building proprietary lending technologies internally. The baseline strength of a home equity Internet channel is the quality of its underlying technology. The technology must be highly secure, reliable and consumer-friendly with advanced features and functions. Community banks will need strong technology partners to compete on par with the proprietary Web sites of mega banks and Internet lenders. We believe that the best Web sites will include online applications, real-time decision-making functionality, risk-based pricing, eDisclosures, high security and seamless, electronic data interfaces to loan origination systems and third-party systems.

Banks should support the channel choices preferred by their specific customer base – potentially branch, Internet, mail and call center options. Additional investments to integrate these channels will pay dividends for bankers who are committed to providing channel choice to their customers.

Banks also can remain competitive by continuing to reduce costs and eliminate time from the origination cycle. A greater use of automated valuation models and title insurance alternatives are two ways bankers can reduce time and costs.

Community banks have several compelling factors that continue to work in their favor. Banks have thousands of long-time customers. Banks also have a well-developed knowledge of the local real estate markets and established branch networks. Banks that are able to leverage these strengths with up-to-date customer intelligence, strong Internet technology, channel choice and faster and less expensive origination cycles will ensure their future lending success. ■