Re-Engineering The Loan Process

Recently a high profile investment firm, Sutro & Co, released a report that essentially criticized the top online lenders for not re-engineering the loan process. In their survey of most of the top sites, they found that the back office operation was essentially the same as traditional lenders. Their implication being that the online lenders offered no significant benefit to consumers and that without significantly cutting the back office cost, online lenders would not obtain high profitability. It recommended caution with investing in the on-line lenders.

I would agree that investing in on-line lender IPO's is risky at best and is probably downright foolish. However, the idea that these companies need to move towards re-engineering the back office is also foolish. Let me explain why.

The recent study of mortgage brokers from Wholesale Access found that there was not only no economies of scale in loan production, but the small brokers were actually the most efficient. As the size of the of the production center increases, efficiency decreases. This runs counter to the goals of the on-line lenders who hope to lower costs by handling large volumes.

So why then can't the on-line lenders head the advice of Sutro & Co. and re-engineer the entire loan production environment? Similarly, why doesn't the Internet help in this process?

The answer goes to the core of what it takes to process a loan. The current higher end systems on the market today have already had 10+ years of refinement to the point that most systems have automated just about all that could be automated. A key issue is that so much of the process still requires human decision making and even the best systems have been unable to eliminate the human requirement. One exception to this is that some of the automated underwriting systems that deal with sub-prime loans and home equity loans are fairly close to making decisions without human intervention.

Conforming, FHA and VA loan products simply won't get anymore efficient without divine intervention. This would only come in the form of changes to the guidelines from the GSE's (Freddie Mac and Fannie Mae). For the process to truly become re-engineered, the GSE's must reduce the requirements required for processing a loan or they must significantly change the process. We have already seen progress made along these lines in the form of reduced documentation when using the GSE's automated underwriting systems. These changes will continue over time as the GSE's gain more experience using the newly developed tools. For all these reasons, everyone must continue to process loans in pretty much the same standard way and trying to re-engineer the back office will have little impact.

I've seen dozens of companies spend millions of dollars in their efforts to better streamline the back office. In all cases, I've yet to see anyone make any significant impact on their overall efficiency. While small improvements can be made the kind of changes that really make a competitive impact just aren't there. Instead, I'd argue that the money spent trying to re-engineer the back office is better off being spent on the front lines. This is where technology can help increase market share by capturing more prospects.

The other theory was that the Internet should be used to reduce costs rather than be just a marketing function. This logic also has numerous problems. First, what is it about the Internet that would allow a lender to change how a loan is processed? The Internet can't change the GSE

guidelines and make the loan process any less cumbersome. Secondly, adding the Internet into the equation may actually increase the costs of technology because of the requirements to integrate it with the back office environment. Web sites must be built and maintained, data must move to and from the back office systems, and Internet communication pipes must be made. Thus, without any corresponding efficiency, the Internet could actually make originating a loan more expensive.

However, there are a couple of areas where the Internet can, in fact, reduce costs. The first is in the prequalification process. Borrowers need less hand holding when using well designed web based prequalification tools. Thus, we can take out some of the human cost related to prequal. Second, if the borrower completes the loan application on-line, we then save about 30 minutes of data entry costs. However, the quality of data entry by the borrower is very poor and it requires a human to perform an application "clean up" function. Third, an extensive library on the web site can help educate the consumer about the process of obtaining a loan. This can save staff time and reduce the number of questions. However, sometimes a better-educated customer can ask many complicated questions.

The final area that the Internet can help with is streamlined communications. The use of email throughout the loan process improves response times and reduces traditional telephone tag. Just as important is the posting of information to the web site. This consists of allowing the borrower to view what documents are needed, what the conditions are, what stage the loan is in and a recap sheet of all the pertinent details. Allowing borrowers to view this information 24x7 can dramatically reduce the cost of manual followup and it provides for a happier client.

When you consider the increase costs against the potential savings, it's probably a wash. Overall, there aren't significant cost savings associated with having a great web site. Still, everyone needs to have a web site. Why? Without one, you're unlikely to attract the prospective borrowers of the 21st century. Much like the fax machine in the late eighties, soon you won't be in business without one.