Risk Based Pricing and Rate Distribution

Since mortgage brokers started to grow in numbers in the early 80's, there has been an industry cry for an efficient method to distribute mortgage rates from wholesalers to brokers. Dozens of companies have spent millions answering this cry with little success. In fact, all but a couple have ceased to exist.

Even in today's modern world of communications and the advent of the Internet, little has changed. By and large, most brokers still get their rate sheets by fax and they spend countless hours checking each one for the best rates of the day. When will the insanity end?

There are a couple of companies today that have made significant strides in this area. Both LION, Inc. (www.lioninc.com) and GHR Systems (www.ghrsystems.com) are distributing rates electronically between wholesalers and brokers. Both companies also use the Internet. There are also several companies attempting to enter this market such as GTE's MEL (using a private network) and Loan Rates Online (www.loanratesonline.com). GTE is investing millions into this opportunity. Still, even the longest running of these companies, LION, has not been an overnight success. They have struggled for years and have only gained a decent number of brokers in some geographic areas.

While on the surface it appears to be a gold mine, it's really a difficult market for a wide variety of reasons. The characteristics of our market make it a challenge for such systems to prosper.

On the horizon is a new method that could potentially mitigate the need for these rate distribution systems or at the very least turn them upside down. Risk Based Pricing is on the horizon and even Fannie Mae and Freddie Mac believe in their future. Risk Based Pricing is where each loan package is evaluated to determine it's specific risk of default and then a price is determined. Today, we slot loans into categories (A, A-, B, C and D credit). The reality is that the category for A credit could have an almost infinite number of rates rather than today's single interest rate for a set number of points. The fact is, every "A" credit consumer obtaining a loan does have different risk characteristics. The only reason we've used categories in the past is for the lack of automation. That's right, the lack of technology in years past forced lenders to place loans into one of several buckets.

The technology is becoming available to better analyze each loan package and accurately determine the associated risk. Most of this capability lies within the automated underwriting systems from Freddie Mac and Fannie Mae. These powerful systems can analyze 100+ characteristics passed to them from the industry's leading Loan Origination Systems. Within just a couple of minutes they can create a risk profile or "mortgage score" which is similar to a credit score except it also encompasses information from the loan, the LTV and the property. The next step is to turn the mortgage score into a specific price – an interest rate that a wholesaler would accept for that specific mortgage score.

The future lies in the ability to forward the information from the Loan Origination Systems into the automated underwriting systems and then return a price. Once a mortgage is scored, the loan would then be priced by several wholesalers that the broker is approved with. These automated pricing engines would return a list of wholesalers that would accept the loan along with an interest rate. What these systems aren't, are bidding room environments. The broker is fully able to choose the wholesaler that yields both decent pricing and good service. In a bidding room environment (like IMX), the broker is forced to accept the lowest bidding wholesaler. The broker wants a choice and wholesalers can't be compared on just price alone.

While it's clear that Risk Based Pricing is coming what isn't clear is when. Even the GSE's thought they might have come to market already and today we are still months to perhaps years away from their availability. The one thing that is clear is these systems will be forthcoming and we'll finally get rid of all those pesky faxed rate sheets.

One of the other advantages is that consumers will be better rewarded for keeping their credit squeaky clean. The best rates will be had by those with perfect credit and low LTV's on good properties. Just as importantly, high LTV loans would be available for borrowers with satisfactory credit albeit at a higher interest rate. We'll see the GSE's accepting more and more borrowers as they become better at evaluating all levels of risk grades.

Another interesting impact with this new technology is how it will eventually change broker marketing. Whereas today, brokers constantly compete on rates, rates and rates. Tomorrow, we won't see rates emphasized nearly so much since pricing can't be determined until a full loan application and known property characteristics are in hand. There are probably a lot of brokers that look forward to the days where service and reputation are the top priorities for consumers – I do!