

## Banking & Capital Markets



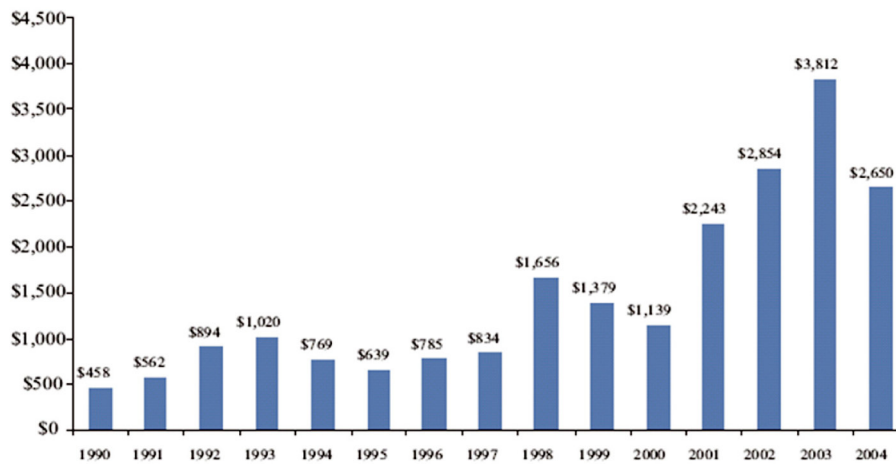
### Light at the end of the Tunnel: A Transformation Framework for the Mortgage Industry

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#### Abstract

From 2000 through 2004, the US Mortgage market was on song - declining interest rates gave prospective homebuyers in the US more purchasing power coupled with rising property prices and increased market for financial instruments such as CDOs & securitization which increased bank's lending capacity manifold enabling them to originate more loans. During this period some homebuyers paid beyond what they could truly afford to buy a house before home prices went even higher, and home prices as a multiple of annual income rose to a record high. As housing affordability went out of reach for most borrowers, lenders loosened credit underwriting standards and introduced riskier loan products to help borrowers qualify. Lenders believed that higher credit risk which they are taking would be mitigated by rising home prices, which would lead to accumulated home equity if borrowers defaulted. Moreover most of the lenders did not hold on to this paper for long - they sold it off to hedge funds and other investment management firms in the secondary market all of whom lapped up the same in the backdrop of a benign credit environment and the lure of making abnormal profits.



Source: Mortgage Bankers Association

But since 2006, the trends have started reversing - interest rates have moved higher, reducing affordability for new buyers, slowing the growth in home prices, and have caused rising mortgage payments for those with ARMs. Lenders are now saddled with increased delinquencies especially with loans they have made to borrowers with questionable credit records, excess capacity & a secondary market which has lost all appetite for mortgage paper. Many of the lenders have been forced to shut shop with several more to follow and the effects are being felt across the entire US economy. Total mortgage production will be down 16 percent to \$1.96 trillion in 2008 from a projected \$2.34 trillion in 2007. Total originations are expected to witness a further drop of four percent in 2009 to \$1.88 trillion.

Once the dust settles down, the question facing most lenders will be how to cope with mortgage cycles in a more effective manner going forward. How will the future state look for the mortgage market participants and what do they need to do to prepare themselves for the same?

## Trends

Despite all the losses and the accompanying pain that has come to characterize the recent crisis it is our firm belief that this will create a very different mortgage market in the medium term compared to its present version. Traditional barriers to outsourcing will break down across mortgage participants; organizational hierarchies will start disappearing as mortgage players will become more cost sensitive and nimble footed to respond to changes in market conditions; the competitive playing field between large and mid sized lenders will start getting leveled. The rules of the future for the mortgage industry are changing fast and market participants need to adapt themselves for the same.

### Trends

Half or 2/3 rds of Sub - Prime Lenders will have to shut shop

Large lenders are closing sub - prime divisions and moving staff to prime/conforming loan divisions

New structures for sub - prime are being worked by Wall Street and the sub - prime market will bounce back but its size will be reduced to half

Mortgage Banks with warehouse lines of credit are in crisis but other lenders who fund mortgages with deposits are doing okay

It is expected that the origination market will bounce back in 2009 - FHA & Conforming loans are there; secondary market players will reprise better

### Possible Outcomes

Potential of outsourcing is even greater going forward as a result of the sub - prime crisis - lenders will look to outsource complete processes instead of the piecemeal approach which was in vogue

Lenders will want to move a variable cost model with flexible ramp up & ramp down capabilities to cover for any industry upturn/downturn in future

Lenders will look to consolidate origination platforms and back - office teams handling origination processes

Tier II & Tier III Lenders will explore Managed Service Outsourcing options to compete effectively with the larger players

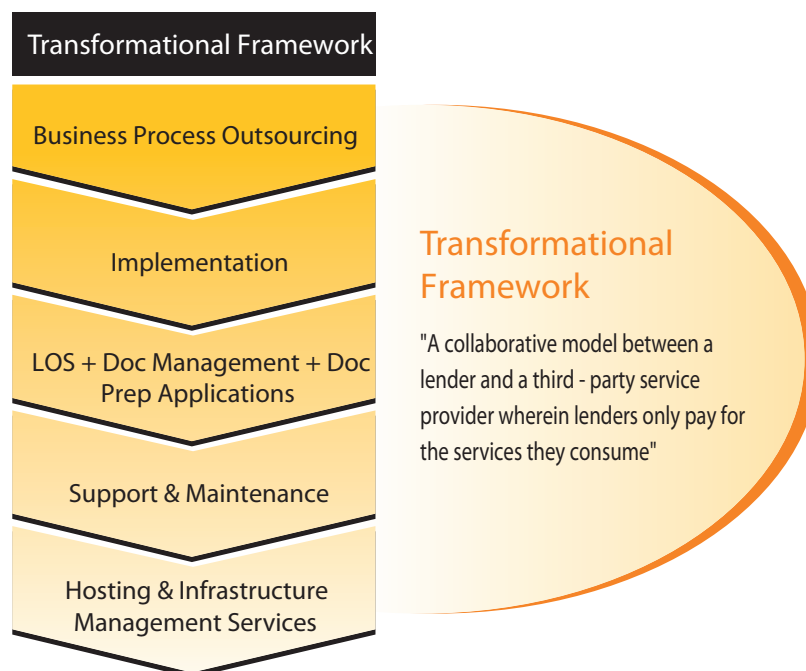
## Shifts

In order to compete effectively in the battlefield of the future mortgage lenders need to make some strategic shifts namely:



## Transformation

How will mortgage lenders bring about the desired transformation to cope effectively with the challenges of the future? This can be achieved by combining people, process & technology and leveraging an outsourcing model which will consist of:



## Operating Model

True Transformation can only be brought about through collaboration - it essentially consists of the lender adopting a third - party managed services model where the risk and rewards are shared between the lender and the third - party service provider proportionately. However there can be several versions of this model depending on the size and business mix of the lender e.g. Offshore Loan Fulfillment Centers for Tier I Lenders which can act as a challenger to its existing loan fulfillment centers; fully hosted managed services model for Tier III and possibly some Tier II lenders etc.

## Business Process Outsourcing

Mortgage Lenders need not worry about losing control in their transformational journey - key origination functions like marketing, underwriting & funding will still need to be retained by the lender. The remaining functions in the origination value chain can be performed by the service provider - who will have access to cheaper labor pools and scalable delivery models to cope with mortgage cycles better.

## Implementation

Implementation will consist of two distinct phases: a) Platform Implementation & b) BPO Transition. These phases can be executed in parallel or sequentially. However the scope of implementations can again vary widely depending on the lender size - for Tier I clients platform implementations & BPO transitions can span across several months whereas for Tier III clients it can be a matter of a few weeks.

## Platforms

One of the pillars of the Transformational Framework will be the underlying technology platforms - this need to include not only LOS & Doc Prep platforms but also enabling applications like Doc Management from an offshoring perspective. While Tier I Lenders can look at transferring their existing platforms to their third party service providers Tier III & some Tier II lenders can leverage the platforms offered by the service provider itself. Some of the key features of the LOS platform which need to be present include:

- Ability to support multiple channels (Retail, Wholesale, Correspondent etc)
- Ability to support multiple products
- Workflow & Business Rule engines
- Built in Interfaces with third - party service providers
- SOA architecture etc

## Support & Maintenance

Lenders can free themselves of the platform support and maintenance issues by transferring the responsibility and risks associated with the same to the third - party service provider. When provided by the same service provider i.e. the one who is also responsible for the BPO activities it will ensure benefits like:

- Proactive Issue Resolution
- Simplified Governance Structure
- Integrated SLAs from an operations & support perspective
- Common Infrastructure
- Single Contract Framework etc

## Hosting & Infrastructure Management

This will be applicable for Tier III & in some cases Tier II Lenders wherein they can leverage the third - party service provider's hosting and infrastructure management offerings

## Pricing

Lenders will only be charged on a pay by drink model i.e. mortgage lenders will be charged:

- On the no of loans originated by channels on a sliding scale basis with a minimum cap on volumes
- Fixed Annual Fee to cover for the hardware & hosting
- One Time Implementation fees (if required)

## Benefits

By adopting the Transformation route Mortgage Lenders will be able to provide answers to critical issues like

### Handling increasing Loan Volume

- Quicker loan decisioning
- “Best-fit” automation
- Channel diversification
- Flexible Resource Ramp up & Ramp down capabilities etc

### Reducing Costs

- Offshoring
- Lower upfront investments

### Increasing Productivity

- Process Improvements using Six Sigma tools
- Elimination of redundant tasks
- Automation of manual tasks etc

### Retaining Customers

- Prompt Customer Service
- Self Service Mechanisms
- Cross - Sell / Up - Sell opportunities through data mining etc

### Finding new revenue streams

- Reduced Cycle Times
- Ability to add or introduce new products as per changing market requirements etc

## Conclusion

The Mortgage industry has witnessed one of its worst crisis in recent times but the situation is not all that despairing - as mortgage lenders start taking a hard look at their existing business models help is at hand in the form of outsourced service providers who can combine technology, process & scale capabilities which will enable lenders to compete effectively for the mortgage market of the future.

## About the Author:

[Abhijit Ghosh](#) is a Principal Consultant, responsible for developing Platform Based Solutions for Infosys BPO in the Banking & Capital Markets space. Has close to 10 years of experience in the IT/ ITES industry primarily from a business analysis and consulting perspective.

Questions? Opinions?

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