MANAGING Cyclicality

By Bill Lehman

DURING THE LAST REFINANCE BOOM SOME OF THE effects of increased loan volume were absorbed by technology, especially through automated underwriting (AU), but there is still much more that can be done. This is evidenced by the industry's falling margins now.

Most mortgage originators have a goal to make their costs more variable—but most fail when it comes down to achieving that goal. Furthermore, the last boom showed many industrywide processes and systems are fundamentally broken. The time to fix them is now while organizations remember the pain, and lower volumes give them some time to focus on improving things.

A strategic approach to system selection and implementation

Achieving profitability over the entire interest rate cycle and scaling up to meet demand are two key drivers for mortgage executives who hope to transition to a variable-cost model. Lenders often look to new technology, including loan origination systems (LOSes) and workflow, to help meet these challenges. However, selecting and implementing the right solutions pose challenges of their own, and the business' strategic goals are often not met.

Lenders are increasingly looking to a variable-cost model to help stabilize their margins over the interest rate cycle. With a variable-cost model, some fixed costs are replaced with variable costs. Under this model, an organization might willingly forfeit some profit during peak demand periods in exchange for improved margins when demand falters.

Lenders are striving to make their origination process more variable but still support a scalable organization that can quickly grow or shrink in a cyclical industry. Executives often turn to technology as the answer.

But new technology is only part of the answer. It is crucial to recognize that new technology, by itself, cannot create a variable-cost organization. A new LOS, no matter how good its workflow engine, can't achieve variable costs unless the lender is willing to change its business practices. Furthermore, the organization must be careful that these information technology (IT) investments do not become a huge fixed cost in and of themselves.

Rather than looking to technology as a panacea, the variable-cost approach requires changes in the lender's business model—including process, technology, organization and structure. This must be recognized within the organization, and this understanding must inform the system requirements and implementation phases of any resulting new systems.

A successful system project must focus on implementing a business vision to achieve a defined outcome—not just on implementing a new system.

"Using technology to meet the scalability needs of the business without it leading to a huge fixed costs in systems is the challenge," says Leo Knight Jr., chairman and chief executive officer of National City Mortgage Co., Miamisburg, Ohio.

This article looks at one aspect of technology and scalability, and centers on lessons learned and success stories from both within and outside the industry. This approach is intended to help mortgage executives formulate strategies that improve their odds of success. Let's start by looking at an industry that is far more extreme in its cyclicality than the mortgage industry—a seasonally oriented catalog company.

Here's how to build an organization that stays profitable no matter what the origination market is doing.

Catalogs—benchmarking a cyclical industry

The mail-order catalog business is highly cyclical, but unlike the mortgage industry, it operates on a predictable cycle. One catalog company we know scales up its work force sixfold for the November–December holiday sales boom.

The company maintains a cadre of core representatives who work year-round (one-sixth of the holiday work force). There is another pool of seasonal workers who work annually, comprising another one-third of the holiday work force. The company's holiday crew thus includes 50 percent who are temporary workers whom the company has never seen before and probably will not see again.

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How can a company manage this type of ramp-up, with half of its work force having no prior experience? It is successful because the entire business—operations, technology and organization—is built around this business cycle.

Rather than working in cubicles, the staff sits at amoeba-shaped tables with extensions that flip out to accommodate from one to six people. Their systems are very easy to learn; all the computer screens have clear instructions, job aids (similar to workflow tools) are built in and product information and frequently-asked-question (FAQ) documentation is readily accessible.

Jobs are clearly partitioned, such that inexperienced workers focus on high-volume products that don't require a great deal of expertise, while orders for more-complex products are routed to tenured specialists who are part of the permanent staff. The company also provides an orientation kit for new employees (quite different than the "go sit with a processor for a day" approach used by some mortgage companies). Finally, the company identifies which new seasonal employees it wants to invest in and retain, using the cyclic boom period as an opportunity to recruit the best permanent workers based on proven performance.

How can we apply these lessons to the mortgage industry?

Variable-cost considerations in the mortgage industry

The purchase mortgage market is relatively stable; it is the refinance business that drives cyclicality for most lenders. So, to implement a variable-cost model, lenders should emphasize the processes, technology and organization around their refi business. Following the retail catalog example, lenders must focus efforts not only on the efficiency of their core employees, but put at least as much effort into making new workers and temps productive quickly.

This dual approach can create conflicts in implementing a new system or process, and this dynamic requires a strong and sustained change-management focus from the start.

Avoiding selection and implementation pitfalls

Workflow and imaging functions are often identified as requirements for a new system. Many lenders tend to develop requirements based on current process, rather than assessing their overall business strategy. The optimal approach is to develop the future process based on critical business drivers, and then develop requirements and formulate the technical solution based on the new process. This is a much more practical and grounded approach than the typical "wish list."

Undue emphasis on workflow is also a common mistake; some lenders see it as the potential solution for every challenge, and aim implementing workflow as an all-encompassing solution. But workflow engines can be beasts that need to be fed—and the cost of the care and feeding is a fixed cost. Therefore, depending on a lender's size, when workflow is overly customized, the maintenance costs can quickly outweigh the benefits.

Many lenders find that skill-based routing is a better approach. With this tactic, unusually complex transactions or exceptions are directed to specialists, rather than trying to automate every product and every potential process deviation.

It's important to gather input from the right individuals across the organization to inform system selection. Forming an implementation team to discuss and prioritize goals is essential. There is often a conflict between the individual's goals and the corporate goals. If these types of disconnects aren't recognized and addressed during the selection process, it can negatively affect implementation, with a great deal of wasted time and money expended downstream to realign the project.

Once a system is selected, the lender must help shape its customization to the organization's requirements and new processes. Senior management must remain actively involved at this point. Without this leadership focus, detailed requirements are likely to be driven from the bottom up, and a schism between individual and corporate goals can arise.

It's logical and natural for people to identify requirements that make their jobs easier, but these may not support strategic corporate goals. Often requirements from core employees are "we must have special screens to support bond loans," or some other requirement to make their lives easier. But you will never assign a new or temporary worker to handle bond loans. Management needs to be involved to say "No, the requirement is that we must have a process and a system that are sufficiently easy to use that temps can be productive from the first day, while enabling them to stay out of trouble by transferring appropriate loans to core employees."

This is why senior management, instead of disengaging, must lead implementation for any new system. They must define their vision and ensure that developers and key managers involved in the project understand that vision and understand how the system will embody and support it.

Senior management must also realistically assess how much effort and time they must commit to the vision and the project. And they must be prepared to help in managing organizational change, including handling potential conflict and uncertainty among personnel.

As you design your new system to allow less-experienced operators to effectively handle your business processes, you must reassure your experienced staffers that they will still have a valued place in the organization. Proactive change management will help ensure that your most valued employees will contribute fully to making the new business model and system successful.

Achieving post-closing balance and flexibility

BancMortgage Financial Corporation, a retail lender in Atlanta, was tailoring a new LOS to its operation. The initial set of requirements from the staff called for a workflow tool to handle exceptions. However, after analyzing current processing challenges and anticipating rapidly accelerating loan volume, management determined a pressing need to help new post-closers become productive immediately.

The initial result was push-back: Both experienced employees and the system developers were concerned that an interface tailored to novices would frustrate and slow experienced employees, and they were reluctant to develop it with the extensive help features proposed.

Management re-engaged and held firm, and the group brainstormed a solution: Develop two parallel workflows in the same system. For new post-closers, a script-oriented interface asked a series of questions to steer the novice through the process. This allowed post-closers with very little knowledge or experience to proceed in the correct processing path, relieved of decision-making for which they were not yet prepared. For experienced post-closers, the same kind of information was presented without the leading questions and automated guidance, allowing them to maintain the efficiency gained through experience.

In addition to this dual-workflow approach, the lender also customized the system with a document-tracking capability linked to loan generation. Data could then automatically flow into tracking modules to prompt generation of the deed, note and other documents through a document print engine, based on whether the document was required or optional. This has contributed to more efficient generation of documents.

The results: higher productivity for both new and experienced employees, and the ability to process loan volume that otherwise would have been unmanageable. Bob Cannon, president of BancMortgage, says, "We would not have made it through the last two years without the ability to pull people off the street and have them be effective in post-closing."

Telemarketing—defending your portfolio

The front end of the origination business is also a good place to have a variable cost structure in place. How can you quickly ramp up a sales force not from the industry and expect them to be producing right off the bat?

Purchase loans obviously have a long learning curve. However, most refi borrowers want to know about three products: a 30-year fixed-rate mortgage (FRM), a 15-year FRM and a one-year adjustable-rate mortgage (ARM). And the refi of an existing customer is pretty simple. Therefore, another ideal area for variable-cost strategy is portfolio defense and telemarketing refinance origination. The challenge here is managing channel conflict, not the technology.

There is a lot of good technology available to allow lenders to identify and route inbound calls, and place these calls effectively with new loan officers. A number of lenders have developed telemarketing script screens to guide relatively inexperienced loan officers through simple refis and assist them in recognizing when they need to transfer calls to a more experienced loan officer. This is a parallel of what we saw occurring in the catalog industry.

Greater Atlantic Mortgage Corporation, Vienna, Virginia, is one example of a company that has implemented this approach. According to Mark Stamm, president of Greater Atlantic, "We offer a few simple products—principally FHA [Federal Housing Administration] refis—but they have complex rules. We have built our sales front end around the product simplicity, and built the rules in to keep new loan officers from making mistakes. This allows us to bring in people from outside the industry with basic sales skills and have them making money in two weeks. The good ones get

WORKFLOW TERMINOLOGY

"WORKFLOW" IS A TERM THAT OFTEN MEANS WHATEVER the user wants it to mean at the time. Here is an explanation of the meaning of the workflow concepts used in this article.

All-encompassing solution: The system is programmed to understand exactly what specific steps are needed for a specific loan. This is an ideal that many large lenders aspire to, as it can overcome many skill- and geography-based limitations. However, it also creates the need for a large group of staff to maintain all of the business rules, usually in information technology (IT). This group becomes a fixed cost, and often a large one. For example, under this solution all bond loans and all rules for bond loans would be maintained in the system.

Skills-based routing: This is a concept in which the system is used to route loans to the appropriate loan expert. For example, it might route loans of more than $500,000 directly to an underwriter with that signature authority. Or, if it is the practice in the organization, it might route the loan to an underwriter with less authority so that he or she can underwrite and then present to someone for the proper signature.

Exception routing: This workflow approach is less intensive than an all-encompassing solution. The normal activities are implemented in the system, but so is the ability to do skill-based routing. For example, under this solution bond loans would be routed to a group that specializes in bond loans.

interested in the industry and move up the ladder."

Stamm adds, "Our more-experienced loan officers are necessary for our product that allows borrowers to refi a slightly delinquent FHA loan out of loss mitigation and into good standing. It is a great portfolio defense product."

To sum it up

Automated underwriting gave the mortgage industry "big-R" re-engineering, steering the industry to the originate-underwrite-process paradigm. But too many organizations stopped at that and never completed "little-r" re-engineering to streamline the functions around the new paradigm.

The last boom proved that things are broken. The time to fix broken processes and systems is when business is down and management has the time and energy to focus on change. In other words: right now.

Applying a variable-cost model requires thorough business analysis. There is no "right" solution, and one size doesn't fit all. However, some general principles can help you make the right choices:

- Design your ideal "future state"—process, technology and organization—and model it across the interest rate cycle.
- Take time to really understand what processes were most broken during the last boom and attack those first.
- Decide how much change you need or can undertake, and determine if you can fix the process with your existing systems or if you must replace them.
- Determine what is the best type of workflow and organization for your size and business model, ensuring that you avoid having the fixed cost in IT from outweighing the benefit to your organization.
- Avoid overcustomizing your system. Focus on those areas that will yield the greatest efficiencies and cost savings, with the least development and maintenance effort. Keep in mind that the more specific and tailored the system, the greater the probable maintenance costs and implementation costs.
- Make sure there is sufficient long-term management commitment. Lack of high-level leadership and support is a frequent cause of system project failure.

As lenders work to achieve a variable-cost organization to maintain profitability across the interest rate cycle, they must remember that technology can only take them so far. Implementing the right system and customizing the right features is a decision worthy of senior management input—but so too is the need for process improvement that will allow lenders to make their resource needs as cyclical as the market. **MB**

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