Booz | Allen | Hamilton

Mortgage Originations in a Down Market

Attacking Cost and Complexity

Mortgage originators in the U.S. had a record-breaking run between 2001 and 2005. Volumes hit an all-time high of $3.8 trillion in 2003. Nearly 90 million purchase and refinancing transactions occurred during the period. To top it off, many originators enjoyed average margins per loan in excess of 100 basis points. But times have changed. Interest rates are rising. The national housing market is slowing down. Volumes have come off nearly 20 percent in the last year, and price competition is heating up. Many originators now expect the downturn to be longer and deeper than initially anticipated.

Declining volumes and margins have a clear implication: Costs need to be cut. Based on Booz Allen Hamilton's modeling of projected profit dynamics for the next few years, we believe a 15 percent to 25 percent industry-wide cost reduction is needed to keep pace with lower volumes (see Exhibit 1). That translates to a $500 million to $750 million cost reduction for each of the mega-originators.

Four Cost Drivers to Address

Reducing costs by this magnitude requires a fundamental review of how costs arise. In our experience, organizations comprise four types of costs, each requiring a different optimization approach (see Exhibit 2, page 2):

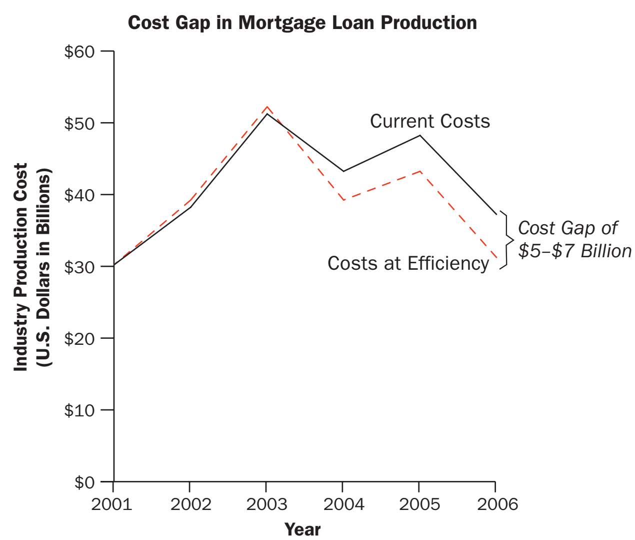
Inherent costs result from the core activities of the mortgage originator. These costs come about based on strategic choices—what customer segments to target, what products to offer, what markets to serve, and so forth. Optimizing these costs usually has the greatest impact on overall cost performance.

Structural costs relate to how the business model is designed. For example, decisions about decentralization, number of processing centers, and outsourcing can all affect how much or how little cost is incurred. Structural costs can also deliver significant bottom line results when optimized.

Systemic costs come about based on how the company goes to market. Choices such as the sales processes the company develops and the incentive structures it provides will influence the level of systemic costs. This is an area of cost where some originators have a decisive advantage over others.

Exhibit 1

Cross-Industry Cost Reduction of 15%–25%



Source: Fannie Mae; Mortgage Bankers Association; Booz Allen estimates.

Exhibit 2
The Booz Allen Hamilton ISSR Framework

	I Inherent Costs	S Structural Costs	S Systemic Costs	R Realized Costs
Underlying Question	What do we do?	Where do we do it?	How do we do it?	How well do we do it?
Common Cost Considerations	▪ Business mix ▪ Customers/markets served ▪ Product/service/IT architecture	▪ Footprint configuration ▪ Scale ▪ Sourcing strategy ▪ Extent of vertical integration	▪ Process, tools, and systems ▪ Organization ▪ Workflow components ▪ Resource and capacity management	▪ Staffing levels/utilization ▪ Spans of control ▪ Productivity ▪ Wage differentials
Improvement Objectives	▪ Attack complexity ▪ Challenge WHAT is done	▪ Consolidate activities ▪ Reconsider WHERE assets are deployed	▪ Streamline processes ▪ Redefine HOW activities are done	▪ Eliminate waste ▪ Improve EFFICIENCY of activities
Cost-Reduction Potential	20%–50%	10%–40%	5%–20%	5%–10%

Source: Booz Allen Hamilton

Finally, *realized costs* pertain to how well the company executes in the marketplace. Realized costs are primarily a function of staffing leverage, productivity, capacity utilization, and prevailing wages. This cost driver is a popular target for short-term cost reduction, but savings from optimization of realized costs are often short-lived: Costs tend to creep back in over time.

Only by addressing all four levers can a low-cost position be achieved.

At the moment, most originators are taking a wait-and-see approach to cost reduction. They are focusing mostly on realized costs by cutting back budgets, downsizing staff, and redeploying resources to areas such as servicing, where activity has picked up. Reductions in realized costs will most likely achieve 5 percent to 10 percent savings but will ultimately fall short of the 15 percent to 25 percent that is required by new market realities. Furthermore, singular attention to realized costs may mask the fact that the company still has inherent and structural cost disadvantages compared to its peers. The question then arises: How can originators attack a broad range of cost drivers to achieve more sustainable cost reductions?

Capturing Longer-Term Savings: Structural and Systemic Cost Drivers

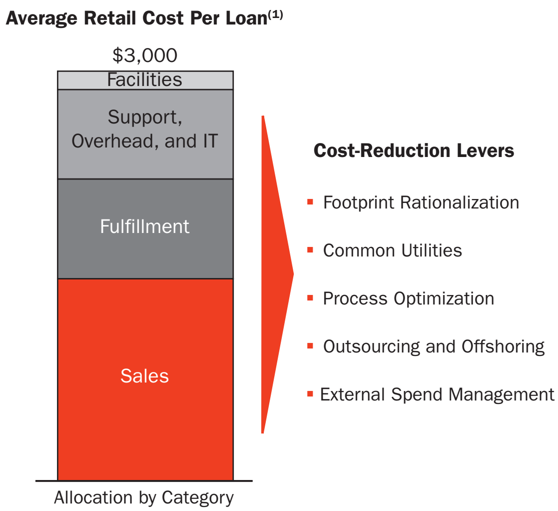
Over the past few decades, the mortgage industry has evolved toward extremely cumbersome and often inflexible business models. Many acquisitions haven't been effectively integrated, leaving a legacy of incompatible systems, proliferating products, and nonstandard processes. Errors in fulfillment are not uncommon. And most large originators still take months, if not years, to launch new products. Resolving these structural and systemic issues is the most expedient way to achieve large, sustainable cost reductions.

Take retail originations, for example. Cost per loan varies by originator; however, many larger players operate around the $3,000 level per loan—a staggering amount if you consider that a plasma television can be manufactured, shipped, and sold for much less. Although a large proportion of the cost per loan is tied up in sales commissions, some 50 percent to 65 percent of each loan's cost can be attributed to fulfillment, support, overhead, information technology, and facilities (see Exhibit 3, page 3). Opportunities for reducing these costs include:

Footprint Rationalization. Many originators have become overbuilt, and operate a number of sites. Although having a large number of facilities might have provided better customer intimacy during the boom years, most originators are now left with subscale operations and an inability to adjust capacity dynamically across facilities. Consolidation is a near-term imperative throughout the industry.

Common Utilities. The majority of large originators operate product and channel silos with redundant

Exhibit 3
Targeted Reductions in Cost Per Loan



(1) Data modeled for sample of top-tier originators.
Source: Booz Allen Mortgage Economics Model.

activities across silos. This is true for call centers, product development teams, and support functions such as finance and human resources. By establishing shared utilities across organizations, originators can significantly reduce duplication, improve standardization, and reduce costs throughout the business.

Process Optimization. Elimination of waste and maximization of efficiency can also deliver large savings. For example, most originators maintain a unique set of forms for each mortgage and home equity product. Our analysis suggests that 75 percent of forms can be standardized, removing significant cost. The key to optimization is to standardize and automate processes while eliminating activities that don't add value.

Outsourcing and Offshoring. Most originators still keep functions in-house even when those functions can be performed more efficiently by another party. Outsourcing options are now plentiful, with many external parties cost-effectively providing services not necessarily core to the originations business. For example, offshore paperwork imaging centers are a promising way to avoid costly domestic imaging facilities as originators increasingly move toward eMortgages.

External Spend Management. Very few originators extract maximum value from their supplier relationships. Opportunities exist to better address drivers of consumption at the source and get a better handle on costs. As an example, some originators are getting quite savvy about how to use automated valuation models (AVMs) during fulfillment as a first pass to determine whether or not full appraisals should be ordered.

Tackling Inherent Costs by Managing Complexity

Even once the above mentioned opportunities have been addressed, the mortgage industry must still confront the problem of needless complexity. There are arguably too many products, a number of which customers don't understand, to say nothing of the reams of paper that creep into the lending process. As many would agree, the industry still has a long way to go to fully embrace the digital age.

Leading originators are now investing heavily to reduce inherent costs that arise from too much complexity. These forward-looking players are rethinking product delivery and adopting practices developed in the aerospace and automotive industries. For example:

Modular product architectures are being used to decompose products into components that can be mixed and matched depending on customer requirements.

Tailored workflows are enabling loan files to be fulfilled in the most efficient way possible based on customer and deal characteristics—stipulations to be cleared, signatures to be obtained, and so forth.

Paperless processing is being adopted to cut costs and cycle time not just by eliminating hard copies of documents but also by managing variation in forms.

In summary, the next few years will certainly be challenging for mortgage originators. Successful players will be those that fundamentally rethink their cost structures, going above and beyond traditional across-the-board cost cutting. Originators that tackle inherent, structural, and systemic costs will emerge in the best position to pick up share once the industry recovers.

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