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Mortgage Origination
Outsourcing
Services

*White Paper: A Survey of Lender Usage, Needs and
Attitudes Regarding Mortgage
Origination Outsourcing Services*

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Table of Contents

Introduction..... 1
Executive Summary 3
Outlook for Originations..... 4
Opportunities and Challenges Facing Lenders 6
Plans for Using Origination Outsource Services 7
Criteria for Choosing an Outsourcing Partner 8
Importance of Outsourcing Outcomes 9
Expectations for Cost Reductions 10
Current Status of Outsourcing Various Origination Functions..... 11
Approach to Outsourcing..... 12

Mortgage Origination Outsourcing Services

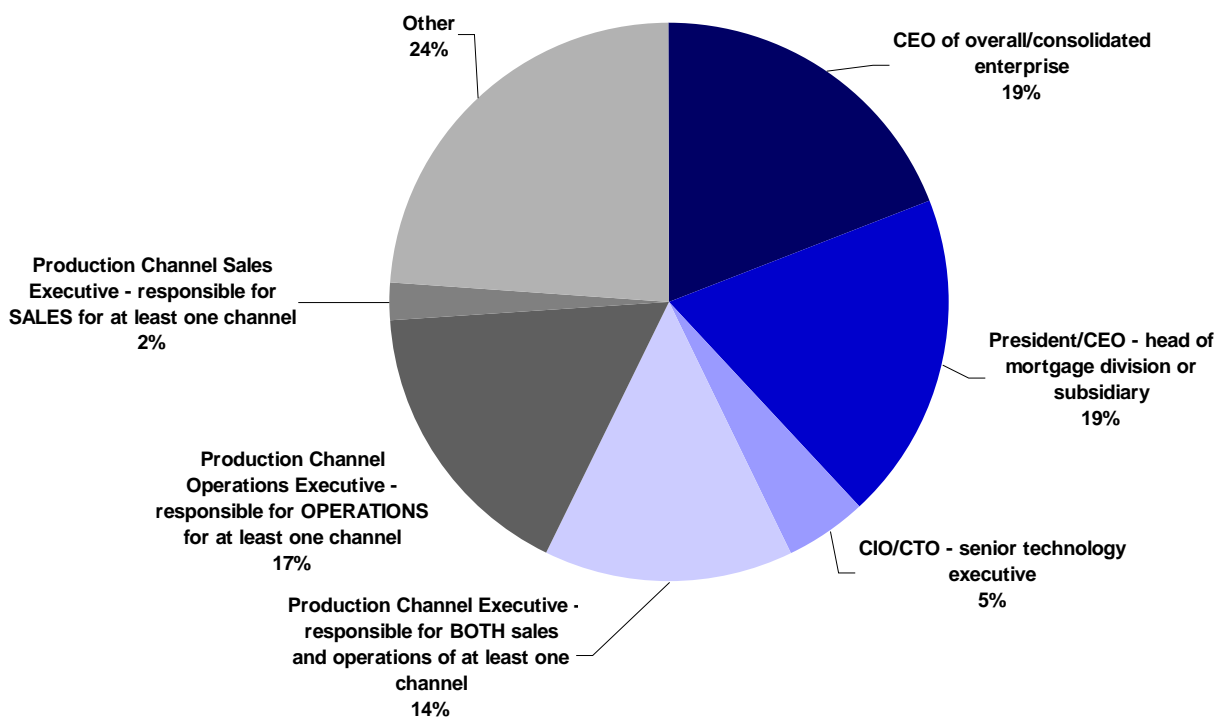
Survey of Lender Usage, Needs and Attitudes Regarding Mortgage Origination Outsourcing Services

Introduction

This white paper presents the results of a survey aimed at identifying the usage, needs and attitudes of senior mortgage lending executives as regards mortgage origination outsourcing services.

The survey was conducted during September 2008 and responded to by 42 senior executives from 38 lenders, most of whom were either parent-company CEOs, President/CEO of a mortgage division or subsidiary or a senior line executive (see Figure 1).

Figure 1
Respondent Position



Responding lenders were generally retail lending-oriented but were otherwise judged to be a representative cross-section of the industry. As illustrated in Figure 2 below, more than 90% of the companies responding were either bank-affiliated (55%) or independent mortgage bankers (36%); and most lenders originated less than \$500 million during the first six months of 2008, with a few originating in excess of \$10 billion (see Figure 3).

Figure 2
Type of Company

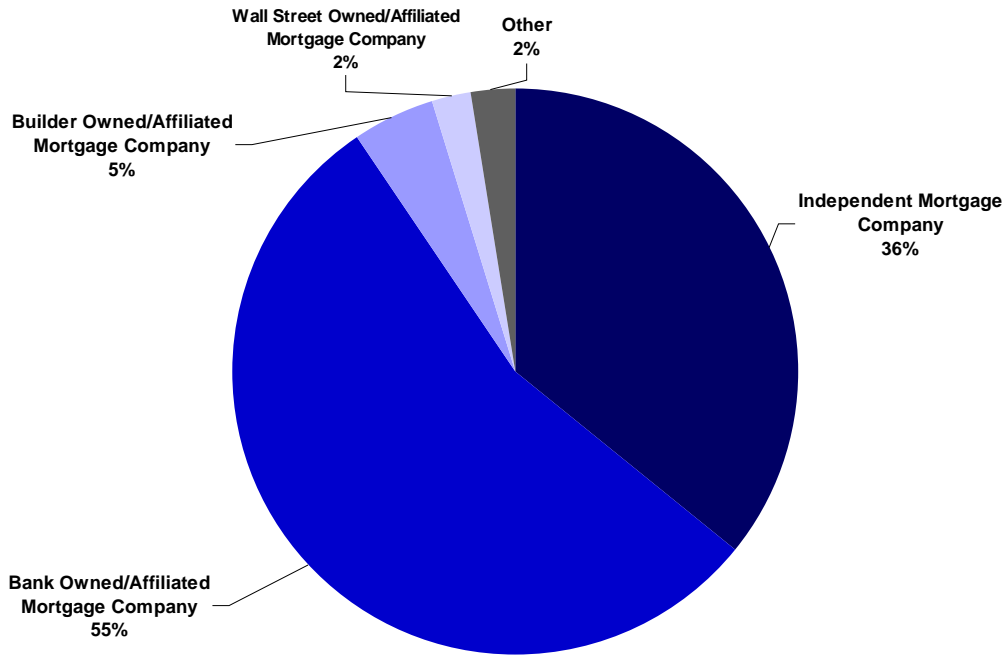
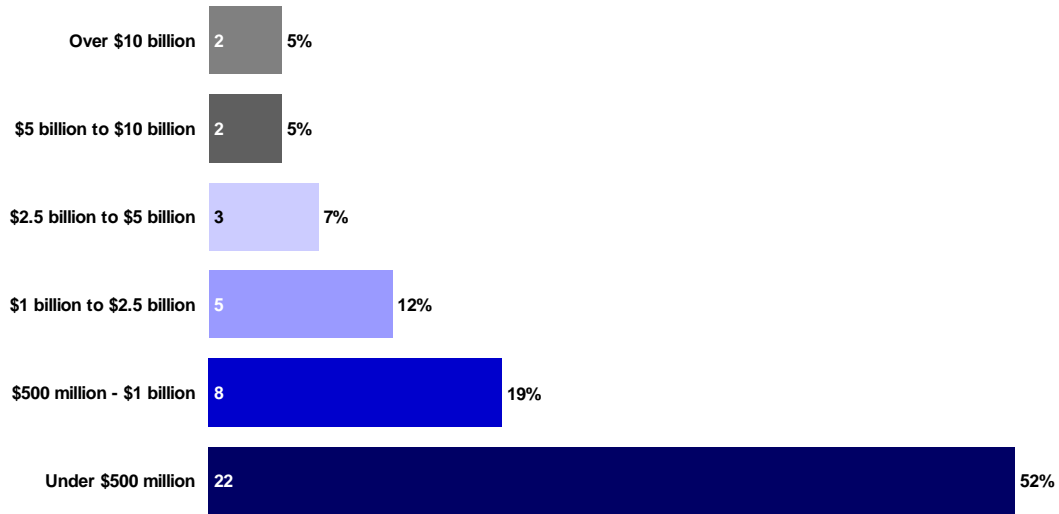


Figure 3
Companies by Origination Volume (1st half of 2008)



While the September responses of survey participants undoubtedly reflect the impact and resulting challenges of the meltdown in the mortgage industry, it's unlikely that their responses take into account the full scale and scope of the credit crisis, falling consumer confidence and rapidly deteriorating economy that currently confronts us. For example, while respondents expressed optimism in the survey about 2009 origination volumes relative to the second half of 2008, it is doubtful that they would express similar sentiments were the survey conducted today.

Nonetheless, we believe that most of the attitudes, usage and plans expressed vis-à-vis origination outsourcing will survive the current economic crisis. Indeed, the potential cost and cost structure benefits of outsourcing become even more compelling in an environment of sharply reduced origination volumes. And, more generally, the disappearance of exotic mortgage products coupled with inevitably tighter regulation points towards a more commoditized industry --- at least with respect to products --- that makes low cost an even more important strategic success factor.

Executive Summary

Of the many findings coming out of our survey, we believe that the following are the most important “takeaways” for the senior executive thinking about mortgage origination outsourcing:

- **Lenders strongly believe that a large proportion of mortgage banking origination tasks or functions have the potential to be outsourced.** In general, however, those functions that typically involve direct contact with borrowers are not viewed as candidates for outsourcing.
- **Independent of company size, a majority of lenders approach origination outsourcing on an “a la carte basis.”** Most lenders want to be able to pick and choose those functions that they will outsource and not be forced into a bundle of outsource services or, at the extreme, “end-to-end” origination outsourcing such as promoted by PHH Mortgage. Lenders perceive that outsourcing all or most of their back office origination functions puts them at great strategic risk to the pricing, performance and continued business operation of their outsource service provider. Thus, in general, they want to be able to adopt outsourcing on a gradual basis and, as discussed below, only where it makes economic and strategic sense.
- **Lenders told us that controlling costs, managing operational risks and improving efficiency and productivity are the primary reasons for outsourcing. Lenders do not look to outsourcing as regards those functions which affect top-line performance.** By and large, lenders look to outsourcing as a means for lowering operational costs, making such costs more variable with origination volume, i.e., scalable, and as a means for gaining access to advanced origination technologies without having to make capital investments and beef-up their IT infrastructure. In general, potential outsourcing functions that are focused on the top-line, e.g., outbound telesales, inbound call-center loan counseling, etc., are not considered for outsourcing. Lenders show little enthusiasm for entrusting direct customer contact within the origination process to outsource firms, in-particular, where outsource personnel are offshore.
- **Lenders told us that control of their business was the primary reason for not outsourcing. In addition, lenders were not inclined to outsource any function that they saw as a “core competency.”** With mortgage products trending towards increased commoditization, many lenders seek to differentiate themselves through their origination fulfillment processes, e.g., faster cycle times, lower cost, greater flexibility, better communications, etc. From this perspective, outsourcing back office origination functions to a third-party is seen as losing control over their ability to build competitive advantage based on operational excellence and customer service. Similarly, other lenders perceive some or all of their current back room origination operations as a “core competency” that provides them with a competitive advantage that would be lost by outsourcing.
- **A majority (55%) of lenders are looking to improve operational efficiency through origination process improvements and, where appropriate, employing new technologies. For such lenders, the use of outsourcing must make economic sense within the context of overall process improvement and smart use of technology.** Most lenders plan to first rethink

their origination processes, workflows and use of technology and then consider outsourcing as a means for implementing some of the functions within their redesigned fulfillment process. In effect, most lenders don't want to put the "cart before the horse" and outsource functions in inherently inefficient processes and workflows.

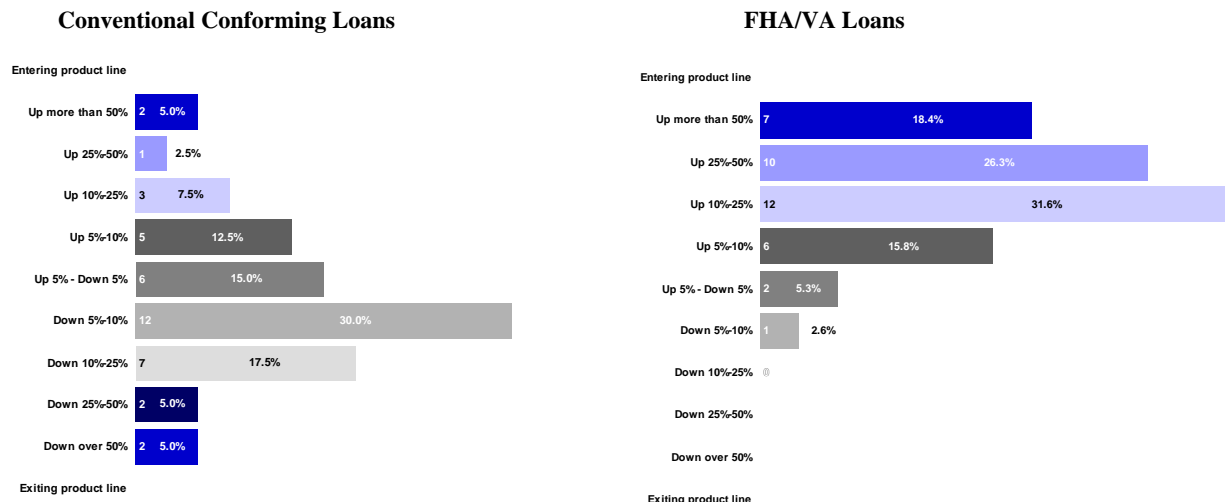
- **Looking ahead, 36% of respondents are planning to increase their use of outsourcing over the next 18 months (measured from September 2008).** Faced with significantly lower volumes, the potentially higher fraud risks of an economy in trouble and tighter regulatory requirements, it is not surprising that a significant proportion (36%) of respondents expect to increase their use of outsourcing over the next 18 months. In particular, for the 55% of lenders that are redesigning or plan to redesign their origination processes before considering outsourcing, it can easily take 12-24 months before they complete their process design and complete any appropriate outsource procurements.
- **Lenders said they expect to achieve significant cost savings from the use of origination outsource services.** Almost two-thirds said they expect cost reductions between 10% and 25%; and almost one out of six expect cost reductions in the 26%-40% range. Based on the survey data, a rough estimate suggests an expected cost reduction of approximately 18.25%.
- **In evaluating and selecting outsource service providers, lenders appear to be looking for the right expertise at the right cost.** While cost and productivity improvements are key objectives for lenders considering outsourcing, lenders are also looking for outsourcing providers that bring mortgage processing skills and expertise to the table. Given the desire of lenders to improve their back office processes, they value providers that can contribute to their process design and reengineering efforts. This underscores the fact that outsourcing services involves a "consultative" sales process in which advisory skills are very important. In other words, many lenders view a potential outsource services provider as a partner to their business and not simply as a vendor of a commodity service.

Outlook for Originations

With the demise of subprime and Alt A loans, most mortgage originations now consist of conventional conforming, FHA/VA, Jumbo, reverse mortgages and HELOC/second lien loans, with conventional conforming and FHA/VA comprising a dominant proportion, e.g., 80%-90%.

Focusing on these two dominant loan types, Figure 4 shows respondents expectations for originations during the second half of 2008 versus the first half.

Figure 4
Expectations for Originations: 2nd Half versus 1st Half of 2008



While a small number of respondents expect conforming originations to either sharply increase or decrease, almost 50% of respondents are expecting either a small-to-moderate decrease in conforming originations. On the other hand, 43% of respondents expect FHA/VA production to increase from 5%-25% with another 41% expecting increases from 25%-50%. This latter result clearly reflects the reemergence of government loans as the loan of choice for high LTV lending.

Among other loan types, tighter credit coupled with sharply higher Fannie Mae/Freddie Mac loan limits in high cost markets result, not surprisingly, in expectations for significant declines in Jumbo, HELOCs and second lien loans. However, among those lenders that currently engage or expect to engage in reverse mortgage lending, expectations generally point to significant growth.

As previously noted, all these results pre-date the recent precipitous declines both in the stock market and the real (overall?) economy. It is likely in our judgment that these developments would lower origination expectations across the board.

Figure 5 below displays respondent expectations for origination growth in the retail and wholesale channels for 2009 versus 2008, including only those lenders that participate in these channels. Strikingly, almost 70% of respondents in the retail channel see growth for retail lending, obviously reflecting the sharp decline in wholesale lending during 2008. But about 44% of wholesale lenders also anticipate growth, a somewhat surprising result. It may be that those respondents who are sticking with their wholesale operations expect to benefit from the large number of lenders--- many of which were very large lenders--- who exited the channel during 2008 (although such lenders were not among our respondents).

Figure 5
Growth in Origination Volume in the Retail and Wholesale Channels (2009 vs. 2008)

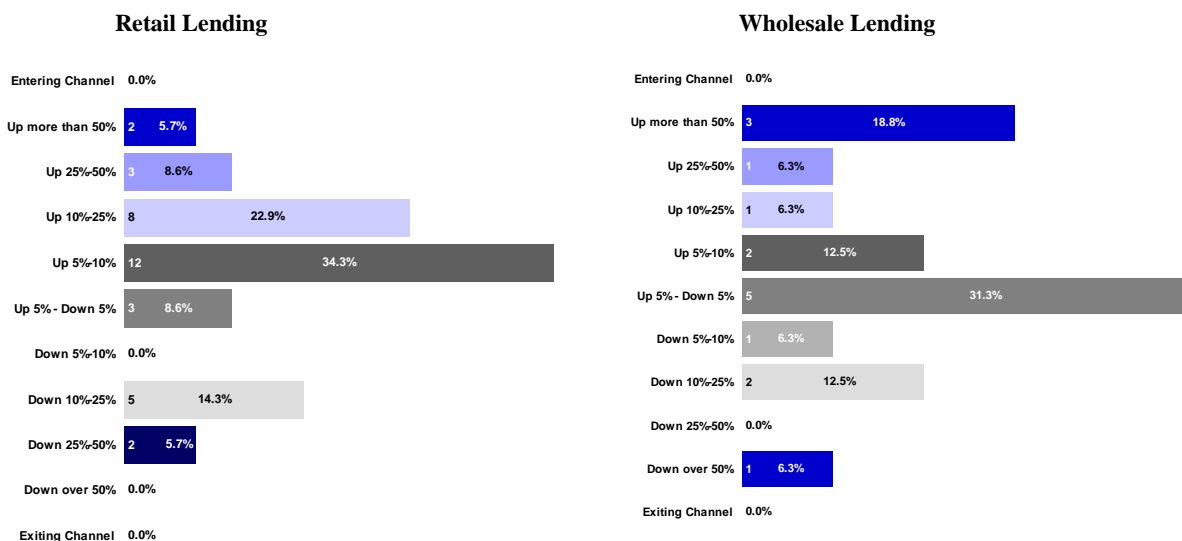
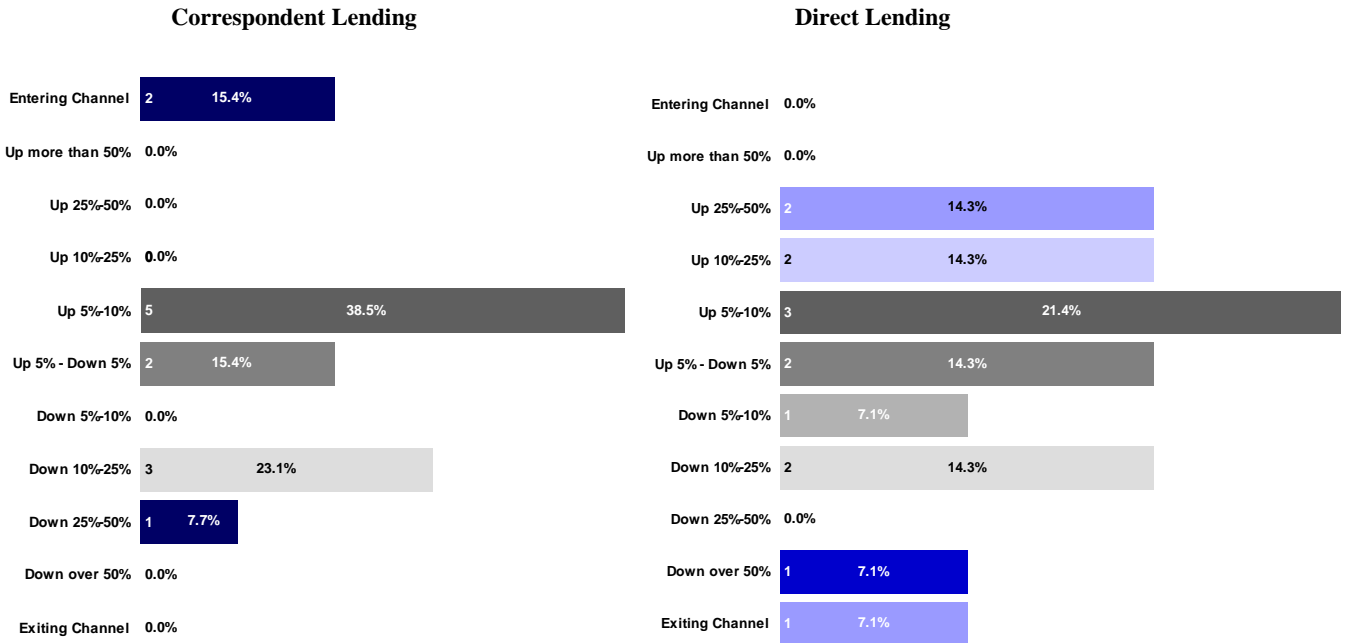


Figure 6 below shows the corresponding results for correspondent and direct lending. Of particular interest is the relatively large number of direct lending respondents who see growth in that channel for 2009. In part, this may reflect an expectation that the paralysis in existing home sales may ease, resulting in an increase in payoffs and increased opportunities for customer retention. More likely, we think, it reflects expectations that with credit tight, more and more consumers will be broadening the base of lenders they contact, including direct lenders.

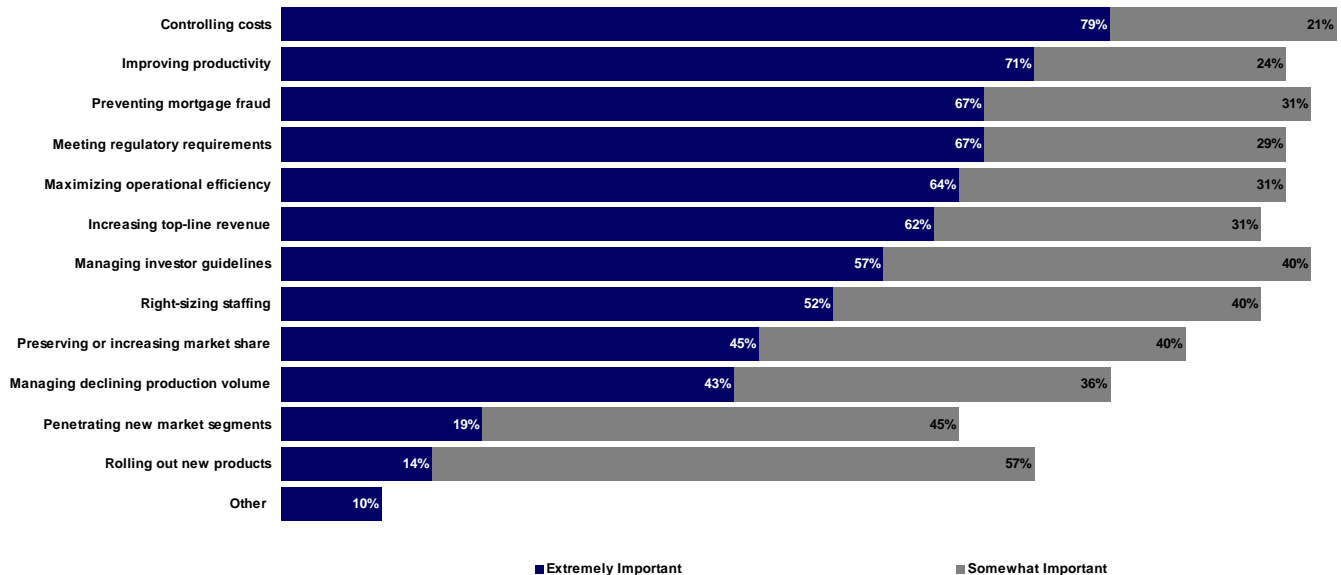
Figure 6
Growth in Origination Volume in the Correspondent and Direct Channels (2009 vs. 2008)



Opportunities and Challenges Facing Lenders

Respondents were asked to identify the most important opportunities and/or challenges faced by their organization over the next eighteen months. These opportunities and challenges, ranked in order of the percentage of responses of “extremely important,” are summarized in Figure 7 below.

Figure 7
Opportunities and Challenges Facing Lenders During the Next 18 Months



Controlling costs, improving productivity and managing operating risks, e.g., fraud, compliance with regulations, etc., stood out as the most important challenges facing lenders. Top line challenges or opportunities --- such things as increasing revenues and market share, penetrating new market segments and rolling out new products--- although not unimportant were not perceived as the most important challenges. In our experience, this represents something of a paradigm shift insofar as in prior down-years, most lenders still seemed to believe that they could grow their way to prosperity.

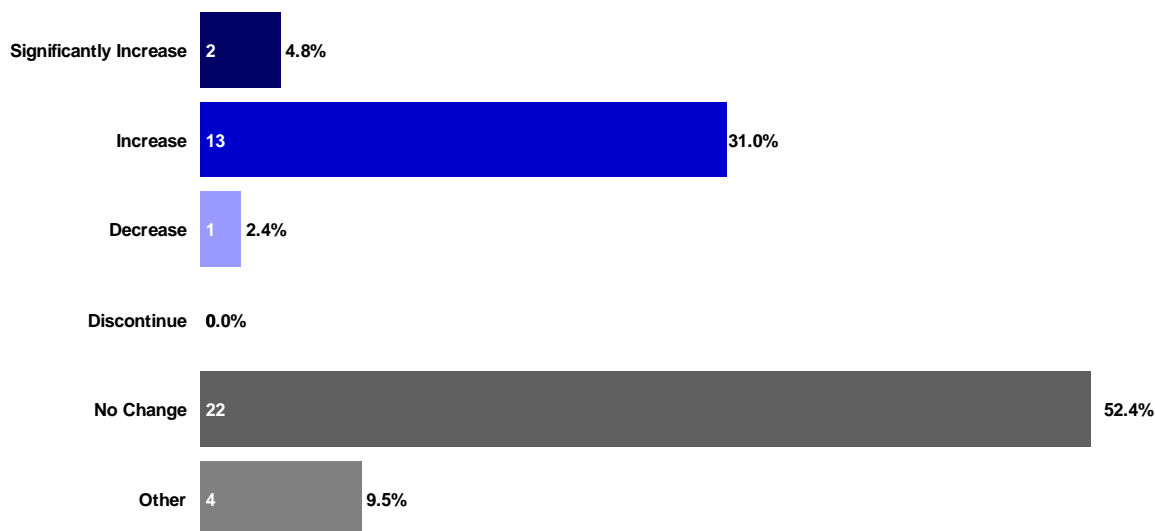
This shift in perspective suggests that many lenders perceive that the meltdown in the mortgage industry is ushering in long-term reductions in origination volumes and growth. Indeed, emerging demographic changes indicate that we are entering an era in which the supply of housing will exceed demand in a growing number of states, a trend that may be amplified by a shift in demand from low to high-density housing as a result of decreasing affordability and the increasing costs of commuting by car.

We would note that included in responses labeled as “Other” in Figure 7 were concerns about warehouse financing and liquidity, both of which were major factors in the failure of so many lenders during 2007 and 2008. Of course, with so much loan production shifting to Fannie, Freddie and FHA/VA loans, liquidity should not be an issue so long as Agency capital is supported by the Government. Availability of adequate warehouse lines, however, can remain a critical issue for those lenders not affiliated with a bank unless they have a strong capital base.

Plans for Using Origination Outsource Services

Survey participants were asked whether they have plans to increase or decrease their use of outsourcing services over the next eighteen months. Their responses are summarized in Figure 8 below.

Figure 8
Plans for Using Outsourcing Services



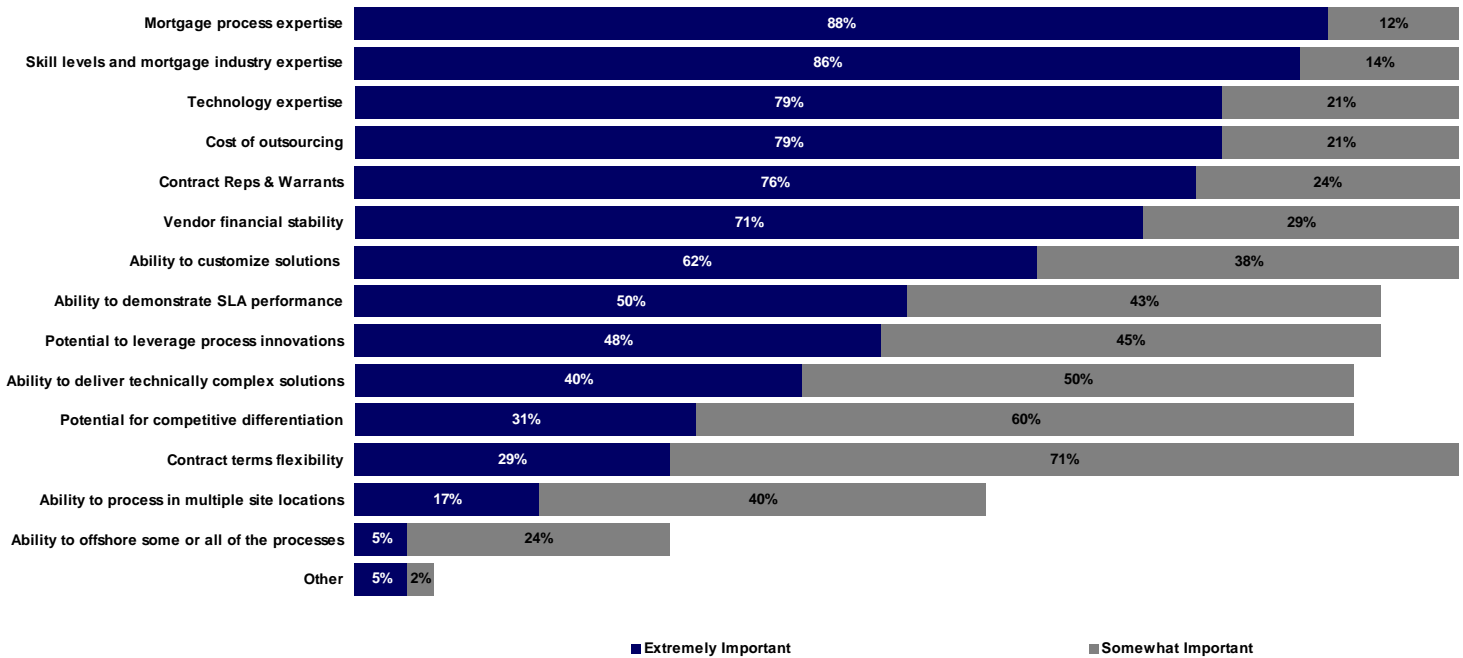
About 36% of responses indicated plans to increase or significantly increase the use of outsourcing services. In addition, 9.5% of responses, classified as “other,” indicated that outsourcing was currently being researched or that they were in the midst of considering their business or operational strategy. Undoubtedly, some of these “other” respondents will opt to increase their use of outsourcing.

Although not presented here, cross-tabulations of the above results against type of company and company origination volume suggest that go-forward plans for outsourcing does not vary significantly with these factors.

Criteria for Choosing an Outsourcing Partner

Figure 9 below summarizes the responses of participants as to the importance of various criteria in choosing an outsourcing partner. These criteria have been ranked in order of the percentage of respondents who ranked a particular criteria as “extremely important.” Also shown is the percentage of respondents who ranked a criteria as “somewhat important.”

Figure 9
Importance of Various Criteria in Choosing an Outsourcing Partner



Our analysis of these results suggests the following:

- **At the highest level, lenders seem to be looking for expertise at the right cost.** The most important criteria (e.g., Extremely Important \geq 70%) involve expertise and cost considerations. Lenders are vitally concerned about an outsourcer’s expertise as regards business processes, technology and general expertise as regards the mortgage industry. They want their outsourcer to be able to participate in the planning of improved or “best practice” processes and the use of technology as well as in implementation. Lenders are also vitally concerned about cost reduction, but in a broader sense than just direct outsourcing transaction fees. Lenders view “cost” as including the strength of contract reps and warrantees along with the financial strength of the outsourcer to fulfill such contract promises; and, perhaps more importantly, demonstrating a commitment to the business backed by financial staying power. Lenders recognize that there are implicit costs and business risks to having to switch outsourcing providers.
- **The ability of an outsourcer to implement the lender’s chosen processes and business rules is also important.** Lenders do not want to be locked-in to the processes and business rules of their outsourcer. Indeed, they want an outsourcer that can customize solutions, take advantage of process innovations and handle complex processes and workflows. Clearly, where a lender has expensed time and money in planning process improvements, they want an outsourcer that can help them implement such improved processes under service level agreements (SLAs) backed by a proven record of performance.
- **The potential for achieving competitive differentiation is not a significant criteria for selecting and outsourcing partner.** Not surprisingly, lenders do not look to outsourcing as a

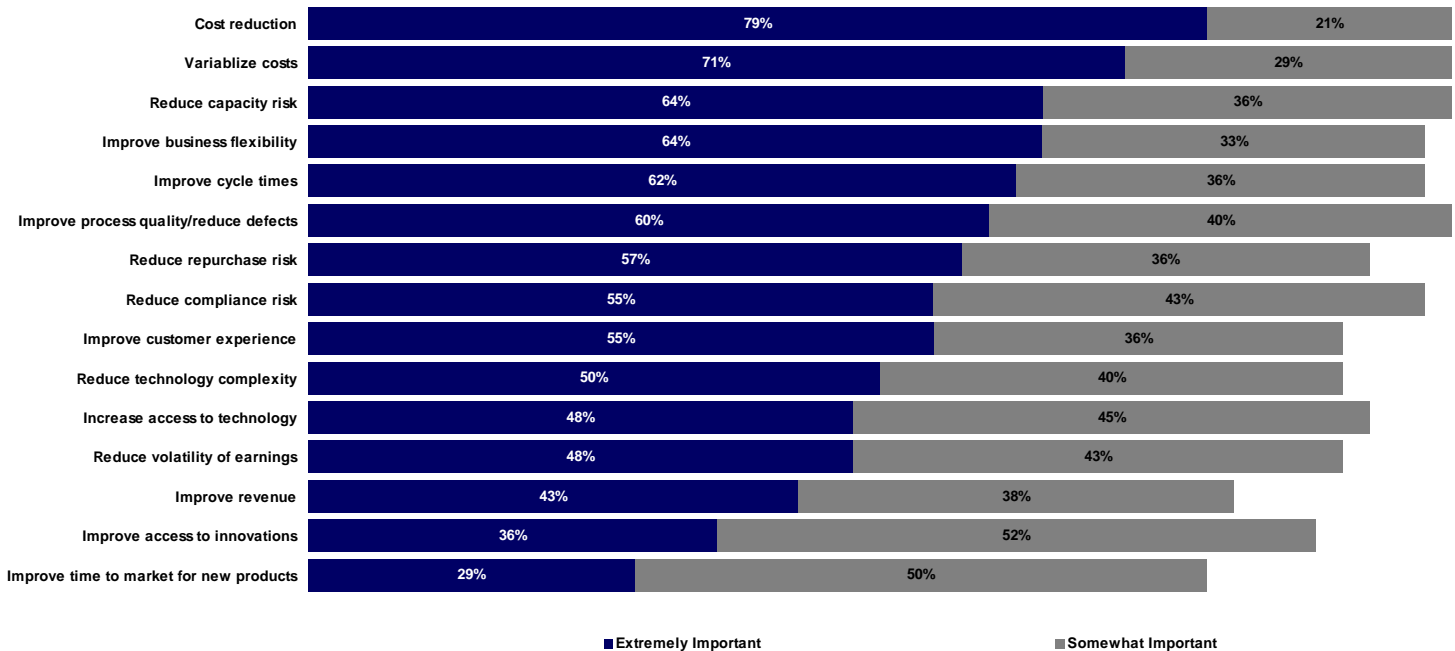
source of differentiation. Indeed, to the extent that an outsourcer’s services and advice are available to any lender, outsourcing is a potential “leveler” of the competitive playing field. Implicitly, lenders seem to realize that longer-term competitive differentiation and advantage will, in part, come from the improvements that they can design into their processes and workflows.

- **Lenders are not particularly concerned with where outsourcing functions are performed.** Interestingly, lenders do not seem to care whether or not outsourcing functions are performed offshore nor do they express significant concern as to whether an outsourcer uses multiple sites. Of course, these “service manufacturing” considerations will likely affect an outsourcer’s fees and service level agreements as regards service availability and reliability. It would seem, therefore, that lenders focus on the contractual costs and service level agreements (and an outsourcer’s track record for delivering on these contracts) without explicitly paying concern to the location(s) at which the services are actually being performed.

Importance of Outsourcing Outcomes

Lenders were asked to rank the importance of various outcomes of outsourcing. In Figure 10 below, these outcomes have been ranked in order of the percentage of respondents who ranked a particular outcome as “extremely important.” Also shown is the percentage of respondents who ranked an outcome as “somewhat important.”

Figure 10
Importance of Various Outcomes from Outsourcing



By and large, the importance that lenders attach to various outcomes from outsourcing reflects the importance of the various criteria by which they say they will choose an outsourcing partner. Direct cost considerations --- both reducing (79%) and variabilizing (71%) costs --- are clearly the most important results that lenders seek from outsourcing. But other considerations that affect costs, e.g., reducing repurchase and compliance risks, improving cycle times, reducing process defects, increasing access to technology, etc., were also ranked relatively high as outsourcing outcomes.

Lenders also gave a relatively high ranking (55%) to improving the customer’s experience; but, somewhat inconsistently, attached lesser importance to improving revenues. Industry experience has shown that a positive customer experience will generate both repeat business and referrals, i.e., higher revenues.

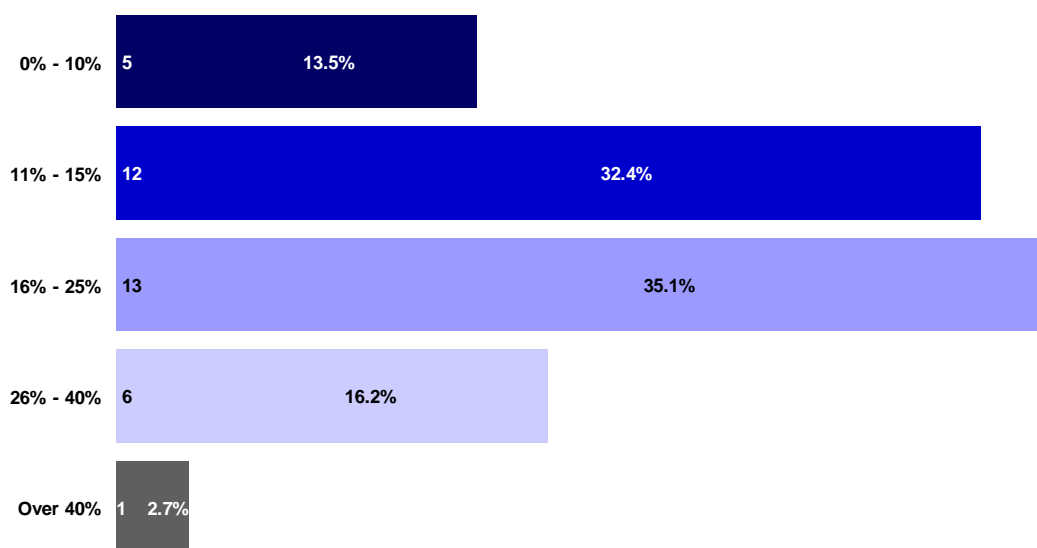
Further, improved cycle times --- which can significantly contribute to a positive customer experience --- has also been shown to result in lower fallout rates, resulting in higher revenues. Our interpretation here is that lenders tend to think of outsourcing in operational terms and tend to downplay the positive marketing and revenue implications of a superior back office.

Expectations for Cost Reductions

Lenders were asked to estimate the range of origination cost reduction they would expect to achieve from outsourcing. Included in this estimate were direct origination costs, costs from lead-generation through closing, plus production support costs, e.g., post-closing, QC, production IT, secondary marketing and shipping and delivery costs.

Figure 11 summarizes the responses, excluding those lenders who said they were not contemplating outsourcing (2 lenders) or said either they don't know or that it depends on the business segment (3 lenders).

Figure 11
Expectations for Cost Reductions



Of the 37 responses depicted in Figure 11, almost two-thirds said they expect cost reductions between 10% and 25%; and almost one out of six expect cost reductions in the 26%-40% range. While the data in Figure 11 is too coarse for calculating a precise average, a rough estimate suggests an expected cost reduction of approximately 18.25%.

Using 6 month MBA/STRATMOR Peer Group data for the first six months of 2008, an 18.25% reduction in direct production and production support costs would be \$486 per loan in the retail channel and \$210 in the broker channel, using average cost data for both the large and mega-lender peer groups.¹

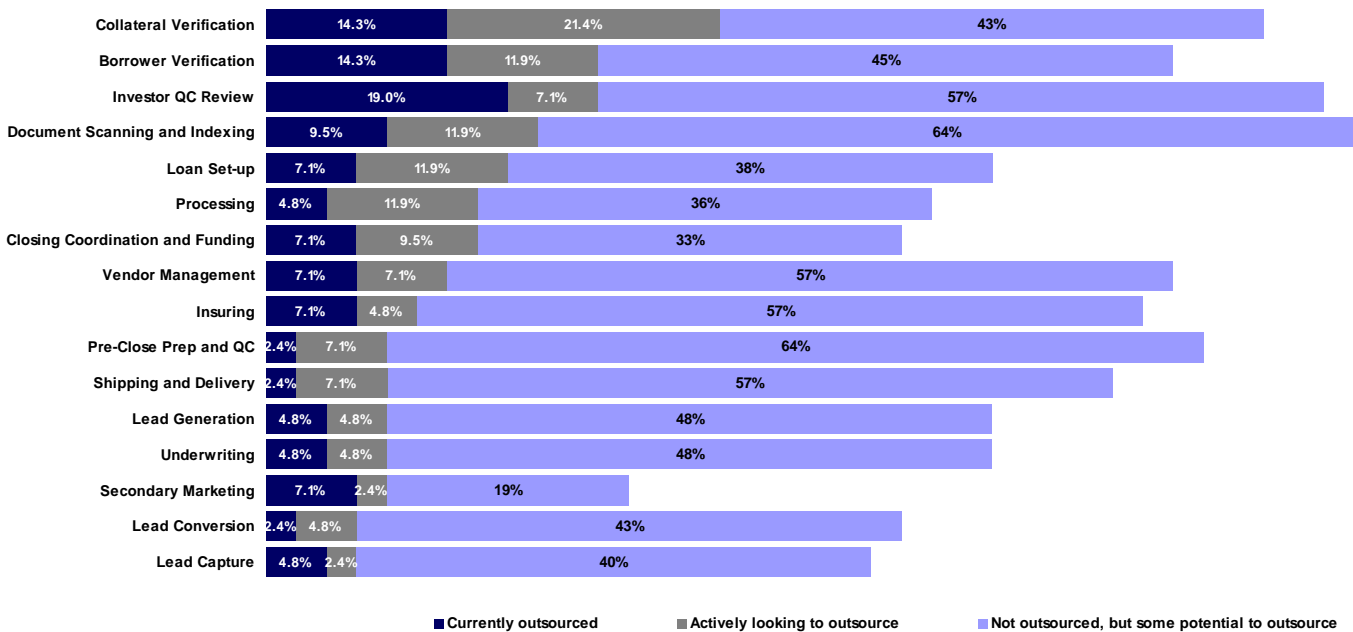
¹ This assumes that outsourcing savings, measured as a % of current costs, are the same for both the retail and wholesale channels.

C

urrent Status of Outsourcing Various Origination Functions

Respondents were asked to tell us where they stood as regards outsourcing various origination functions: Were they currently outsourcing the function? Or, were they currently actively looking to outsource the function? Or, if they neither outsourced the function nor were actively looking to outsource it, did they see some potential to outsource the function? Figure 12 below summarizes the responses.

Figure 12
Current Status of Outsourcing Various Origination Functions



We offer the following observations regarding these results:

- First, that lenders believe that a large proportion of mortgage banking origination functions have the potential of being outsourced.
- Second that a relatively small proportion of these functions are currently being outsourced. By lenders. Indeed, less than 10% of lenders are currently outsourcing 13 out of the 16 origination functions considered. Clearly, there is tremendous room for growth in outsourcing.
- Third, the progress or rate at which lenders are moving to outsource potentially “outsourcable” functions is relatively slow.
- Fourth, the largest gains in outsourcing appear to be concentrated in those functions that do not primarily involve direct customer contact, e.g., borrower and collateral verifications, document scanning and loan setup. Conversely, those functions that may involve substantial customer contact, e.g., lead generation, capture and conversion and loan underwriting, are currently low growth areas for outsourcing

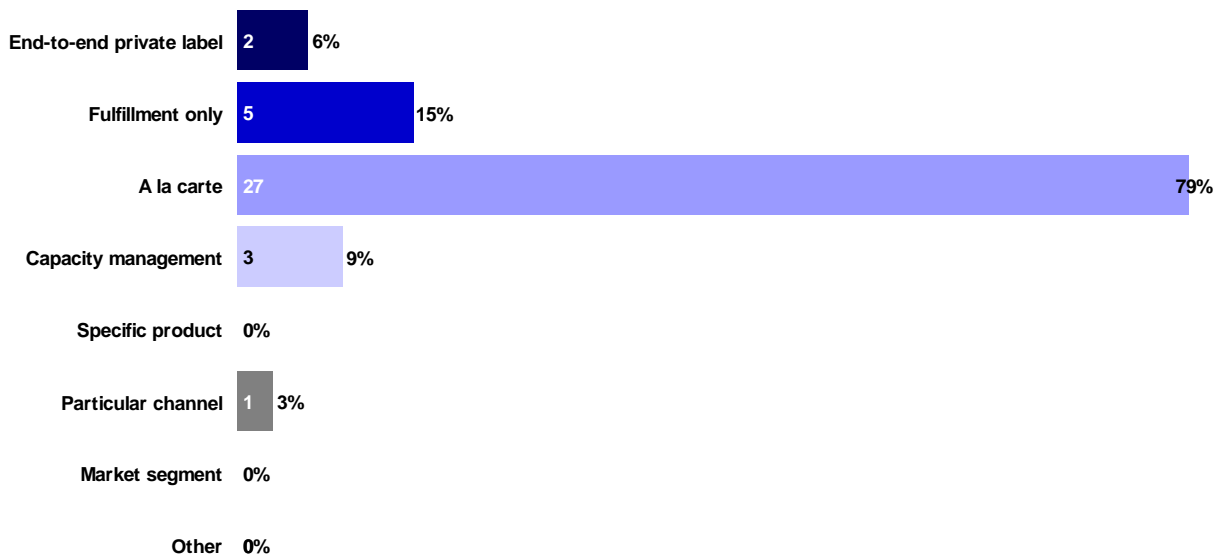
A pproach to Outsourcing

Respondents were asked to select from among seven possible options the one that best describes their approach to outsourcing. As described in the Survey, the possible options included the following:

- **End-to-end private label:** Offload retail origination fulfillment altogether by replacing it with end-to-end private label services (i.e., all activities from just after hand-off of a RESPA compliant point of sale loan application through processing, underwriting, closing, post closing and investor delivery, including the purchase of the originated loan, possibly co-branded servicing, and indemnification from repurchase risk.)
- **Fulfillment-only:** Outsource a substantial portion, but not all, of your internal fulfillment operations, such as processing, underwriting and closing, or closing through servicing transfer, with a contiguous set, or package, of private- or generically-labeled services.
- **A la carte:** Outsource specific steps or segments of your internal fulfillment process with outsourced solutions selected “a la carte” from a menu of service offerings that are integrated into your existing systems and workflow (e.g. case file opening & third party services ordering file imaging and indexing, appraisal underwriting, pre-closing document draw post-closing file review, etc.).
- **Capacity management:** Overflow capacity to satisfy rate-driven peak demand.
- **Specific product:** Fulfillment for a specific product or set of products (e.g. FHA only, HELOC's only).
- **Particular channel:** Fulfillment for a particular channel (e.g. Bank branches, call center, portfolio retention).
- **Market Segment:** Fulfillment support for a specific geographic region or defined market segment (e.g., central states region).

Figure 13 summarizes the results to this question for those respondents who currently outsource, are actively seeking to outsource or would consider outsourcing.

Figure 13
Approach to Outsourcing



As the preferred approach for about 80% of respondents, a-la-carte outsourcing was the clear winner among alternative approaches. Further, cross-tabulations of results (not presented) showed, with a few exceptions, that a-la-carte outsourcing was the outsourcing approach of choice independent of the type of lender, the size of lender or the position of the respondent. In particular, a-la-carte outsourcing was the unanimous choice among lenders with origination volume greater than \$2.5 billion.

One type of lender that did not prefer a-la-carte outsourcing was builder-owned lenders. Of the two such lenders that participated in the survey, one preferred end-to-end private label services, the other fulfillment-only services. This suggests to us the possibility that where mortgage lending is secondary to a company's primary or core businesses, the company may be more disposed to bundling its outsource services.

However, where mortgage lending is a company's primary or a core business, our sense is that it will be extremely reluctant and resistant to outsourcing all or most of its back office origination functions. Doing so would put such a lender at great strategic risk to the pricing, performance and continued business operation of their outsource service provider. Further, to the extent that a lender believes that certain origination functions are core competencies and sources of competitive advantage, it would regard outsourcing of such functions as tantamount to giving up a competitive edge. Thus, in general, we believe most lenders want to be able to adopt outsourcing on a gradual basis and only where it makes both economic and strategic sense.