



THE MORTGAGE INDUSTRY

RIPE FOR DISRUPTION

*THE
COLLINGWOOD
GROUP LLC*

With no fundamental changes to origination processes in decades, lost efficiency, growing regulatory hurdles, high costs and low profits, there is little doubt the mortgage industry is ripe for disruption.



The Collingwood Group®

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Executive Summary

Disruption is inevitable in any industry, but is most predictable in an industry faced with a set of conditions that render the existing model too challenging, too inefficient, too costly, too unresponsive to the needs of consumers and businesses alike. The best innovators recognize and capitalize on the opportunity presented by an increasingly ineffective approach and develop new capabilities to meet the needs of the marketplace.

Mortgage finance has reached this stage.

In this paper, the Collingwood Group will explore the disruption underway in the mortgage industry today – who the innovators are, what they are doing, what market trends are driving them, and why does this all matter.

“You never change things by fighting the existing reality. To change something, build a new model that makes the existing model obsolete,”

-Buckminster Fuller

INNOVATORS

A small group of innovators are finding new ways to serve consumer demands while increasing profitability at all stages of the mortgage process.

The new class of emerging innovators in the mortgage space is primarily composed of technology companies that are working to solve business problems, most often from the customer's point of view. By contrast, many incumbent lenders would describe themselves as mortgage companies that embrace technology as a key business requirement, but not necessarily a core competence. That difference in mindset is likely to effect how companies position themselves and how they strive for success in the rapidly changing world of consumer lending.

Amongst the innovators, crowdfunders and marketplace lenders are the two primary examples of emerging technology-based companies that are building new lending platforms to meet the demand for home loans and other forms of consumer debt. They are making their mark developing and utilizing new technologies to improve the consumer experience, enhance efficiency, expand risk management techniques, and provide a solid return on investment.

The primary difference between these two notable innovators, crowdfunding firms and marketplace lenders, is the connection between the borrower and the investor or contributor. Crowdfunding companies serve as operators, providing a platform to raise capital for a certain purpose from a broad network of contributors or investors. Marketplace lenders, on the other hand, facilitate transactions directly between borrowers and investors, including small investors, accredited investors, and institutional investors. Both leverage private capital to make loans to individuals and companies.



Both types of companies are engaged in activities that represent the very essence of “disruption,” engaging the average citizen in the development and expansion of products and services - fulfilling the new demand coming from an ever-needy population of consumers and/or permitting the general public to support the company’s offerings, by raising capital from individuals in addition to financial institutions or investors.

Marketplace lending began with a basic peer-to-peer lending concept that allowed investors the ability to provide financing more directly to individual borrowers through companies that created online platforms. The use of traditional investment capital, combined with data-driven technology, created a unique collaboration that underpins a growing community of specialty lenders. Among marketplace lending clients are thousands of small businesses who like the quickness and creative approval process that the new data and platforms allow. Many of the new models supplant the need to rely solely on traditional underwriting variables such as credit scores. A number of these marketplace lenders provide specialty student loans, non-qualified mortgage products, and even elective medical procedure loans.

Despite the misperception that marketplace lending is in a fledgling state, this new source of lending is estimated to be a trillion dollar market by 2025 -- far exceeding the \$8.8 billion in lending during 2014 among the estimated 100 marketplace lenders that exist today.

Who They Are

Some examples of disruptors include, but are not limited to, the following:



Groundfloor

Groundfloor is the first microlending community for real estate. It's 100% open to all; you do not have to be an accredited investor to participate.

Groundfloor connects backers to independent builders, screens all borrowers, and grades each loan. Starting at just \$10, anyone can invest in property-secured, short term commercial loans and earn up to 26% in interest.



Realty Mogul

RealtyMogul.com is an online capital marketplace for real estate, connecting borrowers and sponsors to capital from accredited and institutional investors. Their platform gives borrowers access to debt capital, sponsors access to equity capital and investors tools to browse investments, do due diligence and invest online. They offer fix-and-flip loans, bridge and permanent loans and joint venture equity.



LendingHome

Lending Home promises to reimagine the entire mortgage process from start to finish. They brought together the best technology, operations, and data to build the next generation mortgage platform. They have rethought customer acquisition, user experience credit analysis, algorithmic underwriting, operational efficiency, loan servicing, capital markets, financial automation, consumer brand, and more.



RealtyShares

RealtyShares is an online investment platform that pools investors into funds that hold an interest in a pre-identified private real estate investment. Accredited Investor members have access to information on a variety of investment opportunities and can invest as little as \$5,000 into each such opportunity. Execution of investor documents and fund transfers are handled securely through their platform, allowing investors to complete the entire transaction through their website.



RealCrowd

RealCrowd allows Accredited Investors to compare exclusive investment offerings posted by private real estate companies. They also offer a cloud-based solution for real estate fundraising and investor management. Their technology handles the details around marketing, signatures, documents and record keeping for and serves as a real-time communication engine for the term of the investment.



Sofi

With over \$3 billion in loans issued to date, SoFi helps early stage professionals accelerate their success with student loan refinancing, mortgages, mortgage refinancing, and personal loans. Their nontraditional underwriting approach takes into account merit and employment history among other factors. They offer individual and institutional investors the ability to create positive social impact on the communities they care about while earning compelling rates of return.

WHAT THEY DO

Innovators are approaching consumer lending as an event rather than a process and improving usability, documentation, communications and decisioning.

A key differentiator between traditional lenders and crowdfunding or marketplace lenders is their persistent focus on the consumer experience with the lending transaction. They approach consumer lending as an “event” rather than a process, by creating a highly efficient, fully online, transparent, and low cost means to approve a loan. This stands in stark contrast to the legacy mortgage process, which is protracted, complex, and burdensome for both the lender and the consumer.

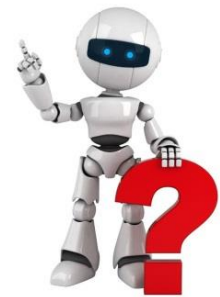
With marketplace lenders, the “event” for the consumer is a quick decision, based on minimal documentation, rather than a labor-intensive process to compile adequate information, often in the form of paper documents, all of which must be validated. Key features of the new form of transaction are:

1. **Usability:** Clean and simple user interface that publicizes the products, the rules, and the costs.
2. **Documentation:** Minimal documentation from borrowers; verification and validation of creditworthiness, capacity, and collateral using public sources of data and information, a function performed instantaneously and electronically.
3. **Communications:** Seamless, online interactions and transmission of documents and signatures, enabled for mobile devices.
4. **Decisioning:** Risk assessment and loan approval analytics and pricing decisions performed quickly and automatically.

The end result of this new approach to consumer lending is a democratized experience, rather than a lengthy and cumbersome bureaucratic approval process. The use of technology creates a powerful vehicle to communicate, collect and validate data, and perform analytics. The frictions associated with the traditional approach - multiple parties to the transaction, paper documents, and manual processes to retrieve or verify information - are all eliminated, which ultimately improves the experience and reduces costs, for the lender and for the consumer.

The housing crisis taught lenders and purchasers of mortgage-backed securities that the traditional indicators of a borrower's future ability to repay are not always the most reliable. The next generation of underwriting engines developed by emerging firms simplifies and correlates multiparty, multistep processes, compiling and validating new sources of information as a more accurate reflection of creditworthiness. In fact, the new approach is specifically designed to create a wider credit box, to serve an emerging generation of buyers – millennials, ethnic minorities, and newer immigrants – generally those underserved in the current market by legacy credit engines.

All of these innovators strive to automate verification and validation functions to reduce costs, subjectivity, and to expedite credit decision-making, and closing. Underwriting functions are largely performed by synchronous service calls that triangulate around a variety of data points to determine present and future collateral value and quality, cash flow and borrowing capacity, and perform pattern analysis to identify potential fraud and misrepresentations.



Artificial Intelligence is playing an increasing role in determining borrowers ability to repay.

Newer emerging models use new technology to correlate household cash flow, employment markets, demographic trends, infrastructure investment and personal preferences with default probability and long term value of the collateral.

MARKET TRENDS

Collectively, the size of the mortgage market, diminishing profit margins, changing consumer demand, and demographic shifts all influence disruption in the market.

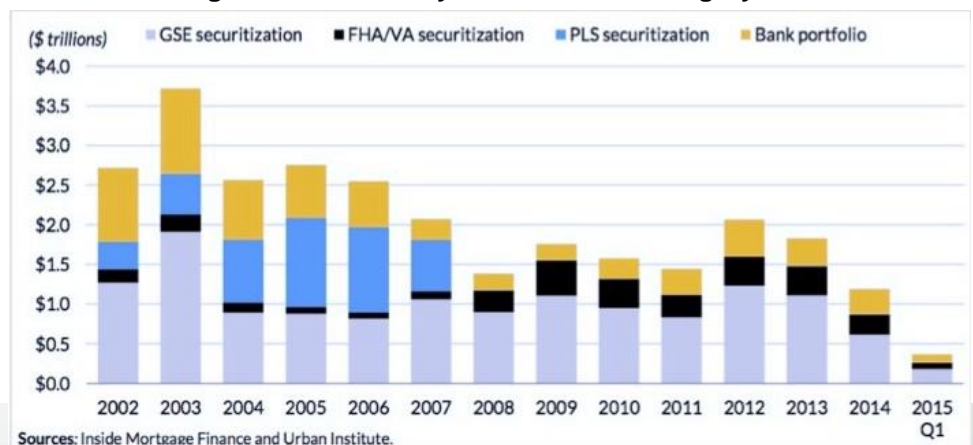
To some extent, marketplace lending was an outgrowth of the regulatory response to the financial crisis, as many large banks paid tens of billions in fines and even today remain focused on litigation and regulatory compliance to the detriment of their customers. Given the rising compliance costs, not surprisingly, large depository banks are chasing customers that yield higher returns – typically large commercial clients.

However, there are a number of obvious market dynamics that are influencing the disruption on the horizon:

Massive Market Size

Even after years of anemic economic growth and a stagnant housing recovery, the mortgage market remains a source of vast revenue potential and strategic value, offering an impressive history of rich top line numbers. According to the [Federal Reserve First Quarter 2015 Flow of Funds report \(June 2015\)](#), the total value of the U.S. housing market is \$21.69 trillion, including \$9.86 trillion in mortgage debt and \$11.8 trillion in household equity.

Total Origination Volume by Securitization Category 2002-2015



Diminishing Profit Margins

In spite of this projected growth in mortgage originations, lenders are not making record profits. In fact, Fannie Mae's [Mortgage Lender Sentiment Survey](#) found that nearly three quarters of respondents reported a 30 percent jump in compliance spending associated with increased regulations, which has negatively impacted business. The survey highlighted that compliance spending and increasing origination costs have significantly contributed to falling profits.

Per Loan Origination Profits FY 2012-2014

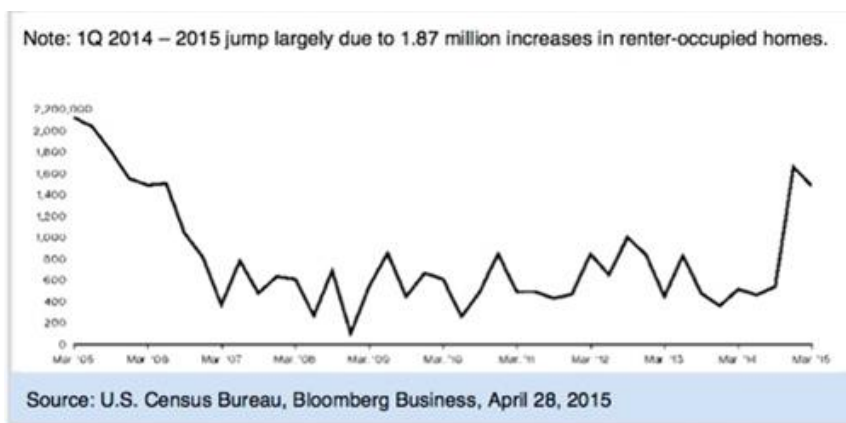


Population Explosion and Demographic Shifts

Despite the long period of slow household formation and demand for rental units, the [2015 National Association of Realtors Home Buyer and Seller Generational Trends](#) reported for the second consecutive year that millennials represented the largest share or 32 percent of recent homebuyers. The survey also noted that most buyers in this generation search for their homes online, but use real estate agents for the purchase. Forty-five percent of millennials also reported having some level of difficulty with the application and approval process. Further, diversity among the millennial generation is greater than the previous generations and will have a significant impact on the mortgage market.

Harvard's Joint Center for Housing Studies' [The State of the Nation's Housing 2015](#) projects that minorities will represent approximately 76 percent of net household growth over the next 10 years and as much as 85 percent over the next 20.

Household Formation 2005-2015

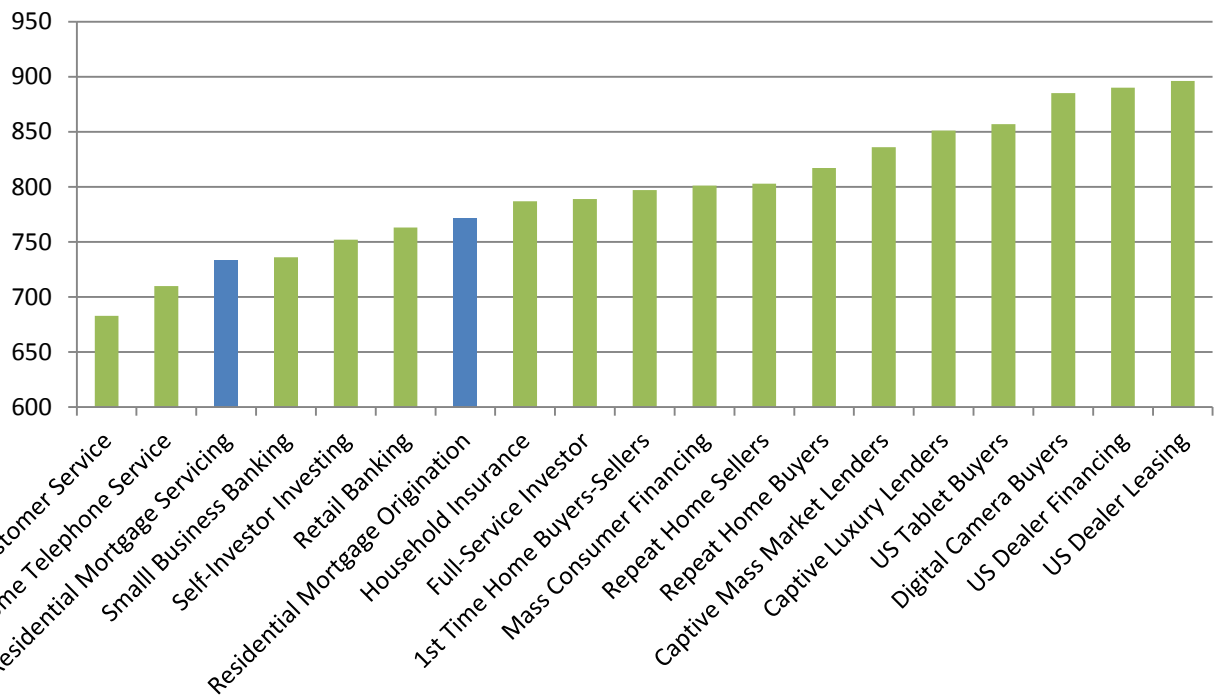


Changing Consumer Demand

J.D. Power's [2014 US Primary Mortgage Origination Satisfaction Survey](#) found that nearly one in four borrowers were dissatisfied with the mortgage origination process. Further, research confirms that while consumers value the accessibility of online mortgage services, high customer satisfaction scores were also the result of personal guidance. For example, Quicken Loans' effectiveness in forging customer relationships, which has ranked them first in customer satisfaction for five years running, is based on telephone calls made almost instantly following a potential borrowers online information request submission. While some assume that younger borrowers may lean more toward online access, there is little evidence that new technologies have done much to replace traditional brick-and-mortar offices where banking relationships are built.

Relative JD Power Consumer Satisfaction Scores

Latest Annual US Customer Satisfaction Index Score by Category (Based on a 1,000 point scale)



Source: J.D. Power and Associates, 2014

WHAT IT MEANS

Disruption may force market participants to move away from proprietary platforms and push regulators to allow for innovation.

While the very nature of disruption is to overturn long-standing business practices and market models, there is an element of uncertainty to the current evolution underway in the mortgage industry today. This uncertainty results, in large part, from the heavy-handed intervention of the government into the mortgage market following the housing crisis. However, it is this very uncertainty that introduces a new void to be filled by innovators and there are a number of likely impacts to keep in mind:

GSEs Will No Longer Drive Innovation

Historically, business and technology innovation in the mortgage industry has been shaped by the requirements and limitations created by the Government Sponsored Enterprises (GSEs) - Fannie Mae and Freddie Mac. This was particularly evident in loan origination and processing activities, where third-party firms could advance only as far as the GSEs, acting as gatekeepers, would allow. While neither GSE has explicitly endorsed third-party mortgage technologies, tacit endorsement has often been achieved by gaining access to the GSE automated underwriting systems - DeskTop Underwriter (DU) or Loan Prospector (LP).

The development and implementation of DU and LP are good examples of disruptive innovation that contributed to GSE market dominance in the early years of the Internet Revolution. This model remained largely intact until large lenders like Countrywide implemented proprietary automated underwriting systems that were accepted by one or more of the GSEs.

Proprietary Platforms Must Be Rethought

The innovation gap left by the GSEs in conservatorship was filled in part by large incumbent technology and service providers that pioneered in proprietary closed systems. Due to the closed nature of the systems, the innovation was only distributed amongst independent and private businesses, essentially creating innovation bubbles that did not benefit the industry as a whole. Arguably, this issue was exacerbated by fear and fatigue among lenders who were unwilling to invest the time and money to adopt new technologies.

Even before these companies jumped in to fill the void, the mortgage industry was biased towards closed, proprietary technology – homegrown or vended. While there has been innovation from providers of loan origination systems (LOS), its reach has been limited due to closed platforms and standards. The housing crisis exposed the challenges of modifying proprietary systems to address rapidly

evolving data and compliance requirements. For example, servicers learned from paying exorbitant compliance-related fines or settlements that the inability to respond to new regulations and information is financially and reputationally devastating.

The housing finance industry would benefit most from open-platform “disruptors” who allow for mass innovation, quickly replacing the platforms and/or vendors who can only offer tools that support outdated standards. From a cost perspective, developing and maintaining proprietary systems is a huge expense. In contrast, disruptors operating in the cloud, with open platforms and standards, can contain costs at a fraction of the incumbents.





Regulatory Environment Must Change as Well

On the regulatory front, regulators need to allow for innovation in the marketplace and, frankly, should consider innovation in their own approach, to offer a faster, more interactive, more pro-active, and flexible approach to rule-making. A level of tolerance in the interpretation and enforcement of laws and rules, that allows for innovation, evolution, and growth is critical to real market recovery.

The current regulatory environment does not promote, reward, or even allow for innovation

Unfortunately, a key challenge facing entrants seeking to leverage new credit models driven by advanced, constantly evolving technology assisted analytics, is the current regulatory environment. In the wake of the financial crisis, it is fair to say that the current regulatory environment does not promote, reward, or even allow for innovation. To be blunt, in certain quarters of government, there is a view that the crisis was at least in part a result of “financial engineering” and “over-creativity.” Hence, new models will also need to overcome the standards of the current regulatory framework.

The regulations implemented as part of the Dodd-Frank housing reform reinforce the underwriting criteria of the old-school practices and models to perform credit analysis. While the traditional criteria still matter, increasingly, advanced analytics and artificial intelligence are able to more heavily correlate household cashflow, employment markets, demographic trends, infrastructure investment, and personal preferences with default probability and long-term value of the collateral.



To Succeed, Market Participants Must Embrace Change

The opportunities for both the new entrant and the incumbent lie in their respective willingness and skill in implementing innovation into their business model. Both incumbent and new companies will need to position themselves to compete in this changing market environment.

Legacy mortgage providers have a brand and enough scale to make a profit. In many ways the incumbent has a better business case for change than the new entrant. Profitability is all about having customers and the mortgage industry's incumbents have a solid base of customers today.

New entrants have made the choice to re-invent and embrace the risk and experimentation necessary to advance the "change" agenda. Legacy providers, have a different challenge. As incumbents they are constrained by expectations based on past performance, and must assess the benefits of innovation with the potential risks of change. If the burden of sustaining current performance crowds out openness to innovation, it may also deter improved performance.

Big Data Will Be Key to Success

Aggregating digital consumer profiles has resulted in the emergence of “Big Data,” a leveraging tool that is reshaping industry practice and processes, as well as approaches to regulatory oversight. Mortgages are incredibly data rich with information on borrower income, employment, assets, credit and usage, and property data from the home to be financed and comparable properties used to establish value. Instead of mining Big Data, most mortgage companies have historically used loan level data very narrowly for tasks such as client prospecting and loss forecasting. Over the last decade access to vast amounts of raw data has initiated an avalanche of new technologies and tools that apply business intelligence and analytics to provide mortgage companies a set of reliable predictors, beyond credit-driven data, to better identify a prospects.

The availability of big data has opened the door to technologies and data management solutions that were never before possible. Big data allows both investors and the industry to leverage the data collection component of the loan origination process to capture institutional knowledge and consumer financial information. This approach can replace existing methods to assess creditworthiness and loan performance. Optimizing data will equate to long-term business opportunities for everyone from Silicon Valley to Wall Street and Main Street.

Vast amounts of raw data has initiated an avalanche of new technologies and tools

What's Next?

We believe there is a wealth of untapped potential in the mortgage market, and we are witnessing more and more clients recognize this opportunity.

We believe that in disruption there is a wealth of untapped potential in the mortgage market, and are witnessing many of our clients seizing this opportunity to drive business progress. Regulatory burdens, demographic shifts, and big data have spurred disruptors to deploy innovative technologies paramount to best address evolving business and consumer needs.

While the goal of the mortgage industry has not changed – providing consumers with suitable, sustainable, and well-priced mortgages – the means to achieve the goal has. The key to harnessing disruption lies in the willingness of incumbents and new entrants to bolster their transformative capabilities to eliminate inefficiencies, reduce costs, and improve customer satisfaction.

Disruptive movements, led by companies like Uber, Amazon, Google, and others have transformed consumer service industries to leverage technology, improve the consumer experience, and enhance business efficiency. By embracing disruption, mortgage industry participants can maximize the potential available in the existing housing market, such as a diverse mix of tech-savvy consumers and emerging and grass roots capital providers.



**ABOUT THE
COLLINGWOOD
GROUP**

The Collingwood Group is a Washington, DC-based business advisory firm focused on growing clients' businesses, promoting revenue growth and increasing investment returns. The firm's core focus is helping companies and investors drive growth, build their businesses and accelerate value creation through the identification and exploitation of differentiated opportunities in the financial services industry. Our expertise spans all aspects of Agency, non-Agency and FHA/VA housing financing programs; Ginnie Mae securitization activities; domestic and international secondary market activities and issues; primary and special servicing; full asset lifecycle vendor and talent management; and all elements of portfolio due diligence, acquisition, property management and asset disposition.

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